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Advisory Panel on Canada's System of International
Taxation Submission
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July 15, 2008

Dear Advisory Panel Members:

Thank you for providing us with an opportunity to provide input regarding the questions set out in your consultation paper *Enhancing Canada's International Tax Advantage* on how to improve the competitiveness, efficiency and fairness of Canada's international taxation system. We support this important initiative, and we are pleased to contribute to the consultation and debate.

Enclosed please find KPMG's submission to the Panel, in which we make a series of recommendations that we believe could improve the ability of Canadian businesses to compete in Canada and abroad. You are most welcome to post this submission on the Panel's website.

Should you have any questions regarding the comments included in this submission, please contact me by telephone at (403) 691-8226.

Yours truly

Firoz K. Talakshi
National Practice Leader – International Corporate Tax

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

KPMG LLP

July 15, 2008

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

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Thank you for this opportunity to provide input regarding the questions set out in the *Enhancing Canada's International Tax Advantage* (the "Consultation Paper") on how to improve the competitiveness, efficiency and fairness of Canada's international taxation system. We support this important initiative, and we are pleased to have the opportunity to contribute to the consultation and debate.

About KPMG

KPMG LLP, one of the largest accounting firms in Canada with over 5,000 employees and 33 offices across the country, provides auditing, tax and advisory services to numerous individuals and companies. Our client base includes large and small multinational companies as well as small and medium-sized enterprises (SME) operating in Canada.

KPMG LLP is the Canadian member firm affiliated with KPMG International, a global network of professional firms providing Audit, Tax, and Advisory services. Member firms operate in 148 countries and have more than 113,000 professionals working around the world.

KPMG's over 250 International Tax professionals provide advice to Canadian companies or individuals that conduct business outside of Canada and to foreign businesses with operations or transactions in Canada. Through this work, we have gained significant experience in the practical taxation issues facing these clients and have learned a great deal about the impact of Canada's system of international taxation on Canadian and foreign-owned businesses, in terms of tax policy, legislation and administration and compliance matters. This knowledge gives KPMG keen insight into the effectiveness of Canada's system of international taxation.

1.0 Executive Summary

We generally concur with the statement in the Consultation Paper that Canada's international taxation system has served the country well in many respects over the past few decades. We are also cognizant of and agree with your position, as stated in the paper, that setting international policy entails trade-offs and practical constraints. However, certain aspects of the system should be reviewed to ensure Canada's approach to taxing international business activity is in line with the goals of helping Canadian businesses compete in foreign markets and in attracting foreign investment capital to our country. In this submission, we set forth KPMG's views on:

- the need for certainty and simplicity in Canada's system of international taxation (see 2.0)
- whether Canada should broaden its current exemption system for active business income earned by a foreign affiliate (see 3.0)
- whether the current tax treatment of capital gains on dispositions of foreign affiliate shares should be expanded (see 4.0)
- whether changes should be made to simplify Canada's foreign accrual property income (FAPI) rules (see 5.0)
- whether the current thin capitalization rules should be amended (see 6.0)
- whether recent changes to Canada's general anti-avoidance rule aimed at perceived "treaty shopping" abuses are appropriate (see 7.1)
- whether improvements could be made to Canada's withholding tax system, including the withholding tax requirements themselves and the process for obtaining waivers from the obligation to withhold (see 7.2 and 7.3)
- whether Canada should extend relief from withholding tax on interest to other forms of imported capital (see 8.0).

KPMG's Competitive Alternatives *study*

KPMG recently completed a supplementary study to the 2008 edition of *Competitiveness Alternatives*, our guide to international business costs. According to the study, Canada ranks third (after Mexico and Netherlands), in terms of our tax competitiveness for attracting inbound investment. This supplementary study assesses the general tax competitiveness of 102 cities in 10 countries, focusing on 35 major cities. The 10 countries are Mexico, the Netherlands, Canada, Australia, the US, the UK, Japan, Germany, Italy and France. The report compares the total tax burden faced by companies in each country and city, including corporate income taxes, capital taxes, sales taxes, property taxes, miscellaneous local business taxes and statutory labour costs.

Our study concludes that a country's tax policy choices can significantly affect the tax cost of doing business in that country and the country's competitiveness in general. The study reveals that there is no standard approach in setting tax policy among the countries examined. Although the types of taxes used to raise government revenues are more or less the same, there is a huge range in how these taxes are weighted and applied.

Based on this study, Canada's federal, provincial and local tax policies have combined to put Canada at the forefront of countries for inbound investment in terms of having the lowest tax cost of doing business here. It also indicates that Canadian companies face higher tax costs in most of our major trading partners than they do in Canada. As a result, Canada should take such higher foreign tax costs into account when reviewing how its tax policy regarding outbound investment can help Canadian businesses compete in these countries.

We will forward a copy of this study to the Panel when it is available later in July 2008. In the meantime, the Panel may wish to review the more general information in the broader study of international business costs at: www.CompetitiveAlternatives.com.

Summary of KPMG's recommendations to the Panel

We recommend herein a series of measures that we think could boost the ability of Canadian businesses to compete in Canada and abroad without cutting too deeply into the government's tax revenues. Our key recommendations are as follows.

1. **In any tax system, certainty and simplicity are vital.** Over the years, Canada's international tax system has become far too complex, making it difficult for businesses to understand and comply with the rules. Compounding the problem is the enormous volume of draft tax legislation that has not yet become law. Some of these draft laws have been awaiting enactment for more than five years. Canadian businesses need firm ground on which to grow. The current state of our tax rules frustrates their ability to comply with the law and plan for the future.

2. **Exempt all foreign business income from Canadian corporate tax.** Foreign affiliates of Canadian businesses do not get taxed by Canada on the income they earn from business operations undertaken in their foreign jurisdictions. Canadian corporate shareholders of such foreign affiliates may receive these earnings as tax-free dividends. This treatment is only available for active business earnings generated by a foreign affiliate in a country with which Canada has a tax treaty or, in the future, earned in a country that has agreed to share taxpayer information.

   We think the tax exemption for foreign active business income gives Canadian companies a leg-up when trying to expand into new markets. Tying tax-free dividend status to the government's ability to enter agreements with other countries could penalize companies doing business in countries that, for whatever reason, do not take up the offer to conclude such agreements. If the purpose is to make sure the Canada Revenue Agency can get the data it needs to audit these companies, more direct tax reporting mechanisms could be put in place. Canadian companies should be free to decide where to do business based on economic opportunities, not tax agreements.

3. **Encourage foreign expansion for smaller businesses.** Even if the government does not extend the above exemption for all companies, special rules could be put in place to exempt business income earned in any country by foreign affiliates of small Canadian companies. For example, business income of affiliates of smaller Canadian companies could be exempted from Canadian tax up to the level of the small business deduction. This exemption would greatly reduce the compliance costs incurred by these small businesses and help them gain a foothold in foreign markets.

4, **Exempt capital gains realized on dispositions of foreign affiliate shares.** Many countries exempt from tax not only dividends received from foreign affiliates but also capital gains realized on disposition of foreign affiliate shares. Canada's existing system does not immediately tax capital gains on disposition of foreign affiliate shares held by another foreign affiliate to the extent that the value of the shares is derived from assets used to earn foreign active business income. However, a portion of the capital gain may be subject to Canadian tax at the corporate level on its eventual repatriation to Canada.

We believe that Canada should consider moving to a broader exemption system for gains resulting from dispositions of foreign affiliate shares generating underlying foreign active business income, potentially even permanently exempting such capital gains from corporate-level Canadian tax. Canada could also consider extending such exemption to capital gains on dispositions of foreign affiliate shares held by their Canadian parents directly.

We believe that exempting such capital gains could improve the competitiveness of Canadian businesses abroad and encourage greater repatriation of funds to Canada by making it easier and more beneficial for companies to realize the value of their foreign affiliate shares.

5. **Simplify tax on foreign passive investment income.** Like many other countries, Canada taxes on a current basis certain passive income (for example, interest) earned by Canadian-controlled foreign affiliates, but effectively allows a tax credit for any foreign tax paid on that income. Passive investments are highly mobile, and Canada's rules are designed to stop Canadians from transferring these investments to foreign affiliates in low-tax countries to avoid Canadian tax.

