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Advisory Panel on Canada's System of
International Taxation
333 Laurier Avenue West, 15th Floor
Ottawa, Ontario
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Attention: Mr. David Messier

Dear Mr. Messier:

BP Canada Energy Company ("BP Canada") welcomes the opportunity to submit our views to the Advisory Panel on Canada's System of International Taxation (the "Panel") pursuant to the invitation in the consultation paper issued by the Panel in April of this year.

We support the Panel in its work and find it encouraging that the Government of Canada has, in the past, demonstrated its willingness to adopt recommendations arising from similar consultation processes (e.g. through implementation of many of the measures proposed in the Technical Committee on Business Taxation Report (commonly referred to as the "Mintz Report") released in 1998).

Our comments herein do not address all aspects of Canada's international tax policy, nor do the comments contain an analysis of competing alternatives as this has generally been done very capably elsewhere. We recognize the knowledge and expertise of the Panel and simply outline our recommendations as to the direction we believe the Canadian government should follow.

Introduction

BP Canada's ultimate parent is a publicly traded corporation headquartered in London, England and is the fourth largest company in the world (measured by revenue). It employs over 97,000 employees in 100 countries. In North America, the BP group is the largest oil and gas producer and one of the largest gasoline retailers in the United States. Globally, BP has projected capital spending of between US$21 billion and US$22 billion in 2008.

BP has been active in Canada since 1948, and its current Canadian operations are significant and growing. BP employs in excess of 1,500 people in Canada and currently produces approximately

half a billion cubic feet of natural gas per day. BP is also one of the top three natural gas and oil marketers and traders in Canada.

BP has recently made investments in, and commitments to, some substantial North American projects. It is partnering with Husky Energy Inc. in an integrated oil sands operation that includes development of the Sunrise field in Alberta and concurrent upgrading of a refinery in Ohio to process diluted bitumen. The Denali – Alaska Pipeline project to be undertaken with ConocoPhillips involves building a gas pipeline from Alaska to Alberta and possibly to the Lower 48 states. At an estimated cost of at least US$30 billion, this will be the largest private sector construction project ever built in North America. BP recently acquired exploration licenses in the Beaufort Sea by committing to spend at least C$1.2 billion. Additionally, BP and Irving Oil are jointly undertaking feasibility and engineering studies in respect of building a refinery in New Brunswick with a view to enhancing much needed product supplies for the northeastern U.S. and Canada

General Principles

The Report of the Competition Policy Review Panel released June 26 contains a number of recommendations designed to make Canada more competitive as a nation. A Backgrounder on the Competition Policy Review Panel website states that "The Panel's report, *Compete to Win,* draws one principal conclusion: in order to prosper in the global era, Canada must adopt a more globally competitive mindset."[1]

Consistent with that conclusion, Canada's international tax policies should be formulated from a position of strength consistent with the fiscal opportunities that the current federal budgetary surplus affords – that is, Canada should take a long-term strategic perspective and be prepared to forgo a certain level of possible tax revenue in the short term, if necessary, to position itself for future competitiveness and prosperity.

Like many others, BP Canada believes that three of the cornerstones of an effective tax system are simplicity, certainty and competitiveness. We recognize the challenge governments face in trying to incorporate all of these elements into what is, necessarily, a dynamic and complex system – nonetheless, we believe that, to the extent possible, all taxation policies of the Canadian government should be based on these principles. While clearly there is no one best policy directive, our choices among competing approaches have been made with these three cornerstones in mind.

As cited with approval in *Compete to Win*[2], the Institute for Competitiveness & Prosperity in its *Report on Canada 2008*[3] concludes that Canada should move toward more value-added consumption taxes and reduce corporate and personal income taxes. We agree with the conclusion that "shifting taxation from business expenditure to consumption expenditure will increase the motivation for business investment, which in turn improves wages and job creation"[4] and certain of our recommendations are also predicated on this view.

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[1] Backgrounder to the Report of the Competition Policy Review Panel at http://www.ic.gc.ca/epic/site/cprp-gepmc.nsf/en/h_00001e.html
[2] Report of the Competition Policy Review Panel at page 63 and footnote 3 to Chapter 8.
[3] Institute for Competitiveness & Prosperity, *Report on Canada 2008* at page 43.
[4] Supra footnote 2.

We commend the Canadian government for the actions it has taken to reduce corporate tax rates and its goal to have the lowest statutory corporate tax rate in the G7. As the Panel observed in its consultation paper, "One of the most significant domestic tax factors influencing the competitiveness of Canadian businesses is the corporate tax rate."[5] We strongly urge the Government of Canada not to undertake any action which would cause it to deviate from its current commitment to lower corporate tax rates.

