

**Innovation and Productivity Tax Credit**  
**("IPTC")**  
**For Canadian Small Business**

**October 12, 2004**

# Innovation and Productivity Tax Credit ("IPTC") For Canadian Small Business

## I. Executive Summary

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*The federal and provincial governments respectively, should provide investors (individual and corporate) with a combined 30% IPTC*

### A. Recommendation

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For the last thirty years Canada has been involved in a fundamental change in its economy from natural resources to technology and innovation. Some 85% of Canada's GDP is presently being generated by small and medium-sized enterprises (SMEs). They are without dispute this country's economic engine. The launch of an overwhelming number of SMEs have depended upon capital invested by private investors, commonly known as angel investors. These angel investors assume significant risk in founding these emerging Canadian companies and nurturing their success. As integral components of the success of SMEs and the economic health of our communities, there is public policy value in further encouraging angel investments in Canadian SMEs. Nevertheless, the current tax regime provides little recognition of the risks assumed by angels and does not provide maximum incentive for continued investment and risk-taking by angel investors in Canadian SMEs.

**To recognize and encourage investment in Canadian SMEs, and reap potential benefits of employment and community prosperity, we recommend federal and provincial governments provide qualified and eligible investors (individual and corporate) with a combined 30% Innovation and Productivity Tax Credit (IPTC).**

We recommend the IPTC be provided for investments directly into an Eligible Business Corporation ("EBC"), thus dramatically increasing funding for these ventures.

### B. Discussion and Support

Federal and provincial economic policymakers alike recognize the need to encourage innovation in order to ensure economic growth and prosperity. Canada has an abundance of seed and start-up business development opportunities, based on technology and innovation. Net new economic growth is generated primarily by small and medium-sized enterprises (SMEs). It's imperative that Canada's policymakers support and encourage angel investment in our emerging enterprises. Policies that allow emerging enterprises to capitalize on the management and financial resources provided by angel investors improve the likelihood that such companies will succeed, leading to more jobs and long-term economic strength.

Historically, individual investors have been the primary source of capital for seed and start-up companies. As noted in a recent paper by the US Community Development Venture Capital organization:

***Historically, the primary source of seed capital for companies has been individual investors.***

***Angels are some of the most important (though least understood) players in our entrepreneurial landscape today.***

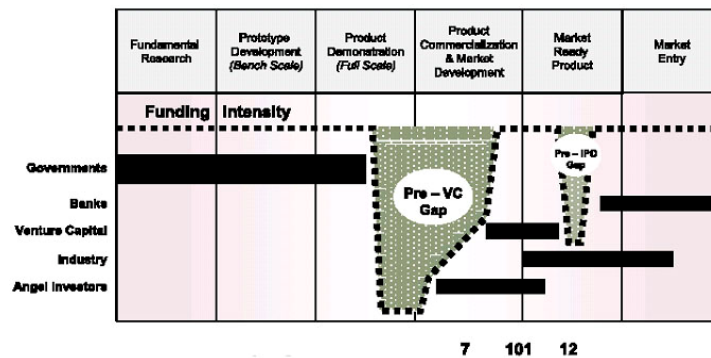
- In the US, Jeffrey Sohl, a professor at the University of New Hampshire estimated that in 2002 approximately 200,000 private individuals invested \$15 billion into 36,000 entrepreneurial ventures.
- Individuals invest at a critical stage generally when the entrepreneur's family and friends' money (otherwise known as "love money") has run out and prior to venture capital money.
- Only 2% of venture capital money is invested in seed and early stage companies.
- Angels are some of the most important (though least understood) players in our entrepreneurial landscape today. In the United States, *angels fund thirty-to-forty times as many entrepreneurial firms as the formal venture capital industry, although their total capital commitment may be less because of the stage of the investment.* Angels as a class, bring BOTH money and a unique strategic guidance to early stage concepts - seeking to become a business.

The National Angel Organization (“NAO”) is the national voice for Canada’s angel investors. In 2003, the NAO surveyed and met with individual investors in round table discussions in 11 cities across the country. Based on their input, the NAO is seeking a tax credit program for qualified investments:

1. It should be an overarching objective of Canadian governments to capture the strategic value of seed and start-up money in our National Innovation Value Chain.
2. Canada must encourage more entrepreneurial companies in order to achieve its economic goals. SME's are the single most important driver of economic growth and job generation in this country.
3. There is a critical shortage of seed and start-up investment in Canada. This shortage, referred to as the Funding Gap in the Innovation Chain, is in the order of \$5 Billion.