   We believe some aspects of these rules could be simplified to better facilitate foreign investment by Canadians. For example, the rules could be greatly simplified for businesses and the Canada Revenue Agency (CRA) alike by exempting all passive income earned in countries that impose tax at rates that are similar to or higher than the Canadian rate. This approach would rid us of much of the complexity involved in tracking and claiming tax credits for foreign passive income, while preserving the rules' intent since passive income earned in low-tax jurisdictions would continue to be subject to Canadian tax.

6. **Ensure commercial terms for foreign related-party debt.** Canada's "thin capitalization" rules are aimed at stopping non-resident shareholders from extracting profits from Canada tax-free by leveraging up Canadian companies with foreign debt and shifting funds out of Canada in the form of tax-deductible interest payments. The rules prevent this by restricting deductions for interest on debt owing to non-resident shareholders by an arbitrary formula: interest payments can be only deducted on debt of up to twice the company's equity, and amounts in excess of this threshold are not deductible.

   The government's 2:1 limit is seen as a rough measure of a commercially reasonable degree of debt financing. The problem is that, while a specific debt-to-equity limit may make sense for some types of companies, a much higher degree of leverage may be commercially appropriate depending on the industry, the entity's credit rating and other factors. The statutory limit forces businesses to look to unrelated third parties for financing at potentially higher costs even where their shareholders could provide such funding on commercially reasonable terms.

We note that some other countries base their thin capitalization restrictions on a general test of commercial reasonableness, with a formulaic debt-to-equity limit serving as a "safe harbour" rather than an absolute threshold. If adopted by Canada, such an approach would help foreign-owned Canadian businesses obtain financing on the best available terms, while still limiting their ability to shift profits from Canada through tax-deductible interest payments.

7. **Target "debt dumping" transactions more directly.** The March 2007 federal budget proposed broad rules denying interest deductibility on debt incurred to acquire or finance foreign affiliates. In May 2007, revised proposals were released, refocusing on debt financing in the "outbound double-dip" context; the latter proposals were enacted in new section 18.2 of the Act. However, these rules are broader in scope than required to address so-called "debt dumping" transactions, which are the true subject of concerns expressed by the Auditor General.[1]

   Such transactions involve the leveraged acquisition of foreign affiliates by a foreign-owned Canadian corporation of shares of another foreign affiliate from the foreign parent. The Auditor General's concern relates to "foreign-owned Canadian corporations that then invest in a foreign affiliate" and situations where a Canadian company has a foreign affiliate and deducts interest on loans for Canadian tax purposes, but does not pay any tax on that foreign affiliate.

   In our view, the concern over debt dumping should focus on investments in foreign affiliates where the Canadian corporation bears no material economic risk with respect to the foreign affiliate. The rules should distinguish between *bona fide* foreign affiliate investment and the acquisition of risk-free fixed-value equity of foreign affiliates which simply increases size of the Canadian corporation's balance sheet and thus its thin capitalization room. Debt owing to a foreign parent that is traceable to the acquisition of fixed-value equity of a foreign affiliate might then be subject to an interest deduction disallowance, while debt traceable to acquisition of common equity of a foreign affiliate might still give rise to an interest expense deduction.

8. **Target "treaty shopping" only through treaty negotiations.** The CRA has recently launched a series of challenges to international corporate structures involving holding companies located in jurisdictions which have tax treaties with Canada and which may not impose substantial incremental tax or other costs. Recent changes to Canada's general anti-avoidance rule (GAAR) may suggest a concern with such structures on the part of the government.

From the perspective of Canadian international relations, we do not believe it is appropriate for Canada to first negotiate relatively clear bilateral tax treaties, and then use GAAR-based challenges or expansive notions of beneficial ownership to circumvent treaty terms negotiated in good faith with other countries. If Canada has a tax policy concern with the use of foreign holding companies in treaty jurisdictions, it should address those concerns directly in its treaty negotiations (for example, through the use of so-called limitation on benefits provisions found in many modern tax treaties to which the United States is a party, including Canada). Where Canada has chosen not to negotiate such clauses, it should live by that choice or enter into renegotiations.

9. **Cut withholding taxes on more types of payments.** Foreign investors and other non-residents generally are subject to a withholding tax on amounts such as interest, dividends, royalties and rents received from a Canadian source. Recent changes to Canadian domestic law and the Canada-U.S. tax treaty have reduced or eliminated withholding taxes on some types of payments. We think the government should look into expanding the scope of these withholding tax cuts.

   Given how easily international capital can move from one country to another, it's hard to quantify how much the withholding tax costs Canada in lost investment – foreign investors who are deterred by the tax simply take their capital elsewhere and Canada is the poorer. More withholding tax cuts might not only help increase foreign investment, they could also help home-grown businesses by giving them readier access to lower-cost foreign capital. While the government's withholding tax revenues may decline, overall levels of business activity in Canada would likely increase and ordinary income tax revenues may rise accordingly.

   With this trade-off in mind, we believe that the government should consider reducing withholding taxes on the cost of other forms of capital, such as rents and royalties.

10. **Simplify the process for waiving withholding tax obligations.** Canada has a very onerous system for dealing with withholding tax obligations with respect to payments to non-residents for services rendered in Canada. In many cases, no tax will be ultimately payable by the non-resident. The current system causes hardship for both the payer and the service provider that may cause over-withholding of taxes or create an incentive for non-compliance. The U.S. system for eliminating withholding taxes on payments for services rendered in the United States is generally simple to follow and comply with for both the service provider and the payer. We submit that the Panel should recommend that the government consider adopting a simplified system similar to that in place in the United States.

Canada's international tax system can play a big role in fostering the ability of our businesses to compete in foreign markets and our country's ability to attract foreign investors. We hope the Panel will steer the government toward measures that will promote more international business activity like those we suggest above.

2.0 Certainty and Simplicity in Tax Law and Administration

Our overriding concern with Canada's international tax system is that it has become far too complex, making it difficult for taxpayers to understand and comply with the rules. For a number of years, Canada's foreign affiliate system has been in a state of uncertainty. Draft tax rules affecting foreign affiliates have been outstanding for more than five years, some of which would have effect as of 1995. Changes in this area included in draft tax legislation released in 2002 and 2004 will, if enacted, greatly increase the complexity of the foreign affiliate rules. Since 2004, the Department of Finance has issued more than 20 comfort letters to address concerns about unintended results of the draft proposals.

The current status of the foreign affiliate rules is hampering the ability of Canadian businesses to plan, report and comply with the tax obligations arising from their foreign business transactions. Taxpayers are obliged to plan their business transactions based on draft proposals, but they must report the tax effects of those transactions in their financial statements based on existing legislation. This increases the workload for Canadian companies by requiring two sets of analyses for all material transactions: one that assesses the tax impact under proposed legislation and another that assesses that same tax impact under current law. Further, the financial statements do not reflect "tax reality", as shareholders are given financial information based on legislative provisions that are still legally in force but will not ultimately govern a particular transaction.

Planning for transactions is difficult because it must be based on draft legislation that is subject to change and comfort letters that outline changes in general without specific detail. Given this state of flux, we applaud the Panel's statement of support for "… certainty and simplicity in tax legislation and its administration", and we look forward to your recommendations in this regard.

Some of the problems in this area may stem from a lack of resources within the Department of Finance to draft new legislation, consult with taxpayers and their advisers on its practical implications as drafted, and respond with revised proposals within a reasonable timeframe. The Panel should consider whether the Department of Finance should increase its resources in this area. The Panel should also consider recommending that the Department of Finance institute a formal exchange program with tax accounting and legal service providers to strengthen its resources and benefit from their first-hand knowledge and practical experience with Canada's system of international taxation.

