Strengthening Canada’s International Tax Advantage

The Canadian Bankers Association’s submission to the Advisory Panel on Canada’s System of International Taxation

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CANADIAN BANKERS ASSOCIATION

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Executive Summary

The Canadian Bankers Association welcomes the opportunity to provide input into the Advisory Panel on Canada's System of International Taxation's deliberations. We bring the perspective of an industry characterized both by intense competition in Canada and the active involvement of our banks internationally. We believe the work of this Panel, in conjunction with the findings of the Competition Policy Review Panel and the policies outlined in *Advantage Canada*, offers Canadians a valuable opportunity to recast our economic policy framework to ensure Canada's future competitiveness.

The banking industry believes that Canada's system of taxation can become a source of competitive advantage both in helping Canadian firms compete on the world stage and in making Canada a magnet for foreign investment. The government has already taken steps towards that objective both through domestic tax measures such as significant corporate income tax reductions and international tax measures such as the Canada-U.S. tax treaty amendments to eliminate withholding tax on interest income. However, more can and should be done to build a Canadian advantage.

Overall, international tax competitiveness is about more than simply having the lowest tax rate. It is about ensuring that investors are offered a vibrant economy and a competitive tax rate that affords them the opportunity to earn high potential returns from investment. Capital migrates to hubs of economic activity. The competition for capital is growing, and new international competitors are being formed in rapidly-developing countries. At the same time, for many domestic firms and industry sectors, Canada represents a mature market. Those firms and investors must look abroad for significant growth opportunities. It is in Canada's interest to encourage the transformation of these firms into global corporate powerhouses headquartered in Canada.

Taken together, the measures proposed here would help to energize the Canadian economy, encourage Canadian firms to look beyond their domestic borders, and make Canada the destination of choice for foreign investors. The growth this generates will translate into improved productivity and, ultimately, more high-paying jobs for Canadians. These advantages can be further underpinned by what the Competition Policy Review Panel described as an historic opportunity for Canada to turn its fiscal advantage into a competitive advantage.

Specifically, the CBA recommends that the Panel focus on the following four issues:

Taxation Structure: The international trend is towards a full exemption system. Canada should also move towards a full exemption system for the treatment of foreign dividends, rather than the current costly and cumbersome system of exempting dividends for countries with whom we have a tax treaty or Tax Information Exchange Agreement, and maintaining a credit system for all other countries. The benefits are clear and it is simpler to administer for all concerned. A full exemption system removes any elements of extraterritoriality in tax policy and it does not create inefficiencies in capital investment decisions that would otherwise arise by channelling investment towards some countries and away from others.

Taxation Levels: Some have expressed concerns about whether a full exemption system will incent outbound foreign direct investment at a cost to domestic investment. However, that is only a concern in instances where the domestic tax system is uncompetitive. Therefore, we must strive to be best-in-class in terms of tax competitiveness. The federal government has stated that its objective is to give Canada the lowest marginal effective tax rate in the G7 by 2012 **.** While that is a laudable goal that the CBA supports, many countries in the OECD offer a more competitive tax regime than the G7. Canada has an opportunity to transform a modest tax advantage over the G7 into an economic advantage over most developed countries by building on its 2012 goal and becoming not just a G7 leader but one of the OECD leaders[1].

Tax Administration: Tax administration is an important element in Canada's international tax regime because of the high administrative costs and growing complexity of international tax rules. The CBA also identified this as an important issue in our submission to the Competition Policy Review Panel. That Panel in turn noted "regulations often unnecessarily or inadvertently constrain Canadian competitiveness because public policy initiatives are rarely designed to minimize their impact on competition."[2] At times, the international tax system has built complex mechanisms to address relatively small issues. From a cost-benefit perspective, this is a questionable approach. A full exemption system would enhance the efficiency of tax administration, both for the taxpayer and for the government.

Policy Process: The impact of technical tax changes can often be difficult to gauge in the abstract. International tax policies developed with the best of intentions to be limited and targeted can in fact yield significant unanticipated consequences. They can also lead to retroactive application of tax changes that have been long in development. This benefits neither the government's nor the business community's interest. Reorienting the policy development process to consult with industry at the conceptual stage and use that input to develop policy proposals would ultimately lead to greater predictability of results and shorter development times.

[1] According to the Department of Finance's Fall 2007 Economic Statement, by 2012 Canada's METR on new business investment will be 25.3 per cent. If the provinces are able to achieve a uniform 10 per cent corporate income tax rate, Canada's METR would be 23.7 per cent . This is much lower than the G7 average, but very close to the OECD average of 21.8 per cent, and the small developed country average of 20.6 percent.
[2] Competition Policy Review Panel, "Compete to Win", June 26, 2008, P. 90.

I. Introduction

The Canadian Bankers Association appreciates the opportunity to provide the banking industry's perspectives and recommendations to the Advisory Panel on Canada's System of International Taxation in response to its April 2008 Consultation Paper, *Enhancing Canada's International Tax Advantage*. In our view, it is both timely and of critical importance that there be a thorough assessment of Canada's international taxation policy framework, and we welcome the government's initiative to launch this review. We also welcome the Panel's objective to integrate their policy prescriptions with those of the Competition Policy Review Panel. Together, these afford Canadian industry and taxpayers an opportunity to be at the forefront of a rapidly changing and highly competitive global business environment. For Canadian industry to thrive, our public policy framework needs to be focused on creating a Canadian advantage for our businesses on the world stage, and an economy here at home that is as strong and dynamic as possible.

The Canadian Bankers Association fully supports the Advisory Panel's objective to improve the competitiveness, efficiency and fairness of Canada's international taxation and minimize the compliance costs for business and administration by the Canada Revenue Agency (CRA). However, before discussing our views as to what the Advisory Panel's recommendations should be, we note that the objective of improving the competitiveness of Canada's system of international taxation merits definition.

The Advisory Panel notes in its Consultation Paper that the Canadian government has indicated a key element of its long-term economic plan is to build a "tax advantage" for Canadian businesses.[3] In this regard, the government has already committed to lowering corporate income tax rates. Furthermore, the government has articulated its objective of achieving the "lowest effective tax rate" on new business investment in the G7.[4] These comments suggest that the government intends to do more than merely put Canadian business on a level playing field with competition from other jurisdictions; the government is striving for a tax policy framework that is on the leading edge in terms of competitiveness. Accordingly, we look forward to recommendations from the Advisory Panel that will provide Canadian business with a competitive *advantage* through the Canadian international tax system, which will encourage and facilitate international expansion of Canadian domestic companies.

With respect to the domestic context, we encourage the Advisory Panel to make recommendations that encourage foreign businesses to invest and build their operations here in Canada by creating a tax environment that is the most attractive among the relevant jurisdictions against which Canada competes. However, in doing so, the Advisory Panel must also be careful to make recommendations that do not provide foreign-owned businesses with a tax advantage when competing against domestic businesses within Canada. We need a tax system that fosters a healthy and competitive domestic business environment and encourages both domestic and foreign investment.

