

## THE STANDING SENATE COMMITTEE ON NATIONAL FINANCE

## EVIDENCE

OTTAWA, Tuesday, November 27, 2012

The Standing Senate Committee on National Finance met this day at 9:30 a.m. to examine the subject matter of all of Bill C-45, A second Act to implement certain provisions of the budget tabled in Parliament on March 29, 2012, and other measures introduced in the House of Commons on October 18, 2012 (topics: Part 1/amendments to foreign affiliates rule; and Part 1/amendments to the (SR & ED) investment tax credit).

**Senator Joseph A. Day** (*Chair*) in the chair.

**The Chair:** I call this meeting of the Standing Senate Committee on National Finance to order. This is our eighth meeting on the subject matter of Bill C-45, A second Act to implement certain provisions of the budget tabled in Parliament on March 29, 2012 and other measures that are also included in Bill C-45.

(French follows -- The Chair cont'g -- Ce matin, nous consacrerons...)

(après anglais)

Ce matin, nous consacrerons la première session de l'étude de l'article 49, à la partie 1, page 93, du projet de loi concernant les modifications apportées à la Loi de l'impôt sur le revenu et à la réglementation qui en découle, plus particulièrement, les opérations de transfert de sociétés étrangères.

(Mr. Chair : We are pleased to welcome Pierre Gratton...)

(anglais suit)

(Following French -- The Chair cont'g -- transfert de sociétés étrangères.)

We are pleased to welcome Pierre Gratton, President and Chief Executive Officer of the Mining Association of Canada; Ross Gallinger, Executive Director of the Prospectors and Developers Association of Canada; Steve Suarez, Taxation Lawyer, with the law firm of Borden Ladner Gervais; and Jocelin Paradis, Vice President Taxation Canada, Rio Tinto.

We are pleased that you are here to help make what appears to be a complicated set of rules more understandable so that we can decide what to do with those proposals. I should point out we have a submission that will be the basis of Mr. Gallinger's submission to us today, and we have also received a letter from the Toronto Stock Exchange and the Venture Exchange that relates to this issue. They have not been able to arrange for their appearance here, but their letter to us will be put in as evidence as well.

With those introductory remarks, Mr. Gallinger, if you would like to get us started on this particular section we would be pleased to hear from you.

**Ross Gallinger, Executive Director, Prospectors and Developers Association of Canada:** I am Ross Gallinger, Executive Director of the Prospectors and Developers Association of Canada, who represent over 10,000 individuals and corporate members, many of whom will be directly impacted by the proposed changes. I am joined by my colleague Pierre Gratton, President and CEO of the Mining Association of Canada. MAC is the national voice of Canada's mining and mineral processing industry and represents more than 30 members engaged in diverse mining and mining-related activities. We are also joined today by tax specialist Steve Suarez and Jocelin Paradis.

Thank you for the opportunity to appear today and share perspective on this important piece of legislation. The focus of my remarks centres on the foreign affiliate dumping measures currently before this committee for consideration in Bill C-45.

The fundamental policy objectives of the foreign affiliate dumping measures were described in Budget 2012 as being to curtail transactions that:

. . . reduce the Canadian tax base without providing any significant economic benefit to Canadians.

Let me begin by saying unequivocally that PDAC and MAC fully endorse these policy objectives. However, our members are very concerned that the current drafting of these measures exposes the Canadian economy to the risk of serious adverse consequences. In particular, this includes harmful impact on the junior exploration and mining sector and Canadian capital markets, as well as other elements of the mining ecosystem that provide a broad range of significant economic benefits to Canadians, on Main street and on Bay and Howe Streets, and in numerous and often remote communities across the country.

It is our respectful submission that these measures can and must be refined in a manner that would exclude their application to bona fide Canadian public corporations that meet certain conditions that would be designed to ensure that they do not dilute their effectiveness in achieving their fundamental policy objectives, while at the same time, also as noted in Budget 2012, ensuring that bona fide business transactions are not affected. We have outlined our suggestions in this regard in our submission to the Minister of Finance, a copy of which has been provided to members of the committee.

The main focus of our concerns relates to the manner in which these measures could impede the normal growth of Canadian public corporations and their pursuit of bona fide business transactions, to the general detriment of the Canadian economy.

Under the foreign affiliate dumping measures as currently drafted, bona fide expansion of an existing business line or diversification into a new business line remains unaffected if it occurs within Canada. In contrast, bona fide diversification outside Canada would be penalized, even where no Canadian tax advantage is being sought. In addition, even the bona fide expansion of an existing business line would be penalized if the existing business line is located outside Canada.

The penalty would come in the form of the imposition of a special tax equal to between 5 per cent and 25 per cent of the cost of the investment. For example, in a conceivable scenario, an investment of \$1 billion

would give rise to an immediate tax cost of \$250 million, and this would apply even before a single penny of profit is made by the corporation. It is also conceivable in certain scenarios that these measures could give rise to multiple impositions of this type of penalty, as companies dispose of unattractive ventures in order to reinvest in more promising ventures.

We do endorse the minister's bold action to protect the Canadian tax base from abusive transactions.

However, we do not believe that it is appropriate for these measures to categorically presume that the expansion of an existing foreign business line or diversification into a foreign business line is abusive. Public corporations generally make bona fide investments for bona fide business reasons and do not generally make what might be referred to as "investments of convenience."

Under Canadian law, public corporations are controlled by a board of directors bound by fiduciary duties to all their shareholders. Despite the ability to elect and remove the directors from the public corporation, the controlling shareholder cannot unilaterally direct the actions of a public corporation. Public corporation directors have full decision-making authority over the company's foreign subsidiaries and, due to their fiduciary duties, must act in the best interests of the company and all of its shareholders.

Canada's mining industry is particularly affected by the foreign affiliate dumping proposals. In a majority of cases, investors use Canadian corporations as a vehicle for investing in mining projects outside of Canada, not because of any perceived Canadian tax benefit but rather because they are attracted to the infrastructure located in Canada that exists to support the mining industry: the bankers, lawyers, accountants, geologists, the TSX and the TSX-V, and Canadian corporate and securities laws applicable to corporations created and listed here. These investors currently choose to come to Canada, but they have alternatives and cannot be taken for granted.

To understand what is at stake, one must understand how the current state of affairs will be affected by these measures. Currently, Canada is home to the largest concentration of junior companies in the world, hosting 70 per cent. In 2011, 152 new junior companies were listed on the TSX Venture Exchange, one company every two and a half days. These new companies accounted for approximately 12 per cent of the exchange's total 1,275 listings for the year.

In 2012, Canadian-based companies accounted for the largest share, 37 per cent or \$7.5 billion, of global exploration spending. Eight hundred of these companies are active exploring outside Canada in over 100 countries, resulting in Canadian firms accounting for the largest share of exploration spending in the United States, Central and South America, Europe and Africa.

TSX-listed mining companies operate a total of approximately 3,500 projects, of which 63 per cent are located outside of Canada. An additional 2,408 projects outside of Canada are owned by TSX Venture-listed companies. Investors from Canada and around the world injected a total of \$7.25 billion in TSX and TSX Venture mining companies operating projects outside of Canada compared to \$2.16 billion raised for mining companies with projects located in Canada.

The robust picture painted by the above statistics cannot be taken for granted and will erode under the FAD measures as proposed. By constricting the ability of Canadian mining companies to make and finance bona fide foreign investments, these measures reduce their ability to compete internationally. The result will be a deterrent for new mining companies to incorporate in Canada, an incentive for those already here to leave for a more favourable tax jurisdiction. As the junior sector erodes, the supporting financial, legal and other areas of expertise that surrounds it, namely our competitive advantage, will erode with it.

International competition is intense for the high-value financing and management activities arising from mining projects in Africa, Latin America and Asia, particularly from the United Kingdom, which recently revised its tax regime to make it very attractive for foreign investors to use U.K. companies for foreign projects, and its AIM market.

These competitors will be very quick to identify and alert mining decision makers to changes in Canadian tax law which makes Canada less tax-neutral and therefore prohibitive on a base of operations for foreign projects. This makes it very important to ensure that anti-avoidance provisions, such as the foreign affiliate dumping proposals, are carefully targeted so as not to impose prohibitive tax costs or create needless complexity and expense for the junior mining companies that have neither the funds nor the management tolerance to plan their way around rules that ought not to apply to them in tax policy terms.

As indicated above, new mining companies are created almost daily, and it is important for Canada not to give those deciding where to establish their operations any reason to look elsewhere. Although it is not too late to refine these measures, I would be remiss not to advise the committee that the proposed measures have already begun to have an impact. PDAC and MAC have been alerted that the tax experts are already advising their junior mining clients not to incorporate in Canada in anticipation of the proposed FAD measures.

Specifically, we submit that it would be appropriate to exclude all Canadian public corporations from the application of the proposed FAD measures. Short of that, it would be appropriate at a minimum to exclude Canadian public corporations that meet conditions that are designed to protect the Canadian tax base. Such an exclusion would ensure that Canada remains an attractive location for junior mining companies that may require significant additional investment in the future and enhance the value of existing Canadian-controlled companies that are currently seeking additional investors, whether they be Canadian or foreign.

