International Financial Activity Program Review ~~(December 7, 2009 draft)~~(January 10, 2010 draft)

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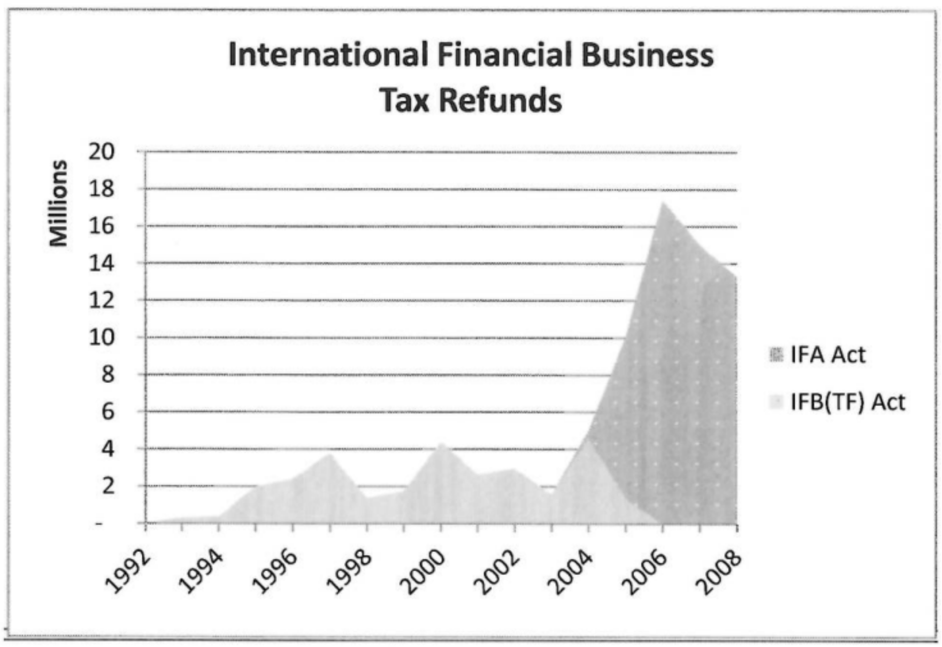
International Financial Activity Program

In 1987 the federal government enacted legislation designating Vancouver and Montreal as international banking centres, and providing corporate income tax exemptions for profits earned on loans made to, and deposits received from, non-residents. The legislative changes were made in response to concern about the possible exit of international activities and the associated employment of leading banks from Canada. The concern was Canadian banks operating through offshore branches could avoid the impact of foreign taxes and Canadian provincial taxes. A federal report had recommended Canada match the tax treatment for international business booked in Canada that was given when it was booked aboard (Abrary, 2004).

The federal changes formed the basis for complementary provincial legislation to be enacted in BC and Quebec. The British Columbia government introduced the *International Financial Business Act* and the *Tax Refund Act* IFB program in October 1988 to encourage the growth of Vancouver as an International Financial business centre. Under this legislation, participation was limited to financial institutions in Vancouver providing a specific range of financial services to non-residents.

In the spring of 2004, the government replaced the original legislation with the *International Financial Activity Act*. At that time, there were about 30 financial institutions registered in the program and tax refunds had reached a level of $4 million per year. By comparison, there were over 130 corporations registered in the Montreal International Financial Centre (IFC) in 2003.



The International Financial Activity Act (the Act) legislation expanded the program to non-financial corporations in all areas of the province, expanded the list of financial activities that qualify and allowed related party transactions for many activities. Under the new legislation, activity in the program increased rapidly to $14 – 16 million per year in tax refunds. The BC IFC has 62 corporations registered in the IFA program under the Act, as of July 2009. The Montreal IFC has dropped to 113 registrants (Montreal IFC, 2009).

Program objectives and changes under the International Financial Activity Act

The International Financial Activity Act was introduced in 2004 with the following objectives.[1]

1) Attract new financial businesses to British Columbia.
2) Encourage the development of new international financial activities such as film and television distribution.
3) Create new employment opportunities and well-paid, highly skilled jobs.

In order to more effectively compete with other financial centres, the government expanded the eligibility for the tax refunds under the program. The program had been restricted to financial institutions in Vancouver; it was expanded include non-financial corporations and all areas of the province. As well, the list of financial activities that qualified was expanded to allow related party activities in treasury functions, back-office support and factoring. An expansion to patents in 2005 introduced the further objective of encouraging retaining intellectual property in BC as they move from research and development into the commercial market (Hansard , 2005). Further details and subsequent changes are shown in the following table.