II. Canada's International Tax Regime

Canada currently operates a dual exemption and credit system for relieving potential double taxation on dividends received from foreign subsidiaries. Credit systems are inherently more complex than exemption systems. Under the current dual regime, a Canadian multinational enjoys some of the benefits of an exemption system but must also absorb the cost and endure the complexity of a credit system. Presumably, the original

[3] See Paragraph 1.12 of the Consultation Paper.
[4] See Paragraph 1.12 of the Consultation Paper

cost/benefit analysis of the current system suggested that the need to maintain the credit portion of the regime outweighed the costs/issues associated with it. However, in light of recent changes (discussed below), it is reasonable to conclude that those same conclusions would not be reached today.

Only a modest amount of tax revenue is derived by the Canadian government under the current regime from taxable surplus dividends paid. In 2005, taxable surplus dividends accounted for only nine per cent of total dividends received by Canadian taxpayers from their foreign affiliates.[5] The combination of tax exempt treatment afforded to income generated in treaty countries and the reinvestment of foreign affiliate income in foreign operations has minimized taxable surplus dividends.

Moreover, the Department of Finance has taken further steps toward a full exemption system by introducing recent amendments concerning Tax Information Exchange Agreements (TIEAs). These changes expand the potential amount of exempt surplus. Other than Foreign Accrual Property Income (FAPI), which is subject to tax in Canada on a current basis and can therefore be returned to Canada without further Canadian taxation in any event, taxable surplus will be limited, in general terms, to active business income earned by a foreign affiliate in a country with which Canada has not negotiated a treaty and not asked to enter into a TIEA. Since Canada has one of the most extensive treaty networks in the world (and is expected to pursue further TIEAs with some vigour), the number of countries that fall into this category is relatively small and should decrease going forward as TIEAs are signed. As a consequence, it can be argued that Canada is already moving toward having, in effect, a virtual full exemption system under the current rules.[6] Unfortunately, in the absence of a true full exemption system, all of the disadvantages of maintaining a dual exemption-credit system (e.g. complex rules, a need to maintain surplus account balances) continue to exist. From a cost-benefit perspective, the value of maintaining the residual credit system is questionable (depending on whether or not the current TIEA regime is maintained as discussed below).

Current Situation for Banks under Existing Regime

As noted by the Advisory Panel, the Canadian domestic market is small, so Canadian corporations must look beyond Canada for growth opportunities. Canada accounts for only 2.2 per cent of world GDP and 3.4 per cent of the worldwide capital market (as measured by stock market capitalization). For domestic banks, the search for growth has led them to expand in foreign markets. As a result of the foreign expansion efforts undertaken by Canada's major banks, over 40 per cent of the net income of Canada's banks now comes from their international operations, although 80 per cent of the employment remains in Canada.[7] Canadian banks are looking beyond Canada's borders for growth, and the Canadian economy is benefiting because of it.

Cost-Benefit of the Current System

While Canada's system of international taxation has some positive elements such as the extensive treaty network, it is far from ideal. Canada's current international tax regime is extremely complex. This complexity makes it unnecessarily (and in many instances prohibitively) difficult for Canadian domestic banks to compete internationally. In particular, the current base erosion rules do not, in practice, adequately take into account the unique circumstances of Canadian financial institutions. The banking industry appreciates that base erosion is a concern. A feature of open economies is a small amount of tax base leakage. However, the tax loss from the

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[5] Enhancing Canada's International Tax Advantage, p.14.
[6] The Advisory Panel has asked whether it would be helpful to adopt a broader exemption system for active business earnings earned by foreign affiliates of Canadian corporations. For purposes of this submission, references to a full exemption system mean a system as described by the Advisory Panel in Section 2.20 of the Consultation Paper.
[7] Source: CBA. Represents figures for 2006 from the six major Canadian bank financial groups.

leakage has to be measured against the impact that addressing it will have on capital investment and competitiveness. The impact on competitiveness can manifest itself in two different ways:

- *Inappropriate Application of Base Erosion Rules* -- A risk often arises that the base erosion rules will apply in circumstances they were never intended to capture. These problems can result in the foreign operations of Canadian banks being less nimble than foreign competitors, thus adversely affecting the ability of Canadian banks to compete.
- *Increased Compliance Burden* -- Another problem with the existing regime is the significant resources and costs associated with compliance. Minimizing these "drags" will greatly enhance Canadian banks' ability to compete in international markets.

The increased cost of compliance and potential for reductions in investment and economic efficiency has to be measured against the potential loss of tax revenue. By this standard, experts such as Professor James Hines of the University of Michigan have concluded that the costs of a complex international tax regime outweigh the benefits. In a recent presentation to the Canadian Tax Foundation, Professor Hines indicated that the cost to providing deductions for interest expenses and other expenses related to financing foreign affiliates is outweighed by the damage that restricting such deductions does to the international competitiveness of a country's multinational firms.[8]

Implications of Moving to a Full Exemption System

In our view, fears of base erosion are misplaced. First and foremost, it must be remembered that most activity is already exempt. More generally, from a broader business perspective, the primary motivation of foreign investment is not tax efficiency. Rather, a key reason that Canadian companies invest abroad is because they have exhausted significant growth opportunities at home. If they are to expand and grow, they must look for opportunities internationally. In this regard, moving to a full exemption system will not encourage outbound investment leading to base erosion but will strengthen the growth prospects for Canadian companies internationally.

When competing in foreign markets for acquisitions, Canadian companies are, in many cases, handicapped through a combination of factors. First, they are seldom able to realize in-market synergies, thus putting them at a cost disadvantage relative to local bidders. Second, in many cases they are competing with firms that enjoy special treatment by nations that foster national champions. Prior to 2007, Canadian firms were able to offset some of these factors through interest deductibility provisions in the Income Tax Act related to debt used to finance equity investments in foreign affiliates. With new restrictions on these provisions, Canadian firms have found themselves at a distinct disadvantage when competing for acquisitions in foreign markets. The Competition Policy Review Panel echoed this same concern, stating "These [interest deductibility] measures will not enhance Canadian tax revenues but will disadvantage Canadian companies seeking to become global players."[9] The recent interest deductibility measures should be reassessed in light of the Competition Panel's report and the International Tax Panels' mandate to improve the competitiveness of Canada's system of international taxation.

Under current rules, a relatively small proportion of foreign affiliate dividends paid are from taxable surplus. It is suggested that most of the taxable surplus dividends that have been paid to date have been sheltered from Canadian tax by sufficient underlying foreign tax. In other words, it is the expectation that taxable surplus

[8] James R.Hines Jr., "Reconsidering the Taxation for Foreign Income", presented at *International Tax Reform: Canada Confronts the Challenge*. Toronto, Ontario. June 2, 2008.
[9] Competition Policy Review Panel, "Compete to Win", June 26, 2008, P. 65.

dividends produce very little Canadian tax revenue under the current regime. Since it is unlikely that the government generates any meaningful tax revenue from unsheltered taxable surplus dividends under the current system, the tax revenue loss from moving to a full exemption system should, at best, be nominal.

RECOMMENDATION 1: The CBA recommends that Canada's current dual credit/exemption international tax system be replaced with a single full exemption system for all foreign affiliate dividends.

