Tax Policy Options for Promoting Economic Growth and Job Creation By Leveraging a Strong Financial Services Sector

January 2016

Prepared for the Toronto Financial Services Alliance

By
Jack M. Mintz (University of Calgary School of Public Policy, and EY LLP)
and
Angelo Nikolakakis (EY LLP)

The Toronto Financial Services Alliance (TFSA) is a unique, public–private partnership dedicated to growing Toronto region's financial services cluster and building it as a "top ten" global financial services centre. Established in 2001, TFSA is a collaboration involving three levels of government, the financial services industry and academia. For more information please visit tfsa.ca.

TFSA | TORONTO FINANCIAL SERVICES ALLIANCE

EY Building a better working world

Table of Contents

1. Introduction

This report reviews and recommends certain tax policy options to promote economic growth and job creation for the benefit of all Canadians by leveraging Canada's world class financial services sector.

An Undeniable Global Centre of Excellence in Financial Services

In the post-2008 global business environment, Canadian financial institutions have emerged as models for excellence, innovation and financial stability.[1] The Canadian ecosystem for financial services includes numerous banks and other deposit-taking institutions, investment firms, pension funds, insurance companies, and securities or derivatives exchanges, with a strong concentration in Toronto but also a very significant distribution throughout the country, including in Montreal, Vancouver, Calgary and other centres.

Toronto is the second largest financial centre in North America and ranks as a "Top Ten" global financial centre overall.[2] Canada more broadly is a global leader in capital markets for resource-based industries, supported by a deep and diverse pool of non-finance professionals and scientists.[3] Four of the largest 20 life insurers in the world are Canadian.[4] Seven of the 10 largest global hedge fund administrators have significant offices located in Canada.[5] In November 2014, an agreement was reached between Canada and China, which designated Canada as the first Renminbi trading hub in the Americas.

The Canadian financial services sector provides high quality employment and personal development opportunities for thousands upon thousands of Canadians throughout the

---

[1] In 2014, for the eighth year in a row, the World Economic Forum ranked Canadian banks as the soundest in the world, three of which rank among the world's largest 25 banks by market capitalization.

[2] See Z/Yen Group, *The Global Financial Centres Index 18*, September 2015. In this ranking, Toronto ranks 8th, Montreal ranks 17th, Vancouver ranks 18th, and Calgary ranks 39th. The only other North American cities in the Top 50 are New York, Washington DC, Chicago, Boston and Los Angeles. Only New York ranks ahead of Toronto, and all these Canadian cities rank ahead of Los Angeles. See also the annual ranking of international financial centres by the U.K.-based *The Banker* magazine (2015), which also places Toronto second among North American centres and seventh in the world. In this ranking, Montreal ranked 26th. The only other North American cities that ranked in the Top 50 were New York (2nd), San Francisco (18th), Chicago (21st) and Boston (27th).

[3] The Toronto Stock Exchange is the third largest equity exchange in North America and seventh largest in the world with a market capitalization of $1.6 trillion (2014). In terms of the number of listed companies, the Toronto Stock Exchange and the TSX Venture Exchange are the second largest overall, and are global leaders in mining, oil and gas and clean tech. The Montreal Exchange is a leader in derivatives and other risk management instruments.

[4] Based on market capitalization, as of March 2015, according to Statistica (see http://www.statista.com/statistics/376359/largest-life-insurance-companies-by-market-cap).

[5] See http://www.aima.org/filemanager/root/site_assets/canada/publications/aima_handbook_2014_-_2nd_edition_-_web.pdf.

country and abroad, with world class open, fair and inclusive workplace standards and environments.[6]

Is it Good Enough?

Nevertheless, the purpose of this report on tax policy options is to demonstrate that more can and should be done to leverage Canada's status as an undeniable global center of excellence in financial services, in order to enhance and promote economic efficiency, innovation, savings, investment, productivity and job creation, across the Canadian economy as a whole.

2. Executive Summary

Although the financial services community is making a tremendous contribution to the Canadian economy and job creation as a global leader in this sector, it continues to labour under unfavourable fiscal conditions both in general and relative to other sectors. Some notable observations in this regard include the following:

- The weighted average federal/provincial general statutory CIT rate for large corporations over the period from 1981 to 2015 reflects a reduction from almost 51% in 1981 to 26.6% in 2015.

- The reduction in statutory CIT rates is not associated with a discernible downward trend in revenue generated by the CIT relative to GDP.

- While accounting for 6.5% of GDP, the financial sector accounts for 23.5% of corporate tax revenue (on average).

- The average tax rate as a percentage of taxable income facing the financial sector is significantly higher than for the non-financial sector.

- Studies generally indicate that a 10% increase in the cost of capital, due to an increase in the marginal effective tax rate or other factors, which affect the cost of capital, leads to a 7% to 10% reduction in investment in the long run.

- The financial sector bears the highest marginal effective tax rate of any sector in the economy due mainly to capital taxes that apply only to financial firms and the HST/GST on capital purchases and outsourcing of services, most of which is not refundable – and results in double-taxation – as most financial services are "exempt" rather than "zero-rated".

[6] According to a report prepared by the Conference Board of Canada, in 2014 the sector directly accounted for 780,000 jobs or 4.4 percent of Canada's workforce. It also accounted for 6.8 percent of Canada's GDP, and is one of the fastest growing sectors of the Canadian economy. See Burt, Michael. *An Engine for Growth: 2015 Report Card on Canada's and Toronto's Financial Services Sector* (Ottawa: The Conference Board of Canada, 2015).

In this regard, it is submitted that serious consideration should be given to the introduction of reforms that would tend to level the playing field in Canada for the financial sector in terms of marginal effective tax rates, including through the elimination of capital taxes applicable only to financial firms.

We would submit, moreover, that a serious effort should be made to resolve the various issues that arise in connection with the application of the GST/HST in the financial sector. This is an important objective in itself but also for another crucial reason. Economic growth is promoted by a shift in the tax mix toward a greater reliance on the GST/HST and a correspondingly lower reliance on income taxes. However, such a shift would further exacerbate distortions in the financial sector given its current treatment under the GST/HST. In other words, increasing reliance on the GST/HST without reforming the tax base in the financial services sector would partly undermine the value of changing the tax mix.

In addition, we are concerned about increasing global controversy in relation to whether multinational companies pay sufficient tax and politically-motivated reform initiatives in that regard which remain incomplete in particular with respect to the financial services sector despite over two years of continuous discussions (under the moniker of Base Erosion and Profit Shifting ("BEPS")) among stakeholders. There continues to be a profound lack of understanding and consensus, and thus considerable and mounting uncertainty as to the potential impact of these and future policy decisions on the global economy in general. These developments have also given rise to considerable uncertainty with respect to the overall level of harmful tax costs to be imposed on global business operations and the distribution of tax revenues among jurisdictions on a going forward basis. Thus, we strongly recommend that Canada should proceed with caution in this area, making only evidence-based policy choices after thorough consultations with stakeholders and subject to appropriate transitional measures, with a view to balancing tax integrity and fairness with the competitiveness of Canada's tax system, including with reference to administrative and compliance costs. Canada should actively monitor the implementation and participate in the further development of these initiatives, as well as revisit certain of Canada's long-standing international tax rules, with a view to ensuring the competitive position of Canadian business in general and the Canadian financial sector in particular, in order to promote employment opportunities and the well-being of all Canadians.

Finally, we would recommend that serious consideration be given to more actively supporting innovation as well as small business investment. For innovation, support can be enhanced through administrative and substantive reforms to existing programs such as the SR&ED program, as well as the potential introduction of new programs in this area. Serious consideration should also be given to the introduction of reforms to the capital gains taxation regime with a view to enhancing economic efficiency in general and with a view to supporting growth and job creation in the small business and "knowledge intensive" sectors in particular.

3. The Role of Corporate Taxation and Implications for the Financial Sector

3(a) Why Tax Corporations?

A common question is: why do we have a corporate income tax? This is a good question – for a number of reasons – including that the OECD has observed that "corporate taxes are the most harmful type of tax for economic growth".[7]

An argument can be made in favour of its abolition since corporations are not real persons that bear the burden of taxation. Instead, corporations are simply legal entities that in effect *collect and remit* taxes indirectly imposed in substance on the real persons who are their various stakeholders. The corporate tax is ultimately shifted to, and economically borne by, either shareholders through lower dividends and capital gains, workers through lower salaries and wages (as well as other input providers), consumers through higher prices, or some combination of the three. Also, any portion that is shifted to shareholders, consumers or workers may detract to some extent from the progressivity of the personal income tax. In this regard, it would be easier to achieve fairness and economic efficiency by taxing individuals directly.

On the other hand, the 1966 Carter Report made arguments in favour of a corporate tax, as did the Mintz Report of 1997. Three main arguments are generally provided.[8]

- *Corporate Tax as a Backstop to the Personal Tax*: Without a corporate tax, it is possible for individuals to avoid paying personal income tax by leaving income in the corporation. As the personal income tax taxes capital gains only when assets are disposed, investors avoid personal income taxes by leaving income at the corporate level by not distributing it as taxable dividends, salaries, rents, interest and other forms of income. This not only creates unfairness but leads to a distortion in behaviour to minimize taxes. This concern is exacerbated as the rate of corporate tax is lowered relative to the rate of personal income tax, and is mitigated by introducing features that distinguish between corporate business income and investment income, and in some cases that produce deemed dividends or tax undistributed profits that are not reinvested in corporate business assets. The Canadian income tax system has historically included and currently includes several such features, in addition to other features intended to better "integrate" the corporate tax with the personal income tax.

---

[7] See OECD, Tax Policy Studies (No. 20), *Tax Policy Reform and Economic Growth* (Paris: OECD Publishing, 2010), page 5. According to this study, "corporate taxes are the most harmful type of tax for economic growth, followed by personal income taxes and then consumption taxes, with recurrent taxes on immovable residential property being the least harmful tax".

[8] See the Royal Commission on Taxation (the Carter Report), *Report*, Supply and Services, Ottawa, 1966 and Technical Committee on Business Taxation, *Report,* Finance Canada, Ottawa, 1997.

- *Corporate Tax as a Source-Based Tax to Withhold Income from Non-residents*: With international capital flows, a country's corporate tax provides revenue to the government where profits are sourced. The corporate tax therefore is a withholding tax on profits that would accrue to foreign investors and governments, and may be coupled with additional withholding taxes on payments of interest, dividends and other amounts to non-residents. Some foreign governments, particularly the United States, provide tax credits for Canadian corporate income taxes paid by their resident individuals and multinationals investing or operating in Canada, which produces a treasury transfer effect from the capital exporting country to Canada. The force of this justification for corporate tax diminishes to the extent that Canadian-resident corporations earn non-Canadian sourced income and have non-resident shareholders.

- *The Corporate Tax as a Surrogate User Pay Tax*: Corporations, whether domestic or foreign-owned, benefit from public services such as transportation and communication networks, protection and the justice system that improve their profitability. When full cost-recovery user fees are not charged, businesses will have higher profitability from access to subsidized public services. A corporate tax captures these gains to businesses. However, this argument is more of a justification for the imposition of taxes on business activities rather than taxes on corporations as such. Increasingly, business activities are carried on through other forms of business organization, including those that get "pass-through" treatment for tax purposes.

As both the Carter and Mintz reports argued, the corporate tax is least distortive if business activities face the same tax burden. Capital is then allocated to its best economic use as businesses invest in those activities that provide the best economic returns while shifting away from those activities that are less likely to earn comparable returns. At times, governments might impose special taxes when specific market failures or externalities arise such pollution, which is not fully priced in terms of its harmful effect on consumers or other producers. Governments might also provide subsidies such as in the case of research since businesses cannot fully appropriate returns. Correcting for cost externalities and subsidizing benefit externalities are symmetrical although inverse policy responses. Nonetheless, even if these market failures exist, it is by no means certain that the best remedy to address them involves tax policies since spending and regulatory powers may be more effective in certain cases.

These points are quite relevant to the taxation of the financial sector. Generally, as argued in the past, the financial sector should be taxed no differently and no more heavily than other sectors. Yet, as spelt out in more detail below, the financial sector, especially larger companies, are often assessed with higher taxes than other businesses for political, not economic reasons. A good example discussed in more detail below is the imposition of capital taxes that only apply to financial institutions. Imposing a high tax on the financial sector can increase the cost of investment across the entire economy, thereby having growth-impeding consequences, as lenders charge higher borrowing rates and/or reduce returns to savings paid to depositors as financial institutions must recover taxes to ensure profitability.

While neutrality among business sectors is appropriate tax policy, a few specific issues arise from time to time that result in higher or lower tax burdens on the financial sector. First, some taxes on the financial sector are difficult to impose resulting in differential treatment of the industry. A specific example is the Goods and Services Tax (GST) or federal-provincial Harmonized Sales Tax (HST). A neutral Value Added Tax such as the GST/HST should be applied to all forms of consumption. However, when it comes to financial services, the consumption service is imbedded in the margins earned by financial institutions arising from the spread between lending and borrowing rates and other service charges. It is not a simple matter to tax the margin, resulting in a common practice to "exempt" the provision of certain financial services from a VAT. The VAT is still paid by financial institutions on their input purchases and thus must be recovered through higher prices charged on their sales to consumers and businesses. This form of double taxation[9] on financial services provided to other businesses results in higher effective tax rates on consumers purchasing goods and services from businesses relying on these financial services. Some countries have tried to deal with "exempt" financial services by applying a special tax on financial revenues but not very successfully. Nonetheless, even if the "exemption" system is maintained, the GST/HST should be applied in a more similar way across different financial services. At the present time, some services are "exempt" and others are fully taxed giving rise to distortions within the sector. A shift to more equal taxation across financial services is warranted.

A further point is related to monetary policy and regulation. To ensure confidence in the financial sector, governments and central banks have been lenders of last resort to banking institutions. Since governments therefore absorb any losses, this creates a potential incentive for businesses to borrow excessive amounts of debt from financial institutions. Some have argued that banks should therefore bear special taxes (e.g. financial transaction taxes) to curtail risky activity (IMF 2010). From a Canadian perspective, the regulatory framework has been successful in ensuring financial stability as seen in the 2008 global financial crisis. Canada has become a leader at the international level in regulatory reform that is far easier to achieve than a global approach to taxation to curtail moral hazard given that taxation is guarded as a sovereign power by governments. We strongly believe that taxation is not a good approach for dealing with moral hazard issues at the domestic or international level.

[9] There is double taxation because the tax is imposed on the inputs provided to the financial institution, and then imposed again when the value of those inputs is reflected in the price changed by businesses to their customers.

