



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

RESTORING CONFIDENCE
IIAC Budget Recommendations

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The Current Economic Climate

The stresses in U.S. financial markets that surfaced in 2007 have since materialized into a widespread global crisis that have shaken all major economies and markets. Global equity markets tumbled during the course of 2008 with some indices down over 40-50% year-to-date. Credit markets have not fared any better as liquidity concerns intensified, credit spreads continued to widen at an unprecedented pace, while the cost of financings increased. High risk issues were impacted the most with larger spreads. However, all corporate borrowers were affected as primary debt markets were unresponsive to issuance from even more established corporations.

The current environment has brought about a massive deleveraging in the marketplace, a flight to increased savings in low risk assets and increased pessimism about the economic outlook. As a result, business and consumer spending has witnessed a sharp pull-back.

The Canadian economy has weakened dramatically over the last several months as a result of spillover effects of the global financial crisis, falling commodity prices, and added strains on Canada's manufacturing sector. Despite a slight growth in GDP of 0.3% witnessed in the third quarter, Canada has now entered into a recession, as unemployment rates continue to rise with November reporting its largest loss in jobs since 1982. With lower consumer spending, and slower income growth, Canadian housing prices have also decreased due to excess supply and lower demand, especially in inflated markets such as Alberta. There has also been an increase in household debt, leaving Canadians more susceptible to a downturn in the economy and increasing the likelihood of defaulting on mortgages.

Government and Bank of Canada Response

In response to the current economic crisis, the IIAC commends the federal government and Bank of Canada (BOC) for taking decisive action to stabilize the domestic financial system including:

1. **Asset Purchases** – purchase, by the BOC via auctions, of up to \$75 billion in insured mortgage pools through the Canada Mortgage and Housing Corporation.
2. **Liquidity Injections** – the BOC increased the size of term PRAs to over \$30 billion, and increased frequency to weekly. Also introduced new facilities such as a money market term PRA that can be accessed by eligible money market participants on an indirect basis.
3. **Collateral Requirements** – the BOC broadened the list of securities eligible for term PRAs and accepted Asset Backed Commercial Paper (ABCP) from affiliated dealers on a temporary basis.
4. **Guarantees on Bank Liabilities** –introduced by the federal government, the Canadian Lenders Assurance Facility insures new issues of certain senior unsecured wholesale debt issued by federally regulated deposit-taking institutions.

The federal government should also be recognized for helping bring an orderly resolution to the ABCP crisis.

Additionally, the government has taken positive measures to promote longer-term economic growth and productivity. These include planned reductions in federal corporate tax rates, and steps to support further savings and investment such as the introduction of the Tax-Free

Savings Account and Registered Disability Savings Plan, as well as recent amendments to the 2008 withdrawal requirements for registered retirement income funds.

The Canadian government is to be commended for adopting these initiatives which have bolstered Canadian capital markets and the savings and investment process. However, additional measures are required to restore confidence to our marketplace and ignite capital formation and investment – the foundation for rebuilding a healthy and productive economy.

The Policy Prescription

Policy measures must be developed to restore investor, business and consumer confidence. Targeted tax incentives can further strengthen the savings-investment process to promote the flow of capital to productive investment, particularly for small businesses dependent on externally sourced capital. Selective tax relief can encourage risk-taking by investors whose appetite for risk has been devastated by the collapse in financial markets, and, can lower the cost of capital to encourage productive investment by business.

The IIAC recommends that the government implement the following:

1. Lower Taxes on Capital Gains

Canada's current framework for capital gains tax is a major impediment to the supply of risk capital for productive investment, particularly for small and medium sized enterprises and start-up businesses. The current high rate of tax on capital gains discourages the flow of scarce investment capital by deterring investment in high risk projects and is an impediment to the transfer of capital to more productive investment. **A reduction in capital gains tax, the IIAC believes, will result in greater business and job creation, enhanced productivity and economic activity and overall wealth creation and prosperity for Canadians.**

Specifically, the Association recommends reducing or eliminating the current 50% inclusion rate for capital gains. The improved after-tax return will compensate for risk and encourage investors to once again participate in equity markets. This will make it easier for corporations to obtain the financings they need to rebuild capital, strengthen balance sheets and fund investment.

The Department of Finance's 2007 *Annual Tax Expenditures and Evaluations Report*, shows that the cost to the federal government stemming from the current partial inclusion of capital gains is approximately \$10 billion.¹ This represents just 4% of total budgetary revenues. Reducing or eliminating capital gains taxes may not have a meaningful negative impact on government revenues and may actually increase overall tax revenues stemming from further business and job creation, increased capital spending, corporate income and profits, and investor wealth.

