Submission for
Pre-Budget Consultations in Advance of the Federal Budget 2024

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List of Recommendations

Recommendation 1:

That the government provides an exemption from capital gains when the proceeds from an investment exit are re-invested in a new venture.

Recommendation 2:

That the government create a national Small Business Venture Capital Tax Credit similar to the BC model.

Recommendation 3:

That the government review and improve the Scientific Research & Experimental Development Credit to make it more accessible and beneficial to innovative start-ups.

Recommendation 4:

That the government consider a new allocation of $200 million under the existing VCCI program for an emerging manager fund to ensure that Canada continues to nurture venture capital talent.

Recommendation 5:

That the government introduce a Patent Box regime where income from patents that were developed in Canada are taxed at a lower rate of 5%.

Recommendation 6:

That the Government offer accelerated depreciation in year 1 of all capital investment except for real estate.

Building a More Innovative, More Competitive Canada

Canada's economy has many strengths but is facing global headwinds. Now is the time for bold action to avert a serious slowdown in the years ahead.

The current investment climate presents a unique challenge for companies looking to grow and scale their operations. The worldwide surge in interest rates has rippled through the global economy and hit capital markets hard, while quantitative tightening has dried up the flood of liquidity that made it relatively easy for companies to borrow. Here in Canada, many businesses are seeing tighter credit conditions and are reporting that rising financing costs are holding back their investment plans.

The question is what we do about it. The actions we take as we enter the 2023-24 economic correction will dictate how we emerge as the global economy rebounds. Making strategic investments now – instead of cutbacks and retrenchment – will allow the Canadian economy to come out roaring.

Background

The Canadian Venture Capital & Private Equity Association (CVCA) represents some of the largest investors in Canada with more than 315 member firms and 3,000 individuals. Our members are as unique as the companies they work with. Our venture capital members are building new enterprises from the ground up, pursuing ground-breaking discoveries and developing novel products, services and platforms. Our private equity members are engines of growth for established firms that are elevating their business. Together, they play a critical role in Canada's economic success, and we believe that by growing the industry they can help Canada rise to its full potential as a world-class investment and innovation powerhouse.

Venture Capital is Rocket Fuel for Innovation

The venture capital (VC) industry provides funding to startups so that an innovative idea can become a commercial product and then later stage VC scales the business up to a global competitor. Canada has amazing skilled workers, innovative universities and world-class R&D. With a dynamic, flourishing VC industry, we can be a global leader in innovation.

We often hear that Canada is good at research, but weak at commercialization. The best way to get more innovations from idea stage to a commercial product is with venture capital.

- Venture Capital is not simply capital. It comes with expertise in taking products to market, and networks to connect an innovative company with the resources they need, whether technical, HR or marketing.
- Canada has immense potential when it comes to sectors such as life science, AI and deep tech. These verticals require patient capital. While we saw impressive growth in 2022, CAD $10B invested across 706 businesses, that amount is not enough. Canada's ambition should be to be a 10th of the US market and have $30-40B invested annually.

Private Equity is Jet Fuel for Business Investment

The Private Equity industry can help solve the biggest economic challenges for Canada: weak business investment and declining productivity. The industry succeeds by providing the capital that businesses need to invest, grow and hire. The majority of deals are under CAD $25M because Canada's PE industry is focused on small and medium-sized businesses (SMEs). Last year, CAD $10B was invested to take 890 businesses to the next level and Canada is well positioned to grow this industry much further. There is strong evidence that private equity investment is driving economic growth, job creation, and innovation by injecting capital alongside top technology and expertise into businesses with high growth potential.

- A study by PwC showed that Capital spending shot up 75% in the three years following a private equity investment.
- At the same time, employment growth tripled, so that the typical PE- backed company increased headcount by 24% in the three years post investment.
- The same study showed that the rate of productivity growth doubled in the 3 years following the initial PE investment.

Finally, growth equity is the fastest growing segment of PE because it focuses on taking innovative companies that are developing new technologies and scaling them up to become global powerhouses.

- There are 6,000 mid-sized Canadian technology companies with revenues between $20M to $50M, hundreds of which have high-growth potential.

The Risks to Innovation and our Future

While private capital is bullish on Canada, financial markets are challenged by a difficult macro environment, with the biggest increase in interest rates in forty years, a sharp slowdown in VC investment in the US, and fears of a recession in 2024. However, within adversity lies opportunity. If the government seizes the opportunity to attract more capital to the sector via incentives and strategic investments, we can create a win-win environment for investors and businesses.

In OECD's Policy Responses to the Economic Crisis: Investing in Innovation for Long-Term Growth, authors of the report examined the success of two countries that went all-in on investment during tough times.

