Tax Executives Institute, Inc.

1200 G Street, N.W., Suite 300
Washington, D.C. 20005-3814
Telephone: 202.638-5601
Fax: 202.638-5607
Web: www.tei.org

Please Respond to:
Munir A. Suleman
Senior Vice President-Taxation
The Bank of Nova Scotia
44 King Street West
Executive Offices - Tax Dept
Toronto, ON M5H 1H1
CANADA

July 15, 2008

Mr. Peter C. Godsoe, OC
Chair
Advisory Panel on Canada's System of International Taxation
15th Floor
333 Laurier Avenue West
Ottawa, ON
K1A 0G5

Re: *Canada's System of International Taxation*

Via email: advisorypanel@apcsit-gcrcfi.ca

Dear Mr. Godsoe:

In November 2007, the Government of Canada created an Advisory Panel on Canada's System of International Taxation (hereafter "the Panel") to study and recommend measures to improve the competitiveness, efficiency, and fairness of Canada's international tax system. The Panel released a consultation paper, *Enhancing Canada's International Tax Advantage* (hereafter the "Consultation Paper"), in April 2008 framing the debate with a series of questions, providing the Panel's initial views on some issues, and inviting public comment. On behalf of Tax Executives Institute, I am pleased to provide the following comments.

Background

Tax Executives Institute is the preeminent association of business tax executives. The Institute's 7,300 members manage the tax affairs of 3,200 of the leading companies in Canada, the United States, Europe, and Asia and must contend daily with the planning and compliance aspects of Canada's business tax laws, including its inbound and outbound international tax provisions. Canadians constitute 10 percent of TEI's membership, with our Canadian members belonging to chapters in Calgary, Montreal, Toronto, and Vancouver, which together make up one of our nine geographic regions. Many of our non-Canadian members (including those in Europe and Asia) work for companies with substantial activities in Canada.

TEI's membership includes representatives from most major industries including manufacturing, distributing, wholesaling, and retailing; real estate; transportation; financial services; telecommunications; and natural resources (including timber and integrated oil companies). The comments set forth in this letter reflect the views of the Institute as a whole, but more particularly those of our Canadian constituency.

TEI is concerned with issues of tax policy and administration and is dedicated to working with government agencies in Ottawa (and around the world), as well as in the provinces (and the states), to reduce the costs and burdens of tax compliance and administration to our common benefit. We are convinced that the administration of the tax laws in accordance with the highest standards of professional competence and integrity, as well as an atmosphere of mutual trust and confidence between business and government, will promote the efficient and equitable operation of the tax system. In furtherance of this principle, TEI supports efforts to improve the tax laws and their administration at all levels of government.

I. Introduction

The last comprehensive review of the Canadian tax system occurred more than forty years ago when the Royal Commission on Taxation (generally known as the Carter Commission) issued a six-volume report with comprehensive recommendations for improving the efficiency and fairness of the tax system. More limited reviews took place in the 1980s (Tax Reform) and the 1990s (The Technical Committee on Business Taxation report). Hence, TEI welcomes the government's decision to establish the Panel to review the framework and administration of Canada's international tax regime, which has been in effect in its current form since 1976.

The Supreme Court of Canada has commented that the tax laws should aim for consistency, predictability, and fairness so that taxpayers can manage their affairs intelligently.[1] We agree. Where those objectives guide the development of tax policy and the administrative environment, Canadian economic activity is likely to be optimized. An alternative approach that seeks to maximize government revenues is less likely to be successful given the mobility of international capital and the complexity of the international tax environment.

Although the Consultation Paper and TEI's analysis are divided generally between the taxation of inbound and outbound investments, the demarcation between the two is not always clear. For example, Canadian multinationals may wish to have their foreign subsidiaries access the Canadian market for technical, administrative, marketing, or management support but face many tax disincentives to doing so. On the other hand, many foreign-owned Canadian taxpayers exercise substantial stewardship activities over outbound investments, which should be encouraged.

[1] *The Queen v. Canada Trustco Mortgage Company*, 2005 CarswellNat 3212, 2005 SCC 54, 2005 D.T.C. 5523 (Eng.), 2005 D.T.C. 5547 (Fr.), [2005] 5 C.T.C. 215, 340 N.R. 1, 259 D.L.R. (4th) 193, [2005] 2 S.C.R. 601 at paragraph 12.

In addition to recommending a substantive policy and administrative framework for Canada's system of international taxation, the Panel should urge the government to adhere to a legislative process that encourages confidence in the fairness and stability of the Canadian legal environment. To ensure that Canada's tax laws are not only fair, but perceived to be fair, Parliament should:

1. refrain from enacting retroactive legislation, except where absolutely necessary and in accord with principles previously articulated by the Department of Finance;

2. afford reasonable consultation periods for proposed legislation;

3. return to the historical practice of providing reasonable transition periods or grandfather rules or delaying the effective date of legislative initiatives that overturn longstanding rules; and

4. ensure that legislative action is prompt and that the effective date either follows the enactment date or is deferred until legislation receives Royal Assent.

II. Tax Policy Environment

To optimize international activity, the Canadian tax system should be modern, fair, and predictable. Decisions to invest over the long term are influenced as much by the perceptions of stability and fairness as by the technical details of the rules. Canada has much going for it in this respect: It enshrines the rule of law in its constitution, possesses an independent and accessible judicial system, and has a long and vibrant tradition of democracy. Its tax administrators have a tradition of fairness rather than an addiction to Morton's fork.[2] It has a relatively uniform tax system from coast to coast with much common administration. Indeed, the list of Canadian positives is too long for this submission. No matter how strong the advantage, though, there are opportunities for improvement.

A. Legislative

1. *Policy Clarity*

TEI urges the Panel to recommend that Parliament articulate an overriding policy that lends predictability to current and, especially, future legislative and administrative policy developments.

We believe that Canadian international tax policy should —

[2] The expression originates from a tax collection policy devised by John Morton, Lord Chancellor of England under Henry VII. Under his approach, if a subject lived in luxury and spent a lot of money on himself, he obviously had sufficient income to spare for the king. Alternatively, if the subject lived frugally, and showed no sign of wealth, he must have substantial savings and can thus afford to give it to the king. These arguments were the two prongs of the fork and, regardless of whether the subject was rich or poor, he did not have a favourable choice.

a. support the development of strong Canadian-based multinational companies, especially in their ability to compete globally;

b. encourage long-term foreign investment into Canada; and

c. ensure that Canadian source income is taxed fairly, regardless of whether earned by Canadian- or foreign-based companies.

2. *Policy Development*

Canada's tax and budget policy development can be improved by greater transparency. It is unclear, for example, what purpose is served by the secrecy that currently shrouds the development of Canada's annual budget. A more open budget development process may forestall public outcries that follow surprise Budget announcements, such as occurred with the March 2007 interest deductibility proposal and the changes to the thin capitalization rules proposed in the February 2000 Budget. Consultations should begin before the government is committed to a particular result and, although time limited, should be open long enough to permit reasonable public participation. A three-week period between the release of draft legislation and its introduction in Parliament, as happened with the far-reaching October 2007 proposal curbing interest deductibility, is insufficient. To provide effective, transparent budget consultations with affected taxpayers, the resources of the Department of Finance devoted to business taxation may need to be enhanced. While Department officials are knowledgeable and committed, they may need assistance to satisfy the government's needs.[3]

3. *Anti-Abuse Rules*

Attempts to correct abuses in the tax system should be addressed through targeted legislation rather than broad anti-abuse rules. Broad anti-abuse rules create uncertainty that hinders legitimate commercial activity and often inflict harm worse than the perceived problem the legislation is designed to curb. TEI recommends that any anti-abuse rules proposed by the Panel — or by the government itself — be subject to extensive consultation with affected taxpayers before the Department of Finance drafts legislation. Such a process will minimize the harm to Canada's business environment and its international competitiveness.

4. *Retroactivity*

Taxpayers must be able to rely on the legislation and regulations in effect when business transactions take place, expenditures are incurred, and other taxable events occur. That is, taxpayers should be able to structure their investments and plan their affairs within the law both to comply with its requirements and to minimize their tax liability. Consequently, except in rare and extreme circumstances, tax legislation should be prospective in scope. Although the government may possess the raw authority to change the tax laws retroactively, the power should be exercised

[3] We recommend also that the Department consider hiring individuals with significant experience outside the government sector.

sparingly. Since retroactive legislation that adversely affects taxpayers detracts from the fairness of the Canadian tax system, Canada's competitiveness vis-à-vis its trading partners suffers. Regrettably, federal and provincial governments have increasingly relied upon retroactive provisions, especially to overturn court rulings with which they do not agree. We urge the Panel to recommend that the government eschew retroactive legislation and recommit itself to the principles espoused in the *Comprehensive Response of the Government of Canada to the Seventh Report of the Standing Committee on Public Accounts.*[4]

5. *Legislative Clarity*

Excessively complex legislation is all too common in Canada. The Foreign Investment Entity (FIE) and Non-Resident Trust (NRT) legislation, which is discussed below, is an example. TEI's opposition to that legislation is *not* based on a policy disagreement, but on the inability of taxpayers to comprehend and comply with its myriad complex provisions as well as Canada Revenue Agency's (CRA) likely inability to properly administer it. Moreover, it is not appropriate for the Department of Finance to delegate to CRA the development of administrative relief in order to remedy the technical flaws in substantive legislation.

