THE CANADIAN CHAMBER OF COMMERCE
LA CHAMBRE DE COMMERCE DU CANADA

Enhancing Canada's International Tax Advantage

Submission to the Advisory Panel on Canada's System of International Taxation

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The Voice of Canadian Business ™
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Advisory Panel on Canada's System of International Taxation
Submission
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RE: CONSULTATION PAPER: *ENHANCING CANADA'S INTERNATIONAL TAX ADVANTAGE*

The Canadian Chamber of Commerce is the largest business organization in Canada, with membership of 175,000 businesses. Our members include both large and small companies in all sectors of the economy and all regions of the country. We pride ourselves on being Canada's Voice of Business and we work hard with governments of all political stripes to ensure that Canada's business community is able to maximize its economic and social contribution to our national wellbeing.

The Canadian Chamber commends the Government of Canada for creating the Advisory Panel to study and recommend measures to further improve the competitiveness, efficiency and fairness of Canada's system of international taxation. It also commends the Advisory Panel for issuing a comprehensive and cohesive consultation paper.

On behalf of our members, we are pleased to provide input to the Advisory Panel as it consults with Canadians on this critically important issue.

PRINCIPLES OF SOUND TAX POLICY

The Canadian economy is increasingly linked to the world economy through trade and investment. In 2007, the stock of foreign direct investment into Canada was substantial, and amounted to approximately $500 billion. American corporations accounted for 58% of the total. The stock of outbound foreign direct investment by Canadians was also significant – about $515 billion – of which, 44% was held in the United States.

Like all firms, multinationals are faced with a number of business decisions, including how much to invest and where. Multinationals also have to decide in which country to locate their headquarters. Each of these business decisions is influenced by tax policy, particularly how countries tax income from foreign investment. Thus, the appropriate tax strategy for Canada must be assessed in relation to the global tax environment.

Furthermore, as the Advisory Panel stated, "Canada's tax policy must anticipate continuous change in the global tax environment and have the flexibility to adapt accordingly".

Additionally, the Canadian Chamber believes the following principles should guide the Government in establishing an international tax policy framework.

- Ensure the tax system is simple, transparent and easy to understand and comply with. By allowing the least possible margin of different interpretations, corporations will have a higher degree of certainty about the effect of tax law.

- Avoid ad hoc changes to tax legislation – like the unexpected and disruptive measures concerning international financing and interest deductibility – which increase uncertainty and negatively affect investor and business confidence.

- Avoid tax legislation sitting around in draft for too long. Assuming that sufficient consultation has taken place, make announcements with respect to changes in tax law only if the Government proposes to introduce enabling legislation within six months, and if the legislation is not issued until later, then make the change(s) effective at the later date and not the date on which the original announcement was made.

- Provide a rationale for changing tax laws on a retroactive basis. The Government has stated in the past that "retroactive clarifying amendments should only be made in exceptional circumstances". Due to the general nature of the Government's rationale, however, it is open to interpretation which only serves to escalate the level of uncertainty regarding tax law.

- Continue to reduce the compliance burden for business. As tax rates come down across the world, the efficiency of tax administration and costs of compliance become more important to tax competitiveness.

- Avoid technical revisions aimed at creating a system that is purer from a theoretical perspective, but adds complexity to tax legislation with little benefit to either taxpayers or administration.

- Make changes to Canada's system of international taxation only in areas where significant improvement will be achieved.

With these overall principles in mind, Canada's tax system should be conducive to attracting foreign investment with the aim of creating a level playing field for domestic business activity carried on by foreign and Canadian businesses. At the same time, international tax rules governing outbound investment should aim to enhance the competitiveness of Canadian businesses operating abroad. Thus, Canadian tax law should put multinationals neither in an unfavourable or favourable position to compete abroad. To a large extent, this depends on tax policies of other countries which Canada has no control over.

1. OUTBOUND DIRECT INVESTMENT

Our members are supportive of Canada's current international tax system governing outbound investment from Canada. As the consultation paper notes, we have a hybrid system - taxing offshore investment income on a current basis, full exemption for active business income earned in foreign affiliates in countries with which Canada has a tax treaty, and deferral with a tax credit for active business income earned in non-treaty countries. Our members believe this system has served Canada well, particularly with respect to active business income earned in foreign affiliates. Many countries that use a deferral with credit system are looking at adopting a Canadian-like system with respect to active business income earned in offshore subsidiaries. They are doing so to avoid the complexity that the credit system entails.