Members of the committee, the concerns we are sharing with you are widely held. In addition to us, concerns have been expressed by every major accounting and corporate law firm in the country with mining clients. The TSE has made identical points to Finance Canada on three occasions. Much is at risk. We are hopeful you will give our remarks serious consideration.

Thank you for your time, and we would be pleased to take your questions.

**The Chair:** Mr. Gallinger, thank you very much. Could you describe a typical situation to which these rules would apply, that they have not been applying to up until now, to a publicly traded company in Canada with subsidiaries? How does this all work in practice?

**Mr. Gallinger:** Could I pose that response to Mr. Suarez? He might be able to walk you through the tax implications and how that works in much simpler detail than I can.

**The Chair:** Thank you.

**Steve Suarez, Taxation Lawyer, Borden, Ladner, Gervais:** Learned members of the committee, thank you for letting me appear today before you. I have a couple of preliminary remarks. First, I am proud to appear alongside MAC and PDAC. The work they do is very important for this country. Second, I am not being compensated in any way today for my appearance and time or expenses. I am here because mining helps puts a roof over my family's head. Mining helps put dinner on the table for my family. This is important.

**The Chair:** Thank you for being here.

**Mr. Suarez:** Yes, sir. In terms of the fact patterns to which these rules would apply today that did not apply previously, I wonder if I could start by laying out the fact pattern that caused the government to act in the first place. It is important to understand what mischief caused the government to act. If we see that base case and compare that to the range of situations in which these rules will apply, I respectfully submit that you will see quite a big gap between the two.

Foreign affiliate dumping or debt dumping can best be explained as follows: Under Canada's rules for taxing distributions from foreign affiliates, basically if a Canadian company, let us call it CanCo., a company resident in Canada, has a 10 per cent or more direct or indirect equity interest in a foreign company, a foreign subsidiary, I will call that Foreign Co., the Canadian rules work to say that if Foreign Co. is resident and carrying on business in a country with which Canada has a tax treaty or a tax information exchange agreement, then dividends from Foreign Co. up to CanCo. will not be taxed in Canada. There is basically an outright exemption for not all but most dividends from Foreign Co. to CanCo. in that situation. That is number one. That is a key tax rule to have in the back of your mind.

Broadly speaking, if CanCo. borrows money or incurs debt to make an investment in Foreign Co., the interest on that debt will be deductible to CanCo. in computing its income.

Therefore, we have a combination of two rules. One is a relatively good interest deductibility regime in Canada; and number two, a fairly robust exemption and credit system whereby dividends from Foreign Co. up to CanCo. generally are not taxed in Canada. The basic principle is that if Foreign Co. is carrying on business in a tax treaty jurisdiction, Canada assumes that it has borne a sufficient level of tax in that Foreign Co.'s home country that we do not need to tax it in Canada. It has already been taxed once in the foreign country's jurisdiction. That is the principle behind exempting dividends from foreign companies to CanCo.

Here is what was happening, and this is what caused the government to act. Let us say CanCo. has a foreign parent company. I will call that "Parent." The picture is Parent, on top of CanCo., on top of Foreign Co. There were instances where Parent would say to CanCo., "I want you to borrow \$100 million from someone else in our group, in our multinational group, and I want you to use that money to buy the shares of

some other foreign affiliate in the group." Let us say it is the Brazilian member of the group. CanCo. borrows \$100 million from the parent and buys the shares of Brazilian Co., which will thereby become a foreign affiliate of CanCo.

What happens, or what could happen, is that now CanCo. will have interest expense deductions on that \$100 million that potentially reduce its Canadian source income, its income from whatever operations it has in Canada. The shares of Brazilian Co., which are now underneath CanCo. and which are supporting the interest expense deduction -- that was the use of the borrowed money; the borrowed money was used to buy shares of Brazilian Co. -- basically that will be a deductible interest expense to CanCo. However, as we discussed at the outset, dividends paid from Brazilian Co. up to Canada will probably not bear tax in Canada.

What the government was upset about was foreign multinationals dumping Brazilian Co. under Canada and incurring a whole bunch of interest expense deductions in doing it. That was debt dumping, explained in a nutshell. It was causing your Canadian subsidiary to borrow a bunch of money from within the group to buy the shares of a foreign affiliate, dividends on which probably will not be taxed in Canada, but the interest expense on the purchase price debt is deductible in Canada.

Canada says, "You know what? You guys are gaming our foreign affiliate system. That is not what these rules were meant to allow." "In particular," says Canada, "you are doing that not for any valid business reason; there is no particular business reason that Brazilian Co. needs to be under Canada. You are just doing this to create a bunch of interest expense deductions in Canada. That is not fair." That, in a nutshell, is debt dumping. That is what the mischief was that caused the government to act.

I think it would be fair to say that if the goal were to stop that, that could be done in a relatively concise, not-too-hard-to-do manner. The FAD rules, however, go far beyond that. They go far beyond that fact pattern to encompass a bunch of other things.

Let me say one thing at the outset. Those responsible for designing and implementing tax policy at the Department of Finance do not have an easy job. I will be the first to tell you that. This relatively small group of dedicated public servants does a huge amount of work. It is difficult to achieve the right balance amongst the goals of raising the revenue that Canada needs to provide the services and do the things that Canada needs to do; protect the tax base from inappropriate erosion, potentially like the debt dumping I just described; ensuring that compliance costs for taxpayers are kept to no more than they need to be for the proper functioning of the system; and encouraging, or at least not impeding, the kind of economic activity that benefits Canada. Reasonable people can fairly differ as to the trade-off amongst those objectives.

That said, it is my respectful submission -- and I think the view of the tax community generally -- that the FAD rules simply put far too much emphasis on preventing basis erosion; and all, or substantially all, of that objective could have been achieved with a much more focused rule that would not create the undue compliance and planning burden generated by the FAD rules or cause foreign groups or investors to reduce the economic activity they undertake in Canada, which is already occurring.

With that background, I have described the kind of transaction that caused the government to act in the first place. These rules would definitely put a stop to that; I can promise you that. However, they go beyond that. If it would help the committee, I would be happy to spend a couple of minutes describing how these rules operate. If that is not what the committee wants, that is fine. I am here to serve you.

**The Chair:** We have to vote on these rules, so we had better try to understand them.

**Mr. Suarez:** Okay, sir. Let us go back to the same three companies I talked about earlier: Parent, which is the foreign company at the top of the group; CanCo., in the middle; and Foreign Co. beneath it, or potentially beneath it. It does not have to start beneath it.

These rules apply where a corporation that is resident in Canada, which I am calling "CanCo.," and that is controlled by a non-resident corporation, which I am calling "Parent," makes an investment -- and that is a defined term -- in a corporation not resident in Canada that is a foreign affiliate of CanCo., that is to say that is, or immediately after the investment is, a company in which CanCo. has at least a 10 per cent-plus direct or indirect interest. You need a foreign-controlled CanCo. that makes an investment in a foreign affiliate.

What is an investment? Here is where we start to go off the road a little bit. An investment includes an acquisition of any debt of Foreign Co. If you loan money to Foreign Co., that is an investment. If you acquire shares of Foreign Co., that is an investment. If you confer a benefit on Foreign Co. or make a capital contribution to Foreign Co., that is an investment. If you acquire options in respect of or an interest in any Foreign Co. shares or debt, that is an investment. If you have a debt of Foreign Co. that you extend the maturity date on, that is an investment. If you have shares of Foreign Co. that have a fixed redemption date and you extend that date, that is an investment. If you acquire shares of another Canadian corporation, more than 75 per cent of whose property is shares of Foreign Co., a so-called indirect acquisition, that is an investment.

What we have is a very broad charging rule, a very broad range of transactions that will trigger the application of these rules. It is not only a broad charging rule, but it is phrased very broadly, so it also applies where CanCo. is not controlled by Parent at the time of the investment but, as part of the same series of transactions that includes the investment, CanCo. becomes controlled by Parent. It also applies where Foreign Co. is not a foreign affiliate after the investment but, as part of the same series of transactions, it becomes a foreign affiliate. Under the Canadian tax jurisprudence, the degree of linkage between two transactions to make them part of the same series of transactions is very low.

To give you a simple example of how these rules might work, let us say you have Parent Co. and CanCo. and Foreign Co., and let us say CanCo. makes a capital contribution of \$100 million down to its wholly owned subsidiary, Foreign Co., so a wholly owned chain. Your starting point for the result that produces is that CanCo. is deemed to have paid a dividend of \$100 million up to Parent.

A payment down the chain to a wholly owned subsidiary is treated as though the money had been distributed up out of Canada, and dividend withholding tax applies. The rate of dividend withholding tax is

25 per cent under the Income Tax Act of Canada, so \$25 million, unless reduced by a tax treaty between Canada and Parent's jurisdiction. It could be as low as 5 per cent. It is somewhere in between there.

These rules apply to, in effect, treat a payment down the chain to Foreign Co., a wholly owned subsidiary -- the money is still beneath Canada -- as the equivalent of a dividend by Canada up the chain, triggering dividend-withholding tax.

