Le Comité mixte sur la fiscalité de l'Association du Barreau canadien et l'Institut canadien des comptables agréés

Institut canadien des comptables agréés, 277, rue Wellington O., Toronto (Ontario) M5V3H
L'Association du Barreau canadien, 865, avenue Carling, bureau 500, Ottawa (Ontario) K1S 5S8

Le 15 juillet 2008

Monsieur Peter C. Godsoe, O.C.
Président
Groupe consultatif sur le régime canadien de fiscalité internationale
333, avenue Laurier Ouest, 15e étage
Ottawa (Ontario) K1A 0G6

Monsieur,

Objet : Régime canadien de fiscalité internationale

Nous sommes heureux de vous présenter notre mémoire sur les moyens d'améliorer l'avantage fiscal du Canada. Nous vous remercions également de fournir aux membres de notre comité l'occasion de rencontrer les membres de votre groupe pour discuter des questions soulevées dans le document de consultation du groupe en avril 2008.

Le document de consultation déclare que la politique fiscale canadienne joue un rôle important à l'égard de la capacité de notre pays de faire concurrence dans un environnement mondial changeant et que le régime canadien de fiscalité internationale doit encourager la compétitivité internationale des entreprises canadiennes et attirer de nouveaux capitaux étrangers au Canada. Nous soutenons ces objectifs, mais nous reconnaissons aussi qu'ils doivent être jumelés au besoin de protéger l'assiette fiscale du Canada.

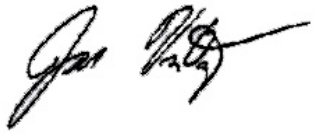
Nous partageons également le point de vue initial du groupe et croyons que le régime d'exemption actuel est fondamentalement solide, bien que, selon nous, il soit désirable de simplifier la conformité tant pour les contribuables que pour l'Agence du revenu du Canada.

Le document de consultation déclare que dans certains cas, la déductibilité complète des intérêts par des sociétés canadiennes détenues par des étrangers peut être inappropriée. Comme nous le mentionnons dans notre mémoire, nous croyons que cette inquiétude est liée à la déductibilité des frais d'intérêts relatifs au financement des sociétés étrangères affiliées.

Nous sommes inquiets par le fait que la législation actuelle et proposée relative à notre système de fiscalité internationale soit devenue trop complexe et, dans un certain sens, presque inapplicable. Dans notre mémoire, nous traitons des modifications proposées aux dispositions sur les sociétés étrangères affiliées et des règlements proposés en ce qui a trait aux entités de placement étrangères et aux fiducies non résidentes. L'objectif de ces changements doit être la certitude et la simplicité. Nous serions tout aussi préoccupés si la mise en œuvre de l'une ou l'autre des recommandations du groupe entraînait un résultat contraire.

Nous espérons que vous trouverez nos commentaires et nos recommandations utiles. Nous serons heureux de vous rencontrer à un moment opportun pour traiter plus avant des questions discutées dans ce mémoire.

Nous vous prions de recevoir, monsieur, l'expression de nos sentiments distingués.



John Van Ogtrop
Président, Comité sur l'impôt
Institut canadien des comptables agréés

Paul Tamaki
Président
Section nationale du droit fiscal
Association du Barreau canadien

Submission of the
CICA-CBA Joint Committee on Taxation

Advisory Panel on Canada's System of International Taxation

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July 15, 2008

Submission of the
CICA-CBA Joint Committee on Taxation

Advisory Panel on Canada's System of International Taxation

A. INTRODUCTION

The Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accounts ("Joint Committee") is pleased to provide this written submission to respond to the Advisory Panel on Canada's System of International Taxation's April 2008 Consultation Paper, *Enhancing Canada's International Tax Advantage* ("Consultation Paper").

The following abbreviations are used throughout this submission:

Act	Income Tax Act (Canada)
CFA	controlled foreign affiliate
CRA	Canada Revenue Agency
FAPI	foreign accrual property income
FIE	foreign investment entity
NRT	non-resident trust
TIEA	tax information exchange agreement

References to subsections, paragraphs, etc., are to provisions of the Act.

