THE CANADIAN CHAMBER OF COMMERCE
LA CHAMBRE DE COMMERCE DU CANADA

Submission to the Department of Finance Canada on the August 14, 2012 Legislative Proposals Relating to the *Income Tax Act* and Regulations

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The Canadian Chamber of Commerce is pleased to have the opportunity to provide comments on the legislative proposals relating to the *Income Tax Act* and regulations released on August 14, 2012.

We focus our remarks on the measures pertaining to the Scientific Research and Experimental Development (SR&ED) Investment Tax Credit program and the so-called foreign affiliate dumping legislative proposals.

The Scientific Research and Experimental Development (SR&ED) Investment Tax Credit (ITC) Program

The expert panel leading the Review of Federal Support to R&D heard during consultations calls for increased direct expenditure support. It also noted that many countries rely much less than Canada on indirect tax incentives as opposed to direct measures. That is why the panel recommended a redeployment of funds from indirect to direct support measures.

In the Canadian Chamber's view, the measures pertaining to the SR&ED ITC program introduce unwelcome economic distortions—they discriminate on the basis of company size and favour labour intensive R&D projects over capital intensive R&D and labour intensive industries over capital intensive sectors.

The measures will reduce SR&ED claims by about $500 million per year by fiscal 2016-17, with roughly 82 per cent of the savings coming from large businesses[1] where the majority of R&D spending is concentrated.

Our goal should be to create a neutral SR&ED ITC program—one that treats all types of R&D inputs and large and small businesses in a more uniform manner—to encourage the best allocation and profitable use of resources in the economy.

1) Reducing the general SR&ED ITC rate to 15 per cent from 20 per cent.

The rationale given in the March 2012 Budget for reducing the general tax credit rate is that the corporate income tax rate reductions have effectively increased the relative generosity of the SR&ED ITC program and resulted in growing pools of unused investment tax credits. While this may be true, the economic case for

[1] Lester, John. "Support for Business R&D in Budget 2012. Two Steps Forward and One Back." SPP Communiqué Volume 4, Issue 2. The School of Public Policy. University of Calgary. August 2012.

government support of R&D is independent of the taxable income of businesses. As the Department of Finance noted, "the rationale for this tax support is that the benefits of SR&ED extend beyond the performers themselves to other firms and sectors of the economy. The existence of these spillovers or externalities means, that, in the absence of government support, firms would perform less SR&ED than desirable for the economy."[2]

Society benefits from new discoveries that serve as a catalyst for the creation of new or improved products, services, technology and processes. Over time, R&D spending can lead to a more innovative economy and higher productivity growth, economic growth and living standards.

"The tax status of firms receiving the credit has no impact on the expected net benefit of the public support for R&D…Lowering the regular SR&ED credit rate to 15 percent slightly reduces the net public benefit from the subsidy."[3]

The drop in the general tax credit rate represents a significant reduction in the support of R&D offered through the tax system to publicly traded, foreign controlled, and large private companies. The measure will reduce SR&ED claims by $770 million over the fiscal 2014-15 to 2016-17 period, or by approximately $295 million per year starting in fiscal 2016-17. The enhanced federal tax credit for small Canadian-controlled private corporations (CCPCs) remains unchanged at 35 per cent of eligible expenditures.

It is not clear why we would want to exacerbate the difference in tax treatment between large and small businesses. To quote Jack Mintz, "I can think of no study that supports that small business research has bigger spillover benefits than large business research, thereby suggesting greater tax support for small businesses. In fact, I suspect the opposite may be true."[4]

While the concentration of R&D spending has shifted somewhat from the largest firms (measured by employment and revenue size) towards small and mid-sized businesses, 25 large companies accounted for about one-third of business spending on R&D in 2011. Seventy-five R&D performing firms, all of which are

