International Fiscal Association
(Canadian Branch)

2007 Travelling Lectureship

"Are the Surplus Rules Surplus?"

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The Canadian foreign affiliate rules are an unique amalgam of avoidance rules to ensure that portfolio income earned indirectly through controlled foreign intermediaries remains taxable and to defer and in practice eliminate taxation of foreign business income also earned indirectly through foreign intermediaries in the interest, among others, of promoting the international competitiveness of Canadian businesses. In both contexts, the rules anticipate and relieve double taxation by rationalizing the application of foreign and Canadian tax to these foreign sources of income through tax credit and exemption.

Much of the complexity of the foreign affiliate rules is attributable to tracking foreign income (and tax) as it is earned relative to periods in which Canadians are direct or indirect shareholders of foreign companies that earned the income, taking into account the degree of foreign tax that may be borne by that income, or more accurately the likelihood that this income would have been subjected to taxation according to tax rules that Canada has evaluated to be meaningful in its terms. This tax accounting regime, which is intrinsic to the architecture and orderly operation of the foreign affiliate rules, divides foreign income into "taxable" and "exempt" pools. In turn, the "taxable" pool includes investment income that is taxed currently to controlling direct or indirect Canadian shareholders; income derived from active businesses carried on or by foreign companies resident in countries with which Canada does not have a tax treaty; and taxable gains from the disposition of shares of foreign corporations.

In view of Canada's extensive treaty network and the commercial realities that affect where business likely is and, indeed in practical terms, probably only can be conducted, foreign business income is largely exempt from Canadian tax until distributed ultimately to individual shareholders of Canadian corporations. To the extent that foreign business income is earned outside Canada's treaty network, there is an implicit assumption, or perhaps presumption, that it has borne little taxation or is earned within a jurisdiction that does not share the same adherence to rigorous tax policy norms as Canada. Consequently, though there is still a competitive interest to be served in not taxing the income as it is being earned but before it is distributed, Canada is not prepared to cede taxation of that income absolutely.

It is interesting to observe then that much of the complexity of the Canadian surplus rules supporting the foreign affiliate system, including the focus of many pending changes, arises from tracking income that Canada has expressed no interest in taxing currently, is rarely, we expect, distributed to its Canadian owner-shareholders as dividends, and

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indeed, with the support of rulings of the Canada Revenue Agency may be accessed by loans to those owner-shareholders. In short, a significant aspect of the surplus regime is devoted to protecting the future taxation of foreign income that in fact is never likely to be taxed, "base company" considerations aside.

Since December 2002, the foreign affiliate regime has been subjected to rigorous scrutiny that strikes at the essential tax policy underlying it. Apart from a number of technical changes that are for the most part relieving with general application as far back as 1994, proposed new rules seek to police transfers of property and the performance of services within a foreign corporate group to avoid the creation of exempt surplus (or non-recognition of losses) that would allow, in effect, "taxable" earnings to be distributed without tax to Canadian shareholders.

We think it is timely to question whether this direction of Canadian tax policy, which will come at the expense of simplicity and efficiency, is necessary, worthwhile, or even faithful to the underlying tenets of Canada's system for dealing with foreign indirect income. We assume that portfolio investment income is, should and will remain taxable to its economic owners without deferral through the application of the "foreign accrual property income" aspect of the foreign affiliate system or by way of the "non-resident trust" and "foreign investment entity" regimes. With this in mind, it seems that important and possibly controversial aspects of the proposed changes to the foreign affiliate rules dealing with the consequences of intra-group transactions aspire to preserve the taxation of foreign income that in practice may never be taxed. On the other hand, relieving the Canadian tax that conceivably would apply on the distribution of this income may encourage another long-standing aspiration of Canadian tax policy to encourage foreign earnings to be "repatriated" to Canada and redeployed by their owners in productive enterprise in a manner that advances Canadian economic interests. At the same time this should contribute to the relative ease of complying with and administering the foreign affiliate rules.

We make these observations in the context of changes being considered and in some cases implemented by other countries to simplify their "controlled foreign corporation" rules by adopting or considering adopting more directly a bias toward a territorial regime for taxing business income. This bias is already reflected as a fundamental and continuing element of the Canadian "CFC" system and its precursors. International developments in this area provide a useful foil for inquiring about our own rules. As well, Canada's tax rules affecting international business must take into account those of other countries that apply to Canadian taxpayers and the income they earn.

Before the most recent fundamental tax reform that created the "modern" foreign affiliate regime in the Income Tax Act and the Income Tax Regulations, the Canadian system for taxing foreign indirect income was essentially a territorial system for investment as well as business income. From 1976, the deferral and, for the most part exemption, from taxation of foreign indirect business income was preserved while an avoidance regime was enacted to eliminate advantages arising from earning investment income through foreign intermediaries. Since then, this basically "simple" system has undergone or been

exposed to only a few significant changes that do not alter the basic design of the foreign affiliate or the tax policy objectives that it serves.

In the early 1980s changes were enacted and existing provisions refined to ensure that foreign corporate reorganizations did not transform business income or the nature of business assets into income or accreting value that would be taxable as "foreign accrual property income." These developments, which included adopting the notion of "excluded property," ensured that business income in all its manifestations remained within the exemption or at least deferral aspect of the system. In the mid 1990s, in response to unsuccessful attempts through court challenges to invest the notion "active business" with a predictable meaning consonant with the underlying tax policy of the foreign affiliate system, prescriptive changes were made to reinforce the avoidance aspect of the foreign affiliate system for taxing investment income.

Aside from certain technical changes and apart from those that most concern us, the proposed changes essentially reinforce the separation between investment and business income. In some cases the business nature of income transmitted between foreign affiliates or that arises collaterally in relation to their dealings and property is preserved. In other cases, proposals protect the integrity of the Canadian domestic tax base by resisting certain "base company" arrangements considered to contribute to domestic "base erosion" essentially at a taxpayer's election. All of these changes are fundamentally consistent with what amounts to a territorial system for taxing foreign business income.

The proposals that concern us relate to possibly significant design changes the force of which, it would appear, is mainly to prevent the avoidance of tax on income that has rarely, if ever, been taxable – undistributed taxable surplus. At the same time that the Canadian rules are becoming potentially more and intractably complicated, other countries engaged in similar reform appear to be headed in the other direction exploring and in some cases acting on the virtues of a "purer" exemption system. We have in mind, in particular, tax policy and in some cases legislative developments in Australia, New Zealand, the United States and certain European countries. In all cases, it is acknowledged that tax regimes need to police the inappropriate avoidance or deferral of taxation of investment income – income that has no intrinsic connection to the jurisdictional or corporate organizational circumstances in which it is earned - and as well so-called "base erosion" arising from exaggerated transfers between resident companies and foreign affiliates that unduly deplete the domestic tax base. That being said, however, and in light of international developments more generally concerning transfer pricing and the attribution of income to branches (permanent establishments) according to tax treaties, we think that Canada should seriously reconsider the utility of complex changes to our foreign affiliate rules that capture income that in fact is unlikely to be distributed to Canadian shareholders or if it were could be redeployed productively in the service of the economic objectives ultimately meant to be supported by the foreign affiliate rules.

In the 2007 Travelling Lectureship, we propose to test the proposition, with reference to the historical development of the Canadian foreign affiliate system and the developments as we see them in similar circumstances in other countries, that the tax policy underlying the foreign affiliate rules be reconsidered, that those aspects of the present system oriented fundamentally only to preserving the taxation of taxable surplus be abandoned and on that platform Canada consider reorienting the rules more directly to achieve territorial taxation of foreign business income.

The Foreign Affiliate System in View and Review

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> Life is the art of drawing sufficient conclusions
> from insufficient premises.[1]

> The endless cycle of idea and action,
> Endless invention, endless experiment,
> Brings knowledge of motion, but not of stillness;
> Knowledge of speech, but not of silence;
> Knowledge of words, and ignorance of the Word.[2]

In View and Review

The 1992 report of the auditor general of Canada[3] identifies the possibility that tax avoidance arising from imperfections in the design and administration of the foreign affiliate system in the Income Tax Act (Canada)[4] may be undermining, materially, the reliability, integrity, and sustainability of the income tax revenue base.[5] Interestingly, aside from a variety of technical amendments enacted since its inception, the basic structure of the foreign affiliate system remains as it was when it was adopted during the 1970s. Much of the debate engendered by the report[6] creates the impression, if not the implication, that the architecture of the system adopted in the Act for taxing income from foreign direct investment is fundamentally deficient, flawed, or outmoded.

This paper is intended to situate the design, in principle, of the foreign affiliate system, and recent criticisms of it, within the context of domestic

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[1] Samuel Butler, *Note-Books, 1912*.

[2] T.S. Eliot, "Choruses from The Rock."

[3] Canada, *Report of the Auditor General of Canada to the House of Commons 1992* (Ottawa: Supply and Services, 1992) (herein referred to as "the report"). See Allan R. Lanthier, "Policy or Abuse? The Auditor General's Report" (1993), vol. 41, no. 4 *Canadian Tax Journal* 613-38.

[4] RSC 1952, c. 148, as amended by SC 1970-71-72, c. 63, and as subsequently amended (herein referred to as "the Act"), together with complementary provisions of the Income Tax Regulations, CRC 1978, c. 945, as amended. Unless otherwise stated, statutory references in this paper are to the Act. See footnote 5, infra, for the definition of "foreign affiliate system."

[5] The Act contains a variety of provisions applicable to earnings from certain types of foreign direct and portfolio investments of taxpayers resident in Canada. Largely, those provisions dealing with foreign direct investment (that is, investments by Canadian residents in foreign intermediaries, usually corporations, in which they have a substantial—in statutory terms—economic interest to which is attributable a degree of influence or control) constitute the "foreign affiliate system." Generally, a "foreign affiliate" of a Canadian resident is defined in paragraph 95(1)(d) of the Act to be a foreign corporation in which the Canadian resident has a direct or indirect equity interest of at least 10 percent (expressed in terms of a class or series of shares). The purposes served by these rules, reflected in their design, are discussed below. The report, supra footnote 3, at 46, suggests that flaws in the foreign affiliate system account for a continuing loss of "hundreds of millions of dollars."

[6] Ibid., at 51-55. See also the record of the proceedings of the Public Accounts Committee: Canada, *Minutes of Proceedings and Evidence of the Standing Committee on Public Accounts*, 34th Parliament, 3d session, 1991-92-93, issue nos. 37 (December 8, 1992), 38 (December 10, 1992), 40 (February 10, 1993), 43 (March 9, 1993), and 48 (with its 12th report to the House, April 23, 1993).

and international tax policy priorities that, in some manner, the system reflects and reconciles.[7] It is impossible within the scope of this presentation to undertake a comprehensive technical or planning-oriented exposition of the foreign affiliate and foreign accrual property income (FAPI) rules in the Act. In any event, there are many fine treatments, from these perspectives, of Canada's system for taxing income from foreign direct investment.[8] The objectives of this analysis are more fundamental. Despite a considerable volume of published thinking about the interstices of this system, very little considered discussion has taken place concerning its underlying significance and implications.[9] Yet a thorough understanding of the goals of the system and the limitations built into it, in particular in relation to the aspects of the Act addressing the taxation of domestic income, is important in explaining the significance of apparently problematic systemic and technical dimensions of the system, in order to give practical meaning to them. Accordingly, this paper is directed to the following objectives:

- to disentangle the critical themes of the report attributable to the foreign affiliate system and to identify those that most directly raise unique, or perhaps intrinsic, concerns about the design or administration of that system as such;

[7] The debate, based on common perceptions of the report taking into account the proceedings before the Public Accounts Committee, demonstrates two important facts. First, setting out a fundamental consideration of the foreign affiliate system in its national and international contexts is difficult to do (although see the elegant study by the US Department of the Treasury, *International Tax Reform: An Interim Report* (Washington, DC: the department, January 1993)). Second, before embarking on any re-evaluation of the basic design of this system, whether in response to the present political controversy or to more substantial ongoing policy evaluations by the Department of Finance, such a consideration is crucial, if only to provide a constructive foil for further informed debate and thereby to assist in protecting this system from ill-considered (but apparently attractive short-term) expedients intended to be palliatives for problems that in fact do not exist, at least to the extent contended.

[8] See, in particular, Brian J. Arnold, *The Taxation of Controlled Foreign Corporations: An International Comparison*, Canadian Tax Paper no. 78 (Toronto: Canadian Tax Foundation, 1986), for a clear explanation of the technical construction of the Canadian foreign affiliate system, in the context of the approaches of other countries.

[9] Generally, national fiscal regimes face novel (or at least more immediate) pressures arising from the homogenization and integration of traditional economic structures and of the organization and conduct of commercial activity within them. The Organisation for Economic Co-operation and Development (OECD) has neatly encapsulated the process in relation, principally, to corporate taxation. "As economic integration in the OECD area proceeds, the economic, technological, and institutional barriers to cross-border investment continue to wane. The pattern of international investment in corporate assets is therefore likely to become increasingly sensitive to cross-country differences in corporate tax rules. In particular, tax differentials may come to exert an important impact on international portfolio investment in shares. Moreover, even though non-tax factors will probably remain the dominant determinants of foreign direct investment in most cases, the influence of tax differentials on the location decisions of multinational enterprises may also be expected to become stronger. The increasing international mobility of capital therefore may increase the need for international coordination of taxes on corporate-source income." Organisation for Economic Co-operation and Development, *Taxing Profits in a Global Economy: Domestic and International Issues* (Paris: OECD, 1991), 21.

- to situate the issues reflected in those criticisms in the context of the existing Canadian fiscal regime for taxing foreign income and the international fiscal norms (that is, principally distributional factors [taxpayer and internation equity], resource allocation or efficiency considerations typically associated with the notions of "capital export" and "capital import" neutrality, simplicity, administrative feasibility and effectiveness, and international "competitiveness"[10]) that, generally, underlie the design of any tax system provisions affecting the taxation of income from foreign direct investment;[11]

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[10] This term is used rather casually in this context (and in the reply of the Department of Finance to the report); however, in analytical terms, it is associated with the notion of "capital import neutrality." Notwithstanding distinctions between the two terms, they essentially reflect the same underlying concern. See Mitsuo Sato and Richard M. Bird, "International Aspects of the Taxation of Corporations and Their Shareholders" (July 1975), 22 *International Monetary Fund Staff Papers* 384-455, at 408, where the authors state that "capital import neutrality requires that capital funds originating in different creditor countries compete on equal tax terms in the capital-importing country." For a general discussion of considerations relevant to Canada's competitive fiscal situation, see Robert D. Brown and Vivien Morgan, "International Competitiveness and Taxation," International Tax Planning feature (1989), vol. 37, no. 3 *Canadian Tax Journal* 745-62. See also the later discussion under the headings "General System Constraints: International Norms" and "Evolving International Policy Considerations."

[11] See Klaus Vogel, "The Search for Compatible Tax Systems," in Herbert Stein, ed., *Tax Policy in the Twenty-First Century* (New York: Wiley, 1988), 76-86, for a critical review of the respect typically paid to certain international tax norms, in particular "capital export neutrality" and "capital import neutrality." Vogel comments (ibid., at 76) on the effect on efficient international resource allocation of deficient international tax coordination; acknowledges the unlikelihood (and perhaps the undesirability in any event) of overt international tax harmonization ("Lack of flexibility, the desire to show a nation's independence, and sometimes sheer self-interest induce governments to cling to their own ways and even to introduce new particularities": ibid., at 77); and evaluates the merits of adhering to the traditional international tax policy norms with reference to worldwide and source-based tax regimes. Interestingly (ibid., at 86), he prefers limitations on the exercise of worldwide tax jurisdiction by countries:

> Worldwide taxation, in contrast to what is generally believed, affects the international flow of investment. It impairs capital import, particularly into low-taxing states, which is detrimental to developing countries. It is also disadvantageous to the capital-exporting states that apply this type of taxation. Moreover, it is neither demanded by reasons of individual equity nor by inter-nations equity; rather, more convincing reasons can be brought forward in favour of source-based taxation. As a consequence, worldwide taxation should be abolished. Its elimination would considerably improve the interaction of tax systems.
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> For the United States, the best time to abolish worldwide taxation is now, because as long as tax rates remain low, there is not as much difference between tax credit and exemption. If such a change is postponed (and realistically we have to expect this), replacing worldwide with source-based taxation in domestic legislation and treaties will be one of the most urgent missions to be envisioned for the 21st century.

Vogel's view is notable in the light of the design of the Canadian foreign affiliate system, which, as is discussed below, is in effect a modified exemption (or source, or territorial) system, which, in certain important cases, is therefore a source-based regime. His com-

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• to identify, in principle, the basic significance of the foreign affiliate system, which is much simpler, conceptually, than its mechanical complexity might otherwise suggest;

• to examine the development of the Canadian foreign affiliate system and, in that regard, to consider the fiscal policy choices, relative to applicable international tax principles, that the Canadian system reflects;[12] and

• to comment on how the combination of what is loosely referred to as the "globalization" of economic and commercial activity and a rethinking of the adequacy and primacy of certain international tax norms relative to the way in which integrated corporate groups organize their operations may, to a limited extent, provoke an evaluation of the consistency of certain aspects of the Canadian foreign affiliate rules with the principles that they are meant to reflect.

The International Context

Canada is not alone in conducting a re-evaluation of the manner in which income from foreign direct investment should be taxed. As the OECD has observed,

> The removal of non-tax barriers . . . to international capital flows and the globalisation of financial markets, has focused attention on the effect of taxation on foreign direct investment. Governments and

[11] Continued . . .
ments also seem to anticipate developments in the United States. The willingness of the United States to acknowledge the possible relative desirability of such a system in preference to that country's complex and byzantine system for identifying, describing, and taxing foreign income earned indirectly by US taxpayers is notable (see Department of the Treasury, supra footnote 7, generally, and also in particular chapter 3A, at 41-46, and "Conclusion"). For a discussion of the relative merits of residence-based (that is, worldwide) and source-based taxation, see Donald J.S. Brean, "Here or There? The Source and Residence Principles of International Taxation," in Richard M. Bird and Jack M. Mintz, eds., *Taxation to 2000 and Beyond*, Canadian Tax Paper no. 93 (Toronto: Canadian Tax Foundation, 1992), 303-33, in particular, at 313-30 and the comments by Brian J. Arnold at 337-42. Arnold expresses the view (ibid. and supra footnote 8, in particular at 70 and following) that in principle there need to be compelling reasons to depart from a worldwide basis of taxation. It may be that a delineation of those issues unique to the foreign affiliate system, as such, distinguished from associated issues of more broadly based concern in relation to the system of the Act, would at least make the relative desirability of a worldwide versus a territorial system more problematic. See also the later discussion under the headings "The Canadian System in Historical and Policy Perspective," "Evolving International Policy Consideration," and "Points To Consider."

[12] In this paper, we accept the legitimacy of a corporate level tax. We do not question or evaluate issues of corporate tax incidence, or aspects of tax neutrality (financial neutrality) associated with the relative effects of capitalizing corporations with equity or debt and with, inter alia, theories of investor preference for dividends versus capital gains and equity-based yields versus interest. However, it should be noted that these issues are formidable aspects of a proper study of international capital flows in relation to the taxation of integrated multinational corporate groups: see OECD, supra footnote 9, at chapter 2. This paper is also confined to examining the application of the foreign affiliate system principally to corporate income; trusts are addressed only incidentally.

> others are concerned about how taxation may influence inward and outward direct investment flows and the ways in which these investments are financed. They are also concerned with the ways in which the revenues from international transactions are shared between countries and the new avenues opened up by globalisation for the avoidance of tax. These factors suggest that governments may need to re-evaluate the traditional criteria used to assess domestic tax policies. An examination of these issues requires an analysis of not only the domestic tax regimes but also how these regimes interact in the context of existing international arrangements.[13]

Thematically, the present international preoccupation with taxing foreign income may be expressed in several ways, including transfer-pricing regulation, the operation of regimes to tax income from foreign direct investment, and the adequacy of conventional tax treaty provisions to ensure a "fair" allocation of tax between legitimate jurisdictional claimants.[14] What is common among all approaches, however, is a strongly expressed view internationally that tax issues, and the effectiveness of fiscal regimes and conventional fiscal principles underlying them, must be reviewed because of the implications of what is loosely described as "globalization."[15]

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[13] Supra footnote 9, at 175-76. The kinds of fiscal concerns raised in the present context find different expressions in the ongoing debate about transfer pricing and also about the adequacy of bilateral tax treaties to apportion tax satisfactorily among jurisdictional claimants in the face of generalized and increasing international economic and commercial integration ("globalization"). In this regard, see Richard J. Vann, "A Model Tax Treaty for the Asian-Pacific Region? Part I" (March 1991), 45 *Bulletin for International Fiscal Documentation* 99-111 and "... Part II" (April 1991), 45 *Bulletin for International Fiscal Documentation* 151-63, for a provocative assessment of these aspects, together, of the international tax dilemma. This subject increasingly is an international preoccupation as income-earning operations become more mobile and less tied, functionally, to particular national jurisdictions that are still, in some sense, asserting fiscal jurisdiction largely on the basis of tangible or physical territorial connections or on the basis of residence.

[14] See OECD, supra footnote 9.

[15] Indeed, these are simply different ways of expressing the same basic jurisdictional issues and concerns facing national tax regimes; that is, how and on what basis can and should pre-eminent national tax claims be asserted in relation to economic and commercial activity of multinational corporate groups that is decreasingly nation-centric, within traditional fiscal limits, and employs relatively valuable factor inputs, whose location of exploitation is harder and harder to determine? These concerns are combined with the historically difficult question of why, in any event, the implications and effects of separate entity accounting (for members of integrated corporate groups), based on the virtually unquestioned hegemony of corporate group legal structures, should so fundamentally determine the income and consequential national tax liabilities of legally separate members of such integrated groups. For generally critical discussion in this area, see Robert L. Palmer, "Toward Unilateral Coherence in Determining Jurisdiction To Tax Income" (Winter 1989), 30 *Harvard International Law Journal* 1-64; Richard M. Bird, "Shaping a New International Tax Order" (July 1988), 42 *Bulletin for International Fiscal Documentation* 293-99; Richard E. Caves, *Multinational Enterprise and Economic Analysis* (Cambridge, Eng.: Cambridge University Press, 1982); Stanley I. Langbein, "Transfer Pricing and Economies of Integration," in *Transfer Pricing: The International Tax Concern of the '90s* (Englewood Cliffs, NJ: Prentice-Hall Law & Business, 1991); Richard M. Bird, *The Taxation of*

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Other jurisdictions, also, are re-evaluating their foreign affiliate rules. An important example from Canada's point of view is the United States. It is currently involved in the same exercise as that which the auditor general suggests is required urgently in Canada. In the United States, the review is proceeding from a fundamental reconsideration of the responsiveness of the existing system to domestic tax policy imperatives and of the norms typically associated with taxing international "outbound" investment income. Interestingly, there are suggestions[16] that a modified credit and exemption system such as Canada's might be preferable to the labyrinth of imputation, accrual, and credit rules that have their origin, ultimately, in subpart F of the US Internal Revenue Code.[17] We suggest that this *review* must also take place in Canada, in *view* of the particular design and function of the Canadian system.

The Auditor General's Report: An Opportunity

Many in Canada regret, at least for latent practical reasons, the attention devoted recently to the foreign affiliate system because of the report. They would argue vigorously (or at least hope) that the resulting focus on perceptions of the report, its implications, and the controversy that it has inspired should be permitted to narrow or blur into insignificance. This is not likely. A failure to accept the proposition, at least in principle, that there is a will, if not a need, in broad international terms and being acted upon in a number of countries, to re-examine the way in which foreign direct investment income is taxed would not be salutary for Canada's fiscal health. Indeed, neither would it be helpful to avoid the present opportunity to improve the quality of public discussion about the system.

The provocative and controversial circumstances in which the present debate so far has taken place may have directed attention away from the desirable possibility of conducting an effective, considered, impartial, and dispassionate evaluation of the foreign affiliate system.[18] Regrettably,

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[15] Continued . . .
International Income Flows: Issues and Approaches (Wellington, NZ: Victoria University Press for the Institute of Policy Studies, 1987); Richard M. Bird, "The Interjurisdictional Allocation of Income" (1986), vol. 3, no. 3 *Australian Tax Forum* 333-54; and A.J. Easson, *International Tax Reform and the Inter-Nation Allocation of Tax Revenue* (Wellington, NZ: Victoria University Press for the Institute of Policy Studies, 1991).

[16] See Department of the Treasury, supra footnote 7.

[17] Internal Revenue Code of 1986, as amended. Canada typically is not in a position to assert fiscal hegemony (or at least its own position, regardless of the interests or views of other jurisdictions) over the rest of the world. It is interesting to observe that in many areas the fiscal interest of the United States in improving the degree of its international tax integration coincides with its evolving status as a net capital importer rather than exporter.

[18] The report, supra footnote 3, and subsequent testimony of officials of the Department of Finance before the Public Accounts Committee of the House of Commons, supra footnote 6, make reference to the ongoing study in this area by the Department of Finance. Will the recent "popularization" and in some respects politicization of issues attributed to the adequacy of the foreign affiliate system imperil the perception of effectiveness of the results of any such study?

in particular, much of this debate has occurred apparently without the benefit of a firm, objective, basic grounding in and clear outline of what the system, as such, in fact is and is designed to be in the context of the Act's entire tax regime. Most notable is the absence, not only within the present debate but also more generally, of either a clearly focused consideration of the international fiscal policy norms to which systems such as this are to some degree responsive or an accessible evaluation of the development, and consequential fiscal policy significance, of the Canadian rules.

Yet constructive evaluation and criticism of the foreign affiliate system require an understanding of what, in principle, the rules are designed to achieve and what policy choices and limitations they reflect, inter alia, in order to facilitate, for the benefit of Canadian taxpayers, some degree of international tax coordination. The same is true with respect to attaining coherent and thoughtful interpretations of the foreign affiliate rules of sufficient consistency and quality to be able to inform their application in a predictable and, in basic policy terms, sensible way. It is at best premature to condemn the foreign affiliate system as such for facilitating, or worse encouraging, tax avoidance that is unacceptable in principle before considering whether the "avoidance" is attributable to deliberate structural limitations imposed on Canada's tax jurisdiction, which not only are consistent with similar limitations adopted by other countries and determined within commonly accepted international norms, but in any case are the result of considered policy "tradeoffs" made to advance Canada's economic welfare generally.

The Present Assessment

The overall significance of the kind of assessment attempted here cannot be overestimated. Designing tax systems to accommodate international commercial and economic pressures,[19] while preserving a measure of sovereignty over the determination and sustainability of the domestic tax base, is inherently difficult.[20] Indeed, it is probably impossible to formu-

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[19] See Donald J.S. Brean, Richard M. Bird, and Melvyn Krauss, *Taxation of International Portfolio Investment* (Ottawa: Centre for Trade Policy and Law, and Institute for Research on Public Policy, 1991). In chapter 1, the authors consider these influences generally; it is interesting to note their observation (at 3) that the balance between "portfolio" and "direct" outbound investments by Canadians is shifting in favour of the latter.

[20] For a discussion of the basic fiscal policy dynamics, see Bird, "Shaping a New International Tax Order," supra footnote 15. See also papers by Richard M. Bird, Lawrence H. Summers, Klaus Vogel, Stanford G. Ross, Arnold H. Weiss and Ferenc E. Molnar, and Herbert Stein, in *Tax Policy in the Twenty-First Century,* supra footnote 11. See also OECD, supra footnote 9, in particular at 35: "In principle, most of the problems under discussion could be alleviated if all countries were to harmonize their corporate tax rules and tax rates. However, the premise of the discussion . . . is that national governments have different preferences regarding the design of their corporate tax systems and the level of tax rates on income from corporate capital. In this setting the challenge of international policy making is to suggest measures of international corporate tax coordination which will leave

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late domestic tax rules, unilaterally, that in any absolute, or perhaps even relative, sense are faithful to all of the fiscal precepts impinging on the policy choices that necessarily will be reflected in the rules adopted. As Richard Bird has commented,

> The fundamental aims in taxing international income flows are three: to allocate tax revenues between jurisdictions in a way recognized by each as fair . . . ; to neither encourage nor discourage international capital flows; and to enable countries, within reason, to impose the domestic tax system of their choice. The present international order does not succeed well at any of these objectives. It produces what all would accept as fair results only in exceptional circumstances (of equal flows between countries with similar tax systems) [a condition that also presumes relatively equivalent degrees of economic development]; it both discourages and especially encourages capital flows of various sorts, thus biasing the international allocation of capital and making the world a poorer place; and it inevitably undermines the viability of domestic tax systems.[21]

Given the likelihood that any rules for taxing foreign income will be unsatisfactory in some respect or will at least reflect difficult "tradeoffs"[22] among legitimate but competing policy principles, it is important to understand the significance of the rules in place in order to be able to evaluate how effectively they achieve the fiscal policy objectives set for them, particularly in the light of changing economic and commercial conditions that include enhanced mobility of capital.[23] Also, it seems

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[20] Continued . . .
national governments with as much room [to] manoeuvre as possible, while at the same time conforming with accepted norms of equity and efficiency in the field of tax policy. This is often a formidable challenge."

[21] Bird, "Shaping a New International Tax Order," supra footnote 15, at 298. See also Lanthier, supra footnote 3.

[22] See Vogel, supra footnote 11; Brean, supra footnote 11; and the comment by Arnold, supra footnote 11.

[23] Brean, Bird, and Krauss, supra footnote 19, comment on the conditions of policy development with respect to the taxation of international income. They emphasize the importance in this area of understanding as clearly as possible the significance of existing legislative arrangements in practical and theoretical terms, and the importance of considering the policy norms typically reflected in domestic law systems for taxing international income. While the following comments (ibid., at 98-99) are expressed in relation to "portfolio investment," they are equally applicable to foreign direct investment.

> The process [to develop appropriate tax policy] must begin with a clear understanding of the effects—at least in principle—of existing tax arrangements. Next, it is imperative to have a similarly clear idea of policy objectives with an understanding of the potential trade-offs among national objectives. . . .
>
> [I]t is not possible to design "better" international tax arrangements without an explicit account of the objective of policy. Further exploration of the aims of current Canadian policy is therefore in order, as is informed discussion of the validity and acceptability of those aims. In particular, both the "neutrality" and "equity" aspects of international taxation require further consideration—the former because of the obvious incompatibility of capital-

(The footnote is continued on the next page.)

unlikely that these rules can be interpreted or applied coherently and consistently without a firm grasp of the premises underlying them. Indeed, a recent case before the Federal Court of Appeal indicates that the court is struggling with a contextual, rather than a literal, interpretation of the foreign affiliate rules to give content to concepts and statutory language whose significance is not evident merely from the words used.[24] It would be reasonable to anticipate that the retrial of the *Canada Trustco* case[25] may reflect a similar interpretative approach to evaluating the significance of "active business," a cornerstone of the foreign affiliate and FAPI systems, as a limitation on the application of those systems.

There is an obvious superficial attraction to adopting "bright line" tests that seemingly would or could have the effect of limiting the manipulation of the foreign affiliate rules in ways or with effects considered to be abusive, or at least of simplifying the delineation of the specific (or perhaps immediate) cases in which aspects of them are meant to apply. However, pursuing this route may be a mistake, and perhaps would reflect as inadequate a distinction between fiscal policy and practice as is evident in elements of the report and the various responses to it. What may be required is a dispassionate and clinical examination of the quality and application of these rules in the light of their underlying fiscal significance. It would be helpful, inter alia, to limit perceptions of these rules as a regime of arcane tax-avoidance calculus. The foreign affiliate system was designed to recognize the implications of the domestic Canadian tax system for the ability of Canadian enterprises to carry on activities in ways and places that would introduce Canadian and foreign tax as cost factors in commercial decisions. It was not, and is not, intended as a mechanical regime that is the Holy Grail of tax avoidance.

It will be the conclusion of this paper that the basic architecture, in policy terms, of how the Canadian tax system applies in relation to income from foreign direct investment in principle may be much more sound than the report seems to suggest.[26] Canada, in effect, acknowledges the desirable primacy of a territorial system for taxing income from foreign direct investment as long as the affected income is generated by activities;

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[23] Continued ...

> export neutrality and national welfare maximization and the latter because of the lack of any clear standards for inter-country sharing.
>
> Secondly, even if the objectives of national policy are more clearly specified, the objectives are not easy to attain in the presence of widely varying foreign tax systems.

See also Arnold, supra footnote 8, at 52 and following.

[24] See the reasons of the Federal Court of Appeal in *The Queen v. Old HW-GW Ltd.*, [1993] 1 CTC 363.

[25] *Canada Trustco Mortgage Co. v. MNR*, [1991] 2 CTC 2728 (TCC), being appealed by way of trial de novo.

[26] See Vogel, supra footnote 11; Department of the Treasury, supra footnote 7; and the later discussion under the headings "The Canadian System in Historical and Policy Perspective," "Evolving International Policy Considerations," and "Points To Consider."

generally outside Canada, that are genuinely "productive" in the national economic and commercial contexts in which they occur, in relation to local enterprises. Canada also addresses the need for limits on territorial primacy for highly mobile income whose connections to any particular jurisdiction are tenuous, and in respect of which there are no compelling reasons to cede or defer tax jurisdiction.[27] Indeed, the implicit balance between competing notions of efficiency reflected in the manner in which the foreign affiliate rules recognize the extent to which foreign income may have borne tax, or at least have been subject to a prior source jurisdiction claim to tax, seems to be attractive to at least one jurisdiction seeking to rationalize the complexity of its foreign affiliate system.[28]

Confining the Implications of the Report: What Are the Fundamental Foreign Affiliate Issues?

The implications of the report for the integrity, in principle, of the foreign affiliate rules, as such, in the Act are rather limited and perhaps not very profound. If there is a constructive criticism of the responses to the report to date, it is that they fail to identify the main sense of the report's assessment of the foreign affiliate system in the light of the auditor general's function and stated concern about the taxation of foreign income. They also do not carefully distinguish between those criticisms that are unique to the foreign affiliate system and those that are generally applicable to fundamental aspects of the Canadian income tax system, the implications of which simply are more dramatically evident when examined in the context of foreign direct investment.

It is the function of the auditor general, generally, to examine and evaluate the financial accounts and operations of the government to determine whether public resources are managed and deployed responsibly; in the fiscal context, this includes an assessment of whether and to what extent there are systemic or practical deficiencies in the tax system that impair revenue collection.[29] The consideration by the auditor general of the foreign affiliate rules is couched in terms of a broad, and broadly stated, concern about impermissible (abusive) tax avoidance by Canadian corporations and related foreign corporate groups. It would be incorrect, however, to interpret or accept the significance of this aspect of the report to be, or to require or justify, a wholesale assault on the architecture of the foreign affiliate system. Yet, the response of the Department of Finance to the report and the investigation conducted by the Standing Committee of the House of Commons on Public Accounts have not been entirely helpful in disentangling

- concerns about tax avoidance generally, for which the foreign affiliate system is merely an immediate context, from concerns about the

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[27] That is, FAPI.

[28] See Department of the Treasury, supra footnote 7.

[29] Auditor General Act, RSC 1985, c. A-17, as amended, notably sections 5, 6, 7, 8, 9, and 12.

systemic adequacy of the income tax rules relating to foreign direct investment;

• concerns about the administration of the rules and their administrative feasibility, distinguished, again, from their adequacy in fiscal policy terms; and

• more generalized concerns about the functional and fiscal policy adequacy of the Canadian income tax system to identify and tax economic income earned within an integrated corporate group but, through the separate accounting convention adopted for determining corporate tax liabilities, attributed to particular and legally separate members of such a group.

With the assistance of a number of examples held out, ostensibly, as evidence of abusive manipulation of the system or examples of structural deficiencies in the system that engender, if not encourage, corporate group arrangements that materially limit the actual taxation of income of Canadian residents, the auditor general criticized

1) the absence of tax rules that would, in effect, limit the deductibility of interest on money borrowed to invest in a foreign affiliate to income of the borrower from the investment;

2) the absence of limitations on the system of integrating corporate and shareholder taxation that would confine tax relief, in effect, to corporate income taxed domestically;

3) transactions designed to "manufacture" foreign income ultimately not taxed under existing tax rules (including transactions designed to convert ultimately taxable amounts into amounts of a character protected from taxation and to shift foreign losses effectively to Canadian members of an integrated corporate group); and

4) intrinsic limitations on the effective application of rules designed to impute passive income to certain Canadian shareholders of closely held foreign corporations, because of the absence of "bright line" rules to delimit "active" and "passive" income.

Of those concerns, arguably only the second and fourth are in some sense unique to the design of the foreign affiliate system. In fact, they represent the key policy issues for a foreign affiliate system.

The Act does not generally confine the deductibility of interest in computing income strictly to the periodic income that is actually reported by a borrower from the use of borrowed funds and against which the interest expense would be offset. There is no generally applicable "restricted interest" expense rule,[30] nor does the Act permit the consolidated

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[30] As is well known, this was proposed in the November 12, 1981 budget but abandoned after much controversy. The present proposals (Canada, Department of Finance, Draft Legislation To Amend the Income Tax Act and Related Statutes, December 20, 1991) to amend the rules in the Act relating to interest deductibility contain some such limitations, but not of general application.

reporting of income by integrated corporate groups.[31] These aspects of the Canadian tax system may result in the mismatching of revenue and expenses in certain cases, and in any event may impose more fundamental limitations on the effectiveness of the Act to tax economic income of Canadian taxpayers. They are not, however, unique to the manner in which foreign affiliate investments are financed.[32] It may be that the effects of these limitations are more clearly evident or stark in this context, but this does not, in itself, reflect a structural deficiency of the foreign affiliate system.

The adoption by corporate groups of functional consolidation strategies to shift income and expense or to recharacterize income also is not unique to the foreign affiliate system.[33] Indeed, in specific contexts, the foreign affiliate system expressly offers this opportunity.[34] If there is a concern, it is, as in the case of criticisms in this context of the interest deductibility regime, that the income generated by foreign affiliates (that is, active income) in many cases is never taxable by Canada; therefore, it is sometimes argued, Canadian members of a corporate group (and their Canadian shareholders) should not have the benefit of tax consequences that may be considered to be consistent only with such taxation.

In relation to the foreign affiliate system, the proper focus should be on whether and to what extent Canada will forgo taxing income earned by foreign affiliates (in effect, to recognize source jurisdictions' primacy to tax) and, as a corollary, whether and to what extent "credit" in a general sense will be extended for foreign underlying tax imposed upon income

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[31] Interestingly, in the context principally of section 245 of the Act (the general anti-avoidance rule [GAAR]), Revenue Canada expressed considerable tolerance of otherwise unnatural transactions and arrangements within controlled corporate groups to achieve functional consolidation for tax purposes. This position is notable in relation to the concern expressed in the report about shifting income and expense, and other financial manipulations within an international group. See *Information Circular* 88-2, "General Anti-Avoidance Rule: Section 245 of the Income Tax Act," October 21, 1988 (with supplement I, July 13, 1990), as well as *Income Tax Ruling* ATR-44, "Utilization of Deductions and Credits Within a Related Corporate Group," February 17, 1992. It might be argued that as long as the basic exemption criteria are satisfied in respect of the original generation of income (in a particular jurisdiction), corporate groups should not be limited in the form that they cause that income to take as it is used outside Canada within a consolidated group. (In this context, consider paragraph 95(2)(a) of the Act and regulation 5907(2)(j).)

[32] See Tim Edgar and Brain J. Arnold, "Reflections on the Submission of the CBA-CICA Joint Committee on Taxation Concerning the Deductibility of Interest" (1990), vol. 38, no. 4 *Canadian Tax Journal* 847-85, and more generally Brian J. Arnold and Tim Edgar, "The Draft Legislation on Interest Deductibility: A Technical and Policy Analysis" (1992), vol. 40, no. 2 *Canadian Tax Journal* 267-303.

[33] See supra footnote 31.

[34] See regulations 5907(1.1) to (1.3). These provisions recognize, for purposes of the Act, corporate tax consolidation regimes of other countries and allow their limited application for purposes of the foreign affiliate system. See also Nathan Boidman, "Review and Analysis of Revisions to the Foreign Affiliate Regulations To Accommodate Consolidated Tax Returns or Group Relief Including Provisions for 'Deductible Losses' and FAPI," in International Fiscal Association, *Special Seminar on International Tax Developments: A Canadian Perspective* (Don Mills, Ont.: De Boo, 1986), 44-66.

earned by foreign affiliates. These are the questions to which the foreign affiliate rules in the Act are and are intended to be responsive;[35] an evaluation of the foreign affiliate system as such should be confined to them. Although they are, in some respects, related to the kinds of technical interest deductibility and tax-avoidance issues referred to above, the tax policy imperatives meant to be served by and reflected in the foreign affiliate system must, for a coherent analysis of the system as such, be kept separate from more systemic considerations, generally, with respect to the Act.[36] There is no presumption or necessary tax policy implication that these related concerns are attributable to either the design or the operational dynamics of the foreign affiliate system, or that the solution to these problems lies in refining that system.[37] It would be unfortunate if the concerns presented by these other issues, and in particular perhaps the kinds of tax avoidance that may properly (in policy and administrative terms) deserve critical and severe scrutiny directly attributable to the manipulation of tax principles directly associated with them, distorted the debate concerning the foreign affiliate system to its ultimate detriment.

The Canadian System for Taxing International Income

The Act encompasses two distinct, but in many respects similar, regimes for taxing international income. One applies to investments by non-residents in Canada; the other to outbound investments by Canadian residents. Each may be further subdivided into two basic subsystems dealing with active and passive investments.

Inbound Investment

A distinction is made between investments in Canada by non-residents that involve, in some sense, a direct expenditure of productive effort by them in Canada and consequently some direct control over the activities concerned, and those of a more passive or indirect sort. Income generated by the former kinds of activities is subject to tax principally under parts I and XIV of the Act. The use of capital in relation to Canada in a more passive way, commonly resulting in the payment out of Canada of what largely are passive amounts, such as interest, dividends, and royalties or royalty-like payments as well as management and administration charges,

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[35] See Vogel, supra footnote 11, and OECD, supra footnote 9.

[36] The report seems to suggest a different view. See also Edgar and Arnold, and Arnold and Edgar, supra footnote 32.

[37] See the later discussion under the headings "The Canadian System in Historical and Policy Perspective," "Evolving International Policy Considerations," and "Points To Consider." It should be noted that the scope of this paper does not permit an investigation of the relative merits of source and residence bases of taxation, except in the context of the foreign affiliate system and to the extent necessary in evaluating that system. See Brean (with the related comment by Arnold), supra footnote 11, for a considered discussion in this area.

is addressed by part XIII of the Act. Investments of this latter nature are commonly referred to as "portfolio" investments.[38]

Outbound Investment

A similar regime applies to investments made by Canadian residents outside Canada. Its principal limitations, as in the case of the system applicable to "inbound" investments by non-residents, are framed in terms of

- the taxpayer's structural or organizational nexus to the income-producing activity (including the extent of the taxpayer's economic interest in that activity where it is conducted through an intermediary),
- the nature of the income-earning activity and consequently of the income arising from it, and
- the manner in which foreign tax borne by the income will be recognized in determining liability for tax under the Act in respect of that income.

In summary, there are three principal income or income-earning divisions:

1) income from carrying on activities directly, to which the general rules in part I of the Act apply;

2) income from investments of a "portfolio" nature, addressed principally by the rules generally applicable in part I of the Act to investment income (apart from those that are in some respect part of the foreign affiliate system), as well as sections 94 and 94.1 of the Act and, in the case of investments in "foreign affiliates," section 91, which imputes to Canadian shareholders certain passive income of their "controlled foreign affiliates"[39] (that is, FAPI);[40] and

3) income that

a) arises in a context in which, by some measure, the Canadian resident has a substantial economic interest,[41] and

[38] See section 3050 of the Canadian Institute of Chartered Accountants, *CICA Handbook* (Toronto: CICA) (looseleaf), in particular, in section 3050.03, the definition of "portfolio investment": "long-term investments that are not investments in subsidiaries, joint ventures, or partnerships, of the reporting enterprise, nor investments in companies that are subject to significant influence by the reporting enterprise."

[39] Paragraph 95(1)(a).

[40] Paragraph 95(1)(b) and subsection 95(2).

[41] See the definitions of "foreign affiliate" and "controlled foreign affiliate" in paragraphs 95(1)(d) and (a), respectively, as well as supporting definitions of "equity percentage" and "direct equity percentage" in subsection 95(4). Presumably, the original policy determination is that a 10 percent interest in a foreign corporation constitutes an interest substantial enough, in economic terms, to warrant having the benefit of the foreign tax recognition extended by the foreign affiliate system. See the discussion of the Carter commission below.

b) is typically "active"[42] (although, as noted in point 2 above, a regime exists to impute passive income to certain shareholders of foreign corporations).

Income Earned Directly

Income earned directly by Canadian residents through productive effort by them in other jurisdictions is subject to tax currently according to the usual rules, principally in part I of the Act. Again, income generated in this way is, in principle, indistinguishable, according to the worldwide income basis of taxation underlying the Act, from any other income earned. Recognition is extended for foreign tax borne by such income, among other limitations, according to the kind of income affected (that is, "non-business," "passive," or "portfolio" income, in contrast to "business" income).[43] There are fewer limitations imposed on the recognition of foreign tax for business income, parallelling, in some respects conceptually, the design of the foreign affiliate system in respect of business income.

Income Earned Through Intermediaries

The deployment of capital, indirectly through intermediate vehicles or arrangements, is the subject of a second set of rules within the regime for taxing income from foreign activities of Canadian residents. Here, the Act distinguishes, again, between "portfolio" and "direct" investment. In principle, the character of "portfolio" investment is suggested by the common notion of investment itself.[44] That is, the investor has limited

[42] There are many technical difficulties with the interpretation and application of particular aspects of the foreign affiliate rules. But, notably with respect to the tax-avoidance concerns expressed in the report, the most fundamental issues revolve principally around their dependence on the distinction between "active" and other kinds of income for their "proper," in policy and systemic terms, interpretation and application. An acceptable definition of "active business" income in this area arguably can only be contextual, in relation to the objectives and underlying policy precepts of the system. As noted above in relation to the *Old HW-GW* case (supra footnote 24, with related commentary), there are indications that the Federal Court may be prepared to approach these rules in this way.

[43] Subsections 20(11) and (12), and section 126. See Robert Couzin, "The Foreign Tax Credit," in *Report of Proceedings of the Twenty-Eighth Tax Conference*, 1976 Conference Report (Toronto: Canadian Tax Foundation, 1977), 69-103. The principal limitations imposed on the availability of the foreign tax credit are type of income (business or non-business), type of tax (income and profits only), extent of related (with respect to the affected income) Canadian tax (here the limitation is more severe for foreign tax on non-business income), and source of income (foreign tax is creditable only in relation to income arising in the jurisdiction levying the affected tax). See Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD) (looseleaf), articles 23A and 23B and the related commentary. Canada's tax treaties typically set out the basis on which the contracting state is obliged to recognize tax imposed by the other state on income earned in it by a resident of the first state. The commentary contains a helpful discussion on how the extent of foreign tax credit may be limited and related policy considerations.

[44] See supra footnotes 38, 41, and 42 and the related discussion.

control over, and likely does not have a substantial interest in or influence in respect of, the income-generating activities. Income earned by Canadian residents, principally through minor investments in corporate shares (that is, shares of corporations that are not foreign affiliates of their shareholders) and in some cases trusts (or equivalent foreign creations), is included in income generally when distributions are made by the intermediate vehicle, although, as noted below, a surrogate for such distributions is in some cases imputed.[45] Recognition for foreign tax borne by the distributed income is extended through the same mechanism in the Act as applies to foreign income earned directly;[46] there is no recognition for foreign underlying tax of a corporate intermediary.

In contrast, income earned from foreign "direct" investments presupposes a substantial, and usually continuing, controlling (or at least substantial economic) interest by a Canadian investor in the intermediate arrangement that is directly conducting income-earning activities.[47] Through a statutory mechanism that is simple in concept, although technical in its implementation, foreign tax, or in some respects the primacy of a foreign nation to assert tax jurisdiction, is recognized according, in large measure, to whether the affected income is "passive" or "active." This is most evident in the case of corporate shareholders of foreign corporations. In the case of individuals, the same regime noted above applies with respect to distributions.[48] In the case of corporate shareholders (of foreign affiliates), such recognition is extended, in effect, through the system in the Act that integrates the taxation of corporations and their shareholders.[49] Separate, but similar and related, rules apply for foreign tax in respect of imputed FAPI.[50] The fundamental policy issues are whether to defer (subject to eventual but limited foreign tax credit) or, in effect, forgive taxation under the Act of income earned through and by a foreign intermediary, at least until it is distributed to individuals in Canada. Another

[45] For example, see section 94.1.

[46] See supra footnote 43.

[47] See supra footnotes 38 and 41 to 44 and the related discussion.

[48] See supra footnotes 43 and 45.

[49] Section 113. Again, the distinction between "active" and "passive" income reflected in a foreign corporate distribution is fundamental. These rules, and their significance, are discussed below under the heading "The Canadian System in Historical and Policy Perspective." See also supra footnotes 44 and 45: the basic design of the method for extending foreign tax credit here is similar to that adopted by section 126, in terms of territorial income limitations and the extent of the credit being restricted by the tax rate limitations of the Act. Examined in this way, not only does the foreign affiliate system appear to be more coherent, and in principle its details easier to comprehend, but the systemic consistency of the entire Act in dealing with international income from outbound investment becomes clearer and more manageable.

[50] Section 91, with section 113. FAPI is, essentially, portfolio income of a foreign corporation in which a Canadian resident, alone or with others (within the limits set out in paragraph 95(1)(a)) has a controlling interest; it is imputed, whether or not distributed, to such shareholders. See paragraph 95(1)(b) and subsection 95(2) for the basic FAPI definition.

way of expressing this is whether the "tax credit" should, in effect, extend to all foreign tax and, importantly, all foreign jurisdictions to tax whether or not tax at all or at rates equivalent to Canada's will have been exacted by the tax system applicable to the foreign intermediary.[51]

The Foreign Affiliate System Simpliciter

In its simplest terms, the foreign affiliate system is the methodology adopted in the Act to provide "international double tax relief to ensure that the competing tax claims of source and residence countries do not seriously hamper border-crossing investments,"[52] within limitations generally in the Act for integrating the taxation of corporate income for foreign direct investments. While overt harmonization or coordination of national tax regimes would be the ideal solution to many problems of taxing international income, this is unlikely.[53] Unilaterally, however, an effect of foreign affiliate regimes is to implement some degree of international tax coordination within limits acceptable in domestic fiscal policy terms.[54]

A Foreign Tax Recognition Regime

Fundamentally, and despite their intimidating mechanical complexity,[55] the foreign affiliate rules are nothing more than a regime for recognizing the prior tax claims of source jurisdictions in respect of income from foreign direct investment. Engrafted on this system is an anti-avoidance qualification designed to limit the circumstances in which Canadian tax on "passive" (principally "portfolio"-type) income may be avoided through the simple formal expedient of foreign incorporation.[56] It is an underlying premise of these rules, effectively, that Canadians will be conducting operations, indirectly, in jurisdictions that may, or may be expected to, tax resulting income, although neither in fact nor in principle is it necessary that tax at any rate be exacted. Notwithstanding this, however, it is likely that the relief extended by this system most likely (and perhaps properly) will be available (at least to cede Canadian tax completely) in cases principally where

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[51] See the discussion immediately following.

[52] OECD, supra footnote 9, at 271.

[53] See Vogel, supra footnote 11.

[54] See OECD, supra footnote 9, at 21; Department of the Treasury, supra footnote 7; and Bird, "Shaping a New International Tax Order," supra footnote 15. The comments of Vogel, supra footnote 11, concerning the relative desirability of worldwide and source-based tax regimes also should be noted.

[55] This is largely to ensure that FAPI is not created gratuitously by events or changes within an affected corporate group that have only organizational or structural significance or in any case are reflective of acceptable consolidated behaviour in a functional sense (see infra footnote 58).

[56] In principle, this is similar to the protection provided by part IV of the Act to the coherent operation of the domestic system for integrating the taxation of corporate income.

• operations are conducted in a jurisdiction that is a natural (and in some respects unique) location for such operations of the affected income-producing kind, and

• the operations actually are conducted there and are competitive, commercially, with similar operations of local enterprises in the same economic and commercial context.[57]

A necessary adjunct is the interaction of this system with that designed to integrate the taxation of corporations and their shareholders. Conceptually, the system is no more complicated than that.

The mechanical complexity of the foreign affiliate rules is in part an outgrowth, common to the international tax rules of many jurisdictions, of balancing domestic and foreign fiscal policy objectives in relation to competing, but frequently substantially different, tax systems of other jurisdictions. Another reason for the complexity is the need to include technical supporting rules that avoid distortions, from a Canadian point of view, that otherwise could be introduced by formal or economically incidental changes within an affected foreign group or to the extent of its ownership by particular owners, or because of certain aspects of its commercial arrangements, but which do not represent any fundamental change in its economic existence.[58] In some cases, technical simplicity and ease of administration are forsaken as well as, without a thoughtful understanding of their origins, apparent substantive and systemic coherence. Indeed, some objectives, in policy terms, necessarily are inconsistent or at least irreconcilable. The rules that have been adopted cannot be understood or applied without an understanding of the fiscal policy precepts underlying their formulation.

Basic Design Questions

The foreign affiliate rules in the Act (and rules of this character enacted by other jurisdictions) essentially respond to four questions:

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[57] See R.J. Dart and R.D. Brown, "Taxing International Income—A Canadian Perspective," International Tax Planning feature (1976), vol. 24, no. 2 *Canadian Tax Journal* 144-52, at 146 ("Policy Considerations on Foreign Dividend Exemption").

[58] For example, corporate reorganizations, changes in ownership patterns (either the identity of the owners or the specific representations of their capital ownership), and such events as foreign exchange translation gains without accompanying asset realizations or retirement of liabilities. See, for example, the various provisions of subsection 95(2) dealing principally with structural relationships of certain kinds of income in the context, in effect, of consolidated foreign groups when examined from the Canadian territorial perspective, corporate reorganizations, and currency factors. These rules are designed to preserve the basic intended effect of the foreign affiliate system without the introduction of gratuitous distortions that otherwise might be produced by events that, from the perspective of the Canadian tax system, do not result in the generation of economic income from a corporate group's perspective, or income of the sort that should be imputed to Canadian shareholders, either because of its connection with active circumstances or because it is, effectively, "phantom." Aspects of part LIX of the regulations have similar significance: for example, regulation 5901(2) (to allocate current-year earnings distributions), regulation 5904 (to define shareholder interests), and regulation 5905 (to accommodate reorganizations and changing shareholder interests, inter alia, in certain cases).

1) In what circumstances, to what extent, and for what reasons (reflected in the legislative concepts adopted) should Canadian taxation of income earned indirectly through foreign intermediaries be deferred?[59]

2) In what circumstances and to what extent should Canada extend relief—for example, in the form of a credit or deduction—for foreign tax borne by income earned indirectly through foreign intermediaries?

3) In part as a corollary of the second question, in what circumstances, to what extent, and for what reasons (reflected in the legislative concepts adopted) should Canadian taxation of income earned indirectly through foreign intermediaries be, and be expected to be, eliminated completely? (Effectively, "forgiveness" of or forbearance from Canadian tax is the ultimate foreign tax credit.)

4) In what circumstances and to what extent should the system of integrating the taxation of corporations and their shareholders apply to income earned indirectly through foreign intermediaries and not subject originally to Canadian tax at the foreign intermediary level?

To address these questions, it is necessary to consider the terms and development of the Canadian foreign affiliate system in the light of the international fiscal policy norms to which it seemingly must respond.

General System Constraints: International Norms

The foreign affiliate system reflects a delicate balance between conflicting policy goals that have been identified and championed by Canadian policy makers and their constituents. While the policy debate is sometimes couched in language specific to the international context, the usual tax policy considerations inform the discussion. The customary rivals—efficiency and equity—appear in the international context instead as "capital export neutrality" and "capital import neutrality" or, more recently, as "globalization" and "competitiveness." Other well-known con-

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[59] The notion of "deferral" is at the heart of the foreign affiliate system. The technical difficulties associated with a full accrual (that is, imputation) and credit system are considered, in practice, to be formidable.

> In short, the practice of deferral provides an incentive for multinational corporations to undertake foreign direct investment by retaining profits in subsidiaries operating in low-tax countries, in clear violation of capital export neutrality.
>
> Unfortunately, however, the abolition of deferral would involve a number of technical difficulties . . . . [R]esidence countries have so far been unwilling to abandon the practice of deferral except in cases where certain types of foreign direct investment is [sic] undertaken in certain tax haven countries.

OECD, supra footnote 9, at 177-78. See also ibid., at 33. The US Treasury study, supra footnote 7, suggests that the difficulties of abandoning deferral in favour of an accrual and credit or modified credit system may not be worth overcoming. This is an implication of Vogel's analysis also, supra footnote 11. See the discussion below under the headings "The Canadian System in Historical and Policy Perspective," "Evolving International Policy Considerations," and "Points To Consider."

tenders also are relevant: administrative feasibility, simplicity, and preservation of the tax base.

International factors, however, add a further dimension of complexity to the policy debate. In this realm, equitable considerations are not limited to the distribution of the tax burden but, significantly, encompass the distribution of tax revenues among countries. A country cannot simply alter the tax treatment of foreign source income to achieve domestic policy goals, without being mindful of the possible reaction of other countries. The task confronting each country is to implement rules that will expand the real income of its citizens in an equitable manner but are feasible in the face of global markets and accepted international norms.

The taxation of foreign source income earned by corporate residents abroad raises, additionally, a spectrum of policy issues not present in the domestic context. The most fundamental of these is whether foreign source income should be taxed at all. In other legal spheres, the corresponding issue would be resolved by reference to the international laws limiting extraterritoriality. In the taxation area, there are no international laws limiting the tax jurisdiction of a country, although practical considerations obviously restrict the ability to tax income with no connection to the home jurisdiction.

In practice, two jurisdictional rules are widely accepted. Under the source principle, a country asserts tax jurisdiction over all income originating within its territorial boundaries and the identity of the recipient is irrelevant. Under the residence principle, a country levies taxes on the worldwide income accruing to certain persons, generally domestic residents, regardless of the source of that income; thus, foreign source and domestic source income are both subject to tax. Generally, neither principle has predominated, largely because of the technical difficulties of attributing income to a single source and because countries are more concerned with the equitable tax treatment of their own residents than of recipients, whoever they might be, of domestic source income. Most countries assert tax jurisdiction on the basis of a combination of the source and residence principles and do, in some measure, tax the foreign source income of domestic residents. However, there are countries that tax exclusively on the basis of source and countries that tax only domestic source income.[60]

Assuming that the jurisdiction to tax extends to at least some forms of foreign source income, the next question is whether it extends to foreign source income earned by foreign affiliates. The response depends on domestic conceptions about the taxation of corporations. For example, if corporations are viewed as mere instruments of their shareholders, the residence principle suggests that the foreign source income earned by a foreign affiliate should be subject to domestic tax. If corporations are considered to be separate persons, the residence principle suggests that dividends paid to the domestic parent corporation, but not the income

[60] Arnold, supra footnote 8, at 65.

earned at the foreign affiliate level, should be subject to domestic tax. An intermediate position would acknowledge the separate legal identity of corporations but also recognize that some benefits accrue to shareholders as the foreign income accrues, and the jurisdiction to tax would fall somewhere between the two extremes described above.

Most nations would consider that they have a valid claim under the residence principle to levy taxes on some portion of the foreign source income earned by the foreign affiliates of domestic corporations. Yet most nations would also consider themselves perfectly entitled to tax income earned within their boundaries. It follows that the income earned by foreign affiliates will frequently be subject to the competing claims of the resident countries of the parent corporation and its foreign affiliate. Without some form of international agreement, the obvious result in many cases would be the international double taxation of income earned by foreign affiliates.

International Double Taxation

There are two reasons why most countries, including Canada, consider international double taxation to be undesirable. First, international double taxation causes taxpayers to bear the burden of competing jurisdictional claims. Although, in any particular instance of double taxation, the two jurisdictions preserve their respective tax bases, they do so at the expense of taxpayers who must pay two levels of tax for the privilege of engaging in cross-border transactions. Second, international double taxation imposes an extra layer of tax on cross-border activity relative to domestic investment and thus creates a disincentive for international investment. This extra burden of taxation raises an impediment to international capital flows, contributing to the inefficient allocation of resources and reducing global income.

Of course, every nation would prefer that international double taxation be eliminated by the withdrawal of the competing jurisdiction's claim to tax the same income. The alternative, which is unilaterally to disavow its own claim, is unattractive for obvious reasons. Accordingly, countries are generally willing to limit their jurisdictional claims only to the extent that other jurisdictions provide reciprocal tax relief. This explains why most developed nations have negotiated double taxation treaties with their primary trading and investment partners.

The spectre of double taxation limits policy choices. A unilateral change to increase domestic taxes on foreign source income could trigger retaliatory measures by the offending country's treaty partners. Retaliation could take the form of a similar increase in the foreign jurisdiction's domestic taxes on foreign source income, a general repudiation of the double taxation treaty, or the implementation of measures designed to increase domestic taxes on foreign affiliates operating in the foreign jurisdiction (to the extent feasible under non-discrimination principles). For these reasons, a country might be better off without the contemplated

increase in taxes on foreign source income. Countries must be particularly attuned to international norms when contemplating such changes.

International Norms: The "Neutralities"

International norms emanate from countries' conceptions about the role of corporate tax, as discussed above, judgments about the responsiveness of capital flows to tax changes, and the importance of capital mobility to domestic and global welfare, as well as concerns about domestic and inter-nation equity. These considerations are brought to bear on two questions: what income earned by foreign affiliates should be subject to domestic tax, and when should such income be taxed? Traditional economic analysis suggests two answers and, therefore, two policy frameworks, each reflecting a different emphasis and a different analysis of the considerations described in this paragraph.

Capital Export Neutrality

The first theoretical approach is referred to as capital export neutrality and is concerned with the efficient allocation of resources globally. Theoretically, an unequal tax burden on foreign source and domestic source income creates an impediment to the efficient allocation of resources. As a result, domestic residents may not allocate capital to productive foreign investments that bear tax at relatively higher rates than less productive domestic alternatives. Conversely, incentives for less productive foreign investment may be created by relatively low foreign taxes that are not "topped up" to the domestic level. Theoretically, therefore, global allocative efficiency is achieved when total foreign and domestic taxes on foreign source income are equal to domestic taxes on the same amount of domestic income.

Capital export neutrality would be advanced by the taxation of foreign source income on an accrual basis and by the implementation of a refundable foreign tax credit. Practically speaking, most countries would be reluctant to implement a refundable credit, since this would effectively amount to a transfer of tax revenues to foreign treasuries. A foreign jurisdiction could impose tax rates in excess of accepted international norms and yet benefit from the foreign investment supported by the refundable credits. A second-best alternative is the current taxation of foreign source income coupled with a non-refundable foreign tax credit. This alternative achieves capital export neutrality so long as the foreign rate of tax does not exceed the domestic rate.

An important objection to capital export neutrality is that it may not actually promote the efficient allocation of global resources. The maximization of world income ascribes the same importance to each dollar of income, independent of the nature of the recipient or the location in which it is earned.[61] If factors of production were all perfectly mobile,

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[61] See the discussion in Oswald H. Brownlee, *Taxing the Income from US Corporation Investments Abroad* (Washington, DC: American Enterprise Institute for Public Policy Research, 1979), 21.

the equal weighting of foreign and domestic source income would achieve allocative efficiency. However, once it is recognized that there are other impediments to the free flow of capital (commodities tax and other taxes, trade barriers, domestic regulations) and of labour (immigration policy, professional licensing requirements), it is less obvious that capital export neutrality would achieve the efficient allocation of resources.[62] That said, capital export neutrality has been widely accepted as a standard reference for policy formulation.

Capital Import Neutrality

The second policy paradigm is known as capital import neutrality and is concerned with the ability of foreign affiliates to compete in local markets. It requires that capital funds invested by foreign residents compete on equal terms in the capital-importing country.[63] This form of neutrality is achieved if the foreign affiliates of domestic residents are subject to the same rates of tax as their foreign counterparts.[64] The justification for capital import neutrality is that domestic taxation should not impede the ability of multinational corporations to compete abroad. The underlying assumption is that the international competitiveness of multinational corporations is beneficial, not just for those corporations, but for the domestic economy of the parent corporations as a whole.

Capital import neutrality is premised on the assumption that the foreign corporate entity is the appropriate point of reference; it does not take into account the benefits of lower total tax rates to domestic corporate shareholders of the foreign affiliate. It might be argued that this treatment of foreign affiliates is appropriate if the income earned by domestic subsidiaries is not taxed on an accrual basis to the parent and intercorporate dividends are free of tax. An American proponent of competitiveness had this in mind when he commented on the tax reform proposals being advocated in the United States in the mid-1970s:

> It is difficult to perceive how the tax reform proposal for the elimination of so-called "deferral" squares with the conventional equity standard that equally situated taxable entities should receive equal tax treatment. In the case of domestic U.S. companies, shareholders are not required to include in their incomes the undistributed profits of

[62] Sato and Bird, supra footnote 10, at 407, comment, "In an imperfectly competitive world, where national governments can establish artificial barriers or provide subsidies to influence the flow of resources to achieve national objectives, it is not possible to prescribe general criteria to achieve world efficiency in the allocation of resources."

[63] Ibid., at 408.

[64] Note, however, that if the foreign competitors are multinational companies based in a third jurisdiction, competitiveness supports the implementation of whatever type of system is used in their respective home jurisdictions—whether exemption, credit, or deduction—provided that, in the case of credits or deductions, their home jurisdictions levy tax at the domestic rate. That is, with respect to other multinationals, home jurisdiction multinationals will be operating at a competitive disadvantage only if and to the extent that they do not obtain benefits that are available to other multinationals.

> the corporations whose shares they own. The tax reform proposal to impose U.S. tax liability on a U.S. company with respect to its share of the earnings of its foreign subsidiaries in the year in which those earnings are realized rather than when they are distributed to the U.S. company clearly would differentiate tax treatment among U.S. corporations solely on the basis of their income-generating activity.[65]

Capital import neutrality would be achieved in its purest form by the exemption of foreign source income from domestic tax. An important benefit of a complete exemption from domestic tax is that there would be no disincentive for the repatriation of foreign profits. The competitiveness of foreign affiliates would also be advanced, to a lesser extent, by the deferral of domestic tax until such time as dividends are paid to domestic shareholders. While this would permit the home jurisdiction ultimately to collect revenues in respect of the foreign source income, the deferred tax would also discourage repatriation of foreign source income.

An objection to capital import neutrality is that it encourages investment in low-tax jurisdictions, even though the capital may have more productive uses elsewhere. Therefore, capital import neutrality may lead to an inefficient allocation of global resources. As well, capital import neutrality is expensive from the perspective of the domestic treasury (at least when considering the first order consequences) because the home jurisdiction forgoes taxes that would otherwise be collected if domestic rates exceeded foreign tax rates. Whatever its merits, capital import neutrality has also had a major impact on the structure of foreign affiliate systems.[66]

National Equity

A third policy paradigm also should be mentioned. It is referred to as "national equity"[67] and is concerned with the maximization of domestic welfare. Economic theory suggests that this goal will be achieved if capital is allocated so that the after-tax return on investment abroad is equal to the before-tax return on investment at home. This follows from the fact that only the after-tax dollars earned on foreign investments

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[65] Norman B. Ture, *Taxing Foreign Source Income: The Economic and Equity Issues*, Government Finance Brief no. 25 (New York: Tax Foundation, 1976), 7.

[66] A recent example is the Australian system. Apparently, the government initially did not propose an active business income exemption, but one was included after extensive lobbying by the Australian business community. See Roger Hamilton, "Australia's CFC Rules: The Active Income Exemption" (May-June 1991), 3 *The CCH Journal of Asian Pacific Taxation* 10-19, at 10.

[67] Peggy B. Musgrave, *United States Taxation of Foreign Investment Income: Issues and Arguments* (Cambridge, Mass.: Harvard Law School, 1969), 122; Peggy Brewer Richman, *Taxation of Foreign Investment Income: An Economic Analysis* (Baltimore: Johns Hopkins Press, 1963), 12; Joel Slemrod, "Competitive Advantage and the Optimal Tax Treatment of the Foreign-Source Income of Multinationals: The Case of the United States and Japan" (Spring 1991), 9 *The American Journal of Tax Policy* 113-43, at 116; and Brownlee, supra footnote 61, at 7.

contribute to national welfare, whereas both tax dollars and after-tax corporate profits benefit domestic residents. National equity would be achieved by allowing foreign taxes to be deducted, rather than credited, against domestic taxes.

A system designed to advance national equity would impose a heavier total foreign and domestic tax burden on foreign relative to domestic investment and thus would discourage foreign investment. In addition to the allocational inefficiencies that would be produced, such a system would violate recognized equitable principles based on the equal treatment of taxpayers in similar economic circumstances. Given the possibility of international retaliation, it is also not clear that a policy of national equity would truly be in a nation's interest.

Resolving Conflicts

Capital export and import neutrality are mutually exclusive if the tax rates and tax regimes of the home and source jurisdictions differ. If the tax rates are the same, and if earnings are included in taxable income at the same rate, capital export neutrality would call for a foreign tax credit that exactly offsets the full amount of domestic tax, and foreign source income would be effectively exempt from Canadian tax. If the foreign tax rate is less than the domestic rate, however, capital export neutrality would produce additional tax in the domestic jurisdiction, whereas capital import neutrality would require the foreign source income to be exempt from tax.

In the next section, it will be shown that the inherent conflict between capital export and capital import neutrality has had a significant impact on the historical development of the Canadian foreign affiliate system, just as it has had on the treatment of foreign source income by other jurisdictions. The tax structures of most capital-exporting countries reflect both principles in some respects. For example, one commentator has concluded, on the basis of a comparative analysis of the taxation by six countries of controlled foreign affiliates:

> Every country's tax system involves a balancing of the conflicting considerations of capital export neutrality and capital import neutrality. The line between these two objectives is drawn differently from country to country, but in no country is either objective pursued to the exclusion of the other. In fact, each country's policy regarding the taxation of controlled foreign corporations contains elements of both capital export and capital import neutrality. Accordingly, it can be characterized in terms of either.[68]

The conflict has resolved itself into different tax treatments of different categories of foreign affiliates, depending on the degree of ownership and the type of income. In general, capital export neutrality is employed where there is a concern about the use of foreign corporations to avoid

[68] Arnold, supra footnote 8, at 409.

domestic tax. For this reason, it is often applied to categories of capital that are highly mobile and responsive to tax changes. Capital import neutrality is typically reserved for authentic business activities undertaken by domestic residents abroad. It is generally assumed that foreign business activity is more likely than passive investments to generate tangible benefits for the domestic economy. Business investment capital is also considered to be less mobile and therefore less likely to be diverted from the domestic tax base.

In Canada, an uneasy balance seems to have been struck between the two objectives; and at various points in time, one or the other has found favour. The Department of Finance described the present resolution of this conflict in its response to the report.[69] After noting that "Canada has opted for a system that ensures capital export neutrality with respect to certain types of income and capital import neutrality with respect to other types of income," the department explained why particular kinds of income fall within each category. Essentially, the FAPI rules are designed to achieve capital export neutrality in respect of passive income earned by certain foreign affiliates. The rationale identified by the department is to ensure that investment income such as interest, dividends, and rent is not sheltered in tax-haven countries in order to defer the payment of Canadian tax. Conversely, active business income earned offshore is not accrued; and if it is earned in a treaty country, it may be repatriated on a tax-free basis. The department explained that, in respect of non-treaty countries, the system is intended as a proxy for the foreign tax credit to which the Canadian corporation would have been entitled if it had carried on business through a branch; and in respect of treaty countries, it is intended to remove any impediments to the repatriation of foreign earnings.

Following a discussion of the historical development of the Canadian rules in the section following, we will attempt to situate the current rules in the context of contemporary policy developments.

The Canadian System in Historical and Policy Perspective

Laying the Foundations: 1917-1971

The Income War Tax Act of 1917

When the somewhat distant ancestor of the Act was enacted as a temporary war measure in 1917, every "person"[70] residing or ordinarily resident in Canada, or carrying on any business in Canada, became taxable in

[69] Report, supra footnote 3, at 52.

[70] The word "person" was defined to include individuals, syndicates, trusts, associations, corporations, and legal representatives of persons: Income War Tax Act, SC 1917, c. 28 (herein referred to as "IWTA"), paragraph 2(d). Persons carrying on business in partnership, however, were taxable only in their individual capacities: IWTA subsection 4(3).

respect of its annual "income,"[71] subject to certain exemptions and deductions applicable in computing income or tax.[72]

While it was clear that non-residents were taxable only in respect of their Canadian source business income,[73] it was not certain—though it

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[71] The word "income" was defined in IWTA subsection 3(1) as follows: "For purposes of this Act, income means the *annual net profit or gain or gratuity*, whether ascertained and capable of computation as being wages, salary, or other fixed amount, or unascertained as being fees or emoluments, or as being profits from a trade or commercial or financial or other business or calling, *directly or indirectly received by a person from any office or employment, or from any profession or calling, or from any trade, manufacture or business*, as the case may be; *and shall include the interest, dividends or profits directly or indirectly received* from money at interest upon any security or without security, or from stocks, *or from any other investment*, and, whether such gains or profits are divided or distributed or not, *and also the annual profit or gain from any other source*; including the income from but not the value of property acquired by gift, bequest, devise or descent; and including the income but not the proceeds of life insurance policies paid upon the death of the person insured, or payments made or credited to the insured on life insurance endowment or annuity contracts upon the maturity of the term mentioned in the contract or upon the surrender of the contract [emphasis added]." Although "income" is no longer defined under the Act, the essential components of the concept were carried forward into other provisions of Canadian fiscal legislation, as amended, and remain largely unchanged.

[72] The income of the governor general and certain other persons, such as foreign consuls, certain Crown corporations, associations, benevolent societies, and insurance companies under certain circumstances, as well income from tax-exempt Canadian bonds or other securities and military or naval pay of persons on active service during (in the words of the IWTA) "the present war," was exempt: IWTA section 5. Deductions in computing income included a "reasonable allowance" at the discretion of the minister of finance in respect of depreciation or other expenditures of a capital nature, and for the depletion of mines and wells, but no deduction was specifically provided for with respect to interest expense: IWTA paragraph 3(1)(a). A deduction in computing income, once again at the discretion of the minister, in respect of "interest on borrowed capital used in the business to earn . . . income" was later added by SC 1923, c. 52, section 2.

The income of a corporation for the year exceeding $3,000 was taxed at a rate of 4 percent: IWTA subsection 4(2) and paragraphs 2(c) and 4(1)(a). Accordingly, and presumably to provide for a limited measure of relief from double taxation, dividends or other amounts received by an individual that were paid out of the net earnings of any company or other person that was taxable under the IWTA were deductible in computing the income of the individual for purposes of the "normal tax" (that is, 4 percent of income exceeding $1,500 in the case of unmarried persons and widows or widowers without dependent children, and exceeding $3,000 in the case of all other persons: IWTA paragraph 4(1)(a)) but not for purposes of the "supertax" (tax applicable in addition to the "normal tax" at progressive rates between 2 percent and 25 percent on income exceeding $6,000: IWTA paragraphs 4(1)(b) to (g)): IWTA paragraph 3(1)(d). In 1919, however, this deduction was converted into an exemption from the normal tax; its scope was restricted to dividends from a corporation that was taxable under the IWTA (as opposed to other amounts paid out of the net earnings of any person that was taxable under the IWTA): SC 1919, c. 55, section 2(2).

It should be noted, moreover, that anti-avoidance rules were applicable in respect of the reduction of the income of a corporation by virtue of the sale by it of its wares at a price below that "which might be obtained therefor" as well as the accumulation of undistributed income in amounts "in excess of what [was] reasonably required for the purposes of the business," inter alia, in a corporation, trust, partnership, or other body "for the purpose of evading the tax": IWTA subsections 3(2) and (4). Such amounts were included, respectively, in the income of the corporation and of the shareholders.

[73] IWTA subsection 3(3). Subsection 4(1) was amended by SC 1918, c. 25, section 3, to provide that non-residents who were employed in Canada would be subject to tax under the IWTA.

was implied by the use of the phrase "all income" in the charging provision—that residents were taxable in respect of their worldwide income, essentially, from all sources. The problem arising from the lack of clarity in this connection was compounded by the uncertainty surrounding the question whether or not taxpayers could obtain relief in respect of any foreign tax that was paid or payable on such income from sources in a foreign country.[74] Although the effects of these uncertainties were mitigated for certain taxpayers by an exemption from Canadian tax provided for in 1918 with respect to the income of what, basically, was a forerunner of the foreign business corporation,[75] only in 1919 was the definition of "income" amended to specify that the concept included amounts "whether derived from sources within Canada or elsewhere"[76] and a deduction in computing taxes otherwise payable under the IWTA (that is, a direct tax credit) provided for in respect of income taxes paid to certain countries on income derived directly from sources therein.[77] Such tax credits, however, were limited to the amount of tax otherwise payable under the IWTA in respect of income from a source in the foreign country.[78]

Thus, as early as in 1919, the basic principles of Canadian taxation in the domestic as well as the international context were given the funda-

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[74] Municipal and provincial taxes paid in the year, as well as federal income taxes paid in a previous year, have been held not to constitute expenses that are deductible in computing income for the year: *Roenisch v. MNR*, [1928-34] CTC 69 (Ex. Ct.); *McLeod v. MNR*, [1928-34] CTC 88 (Ex. Ct.); and *First Pioneer Petroleums Ltd. v. MNR*, [1974] CTC 108 (FCTD).

[75] The phrase "foreign business corporation" was actually first introduced into Canadian fiscal legislation by the Income Tax Act, SC 1948, c. 52 (herein referred to "ITA 1948"), section 64. Under the 1918 amendments to the IWTA, an exemption was provided for in respect of the income of "incorporated companies whose business and assets [were] carried on and situate entirely outside of Canada": SC 1918, c. 25, section 4. These corporations came to be known as "the 4(k) corporations." Nevertheless, in this paper we will refer to corporations qualifying for this exemption as "foreign business corporations." The scope of this concept was thereafter progressively narrowed over time, and no new foreign business corporations could be created after 1959. Subsequently, the grandfathered status of foreign business corporations was greatly affected by the 1971 tax reform. As an aside, there is an interesting similarity in certain respects between the foreign business corporation and the international shipping corporation. See subsection 250(6) of the Act, as enacted by SC 1991, c. 49, section 194. Like the former foreign business corporation, provided that certain conditions are met, an international shipping corporation can be managed and controlled from a place in Canada without being subject to tax as a resident corporation. Similar treatment is also extended to international banking centres. These, however, are branches of a resident taxpayer, located in Montreal or Vancouver, out of which international banking activities are carried on. See section 33.1 of the Act, added by SC 1987, c. 46, section 10.

[76] SC 1919, c. 55, section 2(1).

[77] A deduction in computing taxes otherwise payable under the IWTA was provided for in respect of income taxes paid to Great Britain or any of its self-governing colonies or dependencies on income from sources therein. Income taxes paid to any other foreign country in respect of income from sources therein were deductible only if the foreign country allowed a similar "credit" to persons in respect of income derived from sources within Canada. SC 1919, c. 55, section 3(3).

[78] Ibid.

mental structure that they continue to display. Residents were taxable on their worldwide income for the year from all sources, subject to certain deductions and exemptions, as well as a credit (limited to the amount of Canadian tax otherwise payable) in respect of income taxes paid to certain foreign countries on income from sources therein. However, aside from the limited exemptions in connection with the income of a foreign business corporation and dividends received by or credited to shareholders of a corporation that was taxable under the IWTA, as well as the foreign tax credit and certain anti-avoidance rules, there were no specific provisions at that time dealing with the taxation of foreign corporations and their shareholders. In particular, with the exceptions already noted, there were no specific provisions applicable to the taxation of dividends or other amounts received by a resident from a non-resident entity or from foreign operations and holdings. Generally, all amounts were lumped into the category of "income" and treated accordingly.

By 1926, however, certain important refinements had been introduced into the IWTA.[79] The exemption in respect of dividends from a share of a taxable corporation was restricted to corporate shareholders,[80] and rules were enacted for "personal" and "family" corporations.[81] The income of

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[79] In 1920, "dividends" were defined to include stock dividends: SC 1920, c. 49, section 1. Moreover, in 1924, the distribution in any form of the property of a company upon the winding up, discontinuance, or reorganization of its business was deemed to be a dividend to the extent that the company had on hand any undistributed income: SC 1924, c. 46, section 5. In 1926, rules were added with respect to certain ultra vires loans and advances by a corporation to, or appropriations by, its shareholders; distributions of undistributed income on hand by a corporation to its shareholders upon the reduction or redemption of certain classes of its capital stock; indirect distributions (that is, dividend stripping) occurring upon the transfer of shares of a corporation by a person to a controlled corporation followed by the payment of dividends by the first corporation to the latter and the use thereby of the proceeds thereof, inter alia, in payment to the transferor of the purchase price for the shares; and the capitalization of the undistributed income of a corporation by virtue of a "readjustment" of its capital stock in the course of a reorganization: SC 1926, c. 10, section 8. All of the foregoing events would thereafter, essentially, give rise to deemed dividends that were taxable in the hands of shareholders (except where dividends were actually paid to the controlled corporation in the course of a dividend-stripping transaction, in which case the dividends were deemed to have been paid to the transferor to the extent that the proceeds thereof were used by the controlled corporation, inter alia, in payment to the transferor of the purchase price for the acquired shares) and the undistributed income of the relevant corporations would accordingly, to that extent, be deemed to have been reduced: SC 1926, c. 10, section 9.

[80] SC 1926, c. 10, sections 2 and 3.

[81] A "personal corporation" was a corporation or joint stock company, whenever and wherever created, that was controlled, essentially, by or on behalf of a person who was resident in Canada, either alone or together with any member of his family, which derived one-quarter or more of its "gross revenue" (defined as the sum of the corporation's net profits from each source) from the ownership of or trading or dealing in securities or, inter alia, from rent, royalties, interest, dividends, or any interest in a trust or estate: IWTA paragraph 3(10)(a), as enacted by SC 1926, c. 10, section 3. As an aside, it should be noted that the language used in this provision actually spoke of a corporation controlled, essentially, by a "person *and his wife* or any member of his family" (emphasis added). Moreover, as originally enacted, these rules could apply both to passive investment income and to the

(The footnote is continued on the next page.)

a personal corporation was not taxable to the corporation but, rather, was deemed to have been distributed as a dividend to the shareholders thereof in proportion to the value of any property transferred or loaned to the corporation by each shareholder or by his predecessor in title.[82] The shareholders of a family corporation were permitted to elect that the corporation be treated as though it were a partnership, so that the income of the corporation would thereafter be taxable only in the hands of the shareholders in proportion to their respective interests therein.[83]

The Income War Tax Act of 1927

When the IWTA was re-enacted in 1927 by chapter 97 of the Revised Statutes of Canada, it featured a number of specific provisions applicable, generally, in the manner already described to the taxation of corporations and their shareholders. While certain provisions either were intended to address or, if not, could nevertheless apply to the taxation of a resident's income from a source in a foreign jurisdiction, in certain respects these provisions proved to be inadequate in dealing with issues that arose in the international context.[84]

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81 Continued . . .
income from an active business. Only after 1940 could the application of these rules be restricted if, in the opinion of the minister, the corporation carried on an "active commercial or industrial business": SC 1940-41, c. 34, section 6. The proviso thereby enacted to that effect was extended in 1942 to include corporations that carried on an active "financial" business: SC 1942-43, c. 28, section 2.

A "family corporation" was a corporation (other than a personal corporation) 75 percent of the shares of which were owned by the members of one family, one or more of whom took an active part in the business operations of the corporation, or 80 percent of the shares of which were owned by persons who were actively employed in the business of the corporation or by them and by members of their families: IWTA paragraph 4(7)(a), as enacted by SC 1926, c. 10, section 8.

82 IWTA paragraphs 3(10)(b) and (c), as enacted by SC 1926, c. 10, section 3. The relevant property was valued for these purposes at the time it was transferred or loaned to the corporation and an anti-avoidance rule was applicable to property acquired by one personal corporation from another: IWTA paragraphs 3(10)(d) and (e), as enacted by SC 1926, c. 10, section 3.

83 IWTA paragraph 4(7)(b), as enacted by SC 1926, c. 10, section 8.

84 The exemption provided for in respect of the income of a foreign business corporation and the foreign tax credit provided for in respect of income taxes paid to certain foreign countries were clearly intended to address certain issues that arose in connection with the taxation of a resident's income from a source in a foreign jurisdiction. Other provisions, like the rules in respect of a "personal corporation," may not have been aimed—at least not as their principal focus—at foreign source income, but it appears that they could nevertheless be applied in the international context. For example, the "personal corporation" rules could be applied to any corporation or joint stock company, "no matter when or where created," provided, essentially, that the corporation was controlled by Canadian resident members of a single family and at least one-quarter of its income was derived from lending money or from holding or carrying on a business of dealing in securities or certain other investments: Income War Tax Act, RSC 1927, c. 97 (herein referred to as "IWTA 1927"), paragraph 2(i). Accordingly, these rules could have been applied in an attempt to thwart efforts by Canadian residents to divert investment income into a non-resident-controlled

(The footnote is continued on the next page.)

As tax rates applicable in the various countries were rising and cross-border investments, as well as multinational activities, were increasing, double taxation became a prominent concern among taxpayers and their respective home jurisdictions. The relatively narrow provisions contained in the IWTA at that time could not adequately address this issue. A Canadian resident corporation with foreign and Canadian operations did not qualify for the exemption provided for in respect of the income of a foreign business corporation. Moreover, the foreign tax credit mechanism provided for under the IWTA was available only in respect of taxes imposed by certain countries (that is, Great Britain and other countries that provided for reciprocal treatment in respect of income from Canadian sources) on income derived directly from sources therein. While it would adequately account for withholding taxes, if any, imposed upon distributions to Canadian taxpayers, this mechanism was inept at providing relief in respect of any underlying foreign taxes imposed in the source jurisdiction.

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[84] Continued . . .
corporation. Indeed, for the unwary, such an effort could have had negative fiscal consequences to the extent that the income was derived from a source in a foreign jurisdiction that imposed any tax in respect thereof, since neither the non-resident corporation nor its Canadian shareholders would appear to have qualified for the foreign tax credit otherwise applicable had the source of income been held directly. However, these rules appear to have been relatively easy to avoid—essentially, by interposing a Canadian resident holding company between the non-resident corporation and the Canadian resident family members—provided that the structure was not thwarted on the basis that the resident holding company held the non-resident corporation "on behalf of" the resident family members or that the undistributed profits of the non-resident corporation were deemed to be taxable income of the Canadian holding company and, in turn, deemed to have been distributed by the Canadian holding company as dividends paid to the family members. Such a result could have occurred if the undistributed profits of the non-resident corporation were regarded as having been accumulated "for the purpose of evading the tax": IWTA 1927 section 13. Nevertheless, this result could have been avoided by using a non-resident discretionary trust, to which the foregoing provisions, and provisions analogous thereto, did not apply: IWTA 1927 section 11. Again, however, negative fiscal consequences could have resulted to the extent that the foreign source income of a non-resident corporation or trust was subjected to underlying foreign taxes, or withholding taxes imposed on distributions, that did not qualify for any foreign tax credit. Taxes imposed by certain foreign jurisdictions in respect of the income of a taxpayer from a source therein could be credited only against Canadian tax otherwise payable: IWTA 1927 section 8. Accordingly, given that a Canadian resident "personal corporation" was not taxable on its income (except, after 1934, to the extent that the same was deemed to have been distributed to a non-resident: SC 1934, c. 55, section 11), it appears that any withholding or other taxes paid by it in respect of distributions from a non-resident corporation would not have qualified. This situation was addressed in 1949 insofar as taxes paid by a personal corporation to a foreign corporation were concerned (for example, in respect of business income or dividends from sources therein), when the rules were amended such that, thereafter, any foreign income taxes paid by a "personal corporation" were deemed, for purposes of the direct foreign tax credit, to have been paid by its shareholders; but no relief in respect of any underlying foreign taxes paid, for example, by its non-resident subsidiary was thereby provided for: SC 1949, c. 25, section 30(1). Moreover, although the exemption in respect of the income of a foreign business corporation could apply to a "personal corporation," this gap in the system was filled by SC 1932-33, c. 14, section 2. Finally, although it appears that any withholding taxes imposed in respect of distributions from a non-resident trust to a resident taxable person would have qualified for the direct tax credit, no relief was provided for in respect of any underlying foreign taxes paid by the non-resident trust.

Curiously, although double taxation appears to be a matter of international (or at least bilateral) scope, Canada's early initiatives to address this area of the law were unilateral. Canada's first bilateral efforts in this area resulted in an exchange of notes between Canada and the United States in 1928.[85] Moreover, the understanding between the two countries incorporated into these notes was restricted to shipping profits, a matter already to an extent provided for unilaterally by Canada under the IWTA pursuant to an amendment enacted in 1926.[86] The first Canadian bilateral income tax convention was executed in 1935 between Canada and the United Kingdom.[87] It provided, essentially, for the exemption from income tax imposed in a contracting state of profits from the sale of goods

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[85] See Exchange of Notes Between Canada and the United States, dated August 2 and September 17, 1928, providing for relief from double income taxation on shipping profits. A similar Reciprocal Agreement Re Double Taxation of Shipping Profits was executed between Canada and the United Kingdom on May 8, 1930.

[86] IWTA 1927 paragraph 4(m), as added to the IWTA by SC 1926, c. 10, section 10, excluded the following items from income: "The income of a non-resident person or a non-resident corporation which consists exclusively of earnings derived from the operation of a ship or ships registered under the laws of a foreign country which grants an equivalent exemption to residents of Canada and to corporations organized in Canada." The language of this provision has been amended from time to time, but its substance has been preserved, as well as extended to cover income from the operation of aircraft, under the current Act: paragraph 81(1)(c). The Canadian note, supra footnote 85, made direct reference to paragraph 4(m), as follows: "Whereas it is provided by Section 4(m) of the Revised Statutes of Canada, 1927, Chapter 97, as amended [by SC 1928, c. 12, section 3], that the income of non-resident persons or corporations arising within Canada from the operation of ships owned and operated by such persons or corporations may be exempt from taxation within Canada if the country where any such person or corporation resides or is organized grants substantially an equivalent exemption in respect of the shipping business carried on therein by Canadian residents or Canadian corporations." The note further provided as follows:

> And whereas it is provided by Section 213(B)(8) of the United States Revenue Acts of 1921, 1924, and 1926, and Sections 212(B) and 231(B) of the Revenue Act of 1928, that the income of a non-resident alien or foreign corporation which consists exclusively of earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States shall be exempt from income tax,
>
> And whereas the respective governments of the United States of America and the Dominion of Canada through their accredited representatives have signified that they regard the respective exemptions provided for in the above referred to legislation as being equivalent within the meaning of the said sections,
>
> Now therefore be it known that. . . .

It was provided, moreover, that the agreement incorporated into the notes would be implemented by the respective countries with effect from 1921 and subsequent years.

[87] See Agreement Between Canada and the United Kingdom for Reciprocal Exemption of Certain Agency Profits from Income Tax, signed at Ottawa on October 3, 1935. This convention and the agreement between the two jurisdictions in respect of shipping profits were superseded by the more comprehensive Agreement Between Canada and the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at London on June 5, 1946.

through an agency in that state to a resident of the other contracting state.[88] This convention was followed by an agreement between Canada and the United States, executed in 1936.[89] This agreement provided, essentially, that dividends, interest, and other amounts derived directly by residents of each contracting state from a source in the other contracting state would be subject to tax in the source country at a maximum rate of only 5 percent (which was well within the limits applicable under the foreign tax credit in respect of Canadian tax otherwise payable).[90] Neither of these conventions, however, attempted to address issues arising in connection with any underlying foreign tax.

By 1938, the time had come to implement provisions designed to address these issues. The foreign business corporation rules were inadequate in this respect[91] and, to further complicate matters, their scope was restricted in 1936.[92] Accordingly, an exemption was introduced in respect of any dividends received, essentially, by a public corporation from a wholly owned non-resident subsidiary corporation, the profits of which were subject to income tax in a foreign jurisdiction that provided similar relief to companies incorporated therein in respect of any dividends

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88 Canada-UK convention, 1935, supra footnote 87, articles 1 and 2.

89 See Reciprocal Tax Convention Between Canada and the United States, signed at Washington, DC, on December 30, 1936. This agreement, but not the exchange of notes in respect of shipping profits, supra footnote 85, was replaced with the Convention and Protocol Between Canada and the United States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion in the Case of Income Taxes, signed at Washington, DC, on March 4, 1942, implemented with effect from January 1, 1941. (See article V with respect to shipping profits.) It should be noted that the 1936 convention was terminated unilaterally by Canada when it departed from the terms thereof by virtue of SC 1940-41, c. 18, sections 16 and 17, amending IWTA 1927 subsection 9B(2), with the effect of increasing the rate of withholding tax imposed upon non-residents, inter alia, in respect of dividends to 15 percent from 5 percent.

90 Canada-US convention, 1936, supra footnote 89, articles I(a) and (b). It should be noted that this limitation did not apply where a resident of a contracting state "engaged in trade or business in the taxing state [or had an] office or place of business therein."

91 Although a multinational's corporate structure could be arranged such that foreign operations would be carried on through a Canadian resident subsidiary corporation that could qualify for the exemption in respect of the income of a foreign business corporation, or carried on through a non-resident subsidiary corporation, in neither case would any dividends paid by the subsidiary be exempt in the hands of the parent, nor could any relief be obtained by it in respect of any underlying foreign tax paid by the subsidiary. Thus, corporations would be required to carry on their foreign activities through direct holdings (that is, branches) in order to qualify for relief in respect of taxes imposed by the host jurisdiction. Doing so, however, would preclude foreign business corporation treatment for corporations with Canadian operations; it would also subject income from foreign operations to Canadian tax and thus compromise the Canadian corporation's international competitiveness to the extent that taxes imposed upon other corporations doing business in a particular foreign jurisdiction were lower than Canadian taxes.

92 By virtue of SC 1936, c. 38, section 4, the exemption was limited to private corporations carrying on foreign business operations "of an industrial, mining, commercial, public utility or public service nature" and to corporations whose shares had been offered to the public or were listed on a Canadian or foreign stock exchange carrying on foreign business operations "of an investment or financial nature."

received from their subsidiary corporations carrying on business in Canada, provided that at least 75 percent of the combined capital of the group[93] was employed in foreign business operations.[94] Thus, foreign source business income derived by a wholly owned non-resident subsidiary in a

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[93] It should be noted that only the capital (that is, assets) of the public corporation and of its wholly owned subsidiary corporations appears to have been considered in determining whether or not this threshold was met. Thus, although the proportion of the group's capital considered to be employed outside Canada could be increased only by the assets so employed by a wholly owned subsidiary corporation, it appears that such proportion could be decreased by the value of any shares of a subsidiary that was not wholly owned. See infra footnote 94.

[94] IWTA 1927 paragraph 4(r), as enacted by SC 1938, c. 48, section 4, provided as follows:

> Dividends received, directly or through any other subsidiary company, by a company incorporated in Canada whose shares are held by the public, from a wholly owned (less directors' qualifying shares) subsidiary non-resident company, if the Minister is satisfied that at least seventy-five per centum of the combined capital of such Canadian company and all of its wholly owned subsidiary companies is employed directly or indirectly outside of Canada;
>
> Provided, however, that the exemption hereunder shall be allowed only if and to the the extent that the country in which the subsidiary company is carrying on business grants substantially similar relief to companies incorporated therein in respect of dividends received from subsidiary companies carrying on business in Canada;
>
> And provided further that the exemption allowed hereunder in any one fiscal period of such Canadian company shall be limited in the aggregate to an amount equal to the sum of the profits of the subsidiary company subject to income tax abroad in the fiscal period of and in the fiscal period next preceding the declaration of such dividend;
>
> And provided further that "capital" for the purposes of this paragraph means all assets owned or employed in the business of such Canadian company and all of its wholly owned subsidiary companies, other than all intercompany obligations between such companies and any good will.

The House of Commons appears to have adopted this measure without much debate. There was, however, the following exchange between certain of the members:

> Mr. Bennett [former prime minister]: What does the minister expect now under paragraph 8?
>
> Mr. Ilsley [minister of finance]: An exemption of a kind here in question has been requested for many years. It is intended to remove an obvious and severe burden of double taxation on Canadian companies which have been enterprising enough to extend their business activities into other countries to an extent that the foreign operations far exceed the Canadian business. At present Canadian parent corporations pay full double taxation on income received from their foreign subsidiaries. For example . . . .
>
> It might be further pointed out that a Canadian company doing business entirely abroad, with no operations in Canada, is entirely exempt from tax under section 4(k) of our act.
>
> Mr. Bennett: Exempt from tax in Canada?
>
> Mr. Ilsley: Yes. Also Canadian companies operating abroad through branch plants are allowed under the Canadian act a deduction on account of taxes paid in respect of its [sic] profits earned abroad.

(The footnote is continued on the next page.)

qualifying corporate group would not be taxable under the IWTA when distributed to the Canadian parent, unless it was not subject to income tax in the source jurisdiction or the latter did not provide for similar treatment in respect of its corporate taxpayers.

In certain circumstances, therefore, it became possible for qualifying Canadian multinational public corporations to obtain relief from double taxation, by way of an exemption mechanism, in respect of any foreign taxes imposed upon the foreign source business income of their wholly owned subsidiary corporations. Moreover, since the exemption was available in respect of the profits of a wholly owned subsidiary that were subject to income tax in a qualifying source jurisdiction regardless of the rate at which such tax was imposed, where the source jurisdiction imposed tax at a rate below the Canadian rate, this mechanism would result in a net reduction of the multinational's overall tax burden.

This exemption mechanism, however, was inapplicable, and consequently inadequate, in respect of any foreign taxes imposed upon the profits of a subsidiary from a source in a jurisdiction that did not provide for such similar relief, where the corporate group of which the subsidiary was a member did not employ at least 75 percent of its assets in foreign business operations, where the subsidiary was not wholly owned, or where the corporation that sought the exemption was not a public corporation. Accordingly, in 1944, a deduction from taxes otherwise payable under the IWTA and under the Excess Profits Tax Act, 1940 (that is, an indirect foreign tax credit) was provided for in respect of any dividends that did not otherwise qualify for the exemption received by any corpo-

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[94] Continued . . .

See Canada, House of Commons, *Debates*, June 24, 1938, 4228. Whereas some, like Mr. Bennett, with a certain degree of surprise, may have considered the Canadian system for reducing double taxation to be generous, others perceived inadequacies and inequities in the rules as they applied at that time to dividends from foreign corporations. There were others, moreover, who were prepared to go even further. Mr. Ilsley was asked the following question:

> Mr. McNiven: Would the minister explain why, in addition to a company being a wholly owned subsidiary, 75 percent of the combined capital must be employed in the foreign country? . . .
>
> Mr. Ilsley: We should lose too much money if we went as far as the United States goes. This is as far as we can afford to go . . . .
>
> Mr. McNiven: Do I gather from what the minister says that he appreciates the fact that this particular provision is a hardship upon certain companies which may be described, in the terms he himself has used, as sufficiently enterprising to invest some of their capital in other countries for the purposes I have named?
>
> Mr. Ilsley: I shall go no further than to say that taxation on these companies and their shareholders is heavy under the system.

Ibid., at 4229. Thus, although the government of the day appears to have been sensitive to the concerns expressed regarding what was, relative to the modern provision, a rather narrow measure, it seems to have felt constrained by the competing practical objective of preserving the integrity of the revenue base.

ration incorporated in Canada from a wholly owned non-resident subsidiary.[95] This indirect foreign tax credit operated such that the Canadian corporation, essentially, could deduct from its taxes otherwise payable an amount equal to the income or excess profits taxes paid to any foreign country by the subsidiary on its income out of which dividends (other than exempt dividends) were paid to the Canadian corporation.[96]

Thus, by 1944, provided that their subsidiaries were wholly owned, Canadian corporations could obtain relief in respect of foreign taxes paid by a subsidiary to any jurisdiction, by way of either an exemption or a credit mechanism, depending upon the existence of the circumstances described above. In 1947, moreover, the indirect tax credit was extended to apply to controlled non-resident subsidiary corporations (that is, where more than 50 percent of the capital stock of the subsidiary having full voting rights under all circumstances was held), as well as to second-tier non-resident subsidiaries controlled by a wholly owned non-resident holding corporation, provided that the latter derived at least 75 percent of its income from dividends paid to it by its controlled non-resident subsidiary corporations in the year in which the credit was sought to be obtained by the Canadian corporation.[97]

The Income Tax Act of 1948

When the IWTA was replaced with the Income Tax Act of 1948, the exemption mechanism was converted to a system that required the inclusion but permitted the complete deduction of qualifying dividends.[98]

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[95] IWTA 1927 subsection 8(2A), as enacted by SC 1944-45, c. 43, section 8(2), provided as follows: "A company incorporated in Canada may deduct from the aggregate of the taxes payable under this Act and *The Excess Profits Tax Act, 1940*, an amount equal to the income tax and excess profits tax deemed to have been paid to the United Kingdom of Great Britain and Northern Ireland, to any of His Majesty's self-governing dominions or dependencies or to any foreign country on the income out of which dividends (other than dividends that are not liable to taxation by virtue of paragraph (r) of section four of this Act) are paid to it by a subsidiary non-resident company (the capital stock of which, except directors' qualifying shares, is wholly owned by it), calculated in accordance with the following rules."

[96] Ibid. The reciprocity requirement restricting the direct foreign tax credit (that is, the deduction from tax provided for in respect of taxes imposed by a foreign jurisdiction on income from a branch operation or other direct source therein, such as dividends) applicable since 1919 also was eliminated: SC 1944-45, c. 43, section 6(1). This requirement was, however, retained with respect to the exemption mechanism.

[97] SC 1947, c. 63, sections 6(1) and (2), amending or adding, inter alia, IWTA 1927 subsections 8(2A), (2B), (2C), (2D), and (2E). It should be noted, moreover, that provisos were added limiting these indirect tax credit mechanisms, respectively, to an amount equal to the tax that would have been payable by the controlled non-resident subsidiary had it earned the income from a source in Canada and to the amount that would have been payable by the wholly owned non-resident holding corporation in respect of dividends received from its controlled non-resident subsidiary as income under the IWTA: ibid.

[98] ITA 1948 section 28. Nevertheless, we will continue to refer to this feature of the foreign affiliate system as the "exemption mechanism." It will be noted that with the

(The footnote is continued on the next page.)

Otherwise, this and other features of the system were not significantly amended, with certain exceptions. That is, whereas the exemption mechanism formerly applied only to a public corporation, it was extended to apply to any corporation resident in Canada.[99] Moreover, whereas the mechanism formerly applied only if and to the extent that "the country in which the subsidiary company [was] *carrying on business* grants substantially similar relief," it was rendered applicable if "the country where the subsidiary corporation *resides* grants substantially similar relief."[100] Accordingly, provided that the other conditions were met, any Canadian resident corporation could thereafter qualify for the exemption in respect of any of its foreign source income derived indirectly through a nonresident wholly owned subsidiary corporation, whether or not the subsidiary was carrying on a business rather than earning passive investment income. Finally, on the basis of this new language, since it was possible for a subsidiary to reside in a jurisdiction that provided similar relief, yet to derive its income from a source in another jurisdiction, subject to the conditions described above, it appears that any dividends paid by such a subsidiary would have qualified for the exemption even though the underlying income was derived from a source in a jurisdiction that did not provide for such similar relief.

In 1949, the requirement that 75 percent of the combined assets of the corporate group be outside Canada was eliminated. Similarly eliminated were the requirements that the profits of the subsidiary be subject to income tax in a foreign jurisdiction and that the subsidiary reside in a foreign jurisdiction that provided similar relief. The exemption was also extended to apply in respect of dividends received from controlled nonresident subsidiary corporations.[101] Thus, the scope of the exemption

[98] Continued . . .

enactment of ITA 1948, the name of the statute was amended to delete the word "War." Interestingly, it was proposed during a debate in the Senate, as early as 1938, that the Act should be named the "Income Tax Act":

> Hon. Mr. Calder: I have one suggestion to make. The War ended about twenty years ago. This Act still continues to be called an Act to amend the Income War Tax Act. I think when the next amending Bill comes before us we might take out the word "War."
>
> Hon. Mr. Dandurand: Yes; but the effect of the War still continues.

Canada, Senate, *Debates*, June 29, 1938, 568. Little did the senators know that yet another war would render the point moot.

[99] ITA 1948 section 28.

[100] Compare IWTA 1927 paragraph 4(r) and ITA 1948 subsection 28(2) (emphasis added).

[101] ITA 1948 paragraph 27(1)(d), as enacted by SC 1949 (2d sess.), c. 25, section 12, provided as follows:

> 27. (1) Where a corporation in a taxation year received a dividend from a corporation that . . .
>
> (d) was a non-resident subsidiary controlled corporation,
>
> an amount equal to the dividend . . . may be deducted from the income of that corporation for the year for the purpose of determining its taxable income.

mechanism was substantially expanded. Indeed, its scope was made broad enough to render unnecessary, in many cases, the indirect foreign tax credit mechanism, which was repealed.[102] In 1951, moreover, the exemption was extended once again to apply thereafter in respect of dividends received from any non-resident corporation, provided that more than 25 percent of its shares (having full voting rights under all circumstances) belonged to the receiving corporation.[103] Finally, and apparently to complete the circle, an exemption was provided for in respect of any dividends received from a foreign business corporation held to the same extent by the receiving corporation.[104]

The Income Tax Act of 1952

With the amendments described above, the foreign affiliate system came to rest for a period of approximately 20 years.[105] The features of the system were not changed with the enactment of the Income Tax Act of 1952, and they remained in place until this statute was amended in the 1970s. Accordingly, revenue officials, policy makers, academics, and practitioners, as well as their respective clients, were given ample opportunity to familiarize themselves with the system, to apply its provisions (even if, at times, aggressively), and to consider whether or not the system adequately responded to the concerns it was designed to address. And so they did.

Reform Proposals

The Carter Commission

The appointment of the Royal Commission on Taxation in 1962[106] marked an important turning point in the development of Canadian fiscal legislation. The commission was given a broad mandate, and it responded to that mandate by proposing an ambitious reform.[107] In general, the commission

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[102] SC 1949 (2d sess.), c. 25, section 18(1). The direct tax credit was retained as ITA 1948 subsection 38(1), re-enacted, with certain amendments, as subsections 41(1) and (1a) of the Income Tax Act, SC 1952, c. 29 (herein referred to as "ITA 1952").

[103] ITA 1948 paragraph 27(1)(d), as amended by SC 1951, c. 51, section 7(1) and later consolidated as paragraph 28(1)(d) of the ITA 1952.

[104] ITA 1948 paragraph 27(1)(e), as enacted by SC 1952, c. 29, section 8(1). It should be noted, moreover, that by then (indeed, as of 1948) a foreign business corporation otherwise carrying on entirely outside Canada its business operations of an industrial, mining, commercial, public utility, or public service nature would not lose its tax-exempt status by reason only of the fact that it kept its management and the designing, purchasing, and transportation of goods inside Canada: ITA 1948 subparagraph 64(2)(c)(i).

[105] In *MNR v. Trans-Canada Invest. Corp.*, [1955] CTC 275 (SCC), the holder of a trust certificate was held to be the beneficial owner of shares held by a trust and therefore entitled to the deduction under ITA 1948 paragraph 27(1)(a). See also *Forest Lawn Development Ltd. v. MNR* (1956), 14 Tax ABC 246.

[106] Herein referred to as "the commission" or "the Carter commission." See PC 1962-1334, September 25, 1962 (1962), vol. 96, no. 40 *Canada Gazette Part I* 3429.

[107] See Canada, *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966) (herein referred to as "the Carter report").

focused its attention on a perceived deficiency in the neutrality and equity prevailing under the existing legislation. In the international context, however, simplicity and other practical concerns, as well as competing policy objectives, were recognized by the commission as reasons to accept the introduction of a "purposeful deviation from tax neutrality."[108]

Accordingly, the commission was prepared to recommend that foreign income taxes paid by residents, not exceeding 30 percent of Canadian tax otherwise payable, should be recognized for Canadian tax purposes,[109] but felt that it was "necessary to eliminate the serious loopholes existing" in the system, which allowed "some Canadian residents to avoid paying full tax on their income by the utilization of companies in tax-haven countries."[110] Thus, the commission announced what is probably the most

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[108] Ibid., vol. 4, at 481. A substantial portion of the Carter report was devoted to this area of Canadian fiscal legislation: ibid., chapter 26, "International Aspects of Income Taxation." This chapter was introduced with the following passage (at 481):

> A major objective that we have sought in our proposals for the domestic tax system has been tax neutrality. A neutral tax system would contribute most to the efficient allocation of resources, and hence to the greatest output of the goods and services Canadians want, and is also a prerequisite of an equitable tax system.
>
> It will be evident by now that the economic and administrative realities of the practical world have forced us to accept compromises with true neutrality and equity in our domestic tax proposals. In our proposals for the taxation of international income we have had to make even greater concessions since here the administrative and economic problems appear in a more acute form. Not only are the problems of valuation and enforcement more difficult in the international area, but market imperfections are likely to be more important. Hence, purposeful deviation from tax neutrality under certain circumstances may become a necessity. In addition to the extreme complexity of the subject, the controversy that surrounds many of its fundamental principles and the lack of guiding evidence by which to settle those controversies militate against the adoption of simple, generally accepted solutions. In this area more is left to opinion and judgment, both because little is known with certainty of the consequences of adopting alternative policies, and because there are substantial differences of opinion as to the relative importance to be attached to the competing objectives. In the international sphere perfect tax neutrality is neither administratively feasible nor necessarily economically desirable.

Remarkably, these themes recur in the current debate surrounding the foreign affiliate system and will be explored below in greater detail. See also the discussion under the headings "General System Constraints: International Norms" and " Evolving International Policy Considerations."

[109] The commission rejected as inappropriate the introduction of both a system that provided credits in respect of foreign taxes in excess of the amount otherwise payable under the ITA and one that provided no credit at all: ibid., at 489 and 506.

[110] Ibid., at 485. The commission elaborated on this aspect of its concerns in the following manner: "The tax minimization possibilities of the exemption privilege, in combination with the use of foreign tax havens, have not gone unnoticed. The provision can be used to reduce Canadian tax on income generated in Canada for the benefit of Canadians. By establishing companies in jurisdictions which impose little or no tax, Canadians can reduce their Canadian tax by engaging in a series of paper transactions which exploit the provisions of tax treaties in combination with section 28(1)(d)." There was also some concern that Canada was being used by non-residents as a conduit jurisdiction: ibid., at 511.

striking of its recommendations, providing for the abrogation of the exemption mechanism then incarnated as paragraph 28(1)(d) of the ITA 1952.[111] In its place, the commission proposed that Canadian taxpayers be subject, essentially, to a "special tax" imposed on an annual accrual basis in respect of certain indirect foreign source earnings at a rate of 30 percent.[112] This tax, in addition to a proposed "withholding tax" imposed at a rate of 20 percent on distributions paid by a Canadian corporation to its shareholders out of foreign source earnings, would result, in most cases, in what the commission viewed as an appropriate overall tax burden.[113] Underlying taxes, if any, indirectly paid in respect of the foreign source earnings, as well as any foreign withholding taxes imposed directly upon distributions, would have been credited against the special tax.[114] (See the appendix to this paper.)

While it was conceded that the proposed special tax was arbitrary as to its rate of 30 percent (which fell somewhere between the rates customarily levied by high-tax and low-tax jurisdictions), it was envisaged as an improvement over the existing system, which in many cases permitted the tax-free patriation of earnings that may never have borne any foreign tax.[115] Moreover, while often dismissed as highly theoretical, the commission's recommendations in this area did address the practical problem of simplicity and commensurate administrative and compliance costs. To this end, the commission proposed that the computation of foreign source earnings for Canadian purposes be made in accordance with either foreign fiscal laws or audited financial statements, with as few changes thereto as possible.[116] Moreover, in respect of earnings derived from a source in either the United States or the United Kingdom (Canada's biggest trading partners at that time), the commission proposed that computations made for purposes of determining geographical source be accepted, in part, for Canadian purposes.[117]

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[111] Ibid., at 486.

[112] Ibid. The proposals of the commission were set forth in a manner that in certain respects was rather difficult to follow. Nevertheless, their essential features were summarized in the following passage (ibid., at 518): "[T]he substance of our proposal is to require that income taxes (foreign and Canadian) of at least 30 per cent be paid on income from a foreign direct investment from year to year as it accrues." The mechanics of this proposal involved the implementation of what the commission referred to as a "gross-up and credit" mechanism, coupled with a "special tax" that would have been applicable to earnings from a "foreign direct investment" in a jurisdiction that did not impose an income tax in respect thereof at a rate of at least 30 percent: ibid., at 516-20. See also the discussion under the headings "General System Constraints: International Norms" and "Evolving International Policy Considerations."

[113] The commission took the view that tax should be imposed, generally, at progressive rates not exceeding 50 percent on income and capital gains: ibid., vol. 1, at 19 and following.

[114] Ibid., vol. 4, 486-87.

[115] Ibid., at 489-91 and 512-15.

[116] Ibid., at 487.

[117] Ibid., at 489.

It is interesting, in addition, to consider briefly the commission's proposal regarding the nature and degree of a Canadian resident's stakeholdings required before its foreign source earnings would be subjected to the special tax. The commission recommended that an interest of 10 percent in the "foreign direct investment"[118] was the appropriate threshold in that it "would appear to be a reasonable dividing line between an investment which is not made for purposes of having a direct influence in the affairs of a company, and one which can carry with it some measure of control."[119] As an important gloss on these rules, the foreign source earnings of a subsidiary of a non-resident corporation that was subject to the rules would give rise to the special tax only if the non-resident corporation held a relevant interest of 50 percent or more in the subsidiary, either alone or together with other shareholders with which it was not dealing at arm's length.[120]

To the contemporary observer, one of the most interesting features of these recommendations was the absence of any distinction based upon the character of the foreign source earnings. Thus, active business income and passive investment income would have received the same treatment.[121] Moreover, although the commission distinguished between foreign jurisdictions that imposed tax at a rate of at least 30 percent in respect of earnings derived from a source in such jurisdictions and those that did not,

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[118] A "foreign direct investment" would have been defined as an interest of 10 percent or more in the voting power, earnings, or assets on the liquidation of a non-resident corporation, or in the value of an unincorporated foreign property or business, held by a Canadian resident or by an associated group thereof: ibid., at 486 and 515. The commission also proposed that the fiscal distinction between earnings derived indirectly through the medium of a non-resident corporation and those earned directly through a foreign branch be abolished so that foreign branch earnings could be taxed, for Canadian purposes, in the same way proposed in respect of the earnings of a non-resident subsidiary: ibid., at 486-87 and 509.

[119] Ibid., at 515. It was proposed, moreover, that taxpayers falling below the 10 percent threshold (that is, whose holdings would have been regarded as a "portfolio investment") be permitted to elect "foreign direct investment" treatment. Failing such an election, the Canadian taxpayer would be entitled to relief only in respect of any foreign withholding taxes imposed on distributions; that is, not in respect of any underlying foreign tax on the earnings: ibid., at 534. Interestingly, it was also proposed that a taxpayer that satisfied the 10 percent threshold but did not control the "foreign direct investment," either alone or together with non-arm's-length parties, could nevertheless elect "portfolio investment" treatment if reasonable efforts had been made to obtain the necessary corporate information and the taxpayer executed a declaration to the effect that it could not do so: ibid., at 528.

[120] Ibid., at 516.

[121] The commission had the following to say (ibid., at 521) in respect of building into its proposed system any features that attempted to draw such a distinction: "As a means of combating tax avoidance we examined the possibility of defining tax havens in order to apply special rules to income derived from those sources. Although we believe that such a definition is possible (perhaps by defining a genuine business operation), any test that essentially must rely on a business purpose rule would be difficult to administer." Accordingly, the commission did "not recommend the use of such a business purpose test or any other definition of a tax-haven operation at the present time": ibid. Rather, it proposed that all earnings from a "foreign direct investment," whatever their character, be subject to the special tax.

there was no proposed distinction based upon whether or not a foreign jurisdiction was one of Canada's treaty partners.[122] Indeed, the deficiencies of Canada's network of double taxation treaties were noted, and the commission recommended that steps be taken to expand this network as a means of addressing certain issues arising in the international context.[123]

The Carter report represented the first installment in a process spanning more than a decade, which culminated in the thoroughgoing reform of Canada's approach to the taxation of foreign source income. The report of the commission, however, did not represent the final word regarding the reform of Canadian fiscal legislation in respect of foreign source earnings. Indeed, while certain features of the current foreign affiliate system are identifiable in the Carterian system, it is obvious, even to the casual observer, that it would be inaccurate to say that the modern foreign affiliate system is modelled upon the commission's recommendations. Rather, there exists a closer link between the present foreign affiliate system and the proposals contained in the white paper on tax reform issued by the Department of Finance in 1969.[124]

The White Paper

The white paper reiterated much of the analysis underlying the recommendations of the Carter commission, inveighing against the diversion of income from both Canadian and foreign sources to tax havens and strongly suggesting that Canada's tax treaty network be expanded.[125] Moreover, like the Carter report, the white paper was premised on the view that Canada should, in principle, maintain a neutral stance regarding foreign investment by Canadian taxpayers; that is, that Canadian tax legislation should neither encourage nor discourage such investment.[126] In this context, recognizing the primacy of the territorial principle as it applies to the taxation of foreign source income, the white paper summarized quite neatly the distinction between providing for relief in respect of international double taxation by virtue of a tax credit mechanism and doing so by virtue of an exemption mechanism.[127] The authors felt that, in order to

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[122] Ibid., at 516-18.

[123] These issues included international double taxation, as well as tax sparing provided for in respect of developing countries. See, inter alia, ibid., at 513 and 532.

[124] The Honourable E.J. Benson, Minister of Finance, *Proposals for Tax Reform* (Ottawa: Queen's Printer, 1969) (herein referred to as "the white paper").

[125] Ibid., chapter 6 ("Taxing International Income"), at 71-79.

[126] Ibid., at 71-72, paragraphs 6.1, 6.2, and 6.8.

[127] The white paper characterized the operation and effect of the pre-1972 system, ibid., at 71, paragraph 6.2, in the following terms: "Canadian residents with foreign income obtain double taxation relief in either or both of two ways. The foreign tax credit provisions generally permit a dollar-for-dollar reduction of Canadian tax for income taxes imposed abroad. In addition, dividends received by Canadian corporations from subsidiaries and certain other affiliated companies abroad are exempt altogether from Canadian corporate tax." It is interesting to note that the authors did not state that qualifying dividends are

(The footnote is continued on the next page.)

make a choice between these two alternatives, it was necessary to determine, inter alia, who truly bears the burden of corporate tax—that is, as between a corporation's customers and its shareholders. In response to this question, however, the authors of the white paper concluded that there was no "right" answer, so that it was indeed difficult to choose between an exemption-based system, which appeared to favour competitiveness, and a credit-based system, which favoured neutrality.[128]

Nevertheless, in their proposals we begin to see the answer to this question adopted by the authors of the white paper, as well as the shape of the foreign affiliate system as we know it today. In brief, the white paper recommended the following:

1) *That the exemption mechanism be retained and that it be restricted to the repatriation of active business income earned in treaty countries.* The advantages of this revision of the scope of paragraph 28(1)(d) of the ITA 1952 were seen to include simplicity and competitiveness. When coupled with the proposed treatment of foreign source passive investment income, it would not encourage capital flight. The requirement that the Canadian corporation own at least 25 percent of the voting shares of the foreign corporation was retained.[129]

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[127] Continued . . .
altogether exempt from Canadian tax but, rather, that such amounts are "exempt altogether from Canadian *corporate tax*" (emphasis added). This is consistent with the understanding of the authors that, in one way or another, either when such amounts are in turn distributed to Canadian individual taxpayers or when the latter dispose of their shares, the foreign source income ultimately may enter the Canadian tax base and accordingly give rise to revenues for the Crown: ibid., at 73, paragraph 6.16. Moreover, with respect to such a disposition of shares, any gain would generate fiscal effects either as a disposition on capital account under the post-1971 system or, if the shares were held on income account, even under the pre-1972 system. See also, in this connection, the Carter report, supra footnote 107, vol. 4, at 489-90.

[128] The white paper includes the following passage in this connection (ibid., at 73, paragraph 6.14): "If the tax is passed on to the customers of the corporation, then the pricing and profit structure of the local corporations in a country likely contemplate the payment of the local corporation tax, and any additional corporate tax [that is, Canadian tax imposed to the extent of the difference in rates between the two jurisdictions] would place an international corporation at a competitive disadvantage. On the other hand, if the tax is borne by the shareholders of the corporation, there is no reason why shareholders of corporations with foreign operations should bear less corporate tax than shareholders of corporations which operate in the home country [that is, Canada]. Unfortunately, although the problem of the incidence of the corporate tax has been the subject of extensive research and analysis, the answer remains largely a matter of opinion." This question is of capital importance; yet the "right" answer in each particular case, it seems, will depend upon any number of variables, including the industrial sector and the geographical location in which the corporation operates, its relative market power, and similar matters, as well as upon who asks the question and what assumptions are made.

[129] Ibid., at 73, paragraph 6.15. The rationale adopted by the authors was articulated as follows (ibid., at 73, paragraph 6.16): "Where it applies, the exemption system would permit Canadian corporations to compete abroad without being at a fiscal disadvantage vis-à-vis their competitors, including the competing subsidiaries of European corporations [that is, corporations that, as the white paper relates, could benefit from similar systems

(The footnote is continued on the next page.)

2) *That the tax paid in respect of income whose source was not in a treaty jurisdiction be recognized under a credit-based system.* Under this proposal, credit would be allowed for foreign withholding tax paid on dividends, as well as foreign corporate tax imposed on the underlying business profits from which the dividend was paid.[130]

3) *That passive income earned by a controlled foreign corporation be taxed on a current basis under rules to be modelled upon those in the United States.* This suggested change would operate regardless of the timing of distributions and would address the twin perceived evils of avoidance and indefinite deferral (the payment of Canadian tax on non-exempt dividends, effectively, at the taxpayer's option—that is, only if it chose to repatriate the income). The items of income expressly identified for such treatment were dividends, interest, royalties, and transshipment profits. In a prophetic aside, the white paper observed that "[t]his proposal involves complicated and difficult law, but the problem is serious and defies easy solution."[131]

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129 Continued . . .
applicable in their respective home jurisdictions: paragraph 6.12]. It is obviously an easier system to comply with than the foreign tax-credit system, although corporations would have to show that their controlled foreign corporations do not run afoul of the passive income provisions. If it is slightly generous in some circumstances [that is, where foreign tax is imposed at a lower than Canadian rate or not imposed at all], it should not divert Canadian investment abroad; to do that it must compete with the system of credit for Canadian corporate tax. And, of course, Canadian personal tax would still be due when the profits are distributed to Canadian shareholders."

130 Ibid., at 74, paragraph 6.17. It should be noted, however, that the authors appreciated that even this credit-based mechanism would operate to reduce or eliminate Canadian tax on any dividends paid to a Canadian corporation to the extent that direct or underlying foreign tax was imposed in respect thereof.

131 Ibid., at 74, paragraph 6.21. The twin evils in question, as well as the appropriate response thereto, were perceived in the following terms (ibid., at 74, paragraphs 6.20 and 6.21):

> As noted above, the exemption privilege is susceptible to abuse. Not all foreign corporations carry on bona fide business operations. Some are merely devices of convenience to which income from other sources—dividends, interest, royalties and trans-shipment profits—may easily be diverted. The dividend exemption system would permit such income to be brought back to Canada tax-free. Even the tax-credit system would permit the Canadian tax on such income to be postponed indefinitely.
>
> To counter this type of tax-haven abuse, the United States now provides that when such income is channelled to a controlled foreign corporation, the U.S. controlling shareholders shall be taxed on a current basis whether or not the income is distributed to them. U.S. taxes are levied in the year in which the profits are earned rather than postponed until the profits are returned home. The government proposes to introduce provisions patterned generally on those in the United States.

Not everybody was satisfied, however, that the problem was serious. One critic argued that this proposal and the rules that it generated were the result of an overreaction on the part of the government; that they were far more complex, and therefore more costly, than could be justified by the projected $10 million per annum in tax revenues that they were expected to raise in their first six years of operation, particularly when that figure was compared with

(The footnote is continued on the next page.)

4) *That the general non-business direct foreign tax credit be limited to 15 percent.* This recommendation was designed, in part, to spur the white paper's objective of an expanding treaty network, which, inter alia, would conform to Canada's view that portfolio investment income flowing between treaty partners should not be taxed at a rate exceeding 15 percent of the gross amount of such income.[132]

5) *That the rules regarding the taxation of foreign branches of Canadian corporations be retained and, consequently, that no attempt be made to ensure tax neutrality between the earnings of foreign branches and those of foreign subsidiaries.* Rather, it was recommended that the direct foreign tax credit rules be amended to provide

a) for a carryover of unused business foreign tax credits, thus addressing the problem of mismatched timing inherent in the credit system; and

b) that taxes paid to political subdivisions of foreign countries be recognized on a reciprocal basis.[133]

6) *That shareholders, whether resident or not, of a Canadian corporation having foreign source income be allowed to credit against Canadian*

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[131] Continued . . .
the $9 billion annual budget of the day: H. Arnold Sherman, "How To Kill a Mouse with an Elephant Gun or Foreign Accrual Property Income: Some Problem Areas" (1972), vol. 20, no. 5 *Canadian Tax Journal* 397-413. Others would view the effectiveness and importance of such a feature in the system not from the point of view of what revenues are raised thereby, which is a small amount, but from the perspective of the integrity of the revenue base in general and, in particular, the potential for a significant loss of tax revenues resulting from the "diversion" of what is regarded, essentially, as Canadian source income in the absence of such a feature. In fairness, Sherman did accede to this point of view, albeit reluctantly: ibid., at 401. See also Arnold, supra footnote 8, at 166 and following. Arnold relates, moreover, that the Canadian FAPI rules were modelled upon the US "foreign personal holding company" rules and subpart F of the Internal Revenue Code, which, he submits, were the only available foreign models at that time.

The related perceived evil referred to in the white paper in connection with the elimination or indefinite deferral of Canadian tax was what may be regarded, essentially, as the creation of net capital losses that would have been deductible in Canada against taxable capital gains by draining the value of a foreign corporation on a tax-free basis and then disposing of its shares for an amount below their acquired cost base: the white paper, supra footnote 124, at 74, paragraph 6.19. This issue has been addressed in the foreign affiliate system in a number of ways. For example, see the definition of "exempt surplus" in regulation 5907(1)(d), which specifies the period during which exempt surplus may be earned, and the deduction from the adjusted cost base of a corporation resident in Canada in respect of pre-acquisition surplus dividends mandated by paragraph 92(2)(a) and subparagraph 53(2)(b)(i) of the Act.

[132] The white paper, supra footnote 124, at 74, paragraph 6.22. This proposal was ultimately enacted as subsection 20(11) of the Act.

[133] The white paper, supra footnote 124, at 75, paragraphs 6.25 and 6.26. The white paper also proposed that a mechanism be introduced into the Act to "recapture" against otherwise exempt dividends any amounts previously deducted from Canadian taxable income in respect of foreign branch losses before the incorporation of the branch as a subsidiary: ibid., at 75, paragraph 6.24. No such provision appears to have been enacted so far; moreover, this does not seem to be a significant imperfection in the system, since the Act does not provide for the tax-free incorporation outside Canada of foreign branches.

tax imposed on them in respect of distributions any withholding tax paid by the Canadian corporation to a foreign jurisdiction. The Canadian corporation would gross up the amount of the dividend paid by it to its shareholders by an amount equal to the foreign withholding tax paid by it to the foreign jurisdiction, and its shareholders would be entitled to claim a credit equal to the grossed-up portion of the dividend. Equivalent treatment would be extended to foreign branch earnings, but only in an amount not exceeding a notional 15 percent branch tax.[134]

7) *That the special tax status of foreign business corporations be withdrawn, thus eliminating Canada's status as a potential tax haven in relation to other countries*. This proposal was designed to terminate the grandfathering extended to existing foreign business corporations in the 1959 budget. It was implemented as part of the 1971 tax reform.[135]

The white paper proposals differed from the recommendations of the Carter commission on a number of significant points. First, and most important, whereas the commission would have applied its "special tax" to all indirect foreign source income, the white paper proposed, in principle, that only passive investment income and transshipment profits be subjected to Canadian tax on an accrual basis. Second, whereas the commission recommended that the deferral of Canadian tax on foreign source income be eliminated and that the exemption mechanism be abolished, the white paper proposed to retain the exemption mechanism in respect of income from an active business carried on in a treaty jurisdiction and to permit deferral for all other active business income. Third, whereas the commission would have limited Canadian recognition of foreign taxes to 30 percent, the white paper proposed that direct and indirect tax credit mechanisms should provide relief to the extent of Canadian tax otherwise payable. Thus, to the contemporary observer, it will be clear that, when translated into legislation in 1971, the white paper gave rise to the first version of the present foreign affiliate system.

Legislative Reform: 1972-1976

Bill C-259

Following extensive study of the white paper by the House of Commons Committee on Finance, Trade and Economic Affairs, and by the Senate Committee on Banking, Trade and Commerce,[136] the minister of finance

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[134] Ibid., at 75-76, paragraphs 6.27 to 6.30. Although no such measure appears to have ever been enacted, with respect to Canadian resident individual taxpayers, it should be noted that, to a certain extent, the dividend tax credit incarnated as section 121 of the Act may, inter alia, provide for what the white paper appears, correctly, to have regarded as a "rough balance" in this respect.

[135] Ibid., at 76, paragraphs 6.31 to 6.33. See also Income Tax Application Rules, SC 1970-71-72, c. 63 (part III), section 60, as amended by SC 1973-74, c. 14, section 85; repealed by SC 1985, c. 45, section 146.

[136] The House committee agreed with the basic thrust and objectives of the reform proposals set forth in the white paper: see Canada, House of Commons, *Eighteenth Report*

(The footnote is continued on the next page.)

tabled a comprehensive set of tax reform proposals on June 18, 1971. Bill C-259[137] divided the universe of foreign corporations on the basis of whether or not they qualified as foreign affiliates, much along the lines proposed in the white paper. It defined a foreign affiliate,[138] essentially, as a corporation not resident in Canada

1) that was controlled by the taxpayer, either alone or together with persons with whom or which it was not dealing at arm's length;

2) in which the taxpayer's voting participation, together with that of persons resident in Canada with whom or which it was not dealing at arm's length, consisted of at least 25 percent; or

3) in which the taxpayer's equity participation, together with that of persons resident in Canada with whom or which it was not dealing at arm's length, consisted of at least 50 percent of the shares of any class of the corporation.

The legislation, moreover, permitted a taxpayer not satisfying any of these three criteria to elect that a foreign corporation be recognized as its

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[136] Continued . . .
of the Standing Committee on Finance, Trade and Economic Affairs Respecting the White Paper on Tax Reform (Ottawa: Queen's Printer, October 1970). Indeed, it welcomed what it regarded as the "treaty development purpose of the proposals." However, it expressed "grave concern about the feasibility of the proposal to introduce rules along the lines of the 'Sub Part F' provisions of the United States," submitting that "the objective may not be worth the price which must be paid to accomplish it." In this connection, the committee suggested that the government should have narrowed its area of concern from that of "passive" income to that of "diverted" income, excluding from the scope of the proposed rules, in particular, "investment type income which is derived as yield from surplus cash of a bona fide foreign business operation." Ibid., at 93:162-74.

The Senate committee, on the other hand, was firmly opposed to certain fundamentals of the white paper proposals: see Canada, Standing Senate Committee on Banking, Trade and Commerce, *Report on the White Paper Proposals for Tax Reform* (Ottawa: Queen's Printer, September 1970). Essentially, except to the extent that the government proposed in the white paper to make the system more generous—for example, by providing a measure of Canadian direct foreign tax credit recognition in respect of taxes paid to a foreign political subdivision—the Senate committee would have retained the old law. In particular, it was opposed to the abolition or even the alteration of the exemption mechanism as it applied under former paragraph 28(1)(d). Indeed, the "treaty development purpose of the proposal," which was welcomed by the House committee, was rejected by the Senate committee as a feature that, improperly in its view, would cause investment decisions to be affected by the government's success or failure in negotiating tax treaties. In the context of the proposals concerning passive income, the Senate committee regarded the introduction of US subpart F-type provisions as a threat to the international competitiveness of Canadian exporters and, in particular, was opposed to the application of any such provisions in respect of transshipment profits. Rather, the Senate committee suggested that what was considered to be unacceptable tax avoidance should be addressed through more rigorous enforcement of then existing law, with particular emphasis upon the residence of foreign corporations and the application of legal doctrines such as "sham." Ibid., at 75-78.

[137] An Act To Amend the Income Tax Act and To Make Certain Provisions and Alterations in the Statute Law Related to or Consequential upon the Amendments to That Act, first reading, June 30, 1971 (herein referred to as "Bill C-259"). See also the white paper, supra footnote 124.

[138] Bill C-259, proposed paragraph 95(1)(b).

foreign affiliate if at least 10 percent of the fully voting shares were owned by it.[139]

The most striking feature of the 1971 version of the foreign affiliate system was that foreign affiliate status gave rise to two very different Canadian income tax consequences, one of which was positive from the taxpayer's point of view and the other negative; namely, that a taxpayer was entitled, regarding the repatriation of dividends from a foreign affiliate, to recognition of underlying foreign taxes (whether under the exemption mechanism or the credit-based system) and, simultaneously, that the taxpayer was subject to taxation on an accrual basis in respect of the passive investment income of its foreign affiliate.[140] Indeed, this feature was criticized on the basis that a taxpayer would be subject to taxation on an accrual basis in respect of the passive investment income of a foreign affiliate that it did not control and therefore could not cause to distribute to it the amounts in respect of which it was taxable.[141]

Foreign source dividends were considered to derive from one of three categories:

1) *Exempt surplus*. Essentially, the pre-1972 exemption system was retained but restricted to the following amounts:

a) active business earnings from carrying on business, generally, in a country with which Canada had concluded a comprehensive tax treaty;

b) FAPI less any foreign tax paid by the foreign affiliate in respect thereof; and

c) most interaffiliate dividends.

2) *Taxable surplus*. Amounts included were, essentially,

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[139] Bill C-259, proposed subparagraph 95(1)(b)(iv).

[140] This remains the case under the current Act with respect to controlled foreign affiliates, but the income of a foreign affiliate that is not a controlled foreign affiliate cannot give rise to FAPI: compare Bill C-259, proposed paragraph 91(1)(a) and subsection 91(1) of the Act.

[141] See Sherman, supra footnote 131, at 402, who articulated this criticism in the following terms:

> It is inequitable to make a Canadian taxpayer pay tax on income to which it has no right, or which it has no way of withdrawing from the foreign company, and serious cash flow problems may result . . . .
>
> The definitions require rewriting so that FAPI will be taxable in Canada only when a foreign company is controlled directly, indirectly, or in any manner whatsoever by a Canadian taxpayer or a group of related Canadian taxpayers, and will never exceed the amount of the taxpayer's entitlement.

The latter point was made in connection with a perceived defect in the proposed definitions of "participating percentage" and "equity percentage," which, in certain circumstances, could have resulted in the taxation of a Canadian corporation in respect of an amount exceeding 100 percent of the FAPI of its foreign affiliate. See Bill C-259, proposed paragraphs 95(1)(c) and 95(4)(a).

a) active business earnings if either the earnings were from a business carried on in a non-treaty country or the foreign affiliate was incorporated in a non-treaty country, and

b) certain interaffiliate dividends.

3) *Pre-acquisition surplus*. Essentially, this was a notional source from which any dividends, other than dividends paid out of the exempt or taxable surplus of a foreign affiliate, were deemed to have been distributed for the purposes of proposed subdivision i.[142]

It should be noted that a taxpayer's entitlement to a deduction in respect of exempt surplus was restricted by the portion of the dividend received that was deductible in respect of passive investment income that the taxpayer should have already recognized for Canadian tax purposes on an accrual basis.[143] This last proposal proved to be very controversial, particularly when considered against the backdrop of the controversy generated by the proposal that passive income be taxed on an accrual basis, even in a non-control situation.[144]

The definition of FAPI in the 1971 legislation is interesting in that it differs dramatically from that to which we are currently accustomed. While it included capital gains, subject to a limited exception for such gains from the disposition of tangible assets used exclusively for the purpose of earning income from an active business,[145] it did not operate with reference to special inclusion and exclusion rules such as those currently found in subsection 95(2) of the Act. Consequently, no special provisions existed to deal with items such as incidental business income, intercorporate charges, services provided by foreign corporations, and capital gains and losses arising as a consequence of corporate reorganizations.[146] Moreover, non-FAPI losses were not allowed as an offset against FAPI.[147]

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[142] Canada, Department of Finance, "Foreign Affiliate Regulations," *Release*, no. 71-94, August 4, 1971.

[143] Bill C-259, proposed paragraph 113(1)(a) and proposed subsection 90(2).

[144] It was argued that the taxpayer's right to claim a deduction in respect of the particular exempt business earnings would always be uncertain, a contention buttressed by the absence of a control requirement for FAPI, as well as by the breadth of FAPI. See, in this connection, D.Y. Timbrell, "Policy and Structural Basis Underlying Canada's Foreign Income Rules," in *Report of Proceedings of the Twenty-Seventh Tax Conference*, 1975 Conference Report (Toronto: Canadian Tax Foundation, 1976), 834-49, at 838.

[145] Bill C-259, proposed paragraph 95(1)(a).

[146] In connection with incidental business income and intercompany charges, Timbrell, supra footnote 144, at 838, made the following observations:

> Included in [FAPI] were a number of items that gave rise to strenuous objections: . . .
>
> 2. Charges made against active business profits of corporations in the group, whether those corporations were in treaty or non-treaty countries. This feature was criticized on the grounds that the receipt of such amounts in a tax haven jurisdiction could not be considered to cause a reduction of Canadian

([146], [147] Continued on the next page.)

As an additional measure, which, strictly speaking, fell outside the FAPI net, interaffiliate dividends were to be recognized on an accrual basis, subject to credit for foreign taxes. It was proposed that the appropriate share of a dividend received by a foreign affiliate from another foreign affiliate be included in the income of the Canadian taxpayer, except to the extent specifically excluded.[148] The objective of this exercise was to ensure that the same treatment would be accorded to dividends received directly by a resident corporation and to dividends received indirectly through the medium of a foreign affiliate. Consequently, the resident corporation would be entitled to exclude from the computation of amounts accruing to it the portion of the dividend paid to the recipient foreign affiliate deriving from the exempt and pre-acquisition surplus accounts of the paying foreign affiliate, as well as any portion deriving from the payer's taxable surplus account on condition that both foreign affiliates were incorporated in the same country. It was the latter type of dividends that were added to the recipient's taxable surplus account; otherwise, interaffiliate dividends were treated as additions to exempt surplus.[149] The non-excluded portion of the dividend would be reflected in the income of the resident corporation, which would be entitled to a deduction for the underlying foreign tax and twice the withholding or other tax applicable to the portion of the interaffiliate dividend reflected in its income.[150] This approach to the taxation of interaffiliate dividends was attacked as overly restrictive, in that it raised a Canadian fiscal barrier to the free flow of funds, outside Canada, among members of a corporate group.[151]

[146, 147] Continued . . .

> tax and Canada should not have any interest in helping to enforce the tax laws of other countries, particularly when other countries did not do so. Canada was seen as being some sort of an international fiscal policeman, a role that was acceptable on the island of Cyprus but definitely not appropriate for the islands of the Caribbean.
>
> 3. Investment income that arose incidentally to or was closely related to the operation of an active business in a foreign country. Examples here were income such as occurs through the operation of the DISC legislation in the United States, income arising from the investments that used to be required to be made in Brazilian Government Bonds and income from the affiliate of a foreign corporation formed for the purpose of acquiring the corporation's commercial paper.

The absence of any carveout from FAPI in respect of items such as incidental business income and intercompany charges was also criticized by the Senate Committee on Banking, Trade and Commerce, which regarded this aspect of Bill C-259 as an "indiscriminate extension of the diverted income rules to include all passive income of foreign affiliates": see Canada, *Proceedings of the Standing Senate Committee on Banking, Trade and Commerce: Preliminary Report on the Summary of 1971 Tax Reform Legislation*, 28th Parliament, 3d session, 1970-71, issue no. 47, 47:5.

[147] That is, there was no proposed provision that was equivalent to subparagraph 95(1)(b)(v) of the Act. See also Sherman, supra footnote 131, at 405.

[148] Bill C-259, proposed paragraph 91(1)(b).

[149] See supra footnote 142.

[150] Ibid.; see also Bill C-259, proposed paragraph 113(1)(b).

[151] See Timbrell, supra footnote 144, at 834.

The Budgets of 1974

The 1971 proposals generated considerable controversy on a number of grounds and, as a consequence, the introduction of the foreign affiliate system was postponed for four years, from January 1, 1972 to January 1, 1976.[152] In two budgets tabled by the minister of finance in 1974, the second necessitated by the defeat in the House of Commons of the first, the foreign affiliate system was dramatically redesigned, rendering it entirely recognizable to the contemporary Canadian income tax observer.[153]

In particular, the May 6, 1974 budget proposed that the universe of foreign corporations be further subdivided, such that only a special category of foreign affiliates controlled on a de jure basis would be subject to FAPI accrual.[154] Control, for these purposes, was limited to that attributable to a taxpayer, a taxpayer and not more than four other persons resident in Canada, or a related group of which a taxpayer was a member.[155] The second circumstance, which did not require any link among the parties, can be viewed as a different manner of retaining the principle running through the Carter report, the white paper, and the 1971 legislation; namely, that something less than de jure control should be sufficient to justify taxation of passive investment income on an accrual basis. Critics had argued that this approach was unreasonable, inter alia, because the information necessary for accurate reporting of FAPI would not be available in a non-control situation.[156] Although this criticism was less compelling where control in the proposed scenario was located in Canada, thus easing the anxiety that compliance would be difficult, the status of a

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[152] Originally, the implementation of the new provisions was deferred to provide an opportunity for concluding a more comprehensive network of treaties. See, inter alia, the white paper, supra footnote 124, at 74, paragraphs 6.18 and 6.22.

[153] The 1974 budgets were tabled by the minister of finance on May 6 and November 18, 1974, respectively. The budget proposals made in this area were ultimately enacted by SC 1974-75-76, c. 26, inter alia, sections 55 to 59 and 73. With regard to the 1974 changes, see in particular J.M. Bradley, "Shareholders of Foreign Affiliates and Beneficiaries of Non-Resident Inter Vivos Trusts," in *Report of Proceedings of the Twenty-Sixth Tax Conference*, 1974 Conference Report (Toronto: Canadian Tax Foundation, 1975), 225-40; A.P.F. Cumyn, "Foreign Accrual Property Income Under the 1974 Spring Budget," ibid., at 240-53; and H. Arnold Sherman, "Tax Treatment of Dividends Received from Foreign Affiliates," ibid., at 253-62.

[154] Subsection 91(1) of the Act.

[155] Paragraph 95(1)(a) of the Act. This provision was amended in 1991 to include additional grounds upon which a foreign affiliate could be regarded as a controlled foreign affiliate of a taxpayer—namely, where the foreign affiliate is controlled by not more than four persons resident in Canada, other than the taxpayer; by a person or persons with whom the taxpayer does not deal at arm's length; or by the taxpayer and a person or persons with whom the taxpayer does not deal at arm's length: SC 1991, c. 49, section 71(1). The first two changes appear to have been introduced in the light of the decision of the Federal Court—Trial Division in *Southside Car Market Ltd. et al. v. The Queen*, [1982] CTC 214, which held that if one person controlled a corporation, it could not be considered to be controlled by a group of which he was a member. The third change is a broader version of the original test, namely, control by a related group of which the taxpayer was a member.

[156] See Timbrell, supra footnote 144, and Sherman, supra footnote 131.

foreign affiliate was restricted in its fiscal effects, essentially, to the recognition of foreign taxes paid in respect of earnings repatriated to Canada as dividends. Consequently, the threshold required for that status was dropped from 25 percent to 10 percent and the relevance of voting rights and equity was eliminated. Therefore, ownership of a mere 10 percent of any class of the capital stock of the foreign corporation would qualify that entity as a foreign affiliate of the Canadian taxpayer.[157] Furthermore, repatriation of exempt earnings was uncoupled from the recognition of FAPI by virtue of an amendment to paragraph 113(1)(a).[158]

The definition of FAPI was also modified to give rise to a version that was roughly comparable to that currently in force under the Act. Subsection 95(2) was drastically amended to include the various provisions found therein dealing with incidental business income, interaffiliate charges,[159] services provided by controlled foreign affiliates, and capital gains and losses arising upon corporate reorganizations.[160] Finally, non-FAPI losses were allowed as a deduction in computing FAPI; and, most important, the taxability, on an accrual basis, of interaffiliate dividends was entirely eliminated.[161]

Further, exempt and taxable surplus were realigned, so that FAPI was transferred from the former to the latter.[162] Moreover, as a consequence of the restriction of FAPI accrual to the income of a controlled foreign affiliate, it was necessary to expand the category of taxable surplus to include FAPI not subject to the accrual rules—that is, FAPI of a foreign affiliate that was not a controlled foreign affiliate. Last, the exempt surplus rules were extended to catch active business income earned in countries with which Canada was negotiating but had not yet concluded a tax treaty.[163] This forward-looking approach highlighted Canada's commitment to the territorial principle of taxation.

As a result of the 1974 changes, the Canadian system of taxing foreign source income, in large measure, attained its current form. The territorial principle of taxation underlying the exemption mechanism was pruned but retained. Notwithstanding the vigorous debate surrounding the merits and deficiencies of paragraph 28(1)(d) of the ITA 1952, and the recom-

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157 Paragraph 95(1)(d) of the Act.

158 SC 1974-75-76, c. 26, section 73(1).

159 It should be noted, however, that subparagraph 95(2)(a)(ii) of the Act does not permit the exclusion from FAPI of interaffiliate charges that are deductible in computing the income of a foreign affiliate of a taxpayer, or of any other non-resident corporation with which the taxpayer does not deal at arm's length, from an active business carried on by it in Canada, thereby protecting the Canadian income tax revenue base from the diversion of income that would ordinarily be subject to tax under part I of the Act.

160 SC 1974-75-76, c. 26, section 59(1).

161 Subparagraph 95(1)(b)(v) and clause 95(1)(b)(i)(B) of the Act.

162 Regulation 5907(1)(i)(ii)(B).

163 Regulation 5907(11), added by PC 1976-2576, SOR/76-704 (1976), vol. 110, no. 21 *Canada Gazette Part II* 2964-91, applicable to the 1976 and subsequent taxation years.

mendations of the Carter commission that it be eradicated from the Canadian fiscal landscape root and branch, the exempt surplus feature of the modern system carries over the spirit of that provision. The territorial principle, however, was restricted in its application, generally, to active business income earned by a foreign affiliate residing in a listed country from an active business carried on in such a country or in Canada.[164] Active business income earned in an unlisted country, while not giving rise to exempt surplus, would not be subject to Canadian tax unless repatriated in the form of a dividend.[165] In that event, recognition would be given to underlying foreign tax, if any, as well as to any foreign withholding tax paid in respect of the repatriated funds.[166] The obvious possibility of indefinite deferral of Canadian tax on such income further affirmed the importance of the territorial principle. Passive income earned by Canadian-controlled foreign corporations was subject to Canadian tax on an accrual basis.[167] These features of the system put in place by 1976 have not undergone significant modification over the years.

Subsequent Amendments

The foreign affiliate system has been closely monitored since it was officially launched on January 1, 1976. The structural changes have been few, including, notably, the enactment of section 94.1 in 1984 as a means of defeating the deliberate avoidance of FAPI accrual.[168] Certain other amendments have been of great practical importance but have not modified the system in principle. For example, the definition of "excluded property" in respect of FAPI was added in the 1981 budget, apparently in response to the criticism that the existing rules were unduly restrictive and unrealistic.[169] The application of non-FAPI losses to FAPI was also refined in 1981; and the 1982 amendments to the regulations included, among several items, a set of rules that would apply to foreign affiliates reporting income on a consolidated basis.[170] Although these amendments had significant practical effects, they did not in any way upset the basic underpinnings of the statutory scheme. Similarly, the 1987 tax reform package did not tamper with the foreign affiliate system;[171] and the Department of

[164] Regulation 5907(1)(b)(iv).

[165] Section 90 of the Act.

[166] Paragraphs 113(1)(b) and (c).

[167] Paragraph 95(1)(b).

[168] SC 1984, c. 45, section 30.

[169] SC 1980-81-82-83, c. 140, section 57.

[170] Regulations 5907(1.1), (1.2), and (1.3), added by PC 1985-467, SOR/85-176 (1985), vol. 119, no. 5 *Canada Gazette Part II* 1285-1320, applicable to the 1982 and subsequent taxation years of foreign affiliates.

[171] Few changes were proposed in the international area. They included new rules relating to the extension of the normal reassessment period to six years for transactions involving non-resident non-arm's-length persons, enacted as subparagraph 152(4)(b)(iii) of

(The footnote is continued on the next page.)

Finance decided in 1988 not to extend the principle of de facto control to the reporting of FAPI on an accrual basis.[172]

Notwithstanding numerous technical modifications since 1974, the present system is the culmination of an evolutionary process dating back to 1917 and the product of efforts to balance the various objectives of tax policy that have been vigorously debated over that period of time.

Evolving International Policy Considerations

The Canadian Policy Evolution

The preceding section has reviewed the history of the Canadian foreign affiliate system. It has demonstrated how different views (not always explicit) at various times on the appropriate balance between competitiveness and efficiency have influenced the development of the Canadian rules. In the pre-Carter era, starting at the time Canada first expressly asserted its jurisdiction to tax foreign source income,[173] a series of measures was introduced that had the effect of both improving efficiency[174] and promoting competitiveness.[175] Apart from the restrictive measures taken in 1926[176] and 1936,[177] this period was notable for a progressive expansion and reinforcement of the exemption system,[178] suggesting an implicit shift in the policy balance in favour of competitiveness, at least during the latter half of this period. The context of these changes was rising tax rates

[171] Continued ... the Act, and certain requirements regarding foreign-based information, enacted as sections 231.6 and 233.1 of the Act. Obviously, GAAR also constituted an important feature of the 1987 tax reform package. See SC 1988, c. 55, sections 136(4), 175, 176, and 185.

[172] When a de facto test for control was introduced into the Act in 1988, as subsection 256(5.1), paragraph 95(1)(a) was amended to substitute the words "controlled by" for the phrase "controlled, directly or indirectly in any manner whatever, by," thereby assuring that the de jure test for control (articulated, notably, in *Buckerfield's Ltd. et al. v. MNR*, [1964] CTC 504 (Ex. Ct.)) would continue to apply in the context of controlled foreign affiliates. See SC 1988, c. 55, sections 192(3) and 65, respectively.

[173] As discussed previously, in 1919 the definition of "income" in the IWTA was amended by SC 1919, c. 55, section 2(1) to clarify that income derived from foreign sources was subject to Canadian tax.

[174] Starting with the credit for income taxes paid to Great Britain or its colonies, introduced in 1919 by SC 1919, c. 55, section 3(3). See supra footnote 77.

[175] Beginning with the introduction of the exemption for foreign business corporations by SC 1918, c. 25, section 4, actually predating the explicit assertion of Canada's jurisdiction to tax foreign source income. See supra footnote 75.

[176] SC 1926, c. 10, sections 2 and 3. See supra footnote 80 and the related discussion.

[177] The scope of the foreign business corporation rules was restricted by SC 1936, c. 38, section 4. See supra footnote 92.

[178] IWTA paragraph 4(r), as enacted by SC 1938, c. 48, section 4; ITA 1948 section 28; ITA 1948 paragraph 27(1)(d), as enacted by SC 1949 (2d sess.), c. 25, section 12; ITA 1948 paragraph 27(1)(d), as amended by SC 1951, c. 51, section 7(1) and later consolidated as paragraph 28(1)(d); and ITA 1952 paragraph 27(1)(e), as enacted by SC 1952, c. 29, section 8(1).

in various countries, increased cross-border activity, and the emerging popularity of multinational corporations.

By the time the Carter commission issued its report,[179] the generosity of the exemption system had become readily apparent. One member of the commission recalled that the relevant provision, found in paragraph 28(1)(d) of the ITA 1952, was perceived as a concession that had "qualified Canada as a tax-haven country."[180] Accordingly, the commission emphasized measures to reduce the tax minimization possibilities of the exemption privilege.

The vigorous and negative reaction to the commission's recommendations implied that the commission's focus on revenue generation had been excessive, at least from the perspective of members of the business community who had participated in the debate. It is interesting to note that while the commission's recommendations would have moved the Canadian system closer to capital export neutrality,[181] it appears that this efficiency gain would have been an unintended consequence of the implementation of the proposals. Indeed, as noted above, the commission thought of its proposals as a "purposeful deviation from tax neutrality."[182] The commission expressed doubt about the feasibility of improving efficiency, given the significance of "market imperfections" in the international area.[183]

By the time the minister of finance released his white paper in 1969,[184] efficiency had gained explicit recognition as a policy objective appropriate to the international sphere. The proposals included in the white paper were "designed neither to provide an incentive to Canadians to invest abroad, nor to place a barrier in the way of their doing so."[185] That said, the proposals also reflected a continuing concern that Canadian companies be competitive internationally.

The white paper expressly identified the conflict between competitiveness, which would require an exemption-based system, and neutrality, which would require a credit-based system. The minister suggested that an exemption system would be appropriate if the corporate tax burden were borne by customers, while a credit-based system would be preferable if corporate taxes were borne by shareholders. He concluded that, since it is probable that corporate taxes are shifted to both customers and

[179] Supra footnote 107.

[180] J. Harvey Perry, *A Fiscal History of Canada—The Postwar Years*, Canadian Tax Paper no. 85 (Toronto: Canadian Tax Foundation, 1989), 1032.

[181] Capital export neutrality would have been achieved, approximately, if the combined federal and provincial tax rate on domestic corporate income had been 30 percent and if foreign tax rates had not exceeded 30 percent.

[182] See supra footnote 108 and the related discussion.

[183] Ibid.

[184] Supra footnote 124.

[185] Ibid., at 72, paragraph 6.8.

shareholders and that the actual burdens vary across countries, products, and time, the choice between the two regimes remains "largely a matter of opinion."[186] His actual recommendations incorporated some elements of both approaches and represented the genesis of the current foreign affiliate regime.

As described above, the draft legislation proposed in 1971[187] engendered a spirited debate, followed by a new set of amendments in 1974.[188] These rules, which were implemented with effect from January 1, 1976, incorporated the central features of the current regime, including the taxation of FAPI earned by controlled foreign affiliates on an accrual basis and the retention of an exemption system for foreign affiliates earning active business income in treaty countries. Thus, the historical development of the Canadian system culminated in the balance between capital export neutrality and competitiveness that is represented by the current Canadian rules and criticized by the auditor general's 1992 report.

Responses to the Report

In its response to the report, the Department of Finance defended each of these policy objectives but provided no assistance with the problem of understanding the particular balance struck by the Canadian rules. For example, while the department explained that the FAPI rules are designed to reduce the tax incentive to shift income offshore, it did not explain why it is appropriate to restrict this policy objective to passive income (technically, income that is not active business income) earned by particular foreign affiliates. Likewise, while it explained that some deferral is permitted in order to preserve international competitiveness of Canadian business, the department did not explore why it is in Canada's best interest to promote international competitiveness or why this principle has particular relevance to business activity in treaty countries. From a broader viewpoint, the department noted that the government generally favours international competitiveness over revenue-generation concerns; however, it did not explain why Canada benefits from this particular emphasis, and it merely alluded to the limits imposed by international norms.[189]

It was perhaps the department's failure to justify the balance between these two policy objectives that fuelled the criticism of the department's response by the Standing Committee on Public Accounts, during its proceedings last winter.[190] But the absence of a defence does not mean that the Canadian rules are indefensible. Even if it were true that each criticism in the report had merit on a stand-alone basis, it would not necessarily

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[186] Ibid., at 73, paragraph 6.14.

[187] See the discussion of Bill C-259 above.

[188] See the discussion of the budgets of 1974 above.

[189] Report, supra footnote 3, at 52.

[190] See Lanthier, supra footnote 3, and Public Accounts Committee, supra footnote 6.

follow that the Canadian rules could be redesigned in a manner that would provide a better resolution of the competing goals. As discussed earlier in this paper, a system cannot simultaneously promote capital import neutrality (competitiveness) and capital export neutrality (the efficient allocation of global resources). Consequently, the proponents of one or the other of these objectives can always find fodder for criticism. Given the inherent conflict between the two underlying policy objectives, it is not surprising that the Canadian foreign affiliate rules, or for that matter their counterparts in other jurisdictions, have been targeted for criticism.

The dilemma has been described in these terms:

> Nevertheless, there may be important psychological implications in characterizing policy for the taxation of controlled foreign corporations as either capital export neutrality, with limited exceptions justified by considerations of capital import neutrality, or capital import neutrality, with anti-avoidance rules designed to preserve a measure of capital export neutrality. . . . In other words, the issue is which side in the debate has the onus to justify changes in the existing balance between capital export neutrality and capital import neutrality. Given the lack of any clear evidence concerning the economic effects of foreign investment and deferral, the issue of onus is very important.[191]

The general implication of the report is that the Canadian foreign affiliate rules do not achieve the right balance between capital export and capital import neutrality. In his review of the rules, the auditor general cited several instances where taxpayers had arranged their affairs to reduce taxes in circumstances in which, in his view, tax should have been paid. But by abstaining from any discussion of the broader policy context for these conclusions, the auditor general begged the real question: why should taxpayers in the described circumstances pay Canadian tax?

Policy Direction

Before there can be meaningful discussion about whether policy objectives are being circumvented by the application of existing rules, it is necessary to reach agreement about the desired policy direction. An assessment of the situations described by the auditor general requires a reevaluation of the merits of capital export and capital import neutrality, so that a judgment can be made about the proper balance between the two objectives.

The kinds of questions that are relevant to this analysis may be illustrated by the example of the Canadian treatment of dividends paid out of active business income earned in listed countries. The practical consequence of treating the dividends as exempt surplus, in combination with the absence of accrual in respect of such income, is that foreign affiliates carrying on active businesses in treaty countries are subject to tax at the foreign rates on such income. Canadian tax is not paid on the active business income earned by these companies in, basically, treaty countries,

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[191] Arnold, supra footnote 8, at 409.

either at the time their profits are earned or when they are repatriated to Canada. The result is that the Canadian rules promote the competitiveness of Canadian multinational companies that invest in treaty countries.

The broad issue raised by this observation is, Why is competitiveness a desirable goal for Canada? This, in turn, raises a whole host of specific questions about the benefits to Canada. For instance:

- What purpose is served by the particular delineation of the exempt surplus rules?
- In what ways does Canada benefit from encouraging Canadian-based multinational corporations to carry on active businesses in low-rate treaty countries?
- Are there non-tax benefits that accrue to Canadians because of this activity?
- Is the benefit of lower foreign taxes shifted to Canadian parent companies?
- Is there a transfer of business and technical knowhow back to Canada?
- Why would similar benefits not accrue from encouraging investment in other countries?
- Is the exempt surplus system necessary to encourage other countries to enter into double taxation treaties with Canada?

Similar questions are raised about the costs of advancing the goal of competitiveness:

- Does the exemption system permit companies to escape higher domestic taxes by moving their operations offshore?[192]
- Does it restrict Canada's ability to impose higher domestic rates?
- If Canada did not have an exemption system, would it collect Canadian tax on the foreign source income or would multinational parent corporations simply emigrate to a more hospitable jurisdiction?
- How mobile is business investment capital?

Contemporary Policy Choices

As discussed earlier, domestic policy choices are tempered by potential repercussions that would follow from adverse foreign reaction to initiatives perceived by the international community to deviate in unacceptable ways from recognized norms. It is noted, however, that a re-evaluation of

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[192] The OECD, supra footnote 9, at 33, points out, "Under the present tax regimes in the OECD area, the corporation tax works very much like a tax based on the source principle, because of the widespread use of the exemption method of international double tax relief, because of the limits on foreign tax credits, and because of the practice of credit countries to defer domestic taxation of profits retained abroad. Generally, this means that a higher domestic corporate tax burden can be fully or partly escaped by investing abroad rather than at home."

the existing policy framework would not be a uniquely Canadian exercise. Modern pressures such as escalating government deficits and the globalization of capital and product markets are generating a renewed interest in the tax treatment of foreign source income. These pressures exacerbate the traditional conflict between capital export and capital import neutrality. Governments are pondering whether they should promote the efficient allocation of resources and, not coincidentally, collect domestic tax on accruing foreign revenues or, instead, encourage domestic residents to participate in the benefits of free trade and enhanced capital mobility by investing abroad.

Dissatisfaction with the limitations of traditional analysis is reflected in recent comments by politicians, government officials, and academics in the United States. An excellent example of the kind of thinking that is being done is found in the interim report on international tax reform released this year by the US Department of the Treasury.[193] In that report, the Treasury decries the complexity of current provisions governing the taxation of income from foreign direct investment by US multinationals, but recognizes that a simpler system is feasible only if policy makers decide which of the competing goals to emphasize. Among the competing goals considered by the Treasury are the preservation of the US tax base, consistency with international norms, efficiency, and competitiveness.

The dual objectives of capital export and capital import neutrality are identified by the Treasury as a source of conflict and complexity. For example, the United States generally defers the taxation of foreign source income earned through a controlled foreign corporation until the income is repatriated. The Treasury notes that deferral promotes competitiveness and "is broadly consistent with one of the two prevailing international norms in this area (the other being the exemption of foreign source income earned in an active business, whether earned directly or through a foreign subsidiary)."[194] Deferral in the United States is qualified by accrual rules that apply in respect of certain types of mobile or low-taxed income. The Treasury observes that "[t]hese anti-deferral exceptions both promote economic efficiency and preserve the U.S. tax base."[195]

The Treasury provides numerous examples of the unknowns that inhibit a resolution of the policy conflicts. The Treasury asks, for example, what type of capital is likely to be responsive to tax considerations and therefore should not be targeted for deferral benefits.[196] Does the potential to reduce their foreign tax liabilities represent a sufficient incentive for US multinational operations to locate operations offshore?[197] How many companies have excess foreign tax credits, and how does this affect the impact

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[193] Department of the Treasury, supra footnote 7.

[194] Ibid., at 3.

[195] Ibid.

[196] Ibid., at 8.

[197] Ibid., at 10.

of accrual?[198] More generally, would an exemption system actually enhance the competitiveness of US multinationals?[199] Would it impair efficiency?[200] How would a current inclusion system affect competitiveness and efficiency?[201]

While the Treasury's sympathies appear to lie with some sort of modified exemption system,[202] the Treasury warns against reaching any conclusions without further study. The Treasury suggests that no decisions should be made in the absence of further economic analysis using "real world" analytical models:

> The implications of capital export neutrality and capital import neutrality are not clearly understood outside the standard analytical framework. The real world departs from the assumptions of the standard analysis, and the policy that represents the ideal in a simplified world may not be optimal in a world with numerous distortions. Modified analytical frameworks that incorporate some "real world" complications are being developed in connection with the ongoing study.[203]

At a recent American conference, Joel Slemrod, a noted economist from the University of Michigan, also raised questions about the appropriateness of traditional analysis.[204] He warned against assuming that international competitiveness is, a priori, beneficial. He noted that the mirror image of international competitiveness is a decline in the terms of trade, which in and of itself may be good or bad. Slemrod observed that capital export neutrality may not make sense in the real world, noting that if global markets are not perfectly competitive, it does not follow that resources will be efficiently allocated by the equalization of marginal returns to capital. He reported that strategic trade policy analysts are now arguing that international markets are oligopolistic and, if this is correct, different conclusions will follow about the appropriate direction for international taxation.

Slemrod suggested that the optimal tax treatment of foreign source income can be achieved only by an analysis that recognizes "the reality of global competition among firms for profits, and among countries for tax revenues."[205] He concluded that the challenge is to determine how a nation may strive to expand the real income of its citizens in the face of global international markets and other countries' policies, which range from "a free trade orientation to aggressive promotion of exports."[206]

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198 Ibid.

199 Ibid., at 53.

200 Ibid.

201 Ibid.

202 See comments, infra footnote 215.

203 Department of the Treasury, supra footnote 7, at 57.

204 Slemrod, supra footnote 67.

205 Ibid., at 115.

206 Ibid.

At the same conference, Stephen Shay also identified the need for further empirical research; in particular, the need for data and models to take into account some of the "real world effects" of possible policy options. He concluded:

> The tax law, like science, is based on policy paradigms and it is important both that the policy paradigms we used [sic] and the one in question this morning, capital export neutrality, be based on currently correct factual premises. In implementing policy in the tax area, it is extremely important that there be broad-based agreement with a paradigm. To the extent that there is not agreement, tax policy becomes less coherent and becomes very much more complex.[207]

In this regard, Shay also made the important point that forays into the international taxation sphere are limited by international reaction. He warned against unilateral policy initiatives in the absence of overwhelming evidence that such initiatives are in the nation's interest.

Alvin Warren Jr., a professor of law at Harvard, also noted, at the same conference, that traditional international tax theory is "ripe" for further development. He concluded that such developments should be based on "clearly articulated principles" applied to "clearly demonstrated evidence."[208]

A common theme in the analyses described above is that the theoretical premises on which existing tax rules are based should be subjected to empirical scrutiny. It is worthwhile to note that concepts such as capital export neutrality and capital import neutrality have informed policy decisions for at least two decades, without any hard evidence that one or the other produces the intended results. Little empirical work has been done since, even though early proponents of this analytical framework readily admitted that no supportive empirical analysis had been undertaken.[209]

The Treasury has indicated that no significant changes will be implemented in the United States until policy makers have had time to initiate and review relevant economic and empirical research:

> There is a substantial body of academic and other literature on the effects of taxation on business decisions. This literature has received insufficient attention, however, in the context of international tax policy. Thus a significant component of the Treasury Department study will be a review of this literature and of other empirical evidence, particularly with regard to the distinction between active and passive income.[210]

[207] Stephen E. Shay, "Commentary" (Spring 1991), 9 *The American Journal of Tax Policy* 149-53, at 149-50.

[208] Alvin C. Warren Jr., "Commentary" (Spring 1991), 9 *The American Journal of Tax Policy* 145-48, at 147-48.

[209] The introduction to the classic study by Sato and Bird, supra footnote 10, at 385, states, "The paper is thus general and expository; it is not an empirical study of tax-induced corporate investment and other responses to taxation nor an analysis of the impacts of tax changes on international capital flows."

[210] Department of the Treasury, supra footnote 7.

The Treasury provides an example of the type of research that should be undertaken:

> For example, further analysis is needed to determine the extent to which passive income is in fact more responsive than active income to differentials in tax rates, as assumed by conventional wisdom, and to determine whether there are types of activities which are particularly unaffected by differences in tax treatment.[211]

Any empirical analysis undertaken in Canada would most fruitfully be directed at assessing the impact of the foreign affiliate rules on the fundamental objectives that are relevant under any tax policy framework. First, do the foreign affiliate rules, as currently structured, improve efficiency, either domestically or globally? To use a well-worn metaphor, do the tax rules increase the size of the pie?[212] Second, are the Canadian rules equitable? Do they protect the Canadian tax base? Do they allow Canadian-based corporations to participate in the benefits of global markets? Finally, does the foreign affiliate regime achieve efficiency and equity at minimum expense?

Even if such broadly defined objectives are elusive, empirical analysis could be used to determine whether the existing rules should be fine-tuned. For example, as suggested by the Treasury in respect of empirical research in the United States, Canadian studies could be used to identify those categories of capital that are particularly responsive to changes in relative tax rates and therefore should not be eligible for deferral. The results of these studies could then be matched against the FAPI rules, to determine whether any change in the scope of the rules is warranted.

In this regard, it is interesting to note recent initiatives of the Australian government concerning fundamental changes to the tax treatment of foreign source income earned by controlled foreign corporations. While the Australian proposals were modelled to a large extent on the Canadian system, the Australians do appear to have made a greater attempt to target the accrual rules to those investments that are particularly responsive to tax considerations. For example, the government decided that the accrual rules should apply to controlled foreign affiliates that earn sufficient amounts of any of 12 defined classes of passive income, "designated concession income" (including untaxed capital gains, certain kinds of investment income taxed at concessional rates, and income earned by designated entities) earned in treaty countries, and certain kinds of active business income that would be particularly prone to transfer-pricing manipulation.

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[211] Ibid., at 56.

[212] Note that global efficiency will be relevant only to the extent that countries can agree to share the benefits of improved efficiency in an equitable manner. Therefore, current and developing international norms are crucial to considerations of how global equity can be achieved.

Looking Ahead in Canada

The current Canadian rules, subject to limitations intrinsic to the FAPI provisions, implement what is, in effect, a territorial system for the taxation of foreign affiliates. The active foreign source income of foreign affiliates in treaty countries is not taxed in Canada at all. Other income escapes Canadian tax so long as the profits are not distributed to domestic residents. While the FAPI rules deviate from this territorial system by bringing into the Canadian tax net inactive income earned by controlled foreign affiliates, the main effect of the rules is to prevent domestic source income from moving offshore, rather than to tax foreign source income. Empirical study may very well show that the Canadian system is fundamentally sound.

