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Advisory Panel on Canada's System of International Taxation
Submission

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Dear Panel Members:

On behalf of the International Financial Centre of British Columbia, I am pleased to respond to the Consultation Paper issued by the Advisory Panel on Canada's System of International Taxation. I commend the Panel for undertaking this review of Canada's system of international taxation and for providing a document that presents the key issues in a straightforward manner and invites focused input on the key issues. I believe the Consultation Paper has dramatically simplified the process for providing input on highly complex subject matter.

When the Federal Government announced new rules relating to interest deductibility in respect of foreign affiliate investments in its 2007 Budget, it signalled a significant proposed shift in Canada's approach to international taxation. Over the years, there have been many piecemeal attempts to change Canada's system of international taxation to correct some perceived problem, perhaps without fully appreciating the impact on other provisions or the ability of taxpayers and the tax administration to cope with the complexity of the system.

As a result of delays in finalizing the draft amendment packages, numerous comfort letters have been issued to allow transactions to proceed with some certainty of the tax consequences. Moreover, the draft amendments have been outstanding for a number of years and have still not been passed into law in a timely fashion, despite the fact that some amendments apply for retroactive treatment of more than 10 years. This has made it difficult for taxpayers to comply with draft law. Further, under Canadian GAAP, companies cannot reflect the tax treatment resulting from draft law until it has received "substantial enactment", and so the financial statements of a company may not reflect the tax treatment that will ultimately prevail once the tax amendments are passed into law.

I believe this situation is symptomatic of an international tax system that needs to be reviewed and stabilized so that taxpayers entering into international transactions can be certain of their tax implications, comply with the law and accurately reflect their international tax situation in their financial statements.

In reviewing Canada's system of international taxation, you have noted the objectives of improving competitiveness, efficiency and fairness while looking to minimize compliance costs for business and administration and enforcement by the tax administration. Inevitably this will involve some trade-offs! To ensure fairness may entail some additional complexity. However, I believe the balance has been tipped to the point where complexity now overrides the objectives of ease of administration and compliance. I believe the impact of any recommended change by the Panel should take into account the costs of complying with and administering the change by performing a cost/ benefit analysis.

I do not believe a rigorous cost/benefit analysis has been performed in the past due to difficulties in accurately identifying these costs. The Department of Finance does attempt to assign a revenue impact to most major tax changes. The costs to taxpayers, the administration and the economy should also be considered. I believe that the Canada Revenue Agency (CRA) could develop some costing analysis to estimate the other costs associated with tax changes and ensure careful consideration of tax changes and their impact on the costs of compliance and administration. I encourage you to provide leadership on this critical issue by ensuring that any recommendations for change also account for the hidden costs of compliance and administration.

The Panel has indicated that, while its recommendations may not necessarily be "fiscally neutral," it will bear in mind the revenue impact of any proposal. I believe that the Panel should also estimate the impact of any proposal on administration and compliance costs. In the past, it appears that complexity has been justified in terms of protecting tax revenues but this view needs to be tempered by the hidden costs of compliance and administration that complexity creates. Further, the overall impact on business competitiveness needs to be factored in when assessing the impact of any recommended changes to the Canada's system of international taxation. While accurately assessing the impact on Canadian competitiveness and the resulting economic effects may be difficult, it should not deter the Panel from ensuring some level of economic analysis is undertaken to measure the impact of proposed changes on Canada's economy.

<u>Taxation of Outbound Direct Investment</u>

Canada's foreign affiliate regime for active business income should be retained largely in its current form, subject to some minor changes aimed at improving competitiveness and ease of compliance and administration. The exemption system has served Canadian businesses well and avoided the complexities of foreign tax credit systems, which have plagued other tax regimes. Our exemption system is being considered for adoption by other tax regimes. The underlying principle that Canada wants to ensure foreign source business income has undergone sufficient taxation should be relaxed. Canadian businesses should be encouraged to expand their international operations and compete with their domestic counterparts in foreign jurisdictions without the cost of the Canadian tax system being imposed on their foreign operations.

The use of the tax credit method and the associated tracking of tax surplus for non-treaty and non-Tax Information Exchange Agreement (TIEA) countries creates additional complexity for companies operating in those jurisdictions. To avoid this additional complexity, our international tax system could designate countries with minimum levels of corporate taxation rates that would be treated in the same way as treaty and TIEA countries. Further, small businesses should be permitted to earn a level of exempt earnings in a non-Treaty or non-TIEA country similar to the annual small business limit. Any tax revenue loss from this change would likely be nominal. However, savings would arise for many companies from eliminating the need to maintain taxable surplus pools and deal with the anti-avoidance rules, helping them to be much more competitive internationally. This change would also allow the tax administration to free up resources to deal with more significant tax revenue sources.

The treatment of capital gains on the sale of shares of a foreign affiliate is a more difficult issue. Currently it is quite easy to defer taxation of any capital gains, which exceeds exempt earnings by not repatriating the income to Canada. On balance, domestic capital gains in excess of accumulated earnings are generally taxed in Canada and it would appear that the same principles should be applied to foreign source capital gains. Therefore, I am not recommending any change from the status quo in the taxation of capital gains on the sale of foreign affiliates.

