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February 23, 2023

The Honourable Chrystia A. Freeland, P.C., M.P.
Deputy Prime Minister and Minister of Finance
Department of Finance Canada
90 Elgin Street
Ottawa, Ontario K1A 0G5
Canada

Via email

Re: Proposed Two Percent Tax on Share Buybacks

Dear Minister Freeland:

On behalf of Tax Executives Institute, Inc. ("TEI"), I am pleased to submit comments on the corporate-level two percent tax on the net value of share buybacks by public corporations in Canada (the "Proposed Tax"), as proposed in the Fall 2022 Economic Statement (the "Statement"). The details of this Proposed Tax will be announced in the 2023 Federal Budget, and the Tax is expected to be effective on January 1, 2024.

We respectfully urge the Department of Finance (the "Department") to carefully consider our comments before tabling the 2023 Federal Budget. As always, TEI would welcome the opportunity to discuss this proposed legislation in greater detail with Department officials, either in person or by telephone at your earliest convenience.

About TEI

TEI was founded in 1944 to serve the professional needs of in-house tax professionals. Today, the organization has 57 chapters across North and South America, Europe, and Asia, including four chapters in Canada. Our over 6,000 members represent 2,800 of the world's leading companies, many of which either are resident or do business in Canada. Over 15% of TEI's membership comprises tax professionals who work for Canadian businesses in a variety of industries across the country. The following recommendations reflect the views of TEI but, more particularly, those of our Canadian constituency.

As the preeminent association of in-house tax professionals worldwide, TEI is dedicated to the development of sound tax policy, compliance with and uniform enforcement of tax laws, and minimization of administration and compliance costs to the mutual benefit of government and taxpayers. TEI is committed to fostering a tax system that works—one that is administrable and with which taxpayers can comply in a cost-efficient manner. The diversity, professional training, and global viewpoints of our members enable TEI to bring a balanced and practical perspective to the legislative proposals discussed herein.

TEI Comments

The Statement sets forth the motivations behind the Proposed Tax. The Department acknowledges in the Statement that buying back shares is a legitimate way for corporations to return value to shareholders. However, the Department posits that buybacks divert corporate resources away from making key investments in the Canadian workforce and business growth and expansion. Thus it appears the Proposed Tax is an attempt by the Department to compel companies to invest in their own businesses to tackle the productivity challenges currently faced by Canada. The Parliamentary Budget Officer estimates that the new tax will raise $3.0 billion over the first 5 fiscal years of its application.

TEI understands the Department's intention in proposing a new share buyback tax. However, TEI believes the proposed tax would not achieve the Department's goal of stimulating the Canadian economy, because the Proposed Tax will increase the cost of capital of corporations, and consequently reduce investments as corporations do not invest in unprofitable projects. Moreover, it is likely that corporations will continue to distribute surplus capital through buybacks (or special dividend) despite the Proposed Tax. Finally, Investors might redeploy their capital in foreign companies rather than Canadian ones.[1]

The Proposed Tax Should Not Be Implemented

TEI believes that the Proposed Tax should not be implemented, for the reasons set forth above and further explained in the Appendix. There are other ways for the Department to achieve its goal of increasing investments in the Canadian workforce by improving current investment tax credits for public companies or creating new ones, such as bonus depreciation.

The Proposed Tax Should Parallel the U.S. Share Buyback Tax

If the decision is made to move forward with the Proposed Tax despite the negative consequences on investments by Canadian corporations, TEI recommends that the tax rate not exceed the rate imposed by the United States on its version of a share buyback tax, which is 1%,[2] and the Canadian tax include

[1] We set forth a detailed discussion of corporate finance issues and how the Proposed Tax will impact corporate investment decision making in the Appendix.

[2] U.S. President Biden proposed to raise the U.S. buyback tax rate to 4% in his recent U.S. state of the union address. We believe any such increase is highly unlikely in the next two years given the current political composition of the U.S. Congress.

the same exclusions as the U.S. tax. The rate difference would place Canadian corporations at a disadvantage compared to their U.S. competitors and reduce overall investment by Canadian corporations.

There are several exclusions that apply to the share buyback rules outlined in the new U.S. legislation, including:

1. Repurchases that are part of a tax-free reorganization.
2. Repurchases contributed to an employee pension plan, an employee stock ownership plan, or other similar plans.
3. Repurchases of $1 million or less during the year.
4. Purchases by a securities dealer in the ordinary course of business.
5. Repurchases by regulated investment vehicles.
6. Repurchases treated as dividends.

The U.S. rules also include a netting concept, such that the fair market value of any issuances of shares during a taxation year offsets the amount of any repurchases of shares in that year. TEI recommends that the Canadian legislation should also include the above exemptions for certain buy-back transactions, as well as a netting approach.

We also recommend that the Proposed Tax, if any, be applicable only if the companies do not reach a minimal annual level of investments generally expected by financial markets (e.g., a certain percentage of earnings before interest, depreciation, taxes, and amortization ("EBITDA")). Finally, TEI recommends the Proposed Tax be deductible to reduce the impact on the weighted average cost of capital of Canadian corporations.

The Department Should Liaise with the United States regarding IRS Notice 2023-2

The U.S. Internal Revenue Service issued Notice 2023-2[3] late last year providing guidance related to the U.S. version of the share buyback tax, including guidance related to foreign corporations. Such guidance is very troubling to Canadian corporations who will be subject to the new Canadian tax rules. The broad reach of the U.S. rules could cause double tax to arise in respect of the same share buy-back transaction. That is, both Canada and the United States could impose their respective share buyback taxes on the same buyback. Additionally, it is unclear how the U.S. "funding" rule[4] will apply to ordinary corporate transactions undertaken either before or after the Canadian share buy-back actually takes place. For example, if a US affiliate makes a loan to a Canadian corporation within a two-year period prior to the Canadian share buyback, this may be considered "funding" the buyback even though the loan bears no relation to the share buyback transaction that will take place in two years' time.