Canada's task will be to evaluate realistically the foreign affiliate rules in the light of the current structure of international markets and developing international norms. Toward this end, Canada should undertake economic and empirical studies of the effect of taxation on international capital flows and particular categories of investments. It should analyze the effect of taxation on location and investment decisions of multinational companies. It should study general patterns of international tax avoidance. It should consider policy developments in other jurisdictions. Once a coherent policy paradigm is identified, it will be possible to judge the adequacy of the Canadian foreign affiliate rules.

In the light of the international scrutiny that would be triggered by any significant Canadian initiatives, and keeping in mind the apparent sympathy in the United States for some sort of modified exemption system, it may be anticipated that the Canadian analysis will validate, to a large extent, the existing foreign affiliate regime. It was observed and demonstrated in earlier sections of this paper that the Canadian rules reflect a delicate balance between the traditional policy objectives of capital export and capital import neutrality. We anticipate that further analysis, both domestically and abroad, will demonstrate that this delicate balance is in keeping with evolving international norms.

Points To Consider

The basic design of the foreign affiliate system is not beyond continuing critical scrutiny as Canada's fiscal policy necessarily evolves to address international economic and commercial developments and changing responses to them by other tax systems. However, on the basis on which it appears to have been examined in the report, the system seems to withstand satisfactorily concerns expressed or implied about its fundamental fiscal characteristics.

In the report, the auditor general is preoccupied with "tax avoidance." While his precise concerns in this regard are difficult to segregate as between tax system architecture and administration, there is a sense that the kinds of deficiencies identified by him as having a direct and significant revenue effect are, uniquely, faults of the foreign affiliate system as

such. Against a backdrop that includes a lengthy exposition about manipulation of the foreign affiliate rules, seemingly on the basis that such manipulation is inconsistent with the objectives or at least the limits of those rules within an acceptable interpretative framework, and therefore is indicative of systemic deficiencies, the auditor general summarized his report in this area by observing that

> the tax rules on foreign source income and foreign affiliates have now been in place for about sixteen years. We recognize that these problems are complex and that they are not unique to Canada. Nevertheless, the tax base is vulnerable and losses will continue until the issues are resolved.[213]

We do not share the auditor general's circumspection (and seemingly consequential analytical limitations) or his apparent cynicism about the fiscal quality of the foreign affiliate system. We believe that the architecture of the Canadian foreign affiliate system reflects many sound characteristics that such a system must incorporate and that have been pursued consistently and thoughtfully in the development of Canadian fiscal policy. Although too much significance should not be attributed to the review by the US Department of the Treasury (at least at this stage of its study), it is interesting, as a foil to the report, to observe that the United States' rethinking of its rules for taxing foreign income identifies only two basic alternatives.[214] The report of the Treasury seems to reflect an underlying sense of sympathy for a form of modified exemption system similar to that of Canada.[215] While it may be true that the interaction of the foreign

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[213] Report, supra footnote 3, at 51, paragraph 2.60.

[214] Department of the Treasury, supra footnote 7, in particular chapter 3. A current inclusion (that is, accrual with credit) and a modified exemption system are the alternatives identified.

[215] Ibid. See also the discussion under the heading "Evolving International Policy Considerations." This is so after taking into account, comprehensively, the various international norms discussed or reflected throughout this paper. The Treasury study is only the beginning of the US review process. However, although it does not express conclusions, the desirability of certain approaches is apparent. Notably, the Treasury study ties together criticisms of the complexity of existing US law in this area and, surprisingly (to us as well as the US Treasury), notes the dearth of supporting research with respect to systems of this sort. "The complexity of current law is largely attributable to . . . [the] compromise among . . . [competing] policy objectives. In a world of different tax systems and different tax rates, efficiency and competitiveness often dictate inconsistent rules. The objective of tax base preservation often conflicts with that of competitiveness as well as the general goal of simplification." (Ibid., at 41.) "[B]oth a 'modified' exemption system and a current inclusion system present some potential for simplification, relative to the structure of current law. This potential can be attributed to their reduced emphasis on efficiency (in the case of an exemption system) or on competitiveness (in the case of current inclusion). Under an exemption system, a reduced emphasis on efficiency could reduce tension on the rules relating to the foreign tax credit and would thus permit significant simplification of those rules. Under a current inclusion regime, the reduced emphasis on competitiveness would eliminate the necessity for the rules . . . that identify income eligible for deferral and terminate deferral on effective repatriations." (Ibid., at 52.) "In each case, however, the overall gains that might be achieved in terms of simplification would depend largely on the

(The footnote is continued on the next page.)

affiliate system with other aspects of the Act's entire regime may reveal as many shortcomings in the "proper" determination of international as well as domestic income, it would be overly critical to attribute to the foreign affiliate system responsibility for these more general concerns about the Act's adequacy in relation to international income.

"Tax avoidance" is not the same as tax not exacted or collected. As we have tried to demonstrate, Canada has consistently accorded considerable pre-eminence to a territorial, or source, regime of taxing foreign direct investment income, except to the extent that such an approach demonstrably is not required to support, or at least not to interfere with, the competitive commercial interests of Canadian taxpayers in jurisdictions in which their operations are located.[216] What has been a considered decision to limit Canadian tax jurisdiction, and in so doing to approach the taxation of international income by making policy choices informed by consistent attempts to reconcile well-accepted international norms, is not the same as "tax avoidance" in the sense that pervades the report's section on the foreign affiliate system.

While a review of the foreign affiliate system raises as many questions as it answers, we suggest that those who would embark on a re-evaluation of the system should be mindful of a number of points.

1) Aspects of a tax system or its administration that do not result in the generation of positive tax liabilities do not necessarily foster or reflect "tax avoidance." As suggested above, "tax avoidance" is not the same as tax that effectively is forgone. Failing to draw this distinction in the course of a fundamental systemic examination of the foreign affiliate rules at best may result in misimpressions about the quality of those rules. At worst, such an approach, when commingled with practical tax administration concerns, may result in a confusing and seamless meshing of distinct, though functionally related, policy and administrative factors. The consequence may be unnecessary and unreasonable compromises in principle both in the design of the system and in its effective application.

[215] Continued . . .
manner in which the regimes were implemented. For example, under a modified exemption system, the degree of precision sought in identifying income eligible for exemption would control the relative simplicity or complexity of the system; likewise, it would determine the relative competitiveness. With respect to a current inclusion regime, the relative simplicity or complexity would largely be controlled by the method chosen." (Ibid., at 53.)

[216] It may be that a shifting of commercial emphasis from productive activity in the manufacturing or processing sense to include equally prominent interests of multinational corporate groups in efficient financing and deployment of intangible property has created the impression that the foreign affiliate system intrinsically is deficient, or has made less obvious and compelling the balancing of international norms reflected in the Canadian system. These are legitimate issues that need to be addressed in a thoughtful way. But the revenue that is not collected because the foreign affiliate rules are different from what they could be is not "tax avoidance." Neither is it appropriate to tar the fiscal quality of this system, as such, because the rules are manipulated (perhaps, indeed, inappropriately, given a thorough and contextual interpretation) in much the same way, to much the same end, and in much the same context as rules in the Act of exclusively domestic significance.

2) It is important, in evaluating the foreign affiliate system, to distinguish between tax policy concerns that are exclusive to it and those of more general import (despite necessary associations with the foreign affiliate rules).

3) It is at best unclear that the adoption of "bright line" tests, such as a definition of "active business income," would be helpful in this context. In our view, this concept in particular is satisfactorily defined by its context; indeed, much of this paper is devoted to describing and supporting this conclusion.

The foreign affiliate system is not an accounting regime. It can be interpreted and applied effectively, and faithfully to its objectives, only if its origins and objectives are properly understood and factored into specific situational analyses. In any event, definitional limits such as those found in section 125 of the Act are not appropriate for the foreign affiliate context; their objectives are fundamentally different. The small business rules in the Act derive their significance from commercial circumstances that are, in a sense, self-contained by the Canadian domestic context. On the other hand, the significance of rules related to the taxation of earnings arising from active foreign business operations is found in the relationships between the Canadian tax system and other tax systems, and, importantly, in the competitive commercial activities of Canadian taxpayers in other jurisdictions relative to the commercial situations of local persons and enterprises in those jurisdictions. An issue that essentially is "outward looking" cannot be assisted, seemingly, by an "inward-looking" approach that has been employed to serve exclusively domestic objectives of a much different sort.[217]

4) The related concern about how to define limits in the Canadian system in terms of the relative sophistication of other countries' tax systems and their resulting tax liabilities[218] also may be somewhat illusory. In addressing the responsiveness of foreign affiliate systems to international tax norms, much is frequently and freely made of the tax burdens exacted by foreign countries to justify the limited use of a (modified) exemption system for business income. The argument, framed as much in terms of simplicity and administrative feasibility as in terms of the competing "neutralities," is that an exemption system in effect functions as a credit system if

a) the source country exacts an income tax comparable to that of the residence state;

b) the residence state typically would recognize the pre-eminence of source state tax by extending a virtually complete foreign tax credit; and

[217] If there are concerns with the content of concepts such as this in marginal cases, they should be dealt with on the usual interpretative plane in the administration of the Act (using whatever information disclosure is necessary).

[218] The list of jurisdictions in regulation 5907(11).

c) consequently, little residence state tax would be expected to result from an inclusion and credit system as such.[219]

In terms of the way in which the auditor general's comments are framed, however, the focus perhaps should not be so much on whether any foreign tax is paid in the source jurisdiction;[220] rather, the basic issue that must be considered, even before tax "credit" methodology is addressed, is whether it is important to try to ensure that Canadians conducting foreign commercial operations through foreign corporations are not impeded by business costs, in the form of Canadian taxes, that their competitors do not face.[221] When the international issue is expressed in this way, any Canadian tax is problematic. Hence, as Canada has recognized, the fundamental system building block is a territorial or source-based regime. Nevertheless, particularly for highly mobile or conventional (that is, "portfolio") investment or non-active business income, there may not be the same justification for limiting Canadian tax, at least structurally, in the same way as for active business income. The Canadian system deals with this, among other ways, in the guise of FAPI and supporting rules that limit the tax-effective use of what amount to foreign investment funds (including those created, for example, in limited family circumstances), as well as by imposing limitations that may permit only deferral of but not exemption from Canadian tax.[222] While "global trading"[223] may make these implicit policy choices more difficult to discern, this is not necessarily a system flaw.

These qualifications of the application of the exemption aspect of the Canadian system sometimes are attributed to the geographical limits in regulation 5907(11). The typical observation is that, for the most part, the listed countries have income tax systems roughly comparable, at least in principle, to Canada's. Consequently, Canadian tax can be forgone in relative confidence that the affected income still will be taxed; the only issue is the "split" of tax revenue between competing jurisdiction claimants based on accepted policy norms. This may accord too much significance to the list as such, in particular as a useful solution for the difficult cases.[224] It may be that historically, at least outside the financial services and financing context, Canadian taxpayers chiefly have conducted activities in relatively high-tax jurisdictions. Or, to put it another way, the affected activities largely have been conducted in, and have been amenable to (and only to), jurisdictions that more likely than not are high-tax jurisdictions. But this may obscure the implicit analytical conclusion that the underlying activities in any case are properly the subject of an exemp-

[219] See Department of the Treasury, supra footnote 7, in particular chapters 3 and 4.

[220] See the discussion under the headings "The Canadian System in Historical and Policy Perspective" and "Evolving International Policy Considerations."

[221] See "Evolving International Policy Considerations."

[222] As under sections 94 and 94.1 of the Act.

[223] Including international group financial operations.

[224] See Lanthier, supra footnote 3, and supra footnote 64 and the related discussion.

tion treatment, according to Canada's adherence to certain international norms in the design of the foreign affiliate system. That is, the result may have been essentially the same regardless of the existence of the list.

5) The Act cannot be administered in this area mechanically or through continual reactive amendments. As is evident in this review, the main issues do not concern the technical interstices of the system but are centred on the principal concepts that define its purpose and scope. The burden (and expectation) of overdefinition[225] must be relieved, and an appropriate emphasis placed upon the interpretation and application of the foreign affiliate rules in their context.

Appendix

The "principal proposals" of the Royal Commission on Taxation in the international context, in relevant part, were set forth as follows:[226]

> 1. The present exemption from tax of certain foreign dividends received by a resident corporation which is provided by section 28(1)(d) should be withdrawn. Dividends received from foreign direct investment should be grossed-up at an arbitrary rate of 30 per cent and a foreign tax credit of the same amount should be allowed. If the dividend was received by a resident individual, then the applicable Canadian tax on the grossed-up amount would be payable at the time of receipt. However, if the dividend was received by a resident corporation, no tax would be payable until the income was in turn distributed or allocated, at which time a withholding tax of 20 per cent of the grossed-up amount should be collected so that the resident shareholders would be entitled to a tax credit of 50 per cent of the grossed-up distribution (the original 30 per cent foreign tax credit plus the additional 20 per cent withheld).
>
> 2. A foreign direct investment should be defined as an investment by a Canadian resident or associated group of Canadian residents:
>
> a) in a non-resident corporation in which he or the group holds a 10 per cent or greater interest in the voting power, in the profits or in the assets distributed on liquidation of the non-resident corporation, or
>
> b) in a foreign property or business in which he or the group holds a 10 per cent or greater interest.
>
> 3. Canadian taxpayers having foreign direct investments should report annually the foreign income earned and the foreign income taxes paid in each foreign jurisdiction. If the foreign income taxes paid on this current income (including those paid by a non-resident

[225] This sometimes occurs in the false guise of "clarification" or, effectively, to relieve those involved with the system of engaging in a constructive interpretative exercise based on principles that are more clear and consistent than many may acknowledge. See the 12th report of the Public Accounts Committee, supra footnote 6 (issue no. 48). We do not share the conclusions of that committee, which in substantial measure reflect concerns expressed in the report.

[226] Supra footnote 107, vol. 4, at 486-87.

corporation) were less than 30 per cent of the foreign income earned, the difference should be paid to Canada as a special tax. This procedure would ensure that all foreign source direct investment income was immediately subject to income taxes of at least 30 per cent on an accrual basis. If the foreign income was substantially subjected to a withholding tax in the foreign country on distribution to the Canadian investor, the special tax paid on such income would be refunded to the extent of the withholding tax. If a Canadian taxpayer with less than a controlling interest in a foreign direct investment could establish that he was unable to obtain sufficient information to compute the foreign income, he should be entitled to elect that it be taxed as portfolio investment income (i.e., income from an investment other than a direct investment) with credit only for withholding taxes paid.

4. For the purpose of these computations, foreign income should be defined as income reported to the foreign jurisdiction (or in an audited financial statement) with certain adjustments to make this figure generally comparable to income as defined for Canadian tax purposes. These adjustments would not be numerous or detailed, and we will suggest an additional modification that should mean that computations should rarely be necessary for most income derived from the United States and the United Kingdom.

5. Canadian portfolio investors (investors who were not direct investors) should be given an option:

a) to be taxed on the same basis as direct investors as described above; or

b) to be taxed as at present with a credit only for withholding taxes paid.

Moreover, the effect of adopting such modifications to the system was demonstrated in a comparative table, as follows (page 2:71):

TABLE 26-1

AN EXAMPLE OF A TAX ARISING FROM A DIVIDEND RECEIVED BY A RESIDENT SHAREHOLDER OF A RESIDENT CORPORATION WITH INCOME DERIVED SOLELY FROM FOREIGN "DIRECT INVESTMENT," ASSUMING FULL DISTRIBUTION BY THE CORPORATION OF ALL EARNINGS AFTER TAXES

Under the Proposals in this Report

Net Foreign Dividends Received by Resident Parent Corporation		
Annual before-tax income of the foreign direct investment		$100.00
Foreign corporation tax at, say, 50 per cent		-50.00
		$ 50.00
Foreign withholding tax at, say, 15 per cent		-7.50
Dividend received by resident parent corporation		$ 42.50
After-tax Resident Corporation Income Distributed or Allocated to Resident Shareholders		
Resident parent corporation brings into income a/		$ 60.71
Foreign tax deemed to have been paid b/	$ 18.21	
Withholding tax payable on distributions to resident shareholders c/	12.14	$ 30.35
After-tax corporate income distributed or allocated to resident shareholders		$ 30.36

Resident Personal Tax and Rebate	25 per cent marginal rate	50 per cent marginal rate
Resident shareholder brings into income d/	$ 60.71	$ 60.71
Personal tax thereon	-$ 15.17	-$ 30.55
Corporation tax credit	+30.35	+30.35
Canadian tax rebate	$ 15.18	$ 0.00

Under the Present Tax System

Net Foreign Dividends Received by Resident Parent Corporation	$ 42.50
After-tax Resident Corporate Income Distributed to Resident Shareholders	$ 42.50

Resident Personal Tax	25 per cent marginal rate	50 per cent marginal rate
Resident shareholder brings into income	$ 42.50	$ 42.50
Personal tax thereon	-$ 10.62	-$ 21.25
Dividend tax credit	8.50	8.50
Net tax paid	$ 2.12	$ 12.75

(The table is concluded on the next page.)

TABLE 26-1 CONCLUDED

Cash Position of Resident Shareholder	25 per cent marginal rate	50 per cent marginal rate
Cash dividend	$ 30.35	$ 30.35
Net resident tax rebate	15.18	0.00
Net cash	$ 45.53	$ 30.35

Cash Position of Resident Shareholder	25 per cent marginal rate	50 per cent marginal rate
Cash dividend	$ 42.50	$ 42.50
Net resident tax paid	2.12	12.75
Net cash	$ 40.38	$ 29.75

Notes:

a/ $\$60.71 = \frac{\$42.50}{100 - 30 \text{ per cent}}$ (i.e., $42.50 dividend received grossed-up at a rate of 30 per cent)

b/ $18.21 = 30 per cent of $60.71 (or $60.71 less $42.50)

c/ $12.14 = 20 per cent of $60.71

d/ $\$60.71 = \frac{\$30.36}{100 - 50 \text{ per cent}}$ (i.e., $30.36 dividend received grossed-up at a rate of 50 per cent)

Source: Reproduced from Canada, *Report of the Royal Commission on Taxation*, vol. 4 (Ottawa: Queen's Printer, 1966), 519.

Taxing Foreign Business Income

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Introduction

Chapter 6 of the report of the Technical Committee on Business Taxation is entitled "International Taxation." Yet, as the committee recognizes, there is no system of international taxation which accounts for the complexity typically attributed to rules for taxing international income. This notion refers more accurately to the contemporaneous application of the tax rules of more than one jurisdiction to income earned through activities conducted in or in relation to those jurisdictions in a manner that justifies the assertion of tax claims by each according to its own tax rules, subject to any concessions in deference to the tax claims of another.

The report provides a useful opportunity to review the effectiveness of the present international tax rules, even though the work of the committee in this area does not break new ground in a tax policy sense, perhaps partly because of the overall revenue-neutrality constraint to which the committee's deliberations were subject.

Our goal here is to supplement the committee's observations by offering a perspective on the outbound international proposals which concentrates directly on the relevant underlying tax policy issues and in result to make these issues more accessible to the present debate. It is, in our view, partly because these issues, as such, are not for the most part developed this way in the report that the committee's recommendations may seem to be more intrusive in some respects, and the interest deductibility proposal less defensible, as elements of a cohesive whole system for taxing foreign active business income than may in fact be the case. Examined as we perceive them, however, not only are the changes recommended by the committee not terribly provocative but indeed in many respects they are already reflected in the theoretical expectations of the system, albeit perhaps imperfectly in its legislative superstructure. In our view, the recommendations of the committee suggest little more than refinements of Canada's system for taxing foreign direct investment, and are fundamentally consistent with it.

International Taxation and Contemporary Business Activity

Interjurisdictional Income Allocation and Foreign Tax Credit

Broadly, the basis and relative priority of a country's tax claim, in relation to the claims of other nations, depend on the nature of the activity giving rise to income, and in particular on the extent to which that activity and the resulting income have a sufficiently close connection—an economic nexus—to the country to sustain the tax claim.[1] International tax policy increasingly is concerned about allocating international income (and therefore tax base) on an economic basis, and about how to rationalize competing tax claims in respect of income that may be connected to more than one jurisdiction. In part this is because the basic jurisdictional notions of "source" and "residence" incorporated in traditional conceptions of a taxpayer's primary tax jurisdiction, "carrying on business" and "permanent establishment," no longer always reliably capture the ways in which international income is earned and how it flows from one jurisdiction to another.[2] Inherently, then, "international taxation" has two aspects:

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[1] The personal connections of the income earner are also, obviously, relevant, at least in terms of the basic architecture of the tax system. However, increasingly, the "tax home," as it were, of the income earner and the significance of its legal personality as a determinant of how tax is levied are less important than accurately determining where, in an economic sense, the income was earned. Effectively, the international preoccupation with transfer pricing is a manifestation of this.

[2] For perspectives on these issues, see Richard M. Bird and J. Scott Wilkie, *Source vs. Residence-Based Taxation in the European Union: The Wrong Question?* Discussion Paper no. 10 (Toronto: University of Toronto, Joseph L. Rotman School of Management, International Centre for Tax Studies, 1997); and Sijbren Cnossen, "Company Taxes in the European Union: Criteria and Options for Reform" (November 1996), 17 *Fiscal Studies* 67-97.

(The footnote is continued on the next page.)

the measurement of a taxpayer's income according to normative income tax principles, and the interjurisdictional allocation of that income on a basis that reflects general international consensus on principles to guide the sharing of potentially coextensive tax claims. The most significant aspect is the latter, and the committee's recommendations mainly concern it.

Canada evidently has made a tax policy decision to adopt what amounts to a territorial system for taxing foreign incorporated active business income.[3] This entails recognizing the primacy of foreign tax systems to tax foreign incorporated business income earned by Canadians, and providing credit, including through the exemption aspect of the Canadian system, for such tax. It is, accordingly, necessarily in Canada's interest, based on the tax policy for extending credit, to ensure that the implicit expectation that foreign income will in fact have been exposed to foreign tax in a manner roughly consistent with Canadian standards is justified.

The Committee's Recommendations: Tax Policy Themes

The committee's outbound international recommendations manifest these international tax considerations. The most controversial would deny the deductibility of interest on money borrowed to fund investments in foreign incorporated businesses (so-called foreign direct investment, or FDI) unless and until underlying income earned with, or value created from the use of, such funds is paid to or otherwise realized by Canadian shareholders and actually subjected to Canadian taxation. The second, which accounts for virtually everything else in this area, is essentially a collection of seemingly "technical" changes to the "foreign affiliate" rules limiting access to their exemption aspect. These include proposals to increase the degree of FDI required for "foreign affiliate" status, and to deny exempt surplus treatment to income that has enjoyed preferential taxation not generally available for income of corporations ordinarily taxable in the affiliate's home jurisdiction. Essentially, the committee advocates a closer correspondence for tax purposes between financial and economic measurements of business income earned by foreign affiliates, and would exempt foreign business income of foreign affiliates from Canadian tax only where it has been exposed at least to the possibility of meaningful

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[2] Continued . . .
The issues in this area are not confined to systematic economic integration such as that found in Europe, although the experience there serves to highlight the importance of ensuring that tax jurisdiction notions keep step with the economic context in which they are meant to apply.

[3] J. Scott Wilkie, Robert Raizenne, Heather I. Kerr, and Angelo Nikolakakis, "The Foreign Affiliate System in View and Review," in *Tax Planning for Canada-US and International Transactions*, 1993 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1994), 2:1-72. The basic tenets and expectations underlying the system are discussed in this paper. Even in the case of income that is ultimately taxable in Canada as a distribution of "taxable surplus," there is what amounts to perpetual deferral, assuming that such income often, if not usually, is not distributed.

taxation elsewhere. The present recommendations were foreshadowed by criticisms levelled in the 1992 auditor general's report[4] and the 1993 report of the Public Accounts Committee of the House of Commons,[5] which resulted in a variety of changes to the Act[6] that, for the most part, were consistent with the conceptual thrust of the present proposals.

The observations of the committee actually reflect tax policy already deeply entrenched in the development of the Canadian tax system, notably the foreign affiliate rules. In our view, however, their force is much easier to understand with the benefit of a more direct examination of their specific historical tax policy and legislative context. The recommendations in fact are part of a continuum of changes that, since the inception of the modern system for taxing foreign active business income, have continued to refine definitional and other limits to ensure that the full benefit of the exemption system is normally only available with respect to income that is genuinely both "active" and "foreign," and in respect of which Canadian shareholders are in a position to enjoy a meaningful degree of influence and ownership. Indeed, if implemented, the proposed changes would for the most part merely refine the coherent application of rules targeted at the taxation of incorporated foreign business income, which have been a mainstay of the Canadian tax system for some time.

The Evolution of the Canadian Foreign Affiliate System: Important Stages[7]

The genesis of the exemption system was evident in the period prior to 1952. In this period, although various restrictive measures were taken from time to time, for the most part the rules developed and expanded the exemption system of taxing foreign income. The system in place at the time of the Income Tax Act of 1952 would be in place for 20 years, and essentially provided comprehensive exemption from Canadian tax of foreign active business and passive income earned by 25 percent owned foreign subsidiaries.

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[4] Canada, *Report of the Auditor General of Canada to the House of Commons 1992* (Ottawa: Supply and Services, 1992).

[5] Canada, *Minutes of Proceedings and Evidence of the Standing Committee on Public Accounts*, Twelfth Report to the House, 34th Parliament, 3d session, 1991-92-93, issue no. 48, April 23, 1993. For an analysis of the 1992 auditor's general report and the 1993 report of the Public Accounts Committee of the House of Commons, see Allan R. Lanthier, "Policy or Abuse? The Auditor General's Report" (1993), vol. 41, no. 4 *Canadian Tax Journal* 613-38; and Wilkie et al., supra footnote 3.

[6] Notably, these included changes ("the 1995 amendments") to section 95 of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"), to expressly set out a statutory regime for identifying income from an "investment business." Unless otherwise stated, statutory references in this paper are to the Act.

[7] For a detailed review of the Canadian foreign affiliate system, see Wilkie et al., supra footnote 3, at 2:27-55.

The report of the Royal Commission on Taxation[8] expressed concern about the potential for avoiding tax on foreign earnings that had not been subject to foreign tax, and proposed the elimination of the exemption system in favour of a special tax that would be levied on taxpayers on an accrual basis in respect of certain foreign source income.

As it turned out, the foreign affiliate system that exists today more closely reflects the recommendations released by the Department of Finance in 1969.[9] While observing that there was no "right" answer in the choice between an exemption system and a credit-based system, the white paper recommended preserving the exemption system, but only in respect of active business income earned in treaty countries. Following extensive debate and study of the white paper,[10] a series of substantive amendments were made to the foreign affiliate rules in the early 1970s.[11] Various amendments have occurred since the 1970s, but none modified the foreign affiliate system in principle.

In summary, from 1952 and continuing to the present, foreign incorporated active business income has not been subject to immediate, and in many cases any, taxation under the Act, depending upon the circumstances in which it is earned. It may benefit from deferred taxation with credit for foreign withholding and underlying tax, usually when there is an expectation that the income will not otherwise be subjected to any meaningful degree of taxation in default of taxation by Canada ultimately. Or it may be exempt from Canadian taxation entirely (as long as it is not distributed to other than corporate shareholders) when there is at least an expectation that the income will be taxed in terms broadly consistent with the requirements and characteristics of the Canadian tax system.

The 1995 amendments expanded significantly the definition of foreign accrual property income (FAPI). Implemented with general effect for taxation years beginning after 1994, the 1995 amendments created a regime for identifying and subjecting to current taxation as FAPI various categories of investment income. These were essentially the outcome of an exercise in defining, by exclusion, the notion of "active" business income. Until then, this term had not attracted an interpretation consistent with the particular tax policy supporting the exemption aspect of the foreign affiliate system. Many taxpayers, advisers, and the courts had

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[8] See Canada, *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966).

[9] E.J. Benson, Minister of Finance, *Proposals for Tax Reform* (Ottawa: Queen's Printer, 1969) (herein referred to as "the white paper").

[10] See, for example, Canada, House of Commons, *Eighteenth Report of the Standing Committee on Finance, Trade and Economic Affairs Respecting the White Paper on Tax Reform* (Ottawa: Queen's Printer, October 1970); and Canada, Senate Standing Committee on Banking, Trade and Commerce, *Report on the White Paper Proposals for Tax Reform Presented to the Senate of Canada* (Ottawa: Queen's Printer, September 1970).

[11] See SC 1974-75-76, c. 26, inter alia, sections 55 to 59 and 73.

attributed a very low threshold of activity to "active business" and consequently sought to justify what would otherwise be investment-like activities as active even though no circumstances associated with "capital import neutrality" genuinely came into play.[12]

Even in the absence of the committee's recommendations, the 1995 amendments were not expected to be the last of the changes to the Canadian foreign affiliate system. Certain criticisms made by the auditor general in 1992, and by others,[13] were not addressed by the 1995 amendments. Further, it is clear that the Department of Finance has been continuing its review of the system. The extensive new foreign reporting rules will provide Revenue Canada and the Department of Finance with valuable information about foreign affiliates to not only ensure compliance with, but also to evaluate, the current foreign affiliate rules.[14]

The Report: Policy Directions

Whether and how, and more fundamentally why, a country is prepared to acknowledge tax claims of other countries to which international income may have some connection is in the first instance found in its own tax rules, based upon several broad, though imperfect, international tax policy

[12] In *Canada Trustco Mortgage Company v. MNR*, 91 DTC 1312, the Tax Court of Canada attributed a very low threshold of activity to the active business notion upon which the exempt surplus notion in the foreign affiliate rules depends. The test applied by the court drew much of its significance from the active business notion underlying the small business deduction in section 125 of the Act. Arguably, however, the tax policy on which the foreign affiliate system is based, and the neutrality tradeoffs alluded to below, justify assessing "active" in the context somewhat differently; see Wilkie et al., supra footnote 3. In conceptual terms, capital import neutrality (see the discussion below) should only determine how foreign income is taxed under the Act if, indeed, that income is exposed to "competitive taxation" in foreign jurisdictions where Canadian enterprises earn foreign income in competition with local enterprises. In many instances, the activities of foreign corporations to which the "active business" connotation was attributed had nothing to do with local competition. Such income—essentially trading or other investment income—was earned exclusively for the benefit of Canadian shareholders in situations where no element of genuinely indigenous foreign competition was present. The only significance of such entities was to act as repositories of income that otherwise would be subjected to taxation at high rates in Canada or other jurisdictions and which had effectively been diverted to a low-tax regime. As a result of the changes following the auditor general's criticisms, the different connotation of "active" here became more evident impliedly according to what was considered, in the Act, to be of an investment nature.

[13] See, for example, Brian J. Arnold, "The Deductibility of Interest To Earn Foreign Source Income," in *Report of Proceedings of the Forty-Eighth Tax* Conference, 1996 Conference Report, vol. 2 (Toronto: Canadian Tax Foundation, 1997), 45:1-23.

[14] The reporting requirements in respect of foreign affiliates are found in section 2334 of the Act. For a review of these reporting requirements, see Joel Nitikman, "The New Foreign Property Reporting Rules" (1996), vol. 44, no. 2 *Canadian Tax Journal* 425-50; Judith Harris, "Foreign Affiliate Reporting: The March 5, 1996 Proposals," in the 1996 Conference Report, supra footnote 13, vol. 2, 42:1-19; and Nick Pantaleo and Michel Dell'Aniello, "Foreign Reporting for Foreign Affiliates: A Practical Approach," in *Report of Proceedings of the Forty-Ninth Tax Conference*, 1997 Conference Report (Toronto: Canadian Tax Foundation, 1998), 45:1-36.

guidelines or concepts grounded in notions of tax neutrality. The committee acknowledges these as the basic framework for its deliberation in this area. Tax treaties refine the jurisdictional decisions reflected in a country's own tax rules, often when the relationship between the treaty partners warrants tailored solutions to particular jurisdictional issues unique or common to the circumstances of the two countries.

"Capital export neutrality" and "capital import neutrality" generally are considered to establish the end points of reference for evaluating whether and to what extent a country recognizes and defers to the tax claims of others. The place of a country's tax rules on this spectrum reflects whether its approach to taxing international income tends to favour its own interests over accommodating competing tax claims—that is, whether the emphasis is placed on "national" versus "global" neutrality.[15] These rather arcane terms simply express a way, in principle, of assessing whether the tax system of a taxpayer's closest personal connection—the state of residence—or that where the income is actually earned—the state of source—should have the primary right to tax international income.[16] Apart from tax treaties, which in any event normally are only bilateral, there is no systematic regime for harmonizing or integrating separate national tax systems.[17] These norms supply basic constraints, typically observed or at least acknowledged unilaterally by countries, on the degree to which they reasonably should persevere in asserting tax claims on international income relative to each other.

Tax systems that apply to the same degree regardless of the source of income are said to be export-neutral. This means that the degree of income taxation does not change based on the location of the income-producing activity. Taxpayers resident in a jurisdiction are taxed to the same extent

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[15] See the 1991 report of the OECD dealing with neutrality considerations: Organisation for Economic Co-operation and Development, *Taxing Profits in a Global Economy: Domestic and International Issues* (Paris: OECD, 1991). Richard Bird offers an insightful and pragmatic view of the significance of tax policy neutrality theory in Richard M. Bird, "A View from the North" (Summer 1994), 49 *Tax Law Review* 745-57.

[16] The issues here extend beyond rudimentary applications of the neutrality principles. In the context of complex international economic arrangements and the advent of multinational economic zones of interest, questions of tax sovereignty, expressed in terms of the "subsidiarity" principle, are also important. Bird, supra footnote 15, discusses this, as does H. David Rosenbloom, in "What's Trade Got To Do with It?" (Summer 1994), 49 *Tax Law Review* 593-98. The importance of a tax system in funding public consumption—for effecting tax expenditures—according to a jurisdiction's own consumption choices is a fundamental consideration in the debate about whether and to what extent overt prescriptive or even practical and functional harmonization or integration of tax systems ought to take place. This key aspect of assessing tax jurisdiction issues cannot be overlooked or its significance minimized.

[17] An enduring assessment of the limitations of bilateral treaties to adequately allocate income on an economic basis, and therefore to resolve jurisdiction competition for the affected international tax base, is found in Richard J. Vann, "A Model Tax Treaty for the Asian-Pacific Region? (Part I)" (March 1991), 45 *Bulletin for International Fiscal Documentation* 99-111, and " . . . (Part II)" (April 1991), 45 *Bulletin for International Fiscal Documentation* 151-63.

regardless of where or how they earn income. The purest form of an export-neutral tax system recognizes taxes imposed on international income by other countries only as deductible business expenses. Such a system would also be said to be nationally neutral—the effective rate of tax imposed on international income by the residence country is the same regardless of its geographic source. Necessarily, double taxation results. The residence taxpayer is taxed on international income in more than one jurisdiction simultaneously, without offsetting credit in one for taxes imposed by the other.

Contrastingly, an import-neutral tax system exacts no more tax on international income than that imposed by the jurisdiction in which the relevant income-producing activity is conducted. Effectively, the jurisdiction in which a taxpayer is resident recognizes the tax claim of the jurisdiction in which the income is earned as pre-eminent, and to that extent (at least) abandons its own tax claim. A tax system that is import-neutral would also be said to be globally neutral: business income should bear the same taxation internationally wherever it is earned, regardless of the residence or nationality of its economic owner. The hallmark of a globally neutral system is the extension of credit against its own taxes for taxes levied on the same income and taxpayer by another jurisdiction. The purest form of a system based on these principles would exempt foreign income entirely from domestic taxation, and indeed, theoretically, would subsidize the international business activities of its residents by paying "refunds" of domestic tax to the extent that foreign tax was more onerous.

The committee expresses its adoption of these international tax policy norms in terms of promoting "economic growth and job creation" while nevertheless ensuring "protection of the Canadian revenue base."[18] This reflects a practical though somewhat dubious perception of these neutrality norms, which may be directly traceable to the terms of reference of the committee. Economic growth and job creation are recurrent themes in the report, and in the international area are closely tied to a perceived need to reinforce and encourage the competitiveness of Canadian business through the tax system. The outlook of the committee seems to be that the tax system should not impose such a high cost on business conducted in Canada or by Canadian enterprises internationally that Canadian economic growth is unnecessarily stunted, or, alternatively, that Canada subsidizes international operations of non-Canadians disproportionately to the resulting Canadian economic benefit.[19] These are not,

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[18] Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998) (herein referred to as "the report"), 6.1.

[19] The case in point here, addressed by the committee, is the tax treatment of financing charges. Effectively, a high-tax regime that permits interest charges to be deducted on FDI with no corresponding matching of underlying revenue on an economic basis furnishes a subsidy to the corporate group of which the taxpayers directly affected are members. As discussed below, this is an element of the committee's thinking in respect of the proposed interest deductibility limitation.

however, jurisdictional concepts of the sort normally associated with "capital export" or "capital import" neutrality, although the neutrality orientation of a tax regime may affect the responsiveness of economic policy in these two areas. At most, competitiveness is sometimes regarded as synonymous with capital import neutrality insofar as that term tends to treat tax as a kind of business cost from the standpoint of the country whose taxpayers are conducting international business. Indeed, there is a flavour of "tax as a business cost" in chapter 6 that is somewhat at odds, in our view, with the tax policy ideals to which this reform document aspires. However, the report's concern for the sustainability of Canada's tax revenue base does recognize the need to modify or relinquish Canadian taxation of international income only where the claim of another tax jurisdiction is justified based on the connection of the income to that jurisdiction and an ultimate Canadian economic interest is advanced.

In the context of its understanding of the basic tax policy imperatives, the committee does not challenge, and indeed confirms, the territorial nature of Canada's system for taxing incorporated foreign active business income according to classical perceptions of corporate existence and commercial activity on which, generally, the Canadian tax system is based.[20] To the extent that income is from carrying on business in a jurisdiction, the source state is usually accorded primary jurisdiction. There is little point, it may be argued, for the residence state to impose a tax liability only to cede it through foreign tax credit as long as normative tax systems would otherwise be in competition for tax on the income. The committee seems to adopt this jurisdictional perception.

Tax policy with this grounding requires getting the nexus determination "right" in relation to taxpaying units and their activities in or in relation to the jurisdiction to which they have some plausible fiscal connection. Canada's approach is to tax income of legal entities and not economic units,[21] and not to reach for immediate tax on the business

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[20] In fact, much of what would have been interesting and perhaps provocative analysis in respect of a number of the issues to which our comments are directed is dispensed with on the basis that the alternative rules that such analysis would recommend are too complex for various substantive or practical reasons. Even if this is so, the exercise of exposing the relevant analysis to scrutiny would have been informative.

[21] The foreign affiliate regulations, in regulations 5907(1.1) and (1.2), accommodate consolidated group taxation or relief in certain instances, and, of course, Revenue Canada domestically generally is prepared to accommodate planning to effect a degree of corporate consolidation for tax purposes. But, in principle, the Canadian tax system taxes the financial income of legal entities. This approach, in a sense, collides with the expectations of modern transfer-pricing rules and practices, for reasons that, though expressed somewhat differently, are essentially jurisdiction in the same sense as that term is used in our comments. Implicitly, tax systems tax economic income. The markers of tax jurisdiction—the units of taxation and the kind of presence in a country required to sustain a tax liability—historically have corresponded reasonably well with economic determinants of income. Indeed, article 9 of the OECD's *Model Tax Convention on Income and on Capital* (Paris: OECD) (looseleaf) (the so-called transfer-pricing article) refers to income allocations,

(The footnote is continued on the next page.)

income of foreign entities no matter how little tax they pay in other jurisdictions. To the extent that the Canadian tax base would be inordinately depleted by transactions between foreign corporations and their Canadian affiliates, the transfer-pricing rules are meant to apply. Canada is not, at present, prepared to adopt more controversial approaches to solving the nexus issue.[22] Embedded in "nexus," however it is approached, is, nevertheless, the primary question of ceding tax jurisdiction—or extending foreign tax credit. It is on this that the committee concentrates by seeking to ensure that foreign income (and, as a necessary corollary, domestic income) are accurately measured in economic terms, and that tax deferral and credit (and ultimately tax exemption) are extended in respect of foreign income only if certain expectations about the circumstances in which it is earned and actually subjected to foreign taxation are satisfied.

Taxation of Foreign Income of Canadian Investors

General

The committee spent considerable time evaluating the merits of the exemption system of taxing foreign income, and specifically foreign business income, with alternative methods. The committee identified, in addition to the exemption system, the accrual and deferral methods for recognizing income earned abroad by the Canadian taxpayer directly or through a foreign subsidiary or entity.

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[21] Continued . . .
not transactional pricing. The reason for the concern underlying countries' re-evaluation of the territorial reach of their tax systems is the perceived unreliability of the historical connotations of typical markers of tax jurisdiction to adequately identify and associate with those countries contemporary international business income. The need for tax systems to establish a requisite economic nexus of income to the jurisdiction to justify taxation in principle has not changed at all. Nor have the basic economic expectations served by and the implications of such jurisdictional indicators changed. Their historical significance increasingly, however, is outmoded. In the main, this is the issue that confounds those dealing with the income and commodity tax aspects of electronic commerce. One of the dangers in this area is inadequately recognizing the historical significance, in economic terms, of typical jurisdictional concepts (for example, "permanent establishment") as they are seemingly adopted internationally as the touchstones for attributing income from or relating to international electronic commerce to competing national tax claimants. See Canada, *Electronic Commerce and Canada's Tax Administration: A Report to the Minister of National Revenue from the Minister's Advisory Committee on Electronic Commerce* (Ottawa: Revenue Canada, April 1998), notably the discussion in chapters 3 and 4 (and the various international reports referred to).

[22] As Canada's (and other countries') reactions to recent transfer-pricing developments make abundantly clear, at least as a formal matter, unitary or formulary tax systems are not considered to be acceptable as alternatives to the financial income/entity-based systems that, generally, prevail. See Organisation for Economic Co-operation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD) (looseleaf).

Under the accrual method, foreign income is subject to tax on a current basis in the home country (normally the taxpayer's country of residence). For example, if income earned abroad by a taxpayer through a foreign branch is subject to tax in the taxpayer's home country, the income is usually subject to tax on an annual accrual basis.

Under the deferral method, income earned by a foreign entity is recognized when the income is distributed as dividends to the parent company and is subject to tax in the home country at that time. In effect, home country taxation is deferred as long as profits remain and are reinvested offshore. Under the deferral and accrual methods, a credit against home country taxation is available in respect of foreign taxes. As a result, taxes levied on the income will be the greater of the rate of taxation in the home country and the rate of taxation in the foreign country.

Finally, under the exemption system, foreign income is exempt from taxation in the home country, meaning that the income will only be subject to tax in the foreign jurisdiction where the investment takes place. The committee states that the exemption method is really intended to be a proxy for the deferral method, on the assumption that the income in question has been subject to foreign tax at a rate comparable to that which would have applied in the home country.

The Canadian foreign affiliate system that has been in place since the early 1970s incorporates all three methods:

- The accrual method has been adopted with respect to passive income earned by controlled foreign affiliates of taxpayers resident in Canada.
- The deferral method has been adopted with respect to business income earned by foreign affiliates in non-treaty countries and in respect of passive income earned by non-controlled foreign affiliates.
- The exemption system has been adopted for active business income earned by foreign affiliates in treaty countries.

Canadian Taxation of Foreign Active Business Income: A Territorial System

Active business income of a non-Canadian corporation is not subject to current taxation in Canada, wherever it is earned outside Canada. Provided that it is earned in a jurisdiction with which Canada has a tax treaty by a corporate resident of such a jurisdiction, such income in principle is exempt from taxation until distributed to non-corporate shareholders. Otherwise the income will be subject to taxation in Canada, but only when actually distributed to its shareholders, subject to a credit for underlying foreign tax that the income has borne.

The foreign affiliate rules fulfil two functions as part of Canada's territorial system for taxing incorporated foreign business income. First, they are a kind of comprehensive foreign tax credit regime applicable to incorporated foreign income. Second, they control the extent to which any deferral is legitimate by distinguishing between investment income, which

has no necessary or unique foreign connection that would justify domestic tax concessions in deference to a notion of international competitiveness and whose taxation should therefore be guided by the capital export neutrality principle, and business income that qualitatively may and probably does have a local connection in respect of which an emphasis on capital import neutrality, or international competitiveness, would not be misplaced. In the case of the latter kind of income, the further question, which the committee addresses, is whether the degree of foreign taxation should influence how the deferral and credit (including exemption) aspects of the foreign affiliate system should apply.

The committee did consider alternative methods of taxing foreign active business income earned by foreign affiliates of taxpayers resident in Canada.

The Accrual Method

The accrual method was discounted as a reasonable alternative because it would put Canadian businesses at a significant disadvantage vis-à-vis Canada's major trading partners, none of whom has adopted such an approach.

Full Exemption System

Under this system, all dividends received by a Canadian corporate shareholder out of the active business income of a foreign affiliate would not be subject to Canadian tax, irrespective of whether the business operations were carried on in a treaty or a non-treaty country.

This approach is appealing because Canada has treaties with most of its major trading partners and dividends are rarely paid out of taxable surplus to Canadian corporate shareholders. The committee argues that this approach would have a negligible effect on government tax revenues and would simplify significantly the foreign affiliate system and reduce compliance costs. The committee suggests as well that the full exemption system would eliminate detailed computations of exempt and taxable surplus balances, but, presumably, surplus computations would be necessary in order to track active business income and to distinguish it from income that is FAPI.

The full exemption system was rejected by the committee primarily because of the complications and possible distorted investment decisions that might arise as a result of the treatment of capital gains. The committee was concerned that if, under a full exemption system, capital gains from the disposition of shares of foreign affiliates were exempt from Canadian tax, there would be an incentive to seek opportunities for investments in foreign markets, rather than in the domestic market. It is curious that the committee would suggest that capital gains on the disposition of foreign affiliates might be completely exempt from Canadian tax under this approach because such capital gains are arguably more similar to

passive rather than active business income.[23] As suggested above, even under a full exemption system, there would need to be some tracking of passive income, including certain capital gains. The current concept of *excluded property* could be retained under a full exemption system, thereby ensuring deferral of Canadian tax until the proceeds are repatriated back to Canada.

While there seems to be plenty of evidence, as the committee points out, that little if any tax revenue is generated from foreign business income whether or not an exemption or a credit system is used, another problem with the full exemption system for active business income would be the concern that tax-avoidance schemes would be developed to shift or derive more active business income in low-tax jurisdictions.

Deferral Method with Credit

Under this method, all active business income earned by foreign affiliates would be included in taxable surplus, and, essentially, the current rules dealing with dividends paid from taxable surplus would apply. The committee suggests that relief for foreign taxes might be computed on a global basis; alternatively, detailed rules could be put in place requiring separate calculations for specific sources of income. The deferral method with credit is similar to that in place in the United States and the United Kingdom.

The committee rejected this method largely because of the experience in other countries where the rules become far too complicated for the limited tax revenues, if any, that are generated. The committee also expressed concern that abandoning the exempt surplus system would require renegotiation of Canada's tax treaties, which incorporate the benefits of this system. Alternatively, the committee suggests, there would have to be a change to Canadian domestic legislation to override existing treaty obligations.

The committee's desire to avoid changes that might increase the complexity in the foreign affiliate system is laudable. The added complexity of the deferral method would be undesirable compared with the present system. However, there is no evidence that the committee compared the deferral method with the present system, as modified by the committee's recommendations to deny (1) the deductibility of interest on borrowings by Canadian taxpayers to invest in foreign affiliates, and (2) exempt surplus

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[23] Under the current rules, three-quarters of a capital gain derived by a foreign affiliate on the disposition of shares of another foreign affiliate is FAPI unless the shares are *excluded property*, as defined in subsection 95(1). In any event, three-quarters of the capital gain are added to the taxable surplus of the disposing affiliate, and the remainder is added to exempt surplus. If the shares of the disposed affiliate are excluded property, Canadian tax is effectively deferred until the proceeds are paid as a dividend to the Canadian corporate shareholders. The capital gain, however, may be reduced by filing a subsection 93(1) election to the extent of the underlying exempt and/or taxable surplus of the disposed affiliate.

treatment on certain payments made to related, tax-privileged entities. While the matter is not free from doubt, the complexity of the deferral method may be preferable to the present system modified by the committee's recommendations.

The High-Tax Method

This method would maintain the existing distinction between active business income earned in treaty and non-treaty countries and would add the additional requirement that income earned in a treaty country would only be included in exempt surplus if the income was subject to a minimal rate of income tax. The committee presumes that the nominal or statutory rate in the foreign country would not be relevant, since this would not necessarily reflect the actual tax burden. Rather, the relevant rate would be the effective tax rate (total taxes divided by income) that the particular foreign affiliate is actually paying.

The committee rejects this method because complex rules would be required for purposes of determining the income base and the amount of taxes being paid. More important, the high-tax method does not allow Canadian taxpayers to aggregate taxes paid on all sources of business income, as is the case under the deferral with a credit method. Notwithstanding this criticism of the high-tax method, the committee effectively endorses this method in recommending that the government actively renegotiate its existing tax treaties, to ensure that all *tax-privileged* entities in treaty countries be denied access to the exemption system with respect to income from interaffiliate transactions.

The Committee's Overall Assessment

On balance, the committee concludes that the present system of

- exempting active business income earned in treaty countries from Canadian tax,
- deferring Canadian tax on active business income earned in non-treaty countries, and
- taxing FAPI of a controlled foreign affiliate on an accrual basis

is "fundamentally sound and should be maintained."[24] The alternative methods examined by the committee "would introduce significant new

[24] Report, supra footnote 18, at 6.10. It is difficult to find ways in which to measure such a premise objectively. It is interesting to note, however, that in 1993 a report prepared by the United States Treasury Department substantially favoured a system such as Canada's for taxing foreign active business income over that in place in the United States, subject to the adoption of limitations on the domestic deduction interest on financing foreign direct investment. See United States, Department of the Treasury, *International Tax Reform: An Interim Report* (Washington, DC: Department of the Treasury, 1993). That report suggested that income actually favoured by the exemption or deferral and credit aspects of such a system should reflect as much as possible the measurement of foreign and domestic income on an economic basis.

complexity and would discourage some foreign direct investment by Canadian multinationals, with little anticipated revenue gain for Canada."[25] Nevertheless, the committee acknowledges "that there are certain elements of the existing system that weaken its integrity and should be addressed."[26]

The Recommendations: Outbound Investment

Definition of Foreign Affiliate

Recommendations

- The definition of "foreign affiliate" should be strengthened so that only foreign companies in which Canadian corporations have a significant interest can be considered foreign affiliates.
- The present definition of "controlled foreign affiliate" should be maintained.

Background

The determination whether a foreign corporation is a *foreign affiliate* or a *controlled foreign affiliate*[27] is fundamental to the present Canadian system of taxing foreign income. Only the active earnings of a foreign corporation that is a foreign affiliate are eligible for the exemption system,[28] and only the FAPI of a foreign corporation that is a controlled foreign affiliate of a Canadian taxpayer must be reported as income by the taxpayer.[29] The threshold that must be met for a foreign corporation to obtain the benefits or face the wrath of the system for taxing foreign income has changed over time.

In the period immediately prior to 1972, when Canada had a complete exemption system, the threshold was that the Canadian taxpayer had to own 25 percent of the outstanding shares having full voting rights of the foreign corporation. As a result of the amendments made in the early 1970s, including the introduction of the definition of *controlled foreign affiliate*, the threshold was lowered to direct or indirect ownership of 10 percent of any class of shares of the foreign corporation. Currently, the 10 percent threshold is still in place, but it applies to a related group as

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[25] Report, supra footnote 18, at 6.10.

[26] Ibid.

[27] "Foreign affiliate" and "controlled foreign affiliate" are defined in subsection 95(1).

[28] This will be the case if the foreign affiliate is resident and carries on the business in a "designated treaty country." See the definition of "exempt surplus" and "designated treaty country" in regulations 5907(1) and 5907(11)-(11.2), respectively.

[29] Pursuant to subsection 91(1), a taxpayer resident in Canada is required to include in income the FAPI of a controlled foreign affiliate to the extent of the taxpayer's "participating percentage" (defined in subsection 95(1)) in the affiliate at the end of the affiliate's taxation year.

long as the taxpayer's direct or indirect interest in the foreign corporation is at least 1 percent.

Discussion

The focus of the committee in making the recommendation to strengthen the definition of *foreign affiliate* is to prevent access to the exempt surplus of an unrelated foreign corporation, except to the extent that Canadian corporations have a *significant equity interest* in the foreign corporation. The committee suggests that the ownership threshold for access to the exempt and taxable surplus system be increased so that the taxpayer has a direct or indirect interest in a foreign corporation representing at least 10 percent of the foreign corporation's outstanding shares having full voting rights under all circumstances and 10 percent of the value of all outstanding shares.

It is interesting to compare the thrust behind the committee's recommendation with that behind the change to the definition of *foreign affiliate* in 1995, which lowered the ownership threshold of a Canadian taxpayer in a foreign corporation to a direct or indirect interest of 1 percent of any class of outstanding shares of the corporation, provided that the taxpayer is part of a related group that has a combined direct or indirect interest of 10 percent in the foreign corporation.

The change in 1995 was intended to ensure that a taxpayer resident in Canada did not avoid reporting FAPI by arranging the ownership of a foreign corporation to be held among related companies such that the foreign corporation would not be a foreign affiliate and therefore could not be a controlled foreign affiliate of any of the related companies.[30] The change, however, did allow certain Canadian taxpayers to have access to the exemption system.[31] It even appeared that in the early 1970s a low threshold was considered appropriate because, with the introduction of the definition of *controlled foreign affiliate*, the status of a foreign affiliate was really restricted to the recognition of foreign taxes paid in respect of earnings repatriated to Canada as dividends.[32]

It is difficult to argue with this recommendation, especially given the committee's stated concern that taxpayers can have access to the exemption system by investing a de minimis amount in a special class of preferred shares of a foreign corporation.

The specific changes proposed by the committee with respect to the taxation of foreign affiliates if anything reinforce the expectation that

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30 In some cases, the FAPI would still have had to be reported by virtue of section 94.1.

31 See Eric Lockwood and Michael Maikawa, "Foreign Affiliates and FAPI: Problems and Tax-Planning Opportunities Resulting from the 1995 Changes," International Tax Planning feature (1998), vol. 46, no. 2 *Canadian Tax Journal* 378-414, at 378-80.

32 See Wilkie et al., supra footnote 3, at 2:52-53.

foreign active business income will have borne taxation in some jurisdiction in a manner that is broadly consistent with how income earned domestically in Canada is taxed. Access to this system anticipates a meaningful degree of genuine economic as well as legal ownership of the business income as it is earned. Otherwise, income will be treated as FAPI and subjected to current taxation on the same basis as any other investment income, whether earned internationally or not.

Expanding the definition of foreign affiliate may alleviate any current hesitation that Revenue Canada may have in applying the subsection 95(6) anti-avoidance provision to any perceived abusive type of transaction.[33] However, if the ownership threshold recommended by the committee is accepted, Revenue Canada may still attempt to apply subsection 95(6) in situations where there is a perceived abuse of the foreign affiliate system regardless of whether a substantial equity interest exists.[34]

Presumably, the committee intends that related-party holdings would still count in determining whether a taxpayer had a significant equity interest. In other words, if the threshold is raised to 10 percent of the votes and value of the outstanding shares of a foreign corporation, these shares can be held by related parties so that the underlying objective of the 1995 change is not undone. But presumably such a related-party test would or should only involve related Canadian corporations.

In figure 1, under the present rules, Foropco is a foreign affiliate and a controlled foreign affiliate of Canco.[35] Under the committee's recommendations, it is not clear that Foropco would be a foreign affiliate of Canco, since Canco has a direct interest of only 5 percent in Foropco. While Foropco is related to Canco since both are controlled by Forco, applying the committee's criteria, it would not appear that Canco has a significant equity interest in Forco to justify Canco having access to the exempt and taxable surplus system in respect of Foropco. If Foropco is not a foreign affiliate of Canco, it is also not a controlled foreign affiliate of Canco. Therefore Canco will not be required to include FAPI in its income if Foropco earned passive income during the year. However, if Canco is not a controlled foreign affiliate, the rules in section 94.1 may apply to deem

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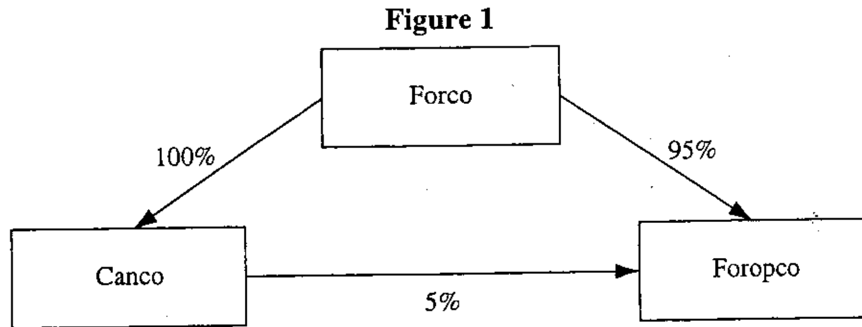
[33] Paragraph 95(6)(b) applies to an acquisition or disposition of shares if the principal purpose is the avoidance, reduction, or deferral of amounts payable under the Act. If the principal purpose test is met, the shares are deemed not to have been acquired or disposed of, and previously unissued shares are deemed not to have been issued.

[34] See example 16 in Canada, Department of Finance, *Amendments to the Income Tax Act: Explanatory Notes* (Ottawa: the department, February 1995), subclause 46(7), in respect of the 1995 amendments. For a recent discussion on subsection 95(6), see Lockwood and Maikawa, supra footnote 31, at 405-8.

[35] Since Canco's interest in Foropco is not less than 1 percent and Canco is part of a related group that owns more than 10 percent of Foropco, Foropco is a foreign affiliate of Canco. Further, pursuant to paragraph (d) of the definition of "controlled foreign affiliate" in subsection 95(1), since Foropco is a foreign affiliate that is controlled by a person (that is, Forco) not dealing at arm's length with Canco, Foropco is also a controlled foreign affiliate of Canco.

Figure 1



Canco to include an amount in its income if its investment is considered an offshore investment fund property.

Interest Deductibility: Financing Foreign Direct Investment

The Committee's Recommendations

- Interest expense on indebtedness incurred to invest in foreign affiliates should be disallowed.
- The tracing method should be used to identify indebtedness allocable to investments in foreign affiliates.
- Disallowed interest expense should be added to the tax basis of the shares of the relevant foreign affiliate and accumulated in a "disallowed interest account."
- To prevent small startup businesses that must resort to borrowing in Canada from being penalized, and also to address the administrative and compliance burden on small and medium-sized business, there should be an exemption for up to $10 million of accumulated indebtedness related to investments in foreign affiliates.
- Indebtedness incurred or committed to under existing rules should be exempted from the new regime or be eligible for a generous transition period.

Background

Of all of the recommendations contained in the report, one of the most significant and in commercial terms certainly the most provocative is the proposal to deny the deductibility of interest on money borrowed to fund FDI unless and until, and then only to the extent of, foreign active business income that is distributed to Canadian shareholders and actually subject to taxation, or of the taxable proceeds of sale of shares of a foreign affiliate. However, when this recommendation is considered in the context of the taxation of foreign direct investment income more generally, it is evidently much less dramatic, though perhaps no less inconvenient for multinational business.

Prior to the last comprehensive revision of the system for taxing foreign direct investment income, which took place in the early 1970s, interest on money borrowed to earn exempt income in the form of non-taxable dividends (that is, to make equity investments in corporations, whether domestic or foreign) was not deductible; at the same time foreign active business (and other) income earned by foreign corporations was not taxable regardless of the jurisdiction in which it was earned. The recommendations of the committee, if implemented, would in large measure restore this regime for taxing foreign active business income. If anything, the foreign affiliate system has been a kind of imbalance since its modern inception. Among other things, this has resulted in inconsistencies in the taxation of foreign active business income, depending upon whether it was earned in incorporated form or directly through a branch.[36]

Discussion

We will not, here, canvass either the basic rules on interest deductibility or the controversy since 1987 about their adequacy. We do not think, however, that the principles of interest deductibility, generally, are what concern the committee. In a study that purports to review the Canadian tax system comprehensively, it would be at least curious that changes in the recognition of interest would be proposed with respect to foreign direct investment but not other kinds of investment, if otherwise was the case. In principle, the basic interest deductibility issues are unaltered by the jurisdictional home of the user of borrowed money.

The committee's focus on outbound foreign investment in this regard can only bear one reasonable explanation. The determination not to tax, or at least to postpone indefinitely the taxation of, and in any case to credit foreign tax on, income from foreign direct investment depends on an accurate and self-contained economic determination of that income. A system that is inherently territorial and fundamentally designed to extend domestic credit for foreign income taxes requires income to be determined with reference not only to the foreign revenue but also to all of the relevant expenses, in an economic sense, incurred to earn it. Approached this way, the theoretical justification for interest charges associated with FDI funding not being deductible domestically against other income is more difficult to dispute.

Interest Deductibility and Foreign Tax Credit

It has remained something of a curiosity in the Canadian tax system that income, net of all relevant expenses including interest, earned directly by a Canadian taxpayer through a non-Canadian branch is currently taxable without offset or deferral, but income of exactly the same character earned in exactly the same functional circumstances in principle may never be

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[36] For a discussion of these issues, see Arnold, supra footnote 13, in particular at 45:11-17.

taxable, regardless of the jurisdiction in which it is earned, if captured within the bounds of a foreign corporate charter—whether or not all relevant charges have been borne by it.[37] The committee's concern is consistent with the present preoccupation of tax and finance authorities internationally with questions about the accurate allocation of income in circumstances where the typical jurisdictional associations—manifestations of nexus—of such income are increasingly uncertain and unreliable.[38] A more common but fundamentally similar reflection of the importance of determining accurate economic allocations of income is found in the transfer-pricing rules of most developed countries, which have been under active review contemporaneously with changes implemented since 1995 but under study before then by the OECD.

It is not surprising, in our view, that interest deductibility would be discussed in a setting focused primarily on when and how to extend foreign tax credit for foreign incorporated income. As has been examined elsewhere,[39] the manner in which interest deductions are treated in reference to income ultimately distributable as dividends on foreign corporate shares is simply another way of expressing and explaining limitations that typically are built into credit for foreign taxes on income earned directly. The Act now requires all relevant expenses, functionally and indeed in certain cases even economically, identified with foreign revenue to be applied against this revenue in determining the foreign *income* base with reference to when direct foreign tax credit under section 126 of the Act is determined.[40] The reason is obvious. An overstatement of the foreign income through a misapplication (understatement) of relevant expenses would result in an overstatement of the base for determining the amount of Canadian tax ceded in favour of another jurisdiction from the

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[37] Ibid.

[38] This issue is considered to be important to the taxation of revenue from foreign direct investment generally. For example, in its review of the taxation of foreign active business income in 1993, the US Department of the Treasury remarked upon the singular importance of adopting a system in which interest charges would be identified on an economic basis with the foreign income to which they pertain. That report, supra footnote 24, at 37, stated: "The rules for allocation and apportionment of interest expense are a significant instance in which the expense allocation rules depart from the 'economic nexus' principle. Specifically, the interest expense allocation rules apply a 'water's edge fungibility' approach . . . over a 'worldwide fungibility' approach more consistent with the 'economic nexus' principle. The resulting effects on the foreign tax credit limitation have introduced significant distortions to the borrowing decision, so that a 'worldwide fungibility' approach merits serious reconsideration. A return to gross income-based apportionment could mitigate the potential complexity." These comments, more generally, are interesting to consider in light of the committee's dismissal of economic approaches to the allocation of interest expense. It is also interesting to notice how the US Treasury perceives the interest deductibility issue essentially to be a foreign tax credit matter.

[39] This is Arnold's fundamental point. See supra footnote 13, at 45:14-17.

[40] See Revenue Canada's comments in *Interpretation Bulletin* IT-270R2, February 11, 1991, notably, as Arnold, supra footnote 13, discusses, in paragraphs 37 and 38, which stress both the territorial aspects of income allocation and functional or economic associations of revenue and relevant expenses.

taxpayer's perspective. Such an outcome clearly is not appropriate, according to the international tax policy norms that condition the unilateral recognition by countries of the tax claims of others.

The same effects can occur when a foreign corporation earns the income. Despite the deference, generally, by the Canadian tax system to entity-based and financial statement income-based taxation, there remains, fundamentally, the need to get the tax base "right," notably when such important considerations as those associated with defining and asserting (exceeding) effective tax jurisdiction are in play. To the extent that foreign (incorporated) income is overstated, because associated charges are not completely applied to it, the base for claiming foreign tax credit is artificially increased and consequently the amount of foreign tax paid with respect to that income available to be credited in Canada is inflated. A more economic association of interest charges and the amount, otherwise, of foreign income earned indirectly through foreign corporations would result, broadly, in a functional equivalence between the direct foreign tax credit for income earned directly, and the indirect foreign tax credit for foreign taxes on income distributed from taxable surplus of a foreign affiliate.

Determining Interest Related to FDI: The Tracing Method

The committee's interest deductibility recommendation has three aspects. First, it deals with how to identify interest charges associated with foreign income. Second, it acknowledges that if foreign income is actually distributed to Canadian shareholders and subject to tax, or its value is reflected in the proceeds of disposition of a foreign investment, then an offset for the disallowed interest charges should, to that extent, be available. Finally, it acknowledges that limited recognition of financing charges unreasonably may impair the ability of developing, and in international terms small, businesses to grow internationally. Consequently, a safe harbour, in which the interest deduction limitation would not apply, is recommended.

The main proposal is that interest on money borrowed to fund FDI should not be currently deductible. After summarizing other possibilities, the committee advocates a direct tracing method of identifying indebtedness associated with FDI. The committee is cognizant of the practical limitations and conceptual shortcomings of "tracing." Presumably, it is attractive because, though imperfect in a theoretical sense, it is thought to be consistent with how, in practice, deductible interest domestically is determined. The "use" requirement in paragraph 20(1)(c) is commonly perceived to require an analysis of this nature. Furthermore, the refinancing rule in subsection 20(3), the "disappearing source" rule in section 20.1, and the proposed rules for limiting interest on money borrowed to fund distributions have strong tracing implications.

Such an approach, however, is open to highly structured tax planning, in the nature of "cash damming," which entails the streaming of borrowed and surplus funds to ensure that borrowed money is directly tied to a use that will not impair interest deductibility. The committee adverts to

the potential need for anti-avoidance rules in this area and indeed anticipates the possibility of a reasonableness test. Presumably such a limit could be fashioned after that contained in subsection 18(3.1), in order to control tax planning in this area.[41] It is beyond the scope of this discussion to anticipate or comment upon the usefulness of specific anti-avoidance rules here or to what their characteristics might be relative to, for example, the "general anti-avoidance rule" in section 245. We note, however, particularly in view of the present debate about the significance of the GAAR and its broad scope as perceived by Revenue Canada,[42] that it would be curious for planning of this nature to require its own anti-avoidance brake. Yet it almost seems as if the committee takes for granted that such planning would not generally be impaired by existing anti-avoidance standards. As a consequence, one might speculate as to whether large multinational business should be too anxious about encountering serious limitations on their financial behaviour as a result of the implementation of this change.[43]

We have several observations. First, it is unlikely that significant borrowings dedicated to, for example, large capital projects would escape the limitations that would be imposed on interest deductibility as conceived by the committee. Indeed, this may be the committee's real focus—to restrict the domestic financing only of large, targeted expenditures. Working

[41] The limiting language in subsection 18(3.1) is broad and contextual: "no deduction shall be made in respect of any outlay or expense made or incurred by the taxpayer . . . that can reasonably be regarded as a cost attributable to [the subject of the expenditure] by or on behalf of the taxpayer, a person with whom the taxpayer does not deal at arm's length, a corporation of which the taxpayer is a specified shareholder or a partnership of which the taxpayer's share of any income or loss is 10% or more and relating to the [subject of the expenditure]."

[42] See the discussion in this area generally in a series of papers presented at the 1997 annual conference of the Canadian Tax Foundation, and in particular J. Scott Wilkie and Heather Kerr, "Common Links Among Jurisdictions: Informing the GAAR Through Comparative Analysis," in the 1997 Conference Report, supra footnote 14, 34:1-30. In this context, recent decisions of the Supreme Court of Canada, *Duha Printers (Western) Ltd. v. The Queen*, 98 DTC 6334 (SCC) and *Neuman v. The Queen*, 98 DTC 6297 (SCC), seem to validate highly structured tax planning patently directed at achieving tax results not necessarily consistent with some notions of economic substance. Indeed, in his reasons in the *Duha* case, Justice Iacobucci follows a very "legal" line, regardless of certain economic inferences that the Federal Court of Appeal had drawn and which Justice Iacobucci found completely out of place in interpreting legislative tax law devoid of an intrinsic "object and spirit." These are pre-GAAR cases, but the reluctance of the Supreme Court to depart from the legal implications of formally proper transactions raises interesting questions about the sustainability of a view that GAAR does (and should) permit a tax construction of taxpayer conduct at odds with what the taxpayer legally accomplished.

[43] Report, supra footnote 18, at 6.14: "In practice, a tracing rule would be most effective in the context of Canadian business enterprises that have significant investments in foreign affiliates in relation to their Canadian operations, or where the company's financing arrangements are such that applying the tracing method is fairly obvious. By contrast, one can expect that larger multinationals, with complex financing structures and substantial operations both in Canada and abroad may, in some circumstances, be able to avoid the full application of the tracing rule."

capital borrowings of multinational corporations with complex capital structures and diverse foreign operations largely, it would seem, may not be impeded seriously by a limitation on interest deductibility, as long as it entails some form of direct tracing to foreign direct investment. It is somewhat puzzling in tax policy terms that circumstantial considerations would have such an influence on what one might have imagined to be a fundamental feature of income determination. It is also curious that the committee actually anticipates such a rule's possibly sporadic practical application, treating some uses of funds differently from others despite, in economic terms, the fungibility of all borrowed and equity capital. This shortcoming of the tracing method is, interestingly, commented upon by the committee in behavioural terms.[44] It seems that the committee is largely concerned not so much with devising a comprehensive, internally consistent prescriptive regime for interest deductibility as with sending a kind of legislative signal to induce a shift in how foreign business is financed. One might speculate on the usefulness of income tax law that in this and other fundamental areas seems less and less "legal" and precise, and more psychological to the point where instructive, predictable interpretation is imperilled.[45]

Second, this proposal seems to raise the possibility of different and perhaps discriminatory treatment of small and medium-sized enterprises whose capital structures may not be complex, and whose uses of funds are much more evident or transparent than those of large multinational corporations. It would be a curious, and perhaps conceptually unsound, rule that allowed large enterprises, effectively by reason of their "bigness," to escape its practical compass (also unimpeded by the other changes to the foreign affiliate system), while corporations that probably are in most need of recognition for the costs of doing business are in fact the enterprises most likely to be affected by the change.

Third, this change may bear some further scrutiny in terms of the continuing depth and functioning of Canadian capital markets to support the financing of Canadian enterprises. It seems almost axiomatic that the proposal, if implemented, will direct significant capital-raising activity outside Canada.[46] Aside from the obvious deleterious effects that this may

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[44] Ibid.: "[I]t is nonetheless the Committee's view that the tracing approach would reduce the amount of funds borrowed in Canada to invest in foreign affiliates, and would *induce* taxpayers to locate a greater amount of indebtedness in foreign affiliates rather than in Canada" (emphasis added).

[45] There are an increasing number of tax rules whose legislative and tax policy compass are unclear, and therefore which function, in some respects, as *in terrorem* limitations. Aspects of the rules governing "tax shelters," limited-recourse financing, investments in foreign funds (section 94.1), certain limitations in the reorganization area (for example, the rules in sections 55 and 88 dealing with divisive reorganizations), and others often defy unambiguous or even intuitive interpretation, and consequently, almost by default, apply much more broadly than the inherent tax policy "mischief" might otherwise demand.

[46] As well, this development will also be enhanced by the committee's recommendation to eliminate withholding tax on interest paid to arm's-length non-residents.

have on the maintenance of competitive Canadian capital markets to serve the largest and most international of Canadian taxpayers (as well as others to the extent that the domestic Canadian financial system suffers generally), it does also raise an interesting question about the deployment of significant pools of capital owned by Canadians for the benefit of Canadian taxpayers. Over the last several years, for example, the "foreign property" rules in part XI of the Act, which limit investments by pension and other deferred income plans in foreign securities, have been subjected to modifications that seem to defy a consistent or coherent underlying tax policy. It might be argued that the foreign property limitations serve no other purpose than to encourage the use of tax-preferred retirement savings in the service of Canadian business. There is, in a sense, a certain economic symmetry to this in tax policy terms. Yet, the recent changes to the "foreign property" rules seem not to reflect any obvious policy thrust of this sort. At the same time, it is commonly understood that the pools of investable capital owned by Canadian pension plans are so vast that the Canadian capital markets are already not deep enough to absorb this capital on internationally competitive terms.

Against this backdrop, the committee effectively offers a recommendation that would make the investment activity of such pension plans more difficult. Debt obligations issued by the direct foreign users of funds outside Canada within Canadian-owned multinational groups would be "foreign property" within the terms of part XI of the Act and therefore would be subjected to limitations foreclosing unlimited participation by pension plan capital in funding the international activities of Canadian multinationals. In a document that seemingly is sensitive to the exigencies and possibilities associated with multinational competitiveness, this would be an unfortunate outcome.

Finally, notwithstanding the theoretical justification for interest charges associated with FDI funding not being deductible domestically against other income, this measure will raise the cost of capital of Canadian-based multinational companies. This could result in Canada's suffering adverse economic effects in terms of foreign and domestic investment, industrial growth, international trade, income, and employment.[47]

Other Possible Methods To Determine Interest Related to FDI

The tracing method was selected rather than any of three other methods, even though they are more in keeping with the territorial theme, economically,

[47] This is discussed in detail in Donald Brean, "A Response to Brian Arnold: The Deductibility of Financing Costs to Finance Investments in Foreign Enterprises" (1997), vol. 5, no. 4 *Corporate Finance* 414-19, an article that is an excerpt from a research paper entitled "Policy Perspectives on Canadian Tax Treatment of the Foreign Source Income of Canadian-Based Multinational Enterprises," prepared by Donald J.S. Brean and submitted to the committee. It is important to note that the committee's recommendations in this area are based on the expectation that Canada's corporate income tax rate would be significantly reduced. See the report, supra footnote 18, at 6.17-18.

that evidently underlies the committee's recommendations. The other three methods are all variations of an economic apportionment of interest expense based upon the relationship between domestic and foreign assets or investment.[48]

The first method is described under the rubric "Canadian domestic allocation formula." Foreign direct investment would be treated as a single foreign asset. The foreign assets, in the form of corporate shares, would be compared to the total assets of the corporation, to determine the extent of an interest disallowance. As the committee seems to recognize, a formulary approach such as this (and in the other cases) is more theoretically sound insofar as it recognizes that "money is fungible" and all forms of funding an enterprise, whether or not borrowed, in some manner directly or indirectly affect all activities of the enterprise. The committee comments on a number of shortcomings presented by this approach. In large measure the focus here is on administrative difficulties associated with applying such a system on an ongoing basis and with transition issues that would make its adoption problematic in the immediate term. Another suggested drawback of this system, although perhaps of less concern in view of the United States' experience than the committee is prepared to acknowledge, is the failure of a domestic allocation formula to take into account the extent to which foreign operations have been financed directly with debt. However, there is no speculative analysis as to how this and other complications might be addressed if a more economic approach to the apportionment of borrowed capital among all capital uses would, indeed, be more sound theoretically.

The second approach, again fundamentally economic, is a modified domestic allocation formula. It is essentially a combination of two interest deductibility limitations. First, as long as the amount of borrowed money would not exceed a domestic thin capitalization limitation (2:1), all interest would be deductible. The amount in excess of the thin capitalization threshold would be limited by a domestic allocation formula. Effectively, this approach would incorporate a generous "safe harbour," which would alleviate the need for many corporations to be concerned at all about limits on interest deductibility. Again, the committee criticizes the approach for complexity in its intrinsic characteristics and with respect to transition.

Finally, a "worldwide allocation" approach is considered as perhaps the best basis for identifying indebtedness the interest on which should be restricted. It would entail a comparison of worldwide foreign assets to worldwide total assets; the ratio would be applied to the indebtedness of

[48] Indeed, the treatment of interest deductions, ideally according to some form of "water's edge" or worldwide allocation formula—that is inherently economic in terms of determining the nexus of income on the correspondence between income in economic and financial senses—may be essential to any kind of meaningful international tax reform. In this regard, see the observations of the US Treasury Department, supra footnote 24.

a corporation in order to apportion domestic and foreign interest expense. To the extent that foreign corporations within a corporate group would have incurred direct foreign borrowings equal to or greater than the allocated foreign capacity based upon the worldwide allocation formula, no interest deductibility restrictions would apply domestically. Conversely, any excess Canadian borrowings would be considered dedicated to foreign investment, and interest deductibility would be limited. The committee acknowledges that among the allocation formulas, this approach is theoretically superior. Again, however, with limited discussion, it is dismissed as administratively complex and "for all practical purposes . . . virtually unworkable."[49] It may well be that the implementation of such an approach, in the context of the taxation of outbound foreign investment otherwise not being fundamentally changed, would in fact be administratively difficult. However, as the committee observes at the outset of chapter 6, the design of a regime for taxing foreign active business income is inherently complex mainly, as we note, because of the need to anticipate the application of domestic rules with considerable sensitivity to difficult questions about the economic nexus of income and legal methods for describing that nexus in terms that are sufficiently reliable that they can be expected to be reciprocated by other countries. We wonder whether a tax reform exercise, even though limited by a revenue-neutrality condition in its terms of reference, should have been so restricted by perceptions of practical reality based on existing legislation.

Protecting the Revenue Base

We have spoken of the significance of the treatment of interest as an adjunct to a territorial system for taxing foreign active business income. Another related concern of the committee is protecting the Canadian tax base. This is closely associated with the committee's recommendation to encourage reduction in the overall Canadian corporate tax rate to approximately 33 percent. Because of relatively high Canadian tax rates, there is an incentive for multinational operations to locate "group" indebtedness in Canada. The committee expresses concern about the combination of high Canadian tax rates and liberal interest deductibility rules creating undue tax-sheltering opportunities in Canada for both Canadian and foreign multinational groups—that is, with Canada effectively being a provider of subsidies to foreign business and foreign treasuries. This, of course, is simply another way of expressing, albeit in somewhat more typical legislative tax terms, the need to ensure that the basic tenets of the tax system are suitably sensitive to the measurement and allocation of international income based upon principles of economic nexus that associate net profit as reliably as possible with the jurisdiction in which it is earned.

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[49] Report, supra footnote 18, at 6.16.

Recovering Lost Interest Deductions

The committee acknowledges that an absolute denial of interest deductibility would be as theoretically unsound as the absence of limits in the present system, which it criticizes. Consistent with taxing tax-preferred foreign active business income when it is distributed to Canadian shareholders, related deductions of interest should be restored. It is not inappropriate to permit interest to be deductible against taxable foreign dividends paid to Canadian shareholders or otherwise for the interest to be capitalized to the cost of foreign direct investment and indirectly recognized upon a disposition of that investment if the income or gain is otherwise subject to tax. Apart from the deferral of taxation, which is endemic anyway in the Canadian system for taxing foreign incorporated business income, the recommendation would effectively ignore the effect of incorporation in measuring foreign income and determining whether and to what extent foreign tax credit is extended, in a manner fundamentally consistent with accessing direct foreign tax credit in equivalent functional circumstances. Accordingly, interest would only be recognized as and to the extent of income that was subjected to foreign taxation.

The committee is much less sympathetic to permitting a deduction for interest associated with earning FAPI. This is another reflection, implicitly, of a perception that international income should be substantially taxable somewhere. In the committee's view, the FAPI rules are effectively an anti-tax-avoidance regime. The committee is not troubled by the double taxation that would result from taxing FAPI currently but not permitting interest to be deductible in relation to funding investments that produce FAPI. Once again, the committee justifies its stand in behavioural terms.[50] In practical terms, it views the resulting double taxation as an inducement to Canadian investors not to adopt foreign investment structures that would have this result. It is curious, as we have noted, that in an area of such pervasive significance for the determination of income, rules would be advanced whose impact is anticipated to be essentially behavioural.

Small Business Tax Harbour

The committee is prepared to acknowledge that businesses with modest capitalization—essentially in a startup or middle development phase—may not be able to raise money to fund foreign operations in ways that would otherwise seem to be envisioned by the proposed interest deductibility limitations. Consequently, it recommends that interest on $10 million of accumulated indebtedness to fund foreign direct investment not be restricted. That threshold, while large in absolute dollar terms, is possibly

[50] Ibid., at 6.17: "It is arguable that interest expense should not be allowable in respect of income which is subject to this type of anti-avoidance provision. While double taxation could arise if a Canadian taxpayer borrowed to invest in foreign affiliates that earned FAPI, the *behavioural* response should be for the income to be earned directly in Canada" (emphasis added).

too modest in terms of the capitalization requirements faced by such businesses in order to compete internationally. It would be appropriate to revisit the suitability of this threshold in discussions that ensue from the report. It may well be that a more realistic level would be much higher.

Practical Effects: Theoretical Issues

It is interesting to speculate whether limiting the deductibility of interest as proposed by the committee would have any meaningful practical effect on the manner in which Canadian multinationals or foreign multinationals with Canadian subsidiaries structure foreign investments. Clearly, the implementation of the recommended changes to the foreign affiliate rules, which would deny an active business characterization of periodic income in subparagraph 95(2)(a)(ii) when paid by a corporation that is not a foreign affiliate of a Canadian corporate taxpayer (see the discussion below), would deter some structured planning of a sort that has been typical for a number of taxpayers. But if the affected corporations are foreign affiliates of a Canadian taxpayer, would things change very much? We consider this question in relation to various scenarios based on the following assumptions:[51]

- Canco owns 100 percent of a US company, USco.
- USco has income before tax of $25 per year.
- The US tax rate is 40 percent; the Canadian tax rate is 44 percent.
- USco needs financing of $2,500.
- The third-party borrowing rate is 6 percent.
- Canco has taxable income.

Scenario 1: In this scenario, Canco borrows $2,500 and lends it to USco at 7 percent, earning a positive "spread" of 1 percent. The result is after-tax Canadian income of $46.90.

US income	$250.00	Canco income	$175.00
Less interest	175.00	Less interest	150.00
		Less withholding tax (subsection 20(12))	17.50
	75.00		7.50
US tax	30.00	Canadian tax	3.30
	45.00		$ 4.20
Withholding tax (5%)	2.30		
		Net consolidated income	$ 46.90
Dividend to Canco	$ 42.70		

[51] To simplify the analysis, foreign exchange fluctuations are ignored.

The effect is to expose $175.00 of North American income of Canco and USco to tax at Canadian rates.[52] US withholding tax is essentially treated as an expense of Canco because USco is Canco's foreign affiliate.

Scenario 2: In scenario 2, the borrowing by Canco is used to invest in equity of USco. The result is a net after-tax Canadian income of $58.50.

US income	$250.00	Canco interest expense	$150.00
Less interest	0.00		
	250.00	Canadian tax saving	66.00
US tax	100.00		
	$150.00	Net cost	$ 84.00
Withholding tax (5 %)	7.50		
		Net consolidated income	$ 58.50
Dividend to Canco ...	$142.50		

A comparison of scenarios 1 and 2 quite clearly indicates the significant enhancement of after-tax income that results from limiting the North American taxation of US income to tax at US rates and at the same time facilitating a reduction in Canadian tax through deducting interest based upon Canadian tax rates. Indeed, as scenario 2 shows, the financial return on the investment by Canco is, in a sense, attributable to the Canadian tax saving associated with deducting financing interest. In pre-tax cash flow terms, the dividend to Canco is exceeded by the Canco interest expense by $7.50; effectively, there is a negative cash "spread." However, the tax recovery engendered by the interest deduction, $66.00, results in a net financial return, after tax, of $58.50. This comparison shows the attractiveness, within the formal limits of the Canadian tax system, of capitalizing foreign affiliates with equity using borrowed funds. Configurations of this sort attracted the auditor general's attention in 1992 and underlie the committee's recommendations on interest deductibility.[53]

Scenario 3: In scenario 3, Canco borrows $2,500 and again capitalizes USco through an investment in shares. No interest is deductible in the United States, clearly, and on the assumptions underlying this example, interest incurred in Canada by Canco is also not deductible. This example demonstrates the effect of the committee's recommendations to deny

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[52] To simplify the calculation, it is assumed that the Canadian foreign tax credit in respect of US withholding tax paid on the interest received from USco is nil because Canco's net foreign income is a nominal amount, and instead the US tax is deducted under subsection 20(12). Generally, it is the inability of the Canadian lender to earn a foreign tax credit that makes it inefficient from a tax perspective to lend to an offshore affiliate.

[53] However, a potential US cost to scenario 2 is that if Canco repays its loan by reducing the capital of USco, such reduction would give rise to a US withholding tax if USco has *earnings and profits* at that time.

interest deductibility on money borrowed domestically to fund foreign corporate operations. As this example shows, if the present recommendations of the committee in respect of interest deductibility are implemented, Canco, in relation to its North American group, can anticipate a net after-tax cost of borrowing in the order of $7.50 (that is, a negative after-tax balance).

US income	$250.00	Canco interest expense	$150.00
Less interest	0.00		
	250.00		
US tax	100.00	Canadian tax saving	0.00
	$150.00	Net cost	$150.00
Withholding tax (5%)	7.50	Net consolidated income	($ 7.50)
Dividend to Canco	$142.50		

A comparison between scenario 2 and scenario 3 makes the implication of interest deductibility on money borrowed to fund FDI even more evident. In scenario 2, it is the interest deduction that effectively produces a financial return for Canco on an after-tax basis. In cash flow terms, Canco would otherwise be in the same position in scenario 2 as it was in scenario 3.

Scenario 4: In this scenario, Canco and USco respond to the behavioural influences of the committee's recommendations by arranging the funding debt directly in the United States. In this case, the after-tax income to Canada is $57.00.

US income	$250.00	Canco—no impact
Less interest	150.00	
	100.00	
US tax	40.00	
	$ 60.00	
Withholding tax (5%)	3.00	
Dividend to Canco	$ 57.00	

Interestingly, a comparison of scenario 2 and scenario 4 reveals very little difference.[54] In the event that the absolute amount of interest expense to earn income from foreign direct investment remains constant at $150.00, the lower rate of US taxation on net income compensates for the financial saving that would have been created by a Canadian tax deduction. In principle, then, the manner in which foreign incorporated operations are financed may not, depending of course upon the circumstances, be greatly affected by the proposed change.

[54] Although scenario 2 has a potential US withholding tax on a reduction of capital of USco.

Scenario 5: The most informative point of comparison in light of the committee's recommendations is provided by scenario 5. In this scenario, Canco is carrying on its US operations through a branch rather than a subsidiary. Canco borrows $2,500 to fund its US operations. The interest is deductible in computing Canadian income, but is also required to be allocated against revenue in determining the income base for Canadian tax credit in respect of US taxes paid.

US income	$250.00	Canco income	$250.00
Less interest	150.00	Less interest	150.00
	100.00		100.00
US tax	40.00	Canadian tax	44.00
	$60.00	Less FTC	43.00
Withholding tax (5%)	3.00		$ 99.00
	$ 57.00		
		Less US tax	43.00
		Net consolidated income	$ 56.00

The result of matching the interest deduction to foreign revenue is after-tax Canadian income, after taking into account foreign tax paid and credit for it, of $56. This compares closely with the result that would apply if the recommendations of the committee were implemented. Indeed, as a comparison of scenario 4 and scenario 5 indicates, a Canadian corporation may be better off, marginally, not only to incorporate its foreign operations, but also to finance them locally.

This analysis also illustrates the significance of an interest deductibility limitation as a foreign tax credit constraint. Because of its close association with the relative payment of foreign or domestic tax, in the context of the various neutrality principles at play an interest deduction limitation is very much connected with an internally consistent territorial system for taxing foreign active business income. Thus, providing for such a limitation seems intrinsic to an apportionment of international income that is consistent with its geographic and economic source.

Summary: Scenarios 1-5: The following table illustrates net cash flow under all five scenarios.

	Canco	*USco*	*Total*
Scenario 1	$ 4.20	$ 42.70	$46.90
Scenario 2	(84.00)	142.50	58.50
Scenario 3	(150.00)	142.50	(7.50)
Scenario 4	—	57.00	57.00
Scenario 5	56.00	na	56.00

FAPI Exemption for Interaffiliate Transactions

Recommendations

- The FAPI exemption for interaffiliate transactions should be maintained.

• Payments in respect of interaffiliate transactions should be included in taxable surplus if the income is received by an entity that, while located in a tax treaty jurisdiction, is expressly denied benefits under that treaty.

• The government should actively renegotiate its existing tax treaties, to ensure that all tax-privileged entities in treaty countries are denied access to the exemption system with respect to income from interaffiliate transactions.

• The FAPI exemption should be denied for payments from related non-resident corporations that are not foreign affiliates of the Canadian taxpayer if the related-party status arises solely as a result of share ownership by foreign parent companies outside Canada.

Background

FAPI is defined in subsection 95(1) to include income from property (for example, interest and royalties), taxable capital gains other than gains from the disposition of excluded property, and income from certain deemed non-active businesses. By virtue of subsection 91(1), a taxpayer resident in Canada is required to include in income the FAPI of a controlled foreign affiliate to the extent of the taxpayer's *participating percentage* in the affiliate at the end of the affiliate's taxation year. Under certain circumstances, the FAPI exemption found in subparagraph 95(2)(a)(ii) will deem the receipt of certain payments that would otherwise be income from property to be active business income.[55]

The effect of subparagraph 95(2)(a)(ii) is illustrated in figure 2. Opco and Finco are both controlled foreign affiliates of Canco. Opco carries on an active business in a designated treaty country (DTC). Finco provides various treasury management and other services to Opco and other affiliates of Canco. Opco pays interest to Finco on funds borrowed to finance Opco's active business activities. As well, Opco pays royalties to Finco for the right to use in its business certain intangible property owned by Finco.

There are many non-tax reasons for companies such as Canco to establish an offshore company such as Finco. Many Canadian companies, especially large multinational companies, have significant operations outside Canada. It is usually more efficient to centralize the treasury functions of their foreign operations in a single offshore company. In addition, an offshore company can be used to develop or to purchase and to license intangible property to other foreign affiliates that will use such property in their active businesses. Finally, it is sometimes more efficient for an offshore company to own and lease fixed assets used by other foreign affiliates in their active businesses.

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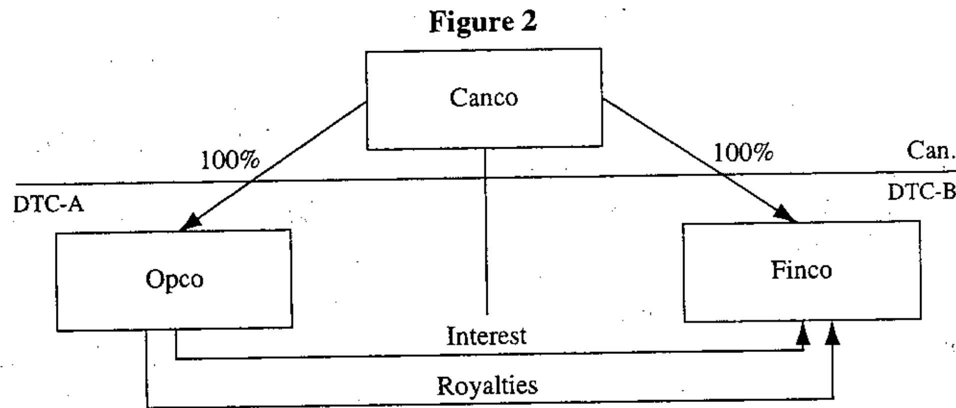
[55] Income that would otherwise be income from property may also be deemed to be active business income if the conditions found in subparagraph 95(2)(a)(i), (iii), or (iv) are met.

Figure 2



In other words, companies such as Finco are an integral part of the active business activities carried on by other foreign affiliates. In the absence of subparagraph 95(2)(a)(ii), the receipt of interest and royalties by Finco would be FAPI, notwithstanding that the payments reduced the active business income, and in these circumstances, because Opco is resident in a DTC, reduced the exempt surplus of payer. Instead, subparagraph 95(2)(a)(ii) ensures that the interest and royalties will be added to Finco's exempt surplus if it is resident in a DTC.

Subparagraph 95(2)(a)(ii) was enacted to ensure that interaffiliate payments that reduced the active business income of one affiliate did not create FAPI in another foreign affiliate.[56] In effect, subparagraph 95(2)(a)(ii) was enacted to recognize that interaffiliate payments need to be treated differently because their passive appearance does not reflect their underlying active business income character. Hence, not only are subparagraph 95(2)(a)(ii) payments not FAPI, they also preserve the underlying active business character of the income.

Discussion

Subparagraph 95(2)(a)(ii) Still Necessary

Subparagraph 95(2)(a)(ii) has attracted considerable attention, especially in recent years, and some argue that it should be repealed because it serves only to encourage tax-planning arrangements that erode the Canadian tax base.[57]

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[56] The original draft legislation enacting the recommendation of the 1969 white paper did not include any provision similar to that currently found in paragraph 95(2)(a). The absence of such a provision gave rise to strenuous objections for the reasons stated above (see, for example, D.Y. Trimbell, "Policy and Structural Basis Underlying Canada's Foreign Income Rules," in *Report of Proceedings of the Twenty-Seventh Tax Conference*, 1975 Conference Report (Toronto: Canadian Tax Foundation, 1976), 834-49, at 838) and, as a result, the addition of paragraph 95(2)(a) was among the changes made to the legislation.

[57] See, for example, Arnold, supra footnote 13, and Lanthier, supra footnote 5.

The committee's recommendation that the FAPI exemption found in subparagraph 95(2)(a)(ii) be maintained is a strong endorsement.

In effect, the committee concluded that the reasons for introducing the provision in the first place are still valid today. As long as the Canadian approach to taxing foreign active business income follows what is essentially an exemption system, subparagraph 95(2)(a)(ii) is necessary. In response to those critics who argued the FAPI exemption erodes the Canadian tax base, the committee was confident that its recommendation on interest deductibility provided the necessary protection to the Canadian tax base. Recognizing that subparagraph 95(2)(a)(ii) facilitates the consolidation of active business income of a foreign affiliate group, the committee warns that the repeal of the FAPI exemption, in addition to denying interest deductibility on funds borrowed to finance foreign affiliates, could "significantly impair the international competitiveness of Canadian businesses."[58]

Tax-Privileged Entities

If the committee is supportive of subparagraph 95(2)(a)(ii), why is the recommendation to add payments for interaffiliate transactions in the

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[58] Report, supra footnote 18, at 6.21. Recently, considerable debate has taken place in the United States concerning controlled foreign corporation planning not dissimilar in some respects to that associated with subparagraph 95(2)(a)(ii): see Notice 98-11, 1998-6 IRB 18, followed by implementing regulations issued on March 23, 1998 and ultimately withdrawn on June 19, 1998 and replaced by a revised proposal in Notice 98-35, 1998-27 IRB 35, commented on in New York State Bar Association, Tax Section, "Notice 98-11: Tax Treatment of Hybrid Entities in the U.S." (May 25, 1998), 16 *Tax Notes International* 1669-76; Reuven S. Avi-Yonah, "U.S. Notice 98-11 and the Logic of Subpart F: A Comparative Perspective" (June 8, 1998), 16 *Tax Notes International* 1797-1800; David P. Hariton, "U.S. Notice 98-11 and the 'Logic' of Subpart F: A Response to Professor Avi-Yonah" (June 15, 1998), 16 *Tax Notes International* 1881-83; Reuven S. Avi-Yonah, "More on U.S. Notice 98-11 and the Logic of Subpart F" (June 22, 1998), 16 *Tax Notes International* 1943-44; and Lee A. Shepherd, "U.S. Notice 98-11 Withdrawn: Who Won?" (July 6, 1998), 17 *Tax Notes International* 5-7. Among other issues, that debate has been occupied with inferring the tax policy significance of the relevant tax rules. One senior US practitioner offered good advice about trying to divine tax policy significance beyond the reasonable content of rules when they were implemented. In light of the proximity of the US issues to those discussed by the committee, his advice is worth noting. David R. Tillinghast, "An Old-Timer's Comment on Notice 98-11" (March 23, 1998), 16 *Tax Notes International* 923-25, at 925, cautions against too vigorous reliance on inferred tax policy, and in our mind, in a way that is perfectly apt here, highlights the importance of understanding relevant tax policy (if any), and its history and reasonable scope, before drawing too many conclusions about its significance:

> I think it is fair to say that the drafters of the 1962 legislation . . . added the sales branch rule, in the Senate, as a kind of "last minute catch": from some source, they learned about this gambit and moved to block it. There were, undoubtedly even then, similar gambits to be played with other transactions in countries that exempted the income of foreign branches. The drafters simply never dealt with them.
>
> I am not sure whether this essay in ancient history helps in resolving the debate over Notice 98-11; but I think the debate might proceed more thoughtfully if the parties understood the historical antecedents.

recipient's taxable surplus, if the recipient is an entity that is expressly denied benefits under the relevant tax treaty, necessary?

This question may be best answered by referring to the committee's conclusion that while the current foreign affiliate system is fundamentally sound, certain elements weaken its integrity.

Since the foreign affiliate system is essentially a foreign tax credit regime, it is not unreasonable to infer that its exemption aspect intrinsically presumes that foreign income is exposed to taxation of a substantial sort, at least in principle. Although there is no prescriptive requirement that foreign active business income bear any particular degree of foreign taxation in order to be treated as exempt income of a Canadian corporate shareholder, it is nevertheless reasonable to expect, because of the constraints on access to the exemption aspect of the system and their theoretical tax policy underpinnings, that exempt income probably will have been exposed to a system of taxation broadly consistent with Canadian tax principles. The ability, facilitated by paragraph 95(2)(a), to shift business income between foreign corporations without disturbing its underlying character is consistent with this expectation—effectively, from Canada's point of view, the rest of the treaty world is treated as a single, homogeneous jurisdiction in which business income can be moved without regard for the effect of national borders. A distortion occurs, however, if as a result of the way in which foreign income is accounted for within this "bilateral" system—on a separate entity basis—the legal and financial dimensions of the foreign affiliate system collide with its theoretical expectations. By putting these implications of the exemption aspect of the system together with the requirement, ultimately, that foreign active business income earned in non-treaty circumstances be subject to Canadian taxation, it is evident that at least in theory there is, even now, an implicit "high tax" requirement as a condition of access to the exemption aspect of the foreign affiliate system.

As the committee acknowledges, in some cases the expectation of foreign taxation will be defeated to the extent that deductible amounts are paid by foreign affiliates in high-tax jurisdictions to those located in jurisdictions offering preferential regimes of tax to international business enterprises (that usually are not conducting and perhaps legally cannot conduct local business in those jurisdictions). Despite the general deference of the Canadian tax system to legal entities as separate, independent taxable units, the foreign affiliate rules, as we noted earlier, in significant measure effectively deal with foreign active business income on a consolidated basis,[59] as if all non-Canadian jurisdictions, and the entities created

[59] See footnote 15, supra. As noted, in the treaty world, there effectively are only two jurisdictions: Canada and everywhere else. The thrust of the rules in paragraph 95(2)(a) recognizes this—it makes little sense to recharacterize income with an active business pedigree as passive simply because of how it is "moved" from one entity to another if the legal configuration of a foreign corporate group does not, as it should not, determine the tax quality of foreign income.

in them, were one as distinct from their Canadian parents. It is at least curious, then, that the same degree of foreign tax credit would be extended regardless of whether foreign tax is payable. Or, put another way, it is odd that the system would actively facilitate the reduction of foreign taxable income, from a Canadian foreign tax credit perspective, without some limitations being imposed consequently on access to foreign tax credit. The proposed changes seem to be directed at this anomaly.[60]

Some of the recent international discussion in this area has tended in the direction of concluding that jurisdictions like Canada and the United States are effectively attempting to police foreign treasuries through limitations imposed on the access to the deferral and exemption aspects of their systems for taxing foreign direct investment income.[61] This is a dubious proposition, and reflects a much too narrow and self-servingly commercial perception, in our view, of these developments. The issue is not whether implicit in the design of regimes for taxing the income of controlled foreign corporations there is some sort of requirement that foreign treasuries not be depleted. Domestic tax rules applicable to income from foreign direct investment essentially function as unilateral systems for relieving international double taxation on a principled basis—for extending foreign tax credit in circumstances in which a foreign revenue authority has, according to normative international tax policy principles, a prior and higher claim to taxation. Perceived this way, countries like Canada do in fact have an interest in determining whether and to what extent foreign income has borne or is likely to bear tax. This is critical to the systemic integrity of the direct and indirect foreign tax credit rules. Just as direct foreign tax credit would not be extended if in fact there was no foreign tax liability, so, it might be reasoned, should there be similar limitations on the availability of foreign tax credit indirectly through the exemption, and the deferral and credit, aspects of our system for taxing incorporated foreign business income. If the recommendations of the committee were implemented, Canada would not so much be taking an interest in the welfare of foreign treasuries as it would

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[60] This change is evidently concerned with foreign affiliate tax planning that has the effect of reducing taxable income in relatively high-tax jurisdictions—that is, reducing consolidated worldwide taxable income—through payments of interest, royalties, and other periodic amounts to foreign affiliates located in jurisdictions with preferential regimes of taxation. This change, conceptually, would effect a modest shift in the emphasis placed upon capital export neutrality, although to the extent that foreign income classified as "taxable surplus" in any event is not distributed to Canadian shareholders, the matter is somewhat academic and indeed, as we discuss below, in relation to various examples of changes in the area of interest deductibility, may in fact shift the bias in the Canadian foreign affiliate system in favour of capital import neutrality. It is interesting to note that the thrust of the foreign tax credit changes proposed in the February 24, 1998 federal budget are similarly directed to offering foreign tax credit only in respect of income that has actually borne foreign tax commensurate with the degree of credit claimed.

[61] See supra footnote 58, pertaining to Notice 98-11 and the tax policy debate that it spawned.

be actively enforcing tax principles underlying its own extension of foreign tax credit to alleviate double taxation.

The committee points out that there are foreign companies in treaty countries that have special or favourable tax treatment—certain of these corporations are even denied treaty benefits under the relevant tax treaty between Canada the foreign jurisdiction. The committee identifies a few of these corporations, including companies licensed under the Barbados International Business Corporations Act.[62] In effect, the committee is saying that these companies should be treated in the same manner as companies located in non-treaty countries, Accordingly, the receipt of interaffiliate payments, while not FAPI, are added to the recipient's taxable, not exempt, surplus. Presumably this recommendation can be achieved by denying such corporations in receipt of interaffiliate payments the benefit of regulation 5907(11.2)(c).[63]

The committee urges the government to renegotiate treaties to deny benefits to special status or "tax-privileged" entities. This process will take some time, and of course there will be issues as to whether a foreign entity is a "tax-privileged" entity. It would appear that the determination as to whether an entity in a foreign jurisdiction is a "tax-privileged" entity will be based on its tax status relative to other entities in that jurisdiction. An Irish International Financial Services Centre company may be a "tax-privileged" entity today because its tax rate is lower than the rate applicable to non-IFSCs. However, if Ireland moves to a uniform corporate tax rate of 12.5 percent in a few years, subject to whatever grandfathering may be available, the IFSC may not be a "tax-privileged" entity. On the other hand, presumably, foreign affiliates located in jurisdictions that exempt foreign branch earnings from tax will not be considered to be "tax-privileged" if normally such tax treatment is available to all corporations in such jurisdictions.

Second-Tier Financing Structures

Maintaining the FAPI exemption in respect of interaffiliate payments when the underlying active business income belongs, albeit indirectly, to the Canadian corporate shareholders is clearly appropriate. However, if the

[62] Corporations resident in Barbados are liable to Barbados income tax at the rate of 40 percent. However, companies licensed under the International Business Corporations Act are subject to a tax rate of 1-2.5 percent. Such companies are not eligible for benefits under the Canada-Barbados Income Tax Convention pursuant to article XXX of that treaty.

[63] By virtue of regulation 5907(11.2), in order for a foreign affiliate to be resident in a designated treaty country, the affiliate must be resident in a country for common law purposes (that is, the controlling mind and management of the foreign affiliate must reside in that country) and the affiliate must be a resident of that country for purposes of that country's tax treaty with Canada. Regulation 5907(11.2)(c) provides, in effect, that a foreign affiliate will be resident in a designated treaty country if it would otherwise be resident in that country but for a provision in the tax treaty that has not been amended after 1994 and that provides that the treaty does not apply to the affiliate.

underlying business income from which the payment arises does not belong to Canadian corporate shareholders (that is, the income did not arise in another foreign affiliate), then the appropriateness of the FAPI exemption from a tax policy perspective is more questionable. This is the apparent conclusion of the committee and the reason for its recommendation to deny the FAPI exemption for payments from related non-resident corporations that are not foreign affiliates of the Canadian taxpayer if the related-party status arises solely as a result of share ownership by foreign parent companies located outside Canada. This situation is depicted in figure 3. FA1, a controlled foreign affiliate of Canco, has made a loan to a related company, Foropco. It is assumed that Foropco used the borrowed funds in its active business and the conditions of clause 95(2)(a)(ii)(A) are met so that the interest paid to FA1 is not FAPI.[64] Under the committee's recommendation, the interest paid to FAI will be FAPI.

The committee does not explain or discuss whether its recommendation would apply if Canco had a *significant equity interest*, however that is determined, in Foropco. Presumably, if this was indeed the case, the FAPI exemption should apply, albeit, given the committee's criteria, perhaps only in proportion to Canco's interest in Foropco.

Interest Deductibility and Subparagraph 95(2)(a)(ii)

It might well be argued that the combination of restricting the deduction of interest to fund FDI and requiring income that is not subjected to normative levels of taxation to be treated as taxable surplus and therefore ultimately to be taxable in Canada effects a modest shift in favour of capital export neutrality as the principle underlying the Canadian tax rules for taxing income for foreign direct investment. As we note, this shift may largely be theoretical. If as a practical matter surplus, whatever its character, is not likely to be distributed to Canada, then the potential taxability of any amounts of foreign active business income not currently subjected to tax is only theoretical; the present value of such tax is limited and in practical terms may be negligible.

We suggest that, in the main, this is the way in which Canadian multinational corporations would ultimately perceive changes to the foreign affiliate regime based on the committee's recommendations. That interest

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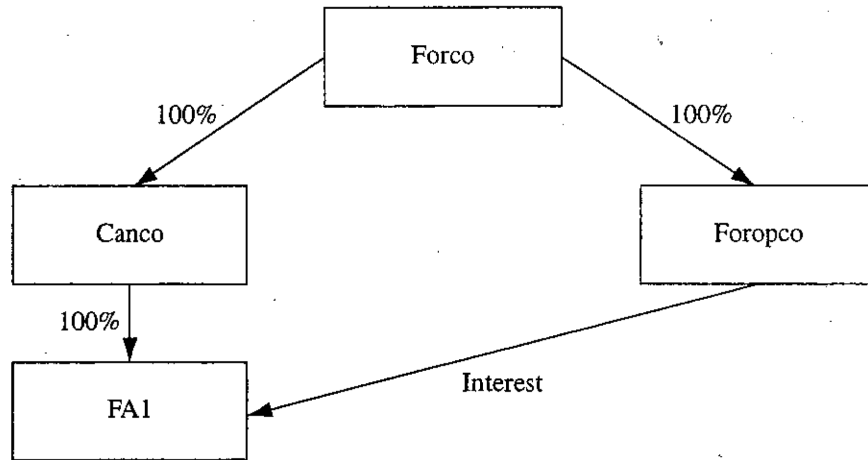
[64] Revenue Canada has indicated that it will challenge such structures using the general anti-avoidance rule found in section 245 (see Wayne Adams, "The General Anti-Avoidance Rule (GAAR) Committee," in *Report of Proceedings of the Forty-Seventh Tax Conference*, 1995 Conference Report (Toronto: Canadian Tax Foundation, 1996), 54:1-9, at 54:8). For a more detailed discussion of this type of financing arrangement, see Larry F. Chapman, "Emerging Tax Issues: Treaty Interpretations and Crown Forest Industries Ltd., Income of Financing Affiliates and the New FAPI Rules, Formation of Financing Affiliates by Non-Resident-Owned Canadian Companies," ibid., 6:1-29, at 6:22; and W. Gordon Williamson, "New Developments Affecting International Corporate Finance," in *Current Issues in Corporate Finance*, 1997 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1998), 15:1-25, at 15:15-25.

Figure 3



on money borrowed to fund foreign direct investment might not be deductible would indeed be a cost relative to the opportunities furnished by the present system. But foreign affiliate planning of the sort to which the committee in its deliberations has drawn attention is not controlled solely by the Canadian domestic interest deduction. Canadian multinationals facing foreign tax rates, whether or not such rates are lower than those prevailing in Canada, will still find it attractive to engage in planning using subparagraph 95(2)(a)(ii). To the extent that income that would otherwise be subjected to relatively high rates of tax can be paid through typical periodic means (interest or royalties) to low-tax jurisdictions, then, in global terms, the effective tax rate of multinational corporate enterprises is managed efficiently.

Scenario 6: In this scenario, Canco borrows $2,500 from a third-party lender and uses the funds to capitalize an Irish financing company (Irishco) that is subject to a 10 percent rate of tax on its income. Irishco makes a loan to USco at interest. Assume further that interest on the borrowing by Canco is not deductible for Canadian tax purposes.

US income	$250.00	Canco interest expense	$150.00
Less interest	175.00		
	75.00	Canadian tax saving	0.00
		Net cost	$150.00
US tax	30.00		
	$ 45.00	Irishco income	$175.00
Withholding tax (5%)	2.30	Less Irish tax	17.50
			$157.50
Dividend to Canco ...	$ 42.70	Net consolidated income	$ 50.20

Under the committee's recommendations, Irishco's net income of $157.50 will be added to its taxable surplus. If these funds are repatriated to Canada, no additional Canadian tax will be exigible. In such circumstances, Canco will be able to claim a deduction under paragraph 113(1)(b) of $28.60, leaving a net taxable dividend of $128.90, which can be offset by some of the previously denied interest expense on the borrowing by Canco to invest in Irishco.

The net consolidated income of $50.20 in this example is lower than that shown in scenarios 2, 4, and 5 above. A superior result may be obtained under different circumstances (for example, if the borrower and lender are located in different jurisdictions and if the tax rate of the lender is less than 10 percent). Alternatively, a superior result could have been obtained in scenario 6 if the third-party borrowing occurred in Irishco, not Canco.[65]

If we assume that the recommendations of the committee will be implemented in their entirety, a reduction in the Canadian corporate tax rate, other things considered, may encourage even more planning of the sort associated with subparagraph 95(2)(a)(ii). This presumes that in the absence of planning, affected income would be subjected to tax in either Canada or the jurisdiction in which it is earned at normative tax rates. (Indeed, as we infer, it seems implicit in the recommendations of the committee that there is a high tax condition to the availment of the exemption aspect of the foreign affiliate system.) To the extent that the differential between Canadian and foreign tax rates would increase as a result of the committee's recommendations being implemented, then there is, curiously perhaps, an increased incentive, from the standpoint of the international tax management by multinationals, to redirect active business income earned outside Canada from high-tax to low-tax jurisdictions. This would seem to be the antithesis of the committee's neutrality goals. But by perceiving the system for taxing income from FDI as, at ground, a foreign tax credit regime, this effect becomes more evident.

For example, it is well known that "mixer" corporations used to collect taxable surplus avoid temporal, geographic and financial limitations on the availability of foreign tax credit. To the extent that the differential between Canadian and foreign tax rates increases, the need and inspiration for this kind of planning should increase. An opportunity afforded by subparagraph 95(2)(a)(ii) is to avoid limitations of the sort imposed under the direct foreign tax credit in section 126. In fact, the contrary would seem to be the case. Assuming that the combined tax rates in Canada for business income are reduced along the lines recommended by the committee, if anything, the existing incentives in the foreign affiliate system to avoid limitations inherent in the direct foreign tax credit regime are in practice amplified. In the result, neither limitations on the deductibility of

[65] Under such circumstances, the net consolidated income would be $65.20, assuming that Irishco's net income is not repatriated to Canada.

interest nor the imposition of a rather theoretical high-tax requirement upon income in order to qualify for the exemption aspect of the foreign affiliate system may generate the kind of improvement in the capital export neutrality of the Canadian system that the committee implicitly seems to expect. Whether one perceives the result in terms of the effect of misallocating of interest expense with respect to foreign income, or more directly in terms of the tax policy significance of the exemption, in contrast with the deferral and credit, aspects of the Canadian foreign affiliate system, the bias of the system in favour of import neutrality will at least be preserved, if not further entrenched, if the committee's recommendations are adopted.

It would seem that the only way in which such a result would not obtain is if, in addition to both limiting interest deductibility and imposing an effective high-tax requirement on foreign active business income that is lightly taxed outside Canada, such income would be treated as FAPI. Without all of these changes occurring, the operation of the foreign affiliate regime for taxing foreign active business income in practical terms will remain largely unchanged, as will the imbalance between the taxation of incorporated foreign active business income and such income earned directly through foreign branch activities of a Canadian-resident taxpayer.

Conclusion

In large measure, the changes recommended by the committee in the outbound international area leave the system for taxing foreign active business income substantially intact. Indeed, the committee finds the present system "fundamentally sound." It is unclear from its recorded deliberations whether this is because intrinsically the system is as good as it can be expected to be or because of the limitations imposed upon the committee, notably with respect to revenue neutrality.

There is a certain elegance insofar as the recommendations, if implemented, would tidy up the present system for taxing foreign direct investment according to its underlying tax policy. From a conceptual perspective, the proposed changes are essentially modest but sound refinements to tax rules whose underlying tax policy is not challenged or disturbed by the committee, which in fact mesh well with changes that have occurred incrementally since 1972 but most recently since 1994. However, the adverse economic consequences of the committee's recommendation to deny interest deductibility on FDI funding could be significant and must be more fully evaluated. Further, this recommendation presents several practical implementation and transitional issues that must be resolved.

Considerable international attention currently is being devoted to evaluating the characteristics and practical limits of typical formulations of tax jurisdiction. Seemingly, the importance of increasing and making more reliable the correspondence between financial or tax income and economic income, as measured by a tax system, based upon the economic

nexus of the income-earning activity to a jurisdiction is becoming more apparent. The activities of international business rely more and more on intangible and financial factors of production and ways of doing business that are less dependent on or reflective of typical, and for the most part physical, business connections in a jurisdiction. There is marked concern about the adequacy of the usual jurisdictional tests to capture contemporary manifestations of business connection or nexus and to coherently and consistently assign income to affected jurisdictions according to generally accepted international taxation "norms." As recently as October 1997, officers of the Fiscal Affairs Directorate of the OECD reviewed a compendium of contemporary international tax issues in this connection.[66] Identified as critical among them were planning to move income from high-tax jurisdictions where it is earned to tax havens, refinements to "control" thresholds for the ownership of tax-deferred or exempt foreign active income, ascertaining the circumstances in which controlled foreign corporation tax principles should govern (in contrast with those applicable to foreign investment funds), and the relationship between tax and trade issues in terms of national economic welfare and national tax sovereignty (the so-called principle of subsidiarity) in the face of increasing difficulties encountered in establishing and measuring objective national income. "Harmful tax competition" is another subject of current international tax study. Despite the connotation suggested by its label, it too essentially concerns the rationalization of multiple assertions of tax jurisdiction by countries and, absent overt harmonization of their tax systems, how to deal with the intersection of those systems.[67] The OECD has recently

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[66] Jeffrey Owens and Jacques Sasseville, "Emerging Issues In Tax Reform," presented at a joint seminar conducted by the OECD and the International Fiscal Association, New Delhi, October 1997.

[67] See Organisation for Economic Co-operation and Development, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD, 1998); and Commission of the European Communities, *A Package to Tackle Harmful Tax Competition in the European Union* (Brussels: CEC, 1997). As the OECD notes, in terms particularly interesting in relation to the committee's recommendations in the foreign affiliate area, harmful tax competition does not need to involve the deliberate exploitation by countries of others' tax systems: "Harmful effects may also occur because of unintentional mismatches between existing tax systems, which do not involve a country deliberately exploiting the interaction of tax systems to erode the tax base of the another country. Such unintentional mismatches may be exploited by taxpayers to the detriment of either or both countries" (OECD, supra, at 15). Recommendation 3 is responsive to these sentiments and strikingly consistent with the thrust of the committee's foreign affiliate recommendations: "Recommendation concerning restrictions on participation exemption and other systems of exempting foreign income in the context of harmful tax competition: that countries that apply the exemption method to eliminate double taxation of foreign source income consider adopting rules that would ensure that foreign income that has benefited from tax practices deemed as constituting harmful tax competition do not qualify for the application of the exemption method" (ibid., at 43). The OECD recognizes the vulnerability of a country's tax base to economic and tax-planning developments by non-"citizens" of and non-"adherents" to a country and its legal system. The absorption of tax base by those who do not contribute economic development in return effects gratuitous tax expenditures in tax policy terms and impairs the usefulness of a tax system to deliver public goods to those who genuinely are members of the country and who consequently have a legitimate claim on its fiscal resources.

reported on this subject in order to stimulate international discussion. At the same time, member nations of the European Community are concerned about both deliberate and incidental effects of national tax systems that result in a depletion of a country's tax revenue base without a corresponding increase in taxation elsewhere.

The committee's recommendations are in step with these issues and the heightened international attention being paid to them. The interest-deductibility proposal is directed essentially to the accuracy with which geographic income is measured and allocated in economic terms. The relatively modest changes to the foreign affiliate system would have the effect of limiting opportunities endemic in the taxation of active business income earned by groups of corporations owned by Canadian shareholders for reducing the tax paid in other jurisdictions and therefore, theoretically, for avoiding Canadian domestic limitations on foreign tax credit—which in principle should not be extended if there is no foreign tax. The committee additionally exhorts Revenue Canada and the Department of Justice to be vigilant in pursuing abuses of foreign trust planning, and encourages Revenue Canada with respect to the administration of its transfer-pricing rules and foreign investment fund ("offshore investment fund property") rules.

But are the committee's recommendations likely to change how Canadian taxpayers respond to the tax system in their international business planning? For the most part, we suggest that the answer is "probably not." As the committee itself anticipates, except in relatively simple business circumstances or in the event of very large commitments of capital to foreign operations, well-advised corporate groups likely will be able to cope with the proposed limitation on interest deductibility through various planning strategies. Furthermore, because the likelihood of foreign active business income, whatever its tax-accounting quality, ever being distributed to Canadian shareholders is generally small (and therefore the present value of that taxation also is small even if, ultimately, distribution is expected), the overall impact of the committee's recommendations may be to preserve the status quo if not perhaps to increase both the incentive for and the likelihood of structured international tax planning regardless of domestic limitations on the recognition of financing charges.

Indeed, the proposed reduction in the overall Canadian corporate tax rate to approximately 33 percent may increase pressure to reduce foreign taxes as much as possible in the tax mix of multinational corporations and therefore, effectively, to eliminate prescriptive constraints in the Canadian foreign tax credit regime as much as possible. Limiting the recognition, directly, for foreign taxes effectively to 33 percent makes it at least as attractive as at present, if not more so, for income from business activities conducted in jurisdictions with higher effective rates of taxation on foreign income to be paid to low-tax jurisdictions so as to reduce the tax base in those high-tax countries. Reducing the Canadian corporate tax rate necessarily limits the extent to which credit can be obtained for foreign taxes in excess of the Canadian tax rate and consequently increases

the incentive to multinational corporations to reduce taxable income in high-tax jurisdictions by "moving it," using typical tax-planning techniques associated with subparagraph 95(2)(a)(ii), to jurisdictions that impose modest rates of taxation, even if the ultimate cost of this planning is taxation of that income if and when distributed to Canada.

All this raises some general questions about the role of a tax reform study. The committee, in the international area, readily accepts Canada's existing tax rules. Moreover, it seems to be guided, despite what its terms of reference otherwise might have tolerated, by tax practice rather than tax theory. Therefore, the recommendations neither entail nor entertain any profound or fundamental shifts or advances in tax policy; all of them are measured by the principles underlying and legislative expressions of existing tax rules.

One of the functions and opportunities of a tax reform study is, however, pedagogical. It should offer an opportunity to test the adequacy and sustainability of existing notions of taxation in the face of prevailing and anticipated economic conditions and contemporary tax theory. The point is not whether tax reform proposals can readily or should (immediately) be translated into legislative form. Rather, the issue is one of how best to enliven tax policy debate that might not otherwise take place in the absence of such a reform opportunity, in order to inform an evaluation of and broaden the perspective on existing tax rules. Accordingly, rather than approach its evaluation of Canada's international tax rules by so readily accepting the basic characteristics of the Canadian system, the committee might have considered challenging the principles upon which the Canadian system for taxing income from FDI is built. Even if alternatives would have been found wanting, proposing them might have spawned a more far-ranging and insightful debate than relatively modest clarifications of the existing system. For example, given the importance being attached, internationally, to devising more reliable ways of testing the nexus of income-earning activity to national taxing jurisdictions, and the pressures on those jurisdictions to preserve some measure of tax sovereignty in order to fund public goods, the advancement of more directly economic techniques for measuring and apportioning international income and asserting tax jurisdiction would have been interesting at least to provoke and inform tax debate from a Canadian perspective.

This is the only fundamental criticism that we offer of the report in this area. The report nevertheless makes a useful contribution to understanding the existing Canadian tax rules in respect of income from foreign direct investment. The debate that will follow this report will be interesting to watch. We do not have answers to the different questions dealt with in chapter 6 any more than others do. We offer these comments essentially to spur and direct debate in ways that both complement and supplement the discussion in chapter 6.

CHAPTER 26

INTERNATIONAL ASPECTS OF INCOME TAXATION

A major objective that we have sought in our proposals for the domestic tax system has been tax neutrality. A neutral tax system would contribute most to the efficient allocation of resources, and hence to the greatest output of the goods and services Canadians want, and is also a prerequisite of an equitable tax system.

It will be evident by now that the economic and administrative realities of the practical world have forced us to accept compromises with true neutrality and equity in our domestic tax proposals. In our proposals for the taxation of international income we have had to make even greater concessions since here the administrative and economic problems appear in a more acute form. Not only are the problems of valuation and enforcement more difficult in the international area, but market imperfections are likely to be more important. Hence, purposeful deviation from tax neutrality under certain circumstances may become a necessity. In addition to the extreme complexity of the subject, the controversy that surrounds many of its fundamental principles and the lack of guiding evidence by which to settle those controversies militate against the adoption of simple, generally accepted solutions. In this area more is left to opinion and judgment, both because little is known with certainty of the consequences of adopting alternative policies, and because there are substantial differences of opinion as to the relative importance to be attached to the competing objectives. In the international sphere perfect tax neutrality is neither administratively feasible nor necessarily economically desirable.

The subject is therefore a challenging one and one which Canada of all countries can least afford to ignore. Canada's heavy stake in foreign trade and investment gives this country a particular interest in well-ordered international tax arrangements. Fortunately a good deal of progress has been made toward some standards of conduct for international tax behaviour

by negotiation and agreement. Over the last half-century the leading tradi nations, under the auspices of world organizations, have developed a few basic ground rules that eliminate the grosser inequities and economic dislo cations that would otherwise arise. While these rules fall far short of th ideals of neutrality and equity, their embodiment in national taxing statut and in international treaties gives some order and certainty where chaos could otherwise rule. The value of these arrangements has also increased with the more extensive use of income taxes by both developed and developin countries as the major source of their revenue. The direct use of income t provisions by many countries for the achievement of domestic economic objectives, and the heightened sophistication of taxpayers in arranging their affairs to minimize their tax liabilities, will add further to the need for international tax arrangements in the future.

MAJOR ISSUES

While the subject bristles with complexities and controversies, the larger issues in international taxation are surprisingly few. Substantiall they are:

1. The treatment to be accorded income of non-residents at the time it is earned in Canada.
2. The treatment to be accorded certain forms of income of non-residents at the time it is withdrawn from Canada.
3. The treatment to be accorded foreign income of residents of Canada at the time it is earned outside Canada.
4. The treatment to be accorded foreign income of residents of Canada at the time it is received in Canada.

The practical questions to be settled are even fewer, since custom and the international tax treaties have already disposed of many of the issues that might have arisen under these headings.

1. For the foreign income of residents, two questions arise:

    a) To what extent should such income be taxed as earned abroad?

    b) What form of recognition should be given to the fact that the country of source of such income will have levied a tax on it?

2. For the Canadian income of non-residents, the main question is the level of withholding tax that should apply on the withdrawal of certain forms of payments from Canada.

In seeking to apply our standards of equity and neutrality to these problems we have proceeded on the basis of certain assumptions which should be stated here:

1. The treatment of foreign income of Canadian residents should include some recognition of foreign taxes levied on that income.

2. Foreign income of Canadian residents should also be taxed under the comprehensive tax base in accordance with procedures which minimize tax deferment and the use of tax havens, which are countries through which income can be channelled at little or no tax cost.

3. The benefits of integration of personal and corporation taxes should be restricted to domestic shareholders. We have adopted this position primarily because a similar alleviation of the tax on dividend distributions to non-residents would result in a cost to the Canadian treasury which would largely accrue to the benefit of foreign treasuries. This is admittedly a form of discrimination. However, we have assumed that this discrimination in favour of residents would not have adverse effects on foreign confidence, nor should it bring about retaliation as the tax position of the vast majority of non-residents would not be worsened relative to their present position except to the extent that non-residents would become worse off because of the removal of specific industry and corporation incentives, an impact that would apply equally to some residents.

4. We should strive for tax arrangements which maintain and, if possible, increase the net economic benefit that Canada derives from capital movements across its borders, consistent with our treaty obligations and the normal standards of international taxation. This implies that tax provisions that would permanently impede capital movements in either direction should be avoided. We do not review in this chapter the full discussion of the international economic issues covered in Chapter 5. In particular, the net benefits that might be secured by increasing foreign portfolio investment in Canada and reducing foreign direct investment correspondingly, are not dealt with further; nor is the question of Canada's dependence on a net capital inflow reopened. However, we take for granted that those who would eliminate the net capital inflow into Canada are not seeking to eliminate gross capital movements between Canada and the rest of the world. Capital movements may be impeded during the adjustment period following the introduction of our integration proposals, but it is not put forward as a measure intended to produce a permanent effect of this kind.

5. The net economic benefit that would result from higher taxes on dividend income going to non-residents would be too small and uncertain to warrant the risk in raising such taxes. An increase would probably provoke retaliation from foreign governments, particularly since the present level of Canadian corporation and withholding tax on dividends is close to, or in some cases even exceeds, the level of tax credit granted by the country of residence of the foreign investor. Where the tax on other forms of income going to non-residents is not subject to this constraint we have proposed an increase.

The domestic tax system which we propose as a means of more completely realizing Canada's economic and social objectives is radically different from the existing Canadian system and is unlike the systems in effect in other countries. Our most important task in this chapter is to develop tax provisions that would allow the adoption of a new domestic system without adversely affecting our economic ties with the rest of the world. This involves working out the technical problems resulting from the taxation of the income flows across the Canadian border. It also requires the development of tax provisions that maintain, and preferably increase, the net economic benefit that Canada derives from foreign investment in Canada and from the investment by Canadians outside of Canada, consistent with our treaty obligations and with the normal standards of international taxation.

The second task is to develop tax provisions that treat Canadians with foreign source income equitably relative to other Canadians. Thus, not only must all foreign source income be brought into the comprehensive tax base and be subjected to progressive rates of income tax, but it must be brought in under procedures that minimize tax deferment. In addition, it is necessary to eliminate the serious loopholes existing in the present system that allow some Canadian residents to avoid paying full tax on their income by the utilization of companies in tax-haven countries.

At the present time the rates of tax imposed on the Canadian source income of non-residents vary with the nature of the payment. Some payments (e.g., dividends) are subject to substantial Canadian tax, others to low rates of tax, and still others are not taxed at all. These disparities place an undue significance on the form of the payment, thus encouraging the adoption of procedures that lessen Canadian tax collections. Reducing these disparities is the third general task with which this chapter is concerned.

PRINCIPAL PROPOSALS

Our principal proposals deal with the form of tax credit to be granted to Canadians in respect of their foreign income, the manner in which such income should be taxed in Canada and the rate of withholding tax to be appli to the income of non-residents originating in Canada. These proposals are discussed in detail later in this chapter but are summarized here for convenience:

1. The present exemption from tax of certain foreign dividends received by a resident corporation which is provided by section 28(1)(d) should be withdrawn. Dividends received from foreign direct investment should be grossed-up at an arbitrary rate of 30 per cent and a foreign tax credit of the same amount allowed. If the dividend was received by a resident individual, then the applicable Canadian tax on the grossed-up amount would be payable at the time of receipt. However, if the divide was received by a resident corporation, no tax would be payable until the income was in turn distributed or allocated, at which time a withholding tax of 20 per cent of the grossed-up amount should be collected so that the resident shareholders would be entitled to a tax credit of 50 per cent of the grossed-up distribution (the original 30 per cent foreign tax credit plus the additional 20 per cent withheld).

2. A foreign direct investment should be defined as an investment by a Canadian resident or associated group of Canadian residents:

   a) in a non-resident corporation in which he or the group holds a 10 per cent or greater interest in the voting power, in the profits or in the assets distributed on liquidation of the non-resident corporation, or

   b) in a foreign property or business in which he or the group holds a 10 per cent or greater interest.

3. Canadian taxpayers having foreign direct investments should report annually the foreign income earned and the foreign income taxes paid in each foreign jurisdiction. If the foreign income taxes paid on this current income (including those paid by a non-resident corporation) were less than 30 per cent of the foreign income earned, the difference should be paid to Canada as a special tax. This procedure would ensure that all foreign source direct investment income was immediately subject to income taxes of at least 30 per cent on an accrual basis. If the foreign income was subsequently subjected to a withholding tax in the foreign country on distribution to the Canadian investor, the special tax paid on such income would be refunded to the extent of the withholding tax. If a Canadian taxpayer with less than a controlling interest in a foreign direct investment could establish that he was unable to obtain sufficient information to compute the foreign income, he should be entitled to elect that it be taxed as portfolio investment income (i.e., income from an investment other than a direct investment) with credit only for withholding taxes paid.

4. For the purpose of these computations, foreign income should be defined as income reported to the foreign jurisdiction (or in an audited financial statement) with certain adjustments to make this figure generally comparable to income as defined for Canadian tax purposes. These adjustments would not be numerous or detailed, and we will suggest an additional modification that should mean that computations would rarely be necessary for most income derived from the United States and the United Kingdom.

5. Canadian portfolio investors (investors who were not direct investors) should be given an option:

   a) to be taxed on the same basis as direct investors as described above; or

   b) to be taxed as at present with a credit only for withholding taxes paid.

6. The basic withholding tax on most payments to non-residents other than dividends should be increased from 15 per cent to 30 per cent. This withholding tax should be applied to gifts and bequests, income from employment in Canada and the income portion of payments from pension plans, in addition to interest, royalties, etc. This 30 per cent rate might be lowered for some specific types of payments (e.g., the present exemption for certain interest payments to tax-exempt entities) and reduced by treaty for certain payments to specified countries.

7. A withholding tax of up to 10 per cent should be imposed on payments for services that were deducted in the computation of business or property income and were not already subject to a withholding tax. These services might well be rendered outside Canada but the benefit from them would be obtained in Canada. This withholding tax should not apply to amounts paid in reimbursement of expenses.

8. In certain specific cases non-residents should be entitled to elect to be taxed as residents of Canada, reporting their world income from all sources and deducting foreign tax credits on the present basis for foreign taxes paid on income from foreign sources. This election should be available in the following cases:

    a) where a Canadian resident became non-resident and elected to be taxed as a Canadian resident for each year after the change of residence; or

    b) where a non-resident received certain kinds of income from Canada, including gifts, inheritances, the income portion of pension and annuity payments and employment income.

The implementation of these recommendations would, we believe, confer the following important advantages:

1. Substitution of a 30 per cent gross-up and credit for the section 28(1)(d) exemption:

   a) Removal of the exemption under section 28(1)(d) for foreign dividends received by a Canadian corporation from a company in which it held at least a 25 per cent interest would eliminate a major loophole in the present tax system through which some Canadians have in effect avoided the payment of their full Canadian tax on Canadian source income which has been diverted through companies in tax havens.

   b) The use of an arbitrary flat-rate tax credit would reduce, to a great extent, the significance of the tax mix of the source country. Thus, the balance between income taxes and withholding taxes would be unimportant and the extent to which other taxes (e.g., sales taxes) were utilized in the foreign jurisdiction would be less important.

   c) Once it was decided that a broad exclusion like section 28(1)(d) was not appropriate, the use of an arbitrary rate would simplify the computations and remove much of the uncertainty. Both of these advantages would be particularly important to ensure that Canadian corporations were not discouraged from establishing foreign operations. Although the procedure would require the measurement of the underlying foreign source income from most countries, this would not generally apply to income derived from the United States or the United Kingdom (from which over three quarters of the foreign source dividends of Canadians are derived). This special treatment could perhaps later be extended to other countries after experience has been gained in administering the provisions. In any case, the adjustments required for the other countries, although arbitrary, would be relatively simple. Because property gains would be taxed in full to Canadians on realization, full Canadian tax would be

collected in the long run. Arbitrary procedures to compute the annual tax liability therefore would not be as inequitable as they might otherwise be.

d) A flat-rate gross-up and credit would result in the progressive rate schedule being applied to foreign source direct investment income.

e) Adoption of a rate of 30 per cent for the gross-up and credit would have two advantages: Canada would derive some (albeit small) net revenue from foreign source dividends, and most shareholders in Canadian companies with foreign direct investments would pay no more Canadian tax on foreign source dividends than they do at present.

f) The gross-up rate could be adjusted from time to time to meet particular circumstances. A reduction in the rate might be necessary if over time the expected before-tax rates of return on corporate assets in Canada declined following the adoption of the integration proposal.

2. Requiring payment of income tax on foreign direct investment income at a rate of at least 30 per cent;

    a) A requirement that taxes of at least 30 per cent be paid each year to either the foreign jurisdiction or to Canada as the foreign income was accrued would reduce the tax deferment and the minimization advantages provided directly or indirectly by tax havens.

    b) The recommended procedure would reduce the importance, from a taxation viewpoint, of the form of organization adopted for carrying on foreign operations. It would also largely eliminate any effect Canadian taxes might have on the decision to retain or remit funds from the foreign operation.

3. Increasing the level and scope of withholding taxes:

    a) The increase in the standard withholding tax (on most payments other than dividends) to 30 per cent would narrow the gap between the rates of tax imposed on different types of return on capital. It would reduce the attractiveness of some of the present methods employed to reduce the Canadian tax liabilities on income derived from this country and would thereby increase Canadian tax revenues.

    b) The application of a withholding tax to another form of remittance from Canada, namely, service fees, would ensure that at least some tax revenue was collected on income from services enjoyed in Canada and performed by non-residents who were not physically present in Canada when the services were rendered.

The balance of the chapter is devoted to further consideration of the concept of neutrality and its implications for our specific tax proposals, to an outline of the actual tax systems in effect in Canada, the United States and the United Kingdom, and to separate consideration of the tax issues and of our proposals for Canada as a country receiving income from abroad and as a country which is the source of income going abroad. We then examine some of the administrative aspects of international taxation and finally we review the nature and effect of the tax treaties.

NEUTRALITY AS AN INTERNATIONAL CONCEPT

Because of its key position in our consideration of the various proposals for international taxation, we will explore at some length in the following paragraphs the meaning of "neutrality" as a guiding concept for these proposals.

To achieve complete international tax neutrality, the tax systems of all nations would have to be so harmonized that each individual would be indifferent, from a tax point of view, about his citizenship, his country of

residence, the location of his property, the location of his business and the location of his job. This would require that all nations:

1. Provide the same public goods, services and transfer payments to those residing or carrying on business in the country 1/.

2. Finance the provision of these public goods, services and transfer payments with the same kinds of taxes levied at the same rates.

3. Avoid, shift and adjust to the same taxes to the same degree and at the same time.

4. Tax each individual on his world income, defined in a uniform manner, at the same rates as those at which he would be taxed if he derived all of his income from his country of residence; these rates would have to be the same whatever his country of residence 2/.

In deciding where to work, where to invest and where to carry on business, tax considerations could be ignored because the ratio of the expected after-tax rate of return to the expected before-tax rate of return would be a constant for each individual. If these conditions were realized, expected before-tax rates of return in different countries would not be distorted, relative to one another, as a result of differences in national tax systems.

The conditions cited above would be extremely difficult to realize even with the best of intentions on the part of all nations. If all nations were to provide the same kinds and levels of public goods to their residents with the same bases and tax rates, per capita national incomes would have to be approximately the same. This condition is unlikely to be met in the foreseeable future—if ever. Differences in national preferences between public and private goods and between different kinds of public goods will continue to prevail. National resource endowments, national market sizes and national mixes of industries are so diverse it is difficult to imagine that

avoidance, shifting and adjustments to taxes will ever be the same in all nations.

In Chapter 19 we discuss how before-tax rates of return on productive assets change in response to changes in taxation. It is useful to briefly review that discussion here.

Unless all taxes are avoided or shifted to exactly the same extent and at the same speed, the imposition of what purports to be a completely neutral tax will nevertheless change the allocation of resources among alternative projects. To illustrate what is involved, assume that in a world with no taxes there are two kinds of projects, types A and B. Each kind of project is expected to yield a before-tax rate of return of 10 per cent. Suppose that a tax of 50 per cent is imposed on the net gains from both kinds of projects and that there is no avoidance. If the tax on the income from type A projects is fully shifted, the before-tax income is doubled and the after-tax income is unchanged; if the tax on type B projects is not shifted the before-tax income is unchanged but the after-tax income is cut in half. Investment in type A projects would be much more attractive than that in type B projects. However, over time the higher rate of return would lead to increased investment in type A projects which would increase the output of the goods produced by these projects. The increased supply of these goods would gradually force their prices down. As a result the before- and after-tax rates of return on investments in type A projects would decline. Conversely, the reduced investment in type B projects over time would result in an increase in the before- and after-tax rates of return from type B projects. Under simplifying assumptions, the before-tax rates of return on both kinds of projects would, in time, converge and once again be equal.

These adjustments of before-tax rates of return to changes in taxes must be taken into account in analyzing international income taxes. Resources would not necessarily be allocated efficiently throughout the world if expected before-tax rates of return were the same in all countries.

The expected before-tax rates of return may differ between two countries not because capital was more productive in one than the other but because the same taxes imposed at the same time in both countries were not shifted to the same extent and the investment adjustment process had not yet reduced the return in the tax-shifting country or raised it in the non-shifting country.

Because of market imperfections, differences in expected before-tax rates of return among alternative projects are an imperfect indication of the net benefit that would be derived from different investments within a nation. The interpretation of international differences in expected before-tax rates of return is even more difficult because, in addition to the "normal market imperfections, nations not only have different tax systems but have purposely adopted substantial barriers to the flow of goods, capital and labour. Because of the distorting effects of these differences in tax structure and of countervailing national economic barriers we cannot presume that the allocation of resources on a world basis in accordance with these expected before-tax rates of return would lead to greater world output.

Realization of the fourth condition would be particularly difficult in a world consisting of debtor and creditor nations. If the types and amounts of each nation's foreign source income were equal to the types and amounts of its domestic source income flowing to (or attributable to) non-residents, the problem would be straightforward. All nations could agree to tax income on a destination basis. Whatever their views about the "proper" allocation of revenues between origin and destination countries, if they all adopted the same policy there would be neither revenue gain nor revenue loss, for the additional revenues obtained from fully taxing the foreign source income of residents would just be offset by the revenues forgone by not taxing the domestic source income of non-residents. But because some nations are net debtors and some net creditors such an easy solution is not possible. To tax solely on a destination basis would mean that debtor

nations would be worse off; to tax solely on a source basis would mean that creditor nations would be worse off.

Thus, even if all nations had identical tax systems, there would be an inescapable conflict between net debtor and net creditor nations as to the "proper" division of revenues between source and destination countries. Debtors would continue to argue that the major share of the revenue should go to the country in which the income originated; creditors would continue to argue that the major share of the revenue should go to the country of residence of the recipient of the income.

From this discussion of the conditions necessary for the realization of international tax neutrality, it is obvious that such an objective is unattainable within the foreseeable future. But what is even more important, international tax neutrality may not even be desirable while other international economic barriers exist (such as tariffs, immigration laws, foreign investment guidelines, and foreign exchange controls). All of these artificial barriers to the free movement of goods, capital and labour among nations distort the international allocation of resources just as much or more than unneutral tax systems. It would only make sense to strive to develop an internationally neutral tax system if by doing so a more efficient international allocation of resources throughout the world would be achieved. As long as these non-tax barriers between nations prevailed, an improvement in the international allocation of resources would probably require national tax systems that deviated from neutrality to compensate for the other barriers.

Once this point is reached we are forced to admit that it is impossible to make any general statements about how international income flows should be taxed by any particular country if the purpose is to achieve an efficient allocation of world resources. It depends entirely upon the particular circumstances. While compensating deviations from a neutral tax system are theoretically possible, it would be extremely difficult in the present state

of knowledge to determine the form and magnitude they should take.

This is a depressing conclusion because we know that, in the absence of all barriers to the movement of labour, capital and goods between nations (or with offsetting adjustments if they could not be removed), world output would be greater. The nations that would gain from the removal of barriers to international mobility could more than compensate the nations that would lose, and still be better off. Although it would be naive to expect that this idyllic state of the world will soon be attained, men of good will must not lose sight of this long-run objective. If they cannot further its realization, they can at least refrain from creating obstacles to its ultimat attainment.

We do not advocate the unilateral removal of all international barriers by Canada. It is impossible to say, except in terms of the particular facts, whether or not a unilateral reduction in a particular barrier would be in our long-run interest. Some Canadian barriers are probably necessary to compensate for the barriers erected in other countries. If other nations raise international economic barriers Canada may have no alternative but to raise countervailing barriers. We need this retaliatory capability. However we should try to avoid situations that would require retaliation by Canada or would lead to retaliation by other countries against Canada.

We do not doubt that Canada should pursue its self-interest. But we believe that a world with lower national barriers to the movement of labour, goods and capital would be in Canada's long-run self-interest. We can hardly expect reductions in international barriers to be made by others if we are busy erecting our own.

PRESENT TREATMENT OF INTERNATIONAL INCOME IN THE UNITED STATES, THE UNITED KINGDOM AND CANADA

As a background to our specific proposals it is useful to set forth a brief composite picture of the present Canadian, United States and United

4. Royalties—copyright royalties are not subject to withholding tax; film and tape royalties—10 per cent; all other royalties—15 per cent. A recipient of timber royalties may elect to be taxed on his net Canadian income by filing a return as in the case of a recipient of real estate rentals.

5. Estate and trust income and patronage dividends—15 per cent.

A 15 per cent tax in lieu of any other tax (including the withholding tax on dividends and interest paid) is imposed on the income of a non-resident-owned investment corporation—a corporation substantially owned abroad whose income is substantially from investments.

Employment Income. A non-resident of Canada who has been employed in Canada must report his Canadian income and pay tax on that income at the usual graduated rates. An appropriate proportion of the Canadian concessions and allowances is granted as a deduction in determining taxable income.

The foregoing describes the main elements of the Canadian tax system for non-residents under the Income Tax Act. Modifications made by treaty have not been discussed.

TAXATION IN CANADA AS THE COUNTRY OF DESTINATION

Equity Considerations

Equity requires that all foreign source income, whether it results from working, investing or carrying on business abroad, be taxed to residents on the same basis as domestic source income. Under our proposal for the full taxation of property gains, this would mean that residents holding rights to or interests in property located outside of Canada would be taxed on the disposition of such rights or interests (including a disposition on death) or on the net gains deemed to have been realized on giving up Canadian residence.

Because income not brought into Canada must necessarily result in an increase in the value of the resident's interest in foreign property (ignoring foreign source income that the resident spends on personal consumption outside of Canada), all foreign source income would ultimately become subject to Canadian taxation. This would close what is now a substantial loophole in the tax system. Residents can now establish a foreign corporation to hold their income-earning assets in a country with low corporation taxes. The income can be retained in the foreign corporation and the resident can realize this income without Canadian tax by the sale of the shares in the foreign corporation.

Unfortunately the full taxation of property gains poses significant problems. If the property gains on rights to or interests in property located outside of Canada were brought into income only when realized, there would be a deferment problem. We have already demonstrated that the postponement of taxes can be about as advantageous as the avoidance or reduction of taxes. On the other hand, if such gains were taxed on an accrual basis, it would be difficult to determine the market value of property located in another jurisdiction.

Our proposal for the domestic tax system initially brings only realized property gains into income. We have also proposed that, unless the current earnings of Canadian intermediaries are brought into the income of shareholders and beneficiaries annually, such income should be subject to tax in the organization—usually at the top personal rate. This prevents the deferment of tax that would otherwise be possible if distributions were subject to additional personal tax. To place residents with interests in foreign corporations and trusts on the same basis as persons with domestic investments, the interest of Canadian residents in the income of these foreign organizations should also be taxed currently at the top personal rate. However, if these organizations did not make cash distributions, some Canadian shareholders or beneficiaries might

not have the cash available to pay the Canadian tax imposed in respect of the accrued income. In addition, there would be a number of administrative problems involved in the determination of the amounts to be taken into account each year.

These administrative questions would basically be concerned with determining what was the foreign source income for Canadian tax purposes, when the foreign income should be brought into account and what was the amount of the foreign tax credit that was to be deductible in determining the Canadian tax liability. Obviously business income for tax purposes in the source country need not be the same as business income for tax purposes in Canada—and in fact the differences in legislation are apt to result in substantial variations. A recomputation of the foreign source business income on the basis of Canadian rules could be an extremely complex procedure for the taxpayer, and yet, without such a recomputation, the amount included in the Canadian tax base would not properly reflect the Canadian rules for the determination of income. The question of timing also has administrative implications because it affects the determination of the amount of foreign source income and taxes that should be taken into consideration in each year.

Economic Considerations

There are economic as well as administrative questions that have to be considered in any attempt to attain neutrality in the taxation of the foreign source income of residents. The principal question is the extent to which Canada should give residents credit for the taxes paid to other governments on their foreign source income. At the one extreme, it can be argued that in so far as the Canadian government is concerned, the taxes paid to a foreign government by a Canadian-controlled foreign corporation are simply an expense of doing business abroad, and no credit should be given for foreign taxes (corporation or withholding taxes) against the resident's Canadian tax liabilities. This would mean that in deciding whether to invest in Canada or in another country that imposed income taxes,

the expected before-tax rate of return on a foreign project would have to be higher than the expected before-tax rate of return on a Canadian project.

At the other extreme, it can be argued that Canada should give full credit for foreign taxes paid against Canadian tax liabilities—even to the point of refunding foreign taxes if they exceeded the Canadian tax liability. If this were done, the Canadian investor would be completely indifferent to the taxes imposed by other countries. Other things being equal, projects with the same expected before-tax rates of return would be equally attractive wherever their location because they would all have the same expected after-tax rate of return to the Canadian resident.

For the reasons outlined in our discussion of international tax neutrality, we are convinced that it is impossible to say categorically what this foreign tax credit should be if Canada wished to achieve an efficient allocation of capital throughout the world. We simply do not know the extent to which the expected before-tax rates of return in different countries reflect the "true" return from capital. We are forced to fall back on pragmatic considerations.

Ignoring the implications of the adoption of our integration proposal, which will be discussed later, we reject the proposition that Canada should provide a full credit for foreign taxes (including the making of refunds if the foreign taxes paid exceeded the Canadian tax liability). We likewise reject the proposition that Canada should give no credit for foreign taxes. The granting of full credit with refunds is rejected because this would require Canada to rebate taxes it had never collected and would leave the Canadian treasury at the mercy of foreign treasuries. Full credit for foreign taxes up to the Canadian tax is rejected because we believe that every resident of Canada enjoys some public benefits and should bear some of the Canadian tax burden of providing these benefits and because the resident should be made aware that foreign investment imposes a revenue

loss on Canada. For, from a restricted point of view, if the before-tax return on a Canadian investment is greater than the after-foreign-tax return on a competing foreign investment, Canada "loses" the amount of the differential if the foreign investment is undertaken.

The net economic benefit that Canada derives from foreign investment by Canadians is uncertain. Some Canadian direct investment extends markets for Canadian goods, secures supplies, and improves Canadian technology. It is undoubtedly profitable to individual Canadians and economically advantageous to the nation. At the other extreme, some foreign portfolio investment is only profitable to individuals because Canada gives credit for the withholding taxes imposed by other governments, and presumably confers little if any net economic benefit on Canada. Unfortunately, there are no adequate measures of the net benefit from either.

Changes in the Canadian tax treatment of residents that would deter investment abroad are less likely to shake international investor confidence in Canada or lead to foreign retaliation than adverse changes in the tax treatment of non-residents who invest in Canada. However, we cannot be indifferent to the reactions of non-residents and foreign governments to changes in Canada's treatment of Canadians who invest abroad. If Canada deters its residents from investing abroad we are obviously in no position to complain when other nations seek to deter their residents from investing in Canada. Although the immediate net benefit to Canada of foreign investment by Canadians may be small (conceivably negative), if Canada adopts tax provisions that discourage foreign investment by Canadians and this results in foreign retaliation, Canada could lose more elsewhere than it would gain through the reduction of foreign investment by Canadians. How this net loss could come about can be readily explained.

Canada obtains a net economic benefit from most investment in Canada by non-residents. The revenues obtained from taxing the income earned by such investments are an important part of that benefit. The revenues that can

be raised by taxing foreign investment in Canada without deterring such foreign investment are dependent upon the credit that foreign governments give to their residents with respect to the taxes paid to Canada. If foreign governments gave lower or no credits for taxes paid to Canada, Canada would be forced to lower its taxes on the income of foreign investments in Canada to prevent a sharp drop in such investment 3/. This would reduce the net benefit we obtain from foreign investment in Canada.

We do not know whether foreign governments would remove or reduce their foreign tax credits if Canada refused to give Canadian residents credit for foreign taxes. But the gains from reducing foreign investment by Canadians would be small and uncertain even if there were no foreign retaliation, while the losses would be large and predictable if there were retaliation. Therefore, we reject the idea that Canada should seek to inhibit investment abroad by Canadians by withdrawing credits for foreign taxes paid on the income resulting from foreign investments by Canadians.

Specific Types of Income

It will be recalled that we are concerned with the tax treatment in Canada of three main types of income: business income, property income and employment income.

Property Income and Employment Income. A discussion of the treatment of property and employment income can be readily concluded since we propose no substantial changes in the present procedures, except for dividends which will be discussed in detail below.

Property income from abroad is now included in Canadian income grossed-up for any withholding tax imposed by a source country and with a credit allowed against the Canadian tax for such a foreign tax to an

amount not exceeding the Canadian tax on the foreign source income. We see no reason for departing from this procedure.

For employment income earned by Canadians abroad we propose continuation of existing procedures without change.

Direct Investment Income (Including Business Income). We bring income derived from direct investment in a foreign corporation and foreign business income together for the present discussion because their underlying similarity raises the same general issues. The conduct of business in a foreign country through a wholly or substantially owned subsidiary differs little, from an economic point of view, from direct operation through a branch, and the same general issues of taxation are involved. The singular difference for tax purposes under the present law is that interposition of the foreign corporation means that the Canadian company operating abroad through direct investment in a corporation includes as income only dividends actually received from that corporation, whereas the Canadian company operating directly through a branch is regarded as having earned and received the full profits of the branch each year and obtains credit for the foreign tax thereon. As we have seen, in the United States and the United Kingdom the same general procedure—the full gross-up and credit procedure—is used for both direct business activity and direct investment income. Canada, although ostensibly reaching much the same general objective by the two routes, has adopted different forms of treatment for branch income and dividends from direct investment. Branch income, as we have said, must be included in Canadian income grossed-up for the foreign income tax and recalculated to conform to Canadian rules for computing taxable business income. The Canadian tax is calculated on the foreign income so adjusted and a credit is allowed for the foreign tax paid, but not in an amount that exceeds the Canadian

tax. On the other hand, dividends derived from direct investment in a foreign corporation—at present where more than 25 per cent of the voting shares are owned—are exempt from Canadian corporation income tax on receipt in Canada. The only condition for this exemption is the required degree of ownership.

It is apparent that within the Canadian treatment of foreign source business income may be found the two classical extremes of allowance for foreign taxation. One provides for the full, accurate and precise measurement of the foreign income and tax liability, with a precisely computed credit against Canadian tax. The other grants an exemption from tax under conditions very easily met. The United States and the United Kingdom have followed the first method both for branch income and direct investment income, and no provision comparable to section 28(1)(d) of the Income Tax Act may be found in the tax system of either country. There are some examples of exemption of foreign dividends to be found in other countries, but Canada is virtually unique in its adoption of a provision as sweeping as section 28(1)(d). Its origins and effects are therefore of considerable interest.

The exemption contained in section 28(1)(d) appears to have had as its original purpose the achievement of an equitable and administratively simple alternative to the complexities of the gross-up and credit procedure. At the time of its introduction in 1949, the bulk of Canadian foreign source income originated in countries having corporation taxes as high as the Canadian, mainly the United States and the United Kingdom. The effect of this section was undoubtedly to provide directly for the virtual exemption of foreign source income from Canadian tax which was the end result of the complicated gross-up and tax credit procedure previously in force. Its origins in section 4(r) and subsections (2A) and (2B) of section 8 of the

Income War Tax Act are clearly discernible, and the fact that both of these sections were repealed in 1949 on the enactment of section 27(1)(d) (now section 28(1)(d)) supports the conclusion that, initially, the provision was looked on mainly as a device for administrative simplification. At first the ownership requirement was 50 per cent or more but in 1951, following the recommendation of the Advisory Committee on Overseas Investment, the ownership test was reduced to its present 25 per cent as a means of encouraging foreign investment by Canadians. It has since remained at that level.

One result of these provisions is that the Canadian taxpayer has enjoyed a much greater simplicity and ease of calculation for foreign income than his United States or United Kingdom counterparts. The tax minimization possibilities of the exemption privilege, in combination with the use of foreign tax havens, have not gone unnoticed. The provision can be used to reduce Canadian tax on income generated in Canada for the benefit of Canadians. By establishing companies in jurisdictions which impose little or no tax, Canadians can reduce their Canadian tax by engaging in a series of paper transactions which exploit the provisions of tax treaties in combination with section 28(1)(d).

There is also evidence that the provision has offered the possibility to use Canada itself as a tax haven for international business. Data compiled for us by the Taxation Division show that over a period of years a very substantial part of the dividends reported under this section has originated in jurisdictions imposing little or no tax, and that a very high proportion of these dividends has been received in Canada by holding companies not having a substantial Canadian economic interest but representing for the most part foreign ownership. Of a total of $1,500 million received by all Canadian corporations (including those that were owned by non-residents) in the five years from 1957 to 1961, only 10 per cent came from the United States and 4 per cent from the United Kingdom.

The defects of the present section 28(1)(d) are obvious, and we therefore recommend its repeal.

Full Gross-up and Credit

The most obvious alternative to the present Canadian treatment of income from direct investment (it is already in effect in Canada for direct business activity in a foreign country) is that employed by both the United States and the United Kingdom—the so-called "full gross-up and credit" method. We have recommended the full gross-up and credit method as the appropriate basis for the taxation of Canadian corporation income for residents. The logical counterpart would be to extend the same principle to the foreign direct investment earnings of Canadian corporations and individuals. The effect would undoubtedly be to produce a more exact calculation of the foreign tax credit and a more accurate allowance of that credit against the Canadian tax.

One serious disadvantage of the full gross-up and credit system in the international field is that it is far more complicated than the present Canadian method and would introduce a whole new range of administrative complexities for both taxpayers and tax authorities. In principle, it would require that the foreign corporate income being grossed-up be completely recalculated on the same basis as the Canadian, so that the taxable income, the tax to be credited and the tax credit limitations would be comparisons of like with like. Such adjustments are required now only in a relatively limited number of cases for direct business activity, mainly involving branches. But the extension of the full gross-up treatment to all foreign companies in which there was a Canadian direct investment would greatly multiply the number of companies affected. Also, consideration would have to be given to allowing a similar grossing-up procedure for the subsidiaries of the main foreign subsidiary (i.e., sub-subsidiaries) in order to carry the taxes of the sub-subsidiaries through the main subsidiary to the Canadian parent. (The United States law now provides for inclusion of only the

second level of foreign subsidiaries.) Furthermore, questions of the method for calculating the average rate of tax, the identification of years in which income was earned by the subsidiary and received by the parent and a host of other problems not now of significance would take on great importance for all Canadian companies having a direct investment in a foreign company.

The effect of the full gross-up and credit system is to bring up to the level of Canadian taxation the corporation income tax on business income earned anywhere in the world. While we do not in general favour the use of taxation for international competitive purposes, we are forced to recognize that in many new countries one of the few means available for granting economic incentives is taxation. To require that the tax on business income earned in those countries must ultimately be at least 50 per cent would completely frustrate, or "neutralize", any incentives extended by the new countries. Also, in these same countries indirect taxes are frequently a large element in the tax mix. These represent a burden on any business operating in a country of source which, in the present state of international taxation, is not taken into account in determining the tax credit in the country of destination. In bringing the ultimate corporation income tax burden up to a rate of 50 per cent, we would be disregarding the existence of these indirect taxes.

The recent experience in the United States with attempts to cope with similar problems is indicative of the complexities that can be encountered where the full gross-up and credit system is extended to overcome tax avoidance through foreign tax havens. As a measure to assist the balance-of-payments problem, President Kennedy recommended to the Congress in 1961 that foreign-earned corporate income be deemed to have been received and to be taxable in the United States as it accrued abroad. It was reasoned that if tax deferment were removed, United States companies would immediately bring home their foreign earnings. The proposal met with a storm of protest from United States industry and, after protracted hearings and Congressional

studies, a measure emerged directed not at tax deferment in general but at deferment of tax on certain forms of income accruing in tax-haven jurisdictions. Income of a "controlled foreign corporation" of a specified character (generally of a "passive" type, that is, not related to the conduct of an economic activity in the actual location of the foreign subsidiary) is deemed to be received by the United States shareholders owning 10 per cent or more of the voting shares of the corporation and is then taxable. Exceptions are made where certain minimum distributions are made by the controlled foreign corporation, where the controlled foreign corporation is operating in a less developed country or where it is a corporation devoted exclusively to export trade 4/.

We have considered this United States legislation as a possible model for Canadian action but have concluded that it is far too complex in its detailed application for our more limited goal. The role of the United States in the world economy is so crucial that a measure of this sort must meet a wide and conflicting variety of objectives, and in the process assume such complexity that its full ramifications are not even yet fully apparent. Much of this complexity stems from the fact that the objective of the legislation was to bring into taxation, at full United States rates, accumulating foreign source income, the natural result of applying the full gross-up and credit mechanism. The conditions under which this onerous treatment should apply and the nature of exemptions from it, therefore, had to be defined with great care. We have concluded that our much less ambitious objectives could be achieved by adopting somewhat more arbitrary but simpler methods. We have designed our proposal with this in mind.

The remaining objective we have sought, a degree of integration of foreign corporation taxes with Canadian personal income tax, could as well be achieved under the gross-up and credit method as under any other by adopting some arbitrary and simplified procedures. However, we have already concluded that full integration of foreign corporation taxes with the

Canadian personal income tax is not acceptable, as it would mean that the Canadian government would be required to make massive refunds to Canadian shareholders of taxes collected by other governments. This, then, is the primary reason for rejecting the use of the full gross-up and credit. We have therefore sought in our solution a degree of integration that is something less than would be achieved by the system of full gross-up and credit for foreign direct investment income.

Our Proposal

We have concluded that Canadian objectives can be met adequately by a solution somewhere between the full gross-up and credit at the one extreme and the exemption provided under the present section 28(1)(d) at the other. We are primarily concerned at this point with the position of companies having foreign subsidiaries which now qualify under section 28(1)(d). The future status of business activities carried on directly abroad through branches will be referred to later.

Foreign Direct Investment Income

Scope of application. We propose that the treatment outlined below should apply to a foreign direct investment. A foreign direct investment would be an investment by a Canadian resident or associated group of Canadian residents (a) in a non-resident corporation in which he or the group held a 10 per cent or greater interest in the voting power, in the profits or in the assets distributed on liquidation of the non-resident corporation, or (b) in a foreign property or business in which he or the group held a 10 per cent or greater interest. This percentage is smaller than the 25 per cent now specified in section 28(1)(d), but would appear to be a reasonable dividing line between an investment which is not made for purposes of having a direct influence in the affairs of a company, and one which can carry with it some measure of control. However, because of other provisions discussed below, this artificial dividing line should not result in any inequity for a taxpayer who had less than a 10 per cent interest and, accordingly, was not

able to qualify for the 30 per cent gross-up and credit. In the case of an investment in a foreign company, the 10 per cent would only apply to direct shareholdings. Subsidiaries of a foreign company in which a direct investment was held should be included if an interest of 50 per cent or more was held by the foreign parent and by other shareholders who were not dealing at arm's length with that company.

Procedure. Where a direct investment was held, the following procedure would apply:

1. The income and tax liability would be computed (as described below) generally in accordance with the broad principles of the Canadian tax law.

2. In the case of a Canadian individual with a direct investment in a foreign property or business, his proportionate interest in the income earned in the foreign jurisdiction would be included in his income for Canadian tax purposes in the year it was earned, the net income after foreign tax being grossed-up to include the foreign taxes paid or deemed to be paid, not exceeding 30 per cent. Therefore, the applicable Canadian tax would become payable immediately and credit would be allowed for the foreign taxes paid or deemed to be paid up to the 30 per cent maximum.

3. In the case of a Canadian individual with a direct investment in a foreign company or with an investment in a Canadian company that itself had a direct investment in a foreign company, property or business, the procedure would be more complex:

   a) Where foreign taxes were paid or were deemed to have been paid at the rate of 30 per cent or more on the foreign source income so recalculated, generally no Canadian income tax should be payable until the foreign income was distributed to Canadian individuals. Thus, no Canadian tax should be payable by a Canadian

shareholders pay only a Canadian withholding tax on distributions paid from foreign direct investment income flowing to a Canadian company in which they hold shares. Because such dividends would continue to be subject to the regular non-resident withholding tax, it is not intended that the total taxes imposed on these shareholders should be increased. Accordingly, the special 20 per cent withholding tax should not be deducted or paid in respect of distributions to non-resident shareholders. In the case of shares beneficially owned by non-residents but registered in the names of Canadian nominees, the special 20 per cent withholding tax on distributions out of foreign direct investment income would, of course, be withheld and remitted to the government by the corporation making the distribution or allocation. In this case the non-resident beneficial owner of the shares should be entitled to apply to the government for a refund.

Where a Canadian corporation had a substantial interest of, say, at least 10 per cent in another corporation which made a distribution or allocation out of foreign direct investment income, the receiving corporation should be entitled to apply to the government for a refund of the 20 per cent tax withheld by the corporation making the distribution or allocation. It could be provided as an alternative that such a receiving corporation could file a form with the distributing corporation which would exempt distributions or allocations to the receiving corporation from the special withholding tax. In either case the distribution or allocation made out of foreign direct investment income would be treated as foreign direct investment income of the receiving corporation, so that the 20 per cent would be withheld when the receiving corporation itself made a distribution.

Effect of Our Proposal for Direct Investment Income. Some effects of the proposal just outlined may be briefly summarized:

1. For income received from direct investment in foreign countries levying direct taxes on corporate income of 30 per cent or more, the simplicity at present achieved under section 28(1)(d) would be retained. Some countries obviously fall into this category. We

suggest that they should be named by the administration as qualified sources. We have in mind particularly the United States and the United Kingdom.

2. The effect of requiring that at least a 30 per cent tax be paid on an accrual basis on the income of a foreign direct investment would at least partially restore equity among individual Canadian shareholders by ensuring that a substantial rate of income tax was paid on all investment income no matter where earned. We believe that this device would reduce tax avoidance by Canadians through the use of tax havens.

3. Foreign source income would be subject to progressive rates of tax. The use of an arbitrary gross-up and credit would extend to foreign source income the same procedure as that applied to Canadian corporate income. This would ensure that the progressive rate schedule would be equitably applied.

4. The credit permitted for foreign income taxes paid would be the maximum credit which is consistent with the collection of some Canadian tax revenue from foreign source direct investment income.

5. An unfortunate side effect of the proposal, although it is not as serious as it would be under a system of full gross-up and credit, would be that the tax concessions granted by under-developed countries would be "neutralized". We chose this alternative rather than the complicated provisions necessary to separate a legitimate investment in an under-developed country from a tax-haven operation. To reduce this undesirable effect, we propose that "tax sparing"—the allowance of a credit for a foreign tax whether payable or not—be authorized on a country-by-country basis. This could be done by treaty.

6. The partial integration of foreign corporation income tax with Canadian personal income tax would restore the relief that would be lost on

withdrawal of the dividend tax credit. This credit is now allowed on dividends declared by a Canadian corporation from foreign source income.

Compared with other countries (for example the United States) the foreign tax credit we recommend might appear small. The Canadian credit would be limited to 30 per cent in respect of foreign corporation and withholding taxes. In some countries the credit is 50 per cent or more. It must be borne in mind, however, that while a credit is given against the United States corporation income tax for the full amount of the foreign taxes (up to the effective United States corporation tax rate), the credit does not go beyond the United States corporation. Its value to the individual shareholder is the benefit he may derive indirectly from a reduced corporation tax. Under our proposal the benefit to the shareholder would be reflected in a direct reduction in his personal income tax and possibly in a refund of tax. The amount of the refund could be material for a low income shareholder. Throughout this Report we have emphasized that it is the tax burden on the individual that is the crucial consideration.

Business Income. The proposal detailed above also encompasses the disposition of business income earned in a foreign country through an unincorporated branch. It is now dealt with simply as income of the Canadian resident. It is taxable in full on a grossed-up basis in the year earned, whether distributed or not, with a credit for direct taxes paid to the foreign jurisdiction. We have had to bear in mind particularly that foreign branch profits of a Canadian company can be the source of dividends distributed to Canadian shareholders. We concluded that foreign business income of a branch should, as far as possible, be dealt with in the same way as income from direct investment in foreign corporations. This would, in general, provide neutrality between the different possible procedures for carrying on business or holding property in a foreign country. The credit for foreign income taxes paid would therefore be limited to 30 per cent,

and the income included in the return of the Canadian taxpayer would be the result of grossing-up the net after-tax foreign business income for taxes deemed to be paid at the rate of 30 per cent, regardless of the actual foreign income taxes paid. Also, the Canadian corporation would not be subject to any Canadian tax, over and above the amount of any special tax due if the foreign income taxes were less than 30 per cent, until such time as the foreign source direct investment income was allocated or distributed to resident shareholders. One discrepancy between forms of business organization would remain, however, as Canadian individuals operating unincorporated businesses abroad would in effect be taxed on the full accrual basis, while incorporating the business would permit them to defer their Canadian tax liability until the profits were both remitted to Canada and distributed or allocated to resident shareholders.

Portfolio Investment Income

Portfolio investment income would be that income received from foreign investments where less than a 10 per cent interest was held in a corporation, a business or a property. We recommend that, generally speaking and subject to the option referred to below, portfolio investment income should continue to be taxed as at present and that the dividend or other payment should be grossed-up for the amount of foreign withholding tax (if any) and included in income. Credit should be allowed only for the foreign withholding tax paid on the dividend or other income and not for any underlying corporation tax. However, for the reasons outlined below, we also recommend that a portfolio shareholder should be permitted to elect to be taxed as a direct investor on certain dividends received. In practice, we would expect that this election would only be used for dividends from United States and United Kingdom companies or companies in other countries designated in the regulations as being countries for which the full 30 per cent credit was allowed. However, it might be extended to other cases if the shareholder was able to provide the necessary detailed and verified information concerning the income of the foreign company and the taxes paid by it.

REPORT

1967
(APRIL)

CONFERENCE

On the Report of

The Royal Commission on Taxation

Canadian Tax Foundation
L'Association Canadienne D'Études Fiscales
100 University Avenue
Toronto 1, Canada

Canadian corporations that carry on international business causing then retreat from these areas. Thus the Carter recommendations will foster econ isolationism.

Speaker: **R. Alan Short**
Canadian Tax Foundation, Toronto

Because the tax system proposed for Canada would depart fundamer from the tax systems of other countries, considerable strain would undoubtedl on the tax treaty process for reconciling major differences. Unfortunately, discussion of the treaty situation is frustrated since the international implications of the proposals are not fully developed.

Nevertheless it is interesting to speculate on some of the concessions that Canada might be required to make in treaty negotiations with other countries.

The Neutrality Gap

The existing tax system in Canada provides a substantial degree of what might be referred to as "border neutrality". On balance, Canadian taxation discriminates little as between domestic and foreign income or as between Canadian and overseas investors. It therefore maintains, in the jargon of the economist, a reasonable degree of "capital-export" and "capital-import" neutrality.

The proposed integration of the corporate and personal income tax would result in a radical departure from neutrality since the substantial benefits would generally be confined to the Canadian investor in Canadian securities.