That said, certain business income earned in offshore subsidiaries are considered "investment businesses" and, therefore, not eligible for the exemption system unless the foreign subsidiary has more than five full-time employees. This is particularly problematic in the real estate development industry. The Canadian Chamber urges the Government to review the definition of investment business to determine whether it is still appropriate and determine the validity for, and the practicality of the five full-time employee test.

With respect to income earned in foreign affiliates in non-treaty countries, Canada currently does not allow for the exemption system to be used. This should be reviewed as this discourages investment by Canadian businesses in non-treaty countries and it often takes years to put a tax treaty in place. There is currently a proposal to allow the exemption system to be used from jurisdictions that sign Tax Information Exchange Agreements (TIEAs) with Canada. Our members are not in favour of this. As this proposal now stands, a Canadian parent is severely penalized if the non-treaty jurisdiction does not enter into a TIEA. This result is particularly unfair when neither the Canadian parent nor its foreign subsidiary have any control over whether a foreign jurisdiction enters into a TIEA. Additionally, many low-tax jurisdictions will not find it advantageous to enter into a TIEA due to the fact that a predominant part of the income generated in those jurisdictions (for example, Bermuda) is already considered foreign accrual income. Rather, our members believe that for non-tax treaty countries, the exemption system should be allowed if the foreign affiliate located in that jurisdiction is subject to a sufficient level of taxation on the income earned in the foreign jurisdiction. In arriving at such a determinant, our members believe that the Canadian corporate rate of tax may not be the appropriate measure, particularly when corporate rates for Canada's non-treaty partners are in some cases lower than Canada's. Our members suggest using the proposed 2012 combined federal-provincial corporate tax rate of 25% or the lowest corporate tax rate from time-to-time of Canada's tax treaty partners. This will accommodate a reasonable number of instances and recognize corporate rates levied by treaty partners. However, doing this (i.e. basically introducing a "white list" in the Act) complicates things. As it currently stands, our tax system is simple – a corporation with a subsidiary in a country which has a tax treaty with Canada gets access to the exemption system for active business income.

The Advisory Panel asks whether Canada should exempt the capital gain on the disposition of shares of foreign affiliates. Our members believe that this warrants consideration. Our members suggest that capital gains earned on the sale of the shares of foreign affiliates located in a country which has a tax treaty with Canada should be exempt from taxation as long as that foreign affiliate is carrying on an active business (currently an election can be filed that will effectively allow the capital gain to be exempt to the extent the foreign affiliate has an exempt surplus balance). This will help with simplification.

In the final analysis, if the cost of adopting a broader exemption system (i.e. exempting the taxation of capital gains on the disposition of shares of a foreign affiliate) is the loss of the ability to deduct expenses such as interest which relate to an investment in a foreign affiliate, then our members prefer that capital gains remain taxable and interest and other expenses relating to the investment are still deductible.

2. INBOUND DIRECT INVESTMENT

In recent years, significant positive steps have been taken to make Canada a more attractive place to conduct business. The general corporate income tax rate will be reduced from 19.5% in 2008 to 15.0% by 2012; the corporate surtax of 1.12% was eliminated in 2008; the federal capital tax has been eliminated; and the small business tax rate was reduced to 11.0% in 2008 and the amount of income eligible for this lower rate was raised to $400,000 from $300,000. A number of adjustments have also been made to capital cost allowance rates to better align them with the useful life of the relevant asset.

Canada needs to remain an important destination for foreign direct investment and our tax rules should reflect this. There are two important aspects of the taxation of inbound direct investment in Canada that need to be considered. The first is the tax treatment of interest expense incurred by Canadian corporations with debts owing to certain non-resident persons. The second is thin capitalization rules.

Our members believe the use of debt dumping is a concern that Canada should be addressing (i.e. a Canadian subsidiary borrows from specified non-residents and the uses the funds to finance foreign affiliates). However, our members are generally comfortable with Canada's thin-cap rules when the debt is financing a Canadian business. Indeed, our members believe our thin cap rules give certainty to Canadian corporations who are borrowing from specified non-residents and prefer this over the earnings stripping rules other countries have.

