Enhancing Canada's International Tax Advantage

Deloitte's comments on the Consultation Paper issued by the Advisory Panel on Canada's System of International Taxation

July 14, 2008

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Mr. Peter C. Godsoe, OC
Chair
c/o
Advisory Panel on Canada's System of International Taxation Submission
Attn.: David Messier
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Ottawa ON K1A 0G5

Dear Mr. Godsoe:

We are pleased to provide our comments on *Enhancing Canada's International Tax Advantage*, the Consultation Paper issued by the Advisory Panel on Canada's System of International Taxation, dated April 2008. We would welcome the opportunity to discuss our comments, which are included in the attached report, with the Advisory Panel.

We believe this review of Canada's international tax policies is timely, in light of the ever increasing levels of global trade and investment.

We agree with the Advisory Panel's observations that it is important that Canada's system of international taxation continues to promote the competitiveness of Canadian business internationally and to attract new foreign investment to Canada. At the same time, we recognize that our tax policies must achieve the correct balance of supporting a competitive business environment while ensuring the tax base is protected.

In preparing our comments, we canvassed our international tax practitioners for their views based on their extensive experience in advising both Canadian businesses operating internationally and foreign businesses with Canadian operations. We also reviewed the publicly available tax information for approximately 70 Canadian public companies identified in the Institute for Competitiveness and Prosperity report as Canada's global leaders.[1] Finally, we reviewed recent developments in international taxation in a number of countries, many of which have either reviewed or are in the process of reviewing their policies.

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[1] Institute for Competitiveness and Prosperity, *Setting our Sights on Canada's 2020 Prosperity Agency* (Toronto: Institute for Competitiveness and Prosperity, 2008) (available at http://www.competeprosper.ca/download.php?file=ICAP_RoC2008_Final.pdf).

Canada's international tax system has a critical role to play in supporting Canadian companies that expand internationally. We believe that Canada's current system of taxing Canadian multinationals modified by the recommendations in our submission will meet the international tax priorities set out in the Competition Policy Review Panel's final report, *Compete to Win.*[2] As noted in the Competition Policy Review Panel's consultation document, *Sharpening Canada's Competitive Edge*,[3] with our small domestic market, Canada must look outward. The Competition Panel also noted the importance in the Canadian economic context of facilitating the participation of small- and medium-sized enterprises in global commerce.

In our experience, Canadian companies are forced into the international arena earlier in their life cycle than many foreign competitors based in countries with larger domestic markets. As a result, they face greater operational and tax risks and costs than these competitors. In addition to the operational challenges of expanding into foreign markets, these companies face a number of tax challenges and costs that are not faced by companies that only operate domestically. They are required to incur substantial costs in order to comply with foreign tax laws and extensive transfer pricing documentation requirements. In addition, they face the risk of incurring losses in foreign jurisdictions without the ability to obtain current tax benefits for such losses. They often also face additional complications and tax costs as a result of foreign currency fluctuations.

In reviewing the information for Canada's global leaders, we observed a number of these companies have been able to benefit from reduced tax rates attributable to foreign operations in order to develop as internationally competitive companies. However, we also observed that a number have suffered higher tax costs because they are unable to obtain any benefit from foreign losses; because of the tax costs associated with foreign exchange fluctuations; and other factors. In addition, we noted that a number of companies have prepaid taxes as a result of realizing profits in one jurisdiction (and paying tax on these profits) and incurring losses in another jurisdiction (without gaining immediate benefit for these losses).[4] We believe it is important for the Advisory Panel to consider not only the benefits of Canada's international tax system but to also recognize the challenges faced by Canadian companies operating internationally.

We note that a number of countries have policies that support companies based in their jurisdiction by providing favourable tax treatment on foreign earnings. For example, the current U.S. tax system allows U.S. based companies to "cross-credit" foreign taxes paid on foreign operating earnings to offset U.S. tax that would otherwise be payable on foreign royalties. A recent report by the U.S. Department of the

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[2] Canada, Competition Policy Review Panel, *Compete to Win: Final Report* (Ottawa: Industry Canada, June 2008) (available at
http://www.ic.gc.ca/epic/site/cprp-gepmc.nsf/vwapj/Compete_to_Win.pdf/$FILE/Compete_to_Win.pdf), 65-66.
[3] Competition Policy Review Panel, *Sharpening Canada's Competitive Edge* (Ottawa: Industry Canada, October 30, 2007) (available at http://www.ic.gc.ca/epic/site/cprp-gepmc.nsf/vwapj/sharpening_e.pdf/$FILE/sharpening_e.pdf).
[4] For example, one Canadian-based multinational on the list had tax assets before valuation allowance that represented over 80% of shareholders' equity and tax assets net of valuation allowance of approximately 30% of shareholder's equity.

Treasury noted that approximately two-thirds of foreign source royalties are essentially exempt from U.S. tax because of cross-crediting with high taxed dividends.[5] Policies like these allow U.S. based companies to achieve reduced effective tax rates on their foreign earnings. In making its recommendations, the Advisory Panel needs to recognize that Canadian based companies must compete with foreign companies which are often based in jurisdictions that allow them to reduce their tax burden on international operations.

We agree with the Advisory Panel's observations that Canada's international tax system has served the country well and that changes should be made only in areas where significant improvements will be achieved. We believe that in order to keep pace with a rapidly expanding global economy, a limited number of targeted changes to our tax system are warranted. We also believe that changes can and need to be made to reduce the administrative burden on both Canadian companies that operate internationally and on foreign companies with Canadian operations.

We note that the Advisory Panel is committed to report by December 1, 2008. We expect that a number of the Advisory Panel's recommendations may have a significant impact on some taxpayers or may involve significant implementation issues. We recommend that in formulating its recommendations, the Advisory Panel provide for a reasonable transition period for significant changes. In addition, we strongly recommend that the Advisory Panel's mandate be continued after December 1, 2008, so that it can receive comments on the recommendations and, if warranted, make modifications before they are finalized for consideration by the Minister of Finance.

If you would like to arrange a meeting to discuss our comments, please contact me at (416) 601-6227 or by emailing adunn@deloitte.ca, or Gord Williamson at (416) 643-8285 or by emailing gowilliamson@deloitte.ca.

Yours very truly,

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[5] United States, Department of the Treasury Office of Tax Policy, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century* (Washington, DC: Treasury Department, December 20, 2007) (available at http://www.treas.gov/press/releases/reports/hp749_approachesstudy.pdf), 61.

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Taxation of outbound direct investment

Canada's system for taxing foreign income has generally served us well, and we do not believe that any radical changes are needed. However, it is our view that a few targeted modifications should be made.

Extension of exemption system

The current exemption system should be made broader to exempt dividends paid from the active business income of all foreign affiliates regardless of the jurisdiction in which they are resident or carry on business. We would not restrict exempt surplus treatment to businesses carried on in countries with which Canada has signed a tax treaty, as is currently the case, or countries with which Canada has signed a tax information exchange agreement (TIEA), as proposed in the 2007 budget.

There are several reasons why Canada should consider a more broad-based exemption system. First, a broader exemption system would be more consistent with current rules or initiatives in most countries. Canada is the only country that predicates eligibility for exemption on a tax treaty or TIEA. Most European countries have a broad-based exemption system, and the United States, the United Kingdom and Japan are all currently contemplating the replacement of their respective deferral-with-credit regimes with an exemption system for foreign affiliates' active business income. Similarly, New Zealand is undergoing tax reform designed to embrace an exemption-based regime and abandon its current accrual system. As more countries move away from an accrual or deferral-with-credit regime, and towards a territorial or exemption-based one, there will be increased pressure on Canada to ensure that its taxation regime remains competitive with that of other countries.

Second, basing the exemption on the existence of a tax treaty was originally an inducement for other countries to enter into treaties with Canada. However, Canada now has a well-established network of tax treaties and this inducement is no longer necessary. While the extension of the exemption to TIEA countries may induce a few countries to enter into such agreements, we do not believe there is any policy reason related to the principles underlying the exemption system for restricting the exemption to the existence of a tax treaty or a TIEA.

Third, the tax treaty requirement, while requiring a foreign affiliate to be subject to tax in a treaty country, has never required the foreign earnings to bear a level of tax similar to the Canadian tax rate. Many foreign affiliates, resident in treaty jurisdictions, are technically subject to tax but pay little to no tax given special tax regimes and tax holidays. Therefore, there is no significant difference from a policy perspective in extending exempt surplus treatment to active business income earned in non-treaty countries, whether or not such countries impose an income tax.

