Advisory Panel on
Canada's System of
International Taxation

Enhancing Canada's International Tax Advantage

A Consultation Paper Issued by the Advisory Panel on Canada's System of International Taxation

April 2008

Advisory Panel on
Canada's System of
International Taxation

Enhancing Canada's International Tax Advantage

A Consultation Paper Issued by the Advisory Panel on Canada's System of International Taxation

April 2008

For additional copies of this document, please contact:

Distribution Centre
Department of Finance Canada
Room P-135, West Tower
300 Laurier Avenue West
Ottawa ON K1A 0G5
Tel.: 613-995-2855
Fax: 613-996-0518

Also available on the Internet at: **www.apcsit-gcrcfi.ca**

Cette publication est également disponible en français.

Cat. No. FF2-184/2008E-PDF
ISBN 978-0-662-48468-4

To the Reader:

Thank you for your interest in this paper, and in Canada's international tax policy and its impact on Canada's prosperity.

Most elements of Canada's current system of international taxation have been in place for over 35 years. In many respects, the system has fostered an environment in which Canadian businesses can compete while treating foreign businesses in Canada appropriately. In fact, some aspects of Canada's system have become a model for other countries seeking to improve the tax treatment of business and investment income flowing across their borders.

But as globalization continues, Canada must keep pace. Cross-border investment is rising, investment capital pools are expanding, and global transactions are becoming ever more sophisticated and complex. It is important to ensure that Canada's system of international taxation continues to promote the competitiveness of Canadian businesses internationally and to attract new foreign investment to Canada. In doing so, Canadians can continue to benefit from the opportunities and wealth that come with international business activity.

In November 2007, the Government of Canada created the Advisory Panel on Canada's System of International Taxation to study and recommend measures to further improve the competitiveness, efficiency and fairness of this system. We are honoured to serve as its Chair and Vice-Chair. We are equally honoured to be joined on this panel by an exceptional group of individuals drawn from a spectrum of public and private sector organizations. Each Panel member brings a unique perspective and shares the goal of ensuring our international taxation system makes our country's businesses more competitive for the benefit of all Canadians. The Panel members are James Barton Love, QC, Nick Pantaleo, FCA, Finn Poschmann, Guy Saint-Pierre, CC, and Cathy Williams.

This consultation paper, *Enhancing Canada's International Tax Advantage*, poses a series of questions about Canada's international taxation system and provides some of our initial views. Together, these questions and views frame the debate we wish to engage in with Canadians. How can Canada's international taxation system do a better job of supporting the competitiveness of our businesses? What aspects of the current system should we preserve? What aspects should we improve? What aspects should we revisit to ensure that our businesses can compete in Canada and abroad so Canadians can continue to prosper?

On behalf of the Panel, we invite you to review this paper or the related Summary and to contribute to this debate by submitting your views in writing by July 15, 2008. By considering the concerns and ideas of as many interested parties as possible, the Panel can craft recommendations that will bolster Canada's international tax advantage and ensure it endures in the years to come.

Sincerely,

Peter C. Godsoe, OC
Chair
Advisory Panel on Canada's System
of International Taxation

Kevin J. Dancey, FCA
Vice-Chair
Advisory Panel on Canada's System
of International Taxation

Contents

1. Introduction

1.1 Canada's tax policy is important to the country's ability to sustain and improve its competitiveness in the changing global environment. In particular, Canada's international taxation system must keep pace with global trends to support business investment by Canadians abroad and to attract foreign investment into Canada. In the past few years, the Government of Canada has made changes that support a competitive international tax policy. Future changes are scheduled that enhance our competitiveness to the benefit of all Canadians. However, more changes to Canada's tax system — and to its international tax system, in particular — may be needed.

1.2 In Budget 2007, the government announced it would strike an advisory panel to review Canada's system of international taxation. On November 30, 2007, the Minister of Finance announced the formation of the Advisory Panel on Canada's System of International Taxation ("the Panel"). The chair and vice-chair of the Panel are Peter C. Godsoe, OC, and Kevin J. Dancey, FCA. The other members of the Panel are James Barton Love, QC, Nick Pantaleo, FCA, Finn Poschmann, Guy Saint-Pierre, CC, and Cathy Williams.

Our Mandate: Enhancing Canada's International Tax Advantage

1.3 The Panel's mandate is to make recommendations to guide the government in establishing an international tax policy framework with respect to investment abroad by Canadian businesses as well as investment into Canada by foreign businesses.

1.4 Our recommendations will aim to improve the competitiveness, efficiency and fairness of Canada's system of international taxation, minimize compliance costs for businesses, and facilitate administration and enforcement by the Canada Revenue Agency (CRA). We will attempt to make recommendations that can be practically implemented and that will increase the certainty and simplicity of Canada's system of international taxation for large, medium-sized and small businesses.

1.5 The Panel will fulfil its mandate with an eye to complementing other elements of the government's overall strategic policy. Establishing Canada's competitive tax advantage is a key area of focus of *Advantage Canada*, the Government of Canada's long-term economic plan. According to *Advantage Canada*, the tax policy needed to create that advantage is clear: Canada must achieve the lowest effective tax rate on new business investment in the G7. The Panel's recommendations regarding Canada's international tax system will harmonize with the direction set out in Canada's long-term economic plan.

1. Introduction

1.6 The Panel is following the work of Canada's Competition Policy Review Panel (the "Competition Panel") with great interest, given the Competition Panel's complementary mandate and the government's need for a coordinated policy approach. In this regard, two passages from the Competition Panel's October 30, 2007 consultation paper will help guide our work:[1]

> *With our small domestic market, Canada must look outward. To that end, the [Competition] Panel has been mandated to investigate how best to encourage outward investment by Canadian firms.*
>
> *[…] the government has a significant role to play in establishing the conditions that will assure Canada's position as an attractive destination for investment, both by Canadians and those from abroad.*

1.7 The work of the Competition Panel and our Panel is based on the same premise: outward investment by Canadians in foreign markets and investment by residents of other countries into Canada are critical to Canada's long-term growth and development. Accordingly, Canada's international tax system should facilitate both outbound and inbound investment.

1.8 The Panel's primary focus will be on how Canada's international tax rules affect Canadian businesses investing abroad as well as foreign businesses investing in Canada.

1.9 Although the Panel has not been asked to ensure its recommendations are fiscally neutral, we will be cognizant of the revenue impact of any proposal.

1.10 The Panel is supported by a secretariat and we will rely on the Department of Finance and the CRA for information and data regarding the current system. These data should help us assess potential concerns with the current system and their magnitude. We will also seek information and independent policy analysis through research from various independent contractors on selected topics, especially with respect to benchmarking Canada's international tax system and understanding future directions that may be taken by our main competitors.

1.11 The Panel intends to provide its recommendations to the Minister of Finance by December 1, 2008.

---

[1] Competition Policy Review Panel, *Sharpening Canada's Competitive Edge*, October 30, 2007, at page 3, available at: **http://www.competitionreview.ca/**

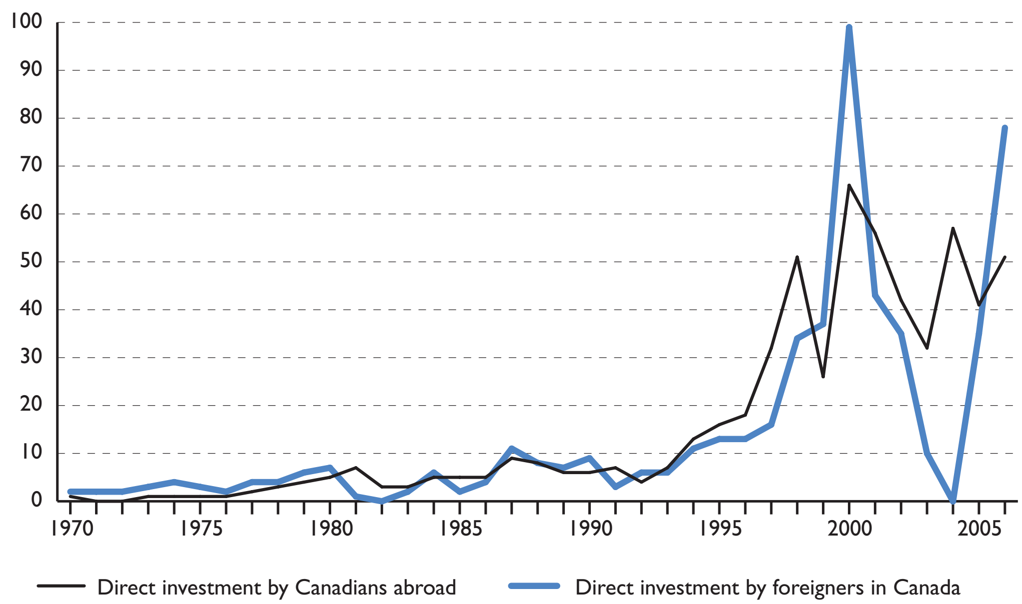
1. Introduction

The Current Tax Environment

1.12 Building a tax advantage for Canadian businesses is a key element of the government's long-term economic plan. Canada's international and domestic tax systems are linked, and changes to the domestic tax system can affect the competitiveness of Canadian businesses within Canada and abroad. One of the most significant domestic tax factors influencing the competitiveness of Canadian businesses is the corporate tax rate. Canada's general corporate tax rate is dropping from about 34 percent at the start of 2007 to about 25 percent by 2012 (assuming a 10-percent provincial rate will apply in 2012). The government's move to lower corporate rates and its objective of achieving the lowest effective tax rate on new business investment in the G7 support a competitive international tax policy.

1.13 Canada's system of international taxation should support both Canadians investing abroad and those investing in Canada in order to promote growth and productivity in the Canadian economy and create wealth for the benefit of all Canadians. The figures below show the amount of foreign direct investment made in Canada by foreign investors as well as the amount of direct investment made by Canadians in foreign countries.