3.0 Active Business Income of Foreign Affiliates

3.1 Broadening the current exemption system

In our view, Canada's current exemption system should be broadened to cover all active business income earned by foreign affiliates of Canadian companies. Under Canada's current system, active business income earned by foreign affiliates in treaty countries or, in the future, countries with which Canada has a tax information exchange agreement (TIEA) is free from Canadian tax when earned and on repatriation. This treatment allows Canadian taxpayers to expand into certain foreign markets without incurring additional Canadian tax on any foreign source income. Expanding this system to active business income earned by foreign affiliates carrying on business in any foreign jurisdiction would enhance the competitiveness of Canadian businesses in a broad range of industries that are currently penalized for operating in non-treaty and future non-TIEA jurisdictions.

A broad-based exemption system that does not rely on the signing of a treaty or a TIEA but rather on the well-established definition of active business income would significantly enhance Canadian taxpayers' ability to grow and compete on a global basis. Canadians should be free to decide where to do business based on opportunities, not tax agreements.

We acknowledge that there is a concern with respect to potential revenue loss if active business income could be earned in low-tax foreign jurisdictions and then be distributed to Canada on an exempt basis. This revenue concern is addressed under the current system by means of the distinction drawn between the treatment of exempt surplus and taxable surplus, which we discuss in 3.3 below.

3.2 The new TIEA rule

Canada has little experience to date to indicate which countries will agree to sign TIEAs. Canadian companies earning active business income in countries that do not agree to sign a TIEA could be penalized because of the government's inability to conclude such an agreement since their active business income earned in the particular foreign jurisdiction will become subject to current taxation in Canada. This risk could impair the ability of such companies to expand outside Canada.

The tax policy underlying the new TIEA condition is not clear to us. Presumably the underlying belief is that the CRA requires more extensive access to external data in order to audit companies with subsidiaries in the applicable foreign jurisdictions. However, there does not appear to be any direct connection between the existence of a TIEA and the characterization of active business income – the condition is evidently intended to place non-TIEA countries at a relative disadvantage in attracting investment capital and economic activity originating from Canadian-based multinationals, in order to give Canadian negotiators leverage in extracting TIEAs from more countries.

If this is the case, we submit that it is a relatively inefficient approach to the matter. In order to obtain a generalized future audit process advantage, Canada is rendering Canadian multinationals relatively non-competitive in expanding into a broad range of foreign jurisdictions. In the absence of a more direct connection with the audit process, we recommend that this new condition be reconsidered. Instead, Canada should consider expanding its existing powers to compel the production of foreign-based information to the extent they may be deficient.

3.3 Distinction between exempt and taxable surplus

While we have not conducted a detailed analysis, we do not anticipate that the impact on government revenues of moving to a pure exemption system for active business income of foreign affiliates would be significant. In our experience, taxable surplus earned by foreign affiliates carrying on business in non-treaty jurisdictions is seldom repatriated to Canada; because of the associated tax cost, it is generally more tax-efficient to keep such earnings offshore. Thus, while it may be theoretically more coherent, the existing taxable surplus system may not actually generate significant incremental Canadian tax revenue. By broadening the exemption system to allow such earnings to be repatriated free of Canadian tax, companies could more easily bring funds back to Canada to invest in expanding their domestic and foreign operations. A system that discourages the repatriation of earnings is inefficient as it discourages investment in Canada – instead, funds will be reinvested in offshore business even if doing so leads to a lower pre-tax return.

In our view, there is little tax policy justification in maintaining the distinction of exempt and taxable surplus for active business income. Proposed changes to surplus rules since 2002 seem to evidence a concern by Finance that corporations are creating “artificial” exempt surplus to avoid paying taxes on taxable earnings and in particular on capital gains derived from the sale of foreign affiliates. These rules, if enacted, will add significant complexity to an already complex set of rules. In our view, these rules will be nearly impossible to comply with or enforce in many cases, and they will raise little tax revenue since multinationals tend to indefinitely defer the repatriation of low-taxed foreign earnings.

Providing a general exemption for foreign active business income would also greatly simplify Canadian companies’ compliance burden. Tracking exempt and taxable surplus pools and underlying foreign tax accounts can be time-consuming and complicated, especially for corporate groups with numerous foreign affiliates. By reducing the need for companies to perform such surplus calculations, the overall compliance costs associated with the foreign affiliate regime could be significantly reduced.

A simpler system would reduce the complexity of the foreign affiliate rules themselves and make it easier for the CRA to audit the activities of foreign affiliates. Simplifying the foreign affiliate system would also ease the compliance burden for smaller Canadian businesses and make it easier for them to expand into foreign markets.

3.4 Conditions for accessing a broader exemption system

In our view, subject to our comments above regarding affiliates carrying on business in countries with tax treaties and TEIAs, the current conditions to access the exemption system are generally appropriate.

In order to access the benefits of the Canadian exemption system, among other things, the foreign entity must qualify as a foreign affiliate of a Canadian corporation, which generally requires a 10% ownership in any class of shares (directly or indirectly). To ensure the Canadian company has a significant economic investment in the affiliate, it may be more appropriate to require an ownership threshold of 10% of the votes and fair market value of the affiliate. This change would also reduce the need to rely on the anti-avoidance rule in subsection 95(6) to prevent the "artificial" creation of foreign affiliate status.

3.5 *De minimus* exemption for small Canadian businesses

If the government does not believe that moving to a broad-based exemption system is warranted at this time, at minimum, the government should consider legislating a *de minimus* exemption from the foreign affiliate rules for the active business income earned in any jurisdiction by foreign affiliates of small Canadian controlled private corporations. For example, such exemption could be provided up to the level of the small business deduction. Such an exemption would greatly reduce the compliance costs incurred by these small businesses and facilitate their ability to expand into foreign markets.

4.0 Capital Gains on Dispositions of Foreign Affiliate Shares

In its Consultation Paper, the Panel notes that many countries exempt from tax not only dividends received from a foreign affiliate but also capital gains realized on dispositions of foreign affiliate shares. Canada’s existing system does not immediately tax capital gains on dispositions of foreign affiliate shares held by another foreign affiliate to the extent that the value of the shares is derived from assets used to earn foreign active business income. However, a portion of the capital gain may be subject to Canadian tax on its eventual repatriation to Canada.

We believe that Canada should consider moving to a broader exemption system for gains relating to dispositions of foreign affiliate shares generating underlying foreign active business income, potentially even permanently exempting such capital gains from Canadian tax at the corporate level. Canada could also consider extending such exemption to capital gains on dispositions of foreign affiliate shares held directly by their Canadian parents. As the Panel points out, this treatment could be achieved through modifications to the current definition of “excluded property” (generally, property of a foreign affiliate used to earn active business income).

Such a change need not imply that Canada must re-evaluate its system of taxation of capital gains on the disposition of shares of a Canadian corporation. In adopting a broader foreign exemption system, Canada would join certain other countries in essentially ceding taxing jurisdiction over foreign active business income and related assets to the relevant foreign country. Conceptually, a capital gain realized on the disposition of foreign affiliate shares represents future active business income of the foreign affiliate that otherwise would be fully exempt from Canadian income tax. (This suggested change actually mirrors the treatment of capital gains realized on disposition of shares in the Canadian domestic context, where such capital gains on shares are generally taxable, but where the future income of the Canadian corporation disposed of would otherwise also be subject to Canadian income tax in due course.)

Canada’s current tax rules allow businesses to transfer shares of a foreign affiliate to another foreign affiliate on a rollover (tax-deferred) basis and to treat realized capital gains as dividends paid from exempt and taxable surplus pools. As a result of this rollover, though we have not performed a detailed economic analysis, we expect that the actual tax revenue derived from the realization of capital gains on dispositions of foreign affiliate shares is probably relatively minor.

Thus we believe that the impact of this change on government revenues may be relatively small and could be weighed against the simplicity that would arise from eliminating the complexities associated with exempt and taxable surplus tracking and the proposed suspended surplus rules (which will defer recognition of corporate surplus on intra-group transactions). We believe that exempting such capital gains could improve the competitiveness of Canadian businesses abroad and encourage greater repatriation of funds to Canada by allowing such companies to realize the value of their foreign affiliate shares without an incremental Canadian tax cost.

