CANADIAN ASSOCIATION OF PETROLEUM PRODUCERS 1

Enhancing Canada's International Tax Advantage

Advisory Panel on Canada's System of International Taxation

Ottawa, Ontario

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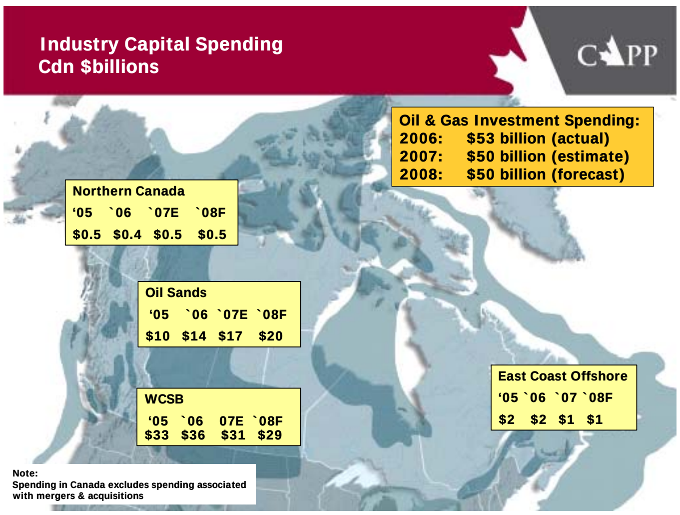
Introduction

The Canadian Association of Petroleum Producers (CAPP) represents 140 companies that explore for, develop and produce natural gas, natural gas liquids, crude oil, oil sands, and elemental sulphur throughout Canada. CAPP member companies produce more than 95 per cent of Canada's natural gas and crude oil. CAPP also has 135 associate members that provide a wide range of services that support the upstream crude oil and natural gas industry. Together, these members and associate members are an important part of a $100-billion-a-year national industry.

Canada is a major international producer of energy, including crude oil and natural gas. We are the third largest producer of natural gas and the seventh largest producer of crude oil in the world. Canadian energy production has almost doubled since 1980, with oil and gas accounting for ninety per cent of that increase. Over ninety per cent of Canada's trade surplus comes from petroleum. Half a million Canadians depend on the industry for employment.

Oil and gas companies make up twenty-five per cent of the Toronto Stock Exchange market capitalization. They also account for a quarter of all Canadian private sector investment. As the industry, its shareholders, employees and suppliers have prospered, so have governments across the country. Provincial and federal governments collected $24 billion in royalties and taxes from petroleum producers in 2007. Billions more are collected in personal taxes paid by employees and shareholders, property taxes, employment taxes, taxes on profits of services used, capital gains taxes and taxes on distributions.

Annual capital spending in Canada across the country hovers in the $50+ billion range, making the industry the largest national private sector investor. In addition, Canadian companies operate in 120 countries around the world and spent $8.5 billion abroad last year.



The Canadian petroleum industry depends on the ability to attract highly mobile international investment capital, a significant portion of which funds the industry's annual $50 billion domestic investment plans.

Positive investment conditions include open access to customer markets, attractive and predictable fiscal regime and political climate, and a tremendous resource base. These help offset finding and development costs which are high by international standards. Development and use of new technologies are key to reducing and containing costs. Equally important is a competitive fiscal regime for both inbound and outbound investment.

The Canadian Association of Petroleum Producers appreciates the opportunity to make a written submission to the Advisory Panel on Canada's System of International Taxation and comment on *Enhancing Canada's International Tax Advantage.* This submission discusses CAPP's concerns and suggestions for improving Canada's tax structure as it affects investment decisions both here and abroad.

Taxation of Outbound Direct Investment

As Foreign Affairs and International Trade Canada has stated in its Global Commerce Strategy, *"As a country with a wealth of resources and ideas, but a relatively small market and consumer base, our prosperity is built on our openness to international trade and investment".*

The tax system can be a very effective lever for improving Canada's competitive position. As part of a growing globally integrated economy, international tax competitiveness is an increasingly important component of international investment decisions. For example, the Netherlands and Luxemburg are two of a number of countries that have set an example and have for many years operated a fair participation exemption for capital gains and dividends. The United Kingdom is also reviewing actively its position with respect to the taxation of foreign dividends. There is a strong suggestion that a UK participation exemption will be introduced.

The fact that Ireland has an attractive tax regime is well known. It includes a low corporate tax rate, no transfer pricing, no *controlled foreign company ("CFC")* rules, no thin capitalization, a stable and growing tax treaty network, capital gains tax exemption for the disposal of certain shareholdings and a simplified method for relief for foreign tax dividends (while this is not a full participation exemption, it does come close). Recent announcements of UK-based Shire Pharmaceuticals and United Business Media relocating to Ireland highlight the competitive nature of countries to attract business and holding companies.

Canada is not known as a favourable holding company regime. The international tax system should be enhanced to allow Canadian taxpayers to compete better on a global basis.

Exemption for Active Business Income

Canada's current exemption system should be broadened to cover all active business and related income earned by foreign affiliates and branches of Canadian companies. Under Canada's current system, active business income earned by foreign affiliates in treaty countries and, in the future, countries with which Canada has a *Tax Information Exchange Agreement ("TIEA")* is free from Canadian tax when earned and on its repatriation. This treatment allows Canadian taxpayers to expand into certain foreign markets without incurring additional Canadian tax on any foreign source income. Expanding this system to active business income earned by foreign affiliates carrying on business in any foreign jurisdiction would enhance the competitiveness of Canadian businesses conducting oil and gas operations that are currently penalized for operating in non-treaty and future non-TIEA jurisdictions. Extending the exemption to branches of Canadian companies would not bias companies with respect to how they conduct their foreign operations. If the income earned in a foreign branch is exempt, we would acknowledge there would be no relief for foreign losses or foreign resource expenses pursuant to subsection 66.21(4), with some transitional relief.