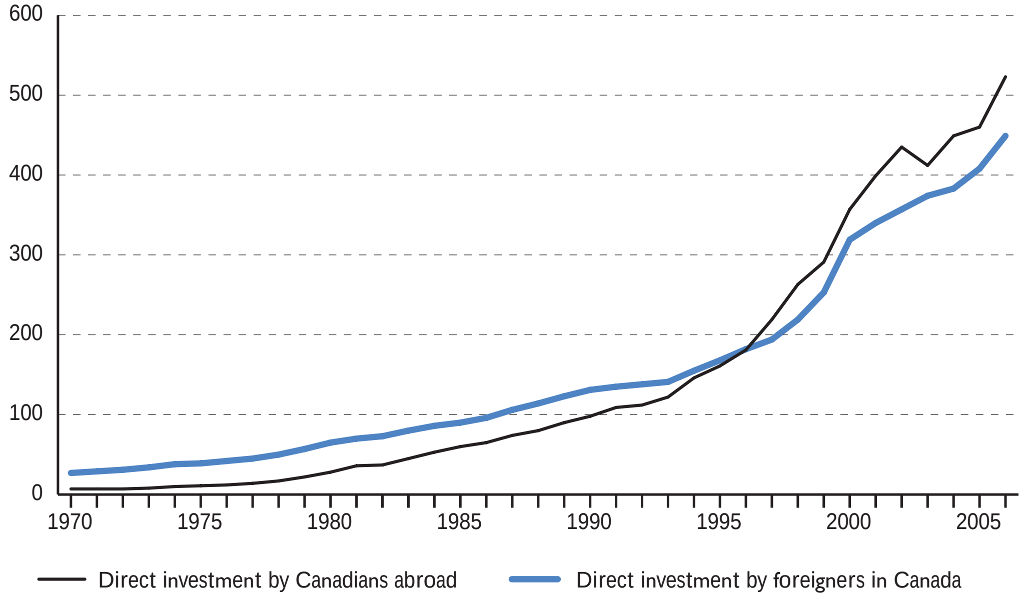
Flows of Direct Investment by Canadians Abroad and by Foreigners in Canada, 1970–2006 ($billions)



Source: Statistics Canada, CANSIM Table 376-0015.

1. Introduction

Stocks of Direct Investment by Canadians Abroad and by Foreigners in Canada, 1970–2006 ($billions)



Source: Statistics Canada, CANSIM Table 376-0037.

1.14 Ensuring the competitiveness of Canada's international tax system is especially important, given the changes in the global economic landscape in recent years. As the figures above illustrate, Canadian businesses are increasing their investments abroad, and foreign businesses are increasing their investments into Canada. A rising proportion of these investments are being made by tax-exempt organizations, including sovereign wealth funds.

1.15 The foreign competitors of Canadian businesses are growing in strength and number, aided in many cases by the tax policies of their home countries. Some countries have already reduced their corporate taxes in their efforts to compete for capital, jobs and growth. For example, the average corporate tax rate of member countries of the Organisation for Economic Co-operation and Development (OECD) has dropped from 34.1 percent in 2000 to 27.8 percent in 2007. A country can change its rules regarding business investment and alter the landscape at any time. Canada's tax policy must anticipate continuous change in the global tax environment and have the flexibility to adapt accordingly.

1. Introduction

Toward a Tax Policy Framework

1.16 Setting international tax policy entails trade-offs and practical constraints. Recognizing these considerations, the Panel's initial views on a framework for developing Canada's international tax policy are as follows:

- Canada's international tax system has served the country well in many respects over the past few decades. Changes to the system should be made only in areas where significant improvement will be achieved.
- Canada's tax system should support the goal of attracting foreign investment. In accomplishing this, Canadian tax rules should aim to create a level playing field for domestic business activity carried on by foreign and Canadian businesses while ensuring Canadian-source income is properly measured and taxed.
- Many countries seek to adopt international outbound tax rules that make their companies competitive. Canada's outbound international tax rules should aim to maintain and enhance the competitiveness of Canadian businesses operating abroad.
- For taxpayers, certainty and simplicity in tax legislation and its administration are important. Business investments are long term, and sudden changes in tax policy without adequate transition cause significant disruption. Complexity should be avoided except, for example, where it is necessary to protect tax revenues.
- To ensure Canada's international corporate and withholding tax regimes remain competitive, they should be benchmarked regularly against international norms and should anticipate global trends and changes.
- Fairness in the international tax context needs to be clarified. The Panel recognizes that this issue involves making policy choices amid conflicting objectives. The Panel's initial view is that the notion of "horizontal equity," whereby taxpayers in similar situations are treated similarly, is useful as a guiding principle. This view of fairness is consistent with the principles noted above and may be summarized as follows:
  - Canada's taxation of inbound investment should facilitate a level playing field for domestic business activity.
  - Canada's rules regarding the taxation of outbound investment should be competitive vis-à-vis the outbound tax rules of other major countries.

1. Introduction

Specific Areas for Review

Outbound Taxation: Keeping Canadian Businesses Competitive

1.17 Canada's domestic market is small: Canadian businesses have difficulty achieving global economies of scale while operating solely within the domestic market. Outbound investment is therefore important for Canadian businesses seeking to grow and compete with foreign businesses that have access to larger markets. Outbound investment also offers a vital means for Canadian businesses to acquire new technologies, resources and skills that may not otherwise be available within Canada, thus raising the economic potential of Canadian businesses and the value of their employees for the benefit of all Canadians.

1.18 A number of other countries have undertaken to change or initiate a detailed review of their current system for taxing foreign income earned through foreign entities of residents of those countries. For some countries, the objective of the change or the focus of the review seems to entail moving the country's system for taxing such income closer to an "exemption system" or to further enhance the country's existing exemption system to boost the competitiveness of its businesses that operate in global markets.[2]

1.19 In light of these developments in other countries, the government's decision to review its current international tax system governing outbound investment is timely. However, it is noteworthy that countries seeking to move to an exemption system are looking at adopting certain features of the existing Canadian system. In examining potential modifications to the existing Canadian system, our preliminary view is that this system should be retained as the basic foundation for outbound investment. Accordingly, the Panel believes that any changes to Canada's existing system likely would not be as comprehensive as those being undertaken by other countries.

[2] See the Appendix, "Selected Reports on International Taxation," for references to studies in this regard undertaken by, for example, Australia, New Zealand, the United Kingdom and the U.S.

1. Introduction

1.20 We will review the current system and assess whether recommendations could be made to improve its efficiency, simplicity and competitiveness. In particular, we will review whether the existing taxation of foreign affiliate dividends could be improved by examining the scope of the exemption, the treatment of capital gains from the disposition of shares of foreign affiliates, and the allocation of costs to foreign-source income.

Inbound Taxation: Levelling the Playing Field for Canadian and Foreign Investment

1.21 Inbound investment is important for Canada in generating highly skilled jobs, research and development, technology and human capital. Canada stands to benefit by attracting such investment, and its tax policy should support this goal. In addition, the tax system should treat foreign and Canadian investors in domestic businesses similarly.

1.22 To this end, Canada's tax rules should aim to balance the desire for domestic and foreign businesses to obtain similar treatment while ensuring that Canadian-source income is properly measured and taxed. Therefore, our review of the Canadian tax rules affecting inbound investment, such as certain interest deductibility rules, will be guided by the desire to strike a balance among these aims.

Additional Areas for Review

1.23 Canada recently eliminated its withholding tax on all arm's-length interest and will phase out withholding tax on Canada–U.S. non-arm's-length interest. We will review whether this policy objective should be broadened.

1.24 Transfer pricing rules are critical in allocating revenues and income with respect to international transactions. We will consult with taxpayers and the CRA to identify potential areas to improve the administration of these rules.

1.25 A simpler, more user-friendly system that is easy to administer and comply with and that provides the appropriate information about Canada's tax system is desirable. We will consider how to improve these aspects of our international tax system.

1. Introduction

1.26 The Panel is interested in understanding whether the increased outbound and inbound investment by tax-exempt organizations raises any specific issues that need to be addressed in assessing Canada's international tax system.

1.27 Canada's system of international taxation comprises numerous complex rules and deals with a wide range of different transactions and taxpayers. Many issues and questions of interest may arise in the course of our consultation process that are not covered in this consultation paper, and there may be options in addition to those identified in this paper. The Panel welcomes input on all issues and options that are relevant to the taxation of international business.

Call for Submissions

1.28 The Panel is committed to an open and consultative approach to obtain input from a broad spectrum of interested stakeholders including small, medium-sized and large businesses.

1.29 The Panel invites written submissions from any and all interested parties, and submissions will be accepted until July 15, 2008. All written submissions will be given our full attention. Submissions will be posted on the Panel's website (**www.apcsit-gcrcfi.ca**) unless we are instructed otherwise. We kindly request that the submissions be written in English or French.

1.30 Chapter 6 provides details on the consultation process and how to make submissions to the Panel.

2. Taxation of Outbound Direct Investment

Active Business Income of Foreign Affiliates

2.1 Outbound taxation generally refers to the Canadian tax rules that deal with income earned from foreign investments by Canadian residents. These investments can be categorized as follows:

- *Foreign portfolio investments:* These are passive investments in shares, debt and similar instruments of foreign corporations and entities.
- *Foreign direct investment:* Direct investments constitute ownership or controlling stakes granting the investor significant influence over the management of the business activities of the foreign entity. The focus of this paper is on foreign direct investment.

2.2 Canada's tax system is designed to tax Canadian residents on their worldwide income. As a result, foreign-source income may be subject to tax twice: once in the foreign jurisdiction where the income is earned, and again in Canada. To alleviate possible double taxation, Canada's tax rules allow for a foreign tax credit to offset the Canadian tax otherwise payable on foreign-source income earned by Canadian taxpayers.