5.0 Foreign Accrual Property Income (FAPI)

5.1 Simplifying the FAPI Regime — Potential approaches

Regardless of how Canada's foreign affiliate provisions may be amended, the FAPI rules will continue to be integral to the regime. In fact, if Canada were to ultimately adopt a broader exemption system, the FAPI rules would likely become even more important, with the CRA's audit enforcement activities becoming correspondingly more focused on these rules. As such, it is difficult to consider changes to the foreign affiliate regime without also considering changes to the FAPI rules.

Overall, we believe that the FAPI rules operate appropriately in the context of their legislative intent. Other than the de-linking of FAPI from the signing of TIEAs discussed above, we do not believe that broad, sweeping changes need to be made to the FAPI rules, regardless of whether Canada adopts a broader exemption system.

Nevertheless, it is unclear to us whether certain elements of the FAPI rules accord with the goal of encouraging Canadian businesses to expand globally. The complexity of the FAPI rules greatly increases the compliance costs of both small and large Canadian businesses. Many companies do not have the in-depth knowledge of the rules in-house to accurately calculate FAPI. We believe certain aspects of the FAPI rules could be simplified and updated to better facilitate offshore investment by Canadians without compromising the overall policy objective of the rules.

For example, now that Canada's general corporate tax rate has been reduced and is scheduled to drop further, the current system could be greatly simplified by exempting from FAPI certain types of income that do not appear to significantly affect Canada's tax revenues, simply by virtue of the circumstances in which such income arises. Simplification could be achieved in these circumstances by eliminating the need for taxpayers to undertake costly and time-consuming analyses and/or calculations with respect to such income (including the requirement to convert such income to Canadian dollars).

Possible approaches to exempting certain types or amounts of income from FAPI may include one or more of the following:

High-tax exception. Under this approach, FAPI would not include any income earned by a foreign affiliate that has been subject to tax at a rate that is similar to or higher than the Canadian rate. Under this approach, the objective of the rules would be preserved and simplification achieved, as FAPI earned in low-tax jurisdictions would remain subject to the existing regime. Countries that currently utilize a variation of a "high-tax exception" include France, Japan, Germany, and the United States.

White-list exception. Under this approach, none of a controlled foreign affiliate's income would be considered FAPI if such affiliate is a resident of a country that is on a prescribed list (i.e., a "white-list"). Unlike the high-tax exception, this measure would automatically apply regardless of the actual amount of tax paid or payable by the foreign affiliate in respect of its income, thereby eliminating the need to perform potentially complex calculations to determine the effective rate of tax imposed on income that would otherwise constitute FAPI. White-list countries could include certain industrialized countries, such as Australia, the United Kingdom and the United States, which impose tax on their residents at rates that are comparable to, or even higher than, the Canadian corporate tax rate. White-list countries could also include certain higher-taxed developing countries, such as Mexico. Countries that currently use a variation of the "white- list" include Australia, Germany, Italy, Japan, New Zealand and Sweden.

De minimus *exception*. The current $5,000 threshold for earning FAPI tax-free has not changed since 1975. Increasing this threshold (and indexing it for inflation) could assist smaller Canadian businesses seeking to grow by expanding into foreign markets. Similar benefits could also be achieved for larger Canadian companies by providing a *de minimus* rule under which none of a controlled foreign affiliate's property income would be treated as FAPI if that property income is less than, say, a fixed dollar amount and/or a specified percentage of the affiliate's active business income.

Ultimately, the degree of simplification that could be achieved from enacting one or more of the above measures would depend on how it is implemented in the enabling legislation.

5.2 "More than five employees" test

Aside from simplification, there are some particular aspects of the FAPI rules that we believe inappropriately discourage offshore investment by Canadians. In certain cases, the existing FAPI rules seem to unfairly penalize certain types of industries more than others, limiting the ability of Canadian businesses in these industries to develop their products and services outside of Canada.

The "more than five full-time employees" test is often particularly onerous for a controlled foreign affiliate that carries on a real estate development business in order for the affiliate's income not to be considered FAPI. It is often not realistic for a small real estate development company to meet this test throughout the life cycle of a typical real estate development project. For example, the test will often be met during the development phase of the project, but no longer met during the sales phase. In such circumstances, the test seems both arbitrary and contrary to the economic policy objective of assisting Canadians to export their entrepreneurial skills and expertise to foreign markets.

Even for larger real estate development companies it is often very difficult to meet the employee test because such companies are commonly required, due to liability concerns, to hold projects in separate companies. Although some recently enacted changes to the FAPI rules are potentially relieving for real estate developers, the rules remain overly complex and still do not reflect many of the practical business realities faced by real estate developers (e.g., single-purpose vehicles, subcontracting of services to third parties, structuring of financing). To the extent that the foreign affiliate meets the employee test in some years but not others, the complexity faced by the foreign affiliate increases significantly due to the application of the "fresh start" rules, which effectively deem the affiliate to have disposed of its properties for fair market value if the requirements in those rules are met.

We believe that any income earned by an affiliate in respect of a business, the primary purpose of which is to develop real property for sale to others, should not constitute FAPI, regardless of whether such business has more than five full-time employees at all relevant times. The exclusion of such income from FAPI would not be inconsistent with a similar exception that is applicable for the foreign investment entity (FIE) rules. In addition, the re-characterization provision contained in subparagraph 95(2)(a)(i) should be relaxed to clearly accommodate common structures in which real estate developers place all of their employees in a single company, yet hold each of their real estate development projects indirectly through an investment in a single purpose entity.

5.3 Exporters of services

The FAPI rules also seem to unfairly penalize exporters of services as compared to those who export products. For example, if a Canadian manufacturing company sells its products to its controlled foreign affiliate for resale to non-residents of Canada, the margin or spread earned by the controlled foreign affiliate is generally not FAPI. By contrast, if a Canadian engineering services company provides services to its controlled foreign affiliate which, in turn, utilizes such services to provide engineering services to non-residents of Canada, the margin or spread earned by the controlled foreign affiliate is generally considered FAPI due to recently enacted changes to the FAPI rules. In both cases, we submit that the transfer pricing rules arguably would limit any leakage from the Canadian tax base, and so it is not clear why the export of services should be treated in certain cases any differently than the export of products. We believe that the FAPI rules should be modified to encourage the export of services from Canada.

5.4 Interaction with foreign investment entity rules

The complexity of the foreign affiliate rules is compounded by the overlaying of a new proposed anti-avoidance regime, known as the foreign investment entity (FIE) rules. Though generally intended to operate parallel to the FAPI regime, the FIE rules overlap with the foreign affiliate regime in some cases, creating significant complexity in computing a foreign affiliate's FAPI and surplus pools.

For example, both the FIE and the FAPI regimes apply to a controlled foreign affiliate if the affiliate is considered a "tracking entity". In other situations, a Canadian shareholder of a foreign affiliate (as opposed to a controlled foreign affiliate), or the foreign affiliate itself, is subject to the FIE rules if the affiliate is, or has a participating interest in, a FIE.

The overlap of these two highly complex regimes increases the compliance burden faced by affected taxpayers exponentially. Such complexity arises in part because:

(i) the exceptions from the FIE rules do not mirror those of the FAPI rules (e.g., the FIE rules do not contain re-characterization provisions similar to those in paragraph 95(2)(a)); and

(ii) any FIE income of a foreign affiliate must be included in computing its surplus pools.

Tax policy-wise, it is not clear why the FIE rules should apply to an investment in, or an investment held by, a foreign affiliate when such investments are already within the scope of the foreign affiliate rules. We submit that eliminating the overlap between the FIE and foreign affiliate regimes would simplify the compliance burden faced by many Canadian companies.

6.0 Taxation of Inbound Direct Investment

6.1 Thin capitalization rules

Canada's existing thin capitalization rules impose a maximum 2:1 debt-to-equity ratio for cross-border related party[2] corporate[3] debt. As such, the rules do not apply to debt owing to residents of Canada, nor to debt owing to unrelated parties. These scope limitations presumably support the tax policy underlying these rules: where interest expense may reasonably be regarded as enabling a non-resident parent entity to extract corporate profits from Canada on a tax-deductible basis, deductibility should be limited or denied.

