CANADIAN VENTURE CAPITAL & PRIVATE EQUITY ASSOCIATION

Written Submission for the Pre-Budget Consultations in Advance of the Upcoming Federal Budget

By: Canadian Venture Capital and Private Equity Association (CVCA)

CVCA's Recommendations

- **Recommendation 1:** That the government repeal the recent increase to the capital gains inclusion rate as outlined in the 2024 federal budget, returning to a 50% inclusion rate and preserving the principle of integration in Canada's tax system.

- **Recommendation 2:** That the government provide a meaningful fiscal incentive to attract more capital to the riskiest corners of the innovation ecosystem by halving the capital gains inclusion rate applicable to capital gains realized on investments in small-cap, innovative Canadian-controlled private corporations (CCPCs).

- **Recommendation 3:** That the government facilitate a pooled $5-billion fund-of-funds with capital from Canada's large pension plans to incentivize domestic investment in the alternative asset class.

- **Recommendation 4:** That the government allow venture capital and private equity funds to be treated as qualified investments for registered, tax-advantaged savings plans within the meaning of the Income Tax Act (Canada).

- **Recommendation 5**: That the government works with the Office of the Superintendent of Financial Institutions (OSFI) to reconsider the proposed implementation of Basel III Capital Adequacy Requirements for Canadian banks, preserving a materiality exemption of 100% risk weighting for unlisted equity exposures – which include venture capital investments – and not implement the proposed 400% risk weighting, even after the proposed one-year delay.

The Canadian Venture Capital & Private Equity Association (CVCA) welcomes the opportunity to share with you our views and recommendations in advance of the upcoming Federal Budget 2025.

The CVCA represents some of the largest investors in Canada with more than 350 member firms and 3,300 individuals. Our members are the investors behind the creation of thousands of jobs, the advancement of innovative technologies, and the strengthening of local economies across the country. They are the backbone of Canada's entrepreneurial spirit, supporting businesses from startup to global expansion. 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 destination.

This submission provides recommendations focusing on two main areas: a) establishing a competitive tax and investment regime that rewards the risks associated with the private capital asset class to increase investment in Canada; and b) attracting greater investment capital to the innovation ecosystem, and to grow Canada's productive enterprises. Now is a critical time to double down on these measures as Canada urgently needs to prioritize growth and productivity. We believe that by implementing the below recommendations, the federal government can support a more robust and dynamic investment environment that drives innovation and economic success.

Creating a competitive tax and investment regime that rewards the risks associated with the private capital asset class to boost investment in Canada

- **Recommendation 1**: That the government repeal the recent increase to the capital gains inclusion rate as outlined in the 2024 federal budget, returning to a 50% inclusion rate and preserving the principle of integration in Canada's tax system.

  The 2024 federal budget increased the capital gains inclusion rate to two-thirds, or 67% from its longstanding previous inclusion rate of 50%. This measure has effectively raised the marginal tax rate higher than 30% across all Canadian provinces, a rate that is significantly higher than many competing U.S. hubs. Policy attempts to mitigate impacts have so far been insufficient to offset the ensuing damaging market signal that is certain to dampen Canadian investment in homegrown enterprises. Moreover, the now broken principle of integration in Canada's tax system has created an arbitrary distinction between individuals and corporations, serving only to disincentivize much-needed investment by Canada's corporations. The measure further creates additional distortion and complexity in Canada's tax code.

  Impacts will be especially acute in three main ways: 1) increased cost of Canadian capital vis-à-vis American capital, worsening the domestic fundraising environment and Canadian ownership of successful startups and technologies; 2) diminished incentives for risk-taking investors, eroding the attractiveness of capital allocation towards Canadian enterprises; and 3) challenges in attracting talent to the private capital sector as higher taxes on capital gains mean significantly smaller compensation for employees at startups and investment firms alike.

  These impacts will be especially acute at a time when capital deployment is crucial to boost Canada's growth and productivity. For this reason, CVCA recommends repealing this measure to send a powerful signal to the market and recover investment sentiment.

- **Recommendation 2**: That the government provide a meaningful fiscal incentive to attract more capital to the riskiest corners of the innovation ecosystem by halving the capital gains inclusion rate applicable to capital gains realized on investments allocated in small-cap, innovative Canadian-controlled private corporations (CCPCs).

  To incentivize more high-risk capital into the innovative startup ecosystem, the federal government should halve the regular capital gains inclusion rate on capital gains realized in respect of investments in innovative startups and small-cap CCPCs operating below a specific taxable capital threshold. This approach would create a targeted incentive towards the most innovative and strategic technology startups without necessitating new definitions, leveraging existing language and concepts that already exist in the tax legislation.

  By reducing the tax burden on successful investments in early-stage companies, this proposal aims to make the asset class more attractive to limited partners (LPs), including angel investors, family offices, and individual investors who are typically drawn to higher-risk opportunities and allocate capital whether directly or through Venture Capital or Private Equity funds into promising emerging enterprises. This would help reinvigorate the early-stage ecosystem, supporting tech-oriented and innovation-focused investment funds.

Attracting even greater investment capital to the innovation ecosystem and to grow Canada's productive enterprises

- **Recommendation 3**: That the government facilitate a pooled $5-billion fund-of-funds with capital from Canada's large pension plans to incentivize domestic investment in the alternative asset class.

