Productivity, Innovation and How Canada's Tax System Can Help

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Introduction

This paper discusses how the existing Canadian income tax system might be amended (short of an overdue wholesale redesign) to help improve Canada's poor productivity performance and cultivate a strong innovation sector within the economy. These are both issues of critical importance to Canada, and there is no time to lose and no stone to leave unturned in developing and implementing strategies for them. This paper' identifies various levers within the tax system that create the right incentives and generate discussion amongst relevant participants in the economy as to which options are best-positioned to achieve the desired results. These potential levers are illustrated in **Figure 1: Summary of Potential Measures** below.

The single most important thing Canada can do to preserve its sovereignty[1] and the future well-being of its citizens is to invest in its own economy, particularly in the face of the Trump Administration's international trade offensive to which we are uniquely exposed. Rather than tinkering around the edges, bold measures forming a co-ordinated and thought-out package (rather than disconnected one-offs) are needed to encourage the risk-taking required to move the needle on matters that will directly impact the quality of life Canadians will have for decades to come. The time has come for Canada to abandon antiquated notions of tax neutrality (i.e., a tax system designed not to influence economic decision-making) and instead, create a fiscal regime designed for economic expansion.

The recently enacted "One Big Beautiful Bill Act" in the U.S. includes the following measures:

- maintaining the 21% general corporate income tax rate (reduced from 35% in 2017), and permanently extending the 20% rate reduction in IRC §199A for "qualified business income" applicable to individuals, partnerships, S-corporations and some LLCs;
- permanently reinstating immediate 100% expensing of the cost of "qualified property" in the year put into service (bonus depreciation) applicable to most property with an expected recovery period of up to 20 years and expanding its scope to include manufacturing buildings;
- permanently allowing immediate expensing of costs for research & experimentation performed in the U.S., along with accelerated deduction of previously-capitalized such costs;
- relaxing the limit on deducting interest expense in IRC §163(j), by no longer reducing the taxpayer's "adjusted taxable income" for this purpose by depreciation, amortization and depletion (deductible interest is limited to 30% of ATI);
- a deduction for employees on qualified overtime compensation of up to $12,500/year;
- for investors, expansion of the benefits provided under IRC §1202 for shares of a "qualified small business", most notably the expansion from $10 million to $15 million of the per-investor capital gain exemption, with this limit to be indexed to inflation after 2026; and
- a major expansion of the foreign-derived deduction eligible income (formerly FDII) export subsidy created by the low 14% tax rate on income from U.S.-based foreign sales in IRC §250.

[1] Much of which we have voluntarily surrendered on fiscal matters by signing on to well-intentioned but impractical and wildly-complex OECD-led initiatives such as the pillar 2 global anti-base erosion (GloBE) rules (which the U.S. and China, among others, have not adopted), arbitrary interest expense deduction limitations, and proposed alignment our transfer pricing rules with OECD Guidelines that elevate ephemeral notions of "economic substance" over the legal rights and obligations that taxpayers actually create.

All of this is in addition to making permanent lower individual tax rates and higher marginal income dollar thresholds for reaching those rates, thereby entrenching the deep personal income tax disadvantage Canada has put itself in on an issue that directly impacts our ability to keep highly-skilled workers and attract new ones. When these actions are viewed in combination with major tariff increases being pursued by the Trump administration, the U.S. (ostensibly a country with no federal sales tax) is effectively moving its tax base significantly away from income taxes and towards sales taxes.[2] Finally, the U.S. is actively pursuing executive action to open up defined contribution retirement plans such as 401(k)s holding an estimated US$ 12 trillion to investment in private assets.

This is the competitive landscape we face. Unless Canada responds to what other countries are doing and designs its tax regime to optimize long-term economic growth and the resulting tax revenues that creates, we risk being left behind in the highly-competitive global economy.[3] A more activist fiscal policy is necessary to "level the playing field" with countries like the U.S. prioritizing economic self-interest. We need a tax system focused on maximizing Canadian economic activity (which in turn generates stable long-term tax revenues), creating national champions in a variety of industries capable of competing globally, encouraging risk-taking and rewarding (rather than redistributing) success. As one high-profile Canadian business figure noted, "We've got this funny disease where everybody helps their companies, but we don't help ours. In fact, we subvert them."[4]

Choosing to invest in our economy is not without cost and could entail short-term deficits, but the alternative is a *status quo* of continuing managed decline and ever-expanding deficit-financed government-provided income supports. Canada can be a winner in this environment, but not without getting its head in the game and making thoughtful, winning policy choices. Now more than ever, "it is paramount that tax policy be used as a tool to drive innovation and productivity."[5]

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2 See York and Durante, "Trump Tariffs Threaten to Offset Much of the "Big Beautiful Bill" Tax Cuts", July 16, 2025, The Tax Foundation. Tariffs are effectively just sales taxes levied on specific goods imported from specific countries.

3 As was observed recently, Canada's *per capita* GDP has fallen from 80% of U.S. levels to about 70%.

4 See "Canada's innovation policies need overhaul to boost economy, experts say", *Globe & Mail*, June 9, 2025, quoting Jim Balsillie.

5 Asselin, R. (2024, September 5), Engines of Growth, Business Council of Canada.

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Figure 1: Summary of Potential Measures

Taxable Canadian Corporations (TCCs)

Canadian Taxable Investors

- Tax credits for investment in TCCs meeting specified activity-related thresholds (i.e., "qualified innovation corporations" or QICs) or used by TCC to make eligible expenditures (i.e., direct investor tax credit for TCC IEP expenditure)
- Capital gains tax relief (partial or full exemption; deferral) on sale of QIC shares
- Flow-through share financing for transfer of deductions (i.e., IEP) incurred by QICs
- More favourable treatment of losses on QIC investments
- Alternative minimum tax relief
- Tax-efficient collective investment vehicle to make investments in smaller businesses by smaller investors cost-effective

Canadian Tax-Exempt Investors

- Tax-efficient collective investment vehicle to make investments in smaller-scale businesses cost-effective, e.g., VC-style partnerships, B.C. VCCs, U.S.-style BDCs
- TFSAs, RRSPs, RRIFs, etc.:
    1. Expand "qualified investment" to allow investment in QIEs
    2. Consider investment incentives such as expanded contribution room, tax-advantaged distributions, etc.
- Pension funds: consider disincentives to excess investment outside of Canada

Non-Residents Investors

- Already largely exempt from Canadian tax (i.e., capital gains from share sales, most interest income); little or no benefit in offering tax incentives

Workers

- Worker/employer tax credits for skills training
- New form of tax-advantaged worker participation in employer business success
- Reduced top marginal rates
- Relief for younger workers
- Tax incentives to encourage highly skilled foreign workers to become Canadian tax residents, create critical mass

Innovation

- Expanded SR&ED program to provide immediate expensing and tax credits for all qualifying expenditures on R&D and pre-commercialization; create "innovation expense pool" (IEP)
- Remove tax disincentives for scaling up or going public, i.e., non-CCPCs
- EIFEL relief for IEP expenditures
- "Innovation box" tax relief on IP-related income to support commercialization

Productivity

- Tax credits for expenditures on capital equipment and IP that enhance productivity
- Immediate expensing of costs of qualifying equipment and IP
- Tax credits for worker training
- Relief from interest deductibility restrictions (no reduction in "adjusted taxable income" for qualifying expenditures under EIFEL rules)

1. Overview

2025 has been an anxious time for Canada and Canadians. Our economy and the civil society and standard of living it supports is showing distinct signs of strain in the face of a variety of issues, including tariff wars, political upheaval, immigration pressures and international conflicts. People are worried about their financial security, their access to health care and the cost of living. Young people in particular are struggling to find traction in a job market that offers less security than ever at a time when rising costs (especially for housing) make it increasingly difficult simply to attain the same lifestyle their parents enjoy. There is an increasing sense of unease about what the future holds and Canada’s place in it, as we find that many things we have previously taken for granted are no longer so sure.

While darkening perhaps, the sky is not falling and we are still a very fortunate people to live in Canada. That said, we can no longer afford to just rely on the country’s natural advantages and past accomplishments. By many economic measures Canada is falling behind in an increasingly competitive world. Rather than passively accept a managed decline coasting on the unsustainable momentum of a depreciating currency and indefinite natural resource extraction, we must use all of the tools at our disposal to create a stronger, more resilient economy that supports the kind of society we wish to bequeath to our children and grandchildren.

One of the principal problems we face in strengthening our economy is the country’s continuing lackluster productivity performance, an issue described by Bank of Canada Governor Carolyn Rogers as a “break-the-glass” emergency. We simply cannot compete in a global economy where others are increasingly able to generate more outputs with the same or fewer inputs. Another serious challenge is ensuring Canada’s place in the rapidly-expanding innovation economy, where knowledge, technology and intangible assets are created, researched, developed, and commercialized. As more of the world’s commerce is generated by this type of highly-mobile activity, countries that fail to create and attract this type of business will find themselves further and further marginalized each year.

This paper considers how Canada's tax system might be used to achieve better productivity and innovation outcomes. While the tax system is by no means the primary determinant of success or failure on these measures, it definitely has a material role to play in terms of creating the right incentives (or at the very least avoiding non-essential disincentives) to engage in the activities that will produce better productivity and innovation results. Written as it is from the perspective of a tax lawyer, it seeks to describe the universe of the possible from a tax perspective: what features of the system *could* be changed to achieve the desired results. From this starting point, hopefully it serves as a useful basis for others better positioned to do so (e.g., technologists, entrepreneurs, business managers or investors whose real-life decisions matter) to consider which such features *would* (if changed) be most likely to actually influence their behaviour and produce those results.

2. Presuppositions and Premises

The discussion that follows is based on and guided by a number of presuppositions and premises, which are most usefully set out explicitly beforehand.

A. What's in Canada's Best Interests

The events of 2025 must serve as a wake-up call. In the current international environment, Canadians must take charge of their own destiny and do what's best for Canada, including asserting our fiscal sovereignty in ways that work to our advantage. We can no longer assume that other countries aren't acting in their own best interests. We should co-operate with other nations and participate in international initiatives such as the OECD's global minimum tax project only where doing so is in Canada's own interests: racing to implement the pillar 2 global anti-base erosion (GloBE) rules while China, the U.S. and others do not is unhelpful. Canada should be especially wary of "one-size-fits-all" solutions. All countries are not similarly positioned, and it is unwise for us to adopt regimes designed by others for their situations and that do not accommodate Canada's particular circumstances. We can agree with other countries on principles without adopting identical means for achieving them. Our unique geography and economic interlinkage with the United States simply positions us differently than European nations and other advanced economies, such that solutions that work for them may not work for us.[6]

B. Letting Go of Tax Neutrality

The existing federal income tax statute (the ***Income Tax Act (Canada)*** (ITA)) was developed out of the work by the Royal Commission on Taxation chaired by Kenneth Carter in the 1960s. The Carter Commission espoused the general principle of "a buck is a buck" to reflect the idea that fairness requires that all accretions to economic well-being should be taxed to the same extent. Despite the superficial attractiveness of this principle, reality is that some activities produce more desirable results than others, and that taxing the results of any activity is quite likely to reduce the amount of it. In some cases, it may make economic sense to reduce or even eliminate the tax on income arising from some such activities if they support or create other activities or

6 Canada's ill-conceived adoption of a digital services tax followed by its Trump-compelled (still pending) repeal is a tragic example. See Suarez, "Elbows Up: Canada's Tax Policy Opportunity in 2025," *Perspectives on Tax Law & Policy*, Volume 6, Number 2, June 2025, Canadian Tax Foundation.

revenue sources that would generate more-than-offsetting tax revenue over time. Canada needs to follow what many other countries are already doing and leave aside ideological tax purity in favour of real-world decisions that ultimately create more of the economic activity (and tax revenue) we need, even if doing so ostensibly appears "unfair" or out of line with the idiom that "a buck is a buck."

C. Distribution of Benefits

Using tax incentives in order to produce a bigger and stronger economy in the aggregate does not mean that everyone is affected equally. There will be relative losers and winners, and a more robust economy creates the ability to redistribute the resulting benefits to the extent desired in order to ensure that no Canadian gets left behind (a topic beyond the scope of the present discussion). While the distributional effects of enhancing Canada's productivity and innovation performance is beyond this scope of present discussion, it should be noted that improved labour productivity has a direct and virtually correlative impact on worker incomes.[7] Making workers more productive makes workers richer, not only the businesses they work for.

D. Cost

While living within our means is desirable and ultimately necessary, we as a country have the fiscal ammunition to make long-term revenue-maximizing investments in our economy, as distinct from politically-motivated handouts. The type of tax incentives discussed below will have a financial cost (which others are better qualified to quantify), but which if successful have the potential to be net-revenue-generating in the medium to long term. Moreover, *not* taking action to strengthen our economy has its own costs, which could potentially be more expensive and societally damaging. Instead of letting our economy atrophy and handing out income supports later, Canada can choose to use its fiscal ammunition proactively to invest now in a stronger economy.

E. Stability

Business and investment are attracted to certainty to the extent it can be obtained, and this has never been more so than in the chaotic environment of 2025. Canada boasts a strong reputation as a stable, rules-based society with a legal system that produces predictable results and a political system that is largely free of corruption. Major policy changes are relatively infrequent and usually well-signalled (the 2024 capital gains debacle being a tragic outlier in this regard). To be effective in affecting commercial decision-making, Canada must continue to offer a legislative regime (including tax laws) that is stable and predictable, and tax incentives should be enacted on a permanent (not time-limited) basis in simple, straightforward terms (i.e., without unnecessary terms and conditions for eligibility). In particular, political agendas must be kept out of the tax system.

F. Confining Benefits to Canadians

To the greatest extent possible, Canadian tax expenditures (i.e., tax incentives offered by Canada) and the downstream benefits they generate should accrue to Canadians. This is not to say that non-residents of Canada should never benefit from Canadian tax incentives if the resulting gains to Canada warrant it. People and capital are mobile and they have many geographic alternatives open to them, and some Canadian taxation of mobile income is better than none. Generally, however, we should try to limit Canadian tax expenditures to those who are fully within the Canadian tax system (i.e., subject to Canadian tax on world-wide income) except where non-residents play a role or fill a gap that Canadian residents cannot or currently do not.

