Certified General
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The Certified General Accountants Association of Canada's
Submission to the Advisory Panel on Canada's System of International Taxation

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Introduction

The Certified General Accountants Association of Canada (CGA-Canada) welcomes the consultative process being launched by the Advisory Panel on Canada's System of International Taxation, and is pleased to provide its views in the spirit of contributing to this important public policy debate.

CGA-Canada is a national professional accounting organization that represents 68,000 CGAs and students. The association sets standards, develops education programs, publishes professional materials, advocates on public policy issues, and represents CGAs nationally and internationally. CGA is the fastest-growing accounting designation in Canada. The CGA designation focuses on integrity, ethics and the highest education requirements. Recognized as the country's accounting financial leaders, CGAs provide strategic counsel, leadership and direction to all sectors of the Canadian economy. This year marks the 100th anniversary of the founding of the CGA designation in 1908.

The subject of taxation has always been of vital importance to CGA-Canada. Our association has put forward many tax-related recommendations to the Minister and House of Commons Standing Committee on Finance through our annual appearances and written submissions. CGA-Canada has called for redefining fair and competitive taxation, presented suggestions on how to ensure the consistent application of tax legislation, and supported major structural reforms to the tax system to improve Canada's productivity relative to its trading partners.

Moreover, CGA-Canada has recommended that the federal government appoint a panel of experts to undertake a fundamental review of the tax system – international and domestic frameworks – as well as how the system affects both businesses and individual taxpayers. Despite the fact that this Advisory Panel is working with a more focussed mandate that seeks *"to make recommendations to guide the government in establishing an international tax policy framework with respect to investment abroad by Canadian businesses as well as investment into Canada by foreign businesses,"* (see **www.apcsit-gcrcfi.ca**) CGA-Canada believes the present study represents a step forward, as the goals are laudable and its recommendations undoubtedly will be important to Canadians.

CGA-Canada's most recent contribution to the subject of taxation is in reference to the study on the structure of Canada's federal revenue-raising system being undertaken by the House of Commons Standing Committee on Finance. A central recommendation of that submission is tax simplification – that the government take immediate and necessary steps to simplify Canada's tax code – and CGA-Canada provided some guiding principles and specific suggestions to approaching this exercise (see **www.cga.org/canada**). We note the Panel's recognition that *"certainty and simplicity in tax legislation and its administration are important…Complexity should be avoided* *except, for example, where it is necessary to protect tax revenues."* For the purposes of this submission, CGA-Canada wishes to further build on our proposals to simplify the tax system while, at the same time, advance additional recommendations for the panel to consider in its deliberations to strengthen Canada's international tax advantage.

Therefore, CGA-Canada's recommendations concern the following areas:

1. Tax simplification
2. Lower corporate tax rates
3. Interest deductibility
4. Repatriation of foreign operations
5. Other (administrative issues, Immigration policies, small business tax benefits)

CGA-Canada believes that the adoption of these particular recommendations would create a more attractive investment climate, ease compliance requirements, facilitate better administration and contribute to an advancement of Canada's overall competitiveness both domestically and in the global marketplace.

Tax simplification

The *Income Tax Act* (ITA) evolved from a few pages of general principles in 1917 to the intricate and exhaustive system that comprises the Act today, with an inordinate array of special rules for a variety of circumstances and transactions that could not have been contemplated 90 years ago.

In fact, current circumstances dictate that taxation is headed in the direction of becoming even more – as opposed to less – complicated. For example, with Bill C-10 (*An Act to amend the Income Tax Act, including amendments in relation to foreign investment entities and non-resident trusts, and to provide for the bijural expression of the provisions of that Act)*, as introduced by federal Finance Minister Jim Flaherty in October 2007, the system may have reached the point of not just defying understanding and therefore compliance, but also beyond the scope of reasonable administration, particularly in its application to foreign investment entities and non-resident trusts (see section below).

The patchwork that is the ITA today has grown in complexity because it serves purposes beyond its original intent as a revenue raising instrument. It is now a political, social and economic instrument that must be responsive and fair, provide certainty as well as raise revenues for the government.