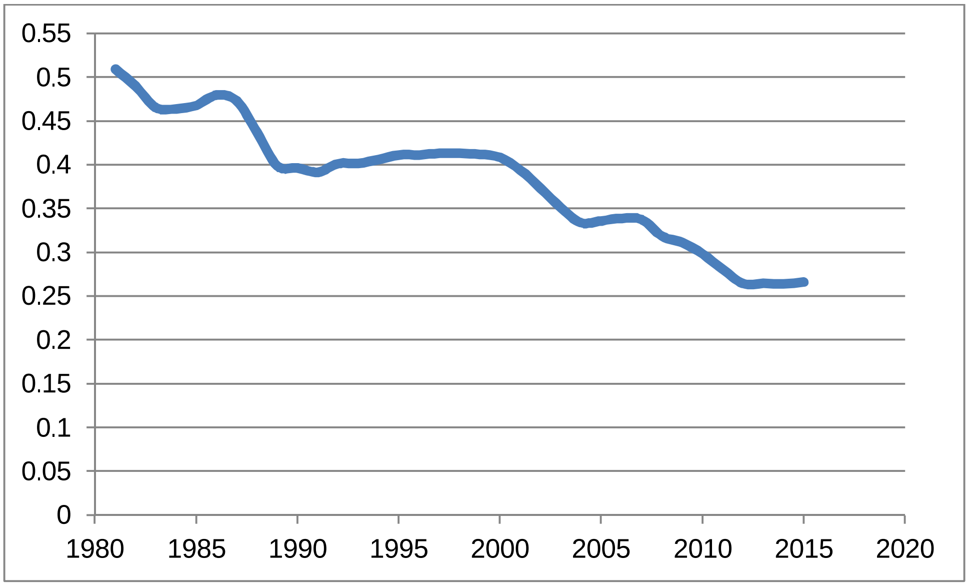
A final point of consideration is related to international capital and competitiveness. Given that Canada itself may set tax policies that are good in isolation but cannot control what other countries do, it is critical to assess tax policies in a global context to ensure the best economic interests for Canada are taken into account. One principle is that Canada's tax system should be neutral by minimizing distortions with respect to investing domestically or internationally. Another consideration is to ensure that Canadian businesses can compete on the same tax basis as other international businesses either in Canada or abroad. Since governments assess taxes on different bases and at different rates, it is virtually impossible to achieve a fully neutral international tax system such that investments no matter where they occur or by whom are taxed at the same rate. Instead, Canada must achieve a policy that reduces tax distortions as best as possible while maintaining its tax revenues to finance public services here.

Overall, as discussed below, this report will focus on policies affecting the financial sector to reduce distortions and achieve greater neutrality amongst business sectors, with a view to enhancing and promoting economic efficiency, innovation, savings, investment, productivity and job creation, across the Canadian economy as a whole and, in particular, both in this sector and in the small business sector.

3(b) Corporate Income Taxes, the Economy and the Financial Sector

To begin, we present data on the overall size of corporate income taxes in Canada, from several perspectives. In the statistics below, we focus on taxes on profits based on Statistics Canada data. These taxes only include corporate income taxes and mining or logging profit taxes. Capital taxes and insurance premiums are not included since these are classified as taxes on property or sales respectively.

Figure 1: Weighted Average General CIT Rate, Federal and Provincial Combined: 1981-2015

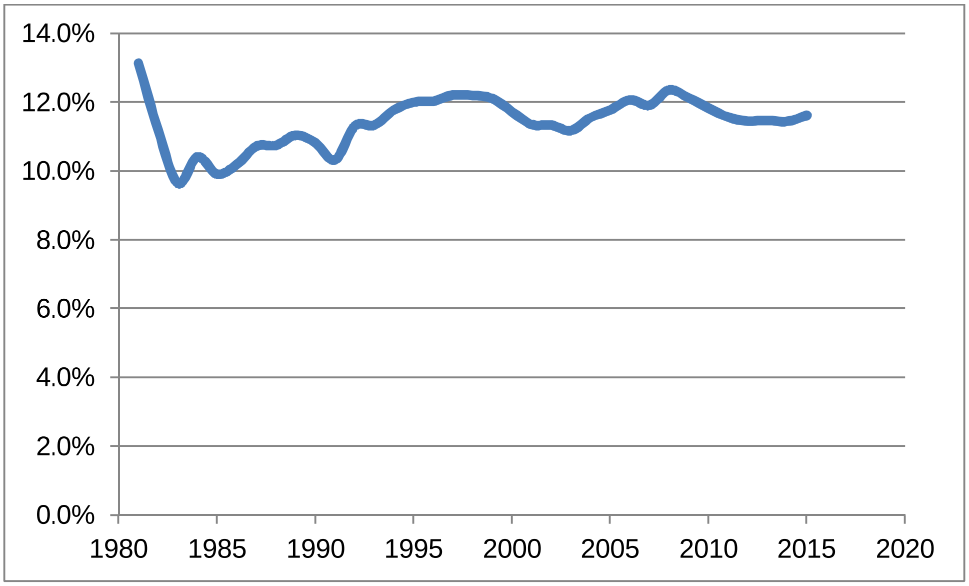


Source: Corporate Tax Rate Database: Canada and the Provinces, 1960-2005, Agriculture Canada; Finances of the Nation, Canadian Tax Foundation, various issues; various federal and provincial government websites; weights are author calculations using data from Ron Kneebone and Margarita Wilkins, Canadian Provincial Government Budget Data, 1980-81 to 2013-14, The School of Public Policy, The University of Calgary.

Figure 1 shows the general combined federal-provincial statutory tax rate for large corporations, including adjustments for surtaxes when appropriate, from 1981 to 2015.[10] It illustrates a general downward trend, in step-wise fashion, in the statutory corporate income tax (CIT) rate over this period from 50.9% in 1981 to 26.6% in 2015. Over the period shown in the figure the federal general statutory CIT rate also fell from 37.8% in 1981 to 15% in 2012, which is where it currently stands; a 55% reduction in the federal statutory CIT rate over this period.

[10] A surtax is a "tax on a tax". It effectively increases the statutory tax rate. The figures reported here roll the surtax into the CIT rate. Surtaxes are typically intended to be temporary, and have been imposed, raised, lowered, and eliminated from time to time for decades.

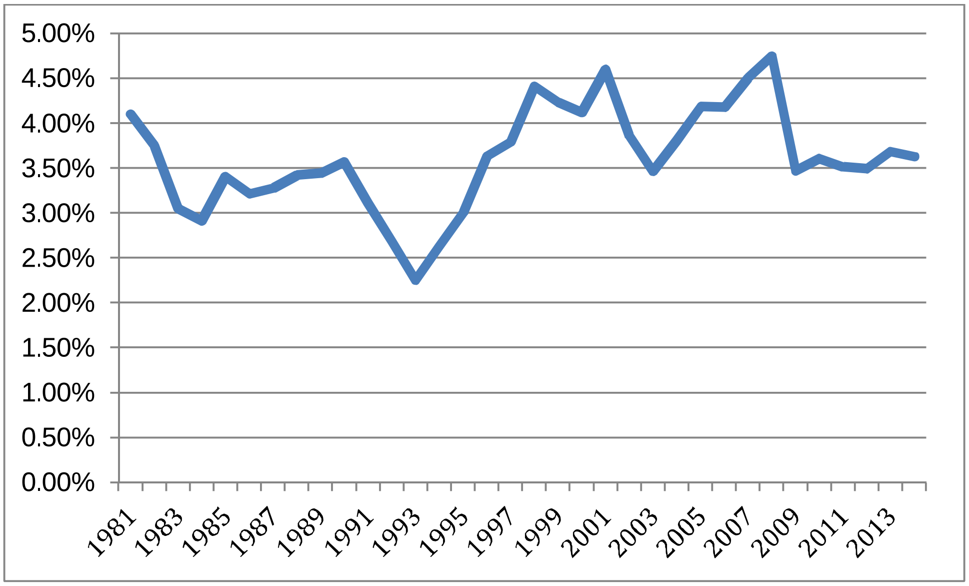
Figure 2: Weighted Average General CIT Rate, Provinces: 1981-2015



Source: Corporate Tax Rate Database: Canada and the Provinces, 1960-2005, Agriculture Canada; Finances of the Nation, Canadian Tax Foundation, various issues; various federal and provincial government websites; weights are author calculations using data from Ron Kneebone and Margarita Wilkins, Canadian Provincial Government Budget Data, 1980-81 to 2013-14, The School of Public Policy, The University of Calgary.

The period from 1981 to 2015 also saw some modest reductions in statutory CIT rates at the provincial level. Rather than looking at these on a province-by-province basis, Figure 2 shows the weighted average general statutory provincial CIT rate for large corporations, weighted by the share of aggregate provincial corporate tax revenue. In 1981 the weighted average provincial CIT rate was just over 13% By 2015 it had fallen slightly to 11.6%, with some fluctuations along the way.

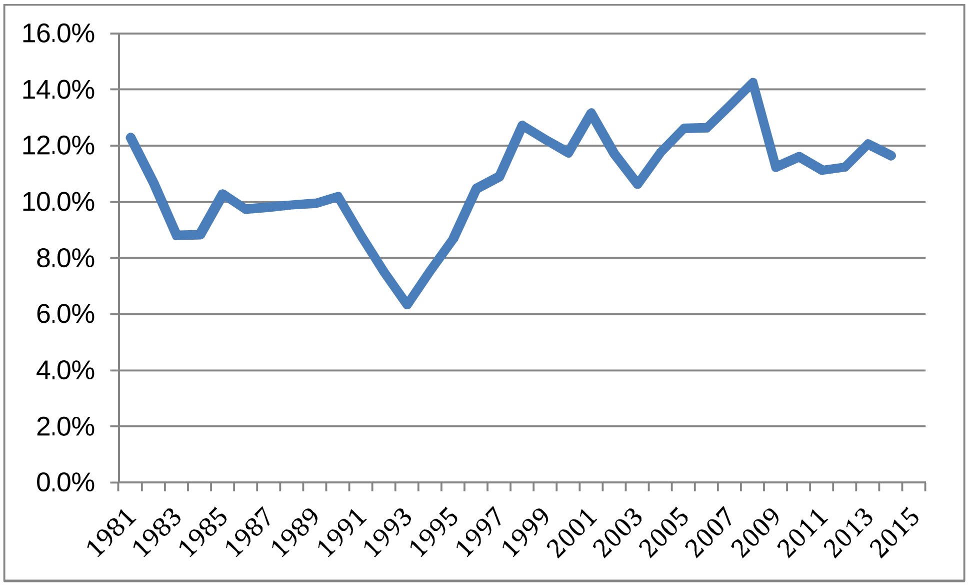
Figure 3: Combined Federal and Provincial CIT Revenue as a Share of GDP: 1981-2014



Source: Author calculations using Fiscal Reference Tables, Department of Finance Canada; Ron Kneebone and Margarita Wilkins, Canadian Provincial Government Budget Data, 1980-81 to 2013-14, The School of Public Policy, The University of Calgary.

Interestingly, the significant reduction in statutory CIT rates is not associated with a discernible downward trend in revenue generated by the CIT. Figure 3 shows combined federal/provincial revenues from the CIT expressed as a percentage of GDP. From 1981 to 1990, CIT revenues as a percentage of GDP fluctuated between 3% and 4%. The period from 1991 to 1994 witnessed a fairly significant reduction in CIT revenue as a share of GDP, reaching a low of 2.25% in 1993. This, of course, was the period marked by a significant worldwide recession and a significant build up of losses from past tax preferences for capital investment including investment tax credits, accelerated depreciation and rate reductions for specific sectors. Corporate income tax revenues are quite sensitive to the business cycles, the effects of which can show up in revenue figures for several years due to the carry-forward of corporate tax losses generated during recessions. From its nadir in 1992, combined federal/provincial CIT revenue as a percentage of GDP recovered to fluctuate between 3.5% and 4.5%, leveling off over the last couple of years at just above 3.5%, in part reflecting base-broadening measures after corporate tax reforms adopted since 1986.

Figure 4: CIT Revenue as a Share of Total Revenue, Aggregate Provincial and Federal Government: 1981-2014



Source: Author calculations using Fiscal Reference Tables, Finance Canada; Ron Kneebone and Margarita Wilkins, Canadian Provincial Government Budget Data, 1980-81 to 2013-14, The School of Public Policy, The University of Calgary.

Combined federal/provincial CIT revenue as a share of total revenue is shown in Figure 4. In aggregate, CIT revenue has accounted for between about 6% and 14% of total government revenues over the period from 1981 to 2014. The low point (6.3%) was again in 1993, and the high point (14.3%) in 2008. Over the last several years combined federal/provincial CIT revenue as a percentage of total revenue has hovered around 12%. As with the GDP share numbers, there does not appear to have been a marked reduction in the share of total revenue accounted for by the CIT associated with the significant reduction in statutory rates.

The fact that a virtual halving of the combined statutory CIT rate over this period is not associated with a sizeable reduction in the amount of CIT collected as a share of GDP nor in the share of total tax revenue accounted for by the CIT is notable. It is well beyond the scope of this paper to investigate this in more detail, and in particular one must be cautious about imputing causal relationships from simple graphs – many other things were going on over this period which may have affected CIT revenue, and a rigorous statistical investigation which seeks to generate a counter-factual hypothesis would need to control for these – but it is evident from the raw data that there has not been a marked reduction in the CIT revenue associated with the very significant reduction in the statutory tax rate.

This is also consistent, however, with the notion that the corporate tax base (taxable income) is quite elastic, or responsive, to statutory corporate tax rate changes. As the CIT rate declines one might expect the corporate tax base to expand. Thus, while the reduction in the CIT rate will lead to a decrease in government revenue due to what economists refer to as the "mechanical effect" of the rate reduction, this will be offset to some extent by an expansion of the tax base due to the "behavioral effect". Several hypotheses can be presented as to the reasons that corporate tax revenue did not decline as a share of GDP despite the fall in corporate tax rates. These include the following:

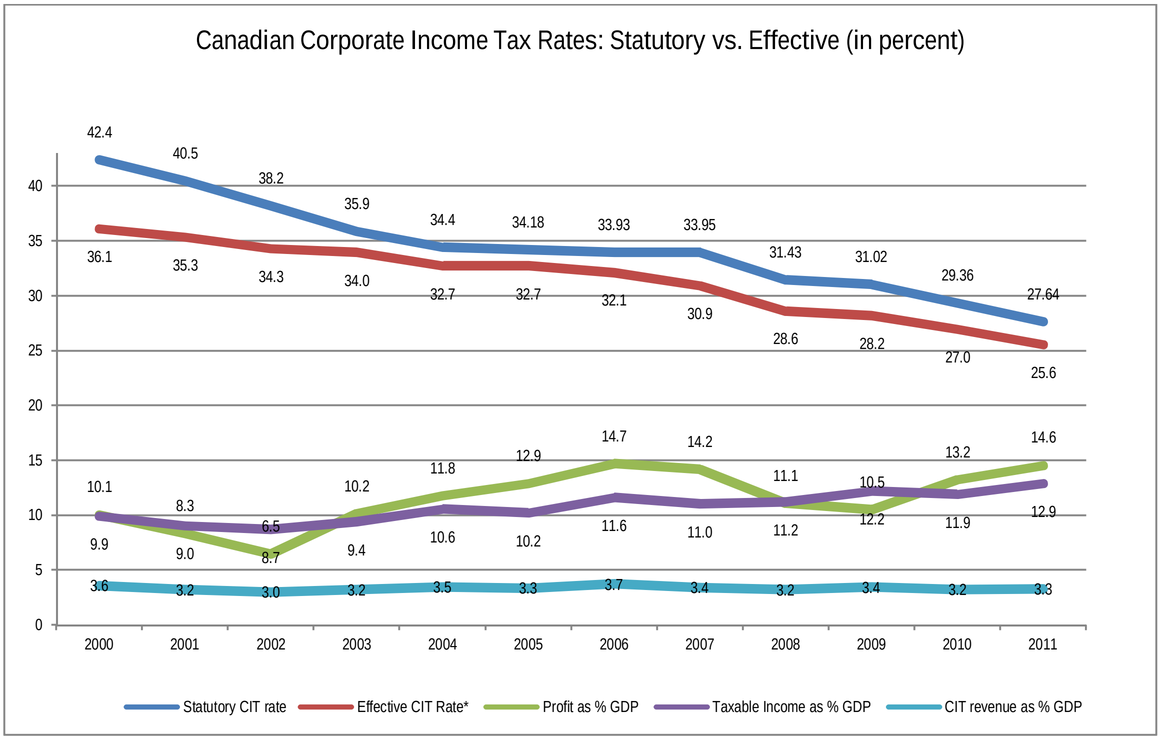
- Federal and provincial governments have reduced some tax preferences to help bolster revenues as they lowered corporate income tax rates. As Chen and Mintz (2015) have shown (see Figure 5 below), the difference between statutory and effective corporate tax rates (corporate taxes as a share of profits) shrunk somewhat.