*The National Angel Organization is the only national voice for Canada's angel investors.*

Figure 1- Early Stage Funding Gap in Canada



\* Source: MacDonald & Associates, Oct 2002

***There is critical shortage of early stage investment in Canada.***

***Early stage investing is very risky business. There is a need for government(s) to incent everyday Canadian angels to take the risks necessary to invest in Innovation.***

4. Canadian governments need to focus resources on this Funding Gap (the Pre-VC stage of business development). Without government(s) help, innovation stalls and does not progress to a later stage, where venture capitalists will invest. (See page 56 of the Primer For Angel Investment in Canada for further information on the funding gap). More distressing is that the failure to better facilitate investments in the early stages of companies could prompt an exodus of Canadians and their enterprises to other jurisdictions with more capital-friendly structures.
5. Seed and start-up investing is a very risky business, but the rewards can be very high for several stakeholders beyond angel investor: owners, employees and their communities benefit when SMEs succeed. There is a need for government(s) to incent everyday Canadian angels to take the risks necessary to invest in Innovation.
6. Angels help entrepreneurs deal with the inherent execution risk of business development, in a very efficient manner. They operate with low overhead, do not charge for their time and have the patience to wait for a payoff many years hence. Entrepreneurs often refer to angels' value to their business as being "priceless".
7. Labor Sponsored Investment Funds (LSIFs) tax credits have been very successful in attracting large pools of capital for private equity investment. The LSIF (and British Columbia) tax credit needs to be extended to angel investments.
8. Investments in Seed and start-up companies have a huge multiplier effect (8 to 10 times) for the Canadian economy and further attract later stage follow on investments (4 to 5 times).

The National Angel Organization is asking public policy planners to make it an over-arching objective that governments seek out and leverage the strategic value of angels' money in our National Innovation Chain. This should be a motherhood priority.

## **II. Introduction and the Issue**

***There are substantially less private funding dollars available in Canada for early stage investment than in the US.***

***Early-stage ventures in Canada tend to be riskier than in the US.***

***When the government provides investment incentives, private investors respond.***

***At an absolute bare minimum, individual investors investing in early-stage businesses need to be on an equal footing with the LSIFs.***

Our national economic health is critically dependent on a continuous flow of activity from laboratory research to company formation, product development, product commercialization and the growth of the business.

There are substantially less private funding dollars available in Canada for early stage investment than in the US. This places Canada at a long-term competitive disadvantage. There is ample innovation at the research level, and ample funding for growth – but the “Funding Gap” to bridge research through start-up and early sales is a serious and chronic problem.

Seed and start-up ventures in Canada tend to be riskier than in the US; due to the smaller domestic market, limited pool of available talent to manage seed and start-up enterprises, and limited infrastructure that fosters rapid creation of commercial enterprises compared to Silicon Valley and other areas of the US.

Available funds for seed and start-up ventures in Canada are sorely limited. The higher risk profile, and, in the case of high net worth individuals, the comparatively smaller number of individuals, and their much smaller average investment capacity – often pits a small Canadian start-up against a US startup with 10 times the capital base.

Individual investors reach a broad population of deserving companies due to their great numbers and geographic location in all parts of the country.

When the government provides investment incentives, private investors respond – examples include Labour Sponsored Investment Funds, Oil and Gas Flow Through Shares, and Scientific Research & Experimental Development Credits.

Further incenting LSIFs will not address the early stage (pre-VC) funding gap (see Figure 2 above). Incentives need to be directed at this funding gap.

**An incentive is needed to encourage investment in seed and start-up businesses by individual (angel) investors. This is the only viable source of seed and start-up capital to address the “Funding Gap” (in the order of \$5 Billion). At an absolute bare minimum, individual investors investing in seed and start-up businesses need to be on an equal footing with the LSIFs in terms of tax credits and related taxation matters. Just going this far – placing them on an equal footing – will free up vast amounts of equity capital for early-stage companies.**

### **III. Background**

*Only the province on British Columbia has a program in place providing a tax credit for a direct investment by an individual into qualified companies.*

Most provinces and the federal government offer individual investors tax credits for investing in a Labour Sponsored Investment Fund (LSIF). These Funds have raised billions of dollars during the last 10 years. Unfortunately many of these funds are consolidating and many LSIF's have abandoned seed and start-up investing and are focusing on follow-on investing to improve their returns.

