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

IIAC Recommendations to the House of Commons Standing Committee on Finance August 2010

Executive Summary

In its 2011 Budget, the Government should continue with its plan to reduce the deficit through a measured course of expenditure reduction. However, it will be important to combine these measures with targeted, specific supply-side incentives to grow the economy and promote investment in Canadian business.

The Investment Industry Association of Canada (IIAC) recommends to the House of Commons Standing Committee on Finance the following:

1. **Lower the effective tax rate on capital gains for common equity shares by reducing the inclusion rate.** Lower capital gains taxes will encourage emerging Canadian businesses to list and offer shares on a Canadian exchange, and provide a liquid market for their shares, which in turn will spur further capital formation by making the financing process in Canada easier for business.

2. **Increase the contribution/deposit maximum limits for Registered Retirement Savings Plans (RRSPs) and Tax-Free Savings Accounts (TFSAs).** Increased limits for RRSP contributions and TFSA deposits will give investors flexibility to recoup market losses in their portfolios and allow them to build savings more quickly.

3. **Increase flexibility for retired Canadians to manage their RRIFs.** Older Canadians should receive the benefit of maximum flexibility to manage their portfolios efficiently, by removing the minimum annual withdrawal limits from RRIFs.

Building Confidence in the Canadian Economy

At the G-20 Summit held in Toronto, Canada agreed upon a framework to strengthen financial systems against risk and “create strong, sustainable and balanced global growth”.[i] Along with the other G-20 nations, Canada has committed to a fiscal plan that will, at a minimum, halve its deficit by 2013 and stabilize or reduce government debt-to-GDP ratios by 2016.

Economic growth has faltered after strongly rebounding in 2009, and continued confidence in the marketplace is uncertain. The Bank of Canada’s most recent estimates show that the country’s economy grew by only 3% in the second quarter of 2010, less than the 3.8% forecast and much slower than the 6.1% pace of growth in the first quarter of the year.[ii] The Conference Board of Canada’s business confidence index (measuring business investment spending intentions) fell in the final quarter of 2009, and business investment remains a weak point in the

Canadian economy.[iii] Capital expenditures (including machinery and equipment) decreased by 33% in the mining and oil and gas sector, and by 11% across all sectors in Canada in 2009.[iv] Markets have experienced volatility caused by the worldwide impact of Europe's debt crisis, and investor confidence in the Canadian capital markets has not been fully restored. New equity financing on the TSX Venture Exchange decreased slightly from 2008 to 2009, and remains at 50% of financing levels in 2007.[v]

The focus of fiscal policy in the Government's 2011 Budget should be expenditure restraint, committed to the plan charted in last year's Budget, to bring the deficit into near-balance by 2014. Sound fiscal management through measured expenditure reduction will strengthen public finances and increase business confidence in Canada.

Despite the recent slowing of the pace of recovery, the Canadian economy has withstood the financial crisis better than most jurisdictions. Accordingly, fiscal policy can be geared to increased restraint and less reliance on stimulus measures, without jeopardizing the fragile recovery process, if the restraint measures are accompanied by targeted and specific incentives to stimulate capital spending. The basic building blocks are in place to build business confidence, increase business spending and investment, and grow the Canadian economy:

- The stimulus has been successful in mitigating the economic slowdown and bolstering confidence, as indicated recently by an improved outlook among senior management for business prospects in Canada.[vi]
- Canada has fostered a positive business climate by creating an internationally competitive corporate tax regime, and through its well-managed public finances (both federally and provincially) that provide confidence in the continued competitiveness of tax rates.
- Expanding opportunities for emerging businesses and markets exist in Canada, particularly in commodities and resources.
- The financial sector in Canada has weathered the recent economic challenges more successfully than in other countries; business credit conditions in Canada have eased over the past year, and access to business credit is growing.[vii]

A catalyst to bolster business and investor confidence, accelerate business spending and promote long-term economic growth is urgently needed to complement a steady course of fiscal restraint. The time is right to implement targeted, specific tax incentives to achieve these goals.