The Advantages of a Full Exemption System

To some extent, the advantages of moving to a full exemption system will depend on what other measures are introduced together with the full exemption system. *The comments below assume that the full exemption system for dividends would be introduced without any further tightening of the FAPI rules (because, as discussed below, such tightening is unnecessary) and without further limitations on the deductibility of expenses, such as interest, in Canada.*

The main benefits of moving to a full exemption system would include:

- *Improvements in the competitiveness of Canadian firms* – Allowing for a full exemption on repatriated dividends derived from active business income, regardless of where the income was earned, would improve the competitiveness of domestic firms in foreign markets and would strengthen their ability to compete globally for preferred acquisitions.

- *more efficient allocation of capital* - The current dual system biases investment decisions towards countries with tax treaties and TIEAs since dividends from foreign affiliates in those countries benefit from exempt surplus status. This may or may not be the optimal use of investment capital. Moving to a full exemption system would remove this bias. The result should be more efficient capital allocation, resulting in higher returns on capital, stronger growth for Canada's multinationals and ultimately more tax revenue for Canadian governments as well as more high-paying head office jobs for skilled Canadians. It would also remove the incentive for companies to reinvest profits from foreign affiliates back into the foreign affiliate rather than repatriating them.

- *simplification of the tax rules which would improve the efficiency of the international tax system for Canadian taxpayers* - For Canadian multinational businesses to succeed in rapidly growing global markets, simplifying and modernizing the current regime concerning foreign dividends (where the underlying source is active business income) would reduce administrative and compliance costs. There is substantial evidence to suggest that Canada's tax system is creating an unnecessarily large compliance burden for Canadian businesses. A recent study conducted by PriceWaterhouseCoopers for the Canadian Council of Chief Executives found that tax compliance for the average large Canadian business consumed 2,483 days of employee time annually.[10] A full exemption system would do away with the need to maintain surplus and underlying foreign tax accounts for each foreign affiliate in the group. This task in particular has recently become more complex with the introduction of rules requiring "suspended surplus" to also be tracked. A further complexity will arise if certain proposals regarding "foreign paid-up capital" (FPUC) are enacted. Significant savings in administration and compliance costs would be realized in a full exemption system.

- *simplification of the reorganization of foreign operations* - Another potential benefit of moving to a full exemption system is that the current rules regarding reorganizations of foreign affiliates could be simplified.

[10] PriceWaterhouseCoopers, Total Tax Contribution – Canada's Tax Regime: Complexity and Competitiveness. May 2008. P. 4.

The existing rules are complex, cumbersome and often serve as an unnecessary barrier to reorganizing the foreign operations of a Canadian multinational group.

- *facilitation of administration and enforcement by the CRA of taxpayers' compliance with the international tax system* - The simplification of the system that would result from moving to a full exemption system would, in turn, simplify the audit and review process for the CRA. As a result, a significant portion of the government resources currently needed to ensure compliance by banks and other taxpayers could be redeployed to other uses that would improve Canada's productivity and enhance our competitiveness as a nation.

Moving to a full exemption system must also be considered in the context of Canadian economic policy, namely to create a vibrant economy that supports a standard of living that Canadians expect. According to Professor Hines, "There is ample evidence that countries do get something in return (for exempting foreign active business income from taxation). Greater outbound investment is associated with greater domestic economic activity. When a company's foreign employment rises by 10 per cent, domestic employment rises by 3.7 per cent on average, even controlling for the source of employment changes".[11]

Finally, as noted in the Consultation Paper, similar consultation processes are underway in competitor jurisdictions with the intent of moving toward full exemption systems in order to support home country multinationals operating and competing in the global marketplace. Canadian multinationals will be put at a disadvantage, from a compliance burden perspective and an efficiency perspective, if Canada does not similarly move towards an exemption system.

Transition Rules

Moving to a full exemption system would raise the question of how to deal with existing taxable surplus. As a practical matter, the least complex route would be to eliminate all existing account balances and allow the corresponding earnings to be repatriated to Canada free of additional tax. Doing so would maximize the benefits to be obtained from moving to the full exemption system and would have little impact on government revenues because the current system tends to discourage repatriation of these funds. Failing to do so would result in increased complexity as the Income Tax Act would then need to maintain parallel regimes for foreign affiliate surplus based on when the underlying earnings were earned.

Current Linkage Between TIEAs and Exemption Unnecessary

The rationale supporting the current tax policy of treating active business income earned in a country with which Canada does not conclude a TIEA (or a treaty) as FAPI will no longer be necessary under a full exemption system. In a full exemption system, the relevant factor in determining whether income earned by a foreign affiliate should be permitted to be repatriated to Canada exempt from Canadian tax is whether the income was earned in the course of carrying on an active business. The point of a full exemption system would be to encourage Canadian businesses to expand their active business operations internationally. In this light, it seems clear that the question of whether the relevant country has entered into a TIEA with Canada should be irrelevant. This is not to say that there will no longer be any need to enter into TIEAs, but rather that whether a country does or does not have a TIEA with Canada will not be a determinant of where Canadian firms choose to expand and invest. If a move to a broader exemption system that maintained a linkage to the TIEA concept were adopted instead of a full exemption system, then the current deferral and credit system would need to be

[11] James R.Hines Jr., "Reconsidering the Taxation for Foreign Income", presented at *International Tax Reform: Canada Confronts the Challenge*. Toronto, Ontario. June 2, 2008.

maintained to address, at a minimum, the period during which a TIEA is being negotiated in a particular jurisdiction (the Income Tax Act now provides for a five year period). The need to maintain any portion of a taxable surplus regime would erode the benefits that would otherwise be derived from a full exemption system.

Furthermore, the current rule that will treat active business income earned in a jurisdiction as FAPI if a TIEA is not entered into by the jurisdiction in question is inappropriate. A TIEA is intended to provide the tax authorities with adequate information to ensure compliance and permit enforcement of the applicable tax rules. Where a country refuses to enter into a TIEA with Canada thereby denying Canadian taxpayers access to the exemption system, we believe that the "penalty" imposed by Canada is inappropriately applied under the current rules to taxpayers who are willing and able to provide the Canadian tax authorities with the requisite information.

Finally, we note that there is some uncertainty regarding the interaction of the surplus rules with the new TIEA regime. Without more clarity in this regard, organizing the foreign operations of Canadian multinationals has been made more difficult which, in turn, potentially impacts adversely the competitiveness of Canadian multinationals. Moving to a full exemption system would eliminate these issues.

Capital Gains/Losses on Shares of Foreign Affiliates

It is also necessary to consider whether capital gains on shares of foreign affiliates should also be exempt from Canadian tax as part of move towards the adoption of a full exemption system (and, as a corollary, capital losses on such shares ignored/denied). As a starting principle, it needs to be understood that direct investments that generate active business income are not undertaken for the purpose of realizing a capital gain. These long-term investments are undertaken as part of a broader business growth strategy.