Canada has little experience to date to indicate which countries will agree to sign TIEAs. Oil and gas operations are often carried out in foreign jurisdictions that have higher rates of tax than Canada, yet it is unlikely that they will sign a TIEA with Canada due to lack of political ties with Canada. One such example is Yemen, where the corporate tax rate is 35 per cent calculated pursuant to a *Production Sharing Agreement ("PSA")* with limited prospect of a TIEA being signed. Canadian companies earning active business income in such a country could be penalized because of the government's inability to conclude a TIEA since the active business income earned by those companies in the particular foreign jurisdiction will become subject to current taxation in Canada. As discussed below, it is unclear whether foreign tax paid under a PSA would qualify as underlying profits tax or foreign accrual tax. As such, there is potential for double taxation in these jurisdictions. Canadian companies already face fierce competition for shrinking oil and gas reserves worldwide. This increased taxation only reduces their worldwide competitiveness.

A broad-based exemption system that does not rely on the signing of a treaty or a TIEA, but rather on the well-established definition of active business income, would significantly enhance Canadian taxpayers' ability to grow and compete on a global basis.

Interest must remain fully deductible under a broad-based exemption system to maintain a cost of capital that is competitive with businesses incorporated in other countries, both in respect to domestic and foreign operations. The Department of Finance has defended the need for interest deductibility numerous times as this represents the international norm and its absence could potentially damage Canada's international competitiveness.

The impact to government revenues of moving to such an exemption system would not be significant. Generally, taxable surplus earned by foreign affiliates carrying on business in non-treaty jurisdictions is not repatriated to Canada. Because of the associated tax cost, it is generally more tax-efficient to redeploy such earnings offshore. By broadening the exemption system to allow such earnings to be repatriated free of Canadian tax, companies could more easily bring funds back into Canada to invest in growing their domestic as well as their and foreign operations. Furthermore, most non-treaty countries have tax rates equal to or in excess of the Canadian tax rate, offsetting any taxable surplus dividend included in income.

Providing a general exemption for foreign active business income would also greatly simplify Canadian companies' compliance burden. Tracking exempt and taxable surplus pools and underlying foreign tax accounts can be time-consuming and complicated, especially for corporate groups with numerous foreign affiliates. By reducing the need for companies to perform such surplus calculations, the overall compliance costs associated with the foreign affiliate regime could be reduced significantly. We recognize that active business income would still need to be tracked separately from passive income - *Foreign Accrual Property Income ("FAPI")* – but the compliance burden would already be reduced with fewer items to track. Further simplifying decisions could be made in this area, such as active business income tracked in foreign currency and according to foreign rules. FAPI could continue to be tracked according to Canadian rules and in Canadian dollars.

A broader-based exemption system that encompassed both branches of Canadian companies and foreign affiliates would eliminate the need for a residency test under Regulation 5907 for foreign affiliates, since the policy is to exempt all active business income and tax all passive income. This would reduce *Canada Revenue Agency's ("CRA")* workload in the area and still achieve policy objectives.

The December 2007 tax amendments made certain changes to the *active business income ("ABI")* deeming rule under paragraph 95(2)(a) of the Income Tax Act, effective 2009. Under the pre-2009 rule, non-ABI income earned by a taxpayer's foreign affiliate *("Primary FA")* from a non-resident corporation *("NR Payer")* that is related to the Primary FA and the taxpayer may be deemed to be ABI of the Primary FA if the amount is deductible by the NR Payer in computing its ABI. The new post-2008 deeming rule added a new requirement (e.g. under sub-clauses 95(2)(a)(i)(A)(I) and 95(2)(a)(ii)(A)(I)) that the NR Payer must be a foreign affiliate in which the taxpayer has a *qualifying interest ("QI")* as defined in paragraph 95(2)(m).

In today's global market, a Canadian taxpayer who is a member of a multinational group may often participate in legitimate business transactions with related parties without owning a QI in those related parties due to valid business reasons. We recommend that the new QI requirements in paragraph 95(2)(a) be eliminated, to remove an undesirable impediment to Canadian international business. In this regard, there are already many Canadian tax rules (e.g. on thin-capitalization, double-dip, transfer-pricing, deemed interest income, etc.) which protect the Canadian tax base from significant erosion.

A simpler system would also reduce the complexity of the foreign affiliate rules themselves and make it easier for the CRA to audit the activities of foreign affiliates and focus on targeting passive income earned offshore, which seems to be more consistent with government policy. Simplifying the foreign affiliate system would also ease the compliance burden for smaller Canadian businesses and make it easier for them to expand into foreign markets.

If the government does not agree with a full exemption system for active business income, at the very minimum, the government should amend and enact proposed Regulation 5910 that allows for tax paid under a PSA to qualify as underlying foreign tax (as defined in Regulation 5907(1)) and foreign accrual tax as defined in subsection 95(1) for the purposes of the deduction under subparagraph 113(1)(b) and 91(4), similar to legislation that specifically deems amounts paid to be an income or profits tax for foreign tax credit purposes pursuant to subsection 126(5). Proposed Regulation 5910 may also need to be clarified because the 40 per cent income limitation appears to apply to income pursuant to Canadian tax rules, which may require a section 9 deduction for foreign tax paid since it does not otherwise qualify as an income or profits tax. Presumably, the 40 per cent rate should be applied to the affiliate's earnings from the business prior to any deduction for foreign taxes.

Capital Gains on the Sale of Shares of a Foreign Affiliate

Many countries exempt from tax not only dividends received from a foreign affiliate but also capital gains realized on dispositions of foreign affiliate shares. Canada's existing system does not immediately tax capital gains on dispositions of foreign affiliate shares held by another foreign affiliate to the extent that the value of the shares is derived from assets used to earn foreign active business income, defined as "excluded property". However, a portion of the capital gain may be subject to Canadian tax on its eventual repatriation to Canada.

Canada should consider moving to a broader exemption system for gains relating to dispositions of foreign affiliate shares generating underlying foreign active business income, potentially even permanently exempting such capital gains from Canadian tax. As the panel points out, this treatment could be achieved through modifications to the current definition of "excluded property" (generally, the property of a foreign affiliate used to earn active business income).