It is clear that the system cannot continue on its growth path the way it has for the last several decades and expect to be perceived as a credible and manageable system. Fundamental changes to the approach of delivering tax amendments to an already complicated system are imperative, and there is no better time than the present – during a period when the rates of tax, particularly at the corporate level, are coming down. While a re-write of the ITA may be desirable over the long-term, a strategic approach in several select areas may be more practical and workable over the short-term.

CGA-Canada believes there are three areas in particular that are ripe for reform – namely, corporate reorganization rules, debt forgiveness rules and the foreign investment entity rules and non-resident trust rules contained in Bill C-10. Furthermore, we believe that changes in these areas would enable corporate filers – both domestic and foreign owned – to organize their business affairs with ease and certainty, to better understand the consequences of certain actions as well as the anticipated administration, which will help foster an atmosphere of confidence where businesses can concentrate on what they do best – compete in the domestic and global marketplace.

Corporate reorganization rules. These rules are among the most complex rules in the ITA and contain levels of subjective testing that lead to uncertainty in compliance, which therefore necessitate a cumbersome and expensive advance rulings application process.

> Recommendation 1: CGA-Canada suggests a review of the existing corporate reorganization rules with all of the ancillary anti-avoidance measures, and proposes an objective test with timelines enabling assets to move within a corporate group without tax consequences, provided such assets are not sold outside the corporate group for a period of three to five years.
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> Any disposition of an asset that has moved within the corporate group prior to the termination of the mandatory holding period would give rise to taxation on disposition based on the gain or loss on disposition having regard to the cost of the asset immediately prior to the transfer in the context of the reorganization. For example, the sale of the asset would give rise to taxation in the normal course without regard to the transfer of the asset that may have mitigated any taxation results.

In terms of corporate competitiveness, this change would enable corporations to arrange their assets on a tax-free basis in the most appropriate manner to conduct their business affairs effectively and efficiently. Moreover, it would eliminate a number of compliance issues, provide certainty of application while alleviating difficult administrative matters, and simplify this area of the ITA considerably.

Debt forgiveness rules (Section 80 of the ITA). These rules were introduced during a period of economic downturn with a significant number of court ordered restructurings which by necessity required an element of fairness so as to mitigate any disruptions and avoid the imposition of inordinate amounts of income tax resulting from debt forgiveness at a time when taxpayers could least afford it. As a consequence, fairness was the motivating factor over simplicity, and a host of relieving complex changes were implemented allowing debtors to grind the tax cost of properties and pools of related companies rather than recognizing income. All of these adjustments distort the carrying values of assets and are cumbersome and difficult to manage. They distract from the business at hand.

The United States takes a far more simplistic approach to debt forgiveness and includes forgiven debt in income in the year of forgiveness. While the result may appear to be harsh in that the full amount of the debt is included in income, that is the trade-off for a less complicated application to dealing with what is in fact an income inclusion for tax purposes.

> Recommendation 2: CGA-Canada recommends a hybrid approach that combines fairness and simplicity. We recommend an income inclusion of forgiven debt in the year of forgiveness similar to the U.S. approach, but with a reserve mechanism that would allow for a spreading of the income over a 10-year period.

In this way, the total debt forgiven is accounted for in the year of forgiveness as income, but the tax consequences are spread out over a 10-year period. This simple approach would be well understood and easy to comply with as opposed to the current mechanism that requires a reduction in the cost base of related assets which could affect depreciation claims and is also difficult to track.

Foreign investment entities and non-resident trusts. These rules were first released as a draft for consultation in the federal budget of February 1999. The impetus for the announced changes at the time was as a result of critical comment by the Auditor General of the day, and was described as necessary to shore up the revenue base resulting from Canadians' investment and participation in "offshore" trusts and "offshore" investments.

These same rules have been re-released no less than four times since then and have been met with consistent criticism as being excessive, unnecessary, complex and beyond administration.