The increasing complexity of the foreign affiliate (FA) rules, with layer upon layer of new legislation and regulations imposing additional compliance and reporting obligations, is similarly a concern.[5] The complexity and changing nature of these rules nearly requires corporate tax personnel to be involved in the day-to-day business operations, which is not economically efficient.

6. *Legislative Timeliness*

A substantial amount of legislation has been introduced that will likely be passed eventually by Parliament, but the proposals have been outstanding for a long time. With effective dates for these proposals fixed in the past but the prospects for action unclear, there is uncertainty about the actual state of the law. In addition, to ameliorate issues identified in legislation after its introduction, the Department of Finance has issued comfort letters and policy announcements affecting the proposed legislation, but in many cases the corresponding amendments have not been made to the pending legislative proposals. Moreover, regulations implementing the proposed legislation have been developed but not issued. No matter how likely that the legislation or the regulations are to be passed, the effects may not be reflected in public company financial statements because of uncertainty about whether the legislation is "substantively enacted." The government should devote more resources to reducing the time lag between the introduction of legislation and its final enactment. Alternatively, Canada should consider adopting a policy of tying the "coming into force" date for major policy initiatives that adversely affect taxpayers (such as the FIE and NRT rules) to the date of Royal Assent.

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[4] Session Paper 8512-351-79, September 1995, Comprehensive Response of the Government of Canada to the Seventh Report of the Standing Committee on Public Accounts (Finance Response) at 15.

[5] The challenge of complying with the FA rules has been exacerbated by new, complex rules that require companies to track "suspended surplus." The suspended surplus rules will, in turn, be made even more mind-boggling if draft proposals relating to foreign paid-up capital (FPUC) are enacted.

B. Administration

An investor's willingness to commit to a business over the long term is affected by its confidence in the fair administration of the tax law. Thus, Parliament has determined that CRA should administer the tax law in an impartial, objective manner rather than asserting positions for the sake of maximizing revenue.[6]

While CRA is one of the most efficient and effective tax administrations in the world, especially in aiding millions of individuals comply with their tax obligations, the Agency, especially the Appeals Division, may lack the resources necessary to address more complex tax matters inherent in the large-case files of multinational business taxpayers.

In recent years, the government has made numerous announcements about and devoted significant additional resources to combating "abusive transactions." Some of that activity is likely in response to unwarranted criticisms of international tax policy and administration made by the Auditor General of Canada.[7] Regrettably, there have been few corresponding announcements about the development of training resources for CRA to understand the complex commercial environment in which business taxpayers operate. Hence, when faced with complex business structures or transactions, the reflexive reaction of CRA auditors often seems that a tax "abuse" must be present. Moreover, if a perceived "abusive" transaction is poorly defined by CRA or the Department of Finance, a CRA audit unit tasked with finding and eliminating "avoidance" or "abusive" transactions may target wholly legitimate transactions. As important, the oversight of audits by CRA's upper management has diminished as the number of trained tax professionals in the Agency's upper management positions has declined. As a result, audit results have become more inconsistent and seemingly arbitrary.

Moreover, the increase in tax litigation involving large taxpayers causes us to question whether the Appeals Division's effectiveness in settling disputes is diminishing. Indeed, the Appeals Division has informed some taxpayers that it cannot address certain transfer-pricing disputes because it lacks a budget for external experts to review the reasonableness of the positions taken by taken by taxpayers or advanced by CRA's international auditors. In such cases, Appeals has advised taxpayers to proceed directly to litigation, thereby precluding taxpayers from a reasonable and independent CRA review. Similarly, Appeals has declined to review cases where the amounts in dispute are large and without regard to the merits of the taxpayer's position.

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[6] *Canada Revenue Agency Act*, S.C. 1999, c.17, s.5.

[7] Specifically, in December 2001 and December 2002 the Auditor General of Canada called into question some of Canada's longstanding international tax policies as well as CRA's enforcement of the regime. In its response, the Department of Finance ably defended the international tax policies underlying the Canadian tax system, but some subsequent legislative proposals seem a reaction to the Auditor General's critique. As important, the Auditor General's reports have seemingly put undue pressure on CRA to adopt an aggressive approach to international tax administration. In making international tax policy recommendations, the Office of the Auditor General may be acting beyond its mandate: "As officers of Parliament, we do not want to be seen to be second-guessing the intentions of Parliament when it approves legislation, or of Cabinet when it selects a certain policy direction." *See* subsection 1.6 of the Performance Audit Manual of the Auditor General of Canada.

Finally, even though Parliament has passed hundreds of pages of legislation in the last eight years and even though the courts have issued many important judgments in the same timeframe, only two wholly new interpretation bulletins have been issued and only a few bulletins and information circulars have been updated.[8] Hence, the Rulings Directorate seems to lack the resources necessary to develop broad-based guidance while also addressing the increase in ruling requests that arises from complex business structures and transactions.

TEI recommends that the Panel recommend that the government provide CRA with additional resources to (i) improve the guidance provided to business taxpayers, (ii) better train CRA auditors and senior management in the global financial and business environment, and (iii) pay competitive salaries and benefits to attract and retain tax professionals at all levels.

III. The Taxation of Outbound Direct Investment

A. *Dividends from Active Business Income of Foreign Affiliates*

Since Canadian residents are taxed on their worldwide income, foreign-source income is potentially subject to tax twice: once in the foreign jurisdiction and again in Canada. To minimize double taxation, the Canadian regime provides an exemption for dividends from active foreign business income earned through a foreign affiliate (FA) if the affiliate is resident, and the business is carried on, in a country with which Canada has a tax treaty or a Tax Information Exchange Agreement (TIEA). If the affiliate is not resident or if its business is not carried on in a treaty or TIEA country, a foreign tax credit is available to offset the taxes paid in the foreign country. The Canadian system for relieving double taxation is thus a hybrid, with a partial exemption and partial deferral with a tax credit.

Investments in FAs generally produce substantial advantages for the Canadian economy — fostering international trade in goods and services, enhancing productivity, creating well-paying jobs, and promoting the development of management expertise, technical know-how, and intellectual property in Canada. Based on the data in the chart on page 14 of the Consultation Paper, the current dual Canadian system for relieving double taxation of foreign dividends likely yields only modest amounts of revenue for the federal and provincial governments. Consequently, TEI urges the Panel to consider recommending a broader — even a full — exemption system for dividends from foreign investments. A broader exemption would enhance the inherent economic advantages of foreign investments at a significant savings to taxpayers and CRA. Specifically, the costs of complying with the complex FA rules to track and report exempt and taxable surplus would be eliminated or substantially reduced. Moreover, the administrative costs to CRA in administering those rules would be minimized.

The principal benefit of a broader exemption system is to eliminate the potential for incurring Canadian tax on the repatriation of profits to Canada. As a result, foreign earnings will be repatriated more quickly for reinvestment. As important, a broader exemption system with simplified

[8] CRA has acknowledged its lack of resources and TEI has worked with CRA to identify areas that deserve immediate guidance.

compliance requirements would encourage taxpayers to streamline their corporate structures to facilitate more rapid and efficient future repatriation.

The Consultation Paper notes that other jurisdictions are considering or have adopted full exemption systems in order to help home country multinationals compete in the global marketplace. TEI believes that unless Canada also does so, Canadian multinationals will be at a competitive disadvantage — not only from the additional potential taxes on repatriation of profits but also from the added compliance burden that the current "split" system produces.

The government's 2007 budget announcement relating to TIEAs signalled support for a broader exemption system, but the expansion of the exemption system would be dependent on the negotiation of a TIEA with the foreign jurisdiction. Concededly, access to tax information in foreign jurisdictions is crucial, but the negotiation of such agreements can be a slow, cumbersome process. Moreover, foreign governments may have non-tax related reasons for refusing to enter into a TIEA. Finally, the announced process may adversely affect Canadian companies by requiring them to recognize active earnings as Foreign Accrual Property Income (FAPI) simply because a country in which they have active business operations fails to enter into a TIEA.

TEI does not believe that the goal of implementing a broader exemption system should be made dependent on a series of time-consuming bilateral government negotiations for TIEAs. Indeed, based on the results of the OECD's Project on Harmful Tax Practices, the government will likely be able to conclude TIEAs in all but the most uncooperative tax-haven jurisdictions, *i.e.*, Andorra, Liechtenstein, and Monaco. Thus, rather than defer implementation of a broader exemption system or hold it hostage to the negotiation of TIEAs, Canada could adopt an approach whereby active income earned in "black-listed" countries (*i.e.*, those designated by Canada as uncooperative in supplying information) will generate taxable surplus.