  The CVCA supports the federal government's ongoing efforts to encourage Canada's pension funds to invest more in Canada, acknowledging the robustness of Canada's pensions system, their global prestige and ability to make market-based decisions.

  Private capital plays a critical role in Canada's economic success. A significant component of Canada's current productivity crisis is domestic underinvestment and challenges in scaling up companies. Canada's private capital is vital to address both.

  Alternative assets have increasingly become a significant component of pension plans' asset mixes. Despite their appeal, however, there is a current mismatch between our pension plans' capital allocation and the efficiency of deploying dollars in Canadian managers. This gap means that incentives are currently tilted in favour of pensions allocating the bulk of their private capital outside of Canada.

  The issue is not so much the absence of capital but having the right channels to deploy it. Canadian pensions are reluctant to make fund investments that are below $200M in size, but there are only a handful of Canadian VC funds large enough to absorb an investment of that size. The end result is that this capital typically flows to the United States, fueling and growing fund managers that invest in American companies instead.

  To address this issue, the CVCA recommends that Canadian pension plans allocate a portion of their investments to the domestic market through a fund-of-funds vehicle. Canadian pension plans have an opportunity to reorient a fraction of their investments and allocate more funds to Canada's alternatives without sacrificing returns. Such a change would significantly accelerate the growth of Canada's emerging VC/PE ecosystem.

The risk/return profile of private capital investments further aligns well with the long-term aspirations and pension liabilities of Canadian pension funds, making them an ideal investment choice for inclusion in a fund-of-funds mechanism.

The CVCA suggests that pension funds should consider pooling capital amounting to $5-billion per year to a proposed fund-of-funds. This amount represents 20% of the domestic market's capital deployment on an average year and is comparable to the market share of pensions in jurisdictions like the U.S. and the Nordic countries. The $5-billion amount should additionally be allocated in a proportion representative of market size, with 31% of that amount going to venture capital investments, 18% into growth capital and 51% into private equity.

This proposal draws inspiration from successful models like the VCAP/VCCI federal seeding programmes, which have been a successful proof-of-concept of public-private co-investment and de-risking strategies.

This long-term strategy has the potential to significantly enhance Canadian productivity while at the same time generate strong financial returns for Canadian pensioners, ensuring a prosperous future for retirees today and in the future.

- **Recommendation 4**: That the government allow venture capital and private equity funds to be qualified investments for registered, tax-advantaged savings plans within the meaning of the Income Tax Act (Canada).

  The CVCA recommends that the government expand the definition of qualified investments to include PE and VC funds in registered vehicles such as Registered Retirement Savings Plans (RRSPs) and Tax-Free Savings Accounts (TFSAs). This change would significantly enhance investment options for sophisticated investors, providing greater access to assets that are well-aligned with long-term retirement savings strategies. Additionally, it would expand the pool of investment capital available to fuel the growth of Canadian companies.

  The existing qualified investment definitions should be modernized to accommodate a broader range of asset classes. The current framework for qualified investments in registered savings plans has been incrementally expanded to include more than forty types of assets over time. As private capital increasingly enters mainstream finance across jurisdictions, it is important that Canadian regulation adapts to growing market demand as investors seek access to more dynamic and high-growth sectors.

  By modernizing the rules to allow private equity and venture capital funds in registered vehicles, the asset class would attract and deploy more investment capital, enhancing the growth and competitiveness of local businesses. Investments in VC and PE funds directly support Canadian businesses, particularly startups and small to medium sized enterprises (SMEs). By allowing such funds in registered plans, more capital could be directed towards innovative and high-growth sectors within Canada. This influx of investment can spur job creation, technological advancement, and overall economic growth.

- **Recommendation 5**: That the government works with the Office of the Superintendent of Financial Institutions (OSFI) to reconsider the proposed implementation of Basel III Capital Adequacy Requirements (CAR) for Canadian banks, preserving a materiality exemption of 100% risk weighting for unlisted equity exposures – which include venture capital investments – and not implement the proposed 400% risk weighting, even after the proposed one-year delay.

  OSFI recently issued guidance on implementation of Basel III Capital Adequacy Requirements (CAR) for Canadian banks. Included in these guidelines is a new risk weighting of 400% for speculative unlisted equity exposures, which include venture capital investments, from a current 100% risk weighting.

  OSFI's implementation guidelines, as proposed, do not fully consider the downstream impacts of the new risk weighting on capital formation in Canada and the resulting reduction of available capital for Canadian entrepreneurs. While OSFI has since announced a delay in implementation, there is as yet no consideration of a phased-in approach, such as it exists in other jurisdictions.

  This is especially concerning given that Canada's banks are among the most prominent Canadian Corporate VCs (CVCs) in Canada, alongside the media and telecom, and technology sectors. In fact, banks make up a third of Canada's CVC activity. A full implementation of Basel III guidance, and absent a phase-in period, would provide a disincentive to investment, likely resulting in this source of capital divesting away from venture as Canadian banks shift or restructure their portfolios to reduce their newly mandated risk exposure. This could have detrimental and irreversible impacts on this important LP-base of CVC investors.

  Therefore, we recommend that the federal government considers engaging with OSFI to reevaluate Basel III implementation and encourage the superintendent to maintain a materiality exemption of 100% risk weighting for unlisted equity exposures.