There are some relieving provisions that, in some but not all circumstances, will allow the deemed dividend to instead be used to reduce the paid-up capital of Can. Co. shares held by parent. That potentially produces a delayed deemed dividend because that paid up capital is something that could have been used by Can. Co. to make a distribution to parent as a return of invested capital. There are two kinds of distributions Can. Co. can make -- a dividend, which triggers dividend-withholding tax, and a return of capital previously invested. The rule is that you get that out without dividend-withholding tax because that is money that you put in in the first place. You are entitled to get your capital back.

Down the chain, payment is either a deemed dividend from Can. Co. to parent today, or, under the rules that allow for this in certain circumstances, the deemed dividend is replaced with a reduction of the paid up capital of Can. Co. shares that will produce a deemed dividend later, when Can. Co. goes to make a distribution and finds its paid up capital gone. It just got absorbed, ground down on the original investment down the chain.

That is a real shift in tax policy. Treating a payment down the chain as if it were a payment up in Canada is a real change in tax policy and could potentially trigger double taxation because, when Can Co. makes the payment to Foreign Co -- a deemed dividend for Canadian purposes -- dividend-withholding tax applies. If Can. Co. then, at some point, takes the same funds or different funds and makes an actual dividend to foreign parent, dividend-withholding taxes will apply again. There is a significant scope for double taxation to arise under these rules, and that is something that really gets foreign investors thinking. It is one thing to prepay your dividend-withholding tax and pay it sooner than you should have. It is another thing again when you are not only potentially incurring immediate tax, just by making a payment to your wholly owned subsidiary but also may end up paying tax twice.

**Pierre Gratton, President and Chief Executive Officer, Mining Association of Canada:** I will ask Mr. Suarez or Mr. Paradis to elaborate a bit more, but, to give a mineral exploration company example, you would have a situation where Can. Co. will invest, say, \$100 million in a exploration project overseas. That \$100 million is there to finance the development of that project. It is a legitimate business transaction. Without that money, that project would not be developed.

When Can. Co. invests in that project -- and that is part of our whole argument around the mining ecosystem that exists in Canada, for which we are globally renowned -- that transaction, though it is an investment in a foreign property somewhere else in the world, will use Canadian lawyers, geologists, assayers and Canadian engineers. Studies done by the Natural Resources Canada, in the past, have shown that, even though it is a foreign property, Canadians are involved in multiple layers. Of course, there are a lot of supply

and services generated in the foreign country, but Canada and our mining ecosystem benefit significantly from that.

These measures take that \$100 million to finance that project and tax that investment, which is a far cry from what the foreign affiliate dumping rules were designed to do. You are not supposed to be taxing an investment in economic development. That is the rub. That is the problem.

**Mr. Suarez:** I just have a couple of comments in terms of why these rules are so much broader than the mischief that they were originally directed at.

The investment that Can. Co. makes in Foreign Co. triggers the rules. The rules apply whether or not that investment generates any taxable deductions in Canada. The original mischief was buying some shares that got you a deduction for interest expense in Canada. These rules apply whether or not the investment that Can. Co. makes in Foreign Co. generates any deductions in Canada. It does not matter whether they do or do not. These rules apply whether or not the investment in Foreign Co. that Can. Co. makes produces taxable income in Canada, income that Canada will get its tax on. It does not matter whether it does or does not. This is sort of goes back to the example we talked about; these rules apply even where no net assets have been extracted from Canada. They apply on a value for value transaction where Can. Co. spends \$100 million and gets \$100 million of property in return. No net assets have been extracted from Canada. Everything is still beneath Canada, but the rules still apply. That is why characterizing it as dividend is such a big change in tax policy. A dividend is when Can. Co. pays the money and gets nothing back in return. The money is gone. That is a dividend. To characterize a value for value transaction where Can. Co. spends \$100 million and gets property of \$100 million back in return as a dividend, I cannot square that circle.

One of the government's objectives was to preventing the undo extraction of corporate surplus from Canada. I understand that. However, these rules apply whether or not Can. Co. has any corporate surplus. You do not have to have retained earnings or a corporate surplus for the rules to apply.

This is probably the most important point: These rules apply whether or not the transaction has any Canadian tax motive or purpose or achieves any Canadian tax advantage. The original version of this rule, when it came out in the budget, had a business purpose test. To be caught, you had to be doing something primarily for tax reasons. The government backed away from that in the August and October versions of the legislation. There is now no business purpose test. That was the primary filter, in my respectful submission, for separating what should be caught from what should not be caught. The original transactions that we talked about -- these debt-dumping things -- were people causing Can. Co. to incur a bunch of debt to buy Brazilian Co. totally for tax reasons, just to generate deductions. There is no business purpose test in these rules. It does not matter if what you are doing has no Canadian tax motivation whatsoever. That is critically important.

As we talked about, it can apply to produce double taxation in numerous instances. Double taxation is a big problem. It really turns foreign investors off. It does not differentiate between investments that Can. Co. makes down the chain to wholly owned subsidiaries that are still beneath Canada and investments that Can. Co. makes up or across the chain to sister companies outside of Canada. These rules do not differentiate

between those things in any meaningful way. They are very different in tax policy terms. If stuff is still beneath Canada, then those assets are still within the Canadian taxation system. Payments that Can. Co. makes to sister companies that are not beneath Canada is different.

These rules do not differentiate between investments Can. Co. makes with other group members and investments that it makes with arms length, totally third party entities. The original transactions that we were focused on were totally intragroup transactions, where parent tells Can. Co, "You buy the shares of Brazilian Co. and incur a bunch of debt." Everything is within the group. These rules apply even on investments that Can. Co. makes with arms lengths third parties. These apply to public corporations, if Can. Co. is a public corporation or if it has minority shareholders. There are severe limitations on what Can. Co. cannot do under Canadian corporate securities law. These rules apply nonetheless, even though Canadian public companies and wholly owned Canadian subsidiaries are in a very different position.

The last point I will make is that there is limited grandfathering and no differentiation between foreign affiliates of the Canadian company in place prior to the announcement of these rules and companies that become foreign affiliates of Canco after these rules are announced. Existing structures are in place where Canada company has foreign affiliates. For perfectly good business reasons, there is no special treatment being offered in a serious way for people in that fact pattern to deal with these rules that change the game.

**The Chair:** Thank you Mr. Gratton and Mr. Suarez for your examples. They are helpful, and you have explained it well, I believe, to honourable senators.

Our briefing note from the Library of Parliament indicates the following in our briefing note, under Foreign Affiliate Dumping Background. It says "the proposed changes would not apply to transactions that meet a business purpose test, such as pertinent loans, indebtedness, corporate reorganization or strategic business expansion." Does that business purpose no longer apply? Has that been dropped?

**Mr. Suarez:** The original version of the rules that came out in March had a business purpose test. That was dropped in the August and October versions. Instead of there being a general business purpose test, there are now specific exceptions for certain corporation reorganizations and for certain kinds of loans. As well, there is something called a "closest business exception test," which is meant to allow for certain investments but which, in my respectful submission, is so complicated and so unworkable that it will be of limited practical value.

There is no longer a general business purpose. There are specific exceptions for the three things that you mentioned.

**The Chair:** That is still referred to by the taxation department as a "business purpose test," notwithstanding.

**Mr. Suarez:** I have not seen the document to which you refer, but in my respectful submission, I would not call that a business purpose test.

**The Chair:** I want to clarify that because honourable senators would have heard your comment, read this, and thought there was a conflict. It is an interpretation of words.

**Mr. Suarez:** I can assume that the Department of Finance looks at those three specific exceptions and says, "That is meant to function as a business purpose test." With the greatest of respect for the Department of Finance, in my view it does not do that.

**Jocelin Paradis, Vice President Taxation Canada, Rio Tinto:** If I may explain the exemption for business purpose test, a company needs to be more closely related than any other company of the group to the business abroad. It means that in our case, there is a Canadian publicly traded company in which we own 51 per cent of the shares and 49 per cent are owned by the Canadian public. It is building a copper mine in Mongolia, which is a \$9-billion project. Rio Tinto has copper mines abroad, and the business of that Canadian company listed on the Toronto Stock Exchange is less closely related to the Mongolian business than to other businesses of Rio Tinto. This means that the Canadian publicly listed company is not doing an investment which is fine from the business purpose test. Even if it is the owner of the mine, even though it did find a project 10 years ago, and even though it spent all the money needed to make the investment, it is not considered to be a bona fide business for the rules, which are too narrowly drafted for us.

**Mr. Gratton:** Between August and the October tabling, these additional measures brought forward, which are not a business purpose test, as mentioned, were welcomed by us. They somewhat addressed some of the concerns we had been raising. In our respectful submission, they sort of play around the edges and do not really solve the core issue at play here, which Mr. Suarez outlined.

**The Chair:** Two things flow from that. One is that there was some consultation prior to the rules being promulgated into a draft bill; is that correct? Have all of you had some input?

