Canadian Manufacturers & Exporters

Manufacturiers et Exportateurs du Canada

Driving Investment, Jobs and Economic Prosperity:

A Global Tax Competitiveness Action Plan for British Columbia

MAY 2012

Content

Tables

Executive Summary

Manufacturing in British Columbia is vital to the economic health and prosperity of the province. With roughly 400,000 employees, the sector contributes $13.2 billion to provincial GDP (8.6 per cent of the total) — more than the agriculture, forestry, fishing, hunting, mining, oil and gas, and the utilities sectors combined. Manufacturers also account for 75 per cent of value added exports and more than 42 per cent of all private sector research and development in the province.

Over the past decade, however, manufacturers across Canada, and in BC, have faced difficult challenges to maintain and expand their operations. In addition to the global economic recession of 2008-2009, manufacturers have faced the appreciation of the Canadian dollar, continued protectionist measures in key export markets, increased competition from foreign competitors, soaring input costs, and tightening labor markets. In BC, companies have also faced uncertain taxation policies with the implementation and repeal of the Harmonized Sales Tax (HST) and the introduction of the provincial carbon tax.

The ability of companies to succeed in the face of these challenges lies in their capacity to invest in people, products, and processes to drive productivity and innovation. Companies must invest to survive. But the location and level of investment is highly dependent on several critical factors, including the overall business environment and tax treatment of companies making investment decisions. With globally integrated supply chains and the ability to supply customer bases around the world from anywhere, creating a competitive climate is critical to attracting investment and growing the provincial economy.

Today, BC has a significant opportunity to transform and expand its economy through the development of its natural resources, shipbuilding and other major projects across Canada that could provide both the private sector and the province with long-term prosperity. These major projects have been estimated at more than $500 billion over the next decade. To maximize the value of these opportunities, we must create world-class up-stream and down-stream value added manufacturing, services and technology supply chains. While these supply chains will — and can — be developed anywhere in the world, our role in industry and government is to implement policies and programs that drive investment and innovation domestically to capture as much of the opportunity as possible.

In light of these critical business and economic growth opportunities, Canadian Manufacturers & Exporters (CME) — Canada's largest trade and industry association, and the voice of BC's critically important manufacturing and exporting sector – fully supports the creation of the Expert Panel on Tax, and believes its focus on tax competitiveness, economic growth and job creation is perfectly timed. In addition to the work of this panel, CME is calling on the Government of British Columbia to implement a broader investment, jobs and economic growth action plan for the province. We believe that an effective and comprehensive action plan, including what is recommended below, would provide the basis for strengthening the role that manufacturing and exporting will play in the province going forward, so that BC remains a destination-of-choice for industry investment and innovation.

Towards this end, CME has several key recommendations for the province:

1. Provide relief to the manufacturing sector to offset the planned increase in the corporate income tax rate;
2. Implement an input tax credit to reduce the costs of direct inputs of manufacturing;
3. Improve the R&D tax credit system to drive innovation;
4. Adopt a clear and transparent loss transfer system;
5. Review the efficiency and the effects of the carbon tax; and,
6. Review and act on the impact of the municipal tax system on industry.

Together, CME believes these recommended tax measures can form the basis for a value added manufacturing and exporting strategy for the province that would drive business investment and innovation, job creation, and long-term economic prosperity.

Background — Manufacturing in British Columbia

Manufacturing has a significant economic footprint across British Columbia and is a key driver of provincial innovation, exports and job creation. Specifically, BC's manufacturing sector represents:

- More than 12,000 companies;
- 400,000 direct and indirect employees;
- $8.6 billion in wages (15 per cent higher wages than the provincial average for all industries);
- $13.2 billion (8.6 per cent total) in provincial GDP;
- 75 per cent of all merchandise exports; and,
- 42 per cent of all private sector R&D investment.

In addition, BC's manufacturing sector was one of the only to meet emissions targets established under the Kyoto Protocol. Furthermore, for every dollar invested by manufacturers, there is a spinoff of $3 in additional economic activity in other areas of the economy — the highest contribution of any sector.