B. TAXATION OF INBOUND DIRECT INVESTMENT

1. Use of Debt by Foreign-Owned Corporations

The use of debt by Canadian corporations with significant foreign ownership is a concern to the extent that it results in inappropriate erosion of the Canadian tax base or puts Canadian-owned corporations at a competitive disadvantage. This is because the use of "foreign related party debt" (including some forms of guaranteed debt) may allow such enterprises to incur deductible interest expenses in Canada at levels that are higher than that available to a Canadian-owned corporation in the same circumstances. This may be particularly a concern if the indebtedness is incurred to acquire interests in foreign corporations, a practice sometimes referred to as "debt dumping".

Guaranteed debt represents a particularly difficult issue. In some cases, third party debt guaranteed by a foreign related party is nothing more than a substitute for foreign related party

debt – except that the current thin capitalization rules do not apply. On the other hand, in other cases a parent or related party guarantee is a normal and necessary condition for third party financing and is equally required of a Canadian borrower. One solution might be to include third party indebtedness guaranteed by foreign related parties within any thin capitalization restriction, but to provide exemptions where the taxpayer can demonstrate the guarantees are provided "in the ordinary course of" and consistent with ordinary commercial borrowing practices in the particular industry.

The current rules provide for a 2:1 debt to equity thin capitalization limit which applies to all Canadian corporations with significant foreign ownership. This existing 2:1 ratio puts some foreign-owned corporations at a disadvantage when compared to Canadian-owned corporations in the same business (i.e., in the financial services sector). This is because the existing thin capitalization rule does not recognize that, in some sectors, the "natural level" of leverage is significantly greater than 2:1. This would be an even greater concern if guaranteed debt is caught by a revised thin capitalization rule. In these cases, a more flexible rule may be needed and it would be particularly important to distinguish guarantees that are given in the ordinary course as described above.

If the objective is to "level the playing field", the theoretically ideal solution would be to have an arm's-length approach (similar to the one used in the United Kingdom) which puts the foreign owned corporation in the same position as a Canadian-owned corporation. In this case, the acceptable level of foreign related-party debt would take into account all debt including third party debt so that that the overall capitalization is consistent with an arm's length standard. However, as the Consultation Paper points out, this approach would be administratively burdensome to taxpayers and the CRA and its consequences unacceptably uncertain. In addition, this approach levels the playing field, but does not provide a "Canadian advantage." It also does not deal completely with "debt dumping" that inappropriately erodes the Canadian tax base. One possible alternative would be to permit taxpayers to develop and support the appropriateness of higher levels of indebtedness (including all indebtedness) and financing costs that are consistent with an arm's-length standard, where they believe the particular circumstances support deviation from formulaic limitations.

We believe that a rule based on tracing would be arbitrary and inappropriate for dealing with this issue. It can require complex bookkeeping. It would encourage uneconomic behaviour (such as cash damming) by those seeking to take advantage of the tracing principle. Such an approach could also create hardship and uncertainty for other corporations that are not able to trace indebtedness including acceptable related foreign party debt to "good" uses. There would be transitional issues for corporations that have existing foreign related party debt, but are unable to trace it to a specific source of income or, even worse, have (inadvertently) structured their affairs so that such debt traced it to a use that does not support interest deductibility. This would be a concern, for example, if specific rules were introduced to restrict the deductibility of interest paid to or guaranteed by a related foreign party and used to finance foreign investments.

Recommendations

The issue of reasonable and appropriate limitations on tax deductible financing costs incurred in Canada by foreign owned enterprises can be addressed in a number of ways.

One alternative would be continuing the existing "thin capitalization" limits but with modifications, including as follows:

- "Restricted debt" should include "guaranteed debt" that inappropriately increases the indebtedness of the Canadian corporation. For example, the rules could initially include all guaranteed debt, but provide exceptions where the guarantee is provided consistently with ordinary commercial practice in the industry.

- The rules may need to take into account "bona fide" third party debt since the overall level of indebtedness is relevant to establishing a level playing field. That is, if a corporation with significant foreign ownership has borrowed to the extent of its ordinary commercial capacity from third parties (i.e. the level at which a Canadian corporation could borrow) the ability to incur further indebtedness to foreign related parties within formulaic thin capitalization limits (to convert what would be equity to related party debt) arguably results in inappropriate erosion of the Canadian tax base.