The most recent version of these rules is contained in Bill C-10 (*An Act to amend the Income Tax Act, including amendments in relation to foreign investment entities and non-resident trusts, and to provide for the bijural expression of the provisions of that Act),* as introduced by federal Finance Minister Jim Flaherty in October 2007. While Bill C-10 has been passed by the House of Commons, it has yet to receive Royal Assent as the Senate Standing Committee on Banking, Trade and Commerce has been reviewing this legislation since December 2007. In fact, some of the comments made by Senators and articles written in a number of tax journals, as well as witnesses appearing before this Senate Committee, have revealed the legislation to be incomprehensible and flawed in certain circumstances. For instance, the current provision in Bill C-10 as it affects non-resident trusts has potentially harmful effects applicable to a wide variety of "onshore" trusts or investment arrangements in Canada. One of these effects is the possibility that Canada will tax all of the income of a foreign trust which has no connection to Canada other than a resident of Canada who transferred any portion of the trust's assets to it. This could potentially turn a U.S. trust into a Canadian taxpayer and the U.S. may well assert taxing authority as well.

In addition to concerns raised about the possibility of casting a tax net far wider than anticipated, there is also the issue of necessity. Given that nine years have passed since the release of draft legislation in 1999 – which was originally designed to take effect in 2002 and subsequent tax years, and deemed necessary to shore up the revenue base because of perceived "offshore" abuses – it would appear logical to raise some questions about the necessity of these rules. In addition, corporate and personal tax rates in 1999 were significantly higher than they are today, which would imply less planning to avoid the tax net.

CGA-Canada is of the opinion that the rules pertaining to foreign investment entities and non-resident trusts would be ideally suited for review by the Advisory Panel on Canada's System of International Taxation for consideration within the context of their overall review.

> Recommendation 3: CGA-Canada would urge a review of these rules particularly since the environment for "offshore" investment has changed both with the foreign reporting rules as well as a significantly reduced level of taxation at the corporate level from what the levels were in 1999.

Lower corporate tax rates

In its consultation paper, the Advisory Panel acknowledges that a key element of the Government of Canada's long-term economic plan is to build a tax advantage for Canadian businesses. Moreover, the Advisory Panel contends that the domestic tax system is linked to the international system, and that changes to the domestic tax system can influence competitiveness both domestically and in the global marketplace. According to the Panel, *"one of the most significant domestic tax factors influencing the competitiveness of Canadian businesses is the corporate tax rate."*

CGA-Canada agrees. Canada's long awaited move to lower corporate tax rates, as announced by federal Finance Minister Jim Flaherty in the 2007 Economic Statement, is a step in the right direction in support of a competitive tax policy. We are pleased with the federal government's legislated tax rate reductions to 15 per cent by 2012. We would encourage the provinces to move on a downward and harmonized track – to achieve a uniform rate across the provinces at no more than 10 per cent, which would help eliminate cross-border interprovincial competitiveness issues and enhance compliance and administration.

As Canada enters a period of economic uncertainty – characterized by stymied economic growth, an inflated Canadian dollar, and increasingly high fuel and food prices – we must continue to hone Canada's competitive advantage. That means providing consideration to further tax reductions and, if circumstances permit, possibly on an accelerated scale. It also means anticipating global trends and benchmarking Canada's tax regime against international norms on a regular basis. Corporate taxes should be reduced to a level that takes into account the tax regimes of other jurisdictions which compete for the same investment dollars. Canada must keep pace with others to secure our competitiveness and enhance our corporate sector's ability to expand and prosper.

A survey released in June 2008 by the international consulting firm KPMG reveals that the recent corporate tax cuts have not increased Canada's attractiveness as a place for foreign firms to invest, and that foreign corporate investment into Canada is expected to remain unchanged across the longer term. Accordingly, the reason is simple: Canada's tax cuts have not gone far enough. Canada still remains at a rate of 33 or 34 per cent (depending on the province), the 15 per cent federal target does not come into effect until 2012, and some provinces have not moved to bring their rates down to the suggested 10 per cent target. Meanwhile, the 25 per cent target has been adopted by most other major countries.

