February 8, 2013

The Honourable James M. Flaherty, P.C. M.P.
Minister of Finance
House of Commons
Parliament Buildings
Ottawa, Ontario
KIA OA6

Dear Minister,

PricewaterhouseCoopers LLP ("PwC") is pleased to provide tax proposals for your consideration as part of your pre-2013 budget consultations.

PwC continues to support the government's efforts to secure Canada's economic prosperity by facilitating of business investment, eliminating the budget deficit and enhancing key economic drivers such as technological innovation and development and access to foreign markets for Canadian produced goods and services. These initiatives are essential in order to maintain and sustain a competitive business environment in Canada.

Our tax proposals seek to enhance the competitiveness of Canada's tax system in order to attract business investment and human capital needed to stimulate economic growth and create more jobs for Canadians while ensuring the government is able to raise revenue in an efficient and sustainable manner.

We appreciate the opportunity to submit our tax proposals and would welcome the opportunity to discuss them in greater detail with you or your staff.

Yours sincerely,

PricewaterhouseCoopers LLP

Nick Pantaleo, FCA
Canadian National Tax Services

cc: Louise Levonian, Associate Deputy Minister, Department of Finance
Nancy Horsman, Assistant Deputy Minister, Department of Finance

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Summary of PwC's Budget 2013 Recommendations

Towards a More Efficient and Competitive Tax System

1. Corporate income, capital and payroll-type taxes should not be increased. In addition, the government should work with the provinces to re-evaluate the efficiency and sustainability of the current mix of revenue generating measures, including conducting a review of the personal income tax and GST/HST systems, to improve the way Canada raises tax revenue while protecting those who are most vulnerable.
2. Adopting a formal system of group taxation would further enhance the efficiency of the federal and provincial corporate tax systems and the government should re-engage all stakeholders in this important initiative.
3. Complete the review and analysis of the remaining recommendations of the Advisory Panel on Canada's System of International Taxation ("the Advisory Panel") in a more open and transparent manner to benefit from a broader consultation with the tax community.
4. Extend the current exemption system to all foreign active business income earned by foreign affiliates.

Providing Better Access to Foreign Markets for Canadian Businesses

5. Continue to enter into international trade, investment protection and tax agreements, particularly with emerging countries, and ensure such agreements are ratified and become effective as soon as possible.
6. To help provide better access to foreign markets for Canada's energy resources:
   - Enhance support for research of enhanced technologies & development of energy transportation; and
   - Create a center of excellence dedicated to energy transportation.

Fostering Innovation through the Tax System

7. Extend the temporary accelerated depreciation rates beyond 2013 and allow other industries to participate as well as ensure capital cost allowance rates for all business assets reflect the true economic life of the assets.
8. Encourage the development and commercialization of Intellectual Property ("IP") in Canada by following the direction of the UK and other countries in studying the possibility of introducing patent or innovation box legislation in Canada.
9. Eliminate or provide a reasonable de minimis rule for employee withholding tax requirements in respect of treaty exempt employment income for non-resident employees of non-resident employers.
10. Allow individual taxpayers to extend the filing of their T1 returns and all relevant forms for a reasonable time period (six months).
11. Consistent with the government's initiative to reduce "red tape," a government review of the existing information reporting requirements in the Income Tax Act is warranted. Existing information reporting requirements that cannot be traced to improved efficiency should be eliminated and the

implementation of additional information reporting provisions should be avoided if real efficiencies cannot be established.

Background Discussion

Towards a More Efficient and Competitive Tax System

1. Raising Revenue

In today's economic environment of slow growth and high deficits, it is tempting for governments to consider implementing measures that they have adopted in the past to raise revenue. However, increasing corporate and personal income, capital and payroll-type taxes, have a negative impact on economic growth and job creation. As we pointed out in our 2012 budget submission, a study published by the C.D. Howe Institute[1] concludes that the marginal cost to raising federal (and provincial) corporate and personal tax rates is very high, indicating that large welfare gains could be obtained by improving how Canada raises revenue.

Canada must be more creative in how it raises revenue, not just in the current economic environment, but also with a view to our changing demographics (for example, the decrease in the number of workers relative to retired individuals), which will put an increase strain on the federal and provincial governments' ability to fund many of the goods and services Canadians expect to receive.