Qualifying Activities (for or with non-residents)

International Financial Business (Tax Refund) Act	International Financial Activity Act
Program available to financial institutions[2] conducting qualifying activities within the Greater Vancouver Regional District. Arms length transactions required (except captive insurance). The qualifying activities, in relation to a non-resident, included: • accepting deposits, making loans • issuing letters of credit, handling documentary collections • dealing in securities • conducting foreign exchange for non-residents • insuring risks (including captive insurance) • acting as a financial advisor, managing investments, preparing financial research • providing fiduciary services, financial leasing, factoring	The program retained the same qualifying activities as the International Financial Business (Tax Refund) Act with the following expansions: • allow non-financial (i.e., general) corporations • permit activities between related parties (except issuing letters of credit, insuring risks other than by captive insurance companies, and dealing in foreign exchange) • permit activities to be conducted province-wide • list of qualifying activities expanded to include: o treasury functions, back-office services and back up office services, o foreign exchange transactions conducted for residents, and by companies primarily engaged in foreign exchange activities o film and television distribution
	Budget, September 2005 expansions (eff. Jan 1,06) • commercialization of life science patents
	Budget 2008 expansions • management and control functions • qualifying patents to include green energy power generation (wind, solar, tidal)

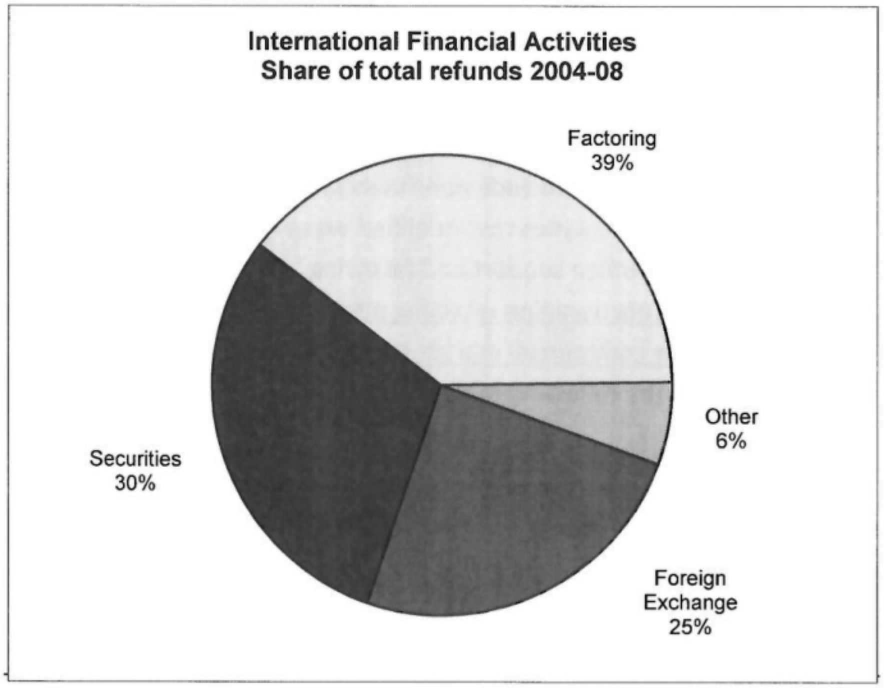
[1] Hansard 2004, May 12th, 1st reading, section 11045 and May 13th, 2nd reading, section 11112.

[2] "Financial institution" includes a bank, trust company, investment dealer, insurer or export financing company.