Of course tax systems are never completely neutral; they exhibit various degrees of acidity in different countries. And one of the less-publicized but important functions of tax treaties is to alkalize the more acidic system so that departures from neutrality in each contracting jurisdiction roughly counteract each other. The acidity of the proposed system might well require a substantial dose of neutralizing treaty salts in bilaterial negotiations with other countries.

For example, a country such as the United States—concerned with balance-of-payments difficulties and reluctant to see Canadian portfolio investors withdraw from American securities markets—would undoubtedly attempt to press for some reduction of the discrimination favouring Canadian investment in domestic over foreign shares. Foreign negotiators would probably explore the extent to which Canada might be willing to exempt foreign dividends from Canadian tax or to further extend the integration of foreign corporate taxes by increasing the arbitrary percentage allowed as foreign tax credit. As a practical matter the recommended 30% rate could probably not be increased for revenue reasons; although if the percentage were lower, especially on portfolio investment, Canada's negotiators might have more room to manoeuvre in treaty bargaining.

An alternative approach might be for the foreign negotiators to press for a reduction of the Canadian tax on capital gains realized by Canadians on the sale of foreign securities. The *Report* itself supports the argument for a preferred rate

> We could not countenance the unwarranted benefits that some shareholders would obtain from full integration if share gains were not taxed in full; similarly, *we could not accept the adverse effects of taxing share gains in full without removing the double taxation of corporate source income.* The two proposals are part of a package. Neither can be recommended in isolation. (Vol. 4, p. 28) (Italics added)

It is difficult to maintain that equity, in these terms, should halt at the Canadian border; and I would expect U.S. negotiators to argue that if capital gains on U.S. securities are to be fully taxable in Canada, U.S. dividends should be exempt from any Canadian tax. Undoubtedly a number of other treaty concessions designed to narrow the "capital-export" neutrality gap (illustrated in the accompanying table) would be considered.

TABLE I

Assume a Canadian resident individual, taxable at 25%, acquired shares for $1,000 in January 1970 in Canadian, American and Bahamian companies. Assume further that the pre-tax earnings attributable to the shares of each company were $100 and that a dividend of $25 was paid.

	Canadian Company	U.S. Company		Bahamian Company	
		Direct	Portfolio	Direct	Portfolio
Corporate earnings	100	100	100	100	100
Corporate Tax	50	48	48	—	—
Net Profit	50	52	52	100	100
Shareholder's Income	100.0	30.36[1]	25.0	35.71	25.0
Shareholder's Tax					
Tax on Accrual	—	—	—	30.0	—
Foreign Tax Withheld	—	3.75	3.75	—	—
Canadian Tax (25%)	25.0[2]	7.59	6.25	8.93	6.25
Less:					
Corporate Tax Credit	(50.0)	—	—	—	—
Foreign Tax Credit	—	(9.11)	(3.75)	(10.71)	—
Net Tax on Dividend—					
Proposed System	(25.0)	2.23	6.25	28.22	6.25
Existing System	1.25[3]	6.25	6.25	6.25	6.25
Additional Tax if Shares Sold for $1,100	18.75[4]	25.00	25.00	[5]	25.00

[1] Net dividend grossed up at 30% (Vol. 4-516).

[2] Assuming $25 distributed and remaining $25 allocated to shareholder.

[3] $6.25 reduced by 20% dividend tax credit.

[4] 25% of $75 (the $100 gain reduced by $25 allocation).

[5] This would appear to be either $5.71 or $2.50—i.e. $25 (25% of the $100 gain) minus either $19.29 or $22.50 (whatever amount is considered to be the unused portion of the tax on accrual), (Vol. 4-529).

It may be suggested that Canada should also be prepared to offer dividend withholding tax concessions to narrow the "capital-import" neutrality gap—that is, the discrimination built into the proposed system favouring the domestic over the foreign investor. Alternatively, it may be argued that if the underlying corporate tax rates are similar in each contracting country, the withholding taxes on dividends crossing the border should be at the same rate. Hard treaty bargaining might be expected in this area since the principles of neutrality and reciprocity would be in direct conflict.

(In this connection one possible modification of the proposed integration as it affects non-residents might be explored before implementation. The accompanying schedule—Table II—indicates that the U.S. tax system does not generally favour domestic over foreign investment by an American portfolio investor. In fact, for many years the U.S. system (like Canada's) favoured investment in the U.K. by permitting a foreign tax credit for the underlying British corporate income tax. Canada's proposed system might well secure a similar benefit to foreign portfolio

investors at no revenue loss to the Canadian Treasury, by treating dividends in much the same way as Britain did prior to the so-called "corporate tax reform" introduced by the U.K. *Finance Act, 1965*. From the Canadian point of view, such a change—treating the dividend as the net distribution grossed up by the underlying corporate tax—would be consistent with the proposed treatment accorded domestic dividends and would represent a change in form only. While it seems unlikely that the U.S. Treasury would ever again accept a provision like that in the old Anglo-American treaty, a modification along the lines proposed might enchance Canada's bargaining position and benefit portfolio investors in some other countries.)

TABLE II

Assume a U.S. shareholder taxable at 30% invests in British, Canadian and American shares and that the distributed corporate profits (before tax) attributable to each share are $100. The following schedule shows the net return to the shareholder.

	U.S. Shares	U.K. Shares		Canadian Shares		
				Existing System	Proposed System	
		1964	1967		Commission	Modified[1]
Corporate Earnings	100	100	100	100	100	100
Corporate Tax	48	56.25	40	52	50	50
Net distribution (1)	52	43.25	60	48	50	50
Shareholder's Income	52	74.47[2]	60	48	50	100
Shareholder's Tax—						
Dividend Withholding	—	—	9.0	4.8	5.0	5.0
U.S. Personal Tax	15.6	22.34	18.0	14.4	15.0	30.0
Foreign Tax Credit	—	(22.34)	(9.0)	(4.8)	(5.0)	(30.0)
Total Tax (2)	15.6	0	18.0	14.4	15.0	5.0
After-tax Return (1 minus 2)	$36.40	$43.25	$42.00	$33.60	$35.00	$45.00

[1] See text for gross-up proposal.
[2] $43.25 grossed up for U.K. income taxes of 41¼%.

International Labour Mobility

Tax treaties are also used to overcome fiscal barriers to international labour mobility. Discussion here is hampered by the difficulty of sorting out the relevant implications of the comprehensive tax base and family unit concepts as they might affect personnel transfers. Take, for example, a U.S. citizen who accepts a three-year executive posting to a Canadian subsidiary and who is later joined in Canada by his 20-year-old son. It is not clear from the *Report* how property belonging to the son would be taxable; but it seems possible that the following might happen.

(i) On the son's coming into Canada the value of his property might be taxable to the family unit as acquisition of economic power under the "net gains" formulation of the comprehensive tax base (Vol. 3, Chapter 8).

(ii) On the son's becoming 21 any subsequent gain on the property would be taxable to the family unit (Vol. 3—137) and at the same time the value of the property in excess of $5,250 (the lifetime and annual exemption) would be included in the son's income.

(iii) When the son became non-resident any further subsequent gain would again be taxed to the son (Vol. 3—394).

This treatment of dependant's property, taken together with other provisions (especially those relating to gifts and inheritances) might be expected to deter all but the most unwitting foreigner from accepting a Canadian posting. Of course much of the dependent child problem could be easily avoided by ensuring that the son retained non-resident status, or if, prior to establishing Canadian residence, all family property were vested in a non-resident trust—a vehicle apparently outside the scope of the Chapter 21 rules and offering considerable scope for the imaginative.

Until these implications are clarified, it would not be unreasonable for the foreign negotiators to suggest that the U.S. citizen resident but not domiciled in Canada be permitted a treaty election to have the Canadian family unit and gift provisions waived or at least modified. The practice in the U.K. of limiting the taxation of non-domiciliaries to income *received in* Britain might well be necessary here if Canada is not to discourage foreign managerial and technical personnel from accepting Canadian employment.

In any event, whether or not the *Report* is implemented, the foreign negotiators might well argue for the non-application of the "soujourner" provision— the so-called "183 day rule"—in section 139(3) of the *Income Tax Act*. The unreasonableness of this provision is perhaps more apparent this year because of the number of overseas employees attached to Expo '67—a world exhibition lasting exactly 183 days. (This is understood to be a co-incidence rather than a diabolical plot of the Revenue Department.) The unfortunate consequences, under present taxation, of treating sojourners as residents of Canada throughout the year, would smack even more of "bloody-mindedness" under the proposed system. The Commission recognized that the concept of personal residence is "not without its share of obscurity" and that its proposals would increase the need for greater certainty (Vol. 4—541); but no specific recommendations were made.

Evasion and Avoidance

International tax avoidance and evasion—a matter of concern in tax treaties— would be frustrated by a number of the Commission's recommendations including:

—the organization of special international tax groups within the Departments of Finance and National Revenue (Vol. 4—563),

—the requirement for "detailed reporting on international transactions between taxpayers not dealing at arm's length" (Vol. 4—565),

—the detailed reporting by all residents of all holdings, acquisitions and disposals of property (Vol. 3—356), and

—the requirement for residents to obtain a tax clearance before emigrating from Canada (Vol. 3—376).

The Commission also expressed legitimate concern with the opportunities for abuse presented by the ease with which corporate residence may be changed (Vol. 3—378). A foreign incorporated company would, in the absence of restrictions, be able to establish Canadian control, and therefore Canadian residence, to avoid tax—the special section 110B tax on Canadian branch earnings and the non-resident withholding tax on Canadian source dividend income—and subsequently re-establish foreign residence in order to avoid the Canadian tax on its property gains and dividend payments. Tightened rules respecting changes in corporate residence, and the other anti-abuse measures noted above, should not have adverse treaty implications.

Reciprocal Enforcement

In addition the Commission recommended that treaties "provide for reciprocal enforcement of tax judgments within defined limits" (Vol. 5—150). The OECD Draft Convention does not call for mutual collection assistance; and Canada, like Britain, has not yet accepted such an obligation. Reciprocal collection assistance in one form or another has been incorporated in a limited number of American and European treaties.[1] There is an abundance of literature on international anti-evasion, and proposals for dealing with it range from making tax fraud an extraditable offense to the establishment of an international organization for world-wide tax co-operation and enforcement.[2]

Reciprocal enforcement provisions have not been widely accepted in the past although several publicized cases (such as *Harden v. U.S.A.*, 1965 DTC 1276, in the Supreme Court of Canada) might serve to gain sympathy for proponements of effective anti-evasion measures. The difficulty, of course, is to devise a treaty provision which (i) effectively thwarts evasion, (ii) adequately protects the taxpayer against discriminatory foreign taxation, and (iii) ensures that the tax authorities of one country would not be burdened with the responsibility of administering a foreign tax that could not otherwise be properly enforced abroad.

The U.S. negotiators might be expected to resist inclusion of a broad reciprocal collection provision in a Canada-U.S. treaty. The Commission suggested that all gains on Canadian property realized by non-residents should be taxable but refrained from recommending such taxation only because of the difficulty of administration and enforcement (Vol. 3—357). A broad treaty collection provision might overcome these difficulties but the U.S. authorities would be unlikely to appreciate the added burden of administering a provision that could expose its citizens and/or residents to a Canadian tax that could not generally be enforced by Canada against other non-residents in non-treaty jurisdictions.

Another anti-avoidance recommendation is that interest payments by Canadian corporations to non-resident affiliates should be treated as non-deductible dividends (Vol. 4—74). The effect would be to force international double taxation on those foreign entities required to include interest in income. (It would, for example, conflict with the proposed U.S. regulations under section 482 of the *Internal Revenue Code* which require a U.S. company to charge an appropriate rate of interest on inter-company indebtedness.) A similar approach was taken in the U.K. *Finance Act, 1965* to curtail potential abuses of the sort described in the *Report*. However Britain has agreed to waive the restriction in its bilateral tax treaties with other countries[3] and Canada would, or at least should, be required to do the same. Double taxation, at current tax levels throughout the world, results in the virtual confiscation of income.

Double Taxation

The final purpose of tax treaties discussed here is that of alleviating international double taxation. Some of the relevant proposals of the Commission are discussed below.

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1 Mutual collection assistance provisions are in U.S. treaties with Denmark, France, the Netherlands and Sweden. However, such provisions have encountered considerable taxpayer and senate opposition and any collection provisions included in American treaties promulgated since 1948 have been of very restricted scope. See *Legislative History of United States Tax Conventions*, Volume 1, pages 522 to 605. In addition several other countries have entered into separate tax administration and collection assistance agreements. See *International Tax Agreements*, United Nations, Vol. IX, Part 1.

2 See, for example, J. V. Surr "Intertax: Intergovernmental Cooperation in Taxation", *Harvard International Law Club Journal*, Vol. 7, No. 2 (Spring, 1966).

3 See, for example, Article 10(4) of the 1966 Canada-U.K. Treaty.

Non-Resident Withholding Tax

The Commission proposed an increase in, and an extension of, the non-resident withholding tax to 30% on interest, rents, royalties, employment income and other payments such as pensions, annuities, gifts exceeding $1,000 and bequests (Vol. 4—540). The 30% rate is probably excessive but necessary to enhance Canada's treaty bargaining position.

The proposals relating to gifts and inheritances would complicate treaty negotiations tremendously by making it necessary for Canada to expand income tax treaties to include provisions usually confined to a separate inheritance and estate tax convention. If the provinces accept the Commission's invitation to withdraw from the succession duty field, some complications may be reduced. In addition the limitation of the Canadian tax on property passing to non-residents on death to 15% of the value of property located in Canada in the case of non-Canadian domiciliaries (Vol. 3—510) should further reduce problems of treaty negotiation.

Elections for Non-Residents

It is proposed that non-residents in receipt of Canadian source gifts, inheritances, employment income and several other types of income be given an option to avoid tax at 30% by electing to file as Canadian residents and to pay tax on their world income (Vol. 4—556). In addition rents, royalties and other income "against which substantial business expenses" may be offset, may be taxed at the option of the taxpayer, not on gross income at 30%, but on net income at the ordinary rates appropriate to the recipient. These elections are reasonable in principle, but a number of practical difficulties seem inevitable which, if not removed in any implementing legislation, might be the subject of a special clarifying treaty provision.[4]

Dividend Withholding

The proposal to impose a flat rate of withholding tax of 15% on dividends going abroad, regardless of the degree of Canadian ownership, to be reduced on a reciprocal basis to 10% in treaty negotiations (Vol. 4—547) presents no special treaty problem. In addition, the proposed retention (and extension) of the special section 110B tax imposed on the Canadian branch earnings of a non-resident corporation at the same rate as is applied to dividends seems reasonable from Canada's point of view and should probably not be sacrificed in treaty negotiations (Vol. 4—546).

Tax Sparing

The Commission accepted the principle of "tax-sparing" under which Canada would agree to allow double taxation relief for foreign taxes waived under foreign investment incentives (Vol. 4—532). Acceptance of this controversial principle should facilitate the extension of Canada's tax treaty program to some of the increasingly treaty-conscious less developed countries.[5]

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[4] One very practical problem is that of calculating reciprocal foreign tax credits where a person is fully taxable in two jurisdictions on the same income. Another problem is that of determining the appropriate expense deductions in calculating net royalty and rental income. It is difficult to appreciate the reasoning underlying the recommendation that foreign expenses "which would be subject to withholding tax if paid by a Canadian resident, should not be deductible" under the election. The Commission's other recommendations, especially that imposing a withholding tax on personal service income (Vol. 4-553) would effectively disqualify a large number of otherwise deductible items.

[5] See "Tax Treaties with Developing Countries", *Journal,* Vol. XIV, No. 2 (March-April, 1966) page 171.

Tax on Services

The proposal to impose a special 10% tax on payments made by Canadian residents for personal services performed abroad by non-residents (Vol. 4—553) is likely to cause concern to foreign taxpayers since, in most foreign countries, the Canadian tax would not qualify for double taxation relief. However, as the Commission pointed out, a number of difficulties flow from the rather arbitrary "distinction between international income from capital, which is taxed where the capital is employed, and international income from services, which is taxed where the personnel physically performed the services". While this oversimplifies the problem, the different source rules are difficult to justify even where a distinction can be made. One must sympathize with the reasons behind this recommendation,[6] but it does seem unfair that the victim in the war for revenue between competing tax jurisdictions should be the innocent taxpayer. It is to be hoped that in treaty negotiations Canada would either agree to forgo this tax or attempt to persuade the foreign country to allow relief for it.

(It is also to be hoped that Canada would enact statutory rules delimiting the geographical source of the various types of income. For the purpose of Canada's foreign tax credit, the Canadian Act should probably also be amended to ensure that the same source rules were made applicable to both residents and non-residents—this would overcome at least one of the important deficiencies of section 41.)[7]

Allocation of Income

The Commission recommended a study of the feasibility of replacing the fair market value rules applicable to individual transactions by a formula method of allocating income as between related entities in different tax jurisdictions, (Vol. 4—562).[8] Under this approach, total profits would presumably be apportioned as between the various jurisdictions on the basis of a formula taking into account any one or combination of factors such as payroll expenses, number of employees, net working assets, turnover and so on.

Formula allocation is rarely used internationally although it is not uncommon for allocating income as between political sub-divisions.[9] The logic for the use of a formula basis of allocation is that the various activities (such as manufacturing, administration and distribution) contribute to earnings and that it is neither practicable nor appropriate to measure their separate profit contributions. However, it is doubtful that a mechanical formula would simplify problems of compliance for the taxpayer or of enforcement for the tax collector.

If equity is to be achieved three conditions must be met: each taxing jurisdiction would be required (i) to accept the same formula, (ii) to employ the formula in the same circumstances, and (iii) to apply the formula to the same

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[6] Although it is difficult to understand why the tax should apply only to payments deductible in computing Canadian business or property income.

[7] For a listing of some of the deficiencies of Canada's foreign tax credit provisions see "Tax Considerations for Exporters" in the Foundation's *1964 Conference Report*, pages 184-192.

[8] In the United States, in 1962, congressional consideration was given to the use of a three-factor formula for allocating income arising from sales of tangible property as between related entities. A proposed amendment to section 482 of the U.S. Code would have imposed a formula based on tangible assets, distribution expenses and payroll except where the taxpayer was able to establish fair market value by reference to comparable transactions with unrelated parties. However, the formula was dropped from the final version of the Revenue Act of 1962 for the reason that a change, if desirable, could be made in regulations and did not require statutory amendment. Formula apportionment is not recommended in the proposed regulations issued by the U.S. Treasury in August, 1966.

[9] It is used in Canada for allocating income as between permanent establishments and has been recommended in the United States by the U.S. Congressional Subcommittee on the State Taxation of Interstate Commerce.

profits. Even if international agreement could be obtained on a standard formula and the circumstances in which it would be applied, it seems unlikely that any two countries would agree on a common measurement of the profits to which the formula would be applied. Without such agreement each country would presumably calculate the allocable profits according to its own tax accounting rules. But it would be wholly impracticable if each taxing jurisdiction were to require the taxpayer to file separate financial statements for each affiliated company and to make the necessary foreign exchange, consolidation and other adjustments necessary to conform to its tax accounting concepts. For example, Alcan Aluminium Limited is reported in the *Financial Post Survey of Industrials* as being engaged in mining, smelting, transportation, power development, fabrication and sales activities in over 100 countries through more than 60 affiliated companies. Such a company could not comply with such a reporting requirement which would presumably be necessary, for administrative reasons, so that each jurisdiction could ensure that the appropriate amount of profit had been properly allocated.

In addition formula apportionment is deficient in that it allocates income retroactively and on a quantitative basis but ignores the qualitative aspects which have important tax and non-tax implications. A value must be assigned to a transaction at the time it takes place, not in the subsequent year when profits have been finally determined. It is necessary, for example, to break revenue down as between product prices, royalties, dividends, fees for services and so on for a variety of purposes, including sales and excise taxes, foreign exchange control, customs duties and non-resident withholding taxes.

An official of the U.S. Treasury Department indicated that, before the proposed U.S. regulations on inter-company pricing were issued, "Consideration was given to the possible use of a formula or mechanical test for determining an arm's length price. . . . However, as the Treasury study continued, it became obvious that what was involved in the pricing area was an infinite variety of factual patterns involving a wide variety of products. Any attempt to arrive at a fixed formula . . . in a desire to provide absolute certainty necessarily would produce arbitrary results far removed from economic reality."[10]

If formula allocation is impracticable, hope none the less remains for reducing some of the uncertainty in the troublesome area of non-arm's length transactions. In August last year the U.S. Treasury released the widely publicized proposed regulations under section 482, setting forth detailed rules for placing a fair market value on inter-company transactions in five situations—interest on indebtedness, fees for services, rents for property, royalties on intangibles and the selling price of property.

The guidelines have received less than wholly enthusiastic acclaim. The rules are said to have technical deficiencies, to be arbitrary and to lack flexibility in some areas and precision in others. It seems apparent that technical rules—even as detailed as those proposed—cannot make a precise science out of the imprecise art of valuation.[11]

Many of the objections stem from the fact that not all countries abide by the same rules. Such objections lose considerable force if two contracting treaty

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[10] Arthur J. Rothkopf, "Section 482 in Perspective" in *Taxes—The Tax Magazine*, November, 1966, page 732.

[11] A basic objection to the proposed guidelines stems from the fact that an assessment carries a presumption of validity and the burden is on the taxpayer to establish, not only that his own method of inter-company pricing was reasonable, but also that the Commissioner's adjustment was unreasonable. The section 482 guidelines might have gained greater acceptance if the onus for justifying a re-allocation were transferred to the Commissioner in certain circumstances—for example, where the profitability or return on investment of the related entities is similar, where the tax rates are reasonably close in the jurisdictions whose revenues would be affected by a proposed re-allocation, or where a substantial minority interest exists in one of the related entities.

countries agree both to accept the same guidelines and to apply them in the same manner. Uniform application of valuation rules might be guaranteed under a safeguard provision such as that contained in the *1964 Model Commonwealth Taxation Agreement* proposed by the Special Taxation Committee of the Federation of Commonwealth Chambers of Commerce. Article 7(2) of the Convention provides that a re-allocation of income by one taxing jurisdiction shall not be made without the concurrence of the other contracting country and that the latter state shall take whatever measures are necessary to ensure that the adjustment does not give rise to double taxation.

Such an idealistic provision has apparently not been given serious consideration in actual bilateral treaty negotiations. The Commission's proposal is for improvement in the "mutual agreement" or "competent authority" provision of tax treaties. This provision, found in one form or another in most conventions, establishes what has been referred to as the taxpayer grievance procedure. However the standard provision calling for inter-governmental consultation to resolve treaty differences affords the taxpayer little real protection against double taxation. It is cumbersome and seldom, if ever, works. The Commission noted that:

> An aspect of the treaties that calls for improvement is the "competent authority" provision. The present arrangements are unsatisfactory, resting as they do on the sufferance of the contending tax authorities. In our opinion, the determination of the existence and degree of double taxation should be made the responsibility of a tribunal consisting of a representative from each country and a third member chosen by them. The tribunal should have power, on a finding of double taxation, to allocate income between the two countries or even to allow a rebate on equitable principles. (Vol. 4—569)

This recommendation is similar to proposals made in 1959 by the Taxation Commission of the International Chamber of Commerce in a brochure entitled *Double Taxation—Settlement of Disputes* and would, if incorporated into a treaty, represent a major breakthrough in the field of international tax relationships. Nevertheless a major breakthrough is necessary if perhaps the most vexing problem of international double taxation is to be resolved. I regard this as one of the more important recommendations in the *Report*.

Conclusion

Canada's existing tax system has not required any basic modification by the treaty process—tax conventions have not appreciably altered the Canadian tax rules or rates applying either to the foreign source income of Canadians or to the Canadian source income of non-residents. Under the proposed system, tax treaties would assume greater importance for both domestic and foreign taxpayers. Predictions as to the concessions that would be required in treaty negotiations simply cannot be made at this time. However it seems reasonable to assume that negotiations, particularly those with the United States, would be protracted and that resulting treaties would be greater in number and far more complex than the (wholly inadequate) ones we now have.

Speaker: **Dr. Jacob Strobl**
Attorney, Munich, Germany

Systems of Corporation Income Tax

General

The tax burden of corporations can be judged only together with the taxation of the shareholders.

International Aspects - - I

Chairman: Harold S. Moffet

Speakers: R. Alan Short
George J. Brady
J. S. Hausman

Chairman: **Harold S. Moffet, F.C.A.**
Deloitte, Plender, Haskins & Sells, Montreal

Speaker: **R. Alan Short**
Department of Finance, Ottawa

International Tax Provisions

On the international tax provisions—those relating to the taxation of foreign income and of non-residents—falls the responsibility of preserving the integrity of the domestic tax system and, at the same time, of accommodating that system to the range of different tax systems of other countries. The proper discharge of this responsibility assumes somewhat greater importance in Canada than elsewhere because of the openness of the Canadian economy and the extent of its dependence on international trade and foreign investment.

Non-Residents

For the foreseeable future, Canada's capital requirements will continue, as they have in the past, to exceed the level of domestic savings. Canada must therefore continue to attract foreign investment. The tax system in general, and the international provisions in particular, cannot ignore Canada's dependence on foreign investment.

Ideal, non-resident provisions would encourage the foreigner to invest in Canada, in a form acceptable to Canada, but in a manner that would not grant him a preferred tax position in any way over the Canadian investor in Canada.

The ideal is unattainable. But non-resident provisions can achieve a less ambitious object of providing for fair treatment of the foreign investor without, at the same time, opening opportunities for abuse. This objective can best be approached, not unilaterally by Canada, but in concert with other countries.

The White Paper proposes to follow the example set by most other developed countries. It opts for two international tax systems for non-residents—a tax treaty system and a statutory system. Bilateral tax treaties have emerged and expanded rapidly in response to the need for a flexible mechanism by which different tax systems can be reconciled. Such treaties have as their object the alleviation of over-

lapping international taxation which, at current levels throughout the world, can constitute a serious fiscal impediment to international capital mobility and foreign trade.

In treaty negotiations, Canada would seek to induce other developed countries to dismantle any fiscal barriers standing in the way of investment in Canada. In exchange, Canada would be expected to offer appropriate concessions. The advantage of the treaty mechanism is that it is flexible—the concessions can better be tailored to particular circumstances and confined to those persons they are intended to benefit.

Few persons have taken issue with the "two-system" approach adopted in the White Paper. Some apprehension has been expressed on the part of non-residents, stemming in large measure from uncertainties—concerning the system itself, concerning the particular countries with which there will be treaties and concerning the concessions Canada will be prepared to make.

There is little that can be said at this time to dispel the uncertainty except to observe that the expressed intention to place a high priority on the expansion of Canada's treaty network implies a willingness on Canada's part to adopt a reasonable attitude in treaty negotiations.

It has become one of the popular games people play to speculate on the extent to which Canada's future treaties will depart from the international norm as reflected in the *pro forma* tax convention adopted in 1963 after protracted study by the Fiscal Committee of the O.E.C.D. In any such speculation, several factors seem relevant.

First, the O.E.C.D. treaty is a consensus agreement. It emerged more as a collection of compromise solutions to practical problems of international taxation than as a codification of any fundamental principles founded on a need for international fiscal harmonization.

Second, the draft convention reflects a bias that exacts tax reductions from the "country of source" of income in favour of the "country of destination". It is not therefore surprising that the capital-importing countries (and particularly the less-developed countries), take exception to some of the provisions that, at least in revenue terms, would not represent reciprocal concessions.

Third, most other countries have a wide selection of devices outside of their tax systems which can be used to protect their taxes—e.g., currency controls, investment regulations, corporation laws and other restrictions which enable the authorities to dictate the terms on which international investment will be accepted. Many European countries and most of the less-developed nations, for example, use such controls to prescribe limits to the royalties and management fees that may be charged within the multi-national business complex, to protect against thin capitalizations, or to ensure that local capital is given an opportunity to "take a piece of the action". The relative freedom from such controls in Canada places a correspondingly heavier burden on the tax system to police the national interest.

Fourth, the O.E.C.D. treaty reflects the influence of the tax systems of member countries in the 1950's and early 1960's, when the "fruit-of-the-tree" concept of income and the "separate identity" concept of the corporate tax prevailed. As these concepts gradually erode, the standard treaty prescriptions change.

The point of the last observation is to emphasize that the players of the treaty guessing game ought not to ignore the process of evolution evidenced in recently

negotiated treaties of the developed and less-developed countries. Significant treaty developments are taking place. Polite society no longer considers it outrageous, or a flagrant violation of established international fiscal morality, to refer to the possibility of taxing the share gains of non-residents.

Foreign Income

Much, but by no means all, of the criticism of the proposals relating to the taxation of foreign income centres on the demise of the blanket exemption privilege now enjoyed by Canadian corporations in respect of dividends from direct investments abroad.

The proposed substitution of a U.S./U.K.-style gross-up-and-credit system for dividends in non-treaty circumstances seems to have few supporters among academic purists. They argue on neutrality grounds that even the American system is too generous.

President Kennedy, in his 1961 tax message to the U.S. Congress, took the position that neutrality required all foreign income, including the earnings of American-controlled foreign corporations (whether repatriated or not), to bear an effective tax burden at least equal to that imposed in the United States. The Treasury proposal to eliminate the so-called "deferral privilege" was rejected by the U.S. Congress after extended debate for a variety of reasons, perhaps the most important being that it would result in a more onerous regime than that in effect in other countries and would, therefore, place U.S. business at a competitive disadvantage abroad.

The "competitive disadvantage" argument, rather than any neutrality argument, generally underlies the criticism, by others, of the White Paper proposals: "Widgets Canada cannot compete with Widgets Europe unless it can enjoy the same tax-exempt privileges on foreign earnings." This objection is often accompanied by the lament that "the disadvantages from the point of view of administration and compliance are likely to be wholly incommensurate with any benefits gained in terms of additional revenues and curtailment of abuse".

Clearly there is no way to reconcile the differences of opinion between those who view the proposals as too generous or as having too diluting an effect on the incentive provided within the system for increased Canadian investment by Canadians, and those who believe the proposals fail to recognize the practical problems of multi-national corporations.

The latter critics generally express doubts that Canada's treaty network can in fact be extended to cover more than but a few of the less-developed countries. Many such countries do not now enter into bilateral treaty relationships with developed countries. And the point is further made that it is inappropriate for Canada, as a developed country, to adopt a system of taxing foreign income that effectively frustrates the incentives given by less-developed countries in their effort to attract much-needed foreign investment.

If tax preferences are to be given to investment in less-developed countries there is good reason to do this on a bilateral treaty basis rather than by the unilateral blanket extension of preferences to all foreign investment. The country-by-country approach has the advantage of flexibility—more effective incentives can be given where appropriate, with greater assurance that they will, in fact, benefit *bona fide* foreign investment.

The prospects for the success of Canada's efforts to conclude tax treaties with less-developed countries remains a matter of conjecture. Much will depend on the attitudes of less-developed countries and on Canada's negotiating demands.

The White Paper indicates a willingness on the part of the government to exempt from corporate tax dividends received on direct investments in treaty countries. The exemption privilege—which is a generous form of tax sparing—would of course be included in any treaties with developing countries. A number of European countries have not insisted in treaty negotiations that the less-developed countries yield those reciprocal concessions ordinarily reflected in treaties between developed countries. Their principal objective appears to be to obtain "most-favoured-nation" treatment—to ensure that the less-developed country treats their taxpayers on an equal tax footing with investors and exporters from other developed countries.

If Canada were to adopt a similar approach in negotiations with the L.D.C.'s, it seems reasonable to expect that Canada's treaty program could proceed fairly quickly once the reform is implemented. In the meantime, the uncertainty concerning the countries with which successful treaty negotiations will take place has the unfortunate effect of making it difficult for Canadians properly to assess the tax implications of proposed investments abroad.

The government is concerned with this problem. In his appearance before the parliamentary committee, the Minister of Finance indicated that he was giving serious consideration to a supplementary proposal designed to overcome the negative effect that such uncertainty might have on Canadian investment overseas.

Conclusion

A country sees the bilateral tax treaty as a means of gaining access to foreign capital and/or export markets. While these are not the only treaty objectives, they are important ones. If these objectives cannot be achieved, a compelling reason for having a treaty is missing.

It should be recognized that a treaty represents a negotiated agreement, settled in the ordinary course of hard bargaining. This means that to get meaningful concessions from other countries, Canada must stand ready to yield concessions in return. The success of Canada's treaty program depends, to a large extent, on its willingness to offer preferential treatment to non-residents and to foreign investment in treaty circumstances. Canada's willingness to do so is openly acknowledged in the White Paper.

It would be a mistake to assume that the proposals relating to non-residents and foreign income are simply bargaining ploys to be given away in treaty circumstances. The international provisions are designed with a view to protecting the domestic tax system. And the restriction of certain privileges to treaties forms an important element in that protection.

The overall tax system is designed to:

(1) ensure that the domestic operations of Widgets Canada and of Widgets Foreign bear their appropriate share of the Canadian tax burden;

(2) ensure that the foreign operations of Widgets Canada bear an appropriate burden;

(3) provide Widgets Canada with an incentive to expand its domestic operations, but in a way that does not prevent it from expanding abroad and does not render it uncompetitive with Widgets Foreign abroad; and

(4) ensure that Widgets Foreign is not discouraged from investing in Canada and from expanding its Canadian operations.

The overall system is also designed to:

(5) ensure that the shareholders of Widgets Canada, both resident and non-resident, bear an appropriate share of the tax burden;

(6) ensure that the Canadian shareholders of Widgets Foreign bear an appropriate tax; and

(7) encourage Canadians to acquire shares of Widgets Canada and to ensure that Canadians are not at a disadvantage over foreign investors in bidding for such shares.

A provision designed to achieve one particular objective may frustrate another. A blanket dividend exemption privilege, for example, designed to protect the competitive position of Widgets Canada abroad may:

(8) encourage Widgets Canada to expand abroad rather than in Canada;

(9) encourage Widgets Canada to serve export markets out of foreign rather than domestic production;

(10) may frustrate Canada's efforts to obtain tax treaties abroad; and

(11) serve as a shelter to reduce the tax on income from other than *bona fide* operations abroad.

In the final analysis, the international provisions inevitably involve compromises to achieve an appropriate overall balance. In my view, the government's proposals achieve a reasonable balance.

Speaker: **George J. Brady, C.P.A.**
Arthur Andersen & Co., New York

The White Paper and U.S. Investors

The opportunity to discuss the implications of the tax proposals in the White Paper with this group is a real privilege. Although I am from below the border, I am pleased to see present many I consider friends.

The proposals for tax reform contained in the recent White Paper have a significantly greater effect on Canadian residents than on U.S. investors and non-residents generally. I commend the time span which has been allowed for discussion and study of the reform proposals since the publication of the Carter *Report* over three years ago.

As most of you know, President Nixon announced the outlines of tax reform proposals in April of last year and the legislation was enacted in December. The final law is far different from the initial proposals. Already it is clear that amendments will be required to avoid unanticipated penalties and benefits.

As in the U.S., the Canadian proposals are stated in general terms and advance broad objectives. It is easy to interpret such statements in accord with one's own preconceived ideas. From our experience it would be highly desirable to have the proposed statutory language also exposed for a period of examination. This would allow time for clarification of ambiguities and definitions.

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HOUSE OF COMMONS

Issue No. 37

Tuesday, December 8, 1992

Chairperson: Jean-Robert Gauthier

CHAMBRE DES COMMUNES

Fascicule nº 37

Le mardi 8 décembre 1992

Président: Jean-Robert Gauthier

Minutes of Proceedings and Evidence of the Standing Committee on

Public Accounts

Procès-verbaux et témoignages du Comité permanent des

Comptes publics

RESPECTING:

Pursuant to Standing Order 108(3)(e), consideration of Paragraphs 2.28 to 2.61 of the 1992 Auditor General's Report (Department of Finance)

CONCERNANT:

Conformément à l'alinéa 108(3)e) du Règlement, étude des paragraphes 2.28 à 2.61 du Rapport du vérificateur général pour 1992 (Le ministère des Finances)

WITNESSES:

(See back cover)

TÉMOINS:

(Voir à l'endos)

[*Texte*]

The Department of Finance's response to the observation as published in the report seems to imply that the kinds of transactions that concern us are the result of conscious policy decisions on the part of the government and reflects a desire to promote the goal of international competitiveness. I appreciate the department's concern about competitiveness, but I am not convinced, Mr. Chairman, that Parliament intended to promote international competitiveness by allowing Canadian corporations to engage in inappropriate tax avoidance practices.

Monsieur le président, je m'inquiétais sérieusement du fait que la réponse du ministère à notre observation, tel que publiée dans notre rapport, puisse être interprétée par les contribuables et leurs conseillers professionnels comme voulant dire que les présentes faiblesses de notre régime fiscal seront maintenues. Cela ouvrirait évidemment la porte à d'autres abus. J'ai été, par conséquent, très heureux de constater que dans son récent exposé économique et budgétaire, le ministre des Finances déclarait qu'il étudierait attentivement mes préoccupations.

• 1610

Il est important que le ministère des Finances termine donc les études qu'il a annoncées auparavant, de sorte qu'il puisse trouver une solution à long terme. Il doit aussi concevoir des mesures provisoires pour garantir que les autres contribuables ne sont pas désavantagés et pour protéger les revenus de l'État. Autrement, le principe de l'équité qui est la pierre d'assise du régime fiscal canadien, sera érodée et l'intégrité générale du régime fiscal sera minée. À mon avis, le Canada ne peut pas se permettre cela.

Merci, monsieur le président.

The Chairman: I made a booboo. I introduced Mr. David Holland but didn't recognize Mr. R.A. Short, General Director, Tax Policy Branch, Department of Finance. Welcome, Mr. Short.

I will now ask Mr. David Dodge to present his testimony.

Mr. David A. Dodge (Deputy Minister, Department of Finance): Mr. Chairman, this is my first appearance as a deputy before your committee. It's nice to be back again after not having met with you for quite a while.

I have with me today, in addition to my colleagues Mr. Bennett, Mr. Short and Mr. Holland, Len Farber and Wally Conway from the department to try to answer any questions you have. In addition, Bob Beith and Mike Hiltz are here from the Department of Revenue to assist the committee.

Mr. Chairman, we really welcome the interest of your committee and the finance committee in this important issue. As my minister has said, we welcome the interest the Auditor General has taken in this difficult and complex area. The AG has raised a number of specific concerns related to the manner in which Canada taxes foreign-source income and the foreign affiliates of Canadian corporations.

[*Traduction*]

La réponse du ministère des Finances semble impliquer que le genre de transactions qui nous préoccupent résultent de décisions de principe réfléchies de la part du gouvernement et témoigne de la volonté de celui-ci de favoriser la compétitivité du Canada à l'échelle internationale. Je comprends l'intérêt que le ministère porte à la compétitivité, mais je ne suis pas convaincu que le Parlement avait l'intention de promouvoir la compétitivité internationale en permettant à des sociétés canadiennes de s'adonner à des pratiques d'évitement fiscal abusives ou inappropriées.

Mr. Chairman, I was deeply concerned that the Department's response to our observation could be interpreted by taxpayers and their professional advisors as meaning that the present weaknesses in the legislation will continue. This would have invited further abuse. I was therefore delighted to see that in his recent economic and fiscal statement the Minister of Finance stated that he will give careful consideration to my concerns.

It is important for the Department of Finance to complete the studies it previously announced so that a long term solution can be developed. It must also devise interim measures to Ensure that others are not placed at a disadvantage and to safeguard revenues. Otherwise the equity principle which is the backbone of the Canadian tax system will be distorted and the overall integrity of the tax system will be undermined. In my view, Canada cannot afford to let this happen.

Thank you, Mr. Chairman.

Le président: J'ai fait une erreur. J'ai présenté M. David Holland, mais j'ai oublié M. R.A. Short, directeur général, Direction de la politique de l'impôt, ministère des Finances. Bienvenue, monsieur Short.

Je demande maintenant à M. David Dodge de présenter son témoignage.

M. David A. Dodge (sous-ministre, ministère des Finances): Monsieur le président, c'est la première fois que je comparais devant le comité en tant que sous-ministre. C'est un plaisir de vous retrouver après un certain laps de temps.

Aujourd'hui, en plus de mes collègues, M. Bennett, M. Short et M. Holland, m'accompagnent M. Len Farber et M. Wally Conway, qui viennent du ministère et qui essaieront de répondre à vos questions. Il y a aussi MM. Bob Beith et Mike Hiltz, du ministère du Revenu national.

Monsieur le président, nous sommes vraiment heureux que votre comité et celui des finances s'intéressent à cette question importante. Comme mon ministre l'a dit, nous sommes ravis que le vérificateur général se soit penché sur ce domaine difficile et complexe. Le VG a soulevé un certain nombre de questions précises concernant la façon dont le Canada impose les revenus de sources étrangères et les sociétés étrangères affiliées à des sociétés canadiennes.

[*Text*]

Our objective is to ensure that the rules in this area operate properly, as Parliament intended they should.

The Chairman: I'm sorry, Mr. Dodge, but on a point of order, could we please have a copy of what you are reading from?

Mr. Dodge: I have a speaking copy here and that is all. I'd be happy to leave it with the clerk at the end. Some notes should have been circulated.

The issues Mr. Desautels has raised are important ones and have been the subject of extensive analysis in the department, as members of the committee know. The foreign affiliate area is, however, a very complex one. Perhaps no other area of the income tax system requires the government to balance as many competing policy objectives.

In the words of the Carter commission 25 years ago:

> In addition to the extreme complexity of this subject, the controversy that surrounds many of its fundamental principles and the lack of guiding evidence by which to settle these controversies militate against the adoption of simple, generally accepted solutions. In this area, more is left to opinion and judgment, both because little is known with certainty of the consequences of adopting alternate policies and because there are substantial differences of opinion as to the relative importance to be attached to the competing objectives.

In dealing with the issues raised by the Auditor General, perhaps it'll be helpful if I were to give you a brief sketch on the background of the tax treatment of foreign dividends.

• 1615

Mr. Chairman, in the early years of our tax system, Canadian residents, including corporations, were required to pay tax on their foreign-source income at full Canadian rates. In 1938 Canadian companies were for the first time permitted to receive dividends from foreign subsidiaries free of Canadian tax. As originally introduced, this exemption was very narrowly drawn. It was available only at 75% if the combined capital of the Canadian corporation and its subsidiaries was used outside of Canada.

Then we went through a long period between 1938 and 1972 where this exemption was increasingly widened. It was extended in 1944 to cover dividends from all wholly-owned foreign affiliates. In 1947 the test was changed from 100% ownership to one of control. In 1951 it moved back to 25% of voting shares. It remained there until the results of the royal commission were transformed into the law of 1972, which was Mr. Benson's tax reform.

The Royal Commission on Taxation had proposed extensive modifications of this old system. The most significant of these changes was the decision to tax passive income earned by foreign affiliates annually and on an accrual

[*Translation*]

Notre objectif est de veiller à ce que les règles dans ce domaine fonctionnent correctement, conformément à l'intention du Parlement.

Le président: Désolé, monsieur Dodge, mais je vais faire un rappel au Règlement; pouvez-vous nous donner un exemplaire du document que vous lisez?

M. Dodge: Je n'ai que des notes ici, et je me ferai un plaisir de les remettre au greffier à la fin. On vous a probablement distribué quelques notes.

Les questions soulevées par M. Desautels sont importantes et ont fait l'objet d'une analyse en profondeur au ministère, comme vous le savez. Toutefois, le domaine des sociétés étrangères affiliées est très complexe. Il n'existe peut-être aucun autre domaine du régime de l'impôt sur le revenu où le gouvernement soit appelé à équilibrer autant d'objectifs de politique incompatibles.

Il y a 25 ans, la Commission Carter disait dans son rapport que

> en plus de l'extrême complexité de cette question, la controverse entourant bon nombre de ces principes fondamentaux et l'absence de preuves permettant de régler cette controverse militent contre l'adoption de solutions simples et acceptables pour tout le monde. Dans ce domaine, il est davantage question d'opinion et de jugement, parce qu'on ne sait pas grand-chose des conséquences de l'adoption d'autres politiques et parce qu'il y a de grandes divergences d'opinions quant à l'importance relative des objectifs incompatibles.

Avant d'aborder les questions soulevées par le vérificateur général, il serait peut-être utile que je vous donne brièvement une idée du traitement fiscal des dividences de sources étrangères.

Monsieur le président, pendant les premières années d'existence de notre régime fiscal, les résidents canadiens, y compris les sociétés, devaient payer l'impôt sur le revenu de sources étrangères aux pleins taux. En 1938, pour la première fois, on a permis aux sociétés canadiennes de recevoir des dividendes de leurs filiales étrangères en franchise d'impôt. Au début, cette exemption était à peine possible. On ne l'accordait qu'à 75 p. 100 si le capital combiné de la société canadienne et de ses filiales était utilisé à l'extérieur du pays.

Ensuite, il y a eu la longue période allant de 1938 à 1972, au cours de laquelle on a progressivement élargi cette exemption. En 1944, on a exempté les dividendes provenant de toutes les sociétés étrangères affiliées possédées en propriété exclusive. En 1947, on est passé de la propriété exclusive au contrôle. En 1951, on est revenu à 25 p. 100 des actions avec droit de vote. Cela a duré jusqu'à ce que les résultats de la commission royale deviennent la loi de 1972, c'est-à-dire la réforme fiscale de M. Benson.

La Commission royale d'enquête sur la fiscalité avait proposé des modifications profondes à l'ancien régime. La plus importante de ces modifications était la décision d'imposer les revenus passifs des sociétés étrangères affiliées,

[*Texte*]

basis, following a transition period, and to exempt dividends paid out of active business income only where the income was derived from a listed country. That means a country where we have a tax treaty. This is the system that's essentially been in place since the Benson reforms of 1972.

The issues raised by the AG require a review also of the dividend tax credit. This was introduced in the 1940s with a twofold objective, which you well know. First, it was to alleviate double taxation. Secondly, it was an incentive for Canadians to invest in Canadian corporations.

The Carter commission recommended a fundamental change to that system as well. It would have restricted credit on dividends to Canadian taxes actually paid by the corporation, but the government of the day, after giving careful consideration to that system, proposed that this particular system not be enacted by Parliament because it would have serious adverse implications for major sectors of the Canadian economy.

Members will recognize that at the time, we had extremely low rates of tax on mining and a few of these important sectors, so it would have had very bad consequences there. It would have had extremely bad consequences for Canadian firms with substantial operations abroad. As a result, the decision was taken not to tie the dividend tax credit to the amount of tax paid, but rather to improve its function as a mechanism for relieving against double taxation, while at the same time retaining its essential purpose, which is to provide an incentive for Canadians to invest in the equity of Canadian corporations.

The dividend tax credit mechanism in its essential purposes, as just described, have not been altered in any basic way in the intervening 20 years.

The question then arises as to whether the existing system relating to foreign affiliates and the dividend tax credit is too generous. This is an essential and legitimate question raised by the Auditor General. There are clearly no absolute right or wrong answers as to how foreign-source income should be taxed in Canada, either at the corporate level or as it's distributed to shareholders.

However, the existing system as legislated by Parliament in 1972 and then reviewed again at the time of tax reform in 1987 strikes a reasonable balance between a number of complex, and in some cases competing, objectives.

Mr. Chairman, our system for taxing foreign-source income is well in line with that adopted by other OECD countries. I'll be very brief in outlining them.

[*Traduction*]

calculés chaque année selon la méthode de la comptabilité d'exercice et après une période de transition, et d'exonérer les dividendes découlant des revenus d'entreprises exploitées activement uniquement lorsque ces revenus proviennent d'un pays désigné, c'est-à-dire un pays avec lequel nous avons conclu une convention fiscale. Tel est le système qui fonctionne depuis les réformes mises en place par M. Benson en 1972.

Les questions soulevées par le VG nous incitent également à examiner le crédit d'impôt pour dividendes. Ce crédit, qui a été instauré dans les années 40, visait un objectif double, comme vous le savez bien. Il s'agissait premièrement d'atténuer la double imposition, et, deuxièmement, d'encourager les Canadiens à investir dans des sociétés canadiennes.

La Commission Carter a également recommandé une modification fondamentale à ce régime, à savoir limiter le crédit pour dividendes aux impôts canadiens effectivement payés par la société; mais le gouvernement de l'époque, après avoir étudié attentivement cette recommandation, a proposé qu'elle ne soit pas mise en oeuvre par le Parlement, parce qu'elle aurait des répercussions très néfastes dans des secteurs importants de l'économie canadienne.

Le comité notera qu'à l'époque nos taux d'imposition étaient extrêmement faibles pour le secteur minier et certains autres secteurs importants; ainsi, les conséquences auraient été très néfastes, surtout pour les sociétés canadiennes ayant de nombreuses activités à l'étranger. C'est ainsi que l'on a décidé de ne pas lier le crédit d'impôt pour dividendes à l'impôt payé, mais plutôt d'améliorer son fonctionnement en tant que mécanisme permettant d'atténuer la double imposition, tout en maintenant l'objectif essentiel, qui est d'encourager les Canadiens à investir dans les sociétés canadiennes.

Tels que nous les avons décrits, les objectifs essentiels du crédit d'impôt pour dividendes n'ont pas été modifiés de façon substantielle depuis 20 ans.

La question qui se pose maintenant, c'est de savoir si le système actuel est trop généreux à l'égard des sociétés étrangères affiliées en ce qui concerne le crédit d'impôt pour dividendes. Il s'agit là d'une question essentielle et légitime soulevée par le vérificateur général. On ne peut pas répondre de façon catégorique à la question de savoir comment les revenus de sources étrangères doivent être imposés au Canada, que ce soit au niveau des sociétés ou au niveau des actionnaires qui reçoivent des dividendes.

Cependant, le système actuel, mis en place par le Parlement en 1972 et révisé lors de la réforme fiscale de 1987, assure un équilibre raisonnable entre un certain nombre d'objectifs complexes et, dans certains cas, incompatibles.

Monsieur le président, notre régime d'imposition des revenus de sources étrangères correspond bien à celui des autres pays de l'OCDE. Je vais vous en parler très brièvement.

[*Text*]

• 1620

There are basically two systems. One is the tax credit system, where companies are given credit directly for taxes paid abroad. The other is the exemption system, which is the system whereby dividends from foreign affiliates simply flow in, free of tax, on the assumption they have been appropriately taxed in the country of origin.

Both these systems are widely used. The United States, for example, uses the credit system. France and Germany, among most European countries, use the exemption system.

The exemption system has the great advantage of being very simple as compared with the tax credit system, which is very complex. Those of you who had any occasion to work with the U.S. system will know this. As well, the major difficulty with the foreign tax credit is that in those circumstances where the foreign tax on earnings is low, there is a significant tax at home on the repatriation of those earnings. Those earnings tend not to get repatriated, or various schemes are entered into to ensure those earnings show up in jurisdictions with high taxes where credits are earned.

My colleagues who know the systems much better than I do can comment further on this if you wish, but I will assert that no country is ever totally happy with the system it has. In virtually all the major countries explorations are always underway to see if there's a better way to deal with it.

Canada's approach to taxing foreign-source income contains elements of both these systems, and thus falls squarely within the international norms. What it seeks to do is to ensure Canadian-based multinationals remain viable and competitive with those based in other countries by allowing active business income earned by a foreign affiliate in a country with which we have a treaty to be repatriated on a tax-exempt basis. At the same time, the specific anti-avoidance rules relating to passive foreign income, the so-called PFI rules the Auditor General has alluded to, together with the newly introduced general anti-avoidance rule seek to ensure the system is not open to abuse. This latter approach parallels that taken in many other countries.

So that's the basic system. It's been in place for a long time. It seeks to balance all the competing objectives.

The question then arises, as the Auditor General puts it, that there may be substantial revenue losses under the existing system. This estimate of substantial revenue loss really rests on two assumptions: first, that it is in some sense not appropriate for Canada to allow the dividend tax credits to go to shareholders if they're paid out of foreign-source earnings that haven't borne Canadian tax; and second, that the exemption should not apply to dividends received from foreign affiliates out of earnings that have not borne a reasonable level of tax in the country of origin. So there are two propositions here, and it's really on those propositions that the estimate is based.

[*Translation*]

Il existe essentiellement deux systèmes. Premièrement, le système de crédits d'impôt, dans lequel on accorde directement aux compagnies un crédit pour des impôts payés à l'étranger. Deuxièmement, le système d'exemption, dans lequel les dividendes provenant des sociétés étrangères affiliées entrent tout simplement au pays, en franchise d'impôt, parce qu'on suppose qu'ils ont été adéquatement imposés dans le pays d'origine.

Ces deux systèmes sont utilisés à grande échelle. Par exemple, les États-Unis utilisent le système de crédits d'impôt. La France et l'Allemagne, comme la plupart des pays européens, utilisent le système d'exemption.

Le système d'exemption a l'énorme avantage d'être très simple par rapport au système de crédits d'impôt, qui est très complexe. Ceux d'entre vous qui ont eu l'occasion de travailler avec le système américain le savent. En outre, dans le système de crédits d'impôt, la principale difficulté réside dans le fait que, lorsque l'impôt étranger sur les revenus est faible, le pays prélève des impôts élevés au moment du rapatriement de ces revenus. On a tendance à ne pas rapatrier ces derniers, ou on met en place divers stratagèmes pour s'assurer qu'ils passent par des pays où les impôts sont élevés et où l'on accorde des crédits d'impôt.

Mes collègues, qui connaissent ces systèmes beaucoup mieux que moi, pourront vous en dire plus si vous le désirez, mais je souligne qu'aucun pays n'est jamais entièrement satisfait de son système. Dans presque tous les principaux pays, on essaie constamment de voir s'il y a lieu d'améliorer le système.

En ce qui concerne l'imposition des revenus de sources étrangères, le Canada s'inspire des deux systèmes et respecte par là même les normes internationales. Il s'efforce de veiller à ce que les multinationales basées au Canada demeurent viables et compétitives par rapport à celles qui sont basées dans d'autres pays, en permettant que l'on rapatrie en franchise d'impôt les revenus actifs gagnés par une société étrangère affiliée dans un pays avec lequel nous avons conclu une convention fiscale. En même temps, les règles anti-évitement précises concernant les revenus passifs de sources étrangères, règles auxquelles le vérificateur général a fait allusion, ainsi que la nouvelle règle générale anti-évitement, visent à protéger le système contre les abus. Cette dernière mesure est comparable à celle qui a été prise dans bien d'autres pays.

Voilà donc le système. Il est en place depuis longtemps. Il vise à concilier tous les objectifs divergents.

Ensuite, le vérificateur général a dit que le système actuel pourrait causer un manque à gagner considérable. En réalité, cette assertion repose sur deux hypothèses: premièrement, dans un certain sens, le Canada ne doit pas accorder de crédits d'impôt pour dividendes aux actionnaires si ces dividendes proviennent de revenus étrangers qui n'ont pas été assujettis à l'impôt canadien; et deuxièmement, l'exemption ne doit pas s'appliquer à des dividendes versés par les sociétés étrangères affiliées et provenant de revenus qui n'ont pas été suffisamment imposés dans le pays d'origine. En réalité, il y a donc deux hypothèses sur lesquelles le vérificateur général a fondé son jugement.

[*Texte*]

As I said before, the provisions in the act are of long standing and have been integral parts of our tax system, and the Canadian dividend tax credit is designed in part to encourage Canadian individuals to invest in our companies. This credit, throughout its existence, has been available for all dividends in such companies, whether or not the underlying earnings have borne Canadian tax. That's true on the foreign side. It's also true on the domestic side, as I said earlier.

To change the basis for calculating the credit would in fact represent a fundamental change to a system we've had in place for over 40 years. That's not to say such a system shouldn't be changed. All it's saying is that this is a long-held system that has been looked at by the Parliament of Canada numerous times over that period.

• 1625

The withdrawal of an exemption of foreign dividends out of earnings that had not borne an appropriate burden of foreign tax would also represent a fundamental change to another long-standing feature of the Canadian tax system, and it would represent an abrogation of a commitment Canada has made in tax treaties negotiated with a number of countries, including developing countries.

All countries with which Canada has concluded tax treaties impose corporate taxes at significant rates. I brought with me a list of the tax rates in the countries with which we do have a treaty. I'd be happy to circulate it. I think you will see that all countries, perhaps with the exception of Ireland, do impose taxes at very significant rates.

There's one exception here, and that's a major category of foreign business profits that are earned in developing countries where they qualify for special fiscal concessions under their special programs designed to encourage economic development. Canada, as a matter of policy, has long maintained the habit of accommodating such concessions provided by Third World countries and not frustrating them by taxing income that has benefited from their fiscal incentives.

Mr. Chairman, at the request of your committee, officials of our department met last week with officials from the AG's office to discuss the respective positions we've taken on the question of the revenue loss with the existing rules. Much of this so-called revenue loss, as I said, was predicated on the assumption that any change in the rules would not trigger a significant corresponding change in the behaviour on the part of taxpayers. On the basis of this methodology the AG's analysis is an entirely valid one. The quantum of revenue that could be achieved if all of this exempt income was taxed is probably, as the Auditor General stated, in the order of hundreds of millions of dollars.

On the other hand, as the Auditor General himself pointed out, change in the tax system would result in a behavioural change on the part of taxpayers, and under a more restrictive, more onerous regime most of the

[*Traduction*]

Comme je l'ai déjà dit, les dispositions de la loi existent depuis longtemps et font partie intégrante de notre régime fiscal, et notre crédit d'impôt pour dividendes vise en partie à encourager les Canadiens à investir dans des sociétés canadiennes. Depuis sa création, ce crédit a été accordé pour tous les dividendes de ces compagnies, peu importe si les revenus sous-jacents ont été assujettis à l'impôt canadien. Cela se fait à l'étranger et cela se fait au Canada, comme je l'ai déjà dit.

Si nous modifions la façon de calculer le crédit d'impôt, nous changerons de façon fondamentale un système qui existe depuis plus de 40 ans. Cela ne veut pas dire qu'un tel système ne devrait pas être modifié. Cela veut tout simplement dire que le système existe depuis longtemps et qu'il a été révisé par le Parlement du Canada plusieurs fois au cours de cette période.

Si nous supprimions l'exonération des dividendes étrangers découlant des revenus qui n'ont pas été suffisamment imposés à l'étranger, nous modifierions de façon fondamentale un autre élément durable du régime fiscal canadien, et nous annulerions l'engagement que le Canada a pris en concluant des conventions fiscales avec un certain nombre de pays, y compris des pays en développement.

Tous les pays avec lesquels le Canada a signé des conventions fiscales imposent les sociétés à des taux élevés. J'ai apporté une liste des taux d'imposition dans les pays avec lesquels nous avons signé une convention. Je vais vous la distribuer. Vous constaterez que tous ces pays, peut-être à l'exception de l'Irlande, ont des taux d'imposition très élevés.

Ici, il y a une exception importante, à savoir les bénéfices que les sociétés canadiennes réalisent dans les pays en développement où elles sont admissibles à des concessions fiscales spéciales dans le cadre de programmes spéciaux visant à encourager le développement économique. Conformément à sa politique, le Canada a toujours tenu compte de ces concessions accordées par les pays du Tiers-monde et évité de les décevoir en imposant les revenus découlant de leurs encouragements fiscaux.

Monsieur le président, à la demande de votre comité, de hauts fonctionnaires de notre ministère ont rencontré ceux du Bureau du vérificateur général la semaine dernière pour discuter de nos positions respectives sur la question du manque à gagner fiscal résultant des règles actuelles. Comme je l'ai dit, une grande partie de ce prétendu manque à gagner est fondée sur l'hypothèse selon laquelle tout changement des règles n'entraînerait pas un changement important de comportement chez les contribuables. Compte tenu de cette méthodologie, l'analyse du VG est tout à fait valable. Le montant des recettes que l'on pourrait obtenir si l'on imposait tous ces revenus exonérés se chiffre probablement à des centaines de millions de dollars, comme l'a dit le vérificateur général.

D'autre part, comme le vérificateur général l'a souligné lui-même, une modification du régime fiscal entraînerait un changement de comportement chez les contribuables, et dans un système plus restrictif et plus onéreux, la plupart des

[*Text*]

transactions that would be in this estimate and that the AG has seen as having escaped tax would simply not take place. In the absence of these transactions, Mr. Chairman, there simply wouldn't be any revenue to tax.

This is an extremely important proposition so I beg the indulgence of the committee to present a couple of examples to try to explain this very fundamental point.

First, let's assume that a Canadian corporation has a foreign affiliate which carries on an active business in, say, the European Community. It requires an additional $100 million in capital. Under the existing rules a typical way for a Canadian corporation to facilitate this investment would be to establish a second foreign affiliate in a country such as Barbados, and to contribute $100 million in equity to that affiliate. The Barbadian affiliate would then on-lend the $100 million to the EC affiliate at the market rate of interest.

The EC affiliate would be able to deduct, under the tax rules applying in the countries of the EC, this interest, and hence not pay tax in the country of origin, for example, in the EC. The interest, if exempt from tax in the intermediate country, if we had a tax treaty with that country, then could come back to Canada in the form of dividends on a tax-exempt basis.

Under the existing rules this $10 million of interest can be repatriated to Canada, in a sense, without ever having it subject to tax. It's not subject to tax in the European Community because there it shows up as interest which is deductible, and it's not taxable in Canada because it's coming back as a dividend. Therefore it's quite correct that a total of $10 million of earnings has come in not taxed abroad, not taxed in Canada. So it is quite appropriate to ask if this is the right way to do business.

• 1630

Shouldn't we in Canada be taxing this? Well, suppose we did impose a tax on that income coming back. That is, we declare it not to be active business income for purposes of the act. Instead of investing through the affiliate, the Canadian corporation could invest directly in its European subsidiary. It would put in $100 million in equity investment. There would be earnings on that investment, and tax would be levied in the European country, and dividends would be paid back to the Canadian corporation. Tax having been levied under the existing rules, I think members of the committee would think it appropriate that we levy no tax. Similarly, if we had a tax credit arrangement, tax credit would be given for the taxes paid in Europe.

In any event, this same transaction would give rise to no tax in Canada, although it would have given rise to some tax in the European country. But the key point is that no tax would be exigible in Canada, and appropriately so.

[*Translation*]

transactions qui feraient partie de ce calcul et qui, selon le VG, échappent à l'impôt, ne se produiraient tout simplement pas. Monsieur le président, s'il n'y avait pas ces transactions, il n'y aurait tout simplement pas de revenus à imposer.

Il s'agit là d'une affirmation extrêmement importante; avec la permission du comité, j'aimerais présenter quelques exemples pour illustrer ce point fondamental.

Premièrement, supposons qu'une société canadienne a une filiale étrangère qui est exploitée activement, disons, dans la Communauté européenne. Elle a besoin d'un capital supplémentaire de 100 millions de dollars. En vertu des règles existantes, une façon normale pour une société canadienne de faciliter cet investissement consisterait à créer une deuxième filiale étrangère dans un pays comme la Barbade, et de lui verser un capital de 100 millions de dollars. La filiale de la Barbade prêterait à son tour les 100 millions de dollars à la filiale européenne au taux d'intérêt du marché.

En vertu des règles fiscales appliquées dans les pays de la Communauté européenne, la filiale européenne pourrait déduire l'intérêt et, par conséquent, ne pas payer d'impôt dans le pays d'origine, par exemple, dans la CE. L'intérêt, s'il est exonéré de l'impôt dans le pays intermédiaire—en supposant que nous ayons conclu une convention fiscale avec ce pays—pourrait revenir au Canada sous forme de dividendes en franchise d'impôt.

En vertu des règles actuelles, les 10 millions de dollars d'intérêt peuvent être rapatriés au Canada, dans une certaine mesure, sans jamais être assujettis à l'impôt. Cette somme n'est pas imposée dans la Communauté européenne parce qu'elle apparaît comme un intérêt qui est déductible, et elle n'est pas imposable au Canada parce qu'elle revient comme dividendes. Par conséquent, il est tout à fait exact qu'une somme de 10 millions de dollars de revenu entre au Canada sans avoir été imposée ni à l'étranger, ni ici. Il est donc assez normal de demander si c'est la façon judicieuse de travailler.

Le Canada ne doit-il pas imposer ce revenu? Eh bien, supposons que ce revenu qui revient au Canada est assujetti à l'impôt, c'est-à-dire que nous ne le déclarons pas comme revenu d'entreprise exploitée activement en vertu de la loi. Au lieu d'investir par l'entremise d'une société affiliée, la société canadienne pourrait investir directement dans sa filiale européenne. Elle ferait un placement en actions de 100 millions de dollars. Ce placement rapporterait des revenus, des impôts seraient perçus dans le pays européens et les dividendes seraient reversés à la société canadienne. L'impôt ayant déjà été prélevé en vertu des règles existantes, je pense que les membres du comité conviendront qu'il n'est plus nécessaire que le Canada prélève d'impôts. De même, si nous avions un système de crédits d'impôt, nous accorderions un crédit pour les impôts payés en Europe.

En tout cas, la même transaction ne serait pas imposable au Canada, bien qu'elle ait été imposée dans le pays européen. L'essentiel, c'est que le Canada ne doit pas imposer un tel revenu, et à juste titre.

[*Texte*]

Another question arises. If that is a large part of the transaction—and to use the Auditor General's example, he says he has looked at roughly $600 million of this type of transaction—would that $600 million from these particular countries actually flow back? Well, the answer is that most of it would not flow back from those countries. It would flow back from the country where the actual hard physical investment was made, and hence would not be taxable in Canada. So we don't lose very much tax revenue because of this. We lose little or none.

Do we gain anything? Well, I think the real answer here is that corporations in other countries can avail themselves of this same mechanism. They compete with the Canadian companies that have operations abroad, and if we tried to tax that Canadian corporation in a way differently, then the foreign corporation would be taxed carrying out the same exercise. Essentially, the Canadian company would be disadvantaged and the foreign company advantaged.

Mr. Chairman, we cannot, of course, give any absolute insurance that in this very complex area of law there are not technical difficulties, the closing of which would not yield some additional tax revenues to the government. In other words, while we think the basic framework is probably appropriate, changes in that basic framework would not yield substantial additional revenue. Clearly, the operation of a very complex piece of tax law always gives rise to some opportunities for companies and individuals to try to plan their way around the intent of the act. It is against this sort of thing that we must always be vigilant.

As soon as we become aware of deficiencies in this area, particular ones with significant revenue consequences, we attempt to correct them, either in the context of a budget or in a technical bill, depending on the circumstances. Indeed, the department initiated the procedure of introducing an annual technical bill in substantial measure for dealing with just such deficiencies in the law, and this annual technical bill exercise is undertaken in very close consultation with our colleagues from Revenue Canada. When they identify some deficiencies in the law, then we try to correct them in these technical bills.

In addition to the extent the rules in the foreign affiliate area are abused by taxpayers, we believe the general anti-avoidance rule, introduced in 1988, will assist Revenue Canada in protecting against abusive transactions in the future. Certainly this was the purpose in enacting GAAR. Indeed, Revenue Canada is in the process of reviewing the AG's concerns, with a view to determining its applicability to post-1988 transactions.

• 1635

In other words, we now have a tool in place to use that we did not have prior to 1988 and we have to ensure that tool gets used appropriately.

In conclusion, I'd like to assure members that we are always seeking ways to make the system work better. In particular, the Auditor General has again highlighted in his annual report that this is an important area of tax law and

[*Traduction*]

Il se pose une autre question. Si cela représente une grande partie de la transaction—dans son exemple, le vérificateur général a dit que ce type de transaction représente environ 600 millions de dollars—les 600 millions de dollars provenant de ces pays y retournent-ils? Eh bien, la plus grande partie de cet argent ne retourne pas dans ces pays. L'argent sortirait du pays où l'investissement a été effectué et, par conséquent, ne serait pas imposable au Canada. Pour cela, nous ne subissons donc pas tellement de pertes de recettes fiscales. Les pertes sont mineures ou nulles.

Est-ce que nous y gagnons? Eh bien, en réalité, dans d'autres pays, les entreprises peuvent bénéficier du même mécanisme. Elles sont en concurrence avec des sociétés canadiennes qui ont des activités à l'étranger, et si nous essayions d'imposer nos sociétés différemment, les sociétés étrangères seraient imposées de la même façon. Essentiellement, la société canadienne serait désavantagée au profit de la société étrangère.

Monsieur le président, bien entendu, nous ne pouvons pas vous garantir de façon absolue qu'il n'existe pas de difficultés techniques dans ce domaine juridique très complexe, et que la résolution de ces difficultés ne ferait pas perdre d'autres recettes fiscales au gouvernement. Autrement dit, bien que nous pensions que le cadre fondamental est probablement adéquat, la modification de ce cadre ne produira pas des recettes supplémentaires considérables. À l'évidence, quand on applique une loi fiscale très complexe, les sociétés et les particuliers cherchent toujours à contourner l'esprit de la loi. C'est pour remédier à ce genre de situation que nous devons toujours être vigilants.

Dès que nous découvrons qu'il y a des lacunes dans ce domaine, et surtout quand ces lacunes nous font perdre beaucoup d'argent, nous essayons d'y remédier, dans le cadre soit d'un budget, soit d'un projet de loi technique, selon les circonstances. En effet, le ministère a commencé à déposer un projet de loi technique chaque année pour corriger les lacunes de la loi, et il le fait en collaboration très étroite avec le ministère du Revenu. Quand on trouve des lacunes dans la loi, nous essayons d'y remédier avec ces projets de loi techniques.

En outre, dans la mesure où les contribuables abusent des règles gouvernant les sociétés étrangères affiliées, nous croyons que la règle générale anti-évitement, adoptée en 1988, permettra à Revenu Canada de protéger le gouvernement contre les transactions abusives dans l'avenir. Tel était certainement l'objectif de la RGAE. En fait, Revenu Canada est en train d'étudier les préoccupations du VG afin de déterminer si elles sont applicables aux transactions effectuées après 1988.

En d'autres termes, nous disposons maintenant d'un outil qui n'existait pas avant 1988, et nous devons veiller à ce que cet outil soit utilisé de façon appropriée.

En conclusion, je voudrais assurer les membres du comité que nous cherchons constamment des moyens d'améliorer le fonctionnement du système. En particulier, le vérificateur général a une fois de plus souligné dans son rapport annuel

[*Texte*]

Mr. Short: The rationale is that when it is a bona fide activity, the appropriate tax is that of the jurisdiction in which the activity is carried out.

Mr. Redway: So are you telling me that in the case pointed out by the Auditor General in Switzerland, this was a bona fide activity?

Mr. Short: Mr. Chairman, I am suggesting that when it is a bona fide activity, the appropriate tax is that of the jurisdiction in which the activity is carried on. Virtually all countries accept that. In some countries, when the dividends, the earnings, are repatriated, they may then impose their tax and give a credit for the tax.

Mr. Redway: Why don't we do that in the case of Switzerland since the Auditor General has pointed out that there has been some type of huge tax break here and you tell me it was all a bona fide deal? Why is it they can get away with it without paying something?

Mr. Short: Mr. Chairman, I did not suggest that it was a bona fide deal. I am suggesting there are significant bona fide investments in the countries.

Mr. Redway: But this particular case was not bona fide.

• 1705

Mr. Short: Mr. Chairman, we believe that particular fact circumstance is one that may well be attackable, if not under the existing law—

Mr. Redway: What do we do to attack it? How do we attack that sort of situation?

Mr. Short: I believe that is an appropriate question to ask the representatives of Revenue Canada who are here.

Mr. Redway: You are the guys with the tax policy that puts in place the regime that allows them to do it, and you're the guys who are supposed to put in place the mechanisms for them to use. What mechanisms are in place to attack that sort of thing?

Mr. Short: We believe the General anti-avoidance rule, GAAR, that was introduced—

Mr. Redway: Why wasn't it used in that case?

Mr. Short: In that case, the circumstances predated the introduction of GAAR.

Mr. Redway: I think he said these cases were in 1990. You told me GAAR was put into effect in 1989. Why wasn't it used in 1990, because National Revenue just sat on their butts and didn't do it? You gave them the mechanism and they didn't do it. Is that what you are telling us?

Mr. Short: It is my understanding, Mr. Chairman, that the arrangements were in place before the introduction of the general anti-avoidance rule. These rules only apply with respect to transactions or arrangements that are established after the introduction of GAAR.

Mr. Redway: If that happened now in that particular case, you would use the GAAR or National Revenue would use them. Is that what you are saying?

[*Traduction*]

M. Short: Lorsqu'il s'agit d'une activité de bonne foi, l'impôt qui convient est celui du pays où se déroule l'activité.

M. Redway: Vous me dites donc que dans le cas signalé par le vérificateur général en Suisse, il s'agissait d'une activité de bonne foi?

M. Short: Monsieur le président, ce que je veux dire, c'est que dans le cas d'une activité de bonne foi, l'impôt qu'il convient d'appliquer est celui du pays où se déroule l'activité en question. À peu près tous les pays sont d'accord là-dessus. Certains pays appliquent leur taux d'impôt sur les dividendes et les profits rapatriés et accordent un crédit pour l'impôt en question.

M. Redway: Pourquoi ne pas le faire dans le cas de la Suisse, puisque le vérificateur général a souligné qu'il existe une importante concession fiscale dans ce cas et que vous me dites qu'il s'agissait d'activités de bonne foi? Pourquoi les intéressés peuvent-ils s'en tirer sans rien payer?

M. Short: Monsieur le président, je n'ai pas laissé entendre qu'il s'agissait d'une activité de bonne foi. Ce que je veux dire, c'est qu'il existe d'importants investissements de bonne foi dans les pays en cause.

M. Redway: Ce n'était toutefois pas le cas en l'occurrence.

M. Short: Monsieur le président, nous croyons que le cas en question pourrait très bien être contestable, sinon en vertu de la loi actuelle...

M. Redway: Que faire pour contester une telle situation?

M. Short: Je crois que c'est une question qu'il conviendrait de poser aux représentants de Revenu Canada qui sont ici.

M. Redway: C'est vous qui formulez la politique fiscale qui met en oeuvre le régime qui leur permet d'agir, et c'est vous qui êtes censés mettre en oeuvre les mécanismes nécessaires à cette fin. Quels mécanismes a-t-on mis en oeuvre pour contrer une telle situation?

M. Short: Nous croyons que la règle générale anti-évitement, la RGAE, qui a été mise en oeuvre...

M. Redway: Pourquoi ne l'a-t-on pas appliquée dans ce cas?

M. Short: Les circonstances se sont déroulées avant la mise en oeuvre de la RGAE.

M. Redway: Sauf erreur, on a dit que ces affaires se passaient en 1990. Vous m'avez dit que la RGAE a été mise en oeuvre en 1989. Pourquoi ne l'a-t-on pas appliquée en 1990? Est-ce parce que Revenu Canada s'est croisé les bras et n'a rien fait? Vous avez donné les moyens au ministère, qui n'a rien fait. Est-ce cela que vous nous dites?

M. Short: Sauf erreur, monsieur le président, les arrangements étaient en vigueur avant la mise en oeuvre de la règle générale anti-évitement. Ces règles ne s'appliquent qu'aux transactions ou aux ententes conclues après l'entrée en vigueur de la RGAE.

M. Redway: Si la situation se reproduisait dans ce cas en particulier, votre ministère ou Revenu Canada appliquerait la RGAE. C'est bien ce que vous dites?

[*Text*]

Mr. Short: Mr. Chairman, it is not up to me to use them. I would certainly not want to discourage National Revenue from using all of its tools.

Mr. Redway: You would be recommending it, would you?

The Chairman: Mr. Redway, we'll have another go at this on Thursday. I want to be fair and give our friends in the New Democratic Party a chance to put questions too. Some questions arise from your questioning. I have a whole series of follow-up questions, so I ask—

Mr. Redway: I just got started, Mr. Chairman. I hope you have me down for the second round.

Mr. Rodriguez: Mr. Chairman, let me congratulate you on setting this up so that we have the Auditor General and the defendants over on the other side. It works very well.

Surely the witnesses can recognize that we hear a lot in Parliament about this great deficit and debt, and we actually shake down widows and orphans to get every nickel and dime we can get out of their hides. If they make $17,000, we tax them and we make sure we get it. If they get any handouts from the provincial government, it becomes a federally taxable item.

You said you started a study of this matter in 1987. That was five years ago. When will we get some proposals to plug these loopholes that were pointed out by the Auditor General? How are we going to collect that $240 million in taxes that have haemorrhaged from the Canadian taxpayer?

Mr. Dodge: Mr. Chairman, at the risk of boring other members, I will repeat what I said before. We do have these problems under continuous study. We have intensified the study since—

Mr. Rodriguez: This is a recording, this is a recording.

Mr. Dodge: Excuse me, you asked—

Mr. Rodriguez: I knew you were going to give that answer. That's a recording, Mr. Chairman. I want to move on. You are not going to waste the committee's time repeating that crap. I want to move to the next one.

The Auditor General said that one of your tax avoidance methods is FAPI. He said these rules are:

> a key anti-avoidance element of the current system. Their purpose is to eliminate the tax advantage of earning passive investment income

As well, he said:

> A key concern is the fact that the Income Tax Act does not define active or passive income in the context of the FAPI rules.

So even if you have a tax avoidance scheme, you can't enforce it because you haven't defined what active and passive income are.

[*Translation*]

M. Short: Monsieur le président, ce n'est pas à moi que revient d'appliquer ces règles. Je ne voudrais certes pas décourager Revenu Canada d'utiliser tous les moyens à sa disposition.

M. Redway: Vous en recommanderiez l'utilisation, n'est-ce pas?

Le président: Monsieur Redway, nous reviendrons sur la question jeudi. Je voudrais être juste et donner à nos amis du Nouveau Parti démocratique la chance de poser des questions eux aussi. Vos interventions soulèvent certaines questions. J'ai toute une série de questions de suivi, et je demanderais donc...

M. Redway: Je venais à peine de commencer, monsieur le président. J'espère que vous allez m'inscrire pour le deuxième tour de questions.

M. Rodriguez: Monsieur le président, permettez-moi de vous féliciter d'avoir organisé la séance de telle façon que nous accueillons le vérificateur général là et les défendeurs de l'autre côté. Cela fonctionne très bien.

Les témoins savent certes que nous entendons beaucoup parler au Parlement de l'énormité du déficit et de la dette et que nous abusons en fait de la veuve et de l'orphelin pour leur arracher leur dernier dollar. S'ils gagnent 17 000$, nous leur faisons payer l'impôt sans faute. Tout ce qu'ils obtiennent des provinces devient imposable au niveau fédéral.

Vous avez dit avoir entrepris une étude sur la question en 1987, soit il y a cinq ans. Quand nous présentera-t-on des propositions afin de colmater les échappatoires mentionnées par le vérificateur général? Comment procéderons-nous pour percevoir les 240 millions de dollars d'impôt qui ont échappé aux contribuables canadiens?

M. Dodge: Au risque d'ennuyer d'autres membres du comité, monsieur le président, je vais répéter ce que j'ai déjà dit. Nous étudions constamment ces problèmes. Nous avons intensifié notre étude depuis...

M. Rodriguez: Ceci est un enregistrement, ceci est un enregistrement.

M. Dodge: Excusez-moi, vous avez demandé...

M. Rodriguez: Je savais que vous alliez me donner cette réponse. C'est un enregistrement, monsieur le président. Je vais passer à autre chose. Vous ne gaspillerez pas le temps du comité à répéter ces foutaises. Je voudrais passer à la question suivante.

Le vérificateur général a déclaré que la RGAE est un de vos moyens de lutter contre l'évitement. Il a dit ceci:

> Ces règles sont un élément clé du régime actuel en vue de contrer le problème de l'évitement fiscal. Elles ont pour objet d'éliminer l'avantage fiscal résultant des revenus d'investissements passifs.

Il a aussi dit ceci:

> Une des principales préoccupations tient au fait que la Loi de l'impôt sur le revenu ne définit pas ce qu'est un revenu actif ou passif dans le contexte des règles sur le revenu étranger accumulé qui est tiré de biens.

Même si vous avez un régime de lutte contre l'évitement fiscal, vous ne pouvez l'appliquer parce que vous n'avez pas défini ce qu'est un revenu actif et un revenu passif.

[*Texte*]

Mr. Dodge: Mr. Chairman, I will give you a short answer to that. Those concepts have been well defined in various court cases. If you would like further elaboration, perhaps Mr. Short could answer.

Mr. Short: Mr. Chairman, it is true that there is not a black and white line dividing active income from passive income for this purpose. This is both an advantage and a disadvantage.

[*Traduction*]

M. Dodge: Monsieur le président, je vais vous répondre brièvement. Ces concepts ont été bien définis par divers tribunaux. Si vous voulez d'autres précisions, M. Short pourrait peut-être répondre.

M. Short: Monsieur le président, il est vrai qu'il n'y a pas de ligne de démarcation très claire entre les revenus actifs et les revenus passifs à cette fin. Il s'agit à la fois d'un avantage et d'un inconvénient.

• 1710

Mr. Rodriguez: How can you decide, if you haven't got something clear to define? Do you wake up in the morning and say you think it's passive income today or wake up in the afternoon and say it's active income?

M. Rodriguez: Comment pouvez-vous décider sans définition claire? Décidez-vous un bon matin qu'il s'agit d'un revenu passif aujourd'hui, pour changer d'idée l'après-midi et considérer le revenu comme actif?

Mr. Short: No. The way in which that and many other disputes are decided when there is a dispute between the taxpayer and the administration is for the courts to determine. Indeed, for the first time, I believe, there is a major—

M. Short: Non. Des différends de ce genre et bien d'autres entre les contribuables et l'administration sont tranchés par les tribunaux. C'est en fait la première fois, sauf erreur, qu'il y a. . .

Mr. Rodriguez: Why would you turn it over to the courts? As the Auditor General said, you should define them. Isn't there a benefit in defining them? When the courts get through with this matter it's the lawyers who will walk away with the money.

M. Rodriguez: Pourquoi vous en remettre aux tribunaux? Comme l'a dit le vérificateur général, vous devriez définir ces revenus. Ne serait-ce pas avantageux? Lorsque les tribunaux en auront terminé avec cette question, ce seront les avocats qui se seront sauvés avec l'argent.

An hon. member: Hear, hear.

Une voix: Bravo!

Mr. Short: We would hope that, in this instance, Mr. Chairman, it would be the government that would walk away with the money. Be that as it may, it's not entirely obvious as to exactly how, if one wanted to define the distinction between active and passive income, you would do so.

M. Short: Nous aimerions croire dans ce cas, monsieur le président, que ce sera le gouvernement qui mettra la main sur l'argent. Quoi qu'il en soit, si on veut établir une distinction entre revenu actif et revenu passif, la façon exacte de s'y prendre n'est pas tout à fait évidente.

Mr. Rodriguez: Well, is the Auditor General out to lunch? He says you can define it. He calls for a definition. Is he in cuckoo land or are you just trying to dodge making a tough decision?

M. Rodriguez: Le vérificateur général est-il stupide? Il affirme que vous pouvez définir ces concepts et demande qu'on le fasse. Est-il complètement cinglé, ou essayez-vous simplement d'éviter une décision difficile?

Mr. Short: Mr. Chairman, I do not know exactly how he would draw the line. Certainly, you cannot simply say interest is passive income in all circumstances.

M. Short: Monsieur le président, je ne sais pas exactement où il tirerait la ligne. On ne peut certes pas affirmer simplement qu'un revenu d'intérêt est toujours un revenu passif.

Mr. Rodriguez: Have you got a definition? What would you call passive income?

M. Rodriguez: Avez-vous une définition? Qu'est-ce que vous considéreriez comme un revenu passif?

Mr. Short: Mr. Chairman, I look at this as a circumstance in which, if it's income that is associated or incidental to an active business that's carried on, it ought to be regarded as active business income. If there is no essential activity then the income is more or less in the nature of portfolio investment income.

Because the distinction is important for purposes of the small business deduction in Canada, in which the difference between active business income and other income is important, as only active business income receives the benefit of the low tax rate on amounts up to $200,000, we have attempted, in our domestic law, to come up with a definition that was more precise, but less satisfactory, in a sense.

We indicated that if it was investment income and if more than five persons were necessary in order to earn that income, it would be regarded as active income. We believe that approach would be singularly inappropriate in the area

M. Short: Monsieur le président, si le revenu est lié ou accessoire à une activité commerciale, il faut le considérer comme un revenu d'affaires actif. S'il n'y a pas d'activité essentielle, le revenu est alors plus ou moins assimilé au revenu d'un portefeuille de placements.

Comme la distinction est importante aux fins de la déduction pour les petites entreprises au Canada, comme la différence entre le revenu d'affaires actif et les autres sources de revenu est importante, car seul le revenu d'affaires actif est assujetti au faible taux d'imposition jusqu'à concurrence de 200 000$, nous avons essayé dans la législation canadienne de formuler une définition plus précise, mais qui est moins satisfaisante dans un certain sens.

Nous avons indiqué que s'il s'agissait d'un revenu de placements et que s'il fallait plus de cinq personnes pour gagner le revenu en question, celui-ci serait considéré comme un revenu actif. Nous croyons que cette définition ne

[*Text*]

of foreign affiliates because it would enable some income that we believe would clearly fall within the passive income category to be easily recategorized as active business income. So the essential problem is one of finding out what the definition should be.

Mr. Rodriguez: It doesn't seem to me to be a perceptual problem. You just very clearly defined what active income is. So if you've got an entrepreneur in Canada, who's a Canadian, and who goes down to Barbados, puts $10 million into a resort—the income earned from that investment is active income—little or no tax is paid in Barbados, and all the money comes back to Canada as dividends. No tax is paid here. That's what I understand to be active income.

If the Barbadians chose not to tax that income, why should the Canadians be dodos and not tax it here? Anybody watching this hearing has to say that we have to be dodos.

Mr. Short: Mr. Chairman, the Barbados is quite clearly a developing country. It has a general corporate tax rate of 34% and a further tax on a distribution. But as part of its economic development program, to improve its economy it has introduced several measures, most of them lasting for a relatively short number of years. There is their Pioneer Industry Relief and their Hotel Aids Act. There are special concessions that it feels are necessary to attract investment.

• 1715

Most of the countries in the Carribean have similar legislation. The Canadian government long ago concluded that it was important for Canada not to try to frustrate the legitimate development of programs of the—

Mr. Rodriguez: I'm sorry, let's hold it right there. In fact, they could do other things. They can go to countries that aren't even designated tax havens. They can do little jobs down in other countries—and I think the Auditor General listed a few of them—with which there are no treaties, such as Argentina and Portugal. They can do their thing there, have the dividends sent up to the Barbados, and then bring the dividends into Canada with no tax. They're doing this even outside of countries with which we have an agreement.

Mr. Short: Mr. Chairman, unless the income is earned in one of the countries listed in the regulations, generally the countries with which we have tax treaties or those with which tax treaty negotiations have long been in process, the dividend will not be exempt.

Mr. Rodriguez: On page 47, 2.44 it says:

> Also, a foreign affiliate in a tax haven country that is not designated may technically be resident in a designated country; dividends from it can then be passed on to its Canadian affiliate, without being subject to Canadian tax,

[*Translation*]

conviendrait vraiment pas dans le cas des sociétés affiliées étrangères parce que cela permettrait dans certains cas de reclasser comme revenu d'affaires actif un revenu que nous considérons clairement comme un revenu passif. Le problème consiste donc essentiellement à formuler la définition.

M. Rodriguez: Pour moi, ce n'est pas un problème de perception. Vous venez juste de définir très clairement ce qu'est un revenu actif. Donc, si vous avez un entrepreneur canadien qui investit 10 millions de dollars dans un centre de villégiature à la Barbade—le revenu tiré de ce placement est un revenu actif—celui-ci paie très peu ou pas du tout d'impôt à la Barbade, et tout l'argent revient au Canada sous forme de dividendes. L'intéressé ne paie pas d'impôt au Canada. C'est ce que je considère comme un revenu actif.

Si les Barbadiens décident de ne pas imposer le revenu en question, pourquoi faudrait-il que les Canadiens soient stupides et ne le fassent pas ici? Quiconque suit cette audience doit se dire que nous sommes vraiment stupides.

M. Short: Monsieur le président, la Barbade est de toute évidence un pays en développement. Le taux général de l'impôt sur le revenu des sociétés est de 34 p. 100, et on y impose une autre taxe sur la distribution. Dans le cadre de son programme de développement économique, pour améliorer son économie, le pays a adopté plusieurs mesures, dont la plupart sont d'une durée relativement courte. Il y a notamment l'allégement destiné aux industries pionnières et la loi concernant l'aide à l'hôtellerie. La Barbade offre des concessions spéciales, qu'elle juge nécessaires pour attirer les investisseurs.

La plupart des pays des Antilles ont des mesures législatives semblables. Le gouvernement canadien a conclu il y a longtemps qu'il importait pour le Canada de ne pas essayer de nuire à l'élaboration légitime de programmes...

M. Rodriguez: Je m'excuse, n'allons pas plus loin. Les investisseurs pourraient en fait faire autre chose et se tourner vers des pays qui ne sont pas reconnus comme des refuges fiscaux. Ils pourraient un peu travailler dans d'autres pays, et je crois que le vérificateur général en a énuméré quelques-uns—avec lesquels nous n'avons pas de conventions, comme l'Argentine et le Portugal. Les investisseurs en question peuvent y faire des affaires, faire virer les dividendes à la Barbade et les importer ensuite au Canada en franchise d'impôt. Ils le font même à l'extérieur de pays avec lesquels nous avons conclu une entente.

M. Short: Monsieur le président, si le revenu n'est pas gagné dans un des pays énumérés dans le règlement, c'est-à-dire en général dans les pays avec lesquels nous avons conclu des conventions fiscales ou avec lesquels nous négocions depuis longtemps en vue d'en conclure une, les dividendes ne seront pas exonérés.

M. Rodriguez: Au paragraphe 2.44 de la page 52, on lit ceci:

> De plus, une corporation étrangère affiliée, dans un pays non désigné, peut techniquement être résidante d'un pays désigné; les dividendes qu'elle rapporte peuvent ensuite être transférés à la corporation canadienne en franchise

[*Texte*]

even though the underlying income has not been subject to foreign tax at a rate that approximates Canadian rates. The Department of National Revenue—Taxation is aware of a number of taxpayers who have used this scheme to be in a position to move $500 million into Canada tax free.

Now, give me a break. Is he out to lunch? Is the Auditor General not right?

Mr. Short: Mr. Chairman, I believe the example used by the Auditor General is one in which a company was held to be resident in Switzerland—

Mr. Rodriguez: Is that the example?

Mr. Short: —but was in fact resident in the Netherland Antilles. It argued that it was properly resident in Switzerland. I find that a very unique and rather perverse set of circumstances. That isn't a common circumstance.

Mr. Rodriguez: But is it happening?

Mr. Short: It's the first time I've heard it. I'm not aware of it happening in any other circumstances.

Mr. Rodriguez: Mr. Auditor General, how did you get that example? How did you find that?

Mr. Desautels: Mr. Elkin can answer that.

Mr. Barry Elkin (Principal, Audit Operations Branch, Office of the Auditor General of Canada): The statement you refer to is at paragraph 2.44, information examined at Revenue Canada.

Mr. Rodriguez: Is there more than one case? Were there others?

Mr. Desautels: It's a similar case to the example given from the Netherland Antilles and Switzerland, but it's a different case. The circumstances resemble the other case.

Mr. Rodriguez: Then it's not just a single...

Mr. Desautels: That's correct.

The Chairman: Mr. Rodriguez, I have to interrupt you. Your 10 minutes are up.

Mr. Rodriguez: Thank you very much, Mr. Chairman, we can't find the $500 million.

The Chairman: There's an awful lot of interest in this question. I take it we'll all have our questions ready for Thursday morning.

As agreed at the beginning of the meeting, this meeting is adjourned until 9 a.m. Thursday, when we'll continue with our examination of this very interesting subject.

[*Traduction*]

d'impôt canadien, même si le revenu auquel ils correspondent n'a pas été imposé à un taux à peu près équivalent aux taux canadiens. Le ministère du Revenu national, Impôt, est au courant qu'un certain nombre de contribuables ont utilisé ce moyen pour être en mesure de transférer 500 millions de dollars au Canada en franchise d'impôt.

Donnez-moi une chance. Est-il complètement cinglé? Le vérificateur général a-t-il tort?

M. Short: Monsieur le président, je crois que le vérificateur général a utilisé un exemple d'entreprise considérée comme résidente de Suisse...

M. Rodriguez: Est-ce là l'exemple?

M. Short: ...mais qui était en fait résidente des Antilles néerlandaises. L'entreprise a soutenu qu'elle était en fait résidente de Suisse. Je crois qu'il s'agit d'une série de circonstances plutôt particulières et perverses. Ce n'est pas fréquent.

M. Rodriguez: Mais cela se produit?

M. Short: J'en entends parler pour la première fois. À ma connaissance, cela ne s'est pas produit dans d'autres cas.

M. Rodriguez: Monsieur le vérificateur général, où avez-vous trouvé cet exemple? Comment l'avez-vous trouvé?

M. Desautels: M. Elkin peut répondre à cette question.

M. Barry Elkin (directeur principal, Direction générale des opérations de vérification, Bureau du vérificateur général du Canada): Les propos que vous avez cités se trouvent au paragraphe 2.44, et ce sont des renseignements que nous avons examinés à Revenu Canada.

M. Rodriguez: Y a-t-il plus d'un seul cas? Y en avait-il d'autres?

M. Desautels: Ce cas ressemble à l'exemple donné au sujet des Antilles néerlandaises et de la Suisse, mais il est différent. Les circonstances ressemblent à celles de l'autre cas.

M. Rodriguez: Il ne s'agit donc pas simplement d'un cas unique...

M. Desautels: En effet.

Le président: Monsieur Rodriguez, je dois vous interrompre. Vos 10 minutes sont terminées.

M. Rodriguez: Merci beaucoup, monsieur le président, nous ne pouvons trouver les 500 millions de dollars.

Le président: Cette question suscite beaucoup d'intérêt. Je crois que nous aurons tous des questions à poser jeudi matin.

Comme nous l'avons convenu au début de la réunion, la séance est levée jusqu'à 9 heures, jeudi matin. Nous poursuivrons alors notre étude de cette question très intéressante.

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HOUSE OF COMMONS

Issue No. 38

Thursday, December 10, 1992

Chairperson: Jean-Robert Gauthier

CHAMBRE DES COMMUNES

Fascicule nº 38

Le jeudi 10 décembre 1992

Président: Jean-Robert Gauthier

Minutes of Proceedings and Evidence of the Standing Committee on

Public Accounts

Procès-verbaux et témoignages du Comité permanent des

Comptes publics

RESPECTING:

Pursuant to Standing Order 108(3)(e), consideration of Paragraphs 2.28 to 2.61 of the 1992 Auditor General's Report (Department of Finance)

CONCERNANT:

Conformément à l'alinéa 108(3)e) du Règlement, étude des paragraphes 2.28 à 2.61 du Rapport du vérificateur général pour 1992 (Le ministère des Finances)

WITNESSES:

(See back cover)

TÉMOINS:

(Voir à l'endos)

[*Text*]

Mr. Dodge: Those are simply the measures that were taken under the current government. Clearly, over the years there have been many measures taken to try to preserve the integrity of the system.

Mr. Young: I take it then that this is a clear indication that what's done by the department—it's obviously the responsibility of the deputy minister and others in the department—is based on statutory requirements as well as government policy. In other words, we're asking you today and we were asking you on Tuesday to respond to observations and concerns put forward by the Auditor General. However, it's really a mix of law, international competition, government policy as opposed to the black and white kinds of things that accountants normally deal with, such as the bottom line, annual returns or financial statements.

Is it a fair assessment to say that you're being asked to deal in a very volatile area that also has a number of components that are not consistent with what one would traditionally consider to be accounting principles?

Mr. Dodge: I'm not sure, Mr. Young, that I would phrase it quite that way. The basic policy with respect to the taxation of income from foreign affiliates really has not changed since the 1972 tax reform. The basic policy has been consistent through the period. But business practices change, and also companies get experience with the act, and we get court decisions. Clearly, in order to try to ensure that the act continues to reflect the basic policy clearly, amendments have to be made from time to time to reflect the changing circumstances. But in this area I think it is fair to say that since 1972 there has been no basic change in policy. Certainly the amendments that we made, that are on the list we passed out this morning, are really to try to ensure that the act does what it is supposed to do.

• 0920

Mr. Young: That is the point I want to pursue, Mr. Chairman. I am not asking the department or the deputy minister to comment on government policy, but it appears, based on the Auditor General's report and what we have heard in this particular session of the committee's hearings with representatives from Finance, that the policy... I think we are all aware that immediately there is a change in the tax law, the senior tax practitioners in this country, within 24 to 48 hours, have on their best clients' desks—if it takes that long—an analysis of what has been done and how best to cope with it, and how to try to maximize exploitation of it. It is a cat and mouse game, and I think we all recognize that.

You suggested that if these loopholes are plugged, major efforts will be made, major behavioural changes will occur that will probably negate any savings that might occur as a result of plugging the loopholes. Everybody will work very hard at finding other ways to arrive at the same ends. The net result, as I understand it, would be a very marginal increase in any amounts that might accrue to the Canadian government.

[*Translation*]

M. Dodge: Ce sont seulement les mesures qui ont été prises par le gouvernement actuel. Évidemment, au fil des ans, on a adopté beaucoup de mesures visant à préserver l'intégrité du système.

M. Young: Je présume alors que c'est une indication claire que le ministère—la responsabilité incombe naturellement au sous-ministre et à ses fonctionnaires—agit en fonction des exigences de la loi et les politiques du gouvernement. En d'autres mots, nous vous demandons aujourd'hui, comme nous l'avons fait mardi, de répondre aux observations et aux préoccupations exprimées par le vérificateur général. Pourtant, les considérations semblent porter sur les dispositions législatives, la concurrence internationale et la politique du gouvernement plutôt que sur des faits bien précis qui intéressent d'habitude les comptables comme, par exemple, le seuil de rentabilité, les rapports annuels ou les états financiers.

Est-il juste de dire qu'on vous pose des questions au sujet d'un domaine très changeant qui comporte des éléments qui ne seraient pas habituellement considérés comme des principes comptables?

M. Dodge: Monsieur Young, je ne suis pas tout à fait certain que je formulerais la question de cette façon. La politique d'imposition du revenu des filiales étrangères n'a pas vraiment changé depuis la réforme fiscale de 1972. La politique de base a été uniforme pendant toute la période. Mais les pratiques commerciales évoluent et les entreprises connaissent de plus en plus cette loi qui fait jurisprudence. Si la loi doit continuer à refléter clairement la politique de base, il faut absolument la modifier de temps en temps pour l'adapter aux circonstances. Toutefois, dans ce domaine, j'estime qu'il est juste de dire qu'il n'y a pas eu de révision fondamentale de la politique depuis 1972. Les amendements que nous y avons apportés et qui figurent sur la liste que nous avons fait circuler ce matin ont pour but d'assurer que cette loi aura bien l'effet voulu.

M. Young: Je voulais justement poursuivre en ce sens, monsieur le président. Je ne demande pas au ministère ou au sous-ministre de faire des observations sur la politique du gouvernement, mais d'après le rapport du vérificateur général et ce que nous avons entendu pendant cette séance du comité avec les représentants du ministère des Finances, il semblerait que la politique... Je pense que nous sommes tous conscients que dès qu'un changement est apporté à la loi fiscale, en dedans de 24 ou de 48 heures, et même moins, les fiscalistes chevronnés de ce pays remettent à leurs clients une analyse de ce qui s'est fait et leur indiquent comment composer avec la nouvelle loi et l'exploiter au maximum. On joue au chat et à la souris, et je crois que nous en sommes tous fort conscients.

Vous avez laissé entendre que si l'on supprime ces échappatoires, des efforts énormes seront déployés et les comportements seront modifiés, ce qui aura probablement pour effet d'annuler toute économie qui pourrait résulter de cette mesure corrective. Tout le monde travaillera très fort pour essayer de trouver le moyen d'arriver au même but. Le résultat, si je comprends bien, sera une augmentation très marginale des sommes qui reviendront au gouvernement canadien.

[*Texte*]

Mr. Dodge: I wouldn't go so far as to say marginal, Mr. Young. As you well know from the many discussions we had on various matters at the finance committee, the world does keep changing and we have to keep moving forward with amendments to the act to ensure the act continues to do what it was supposed to do. This, as we all know, is an extremely difficult area. It is not just that we get various court decisions here, but conditions change abroad. Foreign tax laws change. Also, international business practices have changed dramatically, and financing practices in particular have changed dramatically over the 20 years that have ensued since the basic rules were put in place. Therefore, I wouldn't go so far as to say that these are all marginal changes.

Mr. Young: No, marginal results as opposed to marginal changes, in terms of real income to the Canadian consolidated revenue fund.

Mr. Dodge: What I would say is that they're designed to protect the revenue base that is there from practices that frustrate the intent of the law, and without making those changes on a fairly timely and regular basis, we could lose very substantial amounts.

Mr. Young: Is it fair then to characterize Canadian tax policy now, and in many respects since 1972, as allowing the foreign subsidiaries' losses to be transferred to their Canadian parents, allowing Canadian corporations to move income offshore, and allowing Canadian corporations to convert income into tax-free income? Is that part of the policy? I think that is all we need to know, Mr. Chairman. I don't think the accounting problem here is what worries me, because if we have a policy that allows that to happen, I don't think we should be asking you to do anything differently about it. Governments and Parliament decide what kind of rules we are going to have in place, and if that is the policy then I don't understand how we can turn around here or anywhere else and say we want people in the department who operate as bureaucrats to do things or to put in place mechanisms that will contradict policy. As best as I can ascertain at this point in time, the policy is to allow those kinds of things to happen.

• 0925

Mr. Dodge: I don't think that's a fair characterization of the policy. The basic policy is that dividends arising from active business income offshore ought to come back tax-free. Those that are essentially passive income ought to bear tax when they come back. We try to prevent the international shuffling around of losses.

But perhaps I could ask Mr. Short to comment further on that last point.

Mr. Young: May I ask this on a point of clarification?

So then you disagree with paragraph 2.55 in the Auditor General's report that the tax rules are being used to do this. My point is if the tax rules are being used to do it, most likely because of the longevity of the system, since 1972, this

[*Traduction*]

M. Dodge: Je ne dirais pas nécessairement «marginale», monsieur Young. Vous savez très bien, suite aux discussions que nous avons eues sur diverses questions au Comité des finances, que le monde est toujours en évolution et qu'il faut toujours modifier la loi afin de s'assurer qu'elle accomplit toujours ce qu'elle est censée faire. Nous savons également qu'il s'agit ici d'un domaine extrêmement difficile. Outre que de composer avec les décisions des tribunaux ici, les conditions changent à l'étranger. Les lois fiscales étrangères changent. Les pratiques commerciales internationales ont aussi évolué radicalement, et plus particulièrement, les pratiques de financement se sont métamorphosées depuis l'instauration des règles de base il y a vingt ans. Donc, je n'irais pas jusqu'à dire qu'il s'agit de changements marginaux.

M. Young: Non, je parle de résultats marginaux plutôt que de changements marginaux, pour ce qui est des revenus réels que pourrait obtenir le Trésor canadien.

M. Dodge: Je dirais que ces amendements sont conçus pour protéger la base des revenus existante contre les pratiques qui viennent contrecarrer l'esprit de la loi. Si nous n'effectuons pas de tels changements régulièrement et au moment opportun, nous risquons de perdre des sommes considérables.

M. Young: Ne pourrait-on pas dire que la politique fiscale au Canada permet maintenant, et en fait, à de nombreux égards, depuis 1972, aux filiales étrangères de transférer les pertes qu'elles subissent à leur société mère canadienne, laissant ainsi à ces sociétés le loisir de virer leur revenu à l'étranger, leur permettant du même coup de convertir ces revenus en revenus exonérés? Est-ce que cela fait partie de la politique? Je crois que c'est tout ce que nous avons besoin de savoir, monsieur le président. Ce n'est pas le problème de comptabilité qui m'inquiète, car si nous avons une politique qui permet une telle situation, je ne crois pas que nous devrions vous demander d'agir différemment. Les gouvernements et le Parlement décident des règles à établir, de la politique à adopter, et je vois mal comment nous ou n'importe qui d'autre pourrait demander au ministère de déroger à la politique ou de mettre en oeuvre des mécanismes qui y sont contraires. D'après les renseignements que j'ai actuellement, la politique permet ce genre de situation.

M. Dodge: Je ne crois pas qu'il s'agisse là d'une description juste de la politique. La politique de base veut que les dividendes découlant de revenus d'entreprises étrangères exploitées activement reviennent exonérés. Ceux qui représentent essentiellement un revenu passif devraient être imposés lorsqu'on les ramène au Canada. Nous essayons d'empêcher le remaniement international des pertes.

M. Short pourrait peut-être nous en dire plus long sur ce dernier point.

M. Young: Est-ce que je peux demander une précision?

Vous n'êtes pas d'accord avec le paragraphe 2.55 du rapport du vérificateur général qui dit que les règles fiscales sont ainsi utilisées. Ce que je veux dire, c'est que si les règles fiscales sont utilisées à cette fin, probablement parce qu'elles

[*Text*]

is part of policy. It's not a question of tax avoidance or tax evasion; it's part and parcel of the system we've put in place to allow these things to happen. Why would we be carping about it if that's our policy?

Mr. Dodge: What's fair to say is the policy is for dividends arising from active business income to come back tax-free. What we have is a set of rules to try to confine what comes back exempt of tax from listed countries. We have a set of rules to ensure that it's confined to that area. We're always having to work on those rules to ensure that in that regard they're efficacious.

The Chairman: That was your last question, Mr. Young.

I would like Mr. Short to explain to me his comments of last Tuesday in answer to Mr. Redway. Mr. Redway asked you if the GAAR was being effectively used by Revenue Canada. He said "If National Revenue just sat on their butts and didn't do it", being the GAAR, and you replied, "It is my understanding". Were you saying to us, sir, that you understood that Revenue Canada was sitting on their butts, not doing anything?

Mr. R.A. Short (General Director, Tax Policy Branch, Department of Finance): Mr. Chairman, if you will recall, in answer to Mr. Redway's question I was not allowed to give the answer, nor to several other questions. I was in the process of giving the answer when I was cut off. So to imply that I indicated that Revenue was not invoking GAAR, or that taxpayers were not recognizing it in their behaviour would be entirely misleading and indeed wrong.

The Chairman: You've had your chance to correct that, sir, and I appreciate that.

Revenue Canada, do you have anything to add in your defence that your butts are not that square?

Mr. Robert Beith (Senior Advisor, Fiscal Policy and Technical Interpretations, Department of National Revenue): Mr. Chairman, with respect to GAAR, and it has been mentioned before in the committee, it didn't come into law until 1988, so it would not be effective before 1989 taxation years.

With respect to large corporations, those who are mainly involved in foreign-source income, we're currently auditing the 1989 taxation year. I expect in the course of these audits that are under way that issues involving GAAR will be raised, and we will consider it and apply it when appropriate.

I might also mention that GAAR has been active in the context of advanced ruling requests since it was introduced in 1988. We've had many advance ruling requests involving GAAR. Recently, in at least one, I recall we denied an advanced ruling in respect of an attempt to transfer losses from a foreign source into Canada.

The Chairman: In the documents earlier this morning from Finance regarding section 245, you say:

[*Translation*]

sont établies depuis 1972, c'est que cela fait partie de la politique. Ce n'est pas une question d'évitement fiscal ou d'évasion fiscale. Cela fait partie prenante du système que nous avons établi. Pourquoi s'en plaindre si telle est notre politique?

M. Dodge: Il serait juste de dire que la politique vise les dividendes découlant de revenus d'entreprises exploitées activement, qui peuvent revenir exonérés d'impôts. Nous avons établi une série de règles qui ont pour but de bien limiter ce qui revient exonéré des pays désignés. Nous avons également une série de règles pour nous assurer que la franchise d'impôt se limite à ces situations précises. Nous devons toujours retravailler ces règles pour nous assurer de leur efficacité à cet égard.

Le président: C'était votre dernière question, monsieur Young.

J'aimerais que M. Short nous explique les commentaires qu'il a faits en réponse à une question de M. Redway mardi dernier. M. Redway vous a demandé si Revenu Canada utilisait bel et bien la RGAE. Il a dit: «Si le ministère du Revenu national restait assis sur son derrière et ne faisait rien», en faisant allusion à la RGAE, et vous avez répondu: «C'est ce que je crois comprendre». Étiez-vous en train de nous dire, monsieur, que vous croyez comprendre que Revenu Canada reste assis sur son derrière et ne fait rien du tout?

M. R.A. Short (directeur général, Direction de la politique de l'impôt, ministère des Finances): Monsieur le président, vous vous souviendrez qu'on ne m'a pas permis de répondre à la question de M. Redway, ni à plusieurs autres questions. J'étais en train de répondre lorsqu'on m'a coupé le micro. Affirmer que j'aurais insinué que Revenu Canada n'invoquait pas la RGAE, ou que les contribuables ne reconnaissaient pas la règle d'après leur comportement serait tout à fait faux.

Le président: Vous avez eu l'occasion de corriger cette impression, monsieur, et je vous en remercie.

Les représentants de Revenu Canada ont-ils quelque chose à ajouter pour nous convaincre qu'ils ne se reposent pas sur leurs lauriers?

M. Robert Beith (conseiller principal, Politique fiscale d'interprétations techniques, ministère du Revenu national): Monsieur le président, comme on l'a déjà dit devant ce comité, la RGAE n'a pas été adoptée en tant que loi avant 1988, donc, elle n'était pas en vigueur avant l'année d'imposition 1989.

Pour ce qui est des grandes sociétés, puisque ce sont principalement elles qui ont des revenus de source étrangère, nous sommes actuellement en train de vérifier l'année financière 1989. Je présume qu'au cours de ces vérifications, les questions entourant la RGAE seront soulevées, et nous nous pencherons donc sur la question et appliquerons la règle s'il y a lieu.

J'ajouterais que la RGAE est souvent invoquée dans le contexte des demandes de décision anticipée depuis son entrée en vigueur en 1988. Nous avons eu de nombreuses demandes de décision anticipée qui portaient sur la RGAE. Dans au moins un cas récent, je me souviens que nous avons refusé de rendre une décision anticipée concernant une tentative de transférer des pertes de source étrangère au Canada.

Le président: Dans le document déposé plus tôt ce matin par le ministère des Finances concernant l'article 245, vous dites:

[*Texte*]

It is also a useful tool for overturning tax avoidance schemes. It is an appropriate tool for combating tax avoidance in the foreign affiliate area.

Has it ever been used in that field of foreign affiliates, as of today?

Mr. Beith: It has not been applied in an assessment that I'm aware of, Mr. Chairman. As I said, we're currently auditing the 1989 taxation years.

The Chairman: Thank you very much.

Monsieur Larrivée.

M. Larrivée: Monsieur Dodge, je ne suis pas fiscaliste, et c'est extrêmement difficile de me retrouver dans tout ça.

• 0930

Il y a une chose qui est facile, cependant. Dans le contexte actuel où le gouvernement accumule des déficits et tente par tous les moyens de trouver des façons pour réduire ces déficits-là, au moment où le vérificateur général nous indique qu'il y a des problèmes dans le cas des compagnies qui jouent un peu avec le système, et qu'il y a des montants importants qui pourraient être sauvés, voire récupérés, pour toute réponse vous semblez dire: non, ce n'est pas si pire que ça, le vérificateur général n'interprète pas les choses comme on les interprète. Ça fait longtemps que ça existe, on peut difficilement changer ça.

Je ne vous vois pas tellement faire d'effort, ni nous montrer une certaine volonté pour corriger la situation, sans chercher la perfection, évidemment. Je comprends que ça peut être très complexe, mais vous n'avez jamais dit, depuis qu'on se parle: le ministère va s'engager à corriger cette situation-là.

Il y a des choses qui sont tellement contradictoires; par exemple, le vérificateur dit au paragraphe 2.52:

> 2.52 Une des principales préoccupations tient au fait que la Loi de l'impôt sur le revenu ne définit pas ce qu'est un revenu actif ou passif...

Et dans votre réponse, vous dites: c'est vrai, ce n'est pas défini, mais on s'arrange quand même. Mardi dernier, je pense que c'est M. Short qui disait que ce sont «des zones grises, c'est difficile à interpréter». Mais en tant que représentant de la population qui se fait surtaxer, alors que le gouvernement dit qu'on va couper un peu partout, quand je vois ça je me dis qu'il y a quelque chose qui ne marche pas. Est-ce que le ministère des Finances est conscient de ce qui se passe? Pourtant, au plan du marché canadien, vous semblez avoir tous les moyens pour le faire. Vous semblez avoir des moyens très clairs pour définir ce qu'est un actif, etc. Ça semble clair, et ça semble beaucoup plus facile.

J'aimerais avoir vos commentaires là-dessus. Est-ce que le ministère a la volonté de poser des gestes pour récupérer tout ce qu'on peut récupérer? Ou bien, est-ce que vous dites qu'il n'y a rien à récupérer? À ce moment-là, on se retournera vers le vérificateur général pour déterminer si nous ne pouvons pas, nous-mêmes, trouver des moyens, si vous n'êtes pas capables d'en trouver.

The Chairman: Mr. Dodge.

[*Traduction*]

C'est aussi un instrument utile pour combattre l'évitement fiscal dans le domaine des corporations étrangères affiliées.

Jusqu'à maintenant, cet instrument a-t-il été utilisé dans le domaine des corporations étrangères affiliées?

M. Beith: À ma connaissance, monsieur le président, cela n'a jamais été appliqué à une cotisation. Comme je l'ai dit tantôt, nous vérifions actuellement l'année d'imposition 1989.

Le président: Merci beaucoup.

Mr. Larrivée.

Mr. Larrivée: Mr. Dodge, I'm not a tax expert, and it's very difficult for me to understand all this.

However, there is one thing that is easy to understand. In the current context where the government is accumulating a deficit and attempting by every way possible to find ways to reduce that deficit; at a time when the Auditor General is telling us that there are problems with companies that are manipulating the system somewhat and that considerable amounts could be saved or even recovered, you seem to simply be answering: no, it's not that bad, the Auditor General is not interpreting things the same way we do. This has been going on for a long time and would be very difficult to change.

I'm not seeing you make much of an effort or show much willingness to correct the situation. Obviously, we're not looking for perfection. I understand that this may be highly complex, but since we've been talking, you've never once said: The Department is committed to correcting this situation.

There are things that seem so contradictory. For instance, in paragraph 2.52 of his report, the Auditor General states:

> 2.52 A key concern is the fact that the Income Tax Act does not define active or passive income...

In your answer, you state: That's true, it's not defined, but we get along anyway. Last Tuesday, I think it was Mr. Short who said that these are "grey areas, difficult to interpret". But as a representative of an overtaxed public, at a time when the government says that it will cut everywhere, I see this and I say to myself that there's something wrong here. Is the Department of Finance aware of what's going on? It seems that you have all the means to do what you need to here in Canada. You seem to have very clear-cut ways of defining an asset, etc. It seems clear and it seems a good deal easier.

I would like to hear your comments on that. Is the Department willing to take action to recover everything it can? Or are you indeed saying that there is nothing to recover? If that's the case, we will go back to the Auditor General and determine whether we shouldn't be finding the means ourselves if you are unable to do so.

Le président: Monsieur Dodge.

[*Text*]

Mr. Dodge: I think it's absolutely true, as the hon. member said, that we work hard and are looking to ensure that in all aspects of the operation of the tax act, the amounts owed to the Government of Canada are indeed paid to the Government of Canada. It's extremely important, as I think all members would agree, from the point of view of fairness and from our own fiscal situation, that all moneys owed are indeed paid.

I'd like to assure Mr. Larrivée that we work extremely hard on your behalf and on behalf of the taxpayers of Canada, at Finance and at Revenue, to ensure that takes place.

There are, both in terms of domestic taxation and in terms of the taxation of income arising from foreign sources, a number of grey zones, as Mr. Larrivée has said. And there the Department of National Revenue appropriately applies its interpretation to the benefit of the Government of Canada. Indeed, when challenged by the taxpayer we go to court. We win some of those court cases; we lose some of those court cases. Those issues that go to court clearly are these grey-zone areas. Where there is legitimate grounds for dispute and the taxpayer has legitimate reason to claim that we have interpreted the law incorrectly, we go to court and get that sorted out.

• 0935

Sometimes those court interpretations, we think, fly directly in the face of policy, and what we in the Department of Finance then do is try to amend the law to take those interpretations into account so that indeed the law does what the policy intent is. We work very hard on that, and we present to the finance committee almost every year a great thick bill, the technical bill, which does that precise thing. It tries to close those loopholes, if you will, those gaps in the law that have arisen either because of court interpretations or because of changed practices or whatever. So in that regard we work extremely hard to ensure that the policy is reflected in the law and that the law works.

You raised a very important issue in terms of active versus passive income. A lot of this is very, very clear. It is quite clear, for example, that if income arises from holding debt obligations, that's clearly passive income; absolutely no question. Clearly on the other side, some dividends are flowing from what is clearly active business income. But there are legitimately some grey zones, and those grey zones change over time. I think that is the other important thing to remember. As new forms of business finance arise, some things that look clearly passive could well be active and vice versa.

Therein lies the real difficulty. It is domestic as well as foreign, and we have to continuously amend the act, and the Department of Revenue has to continually work on interpretations to ensure that the policy intent of Parliament is reflected in the law and that the law is applied.

[*Translation*]

M. Dodge: Comme l'honorable député l'a dit, il est tout à fait vrai que nous travaillons très fort et que nous veillons à assurer que dans tous les volets de la Loi sur l'impôt, les sommes dues au gouvernement du Canada lui sont effectivement versés. Je crois que tous les députés ici présents seraient d'accord pour dire qu'il est extrêmement important, du point de vue de l'équité fiscale, que tout argent redevable au gouvernement canadien soit effectivement payé.

J'aimerais donner à M. Larrivée l'assurance que le ministère des Finances et le ministère du Revenu national travaillent très fort pour lui et pour tous les contribuables canadiens pour que ce soit effectivement le cas.

Comme M. Larrivée l'a dit, il y a de nombreuses zones grises dans la fiscalité, que ce soit à l'intérieur du Canada ou dans le cas de revenus de source étrangère. Lorsqu'il y a lieu, le ministère du Revenu national applique ses règles d'interprétation de façon appropriée au profit du gouvernement du Canada. Lorsqu'un contribuable conteste nos décisions, nous allons devant les tribunaux. Nous gagnons certaines de ces causes et dans d'autres cas, nous les perdons. Les cas qui aboutissent devant les tribunaux tombent évidemment dans la catégorie des zones grises. Lorsque le contribuable a une raison légitime d'affirmer que nous avons mal interprété la loi, nous allons devant les tribunaux pour régler le différend.

Nous estimons que les interprétations des tribunaux sont parfois complètement contraires à la politique. À ce moment-là, nous, au ministère des Finances, essayons de modifier la loi pour prendre ces interprétations en ligne de compte afin que la loi soit conforme à l'esprit de la politique. Nous travaillons très fort pour ce faire et presque tous les ans, nous déposons devant le Comité des finances un projet de loi volumineux, un projet de loi technique, qui vise précisément ce but. Il est conçu de sorte qu'on puisse supprimer ces échappatoires, ces vides dans la loi qui résultent soit d'une interprétation des tribunaux soit de changements dans les pratiques d'affaires, etc. Donc, à cet égard, nous travaillons extrêmement fort pour veiller à ce que la politique soit reflétée dans la loi et que la loi fonctionne bien.

Vous avez soulevé une question très importante concernant le revenu actif et le revenu passif. Ces notions sont souvent très, très claires. Il est manifeste, par exemple, que si le revenu provient de titres de créance qu'une compagnie détient, il s'agit de revenu passif. Par contre, certains dividendes découlent de ce qui est de toute évidence un revenu d'entreprise exploitée activement. Mais il y a certaines zones grises tout à fait légitimes, et ces zones grises changent avec le temps. Je crois qu'il est important de se le rappeler. Au fur et à mesure que de nouvelles formes de finances commerciales voient le jour, certains éléments passifs pourraient devenir actifs et vice versa.

Voilà la vraie difficulté. C'est vrai tant au Canada qu'à l'étranger, d'où la nécessité de modifier continuellement la loi. Le ministère du Revenu doit travailler sans cesse ses interprétations afin que l'esprit de la politique du Parlement se retrouve dans la loi et que cette loi soit appliquée.

[*Texte*]

It might help, Mr. Chairman, if we gave you a couple of examples of these sorts of grey zones so that you could understand, but that is up to you.

Le président: Monsieur Larrivée,

it is on your time. You go right ahead if you want to hear.

M. Larrivée: Je comprends mal. Vous me dites: on amende la loi au fur et à mesure qu'on voit qu'il y a des possibilités de récupérer notre argent. Par contre vous nous dites: si on fait des changements d'une manière ou d'une autre, les compagnies vont se trouver d'autres moyens pour camoufler ou éviter de payer de l'impôt. Alors, il y a quelque chose de contradictoire dans cette déclaration-là, pour moi en tout cas.

Mr. Dodge: I understand the frustration. The basic premise of income tax law is that the taxpayer has the right to arrange his or her affairs in the way most advantageous to the taxpayer given the state of the law. That is the fundamental premise on which income tax law works. As you know, successive parliaments have always agreed that it is the appropriate way things ought to be done.

That means that from time to time taxpayers will find ways that are in accordance with the letter of the law to avoid the policy intent of the law, and at that point the government of the day must either accept that or move forward with an amendment to try to reshape the law so that it reflects precisely the policy. Sometimes that is relatively easy to do; other times it is very, very difficult.

• 0940

Some of the areas we have been talking about such as the FAPI rules are there to try to ensure the intent of the law works, but they are difficult pieces of law. They are very complex, and every time a taxpayer finds some way around them, we have to move to try to plug the hole. This is an extremely important issue. We work hard on it. As I said last week, we are clearly willing to take help and advice from wherever we can get it to ensure the law continuously reflects the basic intent of the policy Parliament has given us.

That's quite different, though, Mr. Larrivée, from the broad issue. The broad issue is that dividends arising from active business income abroad ought to come back tax free. We laid out the reasons for that last week. So the basic policy, as Mr. Young pointed out, has essentially been constant. We have to continually work with the law, and Revenue has to continually work with its application to ensure the basic policy is indeed applied. It's not easy.

Le président: Monsieur Larrivée, votre temps est écoulé; vous avez eu une minute additionnelle. Je vais revenir à vous plus tard.

M. Larrivée: Merci, monsieur le président.

[*Traduction*]

Monsieur le président, ce serait peut-être utile de vous donner quelques exemples de ces zones grises afin que vous compreniez bien, si vous le voulez.

The Chairman: Mr. Larrivée,

c'est votre temps qui s'écoule. Allez-y si vous désirez entendre ces exemples.

Mr. Larrivée: I don't understand. You're telling me: We amend the Act as we see opportunities arise to recover our money. On the other hand, you're also saying: If we make any kind of changes, business will find other means to camouflage or avoid paying taxes. There's something contradictory in that statement, at least in my mind.

M. Dodge: Je comprends votre frustration. Le principe de base du droit fiscal est que le contribuable a le droit d'organiser ses affaires de la façon la plus avantageuse pour lui, pourvu qu'il respecte la loi. C'est le principe fondamental qui sous-tend le droit fiscal. Comme vous le savez, les parlements successifs ont toujours été d'accord que c'était la meilleure façon de faire les choses.

Cela signifie que de temps à autre, les contribuables vont trouver des moyens qui sont conformes à la lettre de la loi, mais qui n'en respectent pas l'esprit. À ce moment-là, le gouvernement au pouvoir doit soit accepter cette situation soit présenter un amendement afin de reformuler la loi pour qu'elle reflète plus précisément la politique. C'est tantôt relativement facile, tantôt extrêmement difficile.

Certaines des règles dont nous avons parlé, telles que celles qui gouvernent les revenus étrangers accumulés tirés de biens, existent pour que l'esprit de la loi soit respecté, mais il s'agit de mesures législatives très complexes. Chaque fois qu'un contribuable trouve moyen de les contourner, il faut agir pour supprimer l'échappatoire. C'est une question extrêmement importante et nous y travaillons très fort. Comme je l'ai dit la semaine dernière, nous sommes tout à fait prêts à accepter de l'aide ou des conseils afin de nous assurer que la loi reflète toujours l'intention essentielle de la politique qui nous est donnée par le Parlement.

Cependant, monsieur Larrivée, cela est très différent de la question globale. La question globale, c'est que les dividendes qui découlent de revenus d'entreprises étrangères exploitées activement devraient revenir au Canada en franchises d'impôts. Nous en avons expliqué les raisons la semaine dernière. Donc, la politique fondamentale, comme l'a signalé M. Young, a été essentiellement uniforme. Il nous faut sans cesse travailler avec cette loi et Revenu Canada doit continuellement veiller à son application pour s'assurer que la politique de base est respectée. Ce n'est pas facile.

The Chairman: Mr. Larrivée, your time is up, you had one extra minute. I will come back to you later.

Mr. Larrivée: Thank you, Mr. Chairman.

[*Text*]

The Chairman: Mr. Dodge, I understand it a little more, but I want to make sure I'm reading this correctly. It appears to me, initially, that all foreign affiliates of Canadian corporations are financial intermediaries and indeed financial vehicles. They don't create new jobs here in Canada.

Mr. Dodge: No.

The Chairman: The economic activity they may have generated here in terms of employment or other things is non-existent.

I want to know how GAAR applies to a foreign affiliates operation with regard to a Canadian company. In my interpretation of a GAAR, it applies where there wasn't a legitimate business reason for the transaction, first.

Second, it applies when the transactions result in an abuse or misuse of the provision of the Income Tax Act. Is my understanding correct? Okay.

You make a case of competitiveness and you made a case for international competitiveness here for the committee. You told us if we change the rules, make it difficult or tax this offshore income, it might change the behaviour of international affiliates and wouldn't produce very much in terms of tax. You said in your answer in the Auditor General's report that marginal revenue gains might be realized. I don't know what marginal gains means, but when you're talking hundreds of millions of dollars, I imagine the universe is quite a bit more than what I or members of the general public would understand to be marginal.

I want to ask you this question. Why is the international competitiveness of a foreign subsidiary any different from a Canadian company that exports, for example, to another country and is subjected completely to Canadian tax? Why is an international subsidiary different from a Canadian subsidiary that creates jobs, economic activity, and all that goes with these things? What's the difference?

Mr. Dodge: I would like to take that in two parts: the general, which I'll answer, and then the specific, which I would like to pass to Mr. Short.

Generally, there are many Canadian firms such as Bombardier, Northern Telecom, Canadian Pacific, and many smaller firms whose names are not household words, and it's very important for them to be able to operate, not just nationally but globally. As we sit here in this city, a lot of the jobs we have at Nortel arise because of offshore activities. It may be that the manufacture of a particular unit takes place offshore, but the design and a lot of the sophisticated, high value-added work is taking place here in Aylmer or in Ottawa or whatever.

[*Translation*]

Le président: Monsieur Dodge, je comprends un peu mieux, mais je veux être sûr que je lis ça correctement. À première vue, il me semble que toutes les corporations affiliées des sociétés canadiennes sont des intermédiaires financiers, des véhicules financiers. Elles ne créent pas de nouveaux emplois ici au Canada.

M. Dodge: Non.

Le président: Elles ne donnent lieu à aucune activité économique ici, qu'il s'agisse d'emplois ou d'autre chose.

Je veux savoir comment la RGAE s'applique à une corporation étrangère affiliée par rapport à la compagnie canadienne. Selon l'interprétation que j'en donne, la RGAE s'applique d'abord lorsqu'il n'y avait aucune raison commerciale légitime pour la transaction.

Deuxièmement, elle s'applique lorsque les transactions donnent lieu à un abus ou à une interprétation fautive d'une disposition de la Loi de l'impôt sur le revenu. Ai-je bien compris? D'accord.

Vous avez fait valoir l'aspect de compétitivité et vous avez invoqué la concurrence internationale ici devant le comité. Vous nous avez dit que si nous changeons les règles et que nous rendons les choses plus difficiles ou que nous imposons ce revenu de provenance étrangère, cela pourrait changer le comportement de corporations affiliées étrangères et ne produirait que très peu de revenu d'impôts. Vous avez dit dans votre réponse au rapport du vérificateur général qu'on pourrait peut-être réaliser une augmentation marginale des revenus. Je ne sais pas exactement ce qu'on entend par marginal, mais lorsqu'il s'agit de centaines de millions de dollars, je crois que c'est un peu plus que ce que moi ou les contribuables entendent par cela.

Permettez-moi de vous poser une question. Pourquoi la position concurrentielle internationale d'une filiale étrangère est-elle différente de celle d'une compagnie canadienne qui, par exemple, fait de l'exportation et est complètement assujettie à l'impôt canadien? Pourquoi une filiale internationale est-elle différente d'une filiale canadienne qui crée des emplois, de l'activité économique et tout ce qui en découle? Quelle est la différence?

M. Dodge: J'aimerais aborder cette question en deux volets. L'aspect général, et l'aspect plus précis, auquel je demanderai à M. Short de répondre.

De façon générale, il y a plusieurs entreprises canadiennes telles que Bombardier, Northern Telecom, Canadien Pacifique et de nombreuses compagnies plus petites et moins connues, pour qui il est très important de pouvoir fonctionner non seulement ici au Canada, mais partout dans le monde. Au moment où nous sommes ici en train de discuter à Ottawa, beaucoup d'emplois chez Nortel existent à cause d'activités étrangères. Il se peut qu'un élément donné soit fabriqué à l'étranger, mais la conception et une bonne partie du travail à forte valeur ajoutée qui exige une main-d'oeuvre très perfectionnée s'effectue ici à Aylmer, à Ottawa ou ailleurs au Canada.

[*Texte*]

• 0945

So it is absolutely critical in this modern world, and it becomes more and more critical every day, that Canadian-based companies, companies with their headquarters in Canada, companies with their R and D operations in Canada, companies with their high value-added operations here, indeed, stay here and are allowed to compete around the world on an equal footing with companies with headquarters elsewhere in the world. That's the fundamental proposition. So it is just not correct to say that because Bombardier buys shorts in Ireland that somehow this is taking away jobs from Canada. Indeed, it makes Bombardier a much stronger world-wide company, operating around the world and, hence, much more able to generate those high value-added jobs here in Canada.

So critical in this government's view and, indeed, critical in the view of governments—increasingly since World War II—is to have a tax regime that doesn't discourage those Canadian firms from going abroad, and does not discourage the Canadians that go abroad from repatriating their incomes so that they can provide jobs here in Canada. The fundamental thing is that we want Canadian firms not to be put on an unlevel playing field, if you will, by our own tax law.

You asked some very specific questions and I'd like to turn to Mr. Short for the answer to those.

Mr. Short: Mr. Chairman, I think the competitive position can be looked at internationally. The roles relating to foreign affiliates are designed to ensure that Canadian-based multinationals are treated in the same way and are not put at a competitive disadvantage in their bona fide business activities—if I can put it in those terms—that they carry on in other countries.

In terms of Canada and Canadian exports, our concern is to make sure that we would tax the Canadian firm in the same way, whether it's foreign owned or domestically owned. We seek to ensure that there is not an unfair advantage for the foreign-owned firm in Canada. The competitive circumstance is the same in both circumstances.

For that reason, because multinational companies can set up operations in different countries, depending on a variety of factors, we want to make sure that the Canadian tax system remains competitive with the tax systems of other countries, insofar as activities carried on in Canada are concerned. I don't know if that answers your specific questions, but I think those are the relevant considerations.

The Chairman: At the bottom of this whole thing, these meetings here are to discuss whether there is any advantage to companies offshore operating the way they do and exempting themselves from the tax that Canadian companies normally would have to pay on profits. That is basically what the fundamental question is before the Canadian public.

You're telling me there is equal, equitable treatment. I have grave hesitations about whether I buy that or not at this time, but I understand what you're telling me. But my perception, right now, is that foreign affiliates are, most of

[*Traduction*]

Par conséquent, dans le monde d'aujourd'hui, il est tout à fait critique et il le devient de plus en plus chaque jour que les entreprises établies au Canada, les entreprises dont le siège social est au Canada, les entreprises qui effectuent leur R-D au Canada, les entreprises qui effectuent au Canada leurs activités à forte valeur ajoutée demeurent ici et puissent concurrencer sur un pied d'égalité les entreprises dont le siège social est situé ailleurs. Voilà la question fondamentale. On a tort, par exemple, de reprocher à Bombardier d'avoir privé le Canada de certains emplois en achetant la société irlandaise Shorts. De fait, la transaction rend Bombardier beaucoup plus solide à l'échelle mondiale et de ce fait beaucoup plus en mesure de créer ici, au Canada, des emplois à forte valeur ajoutée.

Ainsi, tant pour le gouvernement actuel que pour ceux qui l'ont précédé depuis la Seconde Guerre mondiale, il est essentiel que le régime fiscal n'empêche ni les entreprises canadiennes d'aller à l'étranger ni celles qui le font de rapatrier leurs revenus de manière à créer des emplois au Canada. Essentiellement, nous souhaitons que les entreprises canadiennes ne soient pas désavantagées par nos lois fiscales.

Certaines de vos questions étaient très précises et je vais demander à M. Short d'y répondre.

M. Short: Monsieur le président, il faut envisager la compétitivité dans une optique internationale. Les règles qui s'appliquent aux filiales étrangères visent à accorder un traitement égal aux multinationales dont le siège social est situé au Canada et à éviter de désavantager par rapport à celles de leurs concurrents les activités légitimes—si je puis m'exprimer ainsi—qu'elles exercent dans d'autres pays.

Pour ce qui est du Canada et des exportations canadiennes, nous veillons à faire en sorte que l'impôt s'applique de la même manière à toutes entreprises canadiennes, qu'elles soient de propriété étrangère ou canadienne. Nous veillons à ce que l'entreprise canadienne de propriété étrangère ne bénéficie pas d'un avantage injuste pour que les deux types d'entreprises soient sur un pied d'égalité.

Étant donné que les sociétés multinationales peuvent s'établir dans divers pays, pour diverses raisons, nous souhaitons faire en sorte que le régime fiscal du Canada reste concurrentiel par rapport à celui d'autres pays, pour ce qui est des activités qui se déroulent au Canada. Je ne sais pas dans quelle mesure cela répond à votre question, mais il me semble que ces aspects sont pertinents.

Le président: Si nous tenons ces réunions, en fin de compte, c'est pour déterminer s'il est avantageux pour des sociétés d'avoir des activités à l'étranger et ainsi être exemptées de l'impôt qui est normalement prélevé sur les bénéfices de sociétés canadiennes. Voilà essentiellement la question à laquelle les Canadiens doivent répondre.

Vous me dites que le traitement est égal et équitable. Je suis loin d'en être certain pour le moment, même si je comprends ce que vous êtes en train de me dire. D'après ce que je peux voir en effet, ce sont les filiales étrangères qui, la

[*Text*]

the time, finding ways to be exempt from tax rather than the Canadian-based companies that operate here in Canada, that create jobs and create economic activity, which are, as you know, taxed to the tune of $9 billion a year—at least that's what the books tells us.

• 0950

Maybe we will get back to you in a few... I don't want to use the time here.

Mr. Rodriguez (Nickel Belt): Mr. Chairman, perhaps we could just continue from where you left off. I heard the example of Bombardier and the shorts in Ireland or whatever, but what about the Canco example? Mr. Dodge used it in his opening remarks. Canco borrows $100 million, buys shares in the Barbados foreign affiliate, the Barbados affiliate lends the money to an operation in Europe, the operation in Europe sends the interest back to the Barbados affiliate, they sprinkle holy water on it and change it from interest to dividends, and they send those dividends back to Canada. After all of this black magic, no tax gets paid.

Let me leave you right there with that and bring in Revenue Canada. Have you been concerned about that sort of stuff?

Mr. Beith: We've drawn to the attention of Finance information we have as to what's going on in the private sector. That would include this example, which I believe is the second example cited by the Auditor General. As far as I'm concerned, it meets the framework of the law and the tax policy. Barbados is a listed country. The interest coming back to Barbados from Europe is active business income, and the dividends flow into Canada tax free. That's the law and the policy as I understand it.

Mr. Rodriguez: But did you write to Finance to verify that this was the law, or did you write to them with some concerns?

Mr. Beith: We did express concerns as to—

Mr. Rodriguez: What were those concerns? Why would you be concerned if it was the law?

Mr. Beith: We expressed concerns with the problem of FAPI versus active business income, which has been discussed here. The issue is in front of the courts. We've pointed out to them the problem of active business income losses occurring overseas that apparently were being absorbed in Canada, and those are three of the examples that the Auditor General cited. In two of these cases we have challenged that position, and as we always do with Finance, we give them information as to what's taking place in the private sector. The only other comment I might have on this particular example is that we would want to be satisfied that the Barbadian company was in fact resident in Barbados, not just artificially contrived to be resident in Barbados.

[*Translation*]

plupart du temps, réussissent à se soustraire à l'impôt et non pas les sociétés établies au Canada dont les activités ici même créent des emplois et des activités économiques qui, vous le savez, nous donnent des recettes fiscales de l'ordre de neuf milliards de dollars par année, du moins c'est ce qui est comptabilisé.

Nous allons peut-être vous revenir dans quelques... Je préfère ne pas m'attarder pour le moment.

M. Rodriguez (Nickel Belt): Monsieur le président, permettez-moi d'enchaîner sur ce que vous avez dit. On nous a cité l'exemple de Bombardier et de Shorts en Irlande. Fort bien, mais que dire de celui de Canco? M. Dodge l'a cité dans ses commentaires d'ouverture. La société Canco, ayant emprunté 100 millions de dollars, achète des actions à la filiale étrangère de la Barbade qui, à son tour, prête l'argent à une entreprise européenne. Cette dernière transfère à la filiale de la Barbade l'intérêt qui, aspergé d'eau bénite, est transformé en dividendes, dividendes qui aboutissent au Canada. Après tous ces tours de passe-passe, aucun impôt n'est versé.

Permettez-moi de vous laisser là-dessus et de faire intervenir Revenu Canada. Est-ce que ce genre de phénomène vous inquiète?

M. Beith: Nous avons attiré l'attention du ministère des Finances sur les renseignements que nous avons au sujet de l'activité du secteur privé. Nous sommes au courant de l'exemple que vous citez; je crois que c'est le deuxième exemple cité par le vérificateur général. Selon moi, il correspond aux critères de la loi et du régime fiscal. La Barbade figure sur la liste. L'intérêt de provenance européenne qui revient à la Barbade constitue un revenu d'entreprise exploitée activement et les dividendes qui entrent au Canada sont exonérées d'impôt. Voilà qui correspond à la loi et à la politique, à ma connaissance.

M. Rodriguez: Oui, mais avez-vous écrit au ministère des Finances pour vérifier la conformité à la loi ou pour manifester certaines inquiétudes?

M. Beith: Nous avons manifesté des inquiétudes au sujet de...

M. Rodriguez: Quelles étaient ces inquiétudes? Pourquoi vous inquiéter si tout est conforme à la loi?

M. Beith: Nous nous sommes montrés inquiets des difficultés que posent les règles FAPI par opposition à la notion de revenus d'entreprise exploitée activement, difficultés qui ont été soulevées ici. Les tribunaux étudient la question. Nous avons signalé que des pertes de revenus d'entreprises exploitées activement à l'étranger semblent être absorbées au Canada, une situation qui correspond à trois des exemples cités par le vérificateur général. Dans deux de ces cas, nous allons contester la position, comme nous le faisons toujours dans nos rapports avec le ministère des Finances en le renseignant sur les activités du secteur privé. Pour ce qui est de l'exemple que vous avez cité, j'ajouterais simplement que nous devons nous satisfaire que l'entreprise de la Barbade réside bel et bien à la Barbade et n'est pas tout simplement un résident fictif.

[*Texte*]

Mr. Dodge: Mr. Chairman, Mr. Rodriguez's question really goes to. . .there is a very important general international issue here. Because we all have different tax systems and different tax laws around the world, there is an opportunity for the taxpayer sometimes to structure his activities in such a way that no tax is paid on income arising from activity in the country abroad where the activity occurs.

That is a problem with the tax laws of the country abroad. We have similar problems that we try to deal with here to ensure that the appropriate tax is paid to Canada by affiliates of foreign companies operating in Canada, and that's our problem. But if there were no mechanisms whatsoever to flow this around, then every foreign company that wanted to operate in France, for example, would be subject to exactly the same regime. They'd pay some French taxes and they would not pay the tax when it comes home.

• 0955

But there are opportunities to flow income differently, which in fact means that the French government gets less tax revenue on the activity in France, but it does not mean that the Canadian government is in fact losing revenue on that activity. Because we're structured differently, we would not get any revenue anyway.

So the real question comes down to this issue. Do we want, let's say, Bombardier to be in a position where it cannot avail itself of tax planning opportunities that are available to every other foreign company when operating abroad? Do we want them to be in that position? For many years the answer to that has indeed been no. The policy of successive governments in Canada has not been to put them in that position. Our policy has been to work through the OECD, and through other ways, to try to get some better coordination of countries in setting corporate income taxes. But that is a very difficult and not very productive exercise.

Mr. Rodriguez: Let me deal with this example of the Canco and Opco thing. It seems to me that if they're using this Barbados tax haven thing, this connection, why not deal directly? If, for example, the money goes from Canco to Opco, if we have a tax agreement to avoid double taxation, they're either taxed in Europe or they're taxed at home; obviously they're using these dodges to avoid paying taxes in the country. Surely we don't need a nuclear bomb to prevent that sort of abuse. How is the Barbados connection helping Canadians? How is running the money through Barbados into Europe, into the Opco, beneficial to Canadians?

Mr. Dodge: Provided it's not fraudulent—let's make that assumption—and is fully legal, and that any company anywhere in the world that wanted to have an operation in France could indeed deal with it in the same way, provided that's the case, then we are not losing any tax revenue. All we are doing is saying that the Canadian company can operate in exactly the same way as a foreign company would in terms of making that investment.

Mr. Rodriguez: When the Canadian company takes its money and buys equity in a Barbados affiliate, there is a tax advantage here for them to do that. So they're able to make arrangements on their taxes in Canada for that investment in

[*Traduction*]

M. Dodge: Monsieur le président, la question de M. Rodriguez débouche sur une dimension internationale de grande importance. Puisque les lois et les régimes fiscaux diffèrent d'un pays à l'autre, le contribuable a parfois l'occasion de structurer ses activités de manière à ne pas verser d'impôts sur les revenus qui découlent d'une activité à l'étranger dans le pays où cette activité est exercée.

Il s'agit en l'occurrence d'un problème qui concerne les autorités fiscales de ce pays. Nous avons des problèmes analogues et nous tentons de les régler en faisant en sorte que les filiales de sociétés étrangères qui ont des activités au Canada nous versent les impôts exigibles. Cependant, s'il n'y avait pas de mécanismes de transferts, toutes les sociétés étrangères ayant des activités en France, par exemple, seraient assujetties au même régime. L'entreprise verserait des impôts en France et n'en verserait pas chez elle.

Il existe toutefois diverses possibilités de transfert de revenus de sorte que, même si le gouvernement français perçoit moins d'impôts sur l'activité en France, cela ne veut pas dire que le gouvernement canadien en perd. Puisque notre structure est différente, nous ne percevrions pas d'impôts de toute façon.

Le véritable enjeu est donc le suivant. Souhaitons-nous qu'une société comme Bombardier ne puisse pas profiter pour ses activités à l'étranger des occasions de planification fiscale qui sont à la portée de toute autre société étrangère? Durant de nombreuses années, les gouvernements canadiens qui se sont succédé n'ont pas voulu priver nos sociétés de telles possibilités. En collaboration avec l'OCDE et autrement, nous nous sommes efforcés d'assurer une meilleure coordination des régimes d'impôt sur le revenu des sociétés entre les divers pays. Cependant, la tâche est extrêmement difficile et donne relativement peu de résultats.

M. Rodriguez: Je reviens à la charge avec l'exemple de Canco et d'Opco. Si la Barbade est utilisée comme paradis fiscal, pourquoi ne pas traiter directement? Si, par exemple, l'argent est transféré de Canco à Opco, un accord fiscal visant à éviter la double imposition ferait en sorte que l'impôt serait perçu en Europe ou au Canada. De toute évidence, ces sociétés utilisent des échappatoires pour éviter de payer de l'impôt chez elles. Il ne faut certainement pas l'arme atomique pour éviter ce genre d'abus. En quoi la filière de la Barbade avantage-t-elle les Canadiens? Si l'argent passe de la Barbade à l'Europe à l'Opco, comment les Canadiens sont-ils avantagés?

M. Dodge: Supposons que la manoeuvre n'est pas frauduleuse, qu'elle est tout à fait légale et que toute société étrangère qui souhaite exercer des activités en France peut en faire autant. Si tel est le cas, alors nous ne perdons aucun revenu fiscal. Nous reconnaissons tout simplement qu'une société canadienne peut faire exactement la même chose qu'une société étrangère.

M. Rodriguez: Lorsque la société canadienne achète le capital d'une filiale de la Barbade, elle bénéficie au Canada d'un avantage fiscal à cet égard. L'investissement dans la filiale de la Barbade entraîne certaines dispositions fiscales au

[*Text*]

the Barbados affiliate. Having taken that equity, that now becomes the opportunity to lend money into Europe, or whatever, and the interest comes back to them, and it comes back into Canada tax-free.

Mr. Dodge: Mr. Rodriguez, as I said, suppose that facility were not available at all, then there would be no tax on the dividends flowing back directly from France. That's—

Mr. Rodriguez: But just a minute. In France, if we have a tax agreement, they would be taxed in France. I have no problem with that because the reverse happens for us. Their companies here get taxed in Canada. That's why we sign these agreements to avoid double taxation. I have no problem with that.

Did the Auditor General want to say something?

Mr. Denis Desautels (Auditor General of Canada): Yes, afterwards.

Mr. Rodriguez: That's the problem, you see. I see a direct operation. I think these things are set up.

Auditor General, why do you call them tax havens? Why do you use that terminology?

Mr. Desautels: The term tax havens, Mr. Chairman, has been used to describe certain countries where there is either no corporate tax, or some types of transactions are taxed at a very low rate.

• 1000

Mr. Rodriguez: Barbados is one of these.

Mr. Desautels: Barbados usually qualifies under that caption, that's correct.

Mr. Rodriguez: Mr. Dodge, that's the concern I have, and a lot of Canadians have that concern. If we enter into an agreement with France or any other country, it's either taxed there or taxed in Canada. You can't tax them twice, but they see this little dodge—pardon the pun—and that's the long and short of it. They sort of get a Barbados hump and they run it through Barbados and that's how they see it. Surely that can be blocked. You don't need the nuclear bomb of GAAR, which we've found has been dismantled in your arsenal, or somebody took the warhead, because you haven't used it. Surely we can block that, can't we? Isn't that simple to block?

Mr. Dodge: First of all, just on GAAR, remember the Department of Revenue is just now assessing 1989, so for the first time they can use that in assessments. As Mr. Beith pointed out, we have been using it in terms of ruling. It's a new tool. In fact, it's just coming into use.

Provided that the basic structure of the transaction is indeed a structure that fits within our law, even though it minimizes the taxes paid abroad—not the taxes paid here but the taxes paid abroad—then it would not make sense to impose on our companies the necessity to pay more taxes abroad than their competitors.

[*Translation*]

Canada pour cette société. La participation au capital se transforme en possibilité de prêt en Europe, prêt dont l'intérêt revient à la société et revient au Canada libre d'impôt.

M. Dodge: Monsieur Rodriguez, supposons, comme je l'ai dit, que ce mécanisme n'existe pas du tout. Alors, les dividendes rapatriés directement de France seraient également libres d'impôt. C'est...

M. Rodriguez: Je vous arrête. Si nous avons une entente fiscale avec la France, elle serait imposée dans ce pays. Cela ne me pose aucun problème puisque c'est l'inverse qui se passe ici: les sociétés françaises sont assujetties à notre impôt. Nous signons justement ce genre d'entente pour éviter la double imposition. Cela ne me pose aucun problème.

Le vérificateur général voulait-il dire quelque chose?

M. Denis Desautels (vérificateur général du Canada): Oui, après.

M. Rodriguez: Voilà le problème, voyez-vous. Je conçois bien une transaction directe. Je crois que nous sommes devant des mécanismes artificiels.

Monsieur le vérificateur général, pourquoi appelez-vous cela des paradis fiscaux? Pourquoi cette expression?

M. Desautels: Monsieur le président, on parle de paradis fiscaux pour décrire certains pays où il n'existe aucun impôt sur le revenu des sociétés ou bien où certains types de transaction bénéficient de taux d'imposition très faibles.

M. Rodriguez: La Barbade est un de ces pays.

M. Desautels: Vous avez raison. En général, on met la Barbade dans cette catégorie.

M. Rodriguez: C'est ma préoccupation, monsieur Dodge, et celle de beaucoup de Canadiens. Si on conclut une entente avec la France ou avec tout autre pays, les recettes sont imposées dans l'autre pays ou au Canada. On ne peut pas les imposer deux fois. Mais il existe cette finesse fiscale dont certaines sociétés profitent. Les Canadiens voient qu'il existe cette astuce de la Barbade. Il faut pouvoir mettre fin à cela. À mon avis, il n'est pas nécessaire d'avoir recours à la bombe nucléaire qu'est la RGAE pour y arriver. De toute manière, quelqu'un a apparemment désarmocé cette bombe, car vous ne l'avez pas utilisée. Il doit être possible de mettre fin à cette pratique, n'est-ce pas?

M. Dodge: Au sujet de la RGAE, il faut rappeler que le ministère du Revenu prépare en ce moment les cotisations pour 1989 et peut donc s'en servir pour la première fois. Comme M. Beith l'a signalé, nous l'utilisons pour prendre nos décisions. C'est un nouvel outil qu'on commence à peine à utiliser.

Si la structure de la transaction cadre avec notre loi, même si elle réduit au minimum les impôts payés à l'étranger—non pas les impôts payés ici, mais bien ceux payés à l'étranger—à ce moment-là, il ne serait pas raisonnable d'obliger nos sociétés à payer davantage d'impôts à l'étranger que n'en paient leurs concurrents.

[*Texte*]

Mr. Rodriguez: Well, the Auditor General has pointed out that this is only one example, but there are other examples.

The Chairman: Mr. Rodriguez, I'm going to have to step in here. You've had an additional 2 minutes. We try to keep it at 10. I'll come back to you in a few minutes, Mr. Rodriguez.

M. Saint-Julien: Merci, monsieur le président. Une question facile pour monsieur Dodge.

On a reçu les *Comptes publics du Canada* avec les détails des dépenses et des recettes. Est-ce qu'il y a dans ces trois livres-là, des notes ou des commentaires concernant les règles fiscales relatives aux corporations étrangères affiliées, ou des détails sur les dépenses, les recettes ou les pertes (pour le Canada) dans la section «Finance»?

M. Dodge: Non.

M. Saint-Julien: Pourquoi?

Mr. Dodge: What the Public Accounts do is report to you as Parliament how much we have raised and how we've spent it, and whether the accounting of what we have raised and what we have spent accords with general accounting principles. That's what Mr. Desautels audits those accounts on.

M. Saint-Julien: Je sais que dans ces livres-là, il y a une section qui parle des pertes et que dans certains ministères, ou dans certains secteurs, on a perdu des milliers et des millions de dollars à la suite de vols ou par négligence, et ainsi de suite. N'aurait-il pas fallu prévoir tout une partie pour les pertes de recettes que les contribuables ont subies au Canada?

Mr. Dodge: It's your word, the word "loss". The Department of Revenue collects according to the laws that the Parliament of Canada has enacted. That's what is reported on in the accounts.

M. Saint-Julien: Merci.

Je reviens à la question de la page 51, article 2.33, où il est mentionné:

> 2.33 Questions. En 1987, le ministère des Finances a annoncé qu'il étudierait les règles fiscales visant la déductibilité des intérêts, le revenu de source étrangère et les corporations étrangères affiliées. C'est études ne sont pas encore terminées.

En parlant de cette étude, combien de personnes y travaillent actuellement dans votre ministère, et qui est-ce? Est-ce que vous avez donné ça à une entreprise privée, ou est-ce directement des fonctionnaires qui travaillent sur cette étude?

• 1005

Mr. Dodge: I'd ask Mr. Bennett to answer that.

Mr. Ian E. Bennett (Senior Assistant Deputy Minister, Tax Policy Branch, Department of Finance): Mr. Chairman, as I indicated at the committee's hearings on Tuesday, the department did provide an increased effort to focus on the foreign affiliate questions beginning in 1987. As I indicated to Mr. Gray at the time, those studies are ongoing. They do produce results.

We circulated to members this morning a list of amendments that have been made to the foreign affiliate rules since 1987. What we tried to indicate there was that while studies are not complete in the sense of having a bound

[*Traduction*]

M. Rodriguez: Le vérificateur général signale que ce n'est qu'un exemple, mais qu'il en existe d'autres.

Le président: Je dois intervenir, monsieur Rodriguez: je vous ai déjà accordé deux minutes de plus. Nous essayons de nous limiter à des tours de dix minutes. Je vais vous donner un autre tour dans quelques minutes, monsieur Rodriguez.

Mr. Saint-Julien: Thank you, Mr. Chairman. I have an easy question for Mr. Dodge.

We have received copies of the *Public Accounts of Canada* with a detailed breakdown of expenditures and revenues. Are there any notes or comments anywhere in these three volumes on the tax rules governing foreign affiliates, or detailed information on the expenditures, revenues or losses (for Canada) in the "Finance" section?

Mr. Dodge: No.

Mr. Saint-Julien: Why is that?

M. Dodge: Dans les Comptes publics, on fait rapport au Parlement des recettes reçues et des dépenses engagées. On examine également si on a respecté les principes de comptabilité générale en ce qui concerne ces dépenses et ces recettes. C'est selon ces critères que M. Desautels fait ses vérifications.

Mr. Saint-Julien: I know that those books contain a section on losses which states that in some departments or some sectors, thousands and millions of dollars have been lost through theft or negligence, and so on. Shouldn't there have been a whole chapter on the lost revenue suffered by the taxpayers of Canada?

M. Dodge: C'est vous qui avez employé le mot «perte». Le ministère du Revenu perçoit les impôts selon les lois adoptées par le Parlement du Canada. C'est ce qui figure dans les Comptes publics.

Mr. Saint-Julien: Thank you.

I come now to the matter raised on page 46, paragraph 2.33, which reads as follows:

> 2.33 Issues. In 1987, the Department of Finance announced it would review the tax rules on interest deductibility, foreign-source income and foreign affiliates. The reviews have not been completed.

How many people in your Department are currently involved in this review, and who are they? Did you give this job to a private firm, or is the review being done by government employees?

M. Dodge: Je vais demander à M. Bennett de répondre à la question.

M. Ian E. Bennett (sous-ministre adjoint principal, Direction de la politique de l'impôt, ministère des Finances): Comme je l'ai dit à la réunion du comité mardi, monsieur le président, le ministère a intensifié ses efforts pour s'occuper des questions des sociétés étrangères affiliées à partir de 1987. Comme je l'ai indiqué à M. Gray, ces études sont permanentes et elles donnent de bons résultats.

Nous avons distribué aux membres du comité ce matin une liste des amendements apportés aux règles concernant les sociétés étrangères affiliées depuis 1987. Même si nous n'avons peut-être pas de livre relié,—et d'ailleurs nous n'en

[*Text*]

volume, and perhaps won't be because it may be inappropriate or unnecessary to present them that way, they do from time to time yield results and changes in the law that we think are appropriate to protect the revenue basis, as Mr. Dodge says.

The studies and the research are done within. From time to time the department might use outsiders, but for the most part it's done by officials in the legislation division in the department.

M. Saint-Julien: Combien de personnes travaillent-elles sur ce dossier-là?

Mr. Bennett: It would very much depend upon what's happening at the particular time. There are about 25 to 30 people in our legislation division. As well, they work very closely with their colleagues at the Department of Revenue to the extent that as they administer the law and observe what is going on in transactions, they have issues that need to be brought to the department's attention. They participate as well in committees that review the ongoing studies.

M. Saint-Julien: Quel est le budget dépensé, depuis 1987, pour cette étude? Vous avez dit qu'il y a des fonctionnaires; vous avez dit aussi que vous vous adressez à des experts-conseils. Quel est le budget depuis 1987 et pour les années à venir?

Mr. Bennett: I wonder if I might take that as notice and get for you a specific answer to that question. I don't have a number on the top of my head.

If I may, Mr. Saint-Julien, I'll provide that number to you later.

M. Saint-Julien: Si je pose ces questions, monsieur le président, c'est pour avoir plus de détails pour savoir de quelle manière fonctionne cette étude-là. Est-ce qu'il y a des fonctionnaires ou des experts-conseils, en ce qui concerne la pièce 2.1, pour les «Pays désignés»? Cette étude-là comprend-elle les voyages, quand vous envoyez des fonctionnaires dans ces pays?

Mr. Bennett: Maybe I'll ask Mr. Short to answer that question.

Mr. Short: Ordinarily, Mr. Chairman, we do the analysis at home in Canada; however, we are members of the fiscal committee of the Organization for Economic Cooperation and Development, which meets a number of times each year. We take an active part in those deliberations. Indeed, I myself go, along with officials from both the analysis and the legislations branch of Finance, and officials from Revenue Canada. We attend these meetings. The subjects vary, but a common subject members from all countries discuss are developments in international taxation and international relations. We discuss the various approaches they hope to adopt and their various concerns.

During the course of the last year, officials in the Department of Finance have attended I think six meetings at separate times, two of the committee on fiscal affairs, the overseeing body, and four of separate working parties

[*Translation*]

aurons peut-être pas, car il ne sera peut-être pas nécessaire de présenter les résultats de ces études sous cette forme—les études nous donnent de temps en temps certains résultats et sont à la source des modifications à la loi que nous jugeons nécessaires pour protéger l'assiette fiscale, comme l'a dit M. Dodge.

Les études et la recherche sont faites à l'interne. De temps en temps, le ministère a peut-être recours aux services externes, mais en grande partie, le travail est fait par la Division de la législation du ministère.

Mr. Saint-Julien: How many people are involved in these studies?

M. Bennett: Cela dépend beaucoup des autres activités de la Division à un moment donné. Il y a environ 25 ou 30 personnes qui oeuvrent au sein de la Division de la législation. De plus, puisque ces employés administrent la loi et sont au courant de certaines transactions, ils travaillent en étroite collaboration avec leurs collègues du ministère du Revenu pour leur signaler les questions qui méritent l'attention du ministère. Ils participent également aux comités qui examinent ces études permanentes.

Mr. Saint-Julien: How much has been spent on this review since 1987? You said that employees of the Department work on it, but that you used outside consultants as well. What is the budget to date since 1987, and what is the forecast budget for the years ahead?

M. Bennett: Je vous demande de me permettre de prendre cette question en délibéré. Je ne peux vous donner de chiffres précis au pied levé.

Je vous demande la permission, monsieur Saint-Julien, de vous transmettre la réponse plus tard.

Mr. Saint-Julien: The reason I'm asking these questions, Mr. Chairman, is that I want more details on how the review works. Are there government employees or consultants who handle the information containted in Exhibit 2.1, entitled "Designated Countries"? Does the review involve any travelling? Are officials sent to the countries on this list?

M. Bennett: Je vais demander à M. Short de répondre à la question.

M. Short: D'habitude, monsieur le président, nous faisons les analyses ici au Canada. Cependant, nous sommes membres du comité fiscal de l'Organisation de coopération et de développement économiques qui se réunit plusieurs fois par année. Nous participons activement aux travaux de ce comité. Je participe à ces réunions moi-même, avec des fonctionnaires de la Direction de l'analyse et de la législation au ministère des Finances et d'autres de Revenu Canada. Nous participons à ces réunions. Les sujets varient, mais un sujet fréquent dont discutent tous les pays membres concerne les développements du côté de la fiscalité internationale et des relations internationales. Nous discutons des préoccupations des différents pays et des approches qu'ils espèrent adopter.

L'année dernière, les fonctionnaires du ministère des Finances ont participé à six réunions différentes, je crois—deux du Comité des affaires fiscales, l'organisme de surveillance, et quatre des groupes de travail différents créés

[*Texte*]

established to look at various things. Ordinarily, there would be one person attending those meetings. The budget constraints of the government prevent us from sending a large contingent of staff.

• 1010

M. Saint-Julien: Merci. Une autre question pour l'article 2.34, page 51, où c'est marqué:

> 2.34... À maintes reprises, ce ministère a avisé le ministère des Finances de ses inquiétudes au sujet de la loi existante.

Monsieur Dodge, est-ce que votre ministère a reçu de la part du ministère du Revenu national des avis quelconques qui notaient leurs inquiétudes concernant ces échappatoires fiscales, et, si oui, ces avis datent de quelle année? Est-ce possible que vous en ayez reçus dans les années 1970, les années 1980, les années 1990? Combien d'avis avez-vous reçu de Revenu Canada, et de tous ces avis-là, combien ont été acheminés au ministre des Finances?

Mr. Dodge: Mr. Chairman, Ian Bennett's people work, almost on a daily basis, with Bob Beith's people at Revenue. The purpose of these very much ongoing meetings is to have issues floated, either issues that come up because of a particular assessment or issues that come up because of a case that's before the courts, or because of something that's happened.

I certainly cannot give you a precise number, Mr. Saint-Julien. It may be that Mr. Short or Mr. Farber could give you a precise number, or Mr. Beith. But it's a very close, ongoing relationship, as it must always be between the authorities responsible for writing the rules and the authorities responsible for the application of the rules.

Le président: Monsieur Saint-Julien, votre temps est écoulé, si je peux me permettre de vous le rappeler.

M. Saint-Julien: J'avais juste une petite dernière question.

Le président: Oui. Trente secondes?

M. Saint-Julien: Monsieur Dodge, on sait d'après les journaux que les échappatoires fiscales font perdre des milliards en impôt à Ottawa, et que le vérificateur général blâme Ottawa de ne rien faire pour remédier à la situation. À la suite de vos réunions et de votre consultation entre les deux ministères, car le vérificateur nous dit qu'il faut remédier à ce problème, avez-vous tenu le ministre au courant? Donnez-vous des avis au ministre? Le coincez-vous dans un couloir pour lui dire: ça va mal? Est-ce que vous le faites? Et combien de fois?

Mr. Dodge: Well, it is evident by the number of changes we've made to the rules...clearly we go at this on a continuing basis. Where we and the Office of the Auditor General differ somewhat is on the question of whether the fundamental policy underlying this is right or wrong. We think, as successive governments have thought, that the basic policy is correct and that there would not be additional revenues to be gained by changing the basic policy.

Where we firmly agree with the Auditor General, however, is that at the edges—those are not unimportant edges, and I don't want anybody to think from what I'm saying that these are unimportant edges—we have to work

[*Traduction*]

pour examiner différentes questions. En général, une personne assiste à ces réunions. Les compressions budgétaires du gouvernement nous empêchent d'y envoyer tout un groupe d'employés.

Mr. Saint-Julien: Thank you. I have one question on paragraph 2.34, on page 46. We read:

> 2.34... On a number of occasions, NRT has advised the Department of Finance about concerns it has with existing legislation.

Mr. Dodge, has your department received any notification from the Department of National Revenue about its concerns with these tax loopholes? If so, in what year did you receive these notifications? Is it possible that you may have received some in the 1970s, 1980s and 1990s? How many such notices have you received from Revenue Canada, and how many of them have been directed to the Minister of Finance?

M. Dodge: Monsieur le président, le personnel d'Ian Bennett travaille presque quotidiennement avec le personnel de Bob Beith au ministère du Revenu. Le but de ces rencontres permanentes est de discuter des questions qui découlent d'une cotisation particulière, d'un cas qui est devant les tribunaux ou d'un incident qui s'est produit.

Je ne peux pas vous donner de chiffre précis, monsieur Saint-Julien. Peut-être que M. Short, M. Farber ou M. Beith pourraient le faire. Mais il s'agit de rapports très étroits et permanents, ce qui doit toujours être le cas entre ceux qui sont responsables de la rédaction des règles et ceux qui sont responsables de leur application.

The Chairman: I would just like to remind you, Mr. Saint-Julien, that your time is up.

Mr. Saint-Julien: I just had a short final question.

The Chairman: All right. Thirty seconds?

Mr. Saint-Julien: We read in the newspapers, Mr. Dodge, that tax loopholes are costing Ottawa billions of tax dollars, and that the Auditor General blames Ottawa for doing nothing to correct the problem. The Auditor has told us that the problem must be solved. Have you kept the minister informed of the consultations between your two departments? Do you advise the minister? Do you corner him in the corridor to tell him that things are going badly? Do you do that? If so, how often?

M. Dodge: Il est clair selon le nombre de modifications que nous avons apportées aux règles que nous travaillons pour remédier à ce problème de façon continue. Mais nous ne sommes pas tout à fait d'accord avec le bureau du vérificateur général sur la question de savoir si la politique fondamentale qui sous-tend tout cela est pertinente. Nous estimons, comme plusieurs gouvernements l'ont fait, que la politique fondamentale est exacte et que ce n'est pas en changeant la politique fondamentale qu'on pourrait augmenter nos recettes.

Là où nous sommes tout à fait d'accord avec le vérificateur général, cependant, c'est en ce qui concerne les détails—et j'insiste pour dire que ce ne sont pas des détails sans importance. C'est là où nous devons faire preuve de

[*Text*]

with great vigilance to ensure that the law works properly. Our colleagues at National Revenue have to work with great vigilance to ensure that the law is applied. It is a a difficult area, it does require a lot of vigilance, and we at Finance are very open to whatever help we can get and whatever advice we can get from the outside as to how to ensure that the basic policy operates properly.

• 1015

Le président: Monsieur Dodge, vous n'étiez pas là l'année passée, mais en juillet 1991, votre ministère a aboli un groupe d'évaluation des programmes fiscaux. Le Comité, ici, s'est penché sur cette question à plusieurs reprises et je voulais vous poser cette question. Est-ce que d'abolir un programme qui évaluait toutes ces possibilités d'abus a eu l'effet d'affaiblir le travail du ministère des Finances en ce qui a trait à la surveillance et à la bonne administration des lois du Parlement? Est-ce que le fait d'avoir aboli cette division, ou cet organisme, a affaibli votre capacité de travailler de façon à maintenir des programmes efficaces et efficients?

Mr. Dodge: Mr. Chairman, we believe that in fact our ability to deal with the problems and to do the evaluations is stronger now than it was, because we can employ somewhat more efficiently the resources that were in that division by having them embedded in the various parts of Mr. Bennett's branch that deal with the various subjects on a day-to-day basis. Mr. Bennett, perhaps you would like to comment.

Mr. Bennett: I don't have very much to add, Mr. Chairman, but I think the fundamental point was that we certainly weren't doing away with the program, but we were rearranging the resources and the structure of that function within the department. The proof of the pudding will be in the eating. I think we made a commitment to you, Mr. Chairman, and to the committee, that we would proceed in an orderly fashion with an evaluation program, and we have submitted that to you.

Before the end of the year we will be providing a report to you on our progress and the timetable during which the studies and the reports will be made available to you. I think a very brief comment would be that I am quite pleased, as I think are others involved in that function in the department, with the progress that has been made. It will be for you to judge, but I hope you will be pleased as well.

The Chairman: You are telling me that there will be some reports available to this committee, some kind of tangible essays or exercises that we will be able to read. How soon?

Mr. Bennett: Absolutely. Very early in the new year. We would hope to be able to get material to you even before the end of this calendar year. Whether we are going to be able to do that or not is uncertain, but what we will certainly have to you before the end of the year is a letter providing a status report on each and every one of the subjects we agreed we would examine.

The Chairman: Those were the subject-matters that were raised with you by this committee, dealing with all kinds of tax policies, including the GST. Will there be an evaluation of the GST, or has there been one done?

[*Translation*]

beaucoup de vigilance pour nous assurer que la loi fonctionne correctement. Nos collègues du ministère du Revenu national doivent faire de même pour s'assurer que la loi est appliquée correctement. Il s'agit d'une question difficile qui exige une surveillance étroite. Nous, du ministère des Finances, sommes très réceptifs à toute aide et à tout conseil que nous pouvons obtenir de l'extérieur qui nous permettent de nous assurer que la politique de base fonctionne comme elle se doit.

The Chairman: Mr. Dodge, you were not here last year, but in July 1991, your department did away with a fiscal program assessment group. Here, this committee studied this matter several times, and I wanted to ask you this question. Did the fact of terminating a program which assessed all these abuse opportunities weaken the Department of Finance's ability to supervise and ensure the sound management of the Parliament acts? Did the fact of doing away with this division, this organization, undermine your ability to maintain effective and efficient programs?

M. Dodge: Monsieur le président, nous pensons en réalité que notre capacité de résolution des problèmes et de réalisation des évaluations est plus forte aujourd'hui qu'auparavant, car nous pouvons utiliser de façon un peu plus efficace les ressources dont disposait cette division en les incorporant dans les sections de la direction de M. Bennett, qui aborde les sujets sur une base quotidienne. Monsieur Bennett, vous aimeriez peut-être faire un commentaire?

M. Bennett: Monsieur le président, je n'ai pas grand-chose à ajouter, mais l'élément fondamental, c'est que nous ne cherchions certes pas à abolir le programme, mais que nous étions plutôt en train de redéployer les ressources et de restructurer cette fonction au sein du ministère. C'est aux résultats que l'on jugera l'entreprise. Monsieur le président, je crois que nous avons pris un engagement envers vous et le comité, à savoir que nous réaliserions de façon méthodique un programme d'évaluation et nous vous l'avons présenté.