Driving Investment, Jobs and Economic Prosperity — Global Tax Competitiveness Action Plan for British Columbia

Over the past several years, recognizing the value of the manufacturing sector and of creating a positive economic environment for companies to operate across Canada, the federal government implemented a number of positive tax policies aimed at boosting investment, creating jobs and fostering innovation. Policies such as reducing the corporate income tax (CIT) rate to 15 per cent (as of January 1, 2012) the introduction of the Accelerated Cost of Capital Allowance (ACCA), and the elimination of import tariffs on all machinery, equipment and production parts used in manufacturing, were spearheaded and promoted by CME as positive measures to drive business investment, growth and innovation.

These policies helped soften the blow of the global economic downturn for manufacturing and helped position Canada around the world as a primary location for investment. This is critical in the face of increasing competition for manufacturing investment. The US (federally and at a state level) has introduced significant tax cuts and direct incentives for manufacturers to invest. China and other Asia-Pacific countries, meanwhile, offer up to 50 per cent direct subsidy on new manufacturing investments. Many countries in the European Union, including Germany and the United Kingdom, have also introduced aggressive tax strategies aimed at maintaining existing manufacturing and winning new investments for new product mandates.

Canadian companies cannot compete with the low-cost and high-volume manufacturing centres in Asia and elsewhere. However, CME believes that a business environment can be created that is conducive to increased investment in production of high-value products and technologies that will be driven by research and innovation, improvements in productivity, and reduced use of environmental resources.

Countries are aggressively competing to capture manufacturing investment for many reasons, but primarily because, more than any other sector, value added manufacturing drives long-term growth across many sectors of the economy, creates high-skilled and high-paying jobs, and drives global exports.

Canada's tax policy changes, including federal CIT rate reductions were aimed to position Canada as offering the lowest tax rate on new business investment in the Group of Seven (G7). Provincial governments across the country are also lowering their corporate tax rates in order to reduce Canada's average combined (federal and provincial) statutory corporate tax rate from 31 per cent in 2010 to 25 per cent in 2012. If fully implemented, this will showcase Canada as having the lowest statutory corporate tax rate in the G7.

In a report published in January 2011 titled *The Economic Impact of Corporate Tax Rate Reductions*, CME found a close correlation between reduced corporate income tax rates and investments in business research and development (R&D) activity. This leads to a reduced unemployment rates, increased GDP, and improved incomes over the long term. Specifically, the report noted that the planned federal and provincial CIT rate reductions in 2011 and 2012 would be expected to:

- Increase after-tax business profits by $12.4 billion or 10.6 per cent;
- Lower Canada's unemployment rate by 0.52 percentage points and boost employment by 98,800 net jobs;
- Increase total business investment by $6.2 billion or 4.4 per cent (investment in new facilities can be expected to rise by $3.0 billion, and investment in machinery and equipment by $3.2 billion);
- Increase business spending on research and development by $546 million or 4.4 per cent;
- Boost nominal GDP by $51.6 billion or 3.2 per cent;
- Increase personal incomes of Canadians by $30.4 billion or 2.4 per cent;
- Increase per capita personal income by $880; and,
- Contribute $2.6–$3.7 billion in additional net revenues for all levels of government.

These conclusions were drawn because the improved tax treatment on corporations would allow companies to increase their after-tax income and reinvest in people, products and processes to make them more profitable in the long term.

In BC, initial steps were taken along the same path to improve provincial tax competitiveness with the announced introduction of the Harmonized Sales Tax (HST) and the lowering of overall corporate income tax rates. This was supported and applauded by CME at the time as being a proactive tax policy to drive investment and job creation. These measures would have made BC a prime location for manufacturing investment across North America, particularly in relation to the significant natural resource development and shipbuilding value chain in the province.

Unfortunately, recent economic and political challenges drove a reversal in these tax policy measures with the unwinding of the HST and the announcement that the provincial CIT rate is scheduled to increase by one percentage point (from 10 to 11 per cent) on April 1, 2014. If the CIT rate increase is implemented as planned, BC will be the first and only province to increase its CIT rate. This will place the province at odds with other jurisdictions across Canada that are continuing to reduce the CIT rate, holding reductions until economic conditions improve, or creating carve-outs for value added industries.