Currently, sales of active business assets by a foreign affiliate qualify as excluded property and are fully exempt from tax. Why should there be any difference for sales of shares such that companies can choose to sell assets vs. shares based on business decisions and not Canadian tax treatment?

Canada could also consider extending such exemption to capital gains on dispositions of foreign affiliate shares held by their Canadian parents directly. Such a change need not imply that capital gains should no longer be taxed on dispositions of shares of a Canadian corporation. In adopting a broader foreign exemption system, Canada would join certain other countries in essentially ceding taxing jurisdiction over foreign active business income and related assets to the relevant foreign country. Conceptually, a capital gain realized on the disposition of foreign affiliate shares represents future active business income of the foreign affiliate that otherwise would be fully exempt from Canadian income tax. This may be distinguished from the Canadian domestic context where the future income of the Canadian corporation disposed of will still be subject to Canadian income tax in future years. This change would eliminate the need for Canadian companies to impose foreign holding companies and encourage greater repatriation of funds to Canada in respect of value of their foreign affiliate shares. These funds may be reinvested in Canada or taxed in the hands of Canadian shareholders or employees.

Canada's current tax rules allow businesses to transfer shares of a foreign affiliate to another foreign affiliate on a rollover (tax-deferred) basis and to treat realized capital gains as dividends paid from exempt and taxable surplus pools. As a result, the actual tax revenue derived from the realization of capital gains on dispositions of foreign affiliate shares could perhaps be quite nominal. The impact of this change on government revenues may be relatively small and could be weighed against the simplicity that would arise from eliminating the complexities associated with exempt and taxable surplus tracking and the proposed suspended surplus rules (which will defer recognition of corporate surplus on intra-group transactions). This would enable Canadian companies to perform business transactions involving their foreign affiliates more efficiently and enable easier CRA audits of these transactions.

Transitional Rules

The Panel has asked for views on the transition to a broader exemption system that exempts active business income earned abroad and the capital gains arising from shares of foreign affiliates conducting an active business. CAPP would like to see an immediate move to the new system such that existing taxable surplus balances could be repatriated free of Canadian tax. All amounts that would be repatriated should be in respect of active business earnings or capital gains on shares of foreign affiliates carrying on an active business, since passive income should have been previously taxed as FAPI such that section 91(5) should currently operate to exempt this income. An immediate transition has the advantage of simplicity and, as mentioned earlier, the impact on government revenues should not be significant. Generally, most foreign non-treaty countries where our industry operates will have a corporate tax rate that exceeds the general Canadian corporate tax rate, hence sheltering any taxable surplus from Canadian tax.

CAPP would also like to see an immediate move to exempt active business income earned in a foreign branch. As mentioned earlier, there should be no relief for future foreign losses or foreign resource expenses, but deductions for existing foreign resource expense pools under subsection 66.21(4) at the current 10 per cent rate against Canadian source income should continue so as not to penalize taxpayers for past investments.

Interest Deductibility Rules under 18.2

CAPP is aware that it is not the intention of the Advisory Panel to consider the rules under section 18.2 which provide for the specific denial of certain types of interest expense in respect of funds utilized to finance foreign affiliates. Since it is our position that the policy underlying section 18.2 is inconsistent with the policy objectives outlined in the Panel's Consultation Paper, we believe that comments need to be made on behalf of the Canadian oil and gas industry.

In the summary to the advisory panel's consultation paper there is a section titled, *"Toward a Tax Policy Framework".* In this section, clarifying the meaning of *"fairness"* in the context of international tax is raised as an issue. The section goes on to state that fairness can be summarized as follows:

- Canada's taxation of inbound investment should facilitate a level playing field for domestic business activity.

- Canada's rules regarding the taxation of outbound investment should be competitive vis-à-vis the outbound tax rules of other major countries.

As mentioned above, the policy trend with many countries around the world is to cede taxing jurisdiction over foreign active business income and related assets to the relevant foreign country. The policy is focussed on ensuring that there is no tax bias for companies in deciding whether to expand domestically or abroad. The proposals under Section 18.2 would increase the cost of capital for Canadian companies to finance the start-up, acquisition, and growth of foreign businesses. A Canadian company competing with a foreign company to acquire a foreign target would be at a competitive disadvantage often, since the foreign acquiring company would likely be able to deduct the interest cost of debt financing more than once, whereas the Canadian company would not. This clearly contradicts the above-stated second policy objective.

We also note that the Competition Policy Review Panel made two specific recommendations in their very recently released report that were directed at the Advisory Panel.

> *"21. The International Tax Panel should give particular attention to an assessment of tax provisions disadvantaging Canadian companies relative to non-Canadian companies in Canadian acquisitions, with the objective of recommending ways to allow Canadian-based companies to compete on an equal footing."*
>
> *"22. The International Tax Panel should assess the provisions of Canadian tax legislation limiting interest deductibility by Canadian companies in respect of foreign acquisitions to ensure that Canadian companies seeking to compete globally enjoy every advantage relative to their foreign competitors."*

To the extent there may be a second deduction of interest in a foreign jurisdiction, it only reduces foreign tax. If a full exemption system were implemented as suggested above, whether or not less tax were collected by the foreign jurisdiction should not be an issue for the Canadian government as it would expect to receive more tax revenues through increased repatriation of earnings back to Canada.

Oil and gas companies often borrow on a long-term basis (in excess of the transitional period provided with the introduction of section 18.2) given the often extended length of time required to complete capital projects. That grandfathering of existing loans will not be permitted once section 18.2 comes into effect will prove detrimental to our industry. Companies will likely incur significant penalties to break loan agreements in order to restructure their affairs and not run afoul of the limitations on interest deductions provided for in section 18.2.

Section 18.2 will be difficult for CRA to enforce and may be applied unevenly across companies depending on their ability to directly track the use of borrowed funds and related interest.

Section 18.2 compromises the international competitiveness of Canadian business and will largely be ineffective in protecting Canada's revenue base.