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[2] Department of Finance Canada. "Tax Expenditures: Notes to the Estimates/Projections 2010." Ottawa: January 18, 2011.
[3] Lester, John. "Support for Business R&D in Budget 2012: Two Steps Forward and One Back." SPP Communiqué Volume 4, Issue 2. The School of Public Policy. University of Calgary. August 2012.
[4] Mintz, Jack. "Small-minded R&D: Ottawa's bias toward small business will hurt research." *FP Comment*. Financial Post. April 2, 2012.

large corporations, accounted for 45 per cent of R&D spending in 2011.[5] According to Industry Canada, small businesses account for about 25 per cent of total R&D expenditures.[6]

"As large businesses are responsible for the preponderance of business research, the tax credit changes will likely have a negative impact on research and development in the country."[7] The reduction in the general SR&ED tax credit rate could adversely impact the ability of Canadian divisions of multinational corporations to attract global R&D mandates to Canada. It could hinder Canada's ability to create a permanent, high-value employment base.

As the government has stated on numerous occasions, "innovation and research and development are crucial to a competitive economy and the creation of new, high-value jobs."[8]

2) **Reducing the prescribed proxy amount, which taxpayers use to claim SR&ED overhead expenditures, from 65 per cent to 55 per cent of the salaries and wages of employees who are engaged in SR&ED activities.**

Firms claiming the SR&ED tax credit currently have the option of itemizing actual overhead expenses or claiming 65 per cent of labour expenditures as a proxy for overhead expenditures. Almost all firms (large and small) claiming the SR&ED tax credit use the proxy method. For some firms, the reduced compliance costs in using the proxy method may justify its use, even when the actual overhead is greater than 65 per cent of salary and wage costs. In other cases, firms may find their overhead costs are less than 65 per cent and so the proxy method provides a net benefit. The fact that most firms use the proxy method suggests that it may be more generous than it needs to be. In this context the reduction to 55 per cent may be justified. Additionally, the proxy method amounts to an increase in the effective tax credit rate for labour[9], which favours

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[5] Statistics Canada. "Industrial Research and Development: Intentions." Catalogue no. 88-202-X. April 2012.
[6] Industry Canada. "Key Small Business Statistics—July 2010." July 2010.
[7] Mintz, Jack. "Small-minded R&D: Ottawa's bias toward small business will hurt research." *FP Comment*. Financial Post. April 2, 2012.
[8] The Honourable Gail Shea, Minister of National Revenue, Charlottetown, Prince Edward Island, May 24, 2012; The Honourable Bernard Valcourt, Minister of State for the Atlantic Canada Opportunities Agency (ACOA) and La Francophonie, Shippagan, New Brunswick, May 23, 2012; the Honourable Peter MacKay, Minister of National Defence; Dartmouth, Nova Scotia, May 23, 2012.
[9] McKenzie Kenneth J. "The Big and the Small of Tax Support for R&D in Canada." SPP Research Paper Volume 5, Issue 22. The School of Public Policy. University of Calgary. July 2012.

labour-intensive R&D relative to capital-intensive R&D. The reduction in the proxy helps to some extent to address this discrepancy.

3) Removing the profit element from arm's length third-party contracts for the purpose of the calculation of SR&ED tax credits.

For simplicity it is proposed that this be achieved by way of a proxy under which 80 per cent (down from 100 per cent) of eligible expenditures incurred for SR&ED performed by arm's length contractors will qualify for SR&ED investment tax credits.

SR&ED contracts with arm's length parties account for 13.5 per cent of SR&ED spending by small Canadian controlled private corporations and 18.4 per cent for large firms. Thus, restricting the tax credit to 80 per cent of contract spending disproportionately disadvantages large corporations and further increases the gap in the R&D subsidy rate between large and small businesses.

Additionally, this measure may negatively impact some sectors more than others, for example, pharmaceutical and biotech companies who may have entered into long-term contracts with research organizations.

4) Removing capital from the base of eligible expenditures for the purpose of the calculation of SR&ED tax incentives.