The proposed CIT increase, combined with the return to the PST-GST sales tax system, will hurt manufacturers — the most productive sector of the economy — more than any other sector in BC, because the costs for inputs would rise again dramatically. The HST would have allowed businesses to recover the tax paid on their inputs through input tax credits, which would lower production costs by an estimated $140 million annually. These expenditures will now factor back into overall production costs for BC manufacturers. These two measures will undoubtedly have a negative impact on investment and job creation in the manufacturing sector.

To compound these challenges, manufacturers are being further disadvantaged in BC as a result of the provincial carbon tax — a tax which was to be revenue neutral — which penalizes industry more than $1 billion annually once planned increases are fully implemented, despite the leadership shown by manufacturers in reducing emissions and meeting the reduction targets of the Kyoto Protocol.

As Canada begins to develop its $500 billion catalogue of major projects over the next decade, manufacturers will invest billions around the world in new facilities, production mandates, technology and R&D, which will sustain and create tens of thousands of jobs. These investments will be placed in those jurisdictions that allow companies to reinvest profits into their people, products and processes to support their long-term growth and economic success.

While BC has significant benefits as a location for manufacturing investment, including a world-class education system, access to major markets, and a low-cost of energy, the overall business and taxation environment will limit the attractiveness of the province for securing manufacturing investment. These current taxation policies will directly and negatively impact economic growth and job creation in the province.

CME believes that the Expert Panel on Tax, along with the opportunities provided by major project developments across BC and Canada, should be the catalyst for the province to implement an action plan for a globally competitive tax policy environment. The following detailed recommendations are the basis for that action plan, which will drive a value added manufacturing and exporting investment strategy to create jobs and long-term economic prosperity in British Columbia.

Detailed Recommendations on Tax Competitiveness, Innovation and Job Creation

1. **Provide manufacturers relief under the planned CIT rate increase**

   CME recommends the province provide relief to the manufacturing sector from the planned increase to the corporate income tax through the following measures:

   a. **Exempt manufacturing from the proposed CIT rate increase**
   Several Canadian provinces have recognized the particular international and domestic factors that affect the manufacturing sector and have decided to offset them by treating this sector more favourably from a tax perspective. Newfoundland and Labrador, Ontario and Saskatchewan have adopted systems where manufacturers benefit from a sector-specific CIT rate, while other sectors are subject to the normal rate. This measure recognizes that the manufacturing sector faces a number of challenges — international and domestic — that other sectors of the economy are less subjected to. CME recommends that the CIT rate for manufacturers should remain at 10 per cent.

   b. **Reinstate the manufacturing and processing (M&P) tax credit**
   Table 1 provides an overview of various tax credits used across Canada by provinces to strengthen the manufacturing sector and attract investment. As detailed in this table, most provinces provide either an M&P tax credit or an M&P investment tax credit to support manufacturing investment, while Saskatchewan provides both. And although BC provides tax credits for book publishing, film and television, logging, mineral and mining exploration, oil and gas, and other sectors of the economy, the manufacturing sector — despite its important contribution to job creation and innovation — doesn't benefit from having a manufacturing sector tax credit. CME recommends that BC reinstate the manufacturing and processing tax credit for manufacturers in order to help the sector recover faster from the global recession and make the province more attractive for investment.