2. Proceed with Planned Reductions to Corporate Taxes

Lower capital gains tax rates will effectively complement the planned steady reduction in federal corporate tax rates to 15% by 2012 to improve after tax cash flows and earnings for large and small Canadian businesses, and increase the prospects for raising new equity capital. **The federal government should remain committed to steadily reducing corporate tax rates.**

¹ Tax Expenditures and Evaluations 2007 (<http://www.fin.gc.ca/taxexp/2007/taxexp2007e.pdf>) Table 1 shows 2007 projections of \$5.06 billion under personal income tax expenditures for partial inclusion of capital gains and Table 2 shows projections of \$5.065 billion under corporate income tax expenditures related to partial inclusion of capital gains.

3. Additional Tax Relief for Small Canadian Public Corporations

The current policy framework provides a lifetime capital gains exemption for individuals of up to \$750,000 for gains from the disposition of qualified small business corporation shares. Additionally, small business investors benefit from the capital gains rollover provision which enables individuals to defer tax on capital gains from small businesses as long as the proceeds are reinvested in another eligible small business. These are important provisions that promote innovation and growth by making it easier for small businesses to access desperately needed risk capital.

However, because these provisions are associated with asset thresholds, they punish small businesses that grow beyond the thresholds. As a consequence, this framework distorts the decisions of shareholder managers who choose to remain below the asset threshold to maintain the provision's benefits. Consideration should be given to increasing or eliminating the asset threshold and to **expand the definition of qualified small businesses to include small publicly listed companies trading on a recognized Canadian marketplace.**

Another measure that could improve financing prospects and provide further tax relief for small companies would be **extending the flow-through share concept to non-resource companies.** Flow-through shares have proven an effective incentive for mining and energy companies and can be equally as potent in other industries. This measure would allow the depreciation expenses, analogous to depletion allowances for resource companies, to flow from businesses to individual investors, improving investor after tax returns while attracting capital for issuers.

4. Needed Reforms in Capital Markets and the Domestic Financial Sector

The recent financial crisis has raised the profile of regulatory reform and emphasized the need for structural changes to the regulatory framework to mitigate systemic risk in the financial sector, and deliver more efficient regulation, as well as bring a national market perspective to securities regulation. The recent crisis also illustrates the need for Canadian securities regulators to adopt a more national and global perspective with respect to capital markets to allow for the monitoring of new financial instruments and changing trading and liquidity patterns in the marketplace which would better safeguard investors and promote well-functioning markets.

The IIAC supports the recommendations put forth by the Expert Panel on Securities Regulation including the establishment of a Canadian Securities Commission to administer a single securities act for Canada. **A common securities regulator provides the optimal structure to provide a national perspective on the markets, achieve regulatory efficiencies, facilitate needed and ongoing consultations with domestic and foreign regulators and develop and implement regulatory policy expeditiously.**

5. Additional Reforms to RRSPs and RRIFs

The federal government recently extended the age eligibility for conversion of RRSPs to RRIFs from 69 to 71 – recognizing that Canadians live longer and need additional time to build retirement savings. The extension of the RRSP conversion age also provides some compensation for the government's comparatively low RRSP annual contribution limits. **The recent financial crisis and stock valuation collapse make a strong case for extending the RRSP conversion age from 71 to 75 to provide additional time for investors to rebuild their retirement portfolios.**

Once Canadians convert their RRSPs to RRIFs, they are required to make defined minimum withdrawals, calculated based on the market value of the RRIF and the age of the plan holder. **Canadians should be given greater flexibility to determine their RRIF withdrawal amounts.** Retirees should be given discretion to withdraw whatever amounts they want from their RRIF accounts –without triggering OAS and GIS claw backs and to provide against larger later-in-life expenses.

The IIAC is pleased the government responded to concerns about required minimum RRIF withdrawals in the November Economic Statement by proposing to lower the mandated minimum withdrawal by 25% in 2008. However, the government should do more. **The minimum RRIF withdrawal requirement should be eliminated altogether; at the very least, a moratorium should be placed on mandatory RRIF withdrawals for the next two years to allow the recovery of portfolio value.**

6. Promote an International Tax Advantage

The IIAC supports several of the recommendations put forth by the Advisory Panel on Canada's System of International Taxation in its December 2008 report. Specifically, Ottawa should **repeal restrictions Canadian multinationals face in deducting interest from foreign-related loans** because it impairs their ability to compete globally.

Conclusion

These recommended measures would not be a significant drain on government revenues. Indeed, it is likely that some measures, such as lowering capital gains taxes, will stimulate the shift of capital to more productive enterprise and result in higher tax revenues. The measures outlined above will also have the desired effect of rebuilding investor and business sentiment which is critical in restoring risk investment in the economy, and contributing to more robust capital markets and improved growth and employment. Tax policy, therefore, can play an important role in reversing the decline in economic activity and setting the economy on the path to recovery.