[7] Cross: (2025) "Higher Labour Productivity Is the Key to Faster Income Growth", p.17 Fraser Institute: "Between 1981 and 2024, labour productivity increased 61.6% while real labour income rose 59.8%."

G. Simplicity

Much of the frustration Canadians feel with the existing tax system is the complexity and effort required to comply, which saps the willingness and good faith that are essential in a self-reporting system. New reporting requirements are added every year. Mid-to-large size businesses endure seemingly non-stop audits. Disputes with tax authorities take years to resolve, generally at considerable cost. Canadian businesses are drowning in tax compliance, and our economy suffers from the deadweight drag these costs impose. This needs to change.

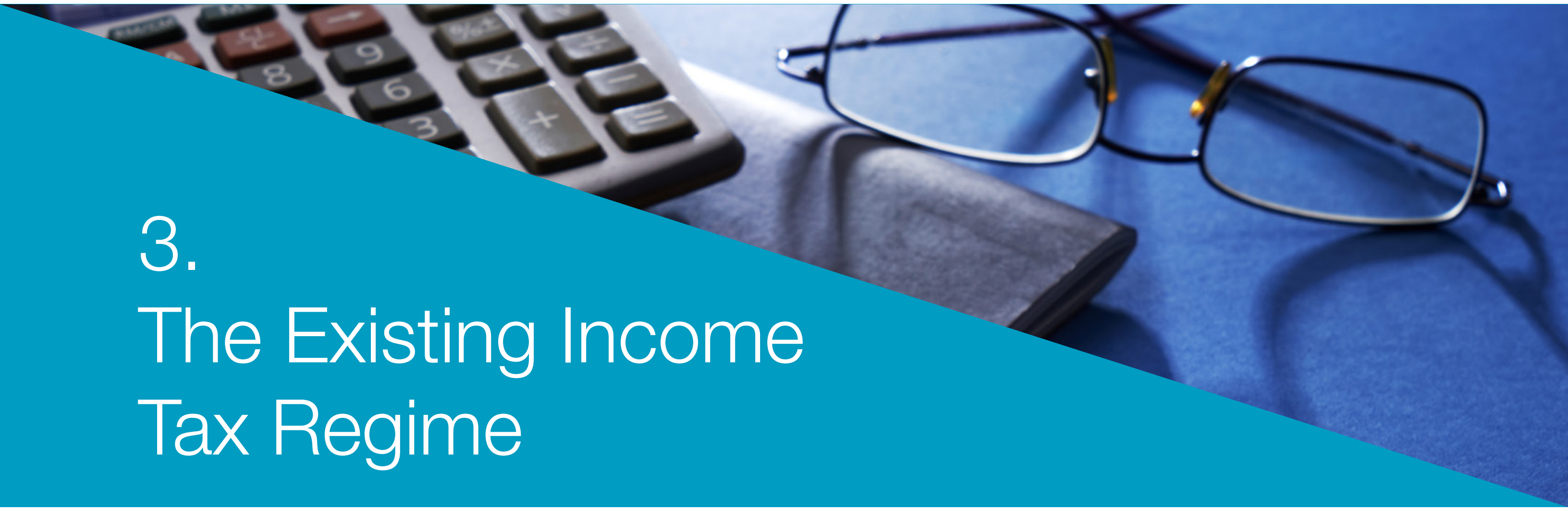
While a tax system with incentivizing preferences could be more complex, it need not be if the parameters of the incentives are reasonably clear, i.e., eligibility conditions are fairly simple to understand and compliance can be readily demonstrated and verified. Incentives that try to achieve too many objectives at once, have too many preconditions or variations, fail to make pragmatic cost/benefit trade-offs between leakage and complexity or cannot be readily understood by someone other than a tax lawyer are more costly to administer and less likely to achieve the desired results. There will always be judgment calls at the margins, but one measure of a successful tax policy is that the vast majority of situations should be easily determinable.

H. Ultimately, Comprehensive Tax Reform is Needed

The discussion following is focused on the existing tax system. As I (and others) have argued elsewhere, fundamentally what Canada needs to do is grasp the nettle and undertake a comprehensive root-and-branch review of what and who we tax, in what ways, and how much (including our trade and tariff policy, which is the other side of the same tax coin). Income taxes are the current backbone of the system, but there are other ways of taxing commercial activity such as cash-flow taxation. For example, Estonia's corporate tax regime of taxing earnings only when distributed has consistently been recognized as the most competitive tax regime in the OECD. An obvious and simple immediate recalibration is to reduce income taxes (in particular getting the top personal marginal rate down below 50%) and increase sales taxes (which as noted above the U.S. is effectively doing with income tax cuts and tariff increases),[8] which act as less of a disincentive to commercial activity and investment.[9] In the longer term however, Canada must revisit whether there are better and more effective ways of raising revenue that support the social programs that all Canadians benefit from and that are easy to comply with and to verify.

8 Canadian governments are already over-reliant on income taxes over sales and other taxes.

9 See Baylor and Beauséjour, "Taxation and Economic Efficiency: Results from a Canadian CGE Model", Department of Finance Working Paper 2004-10, 2004, p. 30: "As with most neoclassical GE models in the literature, tax reductions on saving and investment are found to yield greater efficiency gains than wage and consumption tax reductions. In particular, investment-promoting policies geared towards new capital and personal capital income tax reductions are found to be particularly effective."



3. The Existing Income Tax Regime

This portion of the paper briefly summarizes the key features of the Canadian income tax system at a general, non-technical level, for the purpose of framing the subsequent discussion of which features might impact desired behaviours that encourage productivity and innovation.

A. Fiscal Residence

The concept of fiscal residence is central to the Canadian income tax regime. Essentially, under the ***Income Tax Act*** (Canada) (ITA), natural persons, corporations and trusts who are residents of Canada for ITA purposes (Canadian residents) are taxable on their income from anywhere in the world, while all others (non-residents of Canada) are taxable only on certain specified types of income generated in or with some other nexus to Canada (Canadian-source income). Partnerships are generally "looked through" for tax purposes, such that they are not themselves taxpayers but the partners of the partnership are instead considered to earn the partnership's income, gain or loss.

Determining who is and is not a Canadian resident can be simple in some cases and less clear in others.[10] A corporation created under Canadian federal or provincial law is generally considered to be a Canadian resident, as is a corporation whose "mind and management" is located within Canada. Where two countries both consider the same person to be a fiscal resident of their country, in some cases a tax treaty between those two countries will deem that person to be a resident of one and not the other based on a "tie-breaker" rule. Canada has close to 100 such tax treaties.

B. Taxation of Canadian Residents

Canadian residents compute their income from all sources (i.e., business, employment, investments, gains on property), and determine their Canadian income tax owing as a percentage of that income. Corporations generally pay tax at a "flat" (i.e., uniform) rate on their entire taxable income, subject to a lower rate (the "small business deduction") for "Canadian-controlled private corporations" on the first $500,000 of "active business income".

[10] For more on this topic see https://businesstaxcanada.com/general-principles/ at 3., Residence for Canadian Tax Purposes.

Natural persons pay income tax at "progressive" rates that increase as taxable income increases, topping out at a roughly 54% combined federal/provincial rate in Ontario. Most trusts pay tax at the highest rate applicable to natural persons.[11]

A person carrying on a business computes the income or loss from that business generally starting from accounting principles (i.e., amounts are recognized as they accrue rather than when received or paid) as modified by various specific rules in the ITA. Most notably, transactions considered to occur on "capital account" (rather than on "income account") are subject to special tax treatment. An expenditure that is on capital account generally cannot be deducted in computing income; rather, it is usually either deductible from income over a period of years (for example an expenditure to acquire depreciable property such as machinery or equipment, described below) or not at all (for example an expenditure to acquire shares of a corporation acquired as an investment). In very general terms, an expenditure is likely to be considered on capital account if the benefit it is expected to produce is one that will be realized beyond the year in which the expenditure was made.[12]

Once the taxpayer determines their taxable income (excess of income over deductible expenses), the result is multiplied by the applicable tax rate for that taxpayer to determine tax payable for the year. If the taxpayer has any "tax credits" for the year, these are deducted from tax payable to determine how much the taxpayer owes in tax for the year. If deductible expenses exceed income in a year, that excess becomes the taxpayer's "non-capital loss" for the year, which may be carried back and used against net taxable income in any of the three most recent taxation years or carried forward and used against net taxable income in any of the next 20 taxation years.

Capital Expenditures

A capital expenditure on a property is usually added to the "cost" for tax purposes of that property, such property being a "capital property." In very general terms, capital property may be depreciable capital property or non-depreciable capital property. The taxpayer is entitled to claim a deduction in computing income for tax purposes each year for any depreciable capital property that it owns and uses in a business, such annual deduction being referred to as "capital cost allowance" (CCA). CCA is essentially the tax version of the depreciation expense computed under accounting rules (i.e., tax and accounting depreciation are computed differently), and allows the cost of depreciable capital property to be deducted from income for tax purposes over a period of years.

While the rules under which a taxpayer claims CCA can be quite complex, at a very general level they segregate all of the taxpayer's depreciable property into different "classes", and establish a different rate of tax depreciation (the CCA rate) for each class. For example, the cost of patents is included in Class 44, which has a 25% CCA rate. A taxpayer adds expenditures on all properties of the same "class" that it owns to a "pool" for that class and is allowed to deduct the applicable CCA rate for that class multiplied by the "undepreciated capital cost" (UCC) of that pool each year. For example, a patent that cost $100 and was included in Class 44 would entitle the taxpayer to $25 deduction in the first year ($100 UCC x a CCA rate of 25%), and the Class 44 UCC balance would be reduced by the CCA claimed to $75. The next year the taxpayer would be entitled to claim a CCA deduction of $18.75 (25% of the $75 UCC), and so on.[13]

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11 For Canadian income tax rates see: https://www.ey.com/en_ca/services/tax/tax-calculators.

12 For more on distinguishing capital expenditures from those on income account, see https://businesstaxcanada.com/general-principles/ under 4. Income Tax – Overview – Income Tax – Capital Versus Income.

13 The actual calculations are somewhat more complex - for more on how CCA works with examples, see https://businesstaxcanada.com/canadian-subsidiaries/ under 3. Capital Cost Allowance.

The Value of Tax Deductions

Because of the time value of money, the faster a taxpayer can deduct the cost of an expenditure in computing its income, the more valuable the savings in tax otherwise owing will be. Immediate deduction of the entire expenditure in the year incurred is the most valuable form of tax recognition for expenditures. As the CCA rate for a particular class of depreciable capital property decreases, the amount of each year's annual CCA deduction from income decreases, and the present value of the tax savings thereby generated from that deduction also decreases.

The key points to consider in valuing tax deductions are as follows:

- their dollar value of a deduction depends in part upon the tax rate applicable to any given taxpayer – for example, a $100 deduction is worth $25 of taxes saved to a taxpayer who is paying tax at a rate of 25% on taxable income, and $54 for a taxpayer paying tax at a 54% rate;
- a deductible expense has no immediate value for a taxpayer who does not have net taxable income from which to claim the deduction. For example, a $100 deductible expense incurred by a taxpayer with no net taxable income for the year (deductions exceed income) for the current taxation year simply increases the amount of their non-capital loss for the year by $100, and the present value of that future $100 deduction depends on how soon (if ever) the taxpayer will have positive taxable income to use it against; and
- as noted above, the faster that a taxpayer can deduct an expenditure in computing its taxable income, the more valuable that expenditure is from a present value tax-saved perspective.

Capital Gains and Losses

When capital property (such as shares of a corporation held by an investor) is disposed of, the excess of the proceeds of disposition receivable (i.e. the sale price) over the taxpayer's cost of the property is the taxpayer's "capital gain."[14] In this way, the cost of a capital property is recognized at the time the property is sold, as part of computing the taxpayer's capital gain or loss on sale. Only 50% of capital gains are included in the taxpayer's income, such that they are effectively taxed at half the rate of normal income.

If the proceeds of disposition are less than the taxpayer's cost of the property, the difference is the taxpayer's "capital loss." A capital loss may only be used against (i.e., to offset) capital gains, not income from a business or investment, and if the taxpayer's capital losses exceed capital gains for the year, 50% of the difference becomes a "net capital loss" for the year. A net capital loss can be carried back and deducted from net capital gains in the three most recent taxation years or carried forward and used in any future taxation year. Capital losses are generally worth much less to a taxpayer in taxes saved than are expenditures that permit a deduction from income, because capital losses can only be used against capital gains and not other income. A significant exception is a "business investment loss", which is a capital loss on a share of a "small business corporation". 50% of such a loss (an "allowable business investment loss" or "ABIL") may be deducted against any form of income, not merely capital gains.

[14] In the case of depreciable capital property, a portion of the sale price may also produce a reversal of CCA previously claimed in some instances or reduction of UCC of the relevant class (this topic is beyond the scope of present discussion).

The table below summarizes the tax treatment of profits and expenditures on income versus capital account.

	Income Account	Capital Account
Profit (Loss) on Disposition of Property	Profit is fully included in income; loss is fully deductible from income (or net capital gains if desired) in most cases	Profit is a capital gain, ½ of which (a "taxable capital gain") is included in income; loss is a capital loss, ½ of which (an "allowable capital loss") is deductible only against taxable capital gains; 50% of "business investment losses" may be deducted against any income
Treatment of Expenditure	generally, fully deductible from income	generally, non-deductible from income, usually added to the cost of any related property; in some cases, deduction from income allowed over time, e.g., CCA

Employees

Employees are taxed on their income from employment in much the same way as a taxpayer with a business is taxed on the resulting business income, except that very few deductions are permitted to employees in computing their employment income. Apart from a small list of exceptions, most employment-related benefits enjoyed by an employee must be included in employment income for tax purposes.[15] The only significant form of tax preference employees enjoy is a 50% deduction in computing income realized by eligible employees from certain qualifying employee stock options, which requires the employer to agree to issue shares of itself.[16] Salaries and benefits included in an employee's income generally constitute deductible expenses for the employer.