2.3 In the case of portfolio investments, the foreign tax credit provides some relief for foreign withholding taxes paid on the income. For example, a $100 dividend received by a Canadian taxpayer in respect of a portfolio investment in shares of a foreign corporation may be subject to 15 percent or $15 of foreign withholding tax. The $15 of tax is eligible for a foreign tax credit against the Canadian tax otherwise payable on the dividend received.

2.4 Continuing this example, the foreign corporation paying the dividend was probably subject to foreign income tax. If the $100 dividend was derived from earnings that were subject to a 30-percent corporate income tax rate, the pre-tax earnings needed to pay the $100 dividend would be approximately $143 [$143 – ($143 x 30%) = $100]. For income from portfolio investments, there is no Canadian income tax relief for the $43 of foreign tax.

2. Taxation of Outbound Direct Investment

2.5 Most international tax systems, including Canada's, tax dividends from foreign direct investments differently, by attempting to provide some relief for foreign tax that has already been paid on the earnings from which the dividend is paid (i.e., the $43 of foreign tax in the above example). This tax is generally referred to as "underlying foreign tax."

2.6 In broad terms, domestic tax relief for underlying foreign tax is provided in one of two ways: by credit or by exemption. While there are many variations and special rules governing how the credit or exemption is provided or computed, all systems are generally based on one or the other. Canada's system features elements of both, as described in more detail below.

2.7 Under a foreign tax credit system, if the underlying foreign tax paid is equivalent to or higher than the domestic tax that would otherwise be payable, no additional domestic tax would be paid when the dividend is received by a domestic shareholder. If the underlying foreign tax is less than what the domestic tax would otherwise be, then additional domestic tax would be payable. For example, if the foreign tax rate is 20 percent and the domestic tax rate is 30 percent, then an additional domestic tax of 10 percent would generally be payable on the dividend.

2.8 In an exemption system, the foreign dividend is simply exempt from domestic tax when it is received, thus eliminating the need for foreign tax credit calculations, which are sometimes quite complicated. For example, in Canada, the exemption system applies to certain dividends paid from "active business income." In some countries, other conditions such as a required holding period of the foreign corporation shares may also apply.

2.9 The choice between an exemption system and a foreign tax credit system involves considerations beyond the complexity of foreign tax credit calculations. Some of the economic theories that may influence the choice of one system over another are described in the accompanying box.

2. Taxation of Outbound Direct Investment

Economic Approaches to the Taxation of Foreign Direct Investment Income

Besides being fair and simple, a good tax system should be economically efficient: it should impose the least possible burden on the economy while generating its target revenue.

A tax imposed on foreign-source business income not only affects the competitiveness of multinationals but also may distort the investment and saving decisions of taxpayers and may affect the pattern of ownership of business assets among corporations. Economists have identified three possible objectives that countries might pursue to ensure neutrality in designing their systems for taxing income from outbound direct investment:

- "Capital Export Neutrality" (CEN): If CEN is the chosen objective, a tax system is designed to be neutral regarding resident investor preference for investment at home or abroad, so the more profitable investments (on a pre-tax basis) are made first.
- "Capital Import Neutrality" (CIN): If CIN holds, investors from different countries face the same level of tax when doing business in a given country, so there is neutrality with respect to the investment decisions made by residents of different countries.
- "Capital Ownership Neutrality" (CON): If CON is the objective, a tax system is designed to be neutral regarding which corporations own and exploit capital assets, so the corporations that exploit a given asset most efficiently are willing to pay the most to own that asset.

Different countries, however, tax foreign direct investment income at different rates, so fulfilling the three neutrality standards with a single set of tax rules is impossible. For example, taxing foreign business income on an accrual basis with a credit for foreign taxes paid on that income would conform with the CEN standard but not with CIN or CON. In contrast, providing an exemption for foreign business income could conform with CIN and CON but maybe not with CEN, as it could create a bias in favour of foreign investment.

Of course, countries will consider many other factors beyond neutrality in designing their tax systems, including competitiveness.

2. Taxation of Outbound Direct Investment

Alternatives for Taxing Active Business Income Earned Indirectly through Foreign Corporations

2.10 Broadly speaking, countries have four principal choices in how they tax active business income earned indirectly by resident taxpayers from foreign corporations:

- accrual or worldwide basis of taxation
- deferral with credit
- partial exemption and partial deferral with credit (the "Canadian System")
- full exemption.

2.11 Generally, passive income earned indirectly through controlled foreign corporations is taxed on an accrual basis. The meaning of "accrual" in this context is discussed in the following subsection. The Canadian taxation of such income, for example under the rules for foreign accrual property income (FAPI), is discussed in more detail below starting at paragraph 2.41.

Accrual or Worldwide Basis of Taxation

2.12 Under the Accrual or Worldwide Basis of Taxation, in its purest form, all domestic and foreign-source income earned directly and indirectly is taxable in the country of residence on an accrual basis (i.e., as it is earned), whether or not it is repatriated to the home country. A credit is provided for any underlying foreign tax paid in respect of such income.

2.13 As compelling as this alternative may appear, no member country of the OECD or the European Union (EU) employs this system in its purest sense for taxing foreign business income. The country that comes closest is New Zealand, although it maintains exceptions for foreign corporations located in countries included on a so-called "grey list." Moreover, New Zealand is engaged in a major international tax reform aimed at making its international tax system more competitive for its domestic companies investing abroad, and therefore will likely move closer to an exemption system.[3]

[3] See New Zealand Inland Revenue Department, Policy Advice Division, and New Zealand Treasury, *New Zealand's International Tax Review: Developing An Active Income Exemption for Controlled Foreign Companies*, October 2007, at paragraph 1.7 and discussion from pages 7 to 15, available at: **http://www.taxpolicy.ird.govt.nz/publications/files/internationaldd.pdf**

2. Taxation of Outbound Direct Investment

Deferral with Credit (the "Credit Method")

2.14 The Credit Method defers the taxation of foreign active business income until such income is repatriated to domestic shareholders, and allows for a tax credit for foreign income tax paid on the income. This alternative is employed by the U.S., the United Kingdom and Japan, among others.

2.15 The Credit Method appears to have certain merits. Notably, from an economic policy perspective, Canadian businesses would be more neutral in evaluating whether to invest domestically or outside Canada (see earlier box describing CEN). However, this method also has disadvantages: it is more complicated than the exemption system and would create a more onerous compliance burden for taxpayers and the CRA. The Credit Method also discourages repatriation of business profits, as domestic taxation is deferred so long as those profits remain outside Canada. The additional Canadian tax that would be collected on repatriated foreign profits may not be significant, and so capital export neutrality may not be achieved.[4]

The "Canadian System"

2.16 The Canadian foreign affiliate rules were introduced as part of the 1972 tax reform and have been in effect since 1976. Although changes have been made over the years, the rules' basic premise remains the same: active business income earned by a foreign affiliate of a Canadian resident will not be taxed in Canada until the profits are repatriated to Canada. Generally, a foreign affiliate is a foreign corporation in which a Canadian resident owns 10 percent or more of a class of shares, while a controlled foreign affiliate is a foreign affiliate that is controlled by a Canadian resident or a small group of Canadian residents. For these definitions, there are additional rules that include shares owned by related or non-arm's-length persons in determining whether a foreign corporation is a foreign affiliate or a controlled foreign affiliate.

[4] See United Kingdom, HM Treasury and HM Revenue and Customs, *Taxation of Companies' Foreign Profits: Discussion Document*, June 2007, at page 10, available at: **http://www.hm-treasury.gov.uk/media/E/9/consult_foreign_profits020707.pdf**

2. Taxation of Outbound Direct Investment

2.17 The key features of the Canadian System are as follows:

- Foreign active business income earned through a foreign affiliate is exempt from Canadian tax when such income is paid as a dividend to Canadian corporate shareholders if the affiliate is resident and the business is carried on in a country with which Canada has a tax treaty (a "Treaty Country"). Under recently enacted changes, the same treatment applies to active business income earned in a country with which Canada has a comprehensive Tax Information Exchange Agreement (TIEA).
- If an affiliate is not resident or if its business is not carried on in a Treaty Country or a country with which Canada has entered into a TIEA, the Credit Method applies to the income. If Canada offers to negotiate a TIEA with a country and if an agreement is not reached within five years, the active business income earned by a controlled foreign affiliate in that country is taxed in Canada on an accrual basis.

2.18 The exemption system applies to a significant amount of active business income earned by foreign affiliates because Canada has tax treaties with 86 countries. However, there are still countries with which Canada has not entered into either a tax treaty or a TIEA. These include, for example, certain developing countries where Canadian mining and resource companies have significant investments. The table below, provided to us by the Department of Finance, reports dividends received by Canadian taxpayers from their foreign affiliates for the years 2000 through 2005 (see also paragraph 2.23).

Dividends Received by Canadian Taxpayers from their Foreign Affiliates, by Surplus Account, 2000–2005 ($millions)

	2000	2001	2002	2003	2004	2005
Exempt	5 531	8 320	8 990	11 731	9 676	10 609
Taxable*	177	1 016	527	765	688	1 288
Other**	1 770	3 786	1 289	1 918	1 924	2 167
Total	**7 478**	**13 122**	**10 805**	**14 414**	**12 289**	**14 064**

* Canadian taxes paid on taxable dividends received from foreign affiliates, including those contained in the "Other" category, depend on the taxpaying position of the recipients and the extent to which they are eligible to claim relief in respect of taxes paid on the underlying active business income. Currently available data do not allow for a reliable estimate of Canadian taxes on taxable dividends received from foreign affiliates. Work is under way to refine these data further.

** Includes dividends received by firms that have indicated that the dividends were paid out of more than one type of account (i.e., exempt surplus, taxable surplus and pre-acquisition surplus), or have not indicated the type of surplus account that dividends were paid out of.