Exempting such gains would be consistent with the principle that underlies the full exemption system – leaving tax policy associated with foreign affiliates to the country in which they are domiciled. In addition, it is also consistent with the reasoning that any such gains simply reflect past actual and/or future potential active business earnings (which could have been repatriated to Canada without any additional Canadian tax) or FAPI already taxed in Canada. Amendments may be necessary in this regard to ensure that any FAPI earned in the year of disposition up to the time of that disposition by an affiliate whose shares are disposed of is properly captured and attributed to the Canadian taxpayer in order to avoid any FAPI "leakage" in the year of disposition. It follows that, if capital gains on shares of foreign affiliates are ignored for Canadian tax purposes, capital losses on such shares should be similarly ignored.

Finally, it should be noted that further consideration is necessary to determine whether it would be appropriate to extend the exemption of capital gains (and capital losses) on shares of foreign affiliates to portfolio investments.

RECOMMENDATION 2: The banking industry recommends that capital gains (and capital losses) on dispositions of shares of foreign affiliates be exempted (denied) from Canadian taxation.

III. Key Outbound Investment Issues for Consideration

While moving to a full exemption system is not a radical step for Canada given that the Canadian international tax system already has most of the elements of an exemption system, there will be issues that will need to be considered in making the transition.

Competitive Tax Rates Mitigate Base Erosion

The most important base erosion measures that Canada has taken are measures to improve its domestic tax competitiveness. Investment flows are ultimately driven by the ability of investors and entrepreneurs to generate the best possible return on their investment, with tax being an important element in that investment decision. Canada has made important progress in developing a growth-oriented tax environment. According to the CD Howe Institute[12], Canada's overall marginal effective tax rate (METR) on new investment in 2007 was 30.9 per cent. This is significantly lower than the 36.6 per cent METR Canada had in 2006, resulting from tax reductions announced in 2007. However, this is significantly higher than the OECD average [13] of 20.8 per cent. While progress has been made, clearly more work can and should be done.

The overall METR on new investment masks a significant variation between the manufacturing and the service sectors. Canada's METR in manufacturing is a fairly competitive 23.1 per cent, as compared with the average OECD rate of 21.5 per cent. However, Canada's METR on capital investment in services is particularly poor. The effective tax rate on the service sector is 36.4 per cent, or the 6th highest tax rate in the world, and is nearly 16 per cent above the OECD average of 20.8 per cent. In fact, the only other advanced economy with a higher METR on capital investment in services is the United States, with a rate of 40.1 per cent.

The federal government has recognized the importance of a growth-oriented, competitive tax environment. As a result of the corporate income taxation measures announced in the 2007 fall Economic Statement,[14] by 2012 Canada's METR on new business investment will stand at 25.3 per cent, slightly lower than the current lowest G7 rate of 27.1 per cent. More than any other, these measures will protect the Canadian tax base from base erosion by improving the attractiveness of Canada to domestic and foreign investors, adding to Canada's capital stock and creating new jobs in Canada along the way.

Current Base Erosion Rules are Sufficient

Some observers have suggested that moving to a full exemption system would require enhanced rules to combat base erosion. Subject to comments outlined earlier and below related to FAPI, the CBA believes that Canada's current complement of rules in this area is amply sufficient to address this issue. In recent years, Canada has implemented several measures to protect the Canadian tax base, which include robust FAPI rules, increased scrutiny of international operations and a more rigorous transfer pricing regime. These measures, although they may require some fine-tuning, already sufficiently protect Canada from base erosion, thus allowing for the adoption of a full exemption system. It is also worth repeating that Canada already has most of the elements of an exemption system in place, yet the domestic corporate income tax base is healthy with corporate income tax revenues rising steadily throughout the decade (Figure 1).

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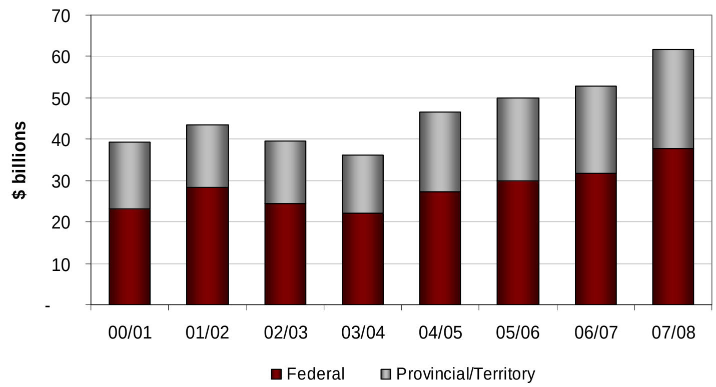
[12] Duanje Chen, Jack Mintz, Finn Poschmann, Andrey Tarasov, "2007 Tax Competitiveness Report: A Call for Comprehensive Tax Reform" C.D. Howe Institute Commentary, No. 254, September 2007, Study in Brief.
[13] Simple average of OECD countries.
[14] Economic Statement – Strong Leadership. A Better Canada, October 30, 2007, pg. 80.

If additional measures are ultimately perceived necessary to protect the tax base, any such measures should be narrowly targeted and their applicability easily verifiable. They should also not be onerous to implement and should have a significant phased-in transition timeframe. From a Canadian bank perspective, any such measures should take into account the unique circumstances of financial institutions and ensure that financial institutions are not inadvertently captured by such additional measures. For example, some observers have suggested that domestic thin capitalization rules may be necessary to combat base erosion under a full exemption system. However, banks are already subject to measures that are equivalent, in effect, to a domestic thin capitalization rule. On the tax side, banks are subject to the Part VI capital tax, which is a minimum tax on financial institutions. The tax is computed at 1.25 per cent of "Capital" (Stated Capital, Retained Earnings and Subordinated Debt). The tax is creditable against Part I tax. While financial institutions typically have sufficient taxable income to offset Part VI tax, their potential Part VI liability is large because banks have such a large capital base. As a consequence, banks cannot eliminate their tax liability by changing their debt-to-equity ratio because they will always be subject to Part VI capital tax irrespective of whether they are able to minimize their corporate income tax. Hence, Part VI constitutes an inherent limitation on the use of debt thereby eliminating the need for a domestic thin cap rule for financial institutions.

Figure 1: Corporate Income Tax Revenue
Federal and Provincial



Note: 07/08 numbers are budget estimates, years prior to 07/08 may reflect revised information. In 2004 NWT had negative income tax revenue as a result from an overpayment from the previous year. Nunavut breakdown between Personal Income Tax and Corporate Income tax is not available.

The Part VI.1 tax further reinforces the thin-cap-like provisions of the Part VI tax. Part VI.1 is a tax on "taxable preferred" share dividends. A Canadian bank will pay Part VI.1 tax based on 40 per cent of preferred share dividends paid. The tax is recoverable as a deduction from taxable income. The recovery is a deduction of three times the Part VI.1 tax paid. Again, this serves, in effect, as an implicit thin capitalization rule eliminating the need for an additional explicit thin cap rule applicable to financial institutions.

In addition to tax-based thin-capitalization-like measures, banks' ability to adjust their balance sheets is subject to prudential rules set out by the Office of the Superintendent of Financial Institutions. Regulators require that banks hold a certain amount of capital for prudential reasons.