- Resource and finance profits increased substantially after 2000 due to higher commodity prices and better economic growth at least until 2008 (see further discussion of the financial sector below).

- With a sharp reduction in statutory corporate income tax rates relative to the rest of the world after 2000, businesses were more willing to keep profits in Canada rather than shift them to other countries where corporate income tax rates were higher. Chen and Mintz (2015) also found taxable income as a share of GDP rose in 2009 even though profits declined as a share of GDP unlike the United States, perhaps suggesting support for this hypothesis.

- Lower tax rates reduce the incentive for tax avoidance and illegal tax evasion. On the other hand, a lower corporate income tax relative to the top personal tax rate encourages income to be shifted from the personal to corporate tax sector (especially at the small business level).

Figure 5: Federal-Provincial Statutory and Effective Corporate Income Tax Rates: 2000-2011

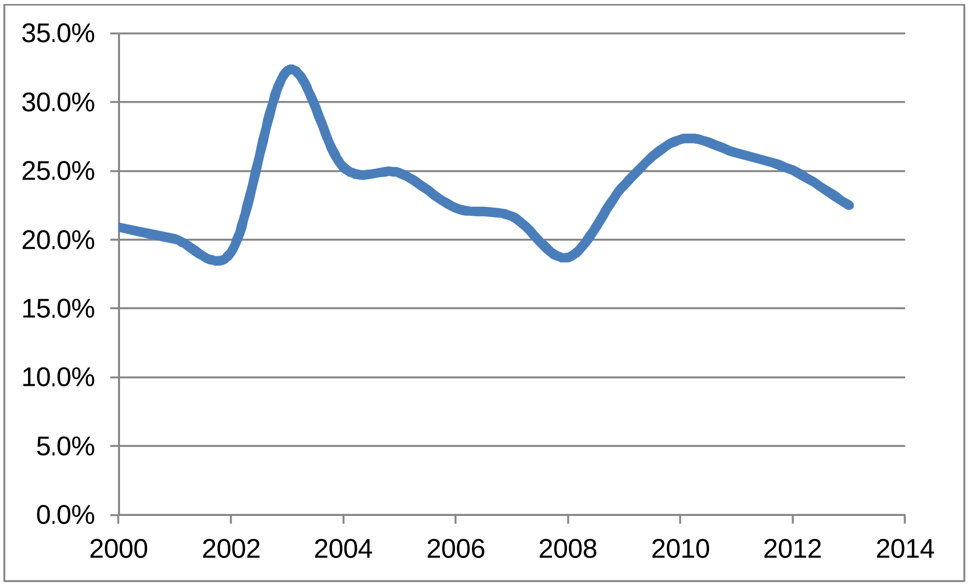


Source: Chen and Mintz 2015

Most studies indicate that the behavioral effect is quite large in the case of the corporate income tax. For example, Dahlby and Ferede (2011) calculate that a one percentage point decrease in the federal corporate tax rate leads to a 2.3% increase in the corporate tax base in the long run. This increase in taxable income (reflecting the behavioral effect) offsets to some extent the reduction in government revenue due to the decrease in the CIT rate (the mechanical effect). In more recent research Dahlby and Ferede (2015) find that corporate taxable income at the provincial level is even more sensitive to changes in the provincial corporate tax rate. For example, they find that the corporate tax base in Quebec is the least responsive of the provinces, but that even in this case a one percentage point decrease in the provincial corporate tax rate leads to a 6.1% expansion in corporate taxable income.[11] For Ontario they find that a one-percentage point decrease in the provincial corporate tax rate increases the corporate income tax base by 13%. Interestingly, Dahlby and Ferede also find that for the smallest provinces (Saskatchewan, New Brunswick, Nova Scotia, P.E.I, and Newfoundland & Labrador), the elasticity of the provincial corporate tax base is so high as to put them on the "wrong" side of the Laffer curve, which means that the behavioral effect of a tax reduction on the amount of government revenue collected actually outweighs the mechanical effect. In other words, in these provinces a *decrease* in the corporate income tax rate will actually lead to an *increase* in tax revenue.

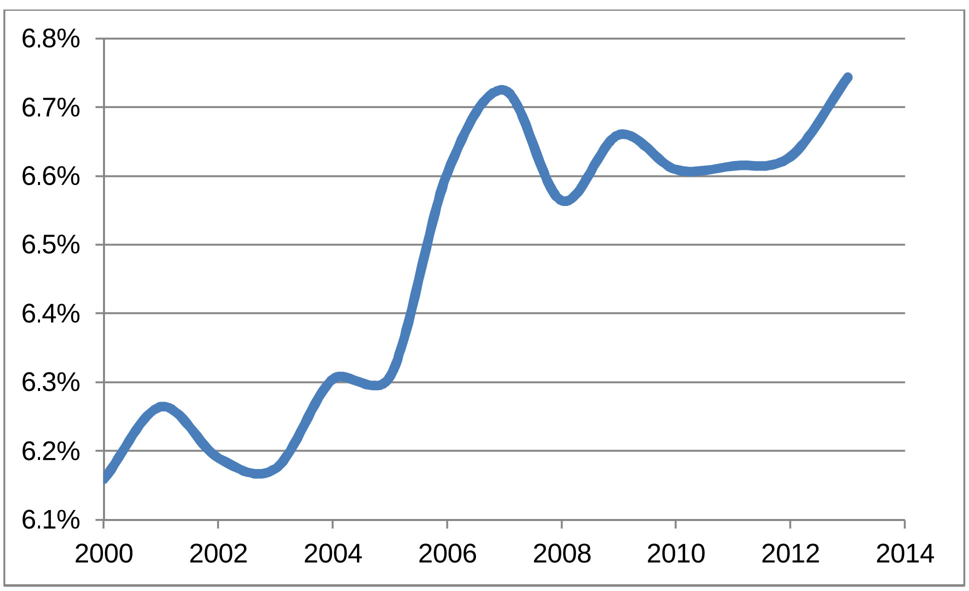
[11] It is important to note that this presumes that the CIT rates in all of the other provinces remain constant.

Figure 6: Financial Sector Share of Total Corporate Income Taxes, 2000-2013



Source: Author calculations using Financial and Taxation Statistics for Enterprises, by North American Industry Classification System, Statistics Canada, CANSIM Table 180-0003.

Figure 7: Financial Sector Share of GDP, 2000-2013

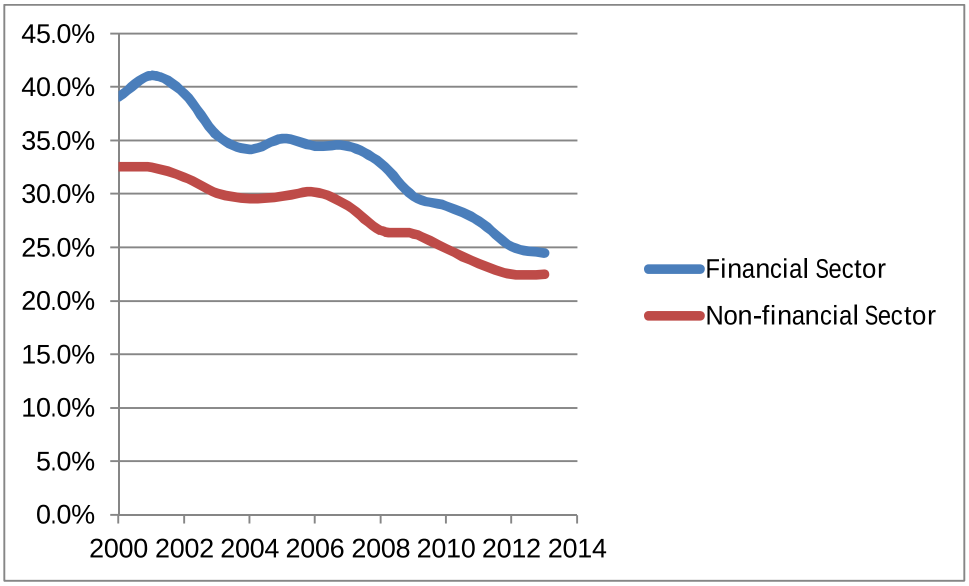


Source: Author calculations using CANSIM Table 379-0031, GDP at Basic Prices, North American Industry Classification System (NAICS)

How does the financial sector fit into this? Figure 6 shows the share of total corporate taxes paid by the financial sector from 2000-2013. Over this period the financial sector accounted for between 20% and 30% of total corporate tax revenue in Canada, with an average over the period of 23.5%. To put this in perspective, Figure 7 shows the financial sector's share of GDP over this same period. It fluctuates between 6.2% and

6.7%, averaging 6.5%. Thus, while accounting for 6.5% of GDP, the financial sector accounts for 23.5% of corporate tax revenue. These calculations do not include capital taxes and insurance premiums that have been used in the past as surrogate corporate income taxes especially at the provincial level.

Figure 8: Income Taxes/Taxable Income, Financial and Non-Financial Sector, 2000-2013



Source: Author calculations using Financial and Taxation Statistics for Enterprises, by North American Industry Classification System, Statistics Canada, CANSIM Table 180-0003.

This narrative is expanded in Figure 8, which shows aggregate corporate taxes as a percentage of taxable income for both the financial and non-financial sectors. While both are trending down throughout the period, due to the reductions in the statutory CIT rate at the federal level, it is clear that the average tax rate as a percentage of taxable income facing the financial sector is significantly higher than the non-financial sector. This is likely due, in part, to the larger share of tax loss corporations in the non-financial sector.

3(c) Corporate Income and Capital Taxes: Impact on Investment

The potential distortionary effects of the corporate tax, most particularly with respect to investment, are a matter of considerable interest. Economists summarize the key elements of the business tax system with respect to investment in a measure called the *Marginal Effective Tax Rate* (METR) on capital. The METR is a summary measure of the *effective* rate of tax imposed on the rate of return generated by the last, or *marginal*, unit of capital a firm invests in. The METR is therefore a summary measure of the total distortion in the rate of return to capital imposed by the business tax system.

The calculation of METRs can be quite complicated, but the idea can be conveyed in a simple example. Say that the hurdle rate of return on an investment is 4% - i.e., the minimum rate of return (ROR) required by the shareholders after the payment of all business taxes is 4%. This after-tax hurdle ROR is the rate of return shareholders must earn to compensate them for the opportunity cost of investing their funds in alternative assets.

The before-tax cost of holding capital on an annualized basis can be thought of as the minimum rate of the return earned on a unit of capital to cover costs including depreciation, financing the capital (a weighted average of the cost of debt and equity finance and risk) and, importantly, any taxes paid on the capital or on the income generated by that capital (for example, the corporate income tax).

Now say that the CIT system, with all its complexity, is such that in order to earn a ROR of 4% *after* the payment of the CIT and other taxes on business income or capital, an investment must earn a *before-tax* ROR of 6%. The METR is the annualized amount of corporate taxes paid as a share of the pre-tax rate of return on capital for investment that earns the minimum rate of return on capital. The METR is then 33.33% (determined as (.06-.04)/.06). The METR therefore measures the share of the investment's before-tax ROR needed to cover the tax costs associated with the investment. The higher the METR the greater the distortion in the ROR caused by the CIT and the larger the disincentive to undertake the investment.

The School of Public Policy at the University of Calgary has developed the most comprehensive METR model in the world. They present an annual *Tax Competitive Report* reporting, and analyzing, METR numbers for 95 countries. The 2014 version of the report provides METR numbers over the past 10 years. Table 1 shows their aggregate calculations for Canada and several aggregate averages for different groups of countries.

Table 1: Aggregate Marginal Effective Tax Rates on Investment (percent): 2005-2014

	2014	2013	2012	2011	2010	2009	2008	2007	2006	2005
Canada	19.0	18.8	17.5	18.8	19.9	27.3	28.0	30.9	36.2	38.8
G7	27.4	27.7	27.9	28.6	28.9	30.1	30.2	32.9	36.2	34.2
OECD Average	19.4	19.6	19.5	19.7	19.6	19.8	20.1	21.0	21.6	22.3

Source: Duanjie Chen and Jack Mintz 2015.

As shown in the table, there has been a marked and significant reduction in the aggregate METR in Canada over the last 10 years. In 2005, Canada's METR was 38.8%, higher than the G7 average of 34.2%, and substantially higher than the OECD average of 22.3%. As such, 10 years ago Canada's corporate tax system was quite distortionary by international standards. By 2014 Canada's METR had fallen to 19.0%, compared to a G7 average of 27.4% and an OECD average of 19.4%. As documented above, a key element of this has been the significant statutory CIT reductions, primarily at the federal level. It bears repeating that these significant reductions in both the statutory CIT rate and the METR have not been accompanied by substantial reductions in either the CIT revenue to GDP ratio or in the share of total revenue accounted for by the CIT.

It is interesting to consider the METR on the financial sector in comparison to the aggregate METRs reported in Table 1. An important consideration in this regard is the imposition of capital taxes on parts of the financial sector. General capital taxes levied on large corporations at the federal level, the so-called Large Corporation Tax (LCT), were eliminated in 2006. The federal capital tax on financial institutions, however, remains. It is levied at a rate of 1.25% on the taxable capital employed in Canada in excess of $1 billion of banks, loan and trust companies, and life insurance companies.

The federal capital tax on financial institutions is reduced by the amount of corporate income taxes that they pay. As such, financial institutions only pay federal capital taxes to the extent that they do not have sufficient income tax liability; in other words, corporate income taxes are creditable against the capital tax. For this reason the financial capital tax is sometimes viewed as a type of minimum tax, paid only by institutions that are not paying a “sufficient” amount of corporate income tax, and may have disparate implications for financial institutions such as life insurers during periods in which interest rates are low.