Fourth, the empirical evidence provided in the Consultation Paper suggests that only a small portion of dividends received by Canadian multinationals from their foreign affiliates (e.g., $1.288 billion out of $14.06 billion in 2005) is paid out of taxable surplus. It is unclear what portion of this taxable surplus was derived from active business earnings in non-treaty countries (as opposed to FAPI or taxable capital gains from dispositions of foreign affiliates or partnership interests). Accordingly, the expansion of exempt earnings to include all earnings from active businesses is unlikely to have a significant detrimental impact on the Canadian revenue base. In the discussion paper[1] released by the United Kingdom last year it was stated that very little revenue is obtained as a result of their credit system.

Finally, a broader exemption would reduce taxpayers' compliance requirements and simplify the rules generally (although the concept of taxable surplus would need to be maintained unless other changes to the system were made, as discussed below).

We do not believe that taxpayers should be penalized for carrying on business in countries where Canada has no tax treaty or TIEA. The 2007 budget measure that will tax income earned in a country

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[1] United Kingdom, HM Treasury and HM Revenue & Customs, *Taxation of companies' foreign profits: discussion document* (London: HM Treasury, June 2007) (available on the web at http://www.hm-treasury.gov.uk./media/E/9/consult_foreign_profits020707.pdf).

which has declined to enter into a TIEA with Canada as foreign accrual property income (FAPI) should be repealed. In very few cases will taxpayers be in a position to induce other countries to enter into such agreements with Canada, and there is no policy reason to treat such taxpayers differently than those carrying on active business operations in other countries.

Recommendation

Adopt a broader exemption system that will exempt from Canadian tax dividends paid from the active business income of foreign affiliates wherever such income is earned and wherever the affiliates are resident. As under the current system, the onus will be on the taxpayer to prove that the relevant income is in fact active business income. Repeal the proposals with respect to TIEAs.

Definition of foreign affiliate

The Consultation Paper asks whether the current threshold for foreign affiliate status should be reconsidered if the exemption system is broadened. In our view, the extension of exempt surplus treatment to active business earnings from non-treaty countries is not a radical change and would not justify tightening the definition of foreign affiliate to add new requirements such as fair market value or voting rights thresholds.

The current test is simple to understand and administer, unlike a test based on fair market value. In many cases involving minority investors, a significant investment can exist in the absence of voting shares.

In the case of abusive transactions, subsection 95(6) of the Income Tax Act[2] or the general anti-avoidance rule (GAAR) can be invoked. In certain cases the recently expanded definition of controlled foreign affiliate will discourage abusive tax planning.

Recommendation

We do not recommend any changes to the definition of foreign affiliate.

Capital gains on sale of shares of a foreign affiliate

Several considerations appear to support the broadening of the exemption system by eliminating Canadian capital gains tax on the disposition of shares of foreign affiliates, both at the first-tier affiliate level and in respect of lower-tier affiliates.

First, elimination of the tax would foster the international competitiveness of Canada's system of taxing foreign investment. The taxation regimes in several other countries currently exempt from tax gains realized on the sale of shares of foreign affiliates.

Second, an exemption from capital gains tax has theoretical appeal because the capital appreciation in a share is presumably derived from the affiliate's earnings and the present value of the share's future earnings stream. A foreign affiliate's earnings are generally exempt from tax under Canada's foreign affiliate system.

Third, an exemption would recognize the practical reality that taxpayers already plan around the capital gains tax by implementing transactions to defer gain recognition indefinitely.

Despite the foregoing arguments, we do not support a capital gains exemption for foreign affiliate shares at this time. Unless parallel treatment were given to capital gains realized on shares of Canadian corporations, an exemption would unduly violate capital export neutrality by creating an incentive to establish operations and invest abroad rather than in Canada. While it is our view that the investments in foreign affiliates are largely driven by business rather than tax considerations, this unequal treatment could not be justified.

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[2] RSC 1985, c.1 (5th Supp.), as amended. Unless otherwise stated, all statutory references are to the Income Tax Act.

Recommendation

We do not recommend the complete exemption from tax of capital gains realized on the disposition of shares of foreign affiliates. In our view, such exemption would create an unacceptably strong bias in favour of offshore investment vis-à-vis Canadian investment.

Simplification of surplus rules

If capital gains on the sale of foreign affiliates are to remain subject to tax, it is necessary to continue tracking exempt and taxable surplus, since the taxable half of capital gains must be segregated from exempt surplus, and surplus must be determined in order to reduce capital gains pursuant to section 93. This is unfortunate considering the increasing complexity of the rules for calculating surplus and for determining the maximum amount of surplus available for section 93 elections.

In our view, the current proposals that provide for the suspension of surplus created on intercompany transactions and the consolidation of surplus for section 93 elections are excessively complex. The draft rules have been outstanding in some form for more than five years. It is understood that substantial changes to the rules are planned to address numerous concerns but it is unclear when taxpayers will see new draft legislation. Based on comments from the Department of Finance, it appears that the new rules will be even more complex, requiring several new surplus accounts. It is difficult to imagine how taxpayers will be able to comply with these rules and how the Canada Revenue Agency (CRA) will be able to administer them.

The proposed rules are an extreme reaction to the perception that taxpayers have been improperly accelerating the creation of exempt surplus. In our view, such transactions should be addressed through targeted anti-avoidance rules, subsection 95(6) (as discussed in the recent Income Tax Technical News[3]) or the GAAR (as proposed in a case to be heard shortly by the Tax Court of Canada). Given the relatively modest level of tax at stake, this approach is preferable to dozens of pages of legislation and vastly increased compliance requirements.

Recommendation

Abandon the proposed surplus suspension rules in favour of targeted anti-avoidance rules or the application of subsection 95(6) or the GAAR. Maintain the existing rules for determining the maximum amount of surplus available for a section 93 election.

Taxation of foreign branch income

We question the policy rationale for taxing the active business income of foreign branches on an accrual basis while exempting active business income earned by foreign affiliates. The current accrual basis taxation of branches is one of the main reasons why few Canadian companies carry on foreign businesses in branch form, regardless of business considerations. We recommend that the active business income earned in a foreign branch be exempt from tax on an elective basis, similar to the treatment of active business income of foreign affiliates. When the election has been made, losses of the branch would not be deductible against other Canadian income. The election would not be revocable. New rules would be required to tax the FAPI of the branch where the election is made.

Currently there is no rollover when branch assets are transferred to a foreign affiliate. When an election is made there should be no tax on the disposition of branch assets to a foreign affiliate (other than assets that do not qualify as excluded property). If an election is not made, the current rules should continue to apply. That is, there should be a disposition at fair market value if branch assets are transferred to a foreign affiliate.

Recommendation

Introduce an elective exemption for the active business income of foreign branches of Canadian companies, supported by an extension of the FAPI rules to branch income.

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[3] Canada Revenue Agency, *Income Tax Technical News* No. 36 (Ottawa: Canada Revenue Agency, July 27, 2007) (available at http://www.cra-arc.gc.ca/E/pub/tp/itnews-36/itnews-36-e.pdf).

Exemption for direct foreign source interest and royalty income

Several factors support the exemption from Canadian tax of interest and royalties received by a taxpayer from foreign affiliates that deduct the payments in computing their active business income. The deeming rule in paragraph 95(2)(a) already allows interest and royalties paid to a foreign affiliate to be included in exempt surplus of the affiliate and paid to the taxpayer as dividends which are exempt from tax. An exemption from Canadian tax on such payments would simply eliminate the need for an intermediary foreign affiliate and the potential need to pay foreign tax on the income in the country where the intermediary is resident.

The ability to cross-credit low-taxed royalty income with high-taxed dividend income currently allows U.S. taxpayers to pay no tax on approximately two-thirds of foreign royalty income.[4] Many European taxpayers pay little or no tax on such income in their country of residence by allocating the loan or intellectual property to a foreign branch. In many cases, little or no tax is paid on the income in the country where the branch is located.

That being said, an exemption for foreign interest and royalty income would be inconsistent with international norms. Hong Kong, for example, is one of the few countries that provide a blanket exemption for all foreign income but it does not allow the deduction of any expenses related to the earning of the income. Given the ability of Canadian companies to use the paragraph 95(2)(a) deeming rule to recharacterize such income as active business earnings, the potential for a challenge at the World Trade Organization and the inconsistent treatment that would be required relative to Canadian-source interest or royalty income, we do not recommend extending the exemption system to direct foreign source interest and royalty income at this time.

If rules restricting the deductibility of interest relating to foreign investments were introduced, it would be worth considering a rule that could "free up" interest deductions to the extent a Canadian company receives such interest and royalty income.

Recommendation

Do not extend the exemption system to interest or royalty income received by Canadian taxpayers from foreign affiliates.

Paragraph 95(2)(a) deeming rule

Paragraph 95(2)(a) has long provided a key competitive advantage for Canadian companies investing outside of Canada. It allows Canadian companies to reduce the foreign tax paid on foreign earnings by allowing a foreign affiliate to deduct interest and other payments against active business earnings in a high-tax country without requiring the income to be FAPI when received by an affiliate in a low-tax country.