RECOMMENDATION 3: If a full exemption system is adopted, the CBA recommends that Canada refrain from adopting any additional base erosion rules, such as a generic domestic thin capitalization rules, or any amendments to broaden scope of the existing rules. If the government ultimately concludes that such additional rules or amendments are necessary, such additional measures should be clear, focussed and easy to implement and apply, and the unique circumstances of financial institutions should be taken into account.

For example, if a domestic thin capitalization rule were introduced, banks should be exempted from those rules since sufficient safeguards already exist for banks that have the same effect as domestic thin capitalization rules.

FAPI Rules - Improvements

While existing FAPI rules are generally sufficient to address base erosion concerns that might arise in the event a full exemption system were adopted, the existing base erosion rules nevertheless could be made more efficient and better targeted in the case of financial institutions regardless of whether a full exemption system is adopted. More specifically, modification of the base erosion rules needs to be considered so they can be applied properly in the financial institution context. The rules are currently drafted using broad language which has the unfortunate potential to capture many common transactions that occur within large financial institution groups. Furthermore, exceptions to the base erosion rules have been drafted in a manner that does not contemplate complicated capital market transactions. Consequently, relief from base erosion rules is often not available even though there is no policy reason for the transaction to be caught. This situation causes financial institutions to spend unnecessary time reviewing and restructuring proposed transactions to avoid the inappropriate application of the rules. These delays can result in lost business opportunities, thus undermining Canadian competitiveness. Two examples of the issues that can arise under the existing base erosion rules are noted below to illustrate this point.

One example of the type of problems encountered by financial institutions when dealing with the existing base erosion rules arises in the context of a rule[15] that was originally introduced to target, among others, situations where a Canadian parent corporation attempts to shift Canadian taxable income to a foreign jurisdiction by arranging to have a foreign affiliate provide services to the Canadian parent in exchange for a fee that is deductible for Canadian tax purposes. In such circumstances, the relevant base erosion rule would deem the Canadian-source fee income earned by the foreign affiliate to be FAPI. Prior to a recent technical amendment, the particular base erosion rule applied only where the fees were deducted in computing taxable income from the Canadian operations of the Canadian taxpayer (i.e., the Canadian tax base was actually being eroded). As a result of the recent technical amendment, the scope of this base erosion rule has now been extended to also deem any service fees earned by the foreign affiliate for providing or undertaking to provide services to any party to be FAPI where employees of an unincorporated foreign branch of the Canadian parent provide the services to the service recipient. In situations where the Canadian parent operates as a foreign branch, Canadian tax on income earned by the branch would be eliminated through the foreign tax credit mechanism in the Income Tax Act if sufficient foreign taxes are paid by the branch and, consequently, there would be no Canadian tax base to erode under these arrangements. Under the current rule, Canadian financial institutions would be forced in the circumstances above to choose between operational inefficiency and an unfair tax burden. This undermines competitiveness of Canadian financial institutions for no apparent tax policy reason.

As another example, one of the existing base erosion rules can also restrict a foreign affiliate's ability to manage risks arising in the normal course of a foreign banking operation. The particular rule[16] operates to deem income from Canadian-source "indebtedness" to be FAPI and the specific language is broad enough to capture certain derivative contracts as well as traditional loan arrangements. There is a "safe harbour" exception for foreign exchange derivatives, but not for other types of derivatives (such as derivatives used to hedge interest rate, credit and equity exposures). Many Canadian banks are expanding their operations in countries with no sophisticated local capital market. Foreign affiliates in these countries may have no alternative but to arrange risk management derivatives with a Canadian counterparty (such as the Canadian parent bank or its Canadian securities dealer). The base erosion rules place these foreign affiliates at an unfair disadvantage relative to local competitors who are free to manage these risks with no tax distortion.

[15] Paragraph 95(2)(b) of the Income Tax Act.
[16] Paragraph 95(2)(a.3) of the Income Tax Act.

RECOMMENDATION 4: The CBA recommends that, in consultation with the financial services industry, the government review the existing base erosion rules in the Income Tax Act and adopt modifications to those rules that ensure they do not hinder the international competitiveness of Canadian financial institutions.

Interest Deductibility Should be Reconsidered in this New Context

While we appreciate that the "double-dip" measures in new section 18.2 of the Income Tax Act are viewed by the government as one of its tools to combat base erosion, the CBA questions whether that provision will be effective in that role and, more broadly, whether it is consistent with the goal of making the Canadian tax system competitive and growth-oriented. Section 18.2 is ineffective at dealing with erosion of the tax base resulting from many forms of debt dumping into Canada by foreign investors and from leveraged buy-outs of Canadian business by private equity pools and domestic tax-exempt entities. In addition, it runs counter to the stated objective of improving the competitiveness of the Canadian international tax system. Many other countries allow, and even encourage, the activities that section 18.2 now targets in an effort to make their own multinational corporations more competitive. Consequently, section 18.2 compromises the international competitiveness of Canadian business.

RECOMMENDATION 5: The CBA recommends that the restrictions on interest deductibility recently added to the Income Tax Act in Section 18.2 be reconsidered as part of a broader migration of Canada's tax system towards a full exemption model.

The Panel should also consider the broader policy context of interest deductibility. The work of both the Advisory Panel on Canada's System of International Taxation and the Competition Policy Review Panel are designed to enhance the competitiveness of Canadian firms in international markets and make Canada an attractive destination for international investment. As the domestic market is mature for Canadian firms, their only option for significant growth opportunities is to grow abroad. This has proven to be a challenge for Canadian firms as their after-tax cost of capital is often higher than their competitors. This means they have missed opportunities that otherwise would have complemented and enhanced their global business strategies. If Canadian firms are to grow abroad at a sustained pace, they have to be able to compete with the largest corporations. These same concerns were recently highlighted by the Competition Policy Review Panel in their report "Compete to Win".

> "Concerns were expressed to the Panel with respect to recent changes to Canadian tax legislation that will deprive Canadian companies making foreign acquisitions of some of the same advantages that foreign companies enjoy when making acquisitions in Canada. These measures will not enhance Canadian tax revenues but will disadvantage Canadian companies seeking to become global players. Our focus on Canadian competitiveness leads us to share the concerns we heard."[17]

Therefore, we agree with both of the recommendations made by the Competition Policy Review Panel with respect to international taxation, namely:

> 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.

[17] Competition Policy Review Panel, "Compete to Win", June 26, 2008, P. 65.

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.[18]

Tax Treatment of Branches of Canadian Taxpayers May Need to be Reviewed

It is important that Canadian taxation of foreign branches of Canadian financial institutions be consistent with the treatment of foreign subsidiaries, particularly after the implementation of a full exemption system for income earned by foreign subsidiaries. Branches remain an important form of business structure for financial institutions. It is often more practical for financial institutions to carry on business in a foreign jurisdiction through a branch rather than a subsidiary. Direct foreign branching is becoming more commonplace. Most developed countries, including Canada, now permit some form of direct foreign branching. Branches currently suffer asymmetric and potentially less advantageous tax treatment compared to foreign subsidiaries. Moving to a full exemption system under which dividends from overseas subsidiaries are exempted from Canadian taxation without any change to the taxation of oversees branches would perpetuate the asymmetry and inequities against branch operations. Making the tax treatment of foreign affiliates and foreign branches similar would remove the tax distortion inherent in choosing one structure over another and enhance the competitiveness of branches.

