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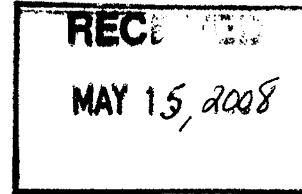

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May 8, 2008

Advisory Panel on Canada's System of International Taxation
Submission
Attn: David Messier
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Gentlemen:

This is a brief submission pertaining to your excellent report, "Enhancing Canada's International Tax Advantage" (hereafter, the "Report"). I am a U.S. tax attorney and I am not licensed to practice in Canada. However, I have been involved in many cross-border transactions into and from Canada over many years, and so have some perspective on how Canada's international tax rules operate. I also have some perspective on how those rules compare to rules in the United States and other countries.

From my perspective, the most interesting (and frustrating) feature of Canadian international tax policy is one not even mentioned in the Report, even in Chapter 4 dealing with withholding taxes. Unlike the United States and many other countries, Canada purports to impose a withholding tax (and a substantive tax) on gains from the sale of "taxable Canadian property," which notably includes shares of Canadian corporations. Although generally relieved by treaty, as explained below the rules create significant burdens to claiming treaty relief in a wide variety of cases.

A withholding tax on gain from the sale of shares is qualitatively different from a withholding tax on periodic income. First, gain from the sale of property typically has a very low "gross income" content as compared to periodic income from property, and may represent in whole or in large part simply the recovery of tax cost. The purchaser of the property usually will not know, and not be in a position to know with certainty, what the

seller's tax cost is. Any flat rate withholding tax is apt to result in overwithholding, necessitating the filing of a tax return to claim a refund. Second, a tax on gain is difficult to enforce by withholding, because the purchaser of shares may be located outside of Canada, or may not know of the withholding requirement, or may ignore it. Third, while such a tax can be exempted by treaty, it cannot be "split" between two treaty countries in the way items of periodic income, such as interest, dividends and royalties, can be. Rather, one country or the other will have the right to tax 100% of the gain. Finally, most countries will not provide a foreign tax credit or exemption for a tax imposed by the "source" country on gains of their residents.[1] Thus, where a source tax is collected, there will often be double taxation.

These and other difficulties explain why Canada's treaties generally exempt treaty residents from the tax. However, implementing an exemption by treaty rather than by domestic law presents a number of obstacles to compliance, obstacles that, as noted below, do not raise revenue for Canada but do encourage wasteful tax planning.

Consider the quite common case in which a U.S. private equity fund, formed as a Delaware limited partnership, invests in the shares of a Canadian corporation. The fund will typically have partners from all over the world, not just U.S. partners. Fortunately, Canada will generally look through the partnership to determine whether the partners individually qualify for treaty benefits.[2] However, even if all of the fund's partners qualify for benefits under a treaty with Canada, such that any one of them could qualify for exemption from the tax on a sale of the shares at a gain, the partners will first have to navigate the difficult procedures for obtaining individual "section 116 certificates" to avoid withholding.

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[1] Clause 4.7 of the Report assumes that income subject to tax by Canada on a source basis would generally qualify for a credit or exemption in the investor's home country. This is patently not the case for gains. Clause 4.8 points out that most withholding taxes are reciprocal, but this is also often untrue in the case of taxes on gains.

[2] Canada generally will *not* look through U.S. LLCs and certain other entities that would be treated as nontransparent under Canadian law, even where the country in which the partner resides treats the entity as tax transparent and therefore imposes tax on that partner's share of the entity's income. This policy, which is contrary to OECD recommendations, results in complete double taxation in violation of treaty norms. The policy will be relaxed for U.S. residents when the new protocol between Canada and the United States enters into force, but will presumably persist for residents of other countries.

