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Investment Industry Association of Canada Association canadienne du commerce des valeurs mobilières

Written Submission to the Department of Finance Canada on Budget 2024 Measures

September 11, 2024

The Investment Industry Association of Canada (IIAC) recommends that the federal government:

- Revoke the budget 2024 tax hike on capital gains.
- Implement a program similar to the UK Enterprise Investment Scheme (EIS) to encourage investment in early-stage, unlisted businesses with high growth potential.
- Make improvements to tax-assisted retirement savings programs.
  - Raise the age at which contributions to tax-deferred retirement saving vehicles must end and which RRIF withdrawals must start.
  - Reduce the RRIF annual withdrawal rates mandated for each age, with the goal of abolishing mandatory withdrawals entirely.
  - Gradually increasing RRSP contribution limits so Canadians that contribute to defined-contribution plans and RRSPs have the same opportunities to accumulate savings for retirement as their counterparts with defined-benefit plans and public-sector plans.
- Undertake an independent and comprehensive examination of the federal tax system to ensure it adheres to long-standing principles of good tax policy, including a thorough review of tax expenditures.
- Re-balance Canada's tax system so it relies less on economically damaging income and profit taxes, and more on consumption taxes.
- Include exceptions to the trust reporting requirements for bare trusts for investment dealers who hold securities for clients in nominee-name.
- Revoke the two-percent tax on share buybacks by public corporations in Canada.
- Chart a credible path to budget balance, with a medium term goal of reducing the federal debt-to-GDP ratio below its pre-pandemic level.
- Undertake a comprehensive review of federal spending.

EXECUTIVE SUMMARY

The Investment Industry Association of Canada (IIAC) appreciates the opportunity to comment on the federal government's key budget priorities as outlined in the August 12, 2024 Department of Finance news release.

The IIAC is the national association comprising investment firms of multiple types. Our members manufacture and distribute a range of investment products, including mutual funds, exchange-traded funds (ETFs), and prospectus exempt products; trade in debt and equity on all marketplaces; provide custodial and clearing services, issue securities in public and private markets; and underwrite issuers in public and private markets.

We advocate for smart public policies and regulatory reforms that strengthen Canada's capital markets, promote investment, and enable Canadians, entrepreneurs and businesses to flourish.

On August 30, 2024, Statistics Canada reported that GDP per capita in Canada declines in the second quarter of 2024, the fifth consecutive quarterly decline (and the seventh decline in the last eight quarters). According to World Bank data, in 2023, real GDP per capita in the U.S. stood at approximately $73,600 (PPP 2021), compared to Canada's $55,800 – representing a gap in living standards of $17,800.

Canada's poor productivity is much to blame. Canada ranks 18th in productivity (GDP per hour worked) in the OECD (2022). In 1970, Canada was the 6th most productive economy in the OECD.

We need to energize entrepreneurship and investment. "History shows that advances in productivity often come from the start-ups, the new companies led by entrepreneurs with groundbreaking ideas." (Carolyn Rogers, Senior Deputy Governor, Bank of Canada).

STIMULATING ENTREPRENEURSHIP

The IIAC continues to urge the federal government to reverse the budget 2024 tax hike on capital gains which discourages entrepreneurship and business investment and, according to Jack Mintz, affects 4.74 million Canadian investors, many with middle or modest incomes.

The introduction of the Canadian Entrepreneurs' Incentive (CEI) in Budget 2024, and the changes to the CEI announced on August 12, 2024, attempt to placate business owners after the harm to innovation and entrepreneurship brought on by the capital gains inclusion rate changes. There appears to be a contradiction in policy goals. On one hand the government is raising capital gains taxes which discourage entrepreneurial risk-taking, savings and investment, and on the other hand it continues to tinker with a new incentive (CEI) to "encourage Canadian innovators to turn their ideas into growing businesses that create good job". Moreover, the CEI continues to be mired in exceptions and complexity. Hundreds of thousands of small businesses in certain industries are specifically excluded resulting in different (unfair) tax treatment. The government is in essence picking winners and losers.

