2016 PRE-BUDGET CONSULTATION

To: Standing Committee on Finance, House of Commons, 42nd Parliament, 1st Session

From: Ungad Chadda, Senior Vice President, Toronto Stock Exchange and John McCoach, President, TSX Venture Exchange

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Subject: Recommendation regarding the Scientific Research and Experimental Development (SR&ED) Tax Incentive Program, as well as comments on proposed stock option tax measures and the flow-through share program

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Introduction

Toronto Stock Exchange (TSX) and TSX Venture Exchange (TSXV) are pleased to submit recommendations to the House of Commons Standing Committee on Finance ahead of the 2016 federal budget. We appreciate the work of the committee and Members of Parliament as they consider recommendations to strengthen the Canadian economy.

In this letter we outline our recommendation that the Scientific Research and Experimental Development (SR&ED) Tax Incentive Program apply consistently to small and early-stage innovative businesses whether they have listed their shares on a stock exchange or remain private.

Canada's Capital Markets

Capital formation is vital to any growing business, both small and large, and it helps drive economic development across the country by contributing to job creation, fostering a culture of innovation and providing opportunities for Canadian investors. Vibrant and competitive capital markets are essential to capital formation and the growth of Canada's economy.

TSXV is the Canadian public venture capital marketplace. It is designed to provide capital formation to small and early-stage companies, from all regions of Canada, across a wide range of sectors, while offering investors a well-regulated market for investing in emerging companies. Investment helps TSXV-listed companies to advance their activities in research and development (R&D), innovation and exploration as they grow from their initial stages to commercialization, production and expansion.

TMX Group's public equities markets, TSX and TSXV, have a strong and proud history of helping Canadian companies access capital to grow and expand their businesses.[1] The Exchanges are also recognized global leaders in serving small and medium-sized enterprises (SMEs) owing to their expansive two-tiered ecosystem, which includes micro to large-cap listings.

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[1] According to World Federation of Exchanges 2015 Statistics, TSX and TSXV, on a combined basis, are ranked fourth in the world by the number of listed companies (second in North America), tenth globally by the amount of public equity capital raised and tenth largest in the world by market capitalization.

The two-tiered ecosystem includes a unique feeder system from the “junior” board (TSXV) to the “senior” market (TSX). Between January 2000 and December 31, 2015, 614 TSXV companies have graduated to TSX and another 175 TSXV-listed companies have merged with companies listed on TSX.

Level Playing Field for Innovative SMEs in Canada

Canadian companies operating in technology and innovation sectors need additional sources of financing to grow their businesses. Currently, Canadian companies in these sectors are faced with the choice between accessing capital by listing their shares on a stock exchange, or staying private to access significant financial benefits provided by the enhanced, refundable tax credit under the SR&ED Program. We believe that these options should not be mutually exclusive. We submit that the current policy situation may actually limit innovation and growth in the Canadian economy.

The SR&ED Program, as it is currently structured, favours private companies over companies whose shares are listed on a public market in Canada. This treatment particularly impacts small and early-stage companies listed on TSXV, many of which have comparable levels of working capital to small or mid-sized private firms, or in many cases, no taxable income. We recommend a level playing field among private and public innovation companies in Canada to help spur their economic growth. Under this recommendation, the SR&ED program would more appropriately focus on early-stage public companies on the same basis as early-stage private companies.

In order to spur more business innovation, it is recommended that the federal government consider a change to its SR&ED policies. We believe our recommendation for SR&ED aligns well with the current government’s plans for strategic investment in jobs and innovation, particularly for SMEs who seek to grow into tomorrow’s global leaders.

Background: The SR&ED Tax Incentive Program

The SR&ED Program aims to stimulate scientific and technological growth for Canadian businesses of all sizes across all sectors. The program is an indirect tax incentive that can provide refundable tax credits and is available to any business operating and carrying out R&D in Canada. For the fiscal year 2012, the most recent statistical data available, SR&ED provided more than $3.6 billion in tax credits to more than 23,000 claimants.

There are three groups of businesses that are eligible for the SR&ED program:

1. Canadian-controlled private corporations (CCPCs)
2. Other corporations (such as those listed on TSX and TSXV)
3. Proprietorships, partnerships and trusts

The SR&ED investment tax credit (ITC) is earned at a basic rate of 15% on qualified SR&ED expenditures for the three business groups noted above. However, a company that qualifies as a CCPC may earn an ITC at an enhanced rate of 35%, up to a maximum threshold of $3 million (also called the “expenditure limit” under Section 3.0 and 3.1). Additionally the ITC for CCPCs may be refunded; however, the ITC is non-refundable for other corporations. For proprietorships, partnerships and trusts, the ITC rate is 20% and they may receive a cash refund on 40% of the balance of the ITCs earned in the tax year.

Effectiveness of SR&ED Tax Treatment

Growing Canadian companies are faced with having to choose between listing their shares on a public market or the significant financial benefits available as a CCPC under the SR&ED Program. That choice may be more challenging for innovative SMEs weighing a public listing on an exchange or going towards private capital, such as venture capital (VC).