Foreign Accrual Property Income

The intent behind taxing passive income earned by a Canadian taxpayer's foreign affiliates on an accrual basis makes economic sense in protecting the Canadian tax base. Unfortunately, the inherent complexity in the current rules has made compliance by Canadian taxpayers and effective audit by CRA difficult.

A broader-based exemption system for active business earnings of foreign affiliates would eliminate much of this complexity. However, it would also enhance the need for clearer rules to tax passive income appropriately. This could, perhaps, be achieved with a more prescribed list of income items targeted (i.e. "black-list"), rather than encompassing all property income with a number of exceptions.

There are a number of exceptions for interest income that is earned to finance foreign affiliates carrying on an active business income in a foreign jurisdiction under subparagraph 95(2)(a)(ii). These exceptions should be maintained to facilitate Canadian businesses growing their foreign businesses. Some of the complexity associated with these rules may be addressed in conjunction with a broader-based exemption system for dividends and capital gains, and a "black-list" targeting specific passive income intended to be taxed on an accrual basis.

The Minister of Finance should clarify the tax policy underlying subparagraph 95(6)(b) and how it is being applied by CRA. There is some concern in the tax community that this rule is being used by CRA as a surrogate for the General Anti-Avoidance Rule ("GAAR") to re-determine a taxpayer's affairs. Unlike GAAR, a misuse or abuse of the Act does not need to be proved and this provision is a very powerful tool for CRA providing taxpayers with limited ability to defend their position.

Certain areas of the FAPI and taxable surplus system could be clarified. Tax compensatory payments that qualify under Regulation 5907(1.3) clearly qualify as foreign accrual tax, but it is far from clear that they also qualify as underlying foreign tax. Therefore, taxpayers may be relieved from a net FAPI inclusion, but repatriation of the taxable surplus may be without the benefit of underlying foreign tax. A relatively simple fix for this would be to add *"foreign accrual tax prescribed by Regulation 5907(1.3)"* to the list of additions in the definition of underlying foreign tax.

Taxation of Inbound Direct Investment

In reviewing the tax rules surrounding inbound direct investment, CAPP recommends strongly that Canadian international tax policy be governed by the following principles:

- Ensure that Canada continues to attract foreign investment as sources of capital within Canada are limited; and
- Ensure a level playing field between Canadian-owned and foreign-owned businesses carrying on business within Canada.

Tax Treatment of Interest Expense Incurred by Foreign-owned Canadian Corporations

There is no current need to amend the rules relating to the treatment of interest expense incurred by foreign-owned Canadian corporations, unless the government wishes to target some specific abuse. If there is a specific perceived abuse, it should be targeted with a specific rule related to that abuse rather than rely on general rules that could have broader implications. Any changes meant to capture perceived abusive transactions can have unintended consequences. They should not deny otherwise justifiable interest expense

The definition of the term *"debt-dumping"* in Canada needs clarification. It could be interpreted broadly as encompassing any situation where interest expense is incurred by a Canadian company that is not directly related to that Canadian company's business activities. For example, commentators have indicated that it could include the leveraging of Canadian companies in order to invest in foreign affiliates. This could be viewed potentially as an abusive structure in the absence of sufficient expectation of income being earned from the foreign affiliates. However, if the interest is incurred for a bona fide business purpose such as the earning of dividend income on common shares from a foreign affiliate, this should not be considered abusive if it is not otherwise considered to be so under the Income Tax Act.

With respect to the thin capitalization rules, the current debt-equity ratio is 2-to-1 for debt from related party non-residents. Although not completely representative of an appropriate financing proxy for all industries in Canada, it is a straight forward and easily administered guideline. However, if changes are made to the calculation of the non-deductible interest amount, this ratio will need to be reviewed since some industries are more capital intensive and cyclical than other industries. Furthermore, the capacity to raise debt in the market for resource-based companies tends to be influenced by a number of factors. Cash flow and reserves, for example, are more important than simple balance sheet calculations such as those based on debt-equity ratios. This results in the resource industry being able to support higher levels of debt than other industries.

Resource projects can require multi-billion dollar up front capital investments and long lead times before production. Debt markets require issuers of debt to carry credit ratings. Therefore, to issue debt, companies in the resource sector may require a guarantee to support the debt issue if the company is unrated. A significant amount of debt is appropriate for the level of project investment. The guaranteed debt is currently addressing a substantial need for large capital expenditures in this industry.

Guarantees are often required on external debt of foreign-owned Canadian subsidiaries as the parent companies manage the financing for the multinational group. As the value of some of these companies is directly related to the proven and unproven resources that they own and because of the inherent risk factors involved with the recovery of these resources, it may be difficult for some of these companies to obtain financing on their own. Including guaranteed debt as debt for the current thin capitalization calculation could adversely affect the interest deduction for companies in that they would not receive the appropriate interest deduction based on the capital they are investing and the potential income from the resource projects. This would restrict severely the economics of the projects and could cause many projects to be discontinued or remain undeveloped.

Determining an appropriate definition of guaranteed debt could also prove problematic in our industry. Many large projects are entered into by consortiums of companies working under some type of joint venture agreement. Under these joint venture agreements it is typical to require parental guarantees from any Canadian subsidiaries that are either unrated by the credit rating agencies or that have insufficient credit ratings. These guarantees are provided to ensure that each party to the joint venture agreement is able to meet the operational requirements for the project being developed. In many cases, these guarantees will be provided by a related non-resident parent company. It is important that such guarantees would not, in any way, be construed as debt from a related non-resident. The quantification of the amount of debt in such a case would prove to be extremely difficult and would likely result in Canadian companies receiving these types of guarantees from foreign-owned parent companies not having any debt from related non-residents that would provide interest deductions.

If guaranteed debt or other guarantees are included as debt in the thin capitalization calculations, a review of the debt-equity ratio would have to be undertaken to address the cyclical nature and high capital intensity of certain industries such as the resource sector. However, to assign different ratios to each industry would be cumbersome and difficult to determine in many cases. This would be similar to a transfer pricing regime, which can be complex because of the difficulty in determining the commercial criteria applicable. There would be increased uncertainty for taxpayers in this case, which is very unfavourable given the need for financial statement certainty in the markets.