The 116 certificate procedures are unworkable in this context for at least three reasons. First, there are usually far too many partners, many of whom invest through upper-tier partnerships and funds of funds, to track down the information needed from each of them (even if they were willing to provide that information). Second, the section 116 rules as applied to partnerships require that the precise amount of gain allocable to each partner be stated in the certificate, which must be provided more or less contemporaneously with the sale. This requirement will often be literally impossible to comply with. Most funds do not provide for "straight up" allocations of all items of income and gain, but instead provide complex preferred returns, hurdles and carried interests. Until the earlier of the close of the year of a sale or the date that the fund's last investment is sold, the fund will simply not know how the gain from a particular sale will be allocated among all of its partners. Finally, the current rules requires each of the partners to file a tax return in Canada even after the section 116 certificate has been issued. Many foreign partners will simply be unwilling to do so, and even if willing, accounting firms charge enormous fees for handling this compliance nightmare.[3]

To avoid these problems, the fund will not invest directly into the Canadian company. Instead, it will invest through a conduit entity, typically set up in Luxembourg. This practice, known as "treaty shopping," is often resorted to in order to secure treaty benefits not otherwise obtainable. But in most of the cases of the type discussed here, the reason to "treaty shop" is not to secure treaty benefits - they are in theory usually available to all or the great majority of the partners - but to limit exposure to Canada's section 116 certificate compliance rules such that only one person (the conduit entity) is required to deal with those rules. Some practitioners worry that using conduits in this manner might run afoul of Canada's GAAR. Although recent case law would suggest that GAAR should not be a real concern in this context, honest taxpayers are left uneasy and the entire set of rules breeds a certain contempt for the law.

"Fixing" the problem presented by a tax on share gains by resort to tax treaties may also result in distortions when treaty rules, which are not generally designed to deal with this type of source conflict, do not match local rules. The most recent example of this is the serious question that arises in the context of the new "limitation of benefits" (LOB) provision that Canada will adopt in its new protocol with the United States. LOB provisions were not drafted with a tax on property sales in mind, and cannot be made to

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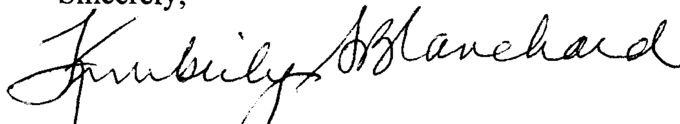
[3] I understand that there is a current proposal to repeal this requirement. While this is certainly progress, repeal of the return filing requirement will not go far enough, and funds will continue to "treaty shop" to avoid the other problems mentioned here.

work in this context. In many cases, the result may be a loss of the treaty exemption in situations not intended by the two countries party to the protocol.

Domestic tax rules that purport to tax nonresidents' share gains on a "source" basis may have had some appeal in an earlier era, in which cross-border investment was less common than it is today, and usually was made on a direct (strategic) basis. In today's complex global economy, monitoring, enforcing and collecting a tax on such gains is nearly impossible to do, and in the end generates more paperwork (and work for tax advisors) than government revenue. Moreover, as a normative matter it is not at all clear that the "source" of such gains should be the country in which the investee corporation is domiciled. In today's global markets, a Canadian corporation may have substantially all of its operations, employees, property and profits outside of Canada, whether or not housed in separate local subsidiaries. It is certainly not apparent why gain on the sale of shares of such a corporation should be regarded as 100% Canadian source.[4]

I believe that the Report should add a chapter addressing the taxation of gains on "taxable Canadian property," and specifically that the concept of assigning "source" in this area should be re-examined. I have written on this general subject and enclose, for your reference, a reprint of that article, providing more detail and comparative analysis. I would be please to discuss this further if you would find it helpful.

Sincerely,



Kimberly S. Blanchard

[4] Clause 3.2 of the Report, as well as a portion of clause 1.16, mentions that any liberalization of Canada's rules on inbound investment must be balanced by the need to protect Canada's interest in taxing Canadian source income. While this statement is certainly true, it is worth noting that there are a number of difficult issues encountered in defining what the source of a particular type of income is, and that countries do not always agree. Moreover, while Canada's rules for outbound investment are, as noted in the Report, quite generous (and intentionally designed to foster competitiveness), Canada's inbound rules are in relative need of liberalization, tending to be far more protectionist than the rules in other developed countries.