The Panel has noted that "deductibility of *bona fide* business costs incurred by Canadian subsidiaries of foreign companies, including interest, is appropriate from a tax policy perspective".[4] In this portion of our submission, we apply this principle to distinguish payments of interest which constitute *bona fide* business costs from payments which, while legally interest, should be regarded as effecting an extraction of corporate profits from Canada. We then advocate an approach to thin capitalization which seeks to deny tax deductibility only in the latter case.

We are sensitive to the revenue concerns associated with any perceived relaxation of the thin capitalization rules. Specifically, we appreciate the concern that foreign-owned Canadian corporations may choose relatively greater levels of foreign related-party debt or acquire foreign assets funded by such debt[5], and as a result inappropriately reduce Canadian tax revenues. We believe we have addressed these issues at a conceptual level below, but we recognize that further study may be warranted.

Thin capitalization as a measure of commerciality

The existing 2:1 limitation is apparently intended as a rough measure of "commercial" levels of interest expense. In the Technical Notes released with the 2000 federal budget, which proposed to reduce the ratio to 2:1 from 3:1, the Department of Finance stated that "the permitted 3:1 debt-equity ratio is high compared to actual industry ratios in the Canadian economy, suggesting that the 3:1 ratio permits inappropriately high debt levels". By reducing the maximum debt-to-equity ratio to 2:1, the government was seeking to apply a standard of commerciality as a way of distinguishing between *bona fide* business costs and disguised extraction of corporate profits.

Unfortunately, even if the current 2:1 ratio limit is closer to what the Department regards as "actual industry ratios" in general, many industries (*e.g.,* financial services, real estate development) clearly exhibit much higher ratios. It cannot be said that such debt levels are not "commercially reasonable": they are incurred for *bona fide* commercial purposes without regard to tax. Subjecting interest expense to a formulaic limitation on deductibility that falls below the "commercially reasonable" threshold in many cases is clearly distortive, forcing such corporations to either finance their activities with third-party debt or obtain equity financing rather than debt financing from related parties.

We submit that neither result is appropriate. If a Canadian borrower constrained by the existing thin capitalization limit finances with third-party non-resident debt, the shelter from Canadian tax should be no less than it would have been had the borrower instead borrowed from its non-resident parent, and it *could be greater*.[6] Alternatively, if the Canadian borrower finances with equity from its non-resident parent, greater tax revenue would arise for the government, but at the cost of sacrificing the tax policy underpinning the thin capitalization rules (that is, the policy that related-party debt should not be permitted to extract otherwise taxable commercial profit from Canada on a tax-deductible basis but that commercially reasonable debt should not be regarded as violating this principle regardless of the relationship with the lender). Where it would otherwise be commercially reasonable for a borrower to incur debt exceeding a 2:1 debt-to-equity ratio, we submit that the related interest should be regarded as an ordinary business expense and not treated as a mechanism for extracting business profits from Canada. In such cases, whether or not the debt holder is related to the debtor is irrelevant.

Impact on Canadian tax revenues

We acknowledge the concern that relaxing the thin capitalization rules could cause material increases in debt levels in Canada and reduced Canadian tax revenues even without regard to so-called “debt dumping” transactions (discussed at 6.2 below). However, we submit that this impact may not be as great as expected for two reasons:

- As Canadian income tax rates continue to fall below rates of many other countries, the benefit of a deduction for Canadian tax purposes may be more frequently offset by income tax imposed in the tax jurisdiction of the lending parent on the correlative interest income.[7]

- Canadian corporations wishing to maximize their interest expense to benefit from the associated tax deductions in Canada may still do so outside the scope of the thin capitalization rules by obtaining such funding from third-party lenders[8]; in these cases, relaxing the thin capitalization rules would likely trigger a switch to related-party debt, with no tax revenue loss to the Canadian government.[9]

The countervailing desire for certainty

Our discussion above suggests that a standard of “commercially reasonable” debt levels should be enacted in place of a specific maximum debt-to-equity ratio. However, switching to such a standard could generate uncertainty, contrary to the countervailing tax policy objective (and preference of taxpayers and government) of certainty of tax treatment. If Canada were to adopt a pure “commercially reasonable” standard for thin capitalization, taxpayers would be faced with the need to make factual determinations which, at least on the margins, could result in uncertainty for taxpayers and the CRA.

We submit that Canada should take the approach of some other countries and adopt a hybrid regime, including both a “commercially reasonable” standard and a formula-based “safe harbour”. We submit that the existing 2:1 debt-to-equity ratio test should be retained as a "safe harbour", but that additional debt up to a "commercially reasonable" level be allowed under the thin capitalization rules. In this way, taxpayers wishing to obtain certainty or in industries in which the 2:1 ratio reasonably approximates commerciality could choose to live within its bounds. At the same time, taxpayers in industries or circumstances where normal commercial debt-to-equity ratios clearly exceed this limit could choose to follow a more fact-based standard.

To help provide certainty for taxpayers who use the fact-based "commercially reasonable" standard, we suggest that the CRA develop and publish guidelines or benchmarks of commerciality, perhaps based on market data in particular industries. These guidelines would also help the CRA determine whether debt capitalization levels of particular taxpayers should be considered more carefully on audit. If establishing commercially reasonable levels of debt in a particular context is viewed as too uncertain for taxpayers or the CRA, a system of CRA pre-clearance like that under section 116 may be appropriate.[10]

In addition, there are numerous ancillary issues regarding the thin capitalization rules that should be considered — some of these issues are outlined in section 6.3.

6.2 "Debt dumping"

While a subject of some discussion in the past,[11] the issue of deductibility of interest expense incurred in relation to the investment of borrowed funds in foreign subsidiaries has achieved greater prominence with the release of the March 2007 federal budget. This budget proposed broad rules denying interest deductibility on debt incurred to acquire or finance foreign affiliates. In May 2007, revised proposals were released, refocusing on debt financing in the "outbound double-dip" context; the latter proposals were quickly enshrined in law in new section 18.2 of the Act.

At about the same time as the May 2007 revised proposals were released, the Auditor General appeared before the House of Commons Standing Committee on Finance to speak to these issues.[12] In that context, she indicated that the concerns of her office were not with respect to interest deductibility generally but specifically to situations involving foreign-owned entities.

On the basis of the hearing transcript, it is apparent that the concerns expressed by the Auditor General have shifted from interest deductibility to fund foreign affiliates generally, through the use of "tax havens" and "double-dip" financings,[13] to arrive at what has been referred to as "debt dumping". Such a transaction involves the leveraged acquisition by a foreign-owned Canadian corporation of shares of a foreign affiliate. The Auditor General expressed the matter as follows: "The major concern we've had over the years is foreign-owned Canadian corporations that then invest in a foreign affiliate," with the issue discussed being "a Canadian company that has a foreign affiliate and uses the Canadian tax system to deduct interest on loans, but doesn't pay any tax on that foreign affiliate".

In our view, there are two ways to look at the "debt dumping" issue: it may be viewed as relating to interest deductibility on borrowing to invest in a foreign affiliate, or it may be viewed as relating to the increase in the capitalization of the Canadian subsidiary in order to increase its thin capitalization "room".

In the 2007 federal budget, the Minister of Finance proposed a broad rule with respect to interest deductibility in respect of investment in foreign affiliates; however, over the following months of consultation, he moved away from that broad rule and focused on so-called "double-dip financing" transactions. For all of the reasons publicly aired during those consultations, we believe that the Minister was right to move away from a general rule disallowing such interest expense, and we do not advocate its application in the debt dumping context. We believe it would harm the competitive position of Canadian corporations expanding abroad if the cost of financing that expansion were not tax-deductible.

The foregoing is true regardless of whether the Canadian corporation is controlled by a foreign parent. In our view, the general rule should be that, where interest expense is incurred by a Canadian subsidiary on funds borrowed from its foreign parent to fund the acquisition of equity of a foreign affiliate, that interest expense should be deductible.