Not all countries have a provision similar to our deeming rule. In many countries, the income earned in the low-taxed affiliate would be picked up under the equivalent of our FAPI rules. Canada may have been ahead of its time. The United States, for example, allows similar planning through its check-the-box rules, and has introduced a temporary exemption from its subpart F rules (which may be extended) that applies in similar circumstances. The United Kingdom proposed an interaffiliate treasury exception to its proposed controlled corporation rules in the discussion document issued last year, albeit one that appears to be narrower than our deeming rule. As a result of significant concerns expressed by business, the United Kingdom is expected to defer introduction of the rules while it consults with multinationals to develop less restrictive rules that would promote the United Kingdom as a competitive country for company headquarters. Canada would be unwise to abandon a rule which provides a competitive advantage to Canadian companies at a time when other countries are either following our lead or considering alternative proposals to support their multinationals.

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[4] United States, Department of the Treasury Office of Tax Policy, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century* (Washington, DC: Treasury Department, December 20, 2007) (available at http://www.treas.gov/press/releases/reports/hp749_approachesstudy.pdf), 61.

The 2007 budget contained rules which restrict the ability to access the deeming rule. The deeming rule will no longer be applicable in respect of payments between affiliates unless, in general, the taxpayer has a qualifying interest in the payer and the recipient. In our view, no additional restrictions are warranted.

Recommendation

Maintain the paragraph 95(2)(a) deeming rule.

Improvements to FAPI rules

In general, the FAPI rules work well and should be maintained. However, there are two issues that should be addressed.

Many businesses, such as real estate development, leasing and management, are carried on in multiple corporate entities for non-tax reasons. As has been described in numerous tax publications, the FAPI rules do not work well in such circumstances. The income of an affiliate will be classified as income from an investment business if the particular affiliate does not employ more than five employees in the active conduct of the business, including employees provided by certain related entities. An affiliate owning a single building, for example, is rarely able to satisfy this test. There is no ability to consolidate the activities of other foreign affiliates of the taxpayer who carry on similar businesses or support functions, such as management, for purposes of determining if the consolidated business meets the employee test. In certain cases the deeming rule in subparagraph 95(2)(a)(i) may apply. However, there are interpretive issues associated with that rule which make its application uncertain in many circumstances.

In addition, activities necessary to carry on the business of an affiliate are often provided by independent contractors rather than employees of the affiliate or related parties (for example, security or janitorial services may be contracted out). The greater-than-five employee test was introduced as a proxy for determining the degree of activity required to carry on a particular business and thus differentiate between active business income and income from property. There is no policy reason for limiting the test to the activities of individuals who are employees of the affiliate or certain related parties rather than independent contractors. The same level of business activity is required in either case.

One additional change to the FAPI provisions could facilitate better supply chain management. Currently, paragraph 95(2)(a.1) provides that income of an affiliate that purchases goods for resale to its Canadian parent company will generally be FAPI unless the affiliate purchases goods that were manufactured or produced in the country where the affiliate is resident. This provision is unduly restrictive and may prevent Canadian companies from establishing the most efficient structures for sourcing products from a business perspective and minimizing tax paid in the source country. It puts Canadian companies at a competitive disadvantage compared to foreign multinationals sourcing goods for their Canadian subsidiaries.

Recommendations

Undertake a review of the investment business rules with a view to applying the greater-than-five employee test on a consolidated basis for foreign affiliates of the taxpayer carrying on related activities.

Extend the greater-than-five employee test to apply to services provided by greater than five individuals. There is no need to limit the individuals who perform the services to employees of the affiliate or of related entities.

Amend paragraph 95(2)(a.1) to allow purchasing affiliates to be established in a country other than the country where goods are produced.

Excluded property test

We recommend an improvement to the current rules for determining the excluded property status of shares of a foreign affiliate. The current definition of excluded property requires a taxpayer to determine the excluded property status of a higher-tier company in a chain of foreign affiliates by determining the status of lower-tier companies and working up. If a lower-tier affiliate has excess investment assets (generally more than 10% of total assets, including, for example, intercompany balances that arise and grow over time due to the manner in which treasury activities are managed) the entire fair market value of the shares of the lower-tier affiliate will be considered a tainted asset for determining the excluded property status of the affiliate that owns its shares. This process is repeated up the chain of affiliates, and can cause a top-tier affiliate to fail the excluded property test even if the amount of investment assets held by the affiliate and lower-tier affiliates is not excessive when viewed on a consolidated basis.

Recommendation

Maintain the existing definition of excluded property with an election to determine excluded property status using consolidated financial statements.

Foreign investment entity and non-resident trust rules (FIE/NRT)

The FIE/NRT rules, which have been pending since 1999 and have gone through many iterations and proposed effective dates, have been passed by the House of Commons, but not yet by the Senate. Witnesses at the Senate hearings on these rules have outlined many problems with this legislation. Since 1999, many tax community organizations, including the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants, the Tax Executives Institute and the Society of Trust and Estate Practitioners, have articulated significant concerns.

The Department of Finance has responded to these concerns, in part, by addressing particular aspects of these rules; however, there appears to be consensus in the tax community that the entire approach to this legislation should be reconsidered. The rules are overly complex and will create an undue compliance burden on taxpayers. In many cases, the information needed by taxpayers will simply be unavailable. As a result of the complex nature and broad language of this legislation, many taxpayers may be subject to these rules despite it being clear, from a policy perspective, that such a result is unintended.

We believe the government should identify and draft anti-avoidance rules to target the specific areas of concern to the CRA and the Department of Finance in regard to the "parking" of investment assets in offshore entities. In our view, the existing legislation could be used as a starting point and modified accordingly to address the areas of concern without introducing entire taxing regimes. A "starting from scratch" approach will better align the legislation and tax policy, while reducing compliance cost and simplifying the legislation. Furthermore, it will give taxpayers greater certainty regarding the application and interpretation of the legislation.

Recommendation

Draft anti-avoidance rules to target the specific areas of concern to the CRA and the Department of Finance in place of the introduction of the proposed FIE and NRT legislation.

Subsection 18.2 anti-double dip rules

Section 18.2 will apply beginning in 2012 to deny the deduction of interest expense and other borrowing costs related to investments in foreign affiliates if the borrowing can be traced, in general terms, to an interaffiliate loan the income from which is recharacterized as active business income under the paragraph 95(2)(a) deeming rule. Interest deductibility on single dips, in which a taxpayer borrows to buy a foreign affiliate or make an equity investment in a foreign affiliate or a loan to a foreign affiliate, will continue to be allowed.

We do not believe that section 18.2 represents good tax policy for Canada. We believe that these rules will harm the international competitiveness of Canadian companies and should be repealed as invited by the Competition Panel's recommendation.[5]

Whether international tax arbitrage is wrong, and, if so, whether governments can realistically stop it, are issues of great debate among international tax academics and commentators.[6] It is certainly worth debating why, on a policy basis, Canada should deny a tax deduction to a Canadian taxpayer solely because a deduction is allowed in a foreign country in accordance with that country's own tax rules (and not deny the Canadian deduction if the investment is financed through equity and no foreign tax reduction is obtained). The foreign country deduction has no impact on Canadian tax revenues and is of benefit to Canadian shareholders and the Canadian economy because it increases the amount of after-tax income available to be returned to Canada.

David Dodge, the former Deputy Minister of Finance, defended outbound financing structures in his testimony before the Public Accounts Committee in 1992:

> Provided that the basic structure of the transaction is indeed a structure that fits within our law, even though it minimizes the taxes paid abroad – not the taxes paid here but the taxes paid abroad – then it would not make sense to impose on our companies the necessity to pay more taxes abroad than their competitors.[7]

Opportunities to double dip interest expense are inevitable because different countries view the same legal entities and contractual arrangements differently based on their own commercial and tax laws. While anti-double dip or anti-arbitrage rules do exist in certain other countries, such rules are not yet pervasive and do not tend to be broadly applicable. As a result, many, if not most, foreign multinationals located in other countries use double dip structures to invest into Canada and other countries. In our experience, for example, most large U.S. multinationals have financed significant investments in Canadian subsidiaries through some form of double dip structure.

Theoretically, double dip financing structures may serve no redeeming purpose — they can result in a negative cost of capital and extremely low marginal effective tax rates, thereby distorting economic decision making (which should be made on a pre-tax basis) and resulting in economic inefficiency. However, while the theoretical value of double dip transactions may be questioned, the policy issue in Canada is whether Canadian companies should be allowed to compete on an equal footing in a world where such tax planning is prevalent. Why should a Canadian company be unable to finance a foreign acquisition using a double dip structure when a foreign acquirer is able to use one to finance a Canadian acquisition? Since many countries permit double dips in one manner or another it would be imprudent for Canada to deny Canadian companies access to them.

Recommendation

Repeal section 18.2.