C. Taxation of Non-Residents

In most cases, non-residents are subject to Canadian income tax only on a relatively limited number of sources:

- income from carrying on business in Canada through some form of physical presence in Canada (a "permanent establishment", such as an office). As such, a non-resident of Canada that is merely selling goods or services to Canadians from outside of Canada will generally not attract Canadian income tax;[17]
- gains from disposing of "taxable Canadian property", most notably (1) an interest in land physically situate in Canada, and (2) shares of corporations that have derived their value primarily from an interest in Canadian land during the preceding 5 years.[18] Thus, as a practical matter, non-residents are typically not subject to Canadian capital gains tax on gains from disposing of shares of a corporation (and virtually never in the innovation/technology sector of the economy, where share valuation is usually based on intellectual property (IP));

15 See CRA Employer's Guide – Taxable Benefits and Allowances.

16 For a comprehensive summary of the tax treatment of different employee equity-based compensation plans, see Lynne Lacoursière and Grace Pereira, Taxation of Equity Compensation Awards – Overview, Practical Law Canada Practice Note.

17 For a more detailed discussion of the nexus required for Canada to tax a non-resident on business income, see https://businesstaxcanada.com/doing-business-with-and-in-canada/.

18 If the shares are publicly listed on a stock exchange, a non-resident seller must also own at least 25% of any class of the corporation's shares at some point in the preceding 5 years in order for Canada to tax the gain. For more on taxable Canadian property, see https://businesstaxcanada.com/exit-from-canada/.

- income from being an employee while in Canada, *viz*., an employee who is doing things for their employer while physically in Canada for a temporary period so as not to become a Canadian resident; and
- certain forms of passive income (e.g., rent, royalties, dividends, and interest) if paid by a Canadian to a non-resident, which the Canadian payer has a legal obligation to withhold and remit to the Canada Revenue Agency ("CRA"). Such tax (referred to as Part XIII withholding tax) is generally imposed on a gross basis as 25% percentage of the payment, which is often reduced to as low as 10% or 5% or in some cases completely eliminated if the non-resident's home country has a tax treaty with Canada.[19] Most notably, Canadian withholding tax applies on interest paid to a non-resident only if, (1) the payer and payee do not deal at arm's length,[20] or (2) the rare cases in which the interest is computed with reference to profits, cash-flow, etc. ("participating interest") rather than a usual fixed or floating rate.

If a Canadian resident becomes a non-resident (i.e., ceases to be fiscally resident in Canada by emigrating), all accrued but unrealized gains and losses on property are realized (*viz.*, marked to market) and subject to tax, and in the case of an emigrating corporation a final departure tax of its corporate surplus applies.[21] Persons who become Canadian residents are not taxed on pre-immigration gains on property (i.e., the cost of their capital property is marked to market), although some issues arise with hard-to-value property and Canada seeking to tax employment-related entitlements that have not be fully received by the time of entry into the Canadian tax system.

The key point is that a well-advised non-resident can invest in and benefit from the Canadian economy without paying material Canadian tax in many cases.[22] As such:

- once a natural person who is a Canadian resident emigrates so as to no longer be a resident of Canada for tax purposes, they largely or completely cease to generate any tax revenue for Canada; and
- Canadian residents and non-residents who participate in the Canadian economy do so on a very unequal footing from a Canadian tax perspective.

[19] For more on how tax treaties work see https://businesstaxcanada.com/tax-treaties/.

[20] U.S. residents entitled to benefits under the Canada-U.S. Income Tax Convention are fully exempt.

[21] For more on the Canadian tax consequences of emigrating, see https://businesstaxcanada.com/exit-from-canada/ under 3., Emigration.

[22] The *quid pro quo* is that the reverse is largely true in a general sense, *viz.*, Canadian residents can often invest in other countries in ways that do not attract material taxes in those other countries.

4. Forms of Tax Preferences

Within the confines of the existing income tax regime, there are a number of tax preferences that influence taxpayers' commercial activity.

Direct Payment (Tax Credits)

The simplest and generally most impactful tax expenditure is a tax credit, a variety of which exist throughout the ITA (including a large number of personal tax credits). As a deduction from (or credit against) tax payable, they have the same value for any taxpayer regardless of what rate of tax applies to that taxpayer, unlike a deduction from income, *viz.*, $1 of tax credit is worth $1 to all taxpayers.

Tax credits can be based on business inputs such as expenditures on property or workers (usually called "investment tax credits" (ITCs)) or business outputs such as kWh of electricity generated ("production tax credits"). Historically Canada has used ITCs rather than production tax credits despite the fact that the latter arguably align better with policy goals.

Tax credits may be either refundable or non-refundable. Most tax credits are non-refundable, meaning that can be used to reduce the tax a person owes, but only to that extent: if the amount of a non-refundable tax credit exceeds the taxpayer's tax otherwise owing for the year, the tax credit simply reduces the tax owing to zero.[23] Conversely, any excess of a refundable tax credit over the taxpayer's tax otherwise owing for the year is paid to the taxpayer as a refund. This makes refundable tax credits particularly valuable. The various clean economy investment tax credits enacted over the past few years in response to comparable tax incentives in the U.S. are examples of refundable ITCs.

Expenditures on scientific research and experimental development ("SR&ED") performed in Canada also generate ITCs. The extent to which a taxpayer can claim SR&ED ITCs on its qualifying expenditures (and whether or not those ITCs are refundable) depends on whether or not it is a "Canadian-controlled private corporation" (and if so the amount of its taxable capital).[24] The 2024 Fall Economic Statement proposed to expand eligibility for SR&ED ITCs by increasing the dollar amount limit of expenditures that generate an ITC, raising the taxable capital limits at which CCPCs get their ITCs reduced, and allowing Canadian public companies to qualify for larger and

[23] In some cases the difference is lost, while in others (for example most investment tax credits) the unused difference can be carried back to the three most recent years or carried forward up to 20 years.

[24] For more on this topic see the CRA SR&ED webpage.

refundable ITCs. Assistance received under government programs such as the National Research Council of Canada's Industrial Research Assistance Program (IRAP) generally reduces the amount of SR&ED ITCs that may be claimed. Various provinces offer more or less similar tax credits for SR&ED conducted in-province by Canadian corporations, 25 which are generally treated as "government assistance" that reduces the taxpayer's federal pool of qualifying SR&ED deductions.

Reduced Taxation of Income or Gains

Another form of tax incentive is a reduced rate of taxation on particular forms of income or gain. Obviously, such incentives are only effective for taxpayers that have positive taxable income or gains in the first place that can benefit from reduced taxation, *viz*., a taxpayer with a loss is not taxed.

The most well-known example of this type of incentive is the reduced (9% federal) rate of taxation that applies to "Canadian-controlled private corporations" on the first $500,000 of "active business income" under the "small business deduction". A more focused example is the outright 10-year provincial tax holiday Quebec offered Canadian corporations created between 2009 and 2014 on income from an eligible marketing business based on IP derived from research carried out in the Quebec public sector.

A similar form of preferential taxation currently under consideration is a regime for reduced rates of taxation on income generated from patents and similar forms of IP.[26] Colloquially known as a "patent box", such regimes are intended to incentivize the development and exploitation of IP within the country and its tax system (exploitation is particularly important, since without that there is little or no income to generate tax revenues or benefit from reduced taxation). Canada announced a consultation on introducing a patent box to the Canadian tax system in early 2024, seeking input on a number of design questions for what such a regime might look like in Canada. To date no specific proposed legislation has been released, although the Liberal platform references this concept.

Comparable investor-level tax relief from gains on sale exist to encourage investment in entities undertaking desirable activity. The best known is the lifetime capital gains exemption ("LCGE") of $1.25 million to which Canadian-resident individuals are entitled on the gains from the disposition of "qualified small business corporation shares" and qualified farm or fishing property, which require compliance with various tests.[27] As of 2025, a Canadian-resident individual meeting certain criteria may also be eligible to claim a reduced rate of taxation on up to $2 million of capital gains from dispositions of qualifying small business corporations via the Canadian Entrepreneurs' Incentive. A further pending initiative is the proposed exemption of up to $10 million of capital gains realized on "qualifying business transfers" to an "employee ownership trust". As noted above, employees can claim a 50% deduction in computing taxable income in respect of benefits received under qualifying employee stock options.

Investor-level relief on income to encourage financing on favourable terms for businesses is another form of tax preference. Debt financing offering tax-free interest to lenders has been a feature of the U.S. tax system for many years, via "muni bonds" issued by state and local governments. The "One Big Beautiful Bill Act" signed

25 E.g., in Ontario, the Ontario Innovation Tax Credit, the Ontario Research & Development Tax Credit and the Ontario Business Research Institute Tax Credit.

26 For more on the type of income generated by IP, see https://businesstaxcanada.com/canadian-subsidiaries/, under 8, Intangible Property.

27 Most notably, all or substantially all of the assets of the issuing corporation must be used mainly in an active business carried on primarily in Canada by the corporation or by a related corporation.

into law July 4, 2025 extended this treatment to certain forms of private activity perceived to have public benefits, such as space exploration.[28]

Deferral

Another form of tax preference is delaying when income or gains are recognized and taxed rather than an outright reduction in the rate of tax. For example, a Canadian-resident seller of capital property who does not receive all of the sale proceeds in the year of the sale may be able to defer recognition of part of any capital gain otherwise resulting over up to 5 years via a capital gains reserve. The maximum reserve period is extended to 10 years for certain inter-generational transfers of qualified farm or fishing properties or "qualified small business corporation shares", and similar treatment has been proposed for, (1) "qualifying business transfers" to an "employee ownership trust" (designed to facilitate the transfer of a business to its employees), and (2) transfers of shares to a worker cooperative pursuant to a "qualifying cooperative conversion".

The most common Canadian tax deferral is the joint election under s. 85(1) ITA to defer the recognition of income or gains otherwise realized on a transfer of property to a taxable Canadian corporation in exchange for property that includes shares of that purchasing corporation. Instead of the seller's accrued but unrealized gains being recognized and taxed, they are "rolled over": the property the seller receives continues to have the same accrued gain as was in the transferred property[29] (to be taxed whenever that property is eventually sold) and the property acquired by the purchasing corporation also has the same accrued but unrealized gain (which will also be taxable when the corporation disposes of that property).

A somewhat similar tax-deferred rollover is permitted under s. 44.1 ITA upon a "qualifying disposition" of shares of an "eligible small business corporation" ("ESBC") in a taxation year, where the individual acquires "replacement shares" of another "eligible small business corporation" within 120 days after the end of the taxation year. The terms and conditions of this tax-deferred exchange are sufficiently complex and challenging to meet as to make it very rarely used in practice. While certain elements of the eligibility rules (most notably the maximum assets of an ESBC) were proposed to be relaxed in the 2024 Fall Economic Statement, it is doubtful that these changes will address the concerns that deter taxpayers from utilizing this rollover.[30]

Deferral of gain recognition is common in mergers and acquisitions where the purchaser corporation wishes to use its shares as currency to acquire the shares of another corporation. Under Canadian tax law, it is only possible for a taxable Canadian corporation to issue shares of itself to a seller of property on a "rollover" basis to allow the purchaser corporation to acquire the seller's property without the seller having to realize any accrued gain on that property. Foreign corporations cannot do so (the exchange of property for shares of a foreign corporation is a taxable exchange), although where the values are large enough to justify the incremental cost, some foreign purchasers offer "exchangeable shares" issued by a Canadian subsidiary of the foreign purchaser to provide tax deferral for Canadian sellers.

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28 See Financial Times, "US space industry gets special break through Trump spending plan", July 8, 2025.

29 The parties can elect to recognize some of the accrued gain if they choose.

30 For example, only shares issued directly by the ESBC to the individual can qualify as ESBC shares, and it can be challenging for a shareholder to be confident that the corporation's assets are such as to meet the "all or substantially all used in an active business" test, which is valuation-based. It is notable that the revenue impact estimates contained in the 2024 Fall Economic Statement quantified the revenue cost to the government from these changes at a negligible $1 million annually. While these changes are appropriate and welcome, these figures suggest that the expected impact is very minimal.

Enhanced Deductibility of Expenditures or Losses

Another form of tax preference is to enhance the tax recognition of business inputs in computing taxable income. In most cases this form of tax preference will only benefit taxpayers that have positive income to reduce in the current year, or that are likely to have such income in the foreseeable future. Since business losses are not refundable (i.e., the government does not issue a cheque to taxpayers whose businesses have negative taxable income for the year), eventually a taxpayer needs to generate taxable income for unused deductions (i.e., the tax recognition of expenditures) to be used to save taxes otherwise owing in a future year. Otherwise, the time value of money is such that the present value of the future years' latent tax savings becomes marginal (in theory this could be mitigated by inflation-adjusting losses carried forward to future year).

While rarely seen, the most direct form of enhanced expenditure recognition would be to increase the deductibility of a specific form of expenditure, *viz.*, simply increase how much taxable income it offsets. For example, a $100 expenditure could be deemed to be $150 for purposes of determining the taxpayer's profit or loss for the year.

As noted above, the faster that an expenditure can be deducted in computing income, the more valuable the expenditure is in terms of the present value of taxes saved (assuming the taxpayer has positive income so as to be paying taxes). The SR&ED tax rules allow a taxpayer engaged in qualifying SR&ED in Canada to include all eligible expenditures on such work in a cumulative pool and deduct as much of them in computing income as quickly as the taxpayer wishes. In the 2024 Fall Economic Statement, the government announced its intention to restore various capital expenditures to what is eligible for inclusion in the SR&ED pool. While the rules to comply with the SR&ED tax program can be onerous[31] and disputes with the CRA as to which expenditures qualify are frequent, the ability to immediately deduct capital expenditures on qualifying SR&ED is a very significant tax preference.32

A similar incentive is to accelerate the rate of CCA (tax depreciation) on particular expenditures, such that the portion of a capital expenditure (e.g., the cost of a depreciable capital property) that can be deducted as CCA in computing the taxpayer's income each year is increased, producing larger deductions from income earlier. For example, in 2024 the government proposed to support innovation by allowing capital expenditures on patents and the right to use patented information to be eligible for a 100% CCA rate in the year such property becomes available for use before 2027.[33]

The 2024 Fall Economic Statement extended certain CCA preferences that were otherwise due to expire. Most manufacturing and processing (M&P) machinery and equipment, as well as certain clean energy generation and conservation equipment, that becomes available for use before 2030 will continue to be eligible for immediate expensing, i.e., a CCA rate of 100%. Most other depreciable property is eligible for the "accelerated investment initiative", which is not as generous as immediate expensing (and considerably more complicated) but still provides somewhat faster tax deduction of the cost of depreciable property. This program will also be extended to property that becomes available for use before 2030, and phased out by 2034.