At the same time, we acknowledge that there may be some balancing of considerations required. Specifically, it may be reasonable to distinguish borrowing to expand the foreign holdings of a Canadian corporation from borrowing merely to acquire equity of such an entity in order to increase the size of the Canadian corporation's balance sheet and create more thin capitalization "room". One approach to drawing such a distinction may be to require that the Canadian corporation have "real economic risk and reward" with respect to the foreign affiliate and not just a fixed value investment. Such an approach would be consistent with those taken in other contexts in the Act.[14]

In our view, the concern over debt dumping should focus on investments in foreign affiliates where the Canadian corporation bears no material economic risk regarding the foreign affiliate. The rules could then distinguish between *bona fide* foreign affiliate investment and the acquisition of risk-free fixed-value equity which simply increases size of the Canadian corporation's balance sheet and thus its thin capitalization room. Debt owing to a foreign parent that is traceable[15] to the acquisition of fixed-value equity[16] of a foreign affiliate might then be subject to an interest deduction disallowance, while debt traceable to acquisition of common equity of a foreign affiliate might still give rise to an interest expense deduction.

Third-party borrowing to acquire or invest in a foreign affiliate should not be subject to the same restrictions as borrowing from related parties. Where a Canadian corporation borrows from a third party to invest in a foreign affiliate without credit support from a foreign parent, it is hard to see that the transaction constitutes the "dumping" into Canada of what would otherwise be related-party foreign debt. This approach would put Canadian-owned and foreign-owned corporations in the same position: *bona fide* debt in the Canadian entity incurred to fund its expansion into other jurisdictions would give rise to deductible interest, while debt "imported" from a foreign parent would not.

If a limitation on debt dumping is required, it would be consistent with the foregoing discussion to integrate that limitation into the Canadian thin capitalization regime. This might be achieved, for example:

- by deducting from "equity" of the Canadian corporation all or some portion of the amount invested[17] by the Canadian corporation in fixed value shares of a foreign affiliate in which the Canadian corporation does not also have a proportionate votes and common equity interest; or

- by measuring the level of "commercially reasonable" debt of the Canadian corporation without regard to the value of fixed value shares of a foreign affiliate in which the Canadian corporation does not also have a proportionate votes and common equity interest.

In either case, the thin capitalization rules would simply deny interest expense or not, as appropriate.

It is apparent from the transcripts of the Finance Committee hearings noted above that the underlying policy concerns of the Auditor General and the Department of Finance with respect to investment in foreign affiliates, both as initially addressed in March 2007 and then as formulated in May 2007 followed by the enactment of section 18.2, were primarily concerned with debt dumping transactions. Accordingly, if appropriate limitations on such "debt dumping" transactions were imposed, then the existing concerns which have been addressed by section 18.2 should be relieved. As a result, that section would no longer be required and could be repealed.

6.3 Ancillary thin capitalization issues

A number of ancillary issues should be further considered in respect of the thin capitalization rules. We raise these issues at the conceptual level below, but would be pleased to provide a more detailed discussion of any issues which the Panel desires to explore further.

- Trade debts arising in the ordinary course and satisfied in accordance with normal commercial terms should be excluded from the thin capitalization ratio computations, even where owing to related parties.

- Since the thin capitalization rules are intended to reflect overall commercial debt-to-equity ratios, presumably all debt financing[18] of the Canadian corporation should be included in the determination of commerciality. That said, as interest payable to third parties clearly should not be regarded as a disguised extraction of profits, deduction of such third-party interest presumably should not be denied.[19]

- The treatment of guaranteed debt should be revisited, especially regarding the potential Canadian tax revenue impact of relaxing the thin capitalization limitations. The determination of “commercially reasonable” debt levels perhaps should be made on the assumption that no foreign parent or other related non-resident party guarantees or otherwise makes available credit support to the Canadian subsidiary.[20]

- The Consultation Paper notes that some countries use a so-called “earnings stripping rule” as an alternative to thin capitalization rules, under which the deductibility of interest is limited by reference to the taxpayer’s pre-interest earnings rather than its balance sheet. Given that this is essentially another blunt approach to determining a commercial level of debt, if a “commercially reasonable” test is adopted, an earnings stripping rule appears unnecessary.[21]

- Under existing law, the deduction of interest on debt exceeding the statutory thin capitalization limit is simply denied, with no way to recover the shortfall in other years.[22] Even if the thin capitalization rules are not amended to provide a “commercially reasonable” standard, the current rules should be amended to allow carryover to other taxation years of amounts the deduction of which is denied under the thin capitalization rules.[23]

- Consistent with the notion that excess interest is disallowed under the thin capitalization rules on the basis that it is a disguised profit distribution, such excess should be deemed to be a dividend for Part XIII purposes.[24]

7.0 Treaty Considerations

7.1 Treaty shopping

The CRA has recently launched a series of challenges to international corporate structures involving holding companies located in jurisdictions which have tax treaties with Canada and which may not impose substantial incremental tax or other costs.[25] Recent changes to Canada's general anti-avoidance rule[26] may suggest a concern with such structures on the part of the Department of Finance. While the CRA and (perhaps) Finance clearly do not "like" the fact that some ultimate indirect owners of Canadian corporations choose to hold those corporations through entities formed in jurisdictions with which Canada has a tax treaty, unfortunately the tax policy basis underlying these concerns is not particularly clear.

We submit that there has been no public policy discussion of these issues. Rather, the CRA has undertaken audit attacks on such structures, while the Department of Finance has incorporated the notion of "abuse of a tax treaty" in the general anti-avoidance rule. Unfortunately, the CRA has provided no indication of what structures it finds to be of concern, while the Department of Finance has similarly given no indication of how the abuse of a tax treaty is to be demonstrated.

Canada's tax treaties are the product of detailed bilateral negotiations between states, the results of which are generally treaties with relatively clear, simple words. Those words are negotiated by the contracting states in good faith, against a background of a variety of international corporate structures and a variety of alternative treaty provisions for addressing such structures. From the perspective of Canadian international relations, it is not appropriate for Canada to first negotiate relatively clear bilateral tax treaties, and then use GAAR-based challenges or expansive notions of beneficial ownership to circumvent treaty terms negotiated in good faith with other countries.

So-called "limitation on benefits" (LOB) clauses are found in many modern tax treaties to which the United States is a party, including Canada. (The Canada-U.S. treaty contained a LOB even prior to the Fifth Protocol, but that clause only applied to U.S. corporations directly owned by residents of Canada; the Fifth Protocol amended the LOB, including making it applicable in both directions.) If Canada has a tax policy concern with the use of foreign holding companies in treaty jurisdictions, it should address those concerns directly in its treaty negotiations. Where Canada has chosen not to negotiate such clauses, it should live by that choice or enter into renegotiations.[27]

7.2 Withholding tax on cross-border services

Where a non-resident provides services in Canada, the non-resident is potentially subject to ordinary Canadian income tax (unless exempted by treaty) on the basis that the non-resident is carrying on business in Canada. The provisions of Regulation 105 impose a withholding regime which attempts to capture this potential income tax by requiring a payer for services rendered in Canada by a non-resident to withhold on account of the non-resident's liability for tax under Part I. The non-resident then must file a Canadian income tax return to seek a refund of this Canadian tax by claiming treaty exemption or by claiming deductible expenses to shelter some or all of the income.

While the foregoing may be theoretically sound, in practice, this withholding regime is ineffective in two ways. Firstly, it penalizes legitimate, compliant businesses by imposing substantial administrative burdens and the financial costs of having to accept reduced revenues for their services and then having to go through the complexities of Canadian tax filings to obtain refunds of amounts that are often not taxable in the first place. Secondly, the regime does not encourage compliance, as enforcement of the withholding tax rule is at best erratic and the ability to obtain waivers from the requirement is highly limited.

These problems are even worse for the individuals who actually enter Canada to provide such services. Their presence in Canada obliges their non-resident employers to make Canadian employee source deductions and remittances and obliges the employees to file individual Canadian income tax returns.

In light of these deficiencies, we urge consideration of a less burdensome system.[28]

For example, the U.S. tax system has a simplified system for eliminating withholding taxes on payments for services rendered in the United States. The U.S. system puts the onus on the service provider to provide representations to the payer that no U.S. tax will be ultimately payable under the terms of a tax treaty; the payer is generally not required to withhold tax on payments for the services provided these representations are made. The procedures are generally simple to follow and implement for both the service provider and the payer, and they promote compliance with the withholding provisions and help to avoid over withholding of taxes. We submit that the Panel should recommend that the government examine the adoption of a more simplified system similar to the system in place in the United States.