However, it must be acknowledged that numerous issues would need to be addressed in attempting to formulate rules implementing a harmonization of branch tax treatment. Consequently, drafting provisions that address all of the relevant issues would likely be a lengthy process. We therefore recommend that branch harmonization should be pursued, but not at the expense of delaying the implementation of the full exemption system for active business income earned by foreign affiliates. Furthermore, harmonization should only be implemented if a harmonization regime can be created without introducing an unacceptable degree of complexity to the Act.

RECOMMENDATION 6: The CBA recommends that the federal government work with the banking industry to study how harmonization of tax treatment between foreign branches of Canadian companies and foreign subsidiaries could be achieved.

Hedging of Investments in Foreign Subsidiaries

Operating abroad creates some unique financial risks that firms must address. One of those risks is foreign exchange rate risk. Canadian entities with substantial investments in foreign affiliates are invariably required to hedge their investments to ensure that they limit their risk of erosion of capital. In the case of Canadian banks, this issue is important as significant foreign exchange losses can negatively impact regulatory capital. There are three principal concerns with the existing hedging rules as they apply to Canadian banks:

(i) The character issue: The general rule applicable to most other taxpayers is that hedging gains and losses assume the character of the underlying asset that is being hedged. Except for very limited exceptions, Canadian banks are required to treat gains and losses on foreign currency-denominated debts and foreign currency derivatives on income account, even when those debts and/or derivatives function effectively as a

[18] Competition Policy Review Panel, "Compete to Win", June 26, 2008, P. 66.

hedge of a foreign currency-denominated capital investment such as shares of a foreign affiliate. As a consequence, foreign currency losses on the underlying investments (which are on capital account) cannot be used to offset foreign currency gains on the related hedges (because they are on income account). This situation is unique to banks because, in the absence of a specific statutory rule providing otherwise, foreign currency-denominated debts and derivatives typically form part of a bank's normal course banking operation. Because of the significant weakening in the U.S. dollar vis-à-vis the Canadian dollar in recent years, this asymmetrical tax treatment has generated material differences between the banks' true economic gain and their income for tax purposes. As a result, the banks have incurred substantial income tax liabilities even though there was no net economic gain from their hedged investments in foreign affiliates. This tax result can have a severely unfavourable impact on the banks' regulatory capital.

(ii) The timing issue: Generally, taxpayers are required to recognize gains and losses on hedges at the settlement or maturity date of the hedging instrument, which may or may not coincide with the sale or liquidation of the underlying hedged asset. Consider a simple example where there is a loss on the shares of a major foreign subsidiary (that will be held indefinitely) and a gain on the related hedge. If the hedge matures more than three years prior to the sale or liquidation of the foreign subsidiary, the bank would have a permanent tax expense for the gain on the hedge with no ability to deduct the corresponding loss on the foreign affiliate shares. This mismatch can have an adverse effect on invested capital and results in unpredictable amounts of volatility in the taxable income of these entities.

(iii) The loss denial issue: Prior to a recent technical amendment, the “stop-loss” rule in subsection 93(2) required a foreign exchange loss on a foreign affiliate share to be reduced by the cumulative exempt dividends received from the foreign affiliate. Recent technical amendments would restore the loss to the extent of certain taxable hedging gains. The proposed amendments are overly restrictive in that only certain hedging gains may qualify to restore a loss. For example, the proposed amendments do not include: (i) hedging gains on income account debts; (ii) hedging gains on debts realized in a period prior to the disposition of a foreign affiliate investment; (iii) hedging gains realized by members of a related group who do not have a direct investment in the foreign affiliate; (iv) hedges that were created subsequent to the initial investment; or (v) instruments that do not provide for the purchase, sale or exchange of currency. Moreover, the formula used to determine the amount of the restored loss does not work properly in circumstances where the amount of exempt dividends received exceeds the loss on the disposed shares.

RECOMMENDATION 7: The CBA recommends that the tax rules for hedging investments in foreign subsidiaries be reviewed in light of the significant issues and challenges faced by the Canadian banks.

Tax Exempt Entities

With respect to the increased significance of tax-exempt entities as investors, the investment profiles of tax-exempt entities and other multinational entities have begun to converge and this convergence is leading to a more competitive environment between these two classes of investors. The tax status of one investor relative to another is a competitive factor and has the potential to create an uneven playing field when assessing a potential investment decision. (To be clear, tax exempt entities need not worry about FAPI and taxable surplus.) Any recommendations of the Advisory Panel should not tilt the balance further still towards the tax-exempt entities.

IV. Key Inbound Investment Issues for Consideration

While international tax rules regarding outbound foreign investment are often the most high-profile elements of international taxation policy, tax rules that govern inbound foreign investment are also very important. Foreign direct investment is a key element in helping to grow the Canadian economy. Inbound foreign investment not only provides additional capital, it also often brings with it new technology and new business strategies acquired from successful international firms. It also adds to the competitive pressures that exist within the Canadian market, which ultimately improves the efficiency of all firms in Canada.

Withholding Taxes

Withholding tax is probably the most visible inbound international tax issue in Canada. Canada has made great strides recently in amending its withholding tax regime to facilitate a more seamless flow of capital across international borders. The CBA commends the federal government for negotiating amendments to the Canada-US tax treaty that will eliminate withholding tax on interest payments to arm's length parties immediately and to non-arm's length parties over a three year phase-in period. This will facilitate access to pools of specialized capital in the U.S. that otherwise may not have considered investments in Canadian firms.

RECOMMENDATION 8: The CBA encourages the Canadian government to negotiate bilateral withholding tax exemptions with other countries, similar to the withholding tax exemptions negotiated in the U.S. In addition to negotiating further bilateral withholding tax exemptions for interest payments, the Canadian government should seek to extend these bilateral exemptions to include other forms of income such as dividends, rent, and royalties. This would further improve cross-border capital flows both for Canadian banks investing abroad and foreign banks operating in Canada.

Transfer Pricing

In the context of today's international market the CBA believes it is critical that Canada have formal transfer pricing documentation and administration that is effective and efficient in promoting international trade while ensuring an appropriate source of taxation for Canada.

The current approach of requiring a taxpayer to prepare contemporaneous documentation and make it available to the CRA, when asked, combined with the annual T-106 reporting, is a reasonable approach. However, there are several issues that make the current system difficult to manage on an effective and efficient basis (lack of acceptable methodologies, bundling of services, protracted audit reviews, etc). On the administrative front, the human resources available to the CRA may need to be enhanced given the pace of change in the industry. In addition, both the CRA and industry would benefit from better dialogue on transfer pricing issues, particularly before the assessment stage.

The concept of the various identified and acceptable methods of transfer pricing is very useful but issues still exist. Particularly important is the unresolved issue of differences in transfer pricing approaches between Canada and our major trading partners. In this instance, a greater degree of cross-border harmonization would reduce compliance costs for Canadian firms operating in multiple jurisdictions.