Preferential tax treatment of expenditures and losses may also occur at the investor level, for example by allowing faster recognition or broader application. As noted above, "business investment losses" are a form of capital loss that may be used against income other than capital gains. By allowing 50% of the loss (an ABIL) to be used against income from various sources (i.e., more than just capital gains), the risk of investing in a

31 See the CRA publication The SR&ED Review Process: A Guide for Claimants.

32 For more on this topic see the CRA SR&ED webpage.

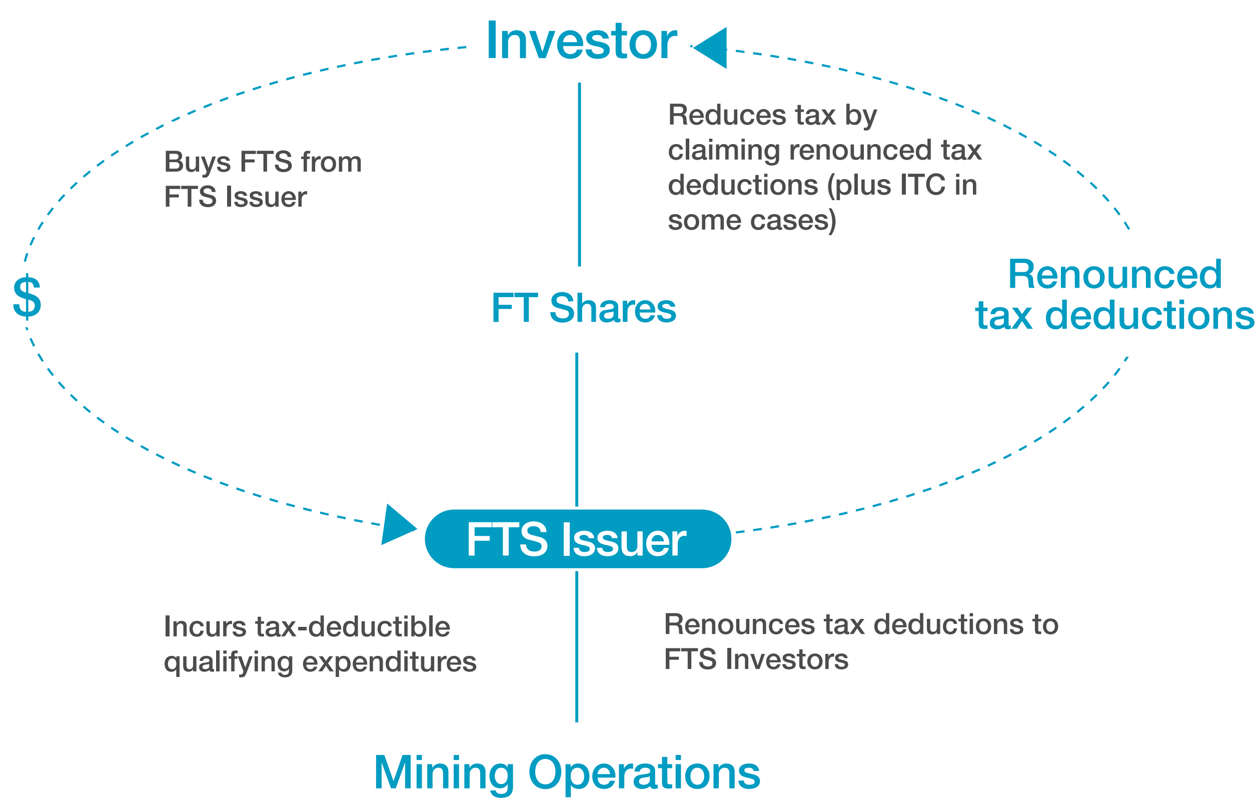
33 For more on the tax treatment of expenditures on IP, see https://businesstaxcanada.com/canadian-subsidiaries/, under 8, Intangible Property.

"small business corporation" is somewhat decreased because a taxpayer is more likely to be able to use an ABIL than an allowable capital loss (although recognition is still limited to 50% of the loss). Given that 50% of all capital gains are included in income, one might fairly ask why 50% of all capital losses ought not to be freely deductible against any form of income.

Flow-Through Shares

Where a taxpayer is not in a position to use a tax deduction or loss because it has no positive taxable income (as is the case with many early-stage businesses), its present value may be very low or even negligible. A uniquely Canadian tax preference on expenditures is the concept of flow-through shares ("FTS").

Flow-Through Share Illustration



The general rule in the ITA is that one taxpayer may not use a loss incurred by another one: such "loss trading" is contrary to the scheme of the statute.[34] FTS constitute an exception to this general principle, by allowing a corporation that incurs certain types of qualifying expenditures to "renounce" (i.e., transfer) them to an investor who subscribes for new shares of the corporation. Essentially, the investor gets to use the tax deductions created by the corporation's qualifying expenditures and transferred to the investor (thereby saving tax otherwise payable), and the corporation receives a premium from the investor in the subscription price for the shares it issues to the investor. In this way, the corporation is able to effectively monetize the value of the tax deductions it incurs in making certain expenses (and surrenders when renouncing them to the investor), with the funds received effectively financing these expenditures.[35] See here for a more detailed explanation of how FTS financings work from a tax perspective.

For some qualifying expenditures, the FTS investor can also claim an ITC (the "mineral exploration tax credit") to create even more generous tax treatment. Such an investor is thus willing to pay an even higher subscription premium to for the issuing corporation. In some cases provincial ITCs are also offered, such that the tax benefits of FTS financing vary across the country but are often quite substantial (see here for a province-by-province overview of estimated tax benefits).

Historically FTS transactions have been limited to the natural resource sector. In its 2025 election platform, the Liberal party undertook to expand the FTS program, by "introducing flow-through shares to our Canadian startup ecosystem, supporting companies in AI, quantum computing, biotech, and advanced manufacturing to raise money faster." Rather than resource-sector expenditures renounced in traditional FTS financings, the proposal will be for these new FTS issuers to "allow investors to deduct eligible R&D expenses [incurred and renounced by the FTS issuer] directly from their taxable income, lowering the risk of investing in innovative Canadian companies."

The cost to the tax system of offering a taxpayer enhanced recognition of expenditures in order to incentivize behavior depends to some extent on who the taxpayer's counterparty is and where that counterparty is resident for tax purposes. Where particular expenditures are incentivized in the hope that taxpayers will incur more of them, that behavioural change produces a corresponding increase the income of the taxpayer's counterparty (i.e., the seller of the good or service that the taxpayer is spending money to incur). If a taxpayer's counterparty (i.e., the seller) is itself a Canadian resident that is not tax-exempt, that seller's taxable income will be increased and (depending on the tax rates applicable to the customer and the seller) Canada may receive less, more or the same direct tax revenue from the incremental spending. However, as the seller of that good or service is likely to be incurring more labour costs in such incremental transactions (using Canadian-resident workers who pay tax on their incomes) and the buyer is presumably incurring incremental tax-deductible transactions in the expectation of itself generating more (taxable) business income, one would expect the overall net impact to be tax revenue-positive for Canada. The important point is that the counterparty's fiscal residence (i.e., Canada vs. elsewhere) drives the impact of the tax preference on the Canadian tax system, and that the down-stream tax effects must also be taken into account.

34 Administratively the CRA allows related Canadian taxpayers to engage in certain forms of self-help planning to use one another's losses from Canadian-source activities, within certain limitations.

35 The FTS concept gives a corporation a modest amount of the fiscal transparency that a partnership enjoys, but only as to the limited range of tax deductions the statute allows to qualify for FTS treatment.

5. Potential Tax Incentive Design Considerations

In thinking about how the Canadian tax system might be modified to incentivize productivity and innovation, it is helpful to first lay out some of the items that might inform the parameters of those incentives: what should and shouldn't factor into the design.

A. Fiscal Residence

Starting from the premise of wanting to keep the benefits of Canadian tax expenditures within the Canadian tax system for the benefit of Canadians, as a general principle we should be limiting tax incentives to Canadian residents, *viz.*, persons who are subject to Canadian income tax on their worldwide income. This typically results in the most or all of the resulting advantages staying within the Canadian tax system. While it is not unimaginable that in some cases offering tax incentives to non-residents could conceivably produce sufficient indirect benefits (tax or otherwise) to Canada to warrant the cost,[36] this would likely constitute the exception rather than the rule.

The reality is that given the very limited extent to which non-residents are subject to Canadian income tax, generating significantly more direct tax revenue from them is unlikely under current rules. Unless we plan on renegotiating (or ignoring, as some countries seem willing to do) our bilateral income tax treaties, there is not a great deal of potential new tax revenue to be obtained from non-Canadian sources.[37] The fact that in some cases higher taxes on non-residents simply get passed along to Canadian counterparties anyways[38] further limits the revenue-generating potential for taxing non-residents enough to the point of making it worthwhile to extend tax incentives to them.

[36] For example, a situation where the incentivized activity results in Canadian residents (e.g., employees or other service providers) thereby generating increased income that is subject to tax in Canada.

[37] The ill-advised digital services tax that Canada recently resiled from is a salutary example of the perils of trying to extend our tax reach too far internationally, and a reminder that we should expect others to do to us what we are willing to do to others.

[38] For example, the unlamented digital services tax was largely borne by the Canadian customers of the intended targets, and non-residents subject to Canadian withholding tax on royalties, interest or services often pass the cost onto their Canadian customers via demands for a gross-up of the amount payable by the Canadian to a sufficiently high number as to leave the non-resident whole after subtracting withholding tax.

In terms of business-level tax incentives, "Canadian corporations" are far and away the most logical way to demarcate who Canadian tax expenditures should be directed at. Such entities are by definition Canadian tax residents, and as a practical matter relatively few businesses of significant size within the scope of the present discussion are unincorporated. Extending eligibility to partnerships composed exclusively of Canadian residents (a "Canadian partnership" within the definition in s. 102(1) ITA) is possible, but adds meaningful potential anti-leakage complexity since the partnership itself is not a taxable entity and its partners can change at any time.

Note: the issue of how to *keep* Canadian those properties and corporations that have been created in Canada is an important one but is largely beyond the scope of the tax system to address and is in any case beyond the scope of present discussion. Short of outright bans on non-residents acquiring Canadian entities or properties (which is present are limited to a very small subset of sensitive cases but has been the subject of suggested expansion), in a market economy the highest bidder generally will always prevail to purchase a Canadian corporation or property. The tax system provides some limited degree of preference to Canadian buyers, and conceivably could be revisited to create more:

- Canadian buyers benefit from the fact that only shares of Canadian corporations, not foreign ones, may be offered to sellers on a tax-deferred basis (although to some degree this advantage is blunted by the exchangeable share structure foreign buyers can use);
- the s. 88(1)(d) ITA cost basis step-up that buyers of a Canadian corporation can use in certain circumstances to eliminate accrued gains on the target's non-depreciable capital property treats securities of a Canadian corporate buyer more favourably than those of other buyers;[39]
- to protect the tax expenditure investment Canada makes in Canadian corporations, it is certainly possible to make emigration from Canada (i.e., ceasing to be a Canadian resident for tax purposes) an event triggering a claw-back of tax credits and comparable tax incentives previously received; and
- conceptually similar reclamation of Canadian tax expenditures or sales taxes could apply to sales of properties or entities that have benefited from specific tax preferences to a buyer outside (or functionally outside) the Canadian tax system, although this is a complex issue.

At the investor level, Canadian residents generally should be the starting point for eligibility for Canadian tax incentives. There will always be exceptional cases, but as a general rule we should not be extending Canadian tax incentives to non-residents except to the extent necessary to create more-than-compensatory benefits to Canadian residents that cannot be generated from domestic sources within the Canadian tax system.

B. Entity Size

A variety of tax incentives in the ITA favour small businesses and thereby encourage them to stay small: for example, the small business deduction and the SR&ED tax rules described above. There is no compelling reason for this preference. Small businesses that grow achieve economies of scale that make them more efficient, competitive and resilient to economic shocks, as well as less susceptible to foreign acquisition. Tax incentives that discourage this are difficult to justify.

That is not to say that small businesses and start-ups don't have special needs or aren't worthy of support – quite the contrary. But in designing incentives it is essential to consider what downstream impacts they have. For present purposes, suffice it to say that improving productivity and innovation is desirable at *all* sizes of business, and while we may or may not want to limit the cost of any particular incentive by putting a ceiling on how much any particular taxpayer (or group of related taxpayers) can claim, this does not justify treating one

39 See the definition of "specified property" in s. 88(1)(c.4) ITA.

taxpayer more generously than another based on arbitrary criteria such as the corporation's taxable capital, revenues or dollar value of asset. Such measures have dubious (at best) tax policy merits and introduce considerable complexity into complying with and administering the rules for no significant benefit.

There is no reason to discriminate against larger Canadian corporations (including larger CCPCs) by giving them less tax support than smaller ones where both are engaged in the same desirable activity (indeed, the evidence is that larger corporation provide higher-paying (and tax revenue-generating) jobs than smaller ones).[40] To the extent that small business has specific needs that require size-based solutions, these are best addressed via direct grants tailored to those specific needs rather than through tax incentives supporting productivity and innovation generally.

C. Entity Ownership

A further question is the extent to which business-level tax incentive entitlement should be conditioned on who the Canadian corporation's owners are. In particular, should we be treating a foreign-owned Canadian corporation differently than one owned primarily by Canadians if both are undertaking the same desirable activity?