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[5] Canada, Competition Policy Review Panel, *Compete to Win: Final Report* (Ottawa: Industry Canada, June 2008) (available at http://www.ic.gc.ca/epic/site/cprp-gepmc.nsf/vwapj/Compete_to_Win.pdf/$FILE/Compete_to_Win.pdf), recommendation 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."

[6] See, for example, Ralph Cunningham, Claire Jones and Tom Young, "Keeping Clear of the Rules" (2006), *International Tax Review*, October 2006, 10-15; Tim Edgar, "Corporate Income Tax Coordination as a Response to International Tax Competition and International Tax Arbitrage" (2003), vol. 51, no. 3 *Canadian Tax Journal* 1079-1158 and Gregory May, "Getting Realistic About International Tax Arbitrage" (2007) vol. 85, no. 3, *Taxes: The Tax Magazine* 37 and the numerous articles and papers cited therein.

[7] Canada, *Minutes of Proceedings and Evidence of the Standing Committee on Public Accounts*, 34th Parliament, 3d sess., 1991-92-93, issue no. 38, December 10, 1992.

Other restrictions on interest deductibility

In addition to recommending the repeal of 18.2, regarding whether Canada needs a comprehensive interest deductibility rule at this time,[8] we recommend caution until the matter has been studied further and the potential consequences of such a rule are better understood. Only then will Canada be in a position to evaluate whether a comprehensive interest deductibility rule would be sound tax policy for Canada.

We recognize that some Canadian-based companies leverage their Canadian operations (excluding investments in foreign affiliates) beyond their global debt/equity ratios, thereby reducing the tax burden on their Canadian-source income. In many cases, these companies may also be deducting interest expense in respect of the same external borrowing in their foreign affiliates as a result of double dip structures currently accommodated by the tax system. We appreciate that it can be argued that this erosion of the domestic tax base is inappropriate in policy terms and that a comprehensive interest deductibility rule would serve to regulate that activity. As well, we agree that such a rule has many attractive design features, including equal treatment of investors regardless of ownership and the use of an enterprise's global leverage ratio as a proxy for an arm's length capital structure. However, the case has not yet been made that such fundamental reform is smart policy for Canada at this time. We base this conclusion on several observations.

First and foremost, Canadian companies compete against enterprises based in countries whose international tax systems accommodate double dips and contain other mechanisms that facilitate lower effective tax rates on foreign earnings.[9] Although some countries have introduced a comprehensive interest deductibility rule (e.g., Australia, Germany), it is not yet a widespread development. If more countries shifted their tax systems to this type of rule, and if the United States tightened its international tax system, Canada might then consider similar changes. In the meantime, there is little to be gained by moving early.

Second, insofar as the current interest deductibility regime in Canada may represent some "looseness" in Canada's international tax rules, it is quite possible that the benefits of this "tax expenditure" exceed the costs. Canada is producing an increasing number of global leaders,[10] which is a cause for celebration. We should strive for even more global leaders, as they produce a wide range of higher value-added jobs – headquarter jobs in management, legal, human resources, finance, science and engineering, consulting, banking and capital markets.

Third, Canada's small domestic market means that Canadian-based businesses usually become multinational enterprises as smaller organizations than their competitors based in countries with larger domestic markets. This size and scale disadvantage means that Canada's up-and-coming global leaders are less able to absorb and manage the risks of doing business internationally. Therefore, it is important that Canada's system of international tax rules be at least as competitive as those of other countries in which competitor organizations are based.

Fourth, we do not observe evidence that outbound foreign direct investment (FDI) is displacing domestic investment. If Canada's outbound international tax rules were so generous as to be displacing domestic investment, we would agree that tightening the international tax rules should be a priority. However, we observe that Canadian companies make outbound FDI decisions based largely on their pursuit of markets (revenue) and supply chain management (costs), not because the tax burden on earnings produced by those investment decisions is lower than it would be in Canada.

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[8] By a comprehensive interest deductibility rule, we mean a rule that governs interest deductibility by all taxable Canadian corporations (irrespective of ownership) and applies to all interest bearing indebtedness (related party, arm's length, and guaranteed). See, for example, Allen R. Lanthier and Jack M. Mintz, "Seeking a More Coherent Interest Deductibility" (2007), no. 3 *Canadian Tax Journal* 629 and Tim Edgar, "Outbound Foreign Direct Investment and the Sourcing of Interest Expense for Deductibility Purposes," Proceedings of the Queen's University Symposium on Globalization and the Impact of Tax on International Investments, February 29, 2008 (available at http://law.queensu.ca/announcements/taxSymposiumAnnouncement/eassonSymposiumDratPapers/TimEdgarInterestDeductionsFeb72008.doc). The income earning purpose rules in the current law would continue to apply.

[9] See supra note 5.

[10] Institute for Competitiveness and Prosperity, *Setting our Sights on Canada's 2020 Prosperity Agency* (Toronto: Institute for Competitiveness and Prosperity, 2008) (available at http://www.competeprosper.ca/download.php?file=ICAP_RoC2008_Final.pdf).

Moreover, recent reductions in corporate tax rates in Canada will further reduce any existing tax-driven distortions in decision-making.

Fifth, it is widely acknowledged that an interest allocation and denial rule can be particularly harsh under an exemption system.[11] To our knowledge, there has been no analysis of the consequences of such a rule change undertaken in the Canadian context and we understand that the data necessary to complete such an analysis is not readily available. Thus, even though the theoretical underpinnings of a comprehensive interest deductibility rule have merit, it would be premature to implement such a rule without a better understanding of the consequences. As U.S. policy-makers have acknowledged, it may also be necessary to introduce certain relieving provisions upon any transition to an exemption system with interest allocation and denial.[12]

Sixth, advocates of a comprehensive interest deductibility rule argue that taxpayers would respond to the potentially adverse results of interest allocation and denial by relocating debt in their foreign affiliates where the financing is required. Because Canadian-based companies operating internationally are often relatively small, commercial lending impediments may preclude them from relocating their borrowings in their foreign affiliates. The alternative of lending money directly to foreign affiliates may also be inefficient if foreign withholding taxes on interest income cannot be credited in Canada. Separate and distinct from the question of whether it is smart policy to remove an existing advantage from Canada's international tax system, it should not be assumed that Canadian businesses (particularly small- and medium-sized businesses) could easily restructure to avoid the penalty of interest allocation and denial.

Lastly, the complexities associated with implementing a comprehensive interest deductibility rule should not be underestimated. These range from the use of financial accounting values in determining global leverage ratios to exceptions for highly leveraged industries. These costs must be evaluated in relation to the benefits that such a rule would seek to achieve.

Recommendation

Changes to the rules related to interest deductibility should be restricted to those recommended under "Taxation of inbound direct investment — Interest deductibility."

Foreign exchange hedging

In order to limit the impact of foreign exchange rate fluctuations on their Canadian financial statements, Canadian companies often hedge all or a portion of their net investment in foreign subsidiaries. Any change in the Canadian dollar value of net investments in foreign subsidiaries does not generally result in any gain or loss for tax purposes. However, if the Canadian company has hedged its net investment by entering into forward exchange agreements, a change in the foreign exchange rate will generally result in a gain or loss being recognized for tax purposes. As a result, the hedging activity must be done on a grossed up basis so that the net of tax cost of the hedge is effective. This increases the cost of the hedge by approximately 50%, assuming a current Canadian tax rate of 33%. In addition, when there are significant fluctuations in the value of the Canadian dollar, the hedging contracts may result in significant increases or decreases in taxable income, making it extremely difficult for these companies to manage their tax payments.

Recommendation

Permit Canadian companies to designate forward hedging contracts that are used solely to hedge net investments in foreign subsidiaries as exempt hedges so that neither the gains nor the losses arising from these hedges are taken into account in determining taxable income.

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[11] See, for example, supra note 4, revenue consequences.
[12] Ibid. In particular, the Treasury Department raised the possibility of extending the exemption system beyond dividends to interest and royalties.

Taxation of inbound direct investment

Interest deductibility

Balancing objectives and identifying the problem

The taxation of inbound direct investment should aim to balance two objectives. First, Canada's tax system should, to the extent appropriate, seek to treat foreign and domestic investors equally. Second, foreign entities doing business in Canada should pay Canadian tax on what is properly considered Canadian-source income.