Table 1 **— Comparison of Tax Credits for the Manufacturing Sector**

Province	General manufacturing and processing tax credit	Manufacturing and processing investment tax credit (production facilities, machinery and equipment)
Nova Scotia	None	10 per cent of total costs of equipment. The program will reimburse companies investing $50,000 or more in a project for 10 per cent of the costs, to a maximum of $1 million.
New Brunswick	None	None
PEI	None	10 per cent investment tax credit for the acquisition of machinery and equipment. Additional 25 per cent enriched investment tax credit: export-focused manufacturing or processing businesses with high productivity levels are entitled to an enriched tax rebate of 25 per cent. This is in addition to the existing investment tax credit of 10 per cent.
Newfoundland and Labrador	Manufacturing and processing profits tax credit: Manufacturers are eligible for a five per cent tax rate instead of the general nine per cent applied to other sectors.	None
Quebec	None	5–40 per cent tax credit, partially refundable (percentage varies according to size and location of the enterprise).
Ontario	Tax rate of 10 per cent for manufacturing instead of 11.75 per cent general CIT rate.	None
Manitoba	None	Corporations earn a 10 per cent tax credit (7/10 refundable and 3/10 non-refundable), which can be applied against Manitoba corporate income tax, payable in the year earned. Unused credits are available for a 10-year carry-forward and a three-year carry-back.
Saskatchewan	Saskatchewan manufacturing and processing profits tax reduction can reduce the corporate tax rate to 10 per cent.	Five per cent tax credit.
Alberta	None	None
British Columbia	None	None

NOTE: In 2001, BC and Alberta eliminated their manufacturing and processing tax credits.

2. Provide an input tax credit for all manufacturing inputs

The Provincial Sales Tax (PST) system allows the exemption of only certain production inputs from the application of retail tax — mainly primary resources used for production and, more recently, the machinery and equipment used for manufacturing. Other inputs such as administrative, sales and distributions assets and expenses are not exempted from the imposition of retail tax. The HST system, meanwhile, allows exemptions for almost all inputs for production (not just primary resources and machinery), except for some related purchases — for example, the acquisition of automobiles. This system reduces input costs for production and was one of the primary reasons for the shift away from the previous PST-GST model in BC (as in other provinces); to make the consumption tax more efficient for business. It is also why the manufacturing sector fully supported the introduction of the HST in BC and why CME continues to support the maintenance of that retail tax in the province moving forward.

While CME recommends the full and permanent implementation of the HST in BC, an alternative model would be to mitigate the impact of a return to the PST by allowing manufacturers to exempt more inputs for production from the application of the PST. As such, instead of applying the PST to everything except primary resources, machinery and equipment (as was the case under the old sales tax regime), we suggest that the government allow for exemptions on all production inputs directly related to manufacturing. In this regard, the Province of Quebec offers a model worth examining, where they have exempted all inputs for manufacturing production from the Quebec Sales Tax, except for five categories of expenses: automobile vehicles, fuel, energy (other than the energy used for manufacturing and processing), telecommunication expenses and leisure (dinners, lunches and other related expenses).

3. Improve R&D tax credits to drive innovation

Innovation is the most important determinant of business competitiveness, productivity growth, and economic prosperity in a world of global markets and rapid technological change. It is driven by investments in productive assets, in knowledge (R&D), technology (machinery and equipment) and workforce training. These business investments are, in turn, driven by after-tax cash flow performance (e.g. the amount of money available to companies for investments after business costs and taxes are paid). In manufacturing and other sectors of Canadian industry, available data shows a close correlation between after-tax cash flow on R&D spending and investments in machinery and equipment. The most democratic way for governments to increase after-tax cash flow for business, and indirectly boost R&D spending and investments in machinery and equipment, is to keep improving the business tax environment and ensure it is as competitive as possible with other jurisdictions.

Table 2 compares the R&D tax credits offered across Canada in each province. As is shown, BC offers one of the least competitive R&D tax credits in the country at 10 per cent with a limit that is set at $3 million. Furthermore, BC's R&D tax credit offers no tax refund. **As such, CME strongly recommends BC increases its allowable R&D tax credit to a minimum of 15 per cent (which is the most common provincial rate) and either eliminate the maximum allowable credit or raise it considerably to encourage R&D and innovation in the province.**

Table 2 — **Provincial Comparison of SR&ED Tax Credits**

Province	SR&ED tax creditt	Partially or fully refundable? (Y/N)
Nova Scotia	15 per cent tax credit	Y
New Brunswick	15 per cent tax credit	Y
PEI	None	N/A
Newfoundland and Labrador	15 per cent tax credit	Y
Quebec	37.5 per cent R&D tax credit on wages and salaries, up to $2 million; rate is gradually reduced to 17.5 per cent for larger corporations	Y
	AND	
	Tax credit for SR&ED under a university research contract; equal to 35 per cent of 80 per cent of the payment made to the university for SR&ED (effective tax credit rate of 28 per cent)	Y

