



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

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President & Chief Executive Officer

February 22, 2007

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

Dear Minister:

Re: Investment Industry Association of Canada Pre-Budget Submission

The Investment Industry Association of Canada¹ thanks you for this opportunity to provide input for the government's budget-planning process. All Canadians – individuals, businesses and governments – need a healthy economy to keep earning a salary, saving for a child's education or retirement, investing in capital and new ideas or, in the case of government, maintaining the infrastructure in a country such as ours.

Our Association's members manage savings for Canadians, transferring the capital from these investors and savers into productive capital investment by companies that will develop new products, create new jobs, export and pay taxes. However, Canada needs access to more risk capital if Canada is to successfully meet the challenges of increased competition from low-cost countries globally, liberalization of trade and financial flows facilitated by technology and an aging population domestically. To this end, the IIAC believes that Canada needs both a comprehensive national competitiveness strategy that has its basis in productivity improvements and a supportive business environment where governments help clear the way for a sustainable prosperous economy and high standard of living by eliminating overlapping, duplicative and excessive regulation. Our recommendations, which we elaborate on in Attachments 1 and 2, are:

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¹ On April 1, 2006, the Investment Dealers Association of Canada (IDA) legally divided into a self-regulatory organization (SRO) and IIAC – the industry association. The Association represents the position of the Canadian investment industry on regulatory and public policy issues. Its mandate is to promote efficient, fair and competitive capital markets for Canada while helping its member firms succeed in the industry.

1. Invest in competitiveness and productivity

- ***To increase risk capital for productive investment***, we recommend that the Government introduce measures to reduce the capital gains tax on reinvested capital gains as identified in the Conservative election platform. We elaborate in Attachment 2 on several ways to achieve this with the issues that each alternative raises.
- ***To further increase the available pool of funds for investment***, we recommend that the capital gains reduction be complemented by other tax changes, for example:
 - A reduction in personal income taxes or increase in the personal tax exemption;
 - An extension in the registered retirement savings plan (RRSP) conversion deadline to age 73;
 - An increase in the maximum annual RRSP limit from 18 to 25 per cent of earned income; and
 - Support for low income-Canadians by eliminating RRSP/registered retirement income fund (RRIF) income from the Guaranteed Income Supplement clawback.
- ***To expand growth opportunities for small- and medium-sized firms***, we recommend the government reduce the capital gains inclusion rate from 50 to 25 per cent for gains on initial public and treasury offerings of shares in small, publicly listed companies.
- ***To focus on key sectors identified as critical to improving Canada's growth and competitiveness***, we support implementation of targeted tax incentives (for example, along the lines of flow-through shares) to increase funding in these areas, notably in the knowledge-based and environmental sectors.
- ***To encourage private research and development (R&D) spending***, we recommend that the Government improve the scientific research and experimental development (SR&ED) tax credit program, at least for small firms that are Canadian-controlled public corporations (CCPCs), by ensuring that such firms can still qualify for the SR&ED credits when listing on the TSX Venture Exchange and know with some certainty early on whether their spending will qualify for tax credits or not.
- ***To promote investment in machinery and equipment***, we recommend that the government lower Canada's effective tax rate on capital and increase the capital cost allowance to better equal the rate of economic depreciation.

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2. Improve the business environment by reducing unnecessary costs and uncertainty

We sincerely appreciate your support and encourage the Government to continue its efforts to address the unnecessary costs of overlap and duplication in the securities industry that burden issuers and investors in this country by, respectively, increasing costs and reducing returns with no measurable benefit. We also congratulate the Government on recent spending cuts that reduce government costs and benefit business through streamlining, namely, the agreement reached by the federal and Ontario governments on joint corporate income tax collection and the Government's elimination of the Canada Retail Debt Agency. We recommend that the Government place a priority on addressing certain costs with respect to insolvency legislation, securities transfer law and tax reporting.