Source: Canada Revenue Agency, T1134 Information Return.

2. Taxation of Outbound Direct Investment

2.19 All foreign income earned by a foreign branch of a Canadian company, including foreign active business income, is generally subject to Canadian tax on an accrual basis, with credit for any foreign tax paid.

Full Exemption

2.20 Under a full exemption system, all foreign active business income is exempt from domestic taxation when paid as a dividend to domestic shareholders, including any income derived from the sale of assets or shares of foreign companies. In simple terms, under a full exemption system, there is generally no need to track foreign earnings and underlying foreign tax as there is under the current Canadian System: the income earned indirectly through foreign companies is either taxed domestically on an accrual basis when it is earned or it is never subject to domestic tax.

Evaluating the Canadian System

2.21 Refinements have been made to the Canadian System over the years. Given today's competitive global environment, it is appropriate to consider whether further refinements or substantive changes are needed. Issues to consider are its ongoing effectiveness in supporting the competitiveness of Canadian businesses operating abroad as well as safeguards against the erosion of the Canadian tax base. Achieving these objectives should not come at the expense of complex rules that create difficulties in compliance for taxpayers and administration for the CRA.

2.22 An added incentive for Canada to evaluate its current system at this time is the number of countries engaging in similar reviews for similar reasons. These countries are considering adoption of features that would either enhance their existing exemption system for active business income or move them to an exemption system and away from an accrual or credit system (for example, New Zealand and the United Kingdom).

2. Taxation of Outbound Direct Investment

2.23 As noted, the Canadian System has elements of both an exemption and a credit system. This requires Canadian corporate shareholders to track the "exempt surplus" and "taxable surplus" balances of each foreign affiliate to determine how dividends will be taxed when received (dividends from exempt surplus are exempt and dividends from taxable surplus qualify for the Credit Method). The Department of Finance has proposed rules that, among other things, aim to prevent taxpayers from creating exempt surplus in certain types of inter-affiliate transactions. These proposed rules will likely increase the complexity of these surplus computations.

Options for Consideration

2.24 In 1998, the Report of the Technical Committee on Business Taxation (commonly referred to as the "Mintz Report") concluded that "[o]n balance [. . .] the existing regime is fundamentally sound and should be maintained." In particular, the Mintz Report ruled out pursuit of the Credit Method for essentially the same reasons noted in paragraph 2.15. While the Panel recognizes there are possible advantages to the Credit Method, its initial view is that there is no compelling reason to believe that the conclusion reached by the Technical Committee does not still apply today. With a number of countries considering a move to an exemption system or an enhancement of their existing exemption systems, the Panel believes it is more appropriate to consider whether Canada should move to a broader or full exemption system.

2.25 Moving to a broader exemption system for all dividends from a foreign affiliate, and possibly exempting capital gains arising from the sale of shares of a foreign affiliate, would be consistent with recent international developments. It would also simplify compliance for both taxpayers and the CRA, for example, by reducing or eliminating the need to track exempt and taxable surplus accounts. However, a broader exemption system raises considerations that may require other consequential changes to the Canadian System.

2. Taxation of Outbound Direct Investment

Principal Considerations in Moving to a Broader Exemption System

2.26 Three major issues need to be examined in reviewing whether or not Canada should move to a broader exemption system:

- the conditions necessary to access the exemption regime (for example, what types of income should qualify)
- the treatment of capital gains from the sale of shares of foreign affiliates
- the deductibility of costs incurred in Canada that relate to earning the exempt income.

These issues and others are discussed below.

Exemption for Active Business Income

2.27 New legislation, effective for taxation years beginning after 2008, will extend the scope of foreign business earnings that can qualify for exempt treatment on repatriation to Canada to active business income earned by a foreign affiliate in a country that has entered into a TIEA with Canada. Previously, only active business income earned in a treaty country qualified for such exemption. Arguably, this is one of the more significant changes to the current Canadian System since its inception, because the exemption is no longer tied to income earned in a Treaty Country.

2.28 At the time the scope of the exemption was broadened, the scope for FAPI was also broadened because active business income earned in a country that is offered the opportunity to enter into TIEA negotiations with Canada but does not conclude a TIEA within five years will be considered FAPI. In these circumstances, active business income earned by a controlled foreign affiliate in such a country will be taxed immediately in Canada, with credit for foreign taxes paid in respect of that income.

2. Taxation of Outbound Direct Investment

2.29 In a broader exemption system, a link between a tax treaty or a TIEA and the exemption of the foreign business income may not be necessary. Some countries provide an exemption on the basis that the earnings are from active business income. Qualification for exemption is also often linked to criteria such as a minimum rate of tax or a minimum holding period.

Qualification as a Foreign Affiliate

2.30 Under Canada's current rules, an investment in a foreign corporation is treated as foreign direct investment if the foreign corporation qualifies as a foreign affiliate. The benefit of foreign affiliate treatment is the availability of an exemption or relief for the underlying foreign tax paid by the foreign affiliate.

2.31 Under the current rules, a foreign corporation qualifies as a foreign affiliate if the Canadian investor has a 10-percent direct or indirect interest in any class of shares of the foreign corporation. In other countries, the threshold ownership level often requires the holding of shares in the foreign corporation that represent a certain percentage of the outstanding shares in terms of value and/or votes.

2.32 If Canada moves to a broader exemption system for dividends received from foreign affiliates, the threshold for qualification as a foreign affiliate may have to be reviewed.

Capital Gains on the Sale of Shares of a Foreign Affiliate

2.33 Many countries exempt not only the dividends received from a foreign affiliate but also the capital gains realized on a disposition of the shares of a foreign affiliate. Exempting capital gains from the sale of shares of a foreign affiliate may be viewed as appropriate if the income that would be generated by the affiliate would also be exempt from Canadian tax. The policy rationale for exempting gains on the disposition of shares of a foreign affiliate while continuing to tax capital gains arising on the sale of shares of a Canadian company would need to be considered.

2. Taxation of Outbound Direct Investment

2.34 In the current system, the need to maintain exempt and taxable surplus accounts to track a foreign affiliate's earnings is important. These accounts indicate the portion of the capital gain that is attributable to previously taxed retained earnings and also the portion of the gain that is taxable and the portion that is not (see accompanying box). If capital gains from the disposition of foreign affiliate shares were no longer taxable, accounts for tracking the foreign affiliate's earnings may no longer be needed.

Capital Gains on the Sale of Shares of a Foreign Affiliate

Under Canada's foreign affiliate rules, where a Canadian resident corporation sells shares of its foreign affiliate, the Canadian corporation may make an election that deems an "elected amount" to be a dividend, rather than proceeds of disposition. As a result, the gain on the shares otherwise determined is reduced by the elected amount. In general terms, this deemed dividend is tax-free in Canada to the extent the affiliate has either exempt surplus or taxable surplus that has been taxed in the foreign jurisdiction at a rate at least as high as the current Canadian tax rate.

For example, assume a Canadian corporation sells shares of a foreign affiliate for $10 million and the cost base of those shares is $6 million. Also assume the foreign affiliate has exempt surplus of $1.5 million. By electing to have $1.5 million of the sale proceeds treated as an exempt dividend, the gain, which would otherwise be $4 million, is reduced by $1.5 million to $2.5 million.

2.35 If Canada chooses to adopt a broader exemption system under which dividends from a foreign affiliate are exempt but capital gains on the disposition of foreign affiliate shares are not, it would be necessary to retain some form of tracking the earnings of a foreign affiliate. In a tax system where dividends are exempt and capital gains are taxable, a taxpayer will generally seek to reduce the taxable capital gain by stripping the value of the company being sold through the payment of exempt dividends by the target company.

2. Taxation of Outbound Direct Investment

2.36 There is a rationale for Canada to have robust FAPI rules to deal with passive income and for Canada to continue to tax the capital gain arising on the sale of shares of a foreign affiliate where a significant part of the value of the shares is derived from passive activity. Under the current rules and in the context of shares of a foreign affiliate held by another foreign affiliate, the concept of "excluded property" determines what is and what is not taxable as FAPI (see accompanying box). Analysis would be required to determine what modifications, if any, would need to be made to this test if Canada adopts a system that exempts all capital gains from the sale of shares of a foreign affiliate.

Excluded Property

A foreign affiliate's "excluded property" is its property used to earn active business income or shares of another foreign affiliate where all or substantially all of the fair market value of the property of the other foreign affiliate is attributable to excluded property. The definition is relevant, for example, where a foreign affiliate realizes a capital gain on the sale of shares of another foreign affiliate. Generally, any capital gain arising on the sale of foreign affiliate shares that are excluded property is not FAPI. If the shares are not excluded property, 50 percent of the gain is FAPI.

Allocable Costs

2.37 The proper measurement of foreign-source income is an important aspect of an exemption system. Certain countries that employ an exemption system have special rules to deal with domestic costs attributable to foreign income that is exempt from domestic taxation. Some of these countries deny the deduction of such costs while others do not fully exempt the income (for example, only 95 percent of the income is exempt) to reflect the costs incurred to earn the income.

2.38 Some countries continue to allow a full deduction of the interest expense incurred to acquire shares that would produce exempt dividends or that are exempt from capital gains tax upon their disposition.

2. Taxation of Outbound Direct Investment

Other Returns from Foreign Affiliates

2.39 Dividends are one way in which shareholders receive returns from their investments in foreign corporations. Shareholders may also make loans to the corporation and receive a return in the form of interest. Shareholders may also rent or license property (tangible or intangible) they own to the foreign corporation, and these rents or royalties also represent a form of return from the investment. Interest, rents and royalties are fully taxable to Canadian recipients and are generally deductible by foreign payers.