Prima facie the answer is no. To the extent that the "Canadian corporation" concept delineates who receives business-level tax incentives, those benefits are being captured in an entity that is entirely within the Canadian tax system. That being so, is there any reason to care who the present owners of the corporation are? If a Canadian corporation is seeking to become more productive or enhance its participation in and contribution to the innovation economy, it is not obvious why the fiscal residence of its owners should matter, at least for business-level (as opposed to investor-level) taxation. While ideally all such corporations would be Canadian-owned, this is an issue best addressed other than via constraining business-level tax incentives to Canadian-controlled entities.

It is fair to note that to some extent, the value of the shares of a Canadian corporation reflects the value of the corporation's underlying property, such that any Canadian tax incentives the corporation enjoys have some indirect impact on the share price an investor can receive from selling them. Given that non-residents are largely not taxable in Canada on capital gains from selling shares of corporations (as discussed above), there is perhaps room for an argument that business-level tax preferences should be extended to Canadian corporations that are primarily Canadian owned. However, these risks allowing the perfect to become the enemy of the good. Strong Canadian businesses that are fully within the Canadian tax system should be the primary focus of business-level tax expenditures, and we should start by focusing on using tax incentives to create value that is directly captured within the Canadian tax system. Trying to refine business-level incentive design based on investor-level capital gains taxation introduces needless complexity for relatively little benefit: between Canadian tax-exempts and capital gains preferences for taxable Canadian residents, there is little guarantee that share sales of Canadian corporations will necessarily yield significant tax revenue. Encouraging Canadian ownership of Canadian corporations is best left to means other than business-level tax incentives.

Certain Canadian tax incentives are also reduced or eliminated for Canadian corporations whose shares are listed on a stock exchange. There is little obvious merit to this tax preference either. The fact that a Canadian corporation's shares are widely held has little bearing on whether or not a desirable activity undertaken by that corporation is deserving of the same Canadian tax support as those that are privately-held. Indeed, scaling

[40] See Atkinson and Zhang, "Assessing Canadian Innovation, Productivity, and Competitiveness", Information Technology & Innovation Foundation, April 29, 2024, page 57-58.

up a business to the point where its shares are publicly traded should be viewed as a successful outcome, particularly if Canada is seeking to create home-grown economic champions.

D. Delivery and Administration

An effective tax incentive is one that achieves as much of its objective as possible with as little taxpayer compliance and government audit cost and effort as possible and with a minimum of potential leakage. There are cost/benefit trade-offs amongst these objectives, and it is important not to add additional program goals or qualification hurdles without a clear understanding of the incremental cost involved. The labour requirements applicable to claiming the full ITC rate for most of the clean economy ITCs are a good example. Requiring a taxpayer who wants the full ITC rate to pay the prevailing wage and include a prescribed percentage of apprentices sounds reasonable, but the practical difficulties these have created and the extra cost and effort required to prove compliance are disproportionate to the incremental benefit from making this an element of the ITC.

Beyond that, administration of tax incentives involves a variety of decisions based on the particulars of the desired activity and how a taxpayer qualifies, including whether one obtains pre-approval from tax authorities or instead simply claims the incentive and then undergoes either a special quasi-audit for compliance or the normal audit process. It is of course essential that any tax expenditure program has sufficient government resources allocated towards supporting it, in terms of assisting taxpayers to understand and comply (e.g., administrative guidance, advance rulings expertise, etc.) and knowledgeable staff to either pre-approve claimants or conduct post-claim audits efficiently.

One final observation would be that business craves certainty, and as such tax incentives that expire or have other elements lacking permanence do not inspire confidence, making them less effective in affecting behaviour. The permanent restoration of immediate expensing for R&D conducted in the U.S. in the July 4, 2025 "One Big Beautiful Bill Act" is especially noteworthy in this regard. If taxpayer behaviour is to be significantly changed, taxpayers must believe the incentives being offered to them will not be snatched away after they have taken the bait and made the investments government wants them to make. Time-limited tax incentives should be the exception rather than the rule.

E. Knock-on Effects

As noted above, when considering the design of tax incentives one must not lose sight of the impact on the beneficiary's counterparty and any secondary or tertiary effects.[41] A deductible expenditure for one taxpayer is frequently accompanied by taxable income for that taxpayer's counterparty; similarly a tax preference for one taxpayer may result in the loss of a tax-deductible expense for another.[42] Where both parties are taxable Canadian residents, the net impact of the tax expenditure may thus be significantly reduced or even eliminated on a consolidated basis. Tax relief for one taxpayer that generates greater tax revenue in the future and/or from other taxpayers should be costed on a comprehensive basis rather than as a stand-alone tax expenditure.

41 E.g., creating disincentives to scale up, as described in B., Entity Size, above.

42 For example, employee stock options generally result in no tax-deductible expense for the employer if the employee benefits from the s. 110(1)(d) ITA deduction in computing his or her taxable income.

F. Employment Levels

It is not uncommon for business-level tax incentives to include a minimum number of employees within the eligibility requirements. This often occurs where the incentive seeks to differentiate between relatively passive and active commercial activities, such that the number of (full-time) employees is being used as a measure of the "busy-ness" of the business.

In the abstract, encouraging more employment is a positive thing, although not necessarily connected to enhancing innovation and possibly counterproductive improving productivity. Careful thought should be put into whether tying business-level incentive qualification to any particular number of employees is appropriate, and if so, why that is and what incentives and effects that creates. To the extent that labour-related measures are desirable, factors to consider include:

- limiting labour-related qualifications to Canadian residents ensures that the flip side of the labour cost deduction claimed by the business is worker income that will be taxed in Canada, reducing the cost of the tax expenditure to the system;
- query whether focusing solely on employees and ignoring independent contractors is an arbitrary distinction, particularly in the "gig economy" environment where many innovation advances are made; and
- rather than the number of workers engaged on a project, perhaps it makes more sense to focus on the total dollar amount of labour costs involved: higher-value workers better reflect the type of work relevant to improving productivity and enhancing innovation, and generate more tax for Canada (since individual rates are progressive rather than flat).

G. Supporting Anti-Avoidance and Exclusions

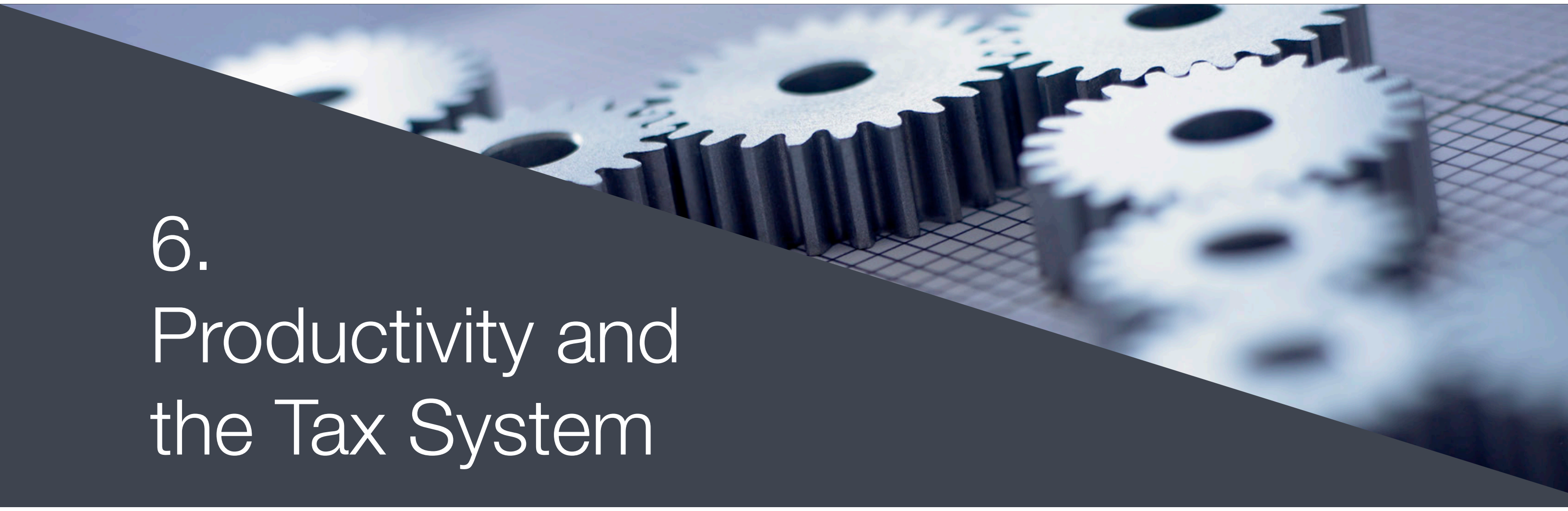
Depending on their objectives and design, tax incentives may be qualified and supported via various measures to direct delivery to where they have the greatest impact or limit total program costs. These may include the following:

- dollar limitation on maximum benefits claimed, either annually or during the taxpayer's existence, potentially supported by rules requiring sharing amongst related entities
- holding periods for investments;
- exclusions for specific properties (e.g., buildings versus machinery) or transactions (e.g., non-arm's-length transactions); and
- benefit claw-backs or recaptures upon specified events (such as departure from the Canadian tax system).

H. Competing Jurisdictions

While Canada's tax policy cannot be beholden to what other countries are doing, neither does it exist in a vacuum. We can and should design our tax system (and tax incentives in particular) with an eye towards what other countries are doing to attract the same people, businesses and capital that we are seeking. While we need not participate in a race to the bottom, we can be selective as to where and when we choose to offer tax incentives and understand what we need in order to be competitive.

As a practical matter Canada's most significant competitor for the type of economic activity we seek is the United States. A significant factor in the complexity of the Internal Revenue Code is the fact that it contains a wide variety of tax incentives, reflecting the fact that the U.S. actively uses its tax system to encourage particular behaviours and to compete with other countries. At noted at the outset, the "One Big Beautiful Bill Act" signed into law July 4, 2025 included a variety of aggressive and substantial tax measures designed to spur economic growth, some of which will inevitably come at the expense of other countries such as Canada. In those areas of the economy where we are trying to compete internationally for people and capital, our tax rules must themselves be reasonably competitive relative to what is on offer elsewhere.



6. Productivity and the Tax System

In simplest terms, productivity is output per unit of input, with the inputs and outputs chosen depending on what it is one is trying to measure. There are various relevant measures of economic productivity.[43] For present purposes one of the most relevant is labour productivity (e.g., value produced per worker hour), which in Canada's case has been described as "dismal"[44] (in large part due to underinvestment in new capital equipment). The OECD stated recently as follows:

> Specifically, Canada's low labour productivity compared to the United States – despite strong economic ties and geographical proximity – has been a long-lasting concern. As of 2023, Canada's workforce generated the equivalent of USD 74.7 in goods and services per hour worked (purchasing power parity corrected), far from the USD 97.0 generated in the United States, and the USD 89.3 in France.[45]

Indeed, the "unprecedented" increase in federal public sector work force to try and address productivity issues, rather than giving existing workers better tools or upgrading their skills, has been the subject of much concern.[46] The result is a worst-of-both-worlds scenario of Canadians working American-level hours for European-level wages, a tragic productivity outcome.

Improved productivity can occur through giving workers better physical tools to work with that result in increased output per worker hour, by upgrading worker skills, and by attracting more skilled workers to Canada.[47] To this should be added retaining the existing skilled workers who are already Canadian residents within the Canadian tax system (i.e., rather than emigrating to benefit another country's economy). The tax system can support each of these by reducing the risk of investment or increasing the potential after-tax return of successful investment. Note: the term "worker" is used to include human capital generally, whether employees, independent contractors or owner-managers.

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[43] For example, one measure of R&D productivity is the number of patents thereby produced.

[44] Atkinson and Zhang, "Assessing Canadian Innovation, Productivity, and Competitiveness", Information Technology & Innovation Foundation, April 29, 2024, page 30.

[45] OECD (2025) "Economic Surveys: Canada 2025", s. 4.1.

[46] Breznitz, "How not to run a country: Government ineptitude and Canada's economic malaise", Globe & Mail, September 28, 2024. Improving the productivity of the tax system itself (i.e., reduced taxpayer compliance costs and government enforcement costs) is a vitally important but separate issue.

[47] Lester, "An Economic Strategy for Canada's Next Government", C.D. Howe Institute, April 4, 2025, page 7.

Because measuring the financial results of (i.e., ascribing a particular amount of income to) productivity-related investments is significantly more difficult than quantifying expenditures on them, as a practical matter effective tax incentives are much more likely to focus on business inputs than outputs. At a macro level, businesses that have more capital to invest and a lower cost of capital are better positioned to take the leap of faith required to invest in improving business productivity. Hence, lowering the cost of capital on productivity-related expenditures generally lowers the cost (and risk) of those investments. This is particularly the case for small and medium-sized enterprises in Canada, which historically have faced "punishingly high interest rates" relative to other countries.[48]

A. Capital Investment

The most direct form of productivity improvement is to acquire and adopt new and more productive technologies and give existing workers more or better tools to work with. Traditionally this has been largely focused on machinery and equipment but can include intangibles such as computer software and AI. Indeed, the OECD recently remarked that "The digital intensity of Canada's industry structure has remained below that of G7 peers, pointing to scope for deeper adoption of digital technologies."[49] Since the digitally-intensive sectors of the economy exhibit significantly higher productivity growth than the economy generally,[50] there seems little doubt that incentivizing growth in these sectors and the adoption of digital technologies generally will generate improved productivity.

In relative terms Canada already offers fairly generous tax depreciation for capital costs, assuming the measures proposed in the Liberal platform[51] are enacted. However, given the immediate expensing of most tangible business property now allowed in the U.S. as a result of the "One Big Beautiful Bill Act", the U.S. tax regime has become more attractive than Canada's on this measure. Canada would be well-served by at least matching (if not surpassing) these U.S. initiatives and permanently allowing immediate expensing of a wide range of productivity-related expenditures (including buildings) that would otherwise be deducted for tax purposes over several years.[52] As with other deductions from income, immediate deduction of capital costs for tax purposes will have the greatest impact for taxpayers with positive income that can be reduced by tax-deductible CCA, as opposed to those unlikely to have taxable income for the foreseeable future.