The above measures are, in some cases, low in cost. Others can be expected to generate taxes that will ultimately more than cover their costs. We believe that our industry can provide value by being involved in the practical aspects of implementation of certain tax measures as soon as possible. We would be pleased to address any questions you may have with respect to our comments and to work with your staff to implement desired changes discussed here that require our industry's support.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Ian Russell", with a horizontal line underneath the name.

cc: Mark Carney, Bob Hamilton, Brian Ernewein, Gerry Lalonde, Rob Stewart



ATTACHMENT 1

CANADA NEEDS A COMPREHENSIVE NATIONAL COMPETITIVENESS STRATEGY BASED ON PRODUCTIVITY IMPROVEMENTS

Productivity is critical to the well-being of Canadians and Canadian businesses. It is essential to maintaining Canadians' standard of living and having the services Canadians want or need at every stage of life – while they are growing up, working and living in retirement. A country's productivity is determined in part by how it manages its resources – financial, human, machinery and equipment, etc. The two sets of measures below are ways in which the Investment Industry Association of Canada believes that the Government can enhance the mix of capital, technology, people and government regulation to improve productivity and foster a sustainable and high standard of living.

1. Invest in competitiveness and productivity

We believe that the surplus announced in October 2006 should be used not for new spending but for tax cuts. To improve productivity, employment and economic growth, we believe that taxes should be shifted, to the extent possible, from the current heavy burden on labour, investment and savings to bases less affected by taxation, such as consumption. ***For this reason, we believe that the government should re-allocate the promised reduction in Goods and Services Tax (GST) to the measures that follow or at least delay implementation of the reduction until measures that have a greater multiplier effect on economic growth have been implemented.***

We were pleased to see this past year's reduction in personal taxes – especially on savings – but this is not enough to stimulate the increase in productivity that we believe the data suggest is required. The tax goals identified in *Advantage Canada* are laudable, as set out in our January 23 letter on the subject. Specific measures that we would like to highlight are:

- ***Stimulate growth in risk capital for productive investment***

The Conservative platform included a deferral of tax on capital gains if re-invested in six months as a way to promote investment. Discussion of options is included in Attachment 2.

- ***Implement measures to further encourage savings and investment***

Investment can be further encouraged by enhancing tax-assisted retirement vehicles. Retirement options are particularly important now due to low deposit and investment returns, and the decline in defined benefit plans. We concur with the following specific measures that are or may be being considered:

- ***Lower personal taxes/raise the personal tax exemption***
- ***Extend the registered retirement savings plan (RRSP) conversion deadline to age 73 in recognition of the aging population and expectation that Canadians will work longer***
- ***Increase the maximum annual RRSP limit from 18 to 25 per cent of earned income***
- ***Address saving for retirement by low income-Canadians by eliminating RRSP/registered retirement income fund (RRIF) income from the Guaranteed Income Supplement clawback.***
- ***Expand growth opportunities for small- and medium-sized firms***

The challenges that small- and medium-sized businesses face in raising funding at a critical stage in their development needs to be recognized. Current tax relief for small businesses is slanted towards private companies. While this relief is important, it, along with increased regulatory costs, tend to encourage companies to stay private – and smaller – longer. Steps need to be taken to promote public participation in Canadian junior public markets and to keep Canadian junior companies in Canada. In an effort to encourage more small companies to go public and avail themselves of greater financing opportunities, we recommend the government reduce the capital gains inclusion rate from 50 to 25 per cent for gains on initial public and treasury offerings of shares in small, publicly listed companies. These companies and other companies would also benefit from a faster reduction in corporate income taxes from 21 to 19 per cent prior to 2010.

- ***Focus on key sectors identified as critical to improving Canada's growth and competitiveness***

We support implementation of targeted tax incentives in select situations. For example, we recommend consideration of a flow-through share concept to increase funding in knowledge-based sectors such as biotech and high-tech.