At the same time, we recommend that Canada rethink recent unilateral initiatives seemingly intended to attack perceived inequities in the way the taxation systems of other countries interact with Canada's. Recent proposals in respect of so-called "double-dip" financing structures do nothing to protect the Canadian tax base, but appear designed to protect the tax revenues of foreign countries by preventing Canadian taxpayers from engaging in widely used international tax planning. And, in the recently completed Fifth Protocol to the Canada United States Income Tax Convention (the "Canada-U.S. Treaty"), provisions were introduced that deny treaty benefits to certain "hybrid entities" even though such entities have been commonly used for many years to conduct active Canadian operations. If Canada wishes to see changes in international taxation principles, it should use its influence to propose such changes through the OECD - trying to effect the changes alone or in conjunction with our major trading partner creates unnecessary uncertainty for Canadian taxpayers, and makes Canadians less competitive in the international arena.

Inbound Investment

As described in *Compete to Win,* one of Canada's competitive weaknesses is its relatively small population and vast geographic land mass and this is consistent with the findings in a recent report published by KPMG.[6] This report issued in June 2008 was based on a research project involving over three hundred corporate investment strategists plus representatives of private equity funds and sovereign wealth funds and the most influential factor identified when choosing a country for investment was "access to new customers." Somewhat surprisingly perhaps, respondents said that "tax policy is a factor, but stability is more important than a low corporate tax rate or specific incentives like tax holidays."

In spite of Canada's abundant natural resources, political stability, impartial rule of law, property rights and good infrastructure, only two percent of participants in the KPMG study expect to invest in Canada in the next year and in five years. Although it appears highly improbable that Canada can use tax policy to overcome the disadvantage caused by the wide geographic dispersion of its small population customer base, certainly Canada's tax policies must not discourage inbound investment, and, provided these policies are not out of step with policies of other developed countries, this should be the case.

Canada's current thin capitalization ratio of 2:1 should be maintained. Although this ratio is arbitrary, it is consistent with international tax norms. Furthermore, the current rules for determining thin capitalization are effective, and importantly, simple, so while it may be appropriate

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[5] Enhancing Canada's International Tax Advantage – A Consultation Paper Issued by the Advisory Panel on Canada's System of International Taxation released April 2008 at page 3.
[6] Global Corporate Capital Flows, 2008/9 to 2013/14 – A study of the investment intentions of companies in 15 countries around the world. Prepared by KPMG International.

to fine tune the rules (e.g. making them applicable to entities other than corporations), the basic structure should not be altered.

As an overall policy directive, Canada should seek to negotiate in its tax treaties bi-lateral elimination of withholding taxes on dividends derived from direct foreign investments. Withholding taxes represent an additional cost of doing business in a country, and are factored into the overall economics of investment decisions of companies such as BP. Consequently, imposing a withholding tax on repatriation of earnings may move an investment down the global priority list when assessing which capital projects will receive funding to proceed. This is true of outbound investment for Canadians as well. Furthermore, we see no rationale for taxing distributions of "after-tax" earnings from direct investments in Canadian corporations where the recipients of the distributions are not residents of Canada.

Outbound Investment

Canada should move toward a full exemption system in respect of active business income earned by foreign affiliates in countries other than Canada. Canada should not concern itself with whether such income is taxed elsewhere in the world[7] – capital import neutrality should be the goal. This will permit Canadian entities to compete with those from other countries (including Sovereign Wealth Funds and other non-taxable entities) on a level playing field, and defers taxing sovereignty to the country where the active business operations are being carried out.

The current system of partial exemption and partial credit is unduly complex, and typically doesn't result in a significant increase in the amount of Canadian tax revenue since Canadian corporations are permitted to repatriate taxable surplus from a foreign affiliate by way of a non-interest bearing loan without such loan being deemed to be a dividend. This allows virtually indefinite deferral of Canadian tax on such earnings.

The proposed broadly based exemption system should not be tied to whether Canada has a tax treaty or tax information exchange agreement with another country. It seems unreasonable that the status of a taxpayer's existing investment in a business in a foreign country could be significantly negatively impacted by whether or not that country and Canada choose to enter into an agreement. This can create significant uncertainty for Canadians with direct foreign investment in active businesses in other countries, particularly given the typically lengthy negotiation process for treaties and protocols.