2.40 Equity and debt instruments held by shareholders in respect of their non-portfolio investments are often substitutable. Therefore, absent tax considerations, shareholders of wholly owned subsidiaries could be indifferent to whether they receive their returns in the form of dividends, interest, royalties or any combination of such income.

Questions on Active Business Income of Foreign Affiliates

A. Should Canada's foreign affiliate regime for active business income be retained in its current form, or should changes be introduced to make it a broader exemption system?

B. What are the conditions that taxpayers should meet in order to access a broader exemption system?

C. If the exemption for active business income earned by an affiliate is expanded, is the new TIEA exemption the most appropriate way of achieving this goal? Should the accrual basis of taxation or some credit system apply to active business income earned by a controlled foreign affiliate in a non-Treaty Country that has failed to negotiate a TIEA with Canada?

D. Should Canada exempt the capital gain on the disposition of shares of foreign affiliates? If so, under what conditions?

2. Taxation of Outbound Direct Investment

E. ***If Canada adopts a broader exemption system, are additional rules needed to deal with expenses allocable to exempt foreign income?***

F. ***Should Canada treat other returns (such as interest and royalties) from a foreign affiliate in the same manner as dividends?***

G. ***Should Canada consider providing an exemption for active business income earned through a foreign branch to the same extent as it does for dividends paid from active business income earned through a foreign affiliate?***

H. ***Does the increased significance of tax-exempt entities as outbound investors raise any particular issues regarding Canada's foreign affiliate regime?***

I. ***How can the foreign affiliate rules be amended to reduce the compliance and administrative burden for taxpayers and the CRA while maintaining the tax policy objectives of these rules?***

J. ***Are there other issues or options related to the taxation of active business income earned indirectly through foreign corporations that should be reviewed and considered?***

Foreign Accrual Property Income

Current Rules

2.41 Regarding passive income, Canada's tax rules are similar to those of many other countries. Canada's tax rules require a Canadian resident shareholder to include in income on an accrual basis amounts related to certain types of income earned by its controlled foreign affiliates, with relief provided for any foreign tax paid on the income. These rules, referred to as the foreign accrual property income (FAPI) rules, have been a fixture of the Canadian tax system since the early 1970s.

2. Taxation of Outbound Direct Investment

2.42 FAPI includes passive income such as interest, dividends (except dividends from other foreign affiliates), royalties, 50 percent of capital gains realized from the sale of property that is not excluded property, and, as a result of the so-called "Base Erosion Rules," certain other specific types of income earned by a foreign affiliate. In addition, certain passive income that would otherwise be FAPI is considered active business income where the business generating the income is conducted principally with arm's-length persons and employs more than five full-time employees. A special exception to the FAPI rules applies to certain payments between related foreign affiliates (see accompanying box).

FAPI Exception for Inter-affiliate Payments

Special exceptions to the FAPI rules may apply in the case of interest, royalties and certain other payments. For example, interest income of a foreign affiliate (FA1) resulting from payments from another foreign affiliate (FA2) generally is not considered FAPI if, among other conditions, FA2 deducted the interest in computing its active business income. This exception is generally referred to as the "inter-affiliate payment exception."

2.43 The FAPI rules are designed to ensure that the Canadian tax base is not eroded by Canadian residents transferring passive investments and certain business activities to foreign affiliates to avoid or defer Canadian tax. Accordingly, there appears to be little debate that taxing FAPI on an accrual basis is appropriate. Because passive income is highly mobile, in the absence of such rules, Canadian businesses could easily convert domestic passive income into foreign income that is unrelated to its foreign business operations, and so escape domestic tax. However, a key issue is the determination of what constitutes passive versus business income, and how each type of income should be computed.

2. Taxation of Outbound Direct Investment

2.44 As an example of how the FAPI rules work, assume a Canadian corporation has excess funds, which it invests in marketable securities. The return on those funds will attract Canadian income tax. Funds invested in marketable securities are a highly mobile form of capital. Therefore, it is relatively simple for the Canadian corporation to set up a subsidiary in a country with a very low tax rate, contribute the funds to that subsidiary and have that subsidiary invest the funds in the marketable securities. Absent the FAPI rules, the income from the marketable securities would be subject to little tax until the time (if ever) it is paid as a dividend to the Canadian corporation. If such income is not treated as FAPI, the deferral and possible permanent avoidance of Canadian tax in this way could erode the Canadian tax base and represent a loss of tax revenue to the government.

2.45 Currently under the FAPI rules, passive income earned by a foreign affiliate that is not a controlled foreign affiliate is not taxed on an accrual basis in Canada (because the affiliate is not "controlled" by the Canadian group). Such income is still considered FAPI and is subject to the Credit Method on repatriation. This treatment reflects the view that, if the foreign affiliate is not controlled by the Canadian shareholder, the foreign affiliate's income should not be included in the Canadian shareholder's income until the income is repatriated as a dividend.

2.46 In addition to the FAPI rules, Canada also has existing and proposed "Foreign Investment Entity" (FIE) rules, which attribute passive income in much the same way as the FAPI rules and are intended to apply to certain circumstances that are outside the scope of the FAPI rules. For example, the FAPI rules only attribute passive income to Canadian shareholders on an accrual basis if the affiliate is a controlled foreign affiliate. One intent of the FIE rules is to tax, in certain circumstances, passive income that would not otherwise be taxed on an accrual basis under the FAPI regime because the foreign corporation is not a controlled foreign affiliate.

2. Taxation of Outbound Direct Investment

2.47 The above explanation of the FIE rules provides only a very brief description of the reach and complexity of these rules. A complete description of their operation is beyond the scope of this paper. The proposed FIE rules were released in 1999 and have since been revised many times.[5] Some argue that these rules are too complex; others argue that they are needed to ensure that the FAPI rules cannot be circumvented by indirectly earning passive income using other structures.

FAPI Issues for Consideration

2.48 As noted above, FAPI earned by a non-controlled foreign affiliate falls under the Credit Method. Under a broader exemption system, the issue that arises is whether such FAPI income should continue to be taxable upon repatriation under this method. If so, there would be a need to maintain the accounts to track these earnings and the related underlying foreign tax. Alternatively, FAPI income earned by a non-controlled foreign affiliate could be exempt on the basis that the FIE regime would capture any passive income that should be taxed on an accrual basis.

Base Erosion Rules

2.49 The Base Erosion Rules target certain arrangements whereby a foreign affiliate of a Canadian resident taxpayer derives income that is considered to be connected to a business carried on in Canada or to Canadian resident persons. The targeted arrangements have the effect of reducing the Canadian tax base. One example of how these rules operate is illustrated in the accompanying box.

[5] Proposed new rules on non-resident trusts (NRT) have also been released. Like the proposed FIE rules, the proposed NRT rules are complex and have been revised many times. They are generally understood to impact individual tax matters, but given their reach, they could have broader application.

2. Taxation of Outbound Direct Investment

Base Erosion Rules

The following example illustrates how the Base Erosion Rules generally operate. Assume a Canadian company ("Canco") chooses to source a product from an arm's-length company located in Country A ("ManufactureCo"). The cost of the product to Canco is $60 and the Canadian company expects to sell the product for $100 to Canadian customers. Assume the transportation costs are $5 and other costs (such as administrative and financial costs) are $15, so the additional costs are $20 and the total profit is also $20 [i.e., $100 – ($60 + $15 + $5)].

Canco could reorganize its structure to create a wholly owned subsidiary in a low-tax foreign jurisdiction ("Subco") and have Subco purchase the product from ManufactureCo. Subco could assume the risks of transporting the product from Country A to Canada and perform other functions such as acting as the central purchasing agent for the entire corporate group. The income flows would now be different: Subco would purchase the product from ManufactureCo for $60 and sell it to Canco for, say $70, so that it could earn a profit. Canco would incur additional costs of $15 (as the transportation costs are borne by Subco) such that its profit would be $15 [i.e., $100 – ($70 product cost + $15 administrative cost)].

The net result is that Subco now earns $5 and the Canadian company's profit on the transaction is decreased by $5 to $15 — the overall profit for the entire group remains $20. While the full $20 was subject to Canadian tax before the introduction of Subco, absent the Base Erosion Rules, now only $15 is taxed in Canada and the other $5 is taxed in the low-tax jurisdiction.

The Base Erosion Rules seek to tax this $5 profit earned by Subco as FAPI. Similar rules seek to tax the profit related to income from services and certain financial transactions that have the same effect. The rules provide for numerous exceptions. For example, if Subco earns more than 90 percent of its gross revenue from this business from arm's-length parties, then its profit ($5 in our example) is not considered FAPI. This exception reflects the view that, if the subsidiary is doing business with third parties, then it may not have been set up principally to shift profit from Canada.

2. Taxation of Outbound Direct Investment

2.50 The Base Erosion Rules include arrangements or activities whereby the affiliate derives income from the sale of property (where the property's cost is relevant in computing the income of a Canadian resident taxpayer) and from certain services and financial transactions.

2.51 One exception to these rules applies where the subsidiary manufactures or sources its product in the same location in which the subsidiary is incorporated. Under this exception, a U.S. subsidiary of a Canadian parent can sell product it produces or sources in the U.S. to its Canadian parent without having the income on that sale considered FAPI. However, it is common for foreign businesses to manufacture and source product in more than one jurisdiction. It seems timely to review the Base Erosion Rules to investigate whether they deal appropriately with such transactions.

2.52 In some cases, it can be argued that the transfer pricing rules should adequately protect the Canadian tax base against this form of erosion. In other cases, however, the effectiveness of such rules is uncertain.