Finally, although strong arguments can be made for adopting a full participation regime, including an exemption for gain on the sale of the shares of an FA, such a regime would provide a limited incentive for international activity because investments in active foreign businesses are rarely made on the assumption of ultimately selling the business to a third party.[9] In addition, a full participation system would likely require administrative rules as complex and perhaps as burdensome as the current system. TEI would be pleased to meet with the Panel to discuss the advantages and disadvantages of a full participation regime.

B. *Expenses Incurred in Support of Active Foreign Businesses*

TEI recommends that the exemption for dividends from active business income be expanded without tightening the FAPI rules *and* without adding limitations on the deductibility of expenses, such as interest, incurred in Canada in support of foreign business investments. Indeed, TEI urges the Panel to consider recommending repeal of section 18.2 of the *Income Tax Act, Canada*

[9] TEI supports an exclusion from taxable surplus where the surplus is generated on the sale of "excluded" property thereby allowing such surplus to be repatriated to Canada without tax. We do not believe that such a provision would produce a significant revenue loss to the Canadian government since the repatriation of such amounts can be postponed indefinitely.

(hereafter "the Act") before it becomes effective in 2012. At a recent conference,[10] academics and tax professionals alike condemned the provision as a substantial impediment to the competitiveness of Canadian multinationals. More recently, the Competition Policy Review Panel (hereafter the "Competition Panel") stated that this provision "will not enhance Canadian tax revenues but will disadvantage Canadian companies seeking to become global players. Our focus on Canadian competitiveness leads us to share the concerns we heard."[11] At a minimum, TEI recommends that the Panel note in its report that the provision curtails an important advantage previously afforded to Canadian businesses on their outbound investments — likely without significantly increasing taxes collected by Canada. The Competition Panel seemingly agrees, recommending that the International Tax Advisory Panel "assess the provisions of Canadian tax legislation limiting interest deductibility by Canadian companies in respect of foreign acquisitions to ensure that Canadian companies seeking to compete globally enjoy every advantage relative to their foreign competitors."

C. *Intellectual Property Rights*

The development and maintenance of intellectual property and know how in Canada are critical to advancing the nation's productivity. Although the Scientific Research & Experimental Development incentive is beyond the scope of the Panel's work, there are two other measures the Panel should consider to enhance the environment for creating and owning intellectual property in Canada. First, TEI recommends providing an exemption for or lower tax rate on foreign-source income (*e.g.*, royalties) earned in Canada from the exploitation of intellectual property resident in Canada.[12] In addition, to encourage Canadian companies to migrate acquired, foreign-owned, intellectual property to Canada, paragraph 13(7)(e) of the Act should be amended to permit the full cost of intellectual property transferred from foreign related parties to Canada to be added to the Canadian taxpayer's undepreciated capital cost pool. Adoption of these proposals would significantly enhance the competitiveness of the tax system by attracting foreign investment and research and development activity to Canada.

D. *Information Reporting for Foreign Affiliates*

The Consultation Paper poses a question whether the current FA rules can be amended to reduce compliance and administrative burdens for taxpayers while maintaining the tax policy objectives of the rules. TEI suggests that, to the extent that an earnings base to determine amounts available for tax-free distributions is necessary (whether under the current regime or a broader exemption system), the consolidated retained earnings maintained in the functional currency (including Canadian dollars) of the payer and determined in accordance with generally accepted accounting principles is a reasonable proxy. Such an approach would eliminate the need for taxpayers to calculate the various tax pools (*e.g.*, exempt surplus and taxable surplus) for each of their foreign affiliates.

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[10] *International Tax Reform: Canada Confronts the Challenge*, A symposium sponsored by the Canadian Branch of the International Fiscal Association, the Canadian Tax Foundation, and the Faculty of Law at the University of Toronto (June 2, 2008).

[11] *Compete to Win: Report of the Competition Policy Review Panel*, Industry Canada (June 2008).

[12] In France, for example, the tax rate on royalties is half the regular rate.

In addition, TEI urges the Panel to recommend that the FA rules be amended to reduce and streamline taxpayers' reporting and administrative burdens. First, CRA should be encouraged to expand the definition of a "dormant" FA for which no information would be required to be reported with taxpayers' returns. In a May 5, 2008, letter to the Department of Finance outlining recommendations for paperwork burden reductions, TEI suggested increasing the dollar thresholds for the determination of a dormant FA or CFA to $1 million in gross receipts and $10 million in assets held throughout the year. We urge the Panel to recommend the same thresholds.

Next, rather than require that Forms T1134-A (*Information Return Relating to Foreign Affiliates that are not Controlled Foreign Affiliates*) or T1134-B (*Information Return Relating to Controlled Foreign Affiliates*) be fully completed for all non-dormant subsidiaries, CRA should adopt a procedure whereby taxpayers and CRA would enter into advance agreements specifying which foreign affiliates are subject to detailed disclosures on a taxpayer's annual return and which affiliates' information can be briefly summarized.[13] Such a procedure should not preclude CRA from making audit inquiries in respect of the FAs for which the annual information report is omitted or summarized. In addition, CRA should permit companies to use consolidated financial statements to report FA information on the forms. Finally, TEI is pleased to have been afforded the opportunity to provide input to the Secretariat for recommendations to combine and simplify these forms.

E. *Branches of Canadian Corporations*

Theoretically, the form of taxpayer's foreign investment — whether as a foreign affiliate or branch — should make no difference in respect of the mechanism for relieving double taxation of foreign-source income. Absent adoption of a territorial system, however, it may not be possible to craft a workable exemption system for foreign branches. Despite the challenges, the current system for taxing branch income should be improved to ensure that Canadian taxpayers obtain the full benefit of the foreign tax credit for taxes incurred by their branches.

There are two primary reasons taxpayers may be denied full relief from double taxation: (1) foreign exchange differences related to the income and expenses earned and translation of the branch assets and liabilities and (2) differences between the foreign and Canadian jurisdictions' treatment of specific items of income and deduction in determining taxable income. In principle, foreign exchange differences should not affect the results. Many countries permit taxpayers to select a currency for calculating income and expenses and translating assets and liabilities as long as the calculating currency is consistently used. Canada has taken the first steps in this direction with the introduction of section 261 of the Act, permitting functional currency reporting in limited circumstances. The government would promote international economic activity if taxpayers were permitted to adopt a calculating currency for their foreign branches rather than requiring the use of the Canadian dollar.

Although it may be problematic to implement rules that fully equate a foreign branch's Canadian taxable income with taxable income determined under the branch's home country rules, consideration should be given to better aligning them. For example, it would be helpful to ensure

[13] As noted in TEI's May 5, 2008, recommendations to the Department of Finance for paperwork burden reductions, T-1134 information returns should be required only for the taxpayer's 10 largest affiliates.

that timing differences (*e.g.*, depreciation expense) arising from differences between Canadian and foreign rules in determining branch net income do not diminish the amount of foreign tax credits available to offset Canadian tax on the branch's activities. In addition, the formula for determining the foreign tax credit limitation for the branch's taxable income should be revised to align the determination of the credit limitation more closely with the foreign tax paid. Deductions from branch net income to determine Canadian taxable income, such as charitable contributions and deductions related to the preferred dividend tax, reduce the branch's foreign tax credit limitation and thus discourage expenditures that the deductions are intended to promote.

F. *Foreign Accrual Property Income (FAPI) Rules*

1. General. The FAPI provisions prevent taxpayers from sourcing mobile, passive income in low-tax jurisdictions by taxing nonbusiness income on an accrual basis. Since most countries have similar provisions, the FAPI provisions *per se* do not render Canadian companies less competitive. To the extent that relief from double taxation of foreign earnings is based on tax credits, the Canadian system treats amounts earned in high tax jurisdictions more harshly. This is troubling when FAPI arises from the application of base erosion rules (such as those set out in paragraphs 95(2)(a.1) through (a.4) and 95(2)(b) of the Act) rather than from passive investments.

The rules for the determination of non-FAPI taxable surplus are generally aligned with a foreign country's tax base. Hence, the amount of foreign tax credits available on the repatriation of non-FAPI taxable surplus will generally offset the proper amount of Canadian tax. The FAPI rules, however, require the determination of Canadian taxable income under Canadian rules and the differences from the local country tax base for any particular year creates mismatches between the taxes paid locally and the credits available in Canada.

As with the foreign branch rules, the principal differences arise from foreign exchange differences as well as differing foreign and Canadian rules for the determination of taxable income. Again, foreign exchange differences should not, in principle, affect the results. The government would promote international economic activity if taxpayers were permitted to adopt a calculating currency for the determination of FAPI rather than requiring the use of the Canadian dollar.

Although it might be challenging to determine FAPI using local country tax rules rather than Canadian tax rules, the current approach to the determination of *non-FAPI* taxable surplus is based on local country rules. Hence, consideration should be given to amending the FAPI rules to ensure that timing differences, *e.g.*, depreciation expense, arising from the differences between Canadian and foreign rules do not diminish the amount of tax credits available to offset Canadian tax on the FAPI.