Corporate income tax

Competitive corporate tax rates are fundamental to creating a globally competitive business environment.

The government is to be congratulated for reducing the federal corporate tax rate to its current level and for encouraging the provinces to do the same.

Corporate income, capital and payroll-type taxes have a negative impact on business investment and hence, economic growth and job creation and should not be increased.

Personal income tax

A comprehensive review of our personal income tax system is overdue.

High personal tax rates have a negative impact on investment and savings by Canadians - savings they will need in the future to offset the impact of any reduced government spending in areas such as pensions and health care. It is also a disincentive to work and to upgrade job skills. Combined, these factors negatively impact productivity and growth.

Also, we need to ensure that the personal tax system does not adversely impact those that are most vulnerable. As an example, Roger Martin and James Milway in their book, Canada: What it is, What it *Can Be,* reveal that low income families and retirees incur high marginal tax rates because financial assistance

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1 See http://www.cdhowe.org/pdf/Commentary_324.pdf.

they receive under various government programs are "clawed-back" as their income increases. Addressing this problem – by smoothing out the claw-back effect as well as looking at the design of the various programs, as Martin and Milway suggest – would help reduce poverty and income inequality.

The personal tax system includes many tax expenditures (for example, deductions, rebates, tax credits, etc.). Individual expenditures should be reviewed to ensure they are cost effective and properly targeted to those that need them the most. Savings resulting from the elimination or reduction of such expenditures could support lower personal taxes by reducing rates and/or broadening the current income tax brackets (i.e., raising the threshold levels). It would also simplify the system.

Goods and Services Tax

Greater reliance on consumption taxes would result in a more sustainable and less volatile revenue stream and would potentially be more robust in terms of being less susceptible to tax avoidance. Other countries are taking actions in this regard by putting greater reliance on consumption taxes and making such systems more efficient.

This does not mean that GST rates should or would have to be increased. The GST system also includes numerous tax expenditures. These expenditures are in the form of goods and services that are exempt from GST and exist for a very good reason: to mitigate the burden on low-middle income families.

But, as the University of Toronto economist, Michael Smart, noted in a recent paper[2], there is a significant cost to such a policy, which is that most of the benefit of these expenditures accrues disproportionately to high income families because they spend a larger absolute amount on tax exempt items, such as food, than low income families.

Reducing some of these exemptions, while providing low-middle income families with enhanced GST income tax credits or rebates, would be a more effective alternative to increasing income tax rates to raise revenue. Reducing such exemptions could also help reduce personal income tax rates.

Recommendations

Corporate income, capital and payroll-type taxes should not be increased. In addition, the government should work with the provinces to re-evaluate the efficiency and sustainability of the current mix of revenue generating measures, including conducting a review of the personal income tax and GST/HST systems, to improve the way Canada raises tax revenue while protecting those who are most vulnerable.

2. Taxation of Corporate Groups

We were pleased that the government accepted PwC's recommendation by announcing in the 2010 budget that it would begin consultations on enacting a formal system of corporate group taxation.

However, while we understand that the government continues to study the matter and consult privately with the provinces, we are disappointed that since releasing its consultation document in November 2010

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[2] http://homes.chass.utoronto.ca/~msmart/smart-GSTbase-oct2011.pdf.

and receiving submissions from numerous stakeholders in April 2011, there has been no further public announcement or consultation.

While we appreciate that the federal (and provincial) government likely have concerns about the short term fiscal costs to enacting such a system, particularly in the current economic environment, we believe that through a more open dialogue and consultations, stakeholders can help the government resolve these and other concerns.

Recommendation

Adopting a formal system of group taxation will further enhance the efficiency of the federal and provincial corporate tax systems and we urge the government to re-engage stakeholders in this important initiative.

3. Enhancing Canada's International Tax Advantage

For Canadian companies to take full advantage of increased access to foreign markets, Canada's tax rules dealing with foreign investment must be competitive with the tax systems of our major trading partners.

It has been over 4 years since the release of the Advisory Panel's recommendations. We applaud the measures taken in the 2009 and 2010 federal budgets that were recommended by the Advisory Panel and note that the foreign affiliate dumping proposals in the 2011 budget were based on another recommendation of the Panel.