- ***Improve the scientific research and experimental development (SR&ED) tax credit program***

While Canada's SR&ED tax credit program is more generous in its parameters than equivalent programs in other countries, it is not as successful in attracting private R&D expenditures:

- ***Small Canadian-controlled private corporations (CCPCs) would be better able to commercialize their innovations if those small corporations did not automatically lose their CCPC status (and access to SR&ED credits) when listing on the TSX Venture Exchange.*** Without a change in SR&ED tax credit provisions, small firms going public lose access at a time when they are looking for both more risk capital to continue bringing innovative ideas to the commercialization stage and greater liquidity for their shares to attract more investors.
- Reasons vary as to why the Canadian SR&ED tax credit program continues not to generate the R&D that is intended. For some, it may be because a firm must have taxable income, which may not be the case at the start-up point. For others, it may be a concern that there is little value in claiming SR&ED tax credits as they may be rejected years after the fact, resulting in associated repayment of benefits with

interest and penalties. ***Further research into what would make the SR&ED tax credit program more effective should be undertaken and action to address findings should be implemented.***

- ***Lower Canada's effective tax rate on capital, notably on machinery and equipment***

With just under a 40 per cent tax on capital on the services industry in Canada, Canadian firms bear the fifth highest rate of over 80 industrial and developing countries examined. The C.D. Howe Institute's recent "The 2006 Tax Competitiveness Report: Proposals for Pro-Growth Tax Reform" identified that capital investment in Canada has averaged \$3,200 per worker less than in the U.S. and \$1,400 less than per OECD country worker. The report quantified the beneficial effects of reductions in the cost of capital as follows:

- a 10 per cent reduction in the cost of capital can increase investment in machinery and equipment by 10 per cent
- a one per cent reduction in the effective tax rate on capital can increase the stock of foreign direct capital by 3.3 per cent.

We particularly encourage accelerating the removal of all remaining capital taxes, especially for those firms whose investors rely on the firms maintaining as strong a capital base as possible.

As well, we recommend an increase in the capital cost allowance to better equal the rate of economic depreciation.

2. Improve the business environment by reducing unnecessary costs and uncertainty

We congratulate the Government both on reaching agreement with the Ontario government on joint corporate income tax collection and on elimination of the Canada Retail Debt Agency. These measures both benefit business through process streamlining and reduce government costs.

More broadly, a number of measures were undertaken under Industry Canada's Smart Regulation program and we believe that there are others to be found in terms of eliminating unnecessary regulation and streamlining what regulation is required, especially where multiple levels of regulation are involved.

- ***Continue efforts to eliminate duplication and over-regulation in the securities industry***

Recognizing that many of the challenges facing the securities industry are not within the federal government's jurisdiction, we appreciate very much the efforts of the Government to press forward with a more efficient securities regulatory structure. The existing multi-jurisdictional regulatory framework imposes from \$200 to \$300 million on investors, issuers and intermediaries with indirect costs of compliance adding considerably more. Where justifiable, these expenses are acceptable; where not, the inefficiencies can raise the cost of capital for business, reduce investor returns and impair the competitiveness and efficiency of our markets. As an example of duplication, a Quebec-based IIAC member reports that in one year, it was examined by three regulatory bodies – the Investment Dealers Association of Canada (IDA) from Toronto, the IDA from Montreal and the Autorité des marchés financiers. Where the costs of regulation result from overlap, duplication and in some cases over-regulation, we believe that the related regulations must be rationalized and streamlined while ensuring that:

- Investment dealers and issuers (especially small ones) can act, wherever possible, as if they are in a uni-jurisdictional environment, reducing or eliminating any unnecessary costs such as the costs of duplication or inconsistency that have little or no impact on the service that Canadian individuals and businesses expect
- Canadian retail and business clients can be comfortable that they will be treated in the same way as everybody else, wherever they are in the country
- Foreign investors and borrowers know what law will apply to their relationships
- Firms can get certainty as quickly as possible – delays in legislative and regulatory implementation and uncertainty as to regulatory responses impede and may dissuade investment.

It is important for most businesses – and for firms in our industry in particular – that the government reduce uncertainty. The securities industry and overall financial sector can be considerably weakened by any perception of uncertainty and it takes much longer to restore confidence in Canadian capital markets than to lose it. Specifically, we believe that the Government should:

- ***Address contradictions and duplications in insolvency legislation that put Canadian capital markets and firms at risk***

Current insolvency laws and/or proposed changes under former Bill C-55 allow automatic or court-ordered stays on collateral, which would affect the repo market, securities lending arrangements, derivatives and other now standard securities market products. Bill C-55 provisions, as well as other bankruptcy and insolvency legislation, put Canadian firms and Canadian markets at a serious disadvantage to foreign competitors. These issues must be addressed to ensure fairness and prevent the loss of capital markets business from Canada and an increase in the related costs of funding for Canadian businesses. The seriousness of this issue is elaborated on in detail in the Association's June 26, 2006 submission to the Minister of Finance and in a series of meetings through February 2007. Some parts are being addressed, but legislative changes have not yet passed and regulations have not yet been made available for review.