2. Services. Under paragraph 95(2)(b) of the Act, fees for services paid by a resident of Canada to a controlled FA are considered FAPI if the fees are deducted in determining the Canadian entity's income from a business. Exceptions for specific services are enumerated in subsection 95(3). The base erosion rules are broadly drafted and consequently capture many routine transactions for multinational groups while the exceptions are narrow and fail to reflect the global

operations of most businesses. Consequently, relief from the base erosion rules is often unavailable even where the services are, by their nature, best performed outside Canada.

Consider, for example, investment advisory services about foreign securities provided to a Canadian individual or business. If a Canadian financial institution purchases the investment advisory services from a foreign third party (*i.e.*, appoints it as a sub-adviser), the FAPI rules do not apply. If the Canadian financial institution establishes a subsidiary in the foreign jurisdiction and appoints that subsidiary as a sub-adviser and pays it fees, the income of the foreign subsidiary from that arrangement is considered FAPI rather than active business income regardless of the substantial nature of the investment advisory business. The lack of a safe harbour for investment advisory services puts Canadian-owned financial institutions at a disadvantage vis-à-vis their foreign-owned competitors because they must spend time reviewing and restructuring proposed transactions in order to avoid the inappropriate application of the rules. As a result, competitiveness suffers; Canadian financial institutions lose business because of delays to restructure transactions or because the rules cannot be avoided.

TEI urges the Panel to recommend broadening the exceptions to the FAPI rules to take account of the need to source certain services in a foreign jurisdiction to better serve domestic Canadian customers. At a minimum, the exceptions for financial services should be broadened.

3. Real Estate Development. Finally, the FAPI rules do not work well for Canadian-based multinational real estate developers. A combination of a poorly drafted statute and unwillingness by CRA to adopt assessment approaches that reflect business practices employed by real estate developers means that the segregation of foreign development projects into separate companies for legitimate business purposes will generate FAPI to a Canadian developer. We recommend that the FAPI rules be revised to permit real estate developers to segregate project activities into different legal entities where necessary to limit legal liability or otherwise efficiently manage the project.

G. *Transfers of Shares of Second and Lower Tier Foreign Affiliates*

TEI believes that, so long as there is a continuity of economic interest within the Canadian control group, reorganizations of a business structure below a first-tier foreign affiliate holding company should not trigger Canadian taxation. This is consistent with how the Canadian tax system treats reorganizations of business structures involving wholly Canadian assets or business structures. (S*ee, e.g.,* sections 55, 85, 85.1, 86, 87, and 88). Thus, where all or substantially all the assets of a foreign affiliate are used in an active business (and regardless of whether the foreign affiliate is in a tax treaty country), sales of shares of a foreign affiliate should be fully exempt — just as a sale of the assets of the business would be exempt.

In addition, the current disincentives to transferring business operations and assets back to Canada should be removed. If a Canadian subsidiary is in the chain of foreign affiliates, an otherwise tax-free reorganization can become taxable. It is odd that such reorganizations would be taxable when dividends would likely constitute exempt surplus.

H. *Foreign Investment Entity (FIE) and Non-Resident Trust (NRT) Legislation*

Since their initial release in 2000, TEI has made numerous submissions to and met with the Department of Finance about the draft Foreign Investment Entity and Non-Resident Trust legislation. Although the draft rules have been revised repeatedly, the fundamental flaws have not been eliminated. We believe the legislation will impede foreign investment by Canadian companies and impair their competitiveness. Hence, TEI recommends that the Panel urge that the FIE and NRT legislation be abandoned as unworkable because:

1. The information necessary to comply with the proposed legislation's myriad reporting requirements or to take advantage of one or more relieving provisions or elections is either (1) unavailable generally or (2) likely unavailable to a Canadian taxpayer where, as will often be the case, it is a minority investor and lacks the requisite control to compel production of the necessary information.

2. It would apply to numerous, compliant taxpayers that are not attempting to avoid Canadian tax by "transferring funds to offshore trusts or accounts."

3. It is not integrated with other provisions of the Act that address the taxation of international operations.

4. The Minister of National Revenue is given nearly unfettered authority to make various determinations, including whether a business is an investment business, property is exempt, or an entity is a FIE or a qualifying entity.

If the FIE and NRT regime is to be retained, the rules should be reconsidered and redrafted because they are overbroad, complex, convoluted, difficult to apply, and virtually impossible for taxpayers to comply with.

IV. The Taxation of Inbound Direct Investment

A. *Thin Capitalization Rules — General*

The Consultation Paper describes the treatment of, and issues relating to, debt incurred by Canadian subsidiaries of foreign businesses and queries whether the rules should be modified.

TEI is concerned that an expansion of the current Canadian thin capitalization rules would adversely affect the Canadian economy and the Canadian business environment. Indeed, we believe the Panel should recommend *easing* the rules rather than making them more restrictive.

In *Advantage Canada: Building a Strong Economy for Canadians*,[14] the government acknowledges that Canada's share of total inward foreign investment into the G7 and OECD countries is falling:

[14] *Advantage Canada: Building a Strong Economy for Canadians*, Department of Finance Canada (November 20, 2006).

> No other country in the G7 comes close to matching Canada's decline, and firms from other G7 countries have reduced their overall relative presence in Canada.
>
> Policy restrictions on foreign investment in Canada have contributed to our economy's overall decline in foreign direct investment flows.[15]

TEI submits that tightening the current thin capitalization rules would further impair foreign investment in Canada. Specifically, we believe that any new restrictions expanding the scope of the current thin capitalization regime, such as including guaranteed debt or non-related party interest within the ambit of the thin capitalization rules or moving to an earnings stripping regime would:

1. Hurt important sectors of the economy;

2. Limit the availability and raise the cost of capital for Canadian businesses and consumers;

3. Disrupt the Canadian capital markets;

4. Deter incremental investments and employment growth in Canada, reducing the business and individual tax bases;

5. Produce new compliance and reporting burdens for many Canadian businesses, contravening the government's objective of reducing business paperwork burden by 20 percent; and

6. Create significant uncertainty because it will be difficult to design a system that effectively addresses the myriad and diverse business structures and operations of affected taxpayers.

B. *Technical Issues*

Expanding the current thin capitalization rules or adopting a new earnings stripping regime would raise numerous complex technical issues adversely affecting many Canadian taxpayers. Failure to resolve the issues will retard rather than promote the fairness and competitiveness of the Canadian tax system. We highlight the most salient issues for the Panel's consideration.

1. Financial Services. Financial services businesses should be exempt or obtain relief from traditional thin capitalization or earnings stripping rules. Although a simple concept, it would be difficult to draft a system that is neither over- nor under-inclusive. Many financial services businesses are not currently regulated in Canada. Thus, defining a financial services company, partnership, trust, or other entity would not be simple. In addition, where a taxpayer's group includes both financial and non-financial businesses (*e.g.*, the captive finance subsidiaries of auto manufacturers,

[15] *Id.* at 87.

heavy equipment manufacturers, and hi-tech companies), it will be difficult to draft rules that exempt the debt related to the financial services businesses while including the debt related to the industrial group.

2. Resource Industries. Determining the proper amount of guaranteed debt to be included in the thin capitalization test would be problematic in the resource industries. Many large projects are undertaken by consortiums of companies under a joint-venture agreement. Under the agreements, parent guarantees are generally required where the debt rating of a Canadian subsidiary participant is too low. The guarantee ensures that each party is able to meet its share of operating expenses during a project's development, which is usually capital intensive and long-term in nature spanning multiple business cycles. In many cases, the guarantee is provided by a related non-resident parent company. Hence, it is critical that foreign-parent guaranteed debt be excluded from the definition of debt from a related non-resident.

3. Consolidated Groups. Canada has not adopted a consolidated corporate tax system. Under the current thin capitalization regime, the test is applied only to the specific entities that borrow from non-resident related parties. Often, the only borrower to which the rules apply is the Canadian parent company, even though the Canadian group may include hundreds of entities. Any change to the rules requiring the application of new tests to group members on an entity-by-entity basis would create a cascade of compliance and reporting burdens for the taxpayer's group of companies. In addition, complex new rules would be required to share the borrowing and interest deductibility capacity among group members.

4. On-lending. Frequently, one legal entity in a corporate group will borrow on behalf of the group and on-lend to related members. This approach facilitates cash management, streamlines the borrowing process, and reduces transaction costs. New rules would be required to ensure such on-lending does not produce unintended restrictions on interest deductibility.

5. Partnerships. Partnerships are increasingly the legal entity of choice for Canadian businesses. Specific, complex rules will likely be necessary to achieve the intended policy goals while avoiding unintended results.

6. Securitization. Securitization is a common form of financing in Canada. The structurally high debt levels that these financial instruments commonly employ would necessitate special rules to ensure that they can still be used by Canadian businesses.

7. Grandfather Existing Debt. Many companies have medium or long-term debt that cannot easily be refinanced without incurring significant transaction costs or prepayment penalties. Such debts should be grandfathered from the adverse effects of any changes.

