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August 29, 2008

Advisory Panel on Canada's System of International Taxation ("Panel")
Submission
Attn: David Messier
333 Laurier Avenue West, 15th Floor
Ottawa, Ontario
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Dear Mr. Messier

Re: Enhancing Canada's International Tax Advantage

The opportunity to have input into this project is greatly appreciated. It should be noted that, although I am somewhat familiar with Canadian taxation, I am not a Canadian tax practitioner. Therefore, the recommendations / observations herein are based on my knowledge of and experience gained in various tax systems. Most importantly, having spent eighteen (18) years in industry, a business perspective is brought to bear.

A brief biography is also attached herewith.

General

There is a general perception that the US Internal Revenue Code ["Code"] (especially the international provisions which constitute my forte) is complex. While that perception may be valid, the complexity arises from very detailed rules which results in the Code and the regulations thereto being voluminous, not from the drafting. Here lies the one major shortfall of the Income Tax Act of Canada ("Act") i.e. its complexity is primarily attributable to its drafting (detailed is fine but plain short sentences should be the norm). This must change.

The global economic environment today is vastly different from that of the 1970s. To "cling" to the Capital Import Neutrality or Capital Export Neutrality principles is no longer valid. Therefore, the rules must reflect that reality and should yield an environment which promotes competitiveness and productivity while encouraging investment (inbound and outbound). Taxation is only one element of competitiveness – it is not a panacea and should not be. This does not imply it cannot act as a catalyst. There are many instances where companies have exited, so-called, low-tax jurisdictions due to low productivity.

This submission may not address the issues in the order presented by the Panel since, I believe, that the issues being addressed by the Panel are interrelated.

Summary of Recommendations (an explanation of each recommendation follows)

- Withholding taxes on dividends and royalties should be eliminated.

- Where interest is paid to a nonresident related party, such interest should be subject to withholding tax of 10%. This is a reduction from the domestic rate of 25% and is line with most jurisdictions and with the reductions in the corporate income tax rate. Where the interest is paid to a nonresident non-related party, such interest should **not** be subject to withholding. The current thin-capitalization rules should also be changed.

- Subject to safeguards, reorganizations within an affiliated group should be tax-free.
- The country-by-country principle vis-à-vis the foreign tax credit ("FTC") regime must be changed to a "basket" system.
- The foreign accrual property income ("FAPI") rules must be streamlined.
- Anti-treaty shopping rules should not be entertained since there is no empirical evidence of substantive abuse. To introduce such rules in the Act simply adds to complexity and uncertainty in today's economic environment.
- There must be a detailed examination of the treatment of tax-exempt organizations (especially the so-called "sovereign funds") in inbound and outbound contexts.

Withholding Tax – Dividends and Royalties

There is a global trend towards the elimination of withholding tax on dividends since this stimulates investment. In addition, why is it necessary for the host country to tax the same income twice?

Turning to the question of royalties, consideration must be given to the elimination of withholding tax on royalty payments for use of intellectual property. Canada's spending on research and development ("R&D") combined with its productivity levels is dismal. Although there may be exceptions (such exceptions being a very small minority), given history, it is highly unlikely that R&D spending will ever be substantial. Therefore, the cost of acquiring the necessary know-how, etc. in order to, hopefully, contribute to increased productivity and, by extension, competitiveness should be reduced by eliminating withholding tax on royalties.

In principle, the loss of tax receipts from the elimination of withholding tax on royalties should be less than the increase in corporate income tax receipts due to increased profitability (productivity and competitiveness levels increased).

Reorganizations

It is understood that a Canadian corporation can tax-efficiently transfer a foreign affiliate to another foreign affiliate by means of a share-for-exchange. Given the increase in acquisitions of Canadian companies by foreign companies (such increased activity is expected to continue), it is difficult for the acquirer to reorganize its holdings to bring them in line with the circumstances under which it historically operated. We understand that certain steps could be taken to minimize any adverse consequences. However, while it is appropriate to ensure that a reorganization is, in substance, not undertaken to facilitate a pending disposition in such a manner as to escape taxation, the current rules are complex and may not achieve the objectives intended.