Avant la fin de l'année, nous vous remettrons un rapport sur nos progrès et le calendrier prévu pour le dépôt de nos études et de nos rapports à votre comité. Pour faire un commentaire très bref, je suis assez satisfait, tout comme d'autres personnes concernées au sein du ministère, des progrès réalisés. Ce sera à vous d'en juger, mais j'espère que vous serez également satisfaits.

Le président: Vous me dites que notre comité recevra des rapports, des exposés ou des documents que nous pourrons lire. Quand?

M. Bennett: Au tout début de l'année prochaine. Nous espérons vous faire parvenir de la documentation avant même la fin de l'année civile en cours. Il n'est pas certain que nous soyons en mesure de le faire, mais nous pourrons assurément vous faire parvenir d'ici la fin de l'année une lettre donnant un rapport d'étape sur chaque sujet que nous avons accepté d'examiner.

Le président: Il s'agit des domaines que les membres du comité ont soulevés avec vous, traitant de tous les types de politiques fiscales, dont la TPS. Y aura-t-il une évaluation de la TPS, ou bien une évaluation en a-t-elle déjà été faite?

[*Texte*]

Mr. Bennett: I think what we agreed to do with the committee was that we would now set the framework for an evaluation of the goods and services tax.

Mr. Kempling (Burlington): This is a very complex and complicated matter. We have a volunteer tax system, and at the same time you have an army of people out there as tax consultants advising how we can avoid tax, and people trying to retain as much of their disposable income as possible. It's very complex.

I can recall many years ago when the policy of the Government of Canada was to encourage Canadian businesses to establish particularly in Commonwealth countries—Barbados being one of them, and Jamaica, and Bermuda and so forth. I guess that was the beginning of some of the tax agreements that they had and some of the avoidance that we are looking at. It is really complex.

I walked into my parking garage one day and a lady asked me whether or not you had to pay tax on your earnings on treasury bills. I said all income was taxable. She said, well, in the group I travel with I'm the only one who pays tax on treasury bill earnings. I said, I'm sure they'll get caught—I didn't know the system—somewhere along the line, and she said, one of my friends rolls over $1 million every 91 days and has never paid any tax on his treasury bill earnings.

• 1020

I came back and asked the minister and found that you had in fact put in a regime where they have to relate their social insurance number, and that is way you're going to catch them, which is good. That's been going on for years in this country, and I've never heard it remarked or never read it in the Auditor General's report.

What I want to ask, Mr. Dodge, is can your officials and yourself give an explanation of the categories of foreign earnings that are not taxable abroad and that can be repatriated tax free into Canada, and the rationale for exempting such income from Canadian tax?

Mr. Dodge: Mr. Chairman, perhaps I could ask Mr. Short to reply to Mr. Kempling's question.

Mr. Short: Mr. Chairman, I should emphasize at the outset that the kind of income that can come back to Canada free from corporate tax is only income from what might be called an act of business; income from a bona fide business carried on in another country. Within that there may be three types, three generic categories of income that wouldn't be taxable in the other country. The first is that in the developing countries, that qualifies for an exemption or for special concessions, usually for a limited period of time, under their program for economic development.

Another category could be derived from any country in which the income earned in fact benefits from investment credits or fast write-offs, much like the incentives Canada has that will reduce or eliminate the tax.

[*Traduction*]

M. Bennett: Nous avons convenu avec le comité de définir les paramètres d'une évaluation de la taxe sur les produits et services.

M. Kempling (Burlington): Il s'agit d'une question très complexe. Nous disposons d'un régime fiscal volontaire et, simultanément, il y a une armée de fiscalistes qui donnent des conseils sur la façon d'éviter de payer de l'impôt, et des gens qui essaient de retenir le montant le plus élevé possible de leur revenu disponible. C'est très complexe.

Je me souviens de l'époque lointaine où le gouvernement du Canada avait pour politique d'encourager les entreprises canadiennes à s'établir surtout dans les pays du Commonwealth—notamment la Barbade, la Jamaïque, les Bermudes, etc. Je crois qu'il s'agissait du début de certaines ententes fiscales et que c'est de là que découle en partie le problème de l'évitement fiscal que nous examinons. C'est vraiment complexe.

Un jour que je marchais pour me rendre à mon garage, une dame m'a demandé s'il fallait ou non payer de l'impôt sur les gains tirés de bons du Trésor. J'ai répondu que tous les revenus étaient imposables. Elle m'a répondu que dans le groupe de ses compagnons de voyage, elle était la seule à payer des impôts sur les gains tirés de bons du Trésor. J'ai répondu que j'étais certain qu'ils se feraient prendre à un moment ou à un autre—je ne connaissais pas le système—et elle m'a rétorqué que l'un de ses amis renouvelait un montant d'un million de dollars tous les 91 jours et n'avait jamais payé d'impôt sur les gains tirés de ses bons du Trésor.

À mon retour, j'ai posé la question au ministre et j'ai constaté que vous aviez en effet mis sur pied un régime fondé sur le numéro d'assurance sociale et que c'est ainsi que nous allions attraper les fraudeurs, ce qui est une bonne chose. Les choses se déroulent ainsi au Canada depuis des années, et je n'en ai jamais entendu parler dans le rapport du vérificateur général.

Monsieur Dodge, ce que je veux savoir, c'est si vos fonctionnaires et vous-même pouvez expliquer les catégories de gains étrangers qui ne sont pas imposables à l'étranger et qui peuvent être rapatriés au Canada en franchise d'impôt, et la raison pour laquelle ces revenus sont exemptés de l'impôt canadien?

M. Dodge: Monsieur le président, je pourrais peut-être demander à M. Short de répondre à la question de M. Kempling.

M. Short: Monsieur le président, je tiens dès le départ à souligner que le genre de revenu qui peut être rapatrié au Canada en franchise d'impôt sur les sociétés n'est que le revenu que l'on pourrait dire tiré d'une entreprise active, le revenu d'une entreprise exploitée de bonne foi dans un autre pays. Dans ce contexte, on peut citer trois types, trois catégories générales de revenu qui ne seraient pas taxables dans l'autre pays. La première est le revenu obtenu dans les pays en développement, qui donne droit à une exemption ou à des dérogations spéciales, habituellement pour une période limitée, en vertu de leur programme d'expansion économique.

Une autre catégorie pourrait provenir d'un pays dans lequel le revenu gagné fait en réalité l'objet de crédits d'investissement ou d'amortissement accéléré, un peu à la manière des stimulants dont dispose le Canada pour réduire ou supprimer l'impôt.

[*Text*]

The third large category, I guess, would be income from certain financial intermediaries set up by most multinational companies in order to finance their operations in different countries. Mr. Dodge, I think, alluded to those. If you have a company in France, it's not unlikely that it would be financed at least in part by a financial intermediary established in any one of a number of countries—Barbados, the Netherlands, Switzerland—and that can receive interest, dividends, royalties, other income derived from an act of business. It will not bear the full tax, and in some cases might bear very little or no tax in the country in which the financial intermediary is established. But inevitably it is income that is directly attributable to the carrying on of a bona fide act of business in a country with which Canada has a tax treaty. If it's from a non-treaty country, it does not qualify for the exemption.

I think the major concerns we have with the policy underlying this are that we want to insure that Canadian companies operating internationally are not put at a disadvantage vis-à-vis multinational companies based in other countries. American companies, British, French, German, other EC companies operating internationally are in a position to set up these financial intermediaries and, to the extent possible, benefit from them. For Canada to impose tax at that stage and to regard the financial intermediary as inappropriate would simply place Canadian-based companies at a considerable disadvantage vis-à-vis those from other countries.

• 1025

Now, as to the question—and I guess the Auditor General has asked it—if the income from one of the three generic categories I've mentioned has not borne tax abroad, should it be taxed in Canada, the Auditor General seems to imply in his report that this is a defect. Our position is that it's not a defect, but that it is, and has long been, a very clear part of the policy; certainly, since it dates back to 1972, when the issue was last examined. It certainly dates back long before that, to the time when all dividends from foreign affiliates were exempt.

The major change in 1972 was to restrict that policy to income from an active business and deny it when the income was pure investment income or was from activities carried on in what we call non-treaty countries. I think the basic rationale for that is if the income has not been taxed abroad or has been taxed at a very low rate, and if Canada were to put its tax on at the time the income was repatriated, it would simply guarantee that the earnings would not be repatriated. It would stand as a real and significant barrier to the repatriation to Canada of foreign earnings. For most companies, they would find it to be a much more profitable use of $100 abroad, rather than approximately 50¢ or $50 at home, if we were to impose the tax.

[*Translation*]

La troisième grande catégorie serait le revenu tiré de certains intermédiaires financiers mis sur pied par la plupart des multinationales en vue de financer leurs opérations dans différents pays. Je crois que M. Dodge y a fait allusion. Si vous disposez d'une société en France, il est probable qu'elle serait financée tout au moins en partie par un intermédiaire financier installé dans certains pays—la Barbade, les Pays Bas, la Suisse—et qui peuvent recevoir des intérêts, des dividendes, des redevances, d'autres revenus tirés d'une entreprise active. Ils ne seront pas imposés au plein taux et, dans certains cas, pourraient être très peu taxés, voire pas taxés du tout dans le pays où se trouve l'intermédiaire financier. Mais il s'agit inévitablement d'un revenu imputable directement à l'exercice d'une entreprise active de bonne foi dans le pays avec lequel le Canada a une entente fiscale. Si ce revenu provient d'un pays non signataire, il n'est pas exonéré d'impôt.

Nous cherchons avant tout à nous assurer que la politique sous-jacente, ne désavantage pas les sociétés canadiennes qui oeuvrent sur le marché international par rapport aux multinationales dont le siège se trouve dans d'autres pays. Les sociétés américaines, britanniques, françaises, allemandes ou autres compagnies européennes qui oeuvrent sur les marchés internationaux sont en mesure de mettre sur pied ces intermédiaires financiers et d'en profiter dans la mesure du possible. Si le Canada imposait le revenu à ce stade et considérait l'intermédiaire financier comme inapproprié, cela placerait tout simplement les sociétés canadiennes en net désavantage vis-à-vis de celles des autres pays.

Maintenant, pour revenir à la question—et je suppose que le vérificateur général l'a posée—si le revenu tiré de l'une des trois catégories générales que j'ai mentionnées n'a pas été imposé à l'étranger, devrait-il l'être au Canada? Le vérificateur général semble sous-entendre dans son rapport qu'il s'agit d'une lacune. D'après nous, ce n'est pas une lacune; c'est plutôt depuis longtemps un volet très clair de la politique, qui remonte certes à 1972, date du dernier examen de la question. Cela remonte assurément à bien plus longtemps, à l'époque où tous les dividendes tirés des filiales étrangères étaient exemptés.

La principale modification apportée en 1972 a consisté à restreindre cette politique aux revenus tirés d'une entreprise active, et à refuser de l'appliquer lorsque le revenu provenait de simples placements ou d'activités exécutées dans des pays non signataires. La principale raison d'être de cette mesure est que si le revenu n'a pas été imposé à l'étranger, ou qu'il a été imposé à un taux très réduit, et si le Canada voulait l'imposer au moment de son rapatriement, cela garantirait simplement que les gains ne seraient pas rapatriés. Cela constituerait un obstacle, à la fois réel et important, au rapatriement des gains réalisés à l'étranger. Si l'on imposait le revenu, la plupart des sociétés considéreraient qu'il est beaucoup plus avantageux d'utiliser 100$ à l'étranger qu'environ 50 p. 100, soit 50$ au pays.

[*Texte*]

This probably outlines what I think would probably be the major differences between the Finance view and the Auditor General's view. We regard the ability to bring earnings back from abroad exempt, provided they're from an active business, as appropriate policy and not as a defect in the law. We believe that if we did attempt to change that policy, to subject such dividends to tax, the firms would simply not repatriate foreign earnings. In a sense, that would be unfortunate for Canada and indeed perverse in policy terms, I would think.

The Chairman: Thank you, Mr. Short. I might just continue on that same thought. The finance department seems to place great emphasis on the FAPI rules, and it seems to me that the trick is to turn passive income into active income if you're offshore and to bring it here as active income.

I just wanted to ask you or officials from Revenue Canada how much in FAPI revenues we have actually taxed in the last year, for example. How much FAPI income has been brought to the Canadian treasury?

Mr. Short: Let me begin the answer to this question, but I will then have to turn it over to Revenue Canada people. I can't suggest how much foreign accrual property income has been taxed. Indeed, if very much had been, it would simply be evidence that the rules are not working as intended. They are intended to send a strong message to Canadians, companies and individuals not to locate their investments offshore and attempt to—

• 1030

The Chairman: I understand that, Mr. Short. My point is that the courts in Canada have said that any income, passive or active, is to be determined as income, and I can refer you to a lot of court cases—the most recent one is Canadian Marconi, for example, where the courts have said, income is income, a buck is a buck. You can't tell me exactly how much FAPI has been collected, and I understand that also. My point to you is, if the definition of passive versus active income has been arrived at in Canadian terms—domestically, for small-and medium-sized business, we have a definition for that. We do not have one for the international operators. My question to you is basically, as a taxpayer, how much is FAPI bringing in, if it is bringing in anything? And you say, I don't know, or it's a universe that is difficult to grasp, like a bowl of Jello, I guess.

Mr. Short: Mr. Chairman, I think you've hit the essential point, and it's a point of concern and a legitimate concern, and that is the distinction between income from an active business and other income, so-called passive income. It

Telles sont probablement les principales différences du point de vue entre le ministère des Finances et le vérificateur général. Nous considérons que la possibilité de rapatrier des revenus de l'étranger en franchise d'impôts, pourvu qu'ils soient tirés d'une entreprise active, est une politique appropriée et non une lacune législative. À notre avis, si nous essayons de modifier cette politique, d'imposer ces dividendes, les entreprises s'abstiendront tout simplement de rapatrier les gains réalisés à l'étranger. Dans un sens, ce serait malheureux pour le Canada et, en fait, contrariant au niveau de la politique.

Le président: Merci, monsieur Short. J'aimerais poursuivre un peu dans la même veine. Le ministère des Finances semble mettre beaucoup l'accent sur les dispositions relatives au revenu étranger accumulé, tiré de biens; il me semble que le truc consiste à transformer un revenu passif en revenu actif si vous êtes à l'étranger et à le rapatrier comme revenu actif.

J'aimerais tout simplement poser la question à vos fonctionnaires de Revenu Canada ou à vous-même pour savoir combien de recettes relatives au revenu couru tiré de biens étrangers ont été effectivement imposés l'année dernière, par exemple. Quel est le montant des revenu couru tiré de biens étrangers qui ont été rapatriés dans les coffres du Trésor canadien?

M. Short: Permettez-moi de commencer à répondre à cette question, avant de passer la parole aux fonctionnaires de Revenu Canada. Je ne peux citer aucun chiffre se rapportant au revenu étranger accumulé, tiré de biens qui aurait été imposé. En réalité, si le montant était élevé, cela prouverait tout simplement que les règles ne fonctionnent pas tel que prévu. Celles-ci sont destinées à envoyer un message clair aux Canadiens, tant aux sociétés qu'aux particuliers, afin de ne pas faire leurs placements à l'étranger et de ne pas chercher à...

Le président: Je comprends cela, monsieur Short. Ce que je veux dire, c'est qu'au Canada les tribunaux ont décidé que tout revenu, passif ou actif, doit être considéré comme un revenu; je peux vous référer à un tas d'affaires qui sont passées devant les tribunaux—la plus récente étant celle de Canadian Marconi, par exemple, sur laquelle les tribunaux ont décidé qu'un revenu est un revenu et qu'un dollar est un dollar. Vous n'êtes pas en mesure de me préciser les montants recueillis en vertu des dispositions relatives au revenu étranger accumulé, tiré de biens, et je comprends cela également. Ce que j'essaye de vous dire, c'est que si l'on est parvenu à donner une définition du revenu passif par opposition au revenu actif en termes canadiens—pour les petites et moyennes entreprises, nous avons une définition. Nous n'en avons pas pour les dirigeants de l'entreprises internationales. Ce que je vous demande essentiellement, à titre de contribuable, c'est le montant que rapportent les revenus étrangers accumulés, tirés de biens; rapportent-ils quelque chose? Et vous répondez que vous ne savez pas ou que c'est un univers difficile à saisir, comme une boule de gélatine.

M. Short: Monsieur le président, vous avez mis le doigt sur l'élément capital, et c'est un sujet de préoccupation tout à fait légitime, à savoir la distinction qui existe entre le revenu tiré d'une entreprise active et les autres revenus,

[*Text*]

is true that in the domestic area and for the purposes of the small business deduction, we have clarified that to some extent. But I would like to caution you that we've clarified it in a way that is basically fairly—

The Chairman: Ambiguous.

Mr. Short: No, wrong. That would be wrong. It is in fact fairly generous, because we're dealing with the small business sector. But we've laid out there a specific formula, inevitably arbitrary, as to how you determine how many employees are necessary with respect to an activity, as to whether or not that will be regarded as active or passive. If we were to use that same approach in the international area, I suspect that what we would be doing is simply providing a road map—a very, very clear road map—as to how to beat the system.

Why haven't we placed more emphasis in the international area? We have looked at this. This issue is now front and centre in a fairly important case that is before the courts, and we want to see what the courts have to say on this before we determine what, if anything, should be done. But having gone that far, maybe I could—

The Chairman: Could I just pursue my thoughts and maybe you'll be able to focus on what I'm trying to get at. Finance, with all due respect, seems to want to ensure that passive income is subjected to Canadian tax. I think that's the objective. But in the law, if I quote from the law, it says "are in FAPI rules,"—that is foreign accrued property income—"intended to ensure..." Well, "intended to ensure" and "ensure" are two different things.

This is why I'm saying it's a grey area for me, as a taxpayer, to understand why in one case in Canada you say, I know what a passive income is, I know what an active income is in Canada, but I intend to ensure that I will be able to be clearer on passive income or active income in international terms. I am thoroughly confused, and that's why I asked the question.

Mr. Short: I think it's a legitimate question. I can't give you an assurance, Mr. Chairman, that all passive income is indeed caught up within the scope of the foreign accrual property income rules. It is a grey area.

The Chairman: That's what I said.

Mr. Short: But by using the word "intended" I was intending to convey what the policy was, and the policy is that the exemption that we now accord to foreign earnings should be restricted to bona fide business activities. It should not cover investment-type income that is passive and unrelated to the business carried on.

[*Translation*]

qualifiés de passifs. Il est vrai que sur le plan national, et aux fins de la déduction accordée aux petites entreprises, nous avons clarifié ce point dans une certaine mesure. Mais je tiens à vous mettre en garde car nous l'avons clarifié d'une façon qui est essentiellement assez...

Le président: Ambiguë.

M. Short: Non, c'est faux. Ce serait malhonnête. C'est en fait assez généreux, parce que cela concerne le secteur de la petite entreprise. Mais nous avons développé une formule spéciale, inévitablement arbitraire, sur la façon de déterminer le nombre minimum d'employés qui doivent être engagés dans une activité, pour déterminer s'il s'agit ou non d'une activité active ou passive. Si nous devions utiliser la même approche dans le domaine international, nous ne ferions tout simplement, à mon avis, que fournir un plan—un plan très très clair—sur la façon de tricher.

Pourquoi n'avoir pas mis davantage l'accent sur le secteur international? Nous avons envisagé la question. Elle est au premier plan d'une affaire assez importante actuellement devant les tribunaux; nous voulons savoir ce que les tribunaux vont décider avant de nous engager, le cas échéant. Mais puisqu'on est allé aussi loin, je pourrais peut-être...

Le président: Puis-je poursuivre mon raisonnement, et vous pourrez peut-être vous concentrer sur ce que j'essaye de cerner. Avec tout le respect que je lui dois, le ministère des Finances semble vouloir s'assurer que le revenu passif est assujetti à l'impôt canadien. Je crois savoir que c'est l'objectif visé. Mais dans la législation, et je cite de mémoire, on dit «les dispositions relatives au revenu étranger accumulé, tiré de biens ont pour but de s'assurer...» Il est évident que les deux expressions «ont pour but de s'assurer» et «s'assurent» sont différentes.

C'est la raison pour laquelle je dis qu'il est difficile, en tant que contribuable, de comprendre pourquoi dans un cas on peut dire, au Canada, je sais ce qu'est un revenu passif et je sais ce qu'est un revenu actif; mais j'ai l'intention de m'assurer que je pourrai donner une définition plus claire du revenu passif ou du revenu actif sur le plan international. Tout cela sème la confusion la plus totale dans mon esprit et c'est la raison de ma question.

M. Short: C'est une question légitime. Monsieur le président, je ne peux vous assurer que tout le revenu passif est en fait couvert par la portée des dispositions relatives au revenu étranger accumulé, tiré de biens. Il s'agit d'un domaine mal défini.

Le président: C'est ce que j'ai dit.

M. Short: Mais en utilisant l'expression «ont pour but», je visais à illustrer l'esprit de la politique, une politique selon laquelle l'exemption que nous accordons actuellement aux gains étrangers devrait être limitée aux activités commerciales véritables. Elle ne devrait pas couvrir le revenu de placement qui est passif et n'a rien à voir avec les affaires traitées.

International Taxation

6

Introduction

International taxation is, by its very nature, one of the most complex and difficult areas in any business tax regime – for policy makers, tax administrators and taxpayers alike. A business carrying on activity in multiple jurisdictions is subject to a myriad of taxes and other levies on its various sources of income, and tax rules related to international income – both in design and application – are extraordinarily complex in many jurisdictions. This is a particular concern when, increasingly, small and medium-sized businesses, often lacking internal tax expertise, are expanding into foreign markets and must comply with the rules. The challenge for policy makers is that Canadian tax rules must take account of disparate rules across many jurisdictions, having regard to the significant potential impact that Canadian rules can have on domestic economic growth, job creation and protection of the tax base.

The issue is not a new one; historically, Canada has been a large capital importer and has placed a relatively heavy reliance on foreign investment. However, as noted in Chapter 3, Canada is now a significant capital exporter as well. The stock of foreign direct investment into Canada is substantial, and amounted to approximately $170 billion in 1995 or 20 percent of assets held by Canadian businesses.[1] However, the stock of outbound foreign direct investment by Canadians is also significant (approximately $140 billion in 1995 or 18 percent of total assets held by Canadian businesses), and is rising faster than inbound investment.

Today's global economy is characterized by the ongoing liberalization of trade policies and increasing transborder flows of goods, services, capital and technology. As the world economy becomes ever more integrated, and as business becomes increasingly mobile, the requirement that Canadian tax rules keep pace with international trends increases in importance.

In this Chapter, we provide an outline of some fundamental concepts of international taxation, and an examination of the major policy issues in this area, with a prime focus on foreign direct investment.

Competing Objectives for International Tax Policy

Tax policies related to inbound and outbound investment are driven by two important objectives: domestic economic growth and job creation on the one hand, and protection of the Canadian revenue base on the other. The Committee recognizes that there are often tensions between these two objectives, and there are many situations where there are no obvious "right" or "wrong" answers. A major constraint is the need to balance domestic considerations against international realities over which Canada has little control.
For example, Canadian tax policies that are more onerous than those of other countries can have the effect of discouraging Canadian business activity and, as a result, can dampen domestic economic growth and job creation. Another constraint when examining Canada's

international tax policy is a pragmatic one: experience under the tax systems of other countries indicates that relatively little domestic tax revenue is raised from outbound foreign direct investment, irrespective of the nature and scope of the particular tax regime that is in place.

Against this background, this Chapter sets out concepts of international taxation that are fundamental to understanding the issues, examines the major policy issues related to inbound and outbound investment, and finally, details its conclusions. Throughout the discussion, a major theme prevails: it is the Committee's view that as a matter of general principle, Canadian tax rules should strike a balance between facilitating international trade and investment, and protecting the Canadian domestic tax base.

Canada derives considerable benefit from the presence of Canadian-based multinationals, and we believe that Canada's tax policy should accommodate the expansion of such companies, and their foreign investments, but on terms that are fair to Canada. It is also important that Canada continues to attract foreign investment, with foreign and domestic investors being placed on a similar footing. The Committee believes that if our proposals – to lower corporate income tax rates to make them competitive with those of our major competitors, offset by a broader tax base, which includes international tax measures where appropriate – were to be adopted, the result would be increased domestic investment and job creation, greater fairness and better protection of Canada's domestic tax base.

Fundamental Concepts for the Taxation of International Income

Multinational businesses are important to the Canadian economy. Many Canadian businesses operate throughout the world by investing in foreign operations; similarly, foreign enterprises operate here. Also, investment outbound from Canada can contribute to economic growth and job creation at home.[2] For example, Canadian-owned multinationals often rely on domestic sources of supply, and Canadian managerial talent and operational efficiency, to develop export markets for Canadian products and services.

Investment outside Canada by Canadian multinational businesses can therefore have significant spinoff effects, which contribute directly and indirectly to increased economic activities here. Further, as international trade in goods, services, capital and technology grows, and as both foreign and domestic markets open up to international competition, many Canadian businesses have found that they must expand abroad in order to achieve the necessary size to be efficient in production. In a number of industries, only large multinational enterprises have the ability to be truly competitive in global markets.

As for inbound investment, foreign multinationals operating in Canada provide capital, management and expertise for the development of key sectors of the economy, thereby also contributing to Canada's economic well-being. Inbound investment can also provide important spin-offs for Canadian-owned businesses that supply products and services to foreign multinationals operating here. Foreign companies also have access to financial markets in their home countries, often providing pools of cheaper capital for Canada.

The tax system of the host country where the business is carried on can have an important impact on both domestically owned and foreign-owned multinational operations. Although taxes are not the only factor that influence business decisions, the evidence is clear that they affect decisions of multinationals to invest at home and abroad.[3] In examining Canada's tax system, the Committee concluded that taxation of investment in Canada has had a significant impact in discouraging investments from being made in Canada by both Canadian-owned and U.S. companies.[4]

Canadian tax rules also influence the way in which investments are structured and whether the Canadian domestic tax revenue base is adequately protected. For example, as pointed out in Chapter 3, there has been a tendency for multinational businesses to shift debt financing and associated interest expense into Canada, thereby eroding the tax base.[5] The contrast between multinational and domestic-only businesses in this regard is striking: Canadian multinational businesses have increased their debt as a proportion of assets from 36 percent in the period 1986 to 1988, to 43 percent in the period 1992 to 1994, and foreign-controlled businesses have increased their debt as a proportion of assets from 20 percent to 26 percent in these same periods. In comparison, Canadian-controlled businesses without foreign affiliates slightly reduced their debt financing as a proportion of assets from 33 percent to 32 percent for these periods.

The growth and size of inbound and outbound investments thus raise two important tax policy issues for Canada: the need to strive for a tax system that is neutral for all businesses, foreign or domestically owned; and the requirement that governments protect their tax revenue base in order to support public-sector activities.

Neutrality in Tax Treatment for Businesses in Canada

Neutrality – the equal treatment of businesses in similar circumstances – results in both economic efficiency and fairness. It fosters international commerce and the flow of capital, by not interfering with the decisions of multinational businesses, and it contributes to economic growth and job creation by permitting businesses to seek economic opportunities for investments without being unduly influenced by taxation. As a principle, neutrality, in its fullest sense, implies that:

- Canadian businesses bear similar amounts of taxes on domestic and foreign investments;
- Canadian businesses operating in foreign jurisdictions bear similar amounts of taxes on their foreign investments as competitors operating in those jurisdictions; and
- foreign-owned businesses operating in Canada bear similar amounts of tax as Canadian-owned businesses operating in Canada.

As a practical matter, however, neutrality is a difficult principle to apply at the international level, since different jurisdictions choose taxes with varying rates and bases. The result is that all three conditions described above cannot be achieved simultaneously. For example, if foreign tax burdens are less than Canada's, payment by Canadian multinationals of taxes at the Canadian rate on their foreign investments may ensure tax neutrality between domestic and foreign investments, but at the same time, cause Canadian businesses to be more highly taxed than companies operating in foreign jurisdictions. Neutrality in the international context, therefore, can never be absolute. The best possible policy objective for Canada is to minimize economic distortions as much as possible.

Neutrality at the International Level

Varying concepts of neutrality are employed when assessing issues of international taxation. Several of the most important include the following:

Global Versus National Neutrality

Global neutrality implies that businesses should pay similar rates of Canadian and foreign tax on income derived from investments in Canada or abroad and regardless of the nationality of the owner operating in Canada. Under global neutrality, foreign taxes paid by businesses would be credited against Canadian taxes owing, so that the total rate of foreign and Canadian tax on income paid on foreign investments is no greater or less than on domestic investments. Similarly, foreign governments would allow their resident multinationals to credit Canadian taxes against the foreign governments' taxes owing on income derived from Canada.

The concept of global neutrality can be contrasted with national neutrality. National neutrality implies that domestic taxes should apply at the statutory rates of the investor country, irrespective of the geographic source of the income, and that foreign income taxes should only be deductible, in the investor country, as an expense of doing business in another country, rather than being treated as a credit against taxes. With deductibility, however, there is an element of double taxation that results in higher taxes on foreign compared to domestic operations. This can impede the efficiency of Canadian multinational businesses.

Most countries have accepted the concept of global neutrality, in that they allow foreign income taxes to be credited against domestic taxes on income earned abroad, or by exempting foreign income from further taxation in the home country when profits are repatriated in the form of dividends. Given Canada's desire to foster trade in international markets, the Committee believes that global neutrality for Canadian businesses is a more appropriate principle to follow.

Capital Export Neutrality

Capital export neutrality is achieved when foreign-source income is subject to the same effective rate as Canadian domestic income. This leaves Canadian multinationals indifferent, from a tax perspective, as to whether they invest in the Canadian domestic market or in foreign markets. In theory, capital export neutrality implies that Canadian tax would be paid on income taxed at lower rates abroad or, alternatively, result in the provision of refundable Canadian credits to bring down foreign taxes to the level of Canadian tax.

Capital Import Neutrality

Under capital import neutrality, a foreign investor is subject to tax at the same level as domestic companies in the country in which the business is carried on, contributing to international competitiveness by ensuring that foreign-source income is taxed in a particular country at the same rate as income earned by businesses owned by residents of that jurisdiction. From a Canadian perspective, capital import neutrality also implies that Canadian taxes on inbound investment should be similar to those on domestic-owned businesses – there should be no discrimination between foreign and domestic businesses.

Conflicting Demands of Neutrality

These various "neutralities" can conflict with each other. In particular, international competitiveness for Canadian businesses operating abroad can conflict with capital export neutrality, since it implies that domestic and foreign investments of Canadian multinationals may be taxed at different rates. The Committee recognizes that there are conflicts between capital export and capital import neutrality when foreign taxes are less than Canadian tax on income earned from abroad. An appropriate balance must be achieved. Canada derives benefits from the operation of multinationals here. The full application of capital export neutrality could impair their competitiveness abroad or, even worse, discourage companies from operating here. On the other hand, if Canadian businesses earn income that bears little or no tax in foreign jurisdictions, multinationals may be encouraged to locate production in foreign jurisdictions.

Fairness and Revenue Protection

The unavoidable outcome of taxing multinational businesses is that Canada is obliged to share the tax revenue raised from their activities with other national governments. Taxes paid by multinationals to Canadian governments contribute to meeting the cost of public activities that benefit all of us, including Canadian and foreign-owned businesses operating here. It is in Canada's interest, therefore, to protect its share of the tax base of income earned by Canadian and foreign multinationals from operations in Canada.

The sharing of tax revenues among national governments raises the issue of fairness – jurisdictions, either of source (where the production or delivery of goods and services takes place) or of fiscal domicile (where the business enterprise is resident or incorporated), are both entitled to tax the income earned by the enterprise. The country of source taxes the income earned in its jurisdiction to ensure that foreign businesses operating there share in the cost of public goods and services. The country of domicile may also choose to tax the foreign-source income of its residents to ensure that they pay a similar level of tax on all sources of income, domestic or foreign, in the interests of efficiency and fairness. In this event, and consistent with neutrality, a credit for foreign income taxes is often provided to recognize that such income has borne tax elsewhere and should not be subject to double taxation.

Challenges in Implementing the Principles of Neutrality and Revenue Protection

While the Committee regards both neutrality for Canadian businesses and revenue protection as crucial to economic growth and job creation, we are also aware of the difficulties inherent in implementing policies that will achieve these goals. National governments have varying revenue requirements and different views on what constitutes an appropriate sharing of business taxes. Every government chooses its own tax levels and tax mix, as well as the rules for defining what income is subject to tax. In the absence of worldwide uniform corporate taxation, full neutrality for all businesses operating in all countries is impossible to achieve. What Canada can do, however, is be fully aware of the impact its system has on international business, and take measures to ensure that Canada and Canadians benefit to the greatest extent possible from these economic activities.

For example, high levels of tax (relative to other jurisdictions) on foreign and domestic investments can affect the competitiveness of Canadian multinationals, and can reduce the economic benefits that Canadians derive from the Canadian multinational's activities. Similarly, high levels of Canadian tax on foreign businesses operating in Canada can discourage investments here. Also, international tax structures that result in the erosion of the Canadian tax base – for example, a tendency to borrow in Canada for foreign direct investment, rather than in the foreign country in which the investment is being made – can result in the need to increase taxes on other taxpayers or reduce public expenditures.

As noted, Canada has historically been reliant on significant levels of foreign direct investment from other countries. While high levels of Canadian tax can impair the flow of capital to Canada, low levels of Canadian tax on Canadian income may be offset by higher taxes paid by foreign parent corporations to their foreign governments where the foreign country applies the credit system, as do the United States, the United Kingdom and Japan. The interaction of the Canadian tax system with those of other countries is thus an important factor to keep in mind when developing Canadian policies for the taxation of inbound investment.

Despite recognition that neutrality is, in theory, a desirable objective, most, if not all, countries have elements within their tax systems that create economic distortions. As well, every government seeks to protect what it regards as its rightful share of the revenue base. In this regard, Canada is faced with the same constraints as its neighbours and trading partners: the Canadian tax regime must balance the goals of neutrality and revenue protection while being neither overly generous nor restrictive vis-à-vis the tax systems of other countries.

What Income is Liable to Canadian Federal Income Taxation?

Canadian federal income tax is generally levied on the worldwide income of persons resident in Canada (subject to credit or deduction for foreign taxes in respect of foreign-source income), and on certain Canadian-source income of non-resident persons. However, a Canadian corporate shareholder is generally not taxable on dividend income received as a result of foreign direct investment in countries with which Canada has entered into a tax treaty.

As discussed in Chapter 2, business and investment income may be earned by corporations, individuals, trusts or partnerships. A corporation is generally considered to be resident in Canada if it is incorporated in Canada, or if its central management and control is located here. The residence of an individual is a question of fact, but includes an individual who is living in Canada on a permanent basis. The residence of a trust is generally determined by the residence status of its trustees. Finally, a partnership is an entity that flows through its income to its partners, rather than a taxpayer itself.

A non-resident of Canada is subject to tax on certain Canadian-source income, under one of two regimes. First, a non-resident who is employed in Canada, carries on business in Canada or disposes of certain types of Canadian property, is subject to tax on net income from these sources, based on the general Canadian tax rates. Second, non-residents may be subject to withholding tax at a flat rate with respect to certain types of income, generally of a passive nature, such as interest, dividends, rents and royalties that are paid or credited by persons resident in Canada. The rate of tax on such income is 25 percent, generally on the gross amount paid or credited. As discussed further below, this rate is often reduced under tax treaties, and such treaties may also reduce the tax liabilities of non-residents carrying on business in Canada or deriving other taxable income from this country.

These Canadian rules establishing liability for tax are generally consistent with those followed by other major countries, although the detailed rules do, of course, vary considerably across countries.

The Role of International Tax Treaties

The bilateral income tax conventions (usually referred to as tax treaties) that Canada has entered into with other countries play an important part in facilitating cross-border trade, income and capital flows, and generally result in a more globally neutral tax regime for investment and business transactions between Canada and its treaty partners. Canada has one of the most extensive tax treaty networks in the world, with about 60 treaties in force, and a number of others under negotiation.

Tax treaties modify the taxation of cross-border income in a number of significant ways, primarily to reduce double taxation. For example, a resident of a treaty country is generally not taxable on income from a business carried on in the other country, unless the business is carried on through a fixed place of business. To minimize the potential for double taxation, countries may agree to either provide a credit for foreign income taxes, or an exemption for dividends received from foreign direct investment in the other country.[6] Also, under most treaties, capital gains realized by residents of one country from assets in the other are generally exempt from tax in that other country, except for real property interests and certain other assets. Most treaties provide for significant bilateral reductions in the rate of withholding tax applicable to income such as interest, dividends, rents and royalties that are paid to residents of the other country. Tax treaties also provide for an exchange of information between the revenue authorities of the two countries to assist in administration and enforcement, as well as dispute-resolution procedures to resolve issues of double taxation, including cross-border transfer pricing issues.

While Canada has tax treaties with almost all of our important trading and investment partners, we have generally not negotiated treaties with tax havens (generally those countries without significant domestic income taxes). However, a number of countries with which we have treaties have domestic systems that do not tax some sources of income, or do permit some types of income or entities to be taxed more favourably than the domestic norm.

Taxation of Foreign Income of Canadian Investors

In this section, we review and examine the alternatives for taxation of foreign-source income earned by Canadian-based multinational businesses from foreign direct investment. Such income is generally subject to tax in the foreign country; however, the home country of the investor will often also assert a right to tax the same income. The difficult policy issues to be addressed include the extent to which double taxation is to be avoided, as well as whether, and to what extent, restrictions should be placed on deductions incurred in the investor's home country that relate to business activities carried on abroad. After an analysis of these issues, we then turn to the taxation of passive income from foreign investment.

Accrual, Deferral and Exemption Methods

There are various alternatives for the recognition of income earned in an investor's home country from foreign direct investment. For example, active business income earned by a foreign subsidiary of a parent company could be taxed on a current basis in the home country (the **accrual** method). As a second alternative, income could be recognized as it is distributed as dividends to the parent company and subject to tax in the home country at that time. This approach, referred to as the **deferral** method, results in the recognition of taxable income in the home country being deferred as long as profits are retained or reinvested abroad. A third alternative is to **exempt** income earned abroad from home taxation, meaning that income will only bear foreign tax. The tax systems of many countries incorporate elements of all three methods, adopting the approach considered most appropriate to the particular nature of different sources of income.

To avoid double taxation of income, countries have generally followed either the deferral method with a credit, or the exemption method. Under the deferral method with credit, which is consistent with capital export neutrality, countries such as the United States, the United Kingdom and Japan tax business income from foreign direct investment, and then provide credit for qualifying foreign taxes up to the amount of their domestic tax liabilities. Under this method, such income is, in theory, ultimately subject to tax at the greater of the statutory rates of the foreign jurisdiction(s) and that of the home country of the investor. Under the exemption method, income derived from foreign direct investment is exempt from taxation in the home country and thus only subject to tax in the country where the investment takes place. The exemption method can be viewed as proxy for the deferral method with credit, on the assumption that the income in question has been subject to foreign tax at a rate comparable to that which would have applied in the home country. Alternatively, the exemption method can be viewed as encouraging international competitiveness, by ensuring that home country investors operating in foreign jurisdictions bear similar tax to businesses owned by residents of that jurisdiction, consistent with capital import neutrality.

An Overview of the Present Canadian System[7]

The Canadian system, consistent with most countries, contains elements of all of the three methods described above. Foreign branch income is taxed on an accrual basis, as is "foreign accrual property income" (FAPI), both with relief for foreign taxes. In the case of the earnings of foreign branches of Canadian companies, accrual taxation is consistent with the basic principle that the world income

of Canadian residents should be taxed in Canada. In the case of FAPI – which, as described below, includes passive investment income of foreign affiliates – accrual taxation serves to protect the Canadian tax base, by preventing Canadians from shifting mobile passive income to low tax jurisdictions. On the other hand, dividends received by a Canadian corporate shareholder out of active business income of a foreign affiliate are only subject to recognition in Canada as received, and Canada uses both the exemption and deferral methods in this regard.

A foreign affiliate is generally defined to be a foreign corporation in which the Canadian taxpayer owns, directly or indirectly, at least 10 percent of any class of shares (or more specifically, at least 1 percent of any class of shares, provided the taxpayer, together with related persons, owns, directly or indirectly, at least 10 percent of any class). Active business income earned by a foreign affiliate in a treaty country is included in what is called exempt surplus, and dividends out of exempt surplus paid to a Canadian corporate shareholder are deductible in computing its taxable income, irrespective of the foreign tax burden that has been incurred. Active business income earned by a foreign affiliate in a non-treaty country is included in taxable surplus and, where a dividend is received by a Canadian corporation out of taxable surplus, deductions (adjusted so as to be equivalent to a credit) are available with respect to both the underlying foreign tax applicable to the earnings being distributed, as well as any foreign withholding tax applicable to the dividend.

Canada's approach is consistent with those of other major investor countries. Japan, the United States and the United Kingdom have opted for the deferral method with a credit in respect of income remitted from foreign subsidiaries. However, many other countries, particularly in Europe, use the exemption method. Certain countries, such as Australia and Germany, operate both systems, as does Canada. Canada provides exemption in the case of dividends received by foreign affiliates in treaty countries, and uses the deferral method with the equivalent of a credit in the case of dividends from foreign affiliates in non-treaty countries.

Alternatives for Consideration

In common with other countries, Canada generally recognizes the active business income of foreign affiliates when it is received as dividends. An alternative would be for Canada to adopt the accrual system, whereby income from all foreign direct investment (whether earned by foreign affiliates or by foreign branches) would be taxable in Canada on a current basis, with credit given for any applicable foreign tax. While this would ensure that domestic and foreign-source income was taxed currently at comparable rates, it would put Canadian business enterprises at a major competitive disadvantage vis-à-vis all of Canada's major trading competitors, none of which has adopted this approach. For this and other reasons, it is the view of the Committee that accrual taxation of all sources of income is not a viable option.

Other methods that might be considered as alternatives to the existing Canadian regime are described below.

The Full Exemption Method: Canada could implement a full exemption system, under which all dividends received by a Canadian corporate shareholder out of the active business income of a foreign affiliate would qualify for exemption, irrespective of whether the business operations were carried on in a treaty or non-treaty country. Such a change might be based, in part, on the fact that Canada has a very extensive tax treaty network, which includes virtually all of our major trading and investment partners. With the exception of industries that operate primarily in developing countries, a very significant portion of active business income of foreign affiliates already constitutes exempt surplus. Also, dividends are rarely paid to Canadian corporate shareholders out of taxable surplus, if this would result in additional Canadian tax. Implementing a full exemption system should accordingly result in little loss of Canadian tax revenue, while significantly reducing administrative and compliance costs, by eliminating the requirement to maintain detailed computations of exempt and taxable surplus balances.

One significant problem, however, is related to capital gains. If Canada were to adopt a complete exemption system, under which both dividends from foreign affiliates, and capital gains from the disposition of shares of foreign affiliates, were exempt from tax in Canada, there would be an incentive to seek opportunities for investments in foreign markets with potential for capital appreciation, to the detriment of similar investment opportunities in the Canadian domestic market. If, on the other hand, capital gains from the disposition of shares of foreign affiliates did not qualify for exemption, there would be a continuing requirement to maintain detailed computations of surplus balances of foreign affiliates (or to enact complex anti-surplus stripping provisions to prevent capital gains from being turned into exempt dividends), which would eliminate much of the simplification that would otherwise be achieved by full exemption. Finally, it might be argued that a complete exemption system, even for dividends, is overly generous, when compared with the regimes of many of Canada's major trading and treaty partners.

The Deferral Method with Crediting: As an alternative to the exemption approach, Canada could follow a full deferral method with crediting, under which all active business income earned by foreign affiliates would be included in taxable surplus. All dividends would be taxable when received by Canadian corporate shareholders, with relief in respect of applicable underlying foreign taxes and withholding taxes. Under the deferral method, relief for foreign taxes might be computed on a global basis; alternatively, more detailed rules could be put in place requiring separate calculations for specific sources of income.

It can be argued that converting to a full deferral system would not add significant additional complexity to the Canadian tax system. Canadian corporate taxpayers have been required, since 1972, to maintain computations of surplus account balances. Accordingly, and after a transitional period, all active business earnings might flow solely into the taxable surplus account. However, experience in other countries that operate under the deferral with credit method has proven that the rules do, invariably, become extraordinarily complex, resulting in a significant increase in administrative and compliance costs.[8] While it is true that Canadian rules for the computation of taxable surplus have been in place for many years, taxable surplus dividends are rarely paid to Canada and, if Canada implemented a full deferral with credit method, the rules would have to be considerably more intricate and sophisticated than they are at present, including dealing with important differences in the timing of the recognition of income in foreign countries and Canada.

It is unlikely that the implementation of a deferral with credit method would, by itself, result in any significant revenue gain to the Canadian treasury. Experience under the tax systems of other countries, notably the United States, indicates that relatively little domestic tax is raised with respect to active business income from foreign direct investment under the deferral systems.[9] Corporations simply tend not to repatriate foreign earnings if the action involves significant domestic tax, or implement planning measures to maximize the availability of foreign tax credits. Finally, entitlement to benefits under the exempt surplus system is embedded in Canada's tax treaty network, and abandoning the system in favour of the deferral with credit method might require either a renegotiation of many of Canada's tax treaties, a process that would take many years, or a change to Canadian domestic legislation, which would effectively override Canada's existing treaty obligations.

The High-tax Method: An additional alternative is a hybrid of the deferral and exemption approaches which would maintain the existing distinction between active business income earned in treaty and non-treaty countries, but would add an additional requirement that income earned in a treaty country would only be included in exempt surplus if the income met a "high-tax" requirement. For example, there might be a requirement that the income bear an effective tax rate equal to a certain, prescribed amount, or a rate equal to a certain percentage of the Canadian corporate income tax rate.

Under the hybrid approach, the nominal or statutory rate in the foreign country should presumably not be relevant, as this would not reflect the actual tax burden that the income in question has borne. Rather, what would be important is the effective tax rate (taxes divided by income) that each particular foreign affiliate is actually paying on its various sources of income. As a result, and similar

to the deferral with credit method, complex rules would be required for purposes of determining both the income base (either under Canadian tax rules, foreign tax rules, or some combination) and the amount of taxes being paid. These rules would have to deal with various issues such as the impact of loss carry-overs, whether computations are to be done on a company-by-company or on a group basis, the impact of tax credits and other foreign tax incentives, and foreign exchange issues. Perhaps most importantly, a high-tax approach limits the ability of Canadian taxpayers to aggregate taxes paid on all sources of foreign business income, as is the case under a deferral with credit method with a global tax credit. This would place Canadian companies at a disadvantage relative to competitors from countries such as Japan, the United States and the United Kingdom, which allow more flexibility for companies to average low- and high-taxed sources of income.

In summary, with only modest anticipated revenue gains to the Canadian treasury, the high-tax method could put Canadian multinationals at a competitive disadvantage and could result in substantial additional complexity.

Conclusions and Recommendations

On balance, it is the Committee's view that the existing regime – providing exemption in the case of active business income earned by foreign affiliates in treaty countries, deferral with credit in the case of such income earned in non-treaty countries, and accrual with credit or current taxation with respect to income earned by foreign branches and FAPI – is fundamentally sound and should be maintained. The alternatives in the form of a total deferral system or a hybrid, high-tax system, would introduce significant new complexity and would discourage some foreign direct investment by Canadian multinationals, with little anticipated revenue gain for Canada. At the same time, however, the Committee believes that there are certain elements of the existing system that weaken its integrity and should be addressed.

RECOMMENDATION

It is the Committee's view that the ownership threshold for access to the exempt and taxable surplus system (generally, direct or indirect ownership of at least 10 percent of any class of shares of the foreign affiliate by the Canadian taxpayer and/or by related parties) is low, both in absolute terms and by international standards. For example (and subject to the possible application of a specific anti-avoidance provision), the ownership of at least 10 percent of a special class of preferred shares, even if *de minimis* in amount, is sufficient to allow access to the system. This may allow certain tax avoidance arrangements, where taxpayers can invest in preferred shares and can access the exempt surplus of otherwise unrelated taxpayers.

We recommend that the present definition relating to foreign affiliates be strengthened, so that only foreign companies in which Canadian corporations have a significant equity interest can be considered as foreign affiliates.

For example, the ownership threshold might be increased to require the ownership (either directly or indirectly, and by the Canadian taxpayer and/or by related parties) of at least (i) 10 percent of shares having full voting rights under all circumstances, and (ii) 10 percent by value of all outstanding shares. At the present time, there is an interrelationship between the rules defining foreign affiliates, and those defining controlled foreign affiliates that are subject to the FAPI rules. The Committee does not consider it appropriate to loosen the scope of the FAPI rules. We suggest, therefore, that the present definition related to controlled foreign affiliates be maintained.

A second weakness in the current regime concerns the manner in which income from foreign affiliates is treated. The exemption method can be argued to act as a proxy for the more complex credit method, on the assumption that the income of the foreign affiliate has borne foreign taxes at rates roughly equivalent to the Canadian rate (although the exemption method can also be viewed as encouraging international competitiveness under the principle of capital import neutrality). However, with the increasing expansion of the Canadian tax treaty network, more and more situations are arising – typically in the context of interaffiliate transactions involving the receipt of passive income such as interest, rents and royalties – where income earned in treaty countries is subject to low effective tax rates under special rules applicable to such income. It is the Committee's view that permitting exempt surplus treatment for such income tends to encourage tax-planning mechanisms that erode the Canadian tax base. Accordingly, we recommend later in this Chapter that interaffiliate income earned by certain low-tax entities in treaty countries be included in taxable surplus.

Interest Expense Related to Foreign Investment of Canadian Investors

Background

Prior to the tax reform of 1972, interest on funds borrowed by Canadian corporations to invest in both Canadian and foreign subsidiaries was non-deductible. Taxpayers used tax-planning techniques to avoid the application of the rule (for example, "cash damming," with cash from operations being accumulated in a separate account and ultimately being used to make investments in Canadian or foreign subsidiaries, and with borrowed funds being used to pay day-to-day operating expenses). At times, such planning was effective, although the rule did have the effect of reducing borrowings in Canada.

Since the 1972 reform, interest has been deductible by Canadian companies on funds borrowed to invest in both domestic companies and foreign affiliates. At the time, it was argued that this modification to the rules would put Canadian companies in the same position as foreign corporations in claiming interest deductions to invest in other companies. While interest deductibility resulted in a significant reduction in the Canadian tax revenue base, it also resulted in a significant decrease in the after-tax cost of such borrowing, and allowed Canadian corporations to be more competitive in making investments, both in Canada and abroad.

Other Countries' Approaches

There is no international norm with respect to deductibility of interest on funds borrowed for foreign direct investment. Some countries (such as Canada) provide for full interest deductibility, while others have direct or indirect limitations. For example, Australia and the Netherlands deny interest deductibility on funds traceable to foreign direct investment, if the dividends from the investment qualify for the exemption method. In certain European jurisdictions, interest expense is effectively denied in a particular year, but only to the extent of exempt dividends received in that year. Finally, some countries, such as the United States, require the apportionment of interest expense between domestic and foreign-source income using a formula approach, where the amount of interest expense allocable to foreign-source income, while still deductible, serves to reduce the entitlement to foreign tax credits.

Alternatives for Consideration

As discussed earlier, while Canada uses both the exemption and deferral methods (exempt and taxable surplus) in respect of foreign direct investment by Canadian corporate shareholders, in practice, dividends are rarely received out of taxable surplus; thus the exemption system is the norm.

Under the exemption system, income repatriated as dividends to Canada bears no domestic tax, meaning that such income is only subject to foreign tax. Against this background, it is arguable that, as a general proposition, the tax system of the foreign country in which the business activities are carried on (and not the home country from which the investment is made) should bear the preponderance of the cost of financing the foreign business activities.

On the other hand, it can be argued that by restricting the exemption system to tax treaty countries (and assuming that Canada would only negotiate tax treaties with countries that impose a reasonable level of taxation), the exemption system serves as a proxy for foreign taxes that have been paid, and is also consistent with capital import neutrality. This suggests that interest deductibility in Canada should not be objectionable from the viewpoint of global neutrality. Furthermore, exempt surplus may be ultimately taxed in Canada when it is distributed as dividends to individuals or realized as capital gains.

Why Businesses Shift their Borrowing Costs to Canada

In addressing the clear differences between these two views on interest deductibility, it must be kept in mind that Canadian corporations frequently have a choice as to whether to borrow funds in Canada for foreign investment, resulting in interest deductions to the Canadian corporation itself, or to cause the foreign affiliate to borrow the required funds. Financing choices are influenced by a number of non-tax considerations; however, tax issues are often critical to the decision as to whether the funds should be borrowed by the parent company or by the foreign affiliate. As noted above, in recent years, and for a number of reasons, it appears that a disproportionate amount of borrowed funds has been incurred in Canada rather than abroad, resulting in a significant reduction of the Canadian domestic revenue base. As discussed earlier in this Chapter and Chapter 3, Canadian multinationals have significantly increased their borrowings of debt in Canada since the period 1986 to 1988. The Committee sees a number of factors leading to this trend.

First, and as discussed in Chapters 2 and 3, the combined federal and provincial corporate income tax rate for non-manufacturing activities in Canada is above the corresponding tax rate in a number of other countries. This creates an incentive for Canadian corporations to incur interest expense in Canada, where a current deduction may be obtained against income taxed at relatively high rates, leading to an increase in debt financing of multinational operations in Canada.

Second, many tax treaty countries provide domestic tax incentives that can often significantly reduce the tax burden in the foreign country. As the amount by which the Canadian rate exceeds those of other countries' increases, so does the incentive to claim interest deductions in Canada.

Third, tax changes introduced by other countries in recent years, most notably the United States, have tended to restrict the deduction of interest costs relating to foreign investment, inducing U.S. and other foreign corporations to shift such costs to their subsidiaries in other jurisdictions such as Canada.

Finally, funds may be borrowed in Canada to invest in a foreign affiliate in situations where losses are expected in the affiliate, such that the foreign affiliate will not be in a position to obtain an immediate deduction for the interest expense.

Weighing Alternatives – Factors to be Considered

In considering possible solutions to tax base erosion, the Committee is fully aware of the potential adverse impact on the amount of foreign direct investment by Canadian companies that could result from a restriction of interest deductibility. We pointed earlier to a number of studies that suggest that foreign direct investment has a beneficial effect on the investor country. It can be legitimately argued that interest deductibility is a reasonable price for Canada to pay to allow Canadian multinationals to continue to expand and compete in the global marketplace. A case can also be made, however, for

the view that a restriction of interest deductibility would affect, for the most part, the manner in which foreign investment is financed, rather than its absolute amount. For example, in most cases, funds that might otherwise have been borrowed by a Canadian parent corporation could be borrowed directly by its foreign affiliates (supported, if necessary, by a parent company guarantee).

The Committee weighed the arguments, and evidence for and against interest deductibility on funds borrowed to invest in foreign affiliates. It is our view that the current rules have resulted in a substantial erosion of the Canadian domestic revenue base, and that other Canadian taxpayers are paying more tax to make good on the shortfall. We are convinced that lower corporate income tax rates, offset by a broader tax base, including measures relating to the taxation of foreign-source income, where appropriate, will encourage domestic investment in job creation, improve fairness, and protect the Canadian domestic revenue base. A restriction of interest deductibility on funds borrowed to invest in foreign affiliates would be one such international tax measure. We also believe that, generally, the tax system of the foreign country in which the business is being carried on should bear the preponderance of the cost of financing the foreign business activities.

For these reasons, the Committee later recommends that interest expense be restricted on borrowed funds related, directly or indirectly, to investments in foreign affiliates. We appreciate that such a rule could, in certain circumstances, penalize small start-up companies, which will only be able to obtain financing directly in Canada, and we accordingly also recommend an exemption for up to $10 million of borrowings related to investments in foreign affiliates, to be shared among members of an associated group.

In arriving at its conclusion that interest expense should be restricted, the Committee considered an alternative approach of continuing to allow full interest deductibility on all borrowed funds used to invest in foreign affiliates and, at the same time, converting to a total taxable surplus regime (the deferral with credit method), described further above. Under such an approach, it would be most appropriate for interest expense to be allocated between foreign and domestic-source income for purposes of computing foreign tax deductions available in Canada, consistent with the system used in the United States. However, this alternative would, of necessity, involve a long and difficult transitional period, and would result in a regime for the taxation of foreign-source income that would be both exceedingly complex, and could act as a severe impediment to taxpayers seeking to invest and expand in foreign markets.

Restricting Interest Expense Deductibility: Methods of Allocation

If, as we propose, rules are introduced to restrict interest expense on funds borrowed in Canada to invest in foreign affiliates, an important issue to be resolved is the method to be used for determining the amount of expense attributable to foreign (as opposed to domestic) investment. The Committee examined four alternative approaches: tracing; a Canadian domestic allocation formula; a modified domestic allocation formula incorporating a "safe-haven" for up to a certain amount of Canadian borrowings; and a worldwide allocation formula. Each, together with its perceived advantages and disadvantages, is set out below.

Tracing

Under tracing, any Canadian taxpayer borrowing to invest in foreign affiliates, whether directly or indirectly through one or more Canadian subsidiaries or affiliates, would be subject to a restriction of the related interest expense. This method would be consistent with general Canadian income tax principles, and avoids many of the arbitrary results, distortions and complexities that can arise under the various allocation methods.

The rule would be broadly drafted, and would include borrowings that can reasonably be considered, having regard to all of the circumstances, to have been used to assist, directly or indirectly, another person to make the foreign direct investment. Additional anti-avoidance provisions would be required to deal with tax-planning techniques that sought to avoid the rule, such as cash damming.

One disadvantage of tracing is that past experience with the enforcement of rules governing the disallowance of interest indicates that taxpayers will seek to construct mechanisms aimed at making borrowings that relate to a direct or indirect investment in a foreign affiliate, appear to be traceable to an investment for which the interest expense is deductible. Also, under tracing, it will be difficult – even with elaborate anti-avoidance rules – to overturn arrangements whereby a Canadian taxpayer borrows to invest in Canadian domestic operations and, in separate transactions, uses existing equity to finance foreign direct investment.

In practice, a tracing rule would be most effective in the context of Canadian business enterprises that have significant investments in foreign affiliates in relation to their Canadian operations, or where the company's financing arrangements are such that applying the tracing method is fairly obvious. By contrast, one can expect that larger multinationals, with complex financing structures and substantial operations both in Canada and abroad may, in some circumstances, be able to avoid the full application of the tracing rule.

Bearing in mind these limitations, it is nonetheless the Committee's view that the tracing approach would reduce the amount of funds borrowed in Canada to invest in foreign affiliates, and would induce taxpayers to locate a greater amount of indebtedness in foreign affiliates rather than in Canada.

Canadian Domestic Allocation Formula

Under a Canadian domestic allocation approach, the amount of a Canadian corporation's indebtedness that is considered to support foreign direct investment, is based on the ratio of foreign assets to total assets. For example, if a Canadian corporate taxpayer has $50 of Canadian assets and $50 of foreign direct investment (total assets of $100), supported by $70 of third-party debt and $30 of equity, 50 percent of the debt would, under an allocation formula, be considered to support the foreign direct investment. Accordingly, interest on indebtedness of $35 would be subject to restriction.

Formula allocation is based on the argument that money is fungible, and that all funds borrowed by a business enterprise should be regarded as effectively supporting its total assets at any point in time. There are, however, a number of major disadvantages to employing such a system, including the following:

- The domestic allocation approach ignores the extent to which foreign operations have themselves been capitalized through third-party borrowings.
- In common with any formula allocation, the domestic allocation approach will inevitably lead to undesirable economic results. For example, consider a Canadian business enterprise with 50 percent of its assets invested in Canada and 50 percent invested in foreign affiliates. If the enterprise decides to borrow to make a new investment in Canada, approximately 50 percent of the related interest expense would, under the allocation method, be restricted. Such a rule could accordingly discourage borrowings for Canadian domestic investment, where a Canadian business enterprise already has a significant proportion of its assets invested in foreign affiliates. On the other hand, if the same enterprise decides to borrow to invest in a foreign affiliate, approximately 50 percent of the interest expense would be allowed in Canada and, to this extent, the Canadian tax system would continue to provide a benefit in the form of partial deductibility of interest expense on funds borrowed to invest in foreign affiliates.
- To be effective, the formula method must be employed on the basis of a corporate group (and not on a taxpayer-by-taxpayer basis), and would require a compulsory consolidation for purposes of calculating all of the assets and borrowings of the corporate group, as defined. In the absence of

such consolidation, the formula method would be largely ineffective, and, with appropriate tax planning, little if any interest expense would ever be subject to disallowance. For example, if a Canadian parent company borrowed funds and invested in share capital of its 100 percent-owned Canadian subsidiary, with the Canadian subsidiary then investing in a foreign affiliate, the Canadian parent company would have used the funds for a qualifying purpose (to invest in another Canadian corporation), and the interest expense would be fully deductible.

- The consolidation rules that would be required under the formula allocation approach would, without question, add a significant amount of complexity to the Canadian tax system, with the attendant increase in administrative and compliance costs. In addition, defining the ownership threshold of the corporate group would itself lead to anomalous results. If the ownership threshold is relatively high, there would be situations where the rules would not apply. For example, assume that the defined ownership threshold is 90 percent, and assume further that a Canadian corporation borrows to invest in an 80 percent-owned subsidiary, with the subsidiary using the funds to invest in a foreign affiliate. As a result of the fact that the subsidiary does not form part of the corporate group as defined, none of the interest expense would be restricted. This contrasts with the tracing method, where the borrowings would have been considered to have been used, directly or indirectly, to assist another person to invest in a foreign affiliate, resulting in a restriction of all of the interest expense. To address this situation, one could set the threshold level for purposes of defining a corporate group relatively low. However, this option has its own shortcomings. In particular, under any corporate group approach, the borrowing and investment decisions of one member of the group might have an adverse impact on the interest deductions available to another; and, the lower the ownership threshold, the greater the possibility that the interests of minority shareholders could be adversely affected.
- The basis on which Canadian domestic assets and foreign assets would be measured must also be defined – does the system employ accounting values, tax values or fair market values? The use of accounting values is the simplest approach but could yield anomalous results. In the United States, interest allocation rules include an election to prepare calculations based on current fair market value, but the result is even further complexity.

For all of the reasons described above, the Committee is of the view that, in addition to introducing additional complexity to the Canadian tax system, a domestic allocation formula would inevitably produce results that are both uncertain and arbitrary, and would, in some circumstances, unduly increase the cost of both foreign and domestic investment by Canadian multinationals. We do not believe that a domestic allocation formula is a viable alternative, particularly in the context of a regime such as Canada's, which relies, to a great extent, on the exemption method, and where disqualified interest would be non-deductible (unlike the United States, where the deferral method is used, and where disqualified interest remains deductible but serves to potentially reduce foreign tax credits otherwise available).

Modified Domestic Allocation Formula

In order to address certain of the anomalies that might result from the domestic allocation method, a modified allocation formula could be devised. Such a formula might have two parts. First, a Canadian corporate group would be allowed to deduct interest on borrowing up to a certain prescribed amount of its total Canadian domestic assets. For example, using a 2-to-1 debt/equity ratio as a hypothetical "safe harbour," interest on indebtedness of a Canadian corporate group would be allowed under all circumstances, up to 66⅔ percent of the amount or value of Canadian domestic assets. Second, any interest expense incurred by the Canadian corporate group in excess of the original base would be subject to the domestic allocation method described above, taking into account both the indebtedness already allowed in Canada and the Canadian domestic assets financed by such borrowings,

both of which would be excluded from the calculation. The overall impact is that indebtedness up to a percentage of Canadian domestic assets would be allowed in full, while any excess indebtedness would be subject to the application of the formula allocation method.

The main advantage to this modified approach is that the safe harbour would permit full deduction of interest up to a reasonable amount, so that for corporate groups falling within the safe harbour range, there would be no adverse economic effect of incurring additional indebtedness to finance new Canadian investment. Its major disadvantage is a level of complexity in design and application similar to that which would likely result from the general domestic allocation method. The modified approach gives rise to two additional concerns. First, there would still be an inducement for Canadian corporate groups that fall below the safe harbour limit to put more borrowings in Canada. Second, for corporate groups operating in business sectors that generally require higher amounts of financial leverage (real estate and certain other industries), there might be difficulty in meeting the safe harbour exception, and consideration would have to be given to industry-specific exceptions, introducing yet more complexities.

Worldwide Allocation Formula

Under worldwide consolidated allocation, the corporate group would be defined with reference to both Canadian domestic taxpayers and foreign affiliates, and worldwide debt would be considered to support foreign assets, based on the ratio of worldwide foreign assets to worldwide total assets. The formula would produce an amount of consolidated debt considered to support foreign assets and, to the extent that foreign affiliates of the consolidated group had third-party borrowings equal to or in excess of this amount, there would be no restriction in Canada. However, to the extent that the amount of debt considered to support foreign assets under the worldwide allocation formula exceeded the amount of third-party borrowing incurred by foreign affiliates, any excess would be considered to have been borrowed in Canada to support foreign investments, and the interest on such excess would be restricted.

From the theoretical perspective, the worldwide formula allocation method is clearly better than the domestic allocation methods described above, in that it recognizes the extent to which debt has been incurred by foreign affiliates. However, the method appears to be so extraordinarily complex that, for all practical purposes, it is virtually unworkable. For example, the existing ownership threshold for foreign affiliate status is, in general terms, the direct or indirect ownership interest of at least 10 percent of any class of shares. The Committee has concluded that in such a context, there would be many circumstances in which any attempt to prepare consolidated worldwide calculations would be effectively impossible.

Restricting Interest Deductibility: Alternative Tax Treatments

Once a method is adopted to identify borrowings related to investments in foreign affiliates, the next step is to decide what treatment should apply to interest expense on such indebtedness. Again, the Committee examined different approaches. For example, any such interest expense could be unconditionally denied, or denied only to the extent of exempt surplus dividends received in the particular year or within a prescribed carry-over period (an approach that would obviously have a negative implication on repatriation). Another approach would be to restrict the interest expense, with deductibility being initially denied, but then being reinstated if the investment in the foreign affiliate results in taxable income in that year, or in a prescribed carry-over period.

As is usual in international taxation, no perfect solution emerges, especially in the context of Canada's current tax regime which employs elements of the accrual, exemption and deferral methods. Any rules that sought to allocate interest expense between "qualifying" and "non-qualifying" foreign

affiliates (for example, foreign affiliates in treaty versus non-treaty countries) would be complex, arbitrary, and unworkable in many situations, particularly given that foreign affiliates can earn varying amounts of exempt and taxable surplus from different sources and different jurisdictions on a year-to-year basis.

On balance, however, an initial denial of interest deductibility appears to the Committee to be appropriate in the context of Canada's broad exemption system, where dividends from foreign affiliates to Canadian corporate shareholders are predominantly paid out of exempt surplus, and where taxation is accordingly restricted to income taxes paid in the foreign jurisdiction in which the business activities are carried on. To the extent that taxable surplus dividends are ultimately received by the Canadian corporation, we believe that it is appropriate to then allow an amount of interest to be deducted, equal to the net inclusion in taxable income (in other words, net of deductions in respect of foreign taxes), on the basis that the interest expense should then be regarded as having been incurred to earn income subject to tax in Canada.

A refinement to this alternative would be to limit the amount of deductions in respect of foreign taxes, by incorporating into the formula for foreign-source income, an allocation of all or a portion of the restricted interest now being allowed as a deduction. However, such an approach would introduce its own set of complex allocation problems, with little anticipated revenue gain to the Canadian treasury.

Under our approach, we suggest that any disallowed interest in respect of an investment by a Canadian corporation in the shares of a directly held foreign affiliate be disallowed and added to the tax basis of those shares. The disallowed interest would also be accumulated and be eligible for carry-over, to be offset against any net taxable dividends received on the shares of that affiliate (and would then be deducted from the tax basis of the shares). The Committee considered other approaches, including the alternative of allowing an offset for disallowed interest against net taxable dividends received from, or capital gains realized on, the shares of any foreign affiliate. However, we concluded that this option would be overly generous.

It is the Committee's view that FAPI, in contrast, requires a different approach than does other taxable surplus. The FAPI rules are primarily anti-avoidance provisions, which include in taxable income, investment or passive income that could have been earned in Canada rather than abroad or which otherwise erodes the Canadian revenue base. It is arguable that interest expense should not be allowable in respect of income which is subject to this type of anti-avoidance provision. While double taxation could arise if a Canadian taxpayer borrowed to invest in foreign affiliates that earned FAPI, the behavioural response should be for the income to be earned directly in Canada. Also, if the cumulative disallowed interest expense balance was available for offset against FAPI, there would be a significant incentive for any Canadian taxpayer who had such balances to establish foreign affiliates for the express purpose of earning FAPI. The FAPI inclusion would simply be offset by the release of a corresponding amount of disallowed interest.

Summary and Recommendations

As set out above, there are a number of competing, and often contradictory, policy objectives and technical issues related to interest expense on funds borrowed to invest in foreign affiliates. These include economic efficiency, international competitiveness, complexity and protection of the Canadian domestic revenue base. As stated earlier, however, the Committee believes that lower corporate income tax rates proposed in our Report, supported by base broadening measures (including international tax measures, where appropriate) will produce a net benefit to Canada. Further, and as a general rule, we believe that the tax system of the foreign country in which the business activities are carried on (and not that of the home country from which the investment is made) should bear the preponderance of the cost of financing the foreign business activities.

With these overall principles in mind:

RECOMMENDATIONS

The Committee recommends that interest expense of Canadian taxpayers on indebtedness incurred to invest in foreign affiliates should be disallowed.

This disallowance should also apply to individuals, to the extent that funds are borrowed to invest in foreign affiliates of the individual through Canadian corporations.

The tracing method should be used for purposes of identifying the amount of indebtedness allocable to investments in foreign affiliates.

This should include interest on funds borrowed by a taxpayer, which can reasonably be considered to have been used, directly or indirectly, to assist another person to make an investment in a foreign affiliate of the taxpayer; other anti-avoidance provisions should be incorporated as discussed above.

Interest expense that is disallowed should be added to the tax basis of the shares of the relevant foreign affiliate, and accumulated in a "disallowed interest account."

To the extent that dividends are received on those shares out of taxable surplus, an amount equal to the lesser of the accumulated balance in the disallowed interest account, and the net inclusion in taxable income should be allowed as a deduction (and deducted from the tax basis of the shares). Accumulated balances in the disallowed interest account should not be available, however, for offset against FAPI.

To prevent small start-up businesses that must resort to borrowing in Canada from being penalized, and also to address the administrative and compliance burden on small and medium-sized business, we recommend an exemption for up to $10 million of accumulated indebtedness related to investments in foreign affiliates (with the exemption to be shared among members of a an associated group).

Indebtedness incurred or committed to under existing rules should be exempted from the new regime or be eligible for a generous transition period.

Grandfathering or transitional provisions are particularly significant in this area, having regard to the fact that taxpayers have made significant borrowing and investment commitments based on existing rules.

Deductibility of Other Expenses Related to Foreign Direct Investment

While the single, major expense incurred in Canada in respect of investments in foreign affiliates is, in most circumstances, interest expense, there are other costs incurred by Canadian business enterprises that relate to foreign direct investment. These include the costs of Canadian management personnel, certain accounting and legal costs, and support services. To the extent that such costs and expenses are custodial in nature (and thus properly the costs of the Canadian taxpayer rather than its foreign affiliate), it is arguable that such costs should be subject to the same general restriction as might apply to interest expense incurred for foreign direct investment.

On the other hand, custodial expenses are fundamentally different from interest expense. If they were to be disallowed, taxpayers might be induced to relocate management personnel out of Canada and into foreign markets. Moreover, disallowing custodial expenses incurred in Canada would result in double taxation, given that such expenses would not be deductible in the foreign country. Finally, the Canadian economy benefits from inbound foreign direct investment, and from the associated custodial expenses incurred outside of Canada by foreign parent companies.

It is the Committee's view, therefore, that while Revenue Canada should continue to be vigilant in ensuring that all costs borne in Canada for services incurred for the benefit of a foreign affiliate are charged to it, there is no compelling reason to change the Canadian tax law related to other expenses that are custodial in nature.

Foreign Accrual Property Income

Any Canadian taxpayer, individual or business, that has an interest in a "controlled foreign affiliate," may be taxed on an accrual basis where such affiliates earn certain types of income, including passive income such as interest and portfolio dividends, as well as prescribed amounts where the corresponding deduction erodes the Canadian tax base. These are the FAPI rules. As an anti-avoidance regime, the FAPI rules are intended to be prophylactic, and as such, they safeguard the Canadian tax base by preventing taxpayers from diverting income abroad. As a result, the FAPI regime can be said to be most effective when little if any FAPI is, in fact, being earned by foreign affiliates of Canadian taxpayers.

Countries vary in their approaches to this type of income; the United States, for example has extremely detailed and complex rules while certain other countries have rules that are extremely limited in scope. Tax policy considerations in this area accordingly involve difficult issues as to the appropriate nature and scope of such rules. Income to be attributed needs to be defined broadly enough to protect the domestic revenue base, but without casting too wide a net, such that the rules hamper the ability of Canadian multinational businesses to compete in the international marketplace.

Background

A controlled foreign affiliate of a taxpayer resident in Canada is defined, in general terms, as a foreign affiliate of the taxpayer that is controlled by the taxpayer (alone or with persons with whom the taxpayer does not deal at arm's length), or by the taxpayer and/or not more than four other persons resident in Canada (whether or not related to the taxpayer). To be defined as a controlled foreign affiliate, a foreign company must first be a foreign affiliate of the Canadian taxpayer. Earlier in this Chapter, the Committee recommends that the ownership threshold to qualify as a foreign affiliate be increased, to require a more significant equity interest in the relevant foreign affiliate for access to the exempt and taxable surplus system. However, the Committee also recommends that the existing (and lower) threshold continue to apply for purposes of the definition of controlled foreign affiliate, to prevent an erosion in the amount of income, potentially subject to the FAPI rules, that would otherwise result.

Taxpayers resident in Canada must include their proportionate amount of any FAPI earned by a controlled foreign affiliate in income on a current basis (subject to deductions equivalent to credits in respect of underlying foreign tax), whether or not the income is distributed by the affiliate as dividend payments. These rules apply to Canadian-resident individuals as well as corporations, and to affiliates in treaty as well as non-treaty countries. The allocable amount is based on the taxpayer's participating percentage (as defined) in the foreign affiliate, determined at the end of each taxation year of the affiliate. FAPI includes an affiliate's income from property and businesses other than active businesses, and taxable capital gains from dispositions of certain property (generally, a property that is not used or held for the purpose of gaining or producing income from an active business).

The definition of FAPI was substantially expanded in scope by the 1995 foreign affiliate amendments, and there are various sources of active business income that are, in fact, characterized as FAPI. In addition to property income, which is purely of a passive nature, FAPI includes income from an investment business unless the affiliate employs more than five employees (or their equivalent) full-time in the active conduct of the business, as well as specified types of income earned by a foreign affiliate, where the corresponding deduction erodes the Canadian tax base. There are also certain relieving provisions, which provide specific exceptions in the case of income that would otherwise be characterized as FAPI, but which arise from payments and other transactions between different foreign affiliates of the same Canadian taxpayer (generally referred to as "interaffiliate transactions").

Interaffiliate Transactions

As noted above, the 1995 amendments to the foreign affiliate rules significantly expanded the scope and definition of FAPI. The Committee is aware, however, of some suggestions that the FAPI provisions be even further expanded, by repealing or severely restricting the exemption provided by the rules related to interaffiliate transactions. We examine the issues relating to interaffiliate transactions below.

Background

Under the FAPI rules, income received by a foreign affiliate of a Canadian taxpayer, and paid by another foreign affiliate of the taxpayer (or by a related, non-resident corporation), is treated as active business income (rather than FAPI), provided the amount reduces active business income of the payor (and other prescribed tests are met).[10] In addition to being exempt from FAPI, income from such interaffiliate transactions is included in exempt surplus provided, in general terms, that the payments reduce exempt surplus of the payor, and are received by an affiliate in a tax treaty country. The rules, accordingly, characterize such income, which would otherwise often be considered passive in nature, both as active business income and, in many circumstances, as exempt surplus.

Exempt Versus Taxable Surplus Characterization

As discussed earlier in this chapter, the exemption method for active business income earned by foreign affiliates in treaty countries can be argued to be based, in part, on the assumption that the income of the foreign affiliate has borne taxes somewhat equivalent to the Canadian tax rate. However, many countries with which Canada has negotiated tax treaties provide rules that allow certain activities or entities to be taxed at rates well below domestic norms. Under Canadian rules, such income qualifies for exempt surplus treatment, even if the entity in question is specifically denied benefits under the treaty.

For example, Canada has a tax treaty with Barbados, a country that has a general corporate income tax rate of 40 percent. Special-status entities such as Barbados international business corporations (IBCs), which are taxed in Barbados at preferential rates of 1 percent to 2½ percent, are specifically

denied treaty benefits, but remain eligible for exempt surplus treatment. This is equally true of certain tax-favoured entities in other jurisdictions, including Cyprus, Israel, Jamaica and Luxembourg. Most typically, income earned by such entities arises in the context of interaffiliate transactions involving offshore financing and similar arrangements, and where the income is passive in nature. It can be argued that this tends to encourage tax-planning mechanisms that erode the Canadian tax base, particularly where the interaffiliate payments relate to amounts that are deductible in Canada. For example, many finance structures involve borrowing in Canada to invest in an offshore, captive finance company, with the finance company, in turn, lending to another foreign affiliate in a higher-tax jurisdiction.

As a general principle, the Committee believes that Canada should not unilaterally seek to claw back general incentives implemented by its treaty partners, involving active business activities carried on in their jurisdictions. However, income from interaffiliate transactions often involves minimal, if any, direct job creation in the foreign country.

For these reasons, the Committee recommends below that the government revise the rule that extends exempt surplus characterization on interaffiliate payments, for income earned by entities that are expressly denied benefits under Canadian tax treaties. Such income would accordingly be included in taxable surplus of the recipient affiliate (even if the payment reduces exempt surplus of the payor affiliate), consistent with the treatment that applies with respect to such income earned by affiliates in non-treaty countries. We also urge the government to aggressively pursue a policy of renegotiating its existing treaties, to ensure that other tax-privileged entities in treaty countries are denied access to the exemption system with respect to interaffiliate transactions that would otherwise be passive in nature.

Exemption from FAPI

It has been suggested that the exemption from FAPI for interaffiliate payments (where the corresponding deduction reduces active business income of the payor affiliate) should be repealed altogether, on the basis that, as discussed above, the exemption tends to encourage tax-planning arrangements which erode the Canadian tax base. On the other hand, the interaffiliate exemption, in and of itself, simply ensures that the active business of one foreign affiliate of a Canadian taxpayer is not, as a result of deductible payments (such as interest, rents and royalties) characterized as FAPI in the hands of the recipient affiliate. The exemption from FAPI therefore facilitates interaffiliate payments, where consolidation of the income of a foreign affiliate group might not otherwise be possible. There are, for example, many situations in which multi-tier structures are required for regulatory and other non-tax reasons (for example within the United States and the European Union).

In addition, there are many situations involving interaffiliate payments such as royalties, interest and various other running expenses, where any fundamental change to the provision would be singularly inappropriate. We also recognize that the exemption allows Canadian businesses to compete more effectively in the global marketplace with the multinationals of certain other countries that can often benefit from similar provisions.

The Committee's recommendation (discussed earlier in this Chapter) with respect to the restriction of interest expense on funds borrowed to invest in foreign affiliates will help to protect the Canadian domestic base erosion from financing transactions. If in addition to this measure, and to the recommendation to repeal the rule that extends exempt surplus status to interaffiliate payments earned by entities denied treaty benefits, the exemption from FAPI for income from interaffiliate transactions were to be eliminated, the cumulative impact of these changes could significantly impair the international competitiveness of Canadian businesses.

Conclusions and Recommendations

In the Committee's view, the FAPI regime – including the extent and scope of the definition of FAPI – is generally sound, and since the expansion of the FAPI rules as part of the 1995 foreign affiliate amendments, operates effectively to protect the Canadian revenue base. However, there are still certain areas in which the system should be tightened.

RECOMMENDATIONS

We recommend that the FAPI exemption for interaffiliate transactions be maintained, but that such payments be included in taxable surplus where the income is received by an entity that, while located in a tax treaty jurisdiction, is expressly denied benefits under that treaty.

As a result, such income would be treated in the same manner as income from interaffiliate transactions earned by entities in tax havens, which do not have tax treaties with Canada.

We recommend that the government actively renegotiate its existing tax treaties, to ensure that all tax-privileged entities in treaty countries are denied access to the exemption system with respect to income from interaffiliate transactions.

In addition to the FAPI exemption for interaffiliate payments, exemption from FAPI applies in respect of income received by a foreign affiliate of a Canadian taxpayer, where it is paid by a non-resident corporation that is not a foreign affiliate of the Canadian taxpayer, provided the payor is a non-resident corporation to which the particular affiliate and the Canadian taxpayer are related. This provision has encouraged the implementation of a number of so-called "second-tier" financing transactions, which may erode the Canadian domestic tax base, in situations where a foreign parent company controls the Canadian corporation, and where the Canadian corporation has little if any economic interest in the foreign operations being financed.

The Committee recommends that the provision that provides FAPI exemption for payments from related non-resident corporations that are not foreign affiliates of the Canadian taxpayer, be revised to exclude situations in which related party status arises solely as a result of share ownership by foreign parent companies outside Canada.

Finally, the Committee is concerned by reports that significant amounts of Canadian assets are being invested in a variety of foreign trust structures, and in circumstances where positions are being taken by Canadian taxpayers and their advisors that income earned by the foreign trusts fall outside the ambit of the Canadian FAPI provisions. These transactions undermine the integrity of (and confidence in) the Canadian tax system. The new foreign reporting requirements should assist Revenue Canada to identify situations in which these transactions are taking place.

The Committee recommends that foreign trust structures identified by Revenue Canada be challenged in the courts, in circumstances in which the trust income may be subject to the FAPI rules, and that, if such challenges prove to be unsuccessful, appropriate amendments be made to the tax legislation.

Later on in our Report (Chapter 10), the Committee also recommends the introduction of expanded civil penalties on gross negligence of tax advisors and promoters – penalties that we believe should also apply in the foreign trust area.

Offshore Investment Funds

As noted, the FAPI rules only apply in respect of controlled foreign affiliates of a Canadian shareholder. As a result, and consistent with the approach that has been adopted in certain other countries that have adopted anti-avoidance provisions similar to the FAPI rules, they do not apply to shares of foreign entities that are widely held by residents of Canada, such as offshore mutual funds and unit trusts or in other foreign entities. Accordingly, the offshore investment fund rules (which were introduced in 1984) serve as a backstop in these situations.

Offshore investment fund rules address situations in which Canadian taxpayer has an interest in a foreign entity that does not qualify as a controlled foreign affiliate, where the interest in the foreign entity derives its value primarily from portfolio investments, and where one of the main reasons for the taxpayer acquiring or holding the interest in the property is to reduce Canadian tax. If the rule applies, the Canadian taxpayer must include in income a notional amount equal to the designated cost of the investment (as defined) multiplied by a prescribed rate. This prescribed rate may of course be greater or less than the actual income earned by the foreign entity and attributable to the interest of the Canadian taxpayer. The rule is arbitrary and, where it applies, can result in a significant penalty to the Canadian taxpayer. However, as an anti-avoidance provision, this result is not necessarily inappropriate. While the offshore investment fund rules could be revised, so that they would operate on a more specific and targeted basis, such changes would not necessarily provide any additional protection to the Canadian domestic tax base.

There appears to be little income being reported by taxpayers or assessed by Revenue Canada under the offshore investment fund rules. This could result from the fact that the rules have had their desired effect, and that offending, portfolio investments are not being made. However, the Committee is concerned that certain transactions are occurring that may fall within the ambit of the rules, but where the income is neither being reported nor assessed. We suggest that Revenue Canada review investments in foreign entities and aggressively apply the offshore investment fund provisions as appropriate.

Taxation of Income of Non-resident Investors

Introduction

As noted earlier in this Chapter (see inset entitled "What Income is Liable to Canadian Federal Income Taxation?"), non-residents are taxable in Canada on Canadian-source employment and business income, on the disposition of certain types of Canadian property, and on the receipt of specified property income (including dividends, interest, rents and royalties) paid or credited by persons resident in Canada. International tax treaties modify these rules on a bilateral basis, generally restricting the right of one country to tax income earned by a resident of the other, so as to facilitate trade and investment, and reduce the potential for double taxation. Also, treaties generally provide for significant reductions in the rate of withholding tax applicable to income such as dividends, interest, rents and royalties, paid to residents of the other country.

With respect to inbound investment, it is the Committee's view that tax policy in this area should work toward two goals: that foreign investors in Canada should, to the extent practical, be on an equal footing with Canadian domestic investors operating in the Canadian marketplace; and that the Canadian treasury obtain its fair share of tax revenue derived from businesses carried on in Canada. Achieving a fair balance between the two includes determining an acceptable level of rates of withholding taxes applied on property income paid to non-residents of Canada, and an appropriate scope of the thin capitalization provisions.

In this section of the Report, after commenting on tax policy objectives related to inbound investment, the Committee reviews the issues noted above, as well as the exemption for interest payments on arm's-length indebtedness and the status of non-resident-owned investment corporations.

Finding a Balance Between Attracting Foreign Capital and Protecting the Revenue Base

As discussed earlier, there are a number of sometimes competing tax policy objectives related to inbound investment. Primary among these are the need to attract foreign capital and know-how to Canada, so as to benefit our economy, and the simultaneous requirement to prevent erosion of Canada's tax revenue base. The conflicting pressures are not easily resolved.

One means of protecting the revenue base is to impose high rates of withholding tax on interest and other deductible amounts paid to non-resident investors. However, such taxes may impede cross-border income and capital flows, and act as a tariff on the importation of capital or knowledge, contrary to neutrality principles. This is particularly the case when such taxes are not fully creditable in the home country of the non-resident. Such situations often arise, since Canadian withholding tax generally applies to gross income (and without reference to related, deductible expenses), but with tax being computed in the home country based on net income after expenses. Withholding taxes can be shifted onto Canadians, to the ultimate detriment of the national economy. For example, withholding taxes on interest are frequently shifted to the borrower, thereby increasing the cost of foreign capital to domestic business enterprises. Similarly, with respect to royalties, withholding tax can increase the cost to domestic business enterprises of accessing foreign technology, representing a tariff on knowledge.

Pulling in the other direction, however, are some equally compelling realities. Withholding taxes on deductible payments such as interest, rents and royalties are an important element in protecting the Canadian domestic revenue base, and represent significant revenue to the Canadian treasury – almost $1.7 billion in 1995.

Foreign Portfolio Versus Foreign Direct Investment

In reviewing the treatment of inbound investment, the Committee remained cognizant of the need to differentiate between foreign portfolio investment and foreign direct investment, particularly with respect to withholding taxes and thin capitalization provisions. Foreign direct investment is generally regarded as an investment by a person with an equity ownership in a business enterprise of at least 10 percent. In practice, this level of ownership interest will often be sufficient to allow the non-resident investor to have influence on the borrowing and investment decisions of the business entity. A foreign direct investor often looks to the rate of return of the business enterprise itself, with a view to deriving income, either in the form of dividend payments, or by capital appreciation realized on an ultimate divestment of the ownership interest. A foreign portfolio investor, on the other hand, will generally have little, if any, control over the borrowing and investment decisions of the business enterprise, and is primarily interested in the return on the shares or indebtedness owned, rather than the underlying performance of the business enterprise itself.

Withholding Taxes

Background

While the general withholding rate is 25 percent under Canadian domestic tax law, under our bilateral tax conventions this rate is almost always reduced. Canada has historically been, and continues to be, a significant importer of capital – both foreign direct and portfolio investment – and has in the past, accordingly, tended to seek higher rates of withholding rates in its tax treaties than many of our major trading and treaty partners.

The OECD Model Tax Convention sets out a uniform basis of withholding tax rates in respect of different sources of income. The Model Convention is intended to act as guidance to member countries in negotiating bilateral tax treaties, but is not binding. The Model Convention suggests a 5 percent dividend withholding rate in the case of foreign direct investment, 15 percent for dividends on foreign portfolio investment, 10 percent on interest and no tax on royalties. In the past, Canada generally sought higher rates in its treaties than suggested in the Model Convention – often 15 percent for dividends (whether direct or portfolio), 15 percent for interest, and 10 percent for royalties.

More recently, however, Canada has taken a different approach in its treaty negotiations, and Canada's position with respect to treaty withholding rates now conforms more closely to the OECD Model Tax Convention. The 1992 and 1993 federal budgets announced Canada's willingness, in its tax treaty negotiations, to reduce the withholding tax rate on direct dividends to 5 percent, and to eliminate withholding tax for royalty payments made for the use of computer software and in respect of rights to use certain patented information or information concerning scientific experience. Canada has now negotiated a number of new treaties, or protocols to existing treaties, which incorporate these reduced rates, as well as a 10 percent withholding tax rate for interest payments.

It is the Committee's view that the present Canadian position with respect to the level of withholding taxes under bilateral tax treaties is consistent with international norms, strikes an acceptable balance between the competing goals of global neutrality and protection of the Canadian revenue base, and, accordingly, requires no modification at the present time.

Exemption for Interest Payable on Arm's-length Indebtedness

Under Canadian domestic tax law, interest payable by a corporation resident in Canada to a non-resident person with whom the corporation is dealing at arm's length is exempt from withholding tax, if certain conditions are met. The exemption generally applies if, under the terms of the obligation, the Canadian corporate borrower may not be obliged to pay more than 25 percent of the principal amount of the obligation within five years from the date of issue of the indebtedness, except in the event of a failure or default under the terms of the agreement. This exemption was introduced as a temporary measure in 1975, to allow Canadian corporate borrowers increased access to international capital markets. The exemption was extended on several occasions, until it became a permanent feature of the Canadian tax system in the 1988 federal budget.

As noted earlier, withholding taxes on interest payments tend to be shifted to the borrower, thereby increasing the cost of capital. The exemption for interest payable on arm's-length indebtedness provides Canadian businesses with increased access to global financial markets at competitive interest rates. The Committee supports the exemption, but has two recommended changes.

RECOMMENDATIONS

The Committee recommends that the withholding tax exemption for interest payments to arm's-length non-resident lenders be extended to all indebtedness, regardless of its term.

We see little compelling rationale for limiting the exemption to longer-term debt. While it can be argued that restricting the exemption in this manner may provide some degree of control over monetary conditions or may facilitate the regulation of Canadian financial institutions, in today's global environment, such arguments have little validity.

We also recommend that the exemption be denied in circumstances involving back-to-back transactions and similar financial support arrangements, in the same manner as discussed below under the thin capitalization provisions.

At present, there is no provision in the income tax rules that specifically denies the exemption in situations involving back-to-back loan arrangements by non-resident investors through third-party, financial intermediaries, or similar arrangements. While the exemption does require that the Canadian borrower and the financial institution deal at arm's length, at present the issue of whether otherwise unrelated parties are dealing at arm's length with respect to a particular transaction has to be determined in each case, thereby introducing uncertainty and complexity.

Rules Applying to Thinly Capitalized Businesses

Background

A business is said to be thinly capitalized when it is financed with a relatively high proportion of debt in relation to its equity base. In the absence of legislative restrictions, foreign investors seeking to minimize taxes associated with an investment in Canada would tend to invest a disproportionate amount of debt (as opposed to equity) in Canada. The interest expense reduces income otherwise subject to tax in Canada. By thinly capitalizing a Canadian business enterprise, a foreign investor can receive a greater proportion of its return in the form of deductible interest payments (generally subject to a 10 percent treaty withholding rate), rather than dividend payments out of after-tax income. The purpose of thin capitalization rules is to prevent this type of erosion of the domestic tax base in the country in which the business enterprise is being carried on.

Canada was one of the first countries to introduce thin capitalization rules, under which interest payable on indebtedness owing to certain non-residents is disallowed, to the extent that the amount of such indebtedness exceeds three times equity.[11] These rules were introduced in 1972 and, with minor modifications, have remained in place since that time. After describing the Canadian rules as well as international comparisons, this portion of the chapter reviews the efficacy of the rules and possible alternative approaches.

Canadian Thin Capitalization Rules – An Overview

Canada has a statutory thin capitalization rule of 3 to 1. This rule disallows interest that would otherwise be deductible, and that is paid by a corporation resident in Canada to a specified non-resident, as defined, where such indebtedness exceeds three times equity. For this purpose,

a specified non-resident includes a non-resident shareholder who, either alone or together with other persons with whom it does not deal at arm's length, owns 25 percent or more (votes or value) of the shares of the Canadian corporation; a specified non-resident also includes any other non-resident persons that deal at non-arm's length with such shareholders.

For purposes of applying the 3 to 1 debt/equity ratio, equity is generally defined to be the aggregate of: (i) the retained earnings of the Canadian corporation on an unconsolidated basis, (ii) the amount of surplus contributed by specified non-resident shareholders of the corporation; and (iii) the corporation's paid-up capital, to the extent that the capital stock is owned by specified non-resident shareholders. Indebtedness is generally defined as the greatest amount of interest-bearing debt owing to specified non-residents at any time in the year.

For example, if a Canadian corporation had $100 of equity and interest-bearing indebtedness of $400 owing to specified non-residents, $100 of the $400 of debt will be treated as being in excess of the allowable limits, and therefore, 25 percent of interest paid for the year to specified non-residents would be disallowed. On the other hand, if the greatest amount of interest-bearing indebtedness to specified non-residents at any time in the year is restricted to an amount of $300, there will be no disallowance.

To the extent that interest expense is disallowed as a result of the thin capitalization formula, double taxation will often result. The interest remains subject to Canadian withholding tax, and will often also be taxable in the home country of the foreign investor. The rules are therefore prophylactic in nature, and are intended to apply to financing that is provided by non-resident shareholders in closely held situations. Canadian corporations in these situations generally carefully monitor their debt/equity ratios to ensure that there is no disallowed interest expense.

Other Countries' Approaches

There is no single, common standard with respect to the application of thin capitalization rules, and the approaches of different countries vary widely, both in concept and in detail. As noted, Canada introduced a thin capitalization rule in 1972, and was one of the first countries to do so. Increasingly, other countries have implemented thin capitalization rules, particularly since the late 1980s. Many countries follow the same type of objective formula approach as does Canada, with the majority using the same statutory debt/equity ratio of 3 to 1 as Canada. More recently, however, lower debt/equity ratios of 2 to 1 are being adopted.

Some countries use a more subjective approach. For example, in the United Kingdom, amounts paid to non-resident investors are generally recharacterized as dividend distributions, and not deductible interest, where (i) the borrower is a 75 percent-owned subsidiary of the lender, or both the borrower and lender are 75 percent-owned subsidiaries of a third company, and (ii) all or any part of the payment would not have been made had the parties been dealing at arm's length. When applying this rule, the U.K. revenue authorities generally consider both the debt/equity ratio, and the amount of "interest coverage" (defined as the extent to which projected earnings or cash flow would be sufficient to satisfy interest expense obligations).

The United States has a unique approach that includes both subjective and objective elements. Under the U.S. legislation, debt may be reclassified as equity in thinly capitalized situations. In addition, the United States adopted an objective test in 1989 referred to as the "earnings stripping rule," which generally applies to a corporate group that has a debt/equity ratio in excess of a safe harbour amount of 1.5 to 1. Subject to this safe harbour, interest on related-party loans is defined to be "disqualified interest," if the recipient of the interest is not subject to U.S. tax, or is subject to tax at less than the U.S. non-treaty rate of 30 percent. The regulation applies whether the recipient is a foreign or domestic investor (for example, a U.S. domestic, tax-exempt entity, which is related to the payor). Disqualified interest is disallowed to the extent that the U.S. corporate group has excess interest expense as defined, and any disallowed interest may generally be carried forward indefinitely.

Certain other countries adopt a substance over form principle, whereby loan capital provided by a shareholder can, under certain circumstances, be considered as equity (for example, where there are no fixed provisions for repayment, or payment of interest is dependent on profits). In other countries, excessive loan financing of a subsidiary company may be subject to general abuse of law concepts (although, in such countries, there appears to have been little significant practical application of the concept in thin capitalization situations). Finally, certain countries have no restrictions whatever.

Canadian Thin Capitalization Rules – An Assessment and Alternatives

Objective Versus Subjective Approaches: The Canadian objective approach, which uses a fixed debt/equity ratio, is, of course, inflexible and somewhat arbitrary. For example, it does not account for different debt/equity ratios that apply in certain industries or between businesses in the same industry. The advantages to the objective approach, however, are significant: the rules are simple to understand and apply, and are generally effective in protecting the domestic revenue base. Subjective approaches tend to increase uncertainty, as well as administrative and compliance costs.

Earnings-based Methods: Another alternative would be to maintain an objective calculation with an income or profits-based test instead of one using a fixed debt/equity ratio – similar to that which applies in the United States under the earnings stripping rule. However, unless the Canadian approach is modified so that the rules apply to interest (and possibly other non-deductible expenses) paid to a broader category of taxpayers such as Canadian domestic investors (as discussed in Chapter 7 of this Report), we do not favour adopting an earnings-based approach. Earnings-based methods, such as the U.S. earnings-stripping rule, are considerably more complex than thin capitalization rules based on a fixed, debt/equity ratio. In addition to a significant increase in administrative and compliance costs, this complexity can also lead to uncertainty in determining the acceptable level of indebtedness, and the extent to which interest expense may be disallowed in any particular year.

Possible Application of Thin Capitalization Provisions to Non-corporate Borrowers: The Canadian thin capitalization rules only apply to corporations that are resident in Canada, and not to other forms of business enterprises, such as Canadian branches of foreign corporations, or to partnerships or trusts. This creates an opportunity for domestic base erosion through the use of such entities. On the other hand, the extension of the thin capitalization rules to Canadian businesses other than Canadian-resident corporations would result in legislative complexity. Rules would be required to define the non-resident stakeholder to which the rules apply, as well as the allocation of equity to such stakeholders, and it is likely that separate rules would be required for each category (Canadian branches of foreign corporations, partnerships and trusts). With respect to discretionary trusts, it may be difficult or impossible to determine amounts attributable to particular beneficiaries.

Back-to-back Arrangements and Guaranteed Debt: A non-resident investor can lend to a Canadian business directly or indirectly using third-party financial institutions or other intermediaries. For example, in the extreme situation (and in the absence of any countervailing rules in the tax legislation), a non-resident investor might make a loan to a third party, with the same amount then being lent by the third party to the Canadian business. In other back-to-back arrangements, the tracing may be less direct. For example, the non-resident investor may undertake, as part of its commercial relationships with a third party (often a financial institution) to leave certain amounts on deposit with it, which may or may not correspond with the amount of the loan that the third party makes to the Canadian business. As another example, the non-resident investor may guarantee the

loan made from a third party to the Canadian business, with the guarantee being supported by a pledge of assets or other security, or possibly simply by the credit rating of the non-resident investor. There is, therefore, a continuum of foreign investor support that could apply, some of which are clearly tax-motivated and seek to avoid the application of the thin capitalization provisions, and others that may be entered into primarily for commercial reasons.

Again, the approach to back-to-back arrangements, and to guaranteed debt, varies among countries. The Canadian thin capitalization provisions deal with the most egregious type of tax planning. In general terms, they provide that where a loan has been made by a specified non-resident shareholder to another person, on condition that a second loan be made by any person to a corporation resident in Canada, the lesser of the amount of the first and second loan is deemed to be subject to the thin capitalization provisions. This rule does not appear to apply, however, in situations where a specified non-resident places funds on deposit with a third party, and where the third party makes a loan to the Canadian business in a different amount, and subject to different terms and conditions. Finally, third-party debt that is only guaranteed by a specified non-resident is clearly outside the application of the Canadian thin capitalization rules.

While it is clear, from a tax policy viewpoint, that back-to-back financing should be addressed by thin capitalization rules, the treatment of guaranteed debt is not as evident. Debt guarantees by related foreign parties can be regarded as a means of circumventing thin capitalization rules, and a number of countries have included such guaranteed debt in the thin capitalization provisions. On the other hand, the inclusion of guaranteed debt might often disrupt normal commercial financing arrangements. For example, there may be situations where a Canadian business enterprise does have sufficient borrowing capacity, or where a lender will nonetheless request a parent company guarantee (normally, a lender will seek the greatest amount of security possible). There are also a large number of circumstances where a Canadian borrower and related foreign parties will enter into joint financing arrangements, which could include, for example, cross-guarantees by each party of the other's indebtedness.

Conclusions and Recommendations

In general, the Committee is of the view that the thin capitalization rules are working well, and are not a major impediment with respect to the day-to-day operations of Canadian businesses. The rules are simple and effective, and the paucity of jurisprudence with respect to the rules suggests that disputes with the Canadian revenue authorities have been rare, notwithstanding the fact that the rules have been in place for more than 25 years. The Committee would not favour technical revisions to create a system that is purer from a theoretical viewpoint, but that adds complexity to the tax legislation with little benefit to either taxpayers or the tax administration. Accordingly, the Committee favours the fixed, debt/equity ratio approach, in lieu of subjective or earnings-based methods. The Committee also sees little merit in technical modifications to the rules dealing with the definitions of equity and indebtedness (such as a global debt/equity ratio that might focus on the total borrowing capacity of the Canadian business enterprise, or on the measurement of equity or debt attributable to the specified non-resident).

RECOMMENDATIONS

The Committee is of the view, however, that the existing rules should be strengthened in certain areas, following appropriate transitional notice, to provide further protection of the domestic revenue base, generally without undue interference with ordinary, commercial transactions.

The Committee recommends that the existing ratio of 3-to-1 should be revised to 2-to-1, as a closer proxy for financing that would generally be available in an arm's-length context.

While some countries allow somewhat higher debt/equity ratios for companies operating in specific industry sectors (financial institutions, for example), these exceptions have not applied to date in Canada, and there is little evidence that higher industry averages are in fact required.

The thin capitalization rules should be revised so that they apply, not only to investments in Canadian corporations, but also to Canadian branches of foreign corporations, and to partnerships and trusts.

While this will result in additional complexity, it is important that the domestic revenue base be protected. In situations involving discretionary trusts where the relevant beneficial interest of each beneficiary cannot be determined, the thin capitalization rule could apply to all debt attributable, directly or indirectly, to non-resident beneficiaries.

The existing provisions with respect to back-to-back arrangements using third-party intermediaries should be strengthened to include all indebtedness (such as amounts on deposit) between a specified non-resident and a third party, where all or a portion of the amount may reasonably be considered to have been loaned or transferred, directly or indirectly, by the third party to a Canadian business.

The rationale for the possible inclusion of third-party debt guaranteed by a "specified non-resident" is, in the Committee's view, not as compelling. On balance, we propose that guaranteed debt not be included in the thin capitalization provisions at this time, but suggest that the issue be reviewed periodically by the government to identify possible abuses.

Non-resident-owned Investment Corporations

Introduction

A non-resident-owned investment corporation (NRO) is a special-purpose vehicle, eligible for special tax treatment. The NRO regime is a holdover from the 1948 *Income Tax Act*, and seems to have been originally introduced to provide non-resident investors (whether direct or portfolio) with the same Canadian tax result, whether they invested in Canada directly, or through a Canadian subsidiary company. In recent years, however, it appears that NROs have often been used primarily for tax-planning purposes.

Analysis of Current NRO Rules

An NRO is, in general terms, a company incorporated in Canada that elects to be taxed as an NRO, and complies with various conditions, including the following:

- All of its issued shares and indebtedness are owned by non-residents of Canada.
- Its income for each taxation year is derived from prescribed sources, including interest, rents and royalties.
- Not more than 10 percent of its gross revenue for each taxation year is derived from rents.
- Its principal business is not the making of loans or trading or dealing in bonds, shares, debentures, mortgages, notes or similar property.

Various special rules apply for purposes of computing the income of an NRO, and it is then taxed at a flat rate of 25 percent on such income. The 25 percent tax is refunded when the income is distributed as dividends to non-residents and, at that time, Canadian dividend withholding tax applies. This means that, ultimately, the final tax payable on most income earned by an NRO is the Canadian dividend withholding tax.

In recent years, it appears that NROs have often been used for tax-planning purposes. For example, if a foreign investor decides to establish or acquire a Canadian corporation, it could form an NRO to provide part of the required capital. An NRO is treated as a non-resident person for purposes of the Canadian thin capitalization provisions discussed above. Assuming, therefore, an investment of $100, the foreign investor might, for example, invest in $25 of equity of the Canadian company and $75 of equity of the NRO, with the NRO using the $75 to acquire indebtedness of the Canadian subsidiary. In this manner, the existing 3-to-1 debt/equity ratio in the thin capitalization provisions have been respected. Interest payments from the Canadian company to the NRO are deductible by it at ordinary corporate rates, and subject to tax at a rate of 25 percent to the NRO. On an ultimate payment of dividends, the 25 percent is refunded to the NRO, and Canadian withholding tax applies.

For the investor, there are a number of potential tax benefits to the type of structure described above. First, the effective Canadian tax rate can, to the extent of deductible interest and royalty payments to the NRO, be reduced from ordinary rates to the special refundable rate of 25 percent, even though the income remains in Canada. This rate will likely be reduced even further, to the applicable dividend treaty rate, when the income is distributed. Second, and depending on the tax regime applicable in the home country of the foreign investor, the investor may be able to defer or eliminate home country taxation. For example, in certain jurisdictions (such as the United States), the payment of a stock dividend is generally not a taxable event. In such circumstances, it may be possible for the NRO to pay stock dividends and reduce the effective tax rate in the NRO from 25 percent, to the dividend withholding rate applicable to NROs under the relevant tax treaty, without any income inclusion in the investor country. Of particular concern to the Committee is the fact that these types of planning alternatives may encourage non-resident investors to transfer indebtedness to their Canadian subsidiaries, in circumstances where this might not have otherwise occurred.

RECOMMENDATION

The Committee recommends the repeal of the NRO provision, subject to a transitional period.

While the NRO could be viewed as a vehicle that encourages both direct and portfolio investment by non-residents in Canadian corporations – thus creating employment and growth in the Canadian economy – the Committee is of the view that the benefits are limited. In the first place, it is not widely used: in 1994, there were less than 100 NROs in existence. Also, it is unclear whether NROs function to attract additional capital to Canada, or whether, in fact, NRO tax planning structures are more often put in place once an investment decision has been made. The existence of NROs may be acting as an incentive to non-resident investors to thinly capitalize their Canadian subsidiaries.

Transfer Pricing

Introduction

Transfer pricing is a term used to describe the price at which goods, services and capital are exchanged between related parties operating in different tax jurisdictions. The design and application of Canadian transfer pricing rules, and their potential impact on the domestic revenue base, is significant. For example, for 1993, related-party, cross-border transactions of $248 billion were reported to Revenue Canada by taxpayers, $166 billion of which was between related parties in Canada and the United States. Considering that Canada raised close to $20 billion in federal and provincial corporate income tax in 1996, even relatively small percentage shifts in income allocable to Canada from related-party transactions have the potential to cause a significant erosion of (or enhancement to) the domestic revenue base.

The Statutory and Administrative Framework for Transfer Pricing

Prior to the February 1997 federal budget, Canadian legislation required that transactions between a Canadian taxpayer and a related non-resident take place at the amount that would have been reasonable in the circumstances had the parties been dealing at arm's length. The 1997 budget announced that the legislation would be revised to more closely reflect the OECD guidelines, and new legislation has been proposed to achieve this change. At the time of the writing of this Report, this legislation has not been enacted.

In response to legislative and administrative pressure from the United States (described immediately below) and other countries, the February 1997 federal budget also proposed that taxpayers be required to provide contemporaneous documentation supporting the transfer pricing methodology used, and the imposition of penalties where these documentation requirements were not met or where the taxpayer did not act diligently in establishing transfer prices in conformity with the arm's-length principle. These requirements for contemporaneous documentation, and penalty provisions, are also included in the proposed legislation.

Statutory and Administrative Approach in the United States

The approach is somewhat different in the United States. While the United States endorses the OECD guidelines, U.S. authorities have also legislated detailed and complex transfer pricing regulations, which, for example, authorize the use of the "comparable profits method." Under this method, the profit performance of a particular related party is, in general terms, compared with the profit performance of arm's-length companies performing similar functions.

In recent years, the United States, from both legislative and administrative viewpoints, has adopted a more vigorous approach than most other countries in the area of transfer pricing. In the statutory area, the U.S. transfer pricing regulations require that contemporaneous documentation be available at the time of filing of a U.S. corporate tax return, to support the transfer pricing methodology used;

otherwise, any transfer pricing adjustments that are ultimately sustained may attract penalties of either 20 percent or 40 percent of the amount of the tax adjustment (depending on the amount of tax at issue). From the standpoint of administration, U.S. revenue authorities devote significant resources in reviewing and pursuing transfer pricing issues, often with teams that include, in addition to international tax agents, economists and industrial engineers.

The Committee is aware of concerns that, because of the statutory and administrative framework in the United States, there has been a tendency for businesses to establish transfer pricing practices that result in a greater proportion of income being recorded in the United States than would otherwise be the case. Further, many taxpayers are tending to rely, in whole or in part, on the comparable profits method when developing their transfer pricing policies, in a manner that may not be entirely consistent with OECD guidelines. These phenomena are of special concern to Canada because of the very significant volume of related-party transactions between the two countries and the potential for serious erosion of the tax base.

Conclusions

The existence of penalty provisions and documentation requirements in certain other countries (most particularly the United States), combined with aggressive transfer pricing audit procedures in those jurisdictions, poses a threat to the Canadian tax base. In particular, many businesses may, in the past, have sought to "overcomply" with tax rules in those foreign jurisdictions, to the detriment of the Canadian revenue base. On the other hand, when other countries respond with their own administrative, enforcement and penalty initiatives, taxpayers face the threat of double taxation and an escalating compliance burden.

While it is important that a balance be struck between protection of the domestic revenue base on the one hand, and the compliance cost and potential for double taxation imposed on taxpayers on the other, the Committee is of the view that, having regard to the volume of cross-border transactions with related parties (particularly in the United States) the threat to the Canadian revenue base is significant, and that Canadian legislation and enforcement should ensure that Canada obtains its fair share of the income from related-party, cross-border transactions. A research study on transfer pricing prepared for the Committee and released in December 1996, recommended that Canada introduce penalties for the underreporting of income stemming from transfer pricing manipulation, and that such penalties differentiate between taxpayers who act in good faith as evidenced by contemporaneous documentation, and those who do not.[12] The Committee supports these recommendations, and also endorses the principles that taxpayers should be required to have adequate documentation on a timely basis supporting the transfer pricing methodology used, and that penalties should be imposed if such documentation requirements are not met.

Further, it is the Committee's view that Canadian transfer pricing legislation should incorporate the following elements:

- The level of penalties should reflect the fact that, unlike in certain other countries, interest on taxes is not deductible in Canada.
- Penalties should not apply if the taxpayer provides adequate contemporaneous documentation.
- The penalty should only apply to any net adjustment against the taxpayer, where a taxpayer has both upward and downward adjustments.
- If a taxpayer is in a loss position, the penalty should apply to reduce the taxpayer's loss, rather than require the immediate payment of cash penalties.
- Canadian law relating to transfer pricing should be consistent with the OECD guidelines.

- In other than exceptional circumstances, the actual nature of transactions entered into by taxpayers should not be disregarded or other transactions substituted for them. Such a rule would be arbitrary, and would also lead to double taxation if the tax administration of the other country does not share the same view as to how the transaction should be restructured. The existing general anti-avoidance rule should be sufficient to deal with those exceptional circumstances where it is appropriate to disregard the structure adopted by the taxpayer.

Transactions between Canadian taxpayers and related parties located in low-tax jurisdictions offer particular opportunities to reduce Canadian taxes through aggressive transfer pricing methodologies. The Committee accordingly urges the Canadian revenue authorities to be especially vigilant in reviewing these types of transactions.

Emerging Issues in the Global Marketplace

Owing to their implications for taxation generally, the emerging issues of electronic commerce and international tax competition in the global marketplace are of special interest to the Committee.

Electronic Commerce

The rapid growth of electronic commerce is challenging many of the traditional concepts of income taxation. For example, when goods or services are provided over the Internet, traditional principles and rules may not be sufficient to determine which jurisdiction should have the right to tax all or a portion of the related income.

As noted earlier, a resident of Canada is generally taxed on worldwide income, and a non-resident is taxable on certain types of Canadian-source income, including income from a business carried on in Canada. Income from services is generally sourced to the country in which the services are rendered. However, it can be difficult to determine the source of income where services are offered electronically. Also, the right to tax business income is generally modified by tax treaty, such that a person resident in a country with which Canada has a tax treaty is generally not taxable on income from a business carried on in Canada, unless the business is carried on through a permanent establishment. In the Canada-United States Income Tax Convention, for example, a permanent establishment includes a fixed place of business such as a place of management, a branch or an office. The nature of electronic commerce is such that, in many instances, a traditional physical presence at the point of delivery or sale need not, and in fact does not, exist.

The electronic delivery of information also blurs the definition of what product is being bought or sold, since the traditional product in tangible form may not be present. Frequently, the nature of a transaction will determine its classification for tax purposes, especially with regard to the taxation of royalties. A sale of a tangible good such as a compact disk by a non-resident into a certain country may not give rise to a liability for income tax in that country, but the payment for that tangible good delivered in electronic format might be considered a royalty to use a copyright, and would thereby subject that transaction to tax in that particular country. The U.S. Treasury has proposed guidelines in this area relating to the classification of income involving computer programs.[13]

In addition to tax policy issues created by electronic commerce, the technology also poses challenges to tax administration at the level of compliance and enforcement. Frequently, the audit trail of electronic transactions is difficult for third parties – including tax authorities – to follow. Although electronic records may exist, they are subject to alteration without detection, and third-party paper records to substantiate transactions often are not available. The development of electronic money or payment systems could challenge tax administrations in the same manner as cash transactions, although electronic systems can be designed so as to establish trails and account for the use of such money in a manner similar to credit card transactions. The nature of the technology, however, points to the need for international co-operation on compliance and enforcement.

Governments and their fiscal agents must continue to monitor the potential impacts of global commerce on tax revenues. The challenge for tax authorities is to devise a means of sourcing such transactions to a particular location, either by extending existing principles to encompass electronic commerce or by creating new rules. Alternatively, source-based taxation may become less relevant, and residence-based taxation could become the standard charging provision for income arising from electronic commerce.

The issues of taxation and electronic commerce have an impact on both governments and businesses – the former confront the risk of tax base erosion, and the latter face uncertainty as to taxation of their operations. Several countries are actively studying these issues, work is being undertaken by the OECD, and a task force dedicated to this issue has been formed in Canada. While the potential risks are well identified, the technology continues to evolve and solutions remain elusive. The Committee favours continued debate and analysis of these issues in Canada, within the OECD, and by businesses undertaking electronic commerce.

Tax Competition

As the pace of economic integration in the global economy accelerates, countries have become increasingly aware of their economic interdependence. Governments have learned that business taxation affects investment and jobs, especially when the taxes levied are higher than those found in competing jurisdictions. However, they are also aware that taxes finance public expenditures on goods and services such as education and transportation – important factors that businesses take into consideration when choosing a jurisdiction in which to locate. Given that different countries have varying preferences for addressing these challenges, it is neither expected nor, we believe, desirable that all countries choose the same level of taxes and public expenditures in the face of global economic integration.

However, knowing the sensitivity of investment and jobs to taxes, a number of capital-importing countries have engaged in "tax competition" by establishing special preferences or low-tax entities to attract capital and jobs to their country from other competing jurisdictions. The most common forms of tax competition include tax holidays, tax-free zones and other tax preferences, such as low statutory income tax rates for designated activities, investment allowances, investment tax credits and accelerated depreciation. Capital-exporting countries have found that, as a result, they are losing more than jobs and investment. Relatively low corporate income tax rates also encourage businesses to shift taxable profits from high to low tax-rate jurisdictions, thereby eroding tax bases of those countries that are trying to maintain the integrity of their own corporate income tax regimes.

Aggressive competition by capital-importing countries to attract jobs and capital tends to encourage capital-exporting countries to retaliate by introducing their own tax preferences. The result is a race to the bottom – a short-term strategy for jobs and investments that results in retaliation by other governments to protect their own interests. In the end, each country chooses an inefficient tax structure. For these reasons, some experts have made the case that governments should strengthen co-operation at the international level, in order to curtail the most harmful effects of tax competition.[14] The Committee encourages the government to involve Canada in these international efforts.

Endnotes

1 Foreign direct investment is generally defined, for this purpose, as investment by a person with an ownership interest of at least 10 percent.

2 In two recent and extensive surveys, Lipsey (1995) argues that foreign activities of Swedish multinationals have resulted in more domestic activity and job creation, while Feldstein (1995) has argued that each dollar of foreign investment has resulted in one dollar less of domestic investment by U.S. multinationals. Brean (1997) suggests that there is substantial complementarity between foreign and domestic activities of Canadian multinationals. In work done for the Committee, Altshuler and Cummins have found that foreign and domestic capital investments are substitutes, ignoring scale impacts and competitive conditions in an industry (Altshuler and Cummins (1997), Technical Committee Working Paper 97-4). In our view, there is some complementarity between foreign and direct activities for Canadian businesses.

3 See Hines (1996).

4 See Cummins (1996), Technical Committee Working Paper 96-4, for an analysis of U.S. multinational investments in Canada and the United States, and Altshuler and Cummins (1997), Technical Committee Working Paper 97-4 for Canadian multinational investment in the United States and Canada.

5 See, for example, Jog and Tang (1997), Technical Committee Working Paper 97-14.

6 This relief from double taxation is often provided unilaterally under domestic tax legislation in addition to tax treaty provisions.

7 For a further description of the current Canadian tax treatment of foreign source income, and comparison with treatment in several other countries, see the working paper prepared for the Committee by Arnold, Li and Sandler (1996), Technical Committee Working Paper 96-1.

8 On the cost of compliance with the U.S. foreign tax credit regime, see Blumenthal and Slemrod (1995).

9 Grubert and Mutti (1995) estimate that the United States has even lost revenue from the taxation of foreign source income under the deferral method.

10 The exemption from FAPI for interaffiliate payments and other transactions includes payments received by certain partnerships; certain payments by foreign affiliate holding companies in jurisdictions that have consolidated or combined tax reporting for members of a corporate group; and income derived by a particular affiliate from factoring of accounts receivable, or from loans or lending assets, provided that the accounts receivable, loans or lending assets were acquired by the affiliate from a related non-resident corporation, and other prescribed tests are met.

11 For a detailed discussion, see Williamson and Garland (1996), Technical Committee Working Paper 96-12.

12 See Turner (1996), Technical Committee Working Paper 96-10.

13 Proposed Treasury Regulation 1.861-18, 61 Fed. Reg. 58, 152 (November 13, 1996).

14 See, for example, Tanzi (1995). The European Council of Finance Ministers also recently agreed to a package of measures to address perceived "harmful tax" competition.

2001 International Tax Seminar

Learning the Ropes for Going Global

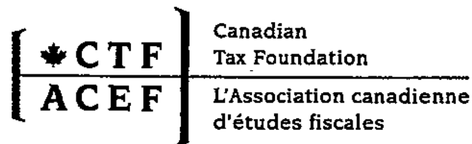
2

Thursday, February 8

9:00 am What Is the Problem with Offshore Income?

- Underlying tax policy issues regarding the taxation of offshore income
- Development of Canadian rules
- The impact of domestic tax changes in light of international trends
- Equitable treatment between residents and non-residents

Wallace G. Conway and J. Scott Wilkie



February 8-9
Hyatt Regency Hotel, Calgary

Canadian Tax Treaties

- Facilitate International Trade and Investment
  - Relief from double taxation
  - Information sharing
  - Dispute resolution
- Generally Follow the OECD Model

Canada's tax treaty network has important implications both for the taxation of foreign source income of residents of Canada and for the taxation of Canadian source income of non-residents. The fundamental purpose of tax treaties is to facilitate international trade and investment by eliminating the double taxation of income from international transactions. Information sharing is also important.

A Tax treaty may allocate the right to tax certain income of a taxpayer exclusively to the country of residence of the taxpayer. It may also provide for the taxation of income of a taxpayer in both countries that are party to the treaty, but require the country of residence to give relief for the taxes levied by the country of the income source.

Canada's tax treaties generally follow the pattern established by the Model Tax Convention on Income and on Capital of the OECD.

Canada's International Tax System - Tax Policy

- Tax Equity and Neutrality
  - Residents compared to residents - income from all sources
  - Non-residents compared to residents - Canadian source income
  - Domestic compared to foreign source income (timing issues)
  - Relief from double taxation
  - Domestic compared to foreign investment

Tax equity and neutrality are the basic reason that residents of Canada are required to pay tax on their income from all sources, including foreign sources to remove any disincentive for investing in Canada. Tax Equity and neutrality also require that that double taxation of foreign source income be eliminated in order to provide for a fair tax result and remove what would otherwise be a disincentive for foreign investment. Timing of recognition of foreign source income also affects tax equity and neutrality.

There are two theoretical views of international neutrality - capital import neutrality and capital export neutrality. Capital export neutrality would be achieved by subjecting foreign source income earned by residents of Canada and their foreign entities to Canadian tax on an accrual basis and providing an unlimited refundable foreign tax credit for foreign taxes on foreign income. Capital import neutrality would be achieved by by exempting residents of Canada from Canadian taxation on their foreign source income and taxing non-residents on their Canadian source income on the same basis as residents.

Elements of both types of international neutrality exist in the Canadian system. Canada taxes income from all sources and provides relief from double taxation. Canada also taxes income of foreign entities of residents of Canada. On the other hand, tax deferral is permitted in respect of foreign active business income earned by foreign affiliates.

Canada's International Tax Regime - Objectives

- Tax Base Protection
- International Competitiveness
- Investment Neutrality
- Administration and Compliance

Tax base protection has been important because Canadian tax rates have historically been higher that the rates of other countries. Therefore, taxpayers are interested in shifting revenue outside and expenses inside Canada. Even with the announced rate decreases in Canada, tax base protection will remain an issue because of the existence of tax haven regimes.

International competitiveness is important in a global economy. Canadians must be able to compete effectively in the international market place with their foreign based competitors. Preserving international competitiveness does not mean exempting foreign income from Canadian taxation. Tax deferral may however be warranted.

Investment neutrality is important to the Canadian economy. Foreign investment must not be favoured over Canadian investment. Incentives to invest outside Canadian are generally detrimental to the growth of the Canadian economy and need to be removed from the Canadian tax system. As well, domestic investment of non-residents should receive the same tax treatment as domestic investment of residents. At the same time it would be inappropriate for Canada to provide incentives for non-residents to invest in Canada that are not available to residents.

Tax compliance and administration are always a problem because of the difficulty in gathering information and the complexity of the rules. Significant costs are associated with the international tax system.

Canada's International Tax System - Global Context

- Small Open Economy of Canada
- Tax Treaties and International Norms Influence Canadian Tax Policy.
- International Co-operation Required to Deal with International Tax Issues.

As a capital exporter, Canada has an interest in ensuring that

- it does not discourage foreign investment by Canadian residents,

- it gets a fair share of the tax revenues from that foreign investment, and

- cross-border transactions are not used to erode the Canadian tax base.

As a capital importer, Canada has an interest in maintaining a tax system that

- encourages investment in Canada by non-residents, and

- does not favour foreign investment over Canadian investment by Canadians.

Canada is a country with a small open economy and it must establish its domestic tax rules giving due consideration to the rules of other countries and the international network of tax treaties which governs the relationships among countries' tax systems.

The Organisation for Economic Co-operation and Development ("OECD") has become much more active over the last decade in disseminating information about international tax and promoting co-operation among member and non-member countries. Since many international tax issues are beyond the capacity of any single country to deal with adequately, these multilateral efforts are extremely important. Canada has taken an active role in the OECD and in other international organisations with respect to international tax issues and must continue to do so.

FAPI Rules - Issues

- Excluded Property
  - Promotes foreign holding company structures
  - Canadian tax avoided
  - Inequitable treatment of taxpayers
- Participating Percentage of FAPI of CFA Share
  - Canadian tax avoided
  - Applies only in respect of shares of CFA

If a Canadian resident disposes of the shares of a foreign affiliate, any taxable capital gain or allowable capital loss must be included in computing the taxpayer's income. Relief is available through the making of an election under subsection 93(1) of the Act to treat some or all of the proceeds of disposition in respect of the shares as a dividend.

Taxable capital gains and allowable capital losses from the disposition of shares of foreign affiliates and partnership interests that constitute excluded property areexcluded from FAPI and included in the affiliate's taxable surplus for purposes of the foreign affiliate rules. Since dividends out of taxable surplus are rarely paid to a Canadian corporation, the treatment of taxable capital gains and allowable capital losses arising from the disposition of shares of a foreign affiliate that constitute excluded property is equivalent to the complete exemption of such amounts from Canadian tax.

The treatment of taxable capital gains and allowable capital losses in respect of shares of foreign affiliates and partnership interests as excluded property seems unnecessary and overly generous in light of the availability of the election under section 93(1).

FAPI Rules - Possible Approaches to Issues

- Excluded Property
  - Exclude shares and partnership interests
  - Exclude a sale of all or substantially all of the business assets
  - consider a replacement property rule
- Participating Percentage of FAPI of a CFA Share
  - Apply in respect of shares of foreign affiliates

It is difficult to justify the more favourable treatment of capital gains and losses realised on the disposition of excluded property (such as shares of foreign affiliates) owned by a controlled foreign affiliate of a taxpayer when compared to those realised on the disposition of such property owned directly by the taxpayer.

The existing rules encourage Canadian taxpayers to structure the ownership of their offshore operations through a holding company located in a low tax jurisdiction. The holding company can dispose of the shares of the operating foreign affiliates without any Canadian tax on the resulting gains.

To correct this inequity, the definition of excluded property could be amended to exclude shares of a foreign affiliate and property sold as part of an asset sale where all or substantially all of the assets of a business are sold. The effect of the exclusion of shares of a foreign affiliate from the definition of excluded property will be to exclude interests in partnerships from qualifying as excluded property.

Consideration could be given to providing deferrals to the extent that proceeds are rolled over into acquisitions of replacement excluded property such as active business assets and shares.

In calculating FAPI inclusions, the rules in subsection 91(1) could be made to apply to shares of foreign affiliates.

ABI Rules - Goals and Tax Policy

- International Competitiveness
- Tax Equity and Neutrality
- Tax Base Protection

ABI Rules - Features

- Foreign Affiliate
- Deferral of Taxation of ABI of Affiliate
- Dividend Income from Affiliate
- Tax Relief-foreign withholding tax

(continues)

Investments in foreign affiliates are intended to be investments in foreign corporations over which the taxpayer has some influence and control. A foreign affiliate is a non-resident corporation in which the taxpayer has an equity percentage of at least 1% and the taxpayer or the taxpayer and related persons have an equity percentage of at least 10%.

Exempt surplus consists of income from an active business carried on in a treaty country by a foreign affiliate of a taxpayer resident in a treaty country, dividends out of exempt surplus of other foreign affiliates of the taxpayer, exempt portion of capital gains and taxable capital gains from dispositions of property used or held in an active business carried on in a treaty country.

The exemption for dividends out of exempt surplus is a proxy for a foreign tax credit and the assumption is that foreign taxes at rates comparable to the Canadian rate has been paid on the active business income.

Taxable surplus includes income, dividends and taxable capital gains not included in exempt surplus.

The deduction for dividends out of taxable surplus is determined by grossing-up the foreign tax applicable to the dividend to reflect the before tax income amount of the affiliate on the assumption that tax was paid at the Canadian corporate rate.

ABI Rules - Tax Base and Policy Issues

- Definition of FA (farming in)
- Excess Foreign Tax Relief-Interest Expense Unrestricted
- Excess Foreign Tax Relief - Low Rate Exempt Surplus
- Foreign Investment Bias
- Administrative and Compliance Complexity

The percentage ownership threshold for foreign affiliate status is quite low. A foreign affiliate of a taxpayer resident in Canada is a non-resident corporation in which the taxpayer has at least a 1% equity percentage and the taxpayer together with related persons has at least a 10% equity percentage. A 10% equity percentage in a corporation can be attained by owning 10% or more of the shares of any class, which is relatively easy for taxpayers to satisfy or avoid depending on the desired result.

Tax base erosion arises because Canada permits the deduction of interest in Canada on funds borrowed and invested in foreign affiliates but does not tax the foreign business income paid to shareholders as dividends out of exempt surplus. Also Canada provides for relief from double taxation on foreign income paid by foreign affiliates as dividends out of taxable surplus to shareholders without reducing the relief by the related interest expense. The timing of the deduction of the interest and the recognition of the revenue also results in tax base erosion.

The exemption surplus system was intended to provide relief from double taxation and is a proxy for a foreign tax credit system. It assumes that the foreign tax rate and base of treaty countries are comparable to the Canadian tax rate and base. Canada has entered into tax treaties with a number of countries with tax rates that are much lower than the Canadian rate and tax bases that differ from the Canadian base. Providing exempt surplus where insufficient foreign taxes have been paid erodes the Canadian tax base.

ABI Rules - Possible Approaches to Issues

- Interest Deductibility
  - Match income and expense,
  - Grind relief from double taxation
- Interest Allocation
  - Domestic allocation formula
  - World-wide allocation formula
  - Tracing
  - Administrative approach

(continues)

The tax base erosion that can be attributed to the lack of matching of interest expense and the related foreign income could be addressed by restricting the deduction of such interest or reducing either the foreign income for foreign tax credit purposes or any deduction in respect of dividends from foreign affiliates under section 113 of the Act by the amount of such interest.

Allocating interest for this purpose poses special challenges and there are several options available. An allocation formula approach involves the assumption that a taxpayer's debt is used to support all of the taxpayer's assets or activities proportionately, whereas a tracing approach assumes that it is possible to match a use of funds with the source of the funds and match income and expense.

A domestic allocation formula would operate by treating a portion of a corporation's interest expenses as having been been used to finance foreign investments equal to the proportion that the value of the corporation's foreign assets is of the total value of all the corporation's assets. To prevent avoidance of the rules, the allocation formula would operate on a group basis with all expenses and assets of a related group of corporations resident in Canada being pooled together. A world wide allocation formula differs from a domestic allocation formula in that the group includes all related corporations, rather than being restricted to corporations resident in Canada.

ABI Rules - Possible Approaches to Issues

- Excess Relief From Double Taxation
  - Credit for foreign taxes paid
  - Taxable surplus approach
  - Designated jurisdiction approach
- Foreign Affiliate Definition
  - Qualifying interest approach

Under a foreign tax credit or taxable surplus approach, a taxable surplus system could be adopted. The relief in Canada would then be based on underlying taxes paid and not on the assumption that taxes have been paid at Canadian rates. Since there would only be one surplus pot, simplicity would be achieved. There would be no need to designate or monitor foreign countries tax systems.

Under a designated jurisdiction approach, all dividends paid by foreign affiliates in designated countries would be exempt from Canadian tax. Dividends paid by other foreign affiliates would be taxable with a foreign tax credit as under the taxable surplus system. The current exemption/credit system of the existing rules would be retained but would be based on an entity approach rather than a transactional approach. A country would only be designated if its tax rate and base were approximately equivalent to the Canadian tax rate and base. By denying exempt treatment to other countries, erosion of the Canadian tax base will be prevented. Complexities would arise under this system.

As most of Canada's tax treaties guarantee exempt surplus treatment, Canada would have to renegotiate tax treaties with countries with such treaty provisions.

The definition of "foreign affiliate" could be amended to include only foreign corporations in which the taxpayer, together with all related persons, owns shares with at least 10% of the votes and 10% of the value of the corporation.

International Tax Policy Directions: Some Thoughts on Recent Canadian Experience

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[N]o country today is an island, sufficient unto itself. Rather, each is a part of the whole and consequently is influenced, directly and indirectly, by what happens elsewhere. At the same time, the precise manner in which such influences are reflected in fiscal change will doubtlessly continue to depend upon a wide range of social, political, historical, and institutional factors peculiar to each country.[1]

[G]overnments will lose some autonomy in taxing powers. . . . [G]lobal economic integration has precisely this impact: governments are constrained in what they can do. Central governments in countries such as Canada . . . are thus doubly pressured on the one hand, from below to "decentralise" in response to the upsurge of regionalism . . . and on the other hand, from international competition to cut the costs of taxation and harmonise.[2]

1 Richard M. Bird, "Experience from a Century of Change," in Herbert Stein, ed., *Tax Policy in the Twenty-First Century* (New York: John Wiley & Sons, 1988), 17-32, at 23.

2 Richard M. Bird and Jack M. Mintz, "Future Developments In Tax Policy" (1994), vol. 22, no. 3 *Federal Law Review* 402-13, at 410.

Tax Policy, Tax Practice, and Contemporary Business Developments

International influences of the sort mentioned above are always in the background of tax policy and practice. Increasingly, however, their practical significance is becoming more acute and perhaps pervasive. Historically, the presence of international business in a jurisdiction was readily apparent because of, and its effects on public policy and regulatory developments in the jurisdiction were as a practical matter limited by, a variety of institutional, physical, industrial, and geographic factors that relate largely to how typical business was and generally in fact only could be conducted in relation to the jurisdiction. Consequently, to be responsive to the influence of external business factors, domestic tax policy did not have to be terribly refined. In any event, those forces tended to be most relevant at the margins of tax policy and practice and even then within regulatory paradigms that, it was perceived, were well understood. An outgrowth, or perhaps element, of business internationalization, however, is that there is often no need to be "anywhere" to access economic opportunities that originate in a jurisdiction—to have the same fundamental "economic presence" in a country as is typified by the characteristics of the business infrastructure that underlies most countries' tax rules. When business and economic exigencies threaten to emasculate the significance and utility of even the most rudimentary markers of tax jurisdiction—effectively of the way in which countries appropriate a measure of the "international tax base" to fund government—we are compelled to reconsider the depth of our understanding of international tax concepts and imperatives that perhaps have been taken for granted as adequate reflections, broadly, of how taxpayers behave. This is so not only in a "large" public policy sense, but also in practice as tax policy choices and pressures become reflected, notably in the international area, in complex legislation that incorporates not only domestic tax policy imperatives but also, implicitly, reactions to similar developments elsewhere. Uncertainty about how to make sound, insightful, and practical judgments about the interpretation and application of the tax law that affects complex transborder transactions and commercial relationships is not a surprising consequence.

The general "internationalization" of business, and more importantly the *way* it has become internationalized, has raised the stakes on the need for a country to develop a coherent international tax policy that is more or less consistent with the policy of its major trading partners. While countries presumably are not prepared to cede economic and social choices implemented with the assistance of their tax systems to the vagaries of international economic and fiscal competition, neither, as the commentators to which we refer at the outset note, can they ignore economic and tax policy choices elsewhere even if fundamentally they reflect societal choices that are not necessarily consistent or easily reconciled with their own. There is a premium accordingly on taxpayers and advisers being aware of the conceptual directions of such tax policy in order to be able to

deliver technical and perhaps more importantly strategic tax advice to international business interests to understand with the necessary insight the implicit characteristics and scope of international tax rules.

The modest goal of this commentary is to reflect broadly on a variety of contemporary tax policy developments in the Canadian setting in a way that makes their themes and possible significance more accessible to those in practice who are dealing with them and their underlying influences whether they realize it or not. These comments are offered from the vantage point of a tax practitioner who is interested in tax policy, not that of a tax policy scholar or fiscal prophet. Hence, these comments are presented with the healthy trepidation that they have failed to reflect, and indeed have oversimplified, the richness and complexity of tax policy that necessarily underlie its legislative formulations. It is hoped, nevertheless, that the personal reflections offered here will help to stimulate practical discussion of international tax developments in Canada, reaching beyond complicated, and for practitioners arcane, theoretical public finance notions that are the preserve of a few, while at the same time not being constrained in the deliberate expansiveness of these observations by specific analyses of recent legislative developments that manifest evolving international tax policy. The interesting objective here lies in identifying and collecting the threads of Canadian tax policy development with a view to enlivening debate about the evolution of Canadian tax rules in the international area.[3]

The Beginning of the Beginning

What is the watershed for increasing interest in international tax policy issues? Forces in that direction have been gaining momentum for some time, certainly

3 For perspectives on these issues, see Jack M. Mintz, "The Future of Canadian Tax Policy or 'What the Minister of Finance Can Look Forward To,'" in Richard M. Bird, Michael J. Trebilcock, and Thomas A. Wilson, eds., *Rationality in Public Policy: Retrospect and Prospect, A Tribute to Douglas G. Hartle*, Canadian Tax Paper no. 104 (Toronto: Canadian Tax Foundation, 1999), 61-78; Jeffrey Owens, "Emerging Issues in Taxing Business in a Global Economy," in Richard Varn, ed., *Taxing International Business: Emerging Trends in APEC and OECD Economies* (Paris: Organisation for Economic Co-operation and Development, 1997), 25-66; Joseph Guttentag, ibid., 67-84; Jack M. Mintz, "Is National Tax Policy Viable in the Face of Global Competition?" (July 5, 1999), vol. 19, no. 1 *Tax Notes International* 99-107; Richard M. Bird, "A View From the North" vol. 49, no. 4 *Tax Law Review* 745-57; John F. Avery Jones, *Are Tax Treaties Necessary?* Tillinghast Lectures on International Taxation (New York: New York University School of Law, 1997); Richard M. Bird and J. Scott Wilkie, "Source vs. Residence-Based Taxation in the European Union: The Wrong Question?" Discussion Paper no. 10 (Toronto: University of Toronto, Joseph L. Rotman School of Management, International Centre for Tax Studies, 1997), as revised to be published in Sijbren Cnossen, ed., *Taxing Capital Income in the European Union: Issues and Options for Reform* (Oxford: Oxford University Press, forthcoming June 2000); Sijbren Cnossen, "Company Taxes in the European Union: Criteria and Options for Reform" (November 1996), 17 *Fiscal Studies* 67-97; and Malcolm Gammie, "Taxation Issues for the European Company" (1998) *EC Tax Review*.

from the mid-to-late 1980s. Interestingly, since 1995, however, when the Organisation for Economic Co-operation and Development (OECD) revised its transfer-pricing guidelines, the fiscal world's attention has been more and more directly focused on the reliability with which international income may be measured and associated with any particular jurisdiction using traditional tax concepts, in terms of the basis for asserting tax jurisdiction and the utility of traditional tax accounting and income allocation devices applied in respect of typical organizational units to connect income with the jurisdictions in which it arises.[4] There is increasing scepticism about the practical effectiveness of typical limits adopted by established tax regimes to assert tax claims.[5] They are perceived to have been impaired in practice by changing business patterns and the absence to any meaningful degree of what innocently is described as international tax harmonization. This same discussion now also takes place in the guise of subjects such as "harmful tax competition," "permanent establishment," jurisdictional nexus, the scope and reliability of "controlled foreign corporation" (CFC) rules, and a variety of other specific subjects, foreshadowing a continuing and increasingly intensive re-examination of fundamental income and other tax principles and practices in light of the pressure exerted on them by international commercial and business freedom commonly associated with the term "globalization."[6] Essentially, a collision is taking place between business activity exemplified by "free trade"—less and less restricted by institutional, regulatory, physical, and

4 The attention that has been paid to transactional profit methods for testing transfer prices by the OECD in *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995) (looseleaf) in chapter 4 reflect this. A similar development is found in the recently published transfer-pricing guidelines of Revenue Canada in *Information Circular* IC 87-2R, September 27, 1999. Article 9 of the *OECD Model Tax Convention on Income and Capital* (Paris: OECD) (looseleaf) focuses on profit or income, a net concept, and inevitably measures of pricing, whether on a transactional basis or not, are destined to test the adequacy of reported income according to the arm's-length standard.

5 The present debate surrounding the application of traditional income tax principles to electronic commerce largely concerns the seeming inadequacy of typical jurisdictional tests to adequately capture the kinds of "activity" that underlie the conduct of business electronically. Indeed, however, it may be that the modern communication medium of the Internet simply illustrates inherent weaknesses in jurisdictional tests that have long been taken for granted but were not tested too severely because of the dependence of traditional trade on physical connections to the jurisdiction in which business was conducted.

6 As Mintz succinctly notes in *Tax Notes International*, supra footnote 3, globalization connotes both factor mobility and increased integration of business activity. As the official discussions of electronic commerce published by various governments, notably the United States, Australia, and Canada (see Canada, *Electronic Commerce and Canada's Tax Administration: A Report to the Minister of National Revenue from the Minister's Advisory Committee on Electronic Commerce* (Ottawa: Revenue Canada, April 1998), at chapter 3) indicate, there is considerable concern about the adequacy of traditional income tax concepts to describe the way in which modern business is conducted, although perhaps "globalization" is too preoccupied with the medium of business rather than its implicit characteristics.

geographic constraints—and the essential "sovereignty" of tax jurisdictions, which has rested easily on constraints of the sort that traditionally have characterized the necessary business and personal connections of economic actors to jurisdictions from whose economies they profit.[7]

Canada, too, seems to be engaged in a re-examination of its "international tax policy." This may or may not be systematic or deliberate, rather than merely evolutionary, but it is occurring. There are some basic themes and patterns that, in our view, reflect significant international developments. Fundamentally, however, they are all associated with a re-examination of how the international income tax base should be shared, if it should be shared at all.[8] In fact, as the ability to define the connection of business with and in a jurisdiction becomes more difficult, fundamental questions that essentially concern why any sharing is appropriate are emerging, if only in veiled form.

The development of tax policy is generally a domestic exercise that expresses itself in the formulation of specific legislative rules to assist governments in influencing patterns of economic behaviour and to fund public expenditures. Apart from rather modest opportunities, primarily through bilateral income tax conventions, taken by countries cooperatively to organize the way in which their tax systems encounter each other, there is no systematic mechanism by which countries actively cooperate in the development of international tax policy. Accordingly, as a platform for our consideration of international tax policy developments in Canada, we consider briefly what we mean by international tax rules. We then comment on broad international developments as we perceive them, organize recent Canadian changes in this light, and then offer some observations as to what the future may hold.

A Simple Thesis: "Foreign Tax Credit" Writ Large

What does it mean to "share the international tax base"? Our thesis is simple and has three main elements. First, what commonly are referred to as "international tax rules" generally arise as a consequence of countries' needs to anticipate how freedom from physical and legal restrictions on trade across the national borders should affect what would otherwise be a jurisdiction's primary sovereign claim

7 See Bird and Wilkie, supra footnote 3, for a discussion of issues in this area. See also H. David Rosenbloom, "What's Trade Got To Do With It?" (1994), vol. 49, no. 4 *Tax Law Review* 593-98, where Rosenbloom reflects on the connection between taxation and the funding of government in considering the unlikelihood that countries will cede "tax sovereignty." By the same token, Bird, supra footnote 3, Bird and Wilkie, supra footnote 3, and Rosenbloom address the possibility of practical solutions to the harmonization conundrum, which is reflected in an approach that could be characterized as cooperative coexistence without integration.

8 This is a question that no longer is being taken for granted. See, for example, Joint Committee on Taxation, "JCT Reports on International Taxation" (July 5, 1999), vol. 19, no. 1 *Tax Notes International* 69-98.

to tax income of its own and non-resident taxpayers from the affected activity (because of its necessarily close original connection to the country based on how income was earned and where the activity takes place), and in so doing to achieve, or preserve, various underlying fiscal and economic objectives. Accordingly, there is an inherent fundamental antithesis, but at the same time interestingly symbiotic connection, between the limits (and freedom from limits) of trade and the imperatives and exigencies of what we refer to as "international tax rules."

Second, the international tax rules and concepts that at present are commonly incorporated in the tax systems of most developed countries are profoundly innocent in relation to contemporary patterns of commercial trade and related organizational and business relationships. International tax rules, whether manifested in direct foreign tax credit regimes, the specific contractual allocations of the international tax base implemented through bilateral income tax conventions, the authority to revalue transactions framed by transfer-pricing rules, or the allocative and tax credit infrastructure that underlies CFC rules, are all devices adopted by countries, mostly unilaterally, to allocate the international tax base based on norms and expectations of trade and, more generally, international flows of capital. Essentially, these devices are intrinsic parts of a foreign tax credit regime that functions as a whole system to define and condition choices about the allocation of the international tax base. It is their function to determine the qualitative circumstances in which and the quantitative degree to which deference should be extended to the primacy of another jurisdiction's tax claim (typically referred to as the source jurisdiction's tax claim), whether by way of rate reduction, direct compensation for foreign tax, or an a priori renunciation of the inclusion of income in the domestic tax base (which is in the basic nature of foreign tax credit).[9] Heretofore, the requirement, or at least the expectation, that conducting business in relation to a jurisdiction entailed certain physical and personal connections limited the need to be very precise about the qualitative characteristics of business that, for example, tax treaty notions of "permanent establishment" and "business income" are meant broadly to reflect.[10]

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9 See Mintz in *Tax Notes International*, supra footnote 3, for his consideration of factor mobility.

10 Most jurisdictional rules are constrained by physical measures of business presence. This is common in tax treaties' definitions of "permanent establishment" and implicit in the "force of attraction" notion that treaties adopt to attribute business income to a permanent establishment. This approach is also reflected in CFC legislation; see, for example, the measure of investment business adopted in 1995 in the Income Tax Act (RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"); unless otherwise stated, statutory references in this paper are to the Act). This measure is fundamentally physical, including those aspects that measure the qualitative characteristics of business in terms of human intervention (the more than five employees test). In this connection, it will be interesting to observe the impact of electronic commerce on the utility of such tests to measure business presence even though intrinsically the relevant activity will be as much "business" as any more typically physical enterprise.

However, the commercial and institutional freedom with which trade increasingly may be conducted without regard to national borders or typical connections within or to a jurisdiction illustrates incipient weaknesses in the theoretical and practical maturity and incisiveness of established jurisdictional rules, at least as they are typically perceived.

Third, embedded, for example, within notions of "harmful tax competition," "permanent establishment," and other current topics on the international tax agenda, the international tax policy discussion at present taking place is increasingly gravitating toward addressing whether and to what extent, in a modern business environment, countries will be prepared or indeed are compelled in tax policy terms to extend foreign tax credits by any of the traditional means or at all.[11] This entails a determination whether the assertion of tax jurisdiction, let alone a relaxation of that jurisdiction, reliably and verifiably can take place in support of domestic wealth creation as a conceptual, substantive, or administrative matter. As the discussion at the conclusion of the session at which the ideas in this paper were presented suggested, it may also entail a reconsideration of the "tax mix,"[12] meaning the relative use of income, consumption, and other taxes in order to generate revenues necessary to support public expenditures and direct economic activity.

It is suggested that much of what appears to be a multifaceted international tax policy study essentially involves two basic elements: a review of countries' foreign tax credit policies and, in a manner of speaking, an evolution toward consistent international tax policy responses to a number of common tax allocation problems among countries through a "convergence" of their tax policies and rules in the direction of common international tax policy without, however, an overt or even covert harmonization of countries' tax legislation.

International Tax Rules

International tax rules are those provisions of a country's domestic tax legislation that deal with international flows of portfolio and business capital, both into

11 See Bird and Wilkie, supra footnote 3, for a discussion of the source-residence debate that is reflected in much of the contemporary discussion concerning the impact of globalization on the allocation of the international tax base.

12 See Bird and Mintz, supra footnote 2, and Mintz, supra footnote 3 in *Tax Notes International*. Inevitably, one of the responses in tax policy discussions that identify fundamental shortcomings in the capacity of the income tax rules to capture business activity and income is to consider the utility of consumption and other tax systems. Fundamentally of concern is the ability to administer the tax system by way of resident consumers being proxy tax collectors as well as the need, perhaps, to adopt new measures of how much value is absorbed or funded by citizens of a jurisdiction. Whether this approach could ever fairly displace the Haig-Simons notion of income is an interesting question. Consumption and other transactional taxes do not capture, and systemically may unfairly prefer, savers.

and out of the jurisdiction. Their essence is a consensual sharing of a finite "tax base" (that is, a zero sum game of allocating international income) among contending national claimants through the adoption, for the most part unilaterally, of allocative devices in the form of CFCs (foreign affiliates), direct foreign tax credits, and tax treaty regimes that in many respects reflect certain common international expectations and characteristics. It is trite, though not trivial, to observe that even in more or less formally developed zones of economic interest such as the European Community, there is no overt sharing of a multicountry tax base or more particularly general harmonization of countries' tax rules.[13] Nevertheless, the existence of these allocative mechanisms adopted as part of a country's tax regime reflects both a sensitivity among contending tax jurisdictions to the possible pre-eminence of another country's (in a business setting, the source country's) primary tax claim, particularly insofar as the taxation of business income is concerned, as well as the assertion of primary hegemony with respect to income that just as easily could have been earned domestically as internationally in the sense that it reflects no special economic attachment to or dependence on a source jurisdiction.

The latter distinction is closely associated with the imperfect notions of capital export, capital import, national welfare neutrality, and international equity that are the traditional foundation of discussions about jurisdictional tradeoffs in the international tax area. A tax system is said to be "export neutral" when it reflects limited institutional preferences in the degree to which income is taxed based on its source. "Capital import neutrality" prevails when there is no bias against investment in a particular jurisdiction induced by tax costs that all participants in the jurisdiction are not required to bear. "National welfare neutrality" is a notion more closely associated with intrinsic social and economic requirements of a jurisdiction that in part are funded by public expenditures generated by taxation; normally it would be asserted that any degree of credit extended by a country in relation to taxes of another would not be justifiable necessarily in terms of promoting national economic welfare. This is balanced by the recognition that countries should fairly share the international tax base

13 It is interesting to consider developments in the European Community. There is no overt harmonization of direct tax systems in the European Community even though arguments can be raised that the freedom of establishment and non-discrimination aspects of the Treaty of Rome would sustain such a development. Even so, however, the issue may not have so much to do with harmonization as with reinforcing the inherently territorial system for taxing business income by rationalizing the tax treatment of various forms of corporate distributions, avoiding the intervention in capital income flows of "free riders" in the form of tax-exempt entities or low-tax jurisdictions and reforming the integrated taxation of corporate income (which involves addressing the impact of taxation on fixed and mobile production factors). See Bird and Wilkie, supra footnote 3, and Cnossen, supra footnote 3. Gammie also considers these issues, supra footnote 3; he and Cnossen consider the significance of corporate taxation for resolving issues associated with "harmonization."

among themselves and in particular should give way to the primary claims of other countries only when there are compelling connections of income and the income-earning activity to the contender jurisdiction.[14]

The origin and continuing significance of international rules in the present setting is perhaps informed by considering conceptually the development of allocative techniques in international tax treaties.[15] Broadly, in a commercial context, international rules are the outcome of a need to avoid income tax impediments to the free flow of business capital or, to put it another way, unrestricted trade in property and services on which domestic economies and more generally open international economies depend.[16] In contemporary terms, however, the rules also reflect a kind of dialectic between traditional notions of domestic tax sovereignty and so-called free trade. As, for example, a comparison of the United Nations and OECD model tax conventions shows, tax treaties anticipate the primary tax claim of a jurisdiction that hosts foreign business enterprise and accordingly try to ensure that particular manifestations of this business reflect a suitable requisite connection in the host jurisdiction to support a tax claim commensurate with the economic opportunities enjoyed by the enterprise in the jurisdiction and the demands that it places on that jurisdiction's economic infrastructure. For example, the limited presence that may be required for a business site to constitute a permanent establishment, particularly in countries that would be disadvantaged by the ability of business enterprises from developed countries to minimize a typical business presence in the host jurisdiction, essentially constitutes a notion of presence in a jurisdiction that is basic and inherently economic from the perspective of what access to the host jurisdiction affords the non-resident in terms of exploitable economic opportunity.[17]

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14 See the discussion in chapter 6 of Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998) (herein referred to as "the Mintz committee").

15 These are primarily in the "permanent establishment" and "business income" articles of tax treaties. Underlying both is a concept of "business presence" in a jurisdiction that typically requires a degree of even temporary permanence or fixedness that justifies the assimilation of a non-resident engaged in commercial activity in a jurisdiction essentially to the same position of a resident in respect of income from that activity. Approached this way, it is not obvious that merely the manifestations of trade, rather than its inherent characteristics, have changed. This does not derogate, however, from serious enforcement issues that arise if there is not an easily taxable-identifiable presence in a jurisdiction.

16 For a discussion of recent cases that address some of these issues in a concrete way, see Joel Nitikman, "Current Tax Treaty Cases of Interest" (September 20, 1999), vol. 19, no. 12 *Tax Notes International* 1089-1109.

17 Compare article 5(3) of the *United Nations Model Double Taxation Convention Between Developed and Developing Countries*, UN Publication no. ST/ESA/102 (New York: UN, 1980) and its counterpart in article 5(3) of the OECD's model tax convention, supra footnote 4. The United Nations model assimilates a 6-month rather than a 12-month period for a site to have the status of a permanent establishment regardless of any other positive tests in the

By design and in result, there is an impetus to limit exploitation of host economies by enterprises from developed countries that are able to manipulate and control the nature of a business presence in the host jurisdiction, notably where a particular physical manifestation of the business is not very instructive of how profitable in economic terms the visiting enterprise is in that jurisdiction or, to put it more objectively, what economic benefit enures to it from the presence there.

Interestingly, these considerations may be closely identified in broad terms with contemporary questions concerning whether a less physical but just as significant economic presence, such as a regular but transient presence of a service consultant or the kind of presence that is manifest by a Web page on a server, should constitute a "permanent establishment." In a sense, the startling implications of electronic commerce for the reliable and verifiable operation of income tax rules is just an updated version of the old permanent establishment issue concerning building sites that we mention above. The concerns being expressed about the practical integrity of the jurisdiction in this context are inherently an expression of concern about avoiding exploitation of a host country—the gratuitous and in a sense selective depletion of its tax base merely because the income-generating activity can take place, the same economic presence can occur, and the same benefit be engaged without an extensive or continuous physical presence. The objective is the same—to preserve a tax claim where sufficient economic "activity" takes place where, perhaps expressed differently, there is a fundamental dependence of the profitability of an enterprise on exploiting opportunities even if the activity is relatively modest in terms of its immediate or continuing physical presence. Another way of looking at this issue is to ask where the economic "value added" is created or matures as a business outcome. Is it at physical manifestations of business in a jurisdiction, or perhaps through less evidently tangible connections (that nevertheless indirectly may sustain or advance the business regardless of their direct connection to the tested taxpayer)? These sorts of connections reflect economic viability in the sense of the economic benefit that implicitly manifests a dependence on custom originating in the jurisdiction. On the other hand, jurisdictions that persist in tax policy that is not sensitive to developments elsewhere risk compromising the economic and fiscal contributions of modern business that can, by the

article, notwithstanding the fact that other provisions dealing with dependent and independent agents would treat service professionals or consultants in themselves as constituting a permanent establishment on the basis of a 6-month aggregate presence within 12 months in a jurisdiction. In this connection, it is interesting to speculate about the evolving standards of the Canadian revenue authorities as to what constitutes a business presence. Notwithstanding an expressed reservation about their substantive significance, Revenue Canada recently published new withholding waiver guidelines with respect to the application of regulation 105, which strongly suggest that even a modest transient presence may be sufficient, in the spirit of what constitutes a permanent establishment, to constitute a taxable business presence.

absence of physical constraints, afford to be more responsive to the effects of taxation on locational decisions.

Typically, the jurisdictional markers on which the original jurisdiction and primacy of income tax systems depend are oriented around notions of "source," "residence," "carrying on business," and "permanent establishment."[18] These limiting concepts were developed and adopted when international trade was less common or at least less complicated commercially and more modest in volume as well as more tied to traditional business and legal forms. The combination of reliance by traditional business on a geographic presence, coupled with a limited volume of international business, mitigated the significance of the innocence of those rules—their need to be refined or precise, or perhaps even to be too significant a concern about administering an income tax on non-residents. These concepts persist as the principal outline of sharing the international tax base. Indeed, they merely effect an artificial though practical reliance for tax jurisdiction on the manifestations of business presence out of which their current interpretation grew, reflecting the incapacity of business generally to be conducted without a typical presence in a jurisdiction.

As more and more attention is paid to economic allocations of income to guide the determination of tax income, it is interesting to observe, though it is not often so perceived, that even in their present form the established jurisdictional compromises are inherently formulaic as a regime for allocating the international tax base. For example, in the notions of "carrying on business" and "permanent establishment" as reflected in articles 5 and 7 of a typical tax treaty is found what is essentially a three-factor formula for apportioning business profits. The permanent establishment article relies fundamentally on an identification of human and physical associations with a jurisdiction; the business profits article, through its profit attribution notion, associates revenue with those physical emanations of business.[19] This is somewhat akin, in a slightly more developed sense, to a formulaic allocation of business income not dissimilar in its fundamental respects to that found in part 4 of the Income Tax Regulations.

These considerations are important in assessing the significance of the developing international tax "order" and indeed for thinking beyond the common established connotations of present tax policy paradigms. Tax regimes are essentially

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18 See the extended discussion on these subjects in Bird and Wilkie, supra footnote 3, as well as the consideration of these and related issues in the sources to which Bird and Wilkie refer.

19 The transfer-pricing rule in the OECD model tax convention, on which the Canadian derivatives are based, speaks in terms of an income (net) notion and not in terms of transactional revenue and expenses. Arguably, in a less sophisticated commercial environment, where the degree of factor mobility and multinational corporate integration was less, there was a likely, though perhaps rough, correspondence between income and transactional revenue offset by expenses. Nevertheless, the focus is on income.

national and in a sense primarily inward-looking in policy terms notwithstanding their adoption of international aspects. Income tax regimes generate the revenue necessary to fund "public goods" (that is, collective consumption by citizens of a jurisdiction) and may be designed to direct economic behaviour to serve national objectives. Largely based on these considerations, it is commonly accepted that the harmonization of income tax systems, whether in the context of a commercial free-trading zone or otherwise, is an unlikely possibility. This would involve limitations on the manner in which domestic economic policy generally would be formed and implemented merely because of the device adapted to fund public expenditures.[20] On the other hand, even within the expectations and limitations of income tax systems, are practical accommodations to the reality of international business occurring in ways that in fact may help the existing tax models to operate notwithstanding their historical antecedents and inherent limitations?

The Thrust of Contemporary Tax Policy and the Business Income Tax Base

Notice can reasonably be taken that developed countries generally are engaged in re-examining the need and their willingness, given the impact of contemporary business practices and their ability to establish reliable connection to economic activity, to extend foreign tax credit in respect of income earned outside their borders and to limit tax claims that arise from insolvent investment. Furthermore, to the extent that there is not a close association of business income with, or a dependence of the earning capacity of business on the characteristics of, a "developed" tax jurisdiction, it would not be surprising if countries became increasingly willing effectively to renounce or limit their right to tax foreign income at all. This is reflected in Canada, among other ways, in an embryonic reconsideration of the foreign affiliate rules, developments that have taken place with respect to section 17 of the Act, modest refinement of the direct foreign tax credit rules that deal with uneconomic sources of income, and in a variety of other areas.

This reconsideration is taking place within theoretical limits established by traditional international tax neutrality notions. Fundamentally, though, it may encompass more deep-seated concerns about the adequacy of typical tax policy

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20 As Bird and Wilkie, supra footnote 3, and Rosenbloom, supra footnote 7, discuss, the subsidiary principle bound up in the notion of tax sovereignty essentially concerns the entitlement of a country to make and fund public choices without being accountable to other countries for those choices through criticism or institutional limitations on tax policy. This is likely the reason that the non-discrimination article of Canada's tax treaties is generally not terribly effective in requiring Canada to provide equal tax treatment to Canadian and non-Canadian enterprises. See Richard Lewin and J. Scott Wilkie, "Canada," in *Non-Discrimination Rules in International Taxation*, proceedings of a seminar held in Florence in 1993 during the Forty-Seventh Congress of the International Fiscal Association (Deventer, the Netherlands: Kluwer, 1993).

responses to deal with difficult allocation issues that pertain to international income, coupled with the systematic attempt to define and control an increasingly fluid and independent tax base that resists confinement according to typical jurisdictional terms. In short, a much more persuasive case needs to be made in order to support the extension of foreign tax credit or limitation of tax jurisdiction in respect of income earned in relation to activity in a host country.

There are several basic tax policy imperatives that seem to influence the taxation of international business income. First, an important characteristic of business income tax regimes, concerning both branch and entity taxation, is their inherently territorial nature notwithstanding an institutional pretension generally to worldwide taxation. The "exemption" aspect of the Canadian foreign affiliate system is essentially a renunciation of tax jurisdiction by way of a blanket foreign tax credit in favour of jurisdictions where business income is earned even if the jurisdiction is not one with which Canada has a tax treaty. Similarly, the computational devices associated with calculating foreign branch income and direct foreign tax credit essentially distinguish between Canadian and foreign business income sources and associated expenses. Second, there is an underlying expectation, which is becoming more prominent in international tax policy discussions, that international trade and investment should proceed in an unrestricted fashion without undue impediments imposed by income and other taxation. This presupposes, however, an ability to identify and characterize trade flows and distinguish business from portfolio investment, which increasingly is difficult in light of the decreasing dependence of modes of business activity on traditional business presences within a jurisdiction with which traditionally the marking of tax jurisdiction has been associated. A third expectation is that income will be subjected to taxation on a "normative" basis somewhere.[21] Underlying much of the present international discussion associated with "harmful tax competition" is a realization by developed tax jurisdictions that it matters not so much which jurisdiction has the pre-eminent taxing authority as it does that the income should be taxed somewhere.[22] What "normative" means, however, is an important question: Rates and bases that are relatively approximate? Something other than tax haven status? Reasonable comprehensiveness and sophistication of tax legislation regardless of differences in the degree of taxation

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21 See the discussion in Jeffrey Owens and Jacques Sasseville, "Emerging Issues in Tax Reform," comments of two senior members of the Fiscal Affairs Directorate at the OECD, presented in India in 1997 at the Annual Congress of the International Fiscal Association, as well as Organisation for Economic Co-operation and Development, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD, 1998).

22 See Bird and Wilkie, supra footnote 3, where the authors conclude with speculation about whether much of the concern about the transience of the international tax base could be addressed by rationalizing the taxation of various manifestations of corporate distributions (that is, the deductibility of some distributions but not others) and eliminating the possibility

attributable to domestic fiscal, social, and economic priorities? Finally, there is an evident theme of "containment" associated with an expectation that eventually the "capital" benefit of international investment will inure to the sponsoring economy and that therefore any modifications in the reach of the domestic tax system are essential only to the extent that the return on the international investment exceeds the present value of the forgone tax.

Reflective of these underlying considerations are two groups of policy issues in play internationally including those in relation to the Canadian system. In a technical sense, these issues merely frame in contemporary terms fundamental questions about whether and how direct or indirect foreign tax credit should be extended and more broadly about the adequacy of the "tax mix" in terms of the suitability of and reliance on income as opposed to consumption or other forms of taxation to describe and capture the value added generated by international enterprise in relation to a particular jurisdiction.

The first is identified with initiatives directed at refining the territorial taxation of business income through attention to the permanent establishment and business profits articles of tax treaties, the scope of CFC rules, and refinements of direct foreign tax credit rules. Included here are aspects of corporate taxation generally, in particular concerning the manner in which corporate income is measured and taxed on its distribution. There is seemingly a "convergence" in the common reactions of tax jurisdictions to these international tax issues. This falls short of a harmonization of tax systems, although in practice it may reflect a similar outcome.

The second is identified with the common concern about where and how business income is earned, its characteristics, and who owns it given the attenuated relevance of and reliance on traditional business forms, traditional forms of property ownership, and typical business presences in earning income. It is necessary to reflect only momentarily on the capacity of a supplier of retail goods located outside Canada to earn business income that in rough terms depends on Canadian custom without having a Canadian business presence simply by "inviting Canadian customers to treat" and then, through traditional distribution mechanics that do not amount to a "permanent establishment," distributing the goods to Canadian customers to understand how infirm in many respects the rudimentary elements of a tax system in fact may be.[23] A related

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that international interaffilite capital income flows can be diverted into situations where no tax is payable and yet the tax base of the paying jurisdiction is depleted because of the deductibility of the charge. See the discussion in Nick Pantaleo and J. Scott Wilkie, "Taxing Foreign Business Income," in *Corporate Management Tax Conference 1998* (Toronto: Canadian Tax Foundation, 1998), 8:1-44.

23 The ineffectiveness, perhaps, of traditional income tax jurisdictional concepts to capture transient business activity conducted via the Internet has drawn attention to "outsourcing" more normative business, taking advantage, for example, of the generosity of Canada's tax

development is the increased prominence of "transactions" as taxpayers.[24] While there always has been a transactional and a personal element to the generation of income in relation to the tax base, it is increasingly evident that legal personality may be less indicative of where and how income is earned than ever before. This has a number of implications. Aside from the reliance of tax systems for jurisdictional purposes on the identification of legal personality and its characteristics in relation to jurisdictional nexus, a transactional presence is inherently more transient and not dependent in any respect on typical jurisdictional characteristics.

International Income Measurement and Allocation

We have identified several conceptual tax policy issues that are made more prominent by the demands and influences of global business. But what specific areas are being considered?

1) A main aspect of any reconsideration of the adequacy of domestic foreign tax credit principles involves evaluating the reasonable scope of foreign affiliate or CFC rules and in particular the essential characteristics of business income and the necessity of that income's being taxable somewhere in order to sustain domestic relief. This involves two main considerations: limits on the capacity to move this income among entities within the multinational corporate group from one jurisdiction to another and retrenchment in the extent to which "passive" international income escapes taxation if earned indirectly.[25]

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treaties to tolerate considerable physical and human presence in Canada without giving rise to a permanent establishment. Recognizing the reality of substantial international "free trade," the Canada-US income tax convention is perhaps the most generous in this regard. Seemingly, a US resident could have an entire distribution network in Canada and with some care avoid being considered to be carrying on business in Canada through a permanent establishment.

24 Hugh J. Ault explores this and related jurisdictional issues in "Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices" (Spring 1992), vol. 47, no. 3 *Tax Law Review* 565-608. The notion of a transaction as a taxpayer takes on much more significance as the operation of income tax systems increasingly cannot reliably depend on the personal characteristics of taxpayers and indeed must contend with divisions of international income which increasingly must reflect underlying economic factors outside the limitations contemplated by traditional business manifestations of such economic factors. It is interesting to consider the evolving willingness of revenue authorities to acknowledge the measurement of income, in a transfer-pricing setting, using profit splits to appreciate that the focus is on economic activity—the transactions—themselves for which taxpayers may simply be a lightening rod. This is notably the case where there is no necessary relationship between the creation of value by way of an income-earning activity and the physical facilities (including taxpayers' personal characteristics) in a jurisdiction to support the income-earning activity. See also Vito Tanzi, *Taxation in an Integrating World* (Washington, DC: Brookings Institution, 1995); and Joel B. Slemrod, "Free Trade Taxation and Protectionist Taxation" (1995), 2 *International Tax and Public Finance* 471-89.

25 See, for example, the OECD's report on harmful tax competition, supra footnote 21, and the comments of OECD officials Jeffrey Owens and Jacques Sasseville, supra footnote 21.

2) Related to the first group of questions is an evaluation of the extent to which, within the confines of a territorial system for taxing business income, there ought to be direct association of deductible charges and the revenue that indirectly is earned with the benefit of those charges. Primarily, this concerns the sustainability in tax policy of domestic interest deductibility on funding raised for foreign incorporated enterprise.

3) In a very basic sense, transfer pricing reflects through the implicit allocation of tax base the same allocative considerations that are more directly implicit in the determination of when and to what extent foreign tax credit should be extended. To the extent that transfer-pricing rules associate taxable income with a jurisdiction, there is an implicit recognition of a primacy to tax that is at the core of a foreign tax credit determination as an allocative device with respect to sharing international income and the associated tax base.

In some respects indeed a transfer-pricing analysis makes these issues easier to understand than the more arcane dimensions of foreign tax credit. In the main, transfer pricing is concerned with developing a reasonable and principled correspondence between economic, and financial or tax, income with reference to the location of business activity that adds value to and within an integrated corporate enterprise. Historical notions of transfer pricing relied heavily on the implications of separate entity accounting in respect of the financial results of legal members of a corporate group—that is, traditional business forms and presence in relation to discrete transactions. Essentially, however, modern transfer-pricing law and guidelines attach less significance to lines of organizational and transactional occurrence than to the measurement of value added in relation to economic enterprise that takes place *in relation to* particular jurisdictions. Hence, there is a guarded recognition of, for example, transactional profit methods for conducting a transfer-pricing analysis.[26]

4) Another area that is attracting attention is the extent to which direct foreign tax credit should be extended in relation to activities that generate only modest income.[27] This is in a sense a version of the credit combination or homogenization issue, which other countries have dealt with in a much more prescriptive and extensive fashion.

5) The electronic commerce debate has inspired considerable analysis of when business activity is sufficient to entail the existence of a taxable presence—a "permanent establishment." Although overtly a jurisdictional issue, again the main concern is whether and to what extent a non-resident has a sufficient presence

26 See, for example, chapter 4 of the OECD transfer-pricing guidelines, supra footnote 4, and part 3 of *Information Circular* 87-2R, supra footnote 4.

27 See the OECD's comments on harmful tax competition as well as the observations of Owens and Sasseville, supra footnote 21.

in, or economic dependence on, a jurisdiction to warrant the application of domestic tax rules to income that in some sense is generated within that jurisdiction or otherwise arises from ties with or custom originating in the jurisdiction. In foreign tax credit terms, the question is whether such a presence is sufficiently prominent in relation to that of the taxpayer in its principal tax jurisdiction to warrant the home jurisdiction's giving up the tax base to the other. Historically, the requisite connections have largely been physical, although these connections have only ever been proxies for what amounts to a formulaic allocation of income based on measurements, then current, of a degree of economic connection with the jurisdiction that more or less is the essence of a profit-making activity.