We agree with these objectives that were put forward by the Advisory Panel. Canada generally treats foreign investors equally under the current international tax system, subject to differential benefits extended under tax treaties. Although foreign investors are not treated as favourably as certain domestic investors — namely Canadian-controlled private corporations and small businesses — the treatment accorded them at the entity level is similar to that of Canadian public companies and large businesses.[13] At the same time, many foreign multinational investors have traditionally shifted income out of Canada via interest expense on related party debt and in so doing have reduced the tax burden on their Canadian source income below that of domestic investors. The ability of foreign multinationals to reduce their Canadian source income through related-party financing arrangements is a significant advantage not available to Canadian companies. In practice, planning of this nature is actively undertaken. Accordingly, measures are required to restore an appropriate balance between these two objectives.[14]

The combination of an exemption system for outbound taxation, adherence to the legal substance principle (with regard to financial instrument and legal entity classification), a generous thin capitalization rule by international standards, and declining rates of withholding tax invites excess leveraging of Canadian operations by foreign multinationals. As indicated above, we believe the exemption system is fundamentally sound and, on balance, the judicially developed legal substance principle also serves Canada well. Reduced withholding tax rates on interest will help lower the cost of (and access to) capital for Canadian businesses and is a welcome development. Accordingly, it is appropriate that Canada adopt a stronger base protection measure than its current thin capitalization rule. Of all the aspects of Canada's international tax system, this area is the most in need of reform.

The current thin capitalization rule only applies to related-party debt. Moreover, there are no restrictions on the use of any such indebtedness (except for an income earning purpose test) and the safe harbour rules apply regardless of the level of third-party debt (including guaranteed debt). This allows foreign multinationals to leverage their Canadian operations to levels beyond that which Canadian companies can achieve; in effect, substituting debt for what would otherwise be equity. The most extreme tax planning involves the transfer by foreign-based multinationals of foreign companies to their Canadian subsidiaries for a mixture of debt and equity (2:1) which satisfies the thin capitalization limitation (so-called debt dumping). The resulting interest expense on the debt is deductible against Canadian source income, even though taxable income may never arise in Canada as a result of the acquisition of the foreign affiliate. More importantly, there is often little complementarity between this tax-driven outbound FDI and domestic investment, thereby distinguishing it from economic-driven outbound FDI. Tighter rules are required to protect the domestic tax base against this type of activity.

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[13] Canada also discriminates against foreign investors at the shareholder level, even compared to Canadian public companies and large businesses. The gross up and credit system applicable to dividends paid by Canadian companies to Canadian resident individuals is the main example.
[14] See also supra note 5, recommendation 21.

Choosing between alternative approaches to base protection

We considered several approaches to strengthening Canada's thin capitalization rules. On balance, we prefer a U.S. style earnings stripping rule over the current rules and certain alternative approaches adopted by other countries. An earnings stripping rule:

- can be targeted more effectively and appropriately at base protection and appropriate income measurement than a balance sheet debt/equity limitation;
- is preferred on the basis of horizontal equity — a balance sheet debt/equity limitation produces different results for similarly situated taxpayers depending on whether the debt and equity components of the calculation approximate the fair market value of the enterprise or reflect historical values;
- will better protect the domestic tax base against excessive debt dumping as the increase in "equity" resulting from the transfer of a foreign subsidiary to Canada will not, in itself, result in greater related-party interest expense deductions; and
- can be designed to apply to highly leveraged industries more appropriately than a balance sheet debt/equity limitation (as indicated below, certain specific exceptions would be required).

We prefer this approach over a Dutch style business purpose test[15] on the basis that a business purpose test in this area would be difficult to formulate and administer, thereby resulting in a significant level of uncertainty that would serve neither taxpayers nor governments well. The adoption of a U.K. style transfer pricing based approach[16] would also likely create significant uncertainty and there is considerable evidence (work on the attribution of profits to permanent establishments by the OECD and related tax treaty cases) to suggest that the application of arm's length principles to internal capital structures is complex. Such an approach in Canada would impose considerable costs on taxpayers and the CRA and for limited potential benefits. Finally, we also rejected a comprehensive interest deductibility sourcing rule (whether based on a balance sheet debt/equity limitation or an earnings stripping limitation) in order to preserve the advantages of the existing system for Canadian-based businesses, as discussed above under "Taxation of outbound direct investment."

There are several important rule design considerations that would serve to determine how and when the earnings stripping rule would apply. It is critical that these provisions be thoroughly considered in order to strike the right balance between adequately protecting the domestic tax base while at the same time ensuring that Canada is an attractive destination for foreign capital.

Recommendations

Basic framework

We recommend modeling the basic framework of the rule after the U.S. earnings stripping provision with several modifications to ensure its effectiveness as a base protection measure in Canada, taking into account Canada's exemption system and the greater extent to which foreign multinationals hold foreign affiliates under Canada compared to non-U.S. multinationals holding foreign affiliates under their U.S. subsidiaries.

The basic framework provides that "excess interest expense" is "disallowed interest" to the extent of "related-party interest." If there is no related-party interest, the rule would not apply. Excess interest expense is "net interest expense" in excess of a prescribed percentage of a defined cash flow measure that would be a recognized commercial lending standard (the "limitation"). Net interest expense is all interest expense (arm's length and related party) less interest income. This accommodates lending businesses, which are usually more highly leveraged than industrial businesses. To the extent there is excess interest expense, related-party interest is disallowed. Arm's length interest is fully deductible but it also crowds out a taxpayer's ability to deduct related-party interest. In effect, related-party interest goes to the back of the line and is first to be disqualified if there is excess interest expense.

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[15] For an overview of these rules, see Sandra Slaats, "Financing Foreign Affiliates: An Overview of the Canadian Proposals and Rules in Selected Countries" (2007), vol.55, no.3 *Canadian Tax Journal* (Toronto: Canadian Tax Foundation, December 2007), 708-709.
[16] Ibid., at 698-703.

Safe harbour

A safe harbour provision would allow taxpayers to avoid having to deal with the calculations if they financed their Canadian operations with a level of internal debt that is clearly not excessive. In principle, the safe harbour should be set at a relatively low level. Current U.S. law sets the safe harbour at 1.5:1 (60/40 debt equity ratio). This includes all debt, not just related-party debt. There is a U.S. proposal to eliminate the safe harbour. We recommend that a 1:1 safe harbour be included.

Specified non-resident shareholder interest and guaranteed debt

For purposes of defining related-party interest and adapting the basic framework to Canada, we recommend retaining the 25% ownership threshold under current law – "specified non-resident shareholder interest." We also recommend including third-party debt that is guaranteed by a specified non-resident shareholder, which includes any person not dealing at arm's length with a specified non-resident shareholder.

There are three important aspects of these guaranteed debt recommendations. First, bringing guaranteed debt within the rule recognizes that foreign multinationals wishing to engage in debt dumping could circumvent the rule by substituting third-party debt that is guaranteed by a foreign parent for debt owing to a specified non-resident shareholder. This recommendation precludes that type of planning. Second, bringing debts guaranteed by persons not dealing at arm's length with a specified non-resident shareholder within the rule ensures that guarantees cannot be provided by a foreign parent indirectly through a foreign affiliate or sister company. Lastly, while these first two aspects of our guaranteed debt proposal broaden the application of the rule in the interest of base protection, consideration must also be given to excluding guaranteed debt from the rule in certain industries where guaranteed debt is a commercially normal arrangement, Canadian competitors are similarly capitalized and none of the main purposes of the guarantee was to achieve a tax benefit.

As indicated above, we do not recommend interest deductibility restrictions for Canadian-based companies. If there are no specified non-resident shareholders, there can be no debt owing to such persons nor can there be any debt guaranteed by such persons. In our view, while this type of provision applies on a discriminatory basis (as does the current thin capitalization rule), it is a justifiable measure to protect the domestic tax base. A particular question arises as to whether a guarantee of an arm's length debt of a Canadian subsidiary provided by a foreign affiliate of such Canadian subsidiary should bring the debt within the earnings stripping limitation. We recognize that a Canadian-based company would not be subject to any earnings stripping limitation in the same situation. Nevertheless, overall, this differential treatment strikes a reasonable balance between equal treatment of foreign and domestic investors and domestic tax base protection which, if not addressed, will enable foreign investors to achieve lower tax rates on Canadian-source income than domestic investors. Lastly, we note that the earnings stripping rule is not engaged unless net interest expense exceeds a prescribed percentage of a defined cash flow measure, which enables foreign investors a reasonable degree of latitude in leveraging their Canadian operations.

Carryover provisions for disqualified interest and excess limitation

An earnings stripping rule is affected by business and economic cycles to a greater extent than a balance sheet debt/equity limitation. Accordingly, reasonably generous carryover provisions are required. However, the carryover provisions must also impose a reasonable limitation on the use of disqualified interest or foreign multinationals may still be inclined to over-leverage Canada. Under current U.S. law, the carryover period for disqualified interest is indefinite. We recommend a more limited carryover period of 10 years.

Excess limitation occurs in years when net interest expense is less than the limitation. Excess limitation may reflect lower leverage ratios, lower interest rates, and/or strong business performance. Because there is no disallowance in an excess limitation year, the case for generous carryover of excess limitation is less compelling. Current U.S. law provides for a three year carryover of excess limitation. We recommend a three year carryover of excess limitation, consistent with the carryover provisions applicable to business foreign tax credits under current Canadian law.