8. Foreign Exchange and Derivatives. The proper tax treatment of foreign currency gains and losses on debt and equity issuances as well as the treatment of financial derivatives is rarely easy to address. The day-to-day business operations of financial services companies will be severely disrupted if the issues are not handled properly.

9. Provincial Issues. Provincial revenue concerns have hindered the introduction of a consolidated corporate income tax system in Canada. If, as TEI recommends, the revised rules permit companies within groups to share their debt and interest capacity with other group members, some provinces will likely express concerns about the effect on their respective tax bases.

C. *Financial Services Industry*

Advantage Canada notes that a strong and vibrant financial services industry is critical for Canada's economic health and growth.[16] An efficient and competitive financial services industry ensures that Canadian businesses and consumers have access to an adequate amount of capital at the lowest cost, thereby encouraging investments in plant and machinery and fostering entrepreneurship.

Canada's financial services industry is dominated by several large domestic banks and insurance companies, but foreign banks and foreign-owned non-bank financial service providers play a critically important role in the Canadian financial services industry. They offer both competitive and complementary products and services to those of the domestic banks, as well as providing billions of dollars in alternative sources of financing for businesses and consumers through products and services not offered by the domestic banks. These foreign companies rely heavily on external sources of debt financing, often raised in the Canadian capital markets using guarantees

[16] "A strong economy must be supported by a financial system that instills confidence and efficiently provides a wide range of financial services to households and businesses. Canada has a strong and sound financial system that serves Canadians well. It is an asset unto itself, providing high-end, knowledge based and well paying jobs for Canadians." *Id.* at 82.

"The financial services industry contributes 6% to Canada's GDP and accounts for 700,000 jobs, or 4% of employment nationally." *Id.* at 82.

"A vibrant financial services industry will be founded on vigorous domestic competition that will deliver the best services to consumers at the best price." *Id.* at 82.

"Our personal prosperity, the prosperity of our businesses and the prosperity of Canada depends on strong and efficient capital markets." *Id.* at 83.

"Foreign direct investment provides additional capital to fuel firms' growth and exposes domestic firms to new technologies, innovative ways of doing business and healthy competition." *Id.* at 87.

"The performance of the Canadian private sector is currently good. It must become great. Businesses must respond by investing more in training, equipment and innovation. To trigger that leap, Canada's New Government will take steps to create a competitive business environment that encourages entrepreneurship by: Reducing taxes on business investment. . . . Reducing the paper burden on business. . . . Building on a leading-edge financial system. Increasing the country's openness to trade and investment." *Id.* at 88.

from their parent companies in order to reduce their funding costs and ensure liquidity and availability of capital for Canadian companies. For these businesses, money is inventory and, as with domestic banks, they can only compete effectively by operating with significantly higher debt-equity ratios than other industry sectors.

The 1998 report by the Technical Committee on Business Taxation (hereafter the "Mintz Committee") expressly rejected proposals to include guaranteed debt in the thin capitalization test because of the potential for distorting the capital markets. Since the report's release, the financial services sector of the Canadian economy, including foreign-owned banks and non-bank financial companies, has grown substantially. Hence, we believe the concerns expressed are even more important today, especially in light of the current "credit crunch" affecting North America. Changes that restrict the thin capitalization rules would have serious adverse consequences on the ability of Canadian companies to access credit from foreign-owned financial institutions.

Most jurisdictions with thin capitalization or earnings stripping rules recognize that financial services businesses are unique and afford exemptions from the application of such rules to avoid harming their economies and capital market systems. Hence, it is important to note that Canada's current thin capitalization rules for financial services companies are more restrictive (and, hence, less competitive) than other G7 jurisdictions. As a result, some companies must employ guaranteed third-party debt to avoid the application of the thin capitalization rules. To reduce the borrowing costs of Canadian businesses and consumers generally, financial services companies should have additional flexibility to access related party debt beyond the currently restrictive two-to-one ratio. Hence, we recommend easing these restrictions.

D. *Interest Deductibility — Other Jurisdictions*

The Consultation Paper indicates that the Panel will examine thin capitalization and earnings stripping rules in other jurisdictions to determine whether other approaches may be suitable for Canada. TEI has conducted an informal survey of other jurisdictions and developed a list of provisions, both favourable and unfavourable, that are worth noting. The summary is in the Appendix.

E. *Recommendations*

TEI believes that Canada's current thin capitalization regime generally works well and should not be changed broadly in order to curb limited abuses. Thus, TEI opposes expanding the restrictions in the current thin capitalization rules or adopting an earnings stripping regime. If the Panel were to recommend either expanding the restrictions in the current thin capitalization rules or moving to an earnings stripping regime, TEI recommends that the Panel adhere to the following principles:

1. To be consistent with comparable jurisdictions, there should be an exemption or relieving provisions for financial services businesses, including leasing companies.

2. To be consistent with *Advantage Canada* and the recommendations made by the Mintz Committee, specific anti-avoidance measures should be drafted in lieu of

broad-based rules. For example, debt guaranteed by foreign related parties should not be included in the thin capitalization ratio.

3. A lengthy consultation period should be afforded to affected taxpayers in order to ensure the proposed changes do not engender unintended results. The Department of Finance should also be encouraged to revise the draft proposals as necessary to alleviate hardships and unintended results. Taxpayers should not be compelled to restructure their business operations to avoid restrictions that should not apply to them.

4. For certainty, simplicity, and ease of administration, bright-line objective rules and safe harbours should generally be employed. Taxpayers, however, should be permitted to use a facts-and-circumstances test to demonstrate when the rules or safe harbours should not be applied.

5. Existing debt should be grandfathered; otherwise, taxpayers will incur significant restructuring or prepayment costs or incur a form of retroactive taxation.

6. To avoid inequitable results and unintended restrictions on large, complex business structures, a consolidated group approach should be used to ensure that interest deductions can be shared among related group members.

7. Disallowed interest expense should carry forward indefinitely until deducted.

8. To be consistent with the government's goal of reducing business paperwork burdens by 20 percent and to ease compliance and administrative burdens for taxpayers and CRA alike, the calculations and reporting requirements should be as simple as possible.

F. *"Debt Dumping"*

On June 3, 2008, the Panel's Secretariat expressed concern about "debt dumping" into Canada and inquired whether TEI has recommendations to address the problem. After discussion, we are uncertain what practices or transactions are encompassed by the term. Before a potential solution can be prescribed, the issues should be more clearly defined and the perceived abuse of the Canadian tax system documented and analyzed by CRA. Once agreement on the underlying practices or transactions is achieved and the revenue loss estimated, an assessment whether and the extent to which "debt dumping" is improperly eroding the Canadian tax base can be made and a properly targeted legislative response developed.[17]

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[17] To the extent abusive tax avoidance practices or transactions are identified, remedial legislation should be crafted narrowly to target and deter the specific abuse. Broad anti-abuse provisions limiting interest deductibility — whether through thin capitalization or earnings stripping rules — would increase the complexity and compliance costs of Canada's tax system, including the vast majority of multinational companies that likely have not participated in "debt dumping."

V. Withholding Taxes

Canada and the United States have negotiated a reduction in the withholding tax rate under the Canada-U.S. Income Tax Convention (hereafter "the U.S. treaty"). Under the proposed agreement, interest paid on arm's length debt will be exempted from withholding tax beginning in the first calendar year following the treaty's entry into force. Subsequent to the treaty's negotiation, Canadian domestic law was amended effective January 1, 2008, to provide an exemption regardless of the lender's country of residence.[18] For interest payments to non-arm's length persons, the maximum withholding rate on interest payments will be reduced to zero over a three-year period following ratification of the U.S. treaty by both governments.

TEI applauds these measures. The reduction in withholding taxes for interest paid on arm's length debt will ensure that Canadian businesses have access to global capital debt markets at the lowest possible cost. We also applaud the reduction in withholding taxes on interest on non-arm's length debt because it will strengthen the already substantial financial and trade ties between Canada and the United States.

Studies, such as one by the C.D. Howe Institute,[19] have shown a strong link between the elimination of withholding taxes on dividends and interest and increased foreign direct investment. The C.D. Howe Institute's study found that the elimination of withholding taxes on all dividends and interest payments would result in an increase in capital investment in Canada of $28 billion, and an increase in income of $7.5 billion annually. The C.D. Howe Institute's study also categorized the detrimental effects of withholding taxes on Canada, including restricting the free flow of capital, deterring direct foreign investment, and interfering with efficient global company operations.

The United States is a key market for Canadian goods, services, and investments by Canadians, as well as a key source of investment capital for Canadian enterprises. Since 2003, the United States has negotiated a nil withholding rate under its tax treaties with the United Kingdom, Mexico, the Netherlands, and Sweden for direct dividends from companies that are more than 80-percent owned. In addition, U.S. protocols with Germany, Denmark, and Finland and a treaty with Belgium ratified late in 2007 include a similar provision. In the U.S.-Japan treaty, the ownership threshold to qualify for nil withholding is 50 percent.