Immediate expensing essentially just defers when a taxpayer pays taxes, since deductions for CCA claimed entirely in the year the property is acquired and put into service are not available to be claimed in later years, *viz.*, all else being equal, less tax today means more tax next year. Consideration should be given to going beyond deferral and offering an ITC (either refundable or non-refundable) on productivity-related expenditures similar in concept to the clean economy ITCs, to further de-risk such activity and offer a modest degree of financial support.[53] Aligning tax recognition of these expenditures with cash flow to reduce the tax burden on

48 Kronick, "Tax Policies To Reverse Current Trends in Productivity in Canada", *Perspectives on Tax Law & Policy*, Volume 4, Number 4, December 2023. See also the OECD "Economic Surveys: Canada 2025", s. 4.3.

49 OECD (2025) "Economic Surveys: Canada 2025", s. 4.3.3.

50 *Ibid.*

51 Page 48: "Reduce the cost of investment for Canadian companies and make sure they are internationally competitive by extending immediate expensing for manufacturing or processing machinery and equipment, clean energy generation, energy conservation equipment, and zero-emission vehicles, as well as the Accelerated Investment Incentive."

52 Initiatives such as the accelerated investment initiative are well-intentioned and definitely better than nothing but more complicated than need be and ultimately half-measures.

53 Query the potential for an enhanced ITC on equipment purchases from Canadian manufacturers, to help level the playing field with manufacturers from countries imposing tariffs on Canadian goods.

marginal investment is "exceptionally efficient" in modifying taxpayer behaviour.[54] Half-measures to increase Canadian investment in capital equipment to improve productivity have proven unsuccessful: now is the time for more significant government support in modernizing the Canadian economy.[55]

In general, interest expense on debt incurred for use in a business is deductible in computing the income of the business. In 2024 the new "excessive interest and financing expense limitation" (EIFEL) rules in s. 18.2 ITA became operative. These rules essentially prevent in-scope taxpayers from deducting interest expense in excess of 30% of the taxpayer's "adjusted taxable income" (ATI). As ATI already adds back CCA deductions claimed, the recent IRC §163(j) amendment described above simply brings the comparable U.S. rule into line with the Canadian equivalent. Any further tax system support for lowering finance costs within the framework of the existing system would likely need to be directed at the investor level, i.e., FTS financing or investor-level tax relief.

B. Enhancing Worker Skills

Upgrading the skills of our existing workers is a significant way in which to enhance their productivity. While much of what can be done in this area lies outside the tax system[56] and there are some Canadian government programs currently in place to support this objective, there is relatively little in the ITA incentivizing this objective.

Employees (other than those earning commission income) are generally not able to deduct the cost of training they incur from their employment income. For persons who are self-employed, training costs may or may not be deductible, depending on the circumstances. Based on existing law, the CRA's administrative policy differentiates between training to "maintain, upgrade or update . . . existing skills or qualifications" and those that result "in a lasting benefit to the taxpayer". The latter are considered to be capital expenditures which are not deductible. Allowing individuals to immediately deduct the costs of all work-related training they incur would be a simple way to incentivize skills upgrading and the increased productivity that results.

A modest tax credit for skills training is available to Canadian residents between 26 and 65 years old. The Canada Training Credit is a refundable tax credit of up to $5,000 on a lifetime basis for eligible training expenses. Availability of this credit accrues at the rate of $250/year in which the taxpayer is both within the age eligibility range and within a minimum and maximum income range. These annual and lifetime limitations on the credit do not seem particularly necessary or helpful and render it of fairly limited effect in terms of incentivizing skills upgrade. The government should invest in the productivity of its workforce with a much more generous tax credit without age or income limits. To preserve the government's investment, the amount of the credit claimed by an individual who emigrates from Canada can be made repayable upon ceasing to be a Canadian resident.

54 Alan Cole, "Canada Can Offer a Contrast to Erratic US Policy" (2025) 6:2 *Perspectives on Tax Law and Policy* 19-21.

55 Incidentally, Schedule 2 to the *Income Tax Regulations* describing the different CCA classes for different properties acquired at different times has now had so many amendments and cross-references as to be approaching indecipherability, even by tax standards. It would be helpful for the government to modernize the description of which properties are in which classes.

56 See for example the "coordinated industry-driven training programs" occurring in Ireland, the consistently top-ranked OECD country for labour productivity.

An existing (non-refundable) tax credit for eligible apprentices exists for employers, but is very modest in support ($2,000/year per person).[57] Consideration should be given to providing a separate tax credit for employers who fund the cost of all employee training, in order to encourage relevant skills upgrading. Since employees are mobile, employers investing in skills upgrading of existing employees face the risk of paying to train someone who leaves to work for a competitor. However, the government continues to benefit from the tax revenue generated from the higher salary and wages produced by such upgraded skills and so can fairly be asked to bear some of the cost.

While productivity in its highest form is focused more on increasing output per unit of work rather than simply working harder, there is nothing wrong with making it more advantageous to work more. The recent U.S. tax initiative to exempt from tax up to $12,500 of "qualified overtime compensation" has been the subject of some criticism and certainly raises a number of design and compliance questions. That said, there is an intuitive logic to the simple idea that people will be willing to work harder if they make proportionately more money doing so on an after-tax basis, and extending a tax break to employees generally who are willing to work longer hours is both fair and equitable. While perhaps not the highest priority, it would be worthwhile to consider whether some more workable version of this concept could be designed to encourage existing workers to do more in exchange for keeping more of the resulting wages.

C. Keeping Existing Highly-Skilled Workers

Canada very much needs to retain the skilled workers that it has and whose cost of training it has funded to a significant degree in most cases. It is widely known that Canadian personal income tax rates are higher than American ones at pretty much every income level, and while both systems are progressive the highest bracket is reached much faster in the Canadian system than in the American one. While linking the tax burden to some extent with the ability to pay is widely accepted as "fair", there are limits to this principle, and Canada has reached them. The type of highly-skilled people Canada needs in order to become more productive can choose where they would like to live, and a top marginal rate of over 50% is having an increasingly damaging effect on that choice. Every effort should be made to get the top marginal rate of tax down to a point where these people are not minority partners in their own paycheques, which can be funded with an increase in other taxes such as GST/HST. Like it or not, Canada is competing with jurisdictions with much lower personal tax rates, and many of our most productive workers are in demand in states with no personal income tax (a bitter reality we are already facing with hockey players). While we may not need to eliminate the gap between Canada and the U.S. completely, in one form or another top marginal rates need to come down and the income threshold at which they are reached needs to go up.[58]

One possible way of incentivizing skilled workers to stay in Canada would be to develop a new tax-advantaged way for workers to share in their employer's business success. At present employee stock options are the only such alternative (the others are all basically just deferrals, not outright tax reductions). These require the employer to agree to issue shares of itself. Not all businesses are willing to accept the equity dilution and legal implications of issuing new shares, i.e., as opposed to simply paying more cash or offering some form of right that will pay out for the employee if the business succeeds. Canada should consider developing a new form of tax-favoured equity-adjacent compensation for workers that creates an incentive to stay with their Canadian employer,

57 The Liberal platform (p. 52) proposes an apprenticeship grant to registered apprentices and (apparently) re-open the Apprenticeship Service program for their employers.

58 See in particular Cross: (2025) "Higher Labour Productivity Is the Key to Faster Income Growth", p.19 Fraser Institute: "[R]eal income growth in Canada since 1981 has almost exactly matched labour productivity growth. At the same time, the share of income going to the top 1%, 5%, or 10% all declined over the same period, whether measured using market income, total income, or after-tax income."

possibly linked to limited or non-deductibility for the employer to help reduce the cost of the tax expenditure.

The loss of a highly-skilled young person with decades of income earning (and tax paying) ahead of them is especially harmful to the Canadian economy. Young people today face many challenges, including housing and other living costs in many of Canada's major cities. It may be time to consider some form of tax incentive directed specifically at them. For example:

- crediting post-secondary tuition fees they have paid against taxes owing, dollar for dollar;
- exempting from tax some amount of employment income up to a lifetime dollar limit; or
- for those under a certain age, limiting the applicable marginal rate on higher amounts of income to something lower than would otherwise be the case, or perhaps offering a flat-rate alternative (something directed at higher marginal rates would be more accurately focused on those income-earners most affected by Canada-U.S. rate differentials and most at risk of leaving the Canadian tax system).

No doubt other (better) ideas can be generated from those closer to these workers and what motivates them. In any case, we need to abandon tax orthodoxy and move aggressively to give high-earning and skilled younger workers every reason to remain within the Canadian tax system. Whether we realize it or not, we are in a competition to keep our best and brightest young people.

D. Attracting Highly-Skilled Workers

Immigration always has been essential to Canada's growth and well-being and will continue to be so in the future. Attracting highly-skilled workers from other countries is an intelligent and cost-effective way in which to obtain badly-needed expertise and expand the country's tax base without paying for the associated training costs. The new government has prioritized "attracting the best talent in the world", and the tax system should reflect this.

While even temporary additions to the tax base are welcome, as a practical matter what would benefit Canda the most is for these sorts of highly-skilled workers to become Canadian residents. Convincing a non-resident to become taxable in Canada on their worldwide income must be made a more enticing choice from a purely tax standpoint.

Many of the same tax issues described above that would help retain existing Canadian residents are relevant to attracting new ones as well: for example, a lower federal/provincial headline personal tax rate (below 50%) and having a higher income threshold before the top rate applies. For the most part Canada does not tax immigrating non-residents on gains or income earned prior to becoming a Canadian resident for tax purposes,[59] this is not universally so and there are some areas (especially in an employee income and benefit context) where Canada does not entirely exempt an immigrant on pre-immigration rights to income. We could make ourselves a more attractive jurisdiction of residence by more cleanly exempting from Canadian tax all pre-arrival entitlements.

Some other countries offer a limited-duration reduced rate of tax for highly-skilled foreign workers. For example, Germany's 2024 growth initiative included a proposal to attract 400,000 skilled workers annually by offering tax reductions from 10% - 30% for the first three years. The Netherlands allows certain highly-educated foreign nationals to receive an annual tax-free allowance from their employer of up to 30% of their salary. Sweden has a similar program for non-citizens who are experts in specifically-identified fields holding "vital positions" in

[59] Under s. 128.1(1) ITA an immigrating non-resident marks to market the cost basis of property owned at the date of becoming a Canadian resident, such that gains accrued to that time are eliminated for tax purposes.

and employed by a Swedish company. Other EU countries such as Spain and Denmark offer time-limited tax incentives for specified foreign workers (in some cases non-citizens) that include flat-rate taxation.

A variety of issues would need to be considered were Canada to adopt some form of tax incentive. The key point is to understand that other countries are actively seeking to add to its economy (and tax base) high-income non-residents with specialized in-demand skills: Canada would be doing itself a grave disservice to dismiss this concept without carefully considering it. Given the present upheaval in the United States, Canada may have a unique opportunity to attract a large number of already-educated taxpayers to its economy, potentially on a permanent basis (indeed, the Liberal platform expresses the goal of "Attract[ing] leading researchers to Canadian institutions").[60] Attracting a sufficient number of these people to create critical mass61 has the potential to be self-perpetuating, as "the best scientists go where they can do the best science." Elbows up, indeed.

60 At p. 50: "Where the U.S. is squeezing out researchers, we will look to welcome research here in Canada. Eligible researchers could include professors and graduate students."

61 "[W]hen science superstars move, article-to-article citations of their work continue apace, but in the area from which the star departs, related article-to-patent and patent-to-patent citations decline (Azoulay, Graff Zivin, and Sampat 2011)": see Pantaleo, Nick and Poschmann, Finn and Wilkie, Scott, "Improving the Tax Treatment of Intellectual Property Income in Canada" (April 25, 2013), C.D. Howe Institute Commentary 379.

7. Innovation and the Tax System

Atkinson and Zhang state as follows:[62]

> The OECD properly defines innovation more broadly as "a new or improved product or process (or combination thereof) that differs significantly from the unit's previous products or processes and that has been made available to potential users (product) or brought into use by the unit (process)."

Assessed on a variety of metrics such as R&D spending, patenting activity and technology use, Canada's performance on innovation can fairly be described as middling. In this regard, the following factors have been noted:

- "particularly poor performance in business expenditures on R&D",[63] due in part to a lack of scale in Canadian businesses;[64]
- inability to commercialize inventions, especially those derived from colleges and universities;[65]
- very low government spending on R&D; and[66]
- relatively few patents obtained (on an economy size-adjusted basis)[67] and a large deficiency in licensing revenue received relative to licensing payments made to foreign patent-holders.[68]

By way of example, a recent study indicated that "only 6.1 per cent of Canadian firms have adopted AI, a level the United States reached in 2018." Venture capital spending as a percentage of GDP is quite significant but still far behind its U.S. equivalent.[69]

Clearly Canada has quite a bit of work to do in nurturing and expanding its innovation economy, and needs a thought-out and coordinated strategy on innovation rather than a series of disconnected initiatives. The

62 Atkinson and Zhang, "Assessing Canadian Innovation, Productivity, and Competitiveness", Information Technology & Innovation Foundation, April 29, 2024, page 6.

63 *Ibid.*, page 8.

64 *Id.*, page 14.

65 *Id.*, page 16.

66 *Id.*, page 17. Increased government R&D spending on defence as part of Canada's new commitment to raise defence spending to 5% of GDP by 2035 would be a logical policy to pursue.

67 *Id.*, page 18.

68 *Id.*, page 19.

69 *Id.*, page 29.

tax system can play a significant role in this, as "firms are both familiar with and prefer tax-based support mechanisms" when seeking to overcome barriers to innovation (particularly financial barriers).[70]

Some of the many challenges faced by businesses seeking to innovate can be addressed at the level of the business entity itself (i.e., a Canadian corporation) while others require action at the investor level. As with productivity, the tax system can help by de-risking some of the many opportunities that businesses face and which government shares in the upside of via future tax revenues.

To some degree employees of and independent contractors providing services to the business entity are part of the solution. To a very large extent these individuals are the same highly-skilled workers that would enhance Canada's productivity performance, and the tax measures described in the preceding section with reference to those people would be equally applicable in this context as well. In particular, some form of tax-advantaged equity-like upside participation for employees (and potentially individuals providing services as independent contractors) other than an employee stock option would likely be especially attractive for both workers and innovation businesses, many of which are small-scale and cash-poor. Workers in this sector tend to be younger and more risk-tolerant and are more likely to accept less cash salary in exchange for the potential of sharing in the eventual success of the business, especially if doing so on a tax-advantaged basis.