- Limits should be placed on the extent to which related party indebtedness can be used to acquire and invest in foreign affiliates. This could be addressed through a modification to the thin capitalization formula to reduce the equity component by some portion of the value of foreign investments. Flexibility would be required, however, to take into account situations where a foreign investment is legitimately connected to a Canadian head office – for example after a Canadian based multinational has been acquired by a foreign shareholder such as a private equity fund.

- Finally, consideration should be given to flexibility for circumstances and industries where the formula may be inappropriate, such as financial services.

Another alternative would be an "earnings stripping" approach. Deductible interest expense to related non-resident lenders would be limited to a fixed percentage of Canadian operating earnings. Interest paid to third parties would be taken into account to reduce potentially deductible related party interest. That is, foreign related party interest expense would be disallowed (or deferred either indefinitely or for a limited period) if and to the extent it exceeds a percentage of operating earnings less third party interest. An earnings stripping rule could also be used as a "safe harbour" for a more comprehensive and rigorous thin capitalization system.

2. Inbound Treaty Shopping

It is not clear to us whether Canada's income tax base is at risk because of treaty-shopping transactions. A response to this question requires a definition of "treaty shopping" which can be applied objectively to a variety of transactions giving rise to claims for treaty exemption or preference. The recent case of *Prévost Car* v. *Her Majesty the Queen* [1] can perhaps be characterized as a treaty-shopping case. It can also be characterized more mundanely as a dispute between taxpayer and a revenue authority as to whether the taxpayer has accomplished the requisite steps required to claim entitlement to claim a treaty benefit.

[1] *Prévost Car Inc*. v. *Her Majesty the Queen* 2008 DTC 3080 (TCC).

We question whether Canada should have additional rules in its tax treaties or its domestic tax law to discourage treaty-shopping transactions. With respect to the possibility mentioned in the Consultation Paper of adopting a "specific, detailed anti-treaty-shopping rule", we note that legislative changes to the general anti-avoidance rule in section 245 and to the Canadian *Income Tax Conventions Interpretation Act* were aimed specifically at abuse of treaties.

Further complicating the picture is an issue not mentioned in the Consultation Paper, namely outbound treaty-shopping transactions. Obviously Canadian taxpayers engage in transactions intended to reduce or eliminate foreign taxes which involve reliance on the outbound provisions of Canada's tax treaties. The economic benefits of such transactions to Canada cannot be readily estimated, but this behaviour casts some considerable doubt on the proposition that a unilateral assault on inbound treaty-shopping is necessarily in Canada's overall economic interest.

We are also concerned that any attempt to draft a domestic anti-treaty shopping rule (or a definition of beneficial ownership) is likely to result in a provision that is practically unworkable and will add to the complexity of the tax system.

Furthermore, we expect that, as a practical matter, most of the investment into Canada comes ultimately from entities which are located in treaty jurisdictions and accordingly which do not have to use other treaties in order to minimize Canadian taxes. If the real issue is sovereign wealth funds or foreign tax-exempt or preferentially-taxed entities that make "commercial investments" in Canada, the matter of any potential erosion of the Canadian tax base should be addressed through thin capitalization rules as discussed under the previous heading.

Recommendation

A review of treaty shopping as inappropriate tax planning should not be a matter of high priority. The matter of treaty shopping should be dealt with under the existing general anti-avoidance rule. This will better ensure that Canada's tax laws in this area will be applied in a manner that is consistent with international norms.

C. TAXATION OF OUTBOUND DIRECT INVESTMENT

1. Interest Expense Related to Foreign Investment and Section 18.2

As discussed in connection with the taxation of inbound investment, Canada permits foreign-owned Canadian corporations to deduct interest on funds borrowed to invest in foreign affiliates, subject only to the existing overall thin capitalization rules. There is no limitation on the deductibility of interest by Canadian-owned Canadian corporations on money borrowed to finance foreign affiliates. This could be said to put Canadian-owned corporations with foreign affiliates at a competitive advantage over Canadian-owned corporations which have no foreign affiliates, to the extent that the former is able to carry more debt the interest on which can be used to shelter Canadian business earnings. The policy question is whether Canada should be encouraging offshore expansion of Canadian-owned enterprises or, to put it another way, to create a preference for foreign investment over domestic investment.