As is noted in the Canadian government's response to the issues posed by electronic commerce, much work remains to be accomplished in determining whether and to what extent traditional notions of business connection that persist as the main determinants of the basis on which Canada, or any other jurisdiction, will assert a primary jurisdiction to tax. The present debate may be likened to the discussion taking place with respect to harmful tax competition; developed tax jurisdictions have an interest in resolving these issues in a common way and more particularly in a way that, among themselves, preserves as much international tax basis as possible for normative tax jurisdictions in relation to those whose systems are either less developed or more prone to formulation to attract tax-exempt business.[28]

In summary, these areas all present fundamental considerations of foreign tax credit in the large sense and, more broadly, questions concerning the extent to which domestic tax regimes should indirectly subsidize the export of capital income. Foreign tax credit, whether delivered directly or indirectly through the manner in which foreign incorporated business income is taxed, effectively conveys an export subsidy for capital income. To the extent that a country adopts an exemption or a full (or substantial) foreign tax credit approach to recognizing the pre-eminence of a foreign tax regime, it is effectively subsidizing the export of economic activity. Ultimately, the expectation is that wealth will be created for the domestic economy as a result of this public expenditure through exertion that uniquely needs to take place outside the typical ambit of a domestic economy and its regulatory institutions. For example, the international debate about harmful tax competition concerns both deliberate schemes to alter the balance of international taxation and, interestingly, the tectonic interaction of normative tax regimes simply because of their inherent characteristics without any malevolent intentions by any country in relation to the tax rules of another. The OECD's harmful tax competition report identifies the elimination of the international tax base through rules such as subparagraph 95(2)(a)(ii) (though not by name) of the Act. That rule does not exist, of course, as a deliberate

28 See Bird and Wilkie, supra footnote 3.

attempt on the part of Canada to exploit other developed tax systems for its benefit. Nevertheless, in some instances, that rule does have the effect of facilitating the depletion of treasuries of other countries without a corresponding increase in taxation elsewhere. Similarly, the Canadian direct foreign tax credit rules historically, although in a limited fashion, have essentially permitted a foreign tax credit to be generated in relation to activities that do not produce meaningful Canadian income.

Recent Canadian Experience

How do these international tax policy influences find their way into recent Canadian experience?

1) There are embryonic indications of limitations on access to "international business tax consolidation" through the foreign affiliate regime even with respect to the taxation of foreign business income. Implicitly, a CFA, or foreign affiliate regime to a significant degree is fundamentally a foreign tax credit device. To the extent that the regime defers to the primacy of taxation by another country, it is effectively providing a domestic foreign tax credit with respect to another country's income tax subject to quantitative and qualitative limitations.[29]

2) There are initiatives to bolster the taxation of foreign portfolio income that concentrate more precisely on the distinction between "portfolio" income and income associated with income activity. Fundamentally, these proposals are targeted at containing subsidies of foreign tax or an absolute renunciation of taxation where certain offshore jurisdictions are convenient—that is, the export of capital income otherwise facilitated by a foreign tax credit regime. In tax policy terms, this is primarily a concern where there is no intrinsic dependence of the income or income-earning activity on the inherent commercial or industrial characteristic of a host jurisdiction or economic environment.

3) There is some modest attention being paid, in Canada and internationally, to the need to recognize multinational corporations' tax groups' reorganizations without generating tax on what amounts to "phantom" income or amounts that are simply distributed between entities within a multinational group through various media but do not implicitly have the requisite pedigree to constitute income of the group.

4) Specific attention is being paid, notably in the transfer-pricing area, to income-measurement principles generally and the associated jurisdictional limits by which that income is allocated among contending countries. This includes analysis of complex transactions, entailing bundled elements in order to determine their inherent economic and legal characteristics and consequently their primary jurisdictional associations.

29 See Pantaleo and Wilkie, supra footnote 22.

At the core of these issues are the basic aspects of an inherently territorial system for taxing business income with a decided expectation that the Canadian tax base should be shared only in situations where a genuinely primary tax claim may be asserted elsewhere. Important questions concern the equivalence of direct foreign tax credit in respect of income earned by a taxpayer through a direct presence in another jurisdiction and the foreign tax credit that is available indirectly through a CFC of the foreign affiliate regime. For example, resolving how to match interest and other expenses that ultimately benefit foreign income-earning activity with the revenue generated by that activity is fundamental in determining the equivalence, or neutrality, of the tax policy to the manner in which foreign income is earned and measured.[30]

It is also interesting to observe an aspect of harmony, or coordination short of harmonization, in present developments. In international tax policy parlance, this manifests a "convergence" of tax policy development and perhaps implicitly of tax administration.[31] This does not require or even foreshadow an overt meshing of countries' income tax regimes. Essentially, a systematic international awareness of tax policy changes and concerns among countries with common interests is evident, accompanied by a natural gravitation, not necessarily in an organized or deliberate way, toward "common" responses without ceding "tax sovereignty."

In some respects, the tax sovereignty issue is the most important aspect of the present evolution of international tax policy. Countries neither wish to nor are in a position necessarily to forgo primary influence over the development of tax rules generally or international tax rules in particular. Implicitly, this would involve, if not a modification of, certainly limitations on how governments fund public expenditures and otherwise use tax systems to effect domestic social and economic policy. On the other hand, it is evident—for example, in tax policy discussions that are taking place in many countries as well as at supranational organizations such as the OECD—that developed tax regimes are contending with common responses to jurisdictional and other issues of the sort that we discuss here. This is occurring in part because the tax policy concerns and the commercial and economic influences to which they must respond are common and in part because of the perceived need to confine as much as possible the taxable income base internationally to jurisdictions with typical or normative tax regimes—in other words, to staunch the inevitable race to the bottom that is a natural outcome of competitive tax practices.

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30 See Brian J. Arnold, "The Deductibility of Interest To Earn Foreign Source Income," in *Report of the Proceedings of the Forty-Eighth Tax Conference*, 1996 Conference Report, vol. 2 (Toronto: Canadian Tax Foundation, 1997), 45:1-23, and the discussion in this regard in Pantaleo and Wilkie, supra footnote 22.

31 The notion of "convergence" is compellingly discussed by Anne Marie Slaughter in "The Real New World Order" (1996), vol. 76, no. 5 *Foreign Affairs* 183-97.

Canadian International Tax Policy Responses

Since 1995, but in a more concerted fashion since 1997, an effective refinement of Canadian international tax policy, in step with the international developments and influences of the sort that we have discussed above, has been underway. In a manner of speaking, it was begun in 1995 with changes to the foreign affiliate rules that restrict more precisely the application of the exemption aspect of that system to business income. This was accomplished essentially by codifying income that lacked a business character. In these changes were seeds of continuing refinement to more carefully deny investment income any deferral advantage or other tax preference and in addition, by implication, to restrict Canada's acknowledgement of other countries' primary tax jurisdiction to income that fundamentally has a business nature and a close intrinsic connection to such a jurisdiction. These changes, however, operated within the traditional limits of the foreign affiliate system, reinforcing the distinction between business and property income in relation to the extent to which foreign taxability of income should be recognized and at the same time the extent to which Canada should modify otherwise current taxation of the income. In 1996, changes with a similar direction were announced with respect to taxpayer migration and the nature of taxable Canadian property. Technical as those changes are, they quite directly amount to an appropriation of the international tax base according to a perception of where economic value or wealth is created; implicitly they amount to a redrawing, from Canada's perspective, of the lines upon which the international tax base conventionally has been divided.[32]

Since 1997, more comprehensive adjustments to the taxation of foreign income have been introduced. Fundamentally, these developments target the circumstances in which Canada should be prepared to renounce tax jurisdiction, even temporarily, in favour of the primary tax jurisdiction of another country. As we have tried to reflect in our earlier discussion, the contemporary tax policy debate mainly concerns the means by which this development has evolved.

1997 Developments

In September 1997, initiated by a budgetary proposal in February of that year, Canada broached the enactment of modern transfer-pricing rules in section 247 coupled with a restatement of its administrative practices in the transfer-pricing area. The legislative proposal was enacted in June 1998, and in September 1999 the revised administrative guidelines were published. Historically, transfer pricing has been associated with rather mundane examinations of the transactional pricing of transfers of goods and services. Increasingly, as important factor

32 Robert Raizenne and Angelo Nikolakakis, "Taxable Canadian Property," in 1996 Conference Report, supra footnote 30, 46:1-72.

inputs in international business enterprise become manifestations of financial capital—money and intangible property (either so-called organizational or transactional intangibles)—and as transfers lose their typical transactional characteristics either because of the intrinsic complexity—the "bundling" of implicit transfers—or because of the elusive associations to tax jurisdictions as a result of the prominence of money and intangibles in or with respect to such transfers, the old-fashioned focus on transactional pricing has been displaced by attention to its essence—namely, the allocation of international income based on where value is added within an integrated multinational enterprise. It is almost trite to observe that separate entity accounting in respect of the legal entities within a multinational organization is not necessarily instructive about where income is earned. Contemporary transfer-pricing standards, generated by the requirements of article 9 of the OECD model tax convention, indirectly attempt to apportion profit among contending tax jurisdictions albeit using analytical tools that are closely identified with transactional revenue measurement. The OECD guidelines admit that the fundamental objective of article 9 of the OECD model tax convention is the measurement and allocation of income or profit in a manner that is consistent with what would have risen in the context of unrelated party dealing. It would not have been surprising, when traditional business forms and transactions were pre-eminent, to expect a close correspondence between gross flows of revenue (and underlying expenses) and net profit. The analysis becomes murkier to the extent that intangible property and money contribute significantly to how income is earned and where it might be apportioned. The goal remains, however, to apportion profit and to justify an appropriation of the international tax base.[33]

The Canadian transfer-pricing rules purport to adopt the international standard advocated by the OECD, which, despite some analytical differences, is essentially compatible in all its fundamental respects with the transfer-pricing rules of all OECD countries including the United States. The guarded acceptance of transactional profit methods for measuring income in default of the traditional methodologies' capacity to apply in the presence of intrinsic or insidious transactional factors that inhibit "comparability" is an indication of the direction in which transfer-pricing analysis, and perhaps the tax policy more generally, must go.[34] Indeed, the Canadian guidelines seemingly reflect an expectation, in many

33 This is at the heart of trying to apply typical income measurement and apportionment concepts to the income generated by "global dealing." Leaving aside how problematic it may be to define and describe the relevant commercial and economic circumstances, the apportionment issues presented by continuous and seamless international transactions provoke the adoption of transactional profit or other global techniques to establish a reasonable and verifiable, or at least plausible, correspondence between economic and financial income in relation to a jurisdiction.

34 See *Information Circular* 87-2R, supra footnote 4.

instances, that at least a high-level profit split will be required in order to effect the analysis that the transfer-pricing rules require.

Also in 1997, although published in 1998, came the Mintz committee report. Chapter 6, which deals with international income, proceeds from a consideration of certain fundamental international tax notions associated with traditional neutrality principles. In this respect, the examination by the Mintz committee is very much in line with an analysis in this area that was recently reflected, for example, in the study by the US Joint Committee on Taxation as a precursor to a re-examination by the United States of its CFC rules.

At their core, however, the international recommendations of the Mintz committee simply reinforce the intrinsic territoriality of the system for taxing foreign incorporated international business income.[35] First, the committee recommended what amounts to the restoration of a system for taxing business income that existed before 1972: essentially to limit expenses from being deducted except in relation to the foreign business revenue to which they pertained. Hence, the committee recommended that interest not be deductible on financing undertaken by Canadian members of a multinational group in order to capitalize the business activities of foreign members of that group. This is not a radical recommendation and indeed, as we note, would restore the balance of income measurement that existed before the introduction of the foreign affiliate rules in their modern form. More to the point, the implementation of such a recommendation in the context of contemporary international tax policy discussion would effectively limit the extent to which a domestic tax system subsidizes the export of foreign capital through the foreign tax credit regime, directly or indirectly (through the interest deduction), to reinforce the allocative principle underlying foreign tax credit regimes. A renunciation of domestic taxation in favour of a foreign tax regime should occur only to the extent that the income-earning activity satisfies certain qualitative requirements and then only to the extent of the tax generated in relation to that foreign business income.

A corollary recommendation targeted the use of provisions such as subparagraphs 95(2)(a)(i) and (ii) effectively to eliminate taxation entirely of foreign business income. As we perceive the foreign affiliate rules, those provisions are dimensions of Canada's foreign tax credit regime. They acknowledge the pre-eminence of the right of tax jurisdictions in which business income-generating activities occur to tax business income regardless of the medium by which this income may be transmitted from entity to entity within a foreign

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35 See Pantaleo and Wilkie, supra footnote 22, and J. Scott Wilkie, Robert Raizenne, Heather I. Kerr, and Angelo Nikolakakis, "The Foreign Affiliate System in View and Review," in *Corporate Management Tax Conference 1993* (Toronto: Canadian Tax Foundation, 1994), 2:1-72, for a consideration of the basic characteristics, conceptual underpinning, and historical development of this system.

multinational group. However, the Mintz committee recognized that there is no reasonable tax policy basis for extending the benefit of the exemption regime to foreign income—for adopting a devise that effectively subsidizes foreign taxation to the extent that as a consequence of the manner in which such income is moved within a multinational group, the international tax basis is absolutely depleted. At that point, a regime that has as its fundament the delivery of foreign tax credit loses its significance.

While these proposals inspired considerable comment by the Canadian tax community and indeed some controversy, their tax policy significance is far from untenable and is in line both with the broad objectives that underlie Canada's international tax rates and with present directions of the refinement of such rules. It is particularly interesting to consider these recommendations in light of observations by the OECD in its harmful tax competition report about the effect of rules such as this[36] and also discussion taking place in the United States about whether and in what circumstances foreign tax credit reasonably should be extended to foreign business income if that income qualitatively is not business income or otherwise is not subject to taxation somewhere.[37] This takes us back to the original premise of our observations about international tax policy developments. There is an expectation that underlies allocative decisions (and concessions) made by countries with respect to the international tax base that the base should not simply disappear as a result of how multinationals organize activities.

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36 See the report on harmful tax competition, supra footnote 21, at 15, where the OECD notes: "Harmful effects may . . . occur because of unintentional mismatches between existing tax systems, which do not involve a country deliberately exploiting the interaction of tax systems to erode the tax base of another county." Hence, the third recommendation in the report "that countries that apply the exemption method to eliminate double taxation of foreign source income consider adopting rules that would ensure that foreign income that has benefited from tax practices deemed as constituting harmful tax competition do not qualify for the application of the exemption method" (ibid., at 43). Thinking in the same general direction is found in the *Report of the Technical Committee on Business Taxation*, supra footnote 14, and it is this point broadly that Bird and Wilkie explore, supra footnote 3. In these comments is an incipient expectation that normative allocative decisions concerning the international tax base demand that income is taxed somewhere. What the normative standard of taxation is, however, is very difficult to decide. Aside from risking intrusion on the public expenditure policies of countries, it is very difficult to decide what is normative merely from a superficial analysis of the most obvious characteristics of a tax system. The equivalence of tax systems in terms of the demands that they make on countries' taxpayers requires consideration of the underlying social and economic choices that are funded and otherwise supported by the tax system and the benefit that those taxpayers enjoy from public consumption.

37 See the report of the US Joint Committee on Taxation, supra footnote 8, as well as the discussion on international competitiveness of planning involving CFCs in the United States. The considerations in play are, however, of universal interest. See Pantaleo and Wilkie, supra footnote 22, at 8:4, footnote 58, and related discussion.

The Mintz committee also identified a need for a more direct prescriptive distinction between foreign portfolio (or passive) investment income and foreign business income. It was this question to a significant degree that inspired the earlier changes in 1995 to the distinction between investment and business income that was based largely on a legislative description of what is *not* business income. The committee recommended a further review of the extent to which the Canadian tax rules should tolerate deferred taxation of investment income. Again, this is in line with the OECD and with the US developments in this area. Based on the neutrality principles that are said to underlie a decision to extend foreign tax credit to foreign incorporated business income, there is a limited basis on which to defer or forgive the taxation of foreign investment income according to where the portfolio that generates the income happens to be located. The OECD has recommended a review, in conjunction with the re-examination of the taxation of foreign business income, of the taxation of foreign portfolio income.[38] Underlying the comments of the US Joint Committee on Taxation is a similar concern. Interestingly, as we discuss below, the Canadian government has recently reacted in a parallel manner.

Canada evidently was at this juncture engaged in the first stages of a very direct re-examination of whether and in what circumstances the Canadian tax system will deliver foreign tax credit for tax actually or notionally paid in respect of investment in foreign business activities. This reflects a retrenchment, common internationally, in the extent to which, without very precise and clear guidelines, a country will be prepared to renounce tax jurisdiction or to tolerate an allocation of the international tax base in favour of another jurisdiction. In part, this may in turn reflect a lack of confidence in, or the inherent limitations of, the allocative devices found in tax treaties. More generally, it is an indication of the essential characteristics of foreign tax credit as a device applied domestically to apportion the international tax base. To the extent that the assertion of tax jurisdiction elsewhere cannot be reliably demonstrated, there is no reason to continue to apply tax base allocation devices as if patterns of business and the reliability of jurisdictional connections to income had not changed.

1998 Developments

In 1998, the minister of finance announced legislative proposals that amounted to the "filling out" of an international tax "code" in the Act. Essentially, the proposals reflect a tax policy perception that tax relief should only extend to taxable international income. This is reinforced legislatively by a distinction between treaty-protected and non-treaty-protected income of non-residents in relation to the deployment of capital in Canada and similarly the income of

38 See the OECD's report on harmful tax competition, supra footnote 21, as well as the comments of Owens and Sasseville, supra footnote 21.

Canadian residents with respect to economic activities in which they engage outside Canada.[39] These categories amount to distinctions between "high-tax" and "low-tax" income[40] and are grounded in several specific changes that essentially concern Canada's willingness to recognize and subsidize foreign tax claims. From the standpoint of inbound investment, these changes prevent the reduction of taxable non-treaty-protected income by losses or other credits or preferences associated with income that is protected by treaty. From the outbound point of view, the revised foreign tax credit rules severely limit foreign tax credit in circumstances where only modest economic income would arise to the Canadian taxpayer from the affected activity or, in certain instances, involve securities transactions from which no economic income is generated. Anti-dividend-stripping rules were implemented in respect of immigrating corporations, and a specific rule for reporting income that is nevertheless protected from taxation based on the application of a tax treaty was enacted. Perhaps, with the benefit of hindsight, the most controversial changes in this direction were the proposed amendments to section 17, on which we comment later. But, the effect of these rules in their present legislative form is to severely limit the extent to which the Canadian tax system will subsidize the "free" export of capital by loans and other indebtedness incurred by non-residents in favour of Canadian suppliers of capital.

In 1998, proposals were also advanced to refine Revenue Canada's approach to treaty-based waiver of withholding tax under regulation 105.[41] Developments in this area, which are now contained in newly announced guidelines, essentially reflect an expectation of what constitutes a "substantial business presence" in Canada in circumstances in which the affected taxpayer lacks the traditional trappings of a Canadian business presence. In light of the permanent establishment and related business presence debate now ongoing, notably with respect to electronic commerce, these guidelines take on special significance far beyond creative compliance. The substantial business notion that underlies these guidelines contemplates a limited or transient connection to Canada over a seven-year period; it hardly needs to constitute a "substantial" intervention of a non-resident

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39 See, for example, paragraph 115(1)(b.1), which is to be replaced by new paragraph 115(1)(b), which is proposed as part of the taxpayer migration package and most recently restated in Canada, Department of Finance, "Revised Legislative Proposals and Explanatory Notes on Taxpayer Migration," *Release*, no. 99-112, December 17, 1999, as well as subsections 126(4.1) to (4.4).

40 For example, the rules referred to in footnote 39 attempt to confine Canadian tax relief, either in the form of typical preferences or in the form of sponsorship of foreign tax through the foreign tax credit, to situations in which the affected income is material and effectively exposed to material taxation.

41 Revenue Canada, *Guidelines for Treaty-Based Waivers Involving Regulation 105 Withholding* (Ottawa: Revenue Canada, International Tax Directorate, November 15, 1999).

in the Canadian business future. These new guidelines, on their face, purport not to advance defirmitive or substantive conclusions about when a permanent establishment should be considered to exist. In fact, however, it is hard to deny the direction in the government's thinking that the guidelines manifest. Where taxpayers are essentially in control of what fundamentally is the transient business presence that is the activity itself, the traditional jurisdictional tests based on a distinction between "business" and "establishment" (the latter requiring the former but more in terms of some material degree of physical connection) may not be effective. The delivery of services is a case in point. Hence, the Canadian authorities implicitly assume the existence of a taxable business presence absent a formal demonstration by a non-resident to the contrary in a treaty-based return.[42]

At one level, many of these changes may be characterized as merely technical. At another more profound level, they contribute to an ongoing rethinking of Canada's view of the international tax order—a kind of protectionist circling of the wagon—consistent with tendencies elsewhere in the world. Absent compelling considerations to the contrary, there is an increasing reluctance to share tax jurisdiction except in the clearest cases and, as Canada's new migration rules provide, to capture that base at least at the point at which it "leaves."

What does this succession of changes suggest about Canada's international tax policy? There is a deliberate focus that underlies these changes on the adequacy of decisions made within the Canadian tax system with respect to the allocation of the international tax base away from Canada; whether because of the way business is conducted or because of the nature of the efficient income, there is an embryonic recognition of the need to limit the circumstances in which the Canadian tax system will subsidize the export of capital income that is not clearly and directly associated with earning business income in a normative foreign tax jurisdiction. These changes reflect specific enhancements of the direct foreign tax credit system and the manner in which non-residents will be taxed on income earned directly by engaging in Canadian commercial activities; they also reflect—for example, in the changes to section 17—an expectation of economic benefit to Canada through Canadian control of a foreign corporate group as a condition to that group's being treated as a consolidated enterprise entitled to benefit from fundamental relief for the taxation of foreign income. More generally, these changes seem to evidence a retrenchment, increasingly common internationally, from a qualitatively unstructured sharing of the international tax base in favour of a more clear and rigorous definition of the expectations that underlie such a sharing and, in international tax policy terms,

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42 See subparagraph 150(1)(a)(ii). Accompanying various substantive recommendations internationally is the advice that taxpayers be required to file tax returns in which they claim the benefit of tax treaties.

the need to share such a tax base only in circumstances where business income is earned and taxed elsewhere.

1999 Developments

The tax policy developments in 1999 continued the tendencies of changes that had begun in 1997 and 1998, and indeed before in 1995. Severe limitations are proposed on the extent to which tax on income earned through investments in foreign investment funds or through foreign trusts should be deferred and otherwise limited. Essentially, the February 1999 federal budget anticipates the implementation of a comprehensive regime to capture foreign passive income, even if earned in a business context, to the extent that taxation of foreign accrual property income (FAPI) does not apply. Interestingly, the budget proposals anticipate the enactment of what is essentially a prescriptive and in some respects "rough" regime for identifying activities that are considered to have an investment quality and for measuring income that arises from them regardless how the income would otherwise be measured. What seems likely is something in the nature of a parallel FAPI regime that will be more comprehensive or less refined than the existing rules in the Act, which in many respects depend on the identification of a taxpayer's purpose and less relevantly on "control" as a determinant of when income earned through non-Canadian vehicles should be taxed on an accrual basis. With the enactment of these rules, coupled with the changes to section 17 and the continuing application of the FAPI rules, there will essentially be a comprehensive regime for taxing passive income on a current basis, recognizing only underlying foreign tax to the extent of withholding tax on amounts distributed to Canadian residents. Furthermore, strict definitional limitations will apply comprehensively to prevent investment income from being cast as business income.

While in some respects a dramatic refinement of the Canadian tax rules, these changes will essentially round out a reorganization of the Canadian foreign rules that was begun with inquiries initiated by the auditor general in 1992, parliamentary hearings in 1993, and legislative changes in 1995 that had as their main effect a more specific determination of the difference between business and investment income. The proposed foreign investment fund, foreign trust rules, and section 17 rules in a sense will implement a form of "rough justice" with respect to foreign investment income. In some respects, their integration with each other may or perhaps can be expected to be less than complete. However, the comprehensiveness in tax policy terms of the initiatives, or at least their potential effect, is clear. The Act will still recognize the primacy of foreign jurisdictions that are actually asserting tax jurisdiction to include foreign business income within their share of the international tax base. In all other circumstances, however, any association of income with a foreign, in contrast with the Canadian, tax jurisdiction essentially will be considered to be at best tenuous and not supported by normative tax policy principles that are loosely associated with tax neutrality concepts. Consequently, either by curtailing the extent to which foreign tax

credit will be extended or by limiting the entitlement of other countries, based on Canadian domestic rules, to share the international income tax base, Canada is refining its view concerning the obligation to extend foreign tax credit.

Some General Comments

In this discussion, we can usefully focus on the interest deductibility rules, "consolidation" rules in subsection 95(2), and changes to section 17 as indicative of the direction of these changes. It is easy to become lost in the detail of each of these areas and as a consequence to lose sight of their thrust. They all reflect more systematic attention to territorial income measurement for foreign business income in keeping with international concern about differential tax treatment of different forms of corporate distributions. In the latter respect, they may implicitly also reflect the underlying puzzlement about why various forms of distributing corporate revenue (or income) should be deductible, particularly where that distinction has the effect of permanently eroding the international tax base. This observation, which most closely concerns subsection 95(2), mirrors the development of a theory that underlies the effective consolidation rules in section 95, which can best be encapsulated by a notion of the "Canadian cone." The Canadian cone essentially describes foreign enterprise directly or indirectly owned by Canadians. It also describes a Canadian view of its proper share of international income and tax base ultimately owned by Canadians in relation to the legitimacy of competing tax claims of other countries. It has been the longstanding position of Canadian finance authorities that foreign incorporated business income owned by Canadian enterprises can and should benefit from the exemption aspect of the foreign affiliate rules but that those rules arguably should not extend to business income of others that by the terms of subparagraph 95(2)(a)(ii) is effectively transformed into business income of foreign affiliates of Canadian taxpayers.[43] A sentiment of this nature underlies important recommendations of the OECD with respect to harmful tax competition.

The changes to section 17 initiated in the 1998 federal budget and developed in various legislative proposals throughout 1998 and 1999 reinforce the notion of the Canadian cone and indirectly effect changes in the way in which subparagraph 95(2)(a)(ii) will apply.[44] In broad terms, the changes to section 17 effect what amounts to a parallel FAPI regime in the context of a rule that seeks to ensure that Canadian enterprises do not effectively direct income from the exploitation of their resources to persons outside Canada, at least without earning an adequate return from and commensurate with the deployment of those

43 See the discussion in Pantaleo and Wilkie, supra footnote 22, with reference to the *Report of the Technical Committee on Business Taxation*, supra footnote 14.

44 See the comments of Evelyn P. Moskowitz concerning section 17 of the Act in "Financing of Non-Residents and the Recent Amendments to Section 17," which is included in this volume.

resources that Canada taxes. Leaving aside for the moment the fact that the changes to section 17 are not integrated very well with the primary FAPI regime, subsections 17(2) and (3) and their supporting rules entrench the tax policy associated with the Canadian cone and indirectly confine the effective application of subsection 95(2) to multinational corporate groups that are owned entirely by Canadian residents or at least in which Canadian residents have significant economic and legal interests. The inherent significance of section 17 in this regard is indirectly to implement the Mintz committee recommendations with respect to the extent to which foreign business income can benefit from an exempt classification when earned and distributed in circumstances that do not reflect fundamental Canadian ownership.

More generally, in light of the tax policy principles discussed here, this change will effectively ensure that Canadian foreign tax credit effected by way of the exemption aspect of the foreign affiliate system will be available only to the extent that the import and national neutrality principles grounding tax policy development in the foreign area may ultimately generate wealth in Canada. In particular, the expectation that the equity of foreign incorporated groups is controlled by Canadians has the effect of ensuring an economic correspondence between forgoing present tax with respect to foreign business income, even if distributed within the foreign group through the medium of investment income devices, and the ultimate value to the Canadian economy of competing internationally in a meaningful way to earn business income.

Also in 1999 the enactment of changes to the Act to facilitate the financial business being conducted by foreign banks in branch form was announced. Essentially, these proposals will permit Canadian subsidiaries of foreign financial institutions to transform themselves into branches without incurring the tax liability that would typically be associated with the liquidation of an incorporated business and its reconstitution in branch form.[45] On an ongoing basis, these branches will essentially be permitted to compute their income on a formulaic basis with the benefit, among other things, of a deduction for notional funding costs associated with financing the Canadian business. The financial regulatory imperative that underlies these changes may have marked the accompanying tax policy developments, perhaps beyond where they would otherwise have been taken.[46] This development is interesting in light of the transfer-pricing

45 See Canada, Department of Finance, "Backgrounder on Foreign Bank Entry Bill," *Release*, no. 99-016, February 11, 1999; "Authorized Foreign Banks: Income Tax Rules," *Release*, no. 99-015, February 11, 1999; and "Changes Proposed to Tax Rules Relating to the Conversion of Foreign Bank Subsidiaries into Foreign Branches," *Release*, no. 99-044, May 11, 1999.

46 The Department of Finance has observed publicly that these initiatives are confined to the banking industry. Yet, one can reasonably ask, in principle, why a similar approach should not apply in other sectors, focusing on the implications that underlie these proposed changes for

considerations and other income measurement issues generally in play internationally. These changes effectively will implement a formulaic system for measuring and taxing income of foreign financial institutions in relation to Canada; in so doing, they implicitly reflect a departure from the significance of organizational form as both an income measurement device and, necessarily, an institutional indicator of where income is earned. They also contain an implicit denial of the ultimate significance of organizational form for measuring not only income but also the connection of an income-earning activity to a jurisdiction. The new rules will facilitate the transformation of an incorporated taxpayer to a branch without any of the consequences normally attendant on liquidation and at the same time preserve the activity's tax characteristics as continuing characteristics of the branch. In this change are the seeds not only of taxation based on a prescriptive or brightline allocation of economic income but also of a practical recognition that business factors, at least in certain industries, so lack intrinsic geographic connections that a more economic construction of a share of the international tax base simply is inevitable.

Canadian Tax Policy Directions

It is interesting to consider whether these various developments are harbingers generally of Canada's tax policy future by design or practical imperative. Viewed from a tax policy perspective, all of these changes implement or foreshadow limitations on or refinements of the extent to which "credit," both in technical and in tax policy terms, will be extended in relation to the tax on income in which Canadian enterprises have no meaningful interest, where there is no unique association of (investment) income with a foreign jurisdiction or there is no expectation necessarily that foreign tax will have been paid. Although situations can be identified in which the imperfections of the changes to section 17 evidently impede Canadian business interests, the scope provided for Canadian business enterprise in subsections 17(3) and (8) in particular will essentially leave the foreign affiliate regime unscathed in relation to its delivery of foreign tax credit via tax exemption for foreign incorporated Canadian-owned business activities. On the other hand, to the extent that the Canadian system would otherwise effectively subsidize through unlimited foreign tax credit the earning of income, business or otherwise, by others that are not generally taxable in relation to Canada, the Canadian tax basis will be preserved.[47]

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the contemporary significance of organizational form and financial accounting as determinants of where and by whom business income necessarily is earned.

47 Refinements not only of the system for taxing portfolio income but also of the consolidation rules in section 95, which deals with the taxation of foreign business income, would not be surprising to achieve the objective that only business income that is taxable elsewhere should benefit from what amounts to a full foreign tax credit via the exemption aspect of the foreign affiliate system.

The 1999 budget proposals concerning the taxation of income from foreign investment funds suggest the eventual assimilation to an investment character of the ownership of all forms of investment property. As a consequence, there will in many instances be the implication that a direct or indirect ownership of an interest in this property necessarily will produce investment fund income, taxable on the basis of Canadian principles and practices either directly in relation to the actual underlying foreign income or indirectly through default to a mark-to-market regime. The changes in this area reflect both a basic intolerance for the depletion of the domestic tax base by technical devices to earn passive income outside Canada and, in the context of the thesis of this paper, a determination to limit circumstances in which the taxation of foreign investment income should be deferred or eliminated. Theoretically, there is no principled tax policy basis for preferring the taxation of foreign investment income by another jurisdiction. Current international debate clearly focuses on this as a necessary element of curbing harmful tax competition and on a more technical basis for dealing with international capital mobility. In this regard then, the Canadian tax rules are developing consistently with those in other jurisdictions. Implicitly, changes in this area manifest a prescriptive retrenchment in favour exclusively of domestic taxation of foreign income without drawing subtle or perhaps irrelevant distinctions based on how or by whom this income is earned if ultimately the owner of the income is a Canadian resident. Again, this can be appreciated as a reinforcement of Canada's foreign tax credit regime as an allocative device in relation to the international tax base.

As has been discussed, the notion of "business presence" is another fundamental focus of the international tax debate in various respects. The traditional characteristics of business presence for tax purposes were developed essentially to preserve source taxation of income that originates, in economic terms, in the jurisdiction. These are essentially proxies for business presence, in respect of which there are common manifestations compelled by the nature of business activity.[48] Indeed, when developed, the historical notions of business presence arguably would have been equally compatible to the same ultimate effect with an economic, commercial, or financial analysis; the modes of conducting business would have enforced a consistency or even a synthesis of these concepts as ways of perceiving business connection. A corollary, however, is the need to avoid unreasonable impediments to the movement of property and people in the conduct of international business activity. Generally, there is an expectation that

48 If appreciated this way, there is perhaps more hope for their continuing utility albeit with new connotations. If the focus is on "business presence," then the nature of concepts such as "permanent" and "fixed" and the significance of human intervention may be more malleable as jurisdictional markers than is commonly thought by focusing primarily on the medium of modern business communication and its capacity to facilitate taxation's becoming, if not elective, highly selective at the discretion of taxpayers.

a traditional, physical business presence is required in order to sustain Canadian taxation of business income (and similarly in relation to the business activities of Canadians elsewhere). In particular, the presence in Canada of executive or managerial activities, certain physical activities associated with the advertising of the availability of property and services and the delivery of goods, and indeed even the presence of representatives may not in themselves give rise to a taxable business presence.

Yet in the face of highly mobile business factors and the prominence of financial and intangible factors of production, there seems to be a re-examination of the adequacy of these limitations and importantly the economic tradeoffs that they enshrine. It is interesting to consider whether the new administrative guidelines under regulation 105 foreshadow or reflect changing tax policy as to the nature of permanent establishment and fixed base and therefore changes in Canada's views on the allocation of the international tax base. Leaving aside whether the legal positions underlying the guidelines are sustainable, about which some doubt is justified, the guidelines essentially are protective in nature and reflect practical difficulties in associating certain business activities with the Canadian tax jurisdiction. Indeed, the Canadian presence required to justify a denial of a withholding waiver—that is, the implied qualities of "*substantial*"—may be at best modest, merely "as much presence as needed" to conduct the affected commercial activity.[49] The changes are interesting insofar as they reflect an acknowledgement of the inadequacy of traditional jurisdictional devices to measure, or at least capture in the first instance, the allocation of the international tax base.

Canada's restatement of its transfer-pricing rules reinforces the essence of transfer pricing as a system of analysis to establish and document a reasonable correspondence between economic income of an integrated enterprise that is allocable in relation to Canada on the one hand and entity-based financial or tax income measured in a traditional way. Transfer-pricing rules can be viewed as a particular manifestation of the jurisdictional issue that is also common to CFC and foreign tax credit regimes. Essentially, of concern in all these areas is the development of a modern or sophisticated economic force of attraction rule that also reflects in large measure a degree of international consensus subsumed in the "convergence" notion about how to attribute income to competing national claimants. We hasten to observe, particularly in light of contemporary developments elsewhere in Canadian tax law, that this is not some loose assertion of taxation on the basis of economic reality, although necessarily it is hard to imagine an income tax regime not paying attention to this share. However, it is

49 It is unclear whether these guidelines are necessarily consistent with the expectations that underlie the permanent establishment article of the OECD model tax convention or indeed evolving Canadian law on this subject.

essential in the design and application of income tax rules that there be basic, reliable indicators of the circumstances in which a jurisdiction may assert tax jurisdiction and then preserve it in light of competing claims of other jurisdictions in respect of which the relevant activity has some nexus. Inevitably, this brings into play more directly some notion of "force of attraction," which establishes the pre-eminence of the tax jurisdiction of one jurisdiction in relation to its competitors.[50]

A similar impetus seems to underlie the government's initiative in relation to electronic commerce. Extensive recommendations in the income and commodity tax areas were made in 1998 essentially with respect to the reliability of the jurisdictional characteristics of the Canadian tax system, both in a large conceptual sense from an income tax point of view and in reference to the reliable identification of transactional characteristics from a commodity tax perspective. While enraptured in some respects by the modern medium of business subsumed in the notion of electronic business, from a tax point of view electronic commerce essentially concerns two issues: the character of business income and adequate compliance mechanisms to ensure that income closely associated with the Canadian tax jurisdiction (or perhaps more closely associated than or as closely associated as others) remains within the Canadian tax base. The latter is perhaps the more important and difficult factor. These issues ultimately concern a re-examination of the notions of carrying on business (which affects modern determinations of the source of income) and the association of income with a jurisdiction based on reliable jurisdictional markers.

Some Concluding Observations

Our objective here has been to sort through various international tax policy trends as they seem to be reflected in issues that are emerging for consideration in Canada. Against the expectations that we stated at the outset and relying on the developments that have in fact occurred in Canada over the last several years, we have a number of observations or predictions that seemingly are in the process already of emerging in the Canadian tax system.

The possibility of departures from qualitative jurisdictional rules in favour of brightline tests for measuring income and effectively attributing it to particular jurisdictions can be foreseen and is perhaps more real. This has both substantive and compliance aspects and could include collecting tax according to a "backup

50 In paragraph 5 of *Information Circular* 87-2R, supra footnote 4, this notion is reflected in Revenue Canada's willingness to consider the application of transfer-pricing principles to the measurement of branch income largely, we would suggest, on the basis that the effect and purpose of branch income computation rules, including those reflected in the business profits article of Canada's tax treaties, is to achieve a measurable degree of correspondence between economic and financial income.

withholding and information reporting" regime that essentially would be an extension of regulations 105 and 805.[51] This is already evident, to our minds, in the attention that is being paid to foreign investment fund rules and transfer-pricing guidelines, for example, but extends beyond this even more subtly to the indications evident from the administered developments in Canada about notions of permanent establishment and fixed base.[52]

This is, of course, a controversial observation. The OECD guidelines and Canada's transfer-pricing practice as reflected in *Information Circular* 87-2R, among others, recite the typical aversion of tax jurisdictions to anything approaching a formulaic measurement or allocation of income. On the other hand, as we observed above, implicit in the notions of "permanent establishment" and "business income" contained in a typical bilateral income tax convention are the seeds of a three-factor formulation for allocating income based on traditional business presences, and the new foreign bank branch proposals are inherently formulaic. While the treaty notions mirrored by these concepts typically would not be analyzed in this way, implicitly, given at least the functions of bilateral tax treaties and the manner in which business presence and attributed income are gauged, this in fact is what is happening.

In a Canadian context, it is interesting to test this prediction by considering the genesis of part IV of the Income Tax Regulations particularly because those allocation rules deal with fluid or transient forms of business or at least transactions that are continuous without typical business connections in any of the provinces. For example, the allocative rules with respect to financial institutions, bus and truck operators, railways, airlines, and others all reflect, presumably, a historical impatience and ultimate frustration with the typical qualitative rules that otherwise apply to most forms of business for the allocation of income among the Canadian provinces—an international tax system in microcosm. Indeed, at the conclusion of the presentation of this paper, the other panel members engaged with us in an interesting discussion about the adequacy of income and commodity tax regimes generally as effective mechanisms, in the tax policy sense, to fund government expenditures. In the main, considerable

51 While a considerable amount of the jurisdictional debate centres on substantive tax concepts, ultimately the tax system needs to be enforceable. If the nexus of the income earners with the taxing jurisdiction is not dependable, perhaps the consumers (in the broadest sense) and their intermediaries (financial or otherwise) will have to fill a tax administration function. This situation is not dissimilar to the enforcement characteristics of consumption and sales, and withholding taxes. One of the attractive features of consumption taxation to deal with some of these perceived jurisdictional shortcomings of income taxation is the enforcement mechanism that involves residents.

52 See the CCRA's new guidelines on waiver of withholding under regulation 105, supra footnote 41.

skepticism was advanced about the adequacy of traditional income tax concepts even if modified to adequately deal with the measurement of international income in respect of any tax jurisdiction's claim to tax. Even then, given the transience of international business and its lack of dependence in important respects on traditional jurisdictional connections, it is increasingly evident that there may be problems associated with actually administering an income tax or even a commodity tax system. In a sense, this is a dangling observation because we, no better than others, can lay claim to a solution for this problem except to note the common interest internationally of tax jurisdictions in re-evaluations of foreign tax credit, which in a sense amounts to a retrenchment in favour of domestic taxation absent compelling reasons to cede taxation in favour of another jurisdiction coupled with the convergence of normative tax jurisdictions' responses to common issues.

We also foresee a general tendency among countries, including Canada, to attempt to retain control over the tax base via a more thoroughgoing "worldwide" tax base model in the absence of clear and precise associations of income and income-earning activity with normative tax jurisdictions in relation to which a meaningful level of taxation can be expected. This tendency is reflected in the recommendations of the Mintz committee, the consequences of the changes to section 17, and the enactment of modifications to section 115 with respect to treaty-protected income, and section 126 with respect to limitations on foreign tax credit in relation to the earning of only modest amounts of income. Another example of this retrenchment is the new "departure tax" regime that was implemented by the changes to section 128.1.[53] These changes conceptually seem to contradict typical expectations for the allocation of international tax bases with respect to unrealized income and can only be explained, in a tax policy sense, by a need to assimilate a portion of the international tax base that historically would have been shared with or ceded to other jurisdictions depending on the sustainability and primacy of the claims of other jurisdictions. The indication, at least for the time being, that Canada is prepared to provide a form of foreign tax credit with respect to foreign tax ultimately levied in relation to income that arises from the sale of property subject to the departure tax charge validates our thesis that countries such as Canada are tending in favour of asserting comprehensive tax jurisdiction and only renouncing it to the extent that in line with domestic tax policy determinations, income is actually taxed elsewhere, and a primary tax claim of another jurisdiction can be established in a manner consistent with domestic tax principles.

It is difficult to predict how international tax policy developments will unfold, but, in light of what clearly seems to be taking place, we should not be surprised

53 See supra footnote 32.

if they entailed several principal characteristics. It is unlikely that in the foreseeable future there will be any measurable degree of income tax harmonization or comprehensive tax reform that would effectively redefine the main elements of international tax regimes to address some of the factors that we see embryonically in evolving tax policy. In that connection, therefore, countries have a number of choices to make. In addition to persevering with refinements of the kinds of tax rules that we have discussed in relation to Canada, we anticipate more general attention being paid to limiting the effects of business income taxation on trading relationships that occur within the context of "normative" taxation somewhere.[54] In addition to more precise constraints on the distinctions between other income and business income and ways to describe the association of business income with a jurisdiction based on its dependence on custom within the jurisdiction, we anticipate an increased focus, even if for expedient reasons, on several basic structural considerations.

The *economic* transactions of the main *economic* actors in defined "economic zones" of interest could be targeted effectively to treat corporate groups more as economic entities despite the legal separateness of their components and the sovereignty of regulatory regimes generally in respect of those components. This would contribute to the establishment of a more systematically harmonious interaction of "freer trading" generally and tax rules that affect the main aspects of that trade. At the same time, this would recognize a practical attractiveness of targeting international tax refinements to a relatively small class of taxpayers whose commercial dealings are prominent in terms of their transactional scope and volume and other economic events that concern the tax system. As experience in the European Community reflects, this would contribute to ensuring that income that has not been realized in an economic sense (for example, that would otherwise arise from dispositions of property in the course of internal group reorganizations or that reflects distributions between entities within a "control group") does not give rise to taxation until these amounts are actually realized in relation to transactions with third parties or are actually distributed outside the corporate group. There is some indirect implicit sensitivity in the Canadian rules to this reflected, for example, in recent changes to subsections 85.1(5) and (6) and 87(8) and (8.1), which essentially broaden the circumstances in which "foreign mergers" and like business combinations may be accomplished on a

54 As we note, this is a difficult notion. In a sense, there is no such thing as normative taxation. There are normative tax rules, as distinguished from rules with a tax expenditure character. But that is not the thrust of comments such as this. The assurance sought is that income is taxable on a meaningful basis. This is what feeds the implicit international bargain underlying so-called international tax rules that a renunciation of jurisdiction in certain cases is justified. It is not justified if the crediting jurisdiction is effectively forgiving tax, and otherwise it can demonstrate a sustainable connection to the taxpayer or the income that the taxpayer earns.

tax-deferred basis for Canadian shareholders as well as in the rules proposed to facilitate the transformation of Canadian bank subsidiaries of foreign banks to branches. One wonders whether taking into account indications of a more economic measurement of income, other changes in this regard would be helpful.

The possibility that distinctions in the tax treatment of various forms of corporate distributions may be limited is also anticipated.[55] This is most directly associated with the tax treatment of deductible charges such as interest and possibly others such as rent and royalties. It also encompasses, however, the integration of corporate- and shareholder-level taxation. Finally, as is reflected, for example, in the international discussion of harmful tax competition, we foresee attention being paid to "free riding" or more specifically the intervention in capital flows of "tax-exempt" persons or nationals of tax-preferred regimes.

In a certain sense, refinements of the sharing of the international tax base present fewer difficult issues insofar as there is expectation of material taxation somewhere. However, when income within the international tax base is effectively depleted by the diversion of what would otherwise be taxable income to jurisdictions in which no tax applies, the assumptions underlying the sharing of international income, which are fundamentally foreign tax credit notions, dissipate. In a sense, this encapsulates our thesis that international tax developments generally are focused on the re-examination of providing foreign tax credit, whether by way of exemption, deferral, or computed credit, without meaningful underlying tax.

This leads us to question the practical viability of an income tax as a taxation regime. On a broader examination, taking into account the discussion that took place at the conclusion of the panel that included our paper, there may be substantial doubt about the adequacy of any income tax regime to accurately, adequately, and reliably capture the tax base. Refinements to devices for measuring business income and associating it with particular enterprises and the activities of enterprises within a jurisdiction may not be very fruitful to the extent that those activities are difficult to describe or define in relation to the jurisdiction, given the increasing mobility of productive factors. The ultimate goal of defining a tax base is to determine a meaningful correspondence between economic and financial income in relation to a jurisdiction. This is at the core of many of the recent tax changes much more directly than may have appeared to be the case with respect to former tax rules. Tax systems necessarily seem to be tending, in the guise of more comprehensive worldwide taxation and less generosity by way of foreign tax credit, in the direction of implicitly acknowledging the need to consider alternative tax bases that measure and make

55 See Bird and Wilkie, supra footnote 3, and Cnossen, supra footnote 3.

claims against economic entitlement with more assurance and control, in part assisted by a systematic adoption of common tax policies and greater cooperation among revenue authorities in evaluating and enforcing them.[56]

56 This could include, as our session concluded, some form of consumption-based taxation. However, developments in this area raise issues at the very foundation of income taxation and the nature of income. How such a system should be structured and various fairness issues resolved, how a rate structure would be developed, and more generally how associated costs and expenses underlying the generation of consumed value would be adequately taken into account are serious imponderables. On the other hand, perhaps such a regime would at the very least help to ensure that the value added/value earned of enterprises whose financial welfare depends on economic activity within a jurisdiction is exposed to taxation by way of the payments made by consumers.

Unlinking Tax Treaties and the Foreign Affiliate Rules: A Modest Proposal

Brian J. Arnold*

INTRODUCTION

The thesis of this note is that the current links between the foreign affiliate rules and Canada's tax treaties should be eliminated. Under the foreign affiliate rules, exempt surplus is restricted to active business income earned in a country with which Canada has a treaty ("treaty country") by foreign affiliates resident in a treaty country. In addition, most of Canada's tax treaties require Canada to exempt from tax dividends received by Canadian corporations out of the exempt surplus of foreign affiliates resident in the other country. More recent treaties entered into since 1998, however, do not contain such a provision. Although this change in Canadian treaty policy is welcome, it is insignificant without appropriate changes to the foreign affiliate rules.

This note argues that the links between the foreign affiliate rules and tax treaties have caused distortions in both Canada's tax treaty network and the foreign affiliate rules. The note recommends that the exemption for dividends received out of exempt surplus should not be included in Canada's tax treaties and that the requirement for foreign affiliates to be resident in treaty countries in order to earn exempt surplus should be deleted from the foreign affiliate rules. As a result, tax treaties and the foreign affiliate rules would operate independently of one another.

OVERVIEW OF CANADA'S TAX TREATY NETWORK AND THE FOREIGN AFFILIATE RULES

The Foreign Affiliate Rules

The Canadian foreign affiliate rules provide a combined exemption/credit system for dividends received by a Canadian corporation from a foreign affiliate. A foreign affiliate is a foreign corporation in which a Canadian corporation owns 10 percent or more of the shares of any class.

All dividends received from foreign corporations are included in income.[1] Dividends received by a Canadian corporation from a foreign affiliate are deductible in computing the corporation's taxable income to the extent that the dividends are

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received out of the foreign affiliate's exempt surplus.[2] Dividends received by a Canadian corporation out of a foreign affiliate's taxable surplus qualify for deductions in respect of the foreign withholding taxes on the dividends and the underlying foreign taxes paid by the foreign affiliate on the income out of which the dividends are paid.[3] These deductions are equivalent to credits for foreign withholding taxes and underlying foreign taxes. Dividends from a foreign affiliate are deemed to have been paid first out of the affiliate's exempt surplus and then out of its taxable surplus.[4] Dividends received from a foreign affiliate in excess of its exempt and taxable surplus are deemed to have been received out of pre-acquisition surplus. Dividends received out of pre-acquisition surplus are deductible in computing taxable income[5] but are subtracted in computing the adjusted cost base of the shares in the foreign affiliate.[6]

The exempt surplus of a foreign affiliate includes the exempt portion of capital gains, certain taxable capital gains, and dividends received out of the exempt surplus of other foreign affiliates of the Canadian corporation.[7] The most important inclusion in exempt surplus is income from an active business carried on in a designated treaty country by a foreign affiliate resident in a designated treaty country. In addition, in certain circumstances income from property is deemed to be income from an active business in a designated treaty country and therefore is included in exempt surplus.[8] The most important example of this type of income is interest earned by a foreign affiliate from financing other foreign affiliates resident in treaty countries that use the funds to finance active business operations carried on in treaty countries.

The taxable surplus of a foreign affiliate consists of all the income earned by an affiliate that is not included in its exempt surplus.[9] In particular, taxable surplus includes any passive investment income (foreign accrual property income or FAPI), dividends received out of the taxable surplus of other foreign affiliates, and active business income earned in non-treaty countries.

In summary, dividends from foreign affiliates received by Canadian corporations are either exempt from Canadian tax or are taxable with a credit for the underlying foreign taxes on the income out of which the dividend is paid. The rationale for the exemption for dividends out of exempt surplus is that exemption from Canadian tax is warranted only if the income out of which the dividends are paid is derived from an active business carried on in a treaty country by a foreign affiliate resident in a treaty country. Thus, two criteria determine the availability of the exemption: the nature of the income earned by a foreign affiliate, and the country in which the foreign affiliate is resident and the income is earned. Limiting the exemption for dividends from foreign affiliates to active business income relates to international competitiveness. For Canadian-based multinational corporations carrying on active businesses in treaty countries through foreign affiliates, the only tax on the income derived from these businesses is the tax levied by the foreign country. Therefore, such corporations are not subject to any additional tax burden as compared to corporations resident in the foreign country and other foreign corporations doing business in the country. Limiting the exemption to income earned in treaty countries is an attempt to ensure that the income is subject to foreign tax that is roughly

comparable to the Canadian tax that would have been levied on the income if the income had been earned directly by the Canadian corporation. As discussed below, the treaty country requirement can be justified only as a proxy for a requirement that a country levy tax at rates and on a base roughly comparable to Canadian tax. As we shall see, the implementation of the exemption system has not been faithful to this rationale because Canada has entered into treaties with several countries that operate as tax havens.

The legislative history of the foreign affiliate rules is not explicit about the policy underlying the exemption for dividends out of exempt surplus. It has been suggested that the exemption system might be intended to operate as an incentive for Canadian multinationals to invest in treaty countries rather than as a proxy for a credit system.[10] It has also been suggested that the exemption system is justified on grounds of international competitiveness[11] or as a means of providing tax sparing for developing countries.[12] Some countries, such as the Netherlands, provide an exemption for all foreign business income and for dividends from foreign corporations irrespective of the level of foreign tax on the income. Nevertheless, it seems reasonably clear that, when the foreign affiliate rules were introduced in 1972, there was no intention to provide any incentive for Canadian corporations to invest abroad, whether in treaty countries or otherwise. The 1966 Royal Commission on Taxation recommended that the income of foreign affiliates should be subject to a minimum tax, Canadian or foreign, of 30 percent levied on a current basis.[13] The 1969 white paper recommended a combined exemption/credit system for dividends from foreign affiliates that, with slight modifications, is the current Canadian system. The white paper stated that the underlying policy objective of its recommendations was "neither to provide an incentive to Canadians to invest abroad, nor to place a barrier in the way of their doing so."[14]

If the Canadian exemption is intended to be an incentive for foreign investment or to allow Canadian corporations to compete internationally, it is difficult to understand why the exemption is restricted to investments in foreign affiliates in treaty countries.[15] The exempt surplus system was adopted as part of the 1972 tax reform to replace a system under which all dividends received from 25 percent owned foreign corporations were exempt from Canadian tax. Moreover, it must be remembered that in 1972 Canada had tax treaties with only 16 countries, most of which were high-tax countries.[16] Accordingly, in 1972 Canada moved from a complete exemption system to a system restricted to dividends out of active business income earned by foreign affiliates in only 16 countries and a credit system for all other dividends. In this context, the exemption system is better viewed as a proxy for a credit system rather than an incentive for foreign investment in treaty countries.[17]

Nevertheless, some people may argue that the legislative history of the foreign affiliate rules concerning the original policy intention of the exemption system is unclear or that the policy intention has changed over the years. These people argue that the exemption system is necessary to allow Canadian corporations to compete internationally or to provide an incentive for Canadian corporations to invest in treaty countries. In my opinion, the exemption system cannot be justified on this basis; the exemption system can be justified in tax policy terms

only as a proxy for a credit system. Active business income earned by Canadian corporations from foreign sources (that is, foreign branch income) is subject to Canadian tax with a credit for any foreign tax on the income. Dividends received from foreign corporations out of the active business income of foreign affiliates in non-treaty countries is similarly subject to Canadian tax with a credit for any withholding taxes and any underlying foreign corporate taxes. Therefore, dividends from treaty country foreign affiliates should be exempt only if the income out of which the dividends are paid is subject to foreign tax in the treaty country that is reasonably comparable to Canadian tax.

Canada's Tax Treaty Network

As of January 2002, Canada had 75 comprehensive income tax treaties in force with other countries.[18] An additional 5 treaties were signed and awaiting the enactment of implementing legislation. Negotiations have commenced with another 11 countries. Therefore, it is likely that in a few years Canada will have tax treaties with approximately 90 countries.

The Canadian treaty network includes all of Canada's major trading partners. It also includes all of the member countries of the OECD, with the exception of Greece and Turkey, and negotiations for treaties with Greece and Turkey are underway. It is not surprising that Canada has tax treaties with these countries. Cross-border transactions, including trade, investment, and the movement of individuals, between Canada and these countries is commonplace and growing. Tax treaties facilitate such cross-border activities. What is surprising, however, is that Canada has tax treaties with many countries that can only be described as minor trading partners. For example, Canada has treaties with Kurdistan, Uzbekistan, and Papua New Guinea; a treaty has also been signed with Lebanon, and negotiations have commenced with Armenia, Gabon, and Moldova.

Canada's tax treaty network includes treaties with several countries that are generally known as tax havens—for example, Barbados, Cyprus, Ireland, and Luxembourg. Moreover, Canada has treaties with a number of countries that have special low-tax regimes for certain types of entities or income. For example, Denmark, Belgium, the Netherlands, Hungary, and Switzerland all provide low-tax regimes for certain holding companies, headquarters companies, and other special corporations. Finally, Canada has signed a treaty with Kuwait and is currently negotiating with the United Arab Emirates, countries that levy income tax only on foreign corporations doing business in Kuwait or the United Arab Emirates (and in the case of the United Arab Emirates, only foreign corporations engaged in oil and gas and banking activities).

The growth of the Canadian tax treaty network over the past 25 years has been extraordinary.[19] As noted above and discussed in more detail below, the introduction of the foreign affiliate rules in 1972 made the exemption for dividends from foreign affiliates of Canadian corporations conditional on the existence of a tax treaty between Canada and the country in which the foreign affiliate is resident and carrying on business. Before 1972, dividends received by Canadian corporations

from foreign corporations were exempt if the Canadian corporation owned at least 25 percent of the shares of the foreign corporation. Consequently, restricting the exemption to dividends from foreign affiliates in treaty countries was a drastic change in the system. To soften the effects of the adoption of the foreign affiliate rules, in 1972 the government committed itself to expanding Canada's tax treaty network and thereby to expanding the exemption system for dividends from foreign affiliates of Canadian corporations. Given that the tax treaty network has expanded from 16 countries in 1972 to 75 countries currently, the government has clearly delivered on its commitment.

Although there may be many reasons why a country may wish to enter into a tax treaty with another country, in Canada's case the primary impetus for entering into tax treaties is the exemption for dividends from foreign affiliates. Any Canadian corporation that is carrying on an active business in a foreign country that imposes income tax or a reasonable proxy for an income tax has a legitimate case for requesting the federal government to enter into a tax treaty with that country.

THE RELEVANCE OF TAX TREATIES FOR THE FOREIGN AFFILIATE RULES

Designated Treaty Country

When the foreign affiliate rules were first introduced (in 1972 but effective from 1976), exempt surplus of a foreign affiliate included income from an active business carried on by the affiliate in a listed country if the affiliate was resident in a listed country. Regulation 5907(11) contained a list of countries for this purpose. Listed countries were intended to be countries with which Canada had concluded tax treaties. Because of difficulties encountered in amending the regulations, the list of countries came to include countries with which Canada had commenced treaty negotiations but had never concluded a tax treaty and did not contain some countries with which Canada did have a tax treaty.[20] It was clear that the list of countries was flawed. Criticisms on this point and other aspects of the FAPI and the foreign affiliate rules were raised in the 1992 auditor general's report[21] and the consequential report of the Public Accounts Committee of the House of Commons.[22] One of the recommendations of the latter report was that the list of countries in regulation 5907(11) be revised. In 1995, as part of a package of amendments to the FAPI and the foreign affiliate rules, the listed-country approach was repealed and new rules were adopted whereby the exempt surplus system would operate automatically with respect to countries with which Canada had entered into a tax treaty.

Under the 1995 amendments, a foreign affiliate's active business income is included in its exempt earnings (and thereby in its exempt surplus) only if the affiliate is resident in a "designated treaty country" and the affiliate's income from an active business is earned in a "designated treaty country."[23] In regulation 5907(11), a country is defined to be a designated treaty country if Canada has entered into a comprehensive income tax treaty with the country that has entered into force and has effect for a particular taxation year of a foreign affiliate. Regulation 5907(11.1) provides that a treaty is deemed to have entered into force and to

have effect for any taxation year of a foreign affiliate beginning with the year in which the treaty is signed and ending with the last day of the last year to which the treaty applies. In general, treaties enter into force once instruments of ratification have been exchanged between the countries. However, treaties often contain provisions establishing an effective date of the treaty that differs from the date of entry into force. The rule in regulation 5907(11.1) ensures that, irrespective of these dates, a country's status as a designated treaty country (or not) applies only for whole taxation years of foreign affiliates. Although a country is a designated treaty country only when the treaty enters into force, once the treaty enters into force the country is considered to be designated for the taxation year in which the treaty was signed and any subsequent years. Similarly, if a treaty is terminated, the country remains a designated treaty country until the end of a foreign affiliate's last taxation year to which that treaty applies.

As indicated earlier, currently there are 75 countries that are designated treaty countries within the meaning of regulation 5907(11). In addition, tax treaties have been signed with another 5 countries but have not yet entered into force. Also as noted earlier, several of the countries that are designated treaty countries for purposes of the foreign affiliate rules provide preferential rates of tax for certain types of income or entities, and can be used effectively as tax havens. These low-tax regimes are widely used by Canadian taxpayers. Treating these countries as designated treaty countries for purposes of the foreign affiliate rules is inconsistent with the rationale underlying the rules, as discussed above. Designated treaty countries should be restricted to countries that impose corporate tax roughly comparable to the Canadian corporate tax. As I have argued above, the exemption for dividends received by a Canadian corporation out of the exempt surplus of a foreign affiliate can be justified only as a proxy for a foreign tax credit system. Under a foreign tax credit system, dividends received from foreign affiliates are taxable and a credit is available for any foreign withholding taxes on the dividends and for the underlying foreign taxes on the income out of which the dividends are paid. If the foreign withholding taxes and the underlying foreign corporate taxes are equal to or greater than the Canadian taxes, any Canadian tax on the dividends will be completely offset. Providing an exemption for such dividends is a simpler method of achieving the same result than would be achieved under a foreign tax credit system.

This justification for the exemption system as a proxy for a foreign tax credit system breaks down to the extent that the exemption is extended to dividends received from foreign affiliates that are not subject to foreign taxes roughly comparable to the Canadian corporate tax. For example, foreign affiliates resident and carrying on business in Ireland are subject to an Irish corporate tax rate of only 12 percent, which is about one-third of the Canadian rate.

Residence of a Foreign Affiliate in a Designated Treaty Country

As mentioned earlier, in order for the active business income earned by a foreign affiliate to be included its exempt surplus, the foreign affiliate must be resident in a designated treaty country and the income must be earned from an active business

carried on in such a country. Until the 1995 amendments to the foreign affiliate rules, residence was not defined for this purpose; as a result, the basic test of central management and control applicable to the residence of Canadian corporations also applied for purposes of determining the residence of a foreign affiliate. This situation was unacceptable because it allowed corporations to incorporate subsidiaries in unlisted tax havens, such as Bermuda, but have central management and control of the corporation exercised in a treaty country, such as the United States. In these circumstances, a foreign affiliate could earn exempt surplus from any businesses carried on in listed countries even though it was not subject to tax in the United States on its worldwide income (because only corporations incorporated in the United States are subject to US tax on their worldwide income).

Regulation 5907(11.2) was introduced in 1995 to prevent this type of tax planning.[24] To qualify for exempt surplus treatment, a foreign affiliate must be resident in a designated treaty country both for purposes of Canadian tax law (reflecting the central management and control test of corporate residence) and for purposes of the treaty between Canada and the country.[25]

The residence article of most Canadian tax treaties follows closely the wording of article 4 of the OECD model treaty.[26] Under article 4 of the OECD model treaty, a person, which includes a corporation, is a resident of a contracting state if it is liable to tax under the laws of that state by reason of domicile, residence, place of management, or any other criterion of a similar nature. In a few Canadian treaties, place of incorporation is added to the list of criteria in the residence article.[27] The wording of the residence article in the OECD model treaty and in Canadian tax treaties raises a number of difficult issues of interpretation. For example, what does "liable to tax" mean? What is the common element that justifies reference to domicile, residence, place of management, and place of incorporation as the basis for taxation? What are criteria of a similar nature?

Some limited guidance with respect to the concept of corporate residence for the purpose of tax treaties is provided by the Supreme Court of Canada's decision in the *Crown Forest* case.[28] That case involved the issue of whether a corporation incorporated in the Bahamas with its head office in the United States was a resident of the United States for purposes of the Canada-US tax treaty. The corporation did not pay any US tax because it qualified for the exemption for international shipping companies in the Internal Revenue Code. The Supreme Court held that the corporation was not a resident of the United States for purposes of the treaty because the corporation was not liable to US tax on the basis of any of the enumerated criteria, or any similar criteria. According to Justice Iacobucci,

> the most similar element among the enumerated criteria is that, standing alone, they would each constitute a basis on which states generally impose full tax liability on worldwide income. . . . In this respect, the criteria for determining residence in Article IV.1 involve more than simply being liable to taxation on some portion of income (source liability); they entail being subject to as comprehensive a tax liability as is imposed by a state.[29]

Since under US income tax law only corporations incorporated in the United States are subject to tax on their worldwide income, the Bahamian corporation could not qualify as a resident of the United States for purposes of the treaty.

Unfortunately, the Supreme Court's decision in the *Crown Forest* case raises more questions than it answers.[30] It is generally accepted that residence for treaty purposes is not limited to persons who are, in the words of the Supreme Court, "subject to as comprehensive a tax liability as is imposed by a state." For example, it is clear that governments, government agencies, and exempt organizations such as charities and pension funds are residents of a country even though they are exempt from tax in the country. Further, it is generally accepted that, if a country taxes on a territorial basis or on a remittance basis, persons subject to such a tax regime are considered to be residents of the country for treaty purposes even though they are not taxable on their worldwide income. The application of the "liable to tax" requirement to transparent entities such as partnerships and trusts is problematic because they are not liable to tax.

With respect to the foreign affiliate rules, the *Crown Forest* case raises enormous difficulties. As noted earlier, many foreign affiliates of Canadian corporations are established in tax haven countries with which Canada has a treaty. Often these foreign affiliates qualify for preferential tax regimes in these countries. For example, several countries offer preferential regimes for international holding companies under which the holding company is exempt from tax on dividends received from foreign corporations, exempt from withholding tax on dividends paid to non-residents, and exempt from capital gains tax on the disposition of shares of the operating subsidiaries it owns. In contrast, other corporations established and doing business in such countries are usually subject to significantly higher rates of tax. Similarly, several countries offer special regimes for international business corporations (IBCs) that earn primarily or exclusively foreign-source income. These international holding companies and IBCs arguably do not satisfy the Supreme Court's test of being subject to as comprehensive a tax liability as a country imposes. As indicated earlier, however, the application of this test is problematic. Canadian-controlled private corporations and even corporations qualifying for the manufacturing and processing profits credit are not subject to as comprehensive a tax liability as Canada imposes. Yet virtually everyone would acknowledge that such corporations should be treated as residents of Canada for purposes of Canada's tax treaties. Therefore, not all foreign companies qualifying for preferential regimes in foreign countries are disqualified as residents of those countries for purposes of a treaty.

Despite the Supreme Court's reference to as comprehensive a tax liability as a country imposes, there seems to be general agreement that a resident of a country for treaty purposes is a person whose connections with that country entitle the country to tax the person on worldwide income, even though the country may decide not to impose tax on the person for some reason. The relevant connections with a country are those enumerated in the treaty (domicile, residence, place of management) or any similar criterion. Thus, if a country exercises its taxing

jurisdiction over corporations incorporated or managed in the country, those corporations would be considered to be residents of the country for purposes of the treaty despite the fact that such corporations qualify for special no-tax or low-tax regimes. Not surprisingly, the Canada Customs and Revenue Agency (CCRA) has not completely accepted this approach. It has sometimes taken the position that foreign affiliates taking advantage of preferential tax regimes are not residents of the foreign country for purposes of the treaty.[31]

It is difficult to distinguish between foreign affiliates that are subject to sufficient tax liability in the foreign country to be considered treaty residents and those foreign affiliates that are not, even on the basis of some notion of tax abuse. If a charity that is exempt from tax in a country is nevertheless considered to be a resident of the country for purposes of the treaty, how can a foreign affiliate incorporated and managed in a country be treated any differently, even if it is subject to a low rate of tax or is exempt from tax? The important point in this regard is that the CCRA should not be placed in the untenable position of policing entitlement to the exempt surplus system through the inadequate requirement of residence in a treaty country.

Whatever the concept of a treaty resident means, it is clear that corporations that are expressly excluded from a treaty and corporations that are treated as flowthrough entities for tax purposes cannot qualify as residents of the country for purposes of the treaty. Exclusion provisions in tax treaties are quite common.[32] Under the terms of several Canadian tax treaties, certain foreign corporations are excluded from the benefits of the treaty. For example, article XXX(3) of the Canada-Barbados tax treaty[33] provides that the treaty does not apply to Barbados IBCs. As a result, such corporations would not be treated as residents of Barbados for purposes of the foreign affiliate rules.[34] Thus, the general rule in regulation 5907(11.2)(a) would have excluded all Barbados IBCs, certain offshore companies in Cyprus, holding companies in Luxembourg, and other foreign corporations from qualifying for exempt surplus treatment. However, a special rule alters this result and allows these corporations to qualify.

Regulation 5907(11.2)(c) provides that a foreign affiliate will qualify as a treaty resident of a country if it would be resident for purposes of the treaty but for a provision in the treaty specifying that the treaty does not apply to the affiliate.[35] The effect of this provision is to ignore the effect of the exclusion provision in the treaty. Thus, a Barbados IBC will qualify for exempt surplus if its central management and control is in Barbados and if it would be a resident of Barbados for purposes of the Canada-Barbados treaty, ignoring the exclusion provision. In other words, Barbados IBCs must be considered to be liable to tax under the laws of Barbados by reason of one of the enumerated criteria or a similar criterion. According to the *Crown Forest* case, IBCs must be subject to as comprehensive a tax liability as Barbados imposes in order to qualify as residents of Barbados for purposes of the treaty. IBCs are subject to Barbados tax at a maximum rate of 2.5 percent. The normal Barbados corporate tax rate is 40 percent. Nevertheless, according to the previous analysis, treaty residence does not require the payment of substantial tax,

or even any tax, to a country. It is understood that the CCRA does not challenge the entitlement of ordinary Barbados IBCs to exempt surplus treatment. As explained in more detail below, regulation 5907(11.2)(c) provides convincing evidence of the complete lack of integrity in the Canadian foreign affiliate rules.

The requirement of treaty residence for purposes of the exempt surplus system also causes a problem with respect to foreign corporations that are treated as flow-through entities under the foreign tax law. For example, certain US entities, such as limited liability companies (LLCs), are treated as corporations and foreign affiliates for Canadian income tax purposes but may be treated as transparent or flowthrough entities for US tax purposes if the appropriate election is made under the check-the-box rules. A US LLC that is treated as a transparent entity is not liable to tax under US law and therefore cannot qualify as a resident of the United States for purposes of the treaty. Therefore, such LLCs would not qualify for exempt surplus treatment. Regulation 5907(11.2)(b) alters this result by providing that a foreign affiliate will be treated as a resident of a country for purposes of the treaty if it would be a treaty resident on the assumption that it was treated as a corporation under the foreign law.

ASSESSMENT OF THE LINK BETWEEN TAX TREATIES AND THE FOREIGN AFFILIATE RULES

The previous section has described in some detail the significance of tax treaties, or more specifically, residence in a designated treaty country, for purposes of the foreign affiliate rules. Next it is appropriate to assess the relationship between tax treaties and the foreign affiliate rules from the perspective of both those rules and the treaties.

Looking first at the effects on the foreign affiliate rules, the key issue is whether it makes sense to have the exemption system for dividends from foreign affiliates apply to active business income earned in treaty countries by foreign affiliates resident in treaty countries. An ancillary part of this issue is whether it makes sense to require foreign affiliates to be resident in a country for purposes of the treaty between Canada and the country. It is convenient to examine this ancillary issue separately from the key point.[36]

As explained earlier, in my opinion, the exemption for dividends from foreign affiliates is justifiable only as a proxy for a foreign tax credit system. Therefore, the exemption should be available only for dividends paid by a foreign affiliate if the aggregate of the underlying foreign corporate tax paid by the affiliate and the foreign withholding tax on the dividend is equal to or exceeds the Canadian corporate tax rate.[37] Under these conditions, as a means of providing relief from international double taxation, an exemption is arguably simpler than a foreign tax credit, in terms of compliance and administration.

To achieve simplicity, the exemption for dividends from foreign affiliates cannot operate on the basis of the actual foreign tax paid by particular affiliates. Such a system would be tantamount to a foreign tax credit system because it would require the computation of the income of each foreign affiliate in accordance with Canadian tax rules. As a result, countries that have an exemption system that is intended

to be a substitute for a credit system need a proxy for the actual foreign tax paid by a foreign affiliate. Several countries, including Canada, use a listed country or designated jurisdiction approach for this purpose.[38] Under this approach, the exemption applies only to dividends received from foreign affiliates resident in certain designated countries.[39] Generally, only high-tax countries are listed so that the exemption system operates as a reasonable proxy for a credit system.

The next issue is how to determine which countries should be designated as high-tax countries. Theoretically, countries should not be listed unless the aggregate of the corporate tax and withholding tax on dividends paid to Canadian corporations is equal to or greater than the Canadian corporate tax rate. Moreover, any foreign affiliates qualifying for a preferential tax regime offered by a country should be excluded from the exemption system. The Canadian foreign affiliate rules use the existence of a treaty with a country as a proxy for ensuring that the country levies tax comparable to Canadian tax. The idea behind this simplistic approach is that Canada would enter into tax treaties only with high-tax countries. Although this approach may have been workable in 1976, when Canada had few treaties, it is clearly inadequate currently. The existence of a treaty with a country offers no assurance that foreign affiliates in the country are subject to foreign tax comparable to Canadian tax. As the earlier overview of Canada's tax treaty network indicates, Canada has treaties with several countries that can be, and are, used as tax havens. Canadian multinationals use foreign affiliates established in these treaty countries to earn income that is subject to low or no tax in the foreign country and no Canadian tax when repatriated to Canada as dividends. It may be appropriate for several reasons for Canada to have tax treaties with countries that function as tax havens; but it is not appropriate for these countries to qualify as high-tax countries for purposes of the exempt surplus system.

Therefore, in my view, basing the exemption system for dividends from foreign affiliates on the existence of a treaty with a foreign country is wrong. The best evidence of the inadequacy of the treaty country requirement is regulation 5907(11.2)(c). As discussed earlier, this rule allows IBCs in certain treaty countries (Barbados, Cyprus, and Luxembourg) to qualify as residents of a designated treaty country even though they are expressly excluded from the treaty. Such corporations are expressly excluded from the benefits of tax treaties for the obvious reason that they are not subject to sufficient tax in the treaty country to justify treating them as residents. If IBCs are not entitled to the benefits of tax treaties because they are not subject to a sufficient level of tax, they should clearly not be entitled to the benefits of the exempt surplus system. They would not be entitled to those benefits but for the specific rule in regulation 5907(11.2)(c).

If foreign affiliates, such as Barbados IBCs, that are excluded from treaties are granted the benefits of the exempt surplus system, it must be asked why foreign affiliates that are resident in non-treaty countries and are subject to rates of tax significantly in excess of the tax rates to which IBCs are subject do not get the same benefits. It cannot be argued that Canada gets the right to exchange of information with respect to IBCs because the treaty does not apply to IBCs. In other words, the effect of regulation 5907(11.2)(c) is that the requirement of a treaty between

Canada and the foreign country is irrelevant with respect to foreign affiliates excluded from treaties, such as Barbados IBCs. Therefore, in principle, other non-treaty foreign affiliates should qualify for the exempt surplus system as long as they are subject to tax at rates equal to or higher than IBCs. Of course, such affiliates do not qualify for exempt surplus treatment. When the 1995 amendments to the foreign affiliate rules were made, the government had no intention to exclude Barbados IBCs, and other foreign affiliates excluded from tax treaties, from the benefits of exempt surplus treatment. Such affiliates had previously qualified for the exempt surplus system even though they should not have qualified in tax policy terms. Obviously, the government was not prepared to annoy Canadian multinationals by depriving them of the use of foreign affiliates excluded from treaties, and, in particular, Barbados IBCs.

The foregoing analysis indicates that the requirement of the existence of a tax treaty between Canada and another country for purposes of the foreign affiliate rules is completely inappropriate. The foreign affiliate rules should be revised to sever the link with tax treaties. This result can be accomplished readily by listing countries for purposes of the exempt surplus system on the basis of criteria that ensure that listed countries levy tax comparable to Canadian tax. The following three criteria would be appropriate for this purpose:

1. Income should be computed on a reasonably comprehensive basis under the foreign tax law that is roughly similar to the computation of income for purposes of the Canadian corporate tax.
2. The aggregate of the foreign corporate tax and the withholding tax on dividends should be roughly comparable to the Canadian corporate tax rate. Perhaps a small difference between the foreign rate and the Canadian rate might be acceptable in the interests of simplicity.
3. The foreign country must have a reasonably effective tax administration to ensure that the corporate and withholding taxes are actually collected.

It might be appropriate to require that there be an income tax treaty between a country and Canada, although such a requirement is not necessary. The existence of a treaty would assist Canadian tax authorities in obtaining information concerning foreign affiliates resident in the country. There is clearly a significant difference between using the existence of a tax treaty as the sole criterion, as under the current rules, and using it as one of several criteria. However, the link between tax treaties and the foreign affiliate rules would still exist.

If a country that qualifies for listing under the criteria set out above provides special tax preferences for certain corporations or certain income, those corporations and foreign affiliates that earn the preferential income should be excluded from benefiting from the exempt surplus system.[40] For example, if Barbados is listed, IBCs resident in Barbados should be excluded.

A complete discussion of this proposed listed country approach is beyond the scope of this note. It is raised here to show that there is an alternative to the

existing designated treaty country rule—an alternative that does not involve any significant change to the policy of the foreign affiliate rules. I recognize that the proposed listed country approach requires the CCRA or Finance officials to make difficult decisions about which countries to list and to monitor the list on an ongoing basis. In contrast, the designated treaty country rule operates automatically. However, the fundamental point is that the designated treaty country rule lacks any integrity. It is fundamentally deficient and should be replaced.

If reliance on the existence of a treaty between Canada and another country were eliminated from the foreign affiliate rules, the current requirements for a foreign affiliate to be resident in a designated treaty country and to earn income from an active business carried on in a designated treaty country also would be eliminated. It would be necessary to have some rule to connect a particular foreign affiliate to a particular listed country for purposes of determining entitlement to the benefits of the exempt surplus system. The rule should be that a foreign affiliate is a resident of a listed high-tax country if the affiliate is subject to tax under the laws of that country on its worldwide income.[41] Residence in accordance with the Canadian central management and control test (the pre-1995 rule) would not be appropriate because it would not ensure that foreign affiliates are subject to tax in a country on their worldwide income. The recommended approach is similar to the test for treaty residence but avoids reference to the provisions of the treaty. It does, however, require reference to the foreign tax law to determine if and on what basis a foreign affiliate is subject to tax in the country. If the existence of a treaty with a country were retained as one of the criteria for listing countries, the current rule in regulation 5907(11.2)(a) also could be retained. It would not be necessary, in my opinion, to require foreign affiliates to also be resident in a listed country under the Canadian central management and control test of corporate residence, although that requirement could be retained quite easily as well.

Severing the link between tax treaties and the foreign affiliate rules would be beneficial not only for the foreign affiliate rules but also for Canada's tax treaty network. The need to enter into a tax treaty with virtually every country in which a Canadian corporation is carrying on an active business would be eliminated. The decision to conclude a tax treaty with a country would be based on several factors, not primarily or exclusively on access to the exempt surplus system. Although, in my view, it is doubtful that Canada needs tax treaties with 90 countries, Canada's treaty network is unlikely to shrink just because the link between the treaties and the foreign affiliate rules is severed. However, unlinking tax treaties and the foreign affiliate rules may remove the pressure for Canada to enter into additional treaties and may permit Canadian tax officials to focus their efforts on renegotiating the more important existing treaties.

THE RELEVANCE OF THE FOREIGN AFFILIATE RULES FOR TAX TREATIES

Most of Canada's tax treaties entered into after 1976, when the foreign affiliate rules became effective, until the late 1990s provided that Canada would give relief

from double taxation in respect of dividends from foreign affiliates by allowing corporations resident in Canada to deduct dividends out of exempt surplus in computing their taxable income. This relief is expressly subject to the existing provisions of Canadian law and to any subsequent modifications of those provisions. However, the general principle of the provision cannot be altered without contravening the treaty. A typical exempt surplus provision in these treaties reads as follows:

> Subject to the existing provisions of the law of Canada regarding the determination of exempt surplus of a foreign affiliate and to any subsequent modification of those provisions—which shall not affect the general principle hereof—for the purpose of computing Canadian tax, a company resident in Canada shall be allowed to deduct in computing its taxable income any dividend received by it out of the exempt surplus of a foreign affiliate resident in [the treaty country].

Not all of the exempt surplus provisions are exactly the same. For example, the treaty with France refers to the "principle" rather than the "general principle" of exemption. Also, some treaties use the expression "regarding the taxation of income from a foreign affiliate" rather than "regarding the determination of exempt surplus of a foreign affiliate."

Two pre-1972 treaties, those with Ireland and Norway, have not yet been renegotiated and do not contain any protection for the exemption of dividends out of exempt surplus. The treaty with Brazil contains a special provision exempting from Canadian tax dividends paid by a Brazilian company to a Canadian company out of active business income but does not refer explicitly to exempt surplus. None of the treaties contains any provision with respect to relief for dividends received by a Canadian corporation out of the taxable surplus of a foreign affiliate.

It seems reasonably clear that the exempt surplus provision was used as an incentive to get countries to enter into treaties with Canada during the 1970s and early 1980s. As explained earlier, the exemption for dividends out of exempt surplus was not available for foreign affiliates in unlisted countries, and the existence of a treaty, or at least the commencement of treaty negotiations with a country, was a prerequisite for listing. This incentive did not exist for countries that already had treaties with Canada. For example, Ireland and Norway were listed countries and are now designated treaty countries for purposes of the foreign affiliate rules, even though there is no exempt surplus provision in the treaties with these countries. Therefore, the only difference between these two countries and other treaty countries is that, with respect to Ireland and Norway, Canada could alter its domestic law concerning dividends out of exempt surplus without violating the treaty.

Article 23 of the OECD model treaty authorizes either the exemption or the credit method as a means of relieving double taxation. With respect to dividends, this means that Canada must either exempt dividends received by Canadian residents from corporations resident in the treaty partner or allow a credit for any foreign withholding taxes on the dividends. The OECD model treaty is silent with

respect to relief for underlying foreign taxes paid by a foreign corporation on income out of which a dividend is paid. The commentary on article 23 of the model treaty deals with the issue of an indirect credit for underlying foreign taxes and concludes that "[i]n the end, it appeared preferable to leave States free to choose their own solution to the problem."[42] Canada has not made any reservation on article 23 of the OECD model treaty or any observations on the commentary.

The exempt surplus provision in Canada's tax treaties goes well beyond the requirements imposed by article 23 of the OECD model treaty. All that Canada is required to do by virtue of the OECD model treaty is to provide a credit for any foreign withholding taxes imposed on such dividends.

The meaning of the typical exempt surplus provision contained in most of Canada's tax treaties is far from clear. The relief is expressly "subject to the existing provisions of the law of Canada regarding the determination of exempt surplus." This reference makes it clear that the details for the deduction for dividends received by Canadian corporations out of the exempt surplus of foreign affiliates (or at least for the calculation of exempt surplus) are provided by Canadian law, not by the treaty. Also, the reference to the "existing" provisions means the exempt surplus provisions of the Act at the time the treaty was signed or entered into. However, the treaty relief is also subject to subsequent modifications of the exempt surplus rules. What is not clear is whether the reference to the general principle of the provision is intended to apply to both the exempt surplus provisions at the time the treaty is entered into and any subsequent modifications of those provisions, or just the latter. This issue of interpretation is crucial to the scope and effect of the provision.[43]

If the limitation of the general principle applies to both the existing exempt surplus provisions and any subsequent modifications, the exempt surplus provision in the treaty establishes an exemption under the treaty that is independent of Canadian law. To the extent that the exempt surplus provisions at the time a particular treaty is entered into conflict with the general principle of the exempt surplus provision in the treaty, the general principle of the treaty will prevail. Moreover, on this interpretation, arguably the effect of the treaty is to freeze the exempt surplus rules for foreign affiliates resident in a particular country at the time the treaty with that country was entered into. Thus, the treaty would entitle Canadian corporations to relief for dividends out of exempt surplus on the basis of the exempt surplus rules at the time the treaty was entered into, irrespective of subsequent changes to those rules restricting the relief.

This argument is available to Canadian corporations in many situations as a result of the 1995 amendments to the foreign affiliate rules. One effect of those amendments was to define income from an active business restrictively so that some amounts that were previously included in exempt surplus were included in FAPI and thereby in taxable surplus. For treaties entered into before 1995 with a typical exempt surplus provision, it can be argued that the treaty entitles Canadian corporations to continue computing exempt surplus of foreign affiliates in those treaty countries on the basis of the pre-1995 exempt surplus rules.

If the general principle of the exempt surplus provision in the treaty applies only to subsequent modifications of the Canadian exempt surplus rules, the effect of the treaty provision is more modest.[44] Under this interpretation, the exemption for dividends out of exempt surplus is whatever the rules of Canada provide from time to time. The effect of the treaty provision is not to freeze the exempt surplus provisions for foreign affiliates resident in a particular country at the time the treaty with that country was entered into. The treaty will override only changes to the exempt surplus system that adversely affect the general principle of the exempt surplus provision in the treaty.[45]

The meaning of the reference to the "general principle" of the exempt surplus provision of the treaty has not been considered by the courts. Similar wording in article XXV(8) of the Canada-US treaty[46] dealing with thin capitalization was at issue in *Ramada Ontario Ltd. v. The Queen*.[47] The wording of the relevant part of article XXV(8) is "including any subsequent modification of such provisions that does not change the general nature thereof." In contrast, the exempt surplus provision in all Canada's treaties refers to the general principle "hereof," meaning the exemption provided by the treaty, not the domestic exempt surplus rules. The Tax Court of Canada appeared to interpret the "general nature" of the thin capitalization rules as being equivalent to their purpose. The court stated:

> [T]he word "general" found in both "general nature" and "general principle" shows a focus on the whole provision, or set of provisions, in question. If only one item has been modified, as in this case, it is unlikely to be enough to change the situation. The impact, or the form, of the provision must be substantially altered.[48]

Although it is difficult to identify the general principle of the exempt surplus provision of the treaty precisely, the principle appears to be that dividends paid out of the exempt surplus of foreign affiliates resident in the treaty country must be exempt from Canadian tax. By virtue of article 3(2) of most treaties, the critical terms ("exempt surplus" and "foreign affiliate") in the exempt surplus provision have the meaning that they have under Canadian income tax law (at the time the treaty is applied, not when it was entered into). The most important ingredient of exempt surplus is income earned in a treaty country by a foreign affiliate resident in a treaty country. The treaty may permit minor changes to the definition of active business, such as occurred in 1995, depending on how the exempt surplus provision in the treaty is interpreted, as discussed earlier. However, unless the exempt surplus provision were construed to be meaningless, which is unlikely, it would override the unilateral elimination by Canada of the exemption for dividends out of exempt surplus. Therefore, for example, if Canada converted the exemption system into a credit system, any treaties with an exempt surplus provision would require Canada to continue to provide an exemption for dividends out of exempt surplus paid by foreign affiliates resident in such countries. Similarly, if, as suggested earlier, the foreign affiliate rules were to be amended to use a listed country approach, rather than the current designated treaty country approach, the

exemption for dividends out of exempt surplus would continue to apply to foreign affiliates in countries with which Canada has a tax treaty with an exempt surplus provision.

Tax treaties entered into since 1998 do not contain any exempt surplus provision. Most of these treaties (those with Algeria, the Czech Republic, Jordan, Kuwait, Lebanon, Luxembourg, the Netherlands, Portugal, Senegal, and Venezuela) provide only that Canada will give a credit against Canadian tax payable for any tax paid to the other country on profits arising in the other country. The treaties with Australia, Ecuador, Germany, Peru, and the Slovak Republic, however, provide that Canada will give an indirect foreign tax credit for the underlying foreign corporate tax paid by a corporation resident in the other country in computing the Canadian tax paid on a dividend received by a Canadian corporation from such a corporation.[49] The Canadian corporation must own at least 10 percent of the voting power of the corporation resident in the other country.

The indirect foreign tax credit provision in these five treaties is strange because, unlike the exempt surplus provision, the indirect credit provision does not mesh well with the foreign affiliate rules. Under paragraph 113(1)(b) of the Act, Canadian-resident corporations are entitled to a deduction in computing taxable income in respect of the underlying foreign tax applicable to a dividend paid out of the taxable surplus of a foreign affiliate. The underlying foreign tax applicable to the dividend is grossed up by the relevant tax factor in order to arrive at an amount equal to the foreign affiliate's pre-tax income on the assumption that its income was taxable at the basic Canadian corporate tax rate. The deduction under paragraph 113(1)(b) is roughly equivalent to an indirect foreign tax credit; however, it is clearly not a credit against tax. Therefore, making the indirect credit in the treaties with Australia, Ecuador, Germany, and Peru "[s]ubject to the existing provisions of the law of Canada regarding the allowance as a credit against Canadian tax of tax payable in a territory outside Canada" does not seem to make sense because the existing provisions of domestic law do not provide any indirect credit.[50] The reference should be to the provisions of the Act regarding the deduction of underlying foreign tax applicable to dividends out of taxable surplus, or perhaps just to dividends out of taxable surplus. Furthermore, the treaty provision operates for dividends from foreign corporations in which a Canadian corporation controls, directly or indirectly, at least 10 percent of the voting power. The deduction under paragraph 113(1)(b) applies to dividends from a foreign affiliate, which is defined to be a foreign corporation in which a Canadian corporation owns at least 10 percent of the shares of any class.[51] For the foreign affiliate rules, the number of shares of a class is the relevant criterion; voting rights, which are critical under the treaty, are irrelevant under those rules.[52]

The new credit provision may be interpreted as establishing an independent treaty credit for the underlying foreign taxes paid by a foreign affiliate on its income out of dividends that are paid to its Canadian corporate shareholders. On this interpretation, the reference to the provisions of Canadian law regarding the foreign tax credit means the credit under section 126. The taxable surplus provisions of the

Act are irrelevant. Accordingly, in computing the credit under section 126 with respect to a dividend received by a Canadian corporation from a foreign corporation in which the Canadian corporation owns at least 10 percent of the voting power, the Canadian corporation is entitled to a credit for foreign withholding taxes on the dividend and the foreign corporate tax payable on the profits out of which the dividend was paid. The difficulty is that section 126 does not provide any rules as to how to calculate such an indirect foreign tax credit. Also, if the new indirect credit provision refers to section 126, it is difficult to reconcile the wording of the standard direct credit treaty provision and the wording of the new indirect credit provision. The direct credit provision refers to "the existing provisions of the law of Canada regarding the deduction from tax payable in Canada of tax paid in a territory outside Canada." This language clearly reflects the credit under section 126 of the Act. In contrast, the corresponding phrase in the indirect credit provision, quoted above, refers to "the allowance as a credit against Canadian tax of tax payable." If both provisions were intended to refer to section 126, presumably the same language would have been used in both.

On the other hand, if the reference to the allowance of a credit against Canadian tax is intended to be a reference to domestic provisions other than section 126, it is unclear what those provisions are. The taxable surplus rules and the deduction under paragraph 113(1)(b) clearly relate to a deduction in computing taxable income, not a credit against tax payable or a deduction in computing tax payable. Because the new indirect credit provision in the treaty with the Slovak Republic refers to the provisions of the law of Canada and not the "existing" provisions, as the direct credit provision does, an argument might be made that the indirect credit is intended to refer to future domestic provisions that did not exist at the time the treaty was entered into. If so, however, the reference to subsequent modifications appears to be meaningless. Moreover, this argument cannot explain the treaties with Australia, Ecuador, Germany, and Peru, which refer to the existing provisions of the law of Canada. Given these difficulties and inconsistencies, it appears that the indirect credit provision in the treaty with the Slovak Republic contains a drafting error.

Whatever the indirect credit provision in recent treaties means, the important point for this note is that the Canadian government has clearly decided not to include the exempt surplus provision in any new treaties and to delete it in any existing treaties that are renegotiated. There has been no announcement or explanation by the Department of Finance of this change in Canada's treaty policy. Nor has the change received much public comment. The effect of the change is that these new treaties will not constrain Canada's ability to amend or even repeal the exempt surplus system with respect to foreign affiliates resident in these countries. Foreign affiliates resident in the countries with which treaties have been negotiated since 1997 are still able to pay dividends out of exempt surplus. The treaty does not deprive Canadian corporations of the benefit of the provisions of domestic law, such as exempt surplus, that are more beneficial than the provisions of the treaty.[53] If, however, Canada chose to amend or repeal the exempt surplus system, the new

treaties would not provide any protection against such changes. In contrast, as discussed earlier, the exempt surplus provision in many existing treaties would provide continuing access to the exempt surplus system despite changes to the Act limiting access to the system for foreign affiliates resident in those countries.

In my view, the decision not to include the exempt surplus provision in Canada's tax treaties is a sensible one. The provision seriously constrains Canada's ability to make major changes to the foreign affiliate rules with respect to any countries with treaties that contain such a provision. This constraint is not required by the OECD model treaty; it is self-imposed. Moreover, it is unlikely that Canada is able to extract any significant concessions from its treaty partners in consideration for the inclusion of an exempt surplus provision in the treaty. As explained earlier, under the foreign affiliate rules, the exempt surplus system is available to foreign affiliates in any treaty country, whether or not the treaty with a particular country contains an exempt surplus provision. Since the only effect of the exempt surplus provision is to limit Canada from making major unilateral changes to the exempt surplus rules, other countries would not likely be willing to give up much in exchange for the inclusion of the exempt surplus provision in the treaty.

CONCLUSION

Currently, Canada's exemption system for dividends from foreign affiliates applies only to foreign affiliates resident in countries with which Canada has a tax treaty. Moreover, until recently, most of Canada's tax treaties contained a provision guaranteeing an exemption for dividends received out of exempt surplus of foreign affiliates resident in the treaty country. This note has argued that these links between the foreign affiliate rules and Canada's tax treaties should be severed. The exempt surplus provision in the treaties limits Canada's ability to make changes to the foreign affiliate rules to maintain the integrity of the exemption system. The requirement of residence in a treaty country as a proxy for ensuring that foreign affiliates are subject to foreign tax comparable to Canadian tax is deficient and undermines the tax policy justification for the exemption system.

NOTES

1 Section 90 of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

2 Paragraph 113(1)(a).

3 Paragraphs 113(1)(b) and (c).

4 Regulation 5901(1).

5 Paragraph 113(1)(d).

6 Subsection 92(2).

7 Regulation 5907(1), the definition of "exempt surplus."

8 Regulation 5907(1), the definition of "exempt earnings," paragraph (d). Such income is also excluded from foreign accrual property income (FAPI) by virtue of subparagraph 95(2)(a)(ii).

9 Regulation 5907(1), the definition of "taxable surplus."

10 Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998), 6.7.

11 See J. Scott Wilkie, Robert Raizenne, Heather I. Kerr, and Angelo Nikolakakis, "The Foreign Affiliate System in View and Review," in *Tax Planning for Canada-US and International Transactions*, 1993 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1994), 2:1-72.

12 In a 1976 paper, Gérard Coulombe, then assistant director, Personal and International Tax Division of the Department of Finance, suggested that the exemption system was a way of providing tax sparing for developing countries. See Gérard Coulombe, "Certain Policy Aspects of Canadian Tax Treaties," in *Report of Proceedings of the Twenty-Eighth Tax Conference*, 1976 Conference Report (Toronto: Canadian Tax Foundation, 1977), 290-303, at 299. In my view, this aspect of the exemption system is more an unintentional consequence than an intentional policy objective. Coulombe's suggestion does not explain the application of the exemption system to developed countries and, in particular, to low-tax regimes provided by developed countries.

13 Canada, *Report of the Royal Commission on Taxation*, vol. 4 (Ottawa: Queen's Printer, 1966), 481-500.

14 E.J. Benson, *Proposals for Tax Reform* (Ottawa: Queen's Printer, 1969), 72.

15 Viewed as an incentive, the exemption should be available for all dividends out of business income and for business income derived from foreign branch operations.

16 The 16 countries were Australia, Denmark, Finland, France, Ireland, Jamaica, Japan, the Netherlands, New Zealand, Norway, South Africa, Sweden, Trinidad and Tobago, the United Kingdom, the United States, and West Germany.

17 In its response to the 1992 auditor general's report, the Department of Finance indicated that the exemption system is, "at least in part," a proxy for a foreign tax credit system. See Canada, *Report of the Auditor General of Canada to the House of Commons 1992* (Ottawa: Supply and Services, 1992), 52.

18 See "Tax Treaties," on the Department of Finance Web site at http://www.fin.gc.ca/treaties/treatystatus_e.html.

19 See generally David A. Ward, "Canada's Tax Treaties" (1995) vol. 43, no. 5 *Canadian Tax Journal* 1719-58.

20 The following countries were listed even though Canada did not have tax treaties with them: Antigua, Belize, Dominica, Liberia, Montserrat, Portugal, St. Kitts and Nevis-Anguilla, St. Lucia, St. Vincent, and Senegal. The following treaty countries were not listed: Czechoslovakia, Hungary, Luxembourg, Mexico, Nigeria, Papua-New Guinea, Poland, South Africa, and Zimbabwe.

21 Supra note 17, at 46-51.

22 Canada, *Minutes of Proceedings and Evidence of the Standing Committee on Public Accounts*, Twelfth Report to the House, 34th Parliament, 3d session, 1991-92-93, issue no. 48, April 23, 1993.

23 Regulation 5907(1), the definition of "exempt earnings," subparagraph (d)(i). It is not necessary for the income to be earned in the same treaty country in which the foreign affiliate is resident.

24 The rules in regulation 5907(11.2) with respect to the residence of a foreign affiliate in a designated treaty country apply for purposes of the foreign affiliate rules generally. Although these residence rules are most important for purposes of determining which foreign affiliates earn exempt surplus, they are also applicable for other purposes, such as the election under regulation 5907(2.1) to use book depreciation rather than depreciation under the foreign tax law.

25 The meaning of regulation 5907(11.2)(a) is not readily apparent. It deems a foreign affiliate not to be resident in a country unless the affiliate is resident in the country for purposes of the treaty. Therefore, even if the negative deeming rule does not apply because a foreign affiliate is

a resident of the other country for purposes of the treaty, it is still necessary for the foreign affiliate to be resident in the country in accordance with Canadian tax law.

26 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD) (looseleaf) (herein referred to as "the OECD model treaty").

27 This addition is unnecessary from the Canadian perspective. Corporations incorporated in Canada are deemed to be resident in Canada under subsection 250(4). As a result, they are liable to tax in Canada by reason of their residence in Canada. In any event, if corporations incorporated in a country are taxable on their worldwide income, place of incorporation is clearly a criterion of a similar nature for purposes of article 4 of the OECD model treaty.

28 *The Queen v. Crown Forest Industries Ltd.*, [1995] 2 CTC 64 (SCC).

29 Ibid., at 76.

30 See generally Allan R. Lanthier, "The Concept of Residence," in International Fiscal Association (Canadian Branch), *Special Seminar on Canadian Tax Treaties: Policy and Practice* (Kingston, ON: International Fiscal Association (Canadian Branch), 2001), 13:1-21; and David A. Ward et al., "A Resident of a Contracting State for Tax Treaty Purposes: A Case Comment on Crown Forest Industries" (1996) vol. 44, no. 2 *Canadian Tax Journal* 408-24.

31 See Lanthier, supra note 30, at 13:13-15. The CCRA has taken the position that foreign-incorporated IBCs that are registered in Barbados are not residents of Barbados under the treaty because they are taxable only on profits arising in Barbados. However, Barbados enclave enterprises that qualify for a 10-year tax holiday and taxpayers subject to tax on a remittance basis are considered by the CCRA to be treaty residents. Also, the CCRA considers Barbados exempt insurance companies not to be residents of Barbados for purposes of both the treaty and the foreign affiliate rules.

32 The commentary on the OECD model treaty recognizes the use of this exclusion approach. Paragraph 15 of the commentary on article 1 of the model treaty provides that the improper use of tax-exempt or nearly tax-exempt corporations may be avoided "by denying the tax treaty benefits to these companies (the exclusion approach)."

33 The Agreement Between Canada and Barbados for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed at Bridgetown on January 22, 1980.

34 If a treaty explicitly does not apply to a corporation, it is impossible for the corporation to be considered a resident of the country for purposes of the treaty. It has been argued that, in the absence of the exclusion provision in the treaty, such IBCs would be residents for purposes of the treaty; otherwise, the exclusion provision would be unnecessary. See Lanthier, supra note 30, at 13:19-20.

35 This rule is qualified by the requirement that the exclusion provision in the treaty has not been amended after 1994. In effect, if an exclusion provision in a treaty is amended after 1994, Canada intends to exclude any foreign affiliates covered by the exclusion provision from the exempt surplus system.

36 Before the 1995 amendments to the foreign affiliate rules, the second issue did not exist because residence in a treaty country was exclusively a question of central management and control.

37 As discussed earlier, the exemption would also be limited to active business income earned in treaty countries.

38 For a discussion of the designated jurisdiction approach for purposes of controlled foreign corporation (CFC) rules, see generally Brian J. Arnold, *The Taxation of Controlled Foreign Corporations: An International Comparison*, Canadian Tax Paper no. 78 (Toronto: Canadian Tax Foundation, 1986), 427-44; and Brian J. Arnold and Patrick Dibout, "General Report," in International Fiscal Association, *Cahiers de droit fiscal international*, vol. 86b, *Limits on the Use of Low-Tax Regimes by Multinational Businesses: Current Measures and Emerging Trends* (The Hague:

Kluwer Law International, 2001), 21-89, at 45-48. As of 2000, 16 of the 19 countries with CFC rules used a designated jurisdiction approach for that purpose.

39 There may be additional requirements with respect to the connection between a foreign affiliate and a country. For example, a foreign affiliate might be required to have a substantial presence in the country or to earn at least a specified percentage of its income from the country.

40 The Technical Committee on Business Taxation was also concerned about this problem, at least with respect to interaffiliate transactions. It recommended that Canada renegotiate its tax treaties "to ensure that all tax-privileged entities in treaty countries are denied access to the exemption system with respect to income from interaffiliate transactions." See supra note 10, at 6.22.

41 A foreign affiliate qualifying for a preferential tax regime under the laws of the foreign country would probably be considered to be a resident of the country under its laws. However, such an affiliate would not qualify for the exempt surplus system because, as mentioned earlier, the list of high-tax countries would exclude any inappropriate preferential regimes provided by the country.

42 Paragraph 52 of the commentary on article 23. The issue of an indirect credit for underlying foreign taxes is discussed in paragraphs 49 to 54 of the commentary on article 23. Most developed countries provide for an indirect credit in their tax treaties with other developed countries.

43 See Nick Pantaleo and John M. Ulmer, "Elimination of Double Taxation: Credit and Exemption Under Canada's Tax Treaties," in *Special Seminar on Canadian Tax Treaties*, supra note 30, 5:1-30, at 5:4-14.

44 Pantaleo and Ulmer, ibid., at 5:7-8, take this view of the exempt surplus provision: "The reference to the 'general principle' does not represent an independent principle of treaty relief, because 'the internal law and the treaty relief are the same at the effective date of the treaty, and the general principle governs only amendments in the law.' [John F. Avery Jones et al., "Credit and Exemption Under Tax Treaties in Cases of Differing Characterization" (1996) vol. 36, no. 4 *European Taxation* 118-46, at 122.] The 'general principle' itself references the 'existing provisions of the law of Canada,' and thus cannot represent a principle greater than the provisions of internal law, subject to modification."

45 One difficulty with this interpretation is that before 1995 foreign affiliates in countries that had entered into treaties with Canada with exempt surplus provisions but were not listed in regulation 5907(11) would not have been entitled to the exempt surplus system. On the competing interpretation, they could rely on the treaty provision to get exempt surplus treatment despite not being listed in regulation 5907(11).

46 The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997 (herein referred to as "the Canada-US treaty").

47 [1994] 1 CTC 2130 (TCC).

48 Ibid., at 2140.

49 Article 23(1)(b) of the Agreement Between Canada and the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Income and Certain Other Taxes, the Prevention of Fiscal Evasion and Assistance in Tax Matters, signed at Berlin on April 19, 2001, provides as follows:

> In the case of a resident of Canada, double taxation shall be avoided as follows: . . .
> b. Subject to the existing provisions of the law of Canada regarding the allowance as a credit against Canadian tax of tax payable in a territory outside Canada and to any subsequent modification of those provisions—which shall not affect the general

principle hereof—where a company which is a resident of the Federal Republic of Germany pays a dividend to a company which is a resident of Canada and which controls directly or indirectly at least 10 per cent of the voting power in the first-mentioned company, the credit shall take into account the tax payable in the Federal Republic of Germany by that first-mentioned company in respect of the profits out of which such dividend is paid.

The corresponding provisions in the treaties with Australia, Ecuador, and Peru are similar. The treaty with the Slovak Republic refers to the "provisions," rather than the "existing provisions," of the law of Canada.

50 In any circumstances where a Canadian corporation would be entitled to more generous relief by way of an indirect foreign tax credit than by way of a deduction under paragraph 113(1)(b), the treaty provides the corporation with the right to claim a credit. Presumably, the treaty provision would not allow a Canadian corporation to claim both a deduction under paragraph 113(1)(b) and a credit under the treaty.

51 Subsection 95(1), the definition of "foreign affiliate," and subsection 95(4), the definitions of "direct equity percentage" and "equity percentage."

52 Another difference between the indirect credit under the treaty and the deduction under paragraph 113(1)(b) is that the treaty limits the credit to the tax payable to the foreign country in which the corporation paying the dividend is resident. In contrast, the deduction under paragraph 113(1)(b) includes underlying foreign tax paid by other lower-tier foreign affiliates from which the affiliate paying the dividend to the Canadian corporation has received, directly or indirectly, dividends out of taxable surplus. The treaty provision is appropriate in this regard. Because the treaty is bilateral, it should deal only with tax paid by a foreign affiliate to the country in which it is resident.

53 Tax treaties are generally relieving in nature. Therefore, as a matter of treaty interpretation, if domestic law provides greater relief than a treaty, the taxpayer is entitled to the greater relief under domestic law. Moreover, virtually all of Canada's tax treaties contain a provision that expressly provides that nothing in the treaty is intended to deprive a person of any deduction, credit, allowance, exemption, or other benefit available under Canadian law. See, for example, article XXIX(1) of the Canada-US treaty, supra note 46.

Response

Exempt Surplus: What's the Problem? A Reply to Brian Arnold

Angelo Nikolakakis*

With "Unlinking Tax Treaties and the Foreign Affiliate Rules: A Modest Proposal,"[1] Brian Arnold has inaugurated this journal's Policy Forum with a further instalment in a series of critiques of Canada's foreign affiliate rules.[2] His paper challenges the very basis of a tax regime that, in the view of successive Canadian governments, and others, is potentially the fiscal backbone of Canada's growing network of multinational enterprises. However, in my opinion, Arnold's arguments are unconvincing, inconsistent, and incomplete—so much so that they should not go unanswered. This paper is highly critical of Arnold's proposal and advances an alternative view that, I believe, is more appropriate to the current economic and ideological climate.

The stated thesis of Arnold's paper is that "the current links between the foreign affiliate rules and Canada's tax treaties should be eliminated."[3] However, on my reading of the paper, that statement does not accurately reflect Arnold's proposal. Rather, Arnold recommends that the exempt surplus features of the current foreign affiliate rules[4] should be emasculated and that Canada should move essentially toward a credit-based system of unilateral relief from double taxation. Specifically, he states that

> the exemption for dividends from foreign affiliates is justifiable only as a proxy for a foreign tax credit system. Therefore, the exemption should be available only for dividends paid by a foreign affiliate if the aggregate of the underlying foreign corporate tax paid by the affiliate and the foreign withholding tax on the dividend is equal to or exceeds the Canadian corporate tax rate.[5]

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In other words, Arnold's proposal is that exempt surplus treatment should be available only in circumstances where it would be essentially irrelevant. Where the aggregate of the underlying foreign corporate tax and the foreign withholding tax is equal to or exceeds the Canadian corporate tax, there is no substantive difference between exempt surplus treatment and taxable surplus treatment.[6] Both give rise to the same result—namely, a complete deduction in computing the taxable income arising from the dividend. Thus, to move to such a regime would essentially be to eliminate exempt surplus.

The following note is attached to the statement quoted above: "As discussed earlier, the exemption would also be limited to active business income earned in treaty countries."[7] This statement is surprising given Arnold's stated thesis that "the current links between the foreign affiliate rules and Canada's tax treaties should be eliminated." It is not the only instance of apparent indecision with respect to the propriety of maintaining the relationship between the foreign affiliate rules and Canada's tax treaties. Elsewhere Arnold states that "the requirement of the existence of a tax treaty between Canada and another country for purposes of the foreign affiliate rules is completely inappropriate";[8] but subsequently, he acknowledges that "[i]t might be appropriate to require that there be an income tax treaty between a country and Canada, although such a requirement is not necessary."[9]

While these inconsistencies weaken Arnold's arguments on the treaty-linkage issue, my main concern in this response is to address his proposal for the substantive elimination of exempt surplus. This proposal, in my view, is by no means "modest" but constitutes a radical departure from the current foreign affiliate regime.

JUSTIFYING EXEMPT SURPLUS

The central thesis of this paper is that the exempt surplus rules reflect a delicate and deliberate balancing of numerous, sometimes conflicting, sometimes only subtly complementary, public policy objectives and constraints, and cannot be justified *only* as a proxy for a foreign tax credit system. In brief, and on the basis of readily available public information, including records of testimony of senior government officials given in contentious circumstances, I submit that the foreign affiliate rules include examples of deliberate non-neutrality, justified in part, but not exclusively, by very legitimate concerns involving the international competitiveness of Canadian-based multinational enterprises, and that the exempt surplus rules add an important element of neutrality to that regime, which is intended to encourage the repatriation of indirect foreign active business income.

Simplicity: The "Proxy" Theory

While simplicity is often acknowledged as a principle animating the articulation of various rules in the Act, it normally occupies a subsidiary position in the hierarchy of fiscal values. Indeed, it is rare that substantive fiscal interests are materially sacrificed in the name of simplicity.[10] Moreover, in the context of the foreign affiliate rules, there seems to be no basis for suggesting, as Arnold does, that the

only justification for the exempt surplus rules is simplicity—that is, the notion of a proxy for a foreign tax credit system. These rules are among the most detailed and complicated components of the Act and Regulations and can hardly be described as a simplified form of anything.

This brings us to another problematic aspect of Arnold's proposal. He advocates, in the interests of simplicity, the replacement of the current regime with an emasculated version of the exempt surplus rules, applicable only where the aggregate of the foreign corporate and withholding taxes are comparable to the Canadian corporate tax rate.[11] But how is this determination to be made? Should it be made on the basis of the nominal foreign tax rates and any obvious general or specific tax preferences? That would not seem to be very effective, since there are often certain not-so-obvious tax preferences. Are Canadian revenue authorities instead to be responsible for reviewing the intricacies of every foreign tax regime on an annual basis, in order to determine which countries should qualify year by year? That would not seem to be very simple. In making this determination, should Canadian revenue authorities take into account tax-planning techniques that may be implemented in particular foreign countries, whether or not explicitly or implicitly sanctioned by the relevant foreign tax administrations? That, too, would not seem to be very simple. Would such determinations have retroactive effect, affecting the treatment of undistributed earnings of previous years? That would not seem to be particularly appropriate. Should the burden be placed on the relevant taxpayer to establish that the effective foreign tax rate is comparable to the Canadian rate? That would not seem to be very different from requiring the taxpayer to determine the amount of foreign taxes paid for the purposes of claiming relief under a foreign tax credit system.

How would the proposed system accommodate foreign jurisdictions that raise the greater portion of their revenues from non-income taxes (such as sales, use, or consumption taxes, capital taxes, payroll taxes, stamp duties, resource royalties, or licence fees) and consequently have lower income tax rates? How would it accommodate foreign jurisdictions that do not have public health-care or education systems, or developed infrastructure, and consequently directly or indirectly offload those costs onto enterprises based or operating within their jurisdiction?

Another problem in the calculation is how to determine the comparable Canadian tax rate. Should it be determined on the basis of Canada's nominal corporate tax rate, or on an industry-specific basis, taking into account all direct and indirect preferences, such as accelerated depreciation, investment tax credits, the small business deduction, and the like? There are significant differences in the rates of Canadian (including provincial) taxes on business income, depending on the industry sector. Currently, they range from 5.5 percent (oil and gas) to 37 percent (construction) for large businesses, and from 7.6 percent (manufacturing) to 20.2 percent (communication) for smaller businesses.[12] Then there are the exemptions for certain non-governmental and non-charitable sectors.[13] Should the comparable Canadian tax rate be determined on a taxpayer-specific basis? That may seem unduly complicated—but, after all, the current foreign tax credit rules in section 126 operate on a

modified taxpayer-specific basis, in that the credit is limited, essentially, to the proportion of the tax otherwise payable *by the taxpayer* that the taxpayer's foreign income is of the taxpayer's overall income.

In brief, it is not a simple matter to determine, in an effective manner, either the applicable foreign tax rate or the appropriate comparable Canadian rate. Consequently, it is puzzling to suggest, as Arnold does, that an emasculated version of the exempt surplus rules should be retained in the name of simplicity.

Although the current exempt surplus rules, which operate in conjunction with Canada's treaty network, can be justified *in part* by the principle of simplicity (which is reflected in the fact that, under this regime, there is no need to compute credits), it is important to emphasize that this is only one of many justifications. Moreover, under the current regime, the more material aspect of this simplification relates to the determination of which countries should qualify, which relies on whatever review may be carried out by the treaty negotiators. Treaty countries are in many cases countries that can reasonably be considered to impose taxes on a basis comparable to Canada's (depending on how loosely that expression is being used) or at the very least on a basis that is considered from a Canadian perspective to be "legitimate" and "reasonable" in the particular circumstances, whether or not comparable to ours.[14] If there is a material proxy under the current rules, it is that the treaty negotiation process is a proxy for a more complicated review of the fiscal attributes of foreign tax regimes. To depart from this approach would be to move to a system based on some sort of "white list" and "blacklist." In addition to other concerns that would arise with respect to such an approach (not the least of which being, as discussed above, that it would impose great practical burdens on both taxpayers and the tax administration), it would make treaty negotiations with blacklisted countries very awkward for the negotiators.[15] Of course, Canada would also be required to renegotiate a very significant number of its existing tax treaties, a process that would take years and would impose a tremendous burden on the tax administration.[16]

Neutrality, International Competitiveness, and Other Considerations

Neutrality is an important fiscal value. The notion of neutrality in tax matters generally describes the degree to which fiscal measures influence resource allocation decisions. In the international tax context, we use the expressions "capital export neutrality" and "capital import neutrality." Capital export neutrality is achieved where there is neither an advantage nor a disadvantage from a fiscal perspective in investing capital abroad rather than domestically. An aspect of capital import neutrality involves the issue of whether there is any advantage or disadvantage from a fiscal perspective in repatriating capital (which includes earnings on capital) from abroad.

The only aspect of the foreign affiliate rules that for the most part seems faithful to *both* of these principles is foreign accrual property income (FAPI).[17] FAPI tends toward consistency with capital export neutrality from a Canadian perspective

because, at least in theory, it is aimed at achieving neither a timing nor a rate advantage or disadvantage in the earning of passive income from capital invested through a controlled foreign affiliate rather than domestically. Both investment alternatives essentially result in current Canadian taxation at full rates.[18] FAPI is also consistent with capital import neutrality because, once the income has been taxed as FAPI on an imputation basis, it can then be repatriated free of any further tax.[19] Thus, there should be neither an advantage nor a disadvantage in repatriating previously taxed FAPI.

The current exempt surplus rules, and the current taxable surplus rules, seem to compromise capital export neutrality, to the extent that foreign income tax rates are lower than Canadian rates, by providing for effective exemption from or deferral of Canadian corporate-level taxes in respect of indirect foreign active business income. That is, to this extent and in this respect, there will be a fiscal advantage to the earning of active business income indirectly and abroad, rather than domestically, when the effective tax burden on foreign earnings is lower than the Canadian burden. Where the income is associated with a treaty country, the repatriated foreign income, after bearing the applicable foreign taxes, is effectively exempt from *additional* Canadian corporate taxes for substantial interest holders, without regard to the rate of any applicable foreign taxes.[20] Where the income is not associated with a treaty country, it is ultimately subjected to additional Canadian corporate taxes if those are higher than the foreign taxes, in that Canadian taxes are applicable upon distribution of the income in the form of dividends, but credit-based relief is provided for in respect of any foreign taxes, essentially to the extent of the Canadian taxes otherwise payable.[21] However, additional Canadian taxes apply only if, when, and to the extent that such income is distributed to Canadian shareholders; thus, deferral is permitted and thereby encouraged. The Canada Customs and Revenue Agency (CCRA) has even issued rulings to the effect that section 245 (the general anti-avoidance rule) does not apply where a Canadian corporation borrows money from a foreign affiliate on an interest-free basis, even though the loan is funded using taxable surplus.[22] In light of these rulings, it becomes difficult to argue that deferral is inconsistent with the "scheme" of the rules.

Was this non-neutrality deliberate or at least contemplated?[23] The answer is "yes." Arnold points out[24] that, in proposing a combined exemption/credit system for the taxation of dividend income of foreign affiliates, the 1969 white paper stated that "[t]he proposals are designed neither to provide an incentive to Canadians to invest abroad, nor to place a barrier in the way of their doing so."[25] He also seems to suggest that this statement reflects, in its entirety, "the underlying policy objective of [the white paper's] recommendations."[26] I cannot agree with this interpretation, given that the white paper also contains statements such as the following:

> Canadian business is often required to go abroad to seek foreign sources of supply and to develop foreign markets. Going international is frequently necessary to enable Canadian companies to achieve the economies of scale which are otherwise denied to them by the relatively small size of the Canadian domestic market. Such companies

> could find it hard to compete on the international scene if they were subject to more onerous taxes than those which apply to their competitors.[27]

There is also the following statement, reflecting the more basic, jurisdictional issue that arises in matters of international taxation, in addition to competitiveness concerns:

> The rationale for [the exemption system] may be over-simplified as "if a corporation tax should be collected, the country in which the profits are earned will collect it, and any further corporate tax collected by the country in which the holding corporation is located would be 'double taxation' and a fiscal barrier to international investment."[28]

In addition, there is the following statement concerning the incidence of corporate tax:

> The choice between [an exemption system and a credit system] is obviously influenced by one's opinion as to who bears the corporation tax. If the tax is passed on to the customers of the corporation, then the pricing and profit structure of the local corporations in a country likely contemplate the payment of local corporation tax, and any additional corporate tax would place an international corporation at a competitive disadvantage. On the other hand, if the tax is borne by the shareholders of the corporation, there is no reason why shareholders of corporations with foreign operations should bear less corporate tax than shareholders of corporations which operate in the home country. Unfortunately, although the problem of the incidence of corporate tax has been the subject of extensive research and analysis, the answer remains largely a matter of opinion. . . . Undoubtedly the extent of shifting varies considerably from one situation to another: from one country to another, from one product to another, and from one point in time to another.[29]

Finally, there is the statement addressing, essentially, the relationship between the non-neutrality resulting from the exemption system and the non-neutrality resulting from domestic incentive measures like the dividend tax credit, and the bottom line reality that corporation tax is, fundamentally, simply a form of advance tax:

> If [the exemption system] is slightly generous in some circumstances, it should not divert Canadian investment abroad; to do that it must compete with the system of credit for Canadian corporate tax. And, of course, Canadian personal tax would still be due when the profits are distributed to Canadian shareholders.[30]

Thus, to the extent that Arnold's position is premised on the proposition that the architects of the current rules were driven solely by visions of neutrality, his position is unfounded. It seems obvious that the designers of the system struggled carefully to balance a variety of considerations and ultimately settled on a deliberate compromise, which reflected their views of the prevailing economic and ideological circumstances of the time both in Canada and internationally, and also represented a clear decision to sacrifice a degree of capital export neutrality in order to maintain

international competitiveness.[31] Also, the last quote is particularly important, in that it recognizes that income from corporate investment abroad is ultimately distributed to individuals in Canada, and on distribution, it is normally taxed. Consequently, exempt surplus dividends cannot properly be described as a form of income that is exempt from tax in Canada.[32]

Is this non-neutrality desirable or at least defensible? From a theoretical and academic macroeconomic perspective, there may be an argument that perfect neutrality is desirable. That is for the economists and the idealists to debate. From the more practical perspective of the Canadian government seeking to achieve specific economic policy objectives—in this context, to encourage the development of Canadian-based multinational enterprises—there are also arguments to the contrary. From that perspective, non-neutrality is not necessarily desirable or undesirable in and of itself; it is simply an instrument. It is a *means*, not an *end*. Moreover, one thing seems clear: Canada is not going to subject indirect foreign active business income to current imputation, because the Canadian government believes that would compromise the international competitiveness of our multinational enterprises. Therefore, here is the question: Is there an alternative that would achieve neutrality without compromising competitiveness? Arnold's proposal, if I understand it correctly, is not such an alternative, because it does not achieve neutrality. Indeed, Arnold's proposal increases non-neutrality on both fronts. It does not achieve capital export neutrality, because of the deferral aspect of taxable surplus, and it diminishes capital import neutrality, in the sense that it creates a disincentive to repatriate capital associated with treaty jurisdictions that do not impose taxes at rates comparable to Canadian rates. Under the current exempt surplus rules, there is no capital import disincentive or non-neutrality with respect to the repatriation of capital associated with treaty jurisdictions.[33] In the end, then, Arnold's proposal seems to score lower on the neutrality scale than the current rules do.

As noted above, the exempt surplus rules promote capital import neutrality. Quite properly in my view, the Canadian government considers this objective to be very important and has designed the exemption system accordingly. Specifically, the exempt surplus rules encourage the repatriation of foreign active business profits, thereby facilitating the redeployment or reinvestment of those profits where the best opportunities lie, *including in Canada*. In contrast, the taxable surplus rules discourage the repatriation of foreign active business profits, thereby encouraging the redeployment or reinvestment of those profits *abroad*. In this context, what exactly is Arnold advocating? He is advocating a change that, among other adverse consequences, would have the effect of encouraging the *foreign* redeployment or reinvestment of active business profits.[34]

Moreover, whenever Canadian tax rates are higher than foreign tax rates, an element of non-neutrality will arise from an overall perspective. If Canadian rules seek to achieve neutrality from a Canadian perspective, Canadian-based multinationals will be placed in a circumstance of non-neutrality on the foreign playing field. Their costs, including tax costs, will be higher than those of their local competitors. Indeed, it seems that the effect of such Canadian rules would be equivalent to the

effect of having rules under the laws of the relevant foreign country that imposed tax on international corporations operating within their jurisdiction at rates exceeding those imposed on local corporations.[35] If a foreign country took such an approach, surely there would be cries of discrimination.[36] Thus, it is not at all clear that perfect overall neutrality can ever be achieved without perfect international harmonization of corporate income tax rates, which at this stage in our evolution as a species is a pipe dream.[37]

Should our government nevertheless try to achieve neutrality from a Canadian perspective? In other words, should Canada subject foreign active business income to current imputation? This question brings us back to the issue of international competitiveness and also raises the spectre of equity. Another subject for consideration that arises in this context is domestic investment incentives. The Act is, of course, riddled with examples of less than perfect horizontal equity and with domestic incentives, originating in attempts to achieve particular social or economic policy objectives. As noted by Justice Estey in *Stubart Investments Limited v. The Queen*,

> [i]ncome tax legislation, such as the federal Act in our country, is no longer a simple device to raise revenue to meet the cost of governing the community. Income taxation is also employed by government to attain selected economic policy objectives. Thus, the statute is a mix of fiscal and economic policy. The economic policy element of the Act sometimes takes the form of an inducement to the taxpayer to undertake or redirect a specific activity. Without the inducement offered by the statute, the activity may not be undertaken by the taxpayer for whom the induced action would otherwise have no *bona fide* business purpose.[38]

Again, in theory, and in a vacuum, equity in tax matters may be desirable. However, the question that often arises in this connection is, "At what cost?" Like neutrality, equity in tax matters is often compromised when it conflicts with specific social or economic policy objectives. In the context in which the foreign affiliate rules are applicable, there is an obvious conflicting economic policy objective—namely, not to compromise in any way the international competitiveness of Canadian-based multinational enterprises.

I am not aware of any country with a mature economy that taxes indirect foreign active business income on an imputation basis.[39] Interestingly, also, I am not aware of any bilateral income tax convention that purports to require its parties to harmonize their corporate income tax rates. Yet, many countries have an exemption system for dividends paid out of foreign active business income. Indeed, the European Community stands as an interesting example of a group of countries that specifically requires members to provide an exemption for dividends from companies in other member countries but does not require members to harmonize their corporate income tax rates. This phenomenon confirms that the exemption system is not simply some sort of proxy for a foreign tax credit system, and that perfect capital export neutrality and equity are not widely regarded by governments as fiscal values that are as important as international competitiveness and capital import neutrality.

Another aspect of this phenomenon is what I refer to as "the jurisdictional issue." The principal mechanism employed under bilateral income tax conventions as a means of eliminating double taxation is the allocation between the parties of primary or absolute fiscal jurisdiction in respect of various items of income. Thus, for example, under the Canada-US income tax convention, 1980, income of a resident of the United States from carrying on a business in Canada is exempt from tax under the Act, except to the extent that the income is attributable to a Canadian permanent establishment.[40] This exemption is not conditional on any requirement that the income be subjected to tax under the laws of the United States at rates comparable to Canadian rates. Thus, this exemption contemplates the possibility of non-neutrality and even what has come to be referred to as "double non-taxation."[41] Similarly, before 1972, the United States imposed capital gains taxes but Canada did not. Yet, article VIII of the Canada-US income tax convention, 1942 provided for a deliberate exemption for capital gains derived by a resident of a contracting state from the disposition of property situated in the other state, unless the taxpayer had a permanent establishment in the other state. Accordingly, a capital gain realized by a Canadian resident from the disposition of, for example, US securities was exempt from tax in *both* countries. Obviously, this exemption was not premised on the proposition that it operated as a proxy for a foreign tax credit.[42] On the contrary, this is an even better example of a provision that must be understood as contemplating the possibility of double non-taxation.[43] Fundamentally, the premise of this type of exemption, I submit, is that the taxing jurisdiction in respect of this particular item of income has been unconditionally allocated, by international convention, to one of the countries. The other country has unconditionally ceded the taxing jurisdiction.

Sometimes Canada is the "other country," and sometimes it is not. In the context of indirect foreign active business income associated with a treaty jurisdiction, Canada is the other country and has deliberately ceded the exclusive taxing jurisdiction to the source country, as we have seen, in significant part for reasons involving the international competitiveness of Canadian-based multinational enterprises, and in a manner that is not fundamentally inconsistent with prevailing international norms.[44] And this is nothing new, nor was it new in 1972. Indeed, there are elements of this type of exemption in the Act that can be traced back to 1918,[45] although the more significant expansion was introduced in 1938, then expanded again in 1948.[46] In 1949, the Act was amended to specifically eliminate the requirement that the income of a foreign subsidiary actually be "subject to foreign tax" as a condition of the exemption from Canadian tax for dividends paid out of such income to substantial corporate shareholders.[47] Also eliminated at the same time was the requirement that the country where the foreign subsidiary resided grant "similar relief"; thus, the exemption was made to operate on a truly unilateral basis. Despite major reconsideration of the rules in 1972 and in 1994, a general "subject-to-foreign tax" requirement has not been reintroduced as a condition of exempt surplus treatment.[48]

Although an amendment was enacted in 1994 requiring a foreign affiliate to be resident in a treaty jurisdiction *for treaty purposes*,[49] Arnold recognizes[50] that this change did not reintroduce the subject-to-foreign-tax requirement—notwithstanding his fairly broad reading of the *Crown Forest* decision.[51] Nevertheless, he asserts that "regulation 5907(11.2)(c) provides convincing evidence of the complete lack of integrity in the Canadian foreign affiliate rules."[52] This statement, in my view, has absolutely no foundation. It is obvious that regulation 5907(11.2)(c) was introduced with the express intention of accommodating certain intragroup financing arrangements, using Barbados international business corporations and similar entities, which Canadian-based multinational enterprises sometimes implement in order to reduce foreign tax burdens within parameters that are acceptable under foreign tax rules.[53] Similarly, regulation 5907(11.2)(b) contemplates the use of hybrid entities such as US limited liability companies. These provisions do not, as Arnold states, reflect any lack of integrity. They reflect the realpolitik of international tax policy. In matters of diplomacy and international relations generally—and international taxation is no different in this respect—countries do not always do exactly what they say they do. The international community is far from being one big happy family when it comes to income taxes.[54] As a result, and for a variety of additional reasons, often it is necessary to read between the lines, and to pay close attention to the history and policy considerations underlying specific rules, in order to fully grasp the scheme of the Act. There is no question in my mind that these foreign tax-planning arrangements are "legitimate" from a Canadian perspective. The extracts that appear below from the 1992 proceedings of the Public Accounts Committee,[55] following up on the 1992 auditor general's report, make the point quite eloquently.

First, from testimony by David A. Dodge, then deputy minister of finance, now governor of the Bank of Canada, we understand that

> it is *absolutely critical in this modern world*, and it becomes more and more critical every day, that Canadian-based companies, companies with their headquarters in Canada, companies with their R and D operations in Canada, companies with their high-value operations here, indeed, *stay here* and are *allowed to compete around the world on an equal footing* with companies with headquarters elsewhere in the world. That's the fundamental proposition. . . .
>
> So critical in this government's view and, indeed, critical in the view of governments—increasingly since World War II—is to have a tax regime that doesn't discourage those Canadian firms from going abroad, *and does not discourage the Canadians that go abroad from repatriating their incomes so that they can provide jobs here in Canada. The fundamental thing is that we want Canadian firms not to be put on an unlevel playing field, if you will, by our own tax law* [emphasis added].[56]

Next, there is this statement by R. Alan Short, then general director, Tax Policy Branch, Department of Finance:

> Mr. Chairman, I think the competitive position can be looked at internationally. The rules relating to foreign affiliates are *designed to ensure that Canadian-based multinationals*

> *are treated in the same way and are not put at a competitive disadvantage in their bona fide business activities*—if I can put it in those terms—that they carry on in other countries [emphasis added].[57]

Then, with specific reference to the type of foreign tax-planning arrangements contemplated by regulations 5907(11.2)(b) and (c), there is this clarification from Bob Beith, then senior advisor, Fiscal Policy and Technical Interpretations, CCRA:

> We've drawn to the attention of Finance information we have as to what's going on in the private sector. That would include this example, which I believe is the second example cited by the Auditor General. As far as I'm concerned, it meets the framework of the law and the tax policy. Barbados is a listed country. The interest coming back to Barbados from Europe is active business income, and the dividends flow into Canada tax free. That's the law *and the policy* as I understand it [emphasis added].[58]

Finally, on the same subject, David Dodge observed:

> Mr. Chairman, . . . there is a very important general international issue here. Because we all have *different tax systems* and different tax laws around the world, there is an opportunity for the taxpayer sometimes to structure his activities in such a way that *no tax is paid on income arising from activity in the country abroad where the activity occurs.*
>
> *That is a problem with the tax laws of the country abroad.* We have similar problems that we try to deal with here to ensure that the appropriate tax is paid to Canada by affiliates of foreign companies operating in Canada, and that's our problem. But if there were no mechanisms whatsoever to flow this [income] around, then every foreign company that wanted to operate in France, for example, would be subject to exactly the same regime. They'd pay some French taxes and they would not pay the tax when it comes home.
>
> But there are opportunities to flow income differently, *which in fact means that the French government gets less tax revenue on the activity in France, but it does not mean that the Canadian government is in fact losing revenue on that activity.* Because [if we were] structured differently, we would not get any revenue anyway.
>
> So the real question comes down to this issue. Do we want, let's say, Bombardier to be in a position where it cannot avail itself of tax planning opportunities that are available to every other foreign company when operating abroad? Do we want them to be in that position? For many years, the answer to that has indeed been no. The policy of *successive governments* in Canada has not been to put them in that position. Our policy has been to work through the OECD, and through other ways, to try to get some better *coordination of countries in setting corporate income taxes. But that is a very difficult and not very productive exercise* [emphasis added].[59]

It is clear from these statements by senior government officials that the exempt surplus rules contemplate not only the possibility that foreign tax rates may be lower than Canadian rates, but also arrangements implemented by Canadian-based multinationals in order to legally reduce foreign taxes. Moreover, the rules are so designed for reasons of international competitiveness and on the basis that Canada has nothing to lose by these arrangements—rather, it can only gain in retaining

capital that would otherwise be paid into foreign coffers. In contrast to Arnold's finding of a "complete lack of integrity in the Canadian foreign affiliate rules," I submit that the rules reflect a coherent scheme for the taxation of indirect foreign active business income.[60] As noted above, Canada has deliberately ceded the exclusive taxing jurisdiction over foreign active business income to the source country,[61] and it is up to the source country to define and defend that tax base. If the source country deliberately elects to impose taxes at rates lower than Canadian rates, or if it is incapable of defending the integrity of its own tax base, or if for policy reasons it simply chooses not to defend its own tax base, it is not for Canada to step into the field and eliminate the savings, thereby compromising the international competitiveness of Canadian-based multinational enterprises.

Moreover, Canadians are not in a position to dictate foreign corporate income tax rates, nor in my view should we be making value judgments as to whether the rates of corporate income taxes in particular foreign countries are "legitimate."[62] Foreign governments are entitled to determine for themselves what corporate tax rates they think they can get away with, based on their needs and their ideological perspectives, and whatever other factors they may think are relevant.[63] They, like Canada, are also entitled to introduce local incentives, in order to stimulate investment and economic activities in a variety of sectors, and Canadian rules should not necessarily be structured so as to defeat these initiatives with respect to investments by Canadian-based multinationals.[64] As a day in Dublin will make evident to anyone who takes the time to look,[65] such incentives may have a material effect on revitalizing and rejuvenating a local economy—and, with it, a local community.

THE MINTZ COMMITTEE REPORT

Many of the considerations discussed above were reviewed by the Mintz committee. In assessing the current foreign affiliate rules, the committee concluded:

> On balance, it is the Committee's view that the existing regime–providing exemption in the case of active business income earned by foreign affiliates in treaty countries, deferral with credit in the case of such income earned in non-treaty countries, and accrual with credit or current taxation with respect to income earned by foreign branches and FAPI—is fundamentally sound and should be maintained.[66]

More specifically, the committee concluded that taxing indirect foreign active business income on an imputation basis "is not a viable option."[67] With respect to the question of eliminating exempt surplus and moving to a credit-based system, the committee stated:

> It is unlikely that the implementation of a deferral with credit method would, by itself, result in any significant revenue gain to the Canadian treasury. Experience under the tax systems of other countries, notably the United States, indicates that relatively little domestic tax is raised with respect to active business income from

> foreign direct investment under the deferral systems. Corporations simply tend not to repatriate foreign earnings if the action involves significant domestic tax, or implement planning measures to maximize the availability of foreign tax credits.[68]

Accordingly, the committee recommended that the current system "is fundamentally sound and should be maintained," subject to some fairly specific modifications and certain more substantive proposals.

Among these,[69] the committee recommended[70] that income from payments arising in connection with interaffiliate financing arrangements should be treated as taxable surplus, even if the payments reduce the exempt surplus of the payer affiliate, but only if such income is earned by an affiliate that is expressly denied the benefits of the treaty between Canada and the affiliate's country of residence.[71] However, given the committee's conclusion that taxable surplus is generally not repatriated, it seems difficult to understand the point of this recommendation. This recommendation is stated to be premised, in part, on the proposition that "income from interaffiliate transactions often involves minimal, if any, direct job creation in the foreign country."[72] Without commenting on the substantive validity or invalidity of this proposition, I submit that this is simply not a relevant consideration from a Canadian perspective. From a Canadian perspective, what is relevant is wealth and job creation *in Canada*. I also submit that the reduction of *foreign taxes* can only help in that regard, assuming that there is no disincentive to the repatriation of the foreign tax savings—that is, assuming exempt surplus treatment.

This recommendation may also reflect the committee's view that interest expense incurred in Canada should not be deductible where the borrowed funds in question are invested in a foreign affiliate that earns exempt surplus. The deductibility of interest is beyond the scope of this paper. However, I will make the following observation. Whether or not interest should be deductible where the borrowed funds are used to earn exempt surplus dividends is a separate question from whether or not exempt surplus should be preserved rather than eroded as it passes through different affiliates. First of all, many of the interaffiliate financing arrangements implemented by Canadian-based multinational enterprises are funded using equity capital of the parent company, rather than borrowed money. Thus, in many cases, these arrangements have absolutely no relationship with interest deductibility in Canada. Second, exempt surplus does not lose its character as it passes from one affiliate to another in the form of a dividend. Indeed, in the context of an interaffiliate dividend payment, the residence of the recipient affiliate is not even relevant. Why should the result be any different in the context of other interaffiliate payments, such as interest, rent, royalties, and similar amounts? The only difference between an interaffiliate dividend payment and an interaffiliate interest payment is that the former is normally made *after foreign tax*, whereas the latter preferably is made *before foreign tax*. Essentially, what we have here is a variety of interaffiliate foreign earnings planning arrangements which, in order to be effective, must comply with thin capitalization rules and other anti-avoidance rules and principles that may be applicable under the relevant foreign laws. Where these arrangements do so comply,

such that they are effective in reducing foreign tax burdens within parameters that are acceptable under the relevant foreign laws, Canada gains an economic benefit that is permitted by the relevant foreign laws. Therefore, quite apart from its policy with respect to interest deductibility, Canada should not be erecting barriers to the implementation of such arrangements or to the repatriation of the resulting foreign tax savings.[73]

THE US EXPERIENCE

An interesting example of realpolitik in matters of international trade and income taxation can be found in the proceedings of the general agreement on tariffs and trade and the World Trade Organization (WTO) between the European Community and the United States, involving assertions that the US "domestic international sales corporation" rules, the "foreign sales corporation" rules, and the "extraterritorial income" rules have conferred prohibited export subsidies on US producers.[74] After repeated, unsuccessful attempts to rescue these rules from WTO prohibition, it seems that US tax policy makers are beginning to consider their options with a more open mind.

Another major concern currently occupying US tax policy makers is the increasing prevalence of so-called inversion transactions being carried out by US multinationals. Essentially, these transactions seek to reorganize the corporate structure in such a way as to ensure that only US-source operating income is exposed to US taxes.[75] The reorganized structure would have a non-US parent company holding US companies on the one hand and non-US companies on the other, so that non-US companies would no longer be subsidiaries of a US company. With its non-US operations outside the US tax net, the multinational could then implement competitive international tax-planning arrangements in order to minimize its worldwide income tax burdens.

What seems to be driving these developments in significant part is the perception that the US tax system (which Arnold would have Canada adopt) is uncompetitive with respect to the treatment of indirect foreign active business income, particularly as it applies to profits on the sale of US-manufactured goods and US-produced services, the treatment of cross-border interaffiliate payments, and the treatment of parent-company interest expense. The current state of US international tax policy was recently described as follows by Congressman Amo Houghton (Rep. NY):

> What has this tax system produced? Some would say that the result is a whole litany of maneuvers—corporate inversions, foreign acquisitions of U.S. multinational corporations, special export regimes (for example, for domestic international sales corporations, foreign sales corporations, exclusions for extraterritorial income), etc., and I could go on. It's no stretch to say that this demands the attention of Congress. *The U.S. tax system is a mess* [emphasis added].[76]

Houghton went on to set out a list of "the top 10 issues that US multinationals care about" and proposed immediate action by way of changes to the Internal Revenue Code of 1986 to address these concerns. Among these changes are the following:

1. *Reform the interest expense allocation rules.* The current rules unfairly can result in the overallocation of interest expense against foreign income and, thus, improperly reduce the amount of foreign tax credits. . . .

5. *Repeal the subpart F foreign base company sales and services income rules.* The repeal of these rules will better enable U.S. multinationals to compete with other multinational companies that are not subject to similar stringent rules on overseas active income.

6. *Provide a permanent exemption for active financing income.* A permanent exemption from the controlled foreign corporation rules of subpart F will provide certainty for financial services entities competing in the global marketplace.

7. *Exempt active rents and royalties generated by the software industry from the controlled foreign corporation rules of subpart F.* The expanded exemptions would recognize the ever-growing importance of the information technology sector in the global marketplace.

8. *Provide exceptions from subpart F for dividends, interest, rents, and royalties paid by a controlled foreign corporation from its active overseas earnings to a related controlled foreign corporation.* These exceptions from the controlled foreign corporation rules would recognize the need for U.S. multinationals to competitively reinvest active overseas earnings for their best business uses.[77] . . .

10. *Provide an exemption or partial exemption for dividends repatriated back to the United States from foreign earnings.* Such an exemption would remove the tax disincentives for companies to reinvest funds back into the United States [emphasis added].[78]

Thus, while US tax policy makers are currently considering the adoption of a complete or partial exemption system for indirect foreign active business income, together with rules that facilitate interaffiliate financing arrangements, as well as more favourable rules concerning the treatment of parent-company interest expense, Arnold is advocating that we in Canada move to a system that is more like the current US system. Wouldn't it be ironic if the United States adopted a system like ours, and we adopted their system? I think that could be a fiscal disaster.

CONCLUSIONS

In light of the above considerations, I do not at all agree with Arnold that the exempt surplus rules can be justified *only* as a proxy for a foreign tax credit system. I believe that this simplistic proposition is unfounded. I also do not at all agree with Arnold's proposal to effectively eliminate or compromise the exempt surplus rules. As successive Canadian governments have, I believe, quite correctly recognized, this would undermine the international competitiveness of Canadian-based multinational enterprises. The exempt surplus rules, in my view, and in the view of successive Canadian governments, reflect a delicate, deliberate, coherent, and intelligent balancing of competing tax policy objectives and constraints, which should not be fundamentally realigned as Arnold proposes in the current national and international economic contexts.

This debate is both very complex and very simple. For reasons of international competitiveness, Canada has decided not to subject indirect foreign active business income to current imputation. This is deliberate non-neutrality, of a kind that, it appears, is universally found in mature tax systems. This decision then gives rise to two choices with respect to the taxation of substantial corporate shareholders.

Either Canada imposes a "top-up" tax once the income is repatriated (that is, tax with credit-based relief for underlying taxes), or not. In deliberately opting as a matter of tax policy for the latter, successive Canadian governments have recognized that if a "top-up" tax is imposed, it is less likely that the income will be repatriated, resulting in pressure to redeploy or reinvest it abroad. After all, as long as the income remains in corporate solution (that is, as long as it is not distributed to ultimate shareholders), it makes little difference, if any, from an ultimate shareholder's perspective whether the income remains in a foreign holding company rather than a Canadian one. In either case, the income is not in the ultimate shareholder's hands. Thus, all other things being equal, there is no reason why the shareholder would prefer to repatriate the income to a Canadian holding company.[79] In contrast, by not imposing a "top-up" tax as long as the income remains in corporate solution, successive Canadian governments have recognized that it is more likely that the income will be repatriated and then redeployed or reinvested in Canada. This is the element of neutrality—capital import neutrality—reflected in the exempt surplus rules.

With respect to rules like paragraph 95(2)(a) of the Act and regulation 5907(11.2)(c), which facilitate interaffiliate planning arrangements that are implemented in order to quite properly minimize foreign taxes, the simple question is this: How can Canada ever be better off if Canadian-based multinational enterprises are forced to pay more foreign taxes? The answer is that foreign taxes are good for foreign countries; they are not good for Canada. Canadian rules should be designed to maximize Canadian wealth and well-being[80]—and not, as some observers would dogmatically have it, to maximize Canadian corporate-level taxes.[81] Thus, Canadian rules should not prevent Canadian-based multinational enterprises from legally reducing foreign taxes or from repatriating the foreign income, including the resulting foreign tax savings.

Canadian-based multinational enterprises are becoming increasingly important players on the international scene. The *Globe and Mail* reported on July 7, 1998 that, during the first six months of that year, Canadians acquired 165 foreign companies in deals valued at $45.8 billion, which represents a significant increase over the same period in 1997, during which Canadians reportedly acquired 142 foreign targets valued at $8 billion. Over half of these transactions reportedly involved US targets, accounting for 110 deals valued at $27.1 billion. In contrast, during the same period, US companies reportedly acquired only 69 Canadian targets valued at $13.3 billion. These reports are consistent with data published in the Mintz committee report, which indicate that direct investment abroad, measured by foreign corporate stock held by Canadian businesses relative to gross domestic product, has doubled since 1980 from 9 percent to 18 percent.[82] Moreover, the Mintz committee reported that the ratio of corporate stock representing Canadian direct investment abroad to corporate stock representing foreign direct investment in Canada has more than doubled from 42 percent to 85 percent.[83] Although the extent to which the exempt surplus rules have contributed to these developments is not entirely clear to me, given that I am not an economist, I would not be prepared to advocate a fundamental realignment at this point.

Nevertheless, and for obviously different reasons, I think I might agree with Arnold's stated thesis—that "the current links between the foreign affiliate rules and Canada's tax treaties should be eliminated."[84] In my opinion, there is a reasonably strong tax policy argument that the only distinction that should be made under the foreign affiliate rules is that between active and passive income, and that all active business income should be included in computing exempt surplus, regardless of the country in which the affiliate resides or in which the active business operations are conducted.[85] This, however, is a subject to be carried over for another time. Moreover, there is not much difference between having no treaty-country requirement and having a treaty with virtually every relevant foreign jurisdiction. While we are not quite there yet, we are getting very close.

NOTES

1 Brian J. Arnold, "Unlinking Tax Treaties and the Foreign Affiliate Rules: A Modest Proposal," Policy Forum (2002) vol. 50, no. 1 *Canadian Tax Journal* 607-29.

2 See, for example, Brian J. Arnold, "The Canadian International Tax System: Review and Reform" (1995) vol. 43, no. 5 *Canadian Tax Journal* 1792-1818; Brian J. Arnold, "Controlled Foreign Corporation Rules, Harmful Tax Competition, and International Taxation," in *Report of Proceedings of the First World Tax Conference: Taxes Without Borders*, 2000 World Tax Conference Report (Toronto: Canadian Tax Foundation, 2000), 17:1-26; Brian J. Arnold, "An Analysis of the 1994 Amendments to the FAPI and Foreign Affiliate Rules" (1994) vol. 42, no. 4 *Canadian Tax Journal* 993-1036; Brian J. Arnold, "The Deductibility of Interest To Earn Foreign Source Income," in *Report of the Proceedings of the Forty-Eighth Tax Conference*, 1996 Conference Report, vol. 2 (Toronto: Canadian Tax Foundation, 1997), 45:1-23; and Brian J. Arnold, "The Taxation of Controlled Foreign Corporations: Defining and Designating Tax Havens" (1985) vol. 33, no. 3 *Canadian Tax Journal* 445-89. I understand also that Arnold was one of the consultants involved in the preparation of the 1992 auditor general's report. See Canada, *Report of the Auditor General of Canada to the House of Commons 1992* (Ottawa: Supply and Services, 1992) (herein referred to as "the 1992 auditor general's report"). For a critical review of the 1992 auditor general's report, see Allan R. Lanthier, "Policy or Abuse? The Auditor General's Report" (1993) vol. 41, no. 4 *Canadian Tax Journal* 613-38, and J. Scott Wilkie, Robert Raizenne, Heather I. Kerr, and Angelo Nikolakakis, "The Foreign Affiliate System in View and Review," in *Tax Planning for Canada-US and International Transactions*, 1993 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1994), 2:1-72.

3 Arnold, supra note 1, at 607.

4 The foreign affiliate rules are contained in the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act") and the Income Tax Regulations, CRC 1977, c. 945, as amended (herein referred to as "the Regulations"). It is beyond the scope of this paper to provide a detailed review of these rules. Instead, see, inter alia, Angelo Nikolakakis, *Taxation of Foreign Affiliates* (Toronto: Carswell) (looseleaf).

5 Arnold, supra note 1, at 616. In other parts of his paper, Arnold takes a more moderate position; for example, ibid., at 618, he asserts that exempt surplus treatment should be available only if foreign underlying and withholding taxes are imposed at an aggregate rate that is "roughly comparable" to the Canadian corporate tax rate.

6 Arnold appears to recognize this equivalence, noting, ibid., at 612, that his proposed, emasculated exempt surplus regime would give rise to the "same result" as that which would arise under a foreign tax credit system.

7 Arnold, supra note 1, at 627, note 37.

8 Ibid., at 618.

9 Ibid.

10 Arguably, the paid-up capital rules applicable in the domestic context (such as those in subsection 84(3)) are an instance where simplicity compromises substantive fiscal interests. These rules are a proxy for a measurement of undistributed corporate earnings, but they approach the matter backward, instead of requiring the much more complicated computations seen in the context of determining "safe income" for the purposes of section 55 or determining "surplus" in accordance with the foreign affiliate rules. This lack of precision may be explained by the fact that these rules were introduced at a time when the overall income tax system in Canada was relatively simple.

11 See Arnold, supra note 1, at 612.

12 See Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998) (herein referred to as "the Mintz committee report"), 3.29, at table 3.10.

13 For example, life insurers are exempt from tax in Canada on their profits from foreign life insurance operations: subsection 138(2). Similarly, certain financial institutions are exempt from tax in Canada on income from their "international banking centres" situated in Montreal or Vancouver: section 33.1. See also the special regime for international shipping companies in subsection 250(6).

14 I will return below to this notion of a "legitimate" or "reasonable" foreign tax system.

15 My understanding is that there are many reasons why tax treaties with certain foreign countries are concluded, and that not all of these are purely fiscal.

16 Canada currently has numerous treaties that contain an exempt surplus provision.

17 See the definition of "foreign accrual property income" in subsection 95(1)—essentially, passive income.

18 The dividend tax credit for individuals detracts from capital export neutrality by creating an incentive to prefer domestic investment. The effective tax rate for foreign interest income is the same as that for domestic interest income.

19 Subsection 91(5).

20 Paragraph 113(1)(a). This treatment is, however, consistent with capital import neutrality.

21 Paragraphs 113(1)(b) and (c). This treatment is not consistent with capital import neutrality. It should be noted that the "relevant tax factor" for corporations drives off a 38 percent rate (which I understand will be reduced in accordance with the ongoing corporate tax rate reductions), so that foreign active business income may still be preferred in certain cases over domestic active business income. That is, the taxable surplus rules provide for a complete deduction if the aggregate underlying foreign tax and foreign withholding tax amount to 38 percent. To the extent that combined federal and provincial rates on active business income exceed 38 percent, there is an advantage to earning foreign active business income that is subject to foreign taxes, even if current repatriation is contemplated.

22 See, for example, CCRA document no. 9826443, September 1, 1999.

23 The history of the foreign affiliate rules has been traced in detail on numerous occasions, and such a review is beyond the scope of this paper. See Wilkie et al., supra note 2.

24 See Arnold, supra note 1, at 609.

25 E.J. Benson, *Proposals for Tax Reform* (Ottawa: Queen's Printer, 1969) (herein referred to as "the white paper"), 72.

26 Arnold, supra note 1, at 609. This statement comes at the end of a paragraph that begins, "The legislative history of the foreign affiliate rules is not explicit about the policy underlying the exemption for dividends out of exempt surplus." Arnold then goes on to cite the Mintz

committee report, supra note 12, and certain published articles that have subsequently "suggested" a number of justifications for the exemption system.

27 White paper, supra note 25, at 72.

28 Ibid., at 73.

29 Ibid.

30 Ibid.

31 The rules that were ultimately adopted in 1972 and 1976 plainly attempted to achieve neutrality only in respect of passive income. Moreover, this attempt was restricted to passive income of *controlled* foreign affiliates. Broader rules, applicable more generally to interests in offshore investment funds, were introduced only in 1984 and are currently being reconsidered. It is significant to note that, even in that context, indirect foreign active business income continues quite properly to be regarded as being beyond the scope of such anti-avoidance rules. This position is also consistent with the treatment of domestic indirect investment income, which achieves a greater degree of integration than is the case for domestic indirect active business income.

32 The taxation of holding companies gives rise to special double taxation considerations in the context of both international and purely domestic situations. The domestic general rule, in subsection 112(1), is that dividends flow free of part I tax between corporations. Even corporate-level capital gains from the disposition of substantial interests in a subsidiary corporation are free of part I tax, except to the extent of any underlying unrealized gains on the assets of the subsidiary corporation. In the domestic context, this result is achieved using a "safe-income strip." In the international context, achievement of this result is facilitated by the deemed dividend election in subsection 93(1). Tying these two systems together is paragraph 55(5)(d), which in part determines safe income by reference to the amount of deductions that would be available on subsection 93(1) deemed dividends. In addition, the "bump-up" rules in paragraphs 88(1)(c) and (d) are intended to eliminate corporate-level capital gains tax where the gain has effectively been realized at the shareholder level in the context of an acquisition of control. This, too, is a rule that reflects the principle that corporate-level tax is only an advance tax and is therefore appropriate only at the bottom of the chain. Interestingly, it has recently been announced that the United Kingdom, currently governed by a left-wing political party, has adopted a broad exemption for corporate-level capital gains from the disposition of substantial interests in a subsidiary corporation. See the materials released with the 2002 UK Budget on April 17, 2002, entitled "A Modern and Competitive Business Tax System" (REV/COE1). This exemption makes sense, on the basis that such gains do not arise at the bottom of the chain, and the assets have not been extracted from corporate solution. The principle that tax should be levied at the operating company level and/or at the non-corporate shareholder level, but not at the intermediary holding company level, is reflected also by the fact that exempt surplus treatment is not available to individuals.

33 There are many aspects of the foreign affiliate rules that reflect a deliberate decision not to compromise capital import neutrality. In addition to the general fact that exempt surplus treatment exists, there is a rule in regulation 5901 that deems dividends to be paid by a foreign affiliate first out of exempt surplus, and then out of taxable surplus only when exempt surplus is depleted. There is also a rule in paragraph (b) of the definition of "underlying foreign tax applicable" in regulation 5907(1) that permits the taxpayer to elect to allocate to a taxable surplus dividend a disproportionately high amount of the underlying foreign taxes paid by the affiliate. This rule permits at least some taxable surplus to be repatriated without the imposition of immediate Canadian taxes.

34 Since income from assets that are held offshore rather than being repatriated would be FAPI if the assets were kept idle, affiliates with taxable surplus must redeploy or reinvest those assets in

foreign active business operations (or lend them into Canada on an interest-free basis) if FAPI is to be avoided.

35 With respect to the issue of international competitiveness (as in the context of customs duties, where we have both import duties and export duties), it does not really matter which country (that is, the home country or the source country) imposes the extra tax. In the latter case, however, the extra tax would be collected by the foreign country rather than by Canada.

36 Of course, Canada might be badly placed to raise such cries, given the small business deduction and other incentives applicable only to Canadian-controlled corporations.

37 This point was acknowledged by David A. Dodge in his testimony before the Public Accounts Committee in 1992. See the extracts reproduced in the text below. See also the Mintz committee report, supra note 12, at 6.5, which makes the following observation: "National governments have varying revenue requirements and different views on what constitutes an appropriate sharing of business taxes. Every government chooses its own tax levels and tax mix, as well as the rules for defining what income is subject to tax. In the absence of worldwide uniform corporate taxation, full neutrality for all businesses operating in all countries is impossible to achieve."

38 84 DTC 6305, at 6322 (SCC).

39 It should be noted that, when the US subpart F rules were first proposed by the US Treasury department, they did impute all foreign income. However, in enacting the subpart F rules, and restricting their scope to passive income, Congress obviously disagreed with adopting such a sweeping approach. See Stanford G. Ross, "A Perspective on International Tax Policy" (1985) vol. 26, no. 7 *Tax Notes* 701-13, at 703-5.

40 See article VII of the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997 (herein referred to as "the Canada-US treaty").

41 I understand that the issue of "double non-taxation" will be the subject of the annual conference of the International Fiscal Association in 2004.

42 Indeed, as Robert Raizenne once pointed out to me, if it had operated on that premise, it would have operated backward, since the gain would have arisen on US property; thus, the United States would not normally be expected to provide a foreign tax credit for Canadian taxes. There is one such somewhat backward foreign tax credit mechanism that is not uncommon under Canada's various tax treaties. Under the "clawback" rule (for example) in article XIII(5) of the Canada-US treaty, Canada retains the right to tax gains from the disposition of property of a US resident who is a former Canadian resident and owned the property (or substituted property) when he or she left Canada. Thus, Canada purports to assert primary taxing jurisdiction over such gains. However, under article XXIV(2)(c), Canada relinquishes any pretence to such primary jurisdiction by agreeing to provide a credit for any applicable US tax.

43 Also see, for example, Canada's income tax conventions with Germany, Belgium, and Barbados, which contain the usual type of capital gains exemption articles. As I understand it, none of these countries taxes capital gains.

44 It should be emphasized that what I am talking about here is tax at the Canadian holding company level. Foreign active business income *is taxed in Canada* when the Canadian holding company pays dividends or when a Canadian resident (or, in some cases, a non-resident) disposes of the shares of the Canadian holding company.

45 With the so-called 4(k) corporations.

46 See Wilkie et al., supra note 2.

47 Former paragraph 27(1)(d), as enacted by SC 1949, c. 25, section 12, subsequently (until 1972) paragraph 28(1)(d).

48 A narrow exception may be the rule in clause 95(2)(a)(ii)(D) of the Act, which requires that the relevant corporate group be "subject to income taxation" in a particular country. It should be noted, however, that this requirement is imposed in respect of the borrower affiliate group, not in respect of the lender affiliate; thus, the rule contemplates that income of an affiliate group that is subject to foreign tax may be paid to an affiliate that is not necessarily subject to foreign tax. If this really is an exception, it is a very narrow one indeed.

49 See regulation 5907(11.2).

50 See Arnold, supra note 1, at 612-16.

51 See *The Queen v. Crown Forest Industries Ltd.*, [1995] 2 CTC 64 (SCC). For a discussion of the application of the reasoning in this decision in the foreign affiliate context, see Nikolakakis, supra note 4, at chapter 2.

52 See Arnold, supra note 1, at 616.

53 Such arrangements generally rely on the rules in paragraph 95(2)(a) of the Act, and corresponding regulations.

54 See the discussion below under the heading "The US Experience."

55 See Canada, *Minutes of Proceedings and Evidence of the Standing Committee on Public Accounts*, 34th Parl., 3d sess., 1991-92-93, nos. 37, December 8, 1992; 38, December 10, 1992; 40, February 10, 1993; 43, March 9, 1993; and 48, April 23, 1993 (the 12th Report to the House).

56 Ibid., issue no. 38, December 10, 1992, at 38:15. For an excellent discussion of the implications of mobility in the tax policy context, see Robert Couzin, "Tax Options for Competitiveness," in *Report of Proceedings of the Forty-Third Tax Conference*, 1991 Conference Report (Toronto: Canadian Tax Foundation, 1992), 7:1-21.

57 Supra note 55, issue no. 38, December 10, 1992, at 38:15.

58 Ibid., at 38:16.

59 Ibid., at 38:17.

60 I believe that Arnold's point (supra note 1, at 626, note 15) about the difference between the regime applicable to foreign affiliates and that applicable to foreign branches is immaterial. Although there may be a theoretical inconsistency here, as a practical matter the reality in this context is that the vast majority of foreign active business operations are carried on indirectly. In determining the "scheme" of the Act, I believe it is far more relevant to look to the rules applicable to the vast majority of foreign economic activity, not to the rules applicable at the margins. Moreover, under the current foreign tax credit rules in section 126 of the Act, Canada has already unilaterally ceded *primary* taxing jurisdiction over direct foreign business income to the source country. In principle at least, Canada will not impose any tax on the income if it is taxed abroad at Canadian rates, and thus is already operating a primarily territorial system in this context as well. In addition, the regime applicable to international shipping companies under subsection 250(6) is effectively equivalent to an exemption for foreign branch profits associated with treaty countries. Finally, I suspect that if, for some practical or legal reason, foreign branch operations became more prevalent, the government would be forced to extend the ambit of subsection 138(2) beyond the life insurance industry. An interesting parallel here can be found in the rules in subclauses 95(2)(a)(i)(A)(II) and (B)(II), and clause 95(2)(a)(ii)(E), which specifically permit the foreign business income of Canadian life insurers to be shifted to their foreign affiliates, and to be treated as active business income.

61 Subject to the proviso that the income is taxed in Canada when the relevant Canadian company pays dividends or when its shares are disposed of by Canadian residents (and, sometimes, by non-residents).

62 I was told that Al Short was once asked what he thought an "appropriate" foreign tax rate was, to which he reportedly replied, "Whatever the foreign tax rate is." Whether or not this quote is properly attributable to Al Short, the point remains—namely, that Canadians have no interest in either dictating or paying foreign taxes.

63 The same can be said for the various levels and other divisions of government within Canada. In a recently issued position piece ("The Fiscal Balance in Canada: The Facts," July 2002, available online at http://www.fin.gc.ca/toce/2002/fbcfacts3_e.html) on the question of "fiscal imbalance" within Canada (that is, an imbalance of tax jurisdiction/responsibility as between the provinces and the federal government), the Department of Finance made the following statements, among others:

> ▪ Provinces in Canada have the constitutional powers and independence to make their own choices about taxes, spending and debt, just like the federal government. Provincial governments have access to all the major tax bases and they are free to set their own priorities.
>
> ▪ The fact that virtually all provinces have chosen to reduce taxes in recent years implies that they believe that they have sufficient revenues to manage their spending pressures. Indeed, provincial tax cuts enacted since 1995 will reduce provincial revenues by about $19 billion this year.

The language of this message is very interesting, with its use of the words "powers," "independence," "choices," "chosen," and "free." But it is not surprising that the federal government would approach the issue on this basis. Its approach simply reflects reality. The federal government cannot dictate provincial tax policy, nor can it dictate foreign tax policy.

64 When the home country deliberately declines to tax foreign income to which a tax incentive applies under the laws of the source country, the home country is said to be engaged in "tax sparing." In certain circumstances, Canada engages in tax sparing even with respect to passive income. See, for example, Canada's income tax conventions with Argentina, Brazil, China, India, Indonesia, Ireland, Korea, Malaysia, the Philippines, Singapore, Spain, and Thailand. See also the decision in *Canada-Israel Development Ltd. v. MNR*, 85 DTC 718 (TCC).

65 I was fortunate enough to visit this increasingly vibrant community in 1999.

66 Mintz committee report, supra note 12, at 6.10.

67 Ibid., at 6.8.

68 Ibid., at 6.9. Interestingly, for financial accounting purposes, "top-up" taxes need not be booked if indefinite deferral is contemplated. See Canadian Institute of Chartered Accountants, *CICA Handbook* (Toronto: CICA) (looseleaf), section 3465, paragraph 40. I extend my appreciation to Albert Baker and Rob McCulloch of Deloitte & Touche LLP for their assistance on this point.

69 Other recommendations made by the Mintz committee will not be addressed herein.

70 Mintz committee report, supra note 12, at 6.21.

71 In this regard, the committee may have been influenced to some extent by the working paper on the tax treatment of foreign-source income, which was co-authored by Brian Arnold. See Brian J. Arnold, Jinyan Li, and Daniel Sandler, *Comparison and Assessment of the Tax Treatment of Foreign-Source Income in Canada, Australia, France, Germany and the United States*, Working Paper 96-1 (Ottawa: Department of Finance, Technical Committee on Business Taxation, December 1996).

72 Mintz committee report, supra note 12, at 6.21.

73 The Mintz committee also noted that Canadian-based multinational enterprises appear to have higher debt-to-asset ratios than purely domestic Canadian-based enterprises. The relationship between this phenomenon and the foreign affiliate rules is far from clear. I note, however, that

it is not surprising that Canadian-based multinational enterprises may borrow at the parent company level in order to expand abroad. Indeed, from a purely commercial perspective, it would be unusual for a lender to be satisfied with banking on the creditworthiness of a foreign affiliate rather than insisting on full recourse against the parent company. Therefore, it is "natural" for this parent company debt to be in Canada. How the use of the proceeds is then structured in order to achieve foreign tax savings is quite another matter. Interestingly, it has been reported recently that the advocate general of the European Court of Justice has decided that the Dutch rule prohibiting interest deductions on money used to earn exempt dividends and capital gains violates freedom of establishment and should be struck down. See the decision in the *Bosal Holding* case (*Bosal Holding BV v. Staatssecretaris van Financiën*, case no. C-168/01 (ECJ)).

74 For coverage of this dispute, see, for example, Chuck Gnaedinger, "WTO Appellate Body Hands U.S. Another Loss over ETI Act" (2002) vol. 25, no. 3 *Tax Notes International* 199; and William M. Funk, "The Thirty-Years Tax War" (2001) vol. 24, no. 1 *Tax Notes International* 65-76. Canada participated in these proceedings on the side of the European Community.

75 A related issue is the increasing tendency of US multinationals to use inversion transactions and transactions involving the acquisition of US companies by foreign concerns to set up earnings-stripping arrangements that are perceived by some to erode the US domestic income tax base.

76 See Amo Houghton, "Is There a Way Out of Our Int'l Tax Maze, Short of Total Overhaul?" (2002) vol. 27, no. 4 *Tax Notes International* 439-41, at 439. Houghton is a member of the House Ways and Means Committee, chairman of the Oversight Committee, member of the Trade Subcommittee, and member of the International Relations Committee; he was formerly the chief executive officer of Corning, Incorporated. See also the editorial entitled "Stanley Worked Over," *Wall Street Journal*, August 5, 2002, advocating reform of the US international tax rules.

77 Under current US rules, interaffiliate payments (including both interest and dividends) are treated as passive income unless, inter alia, made between affiliates established in the same country. Nevertheless, US multinationals often have been able to arrange their international structures, using hybrid entities and other common planning techniques, in such a way as to circumvent the "same country" requirement. In 1998, the US Internal Revenue Service issued Notice 98-11, 1998-6 IRB 18, stating that it would try to eliminate such planning arrangements. However, that notice has subsequently become a dead letter, because of the growing belief that interaffiliate foreign tax-planning arrangements are good for the United States, in that they reduce foreign taxes. See TD 8827, 1999-30 IRB 120.

78 Supra note 76, at 440-41. See also HR Bill 5095, the American Competitiveness and Corporate Accountability Act of 2002, 107th Cong., 2d sess., introduced by House Ways and Means Chairman William Thomas (Rep. Calif.) on July 11, 2002. This Bill contains many but not all of the specific changes listed by Houghton.

79 It is also interesting to note that Arnold, like certain other proponents of a "top-up" approach, does not advocate giving excess credit where foreign rates exceed Canadian rates. This is the "heads I win; tails you lose" approach to tax policy. If the foreign tax is lower, the Canadian tax authority keeps the savings; if the foreign tax is higher, the taxpayer pays the difference. The Mintz committee report, supra note 12, at 6.4, noted that giving such excess credit would be more consistent with capital export neutrality.

80 Who in Canada benefits from the prosperity of Canadian-based multinational enterprises? That is an empirical question—but I suspect that a significant part of this benefit is derived by Canadian pension funds and that, ultimately, it undergoes relatively broad distribution throughout the general population.

81 Again, it is likely that eliminating exempt surplus treatment would not give rise to a material increase in Canadian corporate-level taxes, in that the income will simply be reinvested abroad

rather than repatriated. Moreover, exempt surplus dividends cannot properly be described as income that is exempt from tax in Canada, since the income is ultimately taxed in Canada.

82 Mintz committee report, supra note 12, at 3.10.

83 Ibid.

84 Arnold states, supra note 1, at 624, that there has been no announcement by the Department of Finance regarding an apparent change in Canada's treaty policy reflecting a move away from making a treaty commitment to provide exempt surplus treatment under the provisions of certain newer treaties. Actually, the Department of Finance did make an announcement at the meeting of the Canadian Branch of the International Fiscal Association in Toronto on May 13, 2002, where officials confirmed that this change did not reflect any intention on the part of the department to modify the current exempt surplus rules. While there may be no intention at this time to modify the current exempt surplus rules, this change in Canada's treaty policy provides Canada with the flexibility to do so in the future without either violating or having to renegotiate these treaties. However, a move away from exempt surplus would require the renegotiation of a large number of other treaties.

85 Even if it were only as a temporary measure, it might make sense in the current international economic environment, viewed from a Canadian perspective, to permit all taxable surplus currently being held offshore to be repatriated. It would be interesting to see just how much would in fact be repatriated, and how it would be redeployed or reinvested in Canada. To some extent, the taxable surplus loan rulings (referred to above) are explained by such a desire to encourage repatriation. It should be noted, also, that adopting such a "full exemption system" as a permanent measure would promote simplicity, in that it would eliminate the need to maintain exempt and taxable surplus balances (other than with respect to FAPI). This was noted in the Mintz committee report, supra note 12, at 6.8.

I also note that the treaty-country requirement was somewhat controversial when it was first introduced. The House of Commons Committee on Finance, Trade and Economic Affairs was in favour of this requirement, and the Senate Committee on Banking, Trade and Commerce was against it. The "treaty development purpose of the proposals," which was welcomed by the House committee, was rejected by the Senate committee as a feature that would cause investment decisions to be affected improperly by the government's success or failure in negotiating tax treaties. See, respectively, Canada, House of Commons, *Eighteenth Report of the Standing Committee on Finance, Trade and Economic Affairs Respecting the White Paper on Tax Reform* (Ottawa: Queen's Printer, October 1970), and Canada, Standing Senate Committee on Banking, Trade and Commerce, *Report on the White Paper Proposals for Tax Reform* (Ottawa: Queen's Printer, September 1970).