Eight provinces (the exceptions being Alberta and B.C.) also levy corporate capital taxes on financial institutions, on various parts of the sector, at varying rates and with varying thresholds. However, unlike the federal capital tax, the provincial capital taxes on deposit-taking institutions are deductible from the corporate income tax base and therefore do not operate as minimum taxes. Both Quebec and Ontario levy a 1.25% tax on life insurance companies only (not banks or loan and trust companies) on taxable capital in excess of $10 million employed in the province. Like the federal capital tax, these are minimum taxes. The other provinces levy a capital tax on banks and loan and trust companies, but not life insurance companies, at rates ranging from 2.5% to Manitoba’s 6% as of May 1, 2015 (Newfoundland applies the tax to banks only). Quebec also levies a tax on payroll in the financial sector (this tax affects the cost of labour, not capital).

Incorporating capital taxes into the METR model is simple in principle, but appropriately reflecting the minimum tax element at the federal level is not. Table 2 therefore presents three scenarios for the aggregate of Canada (CA) and the provinces individually for investments in Canada. The first column reports the METR on investment for other sectors in Canada for comparability purposes. The second column provides the METR for the financial sector if only the corporate income tax is applied in 2014 with no capital tax. However, since the first column for other industries includes provincial sales taxes (PST) on capital purchases in British Columbia, Saskatchewan and Manitoba, we also include them in the corporate income tax case as well for comparisons.[12] The next column reports federal and provincial capital taxes *in addition to* the corporate income tax. This reflects the situation when capital taxes would be paid at the margin. The final column reports federal and provincial capital taxes with no CIT; in other words the capital tax is imposed *instead of* the CIT. This would be the case if a financial institution had zero CIT to pay in Canada in which case it would pay capital taxes only. None of these scenarios on their own is an accurate representation of the actual state of affairs, but collectively they tell an interesting story.

Table 2: Financial Sector Marginal Effective Tax Rates on Investments (percent): 2014

	Aggregate Other Sectors	Financial Sector CIT/PST	Financial Sector CIT+CT	Financial Sector CIT+ GST/HST + PST	Financial Sector CIT + CT + GST/HST + PST
Canada	18.96%	25.41%	48.01%	39.81%	56.08%
Newfoundland	10.72%	21.75%	60.52%	42.60%	67.66%
Prince Edward Island	11.38%	26.92%	65.04%	43.77%	70.40%
Nova Scotia	13.39%	23.74%	61.14%	46.62%	69.21%
New Brunswick	4.77%	20.29%	60.25%	42.10%	67.58%
Quebec	15.89%	24.59%	48.07%	43.03%	58.34%
Ontario	18.15%	24.42%	48.07%	41.12%	57.27%
Manitoba	27.87%	37.31%	68.45%	41.99%	70.05%
Saskatchewan	24.25%	31.0%	60.76%	36.76%	63.07%
Alberta	17.04%	18.65%	34.65%	29.14%	41.90%
British Columbia	27.48%	33.10%	44.53%	38.82%	48.75%

Notes:

1. CIT + PST = Corporate income tax and provincial retail sales taxes in three provinces.
2. CIT+ CT+ PST = Corporate income tax, federal and provincial capital taxes, sales tax rates at level consistent with other sectors
3. CIT + GST/HST + PST = Corporate income tax, no capital tax, sales tax rates reflecting non-refundability for financial sector and PST in provinces
4. CIT + CT+ GST = Corporate income tax, federal and provincial capital taxes, GST/HST tax rate reflecting non-refundability for financial sector and PST in provinces

Table 2 shows three key points:

- The first thing to note is that for 2014 the METR on financial institutions, even in the case of no capital taxes and GST/HST impacts, is higher than the aggregate METR for Canada (25.4% vs. 19.0%). This means that the tax system distorts the

[12] By investment we mean investment in physical capital: machinery, buildings, land, inventories.

rate of return ("ROR") on investment, and potentially discourages investment and job creation, more in the financial sector than other sectors in the economy.

- Secondly, in all three scenarios there is quite a bit of variation across the provinces in the METR. This is due to the following:

    - Provincial statutory corporate income tax rates vary across provinces from 11% in British Columbia to 16% in Nova Scotia and Prince Edward Island (until July 1, 2015, Alberta had the lowest corporate income tax rate at 10%, which is now 12%).

    - Various capital tax rates assessed by Saskatchewan, Manitoba and Atlantic provinces on the financial sectors as explained above.

    - Sales taxes on capital purchases under both provincial retail sales taxes in British Columbia, Saskatchewan and Manitoba and non-refundable GST/HST at the federal level and in other provinces except Alberta that has no sales tax.[13]

- Third, capital taxes and sales taxes have a very marked and significant effect on the METR. In the combined tax scenario, where capital taxes and corporate income taxes and sales taxes on capital purchases including the GST/HST are payable, the distortion is very high: 46.08% in aggregate, and ranging from 41.90% in Alberta to 70.05% in Manitoba.

While the METR measures the distortion to the cost of capital caused by the tax system, it does not indicate how sensitive investment ultimately is to this distortion. The impact of corporate taxes on investment is a much debated and somewhat controversial topic, at least in public discourse. Public discussions, in the media and "blogosphere", often rely on very simple correlations between some measure of aggregate investment and some measure of the corporate tax rate, often the statutory rate. A proper analysis of the impact of taxes on investment needs to control for the myriad of other factors that may affect investment aside from, and independently of, taxation. These include fluctuations in aggregate demand, changes in the underlying cost of financing, inflation, financing constraints, etc. Accounting for all of these factors, and isolating the impact of taxes, requires the use of sophisticated statistical techniques.

As documented by Hassett and Newmark (2006) in their very thorough review of the empirical evidence, recent studies in the past couple of decades have shown that private investment is quite sensitive to corporate taxes. The widely held consensus amongst academic economists is that, all else being equal, taxes have a significant

[13] It is presumed that the capital tax is imposed at the top rate in each province where applicable.

impact on investment, which also contributes to more corporate tax revenues being raised by the governments when tax rates are reduced, as discussed above.

While there is a wide diversity of empirical approaches, the key variable of interest in the estimation of investment responses to taxation is the cost of capital. As discussed, the METR on capital measures the share of the cost of capital accounted for by taxes. The METR and the cost of capital are therefore closely related.

As explained by Hassett and Waymark (2006), modern studies of the impact of taxation on investment suggest that the long run elasticity of investment with respect to the cost of capital (adjusted for the METR) may be as high as -1.0. This means that a 10% increase in the cost of capital, due to an increase in the METR or other factors which affect the cost of capital, leads to a 10% reduction in investment in the long run. A more conservative estimate suggests an elasticity of perhaps -0.7, meaning that a 10% increase in the cost of capital leads to a 7% decrease in investment. This, for example, is consistent with a recent Canadian study undertaken by the Department of Finance, which takes advantage of the reduction in the tax rates on non-manufacturing enterprises relative to manufacturing enterprises to identify the impact on investment (see Parsons (2008)).

The substantially high METR on the financial industry therefore deters investment in the sector. It also increases the cost of financial services for households and businesses in Canada. These higher costs will in part pass through to the business sector as higher borrowing rates, leading to a reduction in business investment by other sectors besides the financial sector. Ultimately, excessive taxation of the financial sector reduces jobs for all Canadians and results in lower productivity.

3(d) Eliminating Capital Taxes on Financial Institutions

Given the analysis in section 3, a strong case can be made to repeal capital taxes on financial institutions, which are unique among OECD countries.[14] This would achieve a more competitive tax system in Canada as well as improve neutrality among sectors and firms within the sector. Businesses, especially smaller companies that have less access to international markets, would benefit from lower lending rates. Depositors and others investing in financial institutions would benefit from higher yields on their investments. The federal capital tax, as a minimum tax, unfairly impacts certain segments of the financial sector, and encourages financial institutions to shift capital to other jurisdictions. Provincial governments would lose some revenue, which would need to be made up in other ways.

[14] If the tax is not repealed then the rate should at least be reduced in line with CIT rate reductions. A financial institution now needs virtually double the CIT tax base to absorb the minimum tax.

4. Financial Institutions and the GST/HST

The treatment of financial services under a value added tax (VAT), the GST/HST in Canada, has been the subject of considerable debate and discussion both in Canada and worldwide. Firth and McKenzie (2012) provide an in-depth discussion of the issues. The fundamental issue, which is complex and varies across different types of financial services, is the difficulty in explicitly measuring the value added of financial services in the context of a credit and invoice system. For example, in the case of banking a payment for services is not explicit, but rather is implicit in the "spread" (between the interest rates on borrowing and lending). The difficulty arises in allocating the tax between the two sides of the transaction so as to ensure that businesses are not taxed (i.e., receive a GST/HST credit) while final consumers are taxed.

Perceived difficulties in dealing with this issue, and others, have resulted in the widespread treatment of financial services as VAT "exempt". This means that VAT is not on the whole imposed on financial services, but that financial institutions are not in turn able to claim VAT credits on the tax levied on their inputs. The result is that the inputs employed by financial institutions are subject to tax, which is contrary to the underlying principles of a VAT. The tax is therefore embedded or hidden in the (effective) prices charged by financial institutions, to businesses and consumers alike. While the mechanics of "exempt" treatment vary considerably across different financial services, it is generally held that business-to-business (B2B) transactions are overtaxed (in principle, under a VAT, B2B transactions should not be taxed at all) and business-to-consumer (B2C) transactions are under taxed. The over taxation of B2B transactions is particularly problematic, as it can result in subsequent tax cascading as businesses pass their higher costs on down the line in non-tax "exempt" activities.

The net impact of the "exempt" treatment of financial services on government revenue is controversial. Studies of the banking sector in the EU suggest that "exempt" treatment leads to less government tax revenue on the whole. For example, Huizinga (2002) argues that "exempt" treatment in the financial sector leads to significantly lower government revenue relative to "full taxation". A study by the European Commission (2011) reaches a similar conclusion. A study by PriceWaterhouseCoopers (2011) suggests the revenue effects are more modest. Unfortunately, there has been no research in Canada on this issue.

Some alternatives to the exempt treatment of financial services under a VAT, which would in theory result in the proper treatment under "full taxation", have been suggested:

- *The "cash flow" method of imposing a VAT*. The idea behind the cash flow method is to treat the cash flows of financial transactions in the same fashion as flows from non-financial purchases and sales. Thus, cash inflows to those providing financial services (including interest and principle payments, insurance premiums, etc.) are treated as taxable sales, and cash outflows (including loans made and insurance benefits paid) are treated as the purchase of taxable inputs carrying creditable VAT. This, coupled with the full recoverability of VAT paid on real inputs purchased by financial institutions (materials, equipment, etc.), ensures that all B2B transactions are subject to VAT that is fully creditable, while B2C transactions are taxed.[15] Perceived difficulties in applying the cash flow method to complicated financial transactions have been such that no country in the world has embraced the cash flow approach, and "exempt" treatment remains the norm.

- *Modifications to the existing exemption system*. As suggested by Firth and McKenzie (2011), efforts should be made to reduce the problems with the current "exemption" system. One of their recommendations is to "zero-rate" B2B transactions, rather than "exempting" them. This would allow financial institutions to claim VAT credits on inputs associated with the provision of supplies to business and eliminate subsequent tax cascading and the associated inefficiencies. They also stress the need to eliminate discrepancies in effective VAT rates between different types of financial services, which are widespread in the Canadian approach to "exemption" (for example, leasing is subject to GST/HST but lending is "exempt").

- *Neutral Treatment of Financial Products*. The current system taxes fully some financial services such as fees charged for services and "exempts" others. This distorts the choice among financial products within the financial sector. Although one might be tempted to ensure neutrality between financial services and other goods and services with "full taxation", so long as a large share of financial services is "exempt", the distortions between unrelated goods and services is less important than distortions among related services. Taxation neutrality among financial products is both a fairness issue and a necessary measure to ensure that market forces, not tax considerations, drive consumer consumption of financial products.

  As noted above, since the GST/HST came into effect financial services have been taxed under an "exemption system". However, investment fund investors are fully taxed on the Management Expense Ratio (MER). In 2009 KPMG produced an Overview of VAT/GST Treatment of Investment Funds in foreign jurisdictions and found that mutual funds were overtaxed in Canada compared to other jurisdictions.

[15] Under the cash flow approach, both principal and interest payments to financial institutions would be fully taxed.

The report's key findings were that:

- In other jurisdictions, the ultimate tax burden placed on mutual funds was lowered through rebates or exemptions to achieve equity with competing products;

- No country studied fully taxes both the management and the distribution or delivery components of mutual fund fees.

KPMG updated the report in 2015 and found that:

- Investment funds in Canada generally bear a higher VAT/GST burden than the funds industry in the surveyed countries with the exceptions of China and South Africa;

- There is generally greater VAT/GST neutrality between funds and other financial products in all of the other jurisdictions than there is in Canada.

The Montreal Economic Institute (MEI) also weighed in on this issue, noting the impact that the GST/HST has on Canadians' retirement savings. On October 1, 2015, the MEI released a report analyzing the impact of sales taxes on mutual funds savings. They concluded that while the federal government has created important programs to help Canadians save, it has also undermined this objective by "excessively inflating mutual fund management fees with sales taxes" (e.g., the GST/HST). The heavier tax burden on mutual funds, in comparison to other financial products, slows down Canadians' ability to save for retirement.

Addressing this inequity is important because the GST/HST has become a direct tax on savings for the 55% of Canadians who hold their mutual funds in registered retirement savings vehicles.

In brief, we would submit that a serious effort should be made to resolve the various issues that arise in connection with the application of the GST/HST in the financial sector. The *status quo* clearly has different impacts on different segments of the sector, and thus reforms would likewise have different impacts on different segments of the sector. Accordingly, changes in this area would require meaningful consultation with all segments in order to understand the full range of consequences.

We understand and acknowledge that a considerable amount of work has already been done in this area but we would urge policy makers to continue to build on prior efforts in a manner that leverages existing research and the expertise and resources of the financial sector.

This is an important objective in itself but also important because the promotion of economic efficiency, innovation, savings, investment, productivity and job creation would be served by a shift in the tax mix toward a greater reliance on the HST/GST and a correspondingly lower reliance on income taxes,[16] but such a shift would further exacerbate concerns in the financial sector unless these issues are resolved.

5. Premium Taxes

Provinces currently levy insurance premium taxes that vary by the type of insurance. Life, accident and sickness insurance are subject to rates as low as 2% in British Columbia, Manitoba, New Brunswick, Ontario and the Yukon and as high as 4% in Newfoundland and Labrador. Property and casualty insurance is subject to rates varying from 3% in New Brunswick and Ontario to 4.4% in British Columbia. Other taxes also apply to fire insurance premiums and some provinces add on additional levies on specific insurance such as Saskatchewan's additional levy of 1% on motor vehicle insurance and Quebec's tax of 0.48% on insurance premiums (to be phased out March 31, 2019).