Conyinue on page 6

Table 2 — **Provincial Comparison of SR&ED Tax Credits (cont.)**

Province	SR&ED tax creditt	Partially or fully refundable? (Y/N)
Ontario	Ontario Innovation Tax Credit: 10 per cent tax credit for SR&ED, to a maximum of $300,000 AND 4.5 per cent R&D tax credit AND Ontario Business-Research Institute Tax Credit of 20 per cent on SR&ED expenditures incurred in Ontario as part of an eligible business research institute contract; this tax credit is limited to $20 million in expenditures per year per associated group of corporations	Y N Y
Manitoba	20 per cent tax credit	Y
Saskatchewan	15 per cent tax credit	Y
Alberta	10 per cent tax credit, to a maximum $400,000 per year *NOTE: Alberta is the only province where the credit is also reduced by the prior year federal credit (the portion relating to SR&ED that earned federal credits and took place in Alberta); the 2012 budget, however, includes a proposal to change this format*	Y
British Columbia	10 per cent tax credit, partially refundable for CCPCs only, to a maximum of $3 million	Y

4. Adopt a clear and transparent loss transfer system that would simplify the tax process for corporate groups based or with operations in British Columbia

In 2010, the federal government initiated consultations regarding the taxation of corporate groups. Canada's current loss-utilization rules are uncompetitive, particularly with respect to the US, where corporate group tax consolidation is permissible with an 80 per cent ownership threshold and a wide array of tax attributes that can be combined. The preferred policy approach should be to "level the playing-field" and arrive at a substantially similar tax base.

CME believes the most important benefits that would be expected from a new system of taxation of corporate groups would be:

- Improving fairness by treating all closely controlled legal entities within the same corporate group as one economic unit;
- Reducing costs by allowing companies with a common parent greater flexibility with respect to the offsetting of profits and losses within the corporate group – the current ad-hoc regime is costly to implement and is highly dependent on Canada Revenue Agency rulings, which can be unpredictable; and,
- Increasing competitiveness of the corporation tax system relative to the US and other jurisdictions (more than 80 countries already either allow for the filing of group-consolidated returns or have some form of loss transfer mechanism).

CME recommends that BC cooperate with the federal government and other provinces to improve Canada's global competitiveness through a reform of corporate group taxation.

5. Review the efficiency and the effects of the carbon tax

In addition to general tax competitiveness issues facing BC manufacturers, there are significant concerns relating to the effectiveness and efficiency of the provincial carbon tax. While CME supports the overall goal of reducing GHG emissions, we believe the manner in which the tax has been applied unfairly targets and negatively impacts BC manufacturers, and will erode investment and long-term economic growth in the province.

When the tax was introduced in 2008, it was promised as a revenue-neutral tax on carbon emissions. The rate per tonne of CO_2 equivalent will increase by $5 each year to $30 per tonne by July 1, 2012. According to the Ministry of Finance web site:

> *By law, the government must show how all of the carbon tax revenue flows back to individuals and businesses as tax reductions. To ensure this occurs, by law the government must table in the Legislature an annual plan that clearly outlines how every cent of carbon tax revenue will be returned to taxpayers in tax cuts.*

When the carbon tax is fully implemented in 2013–2014, the government estimates that revenues generated by the tax will reach $1.2 billion annually. A significant portion of this tax will be paid by BC manufacturers, despite the fact that industry has surpassed its emissions reduction targets established in the Kyoto Protocol.

Rather than reinvesting revenue generated under this tax regime to reduce emissions that meet the objectives of government, the revenues have been redirected into a variety of policy programs that have no connection with GHG emissions, including:

Tax credits for individuals

- The Northern and Rural Home Owner Grant, which reduces the amount of residential property tax British Columbians pay;
- Low-income personal Climate Action Tax Credit; and,
- The five per cent reduction in the first two personal income tax brackets.