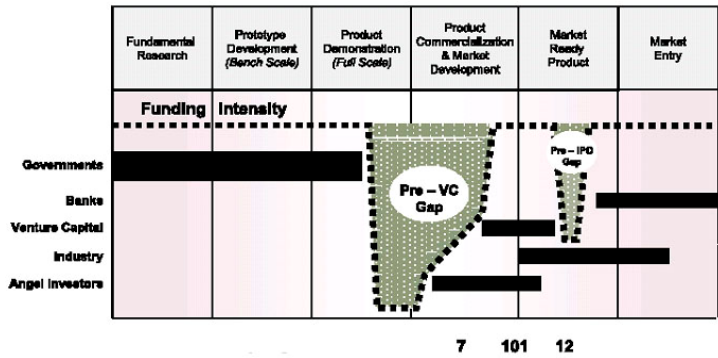
Certain provinces have initiated tax incentive structures to reward early stage investors with tax credits when they make investments in designated small business enterprises or an Eligible Business Corporation (“EBC”).

Only British Columbia has a program in place providing a tax credit for a direct investment by an individual into qualified companies engaged in the knowledge based and value-added product sectors. The provinces of Newfoundland and Labrador, New Brunswick and Nova Scotia also have direct investment programs but have no business restrictions concerning sector eligibility. Manitoba is now considering adopting a model similar to the one in British Columbia.

#### IV. The Financial Market Spectrum

The following chart illustrates the Funding Gap faced by businesses in the product demonstration and the product commercialization stages of the innovation chain. In fact, there are two gaps in the development cycle. One is referred to as the Pre-VC Gap. The other is the Pre-IPO Gap. Further information may be found on this topic in the publication "The Primer for Angel Investment in Canada".

Figure 2- Early Stage Funding Gap in Canada



\* Source: MacDonald & Associates, Oct 2002

*The National Angel Organization is the only national voice for Canada's angel investors.*

*In most cases, it is only the government and angel investors who are willing to fund a company that is doing fundamental research, prototypical product development or product development.*

In most cases, it is only the government and angel investors who are willing to fund a company that is doing fundamental research, prototypical product development or product development before a product is ready to be commercialized. Angels, if they invest, are the most effective group at this stage of development, since they risk their own money. This is what angel investors excel at, typically having accumulated their funds through successfully managing early stage businesses before.

## **V. The Players**

### **1. Venture Capitalists and Labor Sponsored Venture Capital Funds**

*...many VCs have moved to investing in later stages...*

These organizations are normally institutionally sponsored investors who traditionally are investing capital (usually between \$1 million and \$50 million per investment) in companies at a more mature expansion stage of businesses development (see Figure 2 above). Three or four years ago these organizations were investing at a much earlier development stage. However, due to pressures on investment returns, and the size of money under management, many VCs have moved to investing in later stages, where they can invest far greater amounts of money at lower risk with fewer professionals.

### **2. Angels**

Angels are some of the most important (though least understood) players in our entrepreneurial landscape today. Their influence has shaped our nation, since before its founding, and the economic importance continues to be immeasurable. (In fact, the NAO is currently seeking funding to quantify this impact). This group of individual investors invests directly into companies, using their own money. In most cases Angels are the only group that will fund early stage or seed activities. The funding is generally in lower increments (between \$25,000 and \$1,000,000) and to a significantly greater number of enterprises.

For example in British Columbia in 2003, the VC community funded fewer than 10 companies; in contrast, angel investors funded an estimated 40 registered companies through BC's EBC program alone and likely many, many more. Angels help companies during the initial development cycle, until the businesses reach a size and a risk profile that VCs will invest in. Many angel investors also play a needed mentor/advisor role to each business, as well as investing their own capital. But for every angel investment that is concluded, there are many times more companies seeking funding, and those that are funded would often have far better commercial prospects.

## **VI. Present Industry Tax Credits**

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For the last 40 years, investors and companies in both the mining and oil and gas sectors have enjoyed the benefits of tax credits from flow-through shares offerings.

At various times, governments have provided other industries, like software development and movies, with tax incentive programs. While these programs have been terminated, they were effective in attracting capital when active.

In the early 1990s, in an attempt to stimulate early stage investments and promote the innovation agenda, the federal and most provincial governments enacted legislation, which enabled the creation of LSIF funds. The mandate of these funds was to invest directly into Canadian businesses, at an early stage in their life. Unfortunately over time, these funds, plagued by low returns and administrative pressures, have strayed from the mandate and are for the most part funding larger scale investments (\$1 million plus and at a later stage).