Finally, in my view, there is at least an argument that Canada should move to a more explicit territorial system by expanding the scope of subsections 138(2) and 250(6) of the Act. Numerous countries have such a territorial system.

The Joint Committee on Taxation of
The Canadian Bar Association and
The Canadian Institute of Chartered Accountants

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October 8, 2004

Mr. Brian Ernewein
Director, Tax Legislation Division, Tax Policy Branch
Department of Finance Canada
17th Floor, East Tower,
140 O'Connor Street,
Ottawa, Ontario K1A 0G5

Dear Mr. Ernewein:

Re: February 27, 2004 Draft Legislation (the "Draft Legislation")-- Proposed Amendments to the Foreign Affiliate Rules

We would like to first of all thank you for taking the time to meet with us on September 27, 2004, on the occasion of the Annual Conference of the Canadian Tax Foundation in Toronto. We appreciate your receptiveness to the process of discussing outstanding legislative issues with us from time to time.

Among the various matters discussed at that meeting, we noted our continuing concerns with respect to certain aspects of the proposed amendments to the foreign affiliate rules. While many of the proposed amendments are technical and relieving in nature, others seem to introduce restrictive – and, in some cases, unduly burdensome – departures from current rules and underlying principles. Moreover, we noted during the meeting that, in our view, while many of the proposed amendments would seem to be refined enough at this point to merit proceeding forward to the Technical Bill stage, certain of the proposals, as currently structured or drafted, would in many cases appear to be ineffective, overly disruptive of the scheme of the Act and Regulations in this area, and/or fiscally punitive. In particular, we note the following principal areas of concern:

- The proposed amendments with respect to "internal dispositions" would operate on the basis of a "suspended income and gains" mechanism, the introduction of which would in our view result in numerous anomalies in the distribution of economic values and tax attributes within a chain of foreign affiliates. In addition, we are aware of examples where this approach could result in the punitive taxation as FAPI of gains which accrued on excluded property, as well as in the complete ineffectiveness of the proposed amendments. These anomalies would in our view arise because of structural aspects of the approach being adopted, rather than because of drafting issues.

- The proposed amendments with respect to mergers, liquidations and distributions or other reorganizations involving foreign affiliates would also appear to give rise to anomalous consequences in many cases, as a result of certain structural aspects of their formulation. In this context, we have seen examples of transactions that would result in the imposition of taxation under the Act in circumstances involving no more than a simple corporate combination or other reorganization that does not in any substantive way alter the indirect economic relationship between the relevant assets or surplus and the relevant taxpayer(s), as well as examples where radically different consequences would arise under the Act or the Regulations depending on whether a merger rather than a liquidation or other reorganization transaction is implemented even though the exact same corporate and commercial result would be achieved either way.

- The proposed amendments with respect to adjustments to be made to the various surplus and other accounts of a foreign affiliate as a result of the application of the subsection 93(1) deemed dividend rules, and in the context of certain changes to a relevant taxpayer's surplus entitlement percentage, would also appear to result in anomalous consequences in certain cases, including the over-attribution of underlying deficits and, more generally, the "scrambling" of surplus accounts. In addition, these measures would appear to introduce inordinate uncertainty, complexity and administrative and compliance costs into the system.

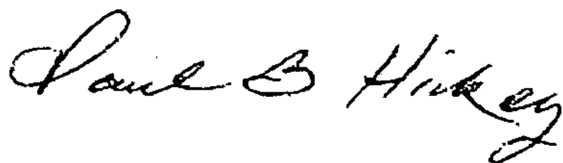
We believe that an alternative approach could be devised for "internal dispositions" that could address the concerns of Finance in this regard in a manner that would not give rise to such anomalies. Similarly, we believe that the concerns of Finance with respect to mergers, liquidations and distributions or other reorganizations involving foreign affiliates could be addressed in a more conceptually coherent manner, and more consistently with certain of the fundamental principles that underlie the scheme of the Act and Regulations in this area. We also believe that Finance's concerns with respect to the surplus account adjustment rules could be addressed in a more efficient manner, that would not disrupt the relationship between tax attributes and economic values, and therefore would be more consistent with the underlying purpose of these rules.

Although we have had certain initial and informal discussions and correspondence with officials of your Department to this effect, we believe that additional representations are warranted in the circumstances. We are quite busy preparing a relatively comprehensive submission on the foreign affiliate proposals that covers a broad range of relevant technical and policy considerations, as well as a separate submission on the other (non-foreign affiliate) aspects of the Draft Legislation. Both should be finalized in the coming few weeks.

At the meeting on September 27 we suggested the possibility of severing certain aspects of the proposed amendments from the coming Technical Bill, such that they may be considered in greater depth, while the balance of the proposals proceed through the legislative process. We would strongly encourage you to adopt this approach, and would recommend for your consideration in this regard severing the three issue areas described above.

We would be pleased to elaborate on our thoughts in this regard, including with respect to transitional issues, should you consider it to be advisable to entertain this possibility further.

Yours truly,



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January 20, 2006

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Dear Mr. Ernewein:

Additional Submission—Proposed Amendments to Foreign Affiliate Rules in February 27, 2004 Draft Legislation (the "Draft Legislation")

We would like to first express our thanks to you and your colleagues for taking the time to meet once again with our Foreign Affiliate Subcommittee (the "Subcommittee") on October 3, 2005. At that meeting, the Subcommittee undertook to provide you with further comments on aspects of the Draft Legislation, and modifications thereto that are under consideration, relating to the treatment under the federal *Income Tax Act* (the "Act") and *Income Tax Regulations* (the "Regulations") of certain foreign affiliate ("FA") distributions. This submission, which contains these comments as well as comments on foreign exchange hedging arrangements, follows our previous submissions of November 3, 2004 and October 8, 2004 on the Draft Legislation and our September 18, 2003 submission on the earlier December 20, 2002 proposed amendments to the foreign affiliate rules.

This submission provides you with our comments with respect to the following three matters:

- ***Foreign Paid-Up Capital.*** The first matter is the basic question of whether or not the characterization of a FA distribution should be determined as a function of the FA's "foreign paid-up capital" ("FPUC"). In this regard, for the reasons set out below, the Joint Committee strongly recommends that the characterization of a FA distribution should not be determined as a function of the FA's FPUC. Rather, the character of a FA distribution should be determined as a function of the FA's underlying surplus accounts, in accordance with the scheme of the Regulations. That scheme, in our view, clearly reflects the principle that, in the FA context, unlike in the domestic context, the "default" treatment for corporate distributions is cost recovery treatment, except to the extent that there exists economic

appreciation reflecting earnings realized after FA status commences, translated into surplus accounts. In this context, FPUC and its domestic analogue, "paid-up capital" ("PUC"), are in our view largely immaterial and often inappropriate measures of the relevant amounts.

- ***FPUC Currency.*** The second matter is the question of which currency such FPUC should be maintained in, assuming such a concept should be introduced. In this regard, and on the basis that FPUC would be introduced as a means of achieving income-measurement objectives, it is our strong recommendation that FPUC should be maintained in the relevant shareholder's calculating currency –Canadian dollars in the case of a taxpayer resident in Canada (and, in certain situations, a FA).

- ***Hedging Arrangement Currency.*** The third matter arises in the context of the proposed amendments relating to foreign exchange hedging arrangements (e.g., proposed paragraph (c.1) of the definition of "excluded property" ("EP") in subsection 95(1), proposed subparagraph 95(2)(a)(vi), and proposed paragraph 95(2)(i)). In this context, we address the question of whether or not there should be any technical limitation on the currency to which a particular foreign exchange exposure (arising in some other currency) could be hedged, and strongly recommend that no such technical limitation be introduced.

We elaborate below on our comments with regard to each of these matters, and include an Appendix that illustrates the operation of our recommended approach.

Foreign Paid-Up Capital (FPUC)

We believe our Subcommittee's discussion with you of the FPUC concept would benefit from revisiting how it evolved, essentially as the measure of the amount (i.e., the cost, as we describe below) of a shareholder's investment in a FA. While PUC has certain connotations for the purposes of the Act, mostly concerning the taxation of Canadian resident corporations and their shareholders more or less on an integrated basis, we suggest and comment below that the same connotations are not typically or even systemically present or appropriate in relation to the taxation of FAs and their shareholders.

We suggest that the FPUC notion has evolved simply as a method for measuring the amount invested by a shareholder in a FA – in effect, as a proxy or measure for the tax-paid cost to a shareholder of FA shares, and in the case of an original investment to acquire treasury shares will align closely if not completely with the adjusted cost base (or "ACB") of those shares to the shareholder, determined in the shareholder's calculating currency. Moreover, as the present proposal for subsection 88(3) as it is developing evidently accepts and does or is expected to reflect, this is the case regardless of whether the invested amount is accounted for by the FA as legal share capital, contributed surplus, share premium or another manifestation of the invested amount. The problem, in our view, arises where the shareholder has in fact incurred or laid out *bona fide* tax-paid cost for FA shares that may not be reflected in its FPUC, or in legal capital reflecting an actual contribution – e.g., where the shareholder acquired the FA shares from another shareholder rather than from treasury, or where the relevant FA has undergone or participated in certain types of capital or other corporate or commercial reorganizations.

We recognize that, from the Department's perspective, this matter to some extent involves the belief that a taxpayer should not be permitted to "convert" undistributed "taxable surplus" into a capital gain, even at the time of ultimate repatriation (i.e., "distributions" into Canada). However, while this principle has been reflected for some time in subsection 93(1.1), this provision has never applied with respect to situations of ultimate repatriation. Thus, to date, the principle that a taxpayer should not be permitted to "convert" undistributed "taxable surplus" into a capital gain at the time of ultimate repatriation has not been reflected in the Act – and, according to our understanding, it is precisely this that the Department proposes to change. Nevertheless, it is also our understanding that this change would not involve the abandonment of the principle that the taxpayer should be permitted to recover its tax-paid investment before recognizing any further income. As a consequence, it would seem to us that these two principles would have to be reconciled appropriately in designing the relevant measure.

Suggested Adjusted Cost Base (ACB) Approach

In this submission, we propose an approach that achieves this objective by adopting ACB (a shareholder concept) rather than PUC (a corporate capital concept) as the best measure of the tax-paid amount invested by a shareholder that may be returned to it without further tax. We suggest that, as a matter of principle, tax-paid cost in this context includes not only the amount paid by a shareholder to subscribe for shares of the issuer, but as well any amounts paid to an unrelated party to acquire such shares. The same interests with respect to the ultimate actual taxation of inherent corporate value and shareholders in the context of the integrated taxation of corporate income, which are served by PUC in the domestic context, simply are not present when dealing with FAs. Indeed, the scheme of the Act and Regulations in this context clearly reflects the principle that an acquiring shareholder of FA shares does not inherit the FA's surplus history from the disposing shareholder, except in certain non-arm's length transfers or reorganizations contemplated by Regulation 5905. Thus, pre-acquisition surplus can and often does reflect what in law or otherwise would constitute corporate "retained earnings". Those pre-acquisition corporate retained earnings are never used in the FA context to determine the character and treatment of FA distributions, since pre-acquisition surplus distributions always give rise to cost recovery treatment for the purposes of the Act and Regulations.

It follows, in our view, that the appropriate measure of the tax-paid invested amount, in the FA context, is cost or ACB from the shareholder's perspective rather than retained earnings or legal capital from the corporation's perspective. To adopt a different approach, we suggest, would in many cases invite double or otherwise inappropriate taxation of the after-tax capital expended by a shareholder to acquire the shares. Thus, while our specific comments which follow proceed on the understanding, based on the Department's perspective, that a taxpayer should not be permitted to "convert" undistributed "taxable surplus" into a capital gain, we believe it is equally important not to abandon the principle that the taxpayer should be permitted to recover its tax-paid investment before recognizing any further income.

Accordingly, assuming that the taxpayer should continue to be permitted to recover its tax-paid investment before recognizing any further income (and assuming that the measure of the taxpayer's investment should be ACB, and that the measure of a FA's relevant undistributed surplus should continue to be "attributed net surplus", as reflected in subsection 93(1.1)), and assuming further that the taxpayer should not be permitted to "convert" undistributed "taxable

surplus" into a capital gain, even at the time of ultimate repatriation, then it would seem to us that any measure introduced in this regard should be engaged only if and to the extent that a capital gain would otherwise arise. As a corollary, if no capital gain would otherwise arise, then it is obvious that the taxpayer would not be "converting" undistributed "taxable surplus" into a capital gain, so no deemed dividends should arise.

What follows from this logic, in our view, is that the Department should consider simply extending the scope of subsection 93(1.1) rather than introducing an additional and inconsistent regime that operates as a function of FPUC. It is submitted that such an extension would be sufficient to address the Department's concerns with respect to the "conversion" of undistributed "taxable surplus" into capital gains, and would be consistent with fundamental aspects of the scheme of the FA rules. For example, subsection 93(1.1) could be extended to circumstances in which the shares of a FA held by a taxpayer resident in Canada are either redeemed, acquired or cancelled by the FA (including on its liquidation and dissolution) or by a person that does not deal at arm's length with the taxpayer, or are deemed to have been disposed of by the taxpayer by reason of subsection 40(3). Under such an extended version of subsection 93(1.1), it would seem to us that it would not be possible for a taxpayer to "convert" undistributed "taxable surplus" into capital gains, and the taxpayer would be permitted to recover its investment (i.e., its ACB) before being required to recognize any income.

Limited Role for PUC in FA Context

In this regard, we submit, as we observed more generally above, that our approach is consistent with the functions performed in the Act of PUC as such, and that those functions and the tax policy underlying the significance of PUC in the domestic context are fundamentally distinguishable with respect to investments in FAs.

- It is our understanding that, in the domestic context, and in the inbound cross-border context (i.e., in the context of a distribution by a corporation resident in Canada), the concept of PUC has been employed in the Act as a means of *indirectly measuring* relevant undistributed corporate surplus. In effect, in this model, undistributed corporate surplus is equated with the difference, if any, between a corporation's PUC and the fair market value of its assets (net of its liabilities). This amount may or may not be reflected in the corporation's retained earnings, in the sense that retained earnings would normally not include any unrealized "appraisal surplus". However, the distribution by the corporation of any amount exceeding its PUC would nevertheless normally be characterized as a dividend pursuant to subsection 84(2), assuming that this provision were applicable in the circumstances, resulting in income recognition rather than cost-recovery treatment. As a corollary, the distribution (by way of a formal return of capital) by the corporation of an amount not exceeding its PUC would normally result in cost-recovery treatment. Similar parameters apply under subsection 84(3). Moreover, this concept is employed as an important element of the various "surplus stripping" rules applicable in relation to a corporation resident in Canada, such as sections 84.1 and 212.1, as a benchmark within which these rules are not engaged. That is, no deemed dividend arises to the extent that the "boot" (i.e., non-share consideration) received by the transferor does not exceed the PUC of the transferred shares. Thus, the principal function of this concept would appear to be to serve, essentially, as an *income measurement tool* – to measure the amounts that are accorded income recognition treatment (i.e., deemed

dividends), rather than cost-recovery treatment, in the context of a distribution by a *corporation resident in Canada.*

- In the context of a distribution by a FA, the concept of PUC has a much more limited function as a practical matter, because of two reasons.

  — First, in the FA context, the Act relies on a very detailed set of rules – the "surplus" computation rules in Part LIX of the Regulations – as a means of *directly measuring* relevant undistributed corporate surplus – which, in this context, does not include appraisal surplus in our view. That is, in this context, in very conceptual terms, we would submit that relevant undistributed corporate surplus includes only *realized* earnings – indeed, only those earnings realized through transactions other than "internal dispositions". Thus, it is not necessary to rely on PUC, or FPUC, in this regard.

  — Second, in our view, relying on PUC, or FPUC, in this regard would be inappropriate, in that it would be inconsistent with the notion that relevant undistributed corporate surplus in this context includes only *realized* earnings (i.e., only FA "surplus"). In other words, in this context, the rules would appear to be (and, in our view, should be) designed as much as possible so as to result in income recognition treatment only in amounts that are reflected in such "surplus", subject to the principle that the taxpayer (or a FA, as the case may be) should be permitted to recover its investment before recognizing any income, to which we will return below. As an illustration of the more general point, we note that both current and proposed Regulation 5902(6), which determines the amount of the deemed dividend arising in the FA context pursuant to subsection 93(1.1), provides for income recognition treatment only in the amount equal to the *lesser of*:

    - the *capital gain*, if any, otherwise determined in respect of the disposition of the relevant share,

    and

    - the amount that could reasonably be expected to have been received in respect of the share if the particular affiliate had at the relevant time paid dividends the aggregate of which on all shares of its capital stock was equal to the amount determined under Regulation 5902(1)(a) to be its *"net surplus"* in respect of the corporation (or, under the Draft Legislation, the amount of *"attributed net surplus"* (as determined under proposed Regulation 5902(1)(f)) in respect of the relevant share), determined on a consolidated basis.

  In other words, even the "surplus stripping" rules applicable in the FA context do not rely on PUC as a means of determining the amounts that should be accorded income recognition treatment. Rather, in the FA context, this determination is made as a function of "surplus" and "basis" (i.e., ACB), being a central determinant of capital gain). Indeed, PUC has nothing at all to do with the application of the surplus

stripping rule in subsection 93(1.1). Similarly, the relevant income measurement and surplus stripping rules in the Act that do rely on PUC (i.e., those in sections 84, 84.1 and 212.1) are deliberately disapplied in the FA context. For example, where FA1 disposes of FA2 for $100 at a time when FA1's ACB in the FA2 shares is nil and FA2 has $50 of "surplus" and no PUC, only $50 of deemed dividends would arise – not $100 as would be the case if PUC were the relevant benchmark. Likewise, where FA1 disposes of FA2 for $100 at a time when the underlying attributes are the same as just mentioned except that FA2 has $100 of PUC, $50 of deemed dividends would still arise – not *nil* deemed dividends as would be the case if PUC were the relevant benchmark. Thus, PUC (and, in our view, FPUC) simply is not (and, in our view, should not be) relevant in this regard. Rather, since the relevant (and direct) measure of undistributed corporate surplus in this context is FA "surplus", the relevant measure of the taxpayer's investment in the FA becomes ACB – once again, not PUC or FPUC. In this manner, the taxpayer is accorded (or, rather, subjected to) income recognition treatment (i.e., deemed dividends) only if and to the extent that the relevant affiliate has "attributed net surplus" in an amount that exceeds the taxpayer's investment (i.e., its ACB) in respect of the relevant shares. It is submitted that it would be inconsistent with this well developed infrastructure to now introduce a measure that would operate to produce deemed dividends in this context as a function of an affiliate's FPUC. Indeed, such a measure would seem to us to directly conflict with, and to produce results that would be inconsistent with those arising under, the regime reflected in current and proposed Regulation 5902(6).

- Thus, while PUC still plays a role under current rules in the context of FA distributions, that role is largely redundant, in that a FA distribution made in the form of a "return of PUC" is accorded essentially the same treatment as a FA distribution in the form of a dividend out of "pre-acquisition surplus", with two important exceptions.

  - A FA distribution made in the form of a "return of PUC" is accorded cost-recovery treatment in accordance with common law principles (to the effect that the distribution does not result in the recognition of income by the shareholder) and pursuant to subparagraph 53(2)(b)(ii). A FA distribution in the form of a dividend out of "pre-acquisition surplus" is also accorded cost-recovery treatment – in accordance with paragraph 113(1)(d), subsection 92(2) and subparagraph 53(2)(b)(i).

  - However, whereas a "return of PUC" can be used to "bypass" undistributed "taxable surplus" (subject to certain "exceptions"), a dividend out of "pre-acquisition surplus" arises only after "taxable surplus" has been depleted. We refer to "exceptions" to indicate that a "return of PUC" cannot be used to "bypass" undistributed "taxable surplus" if it results in a deemed disposition of the relevant shares under subsection 40(3), because the "return of PUC" exceeds the relevant ACB, and subsection 93(1.1) is applicable. In such a case, a deemed dividend would arise, thereby capturing the "taxable surplus". Nevertheless, a "return of PUC" can be used to "bypass" undistributed "taxable surplus" in all cases where there is sufficient ACB, which is appropriate in our view. Moreover, a "return of PUC" can be used to "convert" undistributed "taxable surplus" into a capital gain where the distribution is governed by subsection 88(3), or where the relevant shares are not EP, even where the

distribution exceeds ACB, since subsection 93(1.1) does not currently apply in either case. We will return to this issue below.

— Another important difference is that, in the context of a "return of PUC", no relief whatsoever is provided for under the Act in respect of any applicable foreign withholding taxes. In contrast, in the context of a dividend out of "pre-acquisition surplus", the ACB reduction provided for under subsection 92(2) is itself reduced by any applicable foreign withholding taxes, thereby granting relief under the Act in the form of latent loss (or less latent gain) on the relevant shares, given that such dividends do not constitute "exempt dividends" as defined in subsection 93(3) for the purposes of the stop-loss rule in subsection 93(2). Thus, assuming that there is no material undistributed "taxable surplus", the taxpayer would have an incentive under the Act to cause the distribution to be made in the form of a dividend out of "pre-acquisition surplus", if that would result in relief for any foreign withholding taxes that would be applicable in either case. Of course, if a "return of PUC" would in the first place avoid the application of foreign withholding taxes, that would remain the preferred form of distribution from a Canadian perspective, since the avoidance of foreign withholding tax would always be preferable to the limited form of relief in that regard provided for under subsection 92(2).

- It would seem to us that a regime that relies on FPUC would almost invariably violate at least one of the two principles intrinsic to the FA system even as it would be modified by proposed changes to the FA rules, and would give rise to inequitable results in many cases. For example, where a taxpayer acquires a FA from a third party and the FA has FPUC that exceeds its FMV at that time, a regime that relies on FPUC could put the taxpayer in a position to enjoy a tax benefit windfall at some point in the future, in allowing the taxpayer to "convert" undistributed "taxable surplus" into a capital gain by making an FPUC distribution that exceeds ACB. Similarly, and unless remedial action is taken, where a taxpayer acquires a FA from a third party and the FA has FPUC that is lower that its FMV at that time, a regime that relies on FPUC could put the taxpayer in a position to suffer a tax disadvantage at some point in the future, in that the taxpayer would not be permitted to recover its actual investment (i.e., its ACB) before being required to recognize income.

Recommendations

Against that background, and as a means of mechanically implementing these principles, our recommendations are as follows. A number of examples of the application of the regime described below are set forth in the Appendix.

1. Where shares of a FA held by a taxpayer resident in Canada are redeemed, acquired or cancelled by the FA (including on its liquidation and dissolution, or on a merger) or by a person that does not deal at arm's length with the taxpayer, the position would be mandatory (i.e., the extended subsection 93(1.1) would be engaged) and would provide for income recognition treatment (i.e., deemed dividends) to the extent of the lesser of the amount of any capital gain otherwise resulting from the disposition and the amount of the relevant "attributed net surplus", and would provide for cost-recovery treatment (i.e., proceeds of disposition or deductions from ACB) for the balance.

2. Where a dividend payment or other distribution of property (excluding, for greater certainty, any transaction described in the preceding paragraph) is made by a FA, the position would be elective, with income recognition treatment (i.e., an actual or deemed dividend) being the default position. That is, the distribution would either be or would in any event be treated as a dividend, except to the extent that the taxpayer designated that all or part of the amount of the distribution should be accorded cost-recovery treatment (i.e., deducted from ACB). If the amount of the distribution that is designated for cost-recovery treatment exceeds the taxpayer's ACB in the relevant shares, then a capital gain would arise under subsection 40(3), and dealt with as described below. Although we have struggled with this notion to some extent, we ultimately concluded that an elective mechanism would be most neutral, most efficient and most equitable in the circumstances. In particular, we note that, since there would be a difference between FPUC and corporate legal character if an FPUC regime were introduced as contemplated, some type of mechanical rule would have to be introduced to determine when a distribution that in law is made in the form of a dividend should be treated as a distribution of FPUC. In this regard, we understand you are considering the use of a designation mechanism. Inspired by this approach, we suggest a designation mechanism be used for all dividends or other distributions. This would be most efficient, as time and expense would not have to be spent by taxpayers or the tax administration trying to characterize the distribution as a matter of foreign corporate law. Also, this would be most neutral and most equitable, since it would eliminate the possibility of anomalies in Canadian tax treatment resulting from differences in the foreign corporate laws of various countries. Moreover, it would eliminate the possibility of anomalies in Canadian tax treatment resulting from differences in the foreign tax laws of various countries (ie, taxpayers often prefer to capitalize FAs without creating formal legal capital, as a means of minimizing foreign capital duties).

3. Where a taxpayer is deemed to have realized a capital gain under subsection 40(3) because of a cost-recovery designation (as opposed to because of the "attributed net surplus" of the relevant FA having been depleted), the extended subsection 93(1.1) would be engaged, such that the taxpayer would be precluded from 'converting" undistributed "taxable surplus" into a capital gain. In contrast, where a taxpayer is deemed to have realized a capital gain under subsection 40(3) but the "attributed net surplus" of the relevant FA has been depleted, a capital gain would quite properly arise.

4. The "amount" of the distribution (whether ultimately accorded income recognition treatment or cost-recovery treatment) would be determined largely as described in the Draft Legislation (i.e., in certain cases, as a function of whether or not EP is being distributed; in certain cases, as a function of the taxpayer's percentage equity interest in the relevant FA – such as under proposed paragraph 95(2)(e.1); in certain cases, as a function of the nature of the transaction – such as in the case of a "foreign merger" governed by the broader form of paragraph 95(2)(d.1) currently under consideration, etc.).

5. A similar approach would be taken in the context of inter-affiliate distributions and analogous transactions. Subsection 93(1.1) would be applicable as a matter of course in respect of share dispositions, and otherwise distributions would result in deemed dividends subject to the taxpayer's cost-recovery treatment designation.

6. Reorganizations of capital and share-for-share exchanges with issuer FAs (e.g., transactions to which section 51 or 86 is applicable) would be excluded from the scope of a "distribution" as such, but would engage the application of subsection 93(1.1) to the extent that a capital gain would otherwise arise and there is "attributed net surplus".

Finally, we would note in this regard that the introduction of such a broad deemed dividend/cost-recovery designation regime would seem to us to be perfectly consistent in fundamental respects with the notion of recharacterizing proceeds of disposition as deemed dividends under subsection 93(1.1) or otherwise. For example, both under existing rules and under the Draft Legislation, the treatment of a share redemption is not constrained by foreign corporate and commercial law, in the sense that the Act generally permits under subsection 93(1) and in certain cases requires under subsection 93(1.1) that what would otherwise be characterized as proceeds be recharacterized as dividends. A broad deemed dividend/cost-recovery designation regime would seem to us to be analogous -- and would facilitate efficient administration of and compliance with the Act. In the latter regard, we would submit that any regime that can "piggy-back" off existing infrastructure in the Act and Regulations would be preferable to one that would require the development of new concepts and the tracking of information that is not otherwise useful. Thus, our recommended approach has been designed to operate on the basis of information that is already required to be maintained and serves various material purposes – namely, ACB and "surplus". In contrast, the adoption of a new regime that operates on the basis of FPUC would not only require the introduction of this new concept (which, in itself, is probably not that material) but also would require the gathering and maintenance of information dating back to the creation of the relevant FAs, which could impose material and, in certain cases, insurmountable administrative and compliance burdens on all concerned, particularly in circumstances where a taxpayer has acquired a FA that has undergone or participated in share capital or other corporate and commercial reorganizations, which can result in changes to legal capital accounts without corresponding contributions or distributions.

FPUC Currency

Assuming that the FPUC regime should be introduced, a related question that arises is which currency such FPUC should be maintained in. In this regard, it is our submission that such FPUC should be maintained in the currency that is relevant in computing the affected shareholder's income or capital gain from a disposition of the relevant FA shares. Our view in this regard is based on the proposition that such FPUC would be intended to serve as an indirect (if inaccurate) measure of the amounts that should be accorded income recognition treatment in the context of a distribution of relevant undistributed corporate surplus, and the principle that the taxpayer should be permitted to recover its investment before being required to recognize any income. Assuming this principle is relevant here, it would seem to us to be appropriate that a significant element of the taxpayer's income determination such as FPUC should accordingly be maintained in the same currency.

This approach would also appear to minimize inefficiencies and other arguably inappropriate results that can arise because of fluctuations in the value of the currency in which the FPUC is maintained relative to the value of the shareholder's relevant currency. For example, if FPUC were maintained in a currency other than the shareholder's relevant currency, then an increase in

value of that currency, relative to the value of the shareholder's relevant currency, would increase the amount that could be received by the shareholder as a "return of FPUC" – free of income recognition (i.e., free of deemed dividends), thereby permitting the taxpayer to "convert" a distribution of "taxable surplus" into a capital gain to this extent. Thus, if a Canadian-resident shareholder invested $100 in the capital of a FA, maintaining the resulting FPUC in Canadian dollars would ensure that the shareholder could recover no more and no less than that initial $100 on a cost-recovery basis. In contrast, maintaining that FPUC in another currency would virtually always result in "slippage". If the value of that other currency increased relative to the Canadian dollar, such that the value of the relevant foreign currency units increased, say, from $100 to $150, then the FA could distribute an "amount" equal to $150 to the shareholder as a "return of FPUC", thereby permitting the "conversion" of $50 of "taxable surplus" into a capital gain. Conversely, the shareholder's interests can be adversely affected by a currency movement in the opposite direction, in that the shareholder might not be able to receive its initial investment of $100 as a "return of FPUC" (depending on how distributions would be characterized for this purpose), since the value in Canadian dollars at that time of the FPUC would be less than $100.

Hedging Arrangement Currency

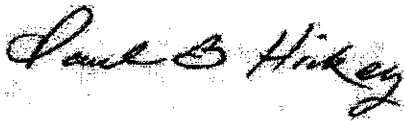
In our submission to you dated September 18, 2003, in relation to the December 20, 2002 version of the proposed amendments, we recommended that certain clarifications and other revisions be made with respect to the proposed amendments relating to foreign exchange hedging arrangements (e.g., proposed paragraph (c.1) of the definition of "excluded property" in subsection 95(1), proposed subparagraph 95(2)(a)(vi), and proposed paragraph 95(2)(i)). In particular, we recommended that the language of these provisions be clarified by providing that a hedging arrangement would qualify under these rules (assuming other relevant conditions were satisfied) if it was entered into by the relevant FA "to reduce its risk, with respect to an amount …, of fluctuations in the value of the currency in which the amount was denominated *relative to any other currency*". Given that the version of these proposals in the Draft Legislation, in relevant part, is effectively the same as the prior version, we reiterate our recommendation in this regard.

Moreover, we note that it would strike us as being anomalous that the combined effect of the FA financing and hedging rules would be to accommodate a situation in which, for example, one FA makes a loan to another FA in a particular currency other than the lender's calculating currency (e.g., the currency in which the lender has issued funding obligations (the "funding currency")) but would not accommodate the analogous and functionally equivalent situation in which the loan is made in a currency other than the lender's calculating currency and other than the funding currency (e.g., the borrower's currency, where that differs), and the lender then hedges its exposure with reference to the risk of fluctuations in the value of the borrower's currency relative to the value of the funding currency by "swapping" its "long" exposure to the borrower's currency for "long" exposure to the funding currency, or *vice versa*. In the first case, the lender would have created a "natural hedge" by lending in the funding currency. In the second case, since the lender would have made the loan in the borrower's currency, there would not be any "natural hedge", but the lender would have created an equally perfect hedge by "swapping" its "long" exposure to the borrower's currency for "long" exposure to the funding currency. In other words, if there is no restriction on the currency in which a qualifying 95(2)(a)(ii) asset can

be initially denominated or subsequently redenominated, then it would seem to us to be anomalous that there should be any restriction on the currency in which a qualifying hedging arrangement can be denominated.

We would be pleased to elaborate on our thoughts in this regard, including with respect to transitional issues, should you consider it to be advisable to consult with us further in this regard.

Yours truly,



Paul B. Hickey, CA
Chair, Taxation Committee
Canadian Institute of Chartered Accountants

William R. Holmes
Chair, Taxation Section
Canadian Bar Association

Cc: Wally Conway – Department of Finance

Appendix

Example 1 – Legitimate Bypassing of Undistributed Taxable Surplus

Facts:

- Canco acquired CFA from a third party for $100, so its ACB is $100
- CFA has undistributed retained earnings (representing "taxable surplus") of $50
- CFA "capitalizes" its undistributed retained earnings
- CFA distributes an "amount" that does not exceed Canco's ACB – say, $100

Consequences:

- No deemed dividend or other consequence when CFA "capitalizes" its undistributed retained earnings
- Canco would be deemed to receive a dividend of $100 (thus, $50 out of "taxable surplus" and $50 out of "pre-acquisition surplus"), unless Canco elected cost-recovery treatment for the entire "amount", in which case no deemed dividend or capital gain would arise, but Canco's ACB would be completely depleted – Canco would have fully recovered its investment of $100, but no more than that.

Example 2 – Capitalization of Undistributed Taxable Surplus

Facts:

- Canco acquired CFA from a third party for $100, so its ACB is $100
- CFA has undistributed retained earnings (representing "taxable surplus") of $50
- CFA "capitalizes" its undistributed retained earnings
- CFA distributes an "amount" that exceeds Canco's ACB – say, $125

Consequences:

- No deemed dividend or other consequence when CFA "capitalizes" its undistributed retained earnings
- Canco would be deemed to receive a dividend of $125 (thus, $50 out of "taxable surplus" and $75 out of "pre-acquisition surplus"), unless Canco elected cost-recovery treatment for at least the portion of the "amount" that is within its ACB (which is assumed), in which case a deemed dividend of $25 (out of "taxable surplus") would arise. No capital gain would arise, but Canco's ACB would be completely depleted. Thus, Canco would have fully recovered its investment $100, and recognized a return on investment of $25, accounted for as a dividend out of "taxable surplus".

Example 3 – Stripping of Undistributed Taxable Surplus

Facts:

- Canco1 acquired CFA from a third party for $100, so its ACB is $100
- CFA has undistributed retained earnings (representing "taxable surplus") of $50
- Canco1 transfers CFA to Canco2 (a wholly-owned subsidiary) in exchange for shares of Canco2 and cash in an amount that exceeds Canco1's ACB – say, $125 (such that a section 85 election is duly made for $125, where FMV is $150)
- CFA distributes an "amount" that exceeds Canco2's ACB – say, $150

Consequences:

- No deemed dividend or other consequence when CFA "capitalizes" its undistributed retained earnings
- On the transfer by Canco1 to Canco2, Canco1 would be deemed to receive a dividend of $25 (out of "taxable surplus"), and this amount would be excluded from its proceeds of disposition of the CFA shares, such that no gain would arise. Canco2's ACB would be $125. Moreover, CFA's "taxable surplus" would be reduced by $25 to $25.
- On the subsequent distribution to Canco2, Canco2 would be deemed to receive a dividend of $150 (thus, $25 out of "taxable surplus" and $125 out of "pre-acquisition surplus"), unless Canco2 elected cost-recovery treatment for the entire "amount" of the distribution, in which case it would still be left with a deemed dividend of $25 out of "taxable surplus". That is, if Canco2 elected cost-recovery treatment for the entire "amount" of the distribution, what would happen is that it would be deemed to have a gain of $25 under subsection 40(3), such that subsection 93(1.1) would apply to result in a deemed dividend of $25 out of "taxable surplus".

Example 4 – Stripping of Undistributed Taxable Surplus

Facts:

- Same as Example 3, except CFA already had PUC of $200 when it was acquired by Canco1, so no "capitalization" is made of its undistributed retained earnings

Consequences:

- Same as Example 3. In contrast, we note that an FPUC regime along the lines of that under consideration would seem to permit the undistributed "taxable surplus" in such a case to be "converted" to capital gains – $25 in the hands of each of Canco 1 and Canco 2 – unless further supporting deemed dividend provisions are introduced, to address "capitalizations", "stripping" transactions, and similar arrangements.

The Joint Committee on Taxation of The Canadian Bar Association and The Canadian Institute of Chartered Accountants

The Canadian Bar Association 500-865 Carling Avenue Ottawa, Ontario K1S 5S8	The Canadian Institute of Chartered Accountants 277 Wellington Street West Toronto, Ontario M5V 3H2

November 3, 2004

Mr. Brian Ernewein,
Director, Tax Legislation Division, Tax Policy Branch
Department of Finance Canada
17th Flr., East Tower
140 O'Connor Street
Ottawa, Ontario K1A 0G5

Dear Mr. Ernewein:

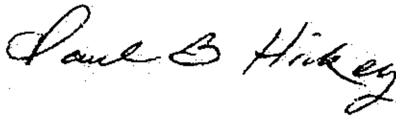
Re: ***Draft Submission in respect of the February 27, 2004, Draft Legislation--Proposed Amendments to the Foreign Affiliate Rules***

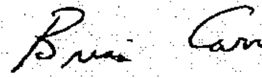
Further to our previous discussions and communications with you and your officials, including our letter of October 8, 2004, we are enclosing our draft submission regarding the above.

Based on what we understand to be the government's current legislative timetable and priorities it has become apparent to us that we are not going to be able to complete this submission in final form in a timely manner. Therefore, in the interest of providing our comments assembled to date, we provide you with our draft submission. The draft submission incorporates many issues previously discussed with you and your officials. As you will appreciate, the topic area and the specific provisions are extremely complicated and new issues are arising on a regular basis. We will endeavor to communicate additional issues to you.

We would be pleased to meet with you once again to discuss these complicated issues and provide our input. As always, we appreciate the opportunity to discuss matters with you.

Yours very truly,





Paul B. Hickey	Brian R. Carr
Chair, Taxation Committee	Chair, Taxation Section
Canadian Institute of Chartered Accountants	Canadian Bar Association

Cc Mr. Wallace Conway, Chief Tax Legislation Division, Tax Policy Branch

SEJ:k
Enclosure

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Submission of the CICA–CBA Joint Committee on Taxation in respect of the February 27, 2004, Draft Legislation Concerning Foreign Affiliates

Introduction

The February 27, 2004, Draft Legislation contains numerous proposals (the "Legislative Proposals") concerning the foreign affiliate rules in the *Income Tax Act* (the "Act") and the *Income Tax Regulations* (the "Regulations"). This Submission is intended to put forth the comments of the CICA–CBA Joint Committee on Taxation in respect of the more salient features of the Legislative Proposals.

Our Submission is divided into two main parts. The first part sets out our comments with respect to the conceptual and policy underpinnings of, as well as the practical considerations associated with, certain of the proposed amendments only – namely, those relating to Internal Dispositions, Reorganizations and Distributions, Surplus Adjustments and Subsection 93(1) Deemed Dividends, as well as certain comments on the regulations corresponding to paragraph 95(2)(a) of the Act. The second part consists of an Appendix, which catalogues a number of our more technical comments and recommendations.

Internal Dispositions, Reorganizations and Distributions

It is our understanding that many of the numerous changes proposed in relation to so-called "internal dispositions", reorganizations and distributions are intended to address concerns of the Department with respect to the "premature" realization and/or "duplication" of exempt surplus (and certain other tax attributes, such as ACB, or "foreign accrual property losses" ("FAPL")). While that objective may be understandable, we respectfully submit that the Department's approach as reflected by the Legislative Proposals gives rise to a number of quite serious concerns with respect to the implications of these measures.

We understand, moreover, that the Legislative Proposals relating to internal dispositions, reorganizations and distributions are being revisited by the Department, and it is in that context that our comments have been formulated. That is, we begin our review of this part of the Legislative Proposals with a discussion of the principles that we believe should govern this aspect of the foreign affiliate regime, and then continue in the Appendix hereto with a summary of numerous technical concerns that arise in relation to the Legislative Proposals as currently drafted, with a view to assisting the Department in its reconsideration of these measures both from a conceptual perspective and from a more technical standpoint.

Internal Dispositions

As noted above, we believe that it is understandable that the Department would be concerned about the "premature" realization and/or "duplication" of exempt surplus and other

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relevant tax attributes. However, we submit that any measures introduced to address these concerns should be consistent with the following principles:

- Arm's Length Principle. These measures should not affect the treatment of transactions between parties dealing at arm's length.

  - We believe that it is inappropriate for transactions between parties dealing at arm's length to be treated as though they are somehow "artificial" and not worthy of recognition for these purposes. Normally, transactions between parties dealing at arm's length by definition carry all the badges of independent market dealings and, therefore, represent the most reliable indicators of realized economic value. Thus, to the extent that the surplus rules are intended to reflect the realized economic value within a particular foreign affiliate, then these transactions should in principle be recognized, subject to appropriate relief in certain cases.

  - The proposed income, gain and loss suspension rules for "internal dispositions" are similar in many respects to certain of the "stop-loss" rules applicable more generally for the purposes of the Act, such as subsection 40(3.4). In general terms, these rules may apply to suspend losses otherwise arising from transactions involving "affiliated persons". These rules are consistent with the arm's length principle, since "affiliated persons" in the corporate context normally share a control bond (or similar relationship).[1] The same is true for a wide range of other anti-avoidance rules scattered throughout the Act, from paragraph 13(7)(e) to section 247, and otherwise.

  - Accordingly, it is our view that any measures introduced to address these concerns in the foreign affiliate context should be applicable only in respect of transactions between persons that are not dealing at arm's length. Thus, the proposed definitions of "specified vendor" and "specified purchaser"[2] should be revised such that they include only persons that are not dealing at arm's length with the relevant taxpayer at the relevant time.

- Consistency/Neutrality. These measures should apply consistently and even-handedly, in a manner which maximizes fiscal neutrality in this context – that is, without regard to whether there is an accrued gain or loss on the particular asset.

  - The proposed income, gain and loss suspension rules for "internal dispositions" as currently drafted reflect what we believe to be an inappropriate bias. That is, income and gains from the disposition of excluded property can be suspended, but

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[1] See the rules in section 251.1.

[2] See the definitions in proposed subsection 95(3.2) and following.

losses cannot. Similarly, losses from the disposition of non-excluded property can be suspended, but income and gains cannot.

- o It is submitted that the "validity" or "artificiality" of a particular transaction should be determined with reference to the circumstantial context in which it occurs (i.e., whether or not it occurs between parties dealing at arm's length), and not as a function of whether it produces a result which is favourable rather than unfavourable to the taxpayer or to the Crown. If a particular transaction should not be recognized because of the circumstantial context in which it occurs, then it seems unfair for the rules to depart from that approach for the singular purpose and only to the extent of imposing unfavourable consequences on the taxpayer.

- o Accordingly, it is our view that the scope of proposed paragraphs 95(2)(c.2) and (f.4) should not be restricted to dispositions of excluded property, and that of proposed paragraph 95(2)(h.1) should be expanded to apply to excluded property, or both should be abandoned.

- Efficiency and International Competitiveness. These measures should not introduce inordinate administration and compliance burdens into the system, or improvidently interfere with the ability of Canadian-based multinational enterprises to arrange and restructure the affairs of their corporate groups in such a manner as to maximize their international competitiveness.

  - o There are three aspects of the Legislative Proposals which we believe are inconsistent with these very important principles. First, there is the aspect of these measures which introduces the notion of suspended income, gains and losses (as opposed to simply introducing another category of surplus or deficit and perhaps grafting it onto the existing infrastructure in the Regulations). Second, there is the aspect of these measures which can result in the realization of FAPI in respect of a disposition of excluded property, rather than simply preventing or discouraging the *Canadian use* of any exempt surplus (or FAPL or other relevant tax attribute) otherwise arising. Third, there is the aspect of these measures that regulates the "unsuspension" or "release" of the suspended items, which does not sufficiently accommodate structured divestitures and certain very important timing considerations.

  - o While the more general concern from the Department's perspective may be described in part as the "premature" realization of exempt surplus and other tax attributes, we understand that one of the more important specific manifestations of this concern arises in relation to the repatriation of economic value into Canada on the basis of such "premature" attributes. That is, we understand that the Department may in certain cases be concerned about circumstances in which, for example, exempt surplus arises from an "internal disposition" of shares of a

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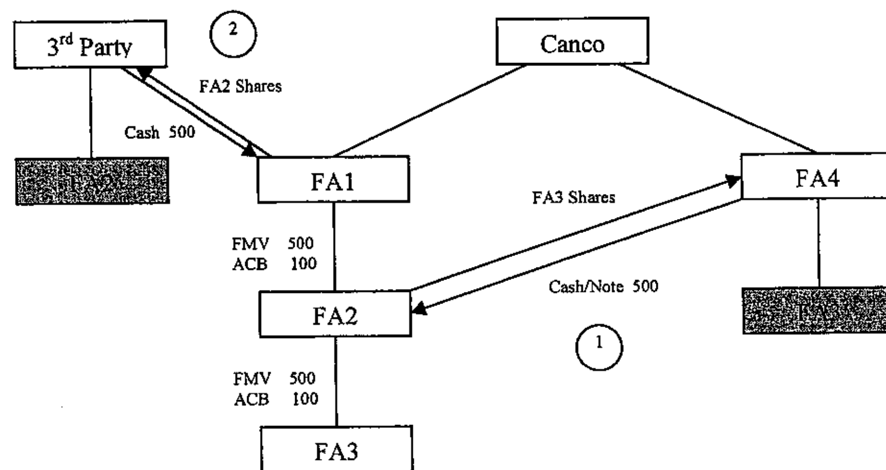
foreign affiliate that constitute excluded property, and then this exempt surplus is used, given the ordering rule in Regulation 5901, to repatriate to Canada economic value which reflects realized taxable surplus unsupported by sufficient underlying foreign tax.

- It is submitted that this concern, while understandable, falls short of justifying the introduction of as intrusive a regime as that reflected in the Legislative Proposals. Moreover, it is submitted that the proposed regime could well be completely ineffective in addressing this concern in many cases, and would produce harsh and otherwise inappropriate results in other cases. Consider the following example:



Essentially, FA2 sells FA3 to FA4 in consideration for cash or a promissory note. Proposed paragraph 95(2)(c.2) would suspend the gain that would otherwise result. FA1 then sells FA2 to a 3rd Party. The gain realized here would reflect the same economic gain as that inherent in the FA3 shares, but proposed paragraph 95(2)(c.2) would not suspend this gain. Moreover, since the gain that would otherwise result from the sale of FA3 by FA2 is suspended, the gain from the sale of FA2 by FA1 would not be reduced by subsection 93(1.1). Thus, the gain from the sale of FA2 by FA1 may produce FAPI or not, depending on whether the FA2 shares are excluded property at the time of their sale, but will in any event produce unsuspended surplus.

- It is submitted that this concern could be addressed by the introduction of a new category of surplus, which could be regarded as "suspended surplus", and which could be grafted onto the existing infrastructure in the Regulations. This approach would permit "suspended surplus" to be used to transfer economic value

between foreign affiliates, but not to repatriate economic value into Canada ahead of taxable surplus.

- Essentially, the principal features of this alternative approach could be summarized as follows:

  - All income, gain or loss from an "internal disposition" of excluded property would result in "suspended surplus" or "suspended deficit", except to the extent that it would otherwise be accounted for in computing "taxable surplus" or "taxable deficit", and only until the relevant "release event" occurs. In other words, "suspended surplus" or "suspended deficit" would include only what would otherwise be included in exempt surplus or deficit. What would otherwise be included in taxable surplus or deficit would not be suspended.

  - Dividends considered to be paid out of such surplus would be excluded from the FAPI of a foreign affiliate, and would be deductible in the hands of a corporate taxpayer resident in Canada only to the extent of any grossed-up withholding or underlying foreign tax applicable thereto. In brief, they would be treated in the same manner as dividends paid out of taxable surplus.

  - Once a "release event" occurs, then the "suspended surplus" or "suspended deficit" would be accounted for in computing exempt surplus or deficit. In the meantime, such "suspended surplus" or "suspended deficit" could be moved from one foreign affiliate to another, and could be adjusted or consolidated in the event of a change to the relevant taxpayer's surplus entitlement percentage ("SEP") or a relevant foreign affiliate reorganization.[3]

  - Since such "suspended surplus" would be treated in the same manner as taxable surplus, it could not be used to repatriate economic value to Canada on a tax-free basis except to the extent that an appropriate amount of foreign withholding or underlying tax has already been paid.[4]

  - Release events would include circumstances in which the relevant vendor affiliate ceased to deal at arm's length with the relevant taxpayer, as well

[3] For example, if FA1 had a "suspended deficit" and FA2 had "suspended surplus", and FA1 received a dividend from FA2 out of the latter's "suspended surplus", then that "suspended surplus" dividend would offset FA1's "suspended deficit", and so on.

[4] It would be our suggestion in this regard that a separate UFT pool be maintained for each of "taxable surplus" and "suspended surplus".

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as those in which the relevant property ceased to be held by a person not dealing at arm's length with the relevant taxpayer (either because the relevant property or the relevant holder was disposed of to an arm's length party, or ceased to exist in certain cases). Timing issues would also be addressed in such a manner as to ensure that these measures would not apply in the context of structured divestitures (i.e., where the relevant property has left the non-arm's length group within 30 days), and to ensure that any "suspended surplus" would become available immediately before an arm's length disposition of the relevant affiliate, particularly where the specified property exits the non-arm's length group at the time of the arm's length disposition of the relevant affiliate (i.e., where the specified property is "downstream" of the relevant affiliate).

- The advantages of this approach would seem to include the following:
  - Because this new category of "suspended surplus" could be grafted onto the existing infrastructure in the Regulations, there would be no need to develop alternative infrastructure to address surplus tracking and continuity issues arising in the context of changes to the relevant taxpayer's SEP or various types of corporate reorganizations.
  - By grafting this new category of "suspended surplus" onto the existing infrastructure in the Regulations, the Department would ensure that the surplus consequences of changes to the relevant taxpayer's SEP or various types of corporate reorganizations would be the same (i.e., appropriately analogous) in the context of realized surplus as in the context of "suspended surplus", so it would be less likely that anomalies could arise that could either be exploited by taxpayers or work to their disadvantage in particular circumstances.[5]
  - This approach would reduce administrative and compliance costs because it would be implemented using existing legislative infrastructure in respect of which both the CRA and taxpayers already have established processes. This would avoid the need to develop new administrative and compliance processes, as well as the associated costs.

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[5] As a further example, because this approach would permit "suspended surplus" to be used to transfer economic value between foreign affiliates, it would not require the development of a whole new set of rules to govern the application and interaction of subsection 40(3). We would note, however, that dispositions arising because of the application of subsection 40(3) should be treated as "internal dispositions" only if the relevant taxpayer and the issuing affiliate do not deal at arm's length.

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- Since this "suspended surplus" would be treated in the same manner as taxable surplus, the Canadian tax base would be fully protected, and there would be no need to require the recognition of FAPI as a condition of surplus recognition.[6]

- Since this approach would permit "suspended surplus" to be used to transfer economic value between foreign affiliates, it would not in any way interfere with the ability of Canadian-based multinational enterprises to arrange and restructure their foreign corporate groups in such a way as to maximize their international competitiveness. We would emphasize that it is very important not to lose sight of the fact that "internal dispositions" are essential tools in the context of structuring and restructuring Canadian-based multinational corporate groups with a view to minimizing foreign costs, including foreign tax and regulatory burdens, and thereby maximizing Canadian competitiveness and wealth.

We would be pleased to discuss this alternative approach with you in greater detail should you be interested in so doing. In addition, with reference to the Legislative Proposals as currently drafted, we offer the more technical recommendations set out in the Appendix hereto.

Reorganizations

A wide range of revisions is proposed in relation to the foreign affiliate rules in the Act and Regulations governing the consequences of certain reorganizations. We refer, in particular, to proposed new paragraphs 95(2)(d) to (e.1), and related provisions.

These proposed revisions appear to be animated significantly by the same concerns as those reflected in the proposed new income, gain and loss suspension rules. That is, in large measure, these proposed revisions would restrict the recognition of surplus otherwise arising in the context of a foreign merger or liquidation. However, in our view, these proposals would appear to go beyond that consequence in important respects, resulting in some cases in the inappropriate recognition of FAPI.

Foreign Mergers

With respect to the aspects of these revisions which are driven by the same concerns as those reflected in the proposed new suspension rules, we would submit the same

[6] We would nevertheless acknowledge that FAPI recognition could still serve as a condition of *exempt surplus* recognition. That is, FAPI recognition could be a condition to the relevant taxpayer electing to opt out of the "suspended surplus" rules in respect of a particular "internal disposition", in which case any income or half of any gain would be FAPI. Presumably, taxpayers may choose to do so if the disposition results in sufficient underlying foreign tax.

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recommendation – namely, that any new rules developed in this context should be consistent with the general principles set out above in relation to the suspension rules – subject to the caveat that the reorganization context may give rise to certain particular considerations and concerns.

- Arm's Length Principle, and Consistency. It is submitted that there is no need to distinguish in this context between circumstances in which the relevant taxpayer has or does not have a SEP of at least 90% in the relevant foreign affiliate(s). Moreover, if any such distinction is to be made, on the basis of the taxpayer's percentage interest in the relevant foreign affiliate(s), then it is submitted that this distinction should be based on whether or not the taxpayer deals at arm's length with the relevant foreign affiliate(s), not based on the taxpayer's SEP in the relevant affiliate(s), and certainly not based on a 90% ownership threshold. We will return to the latter point below.

  - The SEP standard is problematic in this context, since there can be circumstances in which a taxpayer can have *nil* SEP in respect of an indirect wholly-owned foreign affiliate,[7] and there can be circumstances in which a taxpayer can have a SEP of 100% in respect of a particular affiliate even though the taxpayer holds less than 100% of the affiliate's equity.[8] Thus, it is submitted that the SEP standard is simply not a reliable indicator of the relationship between a relevant taxpayer and a particular foreign affiliate.

  - Foreign mergers normally result in a pooling of interests in the underlying corporate assets, without any exchange or extraction of a substantial amount of cash or near-cash consideration, and therefore in our view should not be treated as taxable transactions, even for arm's length shareholders, assuming that the terms of the definition of "foreign merger" in subsection 87(8.1) are satisfied.

    - There is no minimum percentage interest requirement that applies under section 87, whether in the domestic or in the international context. That is, at the shareholder level, subsection 87(4) applies (either on its own in the domestic context or in conjunction with subsections 87(8) and (8.1) in the international context) regardless of the taxpayer's percentage interest in

[7] For example, where Taxpayer holds FA1 (which has a net deficit of, say, $100) and FA1 holds FA2 (which has net surplus of, say, $100), and either FA1 or FA2 has more than one class of shares outstanding. In such a case, the formula applicable under Regulation 5905(13) and related provisions would yield a SEP of *nil* in respect of the taxpayer even in this wholly-owned context.

[8] For example, where Taxpayer holds 100% of a class of an affiliate's shares, and another person holds 100% of another class of the affiliate's shares, and the two classes rank equally with respect to dividends and other distributions, the formula applicable under Regulation 5905(13) and related provisions would yield a SEP of 100% in respect of the Taxpayer at any time at which the affiliate had *nil* net surplus.

the relevant corporation(s). The same is true under proposed paragraph 95(2)(d) and subsections 87(4), (8) and (8.1).[9]

- The anomaly arises at the asset level. Under domestic corporate law, an amalgamation does not normally result in the disposition of property (other than cross-shareholdings and similar items). Thus, although section 87 does not deem the relevant predecessor corporations to have disposed of their properties at tax cost, the underlying assumption of the Act in the domestic context is that there is no disposition as a matter of the governing corporate law, so there is no need for a statutory rollover.[10] In the foreign context, however, that assumption cannot be made, in that the corporate law applicable in various foreign jurisdictions does indeed result in a disposition of predecessor property, particularly where the relevant predecessor does not "survive" the merger.

- Thus, it would be appropriate in our view for proposed paragraph 95(2)(d) to provide for a rollover in respect of any predecessor property which is disposed of in the course of the merger (provided that, as a result of the merger, such property either becomes property of the corporation resulting from the merger or is extinguished by operation of law under the doctrines of merger, confusion or any similar doctrine or principle) and this, without regard to whether or not the property in question constitutes excluded property, and without regard to the taxpayer's percentage interest in the relevant predecessor affiliate.

- In stark contrast, however, proposed paragraph 95(2)(d) not only lacks a rollover in respect of non-excluded property, but in addition deems all non-excluded property to have been disposed of for fair market value consideration even if there is no disposition of such property as a matter of the governing corporate law, all the while deeming excluded property to have been disposed of at tax cost. It is respectfully submitted that this provision, as currently drafted, reflects a considerable bias adverse to taxpayers. This rule never helps the taxpayer – on the contrary, it suppresses exempt surplus from the disposition of excluded property, and it forces the recognition of unrealized FAPI.

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[9] Oddly, voluntary partial gain recognition is permitted only in respect of shares that are excluded property, even though a FAPI addition results from any such gain recognition as if the shares were not excluded property. It is difficult to understand the reason(s) for this distinction.

[10] Reference can also be made to proposed new paragraph (n) of the definition of "disposition" in subsection 248(1), which would deem there not to have been any disposition of certain property (e.g., certain cross-shareholdings) on a qualifying domestic amalgamation or foreign merger.

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- Proposed paragraph 95(2)(d) must be read together with proposed paragraph 95(2)(d.1). Although the primary dividing line for the application of proposed paragraphs 95(2)(d) and (d.1) would continue to be the 90% SEP threshold,[11] that would not be the only one. That is, proposed paragraph 95(2)(d.1) would not apply to a foreign merger:

  > … where, under the income tax law of the country in which the predecessor foreign corporations were resident immediately before the merger, any income, gain or loss was recognized in respect of any property of a predecessor foreign corporation that became property of the new foreign corporation in the course of the merger …

  Thus, where the merger is a non-recognition transaction under the relevant foreign tax law, or where there is no relevant foreign tax law (i.e., where the predecessors are resident in a country that does not have an applicable tax law, or are resident in different countries), proposed paragraph 95(2)(d.1) can apply. Otherwise, it would appear that the application of proposed paragraph 95(2)(d) would not be displaced by proposed paragraph 95(2)(d.1), even if the 90% SEP requirement were met. This is a particularly troubling observation – FAPI could be realized on the merger of two wholly-owned foreign affiliates simply because the transaction is a recognition transaction, with respect to some property, under the applicable foreign tax law.[12]

- If an asset-level rollover is provided for without regard to the relevant taxpayer's percentage interest in the particular affiliate(s), it would seem to be possible for the taxpayer to avoid future FAPI in respect of an accrued gain on non-excluded property of its CFA, by causing the CFA to be merged with another entity in a dilutive horizontal merger, thereby experiencing a dilution of the taxpayer's percentage interest in the CFA and a consequential reduction of future FAPI attribution. However, this is a "sword" that "cuts both ways", in that a merger would normally likewise result in a corresponding reduction of future exempt surplus in respect of any accrued income or gain on excluded property of the CFA. In other words, since there is no mechanism to adjust the amount of any future FAPI or exempt surplus as a function of any change to a relevant

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[11] A similar dividing line is drawn between proposed paragraphs 95(2)(e) and (e.1).

[12] Although this aspect of proposed paragraph 95(2)(d.1) is essentially the same as under current law, the effect is different because, under current law, paragraph 95(2)(d) does not result in a deemed disposition of non-excluded property.

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taxpayer's SEP as between the time when the income or gain accrued and the time it is realized, a merger always produces "slippage" (whether positive or negative from the taxpayer's perspective). Although we would not recommend that a mechanism be introduced to address this type of "slippage", it is our submission that the existence of the possibility of such slippage does not justify restricting access to the asset-level rollover to non-arm's length (or greater percentage interest) circumstances.

- This type of "slippage" also arises where a taxpayer's percentage interest in respect of a particular affiliate is diluted because of a share issuance by the particular affiliate. It would seem pointless to address "slippage" in the context of a merger but not otherwise.

- There would be many circumstances in which a merger does not result in any change to the relevant taxpayer's percentage interest in the particular affiliate – and, therefore, does not result in any such "slippage". A compelling case can certainly be made for an asset-level rollover in this context, regardless of the relevant taxpayer's percentage interest in the particular affiliate. Consider the following example:

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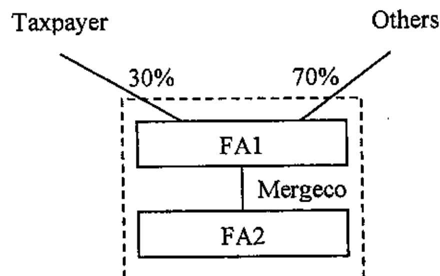

In this example, FA2 was a wholly-owned subsidiary of FA1, until the merger. Before the merger, the Taxpayer's percentage interest in FA2 was 30%, which is the same as the Taxpayer's percentage interest in FA2 after the merger. Clearly, there can be no "slippage" of the kind described above in such circumstances, and therefore there would seem to be no reason to deny a rollover at the asset level, regardless of the taxpayer's percentage interest in particular affiliate. This example illustrates a true case of change in form alone, which in our view should never result in any Canadian tax cost.

- At a minimum, even if an asset-level rollover is not provided for under proposed paragraph 95(2)(d), it is our submission that this provision should be modified such that there would be no deemed disposition of property which is not disposed of as a result of the merger as a matter of the governing corporate law.

  - For an entity that "survives" a foreign merger, the merger is equivalent to an asset acquisition in exchange for shares.

  - It would seem inappropriate for the Act to deem a "surviving" affiliate to have disposed of any of its assets when the Act does not deem an affiliate to have disposed of any of its assets when it carries out a direct asset acquisition in exchange for shares.

- Efficiency and International Competitiveness. It is submitted that the Canadian tax consequences of a foreign merger should not depend on the foreign tax consequences of the merger. That is, even if the Act should continue to draw a distinction between foreign mergers based on the relevant taxpayer's percentage interest in the particular affiliate(s), it is submitted that this should be the only basis of distinction, and no additional conditions should be imposed under proposed paragraph 95(2)(d.1), especially not conditions based on the application of foreign law.

- It is our submission that the Canadian tax consequences of a foreign merger should be determined with reference to the circumstantial context in which it occurs, and not as a function of its foreign tax consequences. Other countries may have other priorities, and certainly would not have the international competitiveness of Canadian multinationals as a priority. Thus, the foreign tax rules do not necessarily reflect Canadian principles and priorities, and therefore should not be determinative of Canadian tax consequences.[13]

- If a particular foreign merger results in the imposition of foreign tax, it may be desirable for the taxpayer to elect to also recognize some income or gain for Canadian tax purposes, in order to utilize that foreign tax. This is a context in which it would perhaps be useful to maintain a distinction between proposed paragraphs 95(2)(d) and (d.1). The former could apply to produce a rollover at the asset (and shareholder) level, and the latter could permit taxpayers to elect to recognize some income or gain. Where a taxpayer elects to do so, that income or gain could be subjected to the same treatment as any income or gain arising from an "internal disposition", as described above, producing "suspended surplus" (treated like taxable surplus), or exempt surplus, in the case of a capital gain, on the condition of FAPI recognition for the taxable portion. Access to this elective regime could be restricted to circumstances in which the relevant taxpayer does not deal at arm's length with the particular affiliate(s), or in which the particular affiliate is a CFA.

- Another aspect of these Legislative Proposals which is troublesome in our view, as currently drafted, is that proposed paragraph 95(2)(d) does not provide for broad entity and attribute continuity. Thus, where a predecessor ceases to exist as a result of a foreign merger, nothing continues all the accounts and other attributes of the predecessor in the "successor".

- Recommendations. In summary, it is submitted that the foreign merger rules in proposed paragraphs 95(2)(d) and (d.1) should be revised in accordance with the following principles:

  - Paragraph 95(2)(d) should apply in respect of all taxpayers, regardless of their percentage interest in the particular affiliate(s), and should provide an asset-level rollover for both excluded property and non-excluded property, regardless of the foreign tax consequences, if any, of the merger. At a minimum, paragraph 95(2)(d) should not provide for any deemed disposition of the property of corporation that "survives" the merger.

[13] For example, while we rely to some extent on foreign tax rules to compute earnings from carrying on an active business, this is not the case for FAPI, and even in the context of computing active business income we make certain adjustments under Regulation 5907(2) and other provisions.

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- Paragraph 95(2)(d.1) should permit voluntary income or gain recognition both at the asset and at the shareholder level. Access to such elective income or gain recognition could be restricted to circumstances in which the taxpayer is not dealing at arm's length with the particular affiliate or where the affiliate is a CFA.

- Any such voluntary income or gain would be subject to the "suspended surplus" rules, as described above, producing "suspended surplus" (treated like taxable surplus), or exempt surplus, in the case of a capital gain, on the condition of FAPI recognition for the taxable portion.

- Paragraph 95(2)(d) should also provide for broad entity and attribute continuity.

We would also draw your attention to the more technical points we raise in relation to foreign mergers as set out in the Appendix hereto.

Foreign Liquidations

Many of the comments made above would be equally applicable in the context of the rules governing foreign liquidations. In particular, we refer to our comments on access to the asset-level rollover for non-excluded property in respect of taxpayers who may not have a 90% SEP in respect of the particular affiliate(s).

However, a number of additional concerns arise in relation to the proposed amendments to subsection 88(3), applicable to liquidations directly into Canada. There are three main areas of concern here.

- The recognition of FAPI on the distribution of excluded property.

- The timing of surplus recognition and availability.

- The release of "suspended income or gain" pre-existing the liquidation.

As a matter of general principles, and the application of section 69, the liquidation and dissolution of a foreign affiliate would normally result in the realization of any accrued income or gain in respect of the property of the liquidating affiliate and in respect of its outstanding shares, determined as a function of the relevant proceeds of disposition, in turn determined as a function of relevant fair market values. In certain circumstances, however, it is considered to be appropriate to provide relief against income or gain recognition, in view of the "formalistic" nature of the transaction, or based on other relevant considerations.

It is respectfully submitted that the following principles could serve as appropriate guideposts in formulating revisions to these very important rules in subsection 88(3), as they apply in the context of a liquidation:

- FAPI should never arise from the distribution of shares of another foreign affiliate of the taxpayer that constitute excluded property, even where the taxpayer elects that the liquidating affiliate's proceeds of disposition be increased above its ACB in the distributed property. There is one very compelling reason for this – namely, that, as a result of this election, the taxpayer's proceeds of disposition of its shares in the liquidating affiliate will increase immediately and in the same amount as the liquidating affiliate's proceeds are increased, such that the relevant gain will be "recognized" immediately and directly in Canada without recourse to the attribution of any FAPI. In brief, FAPI attribution is not necessary because the gain will in any event be "recognized" immediately and directly in Canada. Consider the following examples:

Taxpayer
ACB 100
FMV 500
FA1
ACB 100
FMV 500
FA2

	FAPI on Gain	No FAPI on Gain
PROCEEDS (with RBC election)	500	500
FAPI resulting	200	nil
92 ACB Adjustment	200	nil
ES resulting	200	200
TS resulting	200	200
GAIN on FA1 Shares before 93(1)	400	400
GAIN of FA1 shares after 93(1) at 400	nil	nil
ES dividend	200	200
TS dividend	200	200
91(5) deduction	200	nil
Taxable Income	**200**	**200**
RESULTING ACB in FA2	500	500

As this example clearly illustrates, FAPI attribution on the gain resulting from the RCB election does not in any way increase the taxable income of the taxpayer. Therefore, this measure cannot be justified as a means of appropriately protecting the Canadian tax base. The real issue is whether or not taxpayers should be permitted to achieve even "better" consequences than those illustrated above. There are two examples we would consider to be relevant in this regard, each assuming that no FAPI would arise on the gain resulting from the RCB election, as follows:

Taxpayer
ACB 100
FMV 500
FA1
ACB 100
FMV 500
FA2

	Case A	Case B	Case C
PROCEEDS (with RCB election)	500	500	500
ES resulting	200	200	200
TS resulting	200	200	200
GAIN on FA1 Shares before 93(1)	400	400	400
93(1)	nil	200	400
ES dividend	nil	200	200
TS dividend	nil	nil	200
TAXABLE GAIN on FA1 shares after 93(1)	200	100	nil
Taxable dividends	nil	nil	200
Taxable Income	200	**100**	200
RESULTING ACB in FA2	500	500	500

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As this example clearly illustrates, the only circumstance in which there can be a concern from the Crown's perspective is where the taxpayer is permitted to "cherry-pick" the surplus arising from the gain resulting from the RCB election (Case B above). If a 93(1) election is not made at all (Case A above), the tax consequences are appropriate, in that the taxpayer recognizes a gain of 400, and taxable income of 200. If a 93(1) election in an amount no less than the gain resulting from the RCB election is made (Case C above), again the tax consequences are appropriate, in that the taxpayer recognizes no gain but has taxable income of 200 resulting from a deemed taxable surplus dividend. Only where the taxpayer makes a 93(1) election equal to the exempt surplus resulting from the RCB election (Case B above) is there any concern from the Crown's perspective, but only to the extent that the taxpayer effectively doubles-up on the exempt portion of the capital gain.

Thus, in order to address this concern, it is our recommendation that a taxpayer making a subsection 93(1) election in the context of a liquidation to which subsection 88(3) is applicable be required to elect an amount which is not less than the lesser of:

(a) the capital gain that the taxpayer would realize from the disposition of the shares of the liquidating affiliate if no such election were made, and

(b) the entire amount of any capital gain resulting from a RCB election made in connection with the liquidation.

This would fully address the Crown's concern without subjecting taxpayers to inordinate and inappropriate taxation. In our submission, taxpayers should be permitted to recognize gains resulting from RCB elections in respect of excluded property as capital gains, and taxable capital gains, rather than as attributed FAPI. Capital gains can be offset with capital losses which taxpayers may have, but attributed FAPI cannot be offset with capital losses. In addition, capital gains result in additions to a corporate taxpayer's capital dividend account, whereas FAPI does not. These are very important pillars of the Canadian income tax regime (the ability to offset capital losses against capital gains and the ability for a private corporation to distribute the exempt portion of its capital gains on a tax-free basis through its CDA), and should not be undermined under the Legislative Proposals.

- The distribution of appreciated property other than excluded property to a taxpayer resident in Canada should be permitted to occur on a non-recognition or "rollover" basis. For this, too, there is one very compelling reason – namely, that non-recognition treatment results in the "importation" of a latent gain (or income) which, when the relevant property is subsequently disposed of in a recognition transaction, will result in taxable income under the Act. In other words, it seems inappropriate to deny a rollover where the gain in question is being shifted into the Canadian tax net. After all, the very purpose of the FAPI regime is to bring into the Canadian tax net what would otherwise be

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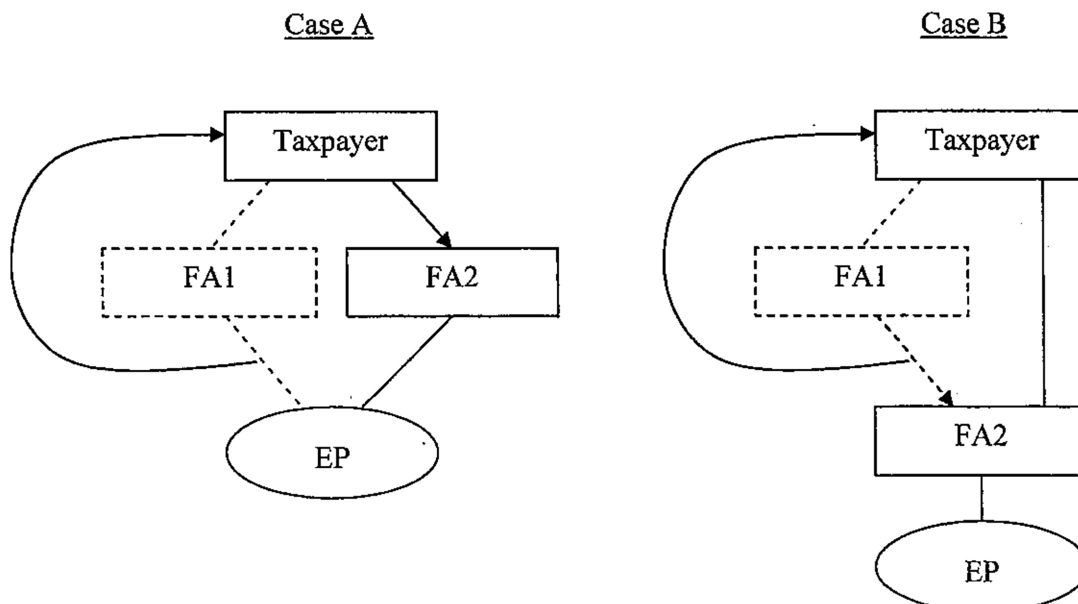
outside its parameters. By bringing the property directly into Canada on a rollover basis, the taxpayer has permanently conceded taxing jurisdiction in respect of the latent gain to Canada. Moreover, since rollover treatment in this context results in the "importation" of latent gain, and therefore cannot adversely affect the Crown, it is our view that it should be permitted regardless of the taxpayer's percentage interest in the liquidating foreign affiliate.

- The timing rules applicable in this regard for surplus computation purposes should be structured so that they clearly permit the use, pursuant to subsection 93(1), of surplus arising from dispositions that occur in the course of the liquidation. This is the case in our view under the current version of Regulation 5907(9), but may not be the case under proposed Regulation 5907(9) as currently worded. Moreover, assuming that this concern were addressed (for example, by adding a timing rule into proposed Regulation 5907(9)(b)(i) deeming the disposition to have occurred "immediately before the end of the affiliate's taxation year deemed to have ended by paragraph (a)", like the rule under current law), it would also be necessary to ensure that the resulting surplus would be available under subsection 93(1).

- The final liquidation and dissolution of a foreign affiliate should release any "suspended" income or gain it may have, such that these items may be taken into account for final surplus computation purposes as described above. If these "suspended" items are not released at this time, they will be lost, which is inappropriate. More importantly, however, we note that since income and gains are not and should not be "suspended" where they arise from dispositions resulting from liquidation distributions into Canada, the liquidation of a foreign affiliate should release any of its "suspended" income or gains. Consider the following comparison:



In Case A, FA1 distributes excluded property to the taxpayer on its final liquidation, thereby realizing all accrued income and gains, and corresponding surplus, which is available for subsection 93(1) purposes. The cost to the taxpayer of the property equals its value, and the taxpayer does not realize any taxable income or capital gain from the disposition of its FA1 shares because a subsection 93(1) election is made (this assumes the taxpayer's ACB of its FA1 shares was not less than FA1's ACB and other cost of its property). The taxpayer then transfers the property to FA2, in exchange for shares of FA2, resulting in the taxpayer having ACB equal to value in the FA2 shares, and FA2 having ACB and other cost equal to value in the underlying property. Arguably, it should be possible to achieve the same results and tax attributes in Case B, where the order of steps is simply reversed but the corporate and commercial result is identical. That is, FA1 first transfers the property to FA2, then distributes the FA2 shares to the taxpayer on its liquidation. Any "suspended" income or gain that arose on the preliminary transfer to FA2 should be released and be available on the liquidation of FA1 in the same manner as it would be if such income and gain had been realized on the liquidation as such rather than on the preliminary transaction.

We would also draw your attention to the more technical points we raise in relation to foreign liquidation as set out in the Appendix hereto.

Distributions

The Legislative Proposals would substantially expand the circumstances in which corporate property can or must be distributed to its shareholders on a non-recognition or rollover basis outside of the context of a liquidation of the distributing corporation. More specifically, new rules would be introduced governing the distribution of the property of a foreign affiliate by way of a dividend or other distribution in kind, or on the redemption, acquisition or cancellation of a share of the distributing affiliate, whether into Canada (as contemplated by proposed subsection 88(3)) or to another foreign affiliate of the relevant taxpayer (as contemplated by proposed paragraphs 95(2)(e.3) to (e.5)).

In general terms, a fair market value disposition would be prescribed in respect of distributions into Canada (as contemplated by proposed subsection 88(3)), except in respect of the distribution of shares of another affiliate that constitute excluded property, unless an RCB election is made, as discussed above in the context of liquidations. In the foreign-to-foreign context (as contemplated by proposed paragraphs 95(2)(e.3) to (e.5)), rollover treatment would be prescribed in respect of dispositions of excluded property (with FAPI treatment for any income or gain resulting from an RCB election), and a fair market value disposition would be prescribed in respect of distributions of non-excluded property.

As noted above, it is our view that such a bias is inappropriate in this context. The rules should be even-handed as between distributions of excluded property and non-excluded property (that is, a rollover should be available in either case), although we would understand that income

and gains resulting from RCB elections in this context from foreign-to-foreign dispositions of excluded property could in some cases be subjected to "suspended surplus" treatment as described above. Indeed, it seems somewhat curious that a rollover would be available for non-excluded property distributed on a liquidation governed by proposed paragraph 95(2)(e.1), but not available in respect of the same property distributed to the same shareholder by way of a dividend in kind governed by proposed paragraph 95(2)(e.3).[14]

It is respectfully submitted that these proposed amendments should be structured in a manner which is consistent with the following principles, in addition to those articulated above in relation to internal dispositions and liquidations:

- As a default, property distributed by a foreign affiliate to the taxpayer (as contemplated by subsection 88(3)), that constitutes shares of another foreign affiliate of the taxpayer (or of a corporation that would as a result of the distribution become another foreign affiliate of the taxpayer), should be deemed to be disposed of at its cost amount, regardless of whether or not the shares are excluded property. The taxpayer should be permitted to make a RCB election, and any income or gain that results therefrom should give rise to a FAPI inclusion only if the property is not excluded property. Any such income or gain should not be "suspended" for surplus computation purposes. If the property is distributed by way of a dividend in kind (including deemed dividends), there is no concern with respect to the taxpayer "cherry-picking" the exempt surplus resulting from the RCB election, because the amount of the dividend will increase in the same amount as the distributing affiliate's proceeds are increased by the RCB election.[15] If the property is distributed on a redemption, acquisition or cancellation of shares of the distributing affiliate, or as a return of capital, and the taxpayer makes a subsection 93(1) election, this "cherry-picking" concern does not really arise in the same way because current-year surplus cannot be used in the context of a subsection 93(1) election (except on a liquidation)[16] and, in any event, can be addressed at least in part by requiring the taxpayer to elect an amount which is not less than the lesser of the gain resulting from the RCB election and the gain otherwise resulting from the disposition of the shares of the distributing affiliate, as noted above.

[14] The same can be said in respect of distributions governed by subsection 88(3) – that is, that it seems somewhat curious that a rollover would be available for non-excluded property distributed on a liquidation governed by proposed paragraph 95(2)(e.1), but not available in respect of the same property distributed to the same type of shareholder in the context of a transaction governed by subsection 88(3), be that a liquidation or other distribution.

[15] It should be noted that the dividend would be considered to have been paid out of surplus arising from the RCB election only to the extent that the dividend is paid after the first 90 days of the affiliate's taxation year, in accordance with Regulation 5901(2).

[16] See Regulations 5901(2) and 5907(9).

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- As for the amount and character of the dividend, distribution or proceeds from the Canadian taxpayer's perspective, we would make the following recommendations:

  - All amounts should be determined as a function of the deemed proceeds of disposition of the distributed property to the distributing affiliate.

  - Amounts distributed legally as dividends in kind should be characterized as dividends.

  - Amounts distributed legally other than as dividends in kind or redemption or other disposition proceeds (i.e., distributions in the form of returns of capital or other legal distributions of property) should be characterized as returns of capital to the extent that the recipient is recovering the cost of its investment – that is, to the extent of the ACB to the recipient of the shares of the distributing affiliate on which such distributions are made – with any excess being characterized as a dividend (and, in turn, as an exempt surplus, taxable surplus or pre-acquisition surplus dividend, in accordance with applicable ordering rules).[17] This approach would permit a shareholder to recover its actual cost of an investment, but would not permit the legal capitalization of retained earnings to be extracted as capital gains. To be clear, it is our view that legal distributions (as opposed to improper appropriations) exceeding the amounts treated as returns of capital should result in deemed dividends, and not result in non-dividend income to the taxpayer or any subsection 15(1) or similar benefit inclusion.

  - Finally, redemption or other disposition proceeds should be characterized as such, except to the extent that a subsection 93(1) election is made.

- Similar principles should be applicable in the context of foreign-to-foreign distributions to specified purchasers (as contemplated by proposed paragraphs 95(2)(e.3) to (e.5)), subject to the following:

  - Income and gains resulting from a RCB election in respect of excluded property should not result in FAPI attribution, but rather in "suspended surplus" as described above, treated in the same manner as taxable surplus unless and until a

[17] Moreover, we understand that the Department is presently considering the adoption of a specific definition of "paid-up capital" which would be applicable for these purposes (and which we will refer to as "foreign paid-up capital" or "FPUC"), and that this definition would include all amounts contributed to a corporation by a shareholder or as consideration for the issuance of its shares (whatever the designation of those amounts may be for foreign corporate law purposes, be it "share premium", "contributed surplus" or some other designation). We believe the cost-recovery approach suggested above would be a simpler and more appropriate approach in these circumstances.

relevant release event occurs – unless the taxpayer elects FAPI treatment.[18] Moreover, it seems inappropriate, and not even-handed, for the proposed description of B in the definition of FAPI to continue to include a portion of gains arising from the disposition of excluded property in certain reorganization circumstances, when the proposed description of E in the definition of FAPI is being amended to specifically exclude losses arising from the disposition of excluded property in such circumstances.

- Redemption or other disposition proceeds should be characterized as such, except to the extent that a subsection 93(1) election is made or is deemed to be made in accordance with proposed subsection 93(1.1).

- Taxpayers should be permitted to suppress the recognition of gains arising in respect of shares that are not excluded property and which arise in respect of a transaction governed by proposed paragraph 95(2)(e.3) to (e.5), whether by reason of the application of subsection 40(3) or otherwise.

- Gains arising in respect of shares that are excluded property, whether by reason of the application of subsection 40(3) or otherwise, should simply be subjected to the "suspended surplus" rules described above.

We would also draw your attention to the more technical points we raise in relation to foreign distributions as set out in the Appendix hereto.

Surplus Adjustments and Subsection 93(1) Elections

The Legislative Proposals introduce a number of significant changes to the provisions that determine when and to what extent the surplus balances of an affiliate, or group of affiliates, whose shares are disposed of, may be accessed, other than by paying dividends, in accordance with subsection 93(1). These proposals limit the amount of a subsection 93(1) election to the lesser of the proceeds of disposition of the disposed share and the amount "prescribed", determined by reference to a new "consolidated net surplus" regime. This new regime is intended essentially to offset available surplus by the amount of any deficits in the relevant foreign affiliate chain. In addition, a new adjustment rule would reset the surplus, deficit and underlying foreign tax balances of the relevant affiliates in the event that a subsection 93(1) election is or is deemed to be made in respect of most internal dispositions, and another rule would adjust the ACB of the relevant inter-affiliate shareholdings for certain purposes to reflect these resets and adjustments.

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[18] This would also address a concern which has been raised relating to the permanent disappearance of surplus where excluded property is distributed to a non-resident shareholder in which the taxpayer has no direct or indirect equity interest, if the distribution occurs on a rollover basis.

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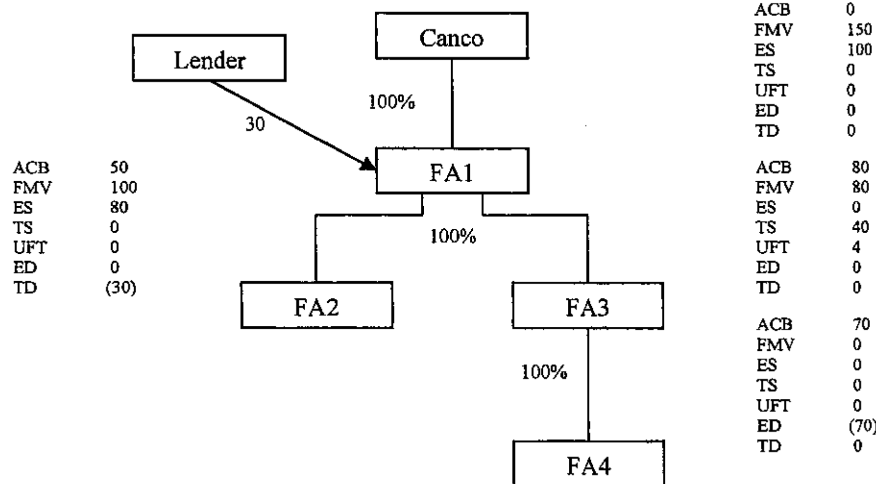
Amount of Election – Proposed Regulation 5902(1)

Under the current rules, where subsection 93(1) applies in respect of the disposition of the shares of a particular affiliate, the surplus of the affiliate is determined by assuming that each other affiliate in which the particular affiliate had an equity percentage had paid dividends on its shares equal to its net surplus, seriatim beginning with the lowest-tier affiliate. Where the disposed affiliate is in a corporate chain including affiliates with deficit accounts (positioned above affiliates with surplus balances, such "blocking deficits" offset the surplus balances in the course of the hypothetical upwardly cascading distributions. However, where the corporate chain includes affiliates with deficit accounts positioned below or level with affiliates with positive surplus balances (what might be referred to as "dangling deficits"), the deficit accounts do not offset the surplus balances. In contrast, under the proposed amendments to Regulation 5902(1), surplus will be consolidated with deficits in all cases to produce "consolidated exempt surplus", "consolidated exempt deficit", "consolidated taxable surplus", "consolidated taxable deficit" and "consolidated net surplus".

More specifically, where a subsection 93(1) election is or is deemed to be made by a taxpayer, the amount prescribed, for purposes that subsection in respect of the disposed share is not to exceed the amount that would be received on that share immediately before the disposition if the disposed affiliate paid a dividend at that time on all of its shares, the total of which is equal to its consolidated net surplus in respect of the taxpayer immediately before the dividend time. The disposing affiliate's consolidated net surplus is defined to be the amount, if any, by which the total of the disposing affiliate's exempt and taxable surplus exceeds the total of the its exempt and taxable deficits, all computed in respect of the taxpayer. The disposing affiliate's consolidated exempt surplus is the total of its own exempt surplus and its proportionate share of the exempt surplus of each underlying affiliate in which it has a direct or indirect equity percentage. For this purpose, the exempt surplus of each affiliate is determined on the assumption that the affiliate had no exempt deficit, no taxable surplus and no taxable deficit. The affiliate's consolidated taxable surplus, consolidated exempt deficit, consolidated taxable deficit, and consolidated underlying foreign tax are similarly determined. For purposes of determining the portion of the whole dividend arising from the subsection 93(1) elected amount that is, for example, prescribed to be paid out of the disposing affiliate's exempt surplus, such exempt surplus is deemed to the amount, if any, by which the affiliate's consolidated exempt surplus exceeds its consolidated exempt deficit, and so on. Consider the following example:

Example A



Assumptions:

- Canco sells 100% of FA 1 (100 shares) to an unrelated non-affiliate for cash of $150.

Under the current rules, FA1 would be deemed, for purposes of a subsection 93(1) election, to have (i) ES of $150 (being its own ES of $100 and ES of $50 from FA2; (ii) TS of $40 from FA3; and (iii) UFT of $4, also from FA3. The ED of $140 in FA4 would be ignored, but the TD in FA2 would reduce its net surplus, and therefore its available exempt surplus. Under current Regulation 5902(1), Canco would presumably make a subsection 93(1) election of $150, all of which would be prescribed to be paid out of ES, and would have no resulting capital gain.

Under proposed Regulation 5902(1), FA1 would be deemed, for purposes of a subsection 93(1) election, to have (i) consolidated ES of $180 (being its own ES of $100 and ES of $80 from FA2); (ii) consolidated TS of $40 (from FA3); (iii) consolidated ED of $70 (from FA4); and (iv) consolidated TD of $30 (from FA2). FA1's consolidated net surplus would be $120 ($180 + $40 – $70 – $30), with the result that the amount of its "attributed net surplus" in respect of each disposed share (the "amount prescribed") would be $1.20. In total, the subsection 93(1) election would be limited to $120. For purposes of determining the surplus accounts out of which the deemed dividend would be prescribed to be paid, FA1 would be deemed to have ES of $110 ($180 - $70), TS of $10 ($40 - $30) and UFT of $4. Although all of the subsection 93(1) election amount of $120 would be fully deductible under subsection 113(1), the result under the proposed changes would be that Canco realizes a capital gain of $30.

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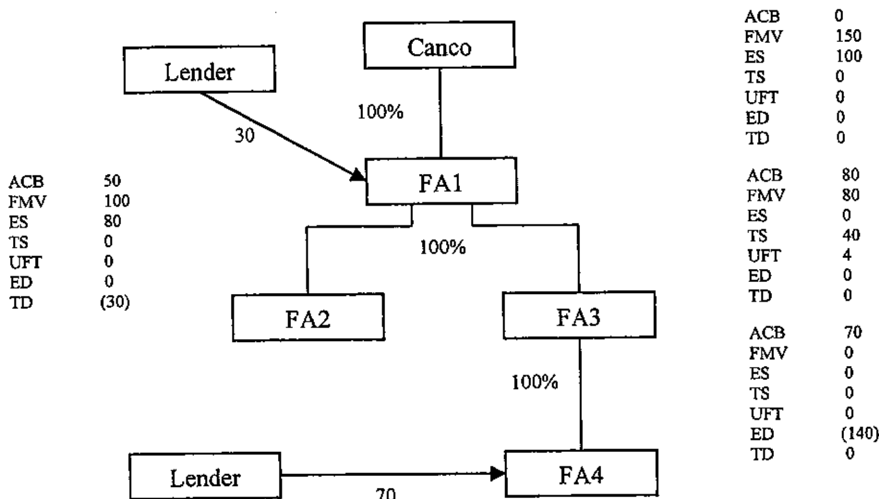
Joint Committee's Comments

While the proposed amendments to Regulation 5902(1) may seem logical at a high level (for instance, in Example A, there is a $30 unrealized gain in the structure – in FA3 – and Canco realizes a capital gain of $30), they appear to suffer from at least one important flaw, namely the possibility of effectively attributing to a shareholder a portion of an affiliate's deficit which exceeds the shareholder's economic loss in respect of its investment in the affiliate. To illustrate this result, assume in Example A that FA4's deficit had been financed with $70 of borrowed capital from a 3rd Party lender. The facts would look as depicted below, the only differences being that FA4's ED is $140 rather than $70 and it has borrowed capital of $70:



In such a case, FA3's economic loss in respect of its investment in FA4 would still be $70 (like in Example A), but under the Legislative Proposals $140 of ED would be attributed. That is, under proposed Regulation 5902(1), FA1 would be deemed, for purposes of a subsection 93(1) election, to have (i) consolidated ES of $180 (being its own ES of $100 and ES of $80 from FA2); (ii) consolidated TS of $40 (from FA3); (iii) consolidated ED of $140 (from FA4); and (iv) consolidated TD of $30 (from FA2). FA1's consolidated net surplus would be $50 ($180 + $40 – $140 – $30), with the result that the amount of its "attributed net surplus" in respect of each disposed share (the "amount prescribed") would be $0.50. In total, the subsection 93(1) election would be limited to $50. For purposes of determining the surplus accounts out of which the deemed dividend would be prescribed to be paid, FA1 would be deemed to have ES of $40 ($180 - $140), TS of $10 ($40 - $30) and UFT of $4. Although all of the subsection 93(1) election amount of $50 would be fully deductible under subsection 113(1), the result under the proposed changes would be that Canco realizes a capital gain of $100. This result is inappropriate because there is still only a $30 unrealized gain in the structure – in FA3. Thus, Canco is being taxed on a "phantom gain" – that is, a gain that does not exist.

Viewed from a slightly different perspective, it is submitted that it would be inappropriate for more than $70 of FA4's deficit to be attributed to FA3, and then to FA1. However, the test under the Legislative Proposals is based on the amount that FA3 would receive from FA4 if FA4 paid a dividend equal to its "consolidated exempt deficit". The fact that this amount could exceed FA3's true economic loss does not enter into the equation. Thus, the proposed amendments over-attribute lower-tier deficits to higher-tier affiliates. Such untoward effects may, in appropriate cases, be avoidable[19] - but, arguably, should not arise in the first place. The structural flaw in this regard in the Legislative Proposals would appear to arise because of the fallacy that shareholders participate in profits to the same extent that they participate in losses. This is false in the case of shareholders of a limited liability company – indeed, that is the entire point of limited liability – to permit shareholders to participate in unlimited economic "upside" with limited exposure to economic "downside". Moreover, even if a shareholder has guaranteed the company's obligations, there is no structural need to attribute deficit on the shares in an amount exceeding the economic loss on the shares, since the shareholder should have a loss on the guarantee. Similarly, if deficit is attributed on the shares in an amount exceeding the economic loss on the shares because of a guarantee, such over-attribution should never exceed the amount guaranteed, and provision should be made to ensure that the shareholder's loss on the guarantee does not result in deficit duplication. Surely, we should be as concerned about deficit duplication as we are about surplus duplication – even-handedness.

Other aspects of this approach also seem to be capable of producing inappropriate results. To illustrate, in Example A, while it is clear that there has been a loss of $70 (the $70 that was invested in FA4), it is not clear that this loss ought to be considered to have eroded any of the exempt surplus in the chain – that would be the case to the extent that the $70 investment in FA4 was funded with a reinvestment of ES earned by FA3, but not the case to the extent that the $70 investment in FA4 was funded with a reinvestment of TS earned by FA3. In Example A, the proposed amendments would seem to allocate the $70 loss against ES as to $40 (reducing the ES dividend from $150 to $110), and against TS as to $30 (reducing TS from $40 to $10). These are not necessarily the appropriate amounts.

These flaws are inherent in the structural mechanics of determining consolidated net surplus, which includes all deficits within the group of relevant affiliates regardless of where in the group the deficits are located or how they are financed. The result is different than the result that would be obtained if dividends where paid up the chain of affiliates. In this respect, the proposed amendments represent a fundamental change to what subsection 93(1) was originally enacted to accomplish, which was to be a proxy for an actual dividend that could be paid up the chain (in Example A, from FA2, FA3 and FA4 to FA1 and then to Canco). As is evident from Example A, that may no longer be the case. Canco could eliminate the capital gain of $30 that would otherwise arise as a result of the proposed amendments if immediately prior to the sale of

[19] For example, it may be possible in certain circumstances to avoid such over-attribution of "dangling deficits" by first selling affiliates that have deficits exceeding the relevant economic loss.

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the FA1 shares, FA2 paid a dividend to FA1 from exempt surplus of $50 followed by a dividend of $150 from FA1 to Canco. This would presumably reduce Canco's proceeds on the sale of the FA1 shares and the capital gain. No Canadian tax would therefore be exigible, which is the result under the current rules, but the dividends from FA2 and FA1 could potentially be subject to foreign withholding tax. In this sense, this proposal would seem to put Canadian multinationals and the Canadian economy in a disadvantageous position, in that it would create an incentive to incur foreign withholding tax to the extent that the amount of such tax would be lower than the Canadian capital gains tax that would be payable if no dividend were paid. Surely, it cannot be in the interests of Canadians to create incentives for Canadian multinationals to incur foreign withholding tax costs – and this is the very foundation of subsection 93(1).

Applicability of a subsection 93(1) election

Subsection 93(1.4)

Pursuant to proposed subsection 93(1.4), no election can or will be deemed to be made under subsection 93(1) or (1.2) by a corporation in respect of the disposition of a share of a foreign affiliate if any of the specified provisions referred to in that subsection applies to the disposition. These are: paragraph 88(3)(a) and subparagraphs 95(2)(d)(i), (d.1)(i), (e)(i), (e.1)(i), (e.2)(i),[20] (e.3)(i), (e.4)(i) and (e.5)(i) (these subparagraphs are discussed above and in the Appendix hereto). Interestingly, neither paragraph 95(2)(c) nor proposed paragraph 95(2)(c.2) is mentioned (these paragraphs are also discussed above and in the Appendix hereto).

The purpose of subsection 93(1.4) seems to be to permit the subsection 93(1) election in respect of dispositions at the shareholder level (indeed, to require it where subsection 93(1.1) applies – where the disposition is by a foreign affiliate of a corporation), but not at the level of corporate assets disposed of in the context of a foreign merger, liquidation or distribution.[21]

Subsection 93(1.1)

The Legislative Proposals expand subsection 93(1.1) such that it will apply whenever shares of a foreign affiliate of a corporation resident in Canada are disposed of by another foreign affiliate of the corporation, whether or not the shares constitute excluded property. The proposed amendment would also eliminate the exclusion from subsection 93(1.1) in respect of dispositions to which any of paragraphs 95(2)(c), (d) or (e) applies. It would render subsection 93(1) applicable in <u>all cases</u> where a share of a foreign affiliate of a corporation is disposed of by another affiliate, subject to the limitations in proposed subsection 93(1.4) noted above.

Joint Committee's Comments

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[20] The reference to proposed subparagraph 95(2)(e.2)(i) would seem to be inadvertent.

[21] An exception is proposed paragraph 88(3)(a), which we understand is a drafting error.

Subsection 93(1.1) has been expanded to apply in every case where there is a disposition of shares of a foreign affiliate held by another affiliate. This provision was intended to prevent taxpayers from converting undistributed taxable surplus into capital gains, with consequent surplus apportionment. If it is appropriate in policy terms to extend the application of this rule, on the basis that underlying surplus should always be apportioned to the same account at the shareholder affiliate level, then it seems difficult to understand why that would not be true in all cases. We are not clear on why subsection 93(1.4) is necessary or what purpose it serves.

The restrictions in subsection 93(1.4) on the application of subsection 93(1) seem to relate to assets of a merging, liquidating, distributing affiliate. We are not clear on why this is necessary. What if the property being distributed is shares of another FA, and there is no disposition of the shares of the distributing affiliate on that distribution? Moreover, even where the distribution results in a disposition of the shares of the distributing affiliate, it seems inappropriate to preclude a subsection 93(1) deemed dividend with respect to distributed property – i.e., shares of another affiliate, since those shares will not be owned by the distributing affiliate at the time of the disposition of the shares of the distributing affiliate, such that the underlying surplus will be completely unavailable.

It is submitted that proposed subsection 93(1.4) should be withdrawn.

Post-Election Adjustments – Proposed Regulations 5902(3) and 5905(2), (4), (5) and (8)

Apart from an additional reference to Regulation 5902(4), Regulation 5902(3) is essentially unchanged, and therefore continues to preclude an adjustment to surplus in respect of a subsection 93(1) deemed dividend, except as provided in Regulations 5905(2), (4), (5) and (8).[22] These latter provisions govern adjustments to be made in respect of certain redemptions, cancellations or acquisitions of foreign affiliate shares, certain foreign mergers involving affiliates, certain Canadian transactions involving interests in foreign affiliates, and certain other dispositions to other foreign affiliates or related persons. The revisions to each of these provisions are substantially similar, and are discussed immediately below in the context of Regulation 5905(8) – sale of shares of a foreign affiliate to another foreign affiliate.

Current Approach

Under the current rules, where a subsection 93(1) deemed dividend arises in respect of a relevant sale of shares, Regulation 5905(8) makes corresponding adjustments to the surplus accounts of the affiliate whose shares were disposed of, which could result in such accounts becoming a deficit, but no adjustments are made to the accounts of any lower-tier affiliates, even though the amount of the deemed dividend would reflect the attribution of their exempt and taxable surplus. This is not an illogical approach, and in fact has operated relatively well over a number of decades. It is appropriate for no adjustment to be made to the accounts of lower-tier

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[22] The reference to Regulation 5905(5) should probably be a reference to Regulation 5905(6).

affiliates because the value which corresponds to the lower-tier surplus taken into account at the top tier has not in fact been extracted, and remains within the lower-tier affiliates. That lower-tier surplus will also be required in the future in order to in fact distribute that value without eroding the ACB of the shares of the relevant lower-tier affiliates.

However, it is understood that the Department of Finance had perceived concerns with respect to this "separation" of surplus and corresponding deficit, and accordingly is proposing to introduce a more comprehensive and complex "balance adjustment" mechanism under revised Regulation 5905, which would produce adjustments at all relevant tiers.

Proposed Approach

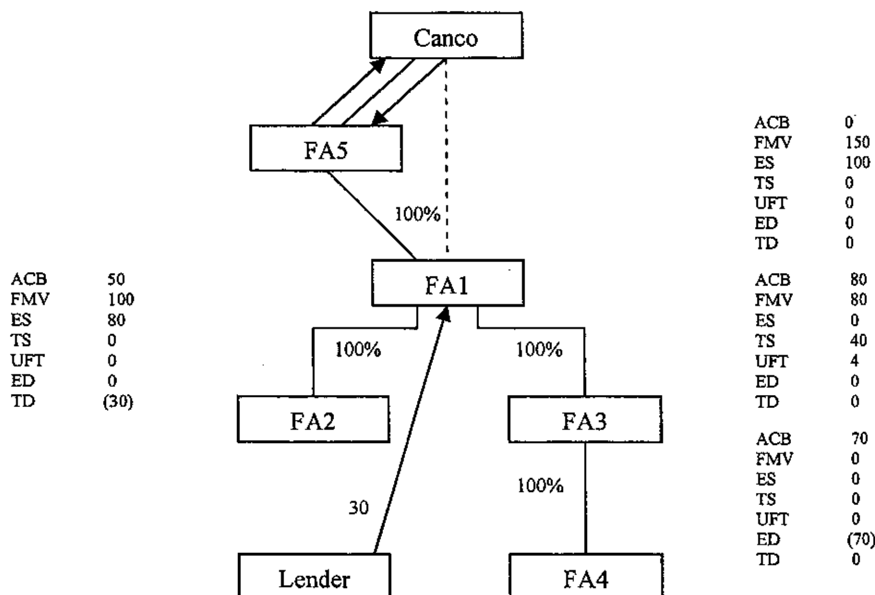
Proposed regulation 5905(8)(a) will essentially require the exempt surplus portion of the 93(1) elected dividend amount to be allocated (through an "exempt surplus reduction" amount) proportionately to, and reduce the ES of, each foreign affiliate in the relevant chain that had a balance of exempt surplus at the dividend time. The proportionate amount for a particular affiliate is determined by the formula A/B, where A is the particular affiliate's ES that can reasonably be considered to have been included in the consolidated ES of the affiliate whose shares were disposed of (such affiliate is referred to as the "issuing affiliate"), and B is the issuing affiliate's consolidated ES.[23] Proposed regulation 5905(8)(a) will require the taxable surplus portion of the elected amount to be allocated (through a "taxable surplus reduction" amount) proportionately to each foreign affiliate in the relevant chain that had a balance of taxable surplus in a manner similar to the ES allocation.

When a subsection 93(1) election is made on the internal sale of a FA share, Regulation 5905(8)(a) will reduce the exempt and taxable deficit of an affiliate in the chain to *nil*, and will require a corresponding proportionate reduction in the exempt and/or taxable surplus balances for those affiliates in the chain that have exempt and/or taxable surplus balances. If the issuing affiliate had consolidated ES in excess of its consolidated ED, the exempt deficits that are eliminated will be allocated (through "exempt deficit reduction" amounts) proportionately to those affiliates that had a balance of ES. If the issuing affiliate had, for example, consolidate ED in excess of its consolidated ES, each affiliate that had a balance of ES will have that balance reduced to *nil* (through the "exempt deficit reduction" amounts), and the excess of the issuing affiliate's consolidated ED over its consolidated ES will be allocated (through "exempt deficit

[23] The proportionate amount so determined is then adjusted for a specified adjustment factor for the particular affiliate. This factor is determined by the formula X/Y, where X is (a) where Canco disposed of the shares, 100%, and (b) when another affiliate disposed of the shares, the surplus entitlement percentage ("SEP") of Canco in that other affiliate immediately before the disposition; and Y is Canco's SEP in the particular affiliate immediately before the disposition.

allocation" amounts) proportionately to those affiliates that had a balance of TS. Similar rules apply to the allocation of TDs that are reduced to *nil*.[24]

Example B



Assumptions:

- Canco sells 100% of FA 1 (100 shares) to FA5 for cash of $120 and shares of FA5, and Canco makes subsection 93(1) election for $120.

As noted in Example A, for purposes of subsection 93(1) under current rules, FA1 would be deemed to have ES of $150, TS of $40 and UFT of $4. A subsection 93(1) election of $120 would result in a dividend prescribed to be paid solely out of ES, and FA1's $100 of ES would become an exempt deficit of $20, and no adjustment would be made to the surplus accounts of FA2, FA3 or FA4. Thus, on a "consolidated basis", the FA1/FA2/FA3 group would have (net) ES of only $30 and (net) TS of $40, which would be appropriate. The fact that FA2 would still have $50 of (net) ES would also be appropriate, because FA2 would still have the value corresponding to that ES, and would need that ES in order to be able to pay a dividend to FA1 equal to $50 without eroding FA1's ACB in FA2. Once that dividend is paid, the $20 blocking deficit in FA1 would result in FA1 having ES of $30, which again is appropriate. In a similar

[24] If the issuing FA had consolidated TD in excess of consolidated TS, the excess would be proportionately allocated to, and reduce, the other affiliates' ES through the "taxable deficit allocation" amounts.

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vein, when FA3 pays a $40 TS dividend to FA1, it will result in FA1 having ES of $30 and TS of $40 (as well as UFT of $4), which again is appropriate

As indicated in Example B, under the proposed rules, the subsection 93(1) elected dividend amount of $120 would be prescribed to be a $110 ES dividend and a $10 TS dividend, and the following adjustments would be made:

- The $110 ES portion would be allocated proportionately between FA1 and FA2. FA1's consolidated ES is $180 and consists of FA1's ES of $100 and FA2's ES of $80. FA1's proportions of the consolidated ES is 55% (100/180) and FA2's proportion is 45% (80/180). The $110 ES dividend amount would be allocated $61 to FA1 and $49 to FA2, and reduces the ES of these affiliates accordingly (these reductions are the "exempt surplus reduction" amounts).

- The TS portion ($10) of Canco's subsection 93(1) elected amount ($120) would be allocated solely to FA3, and would be the "taxable surplus reduction" amount for FA3.

- The $70 ED of FA4 would be reduced to *nil*.

- Since FA1 had a "consolidated exempt deficit" of $70, and had consolidated ES in excess of this amount, this deficit is "allocated" proportionately to FA1 and FA2 (55%, or $39, to FA1, and 45%, or $31, to FA2), and these amounts are the "exempt deficit reduction" amounts to FA1 and FA2.

- Similarly, the $30 TD of FA2 would be reduced to *nil*, and since the consolidated TS of FA1 exceeds its consolidated TD, FA2's TD of $30 would be allocated to FA3 through the "taxable deficit reduction" amount.

- In summary, FA1's ES of $100 would be reduced to *nil* (by the $61 exempt surplus reduction amount and the $39 exempt deficit reduction amount. FA2's ES of $80 would be reduced to *nil* (through the $49 exempt surplus reduction amount and the $31 exempt deficit reduction amount). FA3's TS of $40 would be reduced to *nil* (through the $10 taxable surplus reduction amount and the $30 taxable deficit reduction amount). FA2's TD of $30 and FA4's ED of $140 would also be reduced to *nil*.

Joint Committee's Comments

As noted, we understand that the proposals described above are intended to mitigate possible abuses of the current rules where, as a result of a 93(1) election, a deficit is created within a group of affiliates that is subsequently avoided or eliminated resulting in the effective duplication of, in particular, exempt surplus.

The Committee submits that these perceived concerns would largely be addressed by the proposed revisions to Regulation 5905(7) concerning the elimination of blocking deficits on the

liquidation of an affiliate, and that the addition of these added measures will introduce a significant degree of unnecessary complexity into the foreign affiliate rules, and unnecessarily increase the compliance burden on taxpayers, as well as the administrative burden on the Crown. Further, these proposals, and those discussed below, include a number of significant structural and technical deficiencies.

As a result of these proposals, a subsection 93(1) election could change the make-up of the surplus accounts within a particular group of affiliates in ways that, unlike under the current system, may not be particularly intuitive, or particularly appropriate. In Example B, Canco extracted $120 of cash from FA5 free of Canadian tax, but the subsection 93(1) election of $120 reduced all surplus and deficit accounts of the relevant affiliates to *nil*. If Canco had transferred the FA1 shares to FA5 solely for shares, Canco could have subsequently extracted, free of Canadian tax, $150 of cash from FA5 through the actual payment of ES dividends ($50 from FA2; $100 from FA1). Moreover, in Example B, if Canco had only transferred one FA1 share to FA5 for cash of $1.20, and Canco made a subsection 93(1) election for the $1.20, the ES reduction amount for FA1 and FA2 would only aggregate $1.10, but the ED reduction amount to FA1 and FA2 would still be the $70 amount noted above. As a result of a subsection 93(1) election of $1.20, for subsequent dividend purposes the combined ES of FA1 and FA2 would be reduced to $108.90. It is submitted that this result is completely inappropriate, and is an example of the structural deficiencies inherent in these proposals.

It should be noted also that there may be circumstances in which the proposed amendments would give rise to planning opportunities in this regard. Consider the following example.

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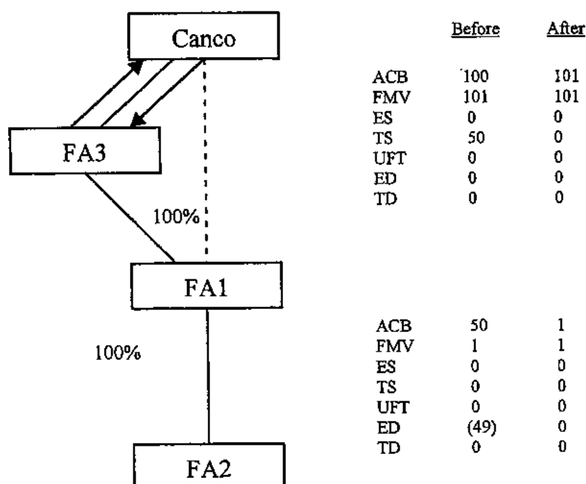
Example C



	Before	After
ACB	100	101
FMV	101	101
ES	0	0
TS	50	0
UFT	0	0
ED	0	0
TD	0	0

	Before	After
ACB	50	1
FMV	1	1
ES	0	0
TS	0	0
UFT	0	0
ED	(49)	0
TD	0	0

Assumptions:

- Canco transfers FA1 to FA3 for $101 cash, and Canco makes a subsection 93(1) election for $1 (deemed to be a TS dividend).

Under proposed regulation 5905(8)(a), FA2's ED of $49 would be reduced to *nil*, and would be applied against FA1's TS. If FA2 subsequently became profitable, ES dividends could immediately begin being paid out through FA2 and FA1. In contrast, if this "balance adjustment" transaction were not carried out, FA2 would have to first accumulate exempt earnings equal to its ED before any ES dividends could be paid by FA2.[25] Again, the structural aspects of these proposals give rise to results that would seem to be inappropriate.

Finally and perhaps most important, these proposed changes are exceedingly complex and are virtually impossible for taxpayers to understand. The complexity starts with the Department's proposal requiring the computation of consolidated net surplus for the relevant group and then requiring the surplus and deficit balances for each member of the group to be adjusted.[26] We refer to the presentation at the conference hosted by the Canadian Branch of the International Fiscal Association on May 10, 2004, during which the Department provided an example of the computation of consolidated net surplus and the adjustments that would need to be made to the surplus accounts of foreign affiliates in a hypothetical transaction. We refer also

[25] It should be noted also that there would be a downward adjustment to FA1's ACB in FA2 (for certain purposes), equal to the amount by which FA2's deficit has been reduced, in accordance with the rules in proposed subsections 92(1.1) to (1.4) and Regulation 5911. See the discussion below.

[26] A further complication, as discussed below, there is also a requirement to adjust the ACB of the shares of the affiliates in the group.

to the examples considered above. We submit that there would be few, if any, taxpayers, that would have been able to prepare such calculations in advance of such a transaction in actual practice, and therefore few, if any, that would have been able to understand or predict the effects that the 93(1) election would have on their affiliates' surplus accounts.

The uncertainty created by the proposed amendments in this regard arises not only because of the complexity of the provisions, but also because of structural aspects of the proposals. That is, because a subsection 93(1) election would require adjustments to be made in respect of the accounts of all relevant affiliates, not just the issuing affiliate, uncertainty or error with respect to the accounts of a single affiliate will have a cascading effect and could result in uncertainty and error throughout the entire group. This could result in significant problems in the context of a foreign affiliate reorganization in actual practice, and thereby compromise the competitiveness of Canadian multinationals.

Accordingly, it is our submission that this proposed measure be withdrawn. To be clear, it is not our submission that Regulation 5905 should not be updated, or that the various technical issues that exist in that regard should be ignored. For example, there does not appear to be any rule currently in Regulation 5905 that would account for a subsection 93(1) election made in the context of a foreign merger, with the result that surplus can be duplicated in that context. Moreover, there are significant issues relating to the determination of a taxpayer's surplus entitlement percentage under Regulation 5905. There is also no rule that would preserve a deficit in the context of a liquidation of one foreign affiliate into another. These and similar issues should be addressed, but it does not follow that the fundamental architecture of the regime reflected in this regulation should be reoriented.

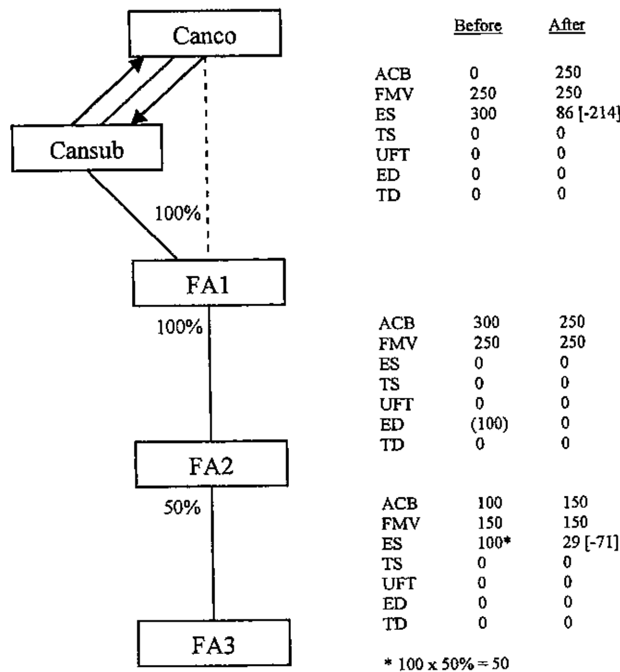
Parallel Regimes – Proposed Regulations 5905(2),(4), and (6)

Parallel regimes would be introduced with respect to subsection 93(1) deemed dividends arising in the context of share redemptions (governed by Regulation 5905(2)) and foreign mergers (governed by Regulations 5905(3) and (4)), and in the context of a disposition by a corporation resident in Canada to a related taxable Canadian corporation (governed by R. 5905(5)(a) and (6)).

With respect to adjustments required for a subsection 93(1) deemed dividend arising on a Regulation 5905(5)(a) transaction (i.e. a sale of shares of a foreign affiliate by a corporation resident in Canada to a non-arms length taxable Canadian corporation), a different approach is proposed in Regulation 5905(6)(a). In particular, the reduction to the exempt and/or taxable surplus of each relevant foreign affiliate to reflect the exempt and/or taxable surplus portion(s) of the subsection 93(1) deemed dividend is not referenced to "exempt surplus reduction" or "taxable surplus reduction" amounts, but rather these reduction amounts are set out in regulation 5905(6)(a). Each of these amounts is computed in a manner similar to the exempt surplus and taxable surplus a reduction amounts.

There also appears to be a deficiency in Regulation 5905(6)(a) with respect to the allocation of relevant affiliates' exempt/taxable deficits. With respect to the allocation of exempt deficits, for example, rather than having both an "exempt deficit reduction" amount and a "taxable deficit allocation" amount, Regulation 5905(6)(a) provides for a "taxable deficit allocation" amount, but also provides for what would otherwise be the "exempt deficit reduction" amount only in a situation where the issuing foreign affiliate has a net consolidated exempt deficit amount.[27]

Example D



Assumptions:

- Canco sells FA1 to Cansub for cash of $250, and makes a subsection 93(1) election for $250 ($2.50 per share) (all deemed to be an ES dividend).

In Example D, FA1 would be deemed to have consolidated exempt surplus of $350, consolidated exempt deficit of $100, and consolidated net surplus of $250. Under proposed Regulation 5905(6)(a)(i)(A), the ES of both FA1 and FA3 would be reduced proportionately to reflect the ES portion ($250) of the subsection 93(1) elected amount. This reduction for FA1 would be $214 (being 300/350 x 250/100%) and for FA3 would be $71 (being 100/350 x 250/.5). Since

[27] In such a situation, the grind to a particular affiliate's ES is the ES amount.

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FA1's consolidated exempt deficit is less than its consolidated exempt surplus, there is no amount determined under proposed Regulation 5905(6)(a)(i)(C). There is also no amount determined under proposed Regulation 5905(6)(a)(i)(D) and Regulation 5905(19), since there is no consolidated taxable deficit. Under proposed Regulation 5905(6)(a)(iv), the ED of FA2 would be reduced to *nil*.

After the Regulation 5905(6)(a) adjustments, the ES of FA1 would be reduced to $86, the ED of FA2 would be reduced to *nil*, and the ES of FA3 would be reduced to $29. Since Canco made a subsection 93(1) election equal to the consolidated net surplus ($250), there should be no ES left in the group. We would expect that Regulation 5905(6)(a)(i)(C) should be modified so that the amount determined in Regulation 5905(6)(a)(i)(C) will be the "exempt deficit reduction" amount as determined under Regulation 5905(17).

Our comments above with respect to the complexity and the compliance burden imposed on taxpayers are relevant here as well.

Basis Adjustments – Proposed Subsections 92(1.1) to (1.4)

In recognition of the fact that decreasing an affiliate's surplus would result in an erosion of the ACB of its shares on a subsequent distribution of the value reflected by that surplus, and in recognition of the fact that deficit duplication could arise as a result of upward deficit attribution because of an inherent loss in the relevant shares, proposed subsections 92(1.1) to (1.4) would introduce a regime that would adjust the ACB of the shares of a particular relevant foreign affiliate (other than the disposed affiliate) to reflect adjustments to its accounts arising because of a subsection 93(1) election. However, these adjustments would only apply (i) to some extent, (ii) only for certain purposes, and (iii) only in respect of shares that are excluded property at the relevant times.

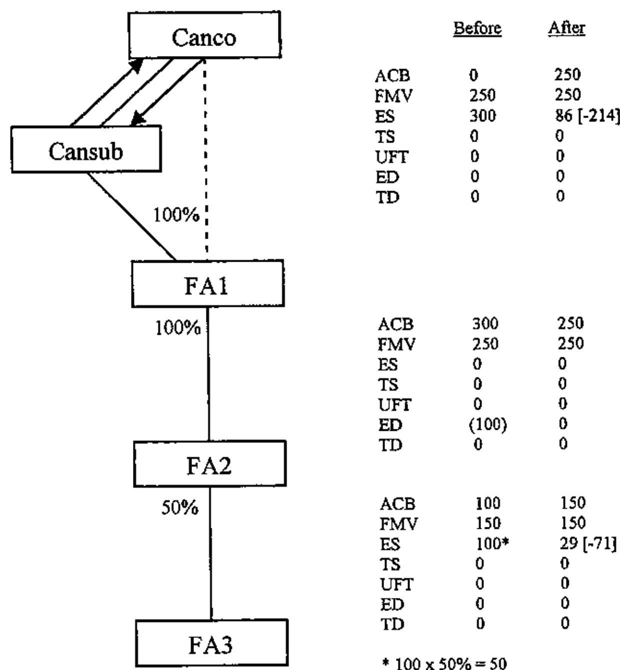
Pursuant to proposed Regulation 5911(1), the amount of the relevant increase to ACB would be the lesser of two amounts. The first would be the amount, if any, by which the FMV of the relevant shares (at the election time) exceeds their ACB. The second amount would be the amount generally determined under Regulation 5911(1)(b), which is the amount (on a per share basis) that the particular affiliate's consolidated net surplus would have been reduced by the Regulation 5905 adjustments if the particular affiliate had been the disposed affiliate.

Similarly, proposed Regulation 5911(2) would prescribe the amount by which the ACB of the shares of a particular relevant foreign affiliate would be reduced to account for the attribution of its deficits. Again, however, this adjustment is the lesser of two amounts. The first is the amount, if any, by which the ACB of the relevant shares exceeds their FMV. The second

amount, determined under Regulation 5911(2)(b), would be the amount (on a per share basis) of the particular affiliate's consolidated net deficit.[28]

In addition, where the relevant share does not have any attributable "consolidated net surplus" or "consolidated net deficit", and therefore no adjustment would be made under proposed Regulation 5911(1) or (2), it appears to be intended that there be an adjustment pursuant to proposed Regulation 5911(3), increasing the ACB of the relevant share by the lesser of any difference between its FMV and its ACB and the amount of any "consolidated net surplus" remaining in the relevant affiliate after the first order adjustments are made as a result of the subsection 93(1) election. The effect and implications of this provision are not clear.

Example E (same as Example D)



Assumptions:

- Canco sells FA1 to Cansub for cash of $250, and makes a subsection 93(1) election for $250 ($2.50 per share) (all deemed to be an ES dividend).

[28] This is not actually an expression defined or used in the proposed amendments, but has been adopted by the authors to refer to the amount by which the total of the relevant affiliate's "consolidated exempt deficit" and its "consolidated taxable deficit" exceeds the total of its "consolidated exempt surplus" and its "consolidated taxable surplus".

Proposed Regulation 5911(1) would prescribe \$0.50 as the amount the ACB of each share of FA3 should be increased under paragraph 92(1.3)(a) (for certain purposes), being the lesser of two amounts, namely

(a) the amount of which the FMV of the share exceeds its ACB (\$0.50); and
(b) the amount(s) by which the consolidated net surplus would have been reduced under Regulation 5905 had the FA3 share been the disposed share (i.e., \$0.71, being A/C x (C – B) = 1.00/100 x (100 – 29)).[29]

With respect to each share of FA2, the amount determined under Regulation 5911(2)(b) would be *nil*, being A/C x (C – B), where A = 0, B = 0 and C = 100. It would appear that the amount under Regulation 5911(1)(b) would also be *nil*, being A/C x (C – B) = 0/0 x (0 – 0).

However, Regulation 5911(3)(b) would not appear to have application for FA2, since the amount determined in both 5911(1)(b) and 5911(2)(b) for FA2 is *nil*, and the amount determined for B in the formula in 5911(1)(b), and for C in the formula in 5911(2)(b), is also *nil*. In any event, the amount determined under Regulation 5911(3) for FA2 would, in this Example, be *nil*, since the FMV of the FA2 shares does not exceed their ACB.

Joint Committee's Comments

The Committee agrees that, conceptually, if the surplus or deficit of an affiliate is adjusted in accordance with the proposed changes to Regulation 5905 discussed above as a result of a 93(1) election, it is appropriate and necessary to adjust the ACB of the shares of the affiliate. However, the purpose, effect and other implications of these provisions are unclear in various respects. The Committee submits that this is, once again, the result of the exceedingly complex nature of the Department's proposals requiring the computation consolidated net surplus and adjusting surplus/deficit balances as a result of a 93(1) election. For example, it is not clear why the "purposes" mentioned in proposed subsection 92(1.4) would not make any reference to the computation of FAPI. The Committee submits these basis adjustments should be made for all purposes of the foreign affiliate rules in the Act and the Regulations, and whether the relevant shares are excluded property, to minimize inordinate tax attribute erosion or deficit duplication.

In addition, it is not clear why the adjustment to ACB of the relevant share, pursuant to Regulation 5911, is restricted in paragraph 92(1.3)(a) to the excess of FMV over ACB and in paragraph 92(1.3)(b) to the excess of ACB over FMV, and not the full amount of the adjustment to the affiliate's surplus/deficit, as the case may be. These provisions seem to assume that the FMV of the shares of a FA will be less than ACB if the FA has a deficit and that the FMV of the shares will be greater than ACB if it has a surplus balance. This is not necessarily the case.

[29] The Committee submits that the reference in Description B in 5911(1)(b) should be to 5902(1)(e)(vi).

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Surplus/deficits could be positively/adversely affected by various timing differences and unrealized gains and losses.

More importantly, the logic reflected in this particular proposal demonstrates that the logic reflected in the proposed corresponding amendments to Regulation 5905 is backwards, in that the amount of the adjustment to the affiliates surplus/deficit should be limited in the first place to the excess of FMV over ACB (in the case of a deficit push-down), and to the excess of ACB over FMV (in the case of a deficit pull-up).[30] As noted above, deficit should never be attributed upwards in an amount exceeding the shareholder's economic loss on the shares. If upward deficit attribution was limited in this manner, then it would make sense and it would be consistent to limit basis adjustments in the same manner – to the difference between ACB and FMV – but such a limitation to basis adjustments is not appropriate if there is no corresponding limitation to surplus and deficit adjustments.

Finally, we would emphasize that the substitution of ACB adjustments for surplus or deficit attributes would not necessarily be appropriate, and would reflect yet another departure from the existing architecture of the system. That is, surplus and deficit attributes are accounted for in the relevant affiliate's calculating currency, but the ACB of its shares would be calculated either in Canadian Dollars or in the shareholder's calculating currency. Thus, if we assume that a particular affiliate has ES of $100 US Dollars, and the ACB of its shares is *nil*, and then its ES is reduced to *nil* and the ACB of its shares is increased by $100 US Dollars – or, rather, by the Canadian Dollar or other calculating currency equivalent of $100 US Dollars at that time – then the amount of value that could subsequently be extracted from that affiliate without any gain or loss at the shareholder level would be the Canadian Dollar or other calculating currency equivalent of $100 US Dollars at that time – that is, the adjustment time, not the subsequent distribution time. Accordingly, if the value of the affiliate's calculating currency (the US Dollar, in our example) increases relative to the Canadian Dollar or its shareholder's calculating currency, then there would be a gain upon the extraction of the original surplus (i.e., the $100 US Dollars). Conversely, if the value of the affiliate's calculating currency (the US Dollar) decreases relative to the Canadian Dollar or its shareholder's calculating currency, then there would be a loss upon the extraction of the original surplus (i.e., the $100 US Dollars). Neither result is appropriate, which explains why the current architecture of the system is configured as it is, and why it should not be reconfigured.

Summary: Joint Committee's Comments on Surplus Adjustments and 93(1) Elections

The Committee respectfully submits that even if it is assumed that the proposed changes with respect to surplus adjustments and subsection 93(1) would improve the current system (and, based on the technical and structural deficiencies noted above, this is far from being the case), it

[30] See Joint Committee's Comments above under *Amount of Election – Proposed Regulation 5902(1)*

must be acknowledged that the price would be a significant increase in the complexity of the foreign affiliate system and in the compliance burden on taxpayers to maintain accurate and up-to-date surplus balances and ACB balances and to make adjustments thereto. In addition, it must be acknowledged that many of the proposed changes go to the very foundation of the system's architecture, and would in many cases give rise to results that are inappropriate.

The surplus balances of any foreign affiliate are difficult to know with any degree certainty at any particular moment in time. Therefore, a transaction that requires knowledge of the surplus balances at the time the transaction is carried out will create greater uncertainty. Even if the relevant foreign tax returns are complete and the surplus balances are computed on the basis of those returns, they are still subject to change as a result of regular day-to-day surplus maintenance. For example, final foreign audit adjustments may only be made years after the taxation year(s) in question ended. Furthermore, surplus balances are open for audit by CRA for all years back to 1972. These issues make it very difficult for a taxpayer to be compliant even before attempting to assess the ability to comply with the 93(1) proposals.

The proposals elevate the importance of the surplus balances of each affiliate, by

- making more affiliates relevant under the consolidated net surplus approach for the purposes of a subsection 93(1) election,
- requiring adjustments to the surplus or deficit balances of each of those affiliates, and
- making the ACB adjustments dependent upon the surplus balances.

However, as indicated above, for various reasons these surplus balances are continually subject to change. By increasing the timely importance of an amount (i.e., a surplus balance), which is already uncertain, the proposals create a system where taxpayers will have to make tax-related decisions despite the inability to know the Canadian income tax results of a particular transaction. In effect, taxpayers are being forced to know the exact surplus balances of their various affiliates regardless of the inherent limitations that prevent such perfect surplus knowledge. As a result, the Committee firmly believes that it will be virtually impossible for many taxpayers to be compliant, not because of unwillingness on their part, but rather because of the inability to cope with (i) the real time certainty of the surplus/deficit balances and ACB calculations that these proposals inherently demand and (ii) the complexity inherent in the relevant provisions that require adjustments to the surplus/deficit balances and the ACB calculations.

In summary, while the Committee acknowledges the Department's concerns with possible abuses under the current 93(1) rules, the proposed approaches contain various technical and structural deficiencies that do not enhance – and, in many cases, compromise – the integrity of the foreign affiliate system. Further, the deficiencies in the current system do not warrant the level of complexity and compliance burden that these proposals would impose. The Committee

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strongly recommends that this proposal to net surplus and deficit accounts at different tiers (and in different currencies) and to substitute ACB adjustments for those attributes should be withdrawn. At a minimum, it is our recommendation that any change to the rules for determining the amount or consequences of a 93(1) election should not result in a burden for taxpayers that will make it nearly impossible for most to understand, let alone comply with the rules. Furthermore, any such changes should not create a bias in favour of paying actual dividends, and a corresponding incentive to incur foreign withholding tax, and should not result in deficit over-attribution, or inadequate ACB adjustments giving rise to potential deficit duplication.

Proposed Regulation 5905(7)

Under current rules, a liquidation of a foreign affiliate results in the elimination of any deficit which it may have had, since the liquidating affiliate is merely deemed to pay a dividend equal to its adjusted net surplus for these purposes. However, proposed Regulations 5905(7) to (7.4) would introduce a regime that would provide for continuity in respect of deficits (and surplus) where a particular affiliate is liquidated into another affiliate.

Surplus Continuity

Once again, a distinction would be drawn between the circumstances in which proposed paragraph 95(2)(e) applies, and those in which proposed paragraph 95(2)(e.1) applies. Where proposed paragraph 95(2)(e.1) applies, each affiliate of the relevant corporation that had a direct equity percentage in the liquidating affiliate would be deemed, pursuant to proposed Regulation 5905(7)(a), to have received dividends from the liquidating affiliate equal to its proportionate share of the liquidating affiliate's net surplus. However, where proposed paragraph 95(2)(e) applies, there would be no such automatic surplus continuity.

Deficits

Surprisingly, deficit continuity would be provided for even if proposed paragraph 95(2)(e) would apply to the liquidation.[31] Pursuant to proposed Regulation 5905(7)(d), the ES of each higher-tier affiliate would be deemed to be decreased by its proportionate share of any ED of the liquidating affiliate and, to the extent that such proportionate share of ED exceeds that ES, the balance would serve to increase the higher-tier affiliate's ED in accordance with proposed Regulation 5905(7)(b). Similarly, pursuant to proposed Regulation 5905(7)(e), the TS of each higher-tier affiliate would be deemed to be decreased by its proportionate share of any TD of the liquidating affiliate and, to the extent that such proportionate share of TD exceeds that TS, the

[31] Very surprisingly, the application date for the deficit continuity in a paragraph 95(2)(e) liquidation and dissolution is dissolutions that occur after December 22, 2002 even though there was no mention in the December 22, 2002 proposals that this amendment would apply in a paragraph 95(2)(e) context.

balance would serve to increase the higher-tier affiliate's TD in accordance with proposed Regulation 5905(7)(c).[32]

These rules could result in effective deficit duplication where the shareholder affiliate realizes a loss as a result of the disposition, and is required to pick up a portion of the liquidating affiliate's deficit, where the loss and the deficit reflect the same underlying economic loss. The liquidation would not result in a loss on the shares of the liquidating affiliate if proposed paragraph 95(2)(e.1) were applicable. However, if proposed paragraph 95(2)(e) were applicable, a loss could result from the disposition of the shares of the liquidating affiliate. If, in addition, the higher-tier affiliate is required to pick up its share of the liquidating affiliate's deficit, then duplication will arise. Moreover, in either context, it would appear that duplication could arise where the higher-tier affiliate has capitalized the liquidating affiliate with debt rather than equity, to the extent that a loss from the disposition of the debt is realized by the higher-tier affiliate and that debt has financed the underlying deficit.

In brief, while the Committee acknowledges (as noted above) that there should be some mechanism to preserve deficits on the liquidation of an affiliate, we would strongly recommend that any changes in this regard be made in a manner that does not result in deficit over-attribution or deficit duplication, with a view to the economic realities of the particular liquidation.

Inter-Affiliate Financing

On a final note, before concluding, we would draw your attention to certain issues that arise under the Regulations in the inter-affiliate financing context. In particular, we refer to the Regulations that correspond to the provisions in paragraph 95(2)(a) of the Act. These would be set out, *inter alia*, in proposed subparagraph (d)(ii) of the definition of "exempt earnings" and proposed subparagraph (c)(ii) of the definition of "exempt loss" in Regulation 5907(1) (hereafter, the "95(2)(a) Regulations".

In principle, the additional conditions for the application of the 95(2)(a) Regulations (over and above the conditions in the corresponding provisions in paragraph 95(2)(a) of the Act) should be designed to distinguish between treaty-country and non-treaty-country income flows and assets, but not otherwise. Thus, for the purposes of the modified paragraph (c) of the definition of "excluded property" applicable in the context of clause (H) of the 95(2)(a) Regulations, all assets that give rise to exempt earnings to their recipients, or would give rise to

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[32] What is not clear is why the rules in proposed Regulations 5905(7)(b) and (c) would increase the higher-tier affiliate's ED or TD, as the case may be, by the "total of" its proportionate share of the liquidating affiliate's ED or TD and the amount, if any, by which this amount exceeds any reduction to its ES or TS under proposed Regulations 5905(7)(d) and (e). Arguably, to the extent that a higher-tier affiliate's proportionate share of a liquidating affiliate's deficits are applied to reduce its ES or TS under proposed Regulations 5905(7)(d) and (e), then that part of such proportionate share of the liquidating affiliate's deficits should not be applied again to increase its ED or TD under proposed Regulations 5905(7)(b) and (c). To do so would seem to be duplicative. Thus, it would seem that these references to the "total of" should be replaced with references to the "lesser of".

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such exempt earnings if there were income from those assets or if those assets were disposed of, should qualify as "excluded property".[33] A similar rule should also be put in with respect to excluded property described in proposed paragraphs (a) and (c.1) of that definition in subsection 95(1). With respect to excluded property described in paragraph (b) of that definition in subsection 95(1), we would suggest the reintroduction of a rule such as that in subclause (H)(IV) of the current 95(2)(a) Regulations, with certain refinements, such that it would read as follows:

> "(IV) the shares of a foreign affiliate (in this subclause referred to as the "non-qualifying affiliate") of the taxpayer that is not resident and subject to income taxation in a designated treaty country are not considered relevant for the purpose of determining whether shares of another foreign affiliate (in this subclause referred to as the "tested affiliate") of the taxpayer are excluded property unless the shares of the tested affiliate would not have been excluded property if the shares of all such non-qualifying affiliates were not excluded property and the tested affiliate had no property that did not constitute excluded property for the purposes of this clause other than the shares of all such non-qualifying affiliates owned by the tested affiliate,"[34]

Moreover, this issue also arises in connection with other clauses in the proposed 95(2)(a) Regulations. In particular, we refer to clauses (L) and (M) of the proposed 95(2)(a) Regulations. Neither of these would seem to include items owing by partnerships, or items such as trade accounts receivable or certain loans and lending assets that generate exempt earnings.

Conclusions

As noted throughout this Submission, we have significant continuing concerns with respect to certain aspects of the proposed amendments to the foreign affiliate rules. While many of the proposed amendments are technical and relieving in nature, others seem to introduce restrictive – and, in some cases, unduly burdensome – departures from current rules and underlying principles. Moreover, in our view, while many of the proposed amendments would

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[33] As currently drafted, the language in subclause (H)(III) of the proposed 95(2)(a) Regulations would seem to exclude (or in any event does not sufficiently clearly include) amounts receivable from related non-resident corporations or partnerships because the latter are not actually entitled to deduct payments thereunder in computing their exempt earnings, because they have no exempt earnings as such, and would not seem to cover trade accounts receivable, or loans and lending assets, where the debtor is a third party, since the third party similarly has no relevant exempt earnings. Similarly, and somewhat ironically, this language would seem to exclude a receivable that generates exempt earnings because of clause 95(2)(a)(ii)(D), because the interest expense on such a receivable may be deducted in computing exempt surplus, but not in computing exempt earnings. These assets should qualify as long as they do or would give rise to exempt earnings to the recipient.

[34] However, we would recommend that the reintroduction of this requirement be made prospectively only, in that there may be taxpayers who have relied on its absence in the period between December 20, 2002, and the release of the next version of proposed amendments.

seem to be refined enough at this point to merit proceeding forward to the Technical Bill stage, certain of the proposals, as currently structured or drafted, would in many cases appear to be ineffective, overly disruptive of the scheme of the Act and Regulations in this area, and/or fiscally punitive. In particular, we note the following principal areas of concern:

- The proposed amendments with respect to "internal dispositions" would operate on the basis of a "suspended income and gains" mechanism, the introduction of which would in our view result in numerous anomalies in the distribution of economic values and tax attributes within a chain of foreign affiliates. In addition, we are aware of examples where this approach could result in the punitive taxation as FAPI of gains which accrued on excluded property, as well as in the complete ineffectiveness of the proposed amendments. These anomalies would in our view arise because of structural aspects of the approach being adopted, rather than because of drafting issues.

- The proposed amendments with respect to mergers, liquidations and distributions or other reorganizations involving foreign affiliates would also appear to give rise to anomalous consequences in many cases, as a result of certain structural aspects of their formulation. In this context, we have seen examples of transactions that would result in the imposition of taxation under the Act in circumstances involving no more than a simple corporate combination or other reorganization that does not in any substantive way alter the indirect economic relationship between the relevant assets or surplus and the relevant taxpayer(s), as well as examples where radically different consequences would arise under the Act or the Regulations depending on whether a merger rather than a liquidation or other reorganization transaction is implemented even though the exact same corporate and commercial result would be achieved either way.

- The proposed amendments with respect to subsection 93(1) elections and adjustments to be made to the various surplus and other accounts of a foreign affiliate as a result of the application of the subsection 93(1) deemed dividend rules, and in the context of certain changes to a relevant taxpayer's surplus entitlement percentage, would also appear to result in anomalous consequences in certain cases, including the over-attribution of underlying deficits and, more generally, the "scrambling" of surplus accounts. In addition, these measures would appear to introduce inordinate uncertainty, complexity and administrative and compliance costs into the system.

We believe that alternative approach could be devised for "internal dispositions" that could address the concerns of Finance in this regard in a manner that would not give rise to such anomalies. Similarly, we believe that the concerns of Finance with respect to mergers, liquidations and distributions or other reorganizations involving foreign affiliates could be addressed in a more conceptually coherent manner, and more consistently with certain of the fundamental principles that underlie the scheme of the Act and Regulations in this area. We also believe that Finance's concerns with respect to the surplus account adjustment rules could be

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addressed in a more efficient manner, that would not disrupt the relationship between tax attributes and economic values, and therefore would be more consistent with the underlying purpose of these rules. We would be pleased to discus with you our thoughts in this regard at your convenience.

Subject/Sujet:	Distributions of Property of a Foreign Affiliate
Date/Date:	August 19, 2004
Author/Auteur:	Brian Ernewein
Section Ref./Références:	ITA 88(3) [proposed]/LIR 88(3) [proposé]

Dear xxxxx,

We are responding to your correspondence and related communications made on behalf of xxxxxxx in connection with proposed subsection 88(3) of the *Income Tax Act* (the "Act"), as contained in the draft technical amendments released on February 27, 2004 by the Minister of Finance, the Honourable Ralph Goodale.

In your correspondence and communications, you mention the case where a foreign affiliate of a taxpayer resident in Canada makes a payment to the taxpayer of an amount in respect of shares held by the taxpayer of a particular class of shares of the capital stock of the foreign affiliate. For the purposes of your submission, you ask us to assume that

- the payment in question is not a dividend under the relevant foreign corporation law governing the foreign affiliate and is a reduction or a return to the taxpayer of the shares' portion of the paid-up capital in respect of the particular class of shares under that law, and

- the amount of the payment in question does not exceed the taxpayer's pro-rata portion (based on the proportion that the number of shares of the particular class of shares held by the taxpayer is of the total number of outstanding shares of the particular class) of the amount of money that had been received by the foreign affiliate on the issuance of shares of the particular class or received by another foreign affiliate of the taxpayer on the issuance of shares of the capital stock of that other foreign affiliate that were exchanged for shares of the particular class.

Under the Act as it currently reads, the payment in question would be treated as a return of the paid-up capital of the shares of the particular class held by the taxpayer and would be deducted, under paragraph 53(2)(b), in computing the adjusted cost base to the taxpayer of the shares. No amount would, under the Act as it currently reads, be included in the income of the taxpayer in respect of the payment except amounts that may be required to be included in the taxpayer's income because of a gain that could arise, under subsection 40(3), in respect of the payment if the amount of the payment exceeded the taxpayer's adjusted cost base of those shares held by the taxpayer.

The proposed subsection 88(3) of the Act that was included in the February 27, 2004 draft technical amendments was not intended to change the tax outcome described above in respect of the payment made as a return of the paid-up capital of the shares of the foreign affiliate described above. Although our Branch is studying further revisions to that proposed subsection 88(3), it is not intended that any such revisions that we would recommend to the Minister of Finance would change that tax outcome in respect of such a payment. I can also confirm that the operation of that proposed subsection 88(3) is not intended to be dependent upon the source of the funds used by the foreign affiliate of the taxpayer to make such a payment to the taxpayer.

I trust that the foregoing provides the clarifications sought.

Yours sincerely,

Brian Ernewein
Director
Tax Legislation
Division Tax Policy Branch

Subject/Sujet:	Distributions of Property of a Foreign Affiliate
Date/Date:	January 19, 2005
Author/Auteur:	Brian Ernewein
Section Ref./Références:	ITA 88(3) [Proposed]/LIR 88(3) [Proposé]

Dear xxxxx,

Thank you for your letter dated July 30, 2004 in connection with proposed subsection 88(3) of the *Income Tax Act* (the "Act"), as contained in the draft technical amendments released on February 27, 2004 by the Minister of Finance.

Your letter relates to the application of that proposed subsection 88(3) to a proposed distribution of money to a taxpayer resident in Canada by a foreign affiliate of the taxpayer made in respect of shares of the capital stock of the foreign affiliate held by the taxpayer. According to your letter, that distribution is in respect of amounts included in the shares' portion of the paid-up capital (determined under the relevant foreign corporation law) in respect of the class of shares of the capital stock of the foreign affiliate to which the shares belong.

Your concern is that the portion of a distribution that is not treated by proposed subsection 88(3) as a reduction to the adjusted cost base to the taxpayer of the shares would be treated by that proposed subsection as income from property (other than dividends) from the shares. You request that that proposed subsection 88(3) be revised so as to treat the amount of that distribution made to the taxpayer in respect of the shares, to the extent that the amount exceeds the total of the amounts of the reductions in respect of the distribution to the adjusted cost base to the taxpayer of the shares, as the payment of a dividend on the shares. You argue that such a revision to proposed subsection 88(3) would, where the taxpayer is a corporation, enable the taxpayer to benefit from the deductions permitted under section 113 of the Act in respect of dividends paid by the foreign affiliate that are prescribed by the Income Tax Regulations to be paid out of the foreign affiliate's exempt surplus in respect of the taxpayer.

From a tax policy perspective, we agree that, in the circumstances described in your letter, it would be appropriate to make the change you have requested. We are currently considering revisions to that proposed subsection 88(3) of the Act, and the requested revision to subsection 88(3) that is described in this letter is to be included in our recommendations to the Minister of Finance.

Thank you again for writing.

Yours sincerely,

Brian Ernewein
Director
Tax Legislation Division
Tax Policy Branch

Subject/Sujet:	Distribution of Property of a Foreign Affiliate When Liquidation or Dissolution
Date/Date:	August 16, 2005
Author/Auteur:	Brian Ernewein
Section Ref./Références:	ITA 88(3) [Proposed]/LIR 88(3) [Proposé]

Dear xxxxx,

I am writing in response to your letter dated July 11, 2005 with respect to proposed subsection 88(3) of the *Income Tax Act* as contained in the foreign affiliate proposals announced on February 27, 2004 by the Minister of Finance. You requested confirmation of certain possible modifications to that proposed subsection 88(3) and, presumably, certain other modifications to section 88 of the Act that would apply in the case of certain liquidations and dissolutions of foreign affiliates of a taxpayer resident in Canada.

As noted in your letter, existing subsection 88(3) of the Act provides that, where a property of a controlled foreign affiliate of a taxpayer resident in Canada that is a share (the "disposed share") of the capital stock of another foreign affiliate of the taxpayer is disposed of to the taxpayer on the dissolution of the controlled foreign affiliate (the "dissolved foreign affiliate"), the dissolved foreign affiliate's proceeds of disposition of the disposed share are deemed to equal its adjusted cost base to the dissolved foreign affiliate immediately before the dissolution (or such greater amount as the taxpayer claims not exceeding the fair market value of the disposed share). The taxpayer's cost of the disposed share is deemed to equal the disposed foreign affiliate's proceeds of disposition in respect of the disposed share. In accordance with the results determined under section 69 of the Act, each other type of property of the dissolved foreign affiliate that is disposed of by the dissolved foreign affiliate to the taxpayer on the dissolution is treated as having been disposed of by the dissolved foreign affiliate for proceeds, and to have been acquired by the taxpayer at a cost, equal to that property's fair market value. The taxpayer's proceeds from the disposition of the shares of the capital stock of the dissolved foreign affiliate are deemed to equal the amount (if any) by which the total cost to the taxpayer of all the property disposed of to the taxpayer by the dissolved foreign affiliate on the dissolution exceeds the total amount of debts and other obligations of the dissolved foreign affiliate (other than dividends payable to the taxpayer or nonarm's length persons) that are assumed or cancelled by the taxpayer on the dissolution.

As you know, proposed subsection 88(3), as contained in the February 2004 proposals, substantially changed the scope and operation of the rule. In particular, the scope of the rule was extended to cover all distributions of property by all foreign affiliates of the taxpayer to the taxpayer, whether or not the distribution was on the dissolution of the foreign affiliate or the foreign affiliate was a controlled foreign affiliate of the taxpayer. For example, a distribution of a property by a foreign affiliate of a taxpayer (the "distributing foreign affiliate") to the taxpayer as a dividend in kind receives the same treatment as the distribution of that property to the taxpayer on a share redemption made by the distributing foreign affiliate or in the course of a liquidation and dissolution of the distributing foreign affiliate. As well, in contrast to existing subsection 88(3), shares of the capital stock of another foreign affiliate of the taxpayer that are distributed by the distributing foreign affiliate to the taxpayer would be treated differently under the February 2004 proposals, depending on whether or not the shares are excluded property of the foreign affiliate. Where such a distributed share is an excluded property of the foreign affiliate, under the February 2004 proposals, the taxpayer is permitted to elect to treat the distributing foreign affiliate's proceeds of disposition of the share as being an amount that is equal to the adjusted cost base, immediately before the distribution, of the share or such greater amount that does not exceed the fair market value of the share immediately before the distribution. Where it is not, the share is treated, in accordance with the results that would be obtained under section 69, as having been disposed of by the distributing foreign affiliate for proceeds of disposition equal to the fair market value of the share immediately before the distribution.

In your letter, you refer to comments made by Department of Finance officials that the Tax Legislation Division is considering requested revisions to proposed subsection 88(3) that would provide an additional and distinct rule in circumstances where a distributing foreign affiliate of a taxpayer, that is wholly-owned or substantially wholly-owned by

the taxpayer, distributes, in the course of its liquidation and dissolution, property to the taxpayer in respect of shares of the capital stock of the distributing foreign affiliate held by the taxpayer. Under such revisions, the taxpayer would be able to elect the distributing foreign affiliate's proceeds of distribution and the taxpayer's cost for each property of the distributing foreign affiliate (not only excluded property) that is distributed by it to the taxpayer in such circumstances. The revisions would provide that the taxpayer could elect an amount that would result in no gain or loss of the distributing foreign affiliate in respect of the distributed property, or such greater amount (not exceeding the distributed property's fair market value) that would result in a gain of the distributing foreign affiliate in respect of the distributed property. You request confirmation that such revisions will be recommended to the Minister of Finance.

From a tax policy viewpoint, we would support such an additional and distinct rule in subsection 88(3) provided that the distributing foreign affiliate is wholly-owned or substantially wholly-owned by the taxpayer. In those circumstances, it could be considered that no substantial change in the ultimate economic interests in the distributed property of the distributing foreign affiliate could occur by reason of the liquidation and dissolution of the distributing foreign affiliate. We note that subsection 88(1) requires ownership of not less than 90 percent of shares of each class and, all things being equal, we would propose to apply the same threshold in the context of subsection 88(3). Based, however, on discussions with representatives of the tax community on this point, we are prepared to adopt a different test in connection with subsection 88(3) to determine whether the taxpayer meets the equity ownership threshold in the foreign affiliate to qualify for such an additional and distinct rule in that subsection. The test would require the taxpayer to hold shares of the capital stock of the foreign affiliate such that, in total, the taxpayer has at least 90 percent of the voting rights at a general meeting of the foreign affiliate in all circumstances (immediately before the commencement of the liquidation and dissolution of the foreign affiliate) and such that the fair market value of all properties distributed to the taxpayer, in respect of shares of the capital stock of the foreign affiliate, by the foreign affiliate in the course of the liquidation and dissolution is equal to at least 90 percent of the total fair market value of all properties distributed to all shareholders of the foreign affiliate, in respect of shares of the capital stock of the *foreign* affiliate, by the foreign affiliate in the course of the liquidation and dissolution.

Although the technical details of the possible modifications to that proposed subsection 88(3) and to section 88 of the Act are still being finalized, we can confirm, in general terms, our intention to recommend that modifications be made to that proposal and to section 88 and other relevant provisions of the Act. Those recommended modifications would treat a liquidation and dissolution of a foreign affiliate of a taxpayer resident in Canada as a qualifying liquidation and dissolution of that foreign affiliate of the taxpayer if the taxpayer meets the required equity ownership threshold in the foreign affiliate. In general terms, the recommended modifications would also provide for the following tax rules in respect of a qualifying liquidation and dissolution of a foreign affiliate of a taxpayer resident in Canada where the taxpayer so elects in writing to have those tax rules apply in respect of the qualifying liquidation and dissolution of the foreign affiliate:

- the foreign affiliate would be deemed to have disposed of each property (the "distributed property") that is distributed, in the course of the qualifying liquidation and dissolution, by the foreign affiliate to the taxpayer in respect of shares of the capital stock of the foreign affiliate held by the taxpayer for proceeds of disposition (assuming that the foreign affiliate has not received consideration from the taxpayer in respect of the distributed property that exceeds the amount described below as the "relevant cost amount" of the distributed property) that are equal to the greater of
    - the "relevant cost amount" of the distributed property to the foreign affiliate in respect of the taxpayer (being essentially the amount that would generally result in no gain or loss to the foreign affiliate in respect of the taxpayer in respect of the disposition of the distributed property), and
    - the amount elected by that taxpayer (not exceeding the fair market value of the particular distributed property);
- any income or taxable capital gain of the foreign affiliate derived from the disposition of the distributed property would be included in computing the foreign affiliate's foreign accrual property income in respect of the taxpayer;
- the taxpayer's cost of the distributed property would be deemed to be equal to the foreign affiliate's proceeds of disposition of that property;
- the amount of the distribution made by the foreign affiliate to the taxpayer in respect of the distributed property would be deemed to be equal to the amount, if any, by which the cost to the taxpayer of the distributed property exceeds the total of all of the following amounts:
    - the portion of an amount owing by or of an obligation of the foreign affiliate (other than dividends payable to the taxpayer or non-arm's length persons) that was assumed or cancelled by the taxpayer

because of that distribution of the distributed property, and

- the cost to the foreign affiliate of a property that was received by the foreign affiliate from the taxpayer as consideration for that distribution by the foreign affiliate of the distributed property; and

- the portion of the amount of the distribution made by the foreign affiliate to the taxpayer in respect of the distributed property that relates to a particular share of the capital stock of the foreign affiliate would be treated as

  - a return of the paid-up capital in respect of the particular share in respect of the taxpayer to the extent of the "foreign paid-up capital" in respect of the particular share in respect of the taxpayer (generally, the particular share's portion of the total amounts contributed by the foreign affiliate's shareholders to the foreign affiliate in respect of the shares of the class to which the particular share belongs, provided that those shareholder contributions were in respect of shares issued to or held by those shareholders), and

  - a dividend paid by the foreign affiliate to the taxpayer resident in Canada in respect of the particular share to the extent that that portion of the amount of the distribution is not treated as a return of the paid up capital in respect of the particular share in respect of the taxpayer.

We would recommend that such revisions to proposed subsection 88(3) of the Act and to section 88 and other relevant provisions of the Act apply to a liquidation and a dissolution, of a foreign affiliate of a taxpayer resident in Canada, that begins after February 27, 2004.

Thank you for writing.

Yours sincerely,

Brian Ernewein
Director
Tax Legislation Division
Tax Policy Branch

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Subject/Sujet:	Liquidation and Dissolution of Foreign Affiliate
Date/Date:	April 12, 2006
Author/Auteur:	Brian Ernewein
Section Ref./Références:	ITA 88(3) [Proposed], 95(2)(e.1) [Proposed] / LIR 88(3) [Proposé], 95(2)e.1) [Proposé]

Dear xxxxx,

I am writing in response to your letters dated December 12, 2005 and January 30, 2006 with respect to proposed subsection 88(3) and paragraph 95(2)(e.1) of the *Income Tax Act* (the "Act") as contained in the foreign affiliate proposals announced on February 27, 2004 by the Minister of Finance. You have requested confirmation of certain possible modifications to proposed subsection 88(3) and paragraph 95(2)(e.1) and certain other identified related provisions of the Act that would apply to a liquidation and dissolution, after February 27, 2004, of a foreign affiliate of a taxpayer resident in Canada.

Subsection 88(3) of the Act

As noted in your correspondence, existing subsection 88(3) of the Act provides that, where a property of a controlled foreign affiliate of a taxpayer resident in Canada that is a share of the capital stock of another foreign affiliate of the taxpayer is disposed of to the taxpayer on the dissolution of the controlled foreign affiliate (the "disposing foreign affiliate"), the disposing foreign affiliate's proceeds of disposition of the share are deemed to equal its adjusted cost base to the disposing foreign affiliate immediately before the dissolution (or such greater amount as the taxpayer claims not exceeding the fair market value of the share). The taxpayer's cost of the share is deemed to equal the disposing foreign affiliate's proceeds of disposition in respect of the share. In accordance with the results determined under section 69 of the Act, each other type of property of the disposing foreign affiliate that is disposed of by the disposing foreign affiliate to the taxpayer on the dissolution is treated as having been disposed of by the disposing foreign affiliate for proceeds, and to have been acquired by the taxpayer at a cost, equal to that property's fair market value. Existing subsection 88(3) also provides that the taxpayer's proceeds from the disposition of shares held by the taxpayer in the capital stock of the disposing foreign affiliate are deemed to equal the amount (if any) by which the total cost to the taxpayer of all the property disposed of to the taxpayer by the disposing foreign affiliate on the dissolution exceeds the total amount of debts and other obligations of the disposing foreign affiliate (other than dividends payable to the taxpayer or non-arm's length persons) that are assumed or cancelled by the taxpayer on the dissolution.

In your correspondence, you asked for confirmation of our intention to recommend that proposed subsection 88(3) be revised to provide an additional and distinct rule in circumstances where a foreign affiliate (the "disposing foreign affiliate") of a taxpayer resident in Canada distributes, in the course of its liquidation and dissolution, property to the taxpayer in respect of shares of the capital stock of the disposing foreign affiliate held by the taxpayer. Under such a revision, the taxpayer would be able to elect to treat the amount of the disposing foreign affiliate's proceeds of distribution for each property of the disposing foreign affiliate (not only excluded property) that is distributed by it to the taxpayer in such circumstances as being such a particular amount that would result in no gain or loss of the disposing foreign affiliate in respect of the distributed property, or to be such an amount (not exceeding the distributed property's fair market value) that would result in a gain o the disposing foreign affiliate in respect of the distributed property. That particular amount would also be treated as the amount of the taxpayer's cost for that distributed property.

From a tax policy viewpoint, such an additional and distinct rule in subsection 88(3) would be supportable provided that the disposing foreign affiliate is wholly-owned or substantially wholly-owned by the taxpayer. It could, in those circumstances, be considered that no substantial change in the ultimate economic interests in the distributed property of the disposing foreign affiliate would occur by reason of the liquidation arid dissolution of the disposing foreign affiliate. We note that subsection 88(1) requires ownership of not less than 90% of the shares of each class and, all things being equal, we would propose to apply the same threshold in the context of subsection 88(3). Based, however,

on discussions with representatives of the tax community on this point, we are prepared to adopt a different test in connection with subsection 88(3) to determine whether the taxpayer meets the equity ownership threshold in the disposing foreign affiliate to qualify for such an additional and distinct rue in that subsection. The test would require the taxpayer to hold shares of the capital stock of the disposing foreign affiliate such that, in total, the taxpayer has at least 90% of the voting rights at a general meeting of the disposing foreign affiliate in all circumstances (immediately before the commencement of the liquidation and dissolution of the disposing foreign affiliate) and such that the fair market value of all properties distributed to the taxpayer, in respect of shares of the capital stock of the disposing foreign affiliate, by the disposing foreign affiliate in the course of the liquidation and dissolution is equal to at least 90% of the total fair market value of ail properties distributed to all shareholders of the disposing foreign affiliate, in respect of shares of the capital stock of the disposing foreign affiliate, by the disposing foreign affiliate in the course of the liquidation and dissolution.

Although the technical details of the possible modifications to that proposed subsection 88(3) and to the related provisions of the Act are still being finalized, we can confirm, in general terms, our intention to recommend that modifications be made to that proposal and to the other relevant provisions of the Act. Those recommended modifications would treat a liquidation and dissolution of a foreign affiliate of a taxpayer resident in Canada as a qualifying liquidation and dissolution of that foreign affiliate of the taxpayer if the taxpayer meets the required equity ownership threshold in the foreign affiliate. In general terms, the recommended modifications would also provide for the following tax rules in respect of a qualifying liquidation and dissolution of a foreign affiliate of a taxpayer resident in Canada where the taxpayer so elects in writing to have those tax rules apply in respect of the qualifying liquidation and dissolution of the foreign affiliate:

1. the foreign affiliate would be deemed to have disposed of each property (the "distributed property") that is distributed, in the course of the qualifying liquidation and dissolution, by the foreign affiliate to the taxpayer in respect of shares of the capital stock of the foreign affiliate held by the taxpayer for proceeds of disposition (assuming that the foreign affiliate has not received consideration from the taxpayer in respect of the distributed property that exceeds the amount described below as the "relevant cost amount" of the distributed property) that are equal to the greater of

- the "relevant cost amount" of the distributed property to the foreign affiliate in respect of the taxpayer (being essentially the amount that would generally result in no gain or loss to the foreign affiliate in respect of the taxpayer in respect of the disposition of the distributed property), and
- where the foreign affiliate is a controlled foreign affiliate of that taxpayer, the amount elected by that taxpayer (not exceeding the fair market value of the particular distributed property);

2. any income or taxable capital gain of the foreign affiliate derived from the disposition of the distributed property would be included in computing the foreign affiliate's foreign accrual property income in respect of the taxpayer;

3. the taxpayer's cost of the distributed property would be deemed to be equal to the foreign affiliate's proceeds of disposition of that property;

4. the amount of the distribution made by the foreign affiliate to the taxpayer in respect of the distributed property would be deemed to be equal to the amount, if any, by which the cost to the taxpayer of the distributed property exceeds the total of all of the following amounts;

- the portion of an amount owing by or of an obligation of the foreign affiliate (other than dividends payable to the taxpayer or non-arm's length persons) that was assumed or cancelled by the taxpayer because of that distribution of the distributed property, and
- the cost to the foreign affiliate of a property that was received by the foreign affiliate from the taxpayer as consideration for that distribution by the foreign affiliate of the distributed property;

5. the portion of the amount of the distribution made by the foreign affiliate to the taxpayer in respect of the distributed property that relates to a particular share of the capital stock of the foreign affiliate would not be treated as proceeds of disposition of the foreign affiliate of the distributed property and would be treated as

- a return of the paid-up capital in respect of the particular share in respect of the taxpayer to the extent of the "foreign paid-up capital" in respect of the particular share in respect of the taxpayer, and

- a dividend paid by the foreign affiliate to the taxpayer resident in Canada in respect of the particular share to the extent that that portion of the amount of the distribution is not treated as a return of the paid-up capital in respect of the particular share in respect of the taxpayer;

6. any loss of the taxpayer resident in Canada from the disposition of a particular share of the foreign affiliate that was redeemed, acquired or cancelled by the foreign affiliate in the course of the liquidation and the dissolution would be deemed to be nil;

7. generally, the foreign paid-up capital of a particular share of the capital stock of the foreign affiliate of the taxpayer resident in Canada in respect of the taxpayer would be the particular share's portion of the foreign paid-up capital of the class of shares of the foreign affiliate's capital stock to which the particular share belongs;

8. generally, the foreign paid-up capital of a particular class of shares of the capital stock of the foreign affiliate of the taxpayer resident in Canada would be the total amounts contributed by the foreign affiliate's shareholders to the foreign affiliate in respect of the shares of the class to which the particular share belongs, provided that those shareholder contributions were in respect of shares issued to or held by those shareholders;

9. however, in computing the foreign paid-up capital of a particular class of shares of the capital stock of the foreign affiliate of the taxpayer resident in Canada in respect of the taxpayer, where property other than money is contributed to the foreign affiliate in respect of shares of the particular class of shares of the foreign affiliate, the amount added in respect of that contribution of property to the foreign paid-up capital of the particular class of shares of the foreign affiliate in respect of the taxpayer would be determined by reference to the cost to the foreign affiliate of that contributed property, except that, where the contributed property is shares of the capital stock of another foreign affiliate of the taxpayer, the amount added would be limited to the foreign paid-up capital in respect of the shares of the other foreign affiliate of the taxpayer in respect of the taxpayer; and

10. the amounts required to be determined under that proposed subsection 88(3) and the related provisions of the Act would be determined in Canadian dollars because those amounts are relevant for Canadian tax purposes.

We propose to recommend to the Minister of Finance that such revisions to proposed subsection 88(3) of the Act and to the other relevant provisions of the Act apply to a liquidation and dissolution, of a foreign affiliate of a taxpayer resident in Canada, that begins after February 27, 2004.

Paragraph 95(2)(e.1) of the Act

In your correspondence, you expressed your views about two of the conditions to the application of paragraph 95(2)(e.l) to a liquidation and dissolution of a foreign affiliate (the "disposing foreign affiliate") of a taxpayer resident in Canada into another foreign affiliate of the taxpayer.

The first condition is the requirement that the taxpayer have a surplus entitlement percentage, in respect of the disposing foreign affiliate, of at least 90% immediately before the liquidation of the disposing foreign affiliate (the "90% SEP requirement"). You seek confirmation of our intention to recommend that, as an alternative to meeting the 90% SEP requirement, paragraph 95(2)(e.l) would be available where, immediately before the liquidation, a foreign affiliate of the taxpayer has a 90% or greater fair market value participating equity interest in the disposing foreign affiliate.

The second condition is the requirement that there be no gain or loss recognized, under the income tax laws of the country in which the disposing foreign affiliate was resident immediately before the liquidation, in respect of any property distributed by the disposing foreign affiliate in the course of the liquidation to another foreign affiliate of the taxpayer (the "non-recognition requirement"). You argue for the removal of the non-recognition requirement as a precondition to the application of paragraph 95(2)(e.1) so as to permit rollover treatment in respect of all property (rather than only excluded property) of the disposing foreign affiliate disposed of to any foreign affiliate of the taxpayer in the course of the liquidation and dissolution.

In your view, where proposed paragraph 95(2)(e.1) applies, that rollover treatment should be provided for by deeming the disposing foreign affiliate's proceeds of disposition of the property to be, subject to a relevant cost base election by the taxpayer, the cost amount of the property to the disposing foreign affiliate immediately before the liquidation.

From a tax policy viewpoint, we are sympathetic to the requests made for such revisions to the proposed paragraph 95 (2)(e.l). Although the technical details of our intended recommendations for modifications in respect of proposed paragraph 95(2)(e.l) and to the February 2004 foreign affiliate proposals in general are still being finalized, we can confirm, in general terms, that our recommended modifications in respect of that proposed paragraph 95(2)(e.1) of the Act would include the following modifications.

First, the recommended modifications to proposed paragraph 95(2)(e.1) would remove the non-recognition requirement that is a condition to the application of that paragraph.

Second, proposed paragraph 95(2)(e.l) would be amended to provide that it apply to a liquidation and a dissolution of a foreign affiliate (the "disposing foreign affiliate") of a taxpayer resident in Canada if one of the two following alternative tests is met by the taxpayer resident in Canada:

- The taxpayer would, immediately before the time of the earliest distribution of property by the disposing foreign affiliate in respect of shares of the capital stock of the disposing foreign affiliate in the course of the liquidation and the dissolution of the disposing foreign affiliate, have a surplus entitlement percentage in respect of the disposing foreign affiliate of not less than 90% (on the assumption that shares of the capital stock of non-resident corporations owned by any taxpayers resident in Canada and related (otherwise than by virtue of paragraph 251(5) (b) of the Act) to the taxpayer were attributed to the taxpayer.
- A foreign affiliate of the taxpayer that is a shareholder of the disposing foreign affiliate has a 90% or greater fair market value participating equity interest in the disposing foreign affiliate. It would be met if the total fair market value of the properties distributed in the course of the liquidation and dissolution by the disposing foreign affiliate to the shareholder foreign affiliate was not less than 90% of the total fair market value of the properties distributed by the disposing foreign affiliate to all of its shareholders.

Third, the recommended modifications to that proposed paragraph 95(2)(e.1) would provide that, where that paragraph applies to a liquidation and a dissolution of the disposing foreign affiliate of the taxpayer resident in Canada, the following rules would apply (except to the extent that subsection 88(3) would apply to the disposing foreign affiliate and the shareholder of the disposing foreign affiliate in respect of the distribution of the property):

- the disposing foreign affiliate would be deemed to have disposed of each property distributed, in the course of the qualifying liquidation and dissolution, to a shareholder of the disposing foreign affiliate that was, immediately before the distribution, a "specified purchaser" (within the meaning to be assigned by draft subsection 95(3.5}) in respect of the taxpayer resident in Canada for proceeds equal to the greater of
    - the "relevant cost amount" of the distributed property to the disposing foreign affiliate in respect of the taxpayer resident in Canada (being essentially the amount that would generally result in no gain or loss to the disposing foreign affiliate in respect of the taxpayer in respect of the disposition of the distributed property), and
    - where the disposing foreign affiliate is a controlled foreign affiliate of the taxpayer resident in Canada, the amount elected by the taxpayer (not exceeding the fair market value of the particular distributed property);
- any gain under subsection 40(3) of the Act of the shareholder from the disposition of a particular share of the disposing foreign affiliate that was redeemed, acquired or cancelled by the disposing foreign affiliate in the course of the liquidation and the dissolution would be deemed to be nil;
- the amounts required to be determined under paragraph 95(2)(e.l) would be determined in Canadian dollars where those amounts are relevant for determining the foreign accrual property income of the disposing foreign affiliate in respect of the taxpayer resident in Canada; and
- the rules listed earlier in this letter numbered as 2 to 9 would apply with necessary changes to fit the context of the shareholders of the disposing foreign affiliate being specified purchasers in respect of the taxpayer resident in Canada rather than the taxpayer.

Fourth, the recommended modifications to paragraph 95(2)(e.l) would clarify that paragraph 95(2)(e.1) applies (except to the extent that subsection 88(3) applies), to the disposing foreign affiliate and its shareholders that are specified purchasers in respect of the taxpayer resident in Canada, in respect of the distribution of the distributed property for the purpose of computing

- the foreign accrual property income, the surplus and tax accounts (as defined in subsection 5907 of the Income Tax Regulations) and the foreign paid-up capital, of the disposing foreign affiliate or any foreign affiliate of the taxpayer resident in Canada or any taxpayer resident in Canada that does not deal at arm's length with that taxpayer resident in Canada that are shareholders of the disposing foreign affiliate, in respect of those taxpayers, and
- the income or capital gains of a taxpayer resident in Canada that, at the time of distribution, was a specified purchaser in respect of the taxpayer resident in Canada and a shareholder (or a member of a partnership that was the shareholder) of the disposing foreign affiliate.

We propose to recommend to the Minister of Finance that these modifications to proposed paragraph 95(2)(e.l) of the Act and the related provisions apply to a liquidation and dissolution of a foreign affiliate of a taxpayer resident in Canada that begins after December 20, 2002, except if the taxpayer makes an election that applies in respect of all liquidations and dissolutions of its foreign affiliates. If the taxpayer makes that election, generally the proposals issued on February 27, 2004 would apply.

Thank you for writing.

Yours sincerely,

Brian Ernewein
Director
Tax Legislation Division
Tax Policy Branch

Subject/Sujet:	Foreign Paid-Up Capital of Shares of a Foreign Affiliate and Distribution of Property
Date/Date:	June 9, 2006
Author/Auteur:	Brian Ernewein
Section Ref./Références:	ITA 88(3) [Proposed] /LIR 88(3) [Proposé]

Dear xxxxx,

I am writing in response to your letter concerning proposed subsection 88(3) of the *Income Tax Act* (the "Act") m contained in the foreign affiliate proposals announced on February 27,2004. In your letter, you express your concern about the wording of draft subparagraphs 88(3)(e)(i) and (ii).

