CANADIAN VENTURE CAPITAL & PRIVATE EQUITY ASSOCIATION

CVCA SUBMISSION TO MINISTER OF FINANCE REGARDING PROPOSED PRIVATE CORPORATION TAX CHANGES

OCTOBER 2017

1. ABOUT THE CVCA

The **Canadian Venture Capital and Private Equity Association** (CVCA) is the voice of Canada's venture capital and private equity industry. We represent over 260 firms and thousands of individuals across the country who invest in Canadian innovation and growth. In addition to providing financing, CVCA members bring leadership, mentoring, talent management, connections and advice to growing Canadian companies at all stages and in all sectors. CVCA members also manage investments from a significant portion of union and non-union Canadian pension plans to help ensure retirement security for the vast majority of Canadians.

Well over **$100 billion** of venture capital and private equity has been invested in the Canadian economy over the past decade.

In 2016 alone, **$3.2 billion** in venture capital was invested in 530 innovation companies from seed to late stage funding, across information communication and technology, health and life sciences, cleantech and agriculture technologies, creating thousands of highly-skilled jobs and helping put Canadian innovation on the global stage.

Over that same period, private equity provided **$13.7 billion** of growth financing toward 536 Canadian companies across a wide range of sectors including oil and gas, automotive, mining, clean technology, information technology, manufacturing, retail and infrastructure.

2. CONSULTATION PROCESS

We are writing today to respond officially to your department's request for feedback regarding the proposed tax increases released on July 18th, 2017.

Since then, we have been actively engaging with government on these issues. We would like to recognize the openness of your government in listening to our concerns and look forward to continue working towards a solution that ensures these measures have no impact on investment in venture capital and private equity, and ultimately on the funding of innovation, growth, and job creation.

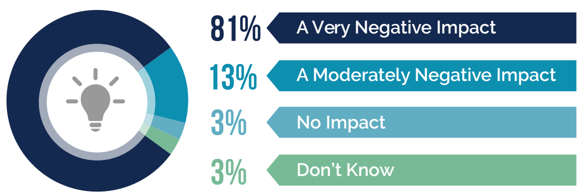
Since the proposals were announced, the CVCA has also engaged its members and others in our ecosystem to assess the impact of these proposals. Overall, while **our members feel most of the proposed tax changes will be harmful to investment**, **savings, growth, innovation, entrepreneurship, and job creation**, **the proposals centering on substantially increasing the tax on investment in private companies is seen as having the biggest negative impact**. Therefore, our submission will be focusing on this proposal.

We recognize that while the consultation process concludes on October 2, 2017, the passive income portion of the proposed changes still require draft legislation and as a result we expect to continue to work with your officials throughout this process.

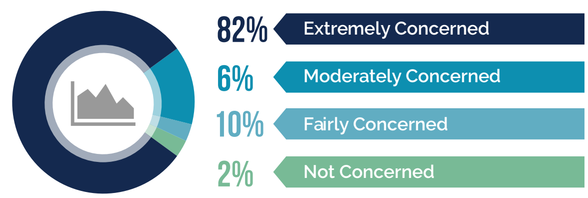
3. GAUGING THE IMPACT

To gauge the level of severity of these tax increases, we conducted a survey of our members which concluded the following:

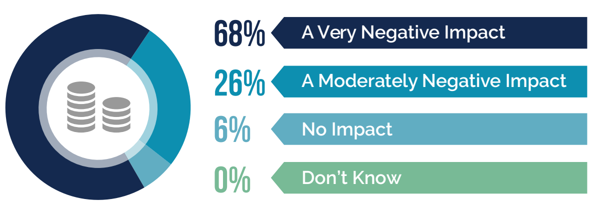
81% say the proposed tax changes will have a **very negative impact** on the **Canadian innovation ecosystem**



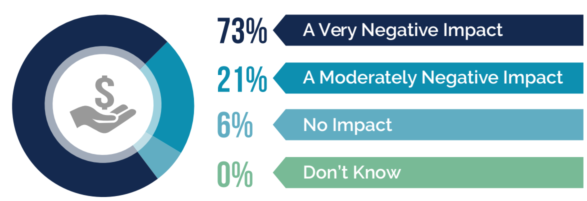
82% are **extremely concerned** about the impact this would have on **venture capital** and **private equity**