Lastly, after an acquisition of control, we recommend that the restrictions which apply to non-capital losses also be applied to disqualified interest.

Setting the limitation

There are two key parameters to setting the limitation – the cash flow measure and the percentage threshold. Current U.S. law defines the cash flow measure as taxable income before interest, operating loss carryovers and non-cash items such as depreciation and amortization. We recommend adopting the comparable Canadian measure as this represents a reasonable commercial measure of an enterprise's ability to borrow money and service debt. The adjustments for non-cash items should operate to appropriately accommodate certain highly leveraged industries such as leasing and real estate.

Current U.S. law provides for a 50% percentage threshold (a 2:1 cash/interest coverage ratio). It has been proposed that this be reduced to 25% (a 3:1 cash/interest coverage ratio). Germany recently introduced a comprehensive earnings stripping limitation using a 30% percentage threshold. We recommend that this percentage threshold parameter be studied further with input gathered from commercial lenders and capital markets participants. We expect that the 50% threshold is overly generous to taxpayers and that 30% is a more appropriate threshold.

We also recommend defining the cash flow measure in the tax law and avoiding the significant complexities that would arise if amounts reported on the financial statements of taxpayers were used. The one exception to this rule should be the application of the balance sheet based safe harbour provision.

Consideration must also be given to incorporating appropriate consolidation mechanisms on an elective basis. For example, in the context of the issuer tax imposed on payers of dividends on taxable preferred shares, taxpayers are entitled to transfer amounts among related corporations. A similar approach should be adopted in the context of an earnings stripping rule that would allow for the transfer of "limitation" among related entities.

Application to non-resident corporations, partnerships and trusts

We recommend that an earnings stripping rule apply to all commercial entities with the requisite 25% non-resident ownership, in order to avoid a migration to other commercial vehicles and structures. Accordingly, supporting rules would be required to replicate the specified non-resident shareholder construct in the context of partnerships and trusts — "specified non-resident members" and "specified non-resident beneficiaries." For purposes of computing the income earned in Canada of a non-resident corporation, the earnings stripping rules applicable to Canadian-resident corporations could be adopted with the necessary modifications.

Other exemptions

We believe that the earnings stripping approach that we have recommended should reasonably accommodate a broad range of industries. Nevertheless, there may be certain industries where the earnings stripping approach recommended does not adequately recognize the unique aspects of that industry. We recommend further study to determine whether additional exceptions may be required for certain industries or where a general exception based on a worldwide debt to equity ratio should be adopted.

Capital gains exemption

Canada currently defines taxable Canadian property (TCP) to include shares of a private corporation resident in Canada. At the same time, Canada's tax treaties cede taxing jurisdiction to the country where the non-resident vendor is resident, provided the shares do not derive their value principally from real property. Based on the large number of tax treaties Canada has concluded, it appears that Canada is prepared to exempt from taxation all gains realized by non-residents, other than gains from the disposition of real property and most real property entity holdings.[17] In light of this treaty policy, we believe that Canada should adopt a broader exemption in its domestic law to exempt gains realized by non-residents other than those arising from the disposition of real property or real property entities. We see little benefit in providing the exemption only on a bilateral basis. The benefit

[17] Generally, shares of a public real estate company or a REIT in which a non-resident holds less than a 25% interest will be exempt from Canadian tax.

of a broader exemption is that it would make Canada a more attractive destination for equity investment by non-residents, including sovereign wealth funds, who do not reside in countries with which Canada has a tax treaty. A broader exemption would also reduce a significant compliance burden that acts as an impediment to FDI in Canada.[18]

Recommendation

Amend the definition of TCP so as not to include shares of a private corporation resident in Canada other than when such shares derive their value principally from real property in Canada. Similar amendments should be made for interests in partnerships, trusts and corporations whose shares are listed. However, consideration could be given to requiring taxpayers to notify the CRA of such dispositions. The existing system would continue to apply to cases involving real property in Canada.

Treaty shopping

As the Advisory Panel notes, a tax treaty is entered into between two countries to avoid double taxation and to prevent fiscal evasion in respect of taxes on income or capital. Treaties are meant to be relieving in nature and can provide important benefits to foreign investors. A particular treaty may reduce withholding rates on Canadian source interest, dividends or royalties or eliminate tax on certain gains from the disposition of Canadian property. Consistent with international norms, Canada generally chooses to grant this relief by way of a tax treaty in order to gain reciprocal benefits for Canadian residents. However, Canada has also provided unilateral exemptions, as was done recently for interest on arm's length loans, where such exemptions are considered to benefit Canadians.

The term "treaty shopping," often called third-country treaty use, generally refers to the use of a particular tax treaty by a party that is not a resident of a country which is party to the treaty. We observe that the main purposes of using a third-country treaty are for a non-treaty country resident to gain access to treaty benefits, for a treaty country resident to gain access to more generous treaty benefits, or to facilitate administrative simplification (e.g., a U.S. partnership with all U.S.-resident partners may use a third-country treaty, not to gain preferential benefits, but to simplify administrative compliance).

It appeared, until relatively recently,[19] that Canada was not overly concerned about third-country treaty usage. As observed by Mr. Justice Bell in MIL (Investments),[20] "Prior to negotiating the Treaty, Canada undoubtedly had knowledge of Luxembourg's treatment of capital gains" and "...it must be presumed that Canada had a valid reason to allow Luxembourg to retain the right to tax capital gains in those specific circumstances, for example, the desire to encourage foreign investment in Canadian property." He went on to state that "reliance upon a Treaty provision as agreed upon by both Canada and Luxembourg cannot be viewed as being a misuse or abuse." We believe that Mr. Justice Bell's comments reflect the generally held view that third-country residents could establish a valid holding company in a treaty country to take advantage of a treaty with Canada.

We believe that a treaty shopping policy should only be developed after further consideration of the policy that Canada will adopt on reducing withholding taxes and providing exemptions for capital gains. Canada has already eliminated withholding taxes on interest on arm's length loans. We have recommended above in the section "Taxation of inbound direct investment — Capital gains exemption" that Canada narrow the scope of its capital gain tax provisions so that only capital gains on Canadian real property and real property entities are taxable in Canada .[21] If this recommendation is accepted, third-country treaty use will be beneficial in more limited circumstances.

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[18] Recently enacted changes regarding the clearance certificate process did not address the issue and are unlikely to reduce the number of situations involving arm's length transactions in which clearance certificates are obtained.
[19] Canada Revenue Agency, *Income Tax Technical News* No. 30 (Ottawa: Canada Revenue Agency, May 21, 2004) (available at http://www.cra-arc.gc.ca/E/pub/tp/itnews-30/itnews-30-e.pdf). The CRA announced that it was examining all treaty shopping cases. The CRA invoked an implicit anti-abuse of treaty theory and the GAAR in order to combat such perceived treaty shopping in *MIL (Investments)*, 2007 FCA 236. The CRA tried to invoke the lack of beneficial ownership as another approach to combat treaty shopping in *Prevost Car*, 2008 TCC 231 (under appeal).
[20] *MIL (Investments)* 2006 TCC 460.
[21] Over time, it may also be useful for Canada to adopt more consistent treaty provisions exempting real property gains.

Even with the elimination of withholding taxes on arm's length interest, and even if the scope of Canada's taxation of capital gains is narrowed, there will still be circumstances in which third-country treaty usage will be beneficial to foreign investors. Non-treaty country residents may still use holding companies to gain access to lower withholding tax rates on non-arm's length interest, certain royalties, and dividends. Treaty country residents may still use third-country treaties to access lower treaty withholding rates or to simplify administrative compliance. However, in these more limited circumstances, we question whether significant anti-treaty shopping measures are required.

Canada currently imposes high rates of withholding taxes under our domestic law. If Canada chooses to adopt anti-treaty shopping provisions, this is likely to reduce access by Canadian companies to certain types of capital. We do not believe that there has been sufficient study of the costs that further restrictions might have on Canadian companies that are seeking foreign capital. As a result, we do not believe that Canada should introduce any anti-treaty shopping measures until such a study has been completed.

If further study concludes that treaty shopping is of concern for Canada, the issue should be addressed bilaterally. This would ensure that Canada is not violating treaty obligations and is conforming to the intent of the other contracting states that have signed tax treaties with Canada. There are likely relatively few treaties that would need to be renegotiated and these would be with countries that offer attractive holding company regimes and which also have favourable treaties with Canada.

Recommendation

Defer consideration of a treaty shopping policy until after further study of the impact of high withholding tax on inbound FDI. If treaty shopping is found to be a concern for Canada, address the issue bilaterally.

Sovereign wealth funds and other tax-exempt entities

Significant pools of capital[22] have and are being accumulated by sovereign wealth funds (SWFs) and by other tax-exempt foreign entities. As a result, the Advisory Panel correctly raises the broad question — does investment in Canada by these entities raise any special tax issues?