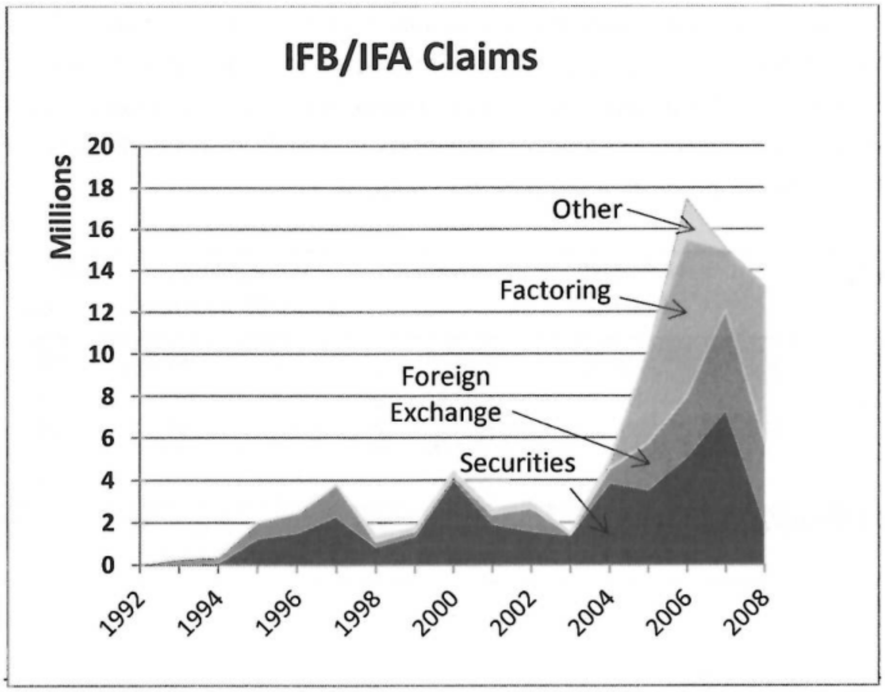
	Budget 2009 expansions • qualifying patents to include wastewater treatment and fuel cell technology

Overview of activity in the IFA program

Three activities have accounted for the overwhelming majority of qualifying activity of the program since 2004: factoring; securities; and foreign exchange. When combined these categories account for 94% of the tax refunds provided under the IFA program.



In all cases, these were qualifying activities under the previous IFB(TR) Act legislation. However, factoring did not really pick up until non-financial corporations and related party transactions were allowed under the IFA program. With these changes, factoring has become the largest category in the IFA program.



As noted above, there 62 corporations registered in the IFA program[3]. Of these, 49 have received refunds or have claims outstanding. Currently there are 45 active claimants, as four claimants have cancelled their registrations.

Of the 42 corporations participating in the program, there are 34 affiliated corporate groups. The three most active corporate groups have accounted 53% of the total participation in the IFA program, since its inception. The top ten have accounted for 87%.

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Income and Employment Associated with the IFA Program

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[3] The total number of registrants under the IFA program since September 1, 2004 is s. In addition to the s.2 corporations that deregistered after making claims, there are s.21 corporations that deregistered without making a claim and s.21 s.21 refused registration due to lack of information.

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Activity	Number of Firms	GDP*	IFA Refunds (2005-08 average)		Direct Employment Low	Direct Employment High
Securities	s.21			30%	s.21	
Foreign Exchange				25%		
Factoring				39%		
Other				6%		
Registered (no refunds)				-		
Total	62	$136 M	$13.6 M[4]	100%	122	271

*IFB net income plus labour costs

Comparison with previous reviews

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Comparison of Estimates[5]	Ference (2002)[6]	MMK (2009)[7]	BC Finance (2009)
Tax refunds	$4 M	$15 M	$15 M
Net Income	$24 M	$125 M	$125 M
Labour Costs	na	$240 - $334 M	s.13
Employment	227	2,726 - 3,635	
Incremental Employment	110	na	

Ference (2002) relied on two surveys assess the impact and scope of activities undertaken by the IFB program, the first with companies that had received IFB tax benefits and the second with potential program participants.

MMK (2009) used data drawn from eight industry specific studies. Key statistics were extracted from the eight studies including profitability ratios, labour cost ratios, numbers of employees and average labour costs per employee. Those statistics were used to estimate the employment associated with the tax refunds that were paid by the Province.

[4] As of July 27, 2009, $26 million of the $68 million paid or outstanding since 2004 under the IFA program was outstanding, i.e. not yet paid.

[5] BC Finance estimates are for the fiscal year 2007/08 for comparison purposes with MMK. Ference estimates are for 2001.

[6] In 2002, Ference Weiker and Co. was hired to conduct a comprehensive review of the IFB program for the Ministry of Finance. The following references are from the final report: tax refunds, p. 8; total revenue, p. 14; incremental revenue, p, 22; total and incremental employment, p. 24.

[7] The MMK (2009) report was prepared by MMK Consulting Ltd. for the IFC BC in April 2009

The BC Finance labour costs and employment estimates are derived from IFA program data using IFB income statements of salary expenses from a sample of active IFA registrants for all years of the IFA program. The sample companies were separated into three categories, so the estimates would not be skewed by the markedly different labour costs relative to IFB income in each of these categories.