- ***Provide certainty to securities transfer law***

Uncertainty is already taking a toll on the Canadian securities industry. In the absence of certainty that updating securities transfer laws would bring, there is evidence that transactions have been moved to the U.S. or abandoned. With an ever-growing focus on legal certainty brought about by 9/11, Sarbanes Oxley and Basle II, the detrimental effect on the securities industry will continue to grow. Federal and provincial securities transfer and related legislation must be updated:

- to give the significant majority of Canadians, who hold securities electronically through an intermediary, appropriate protections when those securities (and interests in them) are transferred, purchased, sold or pledged
- to ensure that securities transfers in Canada meet the same legal standards adopted by the U.S. and European Union countries, thereby:
 - reducing risk, legal uncertainty and ultimately cost; and
 - helping preserve the competitiveness of the Canadian capital markets and industry given evidence that transactions have been moved to the U.S. or abandoned due to uncertainty.

IIAC submitted additional points on this subject to Finance Canada in a letter dated October 18, 2006. The key recommendation was for the federal government to remove

transfer rules from federal statutes, repeal the *Depository Bills and Notes Act* and harmonize federal law governing bills and notes with uniform securities transfer legislation provided that:

1. those provinces that have not already introduced uniform transfer law commit to implementation of uniform securities legislation within a short timeframe and to maintain it thereafter
2. the ceding of jurisdiction in the above fields has no broader implications for federal jurisdiction in other areas now or in the future.

- ***Rationalize tax reporting***

IIAC letters sent in the past year have highlighted significant problems when tax measures are introduced without appropriate consideration of implementation and ongoing administration issues. Investors, issuers, intermediaries and government can be better served. As an example, we commend your government for legislating the elimination of the double taxation of large corporate dividends, but this has caused and continues to cause administrative challenges for payors, intermediaries and taxpayers alike. CRA guidance allows issuers to file notice of the eligibility of dividends in a range of ways, making it extremely difficult for intermediaries to find the status of the dividends to report the favourable tax treatment to their taxpaying clients. The end result is that taxpayers may not receive tax breaks they were promised. A simpler, cheaper and sensible way is to require filing with transfer agents that must disseminate information to a central location, for example, the Canadian Depository for Securities, which already accepts T3, T5013 and other filings. ***We ask that you include this change in the budget or work with the CRA to streamline this process.***

Also related to tax reporting, taxpayers and intermediaries continue to struggle because March 31 is both the date for income trust and other issuers to report details to intermediaries *and* for the intermediaries to report the information to investors. This is a logistical impossibility and means that taxpayers may get tax slips *after* their tax returns must be filed. ***We ask that you change the filing dates for trusts and limited partnerships to February 28 and, for funds of funds, to March 7 as set out in previous submissions. We also ask the Government and CRA to listen to firms responsible for implementing tax reporting to ensure that:***

1. ***taxpayers get the intended benefits and necessary tax slips on a timely basis and***
2. ***intermediaries, whose tax reporting work already goes unpaid, can implement the requirements in the most cost-effective way possible.***



ATTACHMENT 2

PROPOSALS TO STIMULATE CAPITAL INVESTMENT BY INDIVIDUAL CANADIANS

The IAC has considered a variety of proposals to stimulate capital investment by individual Canadians. These can essentially be categorized into one of three alternatives, which are not necessarily mutually exclusive:

1. eliminate or defer the taxation of specified capital gains
2. eliminate the significant tax inequity applicable to capital gains and dividends realized by registered retirement savings plans (RRSPs) and pension funds
3. reduce the effective tax rate applicable to capital gains.