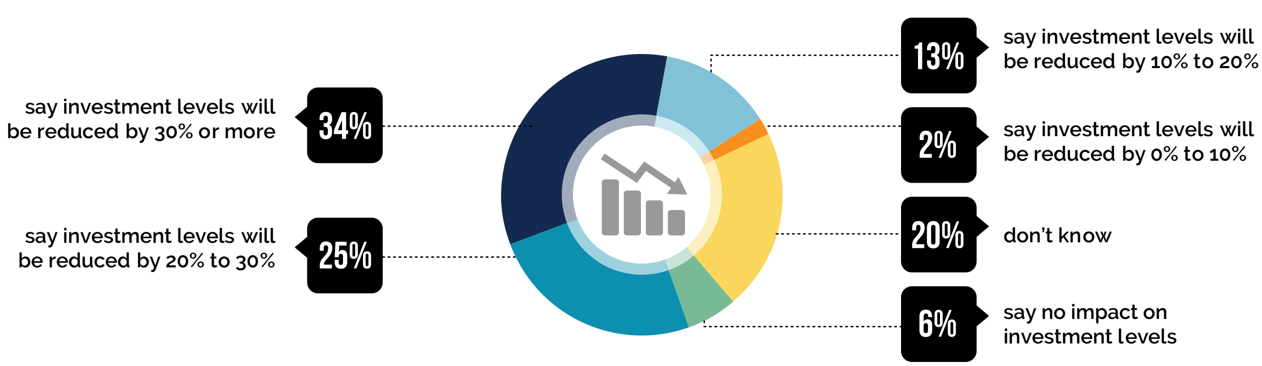
A combined **94%** are **concerned** about the **impact on investment**



A combined **94%** see it having a **negative impact** on **fundraising**



When asked what impact there might be on their firms' **annual investment level**, nearly **60%** said it **could reduce by 20% or more**.



4. SOURCING THE IMPACT

Venture capital and private equity must raise funds in order to invest in Canadian companies. This can be a difficult process, particularly in Canadian private capital, where access to financing suffers from structural issues including the size and number of Canadian institutional investors and the age of the ecosystem.

As a result, many venture capital and private equity firms rely substantially on private corporations for investment, including high net worth individuals, family offices and their holding companies. For instance, based on data from the CVCA, approximately 30% of investors in our members' funds come from these type of private corporations that could be impacted by the proposals. Many members have substantially higher numbers than these given the lack of institutional investors in private capital in Canada.

Because the investments into private corporations are generally viewed as "passive", the proposals will have two potential impacts: either they will significantly lower the amount available to invest in the ecosystem, or they will significantly lower the net returns achieved on those investments—both of which would negatively affect our members' ability to raise capital.

To help illustrate the issue, the CVCA has outlined a detailed example of a business that has generated $1 million in income over a number of years and seeks to invest these gains into a private capital Fund (see Appendix A). This Fund then, in turn, has a good return over a number of years and all the investors in the Fund double their original investment (a 100% return). This is a reasonable target for a typical Fund that spans over 10 years and earns a competitive, but not outsized, rate of return.

The table below is a summary of the appendix and the proposal's various impacts under the current regime and under the proposed regime which provides an "election" for the corporation to pay the taxes immediately.

	Current Regime	**Proposed Regime**	
	Corporation	**Corporation (Non-Eligible)**	**Corporation (PIC Election)**
Income Earned	$1,000,000	$1,000,000	$1,000,000
Tax on Income Earned	($265,000)	($265,000)	($501,700)
Amount Leftover to Invest	$735,000	$735,000	$498,300
Investment Gain of 100% (fund doubles)	$735,000	$735,000	$498,300
Total After-Investment Gain	$1,470,000	$1,470,000	$996,600
Net Tax on Investment Gain (Incl. RDTOH)	($71,663)	($184,375)	$258,116
Tax on Distribution to Ultimate Shareholder	($424,057)	($539,476)	($455,521)
Total Amount Remaining After Taxes & Gains	$974,280	$746,149	$799,194

$ Reduction as a Result of Proposals		($228,131)	($175,086)
% Reduction as a Result of Proposals		-23.4%	-18.0%

As you can see, the proposed regime's impact is substantial. It reduces the amount returned significantly in either scenario (18%-23%). And, under the "election scenario", it reduces the amount available to invest in our members' funds at the outset by over 30% to $498,300.