New section 18.2 of the Act (the so-called "Anti-Tax Haven Initiative") could be said to address the above question and discourage foreign investment by limiting the deductibility of interest on

borrowings to finance foreign affiliates, but this is only in the very limited circumstance of a "double dip structure" where there is a second deduction of interest in a foreign jurisdiction. In fact, it could be said that section 18.2 does not discourage Canadian borrowings to finance foreign affiliates or protect the Canadian tax base– all that it discourages is a second deduction in a foreign jurisdiction. The provision does not prevent the use of tax havens by Canadian taxpayers. In our view, section 18.2 does not effectively address any of the issues raised in the Consultation Paper relating to either the use of debt by foreign owned corporations or the deductibility of domestic costs relating to foreign investment..

Recommendation

We request that section 18.2 be addressed by the Panel in its report to the Minister of Finance. In our view, this provision impairs the competitiveness, efficiency and fairness of Canada's system of international taxation.

2. Alternatives for Taxing Active Business Income

The current exemption system applies to all active business income earned in treaty countries and is being extended to countries that enter into a TIEA. Thus, the scope of exempt surplus is very broad and there is no link to the foreign effective tax rate in order to obtain exemption. The data compiled in the Consultation Paper suggest at most 5-10% of dividends received by Canadian corporations are paid from taxable surplus. We suspect that very little, if any, tax was paid on these dividends as they would mostly represent repatriation of previously-taxed FAPI and high-taxed foreign earnings. The current legislation provides for significant flexibility in deferring tax on taxable surplus including the ability to claim a disproportionate share of foreign taxes. As a practical matter, therefore, Canada already has a full exemption system in practice. Accordingly, there is little policy justification in maintaining the distinction of exempt surplus and taxable surplus for active business income.

On the other hand, we expect that the tax revenue impact of "simplifying" by extending the exemption system would be insignificant. Therefore, the main reasons for simplifying the system (including exempting capital gains on foreign affiliates) would be to simplify the record keeping burden and, one would hope, the legislative provisions. This would be particularly helpful to small and medium sized businesses and start-ups.

Proposed changes to surplus rules in the Income Tax Regulations have been under discussion since 2002. They seem to evidence a concern by Finance that corporations are creating "artificial" exempt surplus to avoid paying taxes on taxable earnings and in particular on capital gains derived from the sale of foreign affiliates. These rules, if enacted, will add significant complexity to an already complex set of rules and in many cases will be impossible to comply with or enforce. We suspect that these rules will raise little in terms of revenue as both Canadian and foreign (especially U.S.) experience demonstrates that multinationals tend to defer the repatriation of low-taxed foreign earnings subject to a credit system almost indefinitely. In the U.S. the temporary introduction of a concessionary 5% tax rate on foreign dividends in 2004 led to substantial repatriation of earnings that otherwise would likely have been maintained offshore indefinitely. A system that discourages the repatriation of earnings is inefficient as it discourages

investment in Canada – instead, funds will be reinvested in offshore business even if doing so leads to a lower pre-tax return.

Recommendation

We support simplification of the current rules. However, we are concerned that any attempt to "simplify" the system will result in complex implementing legislation and extensive consultation as has been the case with the current initiative to "fix" the current regime. We question whether this is a priority given the other important initiatives under consideration. However, pending further decisions in this area, Finance should recognize that we have a de facto full exemption system and drop its work on proposed amendments to tighten up the system.