We have excluded alternatives that we believe would be fiscally or politically untenable. The cost to the government of the proposals, however, has been considered to only a limited degree since each of them can be designed to result in a range of costs. Similarly, which assets should qualify for preferred treatment under any particular proposal will depend on the specific tax policy objectives of the particular proposal and areas of highest priority to the Government.

Table 1 set out different assessment criteria by which each alternative can be judged. We believe that option 1 is closest to the promised proposal to exempt capital gains from tax in the Conservative Party platform – "Stand Up for Opportunity"– released during the last federal election campaign.² In that regard, it may best achieve the Government's policy objectives, however, further discussion is required to ensure that it is manageable from an implementation and ongoing operational perspective.

1. Eliminate or defer the taxation of specified capital gains

a. *Eliminate or defer the taxation of specified capital gains*

Description – The Conservative Party platform³ contained a proposal to exempt capital gains from tax. The platform proposed that capital gains realized by individuals upon the disposition of real and financial assets would be exempt from taxation if the proceeds were reinvested within a six-month period.

In April 2006, the C.D. Howe Institute published a paper, "Removing the Shackles: Deferring Capital Gains on Asset Rollovers", in which it set out a proposal for a capital gains deferral account (a "CGDA Account"). The principal features of the CGDA Account proposal were as follows:

² The platform proposed as follows:

"Eliminate the capital gains tax for individuals on the sale of assets when the proceeds are reinvested within six months. Canadians who invest, or inherit cottages or family heirlooms, should be able to sell those assets and plough their profits back into the economy without taking a tax hit. It is time government rewarded Canadians who reinvest their money and create jobs."

- The Capital Gains Deferral Account was patterned on the 1984 Indexed Stock Investment Plan (ISIP) account legislation.³
- A specified level of contribution would be allowed to a CGDA Account. The C.D. Howe paper used \$150,000 for discussion purposes. The concept was that the chosen amount would allow the government to target the benefit of the proposal and at the same time limit the cost to the government of the proposal.
- Capital gains realized and retained in the CGDA Account would be exempt from taxation.
- Withdrawals from the CGDA Account would be treated partly as a withdrawal of the initial contribution and partly as a withdrawal of a taxable gain.

Advantages – There are several variables with respect to the CGDA concept that can make this option appealing:

Permitted contribution level – The permitted contribution level could be chosen so as to target the benefit of the proposal and at the same time limit the cost to the government.

Qualified assets – The assets that are qualified to be held in the CGDA Account could be chosen so as to incent investment in particular economic sectors. For example, the definition of qualified assets could include all or any of the following:

- (i) Investments relating to carbon emission reduction and the greening of Canada and/or to knowledge-based industries
- (ii) Securities issued by corporations resident in Canada
- (iii) Securities issued by corporations that have more than half of their assets in Canada (determined on a consolidated basis)
- (iv) Mutual funds that hold a specified proportion of qualified assets.

Reinvestment requirement – The Conservative platform proposal suggested that the exemption benefit would be available provided that the proceeds of a disposition were reinvested within six months of their realization. The CGDA Account could be tailored to require reinvestment within either a shorter or longer time period. Additionally, it could be tailored to provide for different reinvestment requirements for different qualified assets.

Deferral or exemption – The CGDA Account could be designed to provide either a deferral benefit (as proposed by the C.D. Howe Institute) or an exemption benefit (as proposed in the Conservative Party platform). For example, the CGDA Account could provide for two levels of benefit as follows:

- (a) The deferral benefit could be available provided that the reinvestment of proceeds took place within a relatively short period of time after realization (e.g., three months).
- (b) The exemption benefit could be available provided that capital was retained in the CGDA Account for a relatively long period of time (e.g., 10 years).