In your letter, you mention the situation where, prior to February 27, 2004, a corporation resident in Canada contributed cash, for no consideration, to a wholly-owned controlled foreign affiliate ("CFA") of the corporation as a contribution of capital in respect of the ordinary shares (common shares) of CFA. Under the relevant foreign corporation law, that capital contribution resulted in contributed surplus of the CFA. Pursuant to paragraph 53(1)(c) of the Act, the taxpayer's adjusted cost base of the ordinary shares of CFA held by the taxpayer increased because of that capital contribution.

You have also indicated that CFA would like to return the contributed surplus to the holders of its ordinary shares. You maintain that, under that foreign corporate law, CFA must make a bonus issuance of ordinary shares in order to increase the legal share capital (in this case, the par value) of those shares and reduce the contributed surplus in respect of the ordinary shares by the amount of the contribution of capital referred to above. CFA must then pass a resolution to make a pro rata reduction of the par value of all its Ordinary shares (including the bonus shares) the total of which would equal the amount of that contribution of capital.

You are concerned that the return of the par value in respect of a share would not meet the requirements under the February 2004 draft wording of proposed subparagraph 88(3)(e)(i) of the Act. This concern arises because the par value in respect of a share being returned to the holders of the ordinary shares was received by the CFA as a contribution of capital rather than on the issuance of ordinary shares.

We intend to recommend certain modifications to the proposed foreign affiliate amendments that, if acted upon, may address the concerns expressed. Under the modified rules, the taxpayer would be required to determine the foreign paid-up capital of each class of shares of a foreign affiliate of a taxpayer resident in Canada. The foreign paid-up capital of a particular share would be determined by dividing the foreign paid-up capital of the class by the number of issued and outstanding shares of the class. The total foreign paid-up capital of the foreign affiliate would be equal to the total foreign paid-up capital for all classes of shares of the foreign affiliate.

As well, the modifications will provide rules for the purposes of determining the foreign paid-up capital of a class of shares of a foreign affiliate of a taxpayer. The foreign paid-up capital of a class of shares of the foreign affiliate will, for example, be reduced by the amount of distributions made by the foreign affiliate as consideration for a return of the paid-up capital in respect of a share of the class. As well, rules are to be provided for the purpose of determining the amounts to be added in computing the foreign paid-up capital in respect of a class of shares of the foreign affiliate in respect of property received by the foreign affiliate for the issuance of shares of the class or as a contribution of capital in respect of shares of the class.

A foreign affiliate that notifies its shareholders that it is making a distribution of property to them as a return of all or a portion of the amounts included in the foreign paid-up capital in respect of shares of a particular class of the foreign affiliate can treat the distribution as a reduction of the foreign paid-up capital in respect of those shares rather than as payment of a dividend on those shares, to the extent that the foreign paid-up capital in respect of those shares exists immediately before the distribution. The distribution must have the same character for all shareholders of that class.

For example, in the situation you describe in your letter and assuming that all of the ordinary shares (other than the bonus shares) were issued for cash, the foreign paid-up capital, at any particular time, of the class of shares to which the ordinary shares belong would be determined as follows. There would be added the total of all amounts received, before the particular time, by CFA on the issuance of ordinary shares or as a contribution of capital in respect of the ordinary shares from holders of the ordinary shares. There would be deducted the total of all amounts paid, before the particular time, by CFA to the holders of ordinary shares as a return of the foreign paid-up capital in respect of those ordinary shares. The foreign paid-up capital, at any particular time, of a particular ordinary share would be determined by dividing the foreign paid-up capital, at that time, of the class to which the particular ordinary share belongs by the number, at that time, of issued and outstanding ordinary shares of that class.

It will be recommended that the above-mentioned modifications would apply to distributions made after February 27, 2004. However, if the taxpayer makes an election that applies in respect of all of its foreign affiliates, there would be a transitional version of new subsection 88(3) that would include a provision that would generally determine the paid-up capital of a class of shares of a foreign affiliate of the taxpayer and of a share of that class by reference to the amounts added under the relevant foreign corporate law to the paid-up capital or the contributed surplus in respect of the class of shares.

Thank you for writing.

Yours sincerely,

Brian Ernewein
Director Tax Legislation Division
Tax Policy Branch

Subject/Sujet:	Consequences of the Distribution of Property in Respect of Shares of the Disposing Foreign Affiliate
Date/Date:	June 9, 2006
Author/Auteur:	Brian Ernewein
Section Ref./Références:	ITA 88(3) [Proposed], 95(2)(e.1) [Proposed] / LIR 88(3) [Proposé], 95(2)e.1) [Proposé]

Dear xxxxx,

I am writing in response to your letter dated May 4, 2006 with respect to proposed subsection 88(3) and paragraph 95 (2)(e.l) of the *Income Tax Act* (the "Act") as contained in the foreign affiliate proposals announced on February 27, 2004.

You were told, in our letter to you dated April 12, 2006, that we are considering modifications to proposed subsection 88(3) and paragraph 95(2)(e.l) of the Act that would characterize the amount of the distribution (determined in respect of a distribution of property in respect of a share of the capital stock of the disposing foreign affiliate) as a dividend paid on the share to the extent that the amount of the distribution exceeds the amount treated by the foreign affiliate as a reduction of the foreign paid-up capital in respect of the share.

You have asked, and we can confirm, that the portion of the amount of a distribution made in respect of a share that is treated by the foreign affiliate of a taxpayer as a reduction of the foreign paid-up capital in respect of the share (not exceeding the amount, immediately before the distribution, of the foreign paid-up capital in respect of the share) will not be a dividend under the foreign affiliate proposals and will reduce the shareholder's adjusted cost base of the share. The foreign affiliate will, therefore, be permitted to distribute property to the shareholder as a return of foreign paid-up capital in respect of a share determined in respect of the taxpayer prior to making distributions of property in respect of any existing surplus of the foreign affiliate determined in respect of the taxpayer.

The amount by which the amount of the distribution in respect of a share exceeds the portion of the amount of the distribution that is treated by the foreign affiliate as a reduction of the foreign paid-up capital in respect of the share is to be characterized as a dividend received by the shareholder on the share. The normal surplus distribution rules will apply to determine the portion of the dividend that is paid out of the various surplus pots of the foreign affiliate determined in respect of the taxpayer. To the extent that a dividend received on a share is paid out of the foreign affiliate's pre-acquisition surplus determined in respect of the taxpayer, the dividend will reduce the shareholder's adjusted cost base of the share.

I trust that these comments have provided the clarification requested. Thank you for writing.

Yours sincerely,

Brian Ernewein
Director
Tax Legislation Division
Tax Policy Branch

Simple, Fair, and Pro-Growth:

Proposals to Fix America's Tax System

Report of the President's Advisory Panel on Federal Tax Reform

November 2005

The President's Advisory Panel on Federal Tax Reform

Panel Members

Chairman	Connie Mack, III
Vice-Chairman	John Breaux
Members	William E. Frenzel
	Elizabeth Garrett
	Edward P. Lazear
	Timothy J. Muris
	James M. Poterba
	Charles O. Rossotti
	Liz Ann Sonders

Executive Director	Jeffrey F. Kupfer

Acknowledgements

On behalf of all the Panel Members, the Chair, Vice Chair, and Executive Director would like to express their deep appreciation to the Panel staff. Working on a project that lasted much longer than they had originally anticipated, the staff provided invaluable support and guidance. Their dedication, knowledge, and good cheer was truly impressive.

Full-time staff:

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Clarissa Potter
Julie Skelton
David Weisbach

We would also like to recognize the support of the Department of the Treasury and the Internal Revenue Service. The Panel relied on them for many essential tasks, from providing expertise and analysis of our tax reform proposals to assisting with meeting logistics and the printing of our report. Numerous people made the extra effort to assist the Panel, and in particular, we would like to thank the Offices of Tax Analysis and Tax Policy.

In addition, we would like to acknowledge the assistance of the Council of Economic Advisors, the Government Accountability Office, the Organization for Economic Cooperation and Development, the nearly 100 witnesses who appeared at the Panel meetings, and the thousands of interested parties who contributed their views and insights to the Panel.

The President's Advisory Panel on

Federal Tax Reform

www.taxreformpanel.gov

November 1, 2005

The Honorable John W. Snow
Secretary of the Treasury
The Department of the Treasury
1500 Pennsylvania Avenue
Washington, DC 20220

Dear Mr. Secretary:

President George W. Bush formed this Panel to identify the major problems in our nation's tax code and to recommend options to make the code simpler, fairer, and more conducive to economic growth. The Panel heard from nearly 100 witnesses and received thousands of written comments. Together, these witnesses and these comments described the unacceptable state of our current tax system. Yet this tax code governs virtually every transaction in the world's largest economy, affecting the daily lives of nearly 300 million people.

Our tax code is rewritten so often that it should be drafted in pencil. Each year, the tax code is adjusted to meet multiple policy goals – some are broadly shared, but many are not. Myriad tax deductions, credits, exemptions, and other preferences may be a practical way to get policy enacted, but it is a poor way to write a tax code. Whether the government spends more or extends a special tax break, the effect is the same: everyone else must pay higher taxes to raise the revenue necessary to run the government.

During the past few decades, panels have been formed repeatedly, legislation introduced annually, and hearings scheduled regularly to study our tax code and recommend changes. In 1986, a bipartisan effort yielded the last major tax reform legislation. But because of the ever-present tendency to tinker with the tax code, we must redouble our efforts to achieve fundamental reform.

Since the 1986 tax reform bill passed, there have been nearly 15,000 changes to the tax code – equal to more than two changes a day. Each one of these changes had a sponsor, and each had a rationale to defend it. Each one was passed by Congress and signed into law. Some of us saw this firsthand, having served in the U.S. Congress for a combined 71 years, including 36 years on the tax-writing committees. Others saw the changes from different perspectives – teaching, interpreting, and even administering the tax code. In retrospect, it is clear that frequent changes to the tax code, no matter how well-intentioned, ultimately undermine the integrity of the code in real and significant ways.

As we moved forward with recommendations for reform, we followed the President's instructions to emphasize simplicity, fairness, and to remove impediments to growth. Achieving all of these principles is no easy task. We recognized from the start of our meetings that while it is relatively straightforward to point out flaws in a tax system and to express a desire for change, it is much more challenging to settle on a specific solution. There are difficult trade-offs. While we have differed at times and we may not all agree with every word in this report, we all fully endorse it.

We unanimously recommend two options to reform the tax code. We refer to one option as the Simplified Income Tax Plan and the other option as the Growth and Investment Tax Plan. Both of them are preferable to our current system. Both satisfy the President's directive to recommend options that are simple, fair, and pro-growth.

The Simplified Income Tax Plan dramatically simplifies our tax code, cleans out targeted tax breaks that have cluttered the system, and lowers rates. It does away with gimmicks and hidden traps like the Alternative Minimum Tax. It preserves and simplifies major features of our current tax code, including benefits for home ownership, charitable giving, and health care, and makes them available to all Americans. It removes many of the disincentives to saving that exist in our current code, and it makes small business tax calculations much easier. It also offers an updated corporate tax structure to make it easier for American corporations to compete in global markets.

The second recommended option, the Growth and Investment Tax Plan, builds on the Simplified Income Tax Plan and adds a major new feature: moving the tax code closer to a system that would not tax families or businesses on their savings or investments. It would allow businesses to expense or write-off their investments immediately. It would lower tax rates, and impose a single, low tax rate on dividends, interest, and capital gains.

As directed by the President, our recommendations have been designed to raise approximately the same amount of money as the current tax system. The issue of whether the tax code should raise more or less revenue was outside of our mandate. Regardless of how one feels about the amount of revenue required to fund our government, all should agree that the tax system needs a solid and rational foundation.

We recognize that our report is just the beginning of the process to fix our broken tax system. The hardest work lies ahead. As a bipartisan Panel, we have heard from witnesses and elicited proposals from members of both major parties. We hope that the Administration and the Congress will carry forward this spirit of bipartisanship.

The effort to reform the tax code is noble in its purpose, but it requires political willpower. Many stand waiting to defend their breaks, deductions, and loopholes, and to defeat our efforts. That is part of the legislative process. But the interests of a few should not stand in the way of the tax code's primary goal: to raise funds efficiently for the common defense, vital social programs, and other goals of shared purpose. If we agree the goals serve us all, we must also agree that the costs must be fairly borne by all.

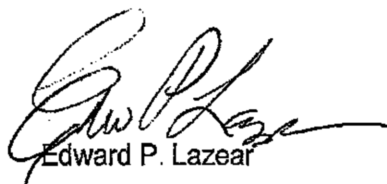
This report aims to give voice to the frustrated American taxpayer and to provide a blueprint for lasting reform. We look forward to a national debate and a better tax system.

Connie Mack, III, Chairman

John Breaux, Vice-Chairman

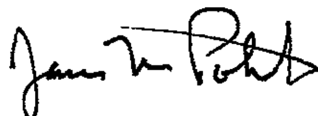
William E. Frenzel

Elizabeth Garrett



Edward P. Lazear

Timothy J. Muris



James M. Poterba

Charles O. Rossotti

Liz Ann Sonders

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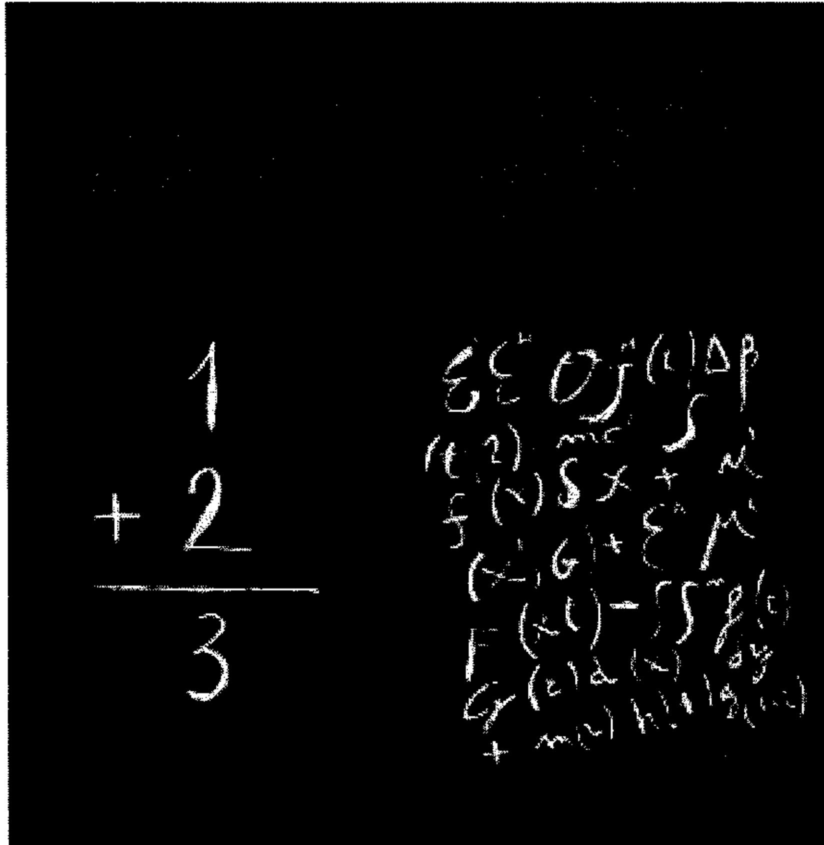
Chapter Six
The Simplified Income Tax Plan



Courtesy of Marina Sagona

The President directed the Panel to submit at least one option using the current income tax system as a starting point for reform. The Panel developed the Simplified Income Tax Plan to meet this objective. This chapter describes the Simplified Income Tax Plan and the impact it would have on taxpayers and the economy. It begins with an explanation of the provisions of the plan, and how they would simplify the tax system for individuals and businesses. Next, it summarizes the effect of the plan on issues of tax fairness, such as tax burden and distribution. Finally, this chapter closes with a discussion of the expected impact on the economy, including improved economic output and reduced compliance and administrative costs.

The Simplified Income Tax Plan would simplify the process of filing taxes and would make it easier to predict tax consequences when planning for the future. It would consolidate and streamline a number of major features of our current code – exemptions, deductions, and credits – that are subject to different definitions, limits, and eligibility rules. It would make the tax benefits for home ownership, charitable giving, and health coverage available to more taxpayers, simpler to calculate, and

Under the simplified depreciation system, taxpayers would increase the balance in each property account by the amount of new purchases and be allowed a uniform allowance each year. Depreciation would be computed by multiplying the account's average balance by the depreciation rate applicable to the specific asset category. As summarized in Table 6.5, there would be only four categories of assets.

Table 6.5. Asset Categories Under the Simplified Depreciation System

	Category I	Category II	Category III	Category IV
Type of Assets	Assets used in the agricultural, mining, manufacturing, transportation, trade, and service sectors	Assets used for energy production, a few other relatively long-lived utility properties, and most land improvements	Residential buildings	Non-residential buildings and other long-lived real property
Annual Recovery Percentage	30 percent	7.5 percent	4 percent	3 percent

Medium-size businesses (and small businesses that depreciate buildings and structures) would be allowed to use a much simpler accounts-based system under which the amount of new assets would simply be added to the existing balance in each asset account. Unlike current law, separate accounts for assets placed in service in each year would not be required. The new depreciation system also would provide a more simple treatment of asset dispositions by not requiring adjustment of the account upon sale, retirement or other disposition of an asset. Depreciation would be allowed for the account balance and, if all assets in a category were disposed of, the remaining adjusted basis in an account would be deducted. Any proceeds received from an asset disposition would be included fully in the taxpayer's gross income. These rules would relieve businesses from detailed tracking of individual assets for tax purposes.

Large businesses would continue to track assets as they do under current law, but would benefit from the simpler process of categorizing assets into one of four asset classes and claiming depreciation deductions based on the simplified method.

Simplifying the Taxation of International Business

The Simplified Income Tax Plan would update our international tax regime by adopting a system that is common to many industrial countries. As explained in Chapter Five, our tax system taxes all income of U.S. corporations regardless of where it is earned and provides a limited tax credit for income taxes paid to foreign governments. Many of our trading partners use "territorial" tax systems that exempt some (or all) of business earnings generated by foreign operations from home country taxation. France and the Netherlands, for example, exempt foreign dividends. Canada, on the other hand, exempts foreign dividends from countries with which it has tax treaties from home taxation. Canada effectively administers a territorial system because it has tax treaties with many countries.

To understand the tax implications of territorial and worldwide systems, consider a simple example. A French multinational company and a U.S. multinational company both have subsidiaries with active business operations in another country, Country X, that imposes a 20 percent tax on corporate income. The U.S. corporate income tax rate is 35 percent. Assume that both companies earn $100 from their operations in Country X and immediately send the profits home as a dividend.

Both the U.S and French subsidiaries pay $20 of tax to Country X on their $100 of earnings. However, the U.S. company faces a "repatriation tax" on the dividend, but the French company does not. The U.S. tax bill of $35 on the $100 of foreign earnings is reduced to $15 because the company receives a credit of $20 for the taxes already paid to Country X by its subsidiary. This means that the U.S. multinational pays a total of $35 in tax: $20 to Country X and $15 to the United States. The French multinational, on the other hand, pays only $20 in tax to Country X. The French company faces a lower tax rate on investments in Country X than the U.S. company because France has a territorial tax system.

Unfortunately, reality is not as simple as this example portrays it. As explained in Chapter Five, the U.S. multinational does not pay U.S. tax on its subsidiary's earnings in Country X until the earnings are repatriated to the United States. The repatriation tax is elective and, as a result, distorts business decisions. If the U.S. multinational redeploys earnings abroad by reinvesting the $80 in an active business, for example, it may avoid the U.S. tax on the earnings. To do so, the U.S. company may forego more attractive investments in the United States or may have to fund investments at home through costly borrowing that would be avoided if there were no repatriation tax on the foreign earnings. Tax planners can devise elaborate strategies to avoid the repatriation tax, but the strategies employed may themselves be costly and wasteful to the economy.

For some firms, arranging corporate affairs to avoid the repatriation tax involves costly and distortionary activity that would not take place except for tax considerations. As explained in Chapter Five, the combination of deferral and the foreign tax credit creates a situation in which the tax rate imposed on investment abroad differs among U.S. multinationals. For example, a multinational that can defer repatriation indefinitely (or avoid the repatriation tax at no cost) pays no repatriation tax. A multinational that is unable to structure operations to avoid the repatriation tax faces the U.S. tax rate.

Under our current tax system, it is also possible for companies to face tax rates on marginal investments abroad that are lower than host country rates. For example, consider a U.S. multinational that finances additional investment in Country X through U.S. borrowing. If the multinational is able to indefinitely defer tax on earnings in Country X (or avoid any repatriation tax through tax planning) it will face a lower than 20 percent rate on its investment. This is because the U.S. company

gets a deduction at the U.S. tax rate for interest payments with no corresponding taxation of income at the U.S. rate. Although territorial tax systems are designed to impose no home country tax on active foreign earnings, the goal of these systems is not to subsidize foreign investment. For this reason, provisions that allocate expenses associated with exempt foreign income against that income (or tax some otherwise exempt foreign income as a proxy for allocating those expenses) are necessary.

The Simplified Income Tax Plan would adopt a straightforward territorial method for taxing active foreign income. Active business income earned abroad in foreign affiliates (branches and controlled foreign subsidiaries) would be taxed on a territorial basis. Under this system, dividends paid by a foreign affiliate out of active foreign earnings would not be subject to corporate level tax in the United States. Payments from a foreign affiliate that are deductible abroad, however, such as royalties and interest would generally be taxed in the United States. Reasonable rules would be imposed to make sure that expenses incurred in the United States to generate exempt foreign income would not be deductible against taxable income in the United States. Because insuring that related entities charge each other "arm's length" prices for goods and services is even more important in a territorial system than under current law, additional resources would need to be devoted to examining these transfer prices. As is common in territorial systems around the world, income generated by foreign assets – such as financial income – that can be easily relocated to take advantage of the tax rules would continue to be taxed in the United States as it is earned. For example, if the U.S. company in our example was to invest the $100 of foreign profits in Country X in bonds instead of in an active business, the interest earned on the bonds would be subject to immediate U.S. taxation (with a credit for any taxes paid to Country X).

Such a tax system would more closely reflect the international tax rules used by many of our major trading partners. It would level the playing field among U.S. multinationals investing abroad. It would allow U.S. multinationals to compete with multinationals from countries using a territorial approach without having to bear the planning costs that are necessary under today's system. In addition, it would make it easier for American companies to repatriate income earned in foreign nations tax-free and reduce the degree to which tax considerations distort their business decisions. Finally, commentators from both industry and academia have concluded that a carefully designed territorial-type system can lead to simplification gains.

Research on the consequences of adopting a territorial system for the United States suggests that this reform could lead to both efficiency and simplification gains. Economists have found that the financial decisions of corporate managers are extremely sensitive to the tax on repatriations – lower U.S. taxes on dividend repatriations lead to higher dividend payments and vice-versa. This correlation implies that repatriation taxes reduce aggregate dividend payouts and generate an efficiency loss that would disappear if active foreign source income were exempt from U.S. tax. Corporate managers would be able to arrange corporate affairs and financial policies to meet objectives other than tax avoidance if they were freed from worrying about how to time repatriations of foreign income to reduce U.S. taxes.

At first glance, one might assume that exempting active foreign source income from U.S. taxation would lead to a substantial reallocation of U.S. investment and jobs worldwide. A careful study of how location incentives for U.S. multinational corporations may change under a territorial system similar to the one proposed for the Simplified Income Tax Plan provides different results. Researchers found no definitive evidence that location incentives would be significantly changed, which suggests that the territorial system the Panel has proposed would not drive U.S. jobs and capital abroad relative to the current system. This result is not surprising. As explained in Chapter Five, the U.S. international tax system has both worldwide and territorial features. For some firms, the U.S. international tax system produces tax results that are as good or even better than those that would apply under a territorial system. Exempting active foreign-source income repatriated as a dividend from U.S. tax provides no additional incentive to invest abroad if, in response to the current tax system, firms have already arranged their affairs to avoid the repatriation tax. Instead, exempting dividends allows firms to productively use resources that were inefficiently employed under current law. The Simplified Income Tax Plan would produce no less revenue from multinational corporations than the current system, but would be less complex and more uniform in its application.

Additional information regarding the Panel's proposals for a new system of international taxation under the Simplified Income Tax Plan can be found in the Appendix.

Strengthening Rules to Prevent International Tax Avoidance

The Simplified Income Tax Plan also would modify the definition of business subject to U.S. tax to ensure businesses that enjoy the benefit of doing business in the U.S. pay their fair share. Under current law, residency is based on the place a business entity is organized. This rule makes an artificial distinction that allows certain foreign entities to avoid U.S. taxation even though they are economically similar to entities organized in the United States. This rule may give businesses an incentive to establish legal place of residency outside the United States to avoid paying tax on some foreign income. Several large U.S. companies have used a similar technique to avoid taxes under our current system. Recently enacted legislation created rules to prevent existing corporations from moving offshore, but does not prevent newly organized entities from taking advantage of the rules.

To prevent this tax-motivated ploy, the Simplified Income Tax Plan would provide a comprehensive rule that treats a business as a resident of the U.S. (and subject to U.S. tax) if the United States is the business's place of legal residency or if the United States is the business's place of "primary management and control." The new two-pronged residency test would ensure that businesses whose day-to-day operations are managed in the United States cannot avoid taxes simply by receiving mail and holding a few board meetings each year at an island resort.

The Tax Lawyer

VOL. 59
NO. 3
SPRING 2006

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Published by
Section of Taxation, American Bar Association
in Collaboration with the
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66 YEARS OF PUBLIC SERVICE

REPORT OF THE TASK FORCE ON INTERNATIONAL TAX REFORM*

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CHAPTER 4: ALTERNATIVES FOR REFORM OF THE INTERNATIONAL TAX RULES: EXEMPTING FOREIGN INCOME AND CURTAILING DEFERRAL

I. DEFICIENCIES OF CURRENT INTERNATIONAL TAX RULES

The discussion and analysis in the preceding Chapter 3 leads to the conclusion that the existing U.S. rules for taxing foreign income do not achieve objectives of fairness, efficiency and administrability. They also do not raise material U.S. revenue. As the Staff of the Joint Committee on Taxation has observed:

> The present-law system thus creates a sort of paradox of defects: on the one hand, the system allows tax results so favorable to taxpayers in many instances as to call into question whether it adequately serves the purposes of promoting capital export neutrality or raising revenue; on the other hand, even as it allows these results, the system arguably imposes on taxpayers a greater degree of complexity and distortion of economic decision making than that faced by taxpayers based in countries with exemption systems, arguably impairing capital import neutrality in some cases.[141]

Some suggest that the solution to this "paradox of defects" is basic reform in key elements of the rules. The Joint Committee Staff and President's Advisory Panel each have proposed consideration of a dividend exemption system in lieu of a foreign tax credit for taxing active foreign income.[142] Both proposals would retain subpart F, but do not propose changes to address its deficiencies.

The Joint Committee Staff highlights several "reasons for change" in support of exemption. These reasons include:

(1) The timing of U.S. taxation upon repatriation of CFC earnings creates incentives for CFCs to re-deploy low-foreign-taxed earnings abroad;

(2) Payment of U.S. tax on foreign-source business income is substantially elective because repatriation of the earnings is elective;

a. deferral can be unlimited in time, and

b. cross-crediting of high- and low-taxed earnings such as royalties may eliminate the residual U.S. tax; and

(3) The result of the U.S. rules may be that taxpayers have to contend with greater complexity, and engage in greater tax-distorted planning than competitors from exemption countries, yet still be taxed at rate greater than local and third-country taxpayers.[143]

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[141] JOINT COMMITTEE STAFF, OPTIONS, *supra* note 17 at 189. The President's Advisory Panel Report similarly criticizes current law; however, it emphasizes the burden of complexity and that other countries employ exemption. That Report also makes an efficiency argument for exemption that is not developed. PRESIDENT'S ADVISORY PANEL REPORT, *supra* note 4, at 132.

[142] *Id.* Others have described exemption proposals as well. *See* Michael J. Graetz & Paul W. Oosterhuis, *Structuring an Exemption System for Foreign Income of U.S. Corporations.* 2001 NAT. TAX J. 771 [hereinafter Graetz & Oosterhuis, *Structuring an Exemption System*]; Rosenbloom, *Taxing CFCs*, *supra* note 22.

[143] JOINT COMMITTEE STAFF, OPTIONS, *supra* note 17, at 188-89.

Current taxation of income earned through a controlled foreign corporation with modified source rules would fully address the Joint Committee Staff's first two reasons for change. While current taxation of a controlled foreign corporation's foreign income would treat foreign income no better than U.S. income, it would not allow taxpayers to be taxed at the same rate as local and third country taxpayers unless the foreign effective rate is equal to or greater than the U.S. effective rate. Neither the Joint Committee Staff nor the President's Advisory Panel explain why lower-taxed foreign business income should be preferred to domestic income by favoring foreign business income with exemption.

This chapter describes and evaluates as reform alternatives (1) exemption of foreign business income, and (2) current taxation of U.S. shareholders' foreign business income.

II. EXEMPTION OF FOREIGN BUSINESS INCOME FROM U.S. TAXATION

A. *Joint Committee Staff Dividend Exemption Proposal*

The Joint Committee Staff proposal has the following elements.

Exemption of Controlled Foreign Corporation (CFC) Dividends to Ten Percent Corporate Shareholder. Dividends by a CFC of earnings not taxed under subpart F to a ten percent or more (by vote) corporate U.S. shareholder would be exempt from U.S. tax. CFCs would continue to be subject to current law subpart F, modified only to exclude inter-company dividends of exempt earnings.[144] As under current law, a foreign tax credit would be allowed with respect to foreign corporate taxes on the subpart F income.[145] The Joint Committee Staff states that passive and highly-mobile income of the foreign corporation would be taxed currently to the U.S. parent corporation under subpart F, and all other earnings would be exempt and could be repatriated free of any tax impediment.[146]

Non-dividend payments from the CFC to the U.S. parent corporation, such as interest, royalties, rents, service fees, and income from inter-company transactions, would be fully taxable to the U.S. corporation.[147] Foreign source income not eligible for exemption, including export income under the export sales rule, could be offset by a credit for foreign taxes on other income; the separate limitation categories of section 904 would be eliminated.[148]

Gain on the sale of CFC stock would be exempt to the extent of undistributed exempt earnings.[149] Gain in excess of this amount would be fully taxed and no deduction would be allowed for losses on the sale of CFC stock.[150]

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[144] JOINT COMMITTEE STAFF, OPTIONS, *supra* note 17, at 190.
[145] *See* I.R.C. § 960.
[146] JOINT COMMITTEE STAFF, OPTIONS, *supra* note 17, at 189.
[147] *Id.* at 191.
[148] *Id.* at 192.
[149] *Id.* at 191.
[150] *Id.*

Foreign Branch Income. Income earned by a domestic corporation through a foreign trade or business would be treated in the same manner as though the income were earned by a CFC.[151] Transactions between the U.S. corporation and the branch would be subject to the full range of rules dealing with inter-company transactions. Except as provided in regulations, trades or businesses conducted in the same country would be treated as a single branch. The subpart F rules would apply to the branch's operations as though it were a separate corporation. Losses of the branch would not flow on to the U.S. corporation's tax return.[152] The Treasury would be authorized to issue rules necessary to place branches and CFCs on an equal footing.

Allocation of expenses to exempt income. Deductions for interest and certain other expenses would be disallowed to the extent allocable to exempt (non-subpart F) CFC earnings as the earnings are earned (not when they are distributed). Thus, for calculation purposes, the U.S. parent would apply the calculation rules as though the CFC's income were fully distributed on an annual basis.[153]

The U.S. parent's interest expense would be allocated between U.S. and foreign income on a worldwide fungible basis taking into account the debt of the CFC. The interest allocated to foreign income would be apportioned between exempt CFC earnings and other foreign income on a pro rata basis according to the assets generating each category of income.[154]

The U.S. parent's R&D expense would be first allocated between U.S. and foreign income under rules similar to current law. The amount allocated to foreign income would be directly allocated to foreign royalty, cost-sharing and royalty-like sale payments to the extent thereof, and then to CFC earnings to the extent thereof. The R&D expense allocated to CFC earnings would be apportioned on a pro rata basis between exempt and nonexempt CFC earnings. Any excess R&D would be allocated to other foreign source income.[155]

General and administrative expense would be allocated to exempt CFC earnings based on the ratio of exempt CFC earnings to the total earnings of the group. Stewardship expenses could be directly allocated to exempt CFC earnings in cases not specified in the Joint Committee Staff description.[156]

Noncontrolled Section 902 Corporations and Noncorporate Shareholders. A U.S. corporate shareholder in a noncontrolled Section 902 corporation would be taxed on dividends from the corporation in the same manner as a portfolio

[151] *Id.*

[152] JOINT COMMITTEE STAFF, OPTIONS, *supra* note 17, at 191. Presumably, the branch would have to maintain an equity account, similar to that utilized under section 987 to track branch currency gain or loss, and currency gain or loss would not be recognized at the time a branch is terminated or becomes wholly worthless.

[153] JOINT COMMITTEE STAFF, OPTIONS, *supra* note 17, at 190.

[154] *Id.*

[155] *Id.*

[156] *Id.*

dividend.[157] The dividend would be fully taxable and no foreign tax credit would be allowed for corporate level-taxes. A 10% corporate shareholder could elect to treat the foreign corporation as a CFC and to be subject to subpart F with respect to its earnings and thereby become eligible for the indirect credit for foreign corporate-level taxes.[158] As under current law, a non-corporate shareholder, such as a private equity fund, would be fully taxable on any dividend from a foreign corporation. Moreover, a non-corporate U.S. shareholder that owns more than 10% by voting power in a CFC would continue to be subject to subpart F with respect to that foreign corporation.

President's Advisory Panel Exemption Proposal. The President's Advisory Panel Report recommends two alternative tax reform plans, the Simplified Income Tax Plan and the Growth and Investment Plan. We do not discuss the Growth and Investment Plan.[159]

Under the Simplified Income Tax Plan, a domestic corporation generally could dividend its domestic earnings to a domestic shareholder and the shareholder would be exempt from tax on the dividend.[160] In other words, the double tax on corporate income would be eliminated though a dividend exemption method. The dividend exemption from a domestic corporation would not be allowed for exempt foreign earnings.[161]

The integration of domestic corporate and shareholder taxation raises issues beyond the scope of this Report. We discuss the President's Advisory Panel's foreign income exemption proposal nonetheless, because of its similarity to the Joint Committee Staff proposal and the possibility that this element of the plan is carried forward as a separate proposal, contrary to the exhortation of the Panel not to adopt individual elements of that Report without taking the reforms as a broader whole.

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[157]*Id.* at 191. A "non-controlled section 902 corporation" is a corporation that is more than 10% owned (by voting power) by a domestic corporation that is entitled to a so-called indirect credit for foreign corporate income taxes imposed on the foreign corporation, but is not more than 50%-owned by 10% United States shareholders and therefore is not a CFC. *Id.*

[158]*Id.* at 192.

[159]The Growth and Investment Plan adopts a hybrid consumption/income tax by taxing business using a form of subtraction method value-added tax (*i.e.*, by exempting dividends and interest and expensing capital investment), taxing individuals on consumption using progressive rates and interest and dividends at low flat rates. The effect of the plan is to exempt foreign business income. More precisely, dividends from a foreign corporation would be exempt. Income earned through a branch would be taxed under a subtraction method consumption tax, which would mean that risk-free returns would be subject to tax, but above normal returns and returns for risk-taking are exempt. This point is discussed extensively in the recent economic literature on consumption taxation. *See generally*, Avi-Yonah, *Risk, Rents, and Regressivity*, *supra* note 3. The implication of this point is that conducting even zero-taxed foreign operations through a foreign corporation assures that the above normal and risky returns are never taxed. This suggests that the Growth and Investment Plan also would retain biases for shifting activity into appropriately low-taxed foreign corporations. This issue is not explored further in this Report, but should be the subject of additional analysis if the Growth and Investment Plan is pursued.

[160]PRESIDENT'S ADVISORY PANEL, REPORT *supra* note 4, at 124-25.

[161]*Id.*

The principal differences between the President's Advisory Panel exemption proposal and the Joint Committee Staff proposal are that:

(1) gains on the sale of foreign corporate stock appear to be exempt under the President's Advisory Panel proposal;[162]

(2) research and development expense would be allocated entirely to taxable income and not to exempt foreign income;[163] and

(3) the President's Advisory Panel Report would allow exemption for all pre-effective date earnings.[164]

B. *Evaluation of Dividend Exemption Proposal*

1. *Income Subject to Exemption*

Condition for Exemption. Under the Joint Committee Staff and President's Advisory Panel proposals, it is not necessary for there to be any minimum level of foreign tax (or even a subject to tax requirement), as a condition for exemption. In other words, the proposals would extend exemption to foreign earnings of a CFC so long as they are not taxed under subpart F even if the foreign country in question imposed no tax on the income.[165] A critical question is whether export sales that pass title outside the United States would be eligible for exemption. If eligible for exemption, this would be contrary to usual international practice. If not eligible for exemption, the U.S. tax on these sales could be offset by foreign tax credits.

The second consequence of not having any "subject to tax" requirement would be that income in zero tax havens will be eligible for exemption without being includible in income under subpart F. Under subpart F, income from manufacturing products, income from performing services in the CFC's country of incorporation, active financing and active insurance income is not included in subpart F income without regard to the level of foreign tax.[166] In addition, there are a variety of techniques that may be used under current law to avoid the reach of the subpart F rules.

[162]*Id.* at 240.
[163]*Id.* at 241.
[164]*Id.* at 240.
[165]The 1993 Treasury dividend exemption proposal and most dividend exemption systems used by other countries would require that exempt income at least be subject to tax. U.S. TREAS. DEPT., INTERNATIONAL TAX REFORM, *supra* note 5. Some countries deny exemption to companies organized in certain black list countries or achieve the same result through controlled foreign company rules. The domestic law exemption for foreign business income in The Netherlands, as one example, applies to foreign income that is earned directly as business income from a foreign permanent establishment, income from real property, and income from employment abroad, and, under a participation exemption for dividends from substantial holdings in a foreign corporation, if the income or foreign corporation is "subject to tax" under an income tax in a foreign jurisdiction. *See* HUGH J. AULT & BRIAN J. ARNOLD, COMPARATIVE INTERNATIONAL TAXATION 372-75 (2d ed. 2004) [hereinafter Ault & Arnold, COMPARATIVE INTERNATIONAL TAXATION].

[166]Thus, for example, if an insurance company earns active foreign insurance income in a country that does not impose income tax, such as Bermuda, these earnings would be exempt from U.S. taxation.

Under the current deferral regime, the benefit of deferral is limited if the U.S. parent corporation needs to use the CFC's earnings in the United States because the earnings will be taxed upon repatriation as a dividend. Consequently, deferral is of most benefit to U.S. multinational corporations that have other non-U.S. businesses in which to invest the deferred earnings. Under these exemption proposals, however, any kind of non-subpart F income that can be earned at a lower tax rate outside the United States could benefit from exemption *and* the cash could be repatriated to the United States. So, for example, a local manufacturer that has only one line of products and only sells products to U.S. customers, could benefit from manufacturing the product in Ireland (whether through a CFC or an Irish branch), selling the product back to the United States, paying the Irish corporate tax on the manufacturing earnings at a 12.5% tax rate and repatriating any unused cash to the U.S. parent as exempt earnings. An exemption regime like that in the Joint Committee Staff or President's Advisory Panel proposal would materially expand the U.S. businesses that could realize tax benefits from earning low-taxed foreign business income.[167]

The Joint Committee Staff and President's Advisory Panel proposals would put pressure on a range of collateral rules. First, consideration would have to be given to whether property should be permitted to be transferred tax-free for use in a trade or business outside the United States that after the transfer would generate exempt income and gains. Transfer pricing would have higher stakes for the taxpayer and the Government and enforcement of the rules would have to be strengthened and, possibly, the rules reviewed.[168] There would be pressure to tighten the subpart F rules, including the manufacturing exception from subpart F, at least insofar as they applied to sales back to the United States. The interaction of the proposal with the foreign tax credit rules is discussed below.

Under the Joint Committee Staff and President's Advisory Panel proposals, deductible payments from CFCs, such as interest and royalties, would not be exempt. While this approach is consistent with the international norm, it will have the effect of encouraging fewer returns in the form of royalties from countries with lower effective tax rates than in the United States. The Joint Committee Staff proposal and the President's Advisory Panel proposal would eliminate the separate passive limitation in favor of a single overall foreign tax credit limitation for foreign income that is not exempt. Accordingly, excess foreign tax credits on subpart F income or on income from non-controlled Section 902

[167]The 1993 Treasury Department Interim Report on International Tax Reform published at the close of the first President Bush's administration included a proposal for a modified exemption system that either would apply an effective rate test, so that only foreign income that bears a certain level of foreign tax would be exempt, or alternatively, and arguably more simply, only would exempt income from certain designated countries. The 1993 Treasury Interim Report acknowledged that the scope of current taxation would be broader than under subpart F and would include foreign manufacturing income that was not taxed or taxed at a low rate. U.S. TREAS. DEPT., INTERNATIONAL TAX REFORM, *supra* note 5.

[168]The President's Advisory Panel acknowledges that "it would continue to be necessary to devote resources to transfer pricing enforcement." PRESIDENT'S ADVISORY PANEL, REPORT, *supra* note 4, at 242. This is an understatement.

corporations could be used to offset U.S. tax on "active" royalties. This would result in taxpayer planning to make high-foreign-taxed income subpart F income in order to be able to cross-credit foreign taxes against other non-exempt foreign income.

Effect of exempt earnings on QDI and UBIT. The Joint Committee Staff proposal does not discuss whether the U.S. parent's exempt earnings should qualify for qualified dividend income treatment and taxed as net capital gain in the hands of an individual shareholder. If no adjustment is contemplated to the definition of qualified dividend income, exempt earnings that are not subject to any foreign tax would be taxed at a 15% rate when distributed to an individual shareholder.[169] Similarly, assuming that no adjustment were made to the definition of unrelated business taxable income, a tax-exempt shareholder, such as a pension fund or an endowment, would pay no corporate level tax on exempt earnings that are not subject to any foreign tax.[170]

Under the President's Advisory Panel's Simplified Income Tax Plan, dividends paid by a domestic corporation to its shareholders would be exempt if paid out of domestic earnings, whether or not the earnings bear full corporate-level tax, but dividends would be fully taxable if from exempt foreign income.[171] In other words, under the President's Advisory Panel proposal, the domestic corporate dividend exemption would not be denied because of corporate-level tax preferences other than the exemption for foreign dividends and foreign non-mobile income.

2. *Stock Gains and Losses*

The Joint Committee Staff Proposal only would exempt gains on the sale of CFC stock to the extent of undistributed exempt earnings. The Joint Committee Staff acknowledges that excess of gain over the exempt earnings amount may be attributable to assets generating exempt income, but believes that the valuation difficulties do not justify exempting this gain.[172] This approach generally would have the effect of taxing foreign generated goodwill recognized in the stock price, which arguably would be inconsistent with exempting active foreign busi-

[169]The same issue exists today with respect to foreign dividend distributions from non-subpart F income to a U.S. individual (or a partnership in which the individual is a partner). If a distribution is paid by a foreign corporation that is not a passive foreign investment company and is eligible for the benefits of a comprehensive income tax treaty, and is taxable as a dividend (*i.e.*, it is not previously taxed income), it will be qualified dividend income to an individual shareholder without regard to whether the earnings distributed were ever subjected for foreign tax. For planning possibilities under this regime, see Timothy J. Devetski and Christopher S. Kippes, *Taxation of an Individual Investor in a Private Investment Fund Exiting An International Project*, 103 TAX NOTES (TA) 1001, 1010-12 (May 24, 2004) (if a foreign holding elects to treat a foreign operating subsidiary as a disregarded entity, sells stock, and avoids subpart F under Dover Corp. v. Commissioner, 122 T.C. 324 (2004), a section 1248 dividend on liquidation may be qualified dividend income to an individual shareholder).

[170]This report does not discuss the issue of whether the unrelated business income tax should apply to foreign business income.

[171]PRESIDENT'S ADVISORY PANEL, REPORT, *supra* note 4, at 124-25.

[172]JOINT COMMITTEE STAFF, OPTIONS, *supra* note 17, at 191.

ness income without regard to whether a foreign tax is imposed on the income. While this approach recognizes that most foreign countries do not tax stock sale gains of a non-resident, a credit arguably should be allowed for the foreign tax if the foreign country taxes the gain. The President's Advisory Panel exemption proposal would exempt all gains on the sale of CFC stock.

The Joint Committee Staff proposal would not allow a deduction for a loss on the sale of CFC stock. While this rule seems appropriate for basis attributable to invested capital earning exempt income, to the extent basis is adjusted upward for subpart F inclusions and has not been reduced by distributions, the basis arguably should result in an allowable loss.

3. *Allocation of Deductions*

The allocation of deductions to foreign income has long been a contentious issue. Under the present law system of deferral, the allocation of deductions to foreign income adversely affects a taxpayer only if the expenses allocated to foreign income reduce the taxpayer's foreign tax credit limitation to the point that foreign taxes are not allowed as a credit. In other words, the issue has practical significance for taxpayers with excess foreign tax credits. To the extent feasible, taxpayers use the timing flexibility offered by deferral to manage the repatriation of foreign taxes so as to avoid being in an excess credit position. This may not be possible if the taxpayer has domestic operating losses, large amounts of interest expense allocated to foreign income or structurally high foreign taxes. With the new 10-year foreign tax credit carryover period, the expense allocation issue should diminish in significance.

In contrast, under an exemption system, every dollar of expense allocated to exempt earnings is a lost deduction. Thus, the issue will affect *every* taxpayer with exempt foreign income. It may be predicted that there will be increased controversies between taxpayers and the Service over the allocation of expenses. Like transfer pricing, the allocation of expenses is highly factual and there is room for a reasonable range of outcomes. The Service will need to hone its skills and devote substantial additional resources to be able to audit this issue effectively.

The Joint Committee Staff and President's Advisory Panel proposals set out a number of expense allocation rules. Both proposals would use the interest expense allocation rules adopted in the American Jobs Creation Act. Those rules add an elective worldwide group expense allocation method. If taking foreign interest expense into account is believed to result in a more accurate allocation of interest expense, it is difficult to identify a valid policy reason for the worldwide method to be elective. The worldwide method should be mandatory.

The Joint Committee Staff proposal for allocation of R&D expense would apply present law rules to allocate the expense between U.S. and foreign income.[173] The amount allocated to foreign income would be directly allocated

[173]Issues raised by the current R&D expense allocation rules and possible changes are discussed in Chapter 6.

first to royalty and similar income.[174] The President's Advisory Panel proposal would go further and allocate R&D only to taxable income.[175] There is little justification for a rule that does not take account of the benefit of R&D expense for intangible income embedded in returns from sales of goods. Returns to intangibles often are earned through an increased sale price on goods using the intangible as an alternative or supplement to returns earned in the form of a royalty. These allocation rules would under allocate R&D expense to exempt income.

There are many general and administration expenses that may be allocated to income on a factual basis. The Joint Committee Staff proposal's requirement that they be allocated on a pro rata basis only may be justified as a rule of administrative convenience. A taxpayer should be permitted to use any reasonable allocation method, consistently applied. The Service should be allowed to mandate a pro rata allocation on a finding that the taxpayer's method is unreasonable.

Stewardship expenses, the costs associated with a shareholder's supervision of its investment in a subsidiary, generally are *not* directly charged to subsidiaries. The failure to charge all shareholder expenses against all of the income of the group, including foreign subsidiaries, is conceptually wrong and inconsistent with the results mandated by treaty for a branch operation. This approach does, however, reflect an international consensus.[176] This consensus is based in part on the inability of the source country to monitor the validity and amount of the deductible charges. Regardless of whether the expenses are charged out to subsidiaries, under an exemption system shareholder expenses should be allocated to exempt earnings on a pro rata basis in relation to all earnings.

Losses of a branch appropriately would not be allowed as a deduction. These losses will have to be tracked and excluded from net operating loss carryovers.

4. *Foreign Tax Credit Limitation*

The Joint Committee Staff proposal and the President's Advisory Panel would adopt a single, overall foreign tax credit limitation, which would permit broad cross-crediting.[177] If export sales of inventory are not exempted and changes are not made to the inventory source rules, substantial cross-crediting would be possible against U.S. tax on this income. The Joint Staff Committee and President's Advisory Panel apparently believe that most foreign income currently taxed under their respective proposals will be low-taxed.[178] It would not

[174] JOINT COMMITTEE STAFF, OPTIONS, *supra* note 17, at 190.
[175] PRESIDENT'S ADVISORY PANEL, REPORT, *supra* note 4, at 241.
[176] ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, COMM. ON FISCAL AFFAIRS, COMMENTARY TO OECD MODEL TAX CONVENTION ON INCOME AND CAPITAL, Art. 7, para 3, ¶ 21 (2005) [hereinafter "OECD Model Commentary"].
[177] Graetz and Oosterhuis also would support a single overall limitation. Graetz & Oosterhuis, *Structuring an Exemption System*, *supra* note 142, at 777.
[178] *See* JOINT COMMITTEE STAFF, OPTIONS, *supra* note 17, at 192.

be difficult, however, to cause otherwise high taxed exempt income to be taxable under subpart F in order to achieve the benefits of averaging against royalties and other low-taxed income. If this were permitted, one of the principal advantages of an exemption system over a credit system that permits cross-crediting would be lost.

Retaining the foreign tax credit for taxable income will cause the reformed system to be even more complex than existing law. It is difficult to see how the objectives of administrability and efficiency would be enhanced by adding yet another tax regime to the taxation of foreign income. Mr. Rosenbloom's exemption proposal, discussed below, which only would allow exemption or full taxation with a deduction for foreign taxes, would be simpler in this regard.

5. *Shareholders in Noncontrolled Section 902 Corporations*

Under the Joint Committee Staff Proposal, a U.S. corporate shareholder in a noncontrolled Section 902 corporation either would be taxed on dividends from a noncontrolled Section 902 corporation when a dividend is received, or would elect to treat the foreign corporation as a CFC so as to be subject to subpart F and exempt on non-subpart F income, allowed a Section 960 tax credit with respect to subpart F income. The Joint Committee Staff proposal does not specify that the election must be made for all CFCs. If it is not so limited, a separate election for each corporation likely will result in foreign tax credit planning as discussed above.

C. *The Rosenbloom Proposal to Exempt Active Business Income Earned Through Permanent Establishments In Designated Countries*

1. *Proposal*

Income Eligible for Exemption. David Rosenbloom proposes a simpler exemption system that would allow exemption of foreign business income, whether earned directly or through a foreign corporation controlled by a U.S. taxpayer, attributable to a substantial business presence in designated foreign countries with "formal and serious tax systems."[179] The Rosenbloom proposal would rest exemption of income on a determination that the income is "attributable" under treaty concepts to a permanent establishment in a "good" country. To achieve its simplification objective, the Rosenbloom proposal would tax all other income currently with only a deduction for foreign taxes. It appears that Mr. Rosenbloom would not exempt gain from the sale of foreign controlled corporation stock. Mr. Rosenbloom would impose tax at the time of transfer on assets transferred to permanent establishments the income from which would be exempt.[180]

[179] Rosenbloom, *From the Bottom Up*, *supra* note 22, at 1544.
[180] *Id.* at 1552-53.

Allocation of Expenses to Exempt Income. Mr. Rosenbloom would disallow deductions allocable to exempt income under expense allocation rules similar to those applied under current law for purposes of the foreign tax credit limitation.[181] Mr. Rosenbloom does not discuss the treatment of losses.

Non-Controlling Shareholders in a Foreign Controlled Corporation. A minority shareholder either (1) would be allowed to exempt income attributable to a permanent establishment if it had sufficient information to determine the amount, or (2) would not be taxed until it receives income and would not be eligible for an "indirect" tax credit for corporate level taxes.[182]

2. *Rationale*

Mr. Rosenbloom grounds his proposal in part on the view that use of the corporate form by a controlling shareholder is purely elective and therefore should not be accorded tax significance.[183] Accordingly, Mr. Rosenbloom's exemption proposal would subject a controlling shareholder to current U.S. tax on all income earned through a foreign controlled corporation, subject to exemption for income for business profits earned in designated countries and a deduction for direct foreign taxes on other income.[184]

3. *Evaluation*

Mr. Rosenbloom's proposal would eliminate the foreign tax credit and its limitation and rely on exemption for income from substantial business activities in countries with "formal and serious" income tax systems to mitigate double taxation. This form of exemption likely would be less onerous to apply than the Treasury's 1993 proposal of an effective tax rate test, but would not provide open-ended exemption for all business income as under the Joint Committee Staff proposal. Indeed, Mr. Rosenbloom acknowledges that it would be necessary to monitor countries' application of their tax laws to avoid allowing exemption where a country has converted to "low-tax status."[185] Rosenbloom also would not allow exemption where there likely would not be a source country tax, such as a source country exemption for foreign income not attributable to a permanent establishment.[186] All non-exempt income of a foreign controlled corporation would be taxed currently and only a deduction allowed for foreign taxes.

Minority shareholders would be treated separately on the grounds that the use of a foreign corporation was not their election. A minority shareholder either (1) would be allowed to exempt income attributable to a permanent establishment if

[181]*Id.* at 1551.
[182]*Id.* at 1550-51.
[183]*Id.* at 1535-37.
[184]It is not clear that Mr. Rosenbloom would limit exemption to a corporate shareholder.
[185]Rosenbloom, *From the Bottom Up, supra* note 22, at 1544.
[186]*Id.* at 1548. Rosenbloom notes: "Systemic holes in a tax system are like the drain in a bathtub; the fact they are limited in diameter is of little importance."

it had sufficient information to determine the amount, or (2) would not be taxed until it receives income and would not be eligible for an "indirect" tax credit for corporate level taxes.[187]

The Rosenbloom exemption proposal would result in substantial simplification at the cost of a "rough justice" approach to efficiency and equity concerns.[188]

D. *Transition to an Exemption System*

Moving to an exemption system for active foreign business income would result in a windfall for United States shareholders in controlled foreign corporations to the extent the value of existing shareholdings increased. Licensors of non-U.S. intangible property and exporters who previously could utilize foreign tax credits to offset foreign royalty and export sales income likely would pay greater tax on this income.

Neither the Joint Committee Staff proposal nor Mr. Rosenbloom discuss how to treat pre-effective date untaxed CFC earnings. While the stakes of transition may be reduced as a consequence of homeland dividend relief under Section 965, in the absence of a transition rule, pre-effective date earnings would continue to be taxed upon repatriation.

One approach would be to extend relief to pre-effective date earnings on the grounds that earnings not repatriated under homeland dividend relief are unlikely to be repatriated in the absence of exemption. Consequently, it could be argued, there would be limited revenue loss and efficiency gains from removing the tax on repatriation. Indeed, this is the approach adopted by the President's Advisory Panel Report.[189]

An alternative argument is that it would be an inappropriate additional windfall to provide relief for pre-effective date earnings. If taxation of pre-effective date earnings were retained, one question would be whether such earnings should be treated as repatriated first, last, or on a pro rata basis. If pre-effective date untaxed earnings were stacked first in the case of a distribution, there would be a disincentive to repatriate earnings unless the cost were modest and the taxpayer desired to re-deploy exempt earnings without a repatriation tax. This could defeat one of the principal benefits of exemption, which is to permit redeployment of earnings without a repatriation tax. If pre-effective date earnings were "stacked" last, however, the effect of extended deferral could come to approximate exemption. A pro rata approach would be consistent with "pooling" under

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[187] *Id.* at 1550-51.

[188] *See* Robert J. Peroni, *Commentary: The Proper Approach for Taxing the Income of Foreign Controlled Corporations*, 26 Brooklyn J. Int'l L. 1579, 1580 (2001).

[189] Were it not for the substantial risk that it would not be adopted, the timing of the President's Advisory Panel proposal was awkward, as it came before the end of a period in which many companies are considering paying very substantial homeland dividends subject to a 5.25% effective tax rate. Such companies must evaluate the possibility of having complete exemption of such earnings if the proposal were adopted.

current law Section 902, but would be complex. An alternative solution would be to cause pre-effective date earnings to be included in income over a reasonable period. One approach would be to follow the model for adjustments resulting from accounting method changes and spread the inclusion over a four year period.

E. *Evaluation of Exemption Proposals Under Policy Criteria*

The Joint Committee Staff and President's Advisory Panel exemption proposals are deficient on several grounds. The failure to include any requirement that the exempt income be subject to a foreign tax will invite substantial tax avoidance planning and place great pressure on transfer pricing rules. This would undermine any efficiency gains from the proposal. Only if there is a reasonable subject to tax condition would the proposal not result in a substantial erosion of the U.S. tax base.[190]

Material simplicity gains from an exemption system only will be achieved if the foreign tax credit regime is restricted to a narrow range of cases or eliminated. In addition to reducing complexity, it would be important to prevent the foreign tax credit regime that is retained from allowing high foreign taxes to offset U.S. tax on income from U.S. economic activity, as occurs under current law, as well as to minimize cross-crediting. Ideally, the scope for the need for a foreign tax credit would be sufficiently restricted that a per item credit limitation might be feasible.[191] If this approach were not followed, it would be important to limit the extent to which income not subject to foreign tax is treated as foreign and thereby easily absorb excess foreign taxes against U.S. tax on that income.

As proposed, the Joint Committee Staff and President's Advisory Panel proposals are difficult to justify under any fairness analysis and it is unclear that any efficiency gains would result from these proposals. The Rosenbloom proposal would achieve some simplicity gains from use of a country-by-country determination of eligibility for exemption, but the criteria for identifying such countries remain open-ended and vague. Without further definition it is not possible to fully evaluate the proposal. The proposal does, however, address the need to eliminate the foreign tax credit to achieve simplification objectives. Moreover, unlike the Joint Committee Staff and President's Advisory Panel proposals, it addresses the deficiencies of current subpart F by ending deferral for shareholders on income that is non-exempt.

Substantial work remains to fashion an exemption proposal that would clearly improve the situation over either current law or current law as it might be reformed under other proposals in this Report.

[190]Also, a subject to tax requirement would clearly exclude export sales from exemption.
[191]*See, e.g.*, I.R.C. § 865(h)(1).

III. PROPOSALS TO EXPAND TAXATION OF FOREIGN INCOME

A. *Alternatives for Expanding Taxation of Foreign Income*

There are two principal elements of reforms that would expand taxation of foreign income in relation to current law consistent with the objectives outlined in Chapter 2. One is to limit the scope of deferral of U.S tax on low-taxed foreign income. The second is to repair the principal flaws of the existing foreign tax credit regime that permit high foreign taxes to offset U.S. tax on other income. These flaws include the miss-measurement of foreign net income, by utilizing defective source and deduction allocation rules, and over-crediting of foreign taxes as a consequence of overly generous cross-crediting. Reforming the foreign tax credit rules does not in our view constitute "fundamental" tax reform. Accordingly, possible improvements to the rules relating to crediting foreign taxes, including possible modifications to the source and expense allocation rules, are discussed in Chapter 6 of this Report. This Part will consider current taxation of income earned through a controlled foreign corporation.

Under prior law, deferral has been restricted and then expanded again.[192] In addition, numerous proposals have been made to end or substantially curtail deferral of U.S. taxation of controlled foreign corporation earnings.[193]

There are two basic approaches to taxing the income of a controlled foreign corporation currently in the hands of a U.S. shareholder. One approach proposed would be to adopt pass-through treatment for earnings of a controlled foreign corporation.[194] This would have the benefit of maintaining character and source of income and subjecting the income to the applicable tax rate of the shareholder. It would permit current pass-through of losses. A pass-through approach would, however, require application of the subchapter K partnership rules in an environment for which they were not designed. While conduit taxation has much

[192]From 1987 through 1996, interest income of banking, financing, and insurance companies was not excepted from foreign personal holding company income. In 1996, deferral was reinstated for income eligible for under the active financing and active insurance exceptions of sections 954(h) and 954(i). From 1993 to 1996, deferral was limited under section 956A, repealed in 1996, to the extent that a controlled foreign corporation or group held more than 25% passive assets. In addition, from 1962 to 1968, a minimum distribution rule under former section 963, repealed by section 602(a) of the Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26 (1975), operated as an alternative to taxation under the other subpart F rules. It generally caused the combined effective foreign and U.S. rate to be comparable to the then applicable U.S. statutory rate. *See* Stuart E. Leblang, *Deferred Gratification: A More Rational Approach for Taxing Multinationals*, 26 TAX NOTES (TA) 1413 (Dec. 14, 1998) [hereinafter Leblang, *Deferred Gratification*].

[193]In 1962 President Kennedy proposed ending deferral. Message from the President of the United States Relative to Our Federal Income Tax System, April 20, 1961, reprinted as H.R. Doc. No. 87-140, at 6-7 (1961). In 1992, Representatives Rostentowski and Gradison included a proposal to end deferral in their Federal Income Tax Rationalization and Simplification Act of 1992, introduced as H.R. 5270, 102d Cong. (2d Sess. 1992). Commentators also have proposed alternatives for ending deferral. *See* Robert J. Peroni, J. Clifton Fleming, Jr. & Stephen E. Shay, *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999) [hereinafter Peroni, Fleming & Shay, *Curtailing Deferral*].

[194]*See* Peroni, Fleming & Shay, *Curtailing Deferral*, *supra*, note 193, at 508-15.

to recommend it as the optimal method to tax foreign income, additional work would be required to address the complexities of applying conduit tax rules to CFCs. CFC capital structures rarely will prescribe "economic" allocations of income under U.S. principles.

This Report considers a second alternative that would expand current taxation under a subpart F-type model.

B. *"Ending Deferral:" Current Taxation of Controlled Foreign Corporation Earnings*

Level of U.S. Ownership. A threshold question for any proposal to end deferral of U.S. tax on income of a controlled foreign corporation is for which U.S. shareholder should deferral be ended? One approach is to cause U.S. persons who today are subject to subpart F, United States Shareholders (10% or greater shareholders by vote) in a controlled foreign corporation (more than 50% owned, by vote or value, directly or indirectly, under constructive ownership rules, by United States Shareholders), to be currently taxed on their share of the controlled foreign corporation's income. The difficult cases are (1) where a foreign corporation has a majority or plurality of U.S. shareholders, but they are not ten percent shareholders, and (2) where the U.S. person owns more than ten percent, but not a controlling interest in a foreign corporation.

It seems appropriate in general to limit current taxation to a ten percent U.S. shareholder; however, the United States Shareholder test, like the current law test for controlled foreign corporation status, should be based on vote or value.[195] We also would consider reducing the threshold for when current taxation would apply to where there is 25% or greater U.S. ownership in the aggregate and U.S. shareholders exceed non-U.S. shareholders from any other single country. In most cases, a 25% U.S. shareholder group would be adequate to cause U.S. tax issues to be taken into account by a company.[196]

Less than 10% U.S. shareholders and 10% U.S. shareholders in foreign corporations that did not have a 25% U.S. shareholder group would be taxed under current law rules on distributions when received. The passive foreign investment company (PFIC) rules would continue to apply, however, the PFIC asset test should be eliminated and the passive income threshold reduced to 50% from 75%. The PFIC taxing rules—a deferred tax with an interest charge, qualified electing fund pass through taxation, or mark-to-market taxation—would apply to a U.S. shareholder in a PFIC.

Simplifying the Shareholder-Level Tax. It has long been a principle of U.S. tax law that Subchapter C shall apply to determine the timing and amount of a

[195]We also would explore whether U.S. shareholders in a controlled foreign corporation who do not own ten percent by vote or value should nonetheless be taxed under the subpart F rules instead of the PFIC rules.

[196]These proposals also may be considered in connection with a proposal to reform subpart F described in Chapter 7.

U.S. shareholder's income from stock in a foreign corporation. This is true even though Subchapter C is designed to implement a classical taxation structure involving tax at both the corporate and shareholder level. The earnings and profits measure of a shareholder-level tax base eliminates most corporate-level tax preference items. Yet, a foreign corporation with no effectively connected earnings bears no U.S. corporate-level tax. The question is raised whether it would be feasible to greatly simplify the measurement of shareholder income under a full taxation regime (recognizing that this could create some arbitrage possibilities).

Under a current taxation regime, a U.S. shareholder would include his or her share of the current year's earnings of the foreign corporation. Under current law, earnings are measured by earnings and profits under U.S. tax principles. One question is whether it would be possible to simplify the calculation of earnings and profits by minimizing the adjustments required from financial statement income. One alternative would be to permit U.S. shareholders in a foreign corporation to use a modified earnings and profits that relies on foreign financial income, determined under Internationally Accepted Accounting Standards (IAAS) or an equally accepted standard, as the starting point for measuring corporate income subject to current shareholder level taxation. If using a foreign financial statement measure of taxable inclusion would vary too much from U.S. tax principles, it would be desirable to identify the minimally necessary adjustments necessary to bring foreign financial statements to an acceptable U.S. base and such a simplified earnings and profits as a measure for determining shareholder income.

Effectively connected income earnings would have to be determined under regular U.S. tax accounting principles. These earnings would be subject to U.S. corporate-level tax and branch tax and would not be subject to the current shareholder-level taxation. When distributed to a domestic corporate shareholder, however, these earnings should be allowed a regular dividends received deduction.

A U.S. shareholder would treat actual distributions as first out of earnings previously-taxed to the shareholder and next from the shareholder's share of effectively connected earnings. Distributed amounts in excess of these measures would be applied to recover the shareholder's basis. Distribution in excess of these amounts with respect to a share would be treated as capital gain with respect to the share. This approach to distributions would eliminate the need to track earnings and profits. Previously-taxed earnings would be measured at the shareholder level and would not transfer to a new shareholder. Simplified reorganization rules should be applied that would permit rollover of tax basis in shares in a transaction.

Indirect Foreign Tax Credit. The indirect foreign tax credit would continue to be allowed to a ten percent corporate shareholder but would be based on the ratio of foreign tax for the year to current year earnings. Since earnings would be deemed distributed currently there would be no need to track pools of historical

earnings and foreign tax credits. In many ways, current taxation of foreign corporate income would be much simpler than under the current deferral regime.

Allowance of Losses. One objection to the controlled foreign corporation model for current taxation is that losses would not flow through to shareholders. In the 1992 Rostenkowski-Gradison bill this was addressed by allowing a controlled foreign corporation an election to be treated as a domestic corporation provided that it included historic earnings and profits in income of its shareholders as would be the case in the event of an inbound liquidation of a foreign corporation.[197] The domestic corporate election was criticized for allowing a one-time deferral from U.S. tax on intercompany transactions with the foreign members of the group electing U.S. corporate status.[198] It is not clear that the one-year deferral is an unacceptable price for such an election.

A U.S. shareholder subject to current taxation under the above rules generally would have the alternative to carry on business through a domestic corporation or a foreign entity classified as a pass through for U.S. tax purposes. Moreover, the shareholder could "hedge" its choice of form and preserve self-help loss recognition through use of intercompany debt as described in Chapter 3. While this choice of form difference in treatment of losses is distortive, it does not seem necessary to allow a domestic corporate election to a controlled foreign corporation as an additional loss pass through alternative.

C. *Evaluation of Current Taxation Alternative*

1. *Efficiency Debate*

Current U.S. taxation of low-taxed foreign income would decrease the after tax returns of non-U.S. investments below what they would be to an investor resident in the local country or in a third country that exempts foreign active business income, as well as in relation to the current law deferral system. Current taxation would not encourage taxation in low-tax countries as occurs under current law and also would be true under an exemption system.

Under a traditional form of an exemption system, foreign taxes on investment in a high tax country could not be used to offset other U.S. tax. Whether this were true under a current tax regime would depend on the foreign tax credit limitation rule employed. This subject is discussed in Chapter 6, but a current taxation proposal should be coupled with reforms to the foreign tax credit that restrict cross-crediting of excess foreign tax credits.

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[197]The inclusion of a prior earnings condition was criticized as creating too large a cost to make the election attractive. *See* Paul W. Oosterhuis & Roseann M. Cutrone, *The Cost of Deferral's Repeal: If Done Properly, It Loses Millions*, 58 TAX NOTES (TA) 765 (Feb. 16, 1993).

[198]It would be possible to treat the electing group of foreign corporations as a separate consolidated group, but this would defeat the ability to use losses against income of the domestic group.

The U.S. banking industry was subject to current U.S. taxation on interest income under subpart F from 1987 through 1996. Although the active banking and financing exception to subpart F was added in 1997, the industry did not fare poorly during the period before 1997.[199]

A reform that increases current taxation of foreign business income ideally would form a part of larger tax reform that expands the business tax base and lowers tax rates on business income. The consequences of moving to current taxation of foreign income on particular taxpayers would be mitigated to the extent that the change is a part of an overall base broadening reform used to reduce U.S. tax rates generally on business income. While it cannot be predicted what will occur under current taxation of foreign income, the experience of the banking industry suggests that most U.S. business could continue to be competitive and even thrive.

2. *Equity and Administrability*

The current taxation alternative described above, would reduce the opportunities for U.S. taxpayers to benefit from lower tax rates in foreign countries, whether under a local tax holiday or as a consequence of tax planning designed to lower the foreign effective tax rate. A reduction in the elective nature of the U.S. tax on foreign income and the rate differential between domestic and international income will enhance the administrability of the income tax by reducing the scope for taxpayer arbitrage between effective tax rates. It would act as a "back stop" to frustrate use of transfer pricing to shift income to lower tax jurisdictions. The more equal taxation of foreign income would enhance the perception that the income tax is fair and as well as the reality of that perception. Current taxation would come closer to satisfying the ability-to-pay criterion.

Whether current U.S. taxation of foreign income would increase or decrease revenues depends in part on how the foreign tax credit and foreign tax credit limitation rules operate. This subject is taken up in Chapter 6.

[199]A study by Rosanne Altshuler and R. Glenn Hubbard found that the application of subpart F to financial services firms after 1986 did decrease the sensitivity of financial firms asset location to host country tax rates. The study was unable to find the significant data necessary to reach a conclusion as to whether the increase in residence taxation under subpart F on operations in low-tax countries reduced market share of U.S. firms in those countries. Rosanne Altshuler & R. Glenn Hubbard, *The Effect of The Tax Reform Act of 1986 on the Location of Assets in Financial Services Firms* 25 (Nat'l Bureau of Econ. Research, Working Paper, No. 7903, 2000).

CHAPTER 6: THE FOREIGN TAX CREDIT AND ITS LIMITATION

I. INTRODUCTION

A. *Background*

The foreign tax credit was introduced in 1918 to relieve double taxation on U.S. taxpayers who are subject to tax on a worldwide basis.[264] The legislative history indicates that Congress was concerned about the "very severe burden" placed upon U.S. citizens by the high rates of tax imposed by certain countries because those taxes only could be deducted.[265]

The first foreign tax credit provision limited the amount of foreign taxes that could be claimed as a foreign tax credit to those taxes imposed by a foreign country on income from sources within that foreign country. This type of source limitation did not prevent foreign tax credits from offsetting U.S. tax on U.S. source income, however, where the foreign tax rate was higher than the U.S. tax rate.[266] As a result of concern over elimination of U.S. tax by higher rate foreign taxes, in 1921, Congress imposed a limitation on the amount of foreign taxes that could be applied as credits against U.S. tax.[267] Under this limitation, the amount of foreign taxes that could be claimed as a credit against U.S. tax was limited to the amount of the U.S. tax that otherwise would be imposed on the foreign source income as determined under U.S. law. This limitation preserved U.S. primary taxing jurisdiction over U.S.-source income.

Under the overall limitation first adopted, the creditable amount was determined by multiplying the U.S. tax due on total worldwide taxable income by the ratio of the foreign net taxable income over worldwide net taxable income both as determined under U.S. principles. By applying this fraction, the formula takes into account the pre-credit effective rate of U.S. tax and allocates that tentative U.S. tax between U.S. and foreign source income.

[264]Revenue Act of 1918, ch. 18, §§ 222 (individuals) and 238 (corporations), 40 Stat. 1057, 1073, 1080.

[265]H.R. Rep. No. 65-767, at 11 (1918). The allowance of foreign taxes only as a deduction against gross income resulted in U.S. taxation of taxable income remaining after the deduction for foreign taxes.

For example, assuming the same taxable base for the United States and Country A, if Country A imposed tax at a 50% rate on $100 of income, or $50, the United States permitted a deduction of $50 against the $100 of gross income, leaving a tax base of $50 on which U.S. tax was imposed. If the U.S. rate was also 50%, the tax on $50 of net income would be $25. Thus, $50 of net income was subject to tax twice—once by Country A and once by the United States. The total amount of tax paid on the $100 of gross income would be $75 or 75% of the gross income.

[266]For example, if the rate in Country A is 70%, the Country A tax on $1000 Country A source income would be $700. If the U.S. tax rate was 50%, and a U.S. company earned $1000 of U.S.-source income in addition to the $1000 in Country A, the U.S. tax on $2000 would be $1000, $500 on the U.S.-source income and $500 on the Country A source income. Under an unlimited foreign tax credit system, the U.S. company would be allowed a $700 foreign tax credit against its $1000 U.S. tax liability, resulting in a net U.S. tax payment of $300. Thus, the $700 foreign tax credit would reduce the U.S. tax on the U.S.-source income by $200.

[267]Revenue Act of 1921, ch. 136, § 238, 42 Stat. 227, 258.

Under such an overall limitation, foreign taxes could offset U.S. tax on other foreign source income. The overall limitation allowed unrestricted cross-crediting of foreign taxes on foreign income. Successive legislative changes modified the rules to restrict cross-crediting and the use of foreign losses,[268] including by creating certain separate limitation categories (baskets). In 1986, the number of separate limitation categories was increased to nine and the rules were tightened to further restrict cross-crediting. For years after 2006, the separate limitation categories are reduced to two (passive and general). Recapture of overall domestic losses as foreign income was added to the existing overall foreign loss recapture regime.[269]

The application of U.S. tax law to determine the tax base for purposes of the limitation fraction is significant. The use of the U.S. tax base for measuring the credit limitation is necessary to assure that the credit for foreign tax is applied to reduce U.S. tax on an apples-to-apples basis. Use of a foreign tax base would be incoherent.[270]

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[268]In 1932, the per country limitation was added to the Code as alternative to the overall limitation in certain circumstances. Revenue Act of 1932. The per country limitation applies the limitation fraction separately to each foreign country rather than applying the limitation to an aggregate of all foreign income and foreign taxes. Under this regime, the foreign tax credit allowed was the lesser of the amount determined under the overall limitation or the total aggregate amounts determined under the per country limitation. As part of the 1954 Code, the overall limitation was repealed leaving only the per country limitation. In 1958, a carryover provision was added for excess taxes that could not be credited under the per country limitation, thereby permitting an averaging effect under the per country limitation that had been possible only under the overall limitation. The provision was enacted to prevent the loss of credits (and therefore double taxation) under the per country limitation system that resulted from timing differences in income inclusions between the United States and foreign countries. P.L. 85-866, § 42. In 1960, an election was introduced that permitted a taxpayer to choose whether to apply the overall limitation or the per country limitation. In 1962, the first income basket, *i.e.*, a separate limitation for a specific type of income, was introduced for "nonbusiness interest income." The Tax Reduction Act of 1975 made important changes to the foreign tax credit as it applied to foreign oil-related foreign source income that were precursors to the more broadly applicable foreign tax credit limitation changes made in 1976. Those changes included the repeal of the per country limitation for oil companies and the enactment of a separate overall limitation for foreign oil-related income. (Oil companies were singled out because most other taxpayers used the overall limitation and did not incur the high level of foreign losses incurred by oil companies.) Another change for oil companies was that overall foreign losses were to be recaptured as U.S.-source income to the extent that foreign operations became profitable in later years. In 1976, the per country limitation was repealed for all taxpayers and the recapture of overall foreign losses as U.S.-source income was applied to all taxpayers.

[269]American Jobs Creation Act of 2004, Pub. L. No. 108-357, §§ 403(b), 404, 118 Stat. 1418, 1492-97.

[270]Some would argue that use of the U.S. tax base also may be considered to implement the fairness principle. By adopting the U.S. tax base—and not the foreign tax base—for the limitation fraction, a taxpayer will at a minimum pay tax at the effective U.S. tax rate on repatriated income. Thus, where the foreign effective rate measured against the U.S. tax base is equal to or less than the U.S. rate, a U.S. taxpayer that earns income outside the United States will pay the same combined effective rate as a U.S. taxpayer that earns only U.S.-source income on the same amount of income. Under this view, the calculation of the foreign tax credit by applying U.S. tax principles promotes equity among U.S. taxpayers. Of course this view presupposes that allowing a credit for foreign taxes instead of a deduction is itself fair, an issue that is discussed in Chapter 2.

1. *Sale of Personal Property and the Inventory Sales Title Passage Rule*

General Rule. In general, gain from the sale of personal property (other than inventory) is sourced to the residence of the seller.[290] A U.S. taxpayer generally will have U.S.-source income from the sale of personal property (other than inventory) unless the gain is attributed to a foreign office and a foreign tax of at least ten percent is imposed on the gain. This generally applicable rule is administratively convenient and limits foreign source treatment to where there is actual taxation of the gain. This approach also is consistent with internationally accepted rules for taxation of gains by a source country in that many if not most U.S. trading partners only tax sales attributable to a permanent establishment in the source country.[291]

If every country adopted similar principles for source taxation of gain from the sale of personal property, there would be little potential for double taxation, even if such source rule were in some sense incorrect from a conceptual viewpoint. However, countries may tax income on a different basis. In the absence of a treaty or unilateral U.S. conformity, the U.S. taxpayer will be subject to potential double taxation if U.S. source rules are applied without regard to whether income is taxed by the source country. One way to alleviate this result is to address such source taxation by treaty (or by interaction of a treaty and the Code).[292]

Inventory Sales. Income from sales of inventory is subject to a special source rule. Gain from the sale of inventory has its source at the place of sale, as determined under the passage-of-title rule.[293] Income from cross-border sales of inventory manufactured or produced by the taxpayer generally is apportioned equally to U.S. and foreign sources if such inventory is produced in the U.S. and sold abroad or vice versa.[294] This place-of-sale sourcing principle based on title passage is susceptible to taxpayer planning and bears no necessary relation to whether a foreign country will tax the gain.[295] Consequently, taxpayers routinely use foreign title passage on export sales to boost their foreign tax credit limitation.

[290]I.R.C. § 865(a).

[291]Many income tax treaties source gain from the sale of personal property to the residence of the seller. *See* OECD MODEL TAX CONVENTION ON INCOME AND CAPITAL, art. 13(4) (Org. for Econ. Co-Operation and Dev., Comm. on Fiscal Affairs 2003).

[292]Under section 864(h), if certain gains from the sale of stock or intangibles are allowed to be taxed under a treaty by the treaty partner, then the income may be treated as foreign source income in a separate limitation category.

[293]I.R.C. §§ 861(a)(6), 862(a)(2).

[294]I.R.C. § 863(b)(2); Reg. § 1.863-3(b)(1).

[295]The passage-of-title rule is vulnerable to manipulation because passage of title does not necessarily reflect economic or commercial reality of sales transactions. Under the modern commercial law, passage of title does not dictate the transfer of rights and burdens in connection with sales. Under the Uniform Commercial Code (UCC), title passes by the express agreement of the parties or, in the absence of agreement, when the seller completes his performance of delivery. UCC § 2-401(1), (2). See also JOSEPH ISENBERGH, INTERNATIONAL TAXATION: US TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME 16:8 (3d ed. 2002) for a more detailed discussion.

2. *Royalties*

Royalties are sourced according to the place were the intangible or the right to exploit the intangible is used. For example, a royalty for use of a U.S. patent generally is U.S. source, because a U.S. patent does not afford legal protection outside of the United States. If a royalty is for exploitation of non-U.S. rights, it generally will be foreign-source income. If a royalty is for use of a bundle of patent rights, including U.S. and non-U.S. rights, it may be necessary to apportion the royalty income among the various geographies.

The disparities between the source rules for sales of personal property and the royalty source rule may give rise to planning possibilities. If gain on a sale to a distributor of property that is subject to a license of a non-U.S. intangible property right includes a return to the intangible, the source of the gain nonetheless will be determined under the personal property sales source rules. If the gain would be domestic source, a taxpayer with excess foreign tax credits may prefer to increase its foreign source income by separately charging the distributor a royalty for use of the intangible with respect to sales to the distributor's customers. Although there is an economic difference between charging a price for the sale of a product to a distributor as opposed to a royalty that only is paid if the product is sold by the distributor, the tax benefit may justify the difference. Where the distributor is a wholly-owned subsidiary, there is no economic risk in deferring the royalty income until the product is sold by the distributor.

D. *Allocation and Apportionment of Expenses*

1. *Background*

As discussed above, the allocation of expense is an integral part of determining the foreign tax credit limitation. If expenses are underallocated to foreign income, the foreign tax credit limitation will increase, and more foreign taxes will be allowed to offset U.S. tax. If, instead, expenses are overallocated to foreign income, the limitation will be decreased and fewer foreign taxes will be allowed to offset U.S. tax.[296] Two of the most significant expenses are for interest and R&D. While there have been longstanding controversies over the specifics of the interest and R&D expense allocation rules, there has been acceptance that U.S. tax concepts should govern the allocation of expense, without regard to whether the expense is allowed under foreign law. This is for the reasons set out above for using the U.S. tax base as the foundation for the foreign tax credit limitation fraction.

In the following sections we review the rules for interest and R&D expense.

[296]For example, if royalties for intangibles developed with R&D expenditures are treated as foreign income, R&D expenses should be properly allocated to the royalties. In an exemption system, foreign royalties generally are not exempt, so the R&D deduction allocable to the royalties should be allowed as an expense.

2. *Interest Expense and the Water's Edge Issue*

Section 864(e), governing interest expense allocation in this context, was enacted as part of the Tax Reform Act of 1986. This subsection, and the related regulations, put in place the group-wide allocation regime commonly referred to as "water's edge fungibility," because it allocates and apportions the interest expense of affiliated domestic corporations, but does not take into account interest expense of foreign subsidiaries.

Specifically, for purposes of the interest expense allocation and apportionment rules, all members of a U.S. affiliated group generally are treated in the aggregate as a single U.S. corporation.[297] Each member of an affiliated group is required to allocate and apportion its own interest expense based on a fraction computed by reference to the assets (measured by fair market value or by tax basis) of the entire group.[298] This fraction represents the value of the total affiliated group's assets in each separate limitation category over the total value of the affiliated group's assets.[299] Significantly, the assets and obligations of foreign affiliates are not included in the group for this purpose; rather, the shares of foreign affiliates are treated as assets of the U.S. group.

The basic approach taken under the section 864(e) rules rests, first, on the premise that money is fungible and hence whether particular borrowings are made to generate U.S. source income versus foreign source income (tracing) would not produce a more accurate determination of foreign source income and, in fact, would permit manipulation by taxpayers. To this extent, the approach is essentially identical to the approach under the pre-section 864(e) rules.[300] The second premise, and the change brought by section 864(e), is that separate calculations for each corporation in an affiliated group also do not reflect economic reality and thus do not provide the best measure of foreign source income, and in addition may serve to permit unwarranted taxpayer manipulation based on mere distinctions between legal entities.

However, as stated above, section 864(e) extends the money-is-fungible approach only to the water's edge. It excludes the interest expense and assets of affiliated foreign corporations from the scope of group-wide allocation. Instead, the stock of a foreign affiliate is generally treated as a foreign asset for purposes of calculating the foreign assets of the U.S. members of the group.[301] Increases

[297]Banks and similar institutions, referred to in the regulations as "financial corporations," are treated as a separate affiliated group for purposes of these rules. I.R.C. § 864(e)(5)(B), (C); Temp. Reg. § 1.861-11T(d)(4). The banking portion of bank holding companies, and nonbank financial subsidiaries owned by bank holding companies, are also treated as financial corporations. I.R.C. § 864(e)(5)(D); Temp. Reg. § 1.861-11T(d)(4)(iii). Life insurance companies are treated as a separate affiliated group unless an election is made to the contrary. I.R.C. § 864(e)(7)(E); Temp. Reg. § 1.861-11T(d)(3). The Secretary has broad powers to create further exceptions. I.R.C. § 864(e)(7)(F).

[298]Reg. § 1.861-11T(c).

[299]Narrow exceptions to apportionment are provided in certain cases, in particular, with respect to qualified nonrecourse indebtedness, as to which a tracing approach is adopted. Reg. § 1.861-10T.

[300]*See* former Reg. § 1.861-8(e)(2) (1977).

[301]Reg. § 1.861-12T(c).

for earnings and profits are required for CFC shares if the tax basis valuation method is used.[302] This allocation rule in effect considers the debt of the U.S. group members to support, in part, the assets and operations of each foreign affiliate regardless of any independent leverage of the foreign affiliate. The effect is that interest expense of a foreign affiliate having only foreign operations is allocated entirely against foreign-source income whereas interest expense of the U.S. group is allocated in part against U.S.-source income and in part against foreign-source income.

In 2004, Congress adopted an elective worldwide group rule effective for years after 2008 that will allow a taxpayer a one-time election to take into account the interest expense and assets of 80%-owned foreign affiliates in determining the proportion of the interest expense of U.S. affiliated group members that should be allocated to foreign-source income.[303] If an election is made, section 864(f) takes account of the interest expense of foreign affiliates and reduces accordingly the amount of the interest expense of the U.S. group allocable to the stock of the foreign affiliates. Under this worldwide fungibility approach, the interest expense of the domestic members of a worldwide affiliated group is allocated and apportioned to foreign-source income only to the extent that (1) the total interest expense of the worldwide affiliated group, multiplied by the ratio which the foreign assets of the worldwide affiliated group bear to the total assets of the worldwide affiliated group, exceeds (2) the interest expense of the foreign members of the worldwide affiliated group that they would have allocated and apportioned to foreign-source income had they formed their own separate affiliated group.[304]

3. *Research and Experimentation Research*

Until the issuance of final regulations in 1995,[305] the allocation and apportionment of research and experimental (R&E) expenditures was the subject of substantial controversy. The issue is of importance to U.S. multinational companies because of its impact on the amount of U.S. foreign tax credits available to such companies.

The first step under the 1995 Regulations is to allocate R&E expenditures "to all items of gross income as a class (including income from sales, royalties, and dividends) related to such product category (or categories)."[306] If a taxpayer conducts R&E with respect to more than one of the categories, the taxpayer is

[302]I.R.C. § 864(e)(4); Reg. § 1.861-12T(c)(2).

[303]American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (2004) § 401(a) (to be codified at Code section 864(f), (g)).

[304]Note that there is a one-way aspect to this formula—excess interest expense associated with foreign assets would not be deemed instead to be associated with U.S. assets, even for purposes of the foreign tax credit limitation.

[305]Allocation and Apportionment of Research and Experimental Expenditures, 60 Fed. Reg. 66,502 (Dec. 22, 1995) [*hereinafter* 1995 Regulations].

[306]*Id.* at 66,503.

permitted to aggregate the categories for purposes of allocating and apportioning R&E expenditures. Where R&E is not clearly identifiable with any one product category, it is considered conducted with respect to all of the taxpayer's product categories. The 1995 Regulations allow the allocation of R&E expenditures to three-digit classifications of the Standard Industrial Classification Manual (SIC) product categories of gross income (or, with consent of the Commissioner, to another classification).[307]

Next, for each relevant product category, all or part of the R&E expenditures in such category are potentially allocated between U.S. and foreign sources under special rules. First, where research is undertaken solely to meet legal requirements imposed by a political entity concerning improvement or marketing of specific products or processes, and the results cannot be reasonably expected to generate amounts of gross income (beyond *de minimis* amounts) outside a single geographic source, the deduction is allocable only to the grouping or groupings of gross income within that geographic source as a class (the legal requirement rule).[308]

Second, if R&E activities accounting for more than 50% of the amount of the deductions in the product category are performed at a single geographic source, the 1995 Regulations provide that a fixed percent of the relevant deductions is allocated to the statutory (or residual) groupings of gross income corresponding to that source.[309] Thus, the 1995 Regulations include a 50% exclusive place-of-performance apportionment under the sales method[310] (described below) and a 25% exclusive place-of-performance apportionment under the optional gross income methods (described below) (in both cases, applied after the application of the legal requirement rule).[311]

That portion of the R&E deduction that is not apportioned either under the legal requirement rule or the place-of-performance apportionment rule is apportioned using either the sales method or the gross income methods.[312] Under the sales method, an amount equal to the remaining portion of such deduction is

[307]Reg. § 1.861-17(a)(2). A two-digit code denotes "major group" (*e.g.*, agricultural services), a three-digit code denotes "industry group" (*e.g.*, crop services), with increasing-digit codes denoting increasingly detailed classifications.

[308]Reg. § 1.861-17(a)(4).

[309]Reg. § 1.861-17(b)(1).

[310]The corresponding figure under prior regulations was 30%.

[311]A rule permitting exclusive apportionment at a higher percent based on facts and circumstances involving very limited or long delayed application abroad may apply to the exclusive apportionment under the sales method and the optional gross income methods. Reg. § 1.861-17(b)(2).

[312]Reg. § 1.861-17(c), (d). The 1995 Regulations provide that if the amount of sales of a licensed product is unknown (for example, when a licensed product is imbedded in or bundled with another product), a reasonable estimate based on the principles of section 482 should be made and, in the case of intangible property, "if the amount of sales of products utilizing the intangible property is unknown, a reasonable estimate of sales shall be made annually." Reg. § 1.861-17(c)(2). (Under the prior regime, the sales amount taken into account was ten times the amount received or accrued for the intangible property during the taxable year.) Permission from the Service is not required to change a method of apportionment that the taxpayer has used for at least five years. Reg. § 1.861-17(e).

apportioned between the statutory grouping (or among the statutory groupings) within the class of gross income and the residual grouping within such class in the same proportions as the amounts of sales from the product category (or categories) that resulted in such gross income within the statutory grouping and the residual grouping, respectively, bear to the total amount of sales from the product category (or categories).[313] For purposes of such apportionment, special rules exist for taking into account sales of uncontrolled and controlled parties, including foreign corporations.[314]

Under the gross income methods, subject to the conditions below, the taxpayer may apportion its R&E expenditures ratably between the statutory grouping (or among the statutory groupings) of gross income and the residual grouping of gross income in the same proportions as the amount of gross income in the statutory grouping and the amount of gross income in the residual grouping, respectively, bear to the total amount of gross income.[315] Preconditions of such apportionment, however, are that (1) the amount of R&E expense ratably apportioned to the statutory grouping (or groupings, in the aggregate) must not be less than 50% of the amount that would have been so apportioned if the taxpayer had used the sales method, and (2) the amount of R&E expense ratably apportioned to the residual grouping must not be less than 50% of the amount that would have been so apportioned if the taxpayer had used the sales method (floor).[316] If either of the conditions is not met, 50% of R&E expenditures that would have been apportioned to the statutory grouping or residual grouping, as applicable, under the sales method, are apportioned to such statutory grouping or residual grouping.[317]

The 1995 Regulations represent the culmination of a continuing series of compromises to accommodate the objections of multinationals to the allocation of R&D expense to foreign income, notwithstanding that income from the intangibles developed generates foreign source income that increases the foreign tax credit limitation.[318] These concessions include (1) use of a gross income alloca-

[313]Reg. § 1.861-17(c)(1).

[314]Reg. § 1.861-17(c)(2), -17(c)(3).

[315]Reg. § 1.861-17(d)(1).

[316]Reg. § 1.861-17(d)(2).

[317]Reg. § 1.861-17(d)(3).

[318]The 1995 Regulations are the most recent in a long series of approaches adopted in this area. The first attempt to create a framework governing R&E expenditure allocations was made in 1977 with the introduction of Treasury regulations under section 861 ("1977 Regulations"). T.D. 7456, 1977-1 C.B. 200. The 1977 Regulations provided two allocation and apportionment methods for research expenses—the sales method and the optional gross income method. Under the sales method, a 30% exclusive apportionment was accorded to the place of performance of the R&D activities. No exclusive apportionment was provided under the gross income method.

The Economic Recovery Tax Act of 1981 suspended the application of the 1977 Regulations for a two-year period and provided that during such period R&E expenses for research activities conducted in the U.S. were to be apportioned entirely to U.S.-source income. Pub. L. No. 97-34, § 223, 95 Stat. 172,249. The Tax Reform Act of 1984 extended this moratorium for two additional years. Pub. L. No. 98-369, § 126, 98 Stat. 494, 648. The Consolidated Omnibus Budget Reconciliation Act of 1985 extended the moratorium for one additional taxable year. Pub. L. No. 99-272, § 13211, 100 Stat. 82,324.

tion method that does not look through to the gross income of foreign subsidiaries, and (2) use of a three-digit SIC product categories to group gross income (versus the broader two-digit classification required by the 1977 Regulations), which allows taxpayers to allocate R&E expenditures to narrower classes of gross income. While in theory this may accomplish a more accurate matching of such costs between U.S.- and foreign-source income, in practice it permits R&D expense to be more easily allocated away from high-taxed foreign income categories.

The rule also provides that a taxpayer may aggregate, disaggregate, or change a previously selected category if the taxpayer establishes to the satisfaction of the Commissioner that, due to changes in the relevant facts, a change in product category is appropriate, and "provides a simple and workable format for balancing the need for consistency with the desire for flexibility."[319] The increase in the percentage of R&E expenditures that may be exclusively apportioned to U.S.-source income under the sales method of apportionment from 30% under the 1977 Regulations to 50% also was favorable to U.S.-based multinational companies. A further change benefiting such taxpayers was to permit a 25% exclusive apportionment for the gross income method (as compared with none under the 1977 Regulations).[320]

The attribution of R&D expense to income is inherently uncertain, and the more so as the research in question approaches basic research. That is the funda-

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The Consolidated Omnibus Budget Reconciliation Act of 1989 ("1989 Act") established a new provision, section 864(f), which superseded Treasury's R&E regulations. Pub. L. No. 101-239. With respect to R&E expenditures not specifically allocated under the legal requirement rule, the 1989 Act provided that 64% of such expenses for research conducted in the United States was allocated to U.S.-source income, and 64% of expenses for foreign-based R&E was allocated to foreign-source income. The 64% allocation formula originally could not be used beyond the first 6 months of the taxpayer's first taxable year beginning after August 1, 1991 (but this period was extended for an additional 18 months in Revenue Procedure 1992-56, 1992-2 C.B. 409). A taxpayer could allocate and apportion the remainder of R&E expenses on the basis of either sales or gross income. However, if the income-based method of apportionment was chosen, the amount apportioned to foreign-source income could be no less than 30% of the amount that would be apportioned to foreign-source income had the sales method been used.

The Omnibus Budget Reconciliation Act of 1993 ("1993 Act") amended section 864(f) by changing the minimum allocation percentage for R&E expenditures from 64% to 50%. Pub. L. No. 103-66, § 13,234, 107 Stat. 312,504. The 1993 Act provides the formula for the first taxable year (beginning before August 1, 1994) that commences immediately following the taxpayer's last taxable year to which Revenue Procedure 1992-56 applies, or would have applied had the taxpayer been in existence and elected the benefits of that Revenue Procedure. On May 24, 1995, the Department of Treasury issued proposed regulations under section 861 relating to the allocation and apportionment of R&E expenditures that were intended to replace the 1977 Regulations. Prop. Reg. § 1.861-8, 60 Fed. Reg. 27,453 (May 24, 1995) ("1995 Proposed Regulations"). With modifications, the 1995 Proposed Regulations were adopted as final regulations in December 1995.

[319]1995 Regulations, 60 Fed. Reg. 66,502 (Dec. 22, 1995).

[320]Some of the changes were justified in a study performed by the Treasury Department, which was published simultaneously with the 1995 Proposed Regulations. U.S. TREAS. DEPT., THE RELATIONSHIP BETWEEN U.S. RESEARCH AND DEVELOPMENT AND FOREIGN INCOME (1995), reprinted in 95 TAX NOTES INT'L (TA) 101-17 (May 25, 1995) (concluding that "reducing the allocation of domestic R&D to foreign income by about 25 percent compared to the 1977 regulations can be expected to increase the fairness of the regulations and still remain within the range of allocations that cannot be rejected in view of the uncertainty of the evidence").

mental reason to favor a broad-based sales allocation method and tie compromises back to that methodology. While the 1995 Regulations addressed many industry criticisms, after the preceding compromises described above, the question may be raised whether the regulations materially underallocate R&D expense to foreign income. Nonetheless, they represent a hard-to-reach compromise of a contentious issue. The stakes would be much greater under an exemption system, however,. because any allocation of R&D expense to exempt income would cause the deduction to be disallowed. Under the current foreign tax credit, the allocation of a deduction to foreign income only has an adverse effect for a taxpayer that cannot credit a foreign tax as a result. Taxpayers with excess limitation are not affected.

II. OBJECTIVES OF THE FOREIGN TAX CREDIT

The foreign tax credit as it has been implemented by the United States is a highly sophisticated and complex mechanism. Over the decades many technical issues have been identified and resolved, and the current rules work well in an extraordinary range of fact patterns. The foreign tax credit is more than a series of technical rules, however. As a central part of the U.S. system for taxing foreign income, the scope of the credit allowed to a U.S. taxpayer reflects fundamental policy choices regarding the degree to which foreign investment will be treated neutrally with U.S. investment or encouraged or discouraged in relation to U.S. investment. The foreign tax credit has not always been analyzed from this broader perspective. Indeed, by focusing on narrow technical issues, such as the intricacies of R&D expense allocation of foreign tax credit limitation categories, taxpayers have sometimes persuaded Congress and the Treasury to adopt changes without regard to broader policy consequences of the changes.

Although the foreign tax credit provisions are detailed and complicated, several fundamental principles underlie them. The need for a foreign tax credit arises from the fact that the United States taxes income on a worldwide basis.[321] The objective of the foreign tax credit is to mitigate double taxation of foreign income. It is not intended that the credit for foreign taxes reduces U.S. tax on U.S.-source income as determined under U.S. principles.[322] Finally, cross-crediting of excess foreign taxes on high foreign-taxed foreign income against U.S. tax on other low foreign-taxed foreign income concedes the residual U.S. tax on such low-taxed income to the high taxing foreign country. It is difficult to see how this is in the interests of the United States.

[321]I.R.C. § 61 (providing that "gross income means all income from whatever source derived . . .").

[322]In the 1921 Senate Finance Committee Hearings, Dr. T.S. Adams identified the abuse possibility resulting from the lack of a foreign tax credit limitation: big corporations paid virtually no U.S. income tax because the English tax rates were three times higher than the U.S. rate at the time. Upon Senator Simmons' statement that Dr. Adams "made that case out so strongly" that it was unnecessary to discuss it further, Dr. Adams replied, "[T]here is nobody ready to object to it. It has been a big hole in the law." *Internal Revenue: Hearings on H.R. 8245 Before the S. Comm. on Finance*, 67th Cong. 73-74 (1921).

With the allowance of a foreign tax credit to its resident taxpayers, the United States unilaterally defers the exercise of its taxing jurisdiction to that of the source country, at least to the extent of the source-country tax. Under the Joint Committee Staff and President's Advisory Panel proposals to exempt certain foreign income, discussed in Chapter 4, the United States would go further in deferring to the source country and decline to tax foreign income even if the income were not taxed by a source country.

The differences between the credit and exemption approaches in relation to low-taxed foreign income are stark and easily understood. Less well understood is the fact that a foreign tax credit system that allows excessive crediting of foreign taxes is actually more generous to investment in high-tax countries than an exemption system. This is because under an exemption system the excess tax credits from high tax countries cannot be used as credits against U.S. tax on other income. Under present U.S. rules, foreign taxes are allowed as a credit against what should be U.S. income because of source rules that inappropriately treat income as foreign, expense allocation rules that over-allocate expense against U.S. income, and an overall limitation that permits extensive cross-crediting of foreign taxes. In many cases, excess foreign taxes may effectively be used to offset U.S. tax on income from U.S. economic activity that is misclassified as foreign under deficient source and expense allocation rules.

III. PROPOSALS FOR MODIFYING THE FOREIGN TAX CREDIT

1. *Source and Allocation Rules for the Foreign Tax Credit Limitation*

A fundamental issue under the foreign tax credit limitation is that it relies on general source rules that do not always take account of the purpose of the foreign tax credit: to mitigate or avoid double taxation. If income is treated as foreign income but is not taxed, or even subject to tax, under customary international tax principles by any source country, the foreign tax credit is inappropriately expanded. The result is that taxpayers, and the high tax foreign country, are relieved by the U.S. Treasury from the economic impact of these high foreign taxes. Similarly, but far less common in practice, if, under customary international tax principles, a foreign country taxes income that the United States treats as U.S. source, a taxpayer will be subject to unrelieved double taxation. The source rules applied in determining the foreign tax credit limitation should take account of both cases.

2. *Proposal: Source U.S. Residents' Gain from the Sale of Inventory the Same As Gain from the Sale of Other Personal Property*

The place of sale inventory source rule generally treats as foreign source gain from sales of inventory property if title passes to the buyer outside the United States. Yet, most foreign countries tax such gains only if they are attributable to a taxpayer's permanent establishment in the source country. For a U.S. taxpayer in excess credit position, foreign taxes can offset U.S. tax on gain from a foreign source sale even where a foreign country would not tax the gain in the absence

of a permanent establishment. The use of the excess credit effectively exempts the foreign source sale from tax and operates as a form of subsidy for sales of goods outside the United States that is not available for the same sales in the United States. Under an exemption system, there generally would be no opportunity for excess foreign tax credits to offset sales income not attributable to a foreign branch.

Proposal. Gain on the sale of inventory by a U.S. resident, as defined in current law by section 865(g), would have its source at the residence of the taxpayer unless the gain is attributable to a foreign office or fixed place of business of the taxpayer and the gain is taxed at an effective rate of ten percent or more. This is currently the rule for sales of personal property other than inventory.[323] The same rule would apply to the sales portion of gain currently sourced under the rule for sales of property manufactured by the taxpayer.

Rationale. The purpose of the change in source rule is to prevent the U.S. tax base from being offset by foreign tax credits. Allowing high foreign taxes on other income to be used as credits against U.S. tax on income from export sales shifts the costs of the foreign governments imposing high taxes onto U.S. taxpayers. Under an exemption system, there would be no opportunity for the excess foreign tax credits to offset this income. The current law rule cannot be justified as an export incentive because it only benefits taxpayers that have excess foreign tax credits and does not benefit purely domestic manufacturers and distributors.

Evaluation. A similar proposal was made in President Reagan's tax reform proposals in 1985. The proposal was not adopted in part because of the attractions of the simplicity of the title passage rule and fears regarding the complexities of applying a rule based on attribution of sales to a foreign office. The current law rule for sales of personal property has been in the law since 1986, however, and has proven relatively easy to apply. We have found no reported controversies regarding the application of the rule.

3. *Proposal: Source U.S. Residents' Income from Licensing Intangibles Consistently With the Source of Income From Sales of Personal Property and Allocation of R&D Expense*

An owner of an intangible may realize a return on the investment in the intangible either by licensing the intangible for a royalty or, if the owner uses the intangible in a product or service, by embedding the return in the sales price of the product or service using the intangible. Under current law, the source of income from an intangible is determined by the place where it is used and therefore derives its legal protection. A U.S. person that licenses its intangible for a foreign-use royalty realizes foreign-source income, but if the same intan-

[323] I.R.C. § 865(a), (e)(1).

gible is used in a product manufactured in the United States and sold abroad by that person the income will have a divided source depending on where title passes. Thus, in the absence of a withholding tax, there can be a foreign tax credit advantage to separately licensing intangibles as in the case of inventory sales on which no foreign tax is imposed. The U.S. tax on the royalty income, however, can be offset by excess foreign taxes on other income. Under most exemption systems, there would be no opportunity for the excess foreign tax credits from exempt income to offset this income.[324]

Proposal. Royalty income of a U.S. resident, as defined in current law by section 865(g), would have its source at the residence of the taxpayer unless the income is attributable to a foreign office or fixed place of business of the taxpayer and the net income is taxed at an effective rate of ten percent or more. If royalty income is not attributable to a foreign office or fixed place of business, but is subject to a foreign withholding tax on the gross amount of the royalty, the royalty income will be treated as foreign-source in an amount equal to the foreign tax divided by the highest rate of tax applicable to the taxpayer.

Evaluation. Under the proposal, the source of royalty income applicable to a U.S. resident for purposes of the foreign tax credit would correspond to the taxation of inventory sales under the preceding proposal. Where a royalty is not subject to a foreign tax, it would not inflate the foreign tax credit limitation. If a royalty were subject to a gross withholding tax, it would be treated as foreign-source income to an extent that would permit the taxpayer to credit the foreign tax if it were the taxpayer's only item of income.

The proposal should be no more difficult, and may be easier, to implement than the current law source rule, which depends on the place the intangible is used. It sometimes is difficult to determine the place of use of an intangible.

If the preceding change were not adopted, consideration should be given to modifying the R&D expense allocation rules to assure that foreign income is bearing its full share of the burden of supporting R&D. Consideration should be given to eliminating the optional gross income method of apportionment or determining gross income on a look-through basis with respect to controlled foreign corporations. Consideration also should be given to (1) reducing the exclusive apportionment to 30% if more than 25% of the revenues from the product area are from outside the jurisdiction where the R&D is performed, because the premise of the exclusive apportionment exception would not appear to be applicable in the particular case, and (2) applying the exclusive apportionment rule only if more than 50% of the worldwide affiliated group's R&D expenditure is performed in a single country.

[324]As discussed in Part II.B.4 of Chapter 4, however, both the Joint Committee Staff's exemption proposal and the President's Advisory Panel's proposal would present the opportunity for taxpayers to cause high taxes income to be taxable as subpart F income and to credit those high taxes against U.S. tax on other foreign income.

4. *Proposal: Adopt Per Country Foreign Tax Credit Limitation*

The purpose of the foreign tax credit is to relieve international double taxation. With respect to an item of income, double taxation is relieved once the foreign tax on that item is creditable against U.S. tax on that item of income. No tax policy purpose is served by allowing the foreign tax on one item of foreign income to offset the U.S. tax on another item of foreign income. Indeed, allowing cross-crediting only creates an incentive to make the investment to earn the second item of lower-taxed foreign income. Moreover, the beneficiaries of that cross-crediting are the two foreign countries—the high-tax foreign country does not suffer the detriment of its high foreign taxes and the low-tax foreign country receives the benefit of the investment. The U.S. taxpayer finances these benefits.

The overall foreign tax credit limitation that is scheduled to be effective for years after 2008 allows virtually unlimited cross-crediting, except with passive income, and therefore places substantial pressure on source and other foreign tax credit rules. The preceding proposals to strengthen the source rules will reduce some of the ability to inappropriately expand the foreign tax credit limitation, but substantial cross-crediting possibilities would remain.

Proposal. The foreign tax credit limitation would be determined with respect to U.S. tax on income earned in or by a qualified business unit in a country. (It is possible that countries with similar tax bases or effective tax rates could be grouped together.) The separate limitation for passive income would be retained. As under current law, income from a controlled foreign corporation would be analyzed on a look through basis. A loss in one country would offset income from other countries, including the United States, pro rata according to income from other countries. Subsequent income in the loss country would be recaptured as income from the country the loss offset.

Evaluation. Use of a per country limitation is logical because in most countries the tax rate and tax base is the same throughout the country (this is less true for a country, such as Switzerland, with substantial differences in cantonal taxes). Consequently, the scope for cross-crediting is reduced. Restricting cross-crediting seeks to treat investment in a high tax country no better than it would be under an exemption system, while preserving the benefit of worldwide taxation with a foreign tax credit for investment in lower-taxed countries.

Any proposal to restrict cross-crediting involves trade-offs, principally relating to complexity. A per country limitation balances these trade-offs, because most smaller taxpayers will be taxable in a limited number of countries. Large multinational taxpayers, which have the greatest incentive to achieve cross-crediting, will be in many countries but also will be best able to bear the burden of the additional complexity.

5. *Proposal: Modify Technical Taxpayer Rule*

The technical taxpayer rule has been used in connection with deferral and either the check-the-box entity classification rules or hybrid instrument planning to achieve the separation of foreign taxes and, from a U.S. perspective, the

income that the taxes are imposed on. This enhances the utility of the foreign taxes, which can be used to cross-credit against other low-taxed foreign income, as well as the value of deferring U.S. tax on the separated untaxed earnings. If other changes in this Report were made, such as tightening source rules, limiting cross-crediting and restricting deferral, the potential for taking advantage of technical taxpayer planning would be eliminated (in the case of ending deferral) or materially reduced (in the case where other changes are made). Even if such changes were made, an adjustment to the technical taxpayer rule would be in order.

The New York State Bar Association Tax Section has suggested a change to the regulations that would permit apportionment of the foreign taxes among related persons (including for this purpose disregarded entities) in cases where the taxes and income were separated. The standard they propose is to be "consistent with the principles underlying the foreign tax credit rules." We understand this to mean that the Service would be empowered by regulation to associate foreign taxes with the income to which they relate.[325]

Proposal. The Service would be authorized to make allocations of foreign taxes among commonly controlled persons to the person that has the income to which the taxes relate under U.S. tax principles to achieve an appropriate matching of income and taxes and so further the objective of the foreign tax credit to avoid double taxation of income. The Service also would be authorized to make such correlative allocations as would be necessary to account for deemed transfers of cash.

Evaluation. The proposal is intended to prevent the separation of income and taxes among commonly controlled persons that would result in inappropriate allowance of credits for foreign taxes that are not associated with the income, as determined for U.S. tax purposes, that is taxed by the foreign jurisdiction. While this may be viewed as a derogation from the simplicity of the technical taxpayer rule, these cases arise most often as a result of taxpayer planning and should be addressed.

[325]NYSBA Tax Section, *Report on Allocation of Foreign Taxes*, *supra* note 214, at 5. As this Report was going to press, the Internal Revenue Service proposed regulations that would modify the technical taxpayer rule effective for foreign taxes paid in tax years beginning after January 1, 2007. *See* Notice of Proposed Rulemaking, 71 Fed. Reg. 44240 (Aug. 4, 2006), 2006 TNT 150-6. Generally, the proposed regulations are consistent with the proposal below, but they would allocate the foreign tax to a reverse hybrid according to each owner's income computed under foreign law.

Review of International Taxation Arrangements Measures and Issues — State Of Play

Date: Friday, 26 May 2006

Content ID: 940

Abstract: This document shows the state of play for measures announced by the Treasurer's Press Release No. 32 of 13 May 2003. Also included are issues on which the Government deferred a decision pending further consultation. Measures and issues are ordered by reference to the tranches identified in Attachment A of the Treasurer's press release.

The table identifies the relevant recommendation number from the Board of Taxation's February 2003 report to the Government on international taxation. Note that the measure or issue as described is the Government's response, which in some cases differed from the Board's recommendations.

Documents Available:

Acrobat (PDF)

State of Play 77.96kb

HTML

State of Play 25.58kb

Related Items: **Treasurer's Press Release No. 32 of 2003 - Review of International Tax Arrangements** - 13/05/2003

This press release announces the outcome of the Government's review of Australia's international taxation arrangements, following an extensive consultation process conducted by the Board of Taxation.

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New International Tax Arrangements Act 2004

The *New International Tax Arrangements Act 2004* was introduced into Parliament on 4 December 2003 and received Royal Assent on 23 June 2004.

The *New International Tax Arrangements Act 2004* saw Parliament legislate five Board of Taxation recommendations. The measures:

- Largely eliminate attribution of most of the income (apart from certain limited types of income) of a controlled foreign company (CFC) in listed countries, Board of Taxation recommendation 3(a). This is done through the *Income Tax Assessment Act 1936* (ITAA 1936) and new regulations contained in the Income Tax Amendment Regulations 2004 (No 115).

  (The New International Tax Arrangements Act 2004 refers to Broad Exemption Listed Countries (BELCs), but this classification was changed to Listed Countries by The New International Tax Arrangements (Participation Exemption and Other Measures) Act 2004. Until a list of listed countries is declared, a transitional provision in section 141 of the New International Tax Arrangements (Participation Exemption and Other Measures) Act 2004 specifies that the existing list of BELC countries (ie. US, UK, New Zealand, France, Canada, Japan and Germany) are taken to be listed countries.)

- Increase the balanced portfolio foreign investment fund (FIF) exemption for all taxpayers from 5% to 10%, Board of Taxation recommendation 4.2;
- Exempt complying superannuation funds and similar entities from the FIF rules, Board of Taxation recommendation 4.4;
- Remove 'management of funds' from the FIF rules, Board of Taxation recommendation 4.5; and
- Exempt Australian public unit trusts from interest withholding tax on interest paid on publicly offered debentures issued to non-residents, Board of Taxation recommendation 4.8C.

The five measures in the *New International Tax Arrangements Act 2004* are explained in more detail below.

Overview of Controlled Foreign Company rules

In general terms, Australia's controlled foreign company (CFC) rules (Part X of the *Income Tax Assessment Act 1936* (ITAA 1936)) tax certain Australian shareholders on their share of a CFC's "tainted income" unless that income is comparably taxed offshore or almost all the CFC's income is from active business activities.

A company will be treated as a CFC where it is controlled by Australians. Control is defined in terms of a percentage shareholding or through a *de facto* control test. A CFC has a share of its taxable income, called *attributable income*, included in the assessable income of its Australian resident controllers.

The CFC rules broadly address the deferral of tax that occurs when highly mobile income, passive income, capital gains or profits are accumulated in an entity outside Australia and not repatriated to the Australian controllers by way of dividends.

Largely eliminate attribution of most of the income of a controlled foreign company in a Broad Exemption Listed Country: Board of Taxation recommendation 3(a)

Where Australian residents control an offshore company, the income of that company may be attributed back to those Australian residents under the CFC rules.

Special attribution rules apply if the offshore company is in a listed country. A listed country is a country listed in the regulations as such. As already noted, until a list of listed countries is declared, a transitional provision in section 141 of the *International Tax Arrangements (Participation Exemption and Other Measures) Act 2004* provides that the existing list of BELC countries (ie. the US, the UK, New Zealand, France, Canada, Japan and Germany) are taken to be listed countries. Listed countries have tax systems broadly similar to Australia's. Only certain types of passive income that are concessionally treated and capital gains that are exempt in the listed country (called designated concession income in the *ITAA 1936* and the *ITAA*

36 regulations) are normally attributed.

The Income Tax Amendment Regulations 2004 (No 115), operating through the *ITAA 1936*, replace the broad classes of income which were previously attributed with a list of specific types of concessionally taxed income or untaxed capital gains. (However, note that other income such as foreign investment fund, transferor trust and certain trust income may also be attributed.)

The specific types of concessionally taxed income (called designated concession income) are set out in the income tax regulations and are listed below.

Item	***Summary of the concessional tax treatment that has resulted in an item being identified as Designated Concessional Income***
201	**Canada: international banking centres** *International banking centres were listed in the previous Schedule 9 as specific DCI.* *Interest income derived in respect of an international banking centre from loans to non-residents is exempt from tax in Canada in certain circumstances.*
202	**Canada: investment corporations and mutual fund corporations** *Investment corporations can deduct from their Canadian tax otherwise payable 20 per cent of the amount by which their taxable income exceeds their taxed capital gains.* *Mutual fund corporations (which may also qualify as an investment corporation) receive a refund of Canadian tax for dividends paid out of realised capital gains.*
203	**France: société d'investissement à capital variable (SICAVs)** *SICAVs were listed in the previous Schedule 9 as specific DCI.* *SICAVs are exempt from French tax on their portfolio income.*
204	**France: tonnage taxed income** *Tonnage tax is a tax based upon shipping tonnage, rather than income or profits related to the shipping. Tonnage tax rates are generally set to provide a significantly concessional tax outcome.*
205	**Germany: passive income of a permanent establishment** *Several of Germany's tax treaties provide an exemption from German tax for the income, including in some cases passive income, of German companies from their permanent establishments outside of Germany.*
206	**Germany: capital gains on shares** *Germany generally exempts from tax capital gains on the disposal of shares by a company, but with five per cent of the gain added to the tax base as a non-deductible business expense.*
207	**Germany: tonnage taxed income** *Tonnage tax is a tax based upon shipping tonnage, rather than income or profits related to the shipping. Tonnage tax rates are generally set to provide a significantly concessional tax outcome.*
208	**Japan: governmental bonds** *Interest on Japanese government bonds received by qualified non-residents (including in respect of such a non-resident carrying on a business in Japan through a permanent establishment) is tax exempt in Japan.*
209	**New Zealand: capital gains**

	New Zealand has no general capital gains tax.
210	**United Kingdom: substantial shareholding exemption** *Companies resident in the United Kingdom are exempt from United Kingdom capital gains tax on the disposal of a non-portfolio interest in another company where certain conditions are satisfied.* *This item only applies in certain conditions to capital gains that benefit from the exemption.*
211	**United Kingdom: tonnage taxed income** *Tonnage tax is a tax based upon shipping tonnage, rather than income or profits related to the shipping. Tonnage tax rates are generally set to provide a significantly concessional tax outcome.*
212	**United Kingdom: open-ended investment companies** *Open-ended investment companies are exempt from tax in the UK on capital gains, and taxed at 20 per cent on other income. In addition, open-ended investment companies that hold mostly debt securities can distribute this taxable income as deductible distributions, meaning that they are effectively exempt from tax in the United Kingdom. Such distributed amounts may not be subject to Australian tax (for example, because of the availability of an exemption under section 23AJ of the Act).*
213	**United States of America: tax-exempt governmental bonds** *Interest paid by a state or municipality of the United States of America is generally tax exempt in the US.*
214	**United States of America: regulated investment companies** *Regulated investment companies receive a US tax deduction for dividends paid, and accordingly do not usually pay tax themselves. Such distributed amounts may not be subject to Australian tax (for example, because of the availability of an exemption under section 23AJ of the Act).*

These CFC changes apply in relation to statutory accounting periods beginning on or after **1 July 2004**.

Question: how will this affect the 2004 tax returns?

Answer: *This measure will not generally affect 2004 tax returns as the measure applies to income years or statutory accounting periods beginning on or after 1 July 2004.*

Overview of Foreign Investment Fund rules

Australia's Foreign Investment Fund (FIF) rules (Part XI of the *Income Tax Assessment Act 1936* (ITAA 1936)) apply to Australian taxpayers who, at the end of an income year, have an interest in a foreign company that is not a controlled foreign company or a foreign trust that is not subject to the attribution rules under Division 6AAA (Transferor Trust provisions) of the *ITAA 1936*. An interest includes shares. Taxpayers with a foreign life assurance policy in an income year may also be subject to the FIF rules.

The operative provision (section 529 of ITAA 1936) includes an amount in a taxpayer's assessable income that represents the taxpayer's share of income that is taken to have accrued to the taxpayer from their interest in the FIF.

Any assessable income under the FIF rules is included in the Australian taxpayer's assessable income for the income year in which the notional accounting period of the FIF or the Foreign Life assurance Policy ends.

The following three measures in the *New International Tax Arrangements Act 2004* changed Australia's FIF rules.

Increase the balanced portfolio foreign investment fund exemption for all taxpayers

House of Representatives New International Tax Arrangements Bill 2003 New International Tax Arrangements Act 2004

Explanatory Memorandum

(Circulated by authority of the Treasurer, the Hon Peter Costello, MP)

Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	Definition
ADF	approved deposit fund
A Tax System Redesigned	Review of Business Taxation: *A Tax System Redesigned*
ATO	Australian Taxation Office
CFC	controlled foreign company
CGT	capital gains tax
Commissioner	Commissioner of Taxation
FIF	foreign investment fund
ITAA 1936	*Income Tax Assessment Act 1936*
IWT	interest withholding tax
PST	pooled superannuation trust

General outline and financial impact

Introduction

In the 2003 Federal Budget, following extensive consultation and a report by the Board of Taxation, the Government announced a package of reforms to international taxation. The measures contained in this bill, along with legislation enacting a new tax treaty with the United Kingdom, are part of the first instalment of these reforms.

Foreign investment funds

Schedule 1 to this bill will:

- exempt from the FIF rules qualifying superannuation entities and fixed trusts where all of the beneficiaries are complying superannuation entities;
- increase the FIF balanced portfolio exemption threshold from 5% to 10%; and
- remove management of funds from the FIF 'blacklist' of non-eligible business activities.

Date of effect: The superannuation exemption and the increase in the balanced portfolio exemption will apply to income years beginning on or after 1 July 2003. The removal of 'management of funds' will apply to notional

accounting periods of FIFs beginning on or after 1 July 2003.

Proposal announced: These proposals were announced in Treasurer's Press Release No. 32 of 13 May 2003.

Financial impact: The FIF exemption and the increase in the balanced portfolio exemption have a total cost to revenue of $15 million for 2004-2005, $20 million for 2005-2006 and $20 million for 2006-2007. The removal of management of funds will have a negligible impact on revenue over these years.

Compliance cost impact: These measures are expected to substantially lower compliance costs for affected taxpayers.

Interest withholding tax exemption for certain unit trusts

Schedule 2 to this bill will:

- remove the need for certain unit trusts to withhold tax on interest payments to non-residents in relation to widely offered debentures; and
- extend this exemption to foreign eligible unit trusts carrying on business in Australia where the interest would otherwise be subject to IWT.

Date of effect: The exemption from IWT will apply to all qualifying debentures issued on or after the day of Royal Assent.

Proposal announced: This proposal was announced in Treasurer's Press Release No. 32 of 13 May 2003.

Financial impact: The financial impact of this measure is estimated to be up to $3 million per annum over the forward estimates period.

Compliance cost impact: The amendments are expected to decrease compliance costs by reducing the need for eligible unit trusts to withhold a portion of interest payments made to foreigners. Furthermore, special purpose companies will not need to be created to enable eligible unit trusts to receive the exemption.

Attributable income of controlled foreign companies

Schedule 3 to this bill amends Part X of the ITAA 1936 to better target certain amounts that are included in the notional assessable income of a CFC resident in a broad-exemption listed country. Certain foreign source amounts will no longer be included in a CFC's notional assessable income, unless the amounts are also of a kind specified in regulations.

Date of effect: The amendments apply in relation to the statutory accounting periods of CFCs beginning on or after 1 July 2004.

Proposal announced: This is part of a proposal announced in Treasurer's Press Release No. 32 of 13 May 2003, as one component of several reforms to the CFC rules.

Financial impact: The financial impact of the amendments is expected to be negligible.

Compliance cost impact: The compliance cost of applying the CFC rules will be reduced.

Preventing double taxation of royalties subject to withholding tax

Schedule 4 to this bill amends the ITAA 1936 to ensure that double taxation does not occur where deductions

for royalty payments have been denied as a result of the operation of the transfer pricing provisions.

The amendment enables the Commissioner to determine that royalty withholding tax is not payable by a taxpayer to the extent that the transfer pricing rules have been used to disallow a deduction to the payer of the royalty.

Date of effect: The amendment made by this Schedule applies to applications of section 136AD of the ITAA 1936 that occur on or after the day of Royal Assent.

Proposal announced: Federal Budget Measures 2003-2004, Budget Paper No. 2.

Financial impact: The revenue impact of this amendment is $1 million per annum.

Compliance cost impact: Nil.

Summary of regulation impact statement

Regulation impact on business

Impact: Changes to the FIF rules are designed to better target the FIF rules and reduce compliance costs for affected taxpayers (principally the superannuation and managed fund sectors).

The IWT change will reduce the cost of obtaining offshore finance for certain unit trusts operating in Australia. The change will have greatest impact on the managed funds sector, which typically operates through unit trust structures. This change will ensure the same tax treatment is given to debentures issued by these trusts as is currently given to companies.

The change to the CFC rules is designed to reduce the cost of complying with these rules.

Note, this bill also contains an amendment that was not part of the review of international taxation arrangements. This amendment ensures royalty payments are not subject to double taxation to the extent that the transfer pricing rules have disallowed a deduction to the payer of the royalty. Due to its minor nature no regulation impact statement is required for this amendment.

Main points:

- Complying superannuation entities are unlikely to bias investments toward the kind of offshore investments that the FIF rules target. A new FIF exemption for qualifying superannuation entities and certain fixed trusts will mean that these taxpayers will no longer be subject to the FIF rules with associated savings in compliance costs. For example, these taxpayers will no longer classify their investments as 'exempt' or 'non-exempt', determine accrual income or maintain attribution accounts.

- The increase in the balanced portfolio exemption will lower compliance costs for fund managers and other taxpayers by reducing the practice of 'selling down' non-exempt FIF assets at the end of the income year in order to meet the balanced portfolio exemption threshold.

- The removal of 'management of funds' from the FIF 'blacklist' will reduce the compliance costs of the FIF rules for those taxpayers that hold investments in offshore funds management companies.

- The IWT measure will make it easier and less expensive for certain unit trusts, typically in the managed funds industry, to borrow offshore. It will remove a distortion in favour of companies over trusts in relation to offshore borrowing.

Consequential amendments

2.17 The consequential amendments to the ITAA 1936 ensure that the operation of the withholding tax provisions is not compromised. These consequential amendments ensure like treatment is provided to debentures issued by companies and eligible unit trusts. ***[Schedule 2, items 1 to 4, subsection 25(2), paragraph 128AAA(2)(b), subparagraph 128B(3)(h)(iv) and section 128D]***

Chapter 3 - Attributable income of controlled foreign companies

Outline of chapter

3.1 Schedule 3 to this bill amends Part X of the ITAA 1936 to better target those amounts that are included in the notional assessable income of a CFC resident in a broad-exemption listed country. Certain amounts will no longer be included in a CFC's notional assessable income, unless the amounts are also of a kind specified in the regulations. This chapter explains the amendments. Context of amendments

3.2 The CFC rules include in the taxable income of an Australian taxpayer, the taxpayer's share of specified income of non-resident companies in which they have a controlling interest. The income that is targeted for attribution to taxpayers is income that can readily be shifted by taxpayers to non-resident companies to take advantage of any lower overseas taxation.

3.3 For CFCs resident in broad-exemption listed countries (currently Canada, France, Germany, Japan, New Zealand, the United Kingdom, and the United States of America) a narrower range of income is attributable. These countries have comparable income tax regimes to Australia, which significantly reduces the scope to avoid tax.

3.4 While a narrower range of income is attributable for CFCs in broad-exemption listed countries, various general categories of income (e.g. royalties and certain foreign source amounts) remain attributable subject to the application of various tests. These categories and tests were introduced in 1991, when the number of countries treated like broad-exemption listed countries was over 60. The large number of countries made precise identification of attributable income difficult.

3.5 As part of the Government's response to the Board of Taxation's report to the Treasurer, the Government will amend the ITAA 1936 and the Income Tax Regulations 1936 to further reduce the categories of income attributable in respect of CFCs resident in broad-exemption listed countries. This will be done by more precisely identifying the types of income that give rise to significant revenue risk. While this will primarily be achieved by future changes to the regulations (not covered in this bill), the amendments in Schedule 3 complement those intended changes. The changes will reduce compliance costs and improve the commercial flexibility of CFCs resident in broad-exemption listed countries. Summary of new law

3.6 The amendments in this Schedule reduce the scope of income attributable in respect of CFCs resident in broad-exemption listed countries, subject to a safeguard that allows amounts to remain attributable if identified in the regulations.

3.7 The amendments apply to statutory accounting periods of CFCs beginning on or after 1 July 2004.

Comparison of key features of new law and current law

New law	Current law
The notional assessable income of a CFC resident in a broad-exemption listed country is calculated taking into account certain foreign source amounts only if those amounts *are of a kind specified in regulations.*	The notional assessable income of a CFC resident in a broad-exemption listed country is calculated taking into account certain foreign source amounts.

Detailed explanation of new law

3.8 A CFC's attributable income is calculated on a notional basis using the rules for calculating the taxable income of an Australian resident company, subject to some modifications and exemptions. The notional assessable income of a CFC depends on whether the CFC is resident in a broad-exemption listed country or elsewhere.

3.9 If a CFC is resident in a broad-exemption listed country, a greater range of otherwise notional assessable income is exempt from attribution. One category of notional assessable income that remains subject to attribution relates to foreign source amounts that are not eligible designated concession income and pass certain tests, whether derived directly or through a partnership (subparagraphs 385(2)(a)(ii) and (d)(ii)).

Limiting the inclusion of foreign source amounts in attributable income

3.10 While these foreign source amounts can potentially give rise to attributable income in a wide range of circumstances, in practice this is unlikely to occur. For example, even where a CFC resident in a broad-exemption listed country derives a relevant foreign source amount, it is not attributable if subject to certain foreign taxes. However, taxpayers can still incur compliance costs to confirm that there is no such attributable income. The amendments remove the need for taxpayers to consider such amounts, except those, if any, specified in regulations. ***[Schedule 3, item 1, subparagraphs 385(2)(a)(ii) and (d)(ii)]***

3.11 The ability to identify in regulations income amounts that should still be attributable is a revenue safeguard (e.g. in the case where a broad-exemption listed country changes its tax system in a way that opens up tax avoidance opportunities for Australian taxpayers). In most cases, though, income of concern is likely to be attributable under other provisions (e.g. as eligible designated concession income under subparagraphs 385(2)(a)(i) and (d)(i)).

Application and transitional provisions

3.12 The amendments apply to statutory accounting periods of CFCs beginning on or after 1 July 2004. ***[Schedule 3, item 2]***

3.13 The statutory accounting period of a CFC is, in general, each 12-month period ending 30 June. However, a CFC can elect for its statutory accounting period to end on a different date. The attributable income of a CFC, in respect of a particular statutory accounting period, is included in the assessable income of relevant Australian taxpayers in the year of income in which the statutory accounting period ends.

Chapter 4 - Preventing double taxation of royalties subject to withholding tax

Outline of chapter

4.1 Schedule 4 to this bill amends the ITAA 1936 to ensure that double taxation does not occur where deductions for royalty payments have been denied as a result of the operation of the transfer pricing provisions.

4.2 The amendment enables the Commissioner to determine that royalty withholding tax is not payable to the extent that the transfer pricing rules have disallowed a deduction to the payer of the royalty.

Context of amendments

4.3 Australia's domestic transfer pricing provisions and the *Associated Enterprises* Article of Australia's tax treaties authorise the adjustment of profits between related parties to reflect an arm's length profit for taxation purposes.

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Bills Digest No. 133 2003-04

New International Tax Arrangements (Participation Exemption and Other Measures) Bill 2004

WARNING:
This Digest was prepared for debate. It reflects the legislation as introduced and does not canvass subsequent amendments. This Digest does not have any official legal status. Other sources should be consulted to determine the subsequent official status of the Bill.

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The following abbreviations and acronyms are used throughout this Bills Digest.

Abbreviation	*Definition*
AFBAP	active foreign business asset percentage
ATO	Australian Taxation Office
CGT	capital gains tax
Consultation Paper	Treasury's consultation paper, *Review of International Taxation Arrangements*
ITAA 1936	*Income Tax Assessment Act 1936*
ITAA 1997	*Income Tax Assessment Act 1997*
RITA	Review of International Tax Arrangements
the Board	Board of Taxation
the Board's Report	Board of Taxation's Report, *International Taxation – A Report to the Treasurer*

Passage History

New International Tax Arrangements (Participation Exemption and Other Measures) Bill 2004

Date Introduced: 1 April 2004

House: House of Representatives

Portfolio: Treasury

Commencement: Formal provisions of the bill commence on Royal Assent. The various measures contained in the bill have various application dates, which are indicated in the Main Provisions section of this Bills Digest.

Purpose

There are 3 Schedules to the bill and the main purpose of each Schedule is set out below.

- Schedule 1 to this bill amends the income tax law to ignore capital gains and losses arising from capital gains tax (CGT) events happening to shares in foreign companies which are held either by Australian companies or by controlled foreign companies in certain, specified circumstances. Broadly, the gains or losses will be disregarded to the extent that the foreign company has an underlying active business.
- Schedule 2 to this bill extends the existing exemptions for branch profits earned in, and non-portfolio dividends paid from, certain listed countries to all countries. It also changes the existing classification of countries as broad-exemption listed countries, limited-exemption listed countries or unlisted countries to either listed or unlisted countries.
- Schedule 3 to this bill amends sections 448 and 450 of the *Income Tax Assessment Act 1936* to reduce the scope of tainted services income. Tainted services income will, in general, no longer include income from services provided by a company to a non-resident associate, or the overseas permanent establishment of an Australian resident.

Generally, the purpose of the measures in the bill is to improve the international competitiveness of Australian companies.

Background

1. On 2 May 2002 the Treasurer announced details of a review of international tax arrangements (RITA) concentrating on at least four principal areas:

- the dividend imputation system's treatment of foreign source income,
- the foreign source income rules,
- the overall treatment of 'conduit income' , and
- high level aspects of Double Tax Agreement (DTA) policy and processes(1).

2. The consultation paper titled – *Review of International Tax Arrangements – Consultation Paper* was released by Treasury on 19 September 2002(2). This paper explored a range of international tax issues that may affect the attractiveness of Australia as a place for business and investment and identified options for consultation to be conducted by the Board of Taxation.
3. After extensive public consultation the Board of Taxation reported to the Treasurer on 28 February 2003(3). This report was titled – *Review of International Tax Arrangements: A Report to the Treasurer*.
4. On 13 May 2003, the Treasurer released the report of the Board of Taxation and announced the Government's response.(4) To enable public consultation to be undertaken on the design of legislation, including addressing integrity issues, the Treasurer announced that the majority of reforms will not commence until 1 July 2004 or later. It was also announced that the package will be introduced in tranches. The Explanatory Memorandum to the bill states that following on from a new tax treaty with the United Kingdom and the New International Tax Arrangements Bill 2003, the measures contained in this bill are a further substantial instalment of those reforms.(5)
5. The New International Taxation Arrangements Bill 2003 was introduced into the House of Representatives on 4 December 2003. The Bill passed the House of Representatives on 4 March 2004 and was introduced into the Senate on 10 March 2004. The Bill has been referred to the Senate Economics Legislation Committee for inquiry and report by 12 May 2004.(6)

Main Provisions

Schedule 1- CGT concession for shares held by Australian holding companies or controlled foreign companies in active foreign companies

Item 3 of **Schedule 1** of the Bill which will insert **proposed Subdivision 768-G** provides a reduction in capital gains and losses from CGT events in relation to non-portfolio interests of an Australian holding company or a controlled foreign company in active foreign companies. The gain or loss is reduced by a percentage called the ***active foreign business asset percentage*** (AFBAP) under **proposed subsection 768-505(2)** that reflects the degree to which the assets of the foreign company are used in an active business. In the case of a controlled foreign company, the rules will apply in the calculation of the controlled foreign company's attributable income under Part X of the ITAA 1936.

Who and what shares will this measure apply to?

Proposed section 768-505 provides that the Australian holding company of a share in a foreign resident company must satisfy the following tests to be eligible for the CGT reduction in **proposed Subdivision 768-G**:

(a) the holding company must hold a direct voting percentage of 10% or more in the foreign resident company when the CGT event happens; and

(b) the requisite share interest was held by the holding company for a continuous period of at least 12 months in the two years before the CGT event; and

(c) the share in the foreign resident company must not be an eligible finance share or a widely distributed finance share as defined in Part X of the ITAA 1936.

The Explanatory Memorandum states in paragraphs 1.37 and 1.38 that the requirement in relation to minimum shareholding and minimum period of holding are included to ensure that the relief is limited to structural holdings of the Australian company and not to mere temporary investments in a foreign resident company. Further, it adds that the intention of this measure is to allow companies to restructure their foreign structural holdings without being overburdened by Australian tax considerations.

The Explanatory Memorandum in paragraph 1.22 states that an eligible finance share or a widely distributed finance share are excluded as such shares are in substance the equivalent of debt and the relief measure is intended for equity interests.

Meaning of voting percentages that an entity has in a foreign company?

Proposed section 768-550 and **proposed section 768-555** provide definitions of direct voting percentage and indirect voting percentage respectively that an entity may have in a foreign company. There is also a definition of total voting percentage in **proposed section 768-560** as being the sum of the direct voting percentage and indirect voting percentage.

What is the meaning of direct voting percentage?

The direct voting percentage that an entity has in a foreign company follows section 160AFB of the ITAA 1936 under **proposed paragraph 768-550(1)(a)**. It is equal to the voting interest it holds in that foreign company as a percentage of the voting power of that company. However, **proposed subsection 768-550(2)** modifies the application of section 160AFB by providing that an entity is not the beneficial owner of a share in a foreign company if a trust or a partnership is interposed between the entity and the trust. In

consequence, where a trust or a partnership is so interposed, **proposed paragraph 768-550(1)(b)** provides that the direct voting percentage is zero.

What is the meaning of indirect voting percentage?

An entity's indirect voting percentage in a subsidiary company as defined in **proposed subsection 768-555(1)** provides for a situation when there is one or more interposed intermediate companies or a chain of intermediate companies between the entity and the subsidiary.

The indirect voting percentage is worked out by multiplying:

(a) the entity's direct voting percentage in an intermediate company:

by:

(b) the sum of:

(i) the intermediate company's direct voting percentage in the subsidiary; and

(ii) the intermediate company's indirect voting percentage in the subsidiary

Proposed subparagraph 768-555(1)(b)(ii) states that in determining the intermediate company's indirect voting percentage it should be worked out under one or more other applications of **proposed section 768-555** in an attempt to avoid the circularity of this definition.

Reduction in Capital Gains and Losses from Certain CGT Events based on active foreign business asset percentage (AFBAP) to total assets

Proposed Subdivision 768-G sets out the manner in which the AFBAP is to be worked out. It offers the holding company the option of two methods to work out the AFBAP under **proposed section 768-515**. The options available are the market value method provided in **proposed subsection 768-510(2)** or the book value method provided in **proposed section 768-510(3)**. Failure to qualify for these options will result in the application of a default method set out in **proposed subsection 768-510(4)**.

Market value method for working out AFBAP

The market value method can be chosen if there is sufficient evidence of the market value at that time of the CGT event of:

(i) all assets included in the total assets of the foreign company at that time; and

(ii) all active foreign business assets of the foreign company at that time.

This requirement is set out in **proposed paragraph 768-510(2)(b)**.

The method statement to work out the AFBAP for the market value method is set out in **proposed section 768-520**. The reader should refer to paragraphs 1.70 to 1.78 of the Explanatory Memorandum to the bill for further explanations and examples of the application of the market value method to determine the AFBAP.

Book value method for working out AFBAP

The book value method can only be adopted if there are recognised company accounts of the foreign company as provided in **proposed subsection 768-510(3)**. A definition of the expression 'recognised company accounts' will be inserted into section 995-1(1) by **item 17** of **Schedule 1**. Under this definition the recognised company accounts of a foreign company are accounts that are prepared in accordance with:

- the accounting standards prepared by the responsible body in Canada, France, Germany, Japan, New Zealand, United Kingdom (UK) or United States of America (USA), or the international accounting standards; or
- commercially accepted accounting principles that give a true and fair view of the financial position of the foreign company.

The reader should refer to paragraphs 1.79 to 1.98 of the Explanatory Memorandum to the bill for further explanations and examples of the application of the book value method to determine the AFBAP.

Default method for working out AFBAP

The default method prescribes the value of the AFBAP in **proposed subsection 768-510 (4)** and varies depending on whether it is to be applied to a capital gain or capital loss. In the case of a gain, the AFBAP will be 0% and the amount of the gain will be fully taxable. In the case of a loss, it will be 100% and the full amount of the capital loss will be disregarded.

The Explanatory Memorandum in paragraph 1.102 states that the default rule is an integrity measure that aims to prevent a company that has made a capital loss from gaining a benefit just because it has chosen not to calculate the AFBAP under the market value method or the book value method.

What are active foreign business assets of a foreign company?

Proposed sections 768-540 and **768-545** provide a definition of active foreign business assets of a foreign company and which is broadly based on existing definitions in the income tax law of 'tainted asset' in section 317 of the ITAA 1936 and 'active asset' in section 152-40 of the ITAA 1997.

The following conditions must be satisfied for an asset to be classified as an active foreign business asset of a foreign company.

(a) The asset must be included in the total assets of the company. (**proposed paragraph 768-540(1)(a))**

(b) The asset must be one of three kinds of assets.

(i) the asset must be used or ready for use in the course of carrying on a business;

(ii) the asset is goodwill;

(iii) the asset is a share.

(proposed paragraph 768-540(1)(b))

(c) The asset is not a CGT asset which has the necessary connection with Australia. **(proposed paragraph 768-540((1)c))**

(d) The asset must not be an excluded asset as defined in **proposed subsection 768-540 (2)**. (**proposed paragraph 768-540(1)(d)**)

(e) The asset is not covered by **proposed subsection 768-540(4)** where the foreign company is an Australian financial institution (AFI) subsidiary. (**proposed paragraph 768-540(1)(e)**.

Assets excluded in working out AFBAP under proposed subsection 768-540(2)

The assets specifically excluded from the definition of active foreign business asset under **proposed subsection 768-540(2)** include financial instruments, certain types of shares, interests in a trust or partnership, life insurance policies, rights or options to certain assets, cash or cash equivalent and assets deriving passive income.

These exclusions are generally based on provisions in tax law dealing with the distinction between active and not active assets or income. Assets whose main use in the course of carrying on business is the derivation of passive investment income such as interest, an annuity, rent, royalties or foreign exchange gains are specifically excluded from the definition of active assets under **proposed paragraph 768-540(2)(g)** except where:

(i) the asset is an intangible asset and its market value has been substantially enhanced through development, alteration or improvement to the asset; or

(ii) the main use for deriving rent was temporary.

Modifications of measures for working out total assets and active foreign business assets for Australian Financial Institutions (AFI)

The measures in the Bill provide for the modification of the rules for working total assets and active foreign business assets of AFI subsidiaries in recognition of the fact that financial institutions hold, trade in and dispose of certain financial instruments as part of their active rather than mere passive investment activities. The modifications provide for derivative assets to be included in total assets under **proposed section 768-545** and certain financial instruments to be included in active business assets under **proposed paragraphs 786-540 (1)(e)** and **proposed subsection 768-540(3). Proposed paragraphs 768-540(1)(e)** and **768-545(1)(c)** and **subsection 768-540(3)** provide that the modified rules for working out total assets and active foreign business assets will apply to AFI subsidiaries whose sole or principal business is financial intermediary business. The meaning of both AFI subsidiary and financial intermediary business is the same as the meaning in Part X of the ITAA 1936.

Modifications of measures for working out the active foreign business asset percentage for insurance companies

The calculation of the active foreign business asset percentage for foreign life and foreign general insurance companies is modified taking into account the special regulatory and solvency requirements for insurance companies. The calculation of the active foreign business asset percentage for both life insurance and general insurance companies is modified in **proposed section 768-530**.

In the case of life insurance companies, the value of active foreign business assets is modified to include the value of non-active assets held to meet untainted insurance policy liabilities (**proposed subsections 768-530(3)** and **(4)**). Untainted insurance policies are insurance policies that do not give rise to tainted services income. The insurance policies that do give rise to tainted services income are those where the owner of the policy is an Australian resident.

For general insurance companies, the value of active foreign business assets is modified to include the value of non-active assets that relate to untainted outstanding claims of the company (**proposed subsections 768-530(3) and (4)**). Untainted outstanding claims are so much of the outstanding claims of the company at the end of the statutory accounting period that are referable to general insurance policies that do not give rise to tainted services income of the company of any statutory accounting period.

The reader is referred to paragraphs 1.178 to 1.213 of the Explanatory Memorandum for further details of the modifications for insurance companies.

Modifications for foreign wholly owned groups to determine the foreign business asset percentage on a consolidated basis

Where the determination of the active foreign business asset percentage involves a tier of foreign companies the calculation may be done on a consolidated basis for wholly-owned companies comprising or within that tier of companies. One calculation is performed for the top foreign company in the wholly-owned group that also covers all its 100% owned foreign subsidiary companies. **Proposed subsection 768-535(2)** gives the holding a choice to calculate the active foreign business asset percentage of the top foreign company on a consolidated basis. However, **proposed paragraph 768-535(1)(b)** provides that this choice cannot be made if the top foreign company of the wholly-owned group is:

an AFI subsidiary

a foreign life company; or

- a foreign general insurance company.

The use of consolidated accounts reflects the principle that within a wholly-owned group, internal transactions, and particularly internal debt and equity funding, should not affect the extent to which the foreign company being disposed of is considered to have an underlying active business.

Application

The measures relating to the reduction in capital gains and losses arising of non-portfolio interests in active foreign companies apply to CGT events happening on or after 1 April 2004 (**Schedule 1, item 1**), the date of introduction of the bill.

Schedule 2 – Foreign branch income, non-portfolio dividends and listed countries

The measures in **Schedule 2** expand the current exemptions for foreign branch profits and foreign non-portfolio dividends received by Australian companies. It also effects changes to the definition of 'listed country'.

Foreign branch income exemption

Currently, resident companies do not include in assessable income certain foreign branch income and certain capital gains derived from a business carried on through a permanent establishment in a listed country. The amounts are not assessable and are not exempt income under section 23AH of the ITAA 1936. Non-assessable non-exempt income as defined in section 6-23 of the ITAA 1997 is not assessable income and is not taken into account in working out a taxpayer's taxable income for an income year. As the amount is also not exempt income, it is not taken into account in working out a taxpayer's tax loss for an

income year or in working out how much of a prior year tax loss is deductible in an income year.

Further, a resident company may be a partner in a partnership or beneficiary of a trust that has a permanent establishment in a foreign country (there may also be several interposed partnerships and trusts between the resident company and the partnership or trust). In such circumstances, similar amounts of foreign branch income and capital gains, derived from a business carried on through the permanent establishment, are also not included in assessable income to the extent of the company's indirect interest in that income or those gains.

Item 1 of **Schedule 2** will repeal section 23AH and substitute **proposed new section 23AH**. The new section provides an exemption to a resident company for most foreign income and gains derived through a foreign permanent establishment in either a listed or unlisted country. The exemption will also continue to be available to resident companies that are partners in a partnership or beneficiaries of a trust (or where there are several interposed partnerships and trusts). The exemption applies to the extent of the company's indirect interest in the amounts derived through the permanent establishment.

Foreign non-portfolio dividends

Non-portfolio dividends paid from a company resident in a listed country are currently not included in the assessable income of resident company recipients under section 23AJ of the ITAA 1936. Some dividends paid by a company resident in an unlisted country may also not be included where the dividend is paid out of profits that were taxed in a listed country. Division 6 of Part X of the ITAA 1936 (about exempting receipts, profits and profits percentage) provides a mechanism for this, particularly for dividends paid by companies resident in unlisted countries. Non-portfolio dividend as defined in section 317 of the ITAA 1936 means a dividend paid to a company where that company has a voting interest amounting to at least 10% of the voting power. It does not include a finance share dividend or a widely distributed finance share dividend.

The policy underlying section 23AJ and Division 6 of Part X was to exempt comparably taxed profits upon distribution to a resident company. The Treasurer's announcement in Press Release No. 32 of 13 May 2003 removed the comparable tax requirement, thus allowing an exclusion from assessable income for all non-portfolio dividends. To give effect to this policy change **Item 4** of **Schedule 2** repeals section 23AJ and substitutes **proposed new section 23AJ. Item 57** of **Schedule 2** repeals Division 6 of Part X.

Foreign tax credits

A foreign tax credit is generally available under Division 18 of Part 111 of the ITAA 1936 where a resident entity includes foreign income in its assessable income and foreign tax was paid on its foreign income. The foreign tax credit was intended to avoid double taxation. As all non-portfolio dividends will be excluded from assessable income under the proposed measures there will be no double taxation of such income and foreign tax credits for underlying foreign company tax now available under section 160AFC of the ITAA 1936 will no longer be required. **Item 37** of **Schedule 2** repeals section 160AFC.

The repeal of section 160AFC will have impacts on several other provisions which are discussed together with the consequential amendments in paragraphs 2.72 to 2.93 of the Explanatory Memorandum to the bill.

Listed countries

The current provisions relating to the exemption of foreign branch income require that it must be subject to tax in a listed country. Income taxed in a listed country generally means that the foreign income is considered to have been comparably taxed to income derived in Australia. Currently, listed countries as defined in subsection 320 of the ITAA 1936 fall into two classes: broad-exemption listed countries and limited-exemption listed countries. Broad-

exemption listed countries are countries with very similar income tax systems to Australia while limited-exemption listed countries are countries with broadly comparable income tax systems to Australia. **Items 85** and **86 of Schedule 2** repeal the definitions of broad-exemption listed country and limited-emption listed country in subsection 320(1) of the ITAA 1936. **Item 87** repeals the definition of listed country and substitutes a new definition in subsection 320(1) of the ITAA 1936. Under the proposed definition a listed country means a foreign country, or a part of a foreign country, that is declared by the regulations to be a listed country for the purposes of Part X of the ITAA 1936 dealing with controlled foreign countries.

Comparison of key features of new law proposed by Schedule 2 and current law

Current law	New law
A foreign non-portfolio dividend paid to a resident company out of comparably taxed profits is not assessable income.	All foreign non-portfolio dividends paid to Australian companies are not assessable income.
Some non-portfolio dividends paid to a controlled foreign company may be attributed to an Australian shareholder.	Non-portfolio dividends paid to a controlled foreign company are no longer attributed to Australian shareholders.
Foreign branch profits derived by a resident company from a comparably taxing country are generally exempt from Australian tax. There is no active income test for branches in broad-exemption listed countries and no income earned in branches in unlisted countries is exempt.	Active foreign branch income derived by a resident company in any foreign country will be non-assessable income. Only tainted income will ever be assessable and that will depend on the branch failing an active income test in all cases.
Foreign tax credits are available for foreign underlying company tax deemed to be paid by a resident company that receives an assessable foreign dividend from a related foreign company.	There will be no foreign tax credit for underlying tax paid on profits from which dividends are paid.
Section 458 directly includes in the assessable income of an attributable taxpayer a non-portfolio dividend paid from a controlled foreign company in an unlisted country to another controlled foreign company in a listed country which doesn't tax the dividend. It also applies to certain other dividends.	Section 458 is repealed.
Section 459 directly attributes deemed dividends paid directly or indirectly between some controlled foreign companies to their Australian shareholders.	Section 459 is repealed but in some cases the deemed dividend may be counted as part of the attributable income of a controlled foreign company.
An attributable taxpayer's assessable income includes: • unrealised gains accumulated on all assets; and • all distributable profits, where a controlled foreign company changes residence from an unlisted to a listed country.	An attributable taxpayer's assessable income will include only: • unrealised gains accumulated on tainted assets; and • adjusted tainted income other than non-portfolio dividends, where a controlled foreign company changes residence from an unlisted to a listed country.
The controlled foreign companies rules,	Countries are either listed or unlisted. The

dividend rules and branch profits rules apply differently depending on the country concerned. Countries are classified as either broad-exemption listed countries, limited-exemption listed countries or unlisted countries.	unlisted category includes countries previously classed as limited-exemption listed countries. The listed class consists of those previously called broad-exemption listed countries. The previous limited-exemption listed country list is used for one provision only.

Source: Explanatory Memorandum at the end of paragraph 2.12

Application

- The expanded exemption for foreign branch profits applies to income years commencing on or after 1 July 2004 (**Schedule 2, item 140(1)**).
- The expanded exemption for non-portfolio dividends apply to dividends paid after 30 June 2004 (**Schedule 2, item 140(2)**).
- The changes to the classification of countries and the definition of a listed country apply to income years and statutory accounting periods commencing on or after 1 July 2004 (**Schedule 2, item 140(3)**).

Schedule 3 – Tainted services income

The controlled foreign companies rules include in the taxable income of an Australian taxpayer, the taxpayer's share of the specified income (known as attributable income) of a non-resident company in which they have a controlling interest. The income targeted for attribution is income that can readily be shifted offshore by taxpayers to non-resident companies that they own or control, to take advantage of any lower tax rates offshore

One category of attributable income is called tainted services income. Tainted services income is, in general, income from services provided by a company to an Australian resident or to an associate of the company (including non-resident associates). It also includes income from services provided to a non-resident in connection with a business carried on by the non-resident through a permanent establishment in Australia.

The measures in **Schedule 3** reduce the scope of tainted services income without altering the tainted services concept. The amendments in **item 1** of **Schedule 3** repeal existing paragraph 448(1)(a) and substitutes **proposed new paragraph 448(1)(a)** which generally removes from the scope of tainted services income, the income a company derives from providing services to non-resident associates.

The removal of services provided to non-resident associates from tainted services income is applied consistently to the treatment of insurance premium income and relevant Australian financial institution subsidiary income by amendments proposed by **items 3, 4, 7, 8** and **9** of **Schedule** 3.

Application

The amendments apply to statutory accounting periods of companies beginning on or after 1 July 2004 (**Schedule 3, item 10**).

Concluding Comments

Economic benefits of the measures in the Bill

The economic benefits resulting from implementing the measures in the Bill are set out in paragraphs 4.22 to 4.26 of the Regulation Impact Statement which is Chapter 4 of the Explanatory Memorandum to the Bill. These are set out below for ease of reference.

CGT relief for disposal of a non-portfolio interest in a foreign company with an active business - Schedule 1 amendments

This measure will align more closely the tax treatment of selling an interest in a foreign company (that has an active business) with the tax outcome that would result if the foreign company disposed of its active foreign business assets and distributed those profits to its shareholders. In other words, there will be no liability to Australian tax if an Australian company (or its controlled foreign company) sells a non-portfolio interest in a foreign company *or* if the Australian company (or its controlled foreign company) procures the foreign company to sell its active assets and distribute those profits as a dividend.

This will increase flexibility in corporate restructuring decisions, and will provide an exemption to Australian companies similar to what is currently available in many European countries. This will ensure that Australian companies are not at a competitive disadvantage when they seek to invest offshore, and will encourage foreign groups to establish a regional headquarters in Australia.

Extension of the exemption for non-portfolio dividends and certain foreign branch profits to all countries - Schedule 2 amendments

The measure will assist Australian companies investing in foreign countries to be more competitive with foreign counterparts, as they will not be required to pay additional Australian tax on foreign active business income. It will also remove income tax impediments for companies who distribute profits from countries not currently eligible for an exemption, but who will benefit from the extended exemption.

The substantial compliance cost savings for companies will also provide economic benefits.

Modified application of the tainted services income rules - Schedule 3 amendments

The measure will allow Australian multinationals to better compete internationally, with negligible risk to the tax base. It will also provide a more neutral treatment of services provided to group companies by offshore group service centres. Achieving these outcomes will increase Australia's ability to retain and attract multinationals and regional headquarter operations

Financial impact of the measures in the Bill

The costs to revenue of the measures contained in the Bill are summarised from information provided in the Explanatory Memorandum, as follows:

Measure	2003-2004	2004-2005	2005-2006	2006-2007
1. CGT relief for disposal of a non-portfolio interest in a foreign company with an active business - Schedule 1	The financial impact of this measure is not quantifiable	The financial impact of this measure is not quantifiable	The financial impact of this measure is not quantifiable	The financial impact of this measure is not quantifiable

amendments				
2. Extend exemption for non-portfolio dividends and certain branch profits to all countries – Schedule 2 amendments	Nil (a)	Nil (a)	-$30 million (a)	-$55 million (a)
3. Modified application of the tainted services income rules Schedule 3 amendments	Nil (b)	Nil (b)	-$10 million (b)	-$10 million (b)

However, the Regulation Impact Statement (RIS) in Table 4.3 titled - Taxpayers affected by measures in the bill - refers to the lack of complete data relating to taxpayers affected by measures in the bill. This would appear to cast doubts on the accuracy of the estimates in rows 2 and 3 of the above table. The reservations in the RIS are set out in paragraphs (a) and (b) below:

(a) Extending the exemptions for non-portfolio dividends and certain foreign branch profits to all countries will potentially impact on all companies considering substantial investments offshore. It is not known how many companies will be affected.

(b) The modified application of the tainted service income rules will primarily benefit Australian resident taxpayers with controlled foreign companies or overseas branches that provide services to non-resident associates. A reliable estimate of the number of overseas permanent establishments of Australian companies is not available given current data holdings.

Endnotes

1. Treasurer's Press Release No 021 of 2 May 2002, http://www.treasurer.gov.au/tsr/content/pressreleases/2002/021.asp
2. *Review of International Tax Arrangement – Consultation Paper* of 19 September 2002, Commonwealth Treasury, http://www.taxboard.gov.au/content/int_tax/int_tax.asp
3. Review of International Tax Arrangements: A Report to the Treasurer, http://www.taxboard.gov.au/content/rita_report/index.asp
4. Treasurer's Press Release No 032 of 13 May 2003, http://www.treasurer.gov.au/tsr/content/pressreleases/2003/032.asp
5. Explanatory Memorandum to the New International Tax Arrangements (Participation Exemption and Other Measures) Bill 2004, p. 3.
6. Explanatory Memorandum, to the New International Tax Arrangements Bill 2003 and the, Bills Digest No 79 2003-04.

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ISSN 1328-8091
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International Taxation

A Report to the Treasurer

Volume 1

The Board of Taxation's Recommendations

The Board of Taxation

28 February 2003

CHAPTER 1: INTERNATIONAL TAX ARRANGEMENTS PROMOTING AUSTRALIA'S COMPETITIVENESS

Introduction

1.1 This chapter provides an overview of the Board of Taxation's (the Board) recommendations. It summarises the Board's recommendations and presents the basic principles that lie behind the Board's reasoning. The succeeding Chapters 2-5 deal with each of the Board's specific recommendations in more detail.

1.2 Competitiveness in an increasingly open and integrated global economy has become a central preoccupation of governments and companies around the world. The last 20 years has seen the weaving of national economies into a more integrated world economy. The Board approached its task of reviewing Australia's international taxation arrangements from the perspective that Australia's future prosperity depends on its capacity to engage competitively in the global economy.

1.3 The basic competitive unit in the global marketplace is the corporation. Hence, a key focus of the Board's consideration has been the ability of Australia's corporations to compete in that marketplace. Australia has a small population and limited capital. It must be able to attract capital from overseas, and its businesses must be able to earn the best possible return on Australians' savings. Indeed, businesses need to be able to earn the best possible return on all the capital they employ, including capital employed overseas. This is particularly so when their domestic opportunities become constrained, as to varying degrees is the case for most larger Australian companies.

1.4 As Australia has integrated into the global marketplace, investment by Australian firms in other countries has increased sharply. This is part of a worldwide trend. It is reflected in ever-rising trade and investment flows, rising labour mobility, and the rapid sharing of know-how and technology. Globally, foreign direct investment (FDI) has increased from 2 per cent of worldwide investment in the early 1980s to more than 8 per cent in the late 1990s.[1] This trend will continue. It is thus becoming increasingly important that the Australian domestic economy offer an attractive investment location for foreign companies. It is also becoming increasingly important that Australian companies are able to invest competitively in international markets. The taxation system should not impede either of these objectives. In this

1 Productivity Commission (2001), *Offshore Investment by Australian Firms: Survey Evidence*, p. xi.

regard, the competitive environment for Australia is not static. Other countries are making relevant changes to their taxation systems. Australia must do so too.

1.5 Australia must regularly review its taxation system to ensure that business competitiveness is not unduly hindered. Global integration provides business and individuals with greater freedom to take advantage of opportunities outside their home country. This includes the commercial reality that investment decisions take into account the level and complexity of taxation in different countries. While economic and commercial factors dominate, government also affects many aspects of the competitive environment notably via taxation regimes.

1.6 A recent Productivity Commission survey of Australian firms found that foreign and domestic taxation regimes were among the most important *government* factors influencing investment decisions.[2] About 55 per cent of firms considering whether to invest offshore in the next five years rated the Australian tax environment as 'important' to their decisions.

1.7 Furthermore, although few submissions made to the Board argued that tax was the primary reason behind companies' business decisions, most submissions did reflect the importance of Australia's taxation arrangements. Many submissions highlighted reforms that other countries have made to international or other relevant aspects of tax regimes to encourage investment flows. They also highlighted the risks which Australia faces if its existing international tax arrangements remain unchanged, and the opportunities which will be missed if Australia and Australian companies fall behind in integrating into the global economy. For example, in a joint letter dated 3 February 2003, the Australian Bankers' Association (ABA), the Business Council of Australia (BCA) and the Corporate Tax Association (CTA) highlighted the competitive boost that United States (US) companies would enjoy from the US Administration's proposals to end the double taxation of dividends. They said that

> 'These developments place a higher imperative on effecting changes to our current international tax regime in relation to the double taxation of foreign profits to ensure that the gulf between US and Australian corporates, in particular those with international activities and a mix of local and foreign shareholders, does not continue to widen.'

1.8 The Review of Business Taxation (RBT) examined a number of aspects of international taxation arrangements. However, due to their complexity, implementation of most reforms was deferred pending further consideration. Consideration of Australia's international tax arrangements is now overdue. It represents the completion of 'unfinished business' from the RBT.

2 Productivity Commission (2001), *Offshore Investment by Australian Firms: Survey Evidence*, pp. 36–37.

1.9 Looking ahead, the increasing global integration of the last 20 years or so is not likely to abate. Despite growing cross-border investment flows, world capital markets are still far from fully integrated. Almost everywhere domestic saving typically funds most domestic investment, and equity portfolios are still heavily weighted toward the stocks of companies based in the investors' home country. Thus, the full gains from global integration have yet to be realised. In pursuit of those gains, economic, technological and regulatory factors will continue to propel foreign investment flows even higher. Unless Australia keeps pace, we will miss out on the benefits from further integration.

1.10 Therefore, the Board's recommendations, and any policy action that might emerge from them, need to be seen as part of a continuous process of ensuring that Australia's taxation system does not hinder business decisions, and that it promotes competitiveness and international integration. For example, the Board's recommendation on shareholder relief for dividends paid out of foreign source income (FSI) may need to be adjusted in light of any future significant movements in domestic and foreign taxation levels. Similarly, keeping our international tax treaties in step with commercial developments should be a continuous goal. A number of submissions stressed the importance of a continuous and holistic approach to examining Australia's international taxation arrangements. They emphasised the need for an ongoing process of review and reform of the tax system, rather than an uncoordinated, intermittent and piecemeal approach to reform as and when significant problems present themselves.

1.11 The Board's recommendations are designed to assist Australia, and Australian corporations, to compete on a neutral basis, by ensuring that Australia's tax system does not unduly hinder business decisions, but rather enhances Australia's status as an attractive place for business and investment. The Board has not sought to use tax as a mechanism either to buy inwards investment or to subsidise outwards investment.

1.12 In making its recommendations, the Board has applied the following widely-accepted tax policy design principles:

- *The efficiency principle*: in raising revenue, the business tax system should interfere as little as possible with the best use of existing national resources, with the efficient allocation of risk, and with long term economic growth. An internationally competitive economy requires, and is sustained by, the efficient use of its economic resources. To this end, a vital precondition for Australia's international competitiveness is that business decisions are not unduly constrained by the business tax system.
- *The neutrality principle:* (which complements the efficiency principle) a tax system should reflect the goals of (1) capital export neutrality (CEN), whereby all residents' income is taxed at the same rate, regardless of whether it is earned domestically or overseas; and (2) capital import neutrality (CIN), whereby the

income from domestically–owned and invested capital is taxed at the same rate as that from foreign inward investment.

- *The equity principle*: a tax system should reflect community concerns of fairness. Individuals in similar circumstances should be taxed similarly (horizontal equity), and tax burdens should depend upon ability to pay (vertical equity), the greater burden falling on those more able to pay.
- *The simplicity principle*: a tax system should be transparent, easily understood, and keep administrative and compliance costs to a minimum.

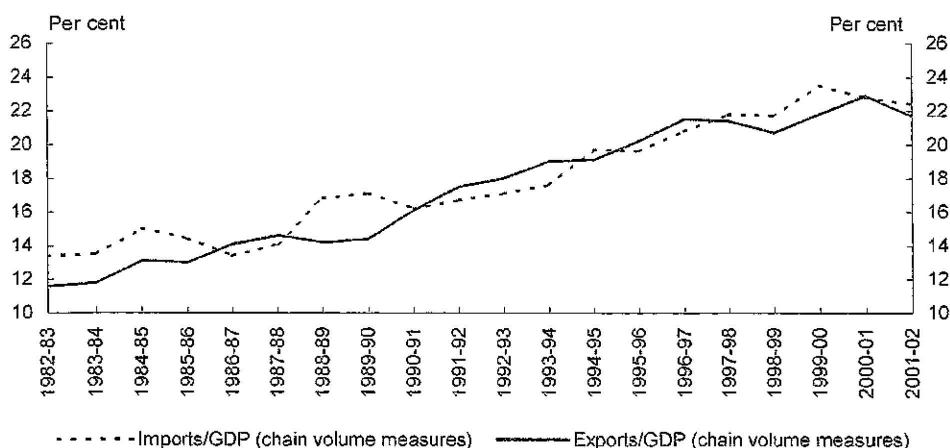
1.13 This chapter outlines what is at stake for Australia's international competitiveness and its international taxation arrangements. It summarises each group of the Board's recommendations, and discusses the benefits to be derived from implementing them.

How Australia benefits from integrating into the global economy

1.14 Over the last 20 years, Australian governments have implemented a series of significant economic reforms aimed at boosting the prospects of growth in Australians' living standards in a more open, competitive and global environment. This has involved removing external barriers and integrating both real and financial sectors into the global economy. Lower trade and foreign investment barriers, financial market deregulation, and pro–competition reforms, have all shown the need for Australian businesses to improve productivity by seeking out ways to become more specialised, to reduce costs, to develop ways to add value, and to access new markets.

1.15 The extent of Australia's increased integration into the global economy can be seen from the increasing significance of trade and income flows between Australia and the rest of the world. Figure 1.1 shows that the value of both exports and imports is now about 22 per cent of Australia's total gross domestic product (GDP) — about 10 percentage points higher than 20 years earlier. Similarly, as a proportion of GDP, the flow of income between Australian-resident firms and individuals and non–resident firms and individuals has increased significantly over the last 20 years (Figure 1.2).

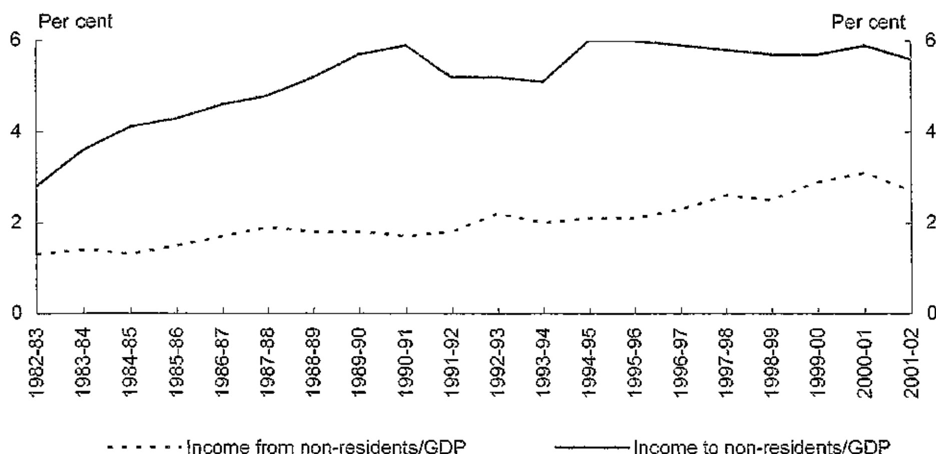
Figure 1.1: Exports and Imports as a proportion of GDP, chain volume measures, 1982-83 to 2001-02



Source: Australian Bureau of Statistics (2002), *Australian System of National Accounts*, Catalogue No. 5204.0, p. 14.

1.16 This increased integration of Australia's economy into the global stage is also highlighted by evidence showing that the number of companies declaring net foreign income increased by 40 per cent between 1994-95 and 1999-2000, to 7,465.[3]

Figure 1.2: Income to and from non-residents as a proportion of GDP, current prices, 1982–83 to 2001–02



Source: Australian Bureau of Statistics (2002), *National Income, Expenditure and Product, Australian National Accounts*, Catalogue No. 5206.0, pp. 42 and 54.

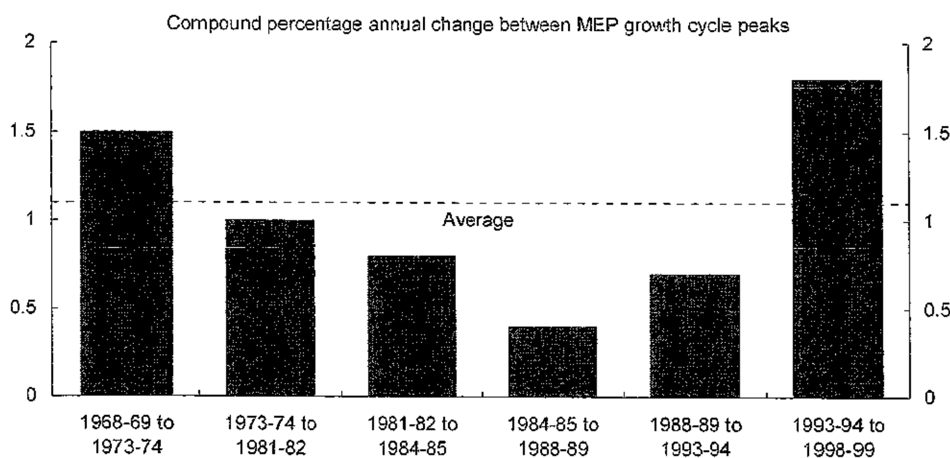
1.17 Australia's increased integration into the global economy has coincided with a surge in productivity growth, underpinning Australia's strong economic performance over the last decade. The Productivity Commission has shown that most of the key

3 Taxation Statistics 1999-2000, Table S4.6.

developments in productivity-related factors reflect the positive influence of reforms to promote efficiency and global competitiveness.[4]

1.18 Figure 1.3 shows the rates of multifactor productivity growth over productivity cycles in the market sector of the Australian economy. The 1.8 per cent annual average multifactor productivity growth reached in the 1990s cycle is a record high (albeit only marginally ahead of the rate in the late 1960s and early 1970s). The underlying rate of productivity growth accelerated a full percentage point in the 1990s, compared with the previous cycle.