A similar system as to section 367 of the Code may be appropriate. If the stock of a foreign affiliate is transferred to, say, the foreign parent (the acquirer), any deemed gain should be deferred subject to a gain recognition agreement ("GRA"). Basically, the GRA will stipulate that if the stock of the transferred entity is disposed of to a person **outside** of the affiliated group within five (5) years of the transfer, such gain would be recognized retroactively, including a toll-charge. Any gain arising from a disposition after five (5) years should not be recognized.

Where the disposition takes place within the five (5) period:

- To the extent that the entity sold has accumulated earnings (determined under Canadian tax principles), that portion of the full gain is treated as a dividend. However, such dividend should be fully taxable with underlying foreign tax credits. In other words, the characterization as exempt surplus or taxable surplus is eliminated.

- Any remaining gain is treated as a capital gain and taxable accordingly.

Although the aforementioned proposal deviates from the current system, it should be viewed as being in line with: (1) the business purpose doctrine (e.g. rearrangement of the group to meet changing economic conditions); (2) the principle of *"no change in beneficial ownership"*; and (3) instituting an anti-abuse rule.

There are two (2) other related aspects: (1) the retention of the exempt surplus system and (2) interrelationship with treaties. The first aspect will be addressed in the section *"Exempt Surplus"*. As to the second aspect, a very disturbing trend in Canada's recent treaties is noted (e.g. Mexico). While the right to tax gains attributable to immoveable property and moveable property attached to a permanent establishment is ceded to the situs state, Canada has started to allow the other state to tax other gains in deference to the principle of the residency of the alienator. This is a material change from the OECD Model and Canada's prior treaties. In addition, given that both states are given the right to tax the gain, in certain cases the "first right" to tax is not clear and no relief is provided for reorganizations (US-Canada treaty excepted). These aspects are impediments to inbound and outbound investments.

Foreign Tax Credits ("FTCs")

The current system is an impediment in today's economic environment and is archaic. There should not be any reason to not adopting a basket system. This should be comprised of two (2) baskets: active and passive and should not be limited by the number of tiers in the chain of the affiliated group.

Exempt Surplus

The key question is whether this system should be retained or not. If capital gains remain taxable, why have a system which allows an otherwise taxable item to be converted to a nontaxable item (i.e. exempt surplus)? [A Canadian tax practitioner indicated that the norm is to strip the foreign affiliate and sell at a lower price. If that is the case, why not exempt capital gains?] With the downward trend to lower corporate tax rates, in most cases there should not be any incremental taxes on a dividend through an adoption of a basket system for FTCs. As a result: (1) the need to institute more complexity in denying deductions would be eliminated (e.g. the so-called "double-dip"); (2) there would not be the need to segregate exempt surplus and taxable surplus; and (3) timing of taxation is simplified. Dividends from an affiliate conducting an active trade or business should be taxed only on repatriation while FAPI income is taxed on a current basis.

In light of the preceding, what constitutes an active trade or business should be clearly defined. The current definition is based on what does not constitute an active business followed by complex rules including deeming provisions converting FAPI to active business income. In addition, such income should not be based on whether the activities are carried out in a country with which Canada has a treaty (or even the proposal re: an exchange of information agreement). The determination of whether an active trade or business is conducted must be based on the existence of substance. This is generally evident by the foreign affiliate's officers and employees carrying out substantial managerial and operational activities. The onus should be on the Canadian parent to provide evidence of the existence of substance.

As a result:

1. The deeming provisions re-characterizing, for example, interest and royalties as active business income in certain circumstances such be repealed. If substance exists, the income is active business income.

2. The base erosion rules ("BER") should be repealed since substance is required. In any event, in the current global economic environment, the BER should not apply to entities which manufacture (including under contract with a third party) and sourcing their products from different jurisdictions. Is the BER not an example of the *"tail wagging the dog"*? Furthermore, the BER creates a disadvantage where a foreign parent establishes a subsidiary in a foreign country to do the same including sales of its products to the Canadian entity which is "brother-sister" to the foreign entity. The same should apply to insurance / reinsurance, etc. If it is more economically beneficial to insure related party risks and the activities of the entity are, in fact and substance, that of an insurer / reinsurer, there should not be any income inclusion on a current basis. Similarly, where a subcontract is provided to an affiliate to perform certain services (e.g. engineering) because it has the know-how (the Canadian company which executed the contract does not itself posses the know-how), such transaction should not be subject to the BER. This type of provision sends the message *"give the subcontract to a third-party notwithstanding the establishment or acquisition of the affiliate was to gain that particular expertise"*. To reiterate, such activities must be viewed under the substance principle and let the transfer pricing provisions deal with the reasonableness of the transactions.