8.0 Part XIII Withholding Taxes and the Cost of Imported Capital

Broadly speaking, Part XIII withholding tax can be seen as providing a partial recovery of tax in Canada on the payment of certain specified amounts which give rise to a deduction in Canada. Historically, one might have taken the imposition of Part XIII tax as a tax policy *quid pro quo* for the grant of a deduction in Canada. However, it now appears that this statement is too broad. Recent changes to Canadian domestic law eliminating withholding tax on interest[29] paid to unrelated non-residents may signal a break with this theory, eliminating withholding taxes on amounts that are deductible for Canadian income tax purposes. The Fifth Protocol also reflects at least a weakening of this theory, albeit on a bilaterally negotiated basis, eliminating withholding tax even on most related-party interest.

These withholding tax changes may be an acknowledgement of the ease with which international capital can move from one jurisdiction to another. By eliminating withholding taxes on such inbound investment, Canada is presumably made more attractive as a place for non-residents to invest relatively mobile capital. As a result, Canadian business should benefit from improved access to sources of capital generally, and to lower-cost capital in particular. While the trade-off could be difficult to quantify, conceptually, withholding tax revenues are being allowed to decline as the price paid for increasing overall levels of business activity in Canada and resulting increases in ordinary income tax revenues.

The Panel’s Consultation Paper provides a breakdown of reported withholding tax revenues in various categories for the period 2000-2005. It is notable that in the most recent year listed, revenues from withholding tax on interest were “only” $381 million, and on rents and royalties only $404 million. While not insignificant, these relatively modest amounts of tax suggest that the countervailing benefits of increased economic activity and improved profitability that could result from elimination of such withholding should be assessed. While such an economic analysis is beyond the scope of the present submission, we would advocate that a detailed review be undertaken.

While relief from interest withholding tax is welcome, interest is only one of many costs of imported capital incurred by Canadian businesses. We not only borrow money internationally, we also “borrow” other capital assets, such as machinery and equipment and intellectual property. There does not appear to be a clear basis to distinguish the costs of these forms of capital from the cost of borrowing money. Accordingly, we submit that consideration should be given to reducing withholding taxes on the cost of other forms of capital, such as rents and royalties, in similar manner to the recent reduction or elimination of withholding tax on interest.

9.0 Conclusion

We thank you for the opportunity to provide our views on this important topic. We believe the implementation of our recommendations above would help improve the competitiveness, efficiency and fairness of Canada's international taxation system.

[1] The Auditor General commented on this matter before the House of Commons Standing Committee on Finance on May 17, 2007. See http://cmte.parl.gc.ca/cmte/CommitteePublication.aspx?SourceId=207689.

[2] The restriction of course extends beyond debt owing to "related" non-residents. As such, the term is used for convenience rather than technical precision.

[3] The application of these rules only to debt of corporations has been commented on in the past by the Department of Finance. Presumably having its genesis when corporations were the sole vehicle for substantial business activity in Canada, the Department has in the past suggested that it would consider whether application to non-corporate entities would be appropriate. We acknowledge this issue, but do not propose to address it herein.

[4] Consultation Paper, paragraph 3.9.

[5] The latter is has been referred to as "debt dumping", and is specifically addressed below.

[6] If the rate that would be charged by a third party were less than that charged by the related party, deduction of the excess should be denied pursuant to section 67, the "reasonable" requirement in paragraph 20(1)(c) and the Canadian transfer pricing rules. The rate charged by the third party might even have been greater if the parent was able to rely on its better knowledge and control of the subsidiary to support lending at a lower rate of interest. In addition, interest on third party debt will normally be exempt from Canadian withholding tax, whereas interest to a related parent may still be subject to Part XIII tax.

[7] The discipline imposed by foreign taxes is less, of course, where the foreign parent is either itself resident in a relatively low tax jurisdiction, funds the Canadian subsidiary debt through such a jurisdiction, or uses other tax structures to defer or eliminate tax on that interest income. It may be appropriate to ask whether Canada should formulate its own tax system in order to discipline the use of such structures by foreign multinationals to minimize their non-Canadian taxes. In this type of case, however, the Canadian and foreign tax savings are arguably inextricably intertwined.

[8] In some cases, such third-party financing may be facilitated by credit support (such as a guarantee) from the foreign parent entity.

[9] Under current law, there could be a revenue gain to Canada if the lender is resident in a country other than the United States, as Part XIII could then impose Canadian withholding tax on the interest. The withholding tax consequences may change if Canada negotiates bilateral exemption from withholding for related-party interest with other countries on similar lines to that provided in the Fifth Protocol. In granting the exemption Canada presumably obtains other benefits by relieving Canadian lenders from foreign withholding. As such, the foregoing of Canadian withholding tax perhaps analytically attaches more to these other benefits and is less a consequence of the thin capitalization analysis.

[10] We acknowledge that implementing a pre-clearance system will entail logistical and cost considerations. However, we regard such an increase in CRA resources as needed in any event, as transfer pricing issues are becoming more prevalent and are subject to more CRA audit scrutiny. Pre-clearance would then be like an audit function that would be required later in any event.

[11] 1992 Report of the Auditor General of Canada, Chapter 2, "Other Audit Observations" (November, 1992). The same issue was also raised in the 1998 report of the Technical Committee on Business Taxation (commonly referred to as the "Mintz Report"), and again more recently in the 2002 Report of the Auditor General of Canada, Chapter 11, "Other Audit Observations" (December 2002).

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[12] See http://cmte.parl.gc.ca/cmte/CommitteePublication.aspx?SourceId=207689. The following comments are of particular relevance.

> A: A number of times in the past we expressed concerns about certain tax arrangements for foreign affiliates. We observed transactions where foreign-owned Canadian corporations incurred debt in Canada to finance investments in third countries. …
>
> It is important to note that my office did not call for the broad elimination of interest deductibility. Rather, we identified the issue as a potential threat to the tax base, and we recommended in 2002 that Finance Canada obtain and analyze current information to reassess the tax revenue impact and the rationale for allowing foreign-owned Canadian corporations to deduct interest on borrowed funds related directly or indirectly to investment in foreign affiliates and for allowing tax-privileged entities in treaty countries to bring income into Canada tax free. …
>
> The major concern we've had over the years is foreign-owned Canadian corporations that then invest in a foreign affiliate. …
>
> Q: Are you concerned about the fact that a Canadian company that has invested in a foreign affiliate abroad borrows money in Canada, is able to deduct the interest for that company [*sic*], but that affiliate does not pay any income tax in Canada?
>
> A: It was raised as an issue, but our main concern was with foreign-owned Canadian companies. What they would do in their corporate structure was move debt into Canada. There were very few benefits to Canada by doing that. One can argue there is a difference between a Canadian-owned corporation that invests abroad ... and then ultimately there can be some benefits back to Canadian shareholders.
>
> Q: A similar situation occurs, though, if you have a Canadian company that has a foreign affiliate and uses the Canadian tax system to deduct interest on loans, but doesn't pay any tax on that foreign affiliate. In fact, Canada, again, subsidizes operations abroad that may help foreign workers abroad and economies abroad, but it does nothing to help Canada.
>
> A: That is true, except that one might argue that ultimately the Canadian shareholders of that company could benefit if there is expansion of that corporation internationally. There could be potentially some benefit there, at least to a Canadian shareholder of that corporation, whereas if it's foreign owned, there is none.

[13] While not entirely clear, the full text of the Committee hearing suggests that there are two possible issues in this area: the establishment of businesses in tax havens generally, and the use of tax havens as an intermediary jurisdiction for double-dip financings. Of these, it seems that the first is more roundly criticized; there is some suggestion that double-dip financings are not of such great concern, as it may not be clear that the Canadian tax base suffers as a result of such transactions. A detailed consideration of these issues is beyond the scope of this submission.