However, as long as some or all of the Advisory Panel's recommendations are still under consideration, and possibly others the government may propose, Canadian companies will lack certainty in terms of the tax policy direction impacting their business decisions.

Recommendation

As we stated in our 2010 and 2011 budget submissions, we urge the government to complete its review and analysis of the Advisory Panel's remaining recommendations as soon as possible and to be more open and transparent in its review so that it can benefit from a broader consultation with the tax community and ensure the international tax system enhances Canada's international tax advantage, minimizes compliance costs for taxpayers and facilitates the administration and enforcement by the Canada Revenue Agency ("the CRA").

4. Exempt all Foreign Active Business Income Earned by Foreign Affiliates

The Advisory Panel recommended that Canada move to an exemption system for all active business income earned by foreign affiliates and eliminate the requirement for such income to be earned in a treaty country or a country with which Canada has entered into a Tax Information Exchange Agreement ("TIEA").

As we stated in our 2012 budget submission, to further delay the "de-linking" of our exemption system to tax treaties and TIEAs does not seem necessary at this point. According to the Department of Finance website, as at February 5th, Canada had entered into or is negotiating tax treaties with 95 countries and had signed or is in the process of negotiating 30 TIEAs. These totals only increased by "one" from about the same time in 2011.

Maintaining the current requirement has a negative impact on Canadian companies investing in poorer countries in places like Africa that are not tax havens and are not likely to have a sophisticated administrative system to allow them to negotiate a tax treaty or TIEA with Canada. Using the exemption system as a "carrot" to entice foreign countries to enter into tax treaties and TIEAs seems inappropriate where those countries do not have the ability to enter into such arrangements. In the meantime, companies with investments in such countries, in particular, Canadian mining companies, are at a comparative disadvantage to global competitors in such countries and to Canadian companies with active business operations in treaty or TIEA countries.

Extending the exemption system to active business income earned by all foreign affiliates can occur while the government continues its review of the other remaining recommendations of the Advisory Panel and would be consistent with the government's previously announced intention to introduce changes to the international tax system on an "incremental" basis.

Recommendation

The government should continue with its incremental approach to introducing changes to Canada's international tax rules by extending the current exemption system to all foreign active business income earned by foreign affiliates.

Providing Better Access to Foreign Markets for Canadian Businesses

5. International trade, Investment Protection and Tax Agreements

We acknowledge again the efforts made by the government to pursue trade agreements, tax treaties and TIEAs. It is important that Canadian businesses be provided with greater access to foreign markets, foreign investment protection and fair tax treatment in foreign nations. These factors are critical to Canadian business decision making and competitiveness. Access to more and bigger markets will help Canadian companies be more productive and to create more jobs.

Recommendation

We recommend that the government continue to enter into international trade, investment protection and tax agreements, particularly with emerging countries, and to ensure that such agreements are ratified and become effective as soon as possible.

6. Providing Better Access to Foreign Markets for Canada's Energy Resources

Canada's success in attracting foreign capital and game-changing technological advances have led to the development of our energy resources at a speed and on a scale not thought possible a short time ago.

As our energy industries expand production, many are looking to the federal government to help access new markets, particularly in Asia and the U.S. Gaining access to new markets presents an enormous array of policy challenges, in particular, the safe and efficient transportation of Canada's energy resources (i.e., (oil and gas, including conventional and non-conventional methods of extraction, green and renewable energy).

In this regard, we have two recommendations.

Enhance support for research of enhanced technologies and development of energy transportation
The federal government should create a fiscal regime that will enhance the research and development ("R&D") of technologies to improve the efficiency and environmental footprint of energy transportation, including the development of transportation networks throughout Canada. Such a regime could include enhanced tax credits with respect to R&D that is directed at improving energy transportation within Canada as well as accelerated depreciation with respect to expenditures on new assets acquired for energy transportation.

Establish a center of excellence for energy transportation
Centers of excellence exist in Canada, but none are dedicated solely to energy transportation. The government, working with the various industries, could establish a center of excellence to promote, fund and structure R&D of energy transportation technology, help plan for an efficient and environmentally friendly transportation infrastructure, and possibly support financing from venture capital with the objective of making Canada a world leader in safe and efficient energy transportation.