In the United States, the staff of the Joint Committee on Taxation released a report[23] on the economic and tax issues raised by SWF investments in the United States. The report notes that the differences in tax treatment of foreign governments and foreign corporations is limited, as a practical matter, to exemption from dividend withholding, certain broader exemptions from interest withholding, and additional exemptions from taxation of gains from certain U.S. real property interests.

The Income Tax Act does not contain any specific provisions exempting foreign governments from taxation. However, Canada recognizes a limited form of sovereign immunity to exempt passive income of certain governments and their agencies from Canadian taxation.[24] The foreign government or agency must apply to the CRA for authorization so that Canadian-resident payers do not have to withhold tax. There is limited exemption in the Act for other foreign tax-exempt entities.

A number of Canada's income tax treaties provide exemptions for certain SWFs. For example, the tax treaty between Canada and the United Arab Emirates[25] provides an exemption from withholding taxes on dividends and an exemption from capital gains (including gains on real property companies) on

[22] United States, Staff of the Joint Committee on Taxation, *Economic and U.S. Income Tax Issues Raised By Sovereign Wealth Fund Investment in the United States,* JCX-49-08 (Washington, DC: Joint Committee on Taxation, June 17, 2008) (available at http://www.jct.gov/x-49-08.pdf). The report quotes a February 2008 study completed by JP Morgan Chase Bank estimating assets under management of between US$2.093 trillion and US$2.968 trillion; and expected to grow to between US$5.0 trillion and $9.3 trillion by 2012.
[23] Ibid.
[24] See *Information Circular* IC77-16R4, "Non-Resident Income Tax," May 11, 1992.
[25] Canada-United Arab Emirates 2002 Income and Capital Tax Convention and Final Protocol, signed June 9, 2002, article XXI.

holdings representing less than a 25% interest in a Canadian company. The tax treaty between Canada and Norway provides an exemption from withholding tax on dividends, but not on gains.[26] A number of Canada's income tax treaties also provide for exemptions from withholding tax on interest and dividends received by exempt pension funds.[27]

We believe the primary considerations relate to possible exemptions from withholding tax on portfolio interest and dividends and possible exemptions on gains from the disposition of portfolio investments. With the recent elimination of withholding tax on interest on arm's length debt and the general exemption for gains on portfolio investments in public companies, we believe there is a relatively narrow field of additional exemptions that should be considered — primarily for dividends and gains on portfolio investments in non-public companies.[28]

Recommendation

We do not believe that there should be any exemptions for business income earned by SWFs or other foreign tax-exempt entities. We recommend, in the section "Withholding taxes," below, further study to determine whether a withholding tax exemption should be provided for dividends on public company shares. We also recommend a broader exemption generally for capital gains.

We do not see the need for specific provisions for SWFs, but if specific exemptions are provided, we recommend that they be introduced by way of bilateral treaty provisions. If specific exemptions are granted to foreign SWFs and other tax-exempt entities, Canada should negotiate for reciprocal treatment for Canadian pension funds. We also recommend that Canada develop and publish a policy position on this matter to ensure a consistent position is taken when treaties are negotiated.[29]

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[26] Canada-Norway 2002 Income and Capital Tax Convention, signed July 12, 2002, article 10, para 3.

[27] See, for example, article XXI of the Canada-United States 1980 Income and Capital Tax Convention, signed September 26, 1980, as amended by protocols signed June 14, 1983; March 28, 1984; March 17, 1995; July 19, 1997. A fifth protocol was signed September 21, 2007, but has not yet been ratified.

[28] Gains on the sale of shares of Canadian companies, other than real property companies, may be exempt in any event if the SWF is resident in a country that has a tax treaty with Canada.

[29] For example, does (and should) the exemption for SWFs provided for in the Canada – United Arab Emirates tax treaty noted above represent Canada's policy on SWFs?

Withholding taxes

Canada imposes high withholding taxes on certain interest and royalty payments, on rents and dividends, and on certain other payments to non-residents. These high rates of withholding are reduced through treaties that Canada has entered into with other countries. The Consultation Paper outlines the total revenue collected from withholding taxes for 2000 through 2005, which is significant relative to the regular corporate tax revenue collected in those years.

Canada recently eliminated withholding taxes on interest (other than on participating debt) paid to arm's length non-residents as a means of reducing the cost of debt financing for Canadian companies. Canada has also agreed to phase out withholding taxes on non-arm's length interest over a three year period under the new protocol to the Canada-U.S. tax treaty.

The reductions in withholding tax will reduce federal revenue received; presumably, the Department of Finance was satisfied there would be a sufficient benefit to Canada's overall economic performance to justify any revenue loss. We suggest that the Department of Finance complete further analysis to determine if there would be overall economic benefits that might justify the cost of further withholding tax reductions.

We note that a number of countries already provide a full exemption for interest payments made to both arm's length and non-arm's length non-resident debtholders. As a result, the need to negotiate reduced withholding tax rates in other treaties may not be as pressing. Nevertheless, we believe that with increased FDI by Canadian companies, the elimination of withholding on interest would provide these companies additional flexibility in financing foreign operations. Therefore, Canada should consider a policy of negotiating zero withholding on non-arm's length interest in other treaties.

The question of eliminating withholding tax on dividends is more complex. We are generally in favour of the elimination of withholding on dividends from substantially owned subsidiaries and believe that withholding taxes should be eliminated through bilateral treaty negotiations. As a result of Canada's exemption system for active earnings, Canadian companies do not obtain credit for foreign withholding taxes on dividends. As a result, Canadian companies often defer repatriation of foreign profits in order to avoid the foreign withholding tax cost (a cash tax cost as well as an income statement cost).

The elimination of withholding taxes may result in Canadian subsidiaries of non-residents paying out accumulated earnings and using debt financing to fund these dividends. Accordingly, we recognize that withholding taxes may, to a certain extent, act as an additional constraint on the amount of debt leverage taken on by Canadian subsidiaries. We believe the issue of debt leverage should be dealt with through appropriate thin capitalization rules so that withholding tax on dividends can be eliminated through treaty negotiations.

We also recommend that there be further study to determine whether there would be sufficient benefits to Canadian public companies if withholding taxes were eliminated on portfolio dividends so that companies that pay dividends can access foreign equity capital on a competitive basis. We note that currently Canadian public companies that do not pay dividends may be able to attract foreign capital on a more competitive basis as the returns to foreign investors, in the form of capital appreciation, are not taxable as long as the investments are portfolio investments.

We note there remains a technical problem when arm's length interest is payable on convertible debt; the Department of Finance is aware of the technical problem. We recommend this technical problem be dealt with so that withholding tax is eliminated on all arm's length interest payments (other than on participating debt).

Recommendation

Conduct analysis into the economic benefits of further withholding tax reductions.

Administration

Transfer pricing

Application of the rules

The transfer pricing (TP) questions raised by the Advisory Panel focus on the identification of administrative issues related to the application of the current rules and measures to address them, as well as whether penalties are assessed fairly and appropriately.

The arm's length principle (ALP), although a reasonable theoretical construct, is often difficult to apply and administer in practice. While there is no obvious replacement at the conceptual level, the subjective nature of the rules significantly increases the costs of preparing annual contemporaneous documentation. In addition, there is limited practical guidance from the CRA on how taxpayers should navigate the many subjective areas involved. Further, trends towards vertical integration in global business operations have also significantly reduced the availability of good comparable data.

We believe the majority of taxpayers are reasonably compliant in preparing contemporaneous documentation. To assist taxpayers the CRA should acknowledge that there are many areas where there is no "perfect answer" and to be more cognizant of the grey areas in the application of the ALP.

Recommendations

We recommend that the CRA:

- Introduce safe harbours for specific transactions (e.g., routine intragroup services) and small taxpayers (e.g., accepting the industry-norms based benchmarks as opposed to comparables-based economic analysis).
- Provide administrative guidance to cover areas of acknowledged shortcomings of the ALP, particularly on key economic issues (e.g., treatment of synergistic benefits of association with the multinational enterprise, pricing and migration of intangible assets, aggregation of intercompany transactions, application of the ALP to financial transactions).
- Provide additional guidance on the accelerated competent authority process to improve effective access, in line with OECD advice.[30]
- Provide more practical guidance to, and coordination among, field auditors for a more uniform approach, particularly for the grey areas in the application of the ALP.

To reduce the burden of compliance on taxpayers, we recommend that the CRA:

- Provide more discussion and rationale before rejecting a particular approach or methodology adopted by the taxpayer or proposing an alternative approach, particularly in light of the grey areas within the ALP.
- Increase the possibility of issues being effectively resolved at the field audit level by changing what we understand to be the CRA's key internal metrics (the efficiency of audits should be measured on the ultimate result and not on initial assessments)..
- Institute statutory benchmarks on response times for tax authorities (including on audit, advance pricing agreement (APA) and competent authority (CA) files) to prevent lengthy and undue delays in resolution, which have a significant financial impact on taxpayers, both in terms of tax compliance costs and the costs of reporting for financial statement purposes.