Insurance premiums are "exempt" from the GST/HST. However, several provinces levy retail sales taxes on insurance premiums even in harmonized sales tax regimes. This includes Ontario (retail sales tax of 8% except for life and health[17] and automobile insurance), Manitoba (retail sales tax of 8% except for individual life and health insurance), and Quebec (retail sales tax of 9% on insurance premiums except individual life and health insurance).

Total premium based taxes borne and paid to the provinces by life and health and property and casualty insurers were over $3.7 billion in 2014. In addition, the insurance industry collected and paid over $3.6 billion in retail sales taxes in 2014 to Ontario, Quebec and Manitoba. These taxes increase the cost of insurance for consumers and businesses and consequently make it more difficult for Canadians to adequately protect themselves, their families and their employees. The premium tax burden is already several times larger than the annual corporate income tax paid by insurers, and the premium tax rate has recently been increased in Quebec and Alberta.

It seems that taxes on insurance premiums have become such a cash cow for the provinces that the disincentive nature of these taxes is being ignored at a cost to both consumers and governments. Not only does the existence of affordable and widespread insurance coverage tend to foster financial stability and reduce serious disruptions for consumers and businesses but it also tends to reduce cost pressures on provincial

[16] See, generally, OECD, Tax Policy Studies (No. 20), *Tax Policy Reform and Economic Growth* (Paris: OECD Publishing, 2010), and the extracts therefrom reproduced in and in association with footnote 7.

[17] Sales tax applies to group life and health insurance.

budgets. A reform which considers the elimination or reduction of all premium and retail sales taxes on insurance premiums (as well as the cost of GST/HST tax cascading as noted earlier) would be worth exploring from a public policy perspective.

6. Financial Transaction Taxes

Financial transaction taxes were a historical feature of the Canadian tax system with stamp duties assessed by the British government in 1765. However, they have largely been eliminated in Canada except for land transfer taxes in several provinces.

In the wake of the 2008 financial crisis, a renewed interest in financial transaction taxes has taken place especially in Europe. The argument advanced in favour of such financial transactions taxes is to curb speculative behavior, reduce risk-taking by financial institutions given the government's role as lender-of-last-resort and provide revenues to offset the cost of financial bankruptcies.

The European proposal is fairly broad and complex. It would apply to a wide variety of financial institutions including banks, insurance and reinsurance undertakings, pension funds and their managers, holding companies and financial leasing companies.[18] The term financial institution would also apply to individuals and institutions carrying out a "significant" amount of financial activities (significant is defined as having financial transactions worth over 50% of average net annual turnover). The transactions that would be subject to taxation are the purchase and sale of shares, bonds, money market instruments, investment funds, and certain financial derivatives and structured products.

As currently proposed, there are four different ways that a financial institution could fall within the scope of a financial transaction tax ("FTT"):

- the worldwide operations of a financial institution headed in the FTT zone;
- a financial institution transacting with an entity that has a presence in the FTT zone (interestingly this does not have to be a financial institution);
- a financial institution that has regulatory authority to operate in the FTT zone; and
- a financial institution engaged in a transaction in respect of an instrument issued by an entity based in the FTT zone.

[18] Information taken directly from the Council Directive implementing enhanced cooperation in the area of a financial transaction tax.

Tax rates that have been proposed are 0.1% of the market value of financial transactions and 0.01% of the notional value for derivative transactions.

Taylor (2014) developed one estimate of revenues that could be obtained by the federal government imposing a European-style financial transaction tax.[19] With a tax on equity, bonds and financial derivatives, she estimated revenues of $360 billion without behavioural effects. With a shifting of activity to other jurisdictions, the revenues would sharply fall to about two-thirds of the total but actual behavioural effects are unknown. Certainly, a financial transaction tax on derivatives is exceptionally difficult to apply, as spreads between long and short sales are very small. Most countries in the world do not apply withholding or financial transaction taxes on derivatives, as it would significantly impact bond markets.

While the financial transaction tax has been proposed in the past to put "sand in the wheels" to reduce speculation, recent interest in Europe was sparked by the global financial crisis to help repay the cost of supporting the financial sector as well as to curb risk-taking behavior. We do not believe that there is a case for a financial transaction tax in Canada for several reasons.

- First, the financial transaction tax could cause large disruptions as a significant portion of the tax base would shift to those countries, such as the United States, that do not adopt a similar tax.

- Second, Canadian financial institutions did not require funding in the financial crisis unlike financial institutions in the United States and Europe. Even if they did, Canadian financial institutions have already been unfairly taxed, especially with special capital taxes.

- Third, a financial transaction tax would not appropriately deal with issues related to moral hazard. Regulations such as with respect to capital requirements have been the main approach used successfully at the international level to curb any excessive risk-taking behavior. Risk-adjusted deposit insurance rates would also be a better instrument to use to ensure a better relationship between risks and insurance.

One further issue related to capital requirements is the tax treatment of Tier 1 capital built up by financial institutions to provide a cushion against potential financial stress. New requirements to have preferred equity and hold government bonds that are easily liquidated impose another form of implicit tax on financial institutions given the costs associated with such financing and the low returns on government bonds. One possible alternative that merits consideration is to allow all related financing costs, including

[19] See Tasha K. Taylor, *Capstone Project: Assessment of a Financial Transaction Tax in the Canadian Context*, Master of Public Policy, School of Public Policy, University of Calgary, 2014.

preferred share dividends, to be deducted for tax purposes (with corresponding full taxation on the recipient side).[20]

7. International Taxation

7(a) OECD/G20 Initiative on Base Erosion and Profit Shifting

The OECD/G20 initiative on so-called "base erosion and profit shifting" (BEPS) has been ongoing since the Action Plan was released in 2013,[21] although there are many precursors. On 5 October 2015, the OECD released "final deliverables" with respect to the 15 Action Items described in the Action Plan. Many of these reports call for further work to be carried out in certain areas during 2016 and 2017, as well as into 2020.

Canada has participated in this process as part of the OECD, and has expressed general support for the initiative as part of the G7, the G20,[22] and in Budget 2014 and Budget 2015. As part of Budget 2014, the Government sought input from stakeholders in order to "help the Government to set its priorities and inform Canada's participation in international discussions".[23] As part of Budget 2015, the Government made the following statement:

> The Government will proceed in this area in a manner that balances tax integrity and fairness with the competitiveness of Canada's tax system. Improving business tax fairness and competeveness has been a central element of the Government's approach to fostering an environment in which businesses can thrive and compete in a global economy. Taxes are one of the main factors that drive investment decisions and the Government is committed to maintaining Canada's advantage as an attractive destination for business investment.[24]

However, the Government has not to date made any pronouncements concerning Canada's position with respect to specific recommendations set out in the 2015 reports, or how Canada will approach any further work to be carried out in the coming years.

---

[20] See, for example, the treatment of dividends on certain shares of credit unions under subsection 137(4.1) of the *Income Tax Act*. Such dividends are deemed to be interest for both the payer and the recipient. It is interesting also to note that Canadian tax policy remains somewhat muddled with respect to the treatment of preferred shares more generally – with the *Income Tax Act* featuring various regimes intended to counteract so-called "after-tax financing", including the rules that can block the inter-corporate dividends-received deduction for a "specified financial institution" such as subsection 112(2.1), as well as the special taxes that may be imposed under Part IV.1 and Part VI.1 of the *Income Tax Act* at rates that no longer reflect the normal CIT rate.

[21] See OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing (the "Action Plan").

[22] The most recent communique from the G20 Leaders' Summit in Turkey on 15 and 16 November 2016 is consistent with this. See https://g20.org/g20-leaders-commenced-the-antalya-summit/.

[23] Budget 2014, page 347.

[24] Budget 2014, page 472.

The most concerning developments to date in connection with this initiative are as follows:

- This initiative has been pursued without a reliable impact assessment of the effects that changes to rules and principles that are relevant to international taxation may have on the global economy and, in particular, on growth. Although the OECD acknowledges that "measuring the scale of BEPS proves challenging given the complexity of BEPS and the serious data limitations", their latest report on measurement issues posits that "global corporate income tax (CIT) revenue losses [can be] estimated [as at] between 4% and 10% of global CIT revenues, i.e. USD 100 to 240 billion annually".[25] It is not clear whether the OECD is suggesting that an objective of their recommendations should be an increase to the global corporate tax burden of between USD 100 to 240 billion annually, rather than simply "leveling the playing field" for businesses in a revenue-neutral manner.[26] There is also no reliable assessment of the potential relative impact to the Canadian economy, Canadian businesses, and to businesses operating in different sectors – in particular, the financial sector.

- Many items that are of particular concern to the financial sector remain outstanding, either with respect to their formulation or with respect to their implementation and application, including:

    - revisions to the Transfer Pricing Guidelines with respect to "profit splits and financial transactions", as well as the attribution of profits to permanent establishments,[27]

    - whether "hybrid mismatch rules" should be applied to mismatches that arise under intra-group hybrid regulatory capital,[28]

    - the application more generally and in the financial sector of rules to restrict the deductibility of interest and other costs of capital, and how such rules should interact with regulatory requirements and standards,[29]

---

[25] See OECD (2015), *Measuring and Monitoring BEPS, Action 11 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris (the "Measurement Report"), page 15.

[26] To be consistent with their proposition that "corporate taxes are the most harmful type of tax for economic growth" (see footnote 7), the OECD should be advocating that the BEPS reforms should be implemented in a revenue-neutral manner overall.

[27] See OECD (2015), *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris (the "Transfer Pricing Report"), page 12.

[28] See OECD (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing (the "Hybrids Report"), Paris, page 11.

- o treaty-based and domestic rules aimed at so-called "treaty shopping", and their application to various types of financial investors, special purpose vehicles, and investment funds,[30] and
  - o the application of revised treaty rules with respect to "agency permanent establishments" and "preparatory and auxiliary" activities in the context of the financial sector, as well as the attribution of profits to permanent establishments in this context.[31]

- The proposed revisions to the Transfer Pricing Guidelines, which have been released to date, would seem to include "special measures outside the arm's length principle", although the materials expressly deny that this is the intent.[32] Our concern is that these revisions would seem to distort the application of pricing methodologies with respect to the allocation of returns and value as between services and capital, and that they tend toward the recharacterization of contractual arrangements and the allocation of economic risks and benefits among related entities. Some of these recommendations may even be inconsistent with existing arm's length security interests to the potential detriment of the financial sector.[33]

- Certain of the OECD's recommendations would suggest a degree of indifference as to the location of taxation relative to the location of value creation – focusing instead on the occurrence of material taxation at least somewhere (i.e., the elimination of so-called "double non-taxation") rather than on whether taxation arises in the right location.[34] We are concerned that such an approach could

---

[29] See OECD (2015), *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris (the "Interest Expense Report").

[30] See OECD (2015), *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris (the "Treaty Benefits Report").

[31] See OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status*, Action 7 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris (the "PE Report").

[32] See the Transfer Pricing Report.

[33] For example, special purpose vehicles are sometimes used to hold and finance income-generating assets, in part to achieve or improve bankruptcy remoteness. They normally do not have any employees, or may have employees but those employees may not be responsible for high-level "control" functions, which are provided to such vehicles by other group entities. The revised Transfer Pricing Guidelines state that such entities should not be entitled to more than a "risk-free return" on their assets. Such an allocation of income is not in accordance with legal and economic reality and arm's length principles, and would be insufficient to cover financing costs borne by such entities, which would thus provoke their insolvency.

[34] One example of this approach is reflected in the report on so-called "hybrid mismatch arrangements", which recommends the introduction of "primary rules" that would permit source countries to deny deductions for otherwise legitimate and reasonable costs of capital (and other items) if the recipient of the relevant payments is not taxable thereon in its country of residence, and even if the recipient is taxable in its country of residence but makes deductible payments to another party in another country that is not taxable on those payments (a so-called "imported hybrid mismatch"). See the Hybrids Report. Another example is the recommendation to consider

perpetuate, if not exacerbate, tax-induced distortions arising as a result of the corporate tax (and withholding taxes) in the cross-border context.

- The OECD's recommendations for national rules to restrict the deductibility of interest and other costs of capital, based on a fixed ratio of EBITDA,[35] would represent sweeping changes to the current Canadian rules, particularly the recommendation to consider extending such rules to wholly "domestic groups".[36] The introduction of "domestic thin-capitalization" rules could have a significant impact on Canadian capital markets, pension funds and other investment funds.[37]

The Canadian Government should proceed with caution in this area, making only evidence-based policy choices, after thorough consultations with stakeholders and subject to appropriate transitional measures, with a view to balancing tax integrity and fairness with the competitiveness of Canada's tax system, including with reference to administrative and compliance costs.[38] The Canadian Government should also be concerned about the potential for these developments to inappropriately increase the Canadian and foreign tax burdens of Canadian financial institutions, to the detriment of Canadians. More specifically, Canada should be vigilant about carefully assessing the real commitment to implementing changes on the part of key trading partners. In addition, given that a number of elements of this initiative that are of particular concern to the financial sector remain outstanding, the focus of the Canadian government with respect to further work streams should be to continue to participate in the process with a view to putting forward alternatives that appropriately serve the interests of Canadians.

---

restricting the deductibility of interest payments and other financing costs if paid to a "related party, which is subject to no or low taxation on the corresponding interest income". See the Interest Expense Report, page 73. A similar example is the recommendation to deny treaty-based withholding tax reductions to such entities. See the Treaty Benefits Report, pages 96-98.

[35] This term refers to earnings before interest, taxes, depreciation and amortization.

[36] See the Interest Expense Report, in general and in particular page 34.

[37] The use of EBITDA for determining the application of an earnings-stripping rule can also be distortionary as it creates an incentive to invest in depreciable assets to create more room for interest deductibility (see Chen and Mintz 2008).

[38] Canada has been very proactive over the years with respect to implementing reforms to the Canadian international tax system in order to address base erosion concerns. As noted in Budget 2015 (page 349), "Since 2006, including measures introduced in Economic Action Plan 2015, the Government has introduced over 90 measures to close tax loopholes, clarify tax rules, reduce aggressive international tax avoidance and improve the integrity of the tax system." Many of the reforms discussed in the BEPS materials would be redundant from a Canadian perspective, and some would be inconsistent with the manner in which Canada has already chosen to address the relevant concerns.

7(b) Investment Management Services for Non-Residents (Section 115.2)

Section 115.2 of the *Income Tax Act* was introduced with effect after 1998 in order to provide a "safe harbor" for certain financial services carried out in Canada by financial institutions and advisers for non-resident clients. Essentially, the concern addressed by this provision is that these financial services could otherwise give rise to taxable *nexus* with Canada for the non-resident clients – in particular, that the non-resident clients might be considered to be carrying on business in Canada through the activities of the Canadian financial institutions and advisers, and thereby become taxable in Canada.

This provision recognizes the success that the Canadian financial services community has had in attracting to Canada the provision of financial services for a global clientele. This provision also accordingly and appropriately recognizes that these non-residents should not be considered to have a taxable *nexus* with Canada simply because they choose to retain Canadian financial institutions and advisers rather than foreign counterparts with respect to investments that are not otherwise taxable in Canada.