3. Tax Information Exchange Agreements

Our understanding is that the new TIEA regime is simply an enforcement tool. While there may have been political objectives in encouraging foreign jurisdictions to enter into TIEAs, it seems that this has very little to do with business, and more to do with Canada's desire to obtain information relating to individuals. In our view, it is inappropriate to hinder the ability of Canadian businesses to carry on their activities outside of Canada in order to address problems with obtaining information relating to individuals. The T1134 and similar reporting requirements already provide detailed information about potential sources of FAPI from compliant taxpayers. We question whether the use of TIEAs will enable Canada to obtain significant information from non-compliant taxpayers. For such persons, the entering into of a TIEA with one country will simply encourage them to relocate their investments to a non-TEIA country.

Recommendation

The proposal to tie the TIEA system to "exempt earnings" should be dropped. If the taxpayer can demonstrate that it is earning active business income in any foreign jurisdiction, the income should not be currently taxed in Canada.

4. Taxation of Foreign Branch Operations

In theory, Canada should provide 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. However, one advantage under the present system is the ability of the Canadian corporation to deduct start-up losses from a foreign branch. This is an area where it would be desirable to provide flexibility for start-up operations.

Recommendation

Canada should have a rule that permits a Canadian corporation to make a one-time "check-the-box" election as to how the foreign branch is taxed. Alternatively, a Canadian corporation should be permitted to deduct start-up losses, with a rule providing for a "recapture" once the branch becomes profitable to the extent of previously deducted losses.

5. Non-Resident Trust Provisions

The proposed NRT rules in Bill C-10 affect more than personal investments by individuals. Business arrangements can be structured using non-resident trusts. Examples are investments in foreign real estate and Australian business trusts. The NRT provisions in Bill C-10 inhibit the ability of Canadian businesses to acquire or invest in such businesses. As pointed out in numerous submissions that the Joint Committee has made to the Department of Finance, we continue to have significant concerns with the NRT provisions. The exemption for commercial trusts is unworkable in practice.

Recommendation

The NRT rules should be rewritten to deal only with the type of tax planning which is intended to be prevented – i.e., the use of foreign trusts to accumulate income offshore without tax for the benefit of an ultimate Canadian beneficiary.

6. Base Erosion Rules

The existing base erosion rules in the Act were introduced in 1994 prior to the enactment of the transfer pricing rules in section 247 of the Act. In principle, base erosion rules should not be required where an effective transfer pricing system exists.

As pointed out in the Consultation Paper, it is common for multinationals to manufacture and source product in different jurisdictions. Base erosion rules create an inequity for Canadian multinationals when contrasted with foreign multinationals. A foreign multinational is in the position to provide goods or services to Canadian subsidiaries subject only to the application of the transfer pricing rules. A Canadian multinational is subject to not only the transfer pricing rules, but also the base erosion rules. The result is a tax policy that favours foreign multinationals.

The base erosion rules penalize exporters of services as compared to those who export products. For example, if a Canadian manufacturing company sells its products to a CFA for resale to a non-resident the margin earned by the CFA is not FAPI. In contrast, where a Canadian engineering services company provides services to a CFA which then provides services to non-residents, the whole margin is FAPI because of recently-enacted changes.

We recognize, however, that there may be policy reasons for having base erosion rules in some circumstances where business transactions with Canadian resident persons can easily be located offshore, such those contemplated in existing paragraphs 95(2)(a.2) and (a.3) of the Act dealing with insurance of Canadian risks and loans to Canadian borrowers.

Recommendation

Base erosion rules should not be expanded where the transfer pricing rules are sufficient to protect any leakage of the Canadian tax base. The existing base erosion rules should be changed to facilitate the export of services from Canada and efficient supply chain management of manufactured products.

7. FAPI and FIE Provisions

In our view the FAPI rules have been generally effective in ensuring that Canadian taxpayers are not able to defer taxation on property income. A broader exemption system for foreign active business income should not, in and of itself, require a change in the scope of the FAPI rules. One change that should be considered, however, is an increase in the $5,000 threshold. This amount has not changed since 1975. Increasing the threshold could assist small businesses seeking growth in foreign markets. Similar benefits would be achieved by larger Canadian companies if a threshold could be set taking into account either a fixed dollar amount or a specified percentage.