[14] An approach requiring a “real risk equity interest” has precedent in other areas of the Act. Subsection 95(6) targets acquisition and disposition of shares which create (or eliminate) status of a corporation as a “foreign affiliate” on a contrived basis without real economic interest. Subsection 17(8) provides a modified version of the definition of “controlled foreign affiliate” for purposes of the section 17 anti-avoidance rule in order to ensure that exceptions to that rule are only available in respect of investments in a “real” controlled foreign affiliate. Both Part IV and Part VI.1 of the Act contain “votes and value” tests that are used to ensure statutory entitlements are available only where the required relationship has some economic substance.

[15] In the extreme view, a tax policy concern could be perceived whenever a foreign-owned Canadian corporation has debt outstanding and holds fixed-value equity interest in a foreign affiliate at the same time. Presumably, the mere co-existence of these two factors should not be sufficient to trigger the concern. For this reason, it may be appropriate to use a tracing approach such as that generally applied to determine the use of borrowed funds for purposes of paragraph 20(1)(c) of the Act. Another tracing

model could be that contemplated in new section 18.2. The need for the latter section could be obviated, however, by introducing a more focused provision that addresses debt dumping only.

16 The model for this might be the existing "taxable preferred share" definition.

17 If this approach were taken, presumably this amount should be "cost" or some portion thereof, rather than being based on the fair market value of the foreign affiliate at the time of measurement; otherwise, Canadian subsidiaries with successful underlying foreign operations would be unduly penalized.

18 Excluding ordinary course trade debts.

19 If all debts are included in the debt-to-equity ratio computation, and the total debt exceeds a commercially reasonable level but third-party debt should not be subject to interest denial, then the question arises as to how to determine which debt is "bad". Is the "excess debt" allocated between third-party and related-party debt on some basis, or is it either all "good" or all "bad"? For example, assume total debt of $1,000, of which $250 is owing to third parties and $750 is owing to related non-residents. Also assume that the "commercially reasonable" debt level is $600, such that the "excess debt" is $400. There are at least three alternative mechanical "ordering" approaches.

- The commercially reasonable $600 debt is comprised entirely of related-party debt. Thus, the $400 "excess debt" consists of the remaining $150 of related-party debt and the $250 third-party debt. Only the $150 of "excess" related party debt could be disallowed. The $250 debt owing to third parties is not subject to disallowance.
- At the other extreme, the commercially reasonable $600 debt is comprised of $250 third party debt and $350 related party debt. The $400 "excess debt" would then be comprised entirely of related-party debt, and thus the full $400 could be disallowed.
- In an intermediate approach, the total debt is comprised of 25% third-party debt and 75% related-party debt. Applying a proportionate approach, 75% of the $400 "excess debt", *i.e.*, $300 of excess debt, could be disallowed.

In addition to the foregoing, an ordering might be established based on the date of borrowing or maturity or on a security ranking. It is not clear to us that there is a principled basis to choose between these alternative views, although presumably one might be developed and should be considered.

20 The inclusion of guaranteed debt was previously raised by the government in the context of the existing 2:1 rule, but that approach was withdrawn on consideration. We submit that was the correct decision in the context of the specific 2:1 limitation. Accordingly, if guaranteed debt is to be included, we believe it should be included only for purposes of determining "commercially reasonable" debt levels.

21 In the context of an explicit "commerciality" test, an earnings stripping rule could be used instead of the existing balance sheet test as a "safe harbour". We do not advocate such a shift, largely for practical reasons: first, reference to earnings as a basis for the limitation would mean that taxpayers could not determine until after yearend what level of interest would be allowed; and second, there seems no real benefit to changing the basic computation with which taxpayers are at least familiar. Having said this, one effect of such a rule would be to limit the utility of "debt dumping" transactions discussed in the immediately following section, at least if income from the foreign affiliate were excluded from the notion of "pre-interest earnings"; this may or may not be an appropriate result, as discussed *infra*.

22 This punitive result is particularly severe where the excess arises from a reassessment in a later year (*e.g.*, due to a determination that a taxpayer's income and thus its retained earnings included in equity are lower than believed). As a result, it may be too late to bring the taxpayer's cross-border debt to within the statutory limits for a particular intervening year.

[23] Presumably both a carryforward and a carryback, perhaps within the same time limitations as applicable to non-capital losses, would be appropriate. We do not propose to belabour this or other technical issues of implementation herein.

[24] Such deemed dividends would then be subject to Canadian withholding tax at the appropriate dividend withholding rates. Assuming a treaty applies, typically this rate could be 5%, 10% or 15%, depending upon whether the recipient of the excess interest is a direct or indirect shareholder and a corporation or some other entity. In most cases, deemed dividend treatment would result in reduced rates of withholding tax; however, in cases where the full exemption under the Fifth Protocol would otherwise be available, imposition of Part XIII tax on a dividend basis could result in higher tax withheld. Where denied interest expense is carried over to other years as contemplated by the preceding bullet in the main text, presumably it would be appropriate to reassess such withholding tax, generating either a refund of the withholding tax or additional withholding on the basis that now-deductible interest expense should be treated as such for the Part XIII purposes as well.

[25] For example, see *R v MIL (Investments) SA*, 2007 FCA 236, aff'g 2006 TCC 460; *Prévost Car Inc v R*, 2008 TCC 231.

[26] Subsection 245(4), retroactively amended by SC 2005, c. 19, subsec. 52(2), applicable with respect to transactions entered into after September 12, 1988.

[27] Where LOBs are negotiated and applied to deny benefits of a given tax treaty on the basis of ultimate ownership of the Canadian entity in a different jurisdiction, we believe Canada should ensure that the impact of denying the benefits is not more harsh than it would be if the Canadian entity were held directly in the jurisdiction of ultimate ownership. In addition, as a transitional matter, any such LOB should have a suitably deferred entry into force so that affected corporations may restructure their affairs and avoid unanticipated and adverse results.

[28] In reviewing potential changes to Canada's process for providing relief from withholding tax obligations, the following points should be considered:.

- At least anecdotally, it seems that the vast majority of services provided in Canada by non-residents are provided by residents of the United States coming to Canada on a relatively casual basis, with no Canadian permanent establishment. At least in the absence of actual knowledge or wilful disregard to the contrary, payers for such services should be entitled to rely on representations from payees that the payees are resident in the United States and thereby exempt from Canadian taxation under the provisions of the Canada-U.S. treaty, and should be relieved from the obligation to withhold under Regulation 105.

- A payer for services provided by a non-resident may have neither actual knowledge nor reason to suspect that the payee is actually a non-resident of Canada. In the absence of actual knowledge or wilful disregard, payers should not be subject to liability for failure to withhold under Regulation 105.

- Regulation 105 applies not only to payments by residents of Canada, but also to payments between non-residents for services rendered in Canada. The result is potentially double withholding. Non-resident payers should be relieved from the withholding obligation at least to the extent that the underlying payment has already been subject to withholding by a resident of Canada.

- Payments to non-resident employees providing services in Canada on a relatively casual or temporary basis should not give rise to a withholding obligation, at least where the employee may reasonably be expected to otherwise be exempt from Canadian tax under the provisions of a treaty.

- Non-resident employees exempt from Canadian tax under the provisions of a treaty and not otherwise subjected to withholding should be exempt from the requirement to file a Canadian income tax return.

- Canada should negotiate with its treaty partners to the effect that, where a non-resident employee is subject to Canadian source deductions, the employee may claim credit in their country of residence (e.g., the United States) for the Canadian tax withheld without having to demonstrate actual liability for Canadian tax (i.e., non-entitlement to relief under the treaty). Of course, the converse should also apply where a Canadian resident is subject to source deductions in the foreign jurisdiction.

We acknowledge that there will be at the margins some “tax leakage”, as withholding may be forgone where there may otherwise be an ultimate liability for Canadian tax. However, we submit that in these cases the administrative burden and consequent real costs imposed on industry and on the CRA vastly outweigh the benefits of capturing these incremental taxes.

[29] Note that so-called “participating interest” is still subject to withholding under the relevant provisions of the Act. This may reflect (albeit imperfectly) the notion that participating interest is more in the nature of an extraction of operating profit rather than an ordinary business expense. Further exploration of this notion is suggested below.