Excluding capital from the SR&ED tax credit base discriminates against capital-intensive research projects. It also discriminates against large businesses—capital equipment accounts for 4.9 per cent of SR&ED spending, on average, for large businesses, almost double that of small firms (2.6 per cent).[10] Finally, it creates a bias towards labour-intensive sectors at the expense of capital intensive sectors like the manufacturing and resource sectors.

On the whole, eliminating capital equipment as an eligible expenditure will hurt efficiency by distorting the choice of inputs and thereby the production decisions of firms.

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[10] The Secretariat to the Review of Federal Support to Research and Development Expert Panel. "Assessing the Scientific Research and Experimental Development Tax Credit." 2011.

Foreign Affiliate Dumping

The Canadian Chamber of Commerce believes that Canadian subsidiaries of foreign controlled companies are an important part of the Canadian economy and, therefore, it is important not to unduly damage the ability of these organizations to do business globally. Otherwise, they may choose to do business in other jurisdictions instead of in Canada.

The Canadian Chamber applauds the government's initiative to consult with the tax community on this complex matter which we recognize does put at risk the Canadian tax base. The revised draft legislation contains some changes that respond to the submissions made. However, the August 14, 2012 debt dumping proposals continue to be overly complex and may have far reaching implications for Canadian subsidiaries of foreign multinationals that conduct legitimate business in Canada. The proposals also represent a significant source of uncertainty with respect to the rules applicable to foreign affiliate investments made by CRICs controlled by non-resident corporations. We provide our concerns with the proposals below and suggestions for better targeting the rules to the abuses they are designed to prevent.

1) Business Purpose Test

The originally-proposed business purpose test consisted of a list of factors that were to be given primary consideration in determining whether an investment in a foreign affiliate could be considered to have been primarily made for *bona fide* purposes other than to obtain a tax benefit. The August 14, 2012 proposals no longer refer to a *bona fide* purpose.

The draft legislation now requires three specific conditions to be met for the rules not to apply to an investment in a foreign affiliate:

- The business activities of the particular foreign affiliate and all of its subsidiary foreign affiliates must be more closely connected to the Canadian business activities of the foreign-controlled corporation resident in Canada (CRIC) than to the business activities of any related non-resident corporation.
- The CRIC's officers must have exercised the principal decision-making authority in respect of the investment in the FA, and the majority of those officers must have been resident and working in Canada at the time that the investment was made.

- It is reasonably expected that the officers of the CRIC will have on-going principal decision-making authority in respect of the investment in the FA. These officers must be resident and working in Canada, and their compensation and performance evaluation must be based on the results of the FA's operations to a greater extent than the compensation and performance evaluation of other officers of any related non-resident corporations.

The revised business test is intended to be narrower and more specific than previously; however, it may be very difficult for a CRIC to demonstrate that all of the conditions for meeting the test are satisfied. Additionally, what exactly must be tested to determine whether activities are "more closely" connected and whether such a test is quantitative or qualitative remains uncertain.

2) Election to reduce the paid-up capital (PUC) of the corporation resident in Canada (CRIC) and PUC reinstatement provision

A provision has been added in the August 14, 2012 proposals that would allow a CRIC to elect, in certain circumstances, to reduce the PUC of its shares to avoid the consequences of a deemed dividend as a result of an investment in a foreign affiliate. The conditions for making such an election differ depending on whether the CRIC has more than one class of shares outstanding.

If the CRIC has only issued one class of shares, it may file an election to reduce the PUC of that class by the amount of the deemed dividend that would otherwise arise. A CRIC may invest in shares of a foreign affiliate and choose to reduce the PUC of its only class of shares by the amount of that investment, rather than incurring the withholding tax cost of triggering a deemed dividend.

Election to reduce the PUC of the CRIC and PUC reinvestment are welcomed additions. We simply note that the intended operation of the PUC reduction election and reinstatements rules is not clear when the CRIC is owned directly by another Canadian corporation and indirectly by the controlling non-resident and the proposed legislation may not provide for it.