As noted in the Consultation Paper, the FIE rules are intended to tax passive income that would not otherwise be taxed on an accrual basis under the FAPI regime because the foreign corporation is not a CFA. There is little coordination between the two sets of provisions. In many respects the FIE provisions are more punitive than the FAPI provisions. For example, under the FIE regime, there can be income accrual to the Canadian taxpayer even though the foreign entity has no earnings in a year, underlying foreign active business income can be subject to current Canadian taxation, and underlying capital gains can be converted into fully-taxed income gains. As the Joint Committee has pointed out in various submissions to the Department of Finance, the FIE provisions are complex and uncertain. In many cases it is virtually impossible for taxpayers to determine whether the provisions apply to a particular investment.

Recommendation

The NRT, FIE and FAPI rules should be coordinated. The NRT rules should be limited to anti-avoidance situations as discussed above. Taxpayers should be able to elect to have the FAPI rules apply to trusts and to non-controlled entities (both corporations and trusts) where sufficient information is available to enable the determination of the amounts included in income. The FIE rules should be rewritten to apply only where the FAPI rules do not apply and it is reasonable to consider that one of the main reasons for making the investment in the foreign entity is to earn a profit or return attributable to underlying activities of the foreign entity that would generate FAPI if the foreign entity were a CFA of the Canadian investor. There should also be an exemption from the FIE rules where the underlying FAPI of the foreign entity is subject to a significant level of foreign tax – i.e., a rate that is not significantly more favourable than the Canadian rates.

The $5,000 threshold to the application of the FAPI rules should be increased.

D. WITHHOLDING TAXES

Canada should continue to pursue tax policies that support the lowest cost of capital for Canadian corporations while avoiding unnecessarily eroding the Canadian tax base. These objectives can generally be accomplished through bilateral tax agreements where any reduction of Canada's withholding that primarily benefits non-residents (e.g. withholding taxes that apply to related party arrangements) is offset by similar benefits for Canadian recipients of foreign payments. On the other hand, consideration might be given to unilaterally reducing withholding taxes if it can be demonstrated that the cost is borne by Canadian corporations through higher costs of capital (e.g. the recent elimination of withholding tax on arm's-length interest.)

E. ADMINISTRATIVE ISSUES

Income Tax Regulation 105 provides that, if a person (who may not be resident in Canada) pays an amount to a non-resident of Canada in respect of services rendered in Canada, that payer must withhold 15% of the payment and remit the amount to the Canadian taxing authority as tax on behalf of the non-resident. As a practical matter, the withholding requirement under Income Tax Regulation 105 imposes hardship on the Canadian recipient of the service because many foreign service providers are not willing to have their fees subject to withholding and would require the Canadian payer indemnify the service provider for the withholding through a gross-up of the fee. Withholding should not be required where the recipient of a payment claims an exemption from tax where Canada can verify and collect the appropriate amount of tax from the service provider by using its collection and information exchange agreements with the non-resident's country of residence.

The withholding obligation under Income Tax Regulation 105 does not apply to payments to employees. Payments to a non-resident employee are subject to withholding under Income Tax Regulation 102 to the extent that the remuneration is reasonably attributable to the duties of employment performed in Canada. The withholding under Income Tax Regulation 102 in respect if remuneration attributable to employment in Canada creates compliance concerns for multinationals that send their officers or employees to Canada on an occasional basis. In such cases, it is not practical to obtain a waiver of the withholding requirement.

Administrative issues related to withholding also arise on dispositions of taxable Canadian property by non-residents under section 116 of the Act and payments of dividends, rents, royalties and similar payments subject to withholding tax under Part XIII of the Act. As a result of the proposed changes to the Canada – U.S. Income Tax Convention, it will be difficult for payers to determine whether the reduced rate under treaty applies. Section 116 compliance is an administrative burden for both taxpayers and CRA.

Recommendation

The administration of the withholding tax requirement should be reviewed in general. Consideration should be given to a system whereby non-resident payees can sign a CRA exemption form certifying that they are exempt from tax under a convention or a provision of the Act (without having to obtain a waiver or certificate from CRA) and the payer is relieved from the withholding requirement.

Consideration should be given to an exemption from Canadian tax and Income Tax Regulation 102 withholding up to a reasonable limit in respect of remuneration to business travellers.