Questions on Foreign Accrual Property Income

A. ***If Canada adopts a broader exemption system, should the scope of the FAPI rules be changed? For example, should Canada consider changes to the Base Erosion Rules?***

B. ***How should the excluded property test be extended to operate appropriately in a broader exemption system?***

C. ***How should passive income earned by non-controlled foreign entities be treated?***

D. ***Should the Base Erosion Rules be reconsidered to accommodate companies that manufacture and source their product from several different jurisdictions?***

E. ***Are there other types of transactions to which the Base Erosion Rules should apply?***

F. ***Is there a way to simplify the FAPI rules while maintaining their tax policy objectives?***

G. ***Are there other issues or options related to the taxation of passive income of foreign corporations that should be reviewed and considered?***

3. Taxation of Inbound Direct Investment

3.1 Direct investment in Canada by foreign businesses is important to Canada's economic well-being. Inbound foreign direct investment generates economic activity and employment in Canada. It contributes to the growth and productivity of the Canadian economy by fostering competition and facilitating the transfer of new technology into Canada.

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

3.3 The government recently implemented several changes to make Canada a more attractive place to conduct business. Significant corporate tax rate reductions have been legislated that will bring the federal rate to 15 percent in 2012 from 20.5 percent in 2008. The government eliminated the withholding tax on interest paid to unrelated foreign lenders effective January 1, 2008. The withholding tax on interest to U.S. related lenders will be eliminated over a three-year period under the revised Canada–U.S. tax treaty.

3.4 One guiding principle regarding inbound tax policy is to ensure the proper measurement and taxation of business income generated from Canadian sources. A policy of keeping Canada's corporate tax rate low complements this approach by helping attract investment, reducing the incentive to shift income out of Canada, and easing pressure on the rules designed to properly measure Canadian-source business income.

3.5 The following sections consider two important aspects of the taxation of inbound direct investment in Canada. The first section considers the tax treatment of interest expense incurred by Canadian corporations with debts owing to certain non-resident persons and discusses whether the current treatment is appropriate vis-à-vis the two objectives stated above. The next section examines the accessibility of foreign investors to Canada's tax treaty network. Canada's withholding tax regime is addressed in Chapter 4. While withholding taxes affect both inbound and outbound investment, changes to further reduce or eliminate them may put additional pressure on some inbound rules such as thin capitalization.

3. Taxation of Inbound Direct Investment

Tax Treatment of Interest Expense Incurred by Foreign-owned Canadian Corporations

Current Rules

3.6 Interest costs incurred in Canada by Canadian subsidiaries of foreign businesses are generally tax deductible under the same rules that apply to other Canadian corporations.

3.7 Canada's so-called "thin capitalization" rules, which apply to Canadian corporations that have incurred debts to certain non-resident persons (foreign shareholders with a significant interest and non-resident persons that do not deal at arm's length with significant shareholders), are a notable exception to this general tax treatment.[6] Under these rules, interest paid by a Canadian corporation on loans received from those non-resident persons is not deductible to the extent that such loans exceed twice the equity (which is subject to special computational rules) of those Canadian corporations. In 2000, Canada reduced the maximum debt-to-equity ratio allowable under the thin capitalization rules from 3:1 to 2:1.

3.8 These rules generally do not apply to loans received from third-party lenders, whether Canadian or foreign. Interest expense denied under these rules cannot be carried forward for use in future years.

Issues under the Current Rules

3.9 The deductibility of *bona fide* business costs incurred by Canadian subsidiaries of foreign companies, including interest, is appropriate from a tax policy perspective. Canada's corporate income tax for the most part is a tax on net income, and the deductibility of business costs offers relief for expenses incurred to earn income. While the deductibility of interest expense reduces the government's revenue from corporate income taxes, it also lowers the cost of capital for foreign businesses that wish to invest in Canada. The fiscal cost to the government of granting interest deductibility must be balanced against the economic benefits that inbound direct investment brings to the Canadian economy.

6 While the scope of these rules is broad and can apply in situations where a Canadian corporation does not have a foreign shareholder, this paper focuses on situations where a significant foreign shareholder is present. For the purposes of this paper, those Canadian corporations are referred to as "foreign-owned Canadian corporations."

3. Taxation of Inbound Direct Investment

3.10 In some cases, the unrestricted deductibility of interest expense incurred by foreign-owned Canadian corporations may not be appropriate. It is reasonable to review whether Canada's thin capitalization rules are effective in dealing with these situations.

3.11 The thin capitalization rules were adopted because foreign businesses are typically able to choose between debt and equity in financing their Canadian subsidiaries, allowing them to optimize their capital structure from a tax perspective. The current maximum debt-to-equity ratio is 2:1 and, as noted, includes only debt from certain non-resident persons. An issue that arises is whether this ratio is a good approximation of the amount of related-party debt a foreign-owned Canadian corporation should be allowed to incur in Canada. In the absence of a principle defining an appropriate level of related-party debt, there may be no clear way to resolve this issue.

3.12 The current rules do not apply to borrowings of foreign-owned Canadian corporations from third-party Canadian or foreign lenders. A foreign business may have an incentive for its Canadian subsidiaries to borrow if the tax deduction claimed in Canada by the subsidiary is worth more than the same deduction claimed in the foreign parent's home country. This incentive will diminish as Canada's corporate tax rate drops.

3.13 Whether or not Canada's thin capitalization rules apply depends on how leveraged a foreign-owned Canadian corporation is, and not on how the amounts borrowed are used. Accordingly, the Canadian subsidiary of a foreign business could incur debt in Canada — within the limit of the thin capitalization rules if they apply — and use the borrowed funds to invest outside Canada. Using Canada as a platform to finance investment made outside Canada is tax-effective if the debt in Canada allows the foreign business to lower its overall tax burden and/or if Canada's taxation of the income derived from the investment in the third country is more generous than the tax regime that applies if the foreign business invests in the third country directly.

Options for Consideration

3.14 If Canada's thin capitalization rules need further revisions, different approaches are available. The maximum allowable debt-to-equity ratio could be adjusted or extended to cover third-party borrowings guaranteed by a related foreign corporation. On the other hand, one view is that thin capitalization rules should apply only where shareholders

3. Taxation of Inbound Direct Investment

are indifferent to whether they finance their subsidiaries with debt or equity, since it is in those circumstances that shareholders can use excess debt to achieve a particular tax result. This view suggests that the appropriate ratio and the scope of shareholders or non-arm's-length creditors subject to the rules should be reviewed, but that the thin capitalization regime should not be extended to third-party borrowings. Other technical changes could also be made, notably extending the application of the thin capitalization rules to non-corporate entities such as trusts and partnerships.

3.15 A different approach, which is in place in the United Kingdom and many other European countries, is based on the so-called "arm's length principle" that has been developed in a transfer pricing context. Under this approach, interest paid by a corporation to a related-party lender is deductible if a comparable corporation could have borrowed the same amount from an unrelated lender. Conceptually, a benefit of this approach is that the maximum debt a corporation can borrow is determined relative to that corporation's particular situation, avoiding the arbitrariness of limits set by reference to some industry or economy-wide averages. However, this approach can be burden-some to apply in practice and may create uncertainty for taxpayers over how much interest expense can be deducted.

3.16 Some countries have adopted broad thin capitalization rules that apply to all companies, rather than only to domestic companies under foreign control. Adopting such an approach involves resolving a number of difficult issues, including the complex task of determining the appropriate debt-to-equity ratio (keeping in mind differences among various sectors of the economy) and appropriate components of the calculation.

3.17 Another possibility is to adopt a so-called "earnings stripping" rule. Such an approach limits the amount of interest deductions that a foreign-owned corporation can claim by reference to that corporation's ability to borrow (generally determined by reference to the corporation's earnings before tax, interest, depreciation and amortization). The U.S., Germany, Italy and France have adopted this approach (in addition to thin capitalization rules in some of these countries). Examples of the application of the thin capitalization and earnings stripping approaches are shown in the accompanying box.

3. Taxation of Inbound Direct Investment

Restricting Interest Deductibility: Thin Capitalization Versus Earnings Stripping Rules

Two alternative approaches can be used to limit the amount of deductible interest expense incurred by the Canadian subsidiary ("CanSub") of a foreign business ("ForCo").

Basic facts

- ForCo invests $10 million in CanSub. CanSub uses those funds in its Canadian operations and has earnings of $1 million.
- Under Scenario A, the investment takes the form of a $4 million loan from ForCo to CanSub and a $6 million equity investment from Forco in CanSub. Interest is payable on the loan at 10 percent.
- Under Scenario B, the investment takes the form of a $7 million loan from ForCo to CanSub and a $3 million equity investment from Forco in CanSub. Interest is payable on the loan at 10 percent.

Thin Capitalization Rules

Countries with thin capitalization rules disallow the deductibility of interest paid on debt that exceeds some fixed ratio. For example, in Canada, interest paid to a related foreign shareholder on debt that is more than twice the amount of equity contributed by this shareholder is not deductible. Under these rules, the interest paid by CanSub to ForCo under Scenario A in respect of the $4 million loan is fully deductible in Canada, as the loan is smaller than twice the equity invested by ForCo ($4 million < 2 x $6 million = $12 million). Under Scenario B, the loan from ForCo to CanSub exceeds the maximum allowed under the thin capitalization rules by $1 million ($7 million > 2 x $3 million = $6 million), such that one-seventh of the interest paid by CanSub to ForCo (1/7 x $7 million x 10% = $100 000) is not deductible.

Earnings Stripping Rules

Countries with earnings stripping rules disallow the deductibility of interest paid on debt where the interest paid exceeds some fraction of the borrower's earnings (generally, earnings before tax, interest, depreciation and amortization). For example, assuming Canada would limit the amount of interest deductible to 50 percent of CanSub's earnings, CanSub is not subject to the limitation under Scenario A, as its interest expense ($4 million x 10% = $400 000) is less than half of its earnings ($1 million x 50% = $500 000). Under Scenario B, its interest expense ($7 million x 10% = $700 000) exceeds the limitation by $200 000, and this amount is therefore not deductible.