Feasibility – The IIAC believes that the legislation to implement the CGDA Account would be relatively simple and could be drafted and enacted quickly. A reasonable first draft of the legislation could probably be prepared in less than a

³ An ISIP was required to be established with a financial institution. Capital gains accruing within an ISIP were taxable on a current basis. However, the holder of the ISIP was entitled to a deduction for the portion of the accrued capital gains attributable to inflation (determined by reference to the change in the consumer price index for the applicable period).

month, with the ISIP legislation providing a useful precedent. However, as noted below, administration issues may prove challenging and must first be addressed.

b. Reintroduce the lifetime capital gains exemption

Description – A cumulative lifetime exemption of \$100,000 of capital gains generally was available to individuals beginning in 1985 and ending in 1994 under special phase-out rules. The exemption was originally to be \$500,000 of net capital gains to be phased in over five years. However, it was substantially revised in 1988 when the general exemption was frozen at \$100,000 of net capital gains, with the \$500,000 exemption specified to be available only for qualified small business or farm assets. More recently, the \$500,000 exemption has been expanded to include qualified fishing assets.

Advantages – There are several variables with respect to the lifetime capital gains exemption concept that can make this option appealing:

Subject assets – The lifetime capital gains exemption is currently only applicable upon the disposition of shares of qualified small business corporations and qualified farm property. The exemption could be expanded to apply to other types of assets, for example, securities of entities whose assets are principally in Canada or are in particular sectors, such as knowledge-based industries.

Amount of exemption – The amount of the exemption could be set having regard to various policy objectives. For example, it could be set so that it is tied in to the retirement income system in some manner (e.g., at a limit determined by reference to prescribed retirement expenditures).

Reinvestment requirement – The original lifetime capital gains exemption had no reinvestment requirement. Consideration might be given to requiring that capital be invested for a minimum period to benefit from any expansion in the availability of the lifetime capital gains exemption.

Conclusion: CGDA account or lifetime capital gains exemption – In our view, there is one main conceptual difference between the two concepts. The CGDA Account is eminently suited to stimulate investment in publicly offered financial assets. The lifetime capital gains exemption is more suited to stimulate investment in assets which are only available privately (e.g., small business securities, farming or fishing assets, private real estate). There is another area of difference, that is, implementation and administration of the two alternatives.

There is a considerable concern that administration costs associated with the CGDA may not be recouped from the benefit derived from any net increase in moneys available for investment. IIAC letters sent in the past year have highlighted significant problems when tax measures are introduced without appropriate consideration of implementation and ongoing administration issues, and the related costs. For a measure such as this to be successful, we believe that discussion must take place between all parties affected, including the Canada Revenue Agency as an entity perhaps best placed to manage the program.

2. Eliminate the Significant Tax Inequity Applicable to Capital Gains and Dividends Realized in RRSPs and Pension Funds

Description – Capital gains and dividends are currently taxed inappropriately where they are realized in an RRSP or pension plan. Consider the following two situations:

- a. Benchmark** – Suppose that an individual purchases a stock for \$1,000 and subsequently sells the stock for \$1,100. The \$100 capital gain will be subject to tax of approximately \$23 (i.e., the effective tax rate will be approximately 23 per cent).
- b. Realization in RRSP or pension plan** – Suppose that the same individual contributes \$1,000 to an RRSP or pension plan that purchases and sells the same stock. Suppose that the \$100 capital gain is immediately distributed to the individual. The \$100 capital gain will be subject to tax of \$46 in this circumstance (i.e., the effective tax rate will be 46 per cent). This is clearly an inappropriate result.

Advantages – The main advantage to this proposal is that it will redress a longstanding inequity in the treatment of assets within RRSPs.

Conclusion – Consideration should be given to the establishment of a special tax account in an RRSP or pension plan. The balance in the account at any particular time (the "Preferred Account Balance") would be the amount, if any, by which:

- a. the total amount of capital gains and dividends earned by the RRSP or pension plan subsequent to the time of establishment of the account and prior to the particular time
exceeds
- b. the total amount deemed to be distributed from the account to beneficiaries under the RRSP or pension plan prior to the particular time.

A simple rule would be needed to determine the portion of any distribution (a "Distribution Amount") by an RRSP or pension plan deemed to be made from the account (a "Preferred Distribution Amount"). One simple alternative would be the following:

$$PDA = (PAB / BVTA) * DA$$

Where:

PDA is the Preferred Distribution Amount

PAB is the Preferred Account Balance

BVTA is the book value of the total assets of the RRSP or pension plan

DA is the Distribution Amount.