**Mr. Gratton:** We have been in regular contact with the Department of Finance since the beginning of September after the draft of proposed legislation was made public for consultation. Certainly, we saw improvements from August through October, but still there are some pretty fundamental issues that we continue to raise. We remain in conversation with the Department of Finance. I should point out that as recently as the last few days, we have received both a letter from the Minister of Finance and a follow-up from officials expressing an interest, which I take is sincere, to sit down with our sector and work through the issues. My sense is that they have heard us and realize that these rules have created unintended consequences, for our sector in particular, and want to work through them. However, we have not solved the problem and still need to work with finance to address them. That is in process. We would be remiss if we did not acknowledge that they seem to have heard us, but we still have a lot of work to do.

**The Chair:** If you have any specific amendments that you would urge the government to make, we would be pleased to hear from you on that.

**Senator L. Smith:** To follow up the chair's point in terms of communication with the government, do you have or will you have your top three points that you want to focus on? It would appear that after listening to you discuss and brief us on the current situation, Mr. Suarez, the government has built something that is like

a trap, and you are trying to catch as much as you can because there has been some manipulation. In order to create the right balance, maybe you could give us some simple suggestions from a business perspective as opposed to a technical perspective. Most of us would not understand the latter necessarily because we are not tax experts. From a macro level, could you give us a couple of ideas?

One of the things in the letter that you received from the government was the implication of the junior sector. There seems to be a strong focus on the junior sector -- usually start-ups and organizations that may not have the capital required to move forward. Could you give us a little background?

**Mr. Suarez:** Certainly. Your question is an astute one. There are differences in terms of how these rules affect the juniors versus the Rio Tintos and other behemoths of the world. I would be happy to spend a couple of minutes on that if it would be helpful. In terms of your specific question, if I had a wish list, honestly, putting the business purpose test back in these rules would truly make a difference. It was in the first version of the rules. Going back to the original mischief that motivated these transactions, we see that these transactions were undertaken purely for tax reasons. It was all about creating interest expense deductions in Canada by dumping a foreign affiliate under Canada. A business purpose test would achieve an awful lot of what the government is trying to do.

If you are doing something that is tax motivated, then it is a different kettle of fish than just trying to start up a project somewhere in Latin American and using a Canadian holding company because that is where all the bankers, lawyers and financiers are. I have a ton of respect for the people at the Department of Finance, who are smart, dedicated public servants that could be earning a lot more in the private sector. They have my respect but, with respect, a business purpose test that differentiates between bona fide business transactions not being undertaken to achieve Canadian tax results and the kind of tax-motivated debt dumping that was the mischief behind these rules would go a long way toward solving the issue. In a way, exemptions for public companies and arm's length transactions are a kind of offshoot of that. They all have the same theme: Guys, we are not doing this to try to erode the Canadian tax base or generate tax deductions. We are doing this for business reasons. If you allow businesses to do the transactions that they would do and create the economic activity in Canada that they want to create, we could get to a place where the Canadian tax base is enhanced rather than eroded while the government's objectives are met.

**Senator L. Smith:** Mr. Gratton, you mentioned that communication is going on between your groups and the government. Obviously you want to continue those discussions. Are you proceeding to that next step of prioritizing your recommendations and moving those forward with the government group?

**Mr. Gratton:** Yes, absolutely. In our submissions to the Department of Finance on the business purpose test question, which was dropped, our recommendations have focused on how to develop some kind of exemption for publicly listed companies with the argument that those companies are accountable to their shareholders and cannot engage in the kind of mischief that Mr. Suarez has been describing. In addition, why would you acquire debt in the mining industry through investments overseas in which you were not interested? You acquire a project overseas because it is a good project. That is your motivation. It is not to avoid tax; it is because you are developing your business.

We have focused on the qualified public company exemption because our perception was that the business purpose test issue was behind us and we had a very short time frame to find ways through this. We are now in the process of assembling a team, as Finance has asked us to do, of people who can work through these issues with their officials. The kind of approach they have outlined is very much what we have been looking for. I would characterize it up until now as largely us putting our views forward and then hearing back from them. What is now being proposed is what we would really like, that is, to have everyone around the table trying to fix a recognized problem.

These are complicated rules and, as Mr. Saurez said, you are trying to find the right balance. The industry does not want to allow mischief to erode the Canadian tax base. We totally accept that the debt dumping that has been going on should be eliminated.

How do you craft that? If we can get together and work through the issues with an understanding and recognition that there is a problem that needs to be solved, then I am hopeful that we will be able to do that.

**Senator L. Smith:** One thing that the government would probably expect from you folks is the creation of the proper discipline within your members to try to avoid the manipulation that can take place when you have --

**Mr. Gratton:** With respect, on that, Finance has acknowledged from the beginning that we were never the target. They did not have their sights on the mining industry. We were never seen to be among those that were engaged in this kind of debt dumping.

They cast the net so wide that we feel like dolphins in the net, and we need to fix that, because we were not the ones they were after.

**Senator L. Smith:** Hopefully you will continue those dialogues and move forward in a positive way.

**The Chair:** "Dolphins in the net" is an interesting analogy.

(French follows -- Senator Hervieux-Payette -- (Pour les pays qui sont un peu...))

(après anglais)

**Le sénateur Hervieux-Payette :** Pour les pays qui sont un peu dans la même situation que nous, comme l'Australie en particulier, qui est un pays qui compte aussi beaucoup de mines, mais aussi le Brésil et probablement les États-Unis, quel est le système de taxation dans ce domaine? Est-ce qu'on fait cavalier seul ou est-ce qu'on rejoint le reste des pays occidentaux qui aiment bien, de temps en temps, collecter des taxes?

**M. Paradis :** Rio Tinto fait affaire dans une cinquantaine de pays et aucun autre pays n'a ce genre de règles. Le Canada fait bande à part.

**Le sénateur Hervieux-Payette :** Donc nous sommes très innovateurs.

**M. Gratton :** Si je peux ajouter, ce qui nous inquiète c'est que la Grande-Bretagne a changé sa réglementation pour être plus attrayante. Comme vous le savez, il y a quelques années, il y a eu une tentative de la part de la bourse de Londres pour acheter la Bourse de Toronto. Il y a eu toute une réaction à cela, et dans cette période, tout le monde a dit qu'il fallait vraiment protéger la Bourse de Toronto, que c'était un grand succès en grande partie à cause de sa spécialisation dans le secteur minier. Ce qui nous inquiète maintenant, c'est que, comme Londres devient plus attrayant, on risque justement de perdre notre joyau, indirectement, à cause de ces nouvelles réglementations. C'est cela qui nous inquiète.

**Le sénateur Hervieux-Payette :** La question que je me pose c'est de savoir si les affaires dont on parle, c'est le financement ou le secteur minier. De la façon dont vous en parlez, on va lever 100 millions sur les marchés financiers – donc effectivement les avocats, les comptables, tout ce monde-là – mais à ce moment-là, si le siège social est au Brésil, s'ils veulent développer une mine dans un autre pays, pourquoi passeraient-ils par le Canada pour lever ces 100 millions, sinon pour des raisons fiscales? Je veux savoir la vraie raison parce que, somme toute, quand on a les états financiers consolidés de Rio Tinto, tout cela va dans le même pot. Alors pourquoi faire un détour par le Canada pour aller investir en Nouvelle-Guinée?

**M. Paradis :** Le Canada est un endroit où on a développé beaucoup de connaissances en ingénierie pour le secteur minier. La ville de Sudbury a des centres de recherche très importants, et même, les gens de Rio Tinto en Australie ont décidé par eux-mêmes d'investir dans la recherche et développement à Sudbury qui est reconnue pour sa compétence en exploitation et en développement de mines souterraines. Le Canada, du fait qu'une grande partie du financement de l'exploration minière se fait à travers le Canada, a développé une expertise mondialement reconnue pour ce genre de projet. Donc, avoir le financement localement, les ingénieurs et les gens qui font la recherche et développement, donne un avantage au Canada. Notre but est que cela continue à être au Canada, et de développer autant Toronto, Sudbury, Vancouver et les autres régions pour créer un environnement qui va être bon pour notre économie. C'est fait à travers le Canada parce que c'était un bon endroit pour le faire. On pouvait investir à travers le Canada sans avoir d'impôts à payer au Canada, mais en créant de l'activité économique. Si on doit se mettre à payer de l'impôt, avoir une taxe à l'utilisation du Canada pour développer des ressources à l'extérieur, les choses risquent de changer et les gens vont peut-être arrêter d'utiliser le Canada comme conduit vers un projet minier à l'extérieur.

**Le sénateur Hervieux-Payette :** Je ne suis pas très convaincue par ce que vous me dites. Ce que je vois à l'heure actuelle c'est que, premièrement, on a des firmes comme SNC-Lavalin qui ont toutes une expertise dans le secteur minier et qui travaillent, comme vous, dans 35, 40 pays; ils peuvent travailler dans tous les pays. C'est la même chose pour vos ingénieurs, ils peuvent aller travailler en dehors du Canada, superviser le développement de nouvelles mines, que ce soit en Afrique ou en Asie. Le savoir-faire technique, c'est une chose; le financement en est une autre. Pourquoi ne serait-ce pas la compagnie mère qui investirait les 100 millions? Pourquoi passer par le Canada pour cela ? Il faut faire la preuve du nombre d'emplois que cela va créer ici.