In its June 2008 report, *Compete to Win*, the Competition Policy Review Panel recommends that the *"federal, provincial and territorial governments should continue to reduce corporate tax rates to create a competitive advantage for Canada, particularly relative to the United States."*

One only has to look to Ireland as an example of how lower corporate tax rates can influence prosperity and productivity. In an effort to improve Ireland's competitiveness in the international arena, the country overhauled its tax system by reducing corporate taxes to a level of 10 per cent with special incentives to attract capital. The result: Ireland's economy boomed. The new measures stimulated the relocation of enterprise to Ireland with the result of expanding educational facilities to meet the labour demand, and the standard of living in Ireland also increased substantially.

> Recommendation 4: CGA-Canada recommends that all levels of government work together in support of a competitive international tax policy where the combined corporate income tax rate is at a competitive low on a global scale.

Interest deductibility

Budget 2007 proposed *"that interest expense on indebtedness incurred to acquire the shares of a foreign affiliate no longer be deductible, unless and until the shares generate income that Canada actually taxes."*

In effect, these proposed changes on interest deductibility represented a major shift in longstanding tax policy affecting Canadian corporations with operations through subsidiaries abroad (Canadian multi-nationals).

While there may be a mismatch between income and expenses in the financing of foreign subsidiaries, such policy issues are not new and, in the case at hand, have been recognized for decades as contributing to the "Canadian advantage" in competing in the global marketplace. Moreover, the ability to finance foreign operations through debt raised in Canada and deductible interest payments in Canada with a second deduction of the interest payments at the cost of a foreign treasury has been sanctioned by the Canadian government for more than thirty years. Canadian corporations have used this interest expense measure consistently and openly with the knowledge and support of both the Department of Finance and the Canada Revenue Agency. If government perceives a mismatch of income and expenses, it could be targeted more specifically without undermining the competitiveness of Canadian firms.

The 2007 measure – which is now law but includes a transition period – will undercut corporate Canada's ability to compete globally by way of foreign investment. Because the Canadian economy is small, many Canadian corporations reach capacity and saturation in Canada quickly and must seek out both export markets and expansion potential in manufacturing and sales to remain competitive and protect against vulnerability to takeover.

The concern that Canadian companies making foreign acquisitions will be deprived or disadvantaged relative to their foreign counterparts making Canadian acquisitions – on account of these recent changes – is echoed in the June 2008 report of the Competition Policy Review Panel.

The fiscal impact numbers cited in the 2007 budget documents as a cost of the international tax package (a net cost of $60 M in its first year of application 2007-08) appear to minimize the impact of the measures and are well below the reported expectations of the actual impact. In addition, the restricted interest measure is a large price to pay for the benefits of the international tax package which includes withholding tax exemptions on arm's length and non-arm's length debt. While arm's length debt is welcomed since it gives Canadian corporations access to expanded capital markets south of the border, non-arm's length debt has raised questions in the professional journals as to its efficacy and necessity.

> Recommendation 5: CGA-Canada recommends that this policy initiative concerning interest deductibility, notwithstanding that it has been legislated, be referred to the Advisory Panel for review and consideration to determine whether it serves a rationale policy imperative, particularly as it impacts competitiveness.

In the alternative or as part of the Advisory Panel's deliberations, CGA-Canada would recommend that interest deductibility be reviewed more from the perspective of containment of foreign multi-nationals using Canada as a base for their foreign investment, without compromising the ability of Canadian global champions to succeed. If there is abuse of the system, we would submit that foreign multi-nationals using the Canadian tax base to support their foreign investments are better targeted for constraint with an absolute cost saving to the Canadian Government than eliminating a deduction outside of Canada's jurisdiction and at a cost to a foreign treasury.

To the extent that concerns exist about discrimination in tax policies that favour Canadian corporations at the expense of foreign corporations, CGA-Canada would recommend that consideration be given to a "domestic thin capitalization rule" – a rule that constrains the amount of money a corporation could borrow and have full deductibility of its interest expense. This approach would level the playing field and support the growth of the Canadian economy.