TEI believes steps should be taken to ensure that Canadian residents can secure benefits similar to those enjoyed by residents of other treaty partners of the United States and effectively compete with those jurisdictions for increased capital investments, exports, and jobs. Hence, we urge the Panel to recommend that the Department of Finance continue to review the competitiveness of the U.S. treaty and consider, at a minimum, negotiating a protocol that eliminates withholding taxes on dividends to related group companies. We also believe that the Department of Finance should review the tax treaties of Canada's major trading partners with a view to negotiating the elimination of all withholding taxes.

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[18] Paragraph 212(1)(b) amended by 2007, c. 35, s. 59(2).

[19] Mintz, *Withholding Taxes on Income Paid to Nonresidents: Removing a Canadian-US Border Irritant,* C.D. Howe Institute Backgrounder (March 5, 2001).

VI. Administrative Issues

A. *Transfer-pricing rules*

Canada must have transfer-pricing rules, documentation requirements, and an administrative system that are effective and efficient in promoting international trade while also protecting the Canadian tax base.

For many industries, the current transfer-pricing rules and the documentation requirements are workable. For example, natural resource industries can generally determine third-party comparable prices for commodities because there is an external market. In addition, in certain service industries, such as engineering services, routine work is often performed at cost or cost plus a fixed mark-up (or at third-party rates if the affiliated company providing the service is in the business of providing these services to third parties). Transfer-pricing disputes often arise in the current system where direct comparables are not available, especially where self-developed intangibles are a significant component of the value of a product or service. Taxpayers can only rely on public and internally available data in developing their transfer-pricing approach, but CRA has access to, and uses data from, other taxpayers in order to develop their views and approach. CRA's use of such "secret comparable" data leads to frequent disputes since, without access to the same data, taxpayers are unable to discuss or explain the differences between their products or services and CRA's choice of comparables. We recommend that CRA be precluded from using "secret comparables" to make transfer-pricing adjustments.

TEI also believes considerable compliance efforts are devoted to documenting routine, non-controversial cross-border service charges. For example, many inbound and outbound businesses manage corporate services and computer systems on a worldwide basis. In many cases, the cost of the services are bundled and allocated to all domestic companies and foreign affiliates based on some metric that simplifies the administration while providing a reasonable allocation to each affiliate. On an overall basis, the bundled services and the allocation metric leads to a reasonable charge, but the charge for each specific service within the bundle may not be easily determinable.[20] To streamline the administration of cross-border service charges, TEI recommends that the government publish safe harbour mark-ups for as many industries and services as possible. For example, engineering services into or out of Canada might be set at between cost and cost plus up to 10 percent.[21] Alternatively, where third-party service rates are publicly available, such rates will often be workable. To the extent that a particular taxpayer's mark-up varies from the published guidelines, the focus of the transfer-pricing documentation should be on the reasons for the difference.

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[20] As another example, cross-border charges from inbound companies often include tax depreciation computed under another country's rules. CRA's practice is to recalculate the charge based on the allowable Canadian rate of tax depreciation. CRA's approach is very cumbersome for a timing difference that will ultimately reverse in favour of (or against) the taxpayer.

[21] In connection with a revision of its transfer-pricing rules for services, the United States published a safe harbour list of low-margin services that automatically qualify for the "services cost method" of valuation. *See* Rev. Proc. 2007-13, 2007-3 I.R.B. 295 (January 16, 2007).

In addition, the government should specifically permit a cost allocation between affiliated companies on the basis of worldwide metrics. If an affiliated group has a particular cost allocation approach for Canada that is different from the metric employed for other countries, the reasons for the different allocation approach for Canada should be the focus of the contemporaneous documentation.

Finally, the current approach of requiring taxpayers to prepare contemporaneous documentation and make it available to the CRA upon request, combined with the annual Form T-106 (*Information Return Of Non-Arm's Length Transactions With Non-Residents*) reporting the quantum of various sources and types of cash flow, is a reasonable approach to the reporting of non-arm's length transactions. We believe, however, that the rules would be improved by adopting a *de minimis* amount below which the detailed supplementary reporting on Form T-106 should not be required. TEI recommends that the Panel suggest a *de minimis* amount of $250,000 in non-arm's length transactions with respect to *each* foreign affiliate. For all transactions with affiliates for which detailed T-106 reporting is omitted (*i.e.*, because the aggregate annual non-arm's length transactions with respect to each FA totals less than $250,000), taxpayers should be required to provide only a total, combined amount.

B. *Administration of Canada's Transfer-Pricing Rules*

The Consultation Paper inquires whether (1) Canada's transfer-pricing rules are being applied and administered in a balanced manner and (2) transfer-pricing penalties are "appropriate" and "being assessed fairly."

1. Audits, Appeals, and Litigation. CRA has earned a reputation among international tax advisers as being extremely aggressive in asserting transfer-pricing adjustments.[22] Indeed, many taxpayers that have been subjected to a CRA international audit do not believe the transfer-pricing rules are being applied in an impartial manner. Moreover, once proposed transfer-pricing adjustments surpass the $5 million threshold, which is an easy hurdle in large-file cases where a small pricing difference is often applied to a large volume of transactions, penalties are asserted routinely rather than after a fair and judicious consideration of the taxpayer's facts and circumstances and efforts to comply with the rules.

When the transfer-pricing penalty of subsection 247(3) was implemented in 1998, taxpayers were led to believe that it would not apply so long as they complied with the contemporaneous documentation requirement of subsection 247(4).[23] Compliant taxpayers generally are those that (1) retain contemporaneous documentation supporting reasonable efforts to apply the arm's length standard and (2) cooperate in response to CRA's reasonable requests to produce such information. Regrettably, since 2004 information demands under paragraph 247(4)(c) have been served at the outset of a transfer-pricing audit on all taxpayers that are subject to such audit.[24] By doing so, CRA

[22] *Around the World*, 16 BNA TRANSFER PRICING REPORT 3, at 86 (May 30, 2007).

[23] Subsections 247(3) and (4) added by 1998, c. 19, s. 238, applicable generally for taxation years and fiscal periods beginning after 1998.

[24] Pursuant to *Memorandum TPM-05 — Contemporaneous Documentation* (October 13, 2004), CRA (cont'd next page)

initiates a strict three-month timeline within which taxpayers must produce *all* relevant transfer-pricing documentation for all possible transactions. By issuing information demands at the outset of the audit and without prior discussions with the taxpayer, CRA is seemingly adopting a "gotcha" audit approach aimed at maximizing assessments (and imposing penalties) rather than attempting to determine the reasonableness of the taxpayer's compliance. TEI urges the Panel to recommend that subsection 247(4) be amended so that it becomes the tool of last resort for obtaining information from taxpayers. Taxpayers that are making reasonable efforts to comply with the transfer-pricing rules should not be subjected to such requests at the outset of an audit and before a potential issue requiring substantiation is identified.

In addition, the Head Office Transfer Pricing Review Committee operates entirely behind closed doors. Taxpayers and their outside advisers generally are not permitted to make representations to the group and thus are denied fair access to the decision makers. In some cases, taxpayers may not even receive an explanation of the basis of CRA's transfer-pricing adjustment, let alone an opportunity for a meaningful exchange of views with CRA audit personnel. As important, the Appeals Division seemingly no longer affords taxpayers an independent review of transfer-pricing issues. As a result, taxpayers are increasingly forced to use litigation — or, under the Canada-U.S. tax treaty, arbitration — to obtain an independent review. We believe that Canadian courts will be hard-pressed to effectively and efficiently handle the disputes because transfer-pricing issues are highly complex, fact intensive, and rest on competing economic analyses that are time consuming to present and digest. As important, the more protracted the controversy, the greater the number of subsequent tax years that will become subject to a potential adjustment, increasing business costs and uncertainty.

To reduce the scope and degree of contentiousness that currently afflicts the administration of Canada's transfer-pricing rules, TEI urges the Panel to recommend that CRA establish an *independent* process to review transfer-pricing disputes. Moreover, the Panel should urge CRA to take a more reasonable approach to its use of paragraph 247(4)(c) information requests. Such requests should be the last resort for obtaining information from noncompliant taxpayers rather than a weapon wielded by CRA. Taxpayers should be encouraged to supply documentation to support their transfer prices and methodology and CRA should engage in a meaningful dialogue about whether additional documentation might be necessary or helpful to support the case. This will reduce the scope, number, and degree of disputes as well as reduce costs and uncertainty for both the government and Canadian business.

2. Competent Authority and Treaty Issues. Many transfer-pricing controversies arise in connection with transactions between Canada and the United States. Until approximately 10 years ago, the Canadian and U.S. competent authorities seemed able to resolve most cross-border disputes effectively and efficiently, with taxpayers accorded full relief from double taxation in nearly every case. In the last decade, the relationship seems to have deteriorated, especially in respect of

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(cont'd from previous page) . . . auditors are required to issue requests for contemporaneous documentation at the initial taxpayer contact in all cases where there are transactions or arrangements between a taxpayer and a non-resident person with whom the taxpayer does not deal at arm's length. If the auditors are not aware of these transactions at the initial taxpayer contact, they must issue requests for contemporaneous documentation when they first identify the existence of such transactions.

resolving transfer-pricing issues. Although all the factors contributing to the deterioration are not public — and not all the problems in a bilateral relationship can be attributed to one side or the other — the relationship between Canada and the United States can and should be strengthened.