As many such businesses (and their early investors) do not wish to issue more actual shares in the Canadian corporation and deal with the accompanying corporate law implications, the only form of existing employee compensation that offers reduced taxation to employees (at the cost of no employer deduction) is not always a practical alternative. Developing some form of worker right that carries a tax advantage at least comparable to the employee stock option[71] and that also benefits innovation businesses by not requiring payment until some later equity liquidity event occurs could be a distinct competitive advantage. We need not be constrained by existing forms of employee compensation but can instead design something specific based on input from innovation businesses and their workers as to what they will find attractive and actually use in practice.

A. Business-Entity Level Measures

Tax incentives supporting innovation that are directed at Canadian corporations take the same basic forms as has previously been described:

- direct payments such as tax credits;
- reduced (or deferred) taxation of income; and
- enhanced tax recognition of expenditures and losses.

While others such as payroll tax relief or export subsidies such as FDDEI-style reduced tax rates on income from Canadian-based sales to foreigners are certainly possible, they are outside the scope of this article.

Measures that reduce the cost of business inputs (including the cost of capital) will be of most importance to smaller or early-stage businesses without enough income to fully absorb tax deductions and so are not in a tax-paying position, while later-stage entities generating revenue will benefit from measures that reduce or defer taxation of income (or non-refundable tax credits).

70 See Catherine Beaudry, 2025, "Unleashing Innovation: Barriers, Government Support Programs, and What Works Best", Toronto: C.D. Howe Institute.

71 I.e., deferral of taxation until maturation, and a reduced 50% income inclusion at that time.

Research & Development and Pre-Commercialization Activities

The existing federal model is based on the concept of "scientific research & experimental development", the scope of which is a frequent item of dispute for the CRA and taxpayers. As noted earlier, SR&ED tax supports include accelerated deductibility of qualifying expenditures and increased levels of ITCs, both of which would be enhanced if the proposals announced in the 2024 Fall Economic Statement are enacted.

As noted elsewhere,[72] the federal government currently provides some degree of support in one form or another across the innovation spectrum, using a mixture of tax expenditures, lending programs (e.g., Business Development Bank of Canada) and grants/subsidies. Not every desirable activity can or should be incentivized through the tax system, and in particular the struggle to find capital that many smaller firms experience can often be addressed more effectively and efficiently via a dedicated lending program rather than through the tax system.

That said, the existing SR&ED tax program has been successful, and the new government's proposed changes to it are welcome.[73] In particular, extending support to public companies and expanding support to larger companies is a step in the right direction. Better still would be to eliminate the distinction between different sizes of taxpayers and simply offer the same tax support for all SR&ED regardless of how big the Canadian corporation performing it is or who its shareholders are.[74]

Going further still, the federal government should strongly consider a broader and more comprehensive program for incentivizing innovation-related business inputs that can serve as the basis for a mixture of tax supports. Creating an "innovation expense pool" (IEP) of qualifying expenditures allows a common demarcation point for potential use across a number of tax preferences, including:

- immediate deductibility from income, as with the existing SR&ED program;
- eligibility for a new innovation-related innovation tax credit;
- interaction with other existing tax items, such as for example, (1) as a CCA-style carveout from what reduces adjusted taxable income for purposes of the EIFEL interest deductibility limitations, or (2) elective transferability amongst related Canadian corporations;
- eligibility for FTS financing; and
- linkage/nexus to preferential tax treatment for income from exploitation (discussed below).

The scope of what expenditures might be sufficiently innovation-related to qualify for inclusion in such an IEP requires broader discussion and analysis beyond the scope of this paper, but an interesting and useful starting point would be the new tax credit for research, innovation and commercialization (CRIC) announced in the 2025-26 Quebec budget of March 25, 2025. The new Quebec CRIC both expands and simplifies the previous network of innovation-area tax supports, by replacing a number of existing tax credits and holidays with a single comprehensive tax credit for expenditures relating to R&D or pre-commercialization activities, including:

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72 John Lester, 2024, "Spurring R&D: Canada Needs Focused Reforms to SR&ED and an IP Box", Table 1: Innovation Support System – Small Firms; Toronto: C.D. Howe Institute.

73 The Liberal platform (p. 48) appears generally consistent with the prior government's proposals in the 2024 Fall Economic Statement: "Drive increased private sector investment in research and development by increasing, to $6 million, the claimable amount under the Scientific Research and Experimental Development Tax Incentive Program (SR&ED) for Canadian companies, along with other reforms, to drive economic growth for small and medium-sized businesses".

74 This position was reiterated by the OECD in "Economic Surveys: Canada 2025" (s. 4.3): "Canada should harmonise R&D tax credit rates, reintroduce capital expenditure in the tax credit base, simplify the application process, and use potential savings to finance better targeted innovation support. To instil business confidence and boost long term innovation and investment plans in Canada, the government should provide predictable conditions with clear orientations."

- salaries or wages paid to the corporation's employees;
- 50% of the amount paid to a subcontractor for a contract carried out in Québec;
- 50% of the payments made to an eligible public research centre, an eligible research consortium or an eligible university entity; and
- property acquisition costs (other than land and buildings).

Qualifying taxpayers receive a 30% tax credit on the first $1 million of qualifying expenditures (20% thereafter), with pre-certification required as to the taxpayer's revenues and business activities,[75] as well as the number of "eligible employees". Most of this tax credit is refundable, while a portion is non-refundable.

Consolidating innovation-related tax support into (largely)[76] one ITC allowed for the following previous tax initiatives to be eliminated:

- the tax credit for salaries and wages of researchers;
- the R&D tax credits for university research or research conducted by a public research centre or a research consortium;
- the R&D tax credit for fees and dues paid to a research consortium;
- the R&D tax credit for private partnership pre-competitive research;
- the tax credit for technological adaptation services;
- the industrial design tax credits; and
- the tax holidays for foreign researchers and experts.

Tax support for the later stage of IP commercialization is provided via the IDCI described below.

Quebec's fiscal authorities frequently develop tax policy (particularly that which is incentive-based) ahead of other Canadian jurisdictions, and in this case "innovation" extends not only to the targeted behaviour but also the tax policy designed to encourage it.

Commercialization

Income-related tax preferences are directed more at the commercialization of innovation, based as they are on the taxation of outputs that pre-suppose the existence of net taxable income. The primary form of income preference already in use in the innovation economy (and being considered by Canada) is the "patent box", whereby income from patents developed within a particular country enjoys a reduced rate of tax in that particular country. To be effective, the scope of these regimes needs to extend beyond patents to income from R&D-derived intellectual property generally, including that embedded in goods sold (i.e., not merely licensing income). As such, broader terms as "innovation box" more accurately capture the scope of what should be covered by such a tax regime, the benefits of which include:

- increased R&D activity, since favourable tax status for resulting income is typically limited to that produced from domestically-performed R&D to avoid "poaching" existing R&D;
- the downstream production activity associated with the relevant R&D, the quality of both of which is generally improved by the co-location of these activities; and

75 These are based on a number of NAICS codes designated as eligible for this purpose.

76 A separate tax credit for the development of e-business exists, which was the subject of amendment in the 2025-26 Quebec budget to target the integration of AI functionalities (see here, at pages A.-30-A.32). This tax credit is discussed in considerable detail here.

- economic activity from the "spillover" local infrastructure (taxed at normal rates) necessary to support such additional R&D and follow-on commercialization activity.[77]

Indeed, the argument has been made that a Canadian "innovation box" regime with a requirement that eligible income arise from underlying R&D performed in Canada "is likely to be a more cost-effective way to promote innovation by large firms than an equivalent increase in the SR&ED investment tax credit."[78] While a variety of design choices beyond the scope of present discussion would need to be made,[79] there seems little doubt that Canada should be adopting some form of innovation box tax program to encourage innovation activities and the commercialization of R&D output, which should exert a "pull" effect on performing the underlying R&D in Canada.[80] Hopefully the "Canada Patent Box" proposed in the Liberal platform will ultimately be defined with sufficient breadth as to move the needle in a meaningful way.[81]

Quebec already has a form of patent box, being the "incentive deduction for commercialization of innovations" (IDCI)[82] which reduces the provincial tax rate on qualifying income from 11.5% down to 2%. The IP eligible for the IDCI regime is limited to the following:

- an invention protected by a patent or a certificate of supplementary protection;
- software protected by copyright; and
- a plant variety protected by a plant breeder's rights certificate.

This incentive is directed at the commercialization phase of innovation and thus complements rather than replaces expenditure-based tax incentives supporting innovation-related R&D and other pre-commercialization activity described above. Collectively they constitute an impressive and thoughtful approach adopted by Quebec's fiscal authorities. Saskatchewan offers a similar incentive (the "Saskatchewan Commercial Innovation Incentive") supporting a somewhat broader range of IP commercialization activities, including exploitation of patents, plant breeders' rights, trade secrets and copyrights (computer programs and algorithms. The federal government would do well to closely study the Quebec and Saskatchewan experience to date and explore what more could be achieved on a national level and with greater fiscal resources allocated to it.

In a measure directed at both innovation and productivity, the Liberal platform expresses the intention to "invest in AI training, adoption and commercialization" by offering a specific new tax credit for "AI deployment" (p. 50):

> Boosting adoption with a new AI deployment tax credit for small and medium-sized businesses that incentivizes businesses to leverage AI to boost their bottom lines, create jobs, and support existing employees. Companies would leverage a 20% credit on qualifying AI adoption projects, as long as they can demonstrate that they are increasing jobs.

Tax support for businesses to invest in AI adoption is certainly a wise investment for Canada to make, particularly given the massive "AI Action Plan" announced by the U.S. in an effort to achieve "global dominance in artificial intelligence".[83] However, the case for limiting such tax support to "small and medium-

[77] Pantaleo, Nick and Poschmann, Finn and Wilkie, Scott, "Improving the Tax Treatment of Intellectual Property Income in Canada" (April 25, 2013), C.D. Howe Institute Commentary 379, p. 6.

[78] 2022. "An Intellectual Property Box for Canada: Why and How." Toronto: C.D. Howe Institute.

[79] See here for a summary for differing international income-based tax incentives for R&D and innovation, and here for the Council of Canadian Innovators submission on the proposed Canadian patent box regime.

[80] Pantaleo, Nick and Poschmann, Finn and Wilkie, Scott, "Improving the Tax Treatment of Intellectual Property Income in Canada" (April 25, 2013), C.D. Howe Institute Commentary 379, p. 2.

[81] Page 48: "Bring IP back to Canada and attract talent by creating a Canada Patent Box that will reward builders who locate or stay in Canada."

[82] See here for a summary of modifications made in the 2025-26 Quebec budget of March 25, 2025.

[83] As noted above, recent changes to the separate Quebec tax credit for the development of e-business are also targeted at AI adoption.

sized businesses" is not strong, for the very reasons previously mentioned: this type of artificial distinction encourages businesses that need to scale up to instead remain small, and adds needless complexity to a tax expenditure that should support Canadian corporations of all sizes.

Moreover, there is no obvious policy reason for linking tax credit eligibility to "creating jobs", particularly for a country whose labour productivity is as poor as Canada's. As the recent explosion in public sector hiring demonstrates, our goal should not be to simply create more "jobs" but rather achieve more outputs with the same or fewer inputs and transition to higher-value jobs. Canada needs more meaningful "jobs", not simply more workers. Properly implemented, AI is likely to make existing workers more productive and create new opportunities for those displaced to pursue higher-value opportunities, and to the extent that this leads to a stronger and more robust business that has the potential to scale up (and generate more tax revenue for Canada), the tax credit has been successful. It will often be very challenging to draw a direct link to the adoption of AI and new jobs doing different things thereby created as a result. The government would be wise to learn from the experience of the clean economy ITC labour requirements and not try to accomplish too many things with one program. Simple is better, and in designing tax incentives less is often more.

B. Investor-Level Measures: Taxable Investors

Given the difficulty that many innovation-sector businesses in Canada experience attracting capital, it makes sense to provide tax support for Canadian-resident investors by modestly de-risking their investment in this segment of the economy. Such support is most important for early-to-mid-stage innovation entities where the shortage of capital is most acute, and while Canadian corporations in the innovation economy of all sizes deserve support, there is a reasonable policy argument for concentrating at least some investor-level support in small-to-medium-sized innovation businesses in Canada. As with other proposed tax expenditures, these tax incentives should be looked at by the government as investments in the Canadian economy that should be tax revenue-positive in the medium-to-long term, especially if Canadian investors displace foreign capital over that time period.

Investment Tax Credits

It is certainly possible to develop an investor-level tax incentive for making an investment that provides a business with funds used by the business to undertake specific activities, *viz.*, a direct investment-to-expenditure link. For example, an investor making a $100 equity investment in a Canadian corporation that makes an equivalent expenditure on a qualifying innovation-related activity (i.e., added to the corporation's IEP) could be granted a tax credit based on the percentage of that $100 investment.[84] Such a structure is simple in terms of not conditioning eligibility on more general criteria relating to the Canadian corporation itself, such as the "qualified small business corporation shares" definition that requires (*inter alia*) that a specified proportion of the corporation's assets consist of or be used in designated assets or activities.

For the most part however, investor-level tax supports are typically defined with reference to the underlying entity itself, rather than any particular activity or expenditure (although these may be relevant in defining the in-scope entity). For discussion purposes, the type of Canadian corporation to which investor-level tax support is directed (herein, a "qualified innovation corporation" or QIC) could be defined with reference to one or more of criteria such as the following:

- the QIC's primary business activity coming within specified NAICS codes designated as eligible for this purpose;

[84] The mineral exploration tax credit available to purchasers of certain FTS is effectively such an incentive.

- a requisite level of expenditures on specified innovation-related activities (i.e., included in the corporation's IEP), either in absolute terms or as a proportion of all of the QIC's expenditures;
- allocation of a particular number of workers (usually employees) engaged in specified innovation-related activities; or
- a requisite level of gross revenue from specified innovation-related activities, either in absolute terms or as a proportion of all of the QIC's revenues.