3. WITHHOLDING TAXES

Canada recently eliminated its withholding tax on all arm's-length interest. As a result, a Canadian corporation can now borrow from an unrelated foreign person or financial institution and that foreign lender will no longer be subject to Canadian withholding tax. Withholding tax on interest paid to related U.S. lenders (non-arm's-length interest) will be phased out over a three-year period under the revised Canada–U.S. tax treaty. As a result, where a Canadian subsidiary pays interest on money borrowed from its U.S. parent corporation, no Canadian withholding tax will apply. This new exemption will apply to Canada–U.S. cross-border interest payments only, and interest paid to non-U.S. non-arm's-length foreign lenders will remain subject to withholding tax.

The Canadian Chamber believes this policy objective should be broadened. The imposition of withholding taxes on interest, dividends and royalties has an immediate, negative impact on the economy. First, withholding taxes can impede cross-border capital flows and act as a tariff on the importation of capital and/or knowledge. For example, investors may require a higher rate of return on their savings in order to invest in Canada. Indeed, withholding taxes on interest payments are frequently shifted to the borrower, thereby increasing the cost of capital. Similarly, withholding taxes on royalties can raise the cost to Canadian business on accessing foreign technology, a key component of the knowledge-based economy.

The Canadian Chamber strongly urges the federal government to immediately commence negotiations with treaty partners to eliminate withholding tax on interest on non-arm's length transactions on a bilateral basis and to negotiate with major tax treaty partners the elimination of withholding taxes on dividends and royalties.

4. ADMINISTRATIVE ISSUES

Foreign Parties Rendering Services in Canada

Section 105 of the Canadian Income Tax Regulations stipulates that "every person paying to a non-resident person a fee, commission or other amount in respect of services rendered in Canada, of any nature whatsoever, shall deduct or withhold 15% of such payment" and remit it to the Canada Revenue Agency (CRA). A payer may reduce or eliminate the withholding when the CRA issues either an income and expense waiver or a treaty-based waiver to the non-resident. Even with a waiver, the non-resident is still required to file a Canadian income tax return to report its Canadian-source income and expenses.

It is becoming increasingly common for organizations to staff projects based on a global skill set rather than looking only to the resources available in their home jurisdiction. The present withholding requirements, as set out in Regulation 105, are severe deterrents to allowing Canadian organizations to effectively compete for global resources. The burden resulting from compliance with the requirements is carried by the organization contracting for services in terms of withholding, tracking, reporting and remitting. This impairs Canadian businesses' ability to effectively procure the skills needed for them to effectively compete on a global basis. There is also an undue burden on the service provider in terms of additional reporting requirements and cash flow, and on the CRA in their administration of the program. Additionally, the requirement drives an unintended result in that many nonresident suppliers merely increase their prices to account for the withholding taxes levied under this regulation.

The OECD has recognized that the implementation of withholding taxes in situations where a permanent establishment does not exist can lead to excessive taxation.

The Canadian Chamber urges the federal government to eliminate Regulation 105.

Transfer Pricing

Transfer pricing has emerged as a major tax planning and compliance issue for multinational companies. Our members are concerned how the CRA is auditing in this area at present. We encourage the CRA to become more receptive to profit split methods of determining fair transfer prices, rather than always insisting that taxpayers find comparable arm's-length prices to justify transfer prices used – comparables that might not exist or that are difficult to determine. It is becoming too often the situation when either the CRA or the taxpayer attempt to claim comparable arm's-length price examples when the volumes in such examples do not justify this pricing method.

Compliance Issues for Crossborder Employers

The Canadian Chamber urges the federal government to look at ways to reduce the burden of compliance (withholding taxes; filing requirements) for non-resident employees when these employees are not taxable in Canada as a result of the application of Article XV of various tax treaties Canada has with other jurisdictions.

The current compliance burden is too onerous and we must find a way to reduce it while ensuring that Canada gets its fair share of tax on employment services performed in Canada.

CLOSING REMARKS

The Canadian Chamber strongly urges the federal government to consult further with Canadians once the Advisory Panel issues its final report. Our hope is that the Government will not "cherry pick" from the final report as there is much linkage between the various tax proposals relating to international taxation. For example, the treatment of interest deductibility should be addressed in an integrated manner with the treatment of low-taxed foreign income and the availability of incentives in the outbound taxation area. These policy choices should also be coordinated with the thin capitalization provisions in the context of investment inbound to Canada. Finally, policies regarding withholding tax are an important part of our international tax system that should not be addressed in isolation.

The Canadian Chamber of Commerce appreciates the opportunity to take part in this important debate. We look forward to reviewing the Advisory Panel's final report.

Sincerely,

Perrin Beatty