During the 1990s, Finland went through a severe economic crisis in which their output decreased by 10% and unemployment rate quadrupled. Finland increased spending on research and development to help the economy recover. This helped lay the foundation for a strong rebound and put the Finnish economy on a path of growth.

In an even more powerful example, in Korea, during the late 1990s, the Asian financial crisis led to downsizing among large companies and a decrease in corporate R&D spending. The government of Korea responded by increasing their R&D budget and using the crisis as an opportunity to develop a technology-based small and medium-sized enterprise sector. Policies were implemented such as government-backed venture funds and tax incentives to improve the environment for startups and support research. This led to a rapid increase in the number of corporate R&D labs and SMEs, which helped fuel long-term growth. The country is now the 10th largest economy in the world.

Canada too has been through this before. Thomas Park, Lead Partner at BDC's Deep Tech Fund, wrote about his concerns about Canadian innovation losing out to other countries. "Downturns mean that the most resourceful founders stay the course, highly specialized talent becomes available, and the best investors remain in the market," said Park, who also calls on Canada to hold nothing back on Innovation.

It's time for Canada to choose the path of being a bold outlier, to leverage our VC strength and make sure our entrepreneurs have the funds they need to ride out the downturn and come out stronger. It's time for Canada to set itself the goal of becoming the best place on earth to invest and build a business.

CVCA is urging the government to think about a variety of tools that will provide a much-needed boost to private capital. CVCA suggests a combination of the following recommendations.

Recommendations to Build up the Innovation Ecosystem

1. **Create an exemption from capital gains tax if the proceeds are invested in a new venture**

   Exempting capital gains from taxes if those dollars are then reinvested in a new startup company has proven successful in France (the "dispositif apport cession" and in the US (in American Economic Opportunity Zones). Successful entrepreneurs, after they exit a business, often become the next generation of angel investors and venture capital financiers and they have the experience to invest successfully.

2. **Implement a Small Business Venture Capital Tax Credit**

   To attract more new investors to consider investing in start-ups, we recommend a national Small Business Venture Capital Tax Credit similar to the one in BC which provides a 30% tax credit on their investment in small business venture capital corporations or eligible growing businesses. The guaranteed return in the form of a tax advantage makes venture capital a far more appealing investment, which is critical to ensuring that it continues to attract funds despite higher interest rates for lower risk investor options.

3. **Review and improve the Scientific Research & Experimental Development Credit**

   The Scientific Research & Experimental Development Credit (SR&ED) has been a hugely positive catalyst for Canada's startup ecosystem. However, there is still room for improvement to make it more accessible and generous to innovative start-ups. We believe that having the program delivered by experts at IRAP instead of CRA would make the program more accessible and less burdensome. Furthermore, reducing support to foreign multinationals and to large established businesses would allow savings to be invested in innovative SMEs that would deliver a better bang for the buck. Finally, we recommend that the first $200,000 of SR&ED be made refundable to give early-stage companies more support and runway to commercialization.

4. **Provide enhanced support for Emerging Managers under VCCI**

   Prioritize a new allocation of $200M under the existing VCCI program for emerging managers (funds who have raised three or fewer funds). Emerging managers typically cannot access institutional investment and are facing challenges in attracting investment dollars in today's difficult fundraising environment.

   The Venture Capital Catalyst Initiative has been enormously successful by partnering with the private sector to provide matching funds that injected a total of $1.8B into the VC marketplace at a critical time for the industry. A new allocation of $200M under VCCI for emerging funds would ensure that general partners that have raised three or fewer funds continue to grow and deploy dollars in Canadian startups. It should be noted that this is not a recommendation to fuel the creation of new fund managers but rather to continue to grow existing ones.

5. **Introduce a Patent Box regime which provides a lower tax rate for Canadian-made patents.**

   A critical incentive to maintaining innovative tech companies in Canada is to have a tax regime that is more competitive than the US. A clear way to achieve this is by implementing a Patent Box regime, wherein income from patents developed in Canada is taxed at a reduced rate of 5%. Canada would have the lowest tax rate in the G7 for innovative companies, a strong incentive that would ensure more innovations are commercialized in Canada.

   There are complexities around implementing the Patent Box but Canada can learn from other countries such as Netherlands, Israel and Switzerland. Closer to home, Quebec has seen some success with its own Patent Box regime, the Incentive Deduction for the Commercialization of Innovations (IDCI). This provincial "Patent Box" tax regime generally allows a qualified corporation to benefit from a reduced 2% Quebec corporate income tax rate on certain income from qualified intellectual property assets. The adoption of a patent box could further position Canada as a leading investment destination.

6. **Offer accelerated depreciation in year 1 of all capital investment except for real estate.**

   Finally, the US has provided accelerated depreciation in year 1 of all essentially all capital investment except for real estate. We recommend that the government of Canada do the same in order to simplify the capital cost allowance schedules and remain competitive with the US.