Under the current SR&ED Program eligibility criteria, Canadian entrepreneurs and early-stage private companies are led towards private sources of funding because they provide access to the full benefits under SR&ED (ie. the enhanced, refundable 35% ITC). Once a company goes public, the tax credit drops from 35% to 15% and becomes non-refundable; this applies to all public companies regardless of size or cash flow.

There is a misperception that once a company goes public it has reached a certain market capitalization and profitability level, and, therefore, may not need to rely on the SR&ED tax incentive program to the same extent as CCPCs. Yet, in many cases, CCPCs and TSXV-listed companies are similar in terms of stage of development, size and value.

The majority of Canadian public companies are SMEs. Among the 1,791 companies listed on TSXV, as of December 31, 2015, 95% (1,708 companies) had a market capitalization of $50 million or less. Of the 273 technology and innovation companies listed on TSXV, many are still at an early stage in their development. Approximately 20% of TSXV-listed companies in the technology, clean technology and renewable energy, and life sciences sectors have no revenue, and about another 32% of companies in those sectors had revenues lower than $1 million in 2015.[2] Nevertheless, these companies are still developing promising and innovative technologies. In many cases, funding provided to pre-revenue companies under the SR&ED Program is the single largest source of operating funds. This important investment helps keep Canadians employed and working on innovation to help diversify and strengthen Canada's economy.

In addition, fewer innovation companies are accessing Canadian public venture capital compared to the natural resource sector. The table below shows the number of new TSXV listings in the technology and innovation sectors compared to the mining and oil & gas sectors over the last five years. While there has been a reduction in the gap in new listings between these two groups, largely due to difficult market conditions for natural resource companies, the statistics show that innovation companies are not accessing capital through TSXV as much as resource companies. It is also worth mentioning that the federal flow-through share tax incentive program for mining companies does not discriminate between public and private companies.

[2] Source: S&P Capital IQ

Table 1. *New listings in the technology and innovation sectors vs. resource sectors on TSXV*

	2010	2011	2012	2013	2014	2015
Technology, clean tech & renewable energy and life sciences	23	17	19	20	37	29
Mining and oil & gas	186	185	128	71	45	28

It is important that companies in Canada have access to financing from different sources. Each segment of the financing chain has its own role to play in financing innovative, emerging companies. That said, angel investors, Canadian VCs and Canadian public venture markets do not always collaborate as much as they could. Data from the Canadian Venture Capital Association (CVCA), for example, illustrates that a public listing transaction is often not the preferred means of exit for Canadian VCs. If a company maintains its CCPC status after conclusion of a merger and acquisition (M&A) transaction it also maintains its full benefits under the SR&ED program. In contrast, listing on a stock exchange brings negative tax consequences with respect to SR&ED.

Table 2. Canadian venture capital activity

	2010	2011	2012	2013	2014
VC-backed Initial Public Offerings	1	6	2	4	6
VC-backed M&A transactions	33	42	29	33	36

Source: CVCA and Thompson Reuters

Angel investors and VCs may be more inclined to consider a public exit for companies in their portfolios if that transaction would be neutral in terms of tax credit treatment received under the SR&ED Program. This would serve to increase the choices available to companies as they seek capital to grow.

Related Tax Measures to Spur Growth in the Knowledge Economy

Damaging consequences of the proposed taxation regime on stock options

Through this submission we also urge the federal government to reconsider its election pledge to re-characterize capital gains as income over $100,000. A detailed and careful assessment should be conducted to adequately measure the full scope of the impact this regime will have on Canada's future competitiveness, productivity and overall economic development. While we recognize the federal government's efforts to create growth for the middle class, we strongly urge policymakers to take a thoughtful and measured approach to achieve its public policy objectives without severely inhibiting entrepreneurialism, risk taking and ease of doing business in Canada. Our country must remain competitive relative to our global peers, especially as advanced economies around the world gradually shift to the innovation economy.

Applying the flow-through share program to innovation sectors

Successful initiatives such as the flow-through share program should also be directed towards industry sectors that represent the "new economy". In particular, the innovation sectors such as technology, clean tech and life science are where jobs and wealth creation of the next generation will be. Canada will continue to be a world leader in the resource sector, but diversifying our economy and adapting it to post-industrial shifts is not optional if Canadians wish to maintain and improve their standard of living. Indeed, flow-through shares are a successful Canadian financial innovation and we have the opportunity to apply it to our knowledge economy sectors to help drive high-quality economic growth in our country.

Conclusion

We believe federal spending on growing innovative businesses could be better optimized if eligibility for the SR&ED Program was extended to innovative public businesses, particularly public SMEs, in the same way as it applies to CCPCs. This change would help further stimulate innovation, economic development and diversification of Canada's economy. Our view is shared by a number of TSXV-listed companies and other market participants.

Every company is unique, but they all have one thing in common: all of them want to succeed. TMX Group and its public equities markets, TSX and TSXV, are committed to helping companies achieve this success. Ultimately, encouraging investment in ideas and nurturing an environment where those ideas can grow and be commercialized is a central part of a growing economy.

We appreciate the review of this submission and welcome any questions from committee members. We would also be happy to meet with Committee members in person at their convenience.

Sincerely,

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