Dans le fond, vous prenez l'expertise qui existe déjà. Est-ce que cela va créer des emplois? Cela va peut-être faire travailler des gens qui en ont déjà un. Mais les emplois seront créés à la mine qui se trouve dans le

pays étranger, pas ici; ils seront créés là où les 100 millions seront investis. J'essaie de voir le bénéfice net pour le Canada de cette mesure.

Pour terminer ma question, je veux savoir ce que c'est que – je ne sais pas quel est le mot français – le *withholding tax*, avec le Brésil? On dit que c'est de 5 à 25 p. 100; je veux savoir ce qu'il en est pour vous, parce que votre siège social est au Brésil.

**M. Paradis :** Non, il est en Angleterre.

**Le sénateur Hervieux-Payette :** En Angleterre, excusez-moi.

**M. Paradis :** Avec l'Angleterre, c'est 5 p. 100. Le point que je veux faire c'est qu'on participe dans un projet en Mongolie à travers une compagnie publique canadienne. Il y a des actionnaires minoritaires qui représentent 49 p. 100 de l'investissement — ce sont des gens comme vous et moi — à la caisse de retraite. Ces gens ont le droit d'avoir un rendement raisonnable sur leur investissement en fonction de la compagnie qu'ils ont achetée. On ne peut pas, à Rio Tinto, contourner les actionnaires minoritaires et faire les investissements directement dans les meilleurs actifs de la compagnie à l'étranger et ne leur laisser que les moins bons actifs. La direction de la compagnie n'aurait pas le droit de faire cela parce qu'ils ont un devoir de fiduciaire envers tous les actionnaires et la compagnie. Ce n'est pas parce qu'on ne veut pas passer à travers le Canada, c'est parce qu'on n'a pas le choix à cause des règles légales canadiennes et parce qu'il faut aussi protéger les investisseurs canadiens.

Dans le cas où la compagnie est une compagnie canadienne qui est possédée à 100 p. 100 par des étrangers, il est facile de contourner le Canada. Dans le cas d'une compagnie publique, cela devient très difficile de le faire sans créer des problèmes aux actionnaires minoritaires.

**Le sénateur Hervieux-Payette :** Et Rio Tinto Canada a des investissements étrangers dans combien de pays à travers le monde, à part la Mongolie?

**M. Paradis :** Il y a une compagnie qui s'appelle Turquoise Hill Ressources qui est une compagnie publique. Cette compagnie a des investissements dans une dizaine de pays. Rio Tinto a seulement 51 p. 100 de l'actif.

Si on fait exclusion de cela, pour ce qui est du reste de Rio Tinto, dans les compagnies qui sont à 100 p. 100 canadiennes, on a actuellement des actifs dans quatre pays et on s'enlignait pour en avoir dans deux autres pays à long terme. Le premier, c'est le Brésil, parce qu'on ne peut pas faire de réorganisation à cause des règles. Il y aurait un gain de capital ou il y aurait des impôts à payer au Brésil. Et le deuxième, c'est à Oman, qui est un pays musulman où les règles pour changer les actionnaires sont très difficiles.

À part cela, dans les activités de Rio Tinto Canada qui sont à 100 p. 100 canadiennes, il y a seulement ces deux investissements, qui ne sont pas très importants. Notre problème c'est la compagnie publique.

**Le sénateur Bellemare :** J'ai une petite question au sujet du Plan nord du Québec. On sait que, depuis quelque temps, il y a des ralentissements dans les activités au Québec. On sait qu'il y a des considérations

internationales. Mais dans la problématique de la fiscalité canadienne, est-ce qu'il y a un lien entre le léger ralentissement au Québec au Plan nord et la fiscalité telle qu'elle est en train de se développer? Ou c'est plutôt pour les investissements étrangers davantage?

**M. Gratton :** C'est un peu trop tôt pour dire que c'est à cause de cela. Je peux vous donner un exemple, qui ne touche pas le Plan nord comme tel mais qui touche le Canada. La compagnie polonaise KGHM, qui a acheté la compagnie Quadra FNX, voulait établir leur division mondiale de cuivre ici au Canada à cause de toutes les raisons que mes collègues ont mentionnées, à cause de l'expertise qui est ici. À cause de ces règles, ils sont en train de reconsidérer cet investissement parce qu'ils trouvent qu'avec les nouveaux règlements, il est peut-être plus avantageux d'établir cette division dans un autre pays.

C'est une compagnie majeure, mais cela nous inquiète que d'autres compagnies, incluant des compagnies juniors, vont commencer à dire que c'est complexe. Et comme M. Gallinger l'a souligné, plusieurs compagnies juniors ne sont pas encore au courant de ces règles, mais quand ils en prendront conscience, ils vont trouver qu'il est plus facile d'aller à Londres que de rester ici. Et le cas échéant, on risque de perdre l'ensemble de l'expertise que nous avons et dont nous sommes très fiers au Canada. Et c'est ce qui va toucher le Plan nord parce que cela risque de nuire à l'investissement étranger dont on a besoin pour développer nos projets miniers au Canada.

(Sen. McInnis : Thank you for your coming...)

(anglais suit)

(Following French, Mr. Gratton)

**Senator McInnis:** Thank you for coming. My question is a follow-up from my learned colleague Senator Smith, more to do with protocol and procedure. How proactive are you in dealing with government? For example, does your organization meet on a regular basis with Finance and/or Natural Resources? You are nodding that you do. What departments do you meet with? Is it an overall briefing that you give? Do you host receptions? What do you do to communicate with government?

**Mr. Gratton:** Is behind your question the question of how we got here?

**Senator McInnis:** I think I know how you got here.

**Mr. Gratton:** I can explain, in part. Everything was going along swimmingly until mid-August. What we were expecting was what they announced in the budget, which was a plan with a business purpose test to address the legitimate issue of debt dumping, and then in mid-August they came out with these draft rules. It was unfortunately the middle of summer, so it was about the first week of September that my colleague Mr. Paradis and a few others within our membership said, "Oh my God, what have they done?"

There was a one-month timeframe for consultation, so a fairly narrow consultation period for some pretty fundamental rule changes that had not been anticipated based on what the budget had indicated

would be happening. We responded very quickly at that time, met with Finance officials and started to submit a series of letters.

By October, so a month after that, the actual legislation came forward, and it addressed a number of the concerns that our members had raised, and I do want to acknowledge that. However, it left a number of issues unaddressed. We have been engaging directly with Finance and NRCan and all the usual suspects you would have expected us to since then, but it is a very complex file. It has taken us some time. I do not know how much experience people have with Finance. It takes a long time. The onus was on us pretty well consistently to convince them that there was a problem. We would raise one set of issues, and we would get another set of questions. We would do some more research and answer those questions, and it would lead to more questions. It has been that kind of relationship up until now.

It has actually been only more recently that we feel we have got to the point where we will sit around the table and work this through. We have certainly been very active on this particular file, but it has only been since the beginning of September, I would suggest. The timeframe for such a significant tax change was really rather narrow, and it has caught a lot of people off guard.

**Senator McInnis:** The mining sector is a major component of the economy of Canada. Do you have ongoing dialogues? Are there briefings? Do you communicate with government on a regular basis?

**Mr. Gratton:** Yes, of course we do. The irony here too is that, as an association, we have in recent years not spent an awful lot of time at Finance because Canada has become, from a general tax perspective, a much more attractive country. We have low corporate tax rates and so on. Within our association, tax issues were not at the top of the list. This issue came out of left field, because there was no reason, based on the budget announcement, to anticipate that this would affect us in this way.

**The Chair:** Gentlemen, we are out of time. This has been a very helpful session. We are very pleased to hear that you are in dialogue.

Our concern is, after a quick look at the bill, that once this bill passes, this provision is retroactive to March; it comes in automatically. There does not seem to be the flexibility to allow for it to be held in abeyance while you continue negotiations. We will work on seeing if we can find a way to allow you to continue that negotiation. We have heard what you have said in relation to what the fix might be, and, hopefully, that can be worked out to the interest of your industries and all Canadians.

**Mr. Gratton:** Finance has indicated to us that they have many tools to try to address this rather quickly. It does not necessarily require, at least in the first instance, new legislation. The minister could issue a bulletin, a news release or a signal like that, which can be done pretty quickly and would have a quick effect across the mining and tax community to provide the reassurance we need. There is the potential, anyway, for a fairly quick response once we all agree on what is required.

**Mr. Suarez:** The point I would like to leave you with is this is what is different in mining from other industries, especially in the junior sector. In mining, it is quite common for foreign investors that have a

foreign project -- nothing to do with Canada -- to use a Canadian company as the headquarters because that is where the bankers, lawyers, geologists, financiers, the TSX and Canadian corporate law is. It is quite common, unlike other industries, for foreigners to decide to use Canada as a base of operations, a headquarters for a project that has nothing to do with Canada -- Latin America, Asia, something like that. These folks do not have to come here. They can go to the U.K., list on the AIM exchange and use the U.K. tax system. Those are the ones we are most at risk of losing. The ones that are here might go, but the real danger from these rules is the ones who will not come. I would just leave the committee with that thought. People have a choice. They do not have to come to Canada. They do in mining because of our infrastructure and all the jobs that creates, but they do not have to come.