There should be a carryover of denied interest to the extent that the thin capitalization rules (or any other rules that limit interest deductions) operate to deny any interest expense in a particular year. Because of the mechanics of the existing thin capitalization calculations, it is possible that an amount of interest could be inadvertently disallowed (due to, for example, a refinancing of a loan being drawn prior to the old loan being retired a day later). Providing a carryover period for the denied interest would ensure that the taxpayer would obtain an appropriate interest deduction in years where the debt level is within the limitations set out in the legislation.

Because of the risk involved with the resource sector, any further limitation of interest expense could discourage foreign investment in Canada. Therefore, any proposed changes to the thin capitalization rules should be done only after careful examination and consultation regarding the economics required for many of the industries in which non-residents invest in Canada. Otherwise, the cost of capital may become too high to justify further investment into certain high-risk industries such as the resource sector.

With respect to alternatives to thin capitalization restrictions, there has been a suggestion that earnings stripping rules may be an option. One issue with respect to these rules is that they may not function appropriately where an industry is highly cyclical in nature. For example, where expenses are incurred over a two to three-year period and then revenues are earned subsequently, there may be substantial earnings in years 3, 4 and 5, but not in the earlier years. Any restrictions on interest deductibility in the first few years would be inappropriate when reviewing the entire project life cycle. Furthermore, earnings stripping rules would be extremely punitive for industries, such as the oil and gas industry with a high capital intensity, since these industries generate less net revenue from a capital investment than those with a lower capital intensity. This leads to a double impact – the higher capital required results in greater financing requirements and higher interest costs while also providing less income.

Any changes recommended that would operate to restrict interest deductibility under the current legislation must be subject to appropriate consultation, transition and grandfathering provisions. It is suggested that existing debt, at the very least, be grandfathered. Otherwise, the refinancing costs could reduce the economics of a project significantly.

Other Inbound Matters

To the extent there is a concern with the use of sovereign wealth funds and other tax exempt entities having an advantage, consider targeted measures on debt financing for those entities. As a general principle there should be equal treatment of the participants in the resource industry. Broad changes to the rules that would generally impact Canadian corporations with foreign shareholders should not be introduced.

Withholding Taxes

Free Flow of Capital – Removing Withholding Taxes on Dividends

We are pleased with the elimination of domestic withholding tax on payments of interest on arm's length debt (regardless of the place of the lender's residence), and the eventual elimination of withholding tax, as provided for in the recent protocol to the Canada-U.S. Treaty, on interest on non-arm's length debt between residents of Canada and the United States. There is a link between elimination of withholding tax on interest and dividends and increased foreign direct investment and allowing for the free flow of capital. These changes are welcome but there has been little public debate on the tax policy reasons to continue to enforce any withholding taxes.

Withholding taxes constitute a barrier to the free flow of capital. Within the European Union, for example, the EU parent-subsidiary directive eliminates withholding taxes on cross-border dividend payments within corporate groups (and a similar directive is applicable to interest and royalties). The U.S., a major source and recipient of investment capital for Canadian businesses, has negotiated, since 2003, a zero withholding rate under its treaties for dividend payments.

Elimination of withholding taxes will ensure that Canadian businesses can access global debt markets at the lowest possible cost. Ideally, we believe that Canada should strive to negotiate in its treaties the elimination of withholding tax on all payments of interest, rents, royalties, and dividends. However, we recognize that the elimination of withholding tax on all such payments may not be possible due to the reluctance of other countries, or potentially significant erosion to Canada's income tax base. If so, the elimination of withholding taxes should be targeted appropriately at certain types of payments, especially dividends.

Given the length of time required to negotiate new treaties with other countries, Canada should also consider amending the *Income Tax Act* to eliminate withholding tax on dividends payable by a Canadian company to a non-resident shareholder who is a resident of a country with which Canada has an income tax treaty. As a result of the recently enacted changes to eliminate withholding tax on payments of interest on arm's length debt (and on non-arm's length debt between residents of Canada and the U.S.), not removing the withholding tax on dividends could possibly create a bias for debt financing in Canada which may ultimately reduce Canada's tax revenues, create issues regarding thin capitalization rules for foreign-controlled Canadian companies, and/or potentially increase the cost of raising equity versus debt. The elimination of withholding taxes on dividends would improve greatly the ability of Canadian companies to attract foreign capital and compete effectively with foreign multinationals.

Given its high quality of life, extensive treaty network, decreasing corporate income tax rate, lack of stamp duty, and its foreign affiliate regime, Canada has the potential makings of becoming a viable holding company jurisdiction that could compete with many European countries. The elimination of withholding tax on dividends and the enactment of a broader foreign affiliate exemption system would assist Canada in competing as a holding company jurisdiction. If Canada becomes regarded ultimately by foreign investors as a potentially acceptable holding company jurisdiction, it is possible that the cost of eliminating withholding tax on dividends payable to non-resident shareholders would be partly or even wholly offset by the economic benefits to be derived from additional investment in Canada.

Non-Resident Services

The current compliance and withholding requirements under Regulation 102 and 105 associated with non-residents providing employee and subcontractor services in Canada are a barrier to economic growth and competitiveness in the Canadian oil and gas industry.

Regulation 105

Paragraph 153(1)(g) and subsection 105(1) of the Regulations requires that every person that pays a fee, commission, or other amount in respect of services rendered in Canada to a non-resident individual, partnership or corporation, other than in the course of regular or continuous employment, must withhold and remit 15 per cent of the gross amount of the payment. This withholding is a prepayment of corporate income tax for which the non-resident may be liable if it is determined that the corporation has a permanent establishment in Canada with profits attributed to it. The non-resident may be able to recover amounts withheld on filing a Canadian income tax return to claim a refund, to claim treaty exemption or to claim a deduction of expenses incurred.