Tax credits for businesses

- Reduction of the general and small business corporate income tax rates (full implementation of which has been delayed);
- Reduction of the CIT to 10 per cent (which is now being increased);
- Introduction of the HST (which is now being reversed);
- Industrial Property Tax Credit, which is applicable to school property taxes payable by light and major industrial properties and have an estimated savings for the entire industry of $71 million in 2012–2013; and,
- 50 per cent tax reduction in school property tax for land classified as *farm.*

While CME could support all or some of these programs, they are hard to justify as offsets for industry to create a revenue-neutral carbon tax. Simply put, the carbon tax has not been revenue-neutral for the manufacturing sector, and will be less so if the CIT rates increase and the HST is eliminated, as these were the so-called ‘offsets’ established to help industry adjust and remain competitive in light of the new tax.

BC is one of the only jurisdictions to implement a tax on carbon, placing manufacturers in the province at a significant competitive disadvantage, with less after-tax profit to invest in their people, processes and products. The few other jurisdictions that have introduced similar tax programs (such as Quebec) have used the revenue to support industry investment in new technologies to help reduce overall emissions.

CME believes that there are more productive and competitive ways to reduce carbon emissions and meet government objectives. Given the tax and competitive implications of the carbon tax, **CME strongly recommends that the government conduct a full review of the effectiveness of the tax in reducing emissions in the province, its impact on manufacturing competitiveness, as well as the kind of programs that are currently implemented as a result of the increasing revenues generated by this tax.**

6. Review and act on the impact of the municipal tax system on industry

Municipal taxation regimes are a very important feature of the province’s competitiveness, but often overlooked when considering investment decisions. CME believes that the provincial government has an important role to play in ensuring fairness between residential and non-residential taxpayers. In almost all municipalities in BC, the property tax impact on business owners (both small and large) is disproportionately high compared to residential property owners. According to various publicly available sources, business owners pay property taxes that often are as high as five or six times greater than residential owners across the province.

This disproportionate taxation on major industries has led to court cases between the pulp and paper industry and various municipalities at a time when all should have been focused on rebuilding the industry. Unfortunately, a noteworthy amount of time and resources have been wasted and businesses have shut down facilities.

CME strongly recommends that the government conduct a complete review of all business property taxation. All businesses, large and small, are paying significantly higher property tax rates than residents. This has a negative impact on businesses and the municipality where they are located, as well as the investment climate and economic competitiveness of the province.

Conclusion

While a business decision to establish manufacturing facilities depends upon a number of factors, there is no doubt that the tax environment plays a significant role in which jurisdiction a company decides to invest. The tax climate has a major influence on a company's ability to generate cash flow and to reinvest profits into productive assets, including people, machinery and equipment, and R&D activities.

In many ways, British Columbia is lagging behind other Canadian provinces, as well as internationally, in terms of tax competitiveness, which is damaging its ability to attract investment into the province. This is especially important as it relates to the manufacturing sector, which is a critical component of BC's economy today and should be moving forward, if the province wishes to drive innovation, economic growth, and exports.

CME's recommendations are aimed at improving the global competitiveness of BC's tax regime and driving new investment to allow the province to fully capitalize on the economic opportunity ahead of us in developing a value added manufacturing, technology and services supply chain to support the $500 billion dollars being invested into major projects over the forthcoming decade.

CME looks forward to working with the government to strengthen the critically important manufacturing and exporting sector in the province through the implementation of these recommendations as an action plan towards building a more robust and diversified economy across BC.

About Canadian Manufacturers & Exporters

Canadian Manufacturers & Exporters (CME) is Canada's largest trade and industry association, and the voice of manufacturing and global business in Canada.

The association represents more than 10,000 leading companies nationwide. More than 85 per cent of CME's members are small and medium-sized enterprises. As Canada's leading business network, CME — through various initiatives including the establishment of the Canadian Manufacturing Coalition — touches more than 100,000 companies from coast to coast, engaged in manufacturing, global business and service-related industries. CME's membership network accounts for an estimated 82 per cent of Canadian manufacturing production and 90 per cent of all goods and services exports.

Since 1871, the association has made a difference for Canada's manufacturing and exporting communities. Fighting for their future. Saving them money. Helping them grow.

For more information, visit **www.cme-mec.ca**.