Consideration should also be given to Canadian enterprises servicing the energy transportation sector (service providers and manufacturers of equipment) developing Canadian-based expertise and technologies that could lead to significant exports. This would help establish Canada as a world class centre for the development and transportation of energy.

Fostering Innovation through the Tax System

It is critical for the government to sustain an atmosphere that will encourage business investment and thereby increase productivity and job growth. The government has made positive changes to the corporate tax system in this regard by, for example, reducing corporate tax rates (and encouraging provinces to do the same) and eliminating capital taxes. We believe more should be done.

7. Modernize Depreciation Classes

We support the recommendation made by the Canadian Institute of Chartered Accountants to adjust the capital cost allowance rates of depreciation for all business assets to reflect their true economic life. This will encourage additional investment and increase productivity.

Given the current economic environment and in light of similar measures being taken in the U.S., the temporary accelerated depreciation rates for manufacturing and processing should be extended and other industries (for example, retail, telecommunications, etc.) should be considered for this as well. In addition, depreciation classes should be updated to ensure they are properly capturing assets used in high value-added service sectors such as telecommunications.

Recommendation

Extend the temporary accelerated depreciation rates beyond 2013 and allow other industries to participate as well as ensure capital cost allowance rates for all business assets reflect their true economic life.

8. Taxation of IP developed in Canada

We agree with the suggestions made in the 2011 report of the Independent Panel on Federal Support to Research and Development ("the Jenkins Panel" or "the Jenkins Report") entitled, "Innovation Canada: A Call to Action," and the 2011 C.D. Howe Institute Commentary by Mark Parsons, "Rewarding Innovation: Improving Federal Tax Support for Business R&D in Canada", that Canada would benefit from a more balanced approach to supporting R&D and innovation.

The current system of tax support for R&D is "front-end" loaded while the rewards for R&D and other innovative activities are taxed at a rate that still exceeds the rates applied by most OECD countries. This creates a disincentive to commercialize and develop new products and services in Canada and likely has a negative impact on the level of R&D investment in and the amount of spillover benefits accruing to Canada.

In recent years there has been a trend in Europe toward lowering the tax on income derived from IP through a mechanism referred to as a patent or innovation box (for example, the UK will adopt such a regime in 2013). As suggested by the Advisory Panel, the government should monitor these developments and study whether there may be opportunities to improve the tax treatment of IP income.

The failure to address the competitive threat created by low taxes on IP income in other countries could result in IP development and commercialization being shifted outside Canada and will reduce the likelihood that IP acquired by Canadian companies, as they invest and carry on business abroad, will be transferred to Canada for further development and commercialization in Canada.

Recommendation

To encourage the further development and commercialization of IP in Canada, we recommend that the government follow the direction of the UK and other countries and study the possibility of introducing patent or innovation box legislation for Canada.

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Enhancing the Efficiency of Tax Administration in Canada

9. Elimination of Employee Withholdings on Treaty Exempt Employment Income

Foreign companies doing business in Canada are required to withhold and remit payroll taxes on behalf of non-resident employees even when the employees, by virtue of a tax treaty, are exempt from Canadian tax on income related to working in Canada.

Some administrative procedures are available, using a waiver exemption request process, but it has been proven to be cumbersome and costly for all of the parties involved. We do applaud the CRA's recent policy that eliminates the need to obtain a withholding waiver or to prepare T4 forms for those attending conferences and seminars, although this is very narrow in scope as to when relief can be applied.

Based on present legislation and CRA policy, an employer must:

- obtain an employer number;
- make and remit timely employee withholdings;
- prepare T4 forms; and
- and file the forms.

The employee, in turn, must obtain a Canadian ITN and file a Canadian T1 return to obtain the refund of the Canadian tax paid on treaty exempt employment income.

The timing of all of these processes can be over a year for the tax withheld to be refunded. The administrative and financial costs to the employer to handle the process is large because often the employer funds the tax withheld (i.e., the employees are already remitting payroll tax to their home country). Hence, they have to pursue the employee (or former employee) for the refund.

Further, the process for obtaining a waiver exemption from payroll withholding on a non-resident employer has parameters to it that are not practical and restrictive. For example, instead of an employer using one tax services centre to process all of the Regulation 102 waiver requests, each waiver request must be sent to the office that is closest to where the employee worked in Canada. That entails having to deal with a number of CRA officers and although processes are supposed to be the same at each centre, often times this is not the case.