3. There should not be any difference between the treatment of branches and subsidiaries i.e. taxation should not dictate the mode of doing business. Was this not the reason for countries to institute a branch remittance tax? However, consideration should be given to prevent losses from being duplicated.

4. FAPI should be restricted solely to income arising from pure passive activities.

5. In the case of foreign investment entities ("FIEs"), the personal foreign investment company ("PFIC") rules in the US may serve as the type of system which should be adopted. Where the FIE rules overlap with the FAPI rules, the FAPI rules apply. In both cases, the objective is to tax income arising from passive activities on a current basis.

Thin-capitalization

Firstly, rules similar to section 163(j) of the Code would be more appropriate than the current rules. Such a proposed system takes into consideration variations by industry. In essence, this methodology measures the cash flow capability of an entity being able to service its debt. If this type of methodology is implemented, the current 2:1 ratio could be maintained as one element to the concept rather than being, in essence, the sole criterion.

Treaties

One does not believe that Canada's tax base is at substantial risk due to treaty shopping. In over ninety-nine percent (99%) of the cases where treaties are utilized, the reasons are business driven. The two (2) primary areas are: (a) linkage with trade and investment agreements and (b) bankruptcy protection (risk mitigation).

The following are some of the more important aspects which must be addressed:

1. The term *"beneficial owner"* must be clearly defined in the Act. The fundamental question is: *"who is liable to tax on the income under the laws of the recipient's country of residence?"* Simply because a group adopts a dividend policy whereby the income of the subsidiaries are to be repatriated should not, by itself, cause Canada (the source country of the payment) to deny treaty benefits. The more appropriate way is to clearly define *"beneficial owner"* complemented by an anti-conduit rule (for example, section 894 of the Code).

2. Treaty overrides of any nature in the Act should be a non-starter. Businesses rely on treaties for certainty – treat overrides remove that uncertainty. In addition, other countries may begin to question the need to enter into a bilateral treaty with Canada if overrides exist.

3. Canada needs to ensure that its treaties have provisions dealing with competent authority relief. If a country (for example Brazil) refuses to do so, negotiations should cease and, where applicable, be terminated. Brazil, for example, does not follow the arm's length principle on transfer pricing. This creates the potential of double taxation and results in FIN 48 type issues.

Transfer Pricing

There does not seem to be any substantive empirical evidence that Canada's transfer pricing rules are not working. When the downward trend in corporate tax rates in Canada and other countries are combined with the redefinition of an active trade or business, any perceived abuses should be mitigated.

Tax-Exempt Organizations ("TEO")

The fundamental question is: *"At what point does a TEO cross the line i.e. it becomes a commercial enterprise"?*

The following is being posited: where an investment (inbound or outbound) in a commercial enterprise by a TEO passes a threshold of 5% and such investment gives the TEO influence over the operating decisions of that commercial enterprise, its tax-exempt status should be lost. This also should apply to sovereign funds.

In the Globe and Mail of June 21, 2008, there was a quote attributed to a person at the Ontario Teachers Pension Plan vis-à-vis its BCE acquisition after the Supreme Court's ruling (emphasis added): *"There is no champagne on ice. **We're running a business here**."* The question is this: to which business is reference being made – BCE's or the Pension Plan? If it's the former, then serious consideration must be given to the aforementioned proposal.

Conclusion

Although the following is not within the Panel's mandate, it cannot be ignored nor set aside for another day.

Any corporate tax reform is destined for failure if not accompanied by personal tax reform. High taxation necessitates complex rules like FIEs. Countries which reformed both systems (through substantial rate reductions) have seen substantial increases in investment and productivity. Low personal taxation on investments and compensation resulted in increased investment and reduced the pressures on labor cost. The result was an increase in competitiveness and productivity. The current system results in the reverse.

Sincerely,

Paul Tadros
Attachment: Biography of Writer