In essence, a borrowing limitation would work essentially as the system worked before the announced changes on interest deductibility, but would deny interest expense on non-Canadian investment except to the extent of a multiple of a corporation's capital employed in Canada. By way of example, if a corporation has $1 billion of capital employed in Canada it could borrow $3 billion to invest off-shore and the interest would be deductible in Canada. This treatment would not discriminate in favour of Canadian or foreign corporations, and would first and foremost serve to ensure a strategic and important level of investment and capital employed in Canada to support jobs and economic development in Canada. This ratio could apply across industrial sectors but should be flexible to accommodate financial institutions where their stock in trade is money.

Repatriation of foreign operations

With high corporate tax rates prevalent in Canada over the last 20 years or so, Canadian corporations have moved activities offshore to better take advantage of cheap labour rates and lower tax jurisdictions. As mentioned earlier, Canada's relatively small open economy lends itself to a situation whereby Canadian corporations reach capacity quickly and our "global champions" must take advantage of new market opportunities or expose themselves to takeover. Many foreign based corporations have subsidiary operations in Canada which are positioned to take advantage of niche market prospects or develop their potential in a particular sector of the Canadian economy.

The federal government's announced corporate tax rate reductions to 15 per cent by 2012, and an invitation to the provinces to apply a standard uniform rate of 10 per cent across the country, represents a great opportunity to put in place mechanisms to both encourage Canadian corporations to bring back or "repatriate" operations to Canada, and for foreign corporations to consolidate head office operations in Canada. In addition, it is noteworthy that under the Canadian tax regime in its application to taxable and exempt surplus, taxable surplus as a practical matter is rarely repatriated to Canada. Under the new legislated regime, exempt surplus is less likely to be repatriated as it will serve to finance other offshore investment activities. Corporations have over the years moved activities offshore to take advantage of lower foreign taxes in offshore jurisdictions in efforts to lower their overall cost of capital and remain competitive.

Given that Canada does not gain any tax revenue from operations offshore that are not considered to be investment earnings, an incentive to repatriate operations to Canada – for example, by granting a tax holiday until 2012 when lower corporate tax rates would begin to apply – may be a powerful incentive for Canadian corporations to repatriate activities as well as foreign corporations to relocate head office operations. In order to ensure that the repatriated or re-located functions are not temporary in order to take advantage of the tax holiday, mechanisms could be introduced to measure the benefits granted, and to track those activities for a minimum period of five years. Once the activities are in Canada, and as Canada continues to improve its corporate tax rate regime, those activities will have become part of the infrastructure of the Canadian operations and will serve to improve and expand overall Canadian activity. In considering this approach, government need only look to the precedent of International Banking Centers which was initiated to facilitate the repatriation of activities that were being conducted off-shore. Given that this topic is also in the international tax arena, we recommend that the Advisory Panel review its merits.

> Recommendation 6: The Advisory Panel on Canada's System of International Taxation should give particular attention to an assessment of tax incentives, with the objective of recommending ways to encourage Canadian multi-nationals to "repatriate" offshore activities, and foreign corporations to relocate head office operations in Canada.

On a final note, CGA-Canada recognizes that the introduction of new tax incentives could be questioned by some as adding another level of complexity to an already excessively complicated tax system. This brings us back to our starting point – there is no substitute for a simple, transparent and fair tax system with low, competitive tax rates. Undoubtedly, a tax regime with these fundamentals would encourage investment and send a strong signal to the global investment community that Canada is not just open for business, but it is the place to do business.

Other

In the Advisory Panel's consultation paper and listed in the category of "Other" under the heading of "Specific Areas for Review", it is noted that *"a simpler, more user-friendly system that is easy to administer and comply with and that provides the appropriate information about Canada's tax system is desirable."* CGA-Canada agrees and also contends that administrative issues, as well as immigration policies and small business tax benefits are important considerations in making a country a destination of choice for corporate investment.