Regulation 105 Waiver

A Regulation 105 waiver can be applied for but it typically involves a very onerous process. Where a non-resident can demonstrate based on treaty protection or estimated income and expense that the normally required withholding is in excess of the ultimate tax liability the CRA may waive or reduce the withholding tax accordingly. To obtain the waiver the non-resident must apply directly to the CRA thirty days prior to the start of services in Canada or thirty days prior to the first payment. Often the non-resident is unaware of the requirement or the process proves to be impractical and/or costly, possibly including the need to hire Canadian tax advisory services. In attempting to cover every scenario the waiver application forms have been made too long, overly complex and with a lack of clarity.

Economic Burden of Regulation 105

In today's labour market one of our scarcest supplies is qualified available employees. Many Canadian companies engage non-resident suppliers to fill this gap. The withholding obligation imposed by Regulation 105 creates the following issues:

- It impedes cross-border commerce.
- In order to engage a non-resident supplier, the non-resident will typically request a gross-up payment in order to maintain the same cash flow position (i.e. net of the withholding). This will increase project costs by up to another 18 per cent. In an environment of rising costs this additional cost increase can render the project uneconomic and the Canadian payer uncompetitive. The non-resident has the ability to file a tax return later, seeking a refund of the taxes paid by the Canadian payer on behalf of the non-resident. If this occurs it results in an economic windfall for the non-resident, since the non-resident generally will not return the withholding tax refund to the Canadian payer.
- Generally most non-resident suppliers do not have a permanent establishment in Canada and the majority of contracts are for short periods.
- Although the non-resident has the ability to file a tax return later and potentially receive a refund, most non-residents will not file a return due to the lack of resources and the cost to engage a Canadian tax advisor. Therefore, the withholding becomes a windfall for the government.
- It may take up to two years from the time of withholding for the taxpayer to get a refund of the withheld amount. This is due to systemic problems in part (e.g. the inability to file a treaty return until the end of the fiscal year) but also due to the CRA's inability to review and process returns and refunds in a more timely fashion.

Recommendations for Regulation 105

The Regulation 105 withholding requirement is inappropriate and the compliance burden is steep. This impairs Canadian business ability to procure the skills needed to compete effectively on a global basis. An undue burden is also placed on the service provider in terms of additional reporting requirements and cash flow implications. CAPP recommends the following:

- Eliminate Regulation 105 for service providers resident in designated treaty countries.
- The T4A-NR filing could continue (absent Withholding Tax), which would provide a basis for audit by the CRA.
- A process similar to that of the United States (W8Ben) should be adopted. This would require the non-resident to file information with the Canadian recipient of their services declaring the non-resident status (i.e. no Permanent Establishment). If the non-resident has a Permanent Establishment in Canada there would be a requirement to withhold.
- Eliminate tax return requirement. If a tax return is deemed necessary, a simplified version should be available (e.g. Canadian source taxable income x tax rate = tax liability).

In the absence of repealing Regulation 105, please consider a de minimis exemption and a simpler and clearer version of the waiver form and the Canadian tax return. The requirement to file the waiver thirty days prior to providing services should also be reduced to one week or ten days (i.e. CRA processing time should be much quicker). The CRA should be resourced appropriately and should implement system changes to process non-resident returns and refund requests within three months of filing a return (six months if a preassessment audit review is felt to be necessary because, for example, the refund is significant).

The quantum of mandatory preassessment reviews should be disclosed to the taxpaying community.

Regulation 102

A precedent was set recently for practical approaches that link treaty exemption status, withholding taxes and clearance certificates. The February 27, 2008 federal budget proposes this with respect to section 116 clearance certificates and related withholding taxes. This budget provision also proposes to eliminate the need for filing tax returns where there is no taxation. In a global market, non-residents enter Canada regularly as part of their work. The non-resident employee may be in Canada to perform work on an undertaking in Canada for their non-resident employer, or to attend to a non-resident employer's Canadian asset(s). They may be in Canada for a few hours, a few days, or possibly months. Canadian Income Tax legislation (Tax Law) provides that a non-resident person is taxable in Canada on any income earned while employed (i.e. performing duties of office or employment) in Canada.

The Act provides that income tax is to be collected by a withholding from any payment of income from employment as prescribed by the Regulations to the Act. The determination of whether withholding is applicable can be a complex exercise as there are no special rules for short-stay non-residents. The requirement to withhold can be waived to the extent it can be established that the payee will be due a refund of income tax.

The CRA will waive the payroll withholding requirement if it can be established that there will be no Canadian income tax due to treaty provisions. There are timing constraints for having this waiver in place that usually make it impractical and the request for this waiver is administratively time consuming.

The Standard OECD Tax Treaty provides that a non-resident person will only be taxable in their State of residence if:

a) they are employed in the other State for less than 183 days,

b) their employer is not a resident of the other State, and

c) related salary and wages are not borne (i.e. deducted in determining taxable income) by a PE of the employer in the other State.

The Canada-US Treaty adds another condition (to the standard OECD exemption): related salary and wages cannot be borne (i.e. deducted in determining taxable income) by a resident in the other State. Also, the Canada-U.S. treaty provides an additional exception: $10,000 of salaries and wages for each employment in Canada will not be taxable in Canada.

Recommendations for Regulation 102

The current payroll withholding and waiver requirements applicable to non-residents are not appropriate for residents of a treaty country. Our recommendations are:

- Regulation 102 requirements should be eliminated for non-resident employees from designated treaty countries that qualify for a treaty exemption under Article XV (waivers should not be required in this situation).
- The non-resident employers of treaty countries should be responsible for making the determination of whether an employee will be taxable in Canada. To reduce the compliance burden further and provide a basis for the CRA to audit, the non-resident employer should be required to file an annual information form. The form could include the names of employees, number of days spent in Canada and treaty exemption claimed.
- In the absence of eliminating Regulation 102 requirements as suggested above for designated treaty countries, there should be a flat exemption from Canadian Income Tax and any payroll withholding for any employment income whether the non-resident is from a treaty or non-treaty country, if the amount earned for any stay in Canada is less than $50,000 to $100,000 CAD.
- See also comments below under *Additional Comments – Canada-U.S. Treaty*.