RECOMMENDATION 9: The CBA recommends that differences in transfer pricing approaches with major trading partners be resolved and communicated, and that a dedicated and independent group of CRA personnel be assigned to review transfer pricing disputes from a reasonableness standpoint at an early stage to resolve uncertainty and reduce costs for the government and Canadian business.

Debt Dumping

Just as there are base erosion issues that impact outbound investment taxation rules, there are also similar issues with inbound investment taxation rules. In the case of inbound investment, policy makers are concerned about the phenomenon of "debt dumping". Debt dumping involves a Canadian subsidiary of a foreign parent being used to borrow funds in Canada to finance non-Canadian subsidiaries in the foreign parent's corporate group. The practice is problematic where the interest on the Canadian debt simply shelters Canadian income that would otherwise be subject to tax and does not lead to any economic benefits in Canada such as the creation of jobs in Canada or the expansion of Canadian business operations. It is understood that one of the objectives of section 18.2 was to discourage at least some forms of debt dumping activities.

Clearly, Canada's tax policy needs to address the issue of debt dumping. Canada already has some measures in place to address debt dumping, such as thin capitalization rules for foreign entities. Some commentators have argued that Canada should go beyond that and develop an expanded thin capitalization rule covering both domestic and foreign firms. For reasons discussed previously (see "Current Base Erosion Rules are Sufficient"), this proposal would not be appropriate in the context of the banking sector. Even in the context of the current foreign thin capitalization rules, it is questionable whether the "one size fits all" approach is effective. Currently, the maximum amount of related party debt allowed is limited by a 2:1 debt to equity ratio. Additional debt would generate interest that is not deductible. Apparently this is a proxy for the normal capitalization of an industrial company. The rule could be made more effective by making it better tailored to fit the industrial sector of the firm. For example, in the case of an authorized foreign bank, in another context, the Income Tax Act reflects an assumption that an appropriate debt-to-equity ratio for a Bank may be 9:1 (S.181.3(3)(e) of the *Income Tax Act*). Conversely, for other sectors a 2:1 ratio may not be tight enough which would allow room for debt dumping to occur. In any event, the definition of related party debt should not be expanded to include third party debt that is guaranteed by a non-resident related party.

Beyond specific rules to target debt dumping, part of the solution to address this issue is to ensure that Canadian tax rates are competitive with those of other developed countries. Debt dumping comes about, in part, because the rate of tax that a firm faces in Canada exceeds the rate it faces in competing jurisdictions. As a consequence, firms try to structure their operations to reduce their taxable income in Canada. A more competitive tax regime would reduce the incentive to artificially reduce taxable income in Canada.

V. Other Investment Issues for Consideration

Legislative Issues

While the structure of the tax system is an important element in making it competitive and efficient, another key element is <u>certainty</u>. Put simply, businesses like certainty because it reduces risk. Part of certainty is ensuring that a process eventually reaches its conclusion within a reasonable timeframe. There have been cases where proposed measures have remained at the proposal stage literally for years without resolution. Unfortunately, there have been several examples of rules being proposed in recent years that were either never enacted or not enacted for an unacceptably long period of time.

For example, proposals regarding foreign investment entities (“FIEs”) and non-resident trusts (“NRTs”) were first announced in the 1999 Federal Budget. Subsequently, numerous drafts of the proposed rules were released without being enacted. Taxpayers were put in an extremely difficult position by the resulting uncertainty as to which set of rules were operative and as of what point in time.

Also, numerous technical amendments to the foreign affiliate rules have been proposed since 2002. Several drafts of the proposed rules have been released with various proposed retroactive effective dates. Furthermore, many of the proposed rules remain outstanding. Taxpayers have again been put in an awkward position when trying to organize their affairs and comply with the tax rules.

RECOMMENDATION 10: From the perspective of the banking industry, achieving finality on the foreign affiliate rules would be a significant step towards improving and clarifying our international tax regime. We would strongly encourage the government to finalize these rules.

Another example is proposed section 3.1 which was first introduced in 2003 and attempted to add a reasonable expectation of profit test to the Income Tax Act. After a consultation process with the tax community, the Department of Finance acknowledged the concerns of the tax community with the proposed provision and indicated in 2005 that it would release a modified proposal to address those concerns. To date, the revised proposal remains outstanding.

These delays typically are not the result of foot-dragging on anyone’s part but rather are often an unfortunate side effect of legislative and technical measures that are developed without sufficient up-front consultation with industry on their consequences. The impact of technical tax changes can often be difficult to gauge in the abstract. From a banking industry perspective, this was clearly the case in the January 2006 proposals to restructure the legislative framework around the application of the Goods and Services Tax (GST) to imported supplies. International tax policies developed with the best of intentions to be targeted and limited yielded significant unanticipated consequences.

RECOMMENDATION 11: The CBA recommends that the government reorient its policy development process to include consultation with industry at the conceptual stage and use that input to develop policy proposals which would ultimately lead to better policy with more predictable results and shorter development times.

Retroactive Legislation Works Against Certainty

One of Canada’s greatest advantages in terms of attracting international business activity, including financial activity, is the stability of its institutions. One of its strongest institutions is a legal system that has been inherited from the UK and from France. Similarly sourced systems in other parts of the world are well recognized as stable bases to support business activity. However, in recent years the federal government, on occasion, has resorted to using legislation with retroactive effect. The Department of Finance issued guidelines in 1995 to determine when it was thought to be appropriate to create retroactive legislation. In summary, the guidelines indicate that legislative tax changes may be enforced retroactively when one or more of the following elements exist:

- the amendments reflect a long standing well known interpretation of the law by the CRA,
- the amendments reflect a policy that is clear and well known by taxpayers,
- the amendments are intended to prevent a windfall benefit,
- the amendments are necessary to preserve the stability of the government’s revenue base, and
- the amendments are corrections of ambiguous provisions that were not in accordance with the objects of the Act.

Retroactive application of tax legislation creates enormous compliance and financial reporting challenges, and substantial uncertainty for corporations. The courts have found that laws passed by Parliament should be read in context. Having done so, corporations should be able to rely on the law as interpreted. They should not be subject to changes in the law that apply to periods in which they have already entered into transactions. To do otherwise puts corporations in the difficult position of having to factor into investment decisions the prospect that retroactive rule changes may alter the fundamental economics of their investment. This may lead to an inefficient allocation of capital which reduces productivity, slows economic growth and ultimately leads to less tax revenue accruing to the government. Retroactivity also erodes Canada's reputation as a stable place to do business in the minds of foreign investors considering Canada as an option for new investment. It conflicts with the perception of the meaning of the rule of law. Overall, retroactive application makes it more difficult to persuade an international financial institution to bring incremental business activity to Canada.

RECOMMENDATION 12: The CBA recommends that the government refrain from enacting tax legislation retroactively.

Administrative Issues

There is an increasing awareness that "the tax burden" is not simply how much a firm pays in tax but also includes the cost of compliance with the tax code. A recent study on international taxation by the World Bank and PricewaterhouseCoopers notes that "(T)ax compliance costs are a significant cost to companies. Simplifying the tax system can offer the potential of a win:win scenario for both government and business."[19] The complexity of tax administration in Canada has grown in recent years and will grow even further if certain proposed legislative initiatives, discussed below, become law. A competitive tax system is one that is simple, clear, and fair.