The spirit of this provision is clear but, as described below, its implementation is somewhat limited under section 115.2 and by other provisions of the *Income Tax Act*. Under section 115.2, the "designated investment services" must be provided to persons that are not "affiliated" with the "Canadian service provider" or in which affiliates of the Canadian service provider have no more than 25% of the interests. This requirement precludes the application of this rule in the context of intra-group services that may be provided by Canadian parent companies to their foreign affiliates or by Canadian affiliates to foreign parent or sister companies. This is an area where the implementation of the rule could be expanded within its existing spirit – in the sense that services provided to a foreign parent or sister company should be the same as services provided to any other non-resident, and services provided by a Canadian parent to a foreign affiliate should be the same as services provided to any other non-resident if funded by the foreign affiliate out of foreign liquidity. This is somewhat analogous to the reforms made in 2012 to certain of the "base erosion" rules in the FAPI system as discussed below – to allow the more efficient and neutral deployment of the "excess liquidity", of an "eligible bank affiliate" of an "eligible Canadian bank".[39] But rather than allowing the deployment of the foreign liquidity into Canada, an expansion of section 115.2 could contemplate the provision in Canada of financial services in respect of the deployment of such foreign liquidity – whether or not deployed in Canada. Provided that such services are priced and provided in accordance with arm's length terms and conditions, it is difficult to justify creating taxable *nexus* with Canada for affiliated non-residents any more than for unaffiliated non-residents.

[39] See the definitions in subsection 95(2.43) of the *Income Tax Act*.

The objective would be to provide for a more seamless market for the provision of such financial services in the cross-border context, and would promote job creation in this sector in Canada.

7(c) Base Erosion Rules and Services

This objective would also be served by a review of certain additional "base erosion" rules in the FAPI system. In particular, there continues to be concern in relation to the application of paragraph 95(2)(b) with respect to the cross-border provision of various financial services, either by a foreign affiliate to a Canadian financial institution or by the Canadian financial institution to the foreign affiliate. This provision can result in FAPI being realized by a foreign affiliate that provides certain services to a relevant Canadian resident, or to which a relevant Canadian resident provides certain services. For these purposes, "services" excludes those "performed in connection with the purchase or sale of goods".[40] However, financial services – including the purchase and sale of securities – would not qualify for this exception.[41]

The income from the provision of such services in Canada should be properly allocated to the Canadian service provider in accordance with the arm's length principle but the services should neither create taxable *nexus* with Canada for the foreign affiliate, parent or sister, nor create FAPI in a foreign affiliate. This would reduce tax-induced frictions against the provision of such services in Canada. As Canadian financial institutions increasingly occupy a global footprint or are part of larger global networks, there will be increasing "internal trade" in financial services among group members. Canadian financial service providers should be able to approach that *bona fide* economic challenge without the fiscal handicap of potentially exposing the foreign source income of their non-resident group members to Canadian taxation, and they should be able to procure services from their non-resident affiliates, and to co-venture or co-perform with their affiliates, without the risk of tainting the foreign income or activities of their affiliates.

7(d) Treasury Management Services

Along similar lines, the objective of reducing fiscal handicaps of Canadian financial service providers would be served by a review of the rules in the *Income Tax Act* which are relevant in the context of the provision of treasury management services for both Canadian-based and foreign-based multinationals. Under current rules, certain treasury

[40] See subsection 95(3).

[41] The purchase and sale of securities may be excluded from other "base erosion" rules, in paragraphs 95(2)(a.1) and (a.3) of the Income Tax Act, under the exceptions in subsection 95(2.31) and related provisions. There are also many other exceptions to the application of the "base erosion" rules in the context of the financial sector, including for currency transactions, but paragraph 95(2)(b) remains overly broad.

management arrangements can create concerns that adverse Canadian tax implications may arise where the accounts of the members of a multinational group are held in a Canadian financial institution. While certain existing rules are somewhat helpful in this regard, their scope is very narrow, particularly in the context of enterprises operating in the financial sector.[42] Again, it should be clear that the rules do not drag foreign active business income into the Canadian tax net simply because the relevant entities use Canadian financial service providers.

7(e) Collective Investment Vehicles

The increasing importance of collective investment vehicles and similar investment funds presents significant opportunities for Canadian financial service providers, but these opportunities are somewhat handicapped by Canadian tax considerations.

For example, current subsection 212(9) of the *Income Tax Act* provides for an exception from Canadian withholding taxes on trust distributions to non-resident beneficiaries where certain somewhat narrow conditions are satisfied. One of these exceptions applies to interest received by a trust, but only if it is a "mutual fund trust" and is "maintained primarily for the benefit of non-resident persons". If these conditions are failed, then Canadian tax can apply on the trust distributions even where no such tax would have been payable in respect of the underlying interest if it had been paid directly to the non-resident beneficiaries (investing individually) instead of to the trust (investing collectively). Arguably, the spirit of these rules is encapsulated in the proposition that Canadian tax should not be applicable to trust distributions where no Canadian tax would have been payable in respect of the underlying trust income in a collective investment vehicle context, but the implementation of this principle is much narrower.

In addition, broader consideration could be given to the Canadian taxation of investment vehicles that have non-resident beneficiaries. Under current rules, annual distributions are required in order to eliminate taxation at the level of an investment vehicle that is a trust. This may be inconsistent with the vehicle's distribution and reinvestment policies, may have adverse foreign tax consequences, and also reduces the net asset value of the vehicle and thus the pool of assets managed on its behalf by Canadian financial service providers.[43] Consideration should be given to dispensing with

[42] See, for example, the definitions of "indebtedness" and "specified deposit" in subsection 95(2.5) of the *Income Tax Act*. Income from a "specified deposit" is excluded from the "base erosion" rule in subsection 95(a.3) of the *Income Tax Act*, but this exclusion does not apply to deposits that arise in the course of an active business if the principal purpose of the business "is to derive income from property (including any interest, dividends, rents, royalties or similar returns, or any substitutes for any of those) or profits from the disposition of investment property".

[43] This concern is mitigated in part by the ability to make distributions in the form of additional interests in the fund, although that still creates inefficiencies in the form of administrative costs, and does not address foreign tax considerations.

this distribution requirement or permitting deemed distributions for Canadian tax purposes. Consideration should also be given to improving neutrality by permitting the flow-through of investment losses.

Finally, on the inbound side, questions remain with respect to the tax treatment applicable to foreign collective investment vehicles, pension funds, private equity funds and sovereign wealth funds holding Canadian investments. In particular, because Canada's withholding tax rates are relatively high (i.e., 25%) before the application of a tax treaty, and because Canada's tax treaties provide for inconsistent rates and standards, considerable complexity and administrative or compliance burden arises in establishing treaty-based entitlements in respect of such funds or at the level of their beneficiaries. It is simply prohibitively inefficient, if not impossible in some cases, for a collective investment vehicle to gather the required information on the residence and status of each of its beneficiaries in order to establish their respective treaty relief entitlements – given that its beneficiaries may number in the thousands and may include further collective investment vehicles to which it does not have direct access. This would be exacerbated by overly broad rules intended to target "treaty shopping", which would undermine Canada's attractiveness as a destination for investment. Canada would be better served by moving to uniform rules on the rates and exemptions applicable to non-resident investors from any jurisdiction, thereby obviating "treaty shopping" considerations and the associated complexities and costs, and thereby reducing tax-induced distortions on the flow of capital into Canada as a function of the origin of the capital. Such an approach on the part of Canada would also be more conducive to enabling Canada to negotiate similar treatment for Canadian investors holding foreign assets, which would benefit Canadians by reducing foreign tax burdens and transaction costs, as well as tax-induced distortions that may influence their investment decisions. It should be noted that this is exactly the approach that Canada has taken with respect to arm's length payments of ordinary interest – which are no longer subject to Canadian withholding taxes. As a result, tax-induced distortions on the flow of capital into Canada have been reduced, costs of capital and administrative and compliance costs have been reduced, and "treaty shopping" has become irrelevant in this regard.[44]

[44] It should be emphasized that non-arm's length interest payments remain subject to Canadian withholding taxes, although these taxes have been eliminated under the *Canada-United States Income Tax Convention*. While this is a positive development, there is no obvious reason why the same approach should not be taken with reference to other major trading partners. In addition, it should be noted that non-arm's length interest payments often in fact reflect arm's length interest payments that have been "pushed down" by parent companies to their subsidiaries (be they Canadian subsidiaries of foreign parent companies or foreign subsidiaries of Canadian parent companies). To that extent, the imposition of withholding taxes on non-arm's length interest payments in substance results in the imposition of withholding taxes on arm's length interest payments, thereby increasing the cost of capital as a result of inordinate taxation or the loss of economic efficiencies that could be achieved through the centralization of market borrowings at the parent company level as multinational groups seek to eliminate these frictions by arranging for more inefficient market borrowings at the subsidiary level. At a minimum, this suggests that non-arm's length interest payments should not be subject to withholding taxes to the extent that a subsidiary bears its proportionate share of a multinational group's net third-party interest expense. This observation is not reflected in the materials that have been released to date as part of the BEPS initiative.

8. Other Tax Measures

8(a) Scientific Research & Experimental Development (SR&ED)

Federal and provincial governments continue to support innovation in a variety of ways including grant and tax support. The most significant incentive is the Scientific Research and Experimental Development (SR&ED) program.

The federal SR&ED program is a tax incentive program designed to encourage economic development and job creation in Canada. The SR&ED program is the largest source of federal funding for industrial research and development (R&D) in Canada. Although the rules of the program have changed a number of times since its inception in 1985, the current income tax benefits of the program include:

- a 35% refundable tax credit for qualifying Canadian-controlled private corporations;
- a 15% non-refundable tax credit for other corporations; and
- tax credits for proprietorships, partnerships, and trusts (refundable, non-refundable or both).

Many provinces have research credit programs that "piggy-back" onto the federal credit providing claimants with additional credits for work performed in the respective provinces.

The legislation governing the program, including the definition of SR&ED, is contained in the federal *Income Tax Act* and *Income Tax Regulations* and is the responsibility of Finance Canada. The Canada Revenue Agency ("CRA") is responsible for the administration of the program. The CRA's objective with respect to this program is to deliver SR&ED incentives in a timely, consistent and predictable manner, while encouraging companies to assess their own claims in compliance with tax laws, policies and procedures. The CRA has also stated that it is committed to:

- making business aware of the program and providing easy access to it (ensuring that entitlements are received, investment benefits of SR&ED incentives are maximized and the costs of compliance and administration are minimized); and
- administering the program with fiscal integrity (i.e. helping claimants correctly self-assess their SR&ED claims, and objectively reviewing these claims so that entitlements are received in a timely manner).

SR&ED and the Financial Services Industry

Financial services companies have been claiming SR&ED tax credits for decades. As banking, financial management and other financial services have moved into the electronic age, integrating technology into the business through the development of innovative software has become a constant and integral part of the industry. It is primarily the work to develop this type of software that meets the requirements of the SR&ED definition that makes up the SR&ED claims in the industry. It must be recognized that financial institutions are very large IT solution developers with applications defined for one of the most complex environments (security, regulation, etc.).

Claiming SR&ED credits has not always been straightforward for this industry. In fact, the CRA imposed a moratorium on the processing of SR&ED claims of financial institutions in the early 90s to allow the CRA the opportunity to fairly and consistently evaluate and process financial institution claims. Once the moratorium was lifted, claims from financial institutions were being processed in a manner that most in the industry viewed as both fair and fiscally responsible.

Legislative changes announced in 2012 significantly reduced the SR&ED credits earned by all companies including financial institutions, by:

- reducing the credit from 20% to 15% for all companies except qualifying Canadian Controlled Private Corporations,
- dropping the proxy amount (the notional calculation used to determine an estimate of overhead costs) from 65% of salaries and wages to 55%,
- decreasing the amount of subcontractors that can be included in the credit calculations from 100% to 80% of eligible expenditures, and
- eliminating from the program the ability to earn credits and receive immediate deductions of eligible capital items .

The significant reductions in the SR&ED credits have negatively impacted the industry's ability to improve productivity (capital items impact this directly) and therefore its efficiency and competitiveness.

In addition to the above legislative changes, the CRA's review of financial services claims has become increasingly burdensome for the industry. Audit approaches can vary depending on the geographic region within Canada and the particular auditor and, generally, audits have become significantly longer and protracted. The types of work that historically may have been allowed by the CRA are now being denied even though the definition of SR&ED has not changed. One such example relates to what CRA terms "due diligence" (note that "due diligence" is not mentioned in the legislation nor is it defined in the CRA's SR&ED glossary). This work, often analogous to a literature review in a scientific research project, used to be viewed as part of the SR&ED project and the associated costs earned tax credits. This type of work is now often denied with the CRA auditors stating the SR&ED project only begins once that due diligence phase is over and experimentation begins. The denial of "due diligence" work is becoming more and more widespread despite the fact that the CRA's policy on the eligibility of work states that "It is recognized that once a scientific or technological uncertainty is identified, work may be required before the hypothesis is tested (that is, before experimentation begins)." Financial institutions are also very concerned with comments being made in other industries which could potentially be applied to them as well be. Specifically, financial institutions are concerned about comments made by reviewers relating to the intention of the work claimed as SR&ED. If it has a commercial objective (a sales order, a defined client application, etc.) then the comment sometimes made is that the intention is commercial and the SR&ED is not allowed. We see no inconsistency at all between the existence of SR&ED and an ultimate commercial application of the innovation.

Documentation requirements have also become more stringent, and again, the level of documentation expected varies by region and by auditor. Historically, CRA reviewers judged the eligibility of the project by taking into account the facts obtained during interviews with company personnel along with those obtained from project documentation provided to them (and court cases support this approach). More recently, the CRA has been putting less and less emphasis on the verbal testimony and relying (almost exclusively) on project documentation. At times, the documentation requirements seem to be at an academic research standard and not at an industrial R&D standard – this despite the CRA having stated on numerous occasions that the necessary SR&ED documentation should be that which is created in the normal course of business.

As a result of the legislative changes, as well as the CRA's narrowing view of eligibility and the increased emphasis on documentation to substantiate work performed, the size of many companies' SR&ED claims, including those of financial institutions, has declined significantly. Some companies have stopped claiming altogether because the administrative burden is just too high and the outcome too unpredictable.

Looking Ahead

Recent comments from the CRA seem to indicate that they may be moving back to a more incentive-based approach to the administration of the program which is positive news and should help improve the environment for the financial services industry. However, it may take some time for new directions to be seen in the field.

The Appropriate Level of Research Support

Investment in intangible R&D capital differs from investment in tangible, physical capital in several important ways. A key difference is that R&D activities are thought to be characterized by significant market failures.