3) Pertinent Loan or Indebtedness (PLI) Exception

The August 14, 2012 draft legislation contained an important addition to the tax measures announced in the March 29, 2012 federal budget – an exception from both the shareholder benefit rules and the foreign affiliate dumping rules for a pertinent loan or indebtedness (“PLI”). Where a loan or indebtedness qualifies as a PLI, the result will be imputed interest income to the extent that the actual interest earned is less than a specified amount. While we agree that the direction the Department of Finance has taken in this regard is necessary, we believe that this measure should be modified in several respects and the application of this concept should be extended to the proposed upstream loan rules, as set out below, in order to maintain Canada’s competitiveness and its position as an attractive place for multinationals to invest.

Proposed Modifications - Rate

We believe Finance’s goal of protecting the Canadian tax base while allowing Canadian corporations to more effectively deploy cash within a related global group would be achieved through a lower rate of interest imputation. Variable “A” in proposed section 17.1 would impute interest at the greater of two amounts, largely to ensure a positive net impact to the Canadian tax base from a PLI and, in any event, to protect against negative spreads. With this in mind, and having regard to foreign transfer-pricing principles which will often be relevant in determining acceptable interest rates from a non-arm’s length borrower’s perspective, we recommend that Finance replace the prescribed rate referred to in clause (i) of Variable “A” of proposed section 17.1 with a rate equal to 3 per cent above the 90-day T-Bill rate described in Regulation 4301(c), unrounded. We believe that such a rate would not only be more consistent with foreign transfer-pricing principles but, by eliminating the necessity to round-up to the nearest whole percentage point, it would be better aligned with arm’s length lending practices and would avoid erratic quarterly movements in the imputed interest rate.

Proposed Modifications – Scope

As proposed, the PLI exception would only apply in situations where the lender is a corporation resident in Canada (a “CRIC”) and the borrower is a non-resident corporation. In light of the prevalent use of partnerships in today’s business structures, we believe Finance should amend the PLI requirements in subsections 15(2.11) and 212.3(9) to effectively allow for a partnership “look-through” rule for either the borrower or lender. We would also request that the PLI election be available on a loan-by-loan basis, rather than applying to all loans between a subject corporation and the CRIC after March 28, 2012 or, at a minimum, that the election be revocable. It is also unclear whether the rules apply to loans made after March 28, 2012 where the proceeds are used to repay a pre-March 28, 2012 loan.

Proposed Extension – Upstream Loans

In the Explanatory Notes that accompanied the upstream loan rules proposed on August 19, 2011, the Department of Finance indicated that the main operative rule, in subsection 90(4), "is modelled on subsection 15(2) of the Act". In light of that parallel and, with Finance's base protection goals in mind, we recommend that Finance extend the concept of PLI's to the proposed upstream loan rules so that foreign affiliates of a CRIC could make loans to non-arm's length parties without triggering an income inclusion under proposed subsection 90(4). Instead, if such a loan or indebtedness were elected to be treated as a PLI, the Canadian tax base could be protected much in the same manner as Finance has proposed in section 17.1, in combination with Canada's foreign accrual property income (FAPI) regime.

4) Corporate reorganization

The August 14, 2012 proposals introduce several exceptions to the foreign affiliate dumping rules for various corporate reorganizations and distributions that result in the acquisition of shares of a subject corporation by a CRIC. Generally, when as a result of a particular reorganization or distribution there is a no new incremental investment being made by the CRIC in a foreign affiliate, the exceptions ensure that the foreign affiliate dumping rules do not apply. Some of the exceptions are subject to a "series of transactions or events" test and some do not apply when the investment being acquired by the CRIC is not a fully participating share (i.e. a preferred share investment) or when there is an assumption of debt by the CRIC.

We believe the introduction of exceptions for certain corporate reorganizations is a welcome change as the proposals as originally announced in Budget 2012 were broadly worded and could have applied to many internal reorganizations that did not result in a new investment in a foreign affiliate being made by a CRIC.