3. Taxation of Inbound Direct Investment

Questions on Tax Treatment of Interest Expense Incurred by Foreign-owned Canadian Corporations

A. Does the use of debt by foreign-owned Canadian corporations raise any concern from a tax policy perspective?

B. Should any of the specific transactions and tax planning structures used by foreign businesses to finance their Canadian subsidiaries be considered inappropriate from a tax policy perspective?

C. Should Canada's current thin capitalization rules be modified? Should Canada pursue another approach?

Inbound Treaty Shopping

Current Rules

3.18 A tax treaty is an agreement entered into between two or more countries, the purpose of which is to avoid international double taxation and to prevent fiscal evasion with respect to taxes imposed on income and capital. Tax treaties are essentially relieving in nature, that is, they do not impose new or additional taxes, but provide relief from taxes otherwise applicable under the domestic tax law of the treaty partners. As such, tax treaties can provide important tax benefits to investors, such as lower withholding taxes on cross-border payments, reduced taxation of capital gains in the countries where these gains arise, and double tax relief in their home countries for taxes imposed abroad.

3. Taxation of Inbound Direct Investment

3.19 The term "treaty shopping" refers to the situation where a person, who is resident in a given country (the home country) and who derives income or capital gains from another country (the source country), is able to gain access to a tax treaty in place between the source country and a third country that offers a more generous tax treatment than the tax treatment otherwise applicable. This situation could arise if the person is resident in a country that does not have a tax treaty with the source country, or if the tax treaty between the source country and the person's home country offers less generous tax treatment than the tax treaty between the source country and the third country.[7]

3.20 Canada generally provides access to reduced withholding tax rates under its tax treaties to the "beneficial owners" of the payments subject to withholding tax. Until very recently, Canada's position has been that it is preferable to rely on general anti-avoidance rules to counter treaty-shopping transactions than to include detailed anti-treaty-shopping provisions in its tax treaties, as the U.S. does. Canada recently agreed to include such a detailed provision in the revised Canada–U.S. tax treaty that was signed on September 21, 2007.[8] It is unclear whether such a provision will be included in future tax treaties negotiated by Canada.

Issues under the Current Rules

3.21 Tax treaties signed by Canada differ in many respects. This may create opportunities for arbitrage through treaty shopping, especially as Canada has signed treaties with a number of countries that have extended treaty networks of their own and that are either low-tax jurisdictions or have preferential tax regimes.

---

[7] The most common way for a person resident in a given country to access the benefits under a tax treaty between a source country and a third country is to set up a corporation in the third country through which the income or capital gains will be channelled. For example, an investor may lend money to a foreign borrower by setting up a corporation in a third country through which the funds will be channelled. Such a triangular structure is tax-efficient, provided that the tax treaty between the source country and the third country allows for a lower withholding tax rate than the rate that would apply if the interest were paid directly from the borrower to the lender, and provided that the interest income is not subject to any significant taxation in the third country.

[8] Such a provision has been part of the existing Canada–U.S. tax treaty since 1995, but it currently applies for U.S. tax purposes only.

3. Taxation of Inbound Direct Investment

3.22 Differences among Canada's treaty withholding tax rates may be due to the long period of time required before a given treaty policy change can be implemented. Certain differences seem to reflect deliberate tax policy choices. For example, Canada has negotiated specific exemptions from withholding tax, usually with a few important treaty partners. In particular, once the revised Canada–U.S. tax treaty is ratified, the U.S. will be the only country with which Canada has agreed to eliminate withholding tax on interest paid to related-party lenders (see Chapter 4). Canada has also agreed with a number of countries to eliminate withholding tax on software, patent and know-how royalties.

Options for Consideration

3.23 As noted above, certain treaty benefits are afforded to "beneficial owners" who are resident in a treaty country. The CRA has challenged some structures on the basis that the person resident in the treaty country who is receiving the payment is not the beneficial owner, and so the treaty benefits should be denied. One option is to define the term "beneficial owner" in Canada's domestic tax law, specifying the criteria that a person must meet to be considered the beneficial owner of a stream of income. This approach could add some clarity and certainty for taxpayers and the CRA alike. Another option is for Canada to update each of its tax treaties to include a specific, detailed anti-treaty-shopping rule, similar to the rules in most U.S. tax treaties. Alternatively, such an anti-treaty-shopping rule could be adopted in Canada's domestic tax law, although this may raise issues regarding the possible override of existing tax treaties.

3.24 In assessing these options, it is important to consider how to ensure a proper balance between the existing risk (if any) to the Canadian income tax base, the additional compliance burden that could be imposed on foreign investors and Canadians under some of these options, and the need for Canada to remain attractive to foreign investment. To the extent that some of these options would apply on a reciprocal basis, it is also important to consider the possible implications for Canadian companies with outbound direct investments.

3. Taxation of Inbound Direct Investment

Questions on Inbound Treaty Shopping

A. Is Canada's income tax base at risk because of treaty-shopping transactions?

B. Which treaty provisions are more likely to encourage treaty-shopping behaviours?

C. Should Canada consider additional rules in its tax treaties or its domestic tax law to discourage treaty-shopping transactions?

Questions on Other Inbound Matters

A. Does investment into Canada by sovereign wealth funds and other tax-exempt foreign entities raise any issues?

B. Are there other issues or options related to inbound investment that should be reviewed and considered?

4. Withholding Taxes

Current Rules

4.1 Foreign investors and other non-residents must pay a 25-percent Canadian tax on interest, dividends, royalties, rents and certain other payments derived from Canada. This tax is commonly referred to as a "withholding tax," as it must be withheld by Canadian residents making payments to foreign parties.

4.2 Tax treaties entered into by Canada generally provide for lower withholding tax rates. Most tax treaties concluded by Canada reduce the rate to 10 percent for interest and royalties and 5 percent for dividends paid by a Canadian subsidiary to a foreign shareholder who holds a substantial interest in the Canadian subsidiary. Dividends derived from portfolio investments are generally taxed at a reduced rate of 15 percent.

4.3 Canada's domestic law provides exemptions from withholding tax for specific types of payments and for payments to or from certain persons. For example, there is no Canadian withholding tax on interest paid with respect to a debt obligation that is guaranteed by the Government of Canada and on certain royalties paid for the use of copyrighted artistic works. Exemptions can also be available under certain tax treaties, notably for royalties paid in respect of computer software, patents and know-how.

4.4 A new exemption for interest paid to unrelated foreign lenders (arm's-length interest) took effect on January 1, 2008. As a result, a Canadian corporation can now borrow from an unrelated foreign person or financial institution and that foreign lender will no longer be subject to Canadian withholding tax.

4.5 Withholding tax on interest paid to related U.S. lenders (non-arm's-length interest) will be phased out over a three-year period under the revised Canada–U.S. tax treaty. Thus, where a Canadian subsidiary pays interest on money borrowed from its U.S. parent corporation, no Canadian withholding tax will apply. This new exemption will apply to Canada–U.S. cross-border interest payments only, and interest paid to non-U.S. non-arm's-length foreign lenders will remain subject to withholding tax.

4. Withholding Taxes

Issues under the Current Rules

4.6 The imposition of a withholding tax can be justified on various grounds. Along with corporate income taxes, countries impose withholding taxes as a way of taxing the income that has its source within their borders. Withholding taxes can also play a role in reducing or mitigating the erosion of the corporate income tax base due to the deductibility of business costs such as interest, rents and royalties. Finally, withholding taxes on dividends paid to foreign portfolio shareholders can be viewed as proxies for personal income taxes that would be payable if these shareholders were residents in Canada.

4.7 Like other taxes, withholding taxes can be expected to adversely affect economic activity. This negative effect arises in part because withholding taxes are imposed on a gross basis and not on net income. Their impact is diminished, however, to the extent that foreign investors can credit those taxes against their home-country tax liabilities (leaving their overall tax rate unchanged) or can mitigate their withholding tax burden by substituting alternative transactions that are not subject to withholding taxes (such as financing a subsidiary with debt rather than equity to avoid the withholding tax on dividends).

4.8 Canadian companies with foreign investments may also be liable to pay foreign withholding taxes on the income derived from these investments. A further benefit of making agreements with other countries to reduce or eliminate withholding taxes may be the reduction of the tax burden of Canadian-based corporate groups, thereby increasing Canada's national return on capital invested abroad by Canadian companies. Canadian companies are most likely to benefit if foreign withholding taxes on dividends are reduced or eliminated, as foreign withholding tax paid on dividends received by Canadian corporations from their foreign affiliates are usually not creditable in Canada.

4.9 From a cost-benefit perspective, in determining whether further reducing Canada's withholding tax is an effective way of reducing taxes in Canada, these potential economic benefits must be weighed against the revenue loss that the government would incur. This loss would amount to the loss of revenues from the Canadian withholding tax reduction minus additional income tax revenues arising as Canadian companies claim less foreign tax credits in respect of foreign withholding taxes paid on their income from foreign investment. Additional tax revenues could also be collected

4. Withholding Taxes

to the extent that reducing or eliminating withholding taxes would generate positive economic spillovers for Canada. The table below, provided to us by the Department of Finance, reports withholding taxes collected by the federal government for the years 2000 through 2005, by type of payment subject to withholding tax.

Withholding Taxes Collected on Payments to Non-residents, 2000–2005 ($millions)

	Direct Dividends	Other Dividends	Interest	Rents and Royalties	Other*	Total
2000						
U.S.	462	244	242	310	142	1 399
Other	251	204	250	252	153	1 110
Total	**713**	**448**	**492**	**562**	**295**	**2 510**
2001						
U.S.	507	242	303	344	163	1 559
Other	232	225	314	272	161	1 203
Total	**739**	**467**	**617**	**615**	**324**	**2 762**
2002						
U.S.	552	289	284	368	246	1 738
Other	238	179	231	308	145	1 101
Total	**790**	**468**	**514**	**676**	**390**	**2 838**
2003						
U.S.	422	303	296	367	244	1 633
Other	268	198	253	363	167	1 249
Total	**690**	**501**	**549**	**730**	**411**	**2 881**
2004						
U.S.	469	455	341	384	214	1 863
Other	309	222	335	349	164	1 379
Total	**778**	**678**	**676**	**733**	**378**	**3 242**
2005						
U.S.	998	431	381	404	533	2 747
Other	364	309	336	326	202	1 537
Total	**1 362**	**739**	**717**	**730**	**734**	**4 283**

* Includes withholding tax on social security benefits, pension income and other types of income.