Canada should continue its current policy of permitting deductibility of interest for Canadian tax purposes even where the borrowed funds are used to capitalize or acquire shares of foreign affiliates. This significantly reduces the cost of capital for Canadians in respect of direct foreign investment and we believe this is important (at least for the time being) given the Panel's finding that "a final weakness for Canadian competitiveness is the lack of sufficient entrepreneurial culture and ambition."[8] Any changes that would increase the after-tax cost of capital for Canadians looking

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[7] According to the KPMG study, supra note 5, both next year and in 5 years, 70 percent of Canadian respondents expected to make investments in the U.S. This is consistent with the finding regarding the most influential factors when choosing a country for investment and suggests that the places Canadians expect to make investments are not so-called "tax havens" but rather countries with access to new customers and the other prime attributes cited for investment.

[8] *Compete to Win* supra footnote 2 at page 25.

to invest outside Canada are certainly unlikely to encourage the desired cultural change toward becoming more entrepreneurial. Furthermore it puts Canadians at an economic disadvantage when competing with investors from other countries that permit deduction of such interest. Starting a business and competing in a foreign country can be daunting, and the Canadian government should not cause any disincentives for Canadian entities to raise capital and pursue opportunities to grow outside of Canada.

The Mintz Report recommendation that interest on funds borrowed to invest in foreign affiliates should not be deductible proved to be very controversial and has never been adopted in Canada. Furthermore, it essentially relied on the well established Canadian principle of tracing to determine the use of the funds. However, it typically isn't difficult for Canadian resident entities to be able to structure their financing so that interest they incur with respect to borrowings will be deductible (e.g. through cash damming to fund a particular expenditure where such use would not provide an interest deduction if the funds were borrowed and simultaneously borrowing to fund Canadian domestic operations). It makes little sense to force such "financial engineering" when the net result will be that all interest incurred in Canada by multi-national corporations will be deductible in any case. This is another example where simplicity should prevail however, and we would expect lower Canadian corporate tax rates should serve to reduce the incentive to leverage Canadian operations with debt relative to operations in countries with higher tax rates.

Capital gains on dispositions of shares of a foreign affiliate (whether held directly or indirectly through another foreign affiliate) should be fully exempt from Canadian taxation. Gains on shares falling within the current definition of excluded property should be included in exempt foreign income, and gains on shares of a foreign affiliate held directly by a Canadian corporation should be excluded from taxation to the extent that those shares would be excluded property if owned by a foreign affiliate.

As noted above, Canada should seek to negotiate elimination of withholding tax on dividends in its tax treaties. This provides the opportunity for Canadians with direct foreign investments in countries with which Canada has a tax treaty to either repatriate after tax earnings to Canada or reinvest the funds in foreign operations without further incidence of tax which we believe is appropriate.

Foreign Accrual Property Income ("FAPI")

The current regime for FAPI is generally reasonable and should be maintained. We believe that the necessity of taxing passive (property) income on an accrual basis (rather than waiting until it is repatriated) is well accepted international tax policy given the ease with which capital can be exported to earn investment income in other countries. The foreign accrual tax deduction which provides relief from Canadian tax to the extent that foreign tax is paid on FAPI at a rate equal to or exceeding the Canadian rate is an appropriate approach to dealing with property income.

Withholding Taxes, Interest and Administration

Canada should seek to negotiate zero withholding tax in its tax treaties in respect of interest between related parties. Initially Canada's focus should be with all of its major trading partners,

but eventually this should be pursued in all of its bi-lateral tax treaties. Free flow of capital within global corporate groups so as to allow capital to be globally allocated where it is most efficiently used should not be discouraged through tax policy.

We believe that section 105 of the Regulations to the *Income Tax Act* generates windfall tax revenue for the Canadian fisc at the expense of Canadian businesses, thus harming those businesses that need to engage non-residents to provide required services. Typically, Canadian taxpayers are faced with a gross-up of the fees for the contracted service in respect of any withholding tax so that the recipient service provider is made whole even though in a significant number of cases that service provider may not be subject to Canadian tax due to not having a permanent establishment in Canada. In such cases, either the Canadian government receives tax to which it is not equitably entitled, or the service provider receives a windfall, but in either case the approximately 17 percent gross-up in the cost of those services is borne by the Canadian business. We question the degree to which material amounts of tax are collected – however, this provision creates continuing frustration and consternation among taxpayers. The Tax Executives Institute and other industry groups have made numerous representations to the Canadian government, but to date no changes have been forthcoming. If the government continues to believe it necessary to retain this provision, exemption certificates should be much easier to obtain.