The IIAC recommends that the federal government implement a program similar to the UK Enterprise Investment Scheme (EIS) to encourage investment in early-stage, unlisted businesses with high growth potential. Importantly, the EIS is a market-based incentive – the market decides which entrepreneurial

ventures receive investors' vote of confidence because it is the investors that are putting their hard-earned money on the table.

The EIS provides personal income tax relief of up to 30% on investments in EIS-eligible share purchases of up to £1m each year (or on investments of up to £2m per year if at least £1 million of that is invested in knowledge-intensive companies); an exemption from capital gains tax for EIS shares held more than three years; and a rollover provision exempting capital gains taxes on the sale of an asset, if the proceeds are reinvested in EIS-eligible shares.

Additionally, the EIS is highly efficient for inheritance tax purposes as EIS investments are exempt of inheritance tax if shares are held a minimum of two years and at the time of death.

The federal government may have concerns over a large tax-revenue loss. To the contrary, the Enterprise Investment Scheme Association (EISA) estimates the tax expenditures of the Program are more than offset by the revenues generated from corporate taxes, taxes paid on salaries to employees, and VAT paid by EIS-financed companies.

Since its inception in 1994, the EIS program has been a resounding success, with 56,000 companies raising funds, of which more than 37,000 are companies raising much-needed capital for the first time, with investments to date totaling £32 billion. An evaluation of the program by His Majesty's Revenue & Customs (HMRC) is available here.

FACILITATING RETIREMENT SAVINGS

Policies that foster saving enhance prosperity – i.e. citizens' personal solvency and independence, and the nation's long-term prosperity through the investments funded by its citizens' savings. Importantly, a nation's retirement savings system plays a major role in creating deep and liquid capital markets.

Budget 2024 states: "After a lifetime of working hard—Canadians deserve to know they have a secure and comfortable income in retirement."

We agree. As such we propose the following:

RRIFs

The tax rules that require individuals in the year they turn 71 to transfer their RRSP assets into RRIFs, and the RRIF rules which force individuals to make mandatory annual minimum withdrawals whether they need the income or not, are outdated. When the modern RRIF calculation was put in place in 1992, life expectancy at age 71 was 13.7 years. This number has increased steadily to 16.1 years (Statistics Canada, Table 13-10-0114-01). The overall survival rate at age 95 has increased from 7.5% in 1992 to 14%. Today, seniors have a higher chance of outliving their savings.

Canadians should not have to deplete their savings prematurely – they should have the freedom and flexibility to manage their savings according to their individual circumstances and in the most tax-efficient manner. We, therefore, recommend that the government:

(i) Raise the age at which contributions to tax-deferred retirement saving vehicles must

end and which RRIF withdrawals must start, and

(ii) Reduce the RRIF annual withdrawal rates mandated for each age, with the goal of abolishing mandatory withdrawals entirely.

The negative fiscal impact of reducing the RRIF annual withdrawal rates mandated for each age will be small on a present-value basis. Eliminating the annual minimum mandatory withdrawals entirely would simply delay the governments' receipt of tax revenue (since RRIF withdrawals are considered taxable income) to either when the RRIF holder voluntarily takes out savings, or when the individual dies.

RRSPs

Under the current rules, individuals can contribute up to 18% of their previous year's earned income, up to a yearly maximum of C$31,560 for 2024 (C$32,490 for 2025) minus any pension adjustment, in a defined-contribution pension plan/RRSP. The 18% rule has been around since 1992 and was based, at that time, on now outdated assumptions of life expectancy after retirement, and how much savings typically earn, to produce retirement income roughly equivalent to that of a typical defined-benefit pension plan. As noted above, people are now living longer and returns on "safe" investments have fallen. The federal government should consider gradually increasing RRSP contribution limits so Canadians that contribute to defined-contribution plans and RRSPs have the same opportunities to accumulate savings for retirement as their counterparts with defined-benefit plans and public-sector plans.