Administrative issues. The Canada Revenue Agency (CRA) is to be commended for efforts taken to stay in tune with the pace of global technological changes, to provide new and enhanced outreach and information tools, as well as accommodate those whose language of common usage is not one of Canada's official languages. Nevertheless, there is always room for improvement.

A case in point is the Canada Revenue Agency's International Taxation Office in Ottawa. Tax practitioners have raised concerns about the length of time involved in assessments and the long delays experienced with processing certain requests at this particular CRA office in comparison to other CRA branches. For example, a relatively simple Section 216 return (alternatives re rents and timber royalties) can take up to a year to assess, although there are reports that some 2007 returns have been assessed more quickly this year. Obtaining Taxpayer Identification Numbers take far too long and the subsequent delay conflicts with the very strict procedures established by the CRA for reporting the sale of taxable Canadian property by non-residents. Similarly, it takes an inordinate amount of time to deal with and process such requests as T2062 forms (reduction of withholding taxes on the sale of taxable Canadian properties by a non-resident) – often three to four months or more – while the vendor's proceeds are withheld throughout this entire period of time.

> Recommendation 7: CGA-Canada recommends that the Canada Revenue Agency should develop clearly defined standards related to certain routine assessments, and be more responsive to the needs of business by fast-tracking processing and providing greater certainty regarding the length of time required to process requests.

Immigration policies. While Canada's immigration policies are not addressed in the Advisory Panel's consultation paper, these same policies have a direct bearing on foreign-based businesses and entrepreneurs looking to invest in Canada, and therefore merit consideration.

Some claim that the current immigration laws and tax laws as well as the interface between these policies may be acting as a deterrent to non-residents trying to establish businesses in Canada. The tax rules relating to immigration and emigration, partial year residency, deemed dispositions and related issues are onerous and create a great deal of confusion for non-residents relocating to Canada. In addition, the significant challenges in obtaining landed immigrant and/or Canadian residency status, coupled with all the bureaucratic red tape, causes more frustration and additional problems for many of those making business or tax decisions based on their immigration status. It is not difficult to see how these factors could discourage and possibly even act as a barrier to foreign investment.

> Recommendation 8: CGA-Canada recommends that the Government of Canada review the tax laws relating to immigration and emigration, and encourage a more collaborative working partnership between the relevant federal government departments (Citizenship and Immigration Canada (CIC), Finance Canada and the Canada Revenue Agency) to ensure seamless co-ordination in the administration of immigration and tax laws and ease the burden imposed on non-residents investing in this country.

Small business tax benefits. It is widely recognized that small and medium-sized enterprises (SMEs) are the backbone of the Canadian economy, the engine of economic growth on which our continued prosperity is vitally dependent. Despite this fact, Canada's tax system continues to deny small business tax benefits to non-resident corporations operating in Canada. For instance, only Canadian-controlled corporations can benefit from the small business deduction and other related benefits. Again, these rules discourage non-residents from setting up shop in Canada – that is, establishing and operating small business corporations.

To CGA-Canada, it does not make sense that non-residents are being discouraged from participating in the most vibrant pillar of the Canadian economy, our SME sector.

> Recommendation 9: CGA-Canada urges the International Tax Panel to review small business tax benefits with a view to recommending that the Government of Canada find ways to ensure that non-Canadian companies are not disadvantaged relative to their Canadian counterparts and thereby allowed to compete on an equal footing.

While it is acknowledged that the tax benefits associated with SMEs that are Canadian controlled private corporations (CCPCs) have limitations within a corporate group, CGA-Canada submits that, in order to attract capital investment to Canada, stimulate a competitive environment and generate jobs with the resulting benefits of growth and prosperity of the Canadian economy, access to tax benefits presently only available to CCPCs be extended to other corporations, whether foreign owned or listed public corporations, but with the same income and capital eligibility requirements for the ownership group.

Concluding remarks

CGA-Canada appreciates the opportunity to be part of this consultative process. We submit our recommendations as part of an effort to provide input on matters of importance to our members and to the broader Canadian economy.