**The Chair:** Thank you very much. I am sorry the time is over. Thank you for being here, Mr. Suarez from Borden Ladner Gervais, Mr. Gallinger, Prospectors and Developers Association of Canada, Mr. Gratton, Mining Association of Canada, and Mr. Paradis, Rio Tinto and the project in Mongolia. Many of us are quite familiar with that Oyu Tolgoi project, and we wish you well on that and your other ventures and hope that you continue to show a strong interest in Canada and the services we have to offer.

Thank you very much, all of you.

We will allow for the members of our next panel to take their places.

(French follows -- the Chair continuing -- Honorables sénateurs, nous allons

continuer notre étude...)

(après anglais)

(La séance reprend)

**Le président :** Honorables sénateurs, nous allons continuer notre étude de la teneur du projet de loi C-45, Loi no 2 portant exécution de certaines dispositions du budget déposé au Parlement le 29 mars 2012 et mettant en œuvre d'autres mesures.

Durant la deuxième session, nous reviendrons sur les modifications apportées au crédit d'impôt applicable au programme de recherche scientifique et de développement expérimental.

(Mr. Chair : That is Article 9, part 1, page 14...)

(anglais suit)

(Following French -- the Chair continuing -- de développement expérimental.)

That is article 9, Part I, page 14.

From the Canadian Advanced Technology Alliance, and it is also referred to by *CATA Alliance* National, we are pleased to welcome Russ Roberts, Senior Vice President, Tax and Finance; and from the Certified

Management Accountants of Canada, we are pleased to welcome Richard G. Monk, Advisor of National Affairs, President and Chief Executive Officer of Msight Global Inc.

I understand that both of you have a few brief opening remarks, and we will begin with Mr. Roberts and then Mr. Monk. After that we will get into a discussion. Mr. Roberts, would you like to begin?

**Russ Roberts, Senior Vice President, Tax and Finance, Canadian Advanced Technology Alliance (CATA Alliance National):** Thank you for inviting us to attend. I will give you my background because it may be relevant to shaping some of your questions. I enjoy answering questions, so I am looking forward to that section of our talk.

My background is that when the tax credits were created, I was brought in from the National Research Council to help set it up. I have seen the policy development process, particularly as it was related to what is eligible SR&ED. I followed it for almost its total period of evolution over time. I have followed its administration, the shifts in it and how it has worked over that same period of time. Eventually, I spent about 8 or 9 years in the private sector working on claims themselves, so I have seen the other side of the story as well.

Maybe that will be useful to you. I will try to explain my observations from that perspective as we go.

In terms of SR&ED and innovation policy, which is where we were last year when the budget was brought forward, we were pleased by some changes that we saw in the discussion. We saw the discussion had shifted very much from focus on research to a focus on commercialization: How do we achieve commercialization? How do we get businesses to focus on taking the IP that they develop here and doing something with it here in Canada?

Our concern was that most of the discussion previously had focused on research, getting more money into research and more researchers creating IP, yet, what were we doing with the IP? It was moving offshore often.

We conducted a discussion on our website for about three months before the budget, and we were surprised by the feedback. It was really focused on whether there was too much going into research. How do we take advantage of all these skill sets? It was not a lack of innovation; it was a lack of ability or willingness to commercialize what we had here.

In that respect, we were strongly in favour of the tone of the budget. It was moving in that direction, but when we looked at the changes that took place in the SR&ED program, we did not see how all this meshed together as a result. Particularly, when we looked at the way the program was being managed by the CRA, what we were being told but also what we saw, the program has been shifting much more to an orientation that is directed at research rather than what engineers do to create innovative and advanced technologies.

It is not getting less complex, in our opinion and in our members' opinion. In that sense, we were not necessarily comfortable with the direction of the changes unless there was more to come with the next budget. That was our fundamental position. Where is all of this going? Can it pick up the slack that is being

created by these changes in the budget? Are there opportunities? We think so. Could these changes all mesh together? Yes. One of the ideas that we have looked at is a patent or innovation box, which is being developed in other countries. It is being looked at closely. It is a way of encouraging companies to actually commercialize their IP. The credit actually applies on the profits when it occurs, so it is a pull by rewarding success rather than using the push approach. We are very much in favour of that.

Our members are also less likely to be comfortable with direct grants or direct funding. They much more prefer the tax mechanisms, tax credits or lower tax rates. The innovation box approach definitely has merit for them.

To balance the losses to SR&ED with this budget proposal, the way it has been shaped, we see that you need something like the innovation box. We also see that the extension of the facilitated write-offs helps because the major impact of these changes is around the incentive for expenditures in capital. That is where the biggest impact occurs, in the large firms as well. That is why it picks up there, will actually pull forward on it and help pick up the gap. That is what we are saying.

Even so, unless we figure out how to get the tax credits to be managed efficiently and effectively, we still have concerns about the effectiveness of the program. The direction it is going in is very much focused on research, and that is a criteria. I can explain that later on if you wish, but that is what is happening and has been happening for a number of years.

We had identified a different way of going at this rebalancing. About a third of the claims are termed retrospective. What occurs is that, as a practitioner, I would go into a firm, go through all of their development projects, figure out where their R & D lay and I would file it after the fact. Our contention is that those are not working effectively as an incentive, so we asked ourselves if there was a better way of doing this. Could we get rid of that group of claims -- somewhere between 500 million and a billion -- and come up with a more effective incentive itself which does not have the same type of structural impacts of the current proposals? We think we could. We do not think there was enough time to get at those questions in the discussions, and we are just now beginning to see people talk about it as we go out into the community.

**The Chair:** Thank you. Mr. Monk?

**Richard G. Monk, Advisor of National Affairs, President and Chief Executive Officer of Msight Global Inc., Certified Management Accountants (CMA):** Honourable senators, I am pleased to be with you this morning representing Certified Management Accountants of Canada, also known as CMA Canada. Thank you for inviting us.

I would like to take a moment to tell you about Certified Management Accountants. We are strategic management accounting professionals who combine accounting skills and business acumen with professional management skills to provide leadership, innovation and integrating perspective to organization decision-making. We have over 50,000 members working in private and public sector and also working in the government sector.

You have asked CMA Canada to discuss the provisions of Bill C-45 regarding changes to the Scientific Research and Experimental Development Tax Credit, commonly known as SR&ED. We think it is fair to say that the SR&ED is Canada's best known and most used vehicle for R & D in this country. As the Jenkins Committee report says, it is the flagship of federal support for innovation.

In spite of this, studies have repeatedly documented that business innovation in Canada lags behind other highly developed countries. Therefore, we believe that it is not unreasonable to make some modifications to the program. Bill C-45 includes some important changes to the SR&ED tax credit.

CMA Canada has been advocating for several years, primarily in pre-budget consultations, including this fall, that government policy measures should focus on improving Canada's productivity. The track record on productivity has been weak over the past decade or longer. CMA Canada has advocated that change to the SR&ED is one of the means of contributing enhanced innovation as a key driver of productivity.

We also participated in government consultations on the Review of Federal Support to Research and Development launched in December 2010. In our submission, we recommended expanding the refundability of the SR&ED tax credits to claimants of all sizes, getting credits more quickly into the hands of innovators and reducing the complexity of program administration. Measures such as these, implemented in tandem with our legal framework protecting the intellectual property of Canada's innovators, would contribute to innovation and productivity. In our view, the ultimate objective of improving Canada's productivity should be to increase the living standards of Canadians.

When looking at the proposed amendments to the SR&ED program in Bill C-45, we suggest that the ultimate question to be asked is this: Will these changes have a positive impact on Canada's innovation and productivity? We think this is the real test of success.

It may be too early to make this judgment. There will be a transition period as these changes come into effect over the next year or two. Moreover, there may be more changes coming in Budget 2013 to respond to the Jenkins report recommendations to shift resources from indirect support through the SR&ED program. We will want to take a closer look at any measures that are introduced in the future before making any comments in that regard.

We understand that Canadian manufacturers are concerned with some of the proposals in Budget 2012 affecting the SR&ED program. Two specific concerns they have are reducing their SR&ED investment tax credit from 20 per cent to 15 per cent and eliminating capital expenditures from expenses eligible for the investment tax credit. This group estimates that these two measures will take out \$770 million and \$94 million respectively from the SR&ED program between 2014 and 2017.

What we do not know is whether this will be balanced with the positive effects resulting from other measures included in Budget 2012 intended to redeploy government funds from the tax credit to a more complete set of direct support initiatives to help encourage businesses to invest in R & D. That is the issue we have.

In closing, CMA Canada supports measures aimed at improving Canada's productivity. The SR&ED is one of the programs that can be improved in ways to effect productivity in a positive manner.

I look forward to your questions and discussion.

**The Chair:** Thank you, Mr. Monk.

**Senator Buth:** Thank you very much for being here today.

Mr. Roberts, you offered -- and I will take you up on your offer -- to comment on how this program focuses more on the research side of things instead of I think you said innovation or commercialization.