The largest group of non-resident employees in Canada is from the U.S. and they are typically in Canada for several days to attend meetings on company business, conduct customer visits, and attend conferences and seminars. The difficulty in timely tracking these individuals is compounded by the fact that many of these trips are not pre-planned, but rather are decided upon within days of the travel occurring. It is not unusual for the employer to learn of the travel long after it occurred. As well, for many, the employment income earned in Canada is less than C$10,000. These typical situations do not fit well into the present tax waiver request process. It is more suited for those non-resident companies having a group of non-resident employees, with advance notice, coming together to one location in Canada for a set period of time, which is no longer a typical scenario in today's business world.

We recognize that something needs to be in place to ensure compliance if employees are subject to tax, however, the present system is not practical. More importantly, there is increasing reluctance by non-resident employers to have employees enter Canada for any purpose because they feel that Canada is not business friendly to non-residents.

Recommendation

The Income Tax Act should be amended to eliminate or provide a reasonable de minimis rule for employee withholding tax requirement in respect of treaty exempt employment income for non-resident employees of non-resident employers.

10. Extension of Personal Income Tax Filing Deadlines

At present, the deadline for filing personal income tax returns for a particular year is April 30th of the following calendar year, unless the individual is self-employed, in which case the deadline is June 15th. Although no penalties are levied if all taxes have been paid, there have been changes in legislation and reporting over the past decade that suggests a need for a T1 return filing extension system to be implemented, similar to the ones in place in the U.S., UK and Australia.

We believe there are several reasons to support this suggestion:

- A growth factor for Canada's economy is to have a highly mobile workforce. It is no longer a rarity for employees to move or commute across borders. In doing so, they find themselves subject to taxes of other countries. In order to properly file the Canadian T1 return, tax returns for the other tax jurisdictions are required. These returns are often not available by the Canadian filing due date, requiring the Canadian returns to be late-filed or amended, often times with significant changes.
- Although they are supposed to be attached to the T1 return, forms such as the T1135, T1161, T1243 and T1244 must be filed by April 30th (or June 15th) in order to avoid significant late filing penalties. The same is true for subsections 45(2) and (3) elections. The predominant group that uses these forms are individuals moving/commuting across borders. This has created a situation where there is a rush to file these forms and elections with the CRA prior to the deadline while the returns are filed later. This has created situations where the CRA has inadvertently assessed the penalties or insufficient information was available prior to the filing deadline to determine the need for the forms or elections.
- The tax filing season is very compressed. Much of this has to do with the deadline for filing of the forms that are required for preparing personal income tax returns. For example, the deadline for Form T3 is March 31st. Taking into account mailing time, this can leave a taxpayer less than one month to complete his return in a complete and timely manner.

Recommendation

We recommend that a T1 return filing extension be instituted allowing taxpayers to extend the filing of T1 tax returns and all attached forms for a reasonable time period (six months).

11. Review of Information Reporting Requirements

In recent years, there has been a significant increase in the amount of financial and other information that taxpayers must provide to the CRA for tax purposes. The stated goal behind this escalation in demand for information is intended to create greater taxpayer transparency so that the tax authorities can better assess tax risk and achieve better tax audit efficiencies.

Efficient tax audits that lead to quality audit results in reasonable time frames would be a welcomed result of this information reporting. However, for most taxpayers, this has not been their experience. In other words, while the increased information reporting requirements have resulted in a significant increase in the tax compliance burden for taxpayers, but they have not yielded the expected tax administration efficiencies.

Recommendations

Consistent with the government's initiative to reduce "red tape," a government review of the existing information reporting requirements in the Income Tax Act is warranted. Existing information reporting requirements that cannot be traced to improved efficiency should be eliminated and the implementation of additional information reporting provisions should be avoided if real efficiencies cannot be established.[3]

3 In this regard, we note that the Advisory Panel had undertaken a preliminary review of options to improve some of the forms and returns to gather information on cross-border transactions. See, Advisory Panel on Canada's System of International Taxation, *Final Report: Enhancing Canada's Competitive Tax Advantage: A Consultation Paper Issued by the Advisory Panel on Canada's System of International Taxation* (Ottawa: Department of Finance Canada, December 2008), paragraph 7.70.