Enhancing Canada's tax-deferred retirement savings plans would also enhance our ability to attract and retain the best and brightest people. Maximum contribution limits in RRSPs pale in comparison to those in the U.S. For 2024, the 401(k) plan contribution limit is US$23,000, or US$30,500 for individuals age 50 or older. Total 401(k) plan contributions by an employee and an employer cannot exceed US$69,000 in 2024. On top of these amounts, employees aged 50 and older can add up to US$7,500 more annually as a catch-up contribution, bumping the 2024 maximum to US$76,500. Some 401(k) plans have extra contribution limits on employees who are highly compensated. The 401(k) contribution limits also apply to other so-called "defined contribution plans".

Qualified Investments for Registered Plan

In the 2024 federal budget, the government launched a consultation on "how the qualified investment rules could be modernized on a prospective basis to improve the clarity and coherence of the registered plans regime." The IIAC made several recommendations in our submission to the Department of Finance, available here.

TAX REFORM

Years of tinkering with the system have added complexity and increased the compliance burden for individuals and businesses, and the administration burden for the government. The federal tax code now includes over 220 tax-preferences (exemptions, credits, deductions, rebates). These include tax preferences to achieve social objectives rather than funding the initiatives through direct program spending. Some tax credits may be subsidizing activities Canadian would have undertaken anyway.

Other credits may stimulate spending in certain areas, prompting price increases that negate the benefit of the tax credit.

The federal Income Tax Act is now over 3,600 pages. The Fraser Institute has estimated total federal compliance costs associated with filing personal income taxes at $2.5 billion and business taxes three-to-four times as much. This is money that could be put towards more productive uses. Federal administration costs related to collecting taxes, maintaining records, and enforcing tax regulations are estimated at $4.6 billion.

The complexity of the system is particularly challenging for small- and medium-sized businesses because they may lack the financial resources to successfully navigate complex reporting requirements. Ultimately, the fixed costs of tax compliance can influence an entrepreneur's decision to enter or exit the industry.

The House of Commons and Senate Finance committees, national business associations, think tanks, tax experts, the Advisory Council on Economic Growth, the Organisation for Economic Co-operation and Development (OECD), and the International Monetary Fund (IMF) have all highlighted the need for a targeted review of Canada's tax system.

Several countries have undertaken major tax system reviews in recent years, including the UK (Mirrlees Review) and New Zealand (Tax Working Group Review). Both of these reviews were independent, non-government reviews. Canada must do the same.

Principles of Sound Tax Policy

Long-standing principles of good tax policy include neutrality, equity and fairness, efficiency, simplicity, and competitiveness. An examination of Canada's tax system should start by looking at how it stacks up against this ideal.

The Tax Base

A tax base that is as broad and inclusive as possible results in a simpler tax system that is easier to administer, is fair and efficient, and reduces the potential for revenue shortfalls as economic circumstances change.

Tax preferences should be scrutinized to determine if they are:

- Effective. Are they achieving their intended goals?
- Efficient. Are the goals being met at a reasonable cost? Do the benefits outweigh the costs?
- Needlessly complex. Do they come with high compliance and administration costs? Can the government achieve similar outcomes though other means?

Those that do not pass muster should be eliminated or redesigned.

A broader tax base would enable lower tax rates for businesses and individuals.

Reducing Our Reliance On Economic Damaging Taxes

According to the OECD, Canada relies heavily on the most economically damaging taxes:

- 36.3% of total tax revenue in Canada comes from taxes on personal income, profits and gains compared to an average of 23.7% in the OECD.

- 13.5% of total tax revenue in Canada is raised from taxes on corporate income and gains compared to an average of 10.2% in the OECD.
- A lower proportion of tax revenues comes from value-added taxes – 13.1% in Canada compared to 20.7% in the OECD.

The tax mix has far-reaching implications for economic growth. Corporate taxes are the most economically damaging (they discourage capital investment and productivity growth), followed by personal income taxes (which reduce the incentive to work and negatively impact saving and investment) and taxes on profits and capital gains (which distort investment decisions, entrepreneurship and venture capital funding). On the other hand, value-added taxes like the GST are less distortive as they do not affect decisions to work or invest.

Canada's tax system should be re-balanced, so it relies less on economically damaging income and profit taxes, and more on consumption taxes which are a more stable and reliable revenue source.