Encouraging Investment in Canadian Businesses

Canada's current framework for capital gains tax is a major impediment to the supply of risk capital for productive investment in Canadian businesses. The current high tax rate on capital gains discourages the flow of scarce investment capital by deterring investment in riskier, innovative projects.[viii] Despite the fact that Canadians have introduced more risk into their portfolios since 2008, studies show that Canadian households are holding more cash in their portfolios – a "sizeable cache of funds" that could be used to invest in Canadian businesses and grow the Canadian economy. [ix]

Recommendation One: The IIAC recommends lowering the effective tax rate on capital gains on shares of publicly listed companies by reducing the current 50% inclusion rate.

Canadian businesses, especially small and mid-sized companies, are dependent upon access to equity capital. Currently, tax incentives in Canada benefit private companies. These incentives include lower corporate tax rates, access to research and development (R&D) tax credits and the $750,000 lifetime capital gains tax exemption. While these incentives are important and necessary, they encourage companies to stay private, and do not improve access to capital for small Canadian public companies. A lower capital gains tax on common shares issued by public companies will rectify this imbalance, encourage small private companies to become public, and assist public companies to access equity financing. Making the financing process in Canada easier for businesses and investors will spur further capital formation, growth in business and job creation, an increase in economic activity and overall wealth creation and prosperity for Canadians.

Furthermore, research suggests that reducing or eliminating capital gains taxes on common equity shares may likely not have a meaningful impact on government coffers and may actually increase overall tax revenues stemming from further business and job creation, increased capital spending, corporate income and profits, and investor wealth. The Department of Finance's 2009 *Annual Tax Expenditures and Evaluations Report,* shows that the total cost to the federal government stemming from the partial inclusion of capital gains in personal and business income is approximately $6.5 billion.[x] This represents just 2.5% of total budgetary revenues. The estimated cost of lowering the inclusion rate by half (from 50% to 25%) on common equity shares would be significantly less.

Costs could be further reduced if the government narrows the types of shares that are eligible for capital gains tax reductions. For example, capital gains inclusion might be lowered only for publicly traded shares of smaller companies (i.e. those with net tangible assets under $10 million or some other amount to be determined), or could be limited to newly issued treasury shares. However, a reduction broadly applied to all common equity shares would deliver the greatest positive impact to the Canadian economy and would be the easiest to administer.

Encouraging Canadians to Invest in the Future

In a financial environment of low interest rates, Canadians seeking growth in their retirement portfolios should be encouraged to seek better returns on their investment and to increase diversification. Lower capital gains taxes on the shares of Canadian public companies will provide an additional incentive for Canadians to find opportunities that will ultimately improve their income upon retirement. However, it will be critical for Canadians investing in these opportunities to have access to resources to improve their financial literacy and skilled financial advice from registered professionals.

To this end, the IIAC commends the efforts of Canada's Task Force on Financial Literacy and supports its mandate to provide recommendations for a national strategy. It will be vitally important for the federal government to implement these recommendations, especially those that identify and coordinate the many financial and investment literacy programs that already exist in Canada. Promoting linkages between financial entities and existing successful programs is an important first step towards a more financially literate population in Canada. The securities industry can play an important role in improving financial literacy, drawing upon useful materials that have already been developed by professionals across the country.

Increasing Tax-Assisted Savings

Lower taxes on capital gains earned on shares of Canadian public companies will provide an incentive for Canadians to invest and provide a necessary boost to the Canadian economy. A complementary increase in tax-assisted savings plan limits will both accommodate increased demand for investment and provide another incentive for Canadians to increase their private savings for retirement.

Recommendation Two: The IIAC recommends increasing the contribution/deposit maximum limits for Registered Retirement Savings Plans (RRSPs) and Tax-Free Savings Accounts (TFSAs).

Research has shown that the incentive of tax-assisted savings plans has the effect of increasing net private savings, and results in a faster accumulation of wealth for retirement.[xi] Prior to the 2010 Budget, the C.D. Howe Institute recommended an increase to RRSP limits (to 34% of earned income from 18%) with a proportional change in the maximum dollar amount to $42,000 (from $22,000), to place Canadians who do not participate in defined benefit pension plans on a more equal footing with their public sector counterparts, and provide Canadians with a greater ability to achieve their lifetime objectives for retirement income (i.e. an ability to increase savings to compensate for losses).[xii] Such a bold increase would provide a much-needed incentive for Canadians to increase their private retirement savings; however, even a more modest or gradual increase in limits would enable Canadians to bolster their savings, at a lower cost to government.