One step in strengthening that relationship — and strengthening Canada's relationships with other major trading partners — would be to reach advance agreements about acceptable transfer-pricing approaches. For example, the United States accepts the profit-split method whereas Canada does not. In addition, the United States recently issued new transfer-pricing regulations requiring a mark-up on certain types of intercompany services. CRA, however, has not disclosed its views on the acceptability of the service charges and has not discussed the Part XIII tax implications with the business community. An advance resolution of differences in transfer-pricing approaches between governments would go a long way toward reducing costs and uncertainty for taxpayers as well as reducing CRA's administrative costs. TEI recommends that the Panel encourage CRA to publish guidelines for acceptable mark-ups on intercompany service charges.

Next, a binding arbitration provision has been negotiated in the latest protocol between Canada and the United States as a means of resolving disputes. TEI welcomes the provision since it should result in all transfer-pricing disputes being resolved with only one incidence of taxation. That said, arbitration will be a costly and time consuming process. More troubling, however, is that if the binding arbitration provision is invoked a taxpayer will be precluded from appealing the case to the Canadian court system. In addition, while arbitration will eliminate the incidence of double tax, it does not eliminate the penalties and interest on the ultimate tax due; during the years in which it takes to resolve a case in competent authority, the accrued interest will often exceed the tax liability. Moreover, interest and penalties are non-deductible.

The purpose of the competent authority and binding arbitration processes is to eliminate double taxation. As such, CRA's focus should be on working with the competent authority of the other nation to resolve issues rather than maximizing revenue. Consequently, TEI urges the Panel to recommend that CRA re-examine its approach to the resolution of double taxation issues with a view to assisting Canadian taxpayers in the timely resolution of such disputes.

3. Penalties. The current transfer-pricing legislation provides for penalties to be imposed on the gross amount of the adjustment resulting in additional taxes payable. Where a favourable transfer-pricing adjustment arises, however, the Minister has discretion to permit the offset. TEI believes that the netting of favourable transfer-pricing adjustments and the use of the net amount of the adjustment in the assertion of potential penalties should not be left to Ministerial discretion. If there is a legitimate transfer-pricing adjustment, it should be made regardless of whether it increases or decreases tax. Moreover, the net amount of the transfer-pricing adjustments should be used to determine the penalty amount. We urge the Panel to recommend that (1) taxpayer-favourable transfer-pricing adjustments be made as necessary, (2) penalties be asserted on a net adjustment basis, and (3) CRA return to the practice of asserting penalties on an exception basis rather than routinely.

VII. Additional Barriers to International Tax Activity

In today's environment, business organizations staff their projects based on global skill sets rather than looking solely to the resources available within their home jurisdiction. Thus, access to skilled services and know-how is another key aspect of international competitiveness, especially where the skills or knowledge workers are not available in the Canadian market. There are three Canadian barriers that impede access to the lowest cost service providers and create inefficiencies in the global services market place: Payroll withholding for non-resident employees, withholding on service providing entities, and uncertainty about the potential inadvertent creation of Dependent Agent Permanent Establishments (PEs).

A. *Regulation 102 — Payroll Withholding for Non-Resident Employees*

Under paragraph 153(1)(a) of the Act, remuneration paid to non-resident employees who provide services in Canada is subject to the same employment and income tax withholding, remittance, and reporting obligations as compensation paid to resident employees.[25] Section 102 of the income tax regulations (hereafter "Reg. 102") implements the statute and requires resident and non-resident employers alike to withhold from a non-resident employee's earnings a stipulated amount of tax for salary, wages, commissions, bonuses, or other remuneration in respect of an office or employment in Canada.

Non-resident employees are eligible to obtain a waiver of Reg. 102 withholding from CRA if they satisfy criteria set out in the dependent personal services article of the income tax treaty of the employee's country of residence. The waiver must be applied for 30 days *before* the earlier of the date employment services begin in Canada or the first payment is made.

The OECD model tax treaty provides guidance on when it would be appropriate as a policy matter for a tax authority to issue a treaty-based waiver of withholding. Specifically, a non-resident person will be taxable in their State of residence (rather than the state where the services are performed) if (a) they are employed in the other State for less than 183 days, (b) their employer is not a resident of the other State, and (c) related salary and wages are not borne (*i.e.*, deducted in determining taxable income) by a PE of the employer in the other State. The Canada-U.S. treaty provides an additional basis upon which a waiver of withholding is appropriate. Specifically, up to $10,000 of salaries and wages for each employment in Canada is not taxable in Canada. Based on the technical explanation of the latest protocol to the Canada-U.S. Treaty, if a U.S. resident works in Canada for more than 183 days (whether or not consecutively) or earns in excess of $10,000 and the cost is borne by a Canadian, the non-resident is taxable in Canada and will not qualify for a waiver. Regrettably, the $10,000 limit, which was first included in the 1980 treaty, has been carried forward into the new protocol without an inflation adjustment.

There are a number of challenges with the current approach to cross-border employment. First, large multinational companies with multiple lines of business can rarely monitor the number of

[25] An exemption for Canada Pension Plan contributions may be available where Canada has implemented a Reciprocal Agreement on Social Security with the employee's home country.

and frequency with which non-resident employees cross the border to perform short-term assignments. Second, the requirement that a non-resident apply for a Reg. 102 waiver 30 days in *advance* of entering Canada or receiving the first payment is impractical since employees who come into Canada are often responding to a critical service need (*e.g.*, an emergency repair of equipment in Canada) or short-term marketing opportunity. Third, the $10,000 threshold for taxability is extremely low. If the 1980 treaty amount were adjusted for inflation it would equate to about $26,500 today.[26] Fourth, many foreign entities cannot withhold and pay Canadian payroll taxes or employment insurance premiums, and the Canadian payroll withholding requirement is generally in addition to the withholding tax requirements for the home country. Fifth, since the withholding tax is not the final liability of the employee for the year, employers must often loan the withholding taxes to the employee until the tax liability for the year is finally determined, though in some cases securities regulations preclude loans to specified employees. Where the cross-border employment results in an incremental tax to the employee, the employer will generally have to "gross up" the employee so that, after tax, they would receive the net compensation they would have received in their home country.27 Finally, the services of a professional adviser are often required to file multiple country tax returns and calculate the tax equalizations for the affected employees. As a result, the added costs of bringing non-residents into Canada are borne directly or indirectly by the Canadian service recipient resulting in significantly increased costs of doing business in Canada.

To reduce the cost of employing skilled non-residents performing services on a temporary basis in Canada, TEI urges the Panel to consider recommending the following changes:

1. Create a bright-line, 183-day test to determine taxability of non-resident individuals for all purposes. Such a test would align personal taxation in Canada for all purposes. Once an individual provides services for more than 183 days during a year, tax would be exigible.

2. Permit annual (rather than per payment) reporting of wages paid to employees of non-arm's length entities that have spent time in Canada. In addition, permit an after the fact "true-up" if an employee's time in Canada unexpectedly exceeds the 183-day limit. The filing date and the payment date for the non-resident's taxes should be made the same as the Corporate T2 income tax return.

3. If it is not feasible to establish a 183-day test for employment income, the *de minimis* threshold for the imposition of personal tax should be increased to at least $50,000 (and the Department of Finance should be urged to negotiate an amendment to Canada-U.S. treaty to reflect the increased threshold).

4. Finally, if the current waiver system is retained, the requirement to apply for the waiver 30 days before commencing employment or receiving wages should be eliminated. Instead, the waiver request should be evaluated when received.

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[26] To calculate an inflation adjusted equivalent, *see, e.g.*, http://www.bankofcanada.ca/en/rates/inflation_calc.html

[27] The gross-up is also subject to tax and must, in turn, be grossed up.

B. *Regulation 105 — Corporate Withholding*

Under Section 105 of the income tax regulations (hereafter "Reg. 105") a 15 percent withholding tax applies to all payments to non-residents in respect of services rendered in Canada. All individuals, partnerships, and corporations (resident and non-resident) making payments to such non-residents (whether individuals or entities) for services rendered in Canada are required to withhold. The withholding is a payment on account of the non-resident's potential Part I tax liability and does not represent the final tax. The ultimate tax liability is determined after the assessment of the non-resident's Canadian income tax return.

As under Reg. 102, non-resident service providers (whether individuals or entities) can apply for a waiver of Reg. 105 withholding from CRA. To be eligible, the third party must demonstrate (1) that it does not have a PE in Canada and is thus eligible for treaty protection or (2) that its estimated income and expenses will result in no net tax liability in Canada. Again, the waiver must be applied for 30 days *before* the earlier of the date the services begin in Canada or the first payment is made.