We are unaware of any policy rationale for the additional three year reassessment period beyond the normal reassessment period in respect of transactions with non-arm's length non-residents of Canada and recommend that it be eliminated. Typically, there is nothing particularly unique about such transactions relative to others that Canadian taxpayers enter into, and the requirement to maintain contemporaneous documentation supporting transfer pricing arguably means that such information is more readily available. What experience has shown is that there is no increase in the quality of audit work done by the Canada Revenue Agency ("CRA") – the Agency simply uses this additional time to start their audits later, thus creating significant challenges for taxpayers trying to access requisite records and people. Being exposed to potential reassessment for seven years in respect of what are often significant dollar transactions causes an unwarranted degree of uncertainty for Canadian taxpayers. Further, because it is out of synch with the window for filing for competent authority notification within the Canada-U.S. treaty (as an example) it is possible for CRA to reassess a corporate taxpayer beyond the time in which that taxpayer (or a related party) can seek corresponding relief from the IRS and avail itself of relief from double taxation under the treaty.

Simplicity and Compliance

Canadian tax law in general is very complex, but more so in the area of international tax (e.g. the foreign affiliate rules). Such complex and convoluted tax law creates a tax and compliance burden that is not borne equally among enterprises. For example, many smaller taxpayers are simply unable to achieve strict compliance with the law as it is not practically possible or economically feasible to do so. However, to the extent that taxpayers effect different levels of compliance with tax law, they will be advantaged or disadvantaged relative to their competitors.

Additionally, those businesses required to provide certification of compliance pursuant to legislation such as Sarbanes-Oxley must undertake to certify that they are compliant with ALL tax laws – a virtual impossibility given the complexity involved. It stands to reason that the CRA which is tasked with administering the Income Tax Act finds it extremely challenging and costly to maintain

the requisite capacity, skills and training to properly interpret and apply the law and ensure compliance with all of the legislation. This is neither unreasonable nor unexpected; however, it creates an uneven playing field in that the administration of certain aspects of the law can be entirely dependent upon the quality of the CRA auditor reviewing a taxpayer's filing. And having scenarios whereby CRA auditors in the course of properly doing their job routinely "catch" taxpayers who are inadvertently non-compliant with arcane tax laws is not conducive to making Canada a competitive environment to do business.

General Comments

We recommend that Canadian businesses and the Government of Canada find ways to work together in a more co-operative manner in formulating and applying tax legislation. CRA's mandate is to administer the law as it is written, but this can often lead to reassessments being issued on esoteric technical grounds, regardless of whether they are consistent with any overarching tax policy. Similarly, an inordinate amount of time and talent is dedicated by taxpayers and their advisors seeking clever ways to avoid the application of tax laws, even where such schemes, while legal, are clearly not consistent with well established tax policy. While this is an intellectually challenging and financially rewarding pursuit on a micro-level to tax professionals and taxpayers, on a macro-level it is essentially a zero-sum game for the government (and Canadian society as a whole) as the tax dollars "saved" by a particular taxpayer must be borne by others, typically through alternative taxing measures but also in some instances through reduction in the programs and services that government provides. This is counter-productive and a waste of talent that could otherwise be put toward more worthwhile pursuits that would enhance Canada's business competitiveness.

We would welcome the opportunity to discuss this submission with the members of the Panel or to answer any questions that you may have. Please feel free to contact Glenn Wickerson at your convenience if you would like to arrange a call or meeting in this regard.

Sincerely yours,

Randy McLeod

Glenn Wickerson
General Manager, Canada Tax
BP Canada Energy Company

Summary of Recommendations

General Principles

- Maintain current commitment to lower corporate tax rates
- Rethink unilateral initiatives seemingly intended to attack perceived inequities in the way taxation systems of other countries interact with Canada's

Inbound Investment

- Maintain thin capitalization ratio of 2:1 and the current rules for determining debt and equity

Outbound Investment

- Move to a full exemption system in respect of active business income earned in countries other than Canada by foreign affiliates
- Decouple the exemption system from whether or not Canada has a tax treaty or tax information exchange agreement with another country
- Continue to permit interest deductibility where borrowed funds are used to capitalize or acquire shares of foreign affiliates
- Exempt capital gains on disposition of shares of a foreign affiliate (whether held directly or indirectly) from Canadian taxation

Foreign Accrual Property Income

- Retain the current regime in respect of foreign accrual property income

Withholding Taxes, Interest and Administration

- Negotiate elimination of withholding tax in tax treaties on dividends from direct foreign investments (inbound and outbound)
- Negotiate zero withholding in treaties in respect of interest between related parties
- Eliminate Regulation 105, or make exemption certificates much easier to obtain
- Eliminate the additional three year reassessment period in respect of transactions with non-arm's length non-residents of Canada

Simplicity and Compliance

- Reduce complexity of tax legislation to enhance compliance

General Comments

- The Government of Canada and Canadian businesses should work more co-operatively in formulating and applying tax legislation