TFSAs have also proven to be a very popular savings option for many Canadians, and recent studies have predicted that TFSAs may also be more advantageous for middle income Canadians, achieving a "higher level of after-tax retirement income with the same level of saving as for registered pension plans or RRSPs".[xiii]

An alternative of providing "retroactive" TFSA deposits for older Canadians (i.e. allowing Canadians over the age of 55 to make higher deposits into their TFSAs to account for the fact that they have not been able to contribute since the age of 18) could compensate for previous pension portfolio losses and supplement current RRSP contributions. It has been estimated that the retroactive application of TFSAs could provide older Canadians who are close to retirement with approximately $160,000 in additional tax-free retirement investment room. Additionally, increased TFSA limits or retroactive TFSA contributions would be more cost-effective for government than increases to RRSP limits, as contributions would be made from the investor's after-tax income.

Flexibility to Manage Savings

Once Canadians convert their RRSPs into Registered Retirement Income Funds (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, even if they have no immediate need for the money. Canadian retirees should be given greater flexibility to determine their RRIF withdrawal amount – to avoid triggering OAS and GIS clawbacks and to provide against larger later-in-life expenses.

Recommendation Three: The IIAC recommends increasing flexibility for retired Canadians to manage their RRIFs.

In 2009, the federal government reduced the minimum withdrawal to prevent Canadians from unnecessarily cashing out their investments at the bottom of the market cycle. Older Canadians should have the discretion to choose the timing of withdrawal from their RRIFs and not be subjected to defined minimums.

The reduction of the required withdrawal amount was a step in the right direction; however, to ensure that older Canadians receive the benefit of maximum flexibility to manage their portfolios efficiently, we recommend the removal of minimum annual withdrawal limits from RRIFs.

Conclusion

The IIAC appreciates the opportunity to offer our recommendations, and looks forward to elaborating upon these recommendations throughout the pre-Budget consultation process.

Ian C.W. Russell
President
Investment Industry Association of Canada
11 King St West, Suite 1600
Toronto ON
M5H 4C7

August 13, 2010

Notes

[i] *The G-20 Toronto Summit Declaration*, June 26-27, 2010.
[ii] *Bank of Canada sees slower growth*, (Globe and Mail, July 22, 2010). Quoting statistics from *Monetary Policy Report*, (Bank of Canada, July 2010).
[iii] *Index of Business Confidence: Winter 2010*, Conference Board of Canada.
[iv] *Capital expenditures by sector, by province and territory*, Statistics Canada.
[v] *TSX and TSX Venture Mining Sector Overview, 2010; TSX Venture Exchange Statistics – December 2009*. TMX Group. The TSX Venture Exchange lists shares of companies with net tangible assets over $1 million (Tier 1) and $500,000 (Tier 2) and pre-tax earnings of $100,000 (Tier 1) and $50,000 (Tier 2).
[vi] *Business Outlook Survey*, (Bank of Canada, July 2010).
[vii] *Monetary Policy Report*, (Bank of Canada, July 2010).
[viii] Empirical evidence has "suggested a direct causality between lower capital gains taxation and more venture capital". Cumming, Douglas. *Financing Entrepreneurs: Better Canadian Policy for Venture Capital*, (C.D. Howe Institute, April 2007).
[ix] *Canadian investors taking on more risk: study*, (Investment Executive, July 18, 2010). Quoting statistics from *Wealthscapes 2010*, Environics Analytics.
[x] *Tax Expenditures and Evaluations 2009*, Department of Finance. Table 1 shows 2009 projections of $3.245 billion under personal income tax expenditures for partial inclusion of capital gains and Table 2 shows projections of $3.21 billion under corporate income tax expenditures related to partial inclusion of capital gains.
[xi] Mintz, J. *Summary Report on Retirement Income Adequacy Research* (Research Working Group on Retirement Income Adequacy of Federal-Provincial-Territorial Ministers of Finance, December 18, 2009).
[xii] Robson, W. *Cutting through pension complexity: Easy steps forward for the 2010 Federal Budget*, (C.D. Howe Institute, February 2010).
[xiii] Laurin, A. and Poschmann, F. *Saver's Choice: Comparing the Marginal Effective Tax Burdens on RRSPs and TFSAs*, (C.D. Howe Institute, January 27, 2010).