1. <u>Arm's length service providers</u>. Non-residents are generally unaware of the requirement to apply for a waiver 30 days prior to beginning to provide services. As important, in many cases the process will prove impractical or too costly to implement since the fee for hiring a Canadian tax adviser to process the application will diminish the service provider's expected net profit. Moreover, despite losing a major case (*The Queen v Dudney*[28]), CRA applies an expansive interpretation of the definition of a PE in Canada. Thus, it is virtually impossible for a non-resident to obtain a waiver by showing that it does not have a PE. The only remaining approach for obtaining a waiver is for the non-resident to demonstrate that its net income will fall below the threshold for Reg. 105 withholding.

As a result of the cumbersome process, and because it can take up to two years to obtain a refund of excess withholding from CRA, arm's length vendors will generally negotiate a gross-up of the Reg. 105 withholding amounts from the Canadian service recipient.[29] By doing so, the arm's length vendors are relieved of the economic cost (if not the administrative requirement) of filing a Canadian tax return in order to obtain the full value of the agreed price for the services. More important, Canadian service recipients bear the economic cost of the Canadian withholding tax.

2. <u>Non-arm's length vendors</u>. The United States has adopted new transfer-pricing regulations that require some intercompany services to be billed at cost plus a mark-up. The actual mark-up depends on the type of service. Regardless of whether the intercompany payment includes a profit element, the administrative burden of withholding from the payments, filing information returns for the payments and withholding to related parties, and filing returns on behalf of related parties is an unnecessary administrative burden for multinational enterprises. The Canadian recipient should be able to file tax returns and pay any necessary taxes on behalf of its related entities and obtain reimbursement from the related party.

[28] 2000 D.T.C. 6169, [2000] 2 C.T.C. 56, 253 N.R. 270.

[29] Because the gross-up is also subject to Reg. 105 withholding, the incremental payments must also be grossed up.

3. Recommendations. TEI offers the following recommendations to the Panel for consideration in reducing the barrier to international activity that Reg. 105 creates:

a. Retain the requirement to report amounts paid to non-residents on Form T4A-NR (*Statement of Fees, Commissions or Other Amounts Paid to Non-Residents for Services Rendered in Canada*) but eliminate the requirement to withhold taxes.

b. Adopt a process whereby non-residents can self-certify that they are entitled to treaty protection (and exempt from tax) by filing a form with CRA. The non-resident can provide a copy of the form to the service recipient to eliminate the withholding obligation. For example, the United States has implemented Form W-8BEN (*Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding*) to permit treaty beneficiaries to certify to the IRS and to the service recipient the availability of the treaty benefit.

c. Permit non-resident, non-arm's length services provided under the new U.S. transfer-pricing rules to be treated as a "cost arrangement" such that even if it is not possible to satisfy CRA that there is no PE in Canada, a waiver of withholding would still be available under the revenue-expense test.

d. Encourage CRA to establish a procedure for issuing blanket waivers of withholding for all non-resident, non-arm's length affiliates within a multinational group providing services to the Canadian member of the group. In addition, the service providing entities should be permitted to report and pay tax their liability on an annual basis after the end of the tax year in which the services were rendered.

e. The requirement to request a waiver 30 days prior to providing services should be eliminated and the waiver request should be evaluated when received.

C. *Agency Permanent Establishments*

Under most country rules, a foreign company can conduct business in another country (the host country) through an entity that facilitates the sale of the foreign company's products or services to customers in the host country. Depending on the facts and circumstances, there may be instances in which the relevant activities of the entity in the host country constitute an "agency permanent establishment" (agency PE) of the foreign company. A highly debated issue in international tax is the attribution of profits to an agency PE, and whether a payment by the foreign company to a dependent agent extinguishes any further tax liability of the foreign company in the host country.

In a December 2006 report on the attribution of profits to a PE,[30] the OECD observed that an arm's length payment by a foreign enterprise to its dependent agent in the host country does not necessarily extinguish the tax liability of the foreign enterprise in the host country. Considerable concern has arisen in the international community over that statement. TEI believes that allaying foreign taxpayer's concerns over their activities in Canada would increase Canadian economic activity. Hence, TEI recommends that legislation or administrative policies be developed announcing that Canada will not apply the OECD's dependent agency interpretation so long as the activities of the foreign company are attributable to subsidiaries (as opposed to employee-like dependent agents) in Canada and appropriate transfer-pricing methods have been followed. A less preferred alternative would be for Canada to adopt the OECD's alternative of applying tax at the subsidiary level rather than requiring the parent (or principal) of the dependent agent to file a tax return.

Conclusion

TEI welcomes the opportunity to meet with the Panel to discuss its comments and recommendations.

TEI's comments were prepared under the aegis of the Institute's Canadian Income Tax Committee, whose 2008-2009 Chair is Rod Bergen. If you should have any questions about the recommendations, please do not hesitate to call Mr. Bergen at 604.488.5231 (or Bergen@jp-group.com) or Munir A. Suleman, TEI's Vice President for Canadian Affairs, at 416.866.4698 (or munir.suleman@scotiabank.com).

Respectfully submitted,

Tax Executives Institute

Robert J. McDonough
International President

cc: Munir A. Suleman, 2007-2008 Vice President for Canadian Affairs
Rod Bergen, 2008-2009 Chair of TEI's Canadian Income Tax Committee

[30] *Report on the Attribution of Profits to Permanent Establishments: Parts I (General Considerations), II (Banks) and III (Global Trading),* Organisation for Economic Co-operation and Development (December 2006).

Appendix

Survey of Thin Capitalization and Interest Stripping Rules in Foreign Jurisdictions

In a survey of various countries' thin capitalization and interest stripping rules we found the following taxpayer-favourable provisions:

1. Most jurisdictions provide complete exemption or specific formulary relief from thin capitalization rules for financial services businesses. Australia, Switzerland and the United Kingdom have separate debt-equity ratios (up to 20 to 1) for financial services businesses. In France and Italy, all financial services businesses are regulated and exempt from the thin capitalization or earnings stripping rules. In Germany and the United States, restrictions on interest deductions apply to net interest expense, which effectively exempts lending businesses. In Germany, the interest deduction limit applies to a percentage of earnings before interest, taxes, depreciation, and amortization (EBITDA) which affords practical (though not always sufficient) relief to leasing businesses.

2. Most jurisdictions, including the United Kingdom, Australia, France, Germany, and Italy, adopt a consolidated group approach to determine the permitted debt-equity ratio or the amount of interest deductions to be shared among separate legal entity group members. As in Canada, they also exempt on-lending within a group from the thin capitalization ratios or interest deduction limits.

3. Most jurisdictions, including the United Kingdom, France, Switzerland, Sweden, the Netherlands, Korea, Japan, and India, do not include unrelated debt in their thin capitalization regime.

4. Germany, France, Italy, and the United States provide a carry forward for the denied amount of interest deductions. This is a very important feature for business because it generally precludes the denial of the deduction from being treated as a permanent difference in the financial statements.

5. Australia, Germany, France, and Italy provide specific exemptions for securitization transactions. Rules in other jurisdictions achieve a similar result without specific exemptions.

Our review disclosed the following taxpayer-adverse provisions:

1. In the United Kingdom there is no clear formula that taxpayers can rely upon in determining the amount of the "excess" of debt to capital. Instead, an arm's length test is used and taxpayers are required to negotiate specific debt-equity ratios with the Her Majesty's Revenue and Customs (the U.K. tax administrator) for prescribed periods of time (generally three to five years). TEI opposes such an approach. This approach creates uncertainty and that makes it difficult for businesses to plan on a long-term basis. Moreover, it is a highly subjective approach that consumes resources of taxpayer and the tax administrator. It is also unclear how such a system would create a level playing field for all taxpayers since the

negotiations are confidential. In Canada, it is unclear whether CRA would have the resources or the experience to negotiate effectively and efficiently with affected taxpayers. Experience in the negotiation of transfer-price agreements and settlements suggests that the scope, number, and frequency of disputes with taxpayers would be substantial. Such an approach would also contravene the spirit of *Advantage Canada* and be inconsistent with the Advisory Panel's mandate of increasing the certainty and simplicity in Canada's system of international taxation.

2. Businesses operating in jurisdictions with earnings stripping rules have found that such rules are more difficult to comply with than fixed ratio thin capitalization rules, add uncertainty in determining appropriate debt levels, and often do not work as intended for legitimate business operations. Cyclical businesses, start-up enterprises, long-term lenders and lessors (*e.g.*, lenders to commercial aircraft or heavy equipment users), and businesses with narrow net-interest operating margins will struggle with restrictions based on profitability. In addition, industries with higher capital intensities would be effectively penalized twice: once because of the greater need for funds and a second time because of lower earnings for a defined amount of capital. As a result, interest deductions would be denied where it clearly would not be an intended result. Such an approach would be inconsistent with the goals of simplifying the tax system, enhancing certainty, and encouraging small business and entrepreneurship.

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