Administrative Issues

Transfer Pricing

Canada's transfer pricing rules contained in section 247 have been in place for just over a decade and are based on the OECD's Transfer Pricing Guidelines. Like many other transfer pricing regimes around the world, the rules in section 247:

- provide for the arm's length principle to be applied to cross-border related party transactions;
- include a requirement to prepare transfer pricing documentation; and
- impose a penalty provision should a transfer pricing adjustment be made by the Canada Revenue Agency and certain other requirements are met or not met as the case may be.

As noted, the Canadian transfer pricing legislation is based on the OECD Guidelines and is not significantly different at a high level from the transfer pricing legislation in many other jurisdictions around the world. As *"transfer pricing rules are critical in allocating revenues and income with respect to international transactions",* Canadian transfer pricing rules are necessary. However, consideration could be given to improving their administration. Potential areas for improvement are discussed below.

Cost Safe Harbour for Low-Value Services

The United States, in the new *Temporary Services Regulations*, recently introduced a safe harbour allowing companies to charge for certain low value services on a cost reimbursement basis without having to determine and charge a profit element. Part of the intention of the cost safe harbour was to reduce the administrative burden on U.S. taxpayers. Consideration should be given to such a safe harbour in Canada to reduce the administrative burden on Canadian taxpayers. It can be difficult for taxpayers to obtain public direct comparables, while the tax authority is able to rely on the transfer pricing data from other taxpayers. This can lead to disagreements and difficulties during any dispute resolution process when the differences cannot be discussed in a full and open manner. In addition, taxpayers have concerns about proprietary business information being disclosed publicly during a legal dispute resolution process.

Consistent Transfer Pricing Documentation Requirements

In 2003, the Pacific Association of Tax Administrators ("PATA") finalized its *Transfer Pricing Documentation Package*. PATA is an inter-governmental organization whose members include Australia, Canada, Japan and the United States. PATA members agreed on principles under which taxpayers can prepare one set of documentation that will meet the documentation provisions of each PATA member country. The intention was to eliminate the need to prepare separate documentation for each country. The PATA Documentation Package was intended to reduce taxpayer burden and provide certainty that a penalty would not be imposed. Despite the PATA initiative there still appears to be a wide diversity of transfer pricing documentation expectations from tax authorities around the world, thus requiring taxpayers to prepare multiple transfer pricing documentation packages. While not just a Canadian issue, consistent transfer pricing documentation requirements would ease the compliance burden on Canadian taxpayers. In addition, there are differences in transfer pricing approaches with Canada's major trading partners with respect to the application and interpretation of the arm's length standard which needs to be resolved and communicated to taxpayers so a consistent approach is applied and expected of taxpayers.

Reassessment Period and Access to Competent Authority

Pursuant to subsections 152(3.1) and (4), the period of time the Minister may reassess a taxpayer in respect of a transaction with a non-resident person with whom the taxpayer was not dealing at arm's length is seven years after the mailing of the original assessment. Pursuant to Canada's tax treaties, the period for seeking competent authority relief is often different from that in section 152. For example, under the Canada-U.S. Tax Convention the time limit for notifying the competent authority that a taxpayer intends to seek relief from double taxation is six years from the end of the taxable year to which it relates. Therefore, the CRA has the potential to reassess outside of the time period for which the taxpayer can apply for relief from double taxation under the Canada-U.S. Tax Convention. Consistency in the domestic and treaty reassessment and notification periods would provide taxpayers additional certainty. The discrepancy between these two time periods should be eliminated.

Forms

On May 2, 2008, CAPP made written suggestions to the department of finance as part of their initiative to reduce the paperwork burden to business within the tax system. We refer to that submission in respect of the following international areas:

- T106 and T1134 – Foreign reporting requirements result in duplicate information being provided. The information should be combined on the T1134, which should have a later due date to facilitate gathering of the information.
- Eliminate forms - for large corporations Schedule 9 – Related party list and the GIFI are unnecessary.
- Eliminate unnecessary election requirements. There are many requirements for elections in prescribed form although a prescribed form does not exist – e.g. Sale of a Foreign Resource Property.

Additional Comments

Fifth Protocol to the Canada-U.S. Treaty: Amendments to Article XV – Dependent Personal Services

Changes to Article XV - Dependent Personal Services, now titled *"Income from Employment"* will have a large negative impact on cross-border mobility programs, particularly where employees are working on a short-term basis (i.e. less than 6 months). Article XV(2) expands the circumstances that Canada and the U.S. may tax each other's residents who exercise employment in the other contracting state.

In XV(2)(b), the reference to *"employer"* is removed. The result is that an employee can be subject to tax in the other Contracting State if the remuneration is paid *"by or on behalf"* of any resident of the other Contracting State. Therefore, it is no longer necessary that the remuneration be borne by an employer resident in the other Contracting State or by permanent establishment or fixed base of an employer in the Contracting State. This will result in a huge administrative and costly burden for short-term visitors or business travelers and their employers, requiring the completion of personal tax returns for the other Contracting State, equalization payments, foreign country payroll withholdings and reporting. The preparation of this tax return along with the employee's home country return is very complex and will require the need to engage services of professional tax advisors.

The change to this Article will basically result in all short-term visitors earning greater than $10,000, with the compliance burdens stated above. In a non-arm's length situation, if there were no charges for such services, transfer pricing issues could result. The present $10,000 remuneration test has not changed since the 1980 Canada-U.S. Treaty and in today's dollars, renders it a virtually irrelevant test.

As well, the 183-day test must now be met in *"any 12-month period commencing or ending in the fiscal year concerned."* In practice, this tends to be a more difficult period for individuals to track. For example, an employee present in Canada from October 1 until April 15 of the subsequent year will have spent less than 184 days in each of two calendar years and would be exempt under the current treaty. Under the new protocol the non-resident employee will have a filing requirement, having spent more than 183 days in Canada in a 12-month period. This presents additional practical difficulties and perhaps retroactive non-compliance.