An example is the Nova Scotia Innovation Equity Tax Credit, which supports investors in "Canadian-controlled private corporations" headquartered in the province that develop new technologies or apply existing ones in new ways to produce new things. The rate of the tax credit for individuals (35% or 45%) depends on whether the CCPC's primary business falls within certain NAICS codes, while corporate investors are eligible for a 15% tax credit. Maximum eligible investments and tax credits apply for any investor, and pre-approval is required for a CCPC to be designated as an "eligible corporation" for tax credit purposes based on meeting various criteria as to size, business activity and payroll.[85]

British Colombia offers investors in "eligible business corporations" a 30% tax credit (refundable for individuals; non-refundable for corporations) on their investment, subject to a variety of terms and conditions (which some potential investors have found onerous). Included in the scope of qualifying activities that an "eligible business corporation" may engage in are the development of clean technologies, advanced commercialization, development of an interactive digital media product and research and development of proprietary technologies. Notably, the scope of permitted investments includes Simple Agreements for Future Equity (SAFEs), which are becoming more prevalent in the venture capital sector. A number of other provinces offer venture capital tax credits with varying degrees of connection to innovation-related activities.

Other countries provide investor tax incentives in innovation businesses. As noted at the outset, the U.S. recently expanded its "angel investor" capital gains exemption provided under IRC 1202 for shares of a "qualified small business". A variety of U.S. states offer specific "angel investor" tax credits. Under Australia's program for investors in qualifying "early-stage innovation companies" (ESICs), qualifying investors can both receive a 20% non-refundable investment tax credit and disregard capital gains on qualifying shares continuously held for 1-10 years (capital losses on such shares are similarly disregarded). For this purpose, there are two paths to eligibility as an ESIC:

- meeting a 100-point innovation test requirement; or
- satisfying five requirements under a principles-based innovation test.

The applicable government website does an excellent job of explaining who qualifies and when, and includes a simple-to-use decision tool to walk prospective claimants through a sequence of questions for the purpose of leading them to an answer. The Australian Taxation Office has clearly prioritized project communications and allocated sufficient resources to support this initiative. Should Canada pursue such an initiative (as indeed it should), there will be useful precedents to be studied provincially and internationally.

[85] Full-time contractors as well as employees are considered for this purpose.

Capital Gains Tax Relief

There is little doubt that in addition to measures that reduce the risks of investment, investors respond positively to measures that enhance the rewards from successful ones. The capital gains inclusion rate debacle of 2024 perpetrated by the previous government created a powerful disincentive for venture capital investment generally and innovation-sector investment specifically,[86] and its successor must act decisively if it wants to encourage Canadian investors.

In addition to providing investment tax credits for eligible investments in a "qualified innovation corporation", the government should consider expanded relief on capital gains tax from the disposition of the shares of such entities. There are various design features that any such relief should include:

- generous deferral treatment to encourage the reinvestment of proceeds from the sale of shares of one "qualified innovation corporation" into the shares of new "qualified innovation corporations" without incurring tax on accrued but unrealized gains;
- interaction with existing capital gains tax preferences such as the lifetime capital gains exemption for gains from "qualified small business corporation shares" and the reduced rate of taxation on up to $2 million of capital gains from dispositions of qualifying small business corporations via the Canadian Entrepreneurs' Incentive;
- hold periods and similar investor eligibility requirements;
- how to treat investments made through collective investment vehicles (discussed below);
- ensuring that the alternative minimum tax treatment of such relief does not disincentivize investment by blunting its impact; and
- whether subsequent investor emigration out of the Canadian tax system within some period of time should cause a recapture of previously-claimed benefits, at least in the case of corporate investors.

The case for capital gains tax relief is particularly strong given the disparity between the tax treatment of capital gains (always included in income, even on many personal properties) and capital losses (non-refundable, usable only against capital gains, not recognized on most personal properties). Indeed, offering more generous (i.e., ABIL-style) relief on losses from investments in innovation businesses should be the bare minimum.

Flow-Through Share Financing

The Liberal platform proposed the extension of FTS financing to certain segments of the innovation economy, apparently via allowing the renunciation to FTS investors of "eligible R&D expenses" incurred by the FTS issuer for the FTS investors to deduct:

> Incentivize investment in innovation, especially in Canada's startups, to help them grow and scale by introducing flow-through shares to our Canadian startup ecosystem, supporting companies in AI, quantum computing, biotech, and advanced manufacturing to raise money faster. This works by allowing companies to issue new shares that allow investors to deduct eligible R&D expenses directly from their taxable income, lowering the risk of investing in innovative Canadian companies.

It is unclear from the limited description provided whether eligible FTS issuers will be subject to some kind of size limitation (e.g., taxable capital or revenues). Such a restriction would be an unfortunate mistake: if the underlying R&D activity is what Canada wants and is being performed in Canada by a Canadian corporation,

[86] Recall that since non-residents are generally not taxable in Canada on capital gains from selling shares, the impact of increasing the capital gains inclusion rate on innovation-sector investment was borne almost entirely by Canadians.

the level of tax support it enjoys should not penalize medium-to-large businesses that have successfully scaled up.[87] Lowering the cost of capital for Canadian businesses engaging in activities Canada deems desirable is good policy at any size level.

For this initiative to be effective, the government will need to put enough resources into establishing up front what constitutes "eligible R&D expenses" with the requisite degree of certainty that FTS investors require to be sure that they get the deductible expenses they pay a premium for in the FTS subscription price, i.e., the CRA will not challenge eligibility on audit. It would be preferable for eligible expenses to be defined more broadly, beyond just R&D and more along the lines of the IEP concept.

It will also be necessary to ensure that the treatment of these deductions for alternative minimum tax purposes does not take with one hand what is given with the other. For FTS issuers whose shares are not publicly-traded and thus are somewhat illiquid, mechanisms will need to develop to handle the potential movement of FTS from original subscribers looking for tax deductions into the hands of longer-term investors willing to hold them indefinitely. However, all of these potential issues are solvable, and anything that supports reducing the cost of capital for innovation-related Canadian companies is welcome. Packaging this proposal with a mineral exploration tax credit-style investment tax credit for investors would super-charge this initiative and potentially turn Canada into an R&D powerhouse.

Collective Investment Vehicles

Many "qualified innovation corporations" will be very small and illiquid. As a practical matter, the diligence work required to review and consider investments in such entities and then monitor ongoing investments made is such as to make them uneconomic for most individual investors. This inevitably leads to the need for a collective investment vehicle (CIV) such as a partnership often used in the venture capital industry. Such a CIV can take in capital from a number of investors, use a professional and experienced manager to diligence investment candidates, and make investments in a number of "qualified innovation corporations" on an economically viable basis and spread the risk over a portfolio of such companies.

Such a CIV could be a partnership that is *per se* fiscally transparent, or a special-status corporation that meets prescribed requirements and is the subject of a specific regime designed to achieve fiscal transparency. In any case, the objective should be to facilitate as much investment as possible with as little tax friction (i.e., difference between direct and portfolio alternatives) as possible.[88] To allow smaller investors to participate in funding Canadian innovation-sector businesses, it is important to have some sort of collective investment vehicle suitable for their participation and which replicates for them the investor-level tax benefits that would otherwise be received on a direct investment in a "qualified innovation corporation."

To be functionally effective, the tax and other features of any such CIV used to facilitate investment in "qualified innovation corporations" must be developed based on the characteristics of who the investors and what the underlying investments are and woven into the fabric of the innovation-support program. For example, the British Columbia investor tax credit described above envisions an investment in a venture capital corporation "formed for the sole purpose of investing in start-ups and emerging and expanding eligible small businesses" and making "eligible investments." These CIVs effectively allow their own investors to claim investment tax credits comparable to what those investors would be entitled to had they invested directly in the same

[87] If the concern is limiting the size of the tax expenditure (which it is plausible but not obvious that Canada may wish to do), this can be achieved by limiting the dollar amount of "eligible R&D expenses" an issuer is permitted to flow-through during any particular period rather than excluding larger corporations outright.

[88] For example, the ITA already has a special form of corporation (a "mutual fund corporation") that is effectively able to flow out to investors capital gains it realizes.

underlying eligible small businesses, *viz.*, both "direct investment" and "portfolio investment" alternatives. The U.S. has a somewhat similar vehicle: the "business development company" designed to provide permanent capital to the BDC and liquidity for its investors. BDCs may or may not be publicly traded, and provide an opportunity for smaller investors to make investments in early-stage businesses on a pooled basis comparable to what larger investors would make through a venture capital fund.

C. Investor-Level Measures: Tax-Exempt Investors

Using the tax system to incentivize investors that are exempt from taxation is a materially different exercise than is one directed at taxable investors. Personalized tax-exempt entities such as registered retirement savings plans (RRSPs), tax-free savings accounts (TFSAs), registered retirement income funds (RRIFs) and similar entities represent a very significant potential source of capital for innovation businesses, many of which need to look to foreign (largely U.S.) investors due to a dearth of Canadian funding sources.

Presently, such personalized tax-exempt entities are generally limited to a relatively narrow set of "qualified investments", such as shares and debt of corporations listed on a "designated stock exchange", exchange-traded mutual funds and GICs. As such, the vast majority of innovation businesses are simply not eligible for investment by personalized tax-exempt entities.

Canada needs to be less overprotective of its citizens, and the prescribed limits on what personalized tax-exempt entities can or should invest in is an excellent example of a well-intentioned but parochial regulation that is outdated, unnecessary and ultimately counterproductive to the economy. Canadians have no shortage of investment advice available to them and are able to make their own investment choices without the government telling them what's good for them. The idea that the beneficiaries of personalized tax-exempt entities need to be coddled via regulation to prevent them from buying some investments rather than others is fallacious and patronizing (particularly as to TFSAs, which have nothing to do with retirement). In contrast, the U.S. is actively pursuing action to open up defined contribution retirement plans such as 401(k)s holding an estimated US$ 12 trillion to investment in private assets. Canada is doing itself a tremendous disservice by preventing a badly-needed source of domestic capital from supporting the Canadian innovation industry, and the "qualified investment" concept is in urgent need of rethinking in today's economic environment. The definition of what constitutes "qualified investments" for Canadian tax-exempts should be expanded to facilitate investment in Canadian innovation businesses.

Indeed, what is truly needed would be to not only allow personalized tax-exempt entities to invest in unlisted Canadian innovation businesses (either as much as they want or within some limit to begin with), but to actively encourage them to do so. There are a variety of levers within the tax system that could be used to encourage this – for example:

- allowing expanded contribution room into personalized tax-exempt entities for funds used to invest in "qualified innovation corporations";
- where a personalized tax-exempt entity has incurred a loss on the sale of an investment in a "qualified innovation corporation", permitting the beneficiary to make an extra contribution to the plan to replenish the plan's investable funds; and
- in the case of personalized tax-exempt entities such as RRSPs and RRIFs that make distributions to beneficiaries on a taxable basis, providing tax-advantaged distribution of gains from investments in "qualified innovation corporations" to beneficiaries.

A government is truly interested in pursuing tax "fairness" could start by taking proactive steps to expand the ability of millions of non-wealthy Canadians to reinvest their accumulated savings in the Canadian economy in a tax-advantaged manner, for the benefit of present and future Canadians.

As noted above with reference to taxable investors, enabling millions of small-scale personalized tax-exempt entities to invest in innovation entities that are themselves often relatively small and generally not freely-trading will likely require some kind of intermediary entity, (i.e., a CIV) that can accept such investments, find, diligence and invest in suitable innovation businesses and spread the risk over a large enough portfolio to manage risk appropriately. Potentially the equity securities of that intermediary itself could be (but need not necessarily be) publicly-traded, to allow a degree of liquidity for investors. In any case, the "qualified investment" status and any associated tax benefits applicable to direct investments made by personalized tax-exempt entities in "qualified innovation corporations" would need to be extended to intermediary CIVs through which RRSPs, TFSAs and similar vehicles invest.

Pension Funds

Pension funds are a very significant potential source of capital for the Canadian innovation industry. At present however, many of the major Canadian pension funds invest most of their funds outside of Canada. It is telling that the House of Commons Finance Committee appeared surprised to learn that only 12% of the Canada Pension Plan's assets are invested in Canada, a number far lower than domestic investment numbers found in other countries such as Australia or the U.S.. While Canada used to have a "foreign property" rule that limited most tax-exempts to no more than 30% of foreign investments, this was removed in 2005.[89]

While a pension fund tasked with maximizing investor returns cannot be blamed for making investment decisions entirely on that basis, it is also fair to observe that the long-term interests of its members are better served with a broader mandate that takes into account the long-term health of the economy in the country in which those members live and from which future contributions will be made. The situation has sparked calls for government action to cause pension funds to increase the proportion of their assets that they invest in Canada, whether through regulation or incentives.[90] Quebec's pension fund has not underperformed its Canadian peers despite having a dual mandate of maximizing returns and stimulating growth within the province, and it may be that maximizing investment returns to the exclusion of all else is a luxury Canada can no longer afford. Given that the government is presently considering a number of relieving rules to facilitate increased pension fund investment in Canada, now may be the right time to consider what else can be done to deploy for Canada's benefit more of the $3 trillion of domestic capital that enjoys an outright exemption from Canadian income tax, especially if they involve "relatively easy fixes". If Canada's nine largest pension funds that have invested over $1 trillion in the United States reallocated a small fraction of that amount to support Canada's innovation economy, the impact would be enormous.

[89] For one venture capitalist's perspective on how the foreign property rule came to be repealed and its impact on the Canadian venture capital industry, see here.

[90] For a detailed discussion of this issue, see here.

Conclusion

While Canada presently faces challenging economic circumstances, we have very significant ability to shape our own future by making the right policy choices. One of those policy choices is designing a tax system that creates the right incentives (and removes unhelpful disincentives) for Canadian businesses and the Canadian workers they support to thrive, along with minimizing the deadweight cost of tax compliance and audit that Canadians currently endure. While we are affected by events in other countries, we need not meekly submit to them.

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