Source: Canada Revenue Agency, NR4 Return.

4. Withholding Taxes

Options for Consideration

4.10 *Non-arm's-length interest:* Withholding tax on interest paid to related lenders in the U.S. will be phased out over a three-year period under the revised Canada–U.S. tax treaty. Should Canada negotiate similar exemptions with countries other than the U.S.? Many developed countries, such as France, Germany, Norway and Sweden, exempt all interest payments to foreign parties from withholding tax. The U.S. and the United Kingdom have agreed to such an exemption with most of their tax treaty partners. Interest paid between associated EU companies is exempt from withholding tax by virtue of an EU directive that entered into force on January 1, 2004.

4.11 *Dividends paid by affiliates to their foreign parents:* Canada's tax treaties generally provide for a maximum rate of withholding tax of 5 percent on dividends paid by Canadian affiliates to their foreign parent corporations that hold more than just a portfolio interest. One option is for Canada to negotiate bilateral exemptions for such dividends with its main economic partners. Intra-EU dividends paid from subsidiaries to their foreign parents have been exempt from withholding tax since 1992 by virtue of an EU directive. Some developed countries, including the U.S., the United Kingdom, Australia and Japan, have recently agreed to eliminate withholding tax on dividends paid by subsidiaries to their foreign parents under some of their tax treaties.

4.12 *Royalties:* Canada's tax treaties generally provide for a maximum rate of withholding tax of 10 percent on royalties. Canada has also negotiated exemptions and lower rates for software, patent and/or know-how royalties in about one-third of its tax treaties. One option for Canada is to negotiate exemptions for other types of royalties (such as unpatented knowledge and technologies, payments for the use of trademarks and trade names, and copyright royalties that are not already exempt). A second option is to negotiate general exemptions for all types of royalties. The U.S. tax treaty policy is to exempt all royalties from withholding tax. Royalties paid between associated EU companies are also exempt from withholding tax by virtue of an EU directive that entered into force on January 1, 2004.

4. Withholding Taxes

Questions on Withholding Taxes

A. ***Should Canada further reduce its withholding tax on payments to residents of other countries? If so, which additional types of payments should be exempt or taxed at a lower rate?***

B. ***Should Canada implement any additional exemptions or rate reductions unilaterally by amending Canada's tax law or bilaterally through changes to Canada's tax treaties?***

C. ***What other changes, if any, could be made to ensure that further reductions in Canada's withholding tax do not erode Canada's corporate income tax base?***

D. ***Are there other issues or options related to withholding taxes that should be reviewed and considered?***

5. Administrative Issues

Current Rules

5.1 Canada's rules for international taxation are some of the most complex provisions of the *Income Tax Act*. Complying with these rules imposes a significant burden not only on Canadian businesses investing abroad and foreign investors doing business in Canada, but also on the CRA, which is responsible for administering the entire Act, including Canada's international tax rules. Given the nature of cross-border transactions and the sophistication of modern businesses, some complexity is inevitable. Even still, every effort should be made to minimize the compliance burden imposed on taxpayers in the international arena.

5.2 This section reviews certain aspects of Canada's international taxation system that give rise to specific concerns regarding process, administration and compliance.

Issues under the Current Rules

Transfer Pricing

5.3 "Transfer pricing" generally refers to the rules that govern the prices (for tax purposes) of goods and services between related parties in cross-border transactions. These rules are intended to ensure that prices charged for goods and services within the corporate group reflect market conditions rather than tax considerations, so the profit reported by a member of the group is close to the profit that would have been earned had that member been a stand-alone company. Canada's transfer pricing rules embody the "arm's length principle," which asserts that transactions between persons not dealing at arm's length (i.e., related parties) should reflect terms and conditions to which arm's-length persons (i.e., unrelated parties) would agree. All OECD member countries have adopted this approach, and Canada has formally endorsed the OECD's published guidelines on how the arm's length principle should be applied.

5.4 As international trade rises, so do the number of cross-border transactions that are subject to the transfer pricing principles. It is possible that a move to a broader exemption system, as discussed earlier in this paper, may exert more pressure on the application and administration of the transfer pricing rules.

5. Administrative Issues

5.5 In 1998, Canada adopted new transfer pricing rules that added a requirement for contemporaneous documentation and increased penalties for failure to make reasonable efforts to estimate appropriate transfer prices. Given the importance of transfer pricing and the large dollar amounts that are often involved, it is appropriate to consult with businesses and the CRA on the effectiveness of administering these rules.

Foreign Parties Rendering Services in Canada

5.6 Canada's tax law subjects payments made to residents of other countries for services rendered in Canada to withholding at a rate of 15 percent. The amount is withheld on account of a foreign party's potential income tax liability in Canada, and it is reimbursed to the extent the foreign party is not taxable in Canada. A foreign service provider may apply for a waiver of withholding tax if the provider can show that the amount to be withheld exceeds the ultimate Canadian income tax liability.

5.7 While this withholding mechanism is intended to ensure compliance by residents of other countries that perform services in Canada, it may also be an obstacle to foreign service providers and to the Canadian companies that need their services.

Returns and Forms

5.8 In order to properly administer and enforce Canada's international taxation system, the CRA needs to collect a great deal of information from taxpayers about their cross-border transactions.

5.9 Many returns and forms must be filed yearly by Canadian businesses and foreign companies doing business in Canada in respect of their cross-border activities. These returns and forms sometimes overlap, and the relevant information needed to determine the state of Canada's income tax system may not be required to be reported.

5. Administrative Issues

Questions on Administrative Issues

A. ***What issues commonly arise regarding the application of Canada's transfer pricing rules? What measures could be implemented to improve the application of these rules?***

B. ***Are the transfer pricing rules being applied and administered in a balanced manner?***

C. ***Are penalties in the transfer pricing area being assessed fairly? Are the penalties appropriate?***

D. ***Is the current withholding tax requirement applicable to foreign service providers appropriate in light of compliance risks and the burden it imposes on foreign persons rendering services in Canada?***

E. ***What measures, if any, could be introduced to improve the waiver application process that is in place in respect of this requirement?***

F. ***What changes to existing returns and forms could be implemented to improve and streamline the existing international tax filing and information requirements?***

6. Consultation Process

6.1 The Panel is committed to an open and consultative approach to obtain input from a broad spectrum of interested stakeholders, including small, medium-sized and large businesses. The issues and questions raised in this consultation paper will form the basis for those consultations.

6.2 Canada's system of international taxation comprises many complex rules and deals with many different types of transactions and taxpayers. Other issues and questions of interest may arise that are not covered in this consultation paper, and there may be options in addition to those identified in this paper. The Panel welcomes input on all issues and options that are relevant to the taxation of international business.

6.3 The Panel invites written submissions from any and all interested parties. Submissions will be accepted until July 15, 2008. All written submissions will be given our full attention.

6.4 Submissions will be posted on the Panel's website (**www.apcsit-gcrcfi.ca**) unless we are instructed otherwise. We kindly request that the submissions be written in English or French.

Submissions should be directed as follows:

By e-mail: **advisorypanel@apcsit-gcrcfi.ca**

By post:
Advisory Panel on Canada's System of International Taxation
Submission
Attn.: David Messier
333 Laurier Avenue West, 15th Floor
Ottawa ON K1A 0G5

By fax: 613-947-2289

For additional information, please contact:

Brian Mustard
Executive Director, Secretariat
613-947-9482

Appendix

Selected Reports on International Taxation

United States

Department of the Treasury. *Report to The Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties.* November 2007. Available at: http://www.treas.gov/offices/tax-policy/library/ajca2007.pdf

Department of the Treasury. *Treasury Conference on Business Taxation and Global Competitiveness: Background Paper.* July 2007. Available at: http://www.treasury.gov/press/releases/reports/07230%20r.pdf

Department of the Treasury, Office of Tax Policy. *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century.* December 2007. Available at: http://www.treas.gov/press/releases/reports/hp749_approachesstudy.pdf

United Kingdom

HM Treasury and HM Revenue & Customs. *Taxation of Companies' Foreign Profits: Discussion Document.* June 2007. Available at: http://www.hm-treasury.gov.uk/media/E/9/consult_foreign_profits020707.pdf

Inland Revenue. *Double Taxation Relief for Companies: A Discussion Paper.* March 1999. Available at: http://www.hmrc.gov.uk/consult/dtrc.pdf

New Zealand

Inland Revenue Department, Policy Advice Division. *New Zealand's International Tax Review: A Direction for Change*. December 2006. Available at: http://www.taxpolicy.ird.govt.nz/publications/files/internationaldd.pdf

Inland Revenue Department, Policy Advice Division, and New Zealand Treasury. *New Zealand's International Tax Review: The Treatment of Foreign Dividends and Transitional Issues*. December 2007. Available at: http://www.taxpolicy.ird.govt.nz/publications/files/intnlip2.pdf

Inland Revenue Department, Policy Advice Division, and New Zealand Treasury. *New Zealand's International Tax Review: Developing an Active Income Exemption for Controlled Foreign Companies*. October 2007. Available at: http://www.taxpolicy.ird.govt.nz/publications/files/intnlip1.pdf

Australia

Department of the Treasury. *Review of International Taxation Arrangements: A Consultation Paper.* August 2002. Available at: http://www.taxboard.gov.au/content/int_tax/downloads/ita.pdf