The changes to Article XV follow the general coming into force provisions. They, therefore, will take effect on January 1st of the calendar year following the year of ratification. If the Treaty is ratified in 2008, the change to Article XV will take effect on January 1, 2009.

In a world of increasing globalization, the changes to this Article contradict the realities of business and will result in a greater impediment to cross-border commerce.

We recommend for non-resident employees from Treaty countries earning greater than $10,000 and spending less than 183 days in the other Contracting State:

- Implement a true 183-day test, such that if the non-resident employee is in the Other Contracting State for less than 183 days, they will have a resulting Treaty exemption and therefore not be taxable in the Other Contracting State.

- In the absence of implementing a true 183-day test, increase the $10,000 remuneration test set in 1980 to an amount that is reflective of today's dollar value. To be of any benefit this would realistically have to be in the range of $50,000 to $100,000.

Fifth Protocol to the Canada - U.S. Treaty: Amendments to Article IV(7)(b) – Unlimited Liability Companies

Paragraph 7(b) of Article IV appears to apply to dividends paid by a Canadian Unlimited Liability Company (ULC) to its U.S. parent out of its ordinary business earnings. Because the dividend payment is disregarded by the United States (i.e., the dividend from the ULC is not treated the same as a dividend from a *"true"* corporation for U.S. tax purposes), treaty benefits are not provided. The policy rationale for subjecting the repatriation of business earnings to a 25 per cent Canadian withholding tax is unclear.

It appears that the Contracting States believed that ULCs are used only as financing vehicles. On the contrary, ULCs are often used as holding or operating companies on their own, permitting effective consolidation of income and losses in the U.S. corporate group and the more efficient use of foreign tax credits. Neither of these activities is generally considered inappropriate from a policy perspective.

The underlying business income of the ULC (earned directly or through its operating subsidiaries) is subject to full Canadian tax as earned and then full U.S. tax (when earned directly by the ULC or when repatriated up through the operating subsidiaries to the ULC).

This provision will punish unduly U.S. corporations operating in Canada, resulting in the ULC's paying an effective tax rate on its business earnings of 49 per cent with no net tax benefit to the U.S. Treasury after the application of foreign tax credits.

We recommend that this issue be addressed as soon as practical.

"Check-the-Box" Entity Classification

The Canadian tax classification of entities is a critical element in the taxation of both outbound and inbound investments. From an outbound perspective, classification of a foreign entity is critical in determining whether the entity is a foreign affiliate. From an inbound perspective, classification of both foreign and Canadian entities is critical in determining access to treaty benefits.

As an outbound example, the hybrid treatment of U.S. limited liability companies ("LLCs") can create anomalies in the Canadian surplus regime. Canada treats LLCs as corporations, while the United States treats LLCs as flow-through entities (unless the LLC has elected to be treated as a corporation under U.S. entity classification regulations). Assume that a Canadian corporation wholly owns a U.S. corporation ("USco"), which in turn wholly owns an LLC. The Canadian foreign affiliate regime would require the LLC to calculate its own surplus and foreign tax pools, notwithstanding that the LLC is not taxed on its earnings under U.S. tax law (USco, as its sole member, would be taxed in the U.S. on the LLC's earnings). Further, it is unclear which tax laws (Canadian or U.S.) should be used to calculate the LLC's surplus because the LLC may not be considered to be required to compute its profit under U.S. tax law. Such anomalies could be avoided by allowing Canadian taxpayers to elect to treat foreign entities the same way that the foreign jurisdiction treats the entity under foreign tax law. In this example, the Canadian corporation could elect to treat the LLC as a disregarded entity for Canadian tax purposes, to mirror the U.S. tax treatment of the LLC. One potential advantage of this approach would be that the calculation of surplus for Canadian tax purposes would mirror more closely the calculation of taxable income for U.S. tax purposes (i.e., all U.S. earnings would be calculated in USco only), and likely make surplus calculations less complicated.

As an inbound example, the hybrid treatment of Canadian Unlimited Liability Companies ("ULCs") can create anomalies, particularly under the 5th Protocol to the Canada-United States income tax treaty (the "5th Protocol"). It is widely known that under the 5th Protocol, dividends, interest and royalties paid by a ULC (that is disregarded for U.S. tax purposes) to its U.S. shareholder would no longer qualify for treaty-reduced withholding rates. Both the Canadian and U.S. fiscal authorities have acknowledged that this is an unintended result, but one that may be difficult to fix, at least within the 5th Protocol itself. One way potentially to fix this anomaly is to allow the ULC to elect to be treated as a disregarded entity for Canadian tax purposes, so that the Canadian and U.S. tax treatments would be the same – that is, as a U.S. resident operating a branch in Canada.

Any Canadian entity classification regime should be elective – that is, Canadian taxpayers should be allowed to either

(1) elect to follow the foreign tax treatment of an entity (e.g., to treat a ULC or an LLC as a flow-through entity, or a partnership as a corporation where a U.S. *"check-the-box"* election has been made to treat the partnership as a corporation for U.S. tax purposes), or

(2) follow the general Canadian tax characterization of an entity (e.g., to treat a ULC or an LLC as a corporation).

We are not advocating a forced entity classification regime, since that would defeat the objective of giving taxpayers flexibility in classifying entities.

Overall, a Canadian entity classification regime that allows taxpayers to elect to treat an entity in the same way that another jurisdiction treats that entity, would give taxpayers more certainty and flexibility in the Canadian tax treatment of the entity. Such an entity classification regime could be designed to minimize the revenue impact for the Canadian government. The U.S. "check-the-box" regulations could be a starting point for the Canadian regime, but differences between the Canadian and U.S. tax systems would need to be taken into account, as well as "lessons learned" by the U.S. Treasury since the "check-the-box" regulations were introduced.

Conclusion

The Canadian Association of Petroleum Producers thanks the Advisory Panel on Canada's System of International Taxation for its consideration of our comments in this submission and for its time and insightful discussion when we appeared before the Panel on June 24, 2008.