In the table below, the three categories represent 93% of participation in the IFA program. Employment estimates were derived by dividing labour costs in each category by average salaries. Average salary ranges and sample representation for each category are shown in the following table.

Employment Estimates	Share of Tax Refunds	Sample Representation	Salary Assumptions[8]
Securities	30%	80%	$90,000 to $200,000
Foreign Exchange	25%	97%	$90,000 to $200,000
Factoring	39%	83%	$40,000 to $90,000
Other	6%	0%	$40,000 to $90,000

A closer look at the similarities and differences in results

The Ference (2002) employment estimate is s.13 the estimate generated in this report, adjusted for the scale of the program. s.13

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An additional check on the likely scale of employment associated with the program is available using information on the number of employees that qualified to a refund as eligible employees under the IFB(TR) Act in 2002. Employees of financial institutions registered under the Act who performed duties primarily devoted to its international financial business were eligible for tax refunds. In 2002, there were 101 individuals who were eligible to claim a refund (Tax Policy Branch, 2004). When this adjusted for the difference in the scale of the former program compared to the IFA program, this is equivalent to 172, s.13

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As noted above, MMK used data and ratios extracted from eight financial services industry studies and applied the ratios to the estimated 2007 IFB net income of $125 million to estimate the total volume of business activity associated with the IFA program (MMK Consulting, 2009 p. 6). MMK note the following limitation of results.

[8] $40,000 is the average salary for credit and collections clerks (CampbellCohen, 2009), $90,000 is the average salary used in the MMK study and $200,000 is an estimate of investment advisors salaries (CSI Global Education, 2009).

"The results presented in this report are subject to the following limitation of which the reader should be aware. Due to privacy and confidentiality restrictions, actual details of business income and expenses for IFA program participants are not available, and therefore the volume of business activity taking place under the IFA program has had to be estimated based on the known value of IFA refunds issued and other industry-relevant studies, as described in section 4 of this report." (p.14)

In contrast, the BC Finance estimates depend on self-reporting of labour costs associated with IFB income by IFA program participants. s.13

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Incremental activity

Incremental employment income and employment are key measures of the success the current IFA and the previous IFB program. To the extent that activity is not incremental it results in a loss of revenue to government and no change in economic activity.

Ference (2002) estimated the portion of activity that through surveys of program participants. MMK (2009) acknowledge the theoretical importance of incremental activity; however, they argue it is not possible to reliably determine what activity is incremental. Instead they estimate that 22% to 34% of IFB activity that is needed for the program to break even from a fiscal perspective, as a result of multiplier effects associated with indirect and induced activity.

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s.13 MMK estimate total output of \$625 to \$883 million and total employment of 2,726 to 3,635. The employment estimates based on program data 134 to 299 FTEs. Using provincial Input/output (I/O) model for the FIRE[9] sector, the output associated with 134 to 299 FTEs is \$47 to \$106 million. The provincial taxes associated with this activity are an estimated \$3 to \$8 million, which implies is a break even ratio of 40% to 80%.

[9] Finance, Insurance and Real Estate.

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Activity	IFA Refunds[10]	Emp't Income	Employment	Est. of % incremental	Incremental Emp't Inc & Emp't
Factoring	s.21				
Foreign Exchange					
Securities					
Other*					
Registered (no tax refunds)					
Total	$13.6 M	s.13			

*Includes patents where the objective is to retain intellectual property in B.C.

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Factoring

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[10] Annual average 2005-08.

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Foreign Exchange

Under the IFB program, banks have made claims since 1992. Under the IFA program, banks and credit unions identified foreign exchange as the primary activity associated with all the claims they made. Foreign exchange claims increased significantly since the IFAA was introduced in 2004, relative to claims by banks under the previous IFB program.[11] During the IFB program, claims by banks averaged s.21 million per year and peaked in 1997 at s.21 Since the beginning of the IFA program foreign exchange claims have averaged s.21 million per year and peaked at s.21 million in 2007.

[11] Under the IFA program, foreign exchange was reported as the primary activity. This information was not available for the IFB program.

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Why did this occur? Was this new or incremental activity that can be attributed to the IFA program?

The IFA Act broadened foreign exchange as a qualifying activity in two ways:

- it allowed "retail" transactions where only one of the parties is a non-resident ~~(one-sided transactions);~~, and
- it allowed corporations dealing primary in foreign exchange to qualify.[12]

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[12] Under the IFB program both parties had to be non-residents and only savings institutions qualified.