TRUST REPORTING

The draft legislation released on August 12, 2024 provided some welcome relief, namely the extension of the exemption for bare trusts from filing requirements for the 2024 taxation year, and several exceptions to the trust reporting requirements for both bare trusts for 2025 and later taxation years. Nonetheless, the rules remain extremely complex.

Many investment dealers hold securities for their clients. For example, units or shares of investments are typically issued in the name of the dealer (nominee-name) rather than the dealer's client (client-name) and are recorded by the issuer as being registered in the name of the dealer ("on book" investments). The dealer is the registered holder of the securities and is responsible for maintaining records of the client's investments. The holding of securities in nominee-name creates a bare trust.

The bare trust exceptions outlined in the August 12, 2024 draft legislation do not specifically exempt this scenario. The IIAC requests relief on this point for securities dealers.

SHARE BUYBACKS

The two-percent tax on share buybacks by public corporations in Canada, that applies as of January 1, 2024, should be revoked.

According to the Fraser Institute:

"Share buyback tax makes the capital market less efficient in discouraging the reallocation of financial capital from companies whose profits are expected to grow relatively slowly to companies whose profits are expected to grow relatively quickly. This likely means that financial capital will be used less efficiently than would be the case in the absence of the new tax, with a resulting loss of productivity for the economy. And that hurts everyone, not just shareholders."

"There's another possible unintended consequence of an excise tax on stock buybacks. Since the tax applies to publicly traded companies, the tax indirectly increases the equity cost of capital for public

companies compared to private companies. Therefore, companies will be incentivized to remain privately owned for longer than would otherwise be the case. But to reach minimum efficient size in many industries, companies typically must access public capital markets, which generally provide less costly equity financing than private sources of financing. A tax on stock buybacks will discourage the growth of small firms that could benefit from economies of scale."

According to the C.D. Howe Institute:

"This proposal also reflects populist impulse rather than economic logic. It is modelled on a US tax that has generated enormous regulatory uncertainty and complexity during the six months it has been in place. The equity in companies belongs to shareholders: imposing a charge on withdrawals of equity will make investors reluctant to put equity in, which will raise the cost of capital and discourage investment."

CHARTING A PATH TO FISCAL BALANCE

In fiscal 2019-2020, before the pandemic, the federal government's net debt-to-GDP ratio stood at 31.2% and public debt charges amounted to $24.4 billion (1.1% of GDP). The 2024 federal budget pegs the net debt-to-GDP ratio at 42.1% for fiscal 2023-24 and public debt charges at $47.2 billion (1.6%) of GDP. To put this into perspective, the cost to service the debt is approximately equal to the Canada Health Transfer to the provinces and territories ($47.1 billion in fiscal 2022-23; $49.4 billion in fiscal 2023-24), and almost twice as much as the government sends to families with children in the form of the Canada Child Benefit ($24.6 billion in fiscal 2022-23; $26.1 billion in fiscal 2023-24).

This is lost opportunity. It underscores the need to get the nation's fiscal house in order, so there is more fiscal room to deliver public services Canadians value, including education, skills training, health care, and tax reductions.

All debt must be financed. When the government taps debt markets to meet its borrowing requirements, it competes with private businesses for the pool of available savings. This pushes up interest rates and crowds out investment by the private sector.

PROGRAM REVIEW

A program review exercise is central to achieving savings as well as reallocating funds to higher priority areas and finding ways to improve the efficiency, effectiveness and fairness of government programs.

Programs and activities should be evaluated every three to four years based on the following criteria:

- Does the program or activity serve the public interest?
- Does the government have a legitimate and necessary role in delivering a particular program or activity, or can the private sector play a role?
- Are Canadians getting value for their tax dollars (based on comprehensive cost-benefit analysis)?
- Can the program's efficiency and effectiveness be improved? For example, by lowering

delivery costs, employing cost-saving technologies, partnering with the private sector (i.e. public-private partnerships)?

- Does the program or activity fall under federal jurisdiction, or is it better aligned with provincial/territorial responsibilities?