[3] *Available at* https://www.irs.gov/pub/irs-drop/n-23-02.pdf.

[4] *See* IRS Notice 2023-2, Section 3.05(2)(a)(ii).

TEI believes that the Department should communicate to the United States that the application of such rules to a Canadian corporation may cause double tax to arise and will also limit the ability of a Canadian foreign affiliate group to undertake routine transactions if the Canadian parent company is planning on undertaking a share buyback within the next two years. This double tax is in addition to any withholding tax that would apply on the distribution of dividends from the United States to Canada to fund the buy-back itself.

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TEI appreciates the opportunity to provide input on the Proposed Tax and would be pleased to discuss further with Department officials as they work to finalize the legislation before its introduction in Parliament. The preceding comments were developed under the aegis of TEI's Canadian Income Tax Committee, whose chair is Steve Saunders. Should you have any questions about TEI's submission, please do not hesitate to contact Mr. Saunders at 403-801-4657 or steve.saunders@atco.com.

Respectfully submitted,

Wayne G. Monfries
International President
TAX EXECUTIVES INSTITUTE

CC: Trevor McGowan, Director General, Tax Legislation Division, Tax Policy Branch,
Department Finance

Appendix

Below are some key corporate finance issues the Department should consider prior to moving forward with the Proposed Tax.

1. **Corporations must create value over the long term to succeeds**. This entails taking inputs, including capital and labor, and making them worth more than their cost over time. Capital allocation is the strategic process organizations use to make capital investment decisions; it plays a central role in value creation. Successful allocation creates lasting capital value for all stakeholders. A company that does a poor job of managing its resources will lose in the marketplace to a better managed business or competitor.

2. **Corporations already have strong internal incentives to invest in profitable projects**. To create value, a corporation will invest in projects that at least compensate for its Weighted Average Cost of Capital ("WACC"). The WACC is the blended return expected by lenders and shareholders providing the capital required for investments. A corporation will pursue all profitable projects (i.e., that meet or exceed its WACC), either by using cash it generates or by financing through capital markets. Not doing so would miss an opportunity to create value and grow the business, which is the expected main goal of management and the main driver of success used by financial markets.

3. **The Proposed Tax will ultimately reduce the amounts re-invested in the business.** A tax on share repurchases will translate into a higher WACC. Share repurchases, together with dividends, are mechanisms by which equity investors obtain value as an expected return on their investments. Not only will corporations need to pay the return expected by the shareholder, but they will also have to fund the tax, resulting in a higher cost of equity and therefore a higher WACC. A higher WACC means some project's return will no longer be sufficient to be pursued since investments that fail to earn the higher cost of capital would negatively impact value creation.

4. **Share repurchases are an efficient way to reallocate capital towards profitable investments outside a given corporation.** Penalizing corporations for returning excess capital by incentivizing it (via the Proposed Tax) to invest it in projects that do not meet the corporation's WACC would impede value creation because the expected return would not be met, and the value of the corporation would go down. Market efficiencies mean excess capital returned to investors through buybacks will likely be redeployed to other corporations with projects meeting their WACC. Were this not the case, shareholders would not sell their shares back at the share prices offered by companies undertaking buybacks. The Proposed Tax will make this capital reallocation process less efficient, with a resulting loss of productivity for the entire economy.
5. **Share repurchases are a tool for corporations to achieve the desired debt to equity mix that will best support profitable re-investments in the business.** Through its financial policy, a corporation will determine the mix of debt and equity deemed optimal (i.e., usually the one that

offers the lowest WACC). For example, without any impact on free cash flow or its level of reinvestment in the business, a corporation could increase its debt to return capital to shareholders through share repurchases. The Proposed Tax could force a less efficient capital structure (i.e., a higher WACC) that would no longer support pursuing some investments that would otherwise be pursued without this additional tax.

6. **Share repurchases do not compete against re-investments in the business.** The return of excess capital to investors, through debt repayment or share repurchases, only occurs when a corporation generates more cash than required to pursue all profitable projects. By definition, and regardless of the amount of cash it generated or distributed through share buybacks, a corporation should always be able to find investors (a target mix of lenders or shareholders) to provide the required capital if its investments are expected to meet or beat the WACC (i.e., the investors' expected return). Having returned capital to shareholders in the past does not preclude future significant profitable investments in the business that capital markets will gladly accommodate.

7. **It is unlikely that the Proposed Tax will reduce the amount of redistribution to shareholders.** Once all profitable investments have been pursued and the optimal capital structure reached, any surplus cash needs to be redistributed to shareholders. Corporations should not and will not start investing in unprofitable projects. The alternative of hording too much cash or having a "lazy" balance sheet with reduced leverage would be severely penalized by markets for the inefficiencies it would create. At best, businesses would respond to the Proposed Tax by replacing share buybacks with dividends. Larger dividends would not achieve the Department's goals.

   Moreover, substituting dividends for share buybacks is not a best business practice. Investors expect dividends to be stable over time and any large fluctuations from one year to the next may be penalized by markets. Special share buybacks also come at a premium, which also means an increase in WACC and a reduction in re-investments. Buybacks are complementary to dividends as their size is expected to vary from one year to the next, with the variations in surplus cash (after all profitable investments have been pursued and dividends paid). At bottom, it is highly likely that corporations will continue to distribute surplus capital through buybacks despite the Proposed Tax