The Competition Policy Review Panel noted the same thing. Quoting the 2004 External Advisory Committee on Smart Regulation, the Panel stated "the current regulatory system often acts as a constraint to innovation, competitiveness, investment and trade. [There is] an increasingly profound disconnect between the regulatory system and 21st century reality. Without rapid and significant change, Canada's ability to innovate and provide citizens with high levels of protection would be impaired." The Competition Policy Review Panel further stated "The 2004 Smart Regulation Report set out useful principles: effectiveness, cost efficiency, timeliness, transparency, accountability and performance. We accept these, placing competitiveness at the top of the list."[20]

The burden of complying with Canada's ever more complex tax system is becoming an increasing part of the overall tax burden on corporations in Canada. A recent World Bank-PriceWaterhouseCoopers study found that Canada ranked eighth in the OECD in terms of the ease of tax compliance, and behind key competing jurisdictions such as the UK. Canada should aim to have the simplest and most efficient tax regime in the world. There are a number of examples of areas where Canada's international tax administration could be improved to reduce the cost of compliance.

While the Panel's discussion paper did not discuss issues related to the GST, it has an international tax dimension that should be part of the Panel's scope for review. In principle, the GST is designed to have no impact on international taxation because it is meant to be a value-added tax. However, in practice, for exempt

[19] The World Bank-PriceWaterhouse Coopers, "Paying Taxes 2008: The Global Picture", pg. 44.
[20] Competition Policy Review Panel, "Compete to Win", June 26, 2008, P. 91.

industries such as financial services, the administration of the GST on international transactions can have a significant effect on banks' tax liability. The proposed GST legislation on imported supplies perfectly illustrates the necessity of having an administratively simple tax regime. The proposed legislation is unnecessarily complex and opaque. If implemented as proposed, the legislation may result in taxing imported financial services such as foreign securities trading desks that are supported by back office operations and trading room operations located in Canada. While this may not have been the intent, the proposals are so complex that they could inadvertently capture these types of transactions. This could result in Canadian banks being forced to relocate these services outside Canada with the result that Canadian jobs will be lost and tax revenues will be adversely impacted.

The foreign affiliate regime also provides an example of where the administration of international tax could be improved. The foreign affiliate regime and the Foreign Investment Entity and Mark-to-Market rules overlap in certain cases. Eliminating this overlap would simplify the compliance burden, and more importantly, prevent potential double taxation, on Canadian companies. For example, a Canadian bank investing in a foreign company that is controlled by four other unrelated Canadians would automatically have to treat that foreign company as a controlled foreign affiliate even if its share ownership is under 10 per cent. These shares would be subject to both FAPI and the Mark-to-Market rules.

RECOMMENDATION 13: The CBA recommends that all new tax measures be subject to a rigorous, quantitative cost-benefit analysis to ensure that the tax measure meets its policy objective while imposing the least compliance burden on taxpayers.

VI. Conclusion

While Canada has an enviable track record in developing a strong, diversified economy, and maintaining our role as one of the leading trading nations in the world, we are facing increasing competition as other countries seek to attract new investment to their domestic markets and support their domestically-headquartered companies to succeed globally.

Both business and government have a role in addressing this challenge. Given the mandate of the Panel, our comments in this submission have been focused on the steps the Government of Canada should be taking to enhance our international tax competitiveness. In our view, the best way to address this challenge is to ensure that the business environment here in Canada is as flexible, forward-looking, and competitive as possible, and that public policy in this country is directed towards creating a Canadian advantage for our businesses on the world stage. To that end, we have focused on the factors that we believe can have the greatest impact: a competitive domestic corporate tax rate, a full exemption system for foreign dividends, a level playing field between domestic and foreign firms operating in the domestic market, and a more simplified and efficient tax administration.

The Canadian Bankers Association hopes that the Panel finds these observations and recommendations of use. The banking industry looks forward to the recommendations from the Panel as this important review of Canada's international tax framework proceeds.

VII. Summary of Recommendations

RECOMMENDATION 1: The CBA recommends that Canada's current dual credit/exemption international tax system be replaced with a single full exemption system for all foreign affiliate dividends.

RECOMMENDATION 2: The banking industry recommends that capital gains (and capital losses) on dispositions of shares of foreign affiliates be exempted (denied) from Canadian taxation.

RECOMMENDATION 3: If a full exemption system is adopted, the CBA recommends that Canada refrain from adopting any additional base erosion rules, such as a generic domestic thin capitalization rules, or any amendments to broaden scope of the existing rules. If the government ultimately concludes that such additional rules or amendments are necessary, such additional measures should be clear, focussed and easy to implement and apply, and the unique circumstances of financial institutions should be taken into account.

RECOMMENDATION 4: The CBA recommends that, in consultation with the financial services industry, the government review the existing base erosion rules in the Income Tax Act and adopt modifications to those rules that ensure they do not hinder the international competitiveness of Canadian financial institutions.

RECOMMENDATION 5: The CBA recommends that the restrictions on interest deductibility recently added to the Income Tax Act in Section 18.2 be reconsidered as part of a broader migration of Canada's tax system towards a full exemption model.

RECOMMENDATION 6: The CBA recommends that the federal government work with the banking industry to study how harmonization of tax treatment between foreign branches of Canadian companies and foreign subsidiaries could be achieved.

RECOMMENDATION 7: The CBA recommends that the tax rules for hedging investments in foreign subsidiaries be reviewed in light of the significant issues and challenges faced by the Canadian banks.

RECOMMENDATION 8: The CBA encourages the Canadian government to negotiate bilateral withholding tax exemptions with other countries, similar to the withholding tax exemptions negotiated in the US. In addition to negotiating further bilateral withholding tax exemptions for interest payments, the Canadian government should seek to extend these bilateral exemptions to include other forms of income such as dividends, rent, and royalties. This would further improve cross-border capital flows both for Canadian banks investing abroad and foreign banks operating in Canada.

RECOMMENDATION 9: The CBA recommends that differences in transfer pricing approaches with major trading partners be resolved and communicated, and that a dedicated and independent group of CRA personnel be assigned to review transfer pricing disputes from a reasonableness standpoint at an early stage to resolve uncertainty and reduce costs for the government and Canadian business.

RECOMMENDATION 10: From the perspective of the banking industry, achieving finality on the foreign affiliate rules would be a significant step towards improving and clarifying our international tax regime. We would strongly encourage the government to finalize these rules.

RECOMMENDATION 11: The CBA recommends that the government reorient its policy development process to include consultation with industry at the conceptual stage and use that input to develop policy proposals which would ultimately lead to better policy with more predictable results and shorter development times.

RECOMMENDATION 12: The CBA recommends that the government refrain from enacting tax legislation retroactively.

RECOMMENDATION 13: The CBA recommends that all new tax measures be subject to a rigorous, quantitative cost-benefit analysis to ensure that the tax measure meets its policy objective while imposing the least compliance burden on taxpayers.