*If angel investors were provided with the same sort of incentives as LSIFs, the program would be very successful.*

## **VII. Support For An Angel Investment Program**

If angel investors were provided with the same sort of incentives as LSIFs, (for early stage investments in technology and productivity) the program would be very successful because:

- Angels invest directly into the business.
- There are thousands of potential angel investors. Consequently, the economic activity is spread significantly more into many more businesses and geographic areas, as has been witnessed in British Columbia. Grassroots programs are ALWAYS more effective than institutional programs that develop their own bureaucratic bottlenecks.
- An angel investor is often prepared to take on more risk at an earlier stage, and make timely investment decisions. This is in part due to placing great reliance on the quality of the people, and in part to the angels playing an active “make-it-work” role in the business.

*An angel investor is often prepared to take on more risk at an earlier stage, and make timely investment decisions. .*

**Angel as a class bring BOTH money and a unique strategic guidance to early stage concepts seeking to become business.**

**Since 1985, the British Columbia Government has had a program that stimulates venture capital investment by individuals.**

- Angels as a class bring BOTH money and a *unique strategic guidance* to early stage concepts seeking to become a business. They invest their own time and their experience to help make Eligible Business Corporations (EBCs) successful
- A tax credit system for seed and start-up individual investors will be a key success factor in determining whether an eligible business corporation will be able to raise sufficient capital to grow its business.
- A direct tax credit system is also very much aligned with the interests of the VCs and LSIFs who are and will be looking for new investments that fit their criteria. By bridging the funding gap, the flow of more mature companies into the VC/LSIF funnel will expand dramatically. As an example, 60% of companies in which US VCs invest have already been financed by US angels. In Canada less than 10% of Canadian VC backed companies have been previously financed by Canadian angels.

#### **VIII. The BC Experience**

Since 1985, the British Columbia Government has had a program that stimulates venture capital investment by individuals. This program has raised \$400 million for 757 companies through 490 registered entities. The average investment has been \$578,000 for each business. The program has created a total of 15,915 jobs and 71% of the companies are still in existence today.

The recent history of the program is shown below:

<u># of Businesses</u>		
<u>Year</u>	<u>\$ Raised</u>	<u>Funded</u>
2000	\$ 28 million	38
2001	\$ 21 million	34
2002	\$ 15 million	28

In April 2003, the system was altered to allow direct tax credits. In the first 6½ months of this program, 110 businesses were approved as eligible (90% of which are technology companies). The total approved investments were \$210 million of which \$63,000,000 (or 30%) would be the tax credit portion. **The BC Government forecasts that this will result in over 40 new businesses being funded.**

These businesses have current employment of 820 people and are located throughout British Columbia, not just in the economic centre of Vancouver.

In contrast, the five largest venture capital funds/labour sponsored funds, in the same period of time, financed five businesses and all of these are in the Vancouver area.

(Note: Data Source: Directly from BC government investment program.)

#### **IX. The Grant Thornton Study and Terry Matthews Presentation to the CVCA**

In March 2001 Grant Thornton reviewed the impact of the British Columbia Investment Program:

***For each \$1 invested there is \$10 in economic activity and further each early stage \$1 invested leads to \$5 of later stage investment. Thus for each early stage \$1 invested this leads to \$50 in economic activity.***

*Terry Matthews, "An Economic Strategy to Retain Intellectual Capital"*

The study concluded that BC collected over \$1.30 in payroll, income and sales taxes for each \$1.00 of tax credit. This of course excluded Federal taxes collected.

Grant Thornton found that the payback period was 2.8 years.

The payback excludes taxes paid to the Federal Government and taxes paid on capital gains on the sale of the investments. For example, capital gains on VCC investments such as ALI Technologies (sold for over \$500 million) and Sierra Wireless likely covered the entire annual cost of the program.

There have been numerous other studies to determine the economic activity and taxes collected from government programs. Terry Matthews, the CEO of March Networks Corporation, in a June 2003 presentation to the Canadian Venture Capital Association titled "An Economic Strategy to Retain Intellectual Capital" documented the Knock On Effect. For each \$1 invested there is \$10 in economic activity and further each early stage \$1 invested leads to \$5 of later stage investment. Thus for each early stage \$1 invested this leads to \$50 in economic activity.