**Mr. Roberts:** What has happened is the following. If you look at what the intent of the legislation originally was, it was to be focused on applied research predominantly, on the research side of the story, but also on something called experimental development, which is the advancement of technologies done very much within the context of advancing products and processes. In other words, it is not standing alone with a nice new advancement in the technology, but a technology that is used for something. That is the way the definition is written.

In the last three years many reviewers have imposed, on top of the engineering design methodologies, the requirement that they be able to see the scientific method employed. While it is quite often there at a micro level in what is done by the engineers, the way you manage these large, complex developments is using a much broader approach to finding problems, bringing them together and seeing where the issues are coming from, and finding the solutions. If you impose this rigid, linear, almost laboratory oriented approach to scientific method in its application, you get down to the micro level and miss the projects. You miss what is there. It requires the imposition of a different methodology on top of what is a good way to get to a product cost effectively. It also requires additional documentation and systems put in place, some of which are contradictory to the efficient design process. The net result is micro projects and a reduction of what can be claimed.

Does that make some sense?

**Senator Buth:** Micro projects and a reduction in what can be claimed?

**Mr. Roberts:** What can effectively be claimed. It does not change the entitlement; it changes what you are able to effectively put into a claim to the point where many people drop out of the program or are not interested in it because of the sheer work required to do so. It explains why the number of consultants is up to 70 per cent of the claims. That was not the case five years ago. Consultants are saying that it has become sufficiently complex and you need me.

**Senator Buth:** I am a curious just about the comment that one third of the claims are retrospective.

**Mr. Roberts:** It is approximately that.

**Senator Buth:** Part of what the government is trying to deal with is to move toward incentivising research, which is what the savings from SR&ED will be focused on.

**Mr. Roberts:** Except they have not approached that issue. They have done a series of changes within the structure of the quantum, while they have not dealt with the claims that are retrospective. You have a system right now where you can file up to 12 months after the 6 month point when the T2 is filed for your corporation. That gives you a minimum of 18 months on a file. These projects are often started before that. You end up with people like myself examining the development work that the company has done, figuring out where R & D was being done and then developing a claim around that, rather than it influencing and having it already influenced the decision making to do that work.

It is basically a claim which generates tax revenue, but it did not have much influence on the way people thought about R & D in the decision making. As we would work with companies, we would get out of that situation because we would put in systems so the company could recognize it. The intention is that, more and more, the company take responsibility and often we develop claim processes that way.

In principle, you would move outside of those claims as you work with companies as a practitioner. That is another part of the story, but still, every year, a large number of claims are retrospective and those are terribly difficult to support because they are after the fact. They were not documented with the SR&ED program in mind and that is where, for most of us, the major issues of the claims have come from. Last year when we were making proposals to the Department of Finance and the government on this, a number of practitioners identified this as an interesting and serious cost-efficiency to the program. They go beyond CATA in that respect.

**Senator Buth:** The savings from the SR&ED program as announced in Budget 2012 will go toward direct support. I am curious about your comment on direct support. Mr. Monk, you made a comment, but I am not sure if the members are or are not in favour of direct support or if it was Mr. Roberts. Could you both comment on that? Clearly the government is committed to that fund for direct support, and will move toward how they are going to disburse those funds. I am curious to hear your comments.

**Mr. Monk:** We have been promoting measures to improve productivity for several years when we appeared before the House of Commons committee on finance and part of that is SR&ED program. We know the SR&ED program is a flagship for our innovators in Canada. We also know, based on research, that we are not moving the bar from a productivity perspective for Canadians. We are encouraged by changes. There is no point in doing the same thing over and over again if it will not make the change. We wholeheartedly agree with intention of taking 5 per cent out of the credit system for large corporations and putting that toward other incentives or measures to improve productivity. The issue is that we do not know what the results will be for some of these and perhaps there are more that could improve productivity; we will be suggesting more when we appear before the House of Commons committee on finance soon. We have other suggestions as well, including the patent box that Mr. Roberts mentioned.

That is the issue we have. At the moment, the issue is not with a change from 20 to 15 or eliminating the capital expenditures from the inputs of the calculations for expenses that qualify. The issue is what happens with those savings.

**Senator Buth:** Thank you very much.

**The Chair:** Perhaps this is a good time to get an explanation of this innovation box or patent box. What is this all about?

**Mr. Monk:** I am sure Mr. Roberts has more information than I, but the patent box is a program that is throughout some countries in northern Europe and the U.K. is bringing it in, in 2013. Revenue earned from patents is taxed at a more favourable rate than regular revenue. It gives a favourable tax rate for direct revenue earned from patents. It is a fairly complicated process, but that is essentially the issue.

**The Chair:** Mr. Roberts is that okay?

**Mr. Roberts:** I agree that is exactly it.

**The Chair:** The term "innovation box" or "patent box" is the same? Does it have to be an actual patent or something less?

**Mr. Roberts:** That is the point of using the word "innovation." It depends on which country you are in. Some only focus on patents and we think it needs to be broader. Other focus on innovative design and copyright, et cetera. It is getting that box right. That is why we used that phrase and other countries are as well. The process of getting to effective box, whatever it is, understands what to include, how you spin off and what your country is able to do in Canada.

**The Chair:** You are recommending that, but we have not seen it in Canada yet?

**Mr. Roberts:** Yes. It needs to be worked on closely and discussed by leading experts to get to the right box.

(French follows – Senator Hervieux-Payette: Je vais attendre que monsieur puisse m'entendre...IN TAKE 1110)

(après anglais)

**Le sénateur Hervieux-Payette :** Je vais attendre que monsieur puisse m'entendre. Je veux juste vous dire que ce n'est pas par paresse, mais bien parce qu'il y a aussi des gens qui nous écoutent et qui parlent français. De temps en temps, ça leur fait plaisir d'entendre parler notre langue.

J'essaie de comprendre vos trois dernières lignes, M. Roberts, quand vous dites :

(Sen. Hervieux-Payette -- quotation -- The CRA's focus is now on the science research model that is making the...)

(anglais suit)

(Following French -- Ms. Hervieux-Payette cont'g -- ...quand vous dit:)

The CRA's focus is now on the science research model that is making the program irrelevant to many historical users of the program. Without attention to how the program is managed, [word] and yours may become irrelevant.

(French follows -- Senator Hervieux-Payette cont'g: Ça ne me semble pas très positif, si je l'interprète bien, et je me posais la...)

(après anglais)(Sén. Hervieux-Payette)

Ça ne me semble pas très positif, si je l'interprète bien, et je me posais la question à savoir s'il fallait mettre tout ce qui s'appelle « recherche et développement » sur un pied d'égalité en matière de formules d'aide du gouvernement.

Je pense à de nouvelles technologies plutôt basées sur le génie; différents types d'utilisations dans des usines du côté ingénierie, que ce soit pour les usines de production d'aluminium ou des usines de produits manufacturés, par opposition au secteur de l'aéronautique, au secteur de la biotechnologie ou encore par opposition au secteur de l'informatique. Dans le cas du secteur informatique, à ce que je sache, l'alinéa 9(11)d)(i) dit :

Pour l'acquisition, auprès d'une personne ou d'une société de personnes, d'un bien qui est une immobilisation du contribuable,

On a la même formule, sauf que nous n'avons pas des dépenses de la même façon, et certainement pas en fonction du pourcentage. Quand on travaille dans une usine et qu'on veut faire un nouveau produit, souvent on fait un projet-pilote et on a besoin de matériel, de nouveaux équipements. Ce que je comprends, c'est que ce ne sera plus possible d'obtenir un crédit d'impôt pour ces équipements, mais seulement pour la personne utilisant l'équipement. Toutefois, l'équipement va coûter souvent cinq, dix ou vingt fois plus cher que la personne qui l'utilise.

Comment peut-on alors augmenter la productivité? Parce que c'est vraiment là où l'on peut créer des gains de productivité, à savoir avec de nouveaux équipements, des nouvelles façons de faire reliées beaucoup plus aux sciences du génie que dans le domaine de l'informatique où, finalement, il ne s'agit probablement que de l'habileté intellectuelle des gens à effectuer de nouveaux programmes et eux n'ont pas beaucoup d'investissements à faire.

En biotechnologie, il y a quand même de plus en plus d'équipements techniques dont on a besoin. En aéronautique – je pense aux Bombardier de ce monde – pour développer de nouvelles choses, ils ont besoin de nouveaux designs et de tables à dessin, mais ils auront aussi besoin de modèles, d'équipements. Est-ce qu'on se trompe de cible lorsqu'il s'agit de la productivité de tout le secteur manufacturier canadien?

(Mr. Roberts : The way it is currently written or in the future?)

(anglais suit)

(Following French -- Senator Hervieux-Payette -- ...secteur manufacturi canadien?)

**Mr. Roberts:** The way it is currently written or in the future?

**Senator Hervieux-Payette:** What I see when we are excluding.

**Mr. Roberts:** The way the legislation is currently written, it has been historically focused on supporting the capital expenses associated with the prototyping, et cetera. That has been very much captured. I mentioned earlier that the impacts of these changes hit very hard on the biotech claims, and any of the prototyping that goes on in the IT sector, as well. That zone is impacted.