Perhaps the most widely discussed market failure is the presence of externalities such as knowledge spillovers, which are thought to emanate from R&D activity. Knowledge spillovers exist if the R&D activity of one firm creates knowledge that is beneficial to other firms. As the firm accounts only for the private benefit of its R&D, and not for the non-appropriable spillover benefits that accrue to others, this suggests that the social rate of return on an R&D investment is greater than the private return to the firms that undertake it. As such, there is a tendency for private firms to under-invest in R&D and knowledge creation relative to the social optimum. This is the typical justification given for government sponsored R&D and for the provision of subsidies to encourage private sector R&D.

However, there is another type of market failure associated with R&D which works in the other direction. It is called the "business stealing effect", and refers to the fact that firms seeking to discover and introduce an innovative product or process do not account for the negative impacts associated with the "destruction" of existing firms. The business stealing effect suggests that potential innovators may over-value their innovations and over-invest in R&D.

There are other potential market failures associated with innovation and R&D, but knowledge spillovers and the business stealing effect are the most widely discussed and thought to be the most important. The problem, of course, is that they tend to work in opposite directions. A key issue from a policy perspective – in particular whether governments should tax or subsidize R&D – is which effect dominates.

The bulk of the empirical evidence suggests that the knowledge spillover effect dominates, and that the social rate of return to R&D is significantly higher than the private rate of return. For example, a recent paper by Bloom, Schankerman and Van Reenan (2013) explicitly account for both types of market failures and shows that the knowledge spillover effect strongly dominates. They conclude that, on a net basis, the social rate of return to R&D is almost twice as high as the private rate of return. This order of magnitude is consistent with other studies. For example, using international data Griffith (2000) estimates social rates of return to R&D of about 100% compared to private returns of 25%. In a Canadian context Bernstein (1988, 1989, 1996) estimates that the social rate of return to R&D exceeds the private rate of return by a factor of two or more in most industries.

It bears mentioning that there are studies that have questioned the evidence of large R&D spillovers. For example, a paper by Comin (2004) argues that econometric R&D spillover studies potentially suffer from problems such as omitted variable bias: that is, there are additional explanations for spillovers that are not covered by the studies, making the effect of R&D appear stronger than it really is. There are also a number of difficult measurement problems in assessing the private and social returns to R&D. These are summarised in Hall (1996), and include: the low variability of R&D spending in individual firms and the difficulties that this creates for identifying the intertemporal aspects of knowledge production; and the importance of R&D depreciation estimates for measuring rates of return.

This suggests the need for some caution in interpreting the existing research. However, on balance the majority of the literature seems to point in the direction of significant positive spillovers from R&D. After surveying the measurement difficulties, Hall (1996) states in her conclusion that there is "overwhelming evidence that some positive externalities exist for some types of R&D".

All of this suggests the need for government subsidies to R&D. However, the research is somewhat lacking in specific guidance in this regard, in particular concerning the precise form and size of the subsidies. There are reasons to believe that the size of spillovers is likely to vary depending on a number of factors such as the type of R&D, the industry, the existence of other protections for intellectual property, and country-specific factors like size and distance from other R&D hubs (in particular the U.S.). For example, in their study Bloom, Schankerman and Van Reenan find that knowledge spillovers emanating from small firms are significantly less than large firms, suggesting the need for lower subsidies for small firms.

Two papers from the School of Public Policy shed some light on these issues in a Canadian context (although it should be noted that they were done prior to the recent legislative reductions to the credit). McKenzie (2012) shows that effective R&D subsidy rates in Canada, taking account of both federal and provincial tax credits for R&D, are very high: ranging from about 60% for large firms who get the regular R&D credit to in excess of 90% for smaller firms eligible for the enhanced credit. Lester (2012) reports results from a preliminary cost-benefit analysis of the Canadian system, which takes account of the need to finance subsidies with other distortionary taxes, compliance and administration costs associated with the subsidies, etc. He concludes that, on balance, the regular credit may generate an effective subsidy rate that is relatively close to the optimal rate, while the enhanced credit for small firms may be too high.

Innovation in the Financial Services Sector

One can imagine two basic types of innovation in the financial sector: innovation leading to new financial products and services, and innovation enhancing the value of existing products. An example of the former would include the development of new financial instruments, while an example of the latter would include enhancements to internet banking, new payment platforms using smart phones, email, etc., educational products designed to promote financial literacy and planning tools for consumers, investors and financial service providers, as well as increasingly important information management systems designed to track, secure and report financial institution client and account information in order to meet requirements imposed by tax and non-tax authorities.

These innovations are not just critical for firms in the financial services industry, but also affect other companies: for instance, enabling them to lower transaction costs and to raise capital in larger amounts and at a lower cost than they could otherwise.

There are some reasons to explain why innovation in the financial services industry may be underprovided in relation to the development of new financial products and services. For example, it would appear that the ability of financial innovators to appropriate their discoveries would be lower than in the manufacturing sector because of the limited ability to protect new ideas through patents, particularly for new financial products. As a result, new product ideas would be expected to diffuse rapidly across competitors, lowering the incentive to develop these innovative products. However, from an industry-wide perspective, and thus from the perspective of governments, supporting such innovation would seem to be justifiable in light of these positive externalities.

On the other hand, some may argue that new financial products could also lead to negative macro-prudential externalities and spillovers, in the absence of thorough research and analysis as well as adequate regulatory oversight. Unfortunately, there has been very little research that explicitly studies these trade-offs in the financial sector, which is thus another area in which support for research in the financial sector would seem to serve broader policy objectives of promoting financial stability. The 2008 financial crisis has provoked significant change with regard to prudential regulation, but not very much support for research and innovation with respect to evaluating and minimizing inherent risks associated with financial products.

It is submitted that both types of innovation in the financial services sector should be supported. Such support can be multifaceted. It can be administrative and substantive. From an administrative perspective, support can take the form of improvements to the administration of the SR&ED regime in order to reduce costs and improve the efficiency of the application and review process. From a substantive perspective, support can take the form of expanding the scope of available tax credit programs and possibly even the introduction of new federal and provincial programs that specifically target and leverage Canada's undeniable status as a centre of excellence for financial services. This is an area in which consultations with stakeholders could further clarify the issues and alternatives.

8(b) Capital Gains Taxation, "replacement property" rules for financial assets, and UK Enterprise Investment Scheme

There is a spectrum of views with respect to the taxation of capital gains, from those suggesting that capital gains should be treated in the same manner as ordinary income (i.e., "a buck is a buck") to those suggesting that they should be exempt from taxation because the taxation of capital gains represents, in effect, a form of double taxation, given that asset values reflect, at least in part, the present value of expected future income which will be subjected to income taxation as and when it is earned. At present, capital gains are subject to a 50% inclusion regime.

Some capital gains are exempt from taxation. There is an unlimited exemption on gains from a "principal residence", and limited exemptions on gains from "qualified small business corporation shares" and "qualified farming and fishing property", subject to a lifetime limit of just over $800,000).[45]

Capital gains taxation was introduced in Canada in 1972. Since that time, the inclusion rate has varied from a low of 50% to a high of 75%, and was set at 66 2/3% for a period. Where capital gains rates are lower than rates applicable to dividends, an incentive is created to realize undistributed corporate value in the form of capital gains rather than dividends (i.e., so-called "surplus stripping").

Currently, capital gains rates are comparable to rates applicable to dividends, although capital gains rates tend to be a bit lower for individuals than the rates applicable to dividends. The average federal-provincial capital gains tax rate is 24.5%, less than the top rate on eligible and non-eligible dividends. In practice, the treatment of capital gains has followed the approach taken in Canada to avoid double taxation of profits and equity income received by shareholders. Similar to dividends, capital gains, to the extent they arise from after-tax retained earnings reinvested in the firm, are effectively integrated when such earnings are taxed at the corporate level and corresponding gains are taxed at lower rates at the individual shareholder level. Without some reduction in capital gains rates at the individual shareholder level, such earnings could bear a higher effective combined corporate and personal tax rate than other sources of income. Thus, similar to the justification for the dividend tax credit, the partial exclusion of capital gains has often been set so that dividends and capital gains are taxed at similar rates for the highest income earner.

However, while similar dividend and capital gains tax rates reduces the distortion between dividend payouts and gain realizations, capital gains are generally favourably treated compared to dividends since investors are able to defer the payment of capital gains taxes until investments are sold. By delaying realizations, the effective tax rate on accruals is therefore reduced.

Two important cases diverge in this regard. First, capital gains are fully taxed (and losses fully written off) for investors holding on income account rather than capital account – such as many financial institutions. Further, capital gains are effectively taxed on an accrual basis when "mark-to-market" rules are used as in the case of financial institutions. This can reduce the competitiveness of financial institutions in capital markets but the "mark-to-market" rules provide a consistent approach with respect to taxation of income and capital gains (losses) from ordinary assets and financial derivatives. Second, while dividends paid between corporations are generally exempt from corporate tax, corporate capital gains arising from share investments are taxed at

[45] Economic Action Plan 2015 proposed to increase the Lifetime Capital Gains Exemption for "qualified farm or fishing property" to $1 million. The broader Lifetime Capital Gains Exemption, which was limited to $100,000, was eliminated in 1994.

half the corporate rate (or at full corporate rates if held on income account). This divergence between dividend income and capital gains at the corporate level encourages companies to pay out dividends to other companies.

Replacement Property Rules

For capital gains that are taxable in principle, deferral may be available in certain circumstances. Deferral is generally available for "paper transactions", whereby financial interests in corporations and certain other assets are exchanged for shares or other such equity interests, except to the extent that (or, in some cases, unless) the taxpayer also receives what may be referred to as "non-equity consideration". These rules are applicable mainly in the context of the recapitalization, combination or divisive reorganization of business entities. Deferral is also available for the "replacement" of business assets in certain circumstances – even though the "exchange" is indirect in the sense that the replaced asset may be sold for cash, which is then used to acquire the replacement property within a specified period of time.[46]

In 1999, the replacement property rules were amended to specifically exclude "a share of the capital stock of a corporation". Moreover, in general, the replacement property rules only apply where the replacement property is used by the taxpayer for a use that is the same as or similar to the use to which the taxpayer put the former property. Thus, they do not apply where financial interests such as shares are sold and the proceeds are reinvested in business property, or *vice versa*.

The question we raise is whether or not these restrictions reflect optimal tax policy choices for Canada at the present time. We raise this question in light of two somewhat different but concurrently important considerations – namely, the impact on economic efficiency and capital allocation across the economy, as well as the impact on long-term savings and investment decisions that may affect retirement planning and preparedness for a broad segment of the Canadian population.

In principle, taxation should be designed so as to minimize its distortive effects on investment decisions. Where a taxpayer would incur a tax burden in relation to exchanging one investment for another, the tax system creates a barrier that impedes the efficient allocation of capital across the economy, since investment decisions will be affected by tax considerations. Such inefficiencies tend to promote the retention of under-performing investments, and to deter the allocation of capital to more productive uses (the so-called "lock-in" effect). They also tend to undermine the liquidity of capital markets, because they tend to suppress transactions that would otherwise occur.

[46] This applies both for the purposes of taxing capital gains and for the purposes of deferring "recapture" of allowances taken on "depreciable property", as well as allowances taken on "eligible capital property". Deferral is also available in certain circumstances for assets transferred between spouses or to children, or for assets gifted to charities and such.

On the other hand, a tax system that avoids taxing earnings that are put to savings and investment more heavily than consumption can have salutary effects not only on capital formation, productivity and economic growth but also on the achievement of long-term social policy objectives of facilitating retirement planning and preparedness for a broad segment of the Canadian population. This includes not only those earning capital gains – which is already a fairly broad segment of Canadian society[47] – but also those who depend on the assistance of others, since increasing the means of those who contribute to our social safety net puts them in a better position to assist those with needs.

Capital Gains Deferral Regime

More specifically, we submit that serious consideration should be given to the introduction of a broader, formal capital gains deferral regime (a "CGDR"), that would permit the deferral of taxation of capital gains that are reinvested in qualifying investments.[48] Capital gains that are not reinvested would be taxable, thereby promoting savings and investment (rather than consumption), while taxpayers would not encounter fiscal barriers to reallocating capital to its most productive uses, thereby together promoting capital formation, productivity and economic growth.

A number of questions would have to be examined more closely in the context considering the policy implications and design features of such a CGDR – including the following:

- Whether the regime should be unlimited *versus* being limited to a maximum lifetime amount of total deferral, or otherwise limited.[49]

---

[47] In 2006, Mintz and Wilson observed that "Almost three-quarters of returns reporting capital gain income are from taxpayers with less than $70,000 in taxable income. They report modest amounts of capital gains that are less than $5000 per return." This was based on figures from 2003-2004. See Jack M. Mintz and Thomas A. Wilson, *Removing the Shackles – Deferring Capital Gains Taxes on Asset Rollovers*, C.D. Howe Institute, Backgrounder No. 94, April 2006.

[48] To some extent, an informal deferral regime applies to investments made through so-called "switch funds", that allow investors to switch from one class of shares of a mutual fund corporation to another class of the same corporation, where each of the two classes tracks a different pool of underlying investments. We would submit that it should not be necessary for shares of the *same corporation* to be acquired in order for deferral to apply. The "switch fund" approach requires the investor, effectively, to retain the same investment manager, which creates barriers to switching between investment managers and thus does not tend to promote efficiencies in the investment management sector. It could also be noted that a taxpayer could borrow against appreciated assets in order to invest in alternative assets without disposing of the appreciated assets, but this would give rise to a different economic paradigm in that the taxpayer would be introducing leverage into its investments, and thus a different risk profile. As a result of the introduction of the "synthetic disposition arrangement" rules in 2013, taxpayers cannot defer the realization of gains through arrangements structured as borrowings but that have the effect of "eliminating all or substantially all the taxpayer's risk of loss and opportunity for gain or profit in respect of the property for a definite or indefinite period of time".

[49] A related or perhaps alternative question is whether there should or should not be any income-testing as a condition to accessing the regime, in order to concentrate access to the regime in favour of particular income classes. Other ways to limit access to the regime would be to impose annual limits.

This question affects the effectiveness of the regime with respect to economic efficiency issues and the promotion of savings and investment (which would be maximized if unlimited), but also the impact of the regime on the progressivity of the tax system (since limiting access to the regime would tend to be more progressive), as well as revenue implication issues (since a limitation would tend to reduce revenue implications in the short-term).[50]

- How to define "qualifying investments" for this purpose:

    - Whether or not the regime should cover investments in publicly-traded financial instruments.

      This question, too, affects the effectiveness of the regime with respect to economic efficiency issues and the promotion of savings and investment (which would be maximized if the regime were applicable to a broader range of investments).[51]

    - If so, whether this should be limited to "Canadian securities" (defined, for example, in accordance with subsection 39(6) of the *Income Tax Act*).[52]

      If limited to "Canadian securities", the regime would be inconsistent with capital export neutrality, and would reduce the effectiveness of the regime with respect to economic efficiency issues.[53]

    - Whether or not an even narrower approach should be taken in this regard – for example, by defining "qualifying investments" for this purpose such that they would include only investments in "qualified small business corporation shares", or other types of investments such as "Labour-Sponsored Venture Capital Corporations".

