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**International Business Taxation and the Competitiveness of Canadian Firms**

(Excerpt from a forthcoming Conference Board briefing on business tax reform)

## Introduction

A very specific and timely business tax issue that deserves public attention is the tax treatment of Canadian international business, and specifically interest payments on monies used by firms for foreign investments and acquisitions. The federal government proposed in the 2007 Budget that these interest payments would no longer be tax deductible. After much outcry from the business community, the government revised its position on May 14, limiting the proposal to "double dips" – situations where firms would be eligible for interest deductibility both in Canada and the foreign host country.

In addition, an independent advisory panel, led by Peter Godsoe, was created in November 2007 to review and make recommendations on Canada's system of international taxation. The government subsequently issued a discussion paper on technical aspects of international business taxation. The advisory panel is expected to report by December 1, 2008.

## Positioning Canadian firms in a global context

The key public policy question for the panel is whether our business tax system places Canadian firms at competitive disadvantage internationally, and whether we should be creating a tax playing field that is level, or even creates competitive advantages.

The Conference Board of Canada is not a centre of technical tax expertise, but we have developed and demonstrated considerable expertise in understanding the evolution of the global economy and of global business. Rather than addressing the more technical aspects of international business taxation that were identified in the government's discussion paper, we wish to offer the advisory panel some insights on the nature of international business today.

A growing body of evidence demonstrates that companies are accelerating their use of global and regional value chains in order to be able to compete globally. Instead of creating an entire product or service in one location, businesses now ask themselves where is the best place to locate each specific activity—such as design, engineering, manufacturing, marketing, and after-sales service. Companies can maximize efficiencies and reap gains from trade for every activity along a value chain, rather than for the goods (or services) as a whole.

Specific functions and activities that Canadian companies carry out in other countries to create products and services make them more efficient and better able to compete globally. China, India, and other large, lower-wage developing economies are now conducting activities that are part of global value chains, tightly integrated with activities in the United States and other richer economies. These changes have important consequences for Canadian living standards, public policies, and business strategies, as competition for each part of the process to make a product or deliver a service intensifies at a dramatic pace.

In addition, a large and growing share of international business takes place through foreign affiliates, rather than through traditional cross-border channels of trade. Though not a new phenomenon, the use of foreign affiliates has accelerated rapidly in recent years and has become a critical part of global sales revenues for Canadian businesses. Canadian insurance companies, for example, set up branches abroad and sell to clients in other countries through those branches, but they do their risk analysis through computing systems and expertise in Canada. This is an example of how foreign direct investment abroad is a key enabler of global business success and of trade; it has replaced the old notion that outward investment is supplanting trade and jobs in Canada. The Organisation for Economic Co-operation and Development (OECD) estimates that each dollar of outward direct investment generates two dollars of additional exports for the originating country.[1]

In concrete terms, FDI has grown dramatically around the world over the past 20 years, significantly outpacing growth in trade and in gross domestic product (GDP). Canada has been part of this trend. Canada's stock of outward FDI grew from $98 billion in 1990 to $523 billion in 2006, and Canada became a net outward investor over a decade ago, in 1997. Our international investment flows are also more diversified than our trade flows. The U.S. share of Canadian outward foreign investment is only around 40 percent, compared to 80 per cent of our exports going to the U.S.

These investments abroad have allowed Canadian firms to develop a significant new source of revenues, namely sales from foreign affiliates. Foreign affiliate sales have grown to nearly $400 billion annually and are an important source of revenue diversification for Canadian businesses, notably in services sectors where service providers must get close to customers in other countries. The creation of foreign affiliates via outward foreign direct investment allows this to happen.

Nevertheless, despite these gains, Canada's share of outward global FDI has slipped relative to OECD countries such as France, Germany, the U.K., Sweden, and Australia. Canadian firms continue to face real competitive challenges as they seek to expand their market presence globally.

**The Conference Board of Canada's Advice**

Canadian businesses need at least a level playing field for investment abroad if they are to take full advantage of global value chains and foreign affiliates and grow their business

[1] Fontagne, "Foreign Direct Investment and International Trade: Complements or Substitutes," Working paper 1999/3. Directorate for Science, Technology and Industry. Paris: OECD, October 1999, p. 22.

revenues based on outward foreign investment activity. This concept should be at the centre of the advisory panel's deliberations.

On that score, the elimination of interest deductibility on offshore investment adds a new barrier to international business growth and risks placing specific Canadian firms at a competitive disadvantage at a time when Canada's share of the global foreign direct investment market is slipping.

Earlier analysis by recognized tax experts stated that "it is difficult to understand why a Canadian tax deduction should be denied because a deduction is allowed in a foreign country. The foreign country deduction has no impact on Canadian tax revenues, and is arguably of benefit to the Canadian tax system, since it increases the amount of after-tax income available to be returned to Canada."[2] We agree with the logic of this analysis. Given the importance of outward foreign investment as a means of expanding the global engagement of Canadian firms, it is our view that this is not the time to remove interest deductibility, even if the removal is applied more narrowly to "double dips".

We would further advise the panel to adopt a similar attitude toward other possible technical changes to our system of international business taxation. The key guiding principle should be a desire to ensure that Canadian firms are able to compete on a tax playing field that is at least level -- or even one that creates competitive advantages.

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[2] Deloitte "Tax Breaks", Special Edition, May 14, 2007.