**Terry Matthews recommended governments pursue a public policy initiative to encourage angel investment.**

#### **X. Summary of Direct Benefits of an Investment Program**

*In addition, for each dollar invested there is an economic multiplier of \$8 to \$10 in economic activity.*

1. The creation of new direct employment with the funded companies. These jobs would never be created unless they received the necessary funding at an early stage.
2. New direct investment in the provincial/Canadian economy that would otherwise not have taken place. In addition, for each dollar invested there is an economic multiplier of \$8 to \$10 in economic activity. Further, each early stage \$1 invested leads to \$5 in later stage funding.
3. An increase in payroll taxes, sales taxes etc. According to a Grant Thornton analysis commissioned by BC, each dollar invested by the Province attracted BC taxes of \$1.30 after a few years. The BC Ministry's internal analysis indicates that the payback for these programs for the provincial government alone is 2.8 years.
4. Diversity of business investment throughout all of Canada and not just in specific urban areas. Angels are located throughout all regions of Canada.
5. Most of the jobs will be created in the high-growth areas like technology and innovation.

*Angels are located throughout all regions of Canada.*

**It is good public policy to invest in a country where innovation and productivity of the work force are rewarded.**

*Governments, both federal and provincial) need to work together to establish guidelines for an Eligible Business Corporation ("EBC").*

## **XI. Suggested Federal Tax Credit Recommendation**

The federal and provincial governments respectively, should provide investors (individual and corporate) with a combined 30% IPTC in respect of their investments directly into an Eligible Business Corporation ("EBC").

As with LSIFs, the IPTC tax credit should not erode the ACB of the investment, and the investment should be RRSP eligible. The BC experience demonstrates the "incentive power" of this level of credit.

Annual maximum IPTC tax credit of up to \$250,000. The tax credit would be repayable in part if the investment is sold within 5 years although a share exchange or re-investment would not be considered a sale. The credit could be amortized on a straight-line basis over the 5 years. In the event that the company goes out of business or the shares are sold at a loss greater than the tax credit, the credit would not be repayable.

Governments (both federal and provincial) need to work together to establish guidelines for an Eligible Business Corporation ("EBC"). British Columbia already has a working model so this should not be hard to do.

Administration of the IPTC tax credit could be at the provincial or federal level (but not both) and eligible small businesses would be pre-approved similar to the system in British Columbia (which provides government with control over the total amount of credits granted).

## **XII. Specific Recommendations for Altering The Income Tax Act**

An individual resident in Canada may claim up to \$ 250,000 in tax credits in one year. Specifically, an investor who is an individual must deduct the lesser of the tax credit or \$250,000 against tax otherwise payable under the *Income Tax Act*.<sup>1</sup> The credit works differently for individuals and corporations as it is refundable for individuals but not for corporations. If a tax credit for an individual exceeds the amount of the federal/provincial taxes payable, the individual will be entitled to a refund of the difference between the lesser of \$250,000 and the tax credit and the tax otherwise payable, after deducting certain other credits available under the *Income Tax Act*.<sup>2</sup> The refund must first apply to offset other amounts payable, including arrears. If an individual has a tax credit in excess of \$250,000, the excess may be carried forward and utilized, subject to the \$250,000 annual limit, in any of the four subsequent taxation years.<sup>3</sup> An individual investor has the option of claiming a tax credit for the prior taxation year if the shares were purchased in the first 60 days of the year.<sup>4</sup>

An investor that is a corporation must deduct the tax credit earned in the taxation year from tax otherwise payable. A corporation must have a permanent establishment in Canada and may claim the tax credit to offset federal/provincial income tax otherwise payable in a year. There is no annual limit on the tax credit for corporations.<sup>5</sup> A corporation is not entitled to a refund in respect of a taxation year if the amount of the tax credit exceeds the amount of its tax otherwise payable for the taxation year. The corporation can carry forward and utilize any excess tax credit in any of the four subsequent taxation years.

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<sup>1</sup> *Income Tax Act* (British Columbia), s21(16).

<sup>2</sup> *Supra*, s.21(3).

<sup>3</sup> *Supra*, s.21(4).

<sup>4</sup> *Supra*, s.21(1), paragraph (b) of the definition of “venture capitals tax credit”.

<sup>5</sup> *Supra*, s.21(8).

***An individual resident in Canada would claim up to \$250,000 in tax credits in one year.***

Tax credit incentives are realized through the issuance of tax credit certificates. An EBC applies to the Administrator of the *Small Business Venture Capital Act* for provincial tax credit certificates on behalf of investors who have purchased newly issued shares.<sup>6</sup> Investors then attach their tax credit certificate to their income tax return to be filed with the Canada Customs and Revenue Agency for processing.<sup>7</sup>

In addition to the programs described above, the provinces and the federal government may have tax credits for specific sectors of the economy.

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<sup>6</sup> *Small Business Venture Capital Act*, ss.20(3) and 20(4).

<sup>7</sup> *Income Tax Act* (British Columbia), s.21(11).