3. Reduce the Effective Tax Rate Applicable to Capital Gains

Description – The tax rate applicable in the U.S. to long-term capital gains realized by individuals upon the disposition of securities is 15 per cent. The same tax rate applies to dividends received on such shares. Canada could consider adopting a similar tax rate. The reduced tax rate could be specified to be applicable to all capital gains or, alternatively, only capital gains realized upon the disposition of assets specified as qualified assets (e.g., equity securities).

Advantages – The principal advantages of this proposal are:

- It would stimulate Canadians to invest in the assets specified as qualified assets under the proposal (e.g., equity securities, knowledge-based industry sectors).
- It would remove the disincentive for taxable individuals to dispose of underperforming securities simply to avoid capital gains tax and encourage them to

reinvest the proceeds in better-performing securities. This proposal would promote capital markets efficiency and greater retirement savings.

Conclusion – The principal drawback of this proposal is the preferred treatment of corporate source business income (income earned by, and taxed at the level of, a corporation and then distributed to individual shareholders) relative to employment income, unincorporated source business income (income earned directly by an individual from personally carrying on a business) and interest income.

- a. Preferred treatment relative to employment and unincorporated source business income** – Where employment or unincorporated source business income is earned directly by a top marginal tax rate individual⁴, the applicable income tax rate is approximately 46 per cent. Where an individual receives corporate source business income, the effective income tax rate applicable to such income is also approximately 46 per cent (i.e., the aggregate of the tax paid by the corporation and the individual). Thus, if either the corporate tax rate or the dividend tax rate were to be reduced, the effective tax rate on corporate source business income would be less than 46 per cent. Thus, employment income and unincorporated source business income would be discriminated against.
- b. Preferred Treatment Relative to Interest Income** – The tax rate applicable to interest income is generally the same as that applicable to employment income. Thus, a reduction in the tax rate applicable to unincorporated source business income would mean that it would be taxed at a lower tax rate than interest income. This might result in structuring investments as equity rather than debt solely for tax reasons⁵.

For several decades (i.e., until the recent reductions in corporate tax rates and elimination of the double taxation of large corporate dividends), corporate source business income was generally subject to a higher effective rate of tax than employment income or unincorporated source business income. The reduction in the taxation of corporate source business income over the last several years means that it is now taxed at approximately the same rate as employment income, unincorporated source business income and interest income. It is questionable whether it would be acceptable from a tax policy perspective to have corporate source business income now become subject to a lower rate of effective tax than employment or unincorporated source business income. This probably means that further reductions in the taxation of corporate source business income will only be possible if there is also a reduction in the taxation of income from these other sources. IIAC supports an across-the-board reduction in tax rates over time to ensure that the level of tax rates in Canada is in line with international levels.

⁴ Wherever an individual is referred to in this submission, it is assumed, for simplicity of exposition, that the individual is an Ontario resident subject to income tax at the top marginal tax rate.

⁵ In other words, there would be additional pressure on the term preferred share, short-term preferred share and taxable preferred share rules.

TABLE 1: SUMMARY COMPARISON MATRIX

	Alternative 1	Alternative 2	Alternative 3
	Defer or eliminate taxation of specified capital gains	Eliminate tax inequity applicable to capital gains and dividends realized in RRSPs and pension funds	Reduce effective tax rate on capital gains
Ongoing Basis			
1. Ability to generally stimulate capital investment	High	High	High
2. Ability to stimulate investment in specific assets	High	Moderate	Moderate
3. Consistency with current tax policy	High	Moderate	Low
4. Cost impact to government	Variable	Variable	Variable
5. Difficulty of compliance by taxpayers	<ul style="list-style-type: none"> • To be discussed • Moderate for modified lifetime capital gains exemption 	Low	Low
6. Difficulty of administration by CRA	<ul style="list-style-type: none"> • To be discussed • Moderate for modified lifetime capital gains exemption 	Moderate	Low
One-time Basis			
7. Complexity of legislation	Moderate	Moderate	Low
8. Time required to implement legislation	Moderate	Moderate	Minimal
9. Difficulty/cost of compliance by tax reporters	To be discussed	To be discussed	Low