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[30] Organisation for Economic Co-operation and Development, *Manual on Effective Mutual Agreement Procedures* (Paris: OECD, February 2007) (available at http://www.oecd.org/dataoecd/19/35/38061910.pdf).

In some cases, legislative and/or policy changes may be required to provide relief in the following areas to:

- Provide relief from non-deductible interest on transfer pricing adjustments by making any interest on underpaid taxes resulting from transfer pricing adjustments deductible.
- Harmonize the waiver and assessing provisions for transfer pricing and permanent establishment (PE) cases.
- Segregate mutual agreement procedure (MAP) and non-MAP issues for purposes of the appeals process (to allow cases involving domestic issues to proceed through appeals without being held up by CA settlements).
- Permit refund interest on Part XIII refunds resulting from APA or CA negotiations.
- Clarify secondary withholding requirements on TP adjustments.
- Allow taxpayers to have recourse if downward adjustment requests are denied.
- Negotiate arbitration provisions in Canada's other tax treaties.
- Clarify the CRA's position on the application of OECD Guidelines to PE cases (specifically by harmonizing section 247 with provisions on the attribution of income to PEs – such as treaty provisions and OECD guidelines).

Penalties

Currently the CRA may apply penalties when taxpayers have failed to meet their transfer pricing documentation obligations. Penalties are only applied by the CRA if approved by an internal review committee. Generally, we believe that this system has worked reasonably well, although taxpayers have had to incur significant costs in making submissions to the CRA's internal review committee in order to have proposed penalties reversed. It is important that the CRA continue to apply penalties only if approved by their internal review committee.

Recommendations

Ensure that penalties are applied only in limited circumstances when taxpayers have clearly not met documentation requirements and that small- and mid-sized companies be provided with reasonable latitude. In addition, we recommend that there should be a process that permits auditors to consult with the internal review committee in advance of issuing their proposal letters to ensure compliant taxpayers are not required to incur the cost of preparing a formal submission. As noted above, we recommend that the law should be changed so that interest on transfer pricing reassessments is tax deducible, thus removing what is essentially a penalty in many cases.

Customs compliance

In addition to the income tax compliance issues that may arise relating to transfer pricing matters, importers often face an additional burden in complying with Canadian customs requirements.

Recommendations

To reduce the burden of customs compliance on taxpayers (related specifically to the area of transfer pricing), we recommend that the CRA and the Canada Border Services Agency (CBSA):

- Ensure CBSA policy group in Ottawa makes all regional officers aware of the its current position regarding taxpayers who have prepared a transfer pricing study. We understand that the policy is that where a taxpayer has such a study, the CBSA officers are not to pursue issues of relationship and influence for the purposes of determining whether the transaction value method of customs valuation applies. It has been our experience that not all regional officers are aware of this policy and, as a result, certain taxpayers have to spend a significant amount of time and resources unnecessarily on audit.
- Consider issuing joint APAs that cover both tax and customs valuation. In such an APA, the base for the customs value could be established. This approach would provide certainty not only from a tax perspective but from a customs valuation perspective as well.

- When a taxpayer has an upward year-end transfer pricing adjustment, allow the importer to report such an upward adjustment by way of a written submission (as can be done in the United States) and not include a B2 form. The CBSA can reply in writing, rather than having to issue a detailed adjustment statement (DAS). This suggestion may require legislative amendment (if DASs were to be eliminated), given the Customs Act (Canada) references the "prescribed form." This recommendation would address a significant administrative burden for importers and would also reduce the paperwork generated by the CBSA.

Regulation 105 and Regulation 102 withholding tax

Regulation 105 requires Canadian payers to withhold income tax at source from payments made to non-resident service providers, regardless of whether the non-resident treaty provider is ultimately taxable in Canada. The non-resident service provider may also be subject to secondary level withholding in respect of payments it makes to other persons, namely non-resident subcontractors. The non-resident service provider is also subject to Regulation 102 withholding and related reporting obligations in respect of its non-resident employees who perform services in Canada, regardless of the period of time they spend in Canada and regardless of whether the employee is ultimately taxable in Canada.

Regulation 105 tax withholding on fees reduces cash flow throughout the year. The withholding becomes an absolute cost if it is not refunded by filing a Canadian tax return or creditable as a foreign tax credit on the non-resident service provider's home country return. In practice, many non-resident service providers shift the economic burden to Canadian payers by seeking gross up clauses to take into account the tax withholdings.

Canadian payers may be audited several years after making a payment to a non-resident service provider and may be held liable for taxes that should have been withheld under Regulation 105 even where the non-resident service provider did not have a permanent establishment in Canada. In these circumstances, it is virtually impossible to recover the tax liability from the non-resident service provider.

The non-resident service provider may apply for a waiver of the Regulation 105 tax withholding (either a treaty based waiver exemption or an estimated income and expenses waiver). However, the detailed information that must be provided to support a waiver application discourages many non-resident service providers from doing so. Proving that the non-resident service provider does not have a permanent establishment will be even more difficult once the recent changes to the Canada-U.S. tax treaty come into effect.[31]

Non-resident employees typically remain on the home country's payroll and thus continue to have tax withheld at source under the domestic tax rules of the foreign country. As a result, Regulation 102 imposes an economic burden on employees unless a waiver of Canadian tax is obtained or the domestic tax withholding is reduced. In practice, the burden to the employee becomes an economic and competitive burden to the non-resident service provider in terms of recruiting employees who will work abroad. Non-resident service providers often do not have the payroll infrastructure or expertise to effect Canadian tax withholdings at source or to do the associated reporting. Consequently, the non-resident service provider will typically pay the tax owing (e.g., to the CRA) on behalf of the employee and then seek to be reimbursed when the employee is refunded the tax withheld. However, the refund does not completely reverse the economic burden as payment of the tax is typically considered a taxable benefit.

The burden that these regulations place on non-resident service providers is not appropriate in light of the collection risk. In many cases, the non-resident service provider and employees are exempt from taxation because of a tax treaty. In other cases, the non-resident service provider may be a parent or related entity. The current system does not differentiate between those non-resident service providers

[31] The changes made to the definition of PE in the Canada-U.S. tax treaty by the fifth protocol, signed September 21, 2007, will significantly broaden the definition and will create many more cases where foreign service providers have a PE in Canada.

and employees who are ultimately exempt from Canadian income tax by virtue of a treaty and those who are not and it does not distinguish related service providers where collection risk should not be significant.

Recommendations

Regulation 105

Canada should move to a self-regulatory system for compliance based on a documentation and filing requirement for the Canadian payer and the non-resident service provider. Under such a system, the Canadian payer would be responsible for collecting certain information about the non-resident service provider on a prescribed form, such as the period during which the services were rendered, the amount of fees and the service provider's home country of residence. In addition, the non-resident service provider would be asked to certify that it did not have a PE in Canada for the period in question. The Canadian payer would be required to keep this information on file and to provide such documentation to the CRA in the event of an audit. If the relevant documentation is not kept, the payer could be jointly and severally liable with the non-resident service provider for the tax that should have been withheld.

These changes would harmonize our treatment of non-resident service providers with those of other countries, many of whom are our trading partners. For example, most European countries do not impose withholding or reporting requirements on payments to non-resident service providers so long as the non-resident service provider does not have a permanent establishment. In the United States, a tax withholding rate of 30% is imposed on gross fees paid to non-residents; however, the withholding tax is exempted if the non-resident service provider represents that it is the beneficial owner of the income, the income is effectively connected with the conduct of a trade or business in the United States and the income is includible in the payee's gross income.

These changes would substantially reduce the administrative burden imposed on non-resident service providers and Canadian payers by simplifying the process and making it work on a real-time basis. The documentation would provide an audit trail to the CRA so that it could verify that the Canadian resident payee and the non-resident payer were appropriately discharging their Canadian tax obligations.

Regulation 102

We recommend that the ability to obtain a Regulation 102 waiver be retained but that it be supplemented with other measures.

We recommend that the CRA adopt an administrative policy exempting non-resident service providers from Canadian tax withholdings (including CPP) and reporting rules for employees working in Canada for a short period of time (e.g., 30 days in a 12 month period).

In addition, we believe that other aspects of compliance could be simplified by adopting the following recommendations:

- That employers be permitted to suspend withholding for employees until it is apparent that the tax threshold will be reached, and that they then be permitted to deposit appropriate amounts without being considered late.
- That employers be able to pay the income tax of short-term employees, if they so choose.
- That short-term employees' income tax compliance be done with no tax identification number, or more limited documentation than currently used for social insurance purposes, and that employers be able to take a role in obtaining and managing those numbers in appropriate situations.

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