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Another way to assess whether foreign exchange activity is occurring in BC as a result of the IFA program is to examine the circumstances that led firms to locate in BC. s.13

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s.21 The company became eligible for tax refunds under the IFA program in s.21 and first received a tax refund in s.21 so there is no evidence that the activity generated to date is a result of the IFA program.

s.21 It has been growing revenue at an annual s.21 per year for the past three years. The firm has an international client base of nearly s.21

s.21 The firm is hiring new staff in Victoria at a fairly high rate.

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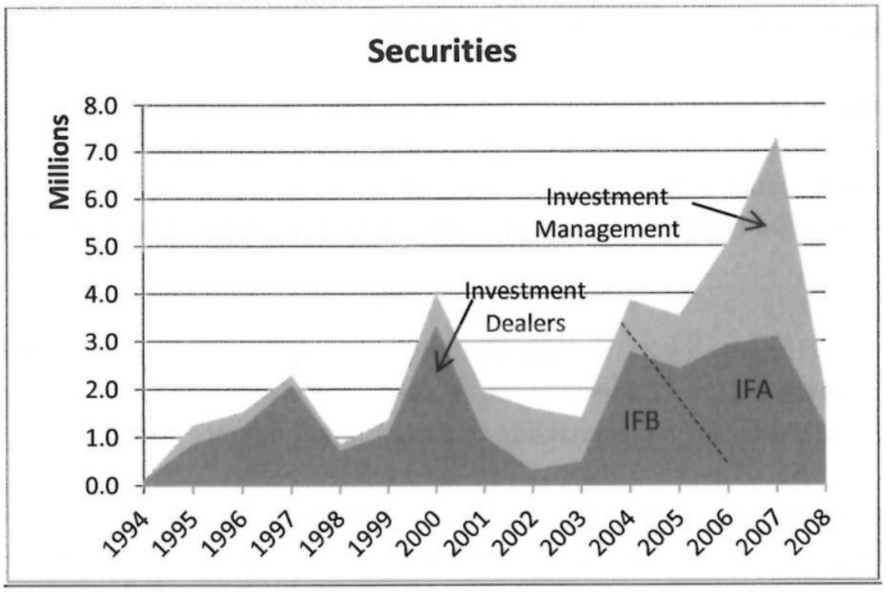
Securities



Investment Dealers

About one-half the survey respondents in Ference (2002) indicated the IFB program had resulted in incremental revenues for their firm. Based on the survey responses, Ference (2002) estimated that approximately 37% of the revenue and 48% of employment associated with the program was incremental. The remaining respondents that stated their revenues had not changed as a result of the IFB program were mostly either investment dealers or investment counsellors. They reported that some or all of their international financial business conducted under the IFB program consisted of the purchase of international financial securities and other investments for Canadian residents (Ference Weicker & Company, 2002 p. 22).

Investment Dealers accounted about 50% of the participation in the IFB program versus 15% in the IFA program, since participation in other categories have expanded while investment dealers have not. The claims by investment dealers averaged $1.5 million per year in the IFB program versus $2.1 million in the IFA program. Over 95% of the claims under the IFA program were by firms that participated in the IFB program since the mid-nineties. s.13
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Investment Management

Investment Management includes providing financial advice, preparing stock market research or managing investments for non-residents. For Canadian residents, Investment management includes the service of managing investments in securities that are issued by a non-resident person and that are not listed with a prescribed (Canadian) stock exchange.

There are s.21 firms participating in the IFA program with investment management as their primary IFA. s.21 firms participated in the IFB program and those firms comprise s.21 of the IFA participation in this activity; the remaining s.2 are new firms.

Under the IFB program, tax refunds for investment management activities increased to roughly s.2 s.21 and remained at level until the legislation was replaced by the IFA Act. Under the IFA program, participation in this category peaked at s.21 s.13

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The majority of the activity is associated with firms that have participated in the IFB/IFA program since 1995. Portfolio managers were part of the group of survey respondents that stated their revenue had not changed as a result of the IFB program (Ference Weicker & Company, 2002 p. 22).

Other Activities

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There are s.21 firms in this category involved in a variety of activities including ~~science, film distribution, back office services,~~ making loans~~,~~ and export financing~~ and~~, film distribution, back-office services, treasury services~~.~~ and patents.

Making loans and export financing are IFA program activities that were carried forward from the IFB program. s.21

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Back-office services and treasury services were added in 2004.

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