Perhaps most alarming is the fact that the investment in the first scenario results in a net gain of only $11,149, despite the original investment of $735,000 actually doubling over its lifetime. Put another way, it reduces the net gain to roughly zero, compared to approximately $240,000 in the current regime.

In short, with riskier investments such as these, the promise of a substantial potential upside must be evident. These changes would severely limit the potential upside and serve to make this asset class much less attractive, if not avoidable entirely for potential investors.

Canada already suffers from a lack of access to capital, particularly in venture capital. Your government has recognized this and much to your credit, acted on it. Budget 2017 provided funding for the Venture Capital Catalyst Initiative (VCCI) in order to help seed fundraising, recognizing that "venture capital is essential" and "will play a critical role in helping realize on the Innovation and Skills Plan's key objectives".

Unfortunately, this tax change would have a significant detrimental impact on the very fundraising the government is attempting to assist.

As well, a key to any ecosystem is recycling. Recycling of talent, expertise and money. Successful entrepreneurs seeding the next generation has been critical to the success of the world's greatest innovation hub, Silicon Valley. We are beginning to see this recycling affect in places like Vancouver, Montreal, Toronto/Waterloo and Ottawa, which will clearly be impacted negatively.

Similarly, growing Canadian businesses in many sectors rely heavily on private equity being able to fundraise effectively. As well, Canada's infrastructure needs, a key priority of this government, depend increasingly on private capital investments—all of which will be negatively impacted by this proposal.

5. OTHER IMPACTS OR UNINTENDED CONSEQUENCES

Capital Flight

Members have highlighted to us that capital is already leaving Canada as investors seek to deploy their funds in more tax competitive environments. Larger institutions are already actively shifting resources elsewhere in anticipation of these changes. We risk a hollowing out of our own investment capital in favour of international investors in Canadian companies as they are unaffected.

Canadian Versus International Capital

Local private capital plays a vital role in any ecosystem—beyond just investing. This role is recognized and cultivated around the world, including in Canada. However, this proposal would put Canadian venture capital and private equity with Canadian investors at a substantial net returns disadvantage to their international counterparts with international investors. This remains true even if both are investing in local Canadian companies. This is not something government policy should be encouraging.

Cumulative Impact

With the recent personal income tax change that puts the highest marginal rate above 50% in some provinces, and now a substantially higher marginal tax on investment, we have a concern that, taken together, will negatively impact the overall international competitiveness for Canadian investment, innovation and growth. Despite having a relatively low small business tax rate, scaling and growing companies look beyond this and look towards the ultimate net returns for their investors once they surpass that level. As well, when determining where to locate, entrepreneurs consider returns and the competitiveness of the tax system overall. We must ensure we are competitive at all levels, not just the very small.

Other Innovation Tax Changes

The government has stated it is committed to reviewing the SR&ED tax credit regime. This could potentially have a substantial impact on funding available for Canadian early stage companies. The CVCA suggests that the two tax changes which could impact innovation substantially be considered together for consistency in policy and to understand the combined impact.

Angel Investment Tax Credits

The proposed tax change on passive investment income would run directly counter to provincial policies and serve to effectively void current available angel tax credits available in British Columbia (BC's Angel Tax Credit Program), Alberta (Alberta Investor Tax Credit) and New Brunswick (Small Business Investor Tax Credit).

Company Fundraising Impacts

When growing companies are in a position to fundraise, they raise more than they immediately need in order to finance their growth or to just save for a rainy day. And while the majority of the funds are likely to be redeployed in the business; principally through high paying jobs, there is confusion over how this would be treated. At best, this will result in an increased amount of reporting and complications associated with demonstrating where funds are deployed and returned—a burden for many scaling companies.

6. **CONCLUSION**

We understand that the above concerns and impacts are likely unintended consequences of an attempt to equalize retirement savings benefits between entrepreneurs and salaried employees. We would contend that the consequences of these measures are outsized by the concerns.

We would also suggest that given all of these consequences, and given the government's intention to create a positive environment for investment and job growth, a broader more comprehensive review is required. The substantial concerns and impacts signify we must take the necessary time to achieve tax reform which won't impede investment at precisely the moment we need to ensure the Canadian economy continues to grow.

Minister, in a recent town hall discussing these proposals, you noted that you want to "ensure that we are creating opportunities for people to invest because we all want to create jobs and help the economy". As the investors in innovation, growth and jobs for the Canadian economy, we could not agree more.