In terms of a balancing and redistribution, we have said that if that is being picked up by new proposals with the next budget, basically we need to see what they are to see how it fits together before we can comment. It is conceivable that a more effective regime, or sets of regimes, can pick up on what is now being not supported as effectively by these proposals with other ideas like the patent box, which would help to pick up what you are talking about -- it would have picked up the capital associated with those production pipes.

**Senator Hervieux-Payette:** Would you see a complement to this budget in 2013 -- that this one would just be part of the changes? When you talk about the next budget, which one are you talking about -- this one or the one after this one?

**Mr. Roberts:** We hope we arrive at very quickly an understanding of how the SR&ED integrates with other measures. Right now, you are correct: These proposals do lead to a gap. That gap is particularly around the capital expenses associated with starting up a new technology and getting it going, as you are saying. If measures are put in place that pick that up, then there is potentially a good balance. It may be better targetted and maybe even less cumbersome than some of the aspects of the current legislation in SR&ED. We made the current legislation in SR&ED work, as it was. In my view, that is not a huge issue but it still was complex.

Does that help?

**Senator Hervieux-Payette:** The other question would then be: Is it well balanced between research and development in terms of the way the program will now be applied? Will we see more development and more commercialization with these measures, or are we missing the target?

**Mr. Roberts:** In our opinion, without another complementary program, it is imbalanced now.

**Senator Hervieux-Payette:** Thank you.

(French follows -- Senator Bellemare: Vous nous avez dit, lors de votre présentation, que le Royaume-Uni...)

(après anglais)

**Le sénateur Bellemare :** Vous nous avez dit, lors de votre présentation, que le Royaume-Uni notamment tend à proposer des mesures incitatives supérieures à ce qui se fait au Canada. Vous avez parlé du « patent box »; est-ce qu'il y a d'autres choses qui sont faites, au Royaume-Uni notamment, pour inciter à la recherche et au développement?

Deuxièmement, comment considérez-vous le fait que dans le programme RS & DE tel qu'on le connaissait, des entreprises du secteur des technologies nouvelles ont incorporé les crédits d'impôt pour le financement de la masse salariale de leurs employés? C'est toujours un peu délicat parce que la recherche et le développement, c'est quelque chose que l'on veut encourager comme un processus continu; mais en même temps, quand on finance les salaires qui peuvent contribuer également à la production, est-ce qu'il n'y a pas un moyen de départager cela? Considérez-vous que le programme, tel qu'il a évolué dans le passé, a pu accorder certaines dépenses excessives parce qu'on finançait les salaires, par exemple? En d'autres mots, les entreprises auraient pu les financer quand même sans le crédit d'impôt; n'y a-t-il donc pas de nouvelles façons d'inciter à la recherche et au développement autrement que par le financement des salaires?

(Mr. Monk: With respect to the U.K. patent box, or the innovation box, there...)

(anglais suit)

(Following French -- Senator Bellemare -- ...commenter un peut?)

**Mr. Monk:** With respect to the U.K. patent box, or the innovation box, there have been other countries, as well. We are suggesting not necessarily implementing that; we are suggesting that it be reviewed with a Canadian perspective to see if that would also be another measure that may incentivize investment and productive and so on. It is just another measure.

There are several other measures, as well. Australia has a lot of programs in place, such as commercialization. They have several separate programs where they offer grants to start-ups. Some are on a 50-50 basis and repayable by royalties from the new products that have been processed. Israel has a technological incubator program you might be aware of that has been going for several years and has seen 1,200 success stories come out of there.

There are many areas to be looked at from a Canadian perspective to see if we can, along with SR&ED, improve productive. That is where we are coming from in that regard with the patent box.

With respect to payroll, many companies have large pools of tax credits that cannot use them up because they do not have taxable income, the credits are not refundable. The large companies accumulate these pools, and some go on for quite a while and do not take advantage of that tax relief that can come for the smaller companies that have the refundable credits.

The other issue is because of the complexities of the administration there is quite a time lag. Mr. Roberts mentioned it could be up to 18 months by the time you incur a cost and get a credit to be recorded. If payroll is part of the cost, you could be outlaying money before receiving anything back from the credit perspective.

**Senator Bellemare:** Thank you very much.

**The Chair:** I had not heard you comment on the reduction from 65 to 55 per cent for the overhead costs and the simple way of doing it, called a proxy method, as opposed to the detailed method of calculating the overhead. Is that a major factor? Is that a reasonable initiative?

**Mr. Monk:** We think so. A corporation investing in SR&ED can calculate the actual amount. Again, they would have to have systems in place to capture that, but most companies now are fairly sophisticated and have good accounting systems. They still have the opportunity of doing the actual overhead calculation. The proxy amount coming down by a little bit may incent people to be more accurate, using actual figures as opposed to a proxy figure.

**Mr. Roberts:** Basically we would say the same thing. Going from 65 to 55 probably in many situations brings you to the point where going over to what is termed the traditional becomes appropriate for a company to figure out if there is an advantage to it. It was close to it for many companies actually at 65, in my experience. You just go with the proxy because it was easier. By lowering it, you have not simplified. You now have companies needing to go through both approaches to see which benefits them the most.

**The Chair:** You indicated as well a concern about money going out to the third parties, and there is provision in here, I understand, that reduces the profit portion to any third-party contracts. Is that a reasonable way to deal with what is perceived as a problem of too much of the funds going to third parties?

**Mr. Roberts:** I was just thinking about my experience. Normally the market defines the cost of those contracts, so I think the market tends to work, but there are exceptions. That is the way to put it. By dropping it to 80, you are bringing it down to what is anticipated to be close to the normal markup. You are legislating a standard. In that sense, it probably stabilizes the points you are making. In other words, you have less of an opportunity to raise the rate, the amount, and inflate the contracts. There would be less of a chance to do that.

**The Chair:** You might be inclined as a third party to put more into overhead than you otherwise would have.

**Mr. Roberts:** It comes down to simply how well the market is working.

**Senator Cordy:** Mr. Roberts, you were speaking about the SR&ED program and in your written documentation to us you talk about the fact that it is becoming more and more complex and that the CRA is out of synch with IT projects, with complex engineering projects, and you are saying it is becoming irrelevant to many historical users. What changes should be made so that SR&ED is in fact up to date, modern and able to deal with more complex engineering projects, as you said? Certainly with the phenomenal changes we have in IT over the past number of years, it seems that CRA has not changed in the way it deals with the

SR&ED program. I think you said 70 per cent of the people applying require assistance of consultants. It should not be the case with government programs to have 70 per cent of the applicants hiring a consultant in order to understand how they can access funding. What do we have to do?

**Mr. Roberts:** The first critical step is to find a way to have companies focus on SR&ED as they start the projects rather than going back and trying to find the SR&ED in what has been done in a company. There are a number of mechanisms for doing that. We had suggested ones for the last budget in our discussions, but that is critical.

It has been proposed that CRA will provide upfront confirmation that it is SR&ED as you file. This will help. There are ways of going at this. If you can get companies to recognize their SR&ED projects at the beginning and to study and follow their timeline and what is happening and mark milestones, then it becomes much easier and better for both parties. That is the beginning of it.

We have been discussing the issue as to what SR&ED is with CRA. The community has been discussing this with the new policies they have been developing. What we saw a year ago certainly did not get there at all. Our hope now is that those policies will clearly show that SR&ED is effectively operational in an engineering environment and how to do it. We are waiting to see that.

**Mr. Monk:** I understand CRA is looking at this whole issue now, which is very good, and I agree with Mr. Roberts' comments. One of the other things to improve or reduce the complexity or the administration of it is to look for ways to get these tax credits, especially the ones that will be refundable, to the smaller companies sooner than, in some cases, almost two years. It is a long time to cash flow your business. That would be something to look at, and there may be ways of doing that through pre-approvals. There are ways it could be done with interim filing and that type of thing.

**Senator Cordy:** Two years is a long time for a start-up company.

**Mr. Monk:** It is very long, and most of them have no revenue stream yet other than funds from family, friends and interested bankers, and these SR&EDs are receivables on the financial statements that take a long time to collect.

**The Chair:** I hear you both say that you recognize changes should be made and changes are being made but it would have been nice if you knew where we were going as opposed to changing and then saying we will just keep talking about this. That is the same message we got from the last group, and you heard that discussion. There are ongoing discussions and changes are being made to the existing situations, but we do not know where we will end up. Is that a fair summary of the discussion this morning?

**Mr. Roberts:** I would agree.

**Mr. Monk:** I would agree, Mr. Chair.

**The Chair:** Thank you very much, Mr. Roberts and Mr. Monk. This has been helpful. We understand what you have told us, and I do hope your negotiations and discussions as to a new program are what you are looking for. In that case, we will probably have you back with the new legislation when it comes along.

Honourable senators, this meeting is now concluded. We will meet again this afternoon on finishing up with the government officials in the last two sections of Part 4 at 2:15 in this room.

(The committee adjourned.)