Probably the most troublesome aspect of Canada's international tax system is the provision that denies interest deductibility on certain loans to foreign affiliates. These new rules will create additional complexity and impact the competitiveness of Canadian companies. The fact that Canadian companies investing abroad can obtain deductions for their financing in Canada and in the foreign jurisdiction while using an intermediate low-tax jurisdiction should not be considered objectionable. It has been a long-standing feature of the Canada's international system of taxation, and it has served to make Canadian businesses competitive. . As a result, I believe the Panel should consider recommending the repeal of this provision (section 18.2 of the Income Tax Act) as part of its review of outbound investments.

<u>Foreign Accrual Property Income (FAPI)</u>

The current policy underlying the FAPI rules appears to be based on a requirement to protect Canada's tax base with respect to highly mobile passive income and appears to be appropriate in that context. On the other hand, rather than attempting to use the FAPI rules to deal with supply chain structures through the use of the Base Erosion Rules, the transfer pricing rules may be more appropriate. Canadian companies should not be restricted from performing some functions as part of their supply chain in lower tax jurisdictions. With the planned reduction in Canada's corporate tax rate, the incentive to shift economic activity and incidence of taxation outside Canada will lessen.

The Foreign Investment Entity (FIE) and FAPI rules need to be reconciled. The FIE rules have extended the reach of Canada's attempts to tax foreign passive income. It is not clear why the FIE rules and FAPI rules should overlap and create additional complexity.

It may be appropriate to exempt the application of the accrual method to investment income earned in countries with a comparable level of taxation as Canada. As Canada continues to see decreases in the level of taxation, it seems pointless to create the compliance burden to track and report investment earnings in a foreign jurisdiction with comparable rates of tax on investment income. Eliminating this burden would ensure the FAPI system was focused on the shift of investment income to lower tax jurisdictions. It would also be appropriate to review the $5,000 *de minimis* exception for reporting FAPI and adjust it to a more realistic level for current economic values.

Inbound Direct Investment

The ability of foreign corporations to use their Canadian affiliates to finance other international investments and thereby erode the Canadian tax base should be reviewed. With the gradual reduction in Canadian tax rates, this practice may diminish as a tax policy concern. Nevertheless, the government may have to consider an anti-avoidance measure to restrict this practice. It will be important to ensure that the anti-avoidance measure does not impact investments by Canadian companies in foreign affiliates where the debt has been financed within Canada.

The current 2:1 debt-to-equity ratio for thin capitalization should be rationalized based on current bona fide debt-to-equity ratios. It appears that the 2:1 ratio is at the low end of the range. The ratio should be reviewed based on an analysis of debt-to-equity ratios over a representative timeframe.

Withholding Taxes

Canada's move to reduce withholding taxes on interest paid to arm's length foreign lenders is a welcome change in promoting Canada as a centre for international finance. The proposed reduction of withholding tax rates on interest from non-arm's length US lenders will also help Canada be more proactive as a world financial centre. The phase-out of withholding taxes on non-arm's length interest payments should be negotiated as part of the tax treaty negotiations with Canada's major trading partners.

A more difficult question is whether the withholding tax on dividends should also be phased out unilaterally or as part of bilateral treaty negotiations. The level of direct foreign investment by Canadians abroad is greater than direct investment by foreigners in Canada, as shown in the chart on page 4 of the Consultation Paper; this suggests that equivalent amounts of withholding tax would be collected by Canada on foreign investments. However, since Canada uses an exemption system, it would appear that much of the withholding tax collected by foreign governments is not creditable in Canada and as such, there may be revenue implications to the Canadian government in removing the withholding tax on dividends.

Administrative Issues

While there are various avenues of appeal and mechanisms to avoid double tax as a result of different transfer pricing assessments, resolving disputes in this area is a long, laborious and costly process. Tax treaties are designed to eliminate double taxation, but it is only recently that the proposed amendments to the treaty with the US have established mandatory arbitration in cases where the revenue authorities do not agree on a transfer pricing adjustment. It is inappropriate that transfer pricing adjustments can leave a taxpayer in a double tax situation. Sometimes the two countries' tax administrations will reach an impasse over a matter of principle that may have implications beyond the taxpayer's situation at hand. There needs to be a simpler, more cost-effective way of to settling transfer pricing disputes between tax authorities.

The withholding tax requirements for non-resident service providers may also be causing administrative problems. While the CRA advertises a waiver procedure, the CRA's administrative resources for processing and granting waivers have led to lengthy delays in the past. While the CRA may have improved its turnaround of waivers, it may be appropriate for the Panel to request up-to-date statistics on turnaround times across the country. Non-resident service providers are often confused by the waiver process. While CRA may grant a waiver based on the fact that the non-resident service provider does not have a permanent establishment, the non-resident is still required to file a tax return, report the income and claim the treaty exemption from taxation. Many non-residents are perplexed that they have a tax filing requirement after they have spent resources satisfying the tax authorities that they do not have a permanent establishment in Canada and are not subject to Canadian tax as a result of the treaty provisions.

I look forward to the Panel's recommendations arising from this important review. If there is anything I can do to assist or you have any questions on these comments, please do not hesitate to contact me.

Yours very truly,

Bruce Flexman, FCA
President