      Such an approach would concentrate access to the regime in favour of investments in small business corporations, thereby promoting capital

[50] Since revenue implications should reverse in the long-term, it may be that the current low-rate environment would support a higher limitation or no limitation at all.

[51] Limitations on the type of "qualifying investments" may also have incidental implications on progressivity and revenue impact, but these would not be structural.

[52] This provision defines the securities in respect of which certain investors may elect capital gains treatment under subsection 39(4), and provides that a "Canadian security" means "a security (other than a prescribed security) that is a share of the capital stock of a corporation resident in Canada, a unit of a mutual fund trust or a bond, debenture, bill, note, mortgage, hypothecary claim or similar obligation issued by a person resident in Canada".

[53] This could also have implications on the promotion of savings and investment, to the extent that one assumes investors would tend to prefer a balanced portfolio before tax considerations. To the extent that this preference prevails over tax considerations, then the promotion of savings and investment would tend to be diminished. To the extent that tax considerations would tend to skew investments toward "Canadian securities", then the effectiveness of the regime would tend to be reduced with respect to economic efficiency issues.

investment in, and the growth of, such corporations. Such an approach would not contribute directly to the promotion of broader economic efficiency objectives, nor to the liquidity of capital markets. On the other hand, such an approach would seem to contribute to the progressivity of the tax system, by supporting that segment of the Canadian entrepreneurial sector.

- o If limited to investments in qualified small business corporation shares, whether or not access to this regime should be restricted to arm's length investors *versus* being available to all investors including controlling shareholders.

  Limiting access to the regime in favour of arm's length investors would diminish the degree to which it would have the effect of promoting capital investment in, and the growth of, small business corporations. On the other hand, this approach would also diminish the possibility of granting tax benefit windfalls to non-arm's length shareholders who would make the investments even in the absence of the regime, and would thereby likewise diminish the short-term revenue impact of the regime.

- Whether the regime should be limited to "same type" investments.

  As noted above, the current "replacement property" rules are limited in this manner. Thus, the question, here, is whether or not such a limitation reflects optimal tax policy choices. Alternatives include permitting deferral where, for example, business property is replaced with investments in financial interests, and where publicly-traded investments are replaced with untraded investments, and *vice versa*.

  Economic efficiency, and the promotion of savings and investment, should be maximized where no such limitations are imposed. On the other hand, the absence of such limitations would tend to increase the short-term revenue impact. However, imposing a "same type" limitation would seem to undermine the effectiveness of using this regime to promote investments in small business corporations, unless the limitation were looser and, for example, treated publicly-traded shares as the "same type" of investments as shares in small business corporations.[54]

- An alternative approach could involve introducing a "pool system", whereby a taxpayer's cost base in qualifying investments would be pooled along the lines of the pooling applicable in the context of depreciable property for "capital

[54] If the regime were applicable to the replacement of unlisted shares with publicly-traded shares, there would be an incentive to engage in "surplus stripping", but the inverse should not be the case to a material extent.

cost allowance" and "recapture" purposes. There are at least two more specific design features that could be considered in this regard, both dealing with the timing and extent of ultimate recognition.

- Under one approach, capital gains would be recognized only to the extent that the taxpayer depletes the cost base of all qualifying investments without replacing them with other qualifying investments. This is the approach taken in the context of depreciable property. Such an approach could be structured by using a "single class" for all qualifying investments, or "multiple classes" for different categories of qualifying investments.

- Another approach could involve triggering the recognition of capital gains in proportion to the value extracted from the pool from time to time. For example, where 10% of the value of the pool is extracted, 10% of the deferred capital gains would be recognized. This is the approach reflected in the work done in 2006 by Mintz and Wilson.[55]

The "pool system" approach would give rise to similar questions as those which are described above with regard to policy implications and other design features.

UK Enterprise Investment Scheme

The United Kingdom also taxes capital gains. Against that background, however, the UK has introduced an Enterprise Investment Scheme ("EIS") in order to "help smaller higher-risk trading companies to raise finance by offering a range of tax reliefs to investors who purchase new shares in those companies".[56] These reliefs include but are not limited to the taxation of capital gains. In particular, the following reliefs are available under this program:

- Income tax relief is available to individuals who subscribe for shares in an EIS, in an amount equal to 30% of the cost of the shares up to a maximum cost of £1 million (so maximum relief of £300,000), which can be set against the individual's income tax liability for the tax year in which the investment was made (or the previous year).[57] This relief is conditional on the shares being held for a period of 3 years from the date they were issued (or 3 years from

[55] See above at footnote 47.

[56] See HMRC's Guidance publication dated 7 October 2013, available at https://www.gov.uk/government/publications/the-enterprise-investment-scheme-introduction/enterprise-investment-scheme. See also VCM10530 - Introduction to EIS income tax relief: form and amount of EIS relief, available at http://www.hmrc.gov.uk/manuals/vcmmanual/vcm10530.htm.

[57] The carry-back mechanism effectively doubles the maximum amount of investment that can be made in a particular tax year.

the date the company's trade actually started, if later), and can only be claimed by individuals who are not "connected" with the company.[58]

- If the conditions for income tax relief are satisfied and the relief is claimed, a complete exemption from capital gains taxation is available for any gains from the disposition of the relevant shares after the minimum holding period.[59]

- If the shares are disposed of at a loss, the investor can elect that the amount of the loss, less any income tax relief previously given, can be set against income of the year in which they were disposed of, or any income of the previous year, instead of being set off against any capital gains.[60]

- Capital gains tax deferral relief is also available to individuals (and trustees of certain trusts) in respect of a capital gain that is invested in shares of an EIS qualifying company. The following should be noted in this regard:

    - The gain can arise from the disposal of any kind of asset.

    - The investment must be made within the period 1 year before or 3 years after the gain arose.

    - There are no minimum or maximum amounts for deferral.

    - It does not matter whether the investor is connected with the company or not.

    - There is no minimum period for which the shares must be held, the deferred capital gain is brought back into charge whenever the shares are disposed of, or are deemed to have been disposed of under the EIS legislation.[61]

- The program also contemplates the establishment and investments made through "EIS Funds".

---

[58] Holding more than 30% of the share capital or voting rights of the company, among other factors (including employment relationships, subject to exceptions for so-called "business angels"), causes such connectedness.

[59] There is also the capital gains tax rate reduction available under the Enterpreneurs' Relief program, which provides for a 10% rate (instead of the normal rate of 18% or 28%) for gains from the sale of shares in a so-called "personal company". See the guidance available at https://www.gov.uk/entrepreneurs-relief.

[60] This is not unlike the treatment of an "allowable business investment loss" under the Canadian *Income Tax Act*.

[61] This is separate from the limited exemption from capital gains tax, on a gain of up to £100,000, which is used to buy new shares in small early-stage companies approved under the Seed Enterprise Investment Scheme (SEIS). See the HMRC Guidance dated 4 July 2014, available at https://www.gov.uk/government/publications/seed-enterprise-investment-scheme-income-tax-and-capital-gains-tax-reliefs-hs393-self-assessment-helpsheet.

- The program only applies to companies that are not listed on the London Stock Exchange or any other recognised stock exchange (which does not include Alternative Investment Market and the PLUS Markets (with the exception of PLUS-listed)). In addition, the company must meet conditions as to its size and similar conditions:

    - The company cannot have its gross assets – or of the whole group if it is the parent of a group – exceeding £15 million immediately before any share issue (and £16 million immediately after that issue).

    - The company must have fewer than 250 full-time employees (or their equivalents) at the time the shares are issued. Under the Summer Budget 2015, this number will be increased to 500 for "knowledge intensive" companies.

    - The company must carry on a "qualifying trade", generally through a UK permanent establishment.[62]

- In general, there is a limit with respect to how much money can be raised by a company under this and other so-called "venture capital schemes". Companies are not allowed to raise more than £5 million in total in any 12 month period from the venture capital schemes.[63] Under the Summer Budget 2015, a lifetime limit will be introduced, which will be £12 million in general and £20 million for "knowledge intensive" companies.[64]

In all, this is clearly a very attractive regime designed to promote investment in entrepreneurship and job creation, particularly in "knowledge intensive" sectors. Based on current estimates, it appears the program has been quite successful in attracting capital – with reports that £1.53bn of funding was raised during the 2013-14 tax year, and an even larger number during the 2014-2015 year, with high concentrations in "knowledge intensive" sectors.[65]

---

[62] See section 2.4 of the Guidance, as well as VCM13000 - EIS: income tax relief: the issuing company, available at http://www.hmrc.gov.uk/manuals/vcmmanual/VCM13000.htm. In general, a qualifying trade excludes financial services, trades dealing in financial instruments, trades dealing with property, and certain other excluded trades.

[63] These are the EIS, the SEIS, and the Venture Capital Trusts.

[64] Certain other restrictions will also be introduced under the Summer Budget 2015.

[65] See http://www.radiusequity.com/technology-companies-planning-to-raise-funds-through-enterprise-investment-scheme-jumps-27-per-cent/. See also http://www.radiusequity.com/record-number-of-start-ups-apply-to-raise-funds-through-seed-enterprise-investment-scheme/. According to these estimates, the number of tech companies planning to raise funds through the Enterprise Investment Scheme (EIS) has jumped by 27% in the last year, up from 510 in 2012-13 to 650 in 2013-14, EIS is playing an increasingly vital role in supporting the UK's booming tech sector, and 15% of all UK companies created within the last year were tech companies.

This lends further support to the proposition that Canada should give serious consideration to capital gains tax reform with a view to promoting growth and job creation across the entire economy and, in particular, in the small business corporation and "knowledge intensive" segments.

9. Conclusions and Recommendations

Although the financial services community is making a tremendous contribution to the Canadian economy and job creation as a global leader in this sector, it continues to labour under unfavourable fiscal conditions both in general and relative to other sectors.

Serious consideration should be given to the introduction of reforms that would level the playing field in Canada for the financial sector in terms of marginal effective tax rates, including the elimination of capital taxes applicable only to financial firms.

A serious effort should be made to resolve the various issues that arise in connection with the application of the GST/HST in the financial sector. This is an important objective in itself but also important because economic efficiency, innovation, savings, investment, productivity and job creation would be improved by a shift in the tax mix toward a greater reliance on the GST/HST and a lower reliance on income taxes, but such a shift would further exacerbate concerns in the financial sector unless these issues are resolved.

With respect to the OECD BEPS proposals, we strongly recommend that Canada should proceed with caution in this area, making only evidence-based policy choices, after thorough consultations with stakeholders and subject to appropriate transitional measures, with a view to balancing tax integrity and fairness with the competitiveness of Canada's tax system, including with reference to administrative and compliance costs. Canada should actively monitor the implementation and participate in the further development of these initiatives with a view to maximizing the competitive position of Canadian business in general and the Canadian financial sector in particular, in order to maximize the employment opportunities and well-being of all Canadians.

We also recommend that serious consideration be given to further reforming Canada's international tax rules applicable to non-residents and Canada's so-called FAPI rules more generally to facilitate, or at least not interfere with, growth and job creation in the Canadian financial services sector.

Finally, we recommend that serious consideration be given to more actively supporting innovation and small business investment through administrative and substantive reforms to existing programs such as the SR&ED program, as well as the potential introduction of new programs in this area. Serious consideration should also be given to the introduction of reforms to the capital gains regime with a view to enhancing economic efficiency in general and with a view to supporting growth and job creation in the small business and "knowledge intensive" sectors in particular.

References

Bernstein, Jeff (1988), “Costs of Production, Intra-and Interindustry R&D Spillovers: Canadian Evidence.” Canadian Journal of Economics 21(May): 324-347.

Bernstein, Jeff (1989), “The Structure of Canadian Inter-Industry R&D Spillovers, and the Rates of Return to R&D.” Journal of Industrial Economics 37(March): 315-328.

Bernstein, Jeff (1996), “International R&D Spillovers between Industries in Canada and the United States, Social Rates of Return and Productivity Growth.” Canadian Journal of Economics 29(April): S463-S467.

Bloom, Nicholas, Mark Shankerman, John Van Reenan (2013), “Identifying Technology Spillovers and Product Market Rivalry”, Econometrica.

Chen, Duanjie and Jack Mintz (2008), “The Taxation of Inbound and Outbound Investments,” Advisory Panel on Canada’s System of International Taxation, Finance Canada, Ottawa, 2008.

Chen, Duanjie and Jack Mintz (2014), “The 2014 Global Tax Competitiveness Report: A Proposed Business Tax Reform Agenda”, The University of Calgary, SPP Research Papers, Vol. 8, Issue 4, February 2015.

Comin, D. (2004), “R&D: A Small Contribution to Productivity Growth”, NBER Working Paper No. 10625.

Dahlby, B. and E. Ferede (2011), “What does it cost the economy to raise a dollar of tax revenue? The marginal cost of public fund”s. C.D. Howe Institute Commentary March(324).

Dahlby, B. and E. Ferede (2015), “Estimating tax base elasticities and the marginal cost of public funds for Canadian provinces”, School of Public Policy Research Paper, University of Calgary forthcoming.

European Commission (1997), Value Added Tax: A Study of Methods of Taxing Financial and Insurance Services, Brussels: European Commission.

Firth, M. and K. McKenzie (2012), “The GST and Financial Services: Pausing for Perspective”, SPP Research Paper Vol. 5, Issue 29.

Griffith, R. (2000), “How Important is Business R&D for Economic Growth and Should the Government Subsidize It?” Institute for Fiscal Studies Briefing Note No. 12.

Hall, Bronwyn (1996) "The private and social returns to research and development: What have we learned?" In Bruce L. R. Smith and Claude E. Barfield eds Technology, R&D, and the economy(Washington, DC: The Brookings Institution and the American Enterprise Institute).

Hasset, K and K. Newmark (2006), "Taxation and Business Behavior: A Review of the Recent Literature Fundamental Issues", in Tax Reform: Issues, Choices and Implications, G. Zodrow and J. Diamond, eds. MIT Press.

Huizinga, Harry (2002), "A European VAT on Financial Services?," Economic Policy, October.

International Monetary Fund [IMF] Staff, A Fair and Substantial Contribution by the Financial Sector [hereinafter IMF Staff, A Fair and Substantial Contribution], in Financial Sector Taxation: The IMF's Report to the G-20 and Background Material, 2, 9-11, 47-53 (Stijn Claessens, Michael Keen & Ceyla Pazarbasioglu eds., Sept. 2010).

Lester, John (2012), "Support for Business R&D in Budget 2012: Two Steps Forward and One Back", SPP Communique, Vol. 4, Issue 2. School of Public Policy, University of Calgary.

McKenzie, (2012), "The Big and the Small of Tax Support for R&D in Canada", SPP Research Paper, Vol. 5, Issue 22.

Parsons, Mark (2008), "The Effect of Corporate Taxes on Canadian Investment: An Empirical Investigation", Department of Finance Working Paper 2008-01.

PriceWaterhouseCoopers (2011), How the EU VAT Exemptions Impact the Banking Sector: Study to assess whether banks enjoy a tax advantage as a result of the EU VAT exemption system.