Figure 1.3: Multifactor productivity over productivity cycles, 1968-69 to 1998-99



Source: Australian Bureau of Statistics (2002), *Australian System of National Accounts*, Catalogue No. 5204.0, p. 35.

Why impediments to continuing integration need to be removed

1.19 The Australian domestic market is small. This means that Australia's companies must continue to exploit expansion opportunities overseas if they are to:

- attain economies of scale;
- establish presence so as to access new markets;
- compete in larger markets;
- access new technologies and business systems;[5] and

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4 Productivity Commission (1999), *Microeconomic Reform and Australian Productivity: Exploring the Links*, p. 81.

5 There is a view that companies operating in more sophisticated overseas markets are more able to quickly access new technologies and business systems, and to apply them at home.

- be rated by international credit agencies for the purposes of being listed on share markets.

1.20 Equally, Australia itself must offer a competitive environment for locating business activity particularly headquarters functions bringing strong demand for high value services. Even as they embark on a diverse range of business ventures, many Australian companies prefer to remain resident in Australia for a host of commercial, regulatory and other reasons. In particular, Australia's strong funds management industry offers a platform to develop a truly global financial services sector in Australia, and thereby attract other financial service companies wishing to locate their regional operations in Australia. In turn this promotes clustering of other high end service activities, such as business and professional services, telecommunications and information technology.

1.21 Removing impediments to Australia's continuing integration into the global economy will bring significant benefits. The Organisation for Economic Cooperation and Development (OECD) has found that attracting FDI lifts a country's economic performance and its living standards.[6] Foreign capital generates increased employment, increased incomes and improved infrastructure, thereby creating a stronger industrial and economic base. Inflows of foreign capital are also believed to improve a host country's productivity. For example, FDI can be a stimulus to indigenous research and development, stimulating expanded production or lower unit production costs. These developments, in turn, can be expected to attract additional investment, bringing with it technical efficiencies such as scale economies, and ultimately increasing a country's wealth. Australia is in direct competition for FDI with other centres in the Asia Pacific region and beyond. The strongest competition is in the finance sector and in other high–end services that can be sourced internationally.

1.22 A study undertaken by The Allen Consulting Group, in conjunction with Arthur Andersen, found that the taxation environment was an important factor influencing senior management decisions about where to locate regional financial headquarters.[7] The study also indicated that the level of Australian GDP could rise by about 1 per cent over ten years if Australia could make all the changes necessary to become a leading Asia Pacific regional financial centre.

1.23 The Board appreciates that its recommendations, particularly those set out in Chapter 2 under the heading *Attracting Equity Capital for Offshore Expansion*, involve a budgetary cost. It also appreciates the benefits to the Australian community of those recommendations will involve a *balance* of effects, and emerge over some time. The other recommendations set out in Chapters 3-5 have (collectively) more readily manageable budgetary costs and clearer and earlier benefits.

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6 OECD (2001) *Corporate Tax Incentives for Foreign Direct Investment*, OECD Tax Policy Studies No. 4, p. 19.

7 The Allen Consulting Group (1996) *Leader or Also-Ran? Australia's Competitive Position in Asia-Pacific Regional Financial Markets*, Report to Financial Services Steering Group.

1.24 However, the Board considers that the budgetary costs (which are in the first instance transfers within, rather than costs to, the nation as a whole[8]) of its recommendations are warranted by benefits flowing to the Australian community generally. In essence, those benefits will increase the national income and the nation's tax base over time. This view is supported by most of the 58 submissions made to the Board, outlining the need for reform to ensure that Australia's international tax arrangements further promote Australia's international competitiveness and future economic success.

1.25 It is difficult to quantify precisely the economic benefits from the Board's recommendations. However, based on advice from its consultants, the Board believes that they are comparable with the net benefits of some of the other microeconomic reforms implemented over the 1980s and 1990s and designed to move companies from a domestic bias towards being better able to compete internationally. A typical estimate of benefits from such a reform is the 0.024 per cent lift (over some years) to GDP estimated as flowing from reducing textile, clothing and footwear tariffs further after 2000-01 — and this was a relatively narrow reform.[9]

1.26 The Board sees the long run benefits of its proposals as likely to compare favourably with those of such a reform. Like that earlier reform, the Board's proposals:

- alter financial incentives in a material way so as to largely remove a bias in favour of domestically oriented activity and investment; and
- as a result, increasingly expose Australian companies in many sectors of the economy to the international marketplace.

1.27 Australian companies have 'lifted their game' in response to comparable reforms over the past two decades, as reflected in the nation's impressive economic performance. The Board acknowledges, however, that there are winners and losers from virtually any reform. In particular, the Board's proposal for tax relief for dividends paid out of FSI (see Chapter 2) may not benefit every company. Those that are and remain domestically-oriented will not be able to access equity capital as easily as they can under the current arrangements, and this could be reflected in their share prices. On the other hand, internationally-oriented Australian companies will benefit. The Board believes that overall, there will be net benefits to the Australian community, and that they will increase over time. The Board draws some comfort from the fact that

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8 This is because the beneficiaries of tax relief afforded under the Board's recommendations will be predominantly Australians, and the budget revenue forgone will be made up (in time) by adjustments either to other taxes, also paid predominantly by Australians, or to expenditures predominantly benefiting Australians. These adjustments are likely to be small and widely spread in the context of the budget as a whole, and their economic effects are also likely to be small and slow to emerge. The Board believes the emergence of benefits flowing directly from its proposals will outweigh such costs. Thus while there will be pluses and minuses within the Australian community, there should be no *net* cost initially, and ultimately a bigger overall 'cake'.

9 Productivity Commission, *The Textiles, Clothing and Footwear Industries — Inquiry Report*, Volume 2, Report Number 59, 9 September 1997, p. N16.

submissions made by the major representative bodies of business did not appear to be concerned with the potential impact of the changes on domestically-oriented companies.

1.28 Also, the Board considers the budgetary cost of its recommendations to be moderate in the context of the Commonwealth's total revenues of around $170 billion or 22.5 per cent of GDP.[10]

1.29 The following sections of this chapter outline the economic gains flowing from the Board's specific recommendations in relation to their revenue costs. An Addendum canvasses these aspects in detail in relation to the recommendation in Chapter 2 for tax relief on dividends paid out of FSI. For this proposed change the benefits are a balance of positives and negatives over time and the budgetary cost is significant. The conclusions of that Addendum are discussed further in the following discussion in this chapter.

Removing impediments to Australian investment abroad

1.30 Parts of the current tax imputation arrangements restrict Australia's ability to respond to emerging global trends, such as increased globalisation and the increasing importance to Australian companies of FSI. The current arrangements provide a credit to resident individual shareholders for company tax paid on Australian source income. However, FSI repatriated to Australian shareholders after it has been taxed overseas does not give rise to significant imputation credits; instead, if distributed to a resident shareholder, the foreign taxes are ignored and the distribution is subject to another layer of tax.

1.31 The Board considers that the current imputation arrangements impede Australian investment abroad. Given that Australian companies most readily raise equity capital from Australians,[11] the current system has the potential to discourage offshore investment relative to domestic investment by Australian multinationals or companies. This is because it raises the cost of capital and lowers the returns for offshore expansion funded by Australian equity. Conversely, it lowers the cost of capital for domestically-focused companies — that is, it could boost their share prices relative to those of internationally-focused companies.

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10 Excluding GST proceeds, passed to the States. The Commonwealth, in the *Mid-year Economic and Fiscal Outlook 2002-03* (MYEFO), projects its revenues to remain about the same percentage of GDP over the three Forward Estimates years, rising to approximately $200 billion per annum over that period.

11 As noted elsewhere, evidence of this is the market value placed on imputation credits, of 40-70 per cent of their face value.

Summary of recommendations

1.32 The Board's recommendations (see Chapter 2) are aimed at providing relief to shareholders from the taxation of FSI at the domestic level. The recommendations include:

- providing limited relief for unfranked dividends paid out of FSI in the form of a 20 per cent credit, and without any requirement that foreign tax has actually been paid or incurred; and
- allowing dividend streaming both for FSI of Australian parent companies and through stapled stock.

1.33 The recommendations are designed to mitigate the current disincentive for resident entities to invest offshore using Australian equity, emphasised as a key issue in many of the submissions, taken up in the Addendum to this chapter.[12] The BCA / CTA submission echoed the statements of many others in arguing that

> '... the current dividend imputation system means Australian based multi-national enterprises with significant overseas operations have to earn a higher pre-tax rate of return than their domestic competitors in order to attract investment.'

1.34 The Board's recommendations in this area are also consistent with promoting a simplified business tax system in Australia.

1.35 Of all the Board's recommendations, these two are estimated to have the greatest net revenue impact. While these revenue impacts are in the first instance transfers among Australians rather than costs to the Australian community as a whole, the Board acknowledges that some costs may flow from consequent budgetary adjustments. Moreover, while the Board judges that significant economic benefits will flow in time from the former change, in particular, it concedes that there will be negative effects as well. However, the Board believes that the balance will ultimately be favourable. The changes will bring significant *net* economic benefits to Australia over time, making it worthwhile to incur the budgetary impacts.

Rationale of recommendations

1.36 Australia's tax system must respond to globalisation, given the increasing importance to Australian companies of FSI. In 2000–01, Australia's top 15 listed companies earned approximately 26 per cent of their total revenues from overseas (Figure 1.4).[13] A Productivity Commission survey found that offshore production is

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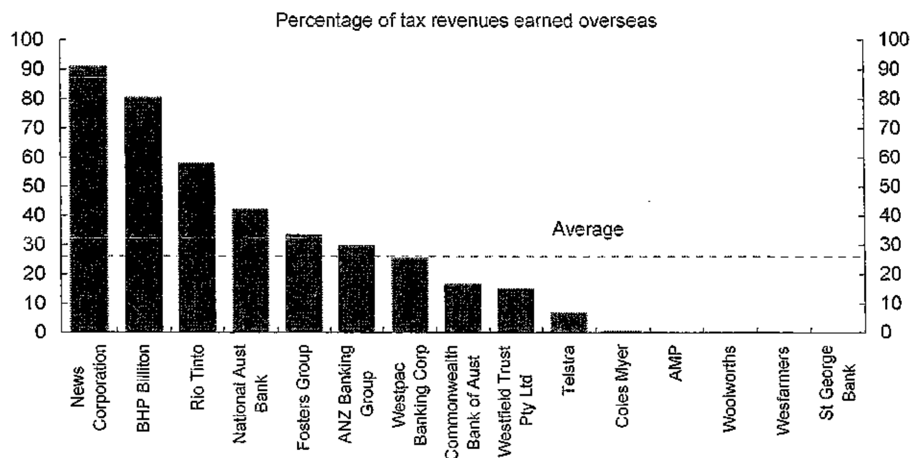
12 For example, those of ABA, the Australian Institute of Company Directors (AICD), The Australian Stock Exchange Ltd (ASX), BCA, CTA, the Institute of Chartered Accountants in Australia (ICAA), the Investment and Financial Services Association (IFSA), the Taxation Institute of Australia (TIA), several of the major accounting firms and a joint submission by ten of Australia's leading listed companies.

13 This is an unweighted average of revenues earned overseas by the top-15 ASX listed companies. This average is not weighted by the respective size of the sales of Australia's top fifteen companies.

becoming more prevalent: 50 per cent of Australia's largest businesses responded that they had actively engaged in offshore investment.[14] The Productivity Commission also found that 'consistent with the increase in FDI, income earned from offshore investments by Australian companies also increased' to around $8 billion in 1999-00.[15] In addition, the Commission found that foreign and domestic taxation regimes were the highest ranked *government* factors, and the second and third highest ranked factors overall, in influencing the decisions of Australian businesses whether to invest in offshore production. Respondents planning FDI in the next five years cited them as being particularly important.

Figure 1.4: Percentage of revenues earned overseas by top-15 ASX listed companies, 2000-01



Source: Compiled by The Allen Consulting Group.

1.37 Dividend relief will improve the ability of Australian companies with FSI to pay franked dividends to Australian shareholders. This will remove an existing barrier to Australian companies expanding overseas — the bias in the present arrangements raising the cost of capital for use in their international operations. The relative attractiveness to Australian shareholders of investments in Australian companies with substantial international operations will improve. Conversely, the relative share prices of domestically-focused companies may weaken. For foreign investors however investments in Australian companies with substantially domestic operations will become relatively more attractive.

1.38 As discussed in the Addendum to this chapter, there are clear advantages to Australia in Australian companies expanding overseas. They include facilitating access

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14 90 of the 201 businesses surveyed responded that they had offshore investment, while half of the 90 and an additional 10 businesses responded they were planning new FDI in the next five years.

15 Foreign direct investment income includes dividends and similar payments, plus reinvested earnings attributable to direct investors. Productivity Commission (2002), *Offshore Investment by Australian Firms: Survey Evidence*, Commission Research Paper, p. 10.

to opportunities for expansion which are less constrained than at home, and the dynamic effects of increased integration of Australian companies into world-class business. The Board's recommendation will work towards these ends by:

- reducing capital cost for overseas expansion. Providing taxation relief to FSI income removes the bias against investment by Australians in Australian companies deriving substantial profits overseas. It also increases the after-tax returns to domestic investors (which include the value of imputation credits to shareholders). This will encourage Australian investors to invest where the rate of return on investment is the greatest; and

- allowing the most efficient capital raising. Providing taxation relief to FSI removes the potential that the current imputation system has for discouraging offshore investment relative to domestic investment by Australian multinationals or companies, by raising the cost of capital and lowering the returns for offshore expansion funded by Australian equity.

1.39 Many of the submissions and other inputs made to the Board[16] emphasised these kinds of benefits, and argued that they justified the budgetary costs, even though none were able to quantify aggregate net benefits for Australia. For example, in a letter dated 3 February the BCA argued that a 30 per cent credit will not

> '... come at an unrealistic cost to the revenue and in the longer term will generate increased economic benefits from investment in Australia. We believe the primary purpose of international tax reform in this area is to change investor behaviour in ways that generate more income to Australian residents and as a consequence, generate new tax revenue over time to offset any tax revenue losses arising from the initial effects of these reforms.'

1.40 The BCA further argued that the combination of that measure and dividend streaming

> '... would not represent an unsupportable cost to revenue. We believe that the expenditure would represent a worthwhile investment in mechanisms that would generate increased economic benefits from investment for Australia and improve the attractiveness of Australia as a place for business and investment.'

1.41 Reducing the cost of capital by removing the current investment distortion will, in the Board's view, allow Australian companies to more effectively deploy capital so that they can more easily achieve increased scale and the up-take of new technologies and business systems. By removing tax-induced distortions in investment decisions, the Board's recommendations will enable internationally-oriented Australian companies and investors in them to derive greater returns. Many submissions to the

16 Including those footnoted earlier, that is, the submissions of ABA, AICD, ASX, BCA, CTA, ICAA, IFSA, TIA, three major accounting firms and ten major companies (in a joint submission).

Board supported that assessment. For example, the ABA submission argued that reform in this area would lead to

> '... increased capacity for Australian multinationals to raise cost effective capital in domestic and foreign capital markets, in order to fund global expansion and growth strategies, resulting in increased earnings ...'

1.42 Lower yielding domestic investments will, on the other hand, not be so readily financed. Over time, this will force an increase in the productivity of Australian companies, flowing through to an increase in national income and the tax base. While the Board does not have precise advice on the relative contributions of individual measures to the overall benefits flowing from its recommendations, the advice available to it suggests that this measure will contribute significantly to the benefits. This is because it makes a substantial and direct change to the financial incentives facing companies and investors.

1.43 In addition, the Board's recommendations are designed to remove the current bias against the repatriation of overseas income to Australian shareholders. In its survey, the Productivity Commission found that only about one half of firms that repatriated profits repatriated less than 25 per cent of their profits; and around 40 per cent of respondents re-invested all offshore earnings.[17] This low rate of repatriation suggests that Australian businesses currently use a significant portion of foreign-sourced profits to build up international investments. By providing dividend relief, the Board's recommendations will remove the bias against repatriation and offshore investment relative to domestic investment by Australian business and shareholders. Again, a number of the submissions to the Board supported this assessment. For example, the joint submission by ten leading Australian listed companies[18] stated that

> 'In many cases, the shareholders will have a marginal tax rate that is higher than the corporate tax rate at which imputation and foreign divided account credits are granted. The repatriation and on-payment of the foreign profits will therefore actually **increase** the collections of Australian tax'.

1.44 The Treasury's estimate of the cost of the Board's recommendation to provide a 20 per cent credit for unfranked dividends paid out of FSI is set out in the Executive Summary. Although relatively large compared to the cost of most other individual recommendations, the Board considers this estimate to be the potential maximum cost. The ultimate net cost is likely to be lower due to:

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17 Productivity Commission, *Offshore Investment by Australian Firms: Survey Evidence,* Commission Research Paper, 2002, p. 28.

18 Amcor Ltd, AMP Ltd, BHP Billiton Ltd, BHP Steel Ltd, Brambles Industries Ltd, CSR Ltd, Lend Lease Corp Ltd, National Australia Bank Ltd, Orica Ltd, Telstra Corp Ltd.

- a possible permanent lift in the pay-out ratio of Australian companies as a result of the Board's recommendation and subsequent increase in the tax base; and

- an increase in the longer-term tax base as a result of the economic efficiencies achieved through this recommendation (reducing the cost of capital and providing the opportunities for companies to achieve critical mass and earn a higher return on their savings, so that GDP and GNI will increase over time).

1.45 IFSA articulated the benefits, in terms of efficiently raising foreign capital to use alongside Australian capital

> '... [while] streaming of dividends primarily benefits companies with existing foreign shareholder bases, it nevertheless recommends that it needs to be considered as a way of encouraging other resident companies to attract foreign shareholders. It also likely improves returns to non-resident shareholders and will accordingly attract them.'

1.46 On balance, the Board has come down to the view that the benefits of both the tax credit and streaming, particularly in the longer-term, are likely to be significant and should be adopted. However, of these two recommendations the Board considers the tax credit to be more universal in its impact. If a choice was needed, because of budgetary constraints, the Board would favour priority being given to the tax credit over streaming.

Competing for key investments, particularly headquarters

1.47 Australia has relatively few home-based global corporate competitors. To grow, Australia must continue to attract international investment into Australia, and accompanying inwards technology transfer. Headquarters operations promote clustering of high-end services. Competing for them must be a key concern.

1.48 Several aspects of Australia's current taxation arrangements add complexity and inhibit investment by corporations into Australia, notably:

- the controlled foreign company (CFC) rules;

- Australia's higher tax rate limits in treaties, relative to OECD norms, and other aspects of treaties (such as capital gains tax (CGT) treatment);

- Australian taxation of 'conduit income'; and

- company residency tests.

1.49 The role that tax plays in inhibiting businesses from retaining their headquarters in Australia is highlighted by the Productivity Commission's recent survey of Australia's 201 largest firms. The survey found that foreign and domestic

taxation regimes were among the most important *government* factors influencing investment decisions.[19]

Summary of recommendations

1.50 In order to promote Australia as a location for internationally-focused companies, the Board's recommendations involve some changes to Australia's FSI rules.

1.51 The Board recommends (see Chapter 3):

- an exemption for attributable taxpayers holding interests in CFCs resident in broad exemption listed countries (BELCs) (subject to possible limited exceptions);
- an extension of rollover relief for corporate restructures;
- abandoning the tainted sales and services income rules (except in relation to certain tax havens);
- developing criteria for inclusion on the BELC list;
- reaching a policy position on outstanding issues in the CFC regime;
- substituting a more residence-based treaty policy for the previous policy based on source of income;
- improving consultation processes for negotiating tax treaties;
- setting government priorities for reviewing key country treaties;
- abolishing the limited exemption country list and providing a general exemption for foreign non-portfolio dividends that Australian companies receive and (subject to some existing exceptions) for foreign branch profits;
- against pursuing a conduit regime at this stage (in view of other relief provided);
- introducing a CGT exemption for the sale by an Australian resident of a non-portfolio interest in a foreign company with an underlying active business;
- proceeding with the foreign income account (FIA) rules as they apply to direct investment flows;
- providing a treaty exemption for capital gains made by non residents on the disposal of shares comprising non-portfolio interests in Australian companies; and

19 Productivity Commission (2002), *Offshore Investment by Australian Firms: Survey Evidence*, Commission Research Paper, pp. 28-30.

- clarifying the test for company residency and treating a non-resident for treaty purposes as a non-resident for all purposes of income tax law.

1.52 In addition, the Board recommends against proceeding with the RBT's proposals to apply CGT to the sale by non-residents of non-resident interposed entities with underlying Australian assets.

Rationale of recommendations

1.53 The Board considers that a number of the current tax arrangements have increased the complexity of the tax system for internationally focused companies, and have materially inhibited investment into Australia. Companies made various submissions to the Board outlining examples of the way in which the current tax arrangements affect their decisions whether to invest in Australia. The complexity of the CFC regime received particular attention. Submissions noted that the current CFC regime has inhibited some companies from restructuring their organisations in response to their increased offshore earnings. Outdated and inflexible Australian taxation arrangements have resulted in companies retaining inefficient international operations.

1.54 The Board's recommendations are designed to ensure that globally-focused Australian companies maintain corporate structures and select headquarter location on the basis of commercial considerations rather than taxation considerations. The recommendations will give companies the incentive to adopt the most efficient corporate structure, enabling them more easily to achieve critical mass and more effectively to deploy their capital and compete on the global stage. The economic benefits of this group of changes are predominantly positive, rather than a balance of positives and negatives. The Board believes that the benefits would begin to flow relatively quickly.

1.55 The estimated gross cost of these measures is set out in the Executive Summary. The Board considers that the net revenue cost of implementing them will be modest, given:

- the cost of reforming Australia's treaties (if the Government follows the lead set by the new US Protocol) that may have occurred even without the Board's recommendations; and

- the way the Board's recommendations would spread the cost to government over a number of years.

1.56 The benefits of the Board's recommendations under this head are significant. They include promoting Australia's economic integration into the global economy by lifting the competitiveness of Australia's own domestic base for business activity, particularly when competing for headquarters on base activity (reducing 'branch

economy' risks). The Board is confident that the benefits will clearly outweigh the revenue cost of the recommendations.

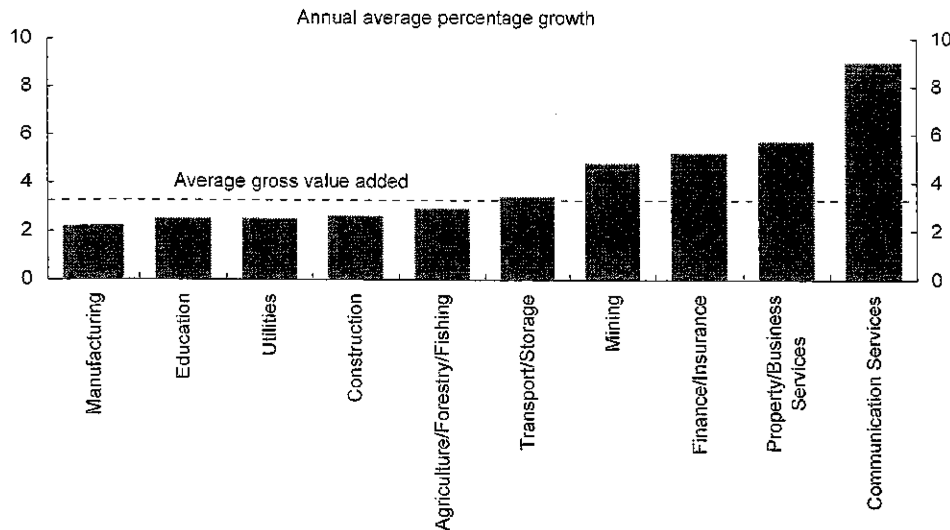
Competing in the financial sector

1.57 Australia's finance sector is a key arena. This is because:

- it is one of the fastest growing sectors of the Australian economy. Between 1986–87 and 2001-02, the financial sector recorded average annual growth of 5.2 per cent, the third fastest rate of industry growth, and well above the rate of growth for the economy itself (Figure 1.5);
- Australia has intrinsic comparative advantages here, in terms of advanced finance and capital markets and sophisticated skills. It also has a large and growing domestically-sourced managed funds pool. Of the 75 countries surveyed for the 2001-02 World Economic Forum Global Competitiveness report,
  - Australia's financial markets were rated as the sixth most sophisticated in the world; while
  - Australia was ranked first for the availability of financial skills, and fifth for availability of skilled labour overall;[20] and
- it plays a key role in providing high-skill jobs for Australians, in the sector itself and in associated high-end services.

20 World Economic Forum, *Global Competitiveness 2001-02*. Accessed from http://www.weforum.org/site/homepublic.nsf/Content/Global+Competitiveness+Programme on 15 December 2002.

Figure 1.5: GDP Growth by Industry 1986-87 to 2001-02



Source: Australian Bureau of Statistics (2002), *Catalogue 5206.0*, June Quarter 2002, Table 47, Industry Gross Value Added, Chain Volume measures.

1.58 As a result of Australia's intrinsic comparative advantage, leading companies are increasing their presence in the country's financial sector. Box 1.1 is one of many case studies highlighting the attractiveness of Australia's financial sector to premier overseas financial firms.

Box 1.1: Case Study — HSBC Centres Its Gold Trading in Australia

HSBC Bank USA, part of one of the world's largest financial services groups is to consolidate its global trading operations in Sydney, underlining Australia's status as a centre of excellence for many of the world's premier financial firms. Attracted by Australia's low-cost environment and standing as a precious metal producer, the centralisation is in line with the bank's move toward single trading hubs, and will involve closing the gold trading unit in Hong Kong.

The shift to Sydney continues HSBC's strengthening of its commitment to Australia.

Source: HSBC, Media Release, 25 September 2002. Accessed from www.http://us.hsbc.com/inside/news/pressreleases2002_nov_4.asp on 2 January 2003.

1.59 However, despite Australia's intrinsic comparative advantage, the Board has identified tax impediments to Australia's competitive position in global finance and capital markets. These impediments include:

- the application of foreign investment fund (FIF) provisions to funds management activity. This discourages possible efficiencies that could be generated by the use of offshore pools;
- the capital gains treatment of foreign investment in Australian funds. This discourages overseas investment into Australia; and
- various other provisions relating to trusts, branch structures, and the like.

1.60 Submissions to the Board provided many examples identifying how the current tax arrangements impede Australia from developing its funds management industry and limit Australia's potential to market products to foreign investors. In particular, submissions noted:

- that the FIF rules are too complex and impose very high compliance costs, including the requirement to keep an attribution account for each investment at the investor level; and
- that more onerous tax consequences arise for investments made by overseas investors in Australian-managed funds compared to direct Australian investments by overseas investors.

Summary of recommendations

1.61 To address these tax impediments, the Board has made recommendations (see Chapter 4) to reduce the adverse impact of the application of the current FIF rules on the Australian funds management industry. Specifically, the Board recommends exempting from the FIF rules:

- funds registered under the managed investment provisions of the *Corporations Act 2001* and companies registered under the *Life Insurance Act 1995* (in certain circumstances);
- funds applying widely-recognised indexes; and
- complying superannuation entities.

1.62 The Board also recommends:

- a general review of the FIF rules;
- increasing the 5 per cent balanced portfolio exemption threshold in the FIF rules to 10 per cent of the overall cost of the assets;
- amending the FIF rules to allow fund management services to be an eligible activity for the purposes of the rules;

- revising the CGT treatment of foreign investment in Australia; and
- revising other taxation arrangements for foreign trusts, transferor trusts, and branch structures.

Rationale of recommendations

1.63 The Board's reforms are designed to improve Australia's access to international capital markets and international capital markets' access to Australia. Improved access will increase the inflow of funds and will benefit Australia by:

- allowing Australian investors to benefit from lower-cost funds services arising from economies of scale (through increased inflow of funds); and
- generating additional GDP as a result of the spin-offs from enhancing Australia's reputation as a financial services centre and from increasing scale, particularly in the key area of funds management.

1.64 The recommendations will also provide a better balance between maintaining the integrity of the tax system while minimising compliance and other costs for taxpayers. The estimated revenue cost is set out in the Executive Summary. Again, the Board believes that the economic impacts of its recommendations in this area are predominantly positive and would begin to flow relatively quickly, and that they justify accepting that revenue cost.

Removing impediments to mobility of key personnel

1.65 Integral to the two-way process of Australian integration into the global economy is mobility of key personnel, within both home-based corporates with overseas operations and foreign-based corporates operating in Australia.

1.66 Taking Australia's personal income tax structure as given (because it is not a subject for this review), impediments identified by the Board include:

- the double taxation of employee share options (ESOs); and
- various other concerns over Australia's tax treatment of expatriates.

1.67 Submissions to the Board emphasised the importance of Australia's taxation arrangements allowing Australian businesses to attract educated and skilled foreign expatriates. There was a general view that Australia's current taxation arrangements regarding foreign expatriates present an unfriendly and unwelcoming tax environment compared to other developed countries.

1.68 Concerns about the unresponsiveness of the current tax system to the continuing integration of national economies and the increasing mobility of capital and

skilled labour were reflected in a national survey of Australian business executives by PricewaterhouseCoopers in May 2002. This survey found that tax reform was the most important factor in boosting Australia's ability to attract overseas talent — see Box 1.2.

Box 1.2: Tax top of 'fix it' list for Australia's competitiveness

Tax, business innovation and immigration policy have been pegged as the top three issues impacting Australia's international competitiveness, according to a PricewaterhouseCoopers' national survey.

Tax was ranked top of the 'fix-it' list by business executives responding to PricewaterhouseCoopers' national survey entitled 'Australia's immigration policy — Does it work for business?'

More than 43 per cent of respondents ranked tax as the number one issue which needed to be addressed in terms of Australia's international competitiveness in attracting overseas talent.

'Business innovation (at 18 per cent) and immigration policy (at just under 17 per cent) ranked closely as second and third priorities, while employee remuneration and reward ranked fourth at 11 per cent) and economic stability (at just over five per cent) were seen as lesser concerns,' said Brendan Ryan, Asia Pacific Leader of PricewaterhouseCoopers' Global Visa Solutions.

'The survey respondents were well aware of the issues and obstacles involved in attracting skilled foreign labour to work in Australia — most (over 91 per cent) had sponsored overseas staff to work in Australia in the past 12 months, with 93 per cent planning to do so in the next 12 months,' Mr Ryan added.

The most important reason given for hiring overseas staff was that the relevant skills were not available in Australia or that overseas skills/experience were viewed as better (according to 72 per cent of respondents).

'Interestingly, though, 31 per cent cited cost considerations as the key deterrent to bringing in overseas staff. I would see this as an important acknowledgment of the additional difficulties Australian businesses face in competing for high quality overseas candidates', Mr Ryan commented.

PricewaterhouseCoopers' survey into 'Australia's immigration policy — Does it work for business?' was conducted during April 2002, surveying over 70 senior human resources and related executives in leading Australian businesses.

Source: PricewaterhouseCoopers (2002), 'Tax—top of 'fix-it' list for Australia's competitiveness', *Media Release*, May. Accessed from http://www.pwc.com.au on 2 January 2003.

1.69 This same concern is supported by Wachtel and Capito (2001), who clearly illustrate how the taxation burden of a non-resident executive working in Australia is less favourable than if he or she were occupying an equivalent position in the United Kingdom, the US, Hong Kong or Singapore.[21]

Summary of recommendations

1.70 The Board's recommendations in this area (Chapter 5) are aimed at providing relief to foreign expatriates and departing residents from the current personal tax treatment of CGT liabilities and employee share options. The Board recommends:

- against proceeding with the RBT's recommendation that residents departing Australia provide security for deferred CGT liability;
- addressing the double taxation of ESOs; and
- against proceeding with the RBT's recommendation to treat ceasing to be an Australian resident as a cessation event for the purposes of Division 13A of the 1936 Act.

1.71 In addition, the Board recommends creating a specialised Australian Taxation Office (ATO) cell, to enable the Australian Taxation Office to work with employers to deal with the tax administration concerns of foreign expatriate employees.

Rationale of recommendations

1.72 These recommendations are designed to remove current impediments to the free flow of ideas and skills, thereby increasing the mobility of personnel between Australia and the rest of the world, and ultimately attracting the human capital which Australian businesses require. The estimated revenue cost is expected to be quite small.

1.73 The benefits from increased personnel mobility include:

- the two-way transfer and development of skills and business ideas; and
- enhancing the ability of Australian companies and individuals to create income.

1.74 Ultimately, the benefits to Australia of removing these impediments include lower costs of obtaining key skills in Australia and the associated transfers of skills and ideas to Australia. This transfer will further contribute to Australia's competitive integration into the global economy, and well justifies the small cost.

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21 Wachtel, M. and Capito, A. (2001), *Removing Tax Barriers to International Growth: Positioning Australia's Tax System to Maximise the Potential Growth Opportunities from International Business*, Report to the Business Council of Australia.

Summing up: benefits and budgetary cost

1.75 The changes recommended by the Board have an estimated short to medium term gross budgetary cost as set out in the Executive Summary of around 0.6 per cent of total Commonwealth revenues or 0.14 per cent of GDP.

1.76 The Board believes that in the short to medium term these budgetary costs are worthwhile,[22] given the net benefits which the changes will generate over time to the Australian community as a whole. The recommended measures will:

- increase GDP (that is, domestic production) through their productivity-raising effects;
- increase national income, through increased returns on investment accruing to Australian shareholders.

The measures will thereby also, over time, increase the overall tax base.

1.77 The Board acknowledges that the balance of benefits and costs, and the time scales over which net benefits will emerge, are not as clear-cut for the proposals in Chapter 2 as for the proposals in other chapters

1.78 Nevertheless, based on the submissions and the Board's own assessment, the Board believes that the benefits outlined above will be achieved and hence the changes should be made (For further discussion see the Addendum to this Chapter). A prime design criterion for the Board's recommendations has been neutrality. The recommendations are intended to ensure that Australia's taxation system does not unduly hinder business decisions. In particular, the Board's recommendation on shareholder relief for dividends paid out of FSI is designed to alleviate the present bias against Australian investment offshore, and the related bias against offshore investment into Australia. While acknowledging that the effects of this change will be a mix of positives and negatives, the Board expects that the balance will, over time, be significantly positive. In the medium to longer term, it will result in higher productivity and growth within the Australian economy. This will come through scale economies and greater take-up of new technologies and business systems as well as through more efficient investment of Australian savings overall.

1.79 Typically, the largest asset class for Australian managed funds, particularly superannuation funds, are shares in Australian corporations. Through these, the benefits of the proposed changes will be widely distributed in the Australian community — particular to Australians (at all income levels) as they retire. The Board considers that this fact, and the relatively modest size of the net revenue effects, means

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22 Although noting earlier that budgetary costs are in the first instance essentially transfers within the Australian community, the Board acknowledges that consequent budgetary readjustments may entail some net costs.

that implementing its recommendations will have minimal implications for the equity characteristics of the overall tax and transfer system.

1.80 The Board believes that the focus should be on the way in which its proposed changes will grow Australians' total incomes and Australia's overall tax base over time. The emphasis should be on the increased *size* of the 'cake' over time — not merely on the relatively small initial effects on *shares* of the 'cake'.

ADDENDUM TO CHAPTER 1

Short and longer-term impacts of providing limited dividend relief

This Addendum discusses the short and longer-term impacts of the Board's recommendation to provide limited relief for unfranked income paid out of FSI.

The Board considers that the revenue costs from the recommendation are outweighed by the benefits flowing from removing the current bias against offshore investment of Australian equity. Advice to the Board suggests that this change will contribute significantly to the benefits flowing from its proposed package as a whole — since it will have the most significant effect on the financial incentives facing companies and investors in respect of their future investment decisions. While its effects will be a balance of positives and negatives, the Board expects that this recommendation will help grow national income, the nation's economy and the overall Australian tax base over time.

Recommendation

The Board's recommendation, detailed in Chapter 2, is that limited shareholder relief should be provided for unfranked dividends paid out of FSI, at a rate of 20 per cent without any requirement that foreign tax has actually been paid or incurred. More specifically, the relief would apply to FSI, including non-portfolio dividends out of foreign profits and foreign branch profits of Australian companies, generated after the commencement date.

Short-term impacts

Since the shareholders of Australian companies are predominantly Australians, Australian tax arrangements are influential in the market valuation of Australian companies. Evidence of this is the fact that the market values imputation credits at 40-70 per cent of their face value. The dominance of domestic shareholders also reflects the reality that Australian companies are better understood, and can typically raise equity capital on better terms, in Australia than elsewhere. When it was first introduced, imputation removed a tax distortion (the 'double taxation of dividends') discouraging equity investment within Australia. But at the same time it raised a bias

against overseas investment and towards domestic investment within Australia. The bias is illustrated by the numerical examples set out in Table 1 below.[23]

Table 1: Tax Treatment of Domestic Foreign Source Income on Companies, Shareholders and Gross National Income: Existing Position

	1. Australian source	2. Overseas source	3. Overseas source
Company			
Investment ($)	10,000	10,000	10,000
Rate of return (%)	10.5%	10.5%	15%
Pre tax income	1,050	1,050	1,500
Company tax - say 30 per cent	(315)	(315)	(450)
Dividend	735	735	1050
Shareholder			
Net dividend	735	735	1050
Gross-up	315	-	-
Taxable dividend	1,050	735	1050
Gross tax — say 50 per cent	(525)	(367.5)	(525)
Franking credit	315	-	-
Net tax	(210)	(367.5)	(525)
Post tax income	525	367.5	525
Gross National Income (GNI) contribution			
Post tax income	525	367.5	525
Company tax	315	-	-
Shareholder tax	210	367.5	525
GNI contribution	1,050	735	1,050

23 For simplicity, rates of return and tax rates are chosen to produce 'round figures' as far as possible. For example, the assumed company tax rate in the table is 30 per cent in both countries. Of course the lower the company tax rate abroad, the lower the bias created by imputation, but a company tax rate abroad similar to Australia's is nevertheless a realistic case. The example assumes a personal tax rate of 50 per cent, again for simplicity. Arguably the 'typical' Australian investor is a superannuation fund with a tax rate of 15 per cent, but qualitatively the picture in terms of comparison of investments is the same regardless of the shareholder's tax rate. Ultimately, of course, superannuation funds distribute benefits to individuals who pay personal tax.

The second and third columns of the table show two alternative overseas investments — one where pre-tax rate of return is the same as that of the Australian investment, and one where post-tax returns to an Australian shareholder are equal to those of the illustrative domestic investment.

Column 2 shows that an offshore investment whose *pre-tax* rate of return matches the domestic rate delivers a significantly lower post tax return. Something like column 3 is more likely to reflect reality: it shows that to deliver the same *after tax* return to an Australian equity investor, an overseas project must yield a (pre-tax) rate of return substantially higher than a domestic project. This is consistent with arguments put forward in a number of submissions, including that of BCA and CTA, as quoted in the body of this chapter.

In practice, different risk characteristics and portfolio diversification considerations may mean that post-tax returns are not fully equalised through the stock market valuation of companies. Nevertheless, the present significant bias in favour of companies with largely domestic investments is apparent and will be reflected to some extent in share prices now. In economic terms, domestic investment of somewhat lower intrinsic merit (rate of return) will tend to be funded ahead of higher-yielding investments available to Australian companies internationally.

An important aspect of this matter highlighted in many submissions, is that for many listed Australian companies, the limited size of the market constrains domestic opportunities for growth. Prospective returns diminish significantly as successive additional investments within Australia are considered. By contrast, the field for investment abroad is far wider. Companies' options for international growth are much less constrained, and the effect of diminishing prospective returns for additional tranches of investment is not so significant a factor.

Under the bias inherent in the present system, shares in Australian companies with largely domestic earnings are made relatively more expensive to foreign investors. For portfolio diversification and other reasons, foreign investors are presently willing to make equity investments in such companies, but are appreciably less willing than they would be without the bias.

The Board's recommendation will substantially reduce the present bias. Not only will companies derive more income from utilising Australian savings to invest internationally, but there should be increasing 'dynamic' effects on Australian companies and their behaviour. By expanding internationally, companies should achieve greater efficiency in all their operations, including within Australia through scale economies, more rapid transfer of technology and business ideas etc.

However, these effects will flow only over time. The Board's recommendations will not have an immediate effect on GDP or national income. GDP is defined as

- the total value of the production of goods and services in Australia; or

- the total value of factor incomes plus taxes; or
- the total value of expenditure on goods and services produced in Australia.

Nor will the Board's recommendations have any effect on the level of gross national income (GNI, or simply 'national income'), defined as GDP plus net primary income from non-residents.[24] The expected absence of a short-term GDP impact assumes that government does not change its budget programs (expenditure programs or other taxes) to offset the cost of the recommendation, and that the spending behaviour of investors does not change significantly in the short-term.

The short-term effects are therefore in the nature of a transfer, a reduction in revenue to the Budget equal to a reduction in tax paid by shareholders in respect of income from investments abroad. The economic effects (and thus the effects on the overall Australian tax base) over time flow from the substantial removal of the bias discouraging investors from investing in Australian companies' international operations, and conversely a reduction in the cost of capital to those companies for those purposes.

Table 2 below, drawing on the same numerical examples of domestic and overseas investments as in Table 1, illustrates the immediate effects of implementing the Board's recommendation on the returns to companies, shareholders, governments and national income.[25] As can be seen from column 2, an overseas investment whose *pre-tax* rate of return is the same as that of the Australian investment (column 1) would now yield after-tax income much closer to, although still below, that from the domestic investment.

Column 3 of the table shows the other (and probably more realistic) example, where *post-tax* returns were equal under present taxation arrangements. It shows that this investment yielding 15 per cent pre-tax now pays the investor $656 or 6.56 per cent after tax, compared with 5.25 per cent under present arrangements. This after tax return now exceeds the 5.25 per cent from the domestic investment, whose pre-tax return was 10.5 per cent. However the 6.56 per cent is still well below the after-tax return (7.5 per cent) which would be derived from a domestic investment[26] that matched the pre-tax return of 15 per cent here assumed for the overseas investment.

The nature and desirability of these outcomes is canvassed in a number of the submissions to the Board. For example, the Australian Stock Exchange Ltd (ASX) considered that this reform would:

24 Net primary income is compensation of employees, property income and current transfers to Australian residents from non-residents, minus corresponding amounts from Australian residents to non-residents.

25 Dollar figures rounded to whole numbers.

26 Not shown as a specific example in the table.

- 'reduce the effective marginal tax rate imposed on that FSI, thereby reducing the disincentive for Australian investors to invest offshore through Australian multinational companies'; and
- 'reduce the cost of capital for those Australian companies with restricted access to international capital markets.'

Table 2: Immediate Effect of Providing a 20 per cent Credit on Dividends from Foreign Source Income

	1. Australian source	2. Overseas source	3. Overseas source
Company			
Investment ($)	10,000	10,000	10,000
Rate of return (%)	10.5%	10.5%	15%
Pre tax income	1,050	1,050	1,500
Company tax	(315)	(315)	(450)
Dividend	735	735	1050
Shareholder			
Net dividend	735	735	1050
Gross-up	315	184	263
Taxable dividend	1,050	919	1313
Gross tax — say 50 per cent	(525)	(459)	(656)
Franking credit	315	184	262
Net tax	(210)	(275)	(394)
Post tax income	525	460	656
Gross National Income (GNI) contribution			
Post tax income	525	460	656
Company tax	315	-	-
Shareholder tax	210	275	394
GNI contribution	1,050	735	1,050

Comparing Table 1 and Table 2 confirms that GNI (national income) does not change in the short-term. GDP (domestic economic activity) should not change either.[27] Less tax is collected, while Australian shareholders have more after-tax income. There may be some transitional positive effects on national income if the new arrangements lead to higher payout ratios to Australian investors from overseas income, temporary or ongoing. These would also bring forward and increase, at least in present value, Australian tax collections, as suggested in some of the submissions,[28] but the Board has no firm basis on which to estimate the magnitudes of such increases.

Consequent and longer-term impacts

The immediate effects illustrated in Table 2 will set in train other adjustments, including fairly quick adjustments to company valuations set in share markets. Australian companies which are domestically-focused and do not have plans, credible to the market, to pursue opportunities internationally, will be marked down. They will not be valued as highly *relative* to companies with substantial international operations and/or plans for expanding offshore. Companies in the former category will accordingly experience an increase in their cost of capital; they will need to apply higher return expectations (or hurdles) to domestic investment projects they are considering.

Companies with international operations and opportunities will, conversely, not have to restrict offshore investment to projects yielding well above domestic hurdle rates, as they must do now. The present gap between hurdle rates for domestic and offshore investment will be narrowed, and Australian capital will, through these adjustments, be utilised more efficiently by Australian companies. Especially given that for many companies domestic opportunities are significantly more constrained than overseas ones, the average effect on market valuations across all Australian companies is likely to be positive, increasingly so over time with dynamic effects on their scale and behaviour.

In the longer-term, therefore, the Board believes that the balance of benefits to be realised from its recommendation will be increasingly net positive over time, and will make the revenue costs worthwhile. The Board acknowledges that this is an 'on balance' judgement — in that investment within Australia by some companies will not be as great with the present bias removed as it would otherwise be, and there may be some economic costs as government finances are readjusted; and therefore, that it will take time for *net* benefits to come through that justify the budgetary costs. In reaching that on balance judgement, the Board sees as the key factors:

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27 This conclusion depends on the assumptions that investors do not change their spending behaviour and government does not change its budget programs in the short-run in response to the Board's recommendation. That is, it is assumed that government initially absorbs the cost of the Board's recommendation in its budget surplus/deficit with any readjustment occurring over time.

28 For example, that of the ten leading companies, as quoted in the body of this chapter.

- reduced cost of capital for Australian companies wishing to expand overseas, only partly offset by an increased cost of capital for those remaining focused on domestic opportunities;
- reduced cost of capital for internationally-oriented companies wishing more readily to combat overseas competitors, to gain scale, to speed up the adoption of new technology and business systems and generally to operate more efficiently, including at home;
- benefits to Australian shareholders from the growth of Australian companies which otherwise would have been unable to grow at comparable rates domestically (again, these positive shareholder gains being only partly offset by *relatively* negative effects on the share prices of domestically-focused companies);
- increased repatriation of profits to Australia, thereby increasing the wealth of Australians and taxes paid;
- increased foreign investment, as the bias which makes Australian domestic investments relatively expensive to foreign investors and relatively cheap to Australians is reduced; and
- reduced levels of borrowing by Australian companies to finance foreign investment, thereby reducing risks and potential credit rating downgrades.

Over the longer-term, the impact on GNI and GDP from the Board's recommendation to provide limited dividend relief depends essentially upon 'supply side' effects — that is, how much more efficiently capital is used, both domestically and internationally, by Australian companies using Australians' savings. Removing the investment distortion will reduce the cost of capital and enable Australian companies to deploy their capital more effectively and make investments based on their intrinsic risk/return commercial characteristics. There may also be a defensive aspect, as ICAA emphasised in its submission

> 'For Australian global companies to retain Australian bases, and raise capital in Australian markets, is an important element in protecting the relationship of those companies with their Australian investors, and their ongoing activity in Australia.'

The benefits in terms of productivity and innovation by Australian companies and ultimately the income they earned in both their Australian and overseas operations for their shareholders, and in turn the Australian tax base, will of course depend on how companies and investors respond to the change.

While the Board's recommendation may conceivably result in increased offshore investment by Australians at the expense of some domestic investment by Australians that might otherwise have occurred, the Board considers, that in economic terms such an effect would be outweighed by the other factors discussed above.

Long-term positive effects on GNI and GDP imply also long-term positive effects on the tax *base* available to Australian governments. In the near-term, however, the Board acknowledges that its recommendation will result in a cost to the Budget. This does not take into account:

- any one-off gain to tax revenues from companies bringing forward the repatriation of their current stock of retained earnings from abroad; and
- any permanent lift in the pay-out ratio of Australian companies out of foreign income.

Even without these factors, the Board considers that the budgetary cost is moderate and worthwhile in relation to the prospective positive net economic benefits flowing to the Australian community albeit over time.

CHAPTER 3: PROMOTING AUSTRALIA AS A LOCATION FOR INTERNATIONALLY FOCUSED COMPANIES

Controlled Foreign Company (CFC) Rules

Policy objectives

3.1 The Treasurer's Press Release of 22 August 2002 identified a high-level aim of improving Australia's attractiveness as a location for internationally focused companies to operate global and regional businesses. Reform of the CFC rules will contribute to this.

3.2 The Treasurer's Press Release of 2 May 2002 specifically outlined the aim of the review in relation to CFCs. The review's task is to examine claims that the rules:

- are complex and impose significant compliance costs on business;
- are out of step with modern business practice; and
- negatively affect decisions to locate in Australia as against countries with less stringent rules or no such rules.

Current law

3.3 The aim of the CFC regime is to prevent residents accumulating 'tainted income' taxed at low or zero rates in foreign companies controlled by Australian residents. A variety of methods and concepts have been developed over time to achieve this aim. They include:

- *Active income test*: If a CFC passes an active income test (that is, the large majority of its income is not tainted income), its income is generally not taxed on a current basis. If it fails the active income test, Australian owners may be taxed on tainted income on a current basis.
- *Tainted income:* This is foreign passive income and certain (mainly related party) sales and services income. Broadly, it arises from investments and arrangements that could be significantly influenced by taxation considerations in the source country.

- *Listed countries:* In the original regime, countries were divided into two categories: 'comparable tax countries' and 'tax havens'. In 1997, the comparable tax countries were subdivided into two lists: broad-exemption listed countries (BELCs), whose tax regimes were closely comparable to the Australian tax system; and limited-exemption listed countries (LELCs), whose regimes were less comparable to Australia, but were not tax havens. There are currently seven BELCs: Canada, France, Germany, Japan, New Zealand (NZ), United Kingdom (UK), and the United States (US).

- *Eligible Designated Concession Income (EDCI):* This is tainted income that is concessionally taxed in a BELC and therefore subject to tax in Australia. Types of EDCI are listed in the Income Tax Regulations. There are two categories — generic and specific. In the generic category are capital gains not subject to tax. In the specific category are usually 'types of entities' which are concessionally taxed in specific jurisdictions.

3.4 These are only a few examples of the tests and definitions within the CFC rules. There is significant complexity and compliance costs for business in applying these rules.

Problem

3.5 The submissions made to the Board supported the basic underlying policy of the CFC rules. Submissions agreed that rules are necessary to prevent Australian-controlled companies from deliberately accumulating passive income in a low tax jurisdiction. However, there are two major problems with the current CFC regime:

- the complexity of the rules leads to high compliance costs; and

- the operation of the rules often impedes genuine business transactions and decisions.

3.6 Specific problems include:

- restructuring is difficult because of insufficient rollover relief for capital gains tax (CGT);

- the interaction of Australia's transfer pricing rules and the CFC regime leads to duplication;

- under the tainted services income rules, Australian-owned businesses providing services into Australia from overseas pay Australian levels of tax on that income. Foreign-owned competitors providing the same services do not. Further, foreign subsidiaries of Australian companies are discouraged from providing services

among themselves, as the income produced is usually attributed to the Australian parent; and

- a long list of technical and policy options produced by the foreign-source income (FSI) subcommittee of the Australian Taxation Office (ATO) National Tax Liaison Group has remained virtually unactioned.

3.7 The following case studies are representative of the views echoed in numerous submissions about the impediments that Australian companies face when dealing with Australia's international tax regime. They also provide indicators of further behavioural effects that might arise from reforms — namely, that Australia might see an increased volume of inbound employment-creating investment into headquarter activities which are currently being located in Europe or Asian countries.

Box 3.1: Case Study — Malaysia preferred to Australia as headquarters

Company Y has been in negotiations with an European Union (EU) company to establish a 50/50 joint venture in Malaysia, China and Thailand. It may expand to other countries in the future.

Company Y has operations in China, Thailand and Malaysia. The EU company has operations in Malaysia.

Company Y and the EU company would prefer that one joint venture (JV) company holds all these interests, rather than owning companies in each individual jurisdiction. This would provide a focal point for proper management of the joint operations. The EU company rejected the use of a partnership or an unincorporated joint venture. The issue is where the JV company should be domiciled for tax purposes. The following two options have been canvassed.

Option 1 — Malaysia as a hub

Dividends from China would flow tax-free to Malaysia, and then again tax-free from Malaysia to Australia and the Netherlands (EU company intermediate holding company jurisdiction). Company Y and the EU company would be no worse off than if they had received dividends directly from China, as there is no Chinese dividend withholding tax (DWT).

Dividends from Thailand would flow to Malaysia after a 10 per cent DWT and then those same dividends could flow out of Malaysia free of DWT to Australia and the Netherlands. Company Y and the EU company would be no worse off, given that Thai dividends to Australia and the Netherlands also suffer a 10 per cent DWT.

Option 2 — Australia as a hub

Dividends from China and Malaysia would flow free of DWT to the Australian joint venture company. The Thai dividends would attract 10 per cent DWT, the same as if Malaysia were the hub.

The dividends received by the joint venture Australian company would be exempt from Australian tax. These dividends could be paid on to the Netherlands free of DWT by utilising the foreign dividend account (FDA). However, Company Y would have to pay Australian tax on the unfranked dividends received from the joint venture Australian company.

Australian CGT would be payable in respect of any gain on disposal of the foreign subsidiaries.

If the three subsidiaries offshore earned any 'attributable income' (as defined under Australia's CFC laws), then the JV Australian company would pay tax in Australia to the extent the Australian rate exceeds the foreign rate on that income.

Conclusion

Owing to Australia's tax on unfranked dividends (albeit sourced from previously taxed foreign income and which was previously tax exempt in Australia), its capital gains tax on sales of foreign subsidiaries, and its CFC laws that top-up taxes to the Australian rate on passive and tainted income, a hub in Malaysia is recommended.[1]

Box 3.2: Case Study — Observation of a multinational

Company Z has provided this background based on its own observations as a multinational. The comments are focused on the tax considerations of holding/owning assets. They do not purport to address other investment considerations such as sovereign risk; nor do they address the question of where headquarters should ultimately reside. (Headquarters can reside separately from the location where assets are held or owned.)

1 Case Study provided in a supplementary submission by BCA/CTA/ABA.

A key question for Company Z, when new businesses are acquired or to be established, is the ongoing ownership structure. A related and important issue is the implications of any ultimate disposal of the investment. The taxation implications of these matters may influence a decision one way or another when weighing up country ownership comparisons. Both these issues bring into sharp focus the extent of DWT and the implications of any CFC regime relating to holding/ownership, and the extent of CGT on exit.

Company Z notes that offshore multinationals have a structuring choice. This potentially allows access to more favourable international tax regimes than in Australia — for example, UK where there is no CGT on the sale of foreign businesses (that is, disposals of shares or assets).

Although Australia has an excellent record of economic growth, its taxes on foreign profits and on the sale of foreign assets make it unattractive as a regional holding centre, and largely isolated in the eyes of global investors. As a result, Australia is generally unattractive for 'flow through' investment, which of itself generates positive economic outcomes from service-related activity and Australian-bound personnel transfers. Company Z is aware that in the UK and the US, Australia's taxation regime is a key reason why companies seeking to conduct businesses in the Asia/Pacific region are advised not to consider Australia as a location for the regional holding company. As a result, business and multiplier effects flow instead to places such as Singapore and Hong Kong. Australia is not considered to be a suitable base from which to establish regional headquarters; for the most part it tends to attract only Australian-focused subsidiaries of multinationals.

Company Z is concerned that the international tax debate has focused on outbound investment. Perhaps this is not surprising, from the perspective of Australian companies attempting to grow globally. However, Australia's international tax regime should also be viewed from the perspective of inbound investors, including multinational companies seeking to invest offshore through Australian-based holding companies. While it would be impossible to quantify the amount of international investment that by-passes Australia, Company Z remains concerned that unless Australia makes its international tax regime more attractive, multinational companies in similar positions will continue to locate their regional service businesses (and consequently, their regional holding companies) outside Australia. This will be due, in part, to other countries' competitive on-going tax regimes on annual profits, combined with their minimal exit tax on foreign investments.

Company Z disagrees with arguments that there is no need for reform in this area. It disagrees that other structures (including the dual listed company structure) deal adequately with the tax problems. Those structures do not benefit Australia in the sense of attracting inbound or 'flow-through' investment. Moreover, Australian companies with outbound investments may have no choice but to adhere to an uncompetitive regime.

Inbound multinationals have a choice concerning ownership of offshore assets. With the current Australian tax regime, they are likely (in all but exceptional circumstances) to favour establishing ownership structures under more attractive regimes outside Australia — places such as the UK. (It seems that the US Administration is likely to propose substantial changes to its CFC and foreign tax credit regimes precisely because of a perception that the nature of its international tax rules makes the US (much like Australia) not a preferred tax regime. This compares with the situation in the UK, which recently sought to relax its rules to attract companies holding foreign assets.)

Therefore, Company Z considers it is crucial that reforms be considered not only to encourage companies to locate their headquarters/regional headquarters in Australia, but also to assure them that Australia will not seek to tax gains on investments held through Australia.[2]

Evidence of the problem

3.8 Australian multinationals often wish to restructure, for various reasons. The lack of CGT rollover relief can make this difficult. Australia has a number of rollover rules for capital gains, and many are incorporated into the CFC regime. However, the CFC provisions sometimes modify the rules. For instance, rollover relief is denied for certain transfers between BELCs (for example, from the US to the UK) and from non-comparably taxed jurisdictions to comparably taxed jurisdictions (for example, Hong Kong to US), and vice versa.

3.9 Submissions noted that the general business environment has changed since the introduction of the tainted sales and services rules. The ATO's enforcement of Australia's transfer pricing rules has improved dramatically. This has led to overlap between the transfer pricing rules and the CFC regime. Originally, taxation under the CFC regime of services provided by CFCs to unrelated parties in Australia was originally on the view that such activity should be discouraged. But the effect in the modern economy is to impede Australian businesses from providing services to Australia in the most economic way. This gives a competitive advantage to foreign-owned business providing the same services.

2 Case Study provided in a supplementary submission by BCA/CTA/ABA.

3.10 Submissions proffered the National Tax Liaison Group's list of issues as strong evidence that the CFC regime is overly complex. The list of issues is extensive. In the Board's view, the list highlights technical and policy issues which have arisen since the introduction of the CFC regime, and which remain unresolved.

Policy issues arising from the problem

3.11 A central concept in the CFC rules is the active income test. It is aimed at ensuring that only passive and certain sales and services income is affected by the CFC rules. This reflects the general policy that an Australian company's foreign subsidiaries should be subject only to the same tax as their local competitors. Australia does not wish to impose additional tax on active income, regardless of whether the foreign country is a high or low taxing country. This policy is generally referred to as 'capital import neutrality' (CIN), meaning that Australian capital deployed overseas should be subject to the same tax burden as foreign capital.

3.12 Under this principle, the CFC regime is applied in two circumstances only:

- to highly mobile income that can be shifted out of Australia more or less at the taxpayer's choice without involving the movement of real activities (passive and services income); and
- to passive sales and services income which is subject to transfer pricing.

3.13 The CFC provisions define notional assessable income. In some areas, particularly tainted services, perceived risk of abuse leads to a broad inclusion of income. This results in high compliance costs, as the regime attempts to pick up all forms of untaxed or lightly taxed income.

3.14 Important changes have occurred in the world economy since the CFC regime was introduced. Relevantly, they include the following:

- many Australian firms have reached the limits of possible growth in Australia. Expansion overseas is driven by business considerations, not merely to find a more favourable tax regime;
- the Organisation for Economic Cooperation and Development (OECD) Tax Competition project is identifying harmful tax practices in some countries and taking steps to remove their harmful features. This facilitates making judgments based on countries' systems overall rather than dissecting all the features of their tax regimes;
- international trade has increased between related parties compared to unrelated parties. This has led to coordinated international action against, and a much higher profile for, transfer pricing. (The OECD produced its Guidelines on Transfer Pricing in 1995 and has updated them several times.) The CFC regime

means that Australian-owned companies (but generally not foreign-owned companies) must deal with two sets of rules, involving high compliance costs in the transfer pricing area; and

- international trade in services is growing much faster than international trade in goods. This has led to international coordination of policy on the taxation of services. The general policy response is to tax services on the same principles as goods; in contrast, the CFC regime treats services significantly differently from goods.

3.15 Submissions universally concluded that the complexity and compliance costs involved in applying the CFC rules, as well as the changes in the international environment, demonstrate the need for urgent reform. Considerations relevant to reforming the CFC rules include:

- developing criteria to assess whether another jurisdiction has a reliable tax system, and then relying on the foreign system rather than trying to assess all its features in detail. Specifically, where a country has a rigorous tax system with features similar to Australia's, then it should be possible to rely on that country's tax system to deal with tax problems, without overlaying Australia's CFC rules;
- identifying changes in international business practices that affect the operation of the CFC rules, and their implications;
- identifying specific situations that constitute genuine and significant risks to revenue to be dealt with by the CFC regime, rather than excluding the regime only where there is no risk to revenue; and
- removing the bias inherent in current tax arrangements so that globally-focused Australian companies maintain corporate structures and select headquarter location on the basis of commercial considerations rather than taxation considerations.

Potential solutions

Exemption for BELCs

3.16 The Treasury Paper proposes a number of options aimed at simplifying the CFC regime and reducing compliance costs. However, many submissions went further and raised the possibility of exempting BELCs from the CFC regime, given that BELCs are countries with broadly similar tax regimes. They argued that the CFC provisions add an unnecessary complex layer of tax compliance. It should be possible to rely on a comparably taxing country without enforcing the CFC rules. Other attributable income not dealt with by the BELC's CFC regime (for example, foreign investment fund (FIF) income) could possibly be included in passive income. In specific situations it may be necessary to list features of a BELC system that should be subject to attribution. For

example, NZ does not have a CGT regime; untaxed capital gains of defined types arising in NZ could be a listed feature. These situations would be specific and much narrower than the current listing.

3.17 The logic that Australia should 'trust' comparably taxed countries applies to income of the CFC sourced in the relevant BELC, or in any BELC. However, a CFC may have income that is sourced outside the BELC, in a jurisdiction that is not comparably taxing. This creates issues that need to be addressed. Possibilities include:

- limiting the BELC exclusion to income sourced in the BELC or otherwise included in its tax base (or sourced in or otherwise included in the tax base of any other BELC); and
- limiting the BELC exemption to CFCs deriving income mainly from a BELC. For example, a de minimis rule could allow a small percentage of income sourced outside the BELC.

Advantages and disadvantages

3.18 The majority of Australia's outbound investment is with BELCs. A virtual exemption for BELCs would substantially reduce overall CFC compliance costs for business.

3.19 A possible disadvantage is that Australia would become more dependent on the tax administration and laws of other jurisdictions, as the CFC rules would no longer provide a backstop to BELCs. Overseas regimes would need to be regularly monitored. The behavioural response of business would also need to be monitored, to ensure that the CFC rules are not undermined by the general exemption. On the other hand, the changes in 1997-1998, which were partly driven by the problem of monitoring overseas systems, have resulted in substantial CFC compliance costs in the private sector, far exceeding the monitoring costs for the public sector.

3.20 While the above comments relate to income and gains derived by the CFC resident in the BELC, a residual issue is the treatment of income and gains of a subsidiary of that BELC where that subsidiary is resident in a non-BELC (including for these purposes, subsidiaries not resident in any jurisdiction).

3.21 An approach would be to rely on the CFC regime of the BELC to prevent diversion of passive income to low tax jurisdictions. The effect would be to exclude from Australia's CFC measures a CFC resident in a BELC and all its subsidiaries wherever resident. Conceptually this option is attractive and would limit the compliance burden of dealing with more than one CFC regime. Some submissions emphasised this existing compliance burden and favoured this approach to limiting the CFC measures.

3.22 The practical problems with this approach are similar to those discussed above. As pointed out in the Treasury Paper, even where a country has a CFC system policies vary regarding the type of income to be attributed. Therefore, there is a risk that exempting from Australia's CFC measures all subsidiaries held by a CFC resident of a BELC may leave scope for BELC 'shopping'.

3.23 Also, once a country is listed as a BELC, that BELC's CFC measures would need to be monitored. There is increased potential for countries to be taken off the BELC list depending on changes to their CFC rules.

3.24 On balance, although the compliance saving is attractive, it would inevitably lead to a restriction of the number of countries that could be listed as BELCs.

3.25 In the Board's view, it is important to balance minimising the overall compliance burden of the CFC measures with maximising the number of countries treated as BELCs. For this reason, the Board considers that subsidiaries in non-BELCs should be exempted from the CFC regime only where the BELC has a comprehensive CFC regime broadly equivalent to that of Australia.

Recommendation 3:

The Board recommends that where an attributable taxpayer holds an interest in a controlled foreign company that is resident in a broad-exemption listed country, the following income should not be attributed to the Australian resident:

(a) the income of the controlled foreign company (which would include its subsidiaries) that is sourced in that broad-exemption listed country or another broad-exemption listed country or is otherwise included in the tax base of a broad exemption listed country;

(b) the income of any subsidiaries of the broad-exemption listed country controlled foreign company where the subsidiaries are not resident in a broad-exemption listed country provided the broad-exemption listed country has a broadly comparable controlled foreign company regime to Australia's controlled foreign company regime.

In limited cases, income arising from specific features of a broad exemption listed country's tax system may be listed as subject to attribution.

This recommendation should be seen in conjunction with the Board's recommendations in 3.1(1) and (2), 3.2, 3.3, 3.4 and 3.10(1), (2) and (3) (below).

Option 3.1: To consider options to expand rollover relief under the controlled foreign company rules, while maintaining the integrity of those rules

3.26 The Treasury Paper suggests the extension of rollover relief under the CFC rules. Suggestions in submissions include extending relief to:

- all forms of corporate reorganisations available under the domestic CGT provisions;
- any rollover relief available under the laws of the relevant foreign jurisdiction;
- any rollover in a BELC;
- any gain of a CFC on disposal of a non-portfolio interest in a non-resident company with underlying active assets (for corporate reorganisations, merger or demerger);
- any rollover between 100 per cent commonly-owned companies; and
- transfer of shares from one CFC to another in exchange for shares.

3.27 Another suggestion is to allow the use of Australian capital losses to offset attributable capital gains of CFCs.

Advantages and disadvantages

3.28 Submissions emphasised that any extension of CGT rollover relief would facilitate corporate reorganisations and other business decisions in relation to foreign jurisdictions-matters, which are currently impeded or prevented by the CFC regime.

3.29 Although extension of Australian rollover relief will solve some problems, it will not meet all the cases where there is no clear policy against rollover. This is because of the wide variety of overseas tax systems to which the rules would have to relate.

3.30 A more targeted overall strategy would involve less complexity and deal with virtually all cases. The strategy would involve three elements, two of which arise from other recommendations of the Board. The first is to virtually exempt BELCs from the CFC rules (see Exemption for BELCs, above). Many submissions suggested this kind of approach as a possible alternative to extending CGT rollover relief. Of course, this will solve problems for BELCs only. For non-BELCS, a second and similar approach is possible — namely, permitting restructures which are specifically permitted under the law of the non-BELC concerned. Thirdly, the Board's recommendations in relation to Option 3.10(2) would effectively permit many corporate restructures in non-BELCs where the restructure involves the transfer of certain non-portfolio shareholdings in CFCs.

3.31 This still leaves some residual restrictions for the restructure of foreign subsidiaries, mainly in non-BELCs. For instance, rollover relief would not be allowed under the CFC measures where the foreign jurisdiction does not generally impose CGT and therefore does not have rollover relief. Therefore, additional rollover relief for companies may be necessary (in certain cases, scrip for scrip rollover relief may be appropriate). Moreover, if recommendation 3.10(2) were not accepted, such additional rollover relief would be critical for both BELC and non-BELC cases. For example, this extended rollover relief would also need to cover the disposal of assets by a CFC resident of a jurisdiction that did not have a CGT regime. Another example would be countries with capital gains and rollover provisions, where the rollover relief was narrow.

3.32 It is arguable this additional rollover relief should be restricted to relief available in Australia. That is, the relief should be restricted to transfers between 100 per cent owned group companies, scrip for scrip rollover, and de-merger relief. This would ensure neutrality between restructures onshore and offshore.

3.33 However, the argument against this restriction is that rollover relief is intended to place the Australian multinational on a consistent footing with the foreign multinational competitor. Since the foreign competitor may not be subject to any tax impediment or restructuring in the country of residence of the CFC, rollover relief should be as broad as possible while maintaining the integrity of the CFC measures.

3.34 The Board prefers the second approach because it gives an Australian multinational greater ability to restructure its business offshore for maximum efficiency. However, this measure will inevitably take some time to design and implement. In the meantime, the existing constraints on the restructure of an Australian multinational's offshore operations would remain. However, in the interim, the Board recommends that in addition to the relief recommended above, rollover relief be provided for transfers between 100 per cent owned group companies and for scrip for scrip and de-merger transactions.

Option 3.1: Extending CGT rollover relief

Recommendation 3.1(1):

The Board recommends that rollover relief should be available for corporate restructuring of controlled foreign companies not resident in a broad-exemption listed country, where the restructuring is covered by, and done in accordance with, the tax law of the country concerned.

Recommendation 3.1(2):

The Board recommends that rollover relief be extended to cover transfers of assets or interests between 100 per cent owned group companies, scrip for scrip transactions and demerger transactions in cases where relief would not otherwise be available as a result of recommendations 3, 3.1(1) and 3.10(2).

Option 3.2: To consider options to appropriately target the tainted services income rules, while maintaining the integrity of the controlled foreign company rules

3.35 There is general agreement that the tainted services income rules need to be reformed. While many submissions suggested the need to narrow the scope of both the tainted sales and services income rules, services were the main focus. Suggestions included that:

- provision of services between CFCs on an 'arms length basis' should be outside the scope of the CFC rules;
- consistent with the tainted sales income rules, provision of services that do not have a direct connection with Australia should be excluded;
- the scope of the rules should be confined to genuinely passive income;
- the scope of the rules should be confined to services which CFCs provide to resident associates; and
- CFCs undertaking an active business of providing services should be excluded.

Advantages and disadvantages

3.36 The Board accepts the need to reform the tainted-income rules. A number of submissions suggested handling the problem by distinguishing between active and passive businesses of providing services. However, rapid developments in the high-value services area make enduring definitions difficult. Further tinkering with the

definitions of tainted sales and tainted services income is likely to add to complexity and compliance costs without fully solving the problems. Where the concern is transfer pricing out of Australia, the Board considers that Australia's transfer pricing regime is sufficient and reliance could be placed solely on the transfer pricing rules, not the CFC regime. Where the concern is the movement of service capacity from Australia, the issue for taxation of income from services under the CFC rules is in essence no different to that for sales income. Different treatment would disadvantage companies deriving services income internationally compared to others.

3.37 An overall strategy to deal with concerns is to remove altogether the concepts of tainted services and tainted sales income. However, the Board recognises that there may be a narrow range of services the location of which are generally accepted as more likely to be motivated by tax minimisation than by commercial considerations. Captive insurance companies may fall into this category; they can be dealt with expressly in the passive income rules.

3.38 A concern remains about the use of tax havens, particularly in view of other changes recommended in this report. For example, those other changes create the potential to more easily establish the residence of a company offshore (Recommendation 3.12), including in tax havens, to generate tainted services or tainted sales income and take advantage of nil or low tax rates to distribute dividends to an Australian parent in a tax-free form (Recommendation 3.9) and to entitle the shareholders of the Australian parent to a 20 per cent tax credit (Recommendation 2.1(1).

3.39 Accordingly, the Board's recommendation in relation to this option does not extend to tainted services income or tainted sales income derived in designated tax havens unless, consistent with Recommendation 3, the income is subject to tax under the tax regime of a BELC (including its CFC regime). In other words, unless the income is subject to tax in a BELC it will continue to be subject to Australia's CFC measures. Care needs to be taken in determining what is a designated tax haven for this purpose, and the Board suggests using the criteria adopted by the OECD to identify tax havens.[3]

Option 3.2: Reforming the tainted services income rules

Recommendation 3.2:

The Board recommends that the tainted sales and services income rules be abandoned (except in relation to income or gains derived in designated tax havens that are not otherwise subject to tax in a broad-exemption listed country), and that services that are considered to raise particular integrity issues be dealt with expressly in the passive income rules under the controlled foreign company regime.

3 Harmful Tax Competition: An Emerging Global Issue — 1998.

Option 3.3: To consider whether additional countries should be included on the broad exemption country list, and to clarify the criteria for inclusion (or exclusion)

3.40 Many submissions called for clear criteria to determine BELC status. Developing such criteria will become crucial if the Board's recommendation to exempt BELCs from the CFC regime is adopted. This is because:

- Australia will be relying more heavily on the tax laws and administration of the BELC; and
- the favourable treatment will result in more pressure to expand the list.

3.41 Submissions suggested including the Scandinavian countries, and some southern European and Asian countries on the BELC list. This would double the current list to approximately 15 members. Until criteria are developed, the Board does not support specific recommendations on countries for inclusion.

Option 3.3: Adding to the list of BELCs, and clarifying criteria for inclusion

Recommendation 3.3:

The Board recommends that criteria for declaring further countries as broad exemption listed countries be developed and published as soon as practicable. Any further declarations of broad-exemption listed countries should be made on the basis of those published criteria. Existing broad-exemption listed countries should remain broad-exemption listed countries.

Option 3.4: To identify technical and other remaining policy issues regarding the controlled foreign company rules, and consider options to resolve them either on a case-by-case basis or as part of a major rewrite of the provision

3.42 The current CFC rules are lengthy, highly technical and complex. There are many compliance problems and unintended consequences (even though, when enacted in 1990, the rules had been subject to very extensive consultation).

3.43 The FSI Subcommittee of the National Tax Liaison Group has maintained a list of CFC issues (CFC issues register) for a decade. A large number of submissions referred to this list, and called for immediate action. The submissions pointed out that

the issues have remained unresolved for many years, even though CFC issues had been raised in two major reviews (the 1997 CFC review[4] and the RBT).

3.44 The Board commissioned a report to examine the issues and to prioritise them: see Attachment 1. On the basis of this report and the submissions, the Board considers that these issues should be resolved as a matter of urgency.

3.45 Many issues may be resolved if other recommendations of the Board in this report are adopted. For example, the issues relating to EDCI will not be relevant if BELCs are exempted from the CFC rules. As noted in the Treasury Paper, one issue in particular is already the subject of consideration and should be resolved swiftly — namely, the treatment of hybrid entities such as limited partnerships and US limited liability companies.

3.46 The Treasury Paper also raised the possibility of a complete rewrite of the CFC provisions. Submissions were divided on whether a rewrite is the best solution. There is concern that a complete rewrite would:

- take some years to complete;
- create other unintended consequences and compliance problems; and
- impose considerable costs of re-learning the rules and re-engineering compliance systems in an environment where tax reform fatigue is already a significant problem.

3.47 Conversely, there is concern that marginal tinkering:

- would deal only with some of the problems and not address systemic issues;
- would receive only a low priority in government business and be drawn-out over time; and
- may lead to greater complexity by merely modifying or qualifying existing rules, not removing them.

Advantages and disadvantages

3.48 As the benefits of a complete rewrite are difficult to demonstrate, a more targeted strategy is likely to be more effective, at least in the short-term. The Board is satisfied that the major CFC recommendations in this report will substantially improve the operation of the CFC provisions and significantly reduce compliance costs. It recognises, however, the need also to work on other technical issues.

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4 *Information Paper: Proposed changes to the taxation of foreign source income,* December 1996.

Option 3.4: Identify technical and remaining policy issues, and consider options to resolve them either on a case-by-case basis or as part of a major rewrite

Recommendation 3.4:

The Board recommends that the policy position on the following issues in the controlled foreign company regime should be resolved by 31 December 2003:

(a) currency exchange fluctuations;

(b) limited liability companies and limited partnerships;

(c) all issues classified as urgent in the consultancy report commissioned by the Board not covered by other recommendations (see Attachment 1); and

(d) an ongoing speedy decision-making process to resolve other issues on the Controlled Foreign Company National Issues Register (see Attachment 2).

Tax Treaties

Policy objectives

3.49 A policy objective of the current Review is to promote Australia as a location for internationally-focused companies. Double tax agreements (DTAs) are a significant element in international tax arrangements and need to be considered alongside domestic tax law. As DTAs are the result of detailed negotiations based on the tax systems of the two countries concerned, general DTA policy necessarily must be concerned with high-level issues and processes. A major policy question is the balance between residence and source taxation, and whether the balance struck in the recent Protocol to the US treaty should be the basis of future policy.

Current position

3.50 DTAs allocate taxing rights between Australia and other countries. They ensure that the same income or capital gain is not subject to double taxation, or to double non-taxation (or exemption). Until recently, Australia's DTAs have generally given greater emphasis to source taxation than to residence taxation. This is reflected in a number of features, such as:

- a wide definition of permanent establishment (PE), which increases Australia's taxing rights over non-residents' business operations in Australia; and
- relatively high withholding tax rate ceilings for dividends, interest and royalties derived by non-residents from Australia.

3.51 When Australia introduced its CGT in 1985, two important issues arose for DTAs: (1) how did existing DTAs apply to the CGT, and (2) how would future DTAs deal with it? Consistent with Australia's broad-source taxing policy, the ATO has taken the position that pre-CGT treaties do not limit CGT taxing rights (see Taxation Ruling TR 2001/12). It has also preserved domestic law source taxing rights over capital gains in treaties negotiated since them. In the case of investment in companies, the CGT taxes non-residents on gains on shares in resident private companies and non-portfolio interests in public companies. The CGT does not extend to shares in non-resident companies which hold Australian assets. The RBT recommended that the CGT be extended to non-portfolio interests in non-resident companies having their principal assets in Australia.

3.52 Australia's DTA with the US dating from the early 1980s had given away more source taxing rights than other DTAs, with a narrower definition of permanent establishment (PE) and a partial non-discrimination article (NDA). A NDA deals only with source taxation rights. In the recently-negotiated Protocol to the US DTA, Australia moved further away from source taxation by significantly reducing withholding tax rates on dividends, interest and royalties, and to a small degree qualifying Australia's levy of CGT on US residents. These changes reflected the RBT's recommendations that Australia renegotiate its treaties with its major trading partners and in particular reduce withholding tax rates on dividends paid from subsidiaries of Australian companies operating in those countries.

3.53 The emphasis of treaty negotiations over recent decades has been on extending Australia's DTA network to new countries, while updating the most important treaties on about a 20-year cycle.

3.54 Like many other contracts entered into by governments, DTAs are negotiated largely in secret. To some extent, this is changing: in Australia in recent years the negotiation process has been partly opened to consultation, through the ATO's Tax Treaties Advisory Panel and direct dealing with specific taxpayers on particular issues. But the balance is still very much on the side of secrecy.

Problems

3.55 The source-based DTA policy has detrimental impacts on Australian firms investing offshore, because it exposes them to high taxes in tax treaty partner countries. Yet Australia has unilaterally given up significant areas of source taxation under domestic law, such as DWT on franked dividends and interest withholding tax on widely-issued debentures.

3.56 Further, the treatment of capital gains has been a vexed issue under pre-CGT treaties for over a decade. The overwhelming private sector view is that pre-CGT treaties override the domestic CGT rules. However, the ATO view is that they do not. This standoff has detrimental effects on investment decisions by non-residents in

relation to Australia, as the CGT treatment of the investment is uncertain. While the position under more recent DTAs is clear, the broad CGT jurisdiction claimed by Australia is out of line with international norms and also affects investment decisions by non-residents under these treaties.

3.57 Extending the CGT to shares in non-resident companies as proposed by the RBT will give even greater emphasis to source taxing rights. Further, the extension would add significant complexities to the tax law and would be very difficult to administer. Although the issue has been well understood internationally for many years, very few countries have sought to extend their CGT to shares in foreign companies. Indeed, apart from land rich companies, the international norm is not to levy CGT on non-residents when they dispose of shares in domestic companies, whether portfolio or non-portfolio interests. In some countries this result follows under domestic tax law; in other countries it follows as a result of DTAs.

3.58 In recent decades, the source emphasis in Australia's DTAs had made updating some major treaties problematical. Several major treaties have now run for more than 20 years without any significant updating (UK, 1967; Japan, 1969; Germany, 1972; several other European countries in the 1970s). The RBT has led to a shift of emphasis towards updating the major treaties. However, the DTA negotiation agenda is large, due to earlier inactivity and the practice of giving priority to extending the DTA network to investment partners that are relatively minor (at least, from Australia's point of view). Political and economic events may also affect negotiation priorities at particular times.

3.59 As Australia's overseas investment is concentrated in a few countries, extending the tax treaty network to countries with which Australia has little trade or investment is less important than revising existing major treaties.

3.60 The submissions suggest that the Tax Treaties Advisory Panel has had mixed success. In recent and current tax treaty negotiations, major companies have found it necessary to bypass this forum to make sure that their concerns receive a proper hearing.

Evidence of the problems

3.61 The evidence on change in investment flows in and out of Australia is now well known, although its implications went largely unnoticed before the RBT. The need to protect source taxation is now far less significant than 20 years ago, when inbound investment was four times the level of outbound investment. The emphasis on source taxation creates significant tax obstacles to foreign investment by Australian-based multinationals, and leads to collection of tax in foreign countries rather than in Australia. The problem of foreign withholding taxes on dividends was a significant element in one major company's recent decision to move out of Australia.

3.62 The standoff in the application of pre-CGT treaties in the CGT context is the subject of many published articles and many disputes with the ATO. No test case has yet been run to settle the issue, despite the ATO's significant general test case activity in recent years. Australia's international treatment of CGT on shares is a recurring theme in the problems of establishing Australia as a base for internationally-focused companies.

3.63 The majority of submissions stated that while the Tax Treaties Advisory Panel has given advice on a number of technical issues, it meets infrequently compared to other Panels, is often presented with proposed treaty texts where there is little or no room for change, and has little input into major policy matters. Also, its practice does not conform to the new consultation processes recently established for tax legislation. Major OECD countries are much more open than Australia in this regard. For example, more information is publicly available in the US on the 1983 DTA with Australia than is available in Australia.

Policy issues arising from the problems

3.64 Two main models are used in international negotiations of DTAs: the OECD Model Tax Convention, and the United Nations (UN) Model Double Tax Convention between Developed and Developing Countries. The OECD Model was designed for treaties between developed countries whose investment and trade flows over time tend to be in balance among themselves. This Model gives more emphasis to residence taxing rights, because when flows are in approximate balance the same division of revenue is achieved whatever the division of source and residence taxing rights. As one country gives up source taxing rights over residents of the other country, it acquires greater taxing rights over its own residents who can no longer be taxed in the other country through that country giving up its source taxing rights.

3.65 The OECD Model prefers residence taxation to source taxation. This is partly because it is administratively easier and partly because of economic distortions caused by source-based taxes:

- gross basis withholding taxes at source often exceed net basis tax in the residence country, resulting either in unrelieved double taxation, or (more commonly) in charging the withholding tax back to the source country through gross-up provisions in loan and licensing agreements; and
- profits in one source country do not effectively offset losses in other source countries, so that companies get taxed even when they are suffering substantial losses.

3.66 The UN Model Double Tax Convention between Developed and Developing Countries was designed for situations where investment and trade flows are not in balance. This is the typical situation between a developed and a developing country. It

gives greater emphasis to source basis taxation to ensure that revenue from trade and investment is shared fairly between the two countries.

3.67 Historically, Australia has been a significant capital importer. Hence its DTA position currently departs from the OECD Model, even though it has been a member of the OECD since 1971. Australia gives greater emphasis to source taxation in a way which is often closer to the UN Model than to the OECD Model.

3.68 As Australia moves towards balance in investment inflows and outflows, the revenue need for source taxation recedes. Even though Australia may remain a net capital importer for many years to come, there will be significant levels of investment outflows as well as inflows. The distorting effects of source based taxes may mean that resulting economic efficiency gains for both inbound and outbound investment will exceed revenue foregone by moving to a residence-based policy for DTAs.

3.69 The recent Protocol with the US has moved more to residence based taxing rights, but still has a considerably greater source-taxing emphasis than the OECD Model.

Potential solutions

Option 3.5: To consider whether the recently negotiated protocol to the Australia-United States tax treaty provides an appropriate basis for future negotiations or whether alternative approaches are preferable

3.70 The Treasury Paper recognised that higher levels of withholding tax may disadvantage Australian companies operating offshore against local competitors, and against competitors resident in countries which negotiate lower withholding tax rates. The rapid growth in Australian direct investment offshore has highlighted the increasing importance of this disadvantage.

3.71 High levels of withholding tax may also detract from Australia's conduit arrangements, as discussed in the 'Conduit income' section in this chapter. The Treasury Paper suggested that Australia might need to change its tax treaty practice to reflect the increasing level of direct investment offshore and the limited use of its withholding tax rights.

3.72 Most submissions which addressed this issue agreed with some or all of the major changes made under the recent Protocol with the US. They included:

- eliminating the DWT for most franked and unfranked non-portfolio dividends;
- reducing the royalty withholding tax rate; and
- reducing the interest withholding tax rate to zero for financial institutions.

Those changes would reduce tax paid by non-residents on Australian-source income, but at the same time reduce the cost to Australian businesses of foreign capital or of accessing foreign technology. They would also mean that when Australian businesses invest in the US, Australia would collect more tax than it currently does on the income they earn.

3.73 As many submissions stated, this approach would facilitate outward and inward investment from and to Australia. A tax treaty policy based on residence taxation, like the OECD Model, would achieve this goal and make renegotiation of major treaties much easier. A tax treaty in OECD form would also override the CGT extension. This should help Australia proceed more speedily with renegotiations of major treaties. However, the Board acknowledges that treaties are bilateral negotiations requiring time and observance of international protocols, and that it is not always possible to reach a speedy conclusion.

Option 3.5: Australia's future treaty practice

Recommendation 3.5:

The Board recommends a move towards a more residence-based treaty policy in substitution for the treaty model based on the source taxation of income.

Option 3.6: To consider whether or not to proceed with the Review of Business Taxation proposal to apply CGT to the sale by non-residents of non-resident interposed entities with underlying Australian assets

3.74 Almost all submissions addressing this issue overwhelmingly opposed the proposal that Australia should extend its source taxing rights to gains made by non-residents on the sale of non-resident interposed entities with underlying Australian assets.

3.75 Such a measure would be difficult to comply with and hard to enforce. It would cause inadvertent breaches by creating hidden tax exposure for overseas investors for relatively small revenue gain. It would also harm Australia's international competitiveness by making Australia a less attractive investment destination. Targeting the measure properly would also increase the complexity of the tax law.

3.76 The uncertainty surrounding the operation of pre-CGT treaties also has detrimental effects on investment in Australia.

Option 3.6: Extending capital gains tax to sale of shares in non-resident companies

Recommendation 3.6:

The Board recommends against proceeding with the Review of Business Taxation proposal to apply capital gains tax to the sale by non-residents of non-resident interposed entities with underlying Australian assets.

Option 3.7: To consider which countries should be given priority for tax treaty negotiations, taking into account negotiations underway with the United Kingdom and Germany, the need to update pre-CGT treaties, and countries that Australia may be obliged to approach because of most favoured nation clauses in existing treaties

3.77 Once the US Protocol takes effect, Australia will be obliged by its tax treaty with eight countries to enter into negotiations with a view to treating them in the same way as those countries with which Australia has a most favoured nation (MFN) clause on rates of withholding tax. The countries are the Netherlands, France, Switzerland, Italy, Norway, Finland, Austria and the Republic of Korea.

3.78 Australia is currently negotiating tax treaties with several countries, including the UK and Germany. If these treaties include a non-discrimination article, then Australia will be obliged to enter into negotiations for a similar article with France, Finland, Republic of Korea, Spain and South Africa, and also in relation to the agreement between the Australian Commerce and Industry Office and the Taipei Economic and Cultural Office. Australia has a MFN clause on a NDA with these countries.

3.79 The obligation to enter into negotiations presents an opportunity to quickly negotiate new treaties or protocols which would clarify Australia's right to apply capital gains tax. It would also be possible to include elements of the US Protocol, such as zero or low rates of tax for permitted dividend withholding.

3.80 The submissions noted that most favoured nation clauses in many of Australia's important DTAs would influence priorities, and that Australia should swiftly seek to renegotiate these DTAs along lines consistent with the recommendations concerning Australia's future DTA policy. Most submissions considered that Australia's priority for tax treaty negotiation should be its major investment partners. Generally, the most important countries are covered by existing negotiations or obligations likely to be triggered by those negotiations. Those negotiations would also deal with most of Australia's pre-CGT treaties, so that uncertainties in this area could be resolved for the future.

Option 3.7: Priorities in negotiation

Recommendation 3.7:

The Board recommends that the Government set the following priorities:

(a) review and keep the key country treaties up to date and in line with Recommendation 3.5; and

(b) enter into treaty negotiations with other countries in the order of most important investment partners with Australia.

Option 3.8: To consider options to improve consultation processes on negotiating tax treaties

3.81 Most submissions agreed that effective consultation arrangements between Australian business, other interested parties and Treasury are important in achieving successful and timely DTA negotiations, and in improving the transparency and effectiveness of the current processes.

3.82 Many submissions noted that stakeholders are invited to comment only after the negotiation process is almost complete, and that the discussions are often about technical wording rather than policy issues.

3.83 The Board agrees that Australia would benefit from following best practice on consultation in the DTA area, in the same way as it does for tax legislation and as other countries do for treaties. Although the way in which such a process will operate in individual cases will always vary, it is important to establish clear guidelines. The Tax Treaties Advisory Panel could be maintained as the forum for such consultation. However, the Panel would be improved by:

- more frequent meetings;
- input into formation of basic policy as well as technical details;
- flexible membership, to allow affected taxpayers to be consulted on relevant treaties; and
- publishing Australia's model tax treaty.

Option 3.8: Improving consultation arrangements

Recommendation 3.8:

The Board recommends that the consultation processes on negotiating tax treaties be improved by adopting processes similar to those of the Board's consultation report as adopted by the Government for domestic tax legislation.

Conduit income

Policy objectives

3.84 Conduit income raises two related policy issues:

- whether the CFC and foreign tax credit/exemption rules are too complex and impose unduly onerous compliance costs on business, are out of step with modern business practice, and negatively affect decisions to locate in Australia; and
- the adequacy of the current conduit rules and their impact on the establishment of regional holding companies in Australia.

Current law

3.85 The current treatment of dividends from foreign companies is very complex, depending on the following factors:

- whether the dividends are portfolio or non-portfolio;
- whether the dividends are received by a company or other taxpayer;
- whether the dividends are received from a company resident in an unlisted country or a listed country;
- whether the dividends are paid out of income that has been attributed under the CFC regime; and
- whether the dividends are subject to withholding tax in the foreign country.

3.86 Depending on these factors, the dividends may be exempt, partially exempt, subject to a foreign tax credit in whole or part (and relating to underlying corporate tax, or dividend withholding tax, or both), or simply taxable. Most dividends paid to Australia are received by Australian companies from non-portfolio interests in foreign companies. They are generally exempt from tax if they are paid by companies resident

in either BELCs or LELCs. The exemption does not generally apply to dividends received directly (or in some cases indirectly) from unlisted countries.

3.87 On the inbound side into Australia, unfranked dividends paid to non-resident owners are generally subject to DWT (usually reduced by treaty to 15 per cent). Some recent treaties adopt lower rates of tax on non-portfolio dividends paid to companies, most notably zero in certain cases under the US Protocol. The withholding tax on unfranked dividends is not payable if the dividend can be traced through an accounting mechanism contained in the tax legislation — foreign dividend account (FDA) — to non-portfolio dividends received by the Australian company from offshore. The FDA currently records only non-portfolio dividends. The purpose of the account is to allow an Australian company to pay unfranked dividends to non-resident shareholders without the imposition of withholding tax, subject to rules which prevent streaming of the account only to such shareholders.

3.88 Capital gains derived by resident companies from disposal of non-portfolio interests in foreign companies are subject to tax; so are gains by non-residents on non-portfolio interests in Australian companies.

3.89 In a broad sense, these treatments of dividends and capital gains are replicated offshore under Australia's CFC regime.

Problems

3.90 The complexity of the current rules for dividends from foreign companies is obvious even from this brief description. Where possible, companies respond by paying dividends which are exempt in Australia from countries which do not levy withholding tax on the dividends; otherwise, dividends are unlikely to be paid to Australia. Where a company's financial position forces it to pay substantial amounts of dividends to Australia from foreign subsidiaries which are subject to significant levels of withholding tax, then it may consider moving offshore. This is because the withholding tax generally operates as an additional tax impost on the company and ultimately on shareholders arising simply from residence in Australia. For similar reasons, companies may be reluctant to locate in Australia.

3.91 Because Australia potentially taxes incoming and outgoing dividends, Australian tax may be levied on conduit income passing from offshore through an Australian company to a non-resident. Interposing the Australian conduit affects the tax outcome. For some dividends, this problem is overcome through the exemption for non-portfolio dividends and the FDA. However, this is not the result in some potentially common cases. For example, if a US company were to set up a JV company in Australia with an Australian company for investing in the Asia-Pacific region, dividends from a Hong Kong subsidiary of the JV would be subject to corporate tax in Australia. Dividends paid by the Australian JV company which were franked would not be subject to withholding tax, and would give rise to franking credits for the

Australian participant in the JV company. Dividends paid out of the FDA would also not be subject to withholding tax, but would be unfranked dividends for the Australian participant and subject to corporate tax at that level. Other dividends paid by the JV company (for example, out of profits of a branch in Hong Kong) would be subject to dividend withholding tax in the hands of the US joint venturer.

3.92 For capital gains on shares in either an offshore subsidiary of an Australian company, or an Australian subsidiary of a foreign parent, there is no attempt to provide any tax relief. Capital gains on shares in controlled companies often represent retained income. To the extent that the profits are paid out as dividends from a foreign company resident in a listed country, or by an Australian subsidiary to a US parent, the profits would not be subject to tax in Australia. This differential treatment of dividends and capital gains is difficult to justify.

3.93 As a result of the treatment of dividends and capital gains on non-portfolio interests in companies into or out of Australia, Australia has not developed as a favoured conduit or headquarter location.

3.94 While the dividend situation is to a degree dealt with in the tax law, conduit treatment does not apply to exit from investments (either offshore subsidiaries of the Australian conduit, or the foreign parent from the Australian conduit).

3.95 In the CFC regime, the complexity of the treatment of dividends and capital gains was considered necessary to prevent movement of profits from companies resident in unlisted countries to companies resident in listed countries.

Evidence of the problems

3.96 The LELC category was created in 1997 when listed countries were separated into BELCs and LELCs. Approximately 88 percent of non-portfolio dividends currently paid to Australia are from BELCs, 9 percent from LELCs, and 3 percent from unlisted countries.

3.97 Very little revenue is thus collected on dividends repatriated to Australia from unlisted countries. In addition, the amount of dividend income from LELCs is small — even though it is exempt. Yet Australian companies and their offshore CFCs incur large compliance costs in tracking the various kinds of dividends and in making deduction allocation and foreign tax credit calculations.

3.98 Many large companies with significant amounts of foreign income have examined their dividend position under the system for relief of double taxation in combination with their imputation position. The prevalence of exempt dividends indicates how they approach dividend policy. The result is a considerable constraint on capital management by Australian-based companies. In extreme cases, companies may move out of Australia.

3.99 Australia has had little success in attracting holding companies and regional headquarters. In the late 1980s and early 1990s, the private sector made a concerted push to make Australia an attractive location. The government gave some ground to the push and introduced a number of tax measures, including some relating to offshore banking units, regional headquarters, and the FDA. However, the private sector regarded the measures as inadequate.

Policy issues arising from the problems

3.100 In common with most countries, Australia levies tax on a source and residence basis. This is relatively easy to apply in the case of individuals. However, in the case of entities such as companies the application becomes complex, for two reasons. The first is the problem of double taxation of dividends. The second is that determining the residence of companies is not as simple as for individuals. For the first problem, mechanisms are put in place such as imputation, and the exemption of dividends from foreign subsidiaries, or underlying tax credit for such dividends. For the second problem, the appropriate policy would be to base the residence of a company on that of its ultimate owners; but to trace ownership through many tiers of entities is not practical, and in any event the ultimate owners will often be resident in several countries.

3.101 Hence, it is common to use a 'management' or 'place of incorporation test'. As these tests can be manipulated, they are backed up by measures such as CFC and FIF regimes. Where FSI is derived by a company resident in Australia under these tests, but the owners of the company are non-residents, Australia is generally considered to have no real tax claim.

3.102 Partly for this reason, the OECD Model tax treaty ensures that little or no tax is levied on dividends or capital gains on non-portfolio interests in companies held by non-residents.

3.103 In addition, many countries in their tax law or treaties provide an exemption for the foreign-source dividends and capital gains received by their residents. The purpose is to avoid international double taxation (given that the underlying profits will have been subject to corporate tax). These measures are supported on the policy basis of CIN — that is, that the company should be subject to the same tax level as its competitors in the countries where it operates, either through branches or subsidiaries. As noted previously, this is the general policy basis underlying Australia's CFC regime.

3.104 The combination of these policies also produces a conduit situation — that is, foreign income passes through a country to non-resident owners without tax in a direct investment situation. Unless appropriate policies are adopted, it becomes necessary to create special rules to deal with conduit situations. The FDA serves this purpose in current law for outgoing dividends (there is no relief for capital gains). But the FDA

covers only incoming dividends; it does not cover other FSI. The RBT recommended that other income be covered by the account, so that conduit treatment is also possible for other types of foreign income such as foreign branches.

Potential solutions

Option 3.9: To consider abolishing the limited exemption country list and provide a general exemption for foreign non-portfolio dividends Australian companies receive and (subject to some existing exceptions) for foreign branch profits

3.105 Clearly, any simplification of the current maze regulating the taxation of foreign dividends will be an advantage. In view of the small amount of tax collected on dividends from companies resident in unlisted countries, and the small amount of dividends received from LELCs, there is a strong case on compliance grounds alone for exempting all non-portfolio dividends received by Australian companies. In policy terms, such a change would also produce greater consistency for foreign income. Active income would be subject to CIN at the corporate level — that is, it would be taxed only in the country of source. Low taxed passive income would be subject to attribution under the CFC regime.

3.106 This policy and compliance approach could greatly simplify the system. Non-portfolio dividends received by Australian companies from foreign companies would be exempt from tax in all cases, with no credit for DWT. All other dividends would be subject to tax, with credit for foreign DWT only.

3.107 This change would also greatly simplify the CFC regime. It would lead to abolition of the LELCs, the only listed countries would be BELCs. Complex rules dealing with disguised distributions from CFCs resident in unlisted countries would no longer be necessary. Further, the exemption would be extended to offshore dividends under the CFC regime, as concerns about moving profits from unlisted to listed countries would no longer arise. Non-portfolio dividends received by CFCs would also be exempt from attribution. Finally, it would no longer be necessary to record and track (through tiers of companies) dividends that are paid out of attributed income under the CFC regime.

3.108 As the treatment of foreign branch profits largely parallels the treatment of CFC income, all foreign branch income would similarly become exempt, except for low taxed passive income.

Option 3.9: General exemption for non-portfolio dividends

Recommendation 3.9:

The Board recommends providing a general exemption for foreign non-portfolio dividends received by Australian companies and their controlled foreign companies and (subject to some existing exceptions) foreign branch profits.

Option 3.10: To consider options to provide conduit relief for Australian regional holding and joint venture companies, including considering the benefits and costs of introducing a general conduit regime providing an exemption from the sale of non-portfolio interests in a foreign company with an underlying active business; and providing conduit restructure relief

3.109 Constructing a targeted conduit regime is fraught with difficulties:

- if not limited to wholly-owned situations, there are significant problems of complexity and risks of leakage;
- if limited to wholly-owned situations, not all the necessary cases will be covered; and
- in either event, there may be problems in meeting forthcoming OECD guidelines on harmful tax practices for what is an acceptable conduit or headquarter regime.

3.110 Also, conduit restructure relief represents a complex and backdoor solution to the problem of conduit income. It would require parties to enter into additional transactions which, though effective under Australian domestic law (as amended under this proposal), may create tax problems under foreign law.

3.111 A systemic solution is therefore to be preferred. Such a solution is possible, consistent with policy developments discussed elsewhere in this report. The solution would also significantly simplify the CFC and related rules.

3.112 The following measures, for example, would in essence achieve a conduit regime without undue complexity:

- exempting certain dividends paid into Australia — see Recommendation 3.9 and exemption available under section 23AJ;
- exempting dividends paid out of Australia — DWT and foreign income account (FIA);

- CGT exemption for sale by an Australian resident of a non-portfolio interest in a foreign company that has an underlying active business — see Recommendation 3.10(2);
- simplifying the CFC regime (exemption for CFCs in relation to income from BELC) — see Recommendation 3; and
- exempting non-portfolio gains on shares in Australian companies — see Recommendation 3.11(2).

3.113 On the CGT side, the solution involves exempting capital gains on direct investment in foreign companies, whether in listed countries or not. Along with this, any capital gain so exempted would then qualify for FIA treatment. This change would parallel the solution in relation to the previous option of exempting all non-portfolio dividends received from foreign companies. The potential simplifying power of these two changes is very significant. They would allow the removal of a significant part of the CFC and associated legislation: potentially sections 23AI, 23AJ, 47A, 422, 423, 457, 458, 459, 459A, Part X Divisions 4, 5, 6, 10 of the 1936 Act. Exemptions would also need to be inserted for capital gains offshore between CFCs in a similar way for dividends. Simplification would flow into the underlying foreign tax credit (FTC) provisions and other parts of the legislation.

3.114 The Treasury paper canvasses whether the CGT exemption should be limited to shares in companies which pass the active income test. The Board considers that this is necessary, but that it should be done on a time-apportionment basis. That is, shares would be regarded as active assets so long as the CFCs effectively disposed of in the sale passed the active income test for at least half of the time they were held by the taxpayer or its associates. This limitation should not prevent the removal of the provisions above (which at the moment do contribute to the CGT calculation where companies do not pass the active income test). Rather, a provision should be inserted that, if the capital gain is taxable, CGT applies only to the extent that it reasonably reflects gains on the assets producing the income which caused failure of the active income test, and reduced by any foreign tax liability in respect of those assets. The interaction of Recommendation 3.10(2) and other recommendations contained in this report, for example Recommendation 2.1, will need to be further considered.

Option 3.10: Conduit relief for Australian regional holding and joint venture companies

Recommendation 3.10(1):

In view of the taxation relief available on certain dividends passing through Australia, and of the Board's recommendations in 3, 3.9, 3.10(2) and 3.11(2), the Board recommends that a separate conduit regime not be developed at this stage.

Recommendation 3.10(2):

The Board recommends that there should be a capital gains tax exemption for the sale by an Australian resident company or its controlled foreign companies of a non-portfolio interest in a foreign company that has an underlying active business.

Recommendation 3.10(3):

The Board recommends that any capital gain by an Australian resident company exempted as a result of Recommendation 3.10(2) would incur no withholding tax if passed to non-residents consistent with the policy intent of the Board's other recommendations on conduits.

Option 3.11: To consider whether to proceed with the foreign income account rules recommended by the Review of Business Taxation, and whether to allow the tax-free flow-through of foreign income account amounts along a chain of Australian companies, subject to Option 2.1

3.115 The discussion of this option has to be considered in the light of Recommendations 3.9 and 3.10(1) to (3). The nature of a FDA or FIA will depend on the purpose or purposes to which it is being put. Chapter 2 recommended that a 20 per cent tax credit be attached to dividends paid out of foreign income and that companies be allowed to stream dividends out of foreign income to foreign shareholders. So far as the FIA is used to support a credit for Australian resident shareholders, it is not appropriate to include such types of income as royalties or interest received from unrelated parties. This is because the account deals with income from direct investment.

3.116 The FDA currently is part of limited conduit arrangements. In the form of an FIA, it will still be used for conduit type treatment of dividends under the streaming proposal in Chapter 2 (see paragraph 2.45). However, Australia is moving to a treaty policy of exempting non-portfolio dividends from Australian withholding tax, as in the recent US Protocol. This treatment goes beyond conduit relief (as it also covers dividends out of Australian source profits). But the adoption of the previous two recommendations will effectively provide conduit relief for non-portfolio dividends

from foreign companies (Recommendation 3.9) and capital gains on non-portfolio interests in foreign companies conducting an active business (Recommendations 3.10(2) and 3.10(3)). Again, the Board considers that broader systemic measures of this kind are more effective than a specific regime to achieve conduit relief. Therefore, it was not considered necessary to include any other form of foreign income in this recommendation. With respect to allowing the tax free flow through of foreign income amounts along a chain of Australian companies, the Board has had insufficient evidence put to it on whether the benefits outweigh the revenue cost and other integrity issues for it to determine whether it should make a recommendation. The Board believes that further work should be undertaken to establish the viability of such a proposal.

3.117 Consistent with the principle underlying conduit income flows, consideration of conduit capital gains is also necessary. There is a strong argument supportive of an exemption of the capital gains on direct investments. This is in fact the international standard under tax treaties. It recognises that any income generated by non-resident investment in Australia should be taxed here, being the country of source, as and when the income is derived. However, any capital gain accruing to the investor reflective of possible future income flows, more appropriately falls to be taxed in the investor's home country. A consequence of such a policy avoids imposing local tax impediments to both the initial investment commitment as well as to future ownership changes that may in fact prove favourable from a local efficiency, technology and management perspective.

3.118 There are questions about how such treatment should be achieved. One possibility is through future tax treaties. The treatment would be available only for treaty partners, and only on condition that Australian companies receive reciprocal treatment in the foreign country. As it would take some time for the treaty network to cover the main countries from which conduit investment into Australia is sourced, in the short term the treatment could be legislated into domestic law for investors resident in BELCs. The purpose would be to ensure that Australia is not used as a conduit to lend respectability to pure tax haven activities. The CFC regime and other features of the tax system of the BELC would be relied upon to ensure continuing integrity in the system.

3.119 While this solution in relation to non-resident investors achieves conduit treatment, it also goes further. It exempts the investor for capital gains generated by the Australian activities of the Australian company. As noted above, it is already possible to achieve this by disposing of shares in a foreign company which holds the Australian assets directly or indirectly. The Board recommends on practical grounds against extending the CGT to such cases. Viewed from this broader perspective, Australia would be relying on its corporate tax system to ensure that Australian activities of the direct investor are appropriately taxed, just as it relies on the tainted income rules in the CFC system to ensure that low taxed passive foreign income does not escape Australian taxation.

3.120 The interaction between the consolidation regime and this option may need further consideration in order to ensure that any capital gain on the Australian assets is ultimately taxed on disposal of the assets (as compared to the company in which the shares are held).

3.121 In addition, the exemption of sales of shares in CFCs held by residents and sales of shares in Australian companies held by non-residents would require measures to prevent Australian residents acquiring Australian companies through CFCs (that is, by looping the investment through a foreign company). This can be achieved by denying the exemption for sales of shares in CFCs operating active businesses in Australia (where the Australian assets form a significant part of the CFC's assets). Further, if a CFC sold directly or indirectly a non-portfolio interest in an Australian resident company, the profit or gain on the sale would be subject to tax in the hands of the Australian controllers, provided the Australian assets form a significant part of the value of the shares sold.

Option 3.11: Adoption of a foreign income account as recommended by the Ralph Review

Recommendation 3.11(1):

The Board recommends proceeding with the foreign income account rules recommended by the Review of Business Taxation as they apply to direct investment flows (such as non- portfolio dividends and branch profits but excluding capital gains, portfolio dividends or similar types of income such as interest and royalties).

Recommendation 3.11(2):

The Board recommends an exemption of capital gains made by non-residents on the disposal of shares comprising non-portfolio interests in Australian companies be provided by treaty, on a treaty by treaty basis. To the extent that these companies hold land in Australia, the same look through measures should apply as apply for other entities holding land in Australia, thus preserving Australia's rights to tax.

Company residence

Policy objectives

3.122 To assist in establishing Australia as a centre for internationally-focused companies, it is necessary to have clear, practical and internationally-acceptable rules for company residence. It is also necessary to resolve issues that arise when a company is a dual resident, that is, treated as a resident in two or more countries under the respective countries' tax laws.

Current law

3.123 Under current law, there are three alternative tests of Australian residence for companies:

- incorporation in Australia;
- central management and control and carrying on business in Australia; and
- majority ownership of shares by Australian residents and carrying on business in Australia.

3.124 It is possible for a company to be resident in more than one country where countries have different tests or a multiplicity of tests — for example, incorporation in one country, and management in another country. Tax treaties solve the problem of dual residence (but only for the purposes of the treaty) by a tie-breaker which allocates the company to one or other country. The OECD Model uses the place of effective management for this purpose; so does Australian law. In addition, Australia has several rules in domestic law for dealing with dual resident companies in specific situations, such as the CFC regime and doubling up on interest deductions.

Problems

3.125 Many submissions argued that the 'central management and control' test creates uncertainty. Under this test, residency could depend on where the board of directors makes its decisions. This leads to stage-management of board meetings of companies which operate in a number of countries and have top management distributed among those countries.

3.126 Another complication is introduced by an early High Court case which held that a company which is managed in Australia is likely to carry on business here. This has the potential to make foreign subsidiaries of Australian companies resident in Australia, even though the subsidiaries are incorporated and operate outside Australia. To prevent this possibility, Australian companies may deliberately seek to appoint a majority of directors resident in the country of incorporation of the subsidiary and hold board meetings there. In practice, however, these directors are likely to closely follow the views of the Australian parent company, thus leaving the place of management unclear.

3.127 The 'treaty' test will not clarify the problem of foreign subsidiaries if they are regarded as managed in Australia. Further, even a treaty tie-breaker applies for the purpose of the treaty only, and so does not deal with all potential cases involving residence of companies. The OECD is currently seeking a solution to the uncertainty inherent in the test. The additional Australian rules on these and other issues result in a complex mosaic of corporate residence tests under Australian tax law.

Evidence of the problems

3.128 Some prominent Australian multinational groups indicated the difficulties they encounter over management-residence issues, particularly in relation to the board of the parent. The residence of subsidiaries is also an ongoing problem for companies, even where no problem exists at the parent level in Australia. The management test imposes considerable rigidity on dual listed company (DLC) structures also.

Policy issues arising from the problems

3.129 As noted above in relation to conduit income, residence tests for companies necessarily represent a departure from the policy ideal — an ideal which would be based on ultimate ownership of companies. As a result, countries generally adopt residence tests based on incorporation and/or management and then use various other measures to deal with problems to which these tests give rise. The main objective of the company residence test should be to produce certainty and ease of operation.

Potential solutions

Option 3.12: To consider options to clarify the test of company residency so that exercising central management and control alone does not constitute the carrying on of a business

3.130 The simplest solution would be to adopt the place of incorporation as the sole residence test in Australia. The recommendations in the earlier part of this chapter, and in other chapters make the test of corporate residence much less of a concern in ensuring the proper operation of the international tax system. The US adopts a place of incorporation test, but it is currently having some concerns as a result of corporate inversions — tax motivated transactions which substitute a tax haven incorporated parent for the US incorporated listed parent company, often at some tax cost. The result is to move residence of the parent out of the US even though it is still managed there and its operations otherwise remain unchanged.

3.131 The place of incorporation test would equally apply to the initial incorporation of a company outside Australia where the company is managed and controlled from Australia.

3.132 The problem arises in the US for three key reasons. First, foreign branch profits and dividends derived by the US parent from its foreign subsidiaries are subject to US tax (with a credit for foreign taxes paid). Second, the US has a comprehensive CFC regime. Third, because the US has no imputation system, the dividends paid by the US parent to its US individual shareholders are taxed. Factors one and three do not exist in Australia.

3.133 The shareholders of the Australian parent currently gain imputation benefits for Australian tax paid by the Australian parent. If the Australian parent company is moved offshore, the shareholders will lose those benefits.

3.134 Finally, many of the Board's other recommendations will remove residual tax impediments for both the Australian companies and their shareholders. For example, credits are recommended in Chapter 2 for certain foreign profits and Australia's existing CFC regime is to be simplified.

3.135 On balance, there would be little incentive to moving offshore. There would also be substantial disincentive in the form of loss of imputation benefits. Thus, for Australian based companies the US concerns with "inversions" are largely unfounded. For this reason, the Board recommends that in the interests of certainty for taxpayers and ease of administration, the test for residency be based solely on incorporation.

Option 3.12: Residence of companies

Recommendation 3.12:

The Board recommends that a company should be regarded as resident in Australia only if it is incorporated in Australia.

Option 3.13: To consider whether a company that is a non-resident for tax treaty purposes should be treated as a non-resident for all purposes of the income tax law, as an alternative to the current dual residency provisions

3.136 Various tax-planning possibilities arise when a treaty tie-breaker applies to a dual resident company. Australian law currently deals with a number of these through specific provisions in domestic law. A number of other countries deal with the issues by projecting the treaty tie-breaker into domestic law — that is, a dual resident company ceases to be a resident under domestic law if a treaty allocates it to another country. This is a simpler and more comprehensive solution than Australia's current law provides.

3.137 However, as the tie-breaker is based on a management test, it can create the same kind of uncertainty mentioned above for DLCs and listed companies with directors distributed around the world. The OECD is currently working on a solution for this problem, which Australia should consider in due course. In the meantime, problems arising from the management test for DLCs and other listed companies could be dealt with by treaty as necessary. At the moment, the problem arises mainly in relation to the UK.

3.138 The submissions made very few comments on this issue. However, those submissions which did discuss the issue favoured excluding dual resident companies from resident status if the tax treaty allocated their residency to the other country. Given the Board's Recommendation 3.12, this is likely to be an issue mainly where an Australian incorporated company is managed from offshore. Such circumstances tend to be rare in practice and may often be motivated by the tax advantages of obtaining Australian tax residency. In these circumstances, if the relevant tax treaty treats the entity as a non-resident of Australia, it would seem appropriate to do so for all income tax purposes. Moreover, this is generally consistent with the intent of the existing dual residency rules.

Option 3.13: Dual residents

Recommendation 3.13:

The Board recommends that a non-resident for treaty purposes should be treated as a non-resident for all purposes of income tax law, as an alternative to the current dual resident company provisions.

Administration and integrity issues

3.139 Exemption for BELCs from the CFC rules would lessen complexity by removing a number of taxpayers from the CFC rules. During the legislative design phase consideration may need to be given to certain integrity issues.

3.140 Removing tainted services from the CFC regime would generally bring compliance and tax benefits. However, there could be some compliance and administration costs associated with the need to identify and address services that raise integrity issues. The extent to which these services can be practically identified and addressed will determine the impact of the recommendation on the integrity of the tax system.

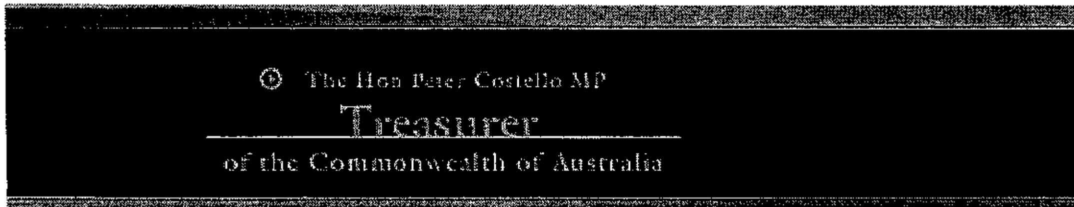
3.141 The recommendation not to proceed with the conduit regime would have no impact on tax administration.

3.142 The incorporation test would provide greater certainty and reduce complexity. Integrity issues associated with this recommendation are expected to be minimal. Of course, any change will need transitional measures.

3.143 The recommendation that rollover relief be available for corporate restructuring of CFCs not resident in a BELC, where the restructuring is covered by, and done in accordance with, the tax law of the country concerned, will present administration difficulties because it will be based on the tax laws of other countries.

The recommendation may also require integrity measures to ensure the appropriate gain is captured when the asset leaves the economic group.

3.144 The recommendation to develop and publish criteria for declaring further countries as BELCs will entail monitoring a BELC's compliance with the criteria. Recommendation 3 concerning non-attribution in BELCs will increase the relevance of ensuring that the BELC list consists of tax-comparable countries.



NO.109

BOARD OF TAXATION REVIEWS

As part of the Government's commitment to ensuring that the tax system is operating effectively, I have asked the Board of Taxation to undertake reviews of two different aspects of the tax system.

First, I have asked the Board to undertake a review of the foreign source income anti-tax-deferral regimes. This review builds on the significant inroads that the Government has achieved to simplify and reduce the complexity of the tax laws through the Government's responses to the Review of International Taxation Arrangements (RITA).

Australia has several anti-tax-deferral regimes which are designed to prevent resident taxpayers from using foreign entities to defer or avoid Australian tax — the controlled foreign company, foreign investment fund, transferor trust and deemed present entitlement regimes.

Business has raised a number of concerns with Government about the anti-tax-deferral regimes, including that they are complex and involve substantial compliance and administration costs. Additionally, in some cases they are poorly targeted, potentially impacting on offshore investment decisions that are not motivated by tax deferral reasons.

Against this background, I have asked the Board to review the operation of the anti-tax-deferral regimes. The objectives of the review are:

- to reduce the complexity and compliance costs associated with the anti-tax-deferral regimes including whether the current regimes can be collapsed into a single regime; and
- to examine whether the anti-tax-deferral regimes strike an appropriate balance between effectively countering tax deferral and unnecessarily inhibiting Australians from competing in the global economy.

The review will involve extensive consultation with stakeholders. Following this broad consultation, the Board will report to Government in mid-2007 on the outcome of the review.

Second, I have asked the Board to undertake a review of the taxation treatment of off-market share buy-backs. This review will help the Government to determine whether the taxation treatment of off-market share buy-backs should be changed with a view to increasing certainty for businesses and reducing compliance costs.

In conducting the review, the Board will take into account:

- the factors influencing the increasing trend towards the use of off-market share buy-backs;
- the implications of the current taxation treatment of off-market share buy-backs for different types of shareholders;
- the compliance cost impacts of off-market share buy-backs;
- the administrative practices of the Australian Taxation Office relating to off-market share buy-backs;
- the basis for splitting the proceeds of off-market share buy-backs into a dividend component and a capital component;

- the application of the dividend streaming rules to off-market share buy-backs;
- the capital gains tax implications of off-market share buy-backs; and
- any other matters the Board considers to be appropriate.

The Board will conduct consultations with stakeholders and make recommendations on the appropriate taxation treatment of off-market share buy-backs. It will report to Government in the second half of 2007.

The Board of Taxation's charter includes providing advice to the Government on the quality and effectiveness of tax legislation along with the general integrity and functioning of the tax system. Details about the Board of Taxation can be found at http://www.taxboard.gov.au.

CANBERRA
10 October 2006

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New Zealand's International Tax Review: a direction for change

A government discussion document

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First published in December 2006 by the Policy Advice Division of the Inland Revenue Department,
PO Box 2198, Wellington.

New Zealand's International Tax Review: a direction for change: a government discussion document.
ISBN 0-478-27149-2

CHAPTER 1

Introduction

1.1 The government is committed to creating an environment that enables New Zealand businesses to thrive in the global economy. The International Tax Review is linked to the government's Business Tax Review, the aim of which is to facilitate economic transformation by improving incentives for productivity gains.

1.2 New Zealand's tax system plays an important role in fostering a competitive business environment. It sits alongside other elements such as infrastructure, skills and education, and research and development that are a key focus of the government within its Economic Transformation agenda.

1.3 It is important that New Zealand's tax system is not out of line with systems in comparable jurisdictions, particularly Australia. Within an increasingly borderless global economy, New Zealand must be able to attract and retain capital, and our businesses must be able to compete effectively in foreign markets.

1.4 New Zealand's rules for taxing offshore investment through controlled foreign companies (CFCs)[1] are more stringent than those of other countries. Since 1988, New Zealand residents have been taxed on all income earned by their CFCs[2] at the time that income is earned (accrual taxation). Other countries limit accrual taxation of offshore income to passive income and certain special categories.[3] Active income is generally exempted or taxation is deferred until the income is returned in the form of dividends.

1.5 Concern has been expressed by the Tax Review 2001[4] and other commentators that the current system could inhibit the internationalisation of New Zealand business.

1.6 This discussion document deals with the taxation of outbound, non-portfolio investment by focusing on:

- relaxation of the current CFC rules by introducing an active/passive distinction – offshore active income would be exempted from accrual taxation, and passive income would continue to be taxed as it accrues;

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[1] A controlled foreign company is essentially a company resident in a foreign jurisdiction that is controlled by a small number of New Zealand residents.

[2] The main exception being CFCs resident in eight grey list countries. This exclusion is described further in chapter 2.

[3] Passive income includes investment income such as interest, dividends, royalties and rents. The concept is often extended to other transactions which could erode the domestic tax base, so-called base company income. Together, such income is often referred to as "tainted" income and is subject to accrual taxation.

[4] The independent Tax Review 2001, under the Chairmanship of Robert McLeod, commissioned to undertake a broad review of the tax system and to develop proposals to guide the future direction of New Zealand tax policy. It made its final report to the government in October 2001.

- the implications for other aspects of our international tax rules to protect the New Zealand domestic tax base; and
- possible changes to New Zealand's tax treaty policy on non-resident withholding tax (NRWT) on dividends, interest and royalties.

1.7 An exemption for the active income of CFCs would put New Zealand companies on a more equal footing internationally by removing an additional tax cost not faced by firms based in comparable jurisdictions, such as Australia.

1.8 Lower treaty limits for NRWT would also reduce tax barriers to offshore investment. New Zealanders receiving payments sourced in countries with which New Zealand has a double tax agreement would enjoy lower rates of foreign withholding taxes.

1.9 Bringing our international tax rules into line with international norms would reduce the barriers faced by New Zealand-based firms, under the current tax rules, to exploiting the benefits of operating offshore. These changes would encourage businesses with international operations to remain, establish and expand.

Links with the Tax Review 2001

1.10 The issues canvassed in the discussion document were raised in the Tax Review 2001 and then, more recently, by other commentators such as the New Zealand Institute.

1.11 Indeed, international tax reform has been on the government's agenda since the release of the *Final Report* of the Tax Review in 2001. Many of the recommendations of the Review centred on proposals to reform the taxation of inbound and outbound investment. As a result, the government has considered the following issues:

- ***A major reduction in taxes imposed on inbound foreign direct investment (FDI) to increase levels of FDI in New Zealand.*** As the government announced in September 2003, it had decided not to proceed with this proposal because the expected spill-over benefits would be outweighed by substantial fiscal costs.
- ***A temporary tax exemption on the foreign income of new migrants, to facilitate the migration of skilled labour to New Zealand.*** The government agreed with the Tax Review's recommendation and has since passed legislation implementing a four-year tax exemption on foreign income for both new migrants and returning New Zealanders.

- ***Examination of a risk-free return method (RFRM) for taxing income from offshore portfolio investments.*** The government has proposed new tax rules for offshore portfolio investment that are broadly consistent with this proposal. The measures examined in this discussion document do not affect those proposed rules.

1.12 The other important recommendation of the Tax Review was that the government explore the merits of adopting an active/passive distinction in our CFC rules. The Tax Review expressed the broad concern that our comprehensive taxation of CFC income was out of step with international norms.

1.13 The New Zealand Institute echoes the Tax Review's concerns. In its 2006 discussion paper, *The Flight of the Kiwi*, the Institute argues that the current CFC rules generate "real economic costs in terms of aspirational companies being lost to the New Zealand economy rather than electing to go global from a New Zealand base (or deciding not to venture abroad at all)."

1.14 The government shares these concerns. Providing an exemption for offshore active business is intended to help retain dynamic companies in New Zealand. Otherwise, there can be economic costs from migration of existing businesses or the establishment offshore of potential businesses, or by inhibiting the expansion of existing business into offshore markets.

Key features of the reform

1.15 The central feature of the reform described in the discussion document is to provide an exemption for *offshore active* income. Consequently, new rules will need to ensure the exemption does not extend to passive or domestic income.

1.16 New Zealand can benefit from extensive international experience in distinguishing between active and passive income. Even so, international experience can take us only so far. In the end, New Zealand's international tax rules need to be developed to reflect the realities of our business environment and other features of our tax system.

1.17 A critical issue informing the development of a new system will be the compliance and administrative burden imposed by new rules. While the rules themselves will inevitably be complex, reflecting the complexity of international business arrangements, the government believes that the system described here could be much simpler in actual operation than the current system.

1.18 While the discussion document expresses a clear preference on the direction for change, many important issues of implementation remain open. Final decisions will be made only after consultation with the businesses that will have to apply the new rules. In the process, trade-offs between the scope of the active income exemption and the implementation of the various base maintenance measures will be inevitable. Submissions will be important in evaluating those trade-offs.

SUMMARY OF POSSIBLE CHANGES

A new direction for taxing CFC income

Possible changes

1. Under a new active/passive distinction, offshore active income would be exempted from accrual taxation, and passive income would be taxed as it accrues.
2. Complementary changes to other aspects of our international tax rules, in particular, the thin capitalisation rules, would be needed to protect the New Zealand domestic tax base.
3. New Zealand's tax treaty policy on non-resident withholding tax could also change.

Implementing an active/passive distinction

Possible changes

1. Offshore active income would be exempt.
2. The broad international consensus to define passive income positively would be adopted, leaving active income as the residual undefined concept.
3. Passive income and base company income (collectively called "tainted income") would continue to be taxed on accrual.
4. The main categories of tainted income would include:
   - ***Passive income***: dividends, interest, royalties and rents. It could include income which is passive in form but the derivation of which involves certain activity.
   - ***Base company income.*** Base company rules would be designed to counter situations where domestic income is shifted offshore to benefit from the active income exemption.

The transactional and entity approaches

Possible approaches

The government could adopt one of two approaches to attributing the income of a CFC to its resident shareholders:

- The *transactional approach* examines each item of income derived by a CFC to determine whether it produces tainted income or non-tainted income. Accordingly, different income streams of the CFC attract different treatment depending upon their category; or
- The *entity approach* looks at whether the company is active or passive. Once categorised, then all of the income of the company is taxed in the corresponding manner, regardless of the nature of the income derived.

Interest allocation and transfer pricing rules

Possible changes

1. The current thin capitalisation rules would be:
    - extended to cover all New Zealand entities with outbound investments, taking into account the compliance cost considerations;
    - modified to deal with outbound investments in CFCs; and
    - reviewed to ensure that the safe harbour ratio is appropriate.
2. Technical aspects of the thin capitalisation rules would be reviewed to make them consistent with the minimum capital requirement rules for banks.
3. The transfer pricing rules would be strengthened by shifting the burden of proof on transfer pricing matters from the tax administration to taxpayers.

Implications for the taxation of dividends and other international tax rules

Possible changes

1. A key issue is whether dividends from CFCs should continue to be taxed. The government is more attracted to the exemption method provided such an exemption would not lead to erosion of the New Zealand tax base.
2. Repeal of the grey list exemption and conduit rules would be consistent with an active/passive distinction that focuses on exempting active income rather than whether the income has been comparably taxed in the host country.
3. Consideration should be given to whether the active/passive distinction should apply in respect of foreign branches and non-portfolio interests in foreign investment funds (FIFs).

Non-resident withholding tax

Possible changes

1. NRWT on dividends could be lowered through bilateral treaty negotiations, although the case for this is stronger for non-portfolio dividends. The changes would have implications for the foreign investor tax credit (FITC) rules.

2. Reducing NRWT on either interest or royalties is a possibility but may not be justified.

3. A number of technical changes to the NRWT and approved issuer levy (AIL) rules would rationalise information requirements and withholding arrangements across different payments.

How to make a submission

1.19 The government invites submissions on the issues raised in this discussion document. Submissions should be made by 16 February 2007 and be addressed to:

International Tax Review
C/- Deputy Commissioner, Policy
Policy Advice Division
Inland Revenue Department
PO Box 2198
Wellington

Or e-mail policy.webmaster@ird.govt.nz with "International Tax Review" in the subject line.

1.20 Submissions should include a brief summary of major points and recommendations. They should also indicate whether it would be acceptable for Inland Revenue and Treasury officials to contact those making the submission to discuss the points raised, if required.

1.21 Submissions may be the source of a request under the Official Information Act 1982, which may result in their publication. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. Those making a submission who feel there is any part of it that should properly be withheld under the Act should indicate this clearly.

1.22 In addition to seeking written submissions, Inland Revenue and Treasury officials intend to discuss the issues raised in this discussion document, including detailed design issues, with key interested parties.

CHAPTER 2

A new direction for taxing CFC income

Possible changes

1. Under a new active/passive distinction, offshore active income would be exempted from accrual taxation, and passive income would be taxed as it accrues.

2. Complementary changes to other aspects of our international tax rules, in particular, the thin capitalisation rules, would be needed to protect the New Zealand domestic tax base.

3. New Zealand's tax treaty policy on non-resident withholding tax could also change.

Details of how the rules within this general framework might work are the subject of consultations and submissions.

2.1 How best to tax income on outbound direct investment is one of the most vexed tax policy issues.

2.2 New Zealand's current system of international taxation is to tax offshore income as it accrues, with credits given for foreign taxes that have been paid. No other OECD country has adopted this approach. All other OECD countries either defer taxing offshore active income or exempt it altogether. Since New Zealand taxes the income of its CFCs more heavily than other countries, it can be attractive for innovative and dynamic firms to migrate from New Zealand, establish themselves in other countries or simply stay small and local.

2.3 Since New Zealand's rules applying to CFCs were introduced in 1988, other countries, including Australia, have liberalised their tax rules for the active income of their CFCs. Moreover, it has become easier for both firms and workers to shift across international borders.

2.4 For these reasons, the government supports a change to New Zealand's paradigm of comprehensive taxation of CFC income toward providing an exemption for offshore active income. Other measures, to protect the domestic tax base, would form an integral part of the new system.

Current approach to taxing CFC income

2.5 New Zealand generally taxes both active and passive offshore income of its CFCs as it accrues, with a credit for foreign taxes. As a departure from this comprehensive taxation, income from CFCs in eight grey list countries[5] is exempt. The policy motivation for the grey list is to reduce compliance costs. Income earned in a grey list country is considered to be taxed comparably to New Zealand-earned income, so there would be negligible New Zealand tax to pay after allowing foreign tax credits.[6]

2.6 It is sometimes argued that despite New Zealand's tax treatment of the income of its CFCs being relatively stringent by world standards, it is not stringent enough. Standard economic analysis would suggest that there is a case for taxing on a pure residence basis. Under a pure residence basis, foreign taxes would be treated as a cost just like other costs of doing business, and deductions rather than credits would be allowed for foreign taxes. Such a tax system is, under strong assumptions, said to promote national welfare maximisation. It would provide incentives for investing abroad only if the benefits to New Zealand (which are net of any foreign taxes) exceed the benefits from investment in New Zealand.[7]

2.7 Even so, under international tax treaties and in practice, countries of residence relieve double taxation by either providing credits for foreign taxes or exempting foreign-source income.

2.8 A system of comprehensive taxation of CFC income, with credits for foreign taxes paid, is sometimes advocated on the grounds of "capital export neutrality". Other things being equal, it provides incentives for capital to be allocated around in the world in ways which lead to the highest, risk-adjusted, pre-tax returns. This is consistent with promoting the global efficiency of capital allocation.[8] In practice, it makes very little sense for a small, open economy like New Zealand's to "go it alone" in promoting capital export neutrality. New Zealand is much too small to do anything significant to promote global efficiency in the way that worldwide capital is allocated.

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[5] "Grey list" countries are those considered to have tax systems similar to that of New Zealand. They are Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom and the United States.

[6] Tax preferences available abroad or asymmetries in tax systems may mean that income sourced from these eight grey list countries need not necessarily be comparably taxed. This is discussed further in chapter 3.

[7] While standard analysis suggests a "first-best" case for full taxation of outbound investment, the see-saw principle suggests that there can be a "second-best" case for a lower tax on outbound investment. If, for some reason, an economy is constrained to levy a higher than optimal rate on inbound investment, there can be a case for a somewhat lower tax rate on outbound investment.

[8] If instead the income of CFCs is exempt or taxed with a credit only when dividends are remitted, this can lead to investment in low-tax jurisdictions being more attractive on an after-tax basis than domestic investments, even when the pre-tax returns are lower than those obtained on domestic investments.

2.9 The main argument in favour of New Zealand's current approach to taxing the income of its CFCs would appear to be that while it falls short of the pure residence base which might be advanced on grounds of national welfare maximisation, it is the nearest internationally acceptable alternative. A secondary attraction of New Zealand's current approach is that it avoids any need to distinguish between active and passive income. Other countries cope with such a distinction, although there are inevitably contentious borderlines.

2.10 The key argument against New Zealand's current approach is the disincentive it provides New Zealand-based companies to internationalise their businesses from a New Zealand base when other countries offer much more lenient rules for CFCs. This will be explored in greater detail in the next section.

2.11 There is a second concern. A foreign tax credit system can provide incentives for domestic firms to channel offshore investment into higher-tax foreign countries in ways which are not in New Zealand's best interest. This is illustrated in Table 2.1. In the example, investment into Country A, a higher-tax country, provides a higher pre-tax return than an investment into Country B, a low-tax jurisdiction. From New Zealand's perspective, it would be better if the investment were channelled into the low-tax country B as there is a higher net return of 990 to New Zealand, split 737 to the investor and 253 to the government. However, under a foreign tax credit system, the investor ends up preferring the investment in Country A on an after-tax basis. Thus investment into higher-tax countries can displace investment into low-tax countries even though New Zealand as a whole would be better off from investment into the low-tax countries.

TABLE 2.1
Investments in high-tax and low-tax countries – an example

	Country A High-tax	**Country B Low-tax**
Gross Return	1200	1100
Host Country Tax	300	110
New Zealand Tax[9]	96	253
Return to Investor	804	737
Return to New Zealand	900	990

[9] New Zealand tax is net of foreign tax credits. In Country A, the potential New Zealand tax of 396 (.33x1200) is reduced by a tax credit for the 300 of foreign tax paid; in Country B, the potential New Zealand tax of 363 (.33x1100) is reduced by a credit of 110.

2.12 Finally, a number of taxpayers have commented that not only are New Zealand's tax rules for CFC income comparatively harsh, the associated compliance costs can also be high, with firms required to restate the accounts of non-grey list CFCs under New Zealand tax rules. This can be very difficult when foreign accounting and tax rules are substantially different from New Zealand's, the degree of control is limited, and the CFC's financial accounts are prepared in a different language. There are also aspects of the CFC rules that are extremely complex and difficult to comply with. As the Tax Review 2001 concluded, it is important to take these into consideration when framing any new rules.

Pressures caused by tax treatment in other countries

2.13 In contrast to New Zealand, other OECD countries either exempt offshore active income or defer taxation of the active income of CFCs until the time that dividends are remitted by the CFCs to their parents. Some non-OECD countries, such as Singapore, have territorial systems which exempt all forms of offshore income from domestic taxation (see Table 2.2). This means that companies with active business subsidiaries in low-tax jurisdictions may pay little or no tax on this income for long periods of time. Even then, tax minimising strategies may reduce the effective tax rate further.

TABLE 2.2
Taxation of outbound investment in other countries

	Accrual taxation of income		**Treatment of dividends**	
	Active	**Passive**	**Exempt**	**Tax with deferral**
Australia	X	√	√	
United States	X	√		√
United Kingdom	X	√		√
Singapore	X	X	√	
Japan	X	√		√
New Zealand (non-grey list)	√	√	NA[10]	NA

[10] New Zealand taxes dividends under the DWP rules but there is no deferral as offshore income is taxed as it accrues.

2.14 Australia's tax rules are particularly important. The proximity of Australia to New Zealand as a choice for a multinational's regional headquarters, the ease of migration, the integration of imputation systems and the large levels of FDI between the two countries make Australia the most likely destination for migrating firms.[11] Greater alignment of New Zealand's tax rules with those of Australia can only enhance and deepen trans-Tasman integration. Such alignment is consistent with the government's wider set of single economic market initiatives.

2.15 If New Zealand taxes offshore income more heavily than other countries (especially Australia), a company planning to expand into active businesses in third countries has a tax incentive to relocate its headquarters outside of New Zealand. If it retains its headquarters in New Zealand, it is taxed on active income from the third-country CFC as the income accrues. This could lead to a substantial tax impost if the third country has low tax rates on active income. If, however, it relocates its headquarters to a country offering an exemption or deferral of taxation on offshore income, no tax need be paid on the income accruing in the CFC.

2.16 There are many commercial factors that influence where firms choose to locate their operations. Firms may be attracted to deeper capital markets, proximity to global markets, and the access to skilled labour and global stocks of knowledge in other countries. Relocation may be the best way to benefit from having a presence in such markets. Given the strength of these factors, some migration of New Zealand firms is likely to continue regardless of tax changes. Nevertheless, it is unattractive for New Zealand's tax treatment of CFC income to inhibit the retention or establishment of New Zealand-based multinational businesses.

2.17 Migration of even one or two of New Zealand's large dynamic firms could have a substantial negative effect on the economy. Such firms help New Zealand to maintain close connection with new ideas and commercial developments in other countries. They also help maintain a base of intellectual property within New Zealand. Not only would migration lead to jobs within head offices being shifted offshore, so too would be the demand for associated professional services.

2.18 Firm migration also reduces the extent to which New Zealand could benefit from cluster effects. When a number of firms locate near each other, or cluster, they can attract higher levels of skilled labour and customers than a single firm could. Once a critical number of firms locate in an area they can become a cluster, and benefits of economies of scale may be available to them. Within New Zealand, potentially in Auckland, clusters involved in specialised areas of R&D could be envisaged. It is important therefore that policies do not prevent the achievement or the maintenance of clusters.

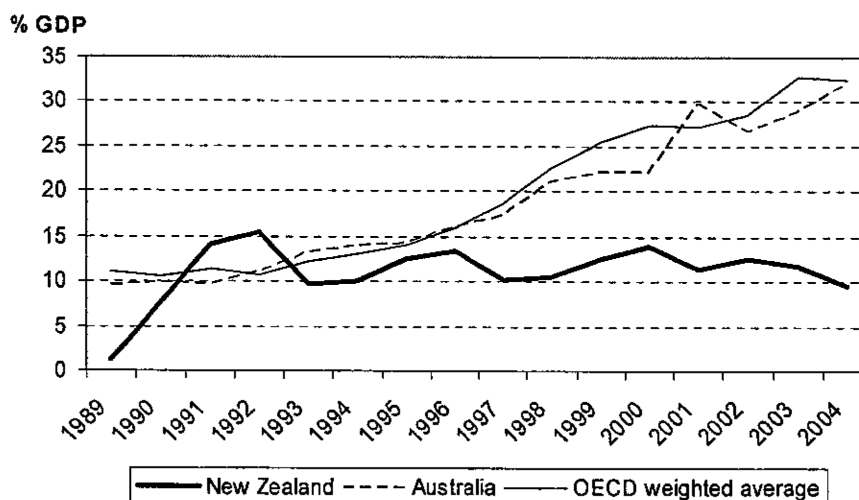
[11] Australia represents New Zealand's most significant source of foreign capital, contributing 46 percent of inward FDI.

2.19 Finally, higher taxes on offshore income may also make it difficult for New Zealand-based firms to expand out of local markets; so, if they stay in New Zealand, they may stay small. For example, a New Zealand-based company which seeks to exploit lower cost production in a non-grey list country might be disadvantaged relative to other companies operating in that jurisdiction.

New Zealand's outbound FDI performance

2.20 It is of interest to examine how New Zealand's level of outbound FDI has compared with that of other countries in recent times. The stock of outbound direct investment from New Zealand has remained relatively constant as a share of GDP, fluctuating between around 10 to 15 percent of GDP over the period since the early 1990s. In contrast, the stock of outbound direct investment in OECD countries increased steadily from around 10 percent of GDP in 1990 to around 30 percent of GDP in 2002 (see figure 1).

FIGURE 1
Outbound FDI stock[12]

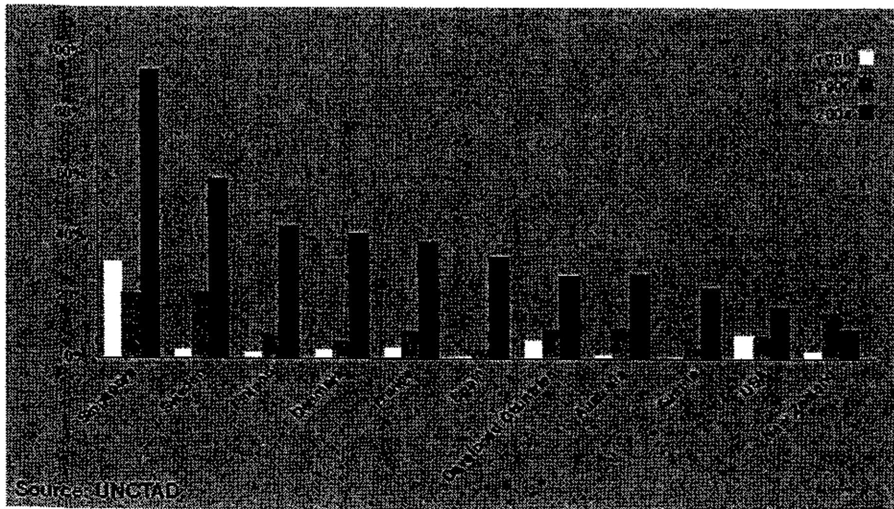


Source: IMF, UNCTAD

2.21 The relative change between 1990 and 2004 in outbound investment as a percentage of GDP is shown for selected OECD countries in figure 2. The data, reported by the New Zealand Institute, show that New Zealand is the only country that has experienced a drop in the intensity of outbound FDI.

[12] Figure 1 illustrates total outbound direct investment, which includes both debt and equity. Ideally, the comparison would focus on outbound direct equity investment only. However, the outbound direct equity investment series for New Zealand is affected by a large structural break in 2001 which makes comparisons difficult.

FIGURE 2
Level of outward FDI as a % of GDP



2.22 There are many factors which may be affecting the evolution of outbound FDI in different countries. Commercial factors such as closeness to markets may be more important influences than taxation.[13] However, over the time that New Zealand's comprehensive international tax rules have been in place, New Zealand has been exceptional in not having the same strong growth in FDI that has been evident in other OECD countries. New Zealand's tax rules may have been a contributing factor on the margin.

Implications for GDP growth and labour productivity

2.23 Any relaxation of New Zealand's CFC rules could increase outflows of FDI from New Zealand. At first sight, this would appear likely to reduce New Zealand's capital stock, thereby reducing labour productivity and GDP growth.

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[13] These figures should be interpreted cautiously for a number of reasons:

- Investment that is taxed under New Zealand's CFC rules is not the same as direct investment as measured by statistical agencies.
- The data are not always comparable – both across time (for example, a methodological change affects the New Zealand data from 2001 onwards), and across countries (for example, countries may use different methodology in compiling the data).
- Tapping into offshore markets and access to offshore distribution channels may be more or less important for firms in different industries. For example, in some industries it may be more important to access offshore distribution channels. Different levels of outbound direct investment across countries may, in part, be explained by differences in industry structure across countries.
- Different levels of outbound direct investment across countries could, in part, be explained by distance from other countries, as this could make it more difficult to invest offshore.

2.24 There are a number of important offsetting factors which can work in the opposite direction. First, New Zealand is a net capital importer. To the extent that some firms invest capital abroad that would otherwise have been located in New Zealand, this provides scope for other firms to profitably increase their investment in New Zealand. Moreover, investment abroad and domestic activity in New Zealand are not necessarily substitutes. Investment abroad can be complementary with the demand for products from New Zealand. Moreover, there can a upgrading of the types of jobs being undertaken, with lower value-added tasks being moved offshore while R&D and higher value-added tasks increase in New Zealand.

2.25 For these reasons, the government believes that there is no strong reason to expect that measures to liberalise the tax treatment of outbound CFC income would reduce capital and productivity in New Zealand. Indeed, to the extent that they provide incentives for firms to locate or stay in New Zealand and to expand to exploit opportunities offshore, they are likely to have the opposite effect.

2.26 Even if New Zealand wanted to prevent outflows of capital from New Zealand, it is unclear that an internationally stringent tax treatment of outbound CFC income is in its best interests, given the real world flexibility for companies and workers to migrate to other countries. Put bluntly, firms can always choose to escape New Zealand tax by moving overseas (or perhaps never coming).

A new paradigm for New Zealand

2.27 In the almost twenty years since New Zealand's rules for taxing CFCs were developed, the world of international finance, investment and production has evolved considerably. FDI and exports of most OECD countries have increased significantly as a percentage of GDP, but New Zealand has not kept pace. There are many reasons for this situation. However, New Zealand stands out as the only country to tax offshore active income on accrual.

2.28 As noted by the Tax Review 2001, while the current system is conceptually attractive, its lack of conformity with international taxing norms puts pressure on the New Zealand tax system. There is a concern that it inhibits the internationalisation of New Zealand business. The current system risks inducing New Zealand businesses with significant international operations to migrate, and it could inhibit the development of multinational enterprises based in New Zealand.

2.29 On balance, the government believes that the current tax rules applying to CFCs are no longer well adapted to the world of international business. Accordingly, the government supports the introduction of an exemption for the offshore active income of CFCs.

2.30 There are two ways of implementing the exemption:

- by deferring taxation of active income earned offshore until the profits are repatriated, with a credit for foreign taxes paid; or
- by allowing a permanent exemption for offshore active income, with no taxation of subsequent dividends.

2.31 The Tax Review recommended a deferral, with credits for investments made outside of the grey list. However, there is considerable debate as to the effectiveness of the deferral-with-credit approach relative to the exemption method. Taxes that are imposed only when the dividend is repatriated may not be particularly effective because imposition is at the discretion of the company distributing the dividend. Attempts by countries to shore up their dividend taxation rules have been sources of tax system complexity and have been of limited effectiveness.

2.32 An exemption system would be simpler. It would go further in improving incentives for New Zealand-based firms to take advantage of international opportunities while remaining in New Zealand, and, it would go further in ensuring that such firms are able to compete and succeed on the world stage.

2.33 There is greater attraction to a permanent exemption for active income earned offshore. Adoption of this approach would require adequate confidence that it would not endanger the taxation of domestic-source income. Otherwise the taxation of dividends with credit might need to be examined further.

2.34 The Tax Review noted that an active income exemption should be enacted in a manner that does not jeopardise New Zealand's domestic tax base. The government agrees.

2.35 A number of measures which are intended to ensure that the active income exemption did not result in an inappropriate reduction of New Zealand's domestic tax base would form an integral part of any package introducing it.

2.36 The Tax Review referred specifically to an enhancement of the thin capitalisation rules as an area for development, and the discussion document examines some significant changes in this area. Consistent with the practice of many other OECD countries, offshore passive income would continue to be taxed on accrual, and its taxation could be extended with the elimination of the grey list exemption for such income.

CHAPTER 3

Implications for the international tax system of an active income exemption

3.1 A move to an exemption for active income earned offshore would represent a major shift in New Zealand's international taxation paradigm. This chapter provides an overview of the implementation issues of such a shift.

3.2 The fundamental implementation concern is to ensure that the exemption is targeted to offshore active income in a manner which does not impose an undue compliance burden on New Zealand businesses. Rules to measure such income properly would form an integral part of providing the exemption. For example, rules would be required to distinguish active income from passive income and the thin capitalisation rules would have to be extended and amended.

3.3 A change in the paradigm would have significant implications for other features of the rules for taxing offshore income. Affected areas would include the taxation of dividends, the grey list, the conduit rules, the treatment of foreign branches and non-portfolio FIFs and the calculation of foreign tax credits.

3.4 Choices among alternative implementation options would involve trade-offs, as the various features are inter-related.

Current approach to taxing offshore income

3.5 New Zealand's current international taxation paradigm is based on comprehensive accrual taxation of offshore income. In principle, to the extent all income is considered to be taxable, all costs are deductible.[14]

3.6 In practice, there are exceptions, and not all income is subject to full New Zealand taxation:

- The grey list effectively exempts income earned in grey list countries from New Zealand taxation.
- Application of foreign tax credits has the effect of removing some foreign income from taxation in New Zealand.
- The conduit and DWP rules effectively lower the rate of tax applied to the offshore income of foreign-owned companies.

[14] For example, in the thin capitalisation rules, which seek to protect the New Zealand base from excessive leveraging by foreign controlled companies, no adjustment is made to New Zealand equity for offshore investments by the New Zealand subsidiary.

3.7 As a consequence, limitations on the deduction of interest expenses are provided for in certain situations:

- A limitation is imposed on foreign tax credit claims to ensure credits do not shelter domestic income from tax. In principle, the limitation is intended to restrict the claiming of interest deductions or foreign tax credits when money is borrowed to fund offshore investment giving rise to foreign tax credits.
- Special thin capitalisation rules, which are intended to ensure that a disproportionate share of the interest costs are not applied against New Zealand-sourced income, apply to conduit and DWP companies. Thus interest costs are restricted when tax-reduced offshore investments are made.

3.8 In practice, however, these limitations to interest deductions are not particularly effective, given the safe-harbours and technical deficiencies in the rules.

3.9 On the other hand, no restriction on interest deductions applies with respect to dividends benefiting from the grey list underlying foreign tax credit (UFTC) rules.

3.10 Furthermore, it is a reality of international taxation that there are, inevitably, asymmetries between the tax systems of different countries. These provide opportunities for deducting offshore financing costs from New Zealand income, while the foreign income is not subject to effective New Zealand taxation. For example, asymmetries can arise when countries have different definitions of "debt" and "equity". Dividends arising from preferred shares may be treated as dividends receiving conduit relief in New Zealand, while being treated as interest and deductible in another country. The current system is vulnerable to such exploitation.

3.11 Therefore, while the current system has in place rules that are designed to attribute interest costs to foreign income when it faces lowered levels of New Zealand tax, they are not comprehensive and not particularly effective in practice.

Considerations in designing an active income exemption

3.12 The change to an exemption for active income earned offshore would mean that borders would need to be defined between active and passive income, and between domestic and offshore income. Such distinctions inevitably involve a degree of complexity. In developing the rules, it would be necessary to make trade-offs between those protecting the tax base and maintaining a reasonable compliance burden for firms. The government's ability to achieve the policy goal of exempting active business income from taxation would depend upon attaining an assurance that there were robust rules to prevent the erosion of the domestic tax base.

3.13 The different aspects of the tax system are linked and must be conceptually consistent for it to function properly. Decisions to relax the rules in one area implies that other features would need to be correspondingly tighter.

3.14 The crucial implementation trade-off would seem to be the precision with which the rules attempt to target the exemption to offshore active income versus the complexity of the rules. A more precise system would require more detailed and potentially more complex rules. A looser system, say, one using higher thresholds, might impose a lower compliance burden, but would be less cost-effective in delivering the intended policy as more room would be available for passive or domestic income to receive the benefit of the exemption intended for active offshore income.

Lessons from international experience

3.15 There is considerable international experience in designing and implementing tax rules that distinguish between active and passive income. New Zealand can learn from that experience.

3.16 All OECD countries, except New Zealand, provide some form of tax relief for active business income that is earned abroad. In most cases, this treatment is not extended to passive income, and considerable efforts are made to ensure comprehensive domestic taxation of such income as it accrues.

3.17 The detailed features of the CFC rules of different countries vary considerably, as can be seen in the Appendix.[15] They have been developed over time and reflect trade-offs that responded to pressures and concerns which existed at that time and place. No single approach is clearly superior on all counts.

3.18 Therefore, while international experience and norms can greatly inform the New Zealand exercise, there is no consensus on the details of taxation of offshore income. New Zealand's system will need to be developed to reflect the realities of its business environment and other features of its tax system. Decisions will be a pragmatic compromise between the policy goals of the new approach, protecting the New Zealand revenue base and keeping the administrative and compliance burden to a minimum. Moreover, as New Zealand's economy and business activity evolves, any rules will need to be monitored to ensure that they remain appropriate for the changing environment in which New Zealand business operates.

[15] The Appendix outlines the systems of a number of New Zealand's major trading and investment partners. They demonstrate the variety of ways that different countries have chosen to deal with the implementation of an active income exemption. Reference to other countries' rules throughout the discussion document have been chosen on the basis of interesting features of their taxation of offshore income. The description of CFC rules in different countries is based on a mixture of publicly available information (such as the websites of revenue agencies in Australia and the United Kingdom); *OECD Studies in Taxation of Foreign Source Income – Controlled Foreign Company Legislation*, OECD (1996); and *Studies on International Fiscal Law*, International Fiscal Association (2001).

Compliance concerns

3.19 Rules to tax and/or exempt offshore income are irreducibly complex, given the variety and complexity of international business arrangements. The rules must be written so that they can be applied to the myriad of transactions and business forms that firms adopt in relation to particular business situations. Therefore a new paradigm, with borders between active and passive income, together with other rules needed to target the exemption appropriately, would be unlikely to result in legislative simplification, indeed, it might result in the reverse.

3.20 In actual application, however, an active/passive distinction could be much simpler for the types of firms and activities which it seeks to benefit. A firm with genuinely active operations abroad would no longer need to face the calculation burden that exists under the current branch-equivalent rules. If dividends could be exempted, the firm would not need to comply with the DWP rules. The one area of extra complexity could be the extension of the thin capitalisation rules, although these rules would rely on domestically available information, and are reasonably straightforward.

3.21 Under the transactional method described in chapter 5, considerably more complexity would be faced by firms with a mix of active and passive income in a single subsidiary. Even so, they would have the opportunity to reduce this potential complexity by arranging their affairs accordingly – for example, by placing passive investments in separate, special purpose vehicles. In this way, the more complex aspects of the rules would provide a precautionary function, rather than being an integral part of most firms' tax compliance.

Major implementation concerns

3.22 The fundamental implementation concern is to ensure that the exemption is appropriately targeted to offshore active income and does not allow tax on domestic New Zealand income to be reduced. As noted earlier, the New Zealand tax system already faces challenges in fully taxing New Zealand-source income. Nevertheless, a general active income exemption would make resolving this problem more critical. Accordingly, the major design challenges (refer to figure 3, at the end of this chapter) are distinguishing active and passive income and ensuring the appropriate allocation of income and expenses between the domestic tax base and offshore.

Distinguishing active and passive income

3.23 Most countries distinguish between the active and passive income of their CFCs. To protect the domestic taxation of investment income, passive income is commonly taxed as it accrues, with a credit for foreign taxes. The rationale is that offshore passive income is easily substituted for domestic investment income, with no fundamental change in the economic characteristics of the investment. Accrual taxation of passive income would be an essential part of protecting the New Zealand tax base.

3.24 Different approaches can be taken to distinguishing active from passive income. One approach, in principle, would be to define "active income" conceptually, based on criteria relating to the nature of the activities performed within the business. International experience suggests that this is a difficult border to police, creating uncertainty for businesses and exposing the tax system to significant erosion, as a small amount of activity can be attributed to what is, in fact, a passive investment.

3.25 New Zealand would adopt the international norm of defining passive income directly, by listing investments which are passive in nature. Other types of income could also be taxed on accrual – for example, some "active" income – so-called base company income – which could otherwise erode New Zealand's tax base.

3.26 A critical question is whether passive income would be taxed on a transaction-by-transaction basis or by the characteristics of the entity (such as having a level of passive income above a prescribed amount). The former method is more consistent with the policy of restricting any exemption to active income. On the other hand, the entity approach appears, at first sight, to be simpler; particularly when it allows generous thresholds for passive income in "active" entities. However, a level of threshold under an entity approach which is too high could expose the New Zealand tax base to erosion.

3.27 These issues are discussed in chapters 4 and 5.

Allocation of expenses

3.28 The appropriate measurement of offshore active income requires that costs which are associated with that income should be deducted against it and should not reduce income that is subject to tax in New Zealand.

3.29 The most significant example of this in the New Zealand tax system is the allocation of interest expense between taxable and tax-exempt activities. The rules applied to tax-reduced conduit income and the new minimum capital rules applied to foreign-owned banks provide a framework for how rules of more general application could be designed. With the provision of an active income exemption to all businesses, it would be appropriate to extend similar rules to all businesses making offshore investments. What level of safe-harbouring to provide would involve a trade-off between the proper measurement of New Zealand and offshore income and minimizing compliance burdens of businesses.

3.30 These issues are discussed in chapter 6.

Other implications of the new approach

Taxation of dividends

3.31 The government favours an active income exemption without taxes being levied on subsequent dividends. However, it would proceed in this direction only if confident that the non-taxation of dividends would not lead to an erosion of tax on New Zealand-sourced income. If this confidence cannot be achieved, it would be necessary to determine whether taxation of repatriated dividends would continue to be required.

Grey list

3.32 The repeal of the grey list exemption would be more consistent with active/passive CFC rules that focused on exempting active income rather than whether the income has been comparably taxed in the host country. On the other hand, a number of countries, including Australia, provide some form of grey list exemption for passive income.

Conduit rules

3.33 The conduit rules were introduced in 1998 to remove the income tax liability of New Zealand companies on foreign income to the extent of their non-resident ownership. These rules were introduced as a result of the comprehensive nature of our CFC rules.

3.34 If foreign active income is no longer subject to accrual taxation, there will be no need for the conduit mechanism in relation to such income. At the same time, there is a strong case for removing the conduit mechanism in relation to foreign passive income, while subjecting it to accrual taxation.

Taxation of foreign branches

3.35 A move to an active/passive distinction to the CFC rules may have implications on the way foreign branches should be taxed. A key consideration is trying to ensure that New Zealand-resident investors are not influenced by tax considerations in deciding whether to operate in a foreign jurisdiction through a subsidiary or a branch.

Treatment of non-portfolio FIFs

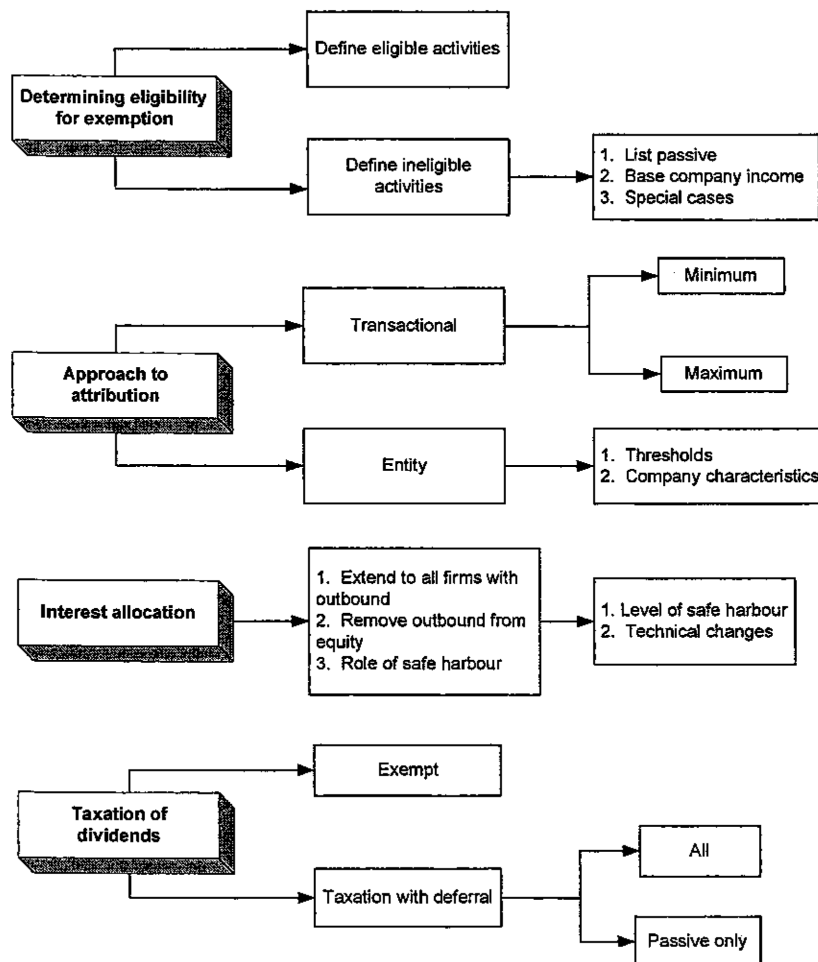
3.36 Changes to our CFC rules are likely to have implications for the tax treatment of New Zealand residents who hold non-portfolio interests in FIFs. Ideally, non-portfolio investors in either CFCs or FIFs would all be subject to the same accrual rules. However, international practice is to distinguish between FIF and CFC interests in terms of implementing an active/passive distinction.

3.37 The tax treatment of offshore portfolio investments (with investor interests of less than 10 percent) is currently being reviewed. The possible changes described in this discussion document would not affect reforms that are already under way.

Calculation of foreign tax credits

3.38 While active business income earned in CFCs would be exempt, some categories of income, such as passive income and income of foreign assets not held through an offshore branch, would continue to be taxed domestically. In that case, foreign tax credits would be provided. An important area for examination would be the allocation of costs to the foreign income for purposes of the limitation rules on foreign tax credits, to ensure that the credits did not effectively offset tax on domestic income.

FIGURE 3
Implementing an active income exemption: major design considerations



CHAPTER 4

Implementing an active/passive distinction

Possible changes

1. Offshore active income would be exempt.

2. The broad international consensus to define passive income positively would be adopted, leaving active income as the residual undefined concept.

3. Passive income and base company income (collectively called "tainted income") would continue to be taxed on accrual.

4. The main categories of tainted income would include:

    - ***Passive income***: Dividends, interest, royalties and rents. It could include income which is passive in form but the derivation of which involves certain activity.

    - ***Base company income***: Base company rules would be designed to counter situations where domestic income is shifted offshore to benefit from the active income exemption.

Details of how the rules within this general framework might work are the subject of consultations and submissions.

Distinguishing between active and passive income

4.1 Passive income generally comprises investment income which the investor does not actively participate in earning.

Approach to defining the active/passive boundary

4.2 There is a question as to how the boundary should be defined. The general approach of many countries is to define passive income positively, with active income defined by default as any income falling outside the passive income definition.

4.3 The challenge of using a positive definition of passive income is that any item which is inherently passive but is omitted from the list will not be passive income for the purposes of the CFC rules, and will therefore be exempt from attribution. There may be drafting techniques, such as the use of an inclusive definition augmented by examples, which would minimise this risk.

4.4 The alternative, a positive definition of active income, may provide legislators with less control and certainty over the scope of the active income exemption than would occur under a positive definition of passive income. That is because even a small amount of "activity" associated with an inherently passive transaction would bring the transaction within the active income net.

4.5 On balance, the government considers it preferable to define passive income positively.

Types of passive income

4.6 The following income types are generally considered to comprise passive income and would generally form part of any definition introduced in New Zealand. Potential exceptions to this approach are discussed later.

Interest

4.7 Interest is generally considered to be part of passive income.

4.8 As a general proposition, a wide definition of "interest" would be required in this context – including income derived from a finance lease or other financial arrangements.

Rents and royalties

4.9 Rent and royalties are generally considered to be passive income.

Dividends

4.10 Dividends received by a CFC are generally considered to be passive income.

4.11 Australia excludes non-portfolio dividends paid to a CFC by a non-Australian resident company. It considers this exclusion to be a natural consequence of the general exemption for participation dividends.[16] If New Zealand exempted dividends (see chapter 7) it would be necessary to consider whether we should also follow the Australian approach to non-portfolio dividends earned by a CFC.

[16] A participation dividend is a dividend paid by a foreign company to an Australian-resident company that has a 10 percent or greater interest in the voting power of that company.

Other passive income

4.12 In addition to the preceding categories of income, the following categories of income could be treated as passive:

- ***Gains from commodities transactions.***[17] The United States includes gains from commodities transactions unless they are part of hedging transactions connected to the CFC's business. Australia also includes such gains, but there is an exception for CFCs that produce or process the commodity, or use the commodity as a raw material (and other conditions are satisfied).
- ***Foreign currency gains.*** Australia, however, treats such gains as active in certain limited circumstances – for example, if the CFC was carrying on the business of currency trading and no other party to the transaction was an associate or Australian resident.
- Income from annuities and insurance products.

Base company income – active in form but subject to accrual taxation

4.13 CFCs engaged in nominally active business could be used to divert income that should properly be taxable as domestic income. The response of many countries (for example, Australia, the United States and the United Kingdom in the context of their active business exemption) has been to carve out "base company income" from their active exemption.

4.14 Generally speaking, "base company income" refers to income derived by a CFC from selling property or providing services on behalf of the group of companies in a manner intended to avoid or defer domestic tax. An example would be a CFC of a New Zealand company that simply processed the paperwork for a sale from New Zealand to some third market, but captured a "marketing" margin which consisted of the bulk of the profits from the sale. The concern would be that the CFC had been established to avoid New Zealand tax. With a base company rule, the margin captured in the CFC would be "base company income" and would be attributable to the controlling New Zealand shareholders on accrual.

4.15 In principle, base company income rules should not apply to commercially driven transactions between New Zealand companies and their CFCs. It would be difficult to draw an appropriate boundary between legitimate commercial transactions and those that should be included within base company income.

[17] Commodities transactions and foreign currency transactions fall within our financial arrangements rules. As such, any gain derived would be "interest", and thus passive income, even in the absence of a specific rule related to these transactions.

4.16 Following international best practice, it would appear to be preferable for New Zealand to have base company income rules as part of a system having an active/passive distinction. There is, however, considerable variation in the design and implementation of base company rules internationally.

4.17 Generally, two major factors are relevant to the determination of base company income: the first is the geographical location of the transaction, and the second is the relationship of the parties to the transaction.

Transactions with the domestic jurisdiction

4.18 Transactions by a CFC with the domestic jurisdiction of its controlling shareholder can clearly reduce the domestic tax base. For example, when a CFC provides services or sells property in the country in which its controlling shareholder is resident, the arrangement could result in an artificial reduction of domestic tax. The income derived by the CFC, unless the CFC has a permanent establishment in the domestic jurisdiction, will not be subject to any domestic tax. The concern is that the sale or services are, in reality, made or provided by the controlling shareholder, or other domestic subsidiary, and income which would be taxable in the domestic jurisdiction has been inappropriately converted to exempt foreign income.

4.19 The United Kingdom's rules focus on transactions in the domestic jurisdiction. Under the United Kingdom's rules, the active business exemption is denied if the CFC performs services in the United Kingdom. Furthermore, a CFC whose main business consists of dealing in goods for delivery to or from the United Kingdom, unless the goods are physically delivered into the CFC's country of residence, is excluded from the United Kingdom's active business exemption.

4.20 Australia's base company income definition is also focused on transactions in the domestic jurisdiction. These rules require income from the supply of services by a CFC to an Australian resident, or Australian permanent establishment of a non-resident, to fall *prima facie* within the definition of base company income. This is true whether the supply is to related or unrelated parties. In addition, in relation to sales transactions, Australia includes income derived when a related Australian resident or an Australian permanent establishment of a related non-resident either purchases the goods from the CFC or supplies goods to the CFC as *prima facie* base company income.

Related party transactions

4.21 Some countries use their base company income concept to supplement their transfer pricing rules. When that happens, the focus is on transactions between related parties.

4.22 Countries vary, however, over whether income derived from related party transactions in a CFC's local market should be outside the concept of base company income. Some countries consider that income from transactions in a CFC's local market should be exempt because current domestic taxation on such income would adversely affect the ability of the CFC to compete there. However, when a CFC derives income outside its local market, current domestic taxation would not affect its ability to compete in its local market.

4.23 Under the United States' rules, if a CFC purchases goods from a related party and sells the goods to any person, or purchases goods from any person and sells to a related party, the sales income will be *prima facie* base company income. However, the income derived will be excluded from base company income if the property purchased was manufactured, used or consumed in the CFC's local jurisdiction.

4.24 Australia's rules similarly provide an exemption for related party sales income. As already noted, income from the sales of goods is included within base company income when a related party resident in Australia or an Australian permanent establishment of a related non-resident is involved. However, the income derived will not be base company income if the CFC substantially alters, manufactures or produces the goods sold.

4.25 The United Kingdom takes a different approach. Under its rules, whether a transaction takes place in the CFC's local market is irrelevant. If a CFC is primarily engaged in a wholesale, distributive, financial or service business, income from related parties could cause the CFC to be ineligible for the active business exemption, whether or not the transactions take place in the CFC's local market.

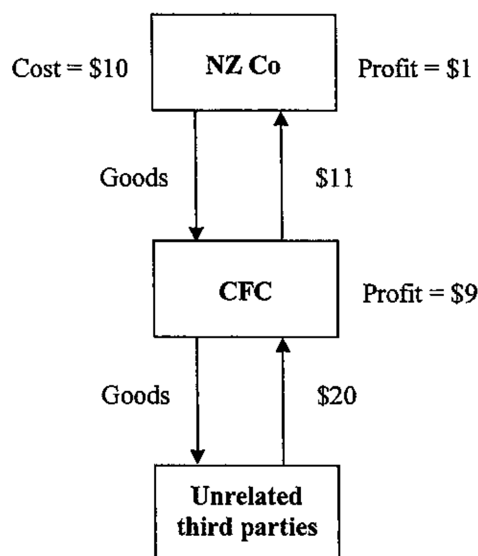
4.26 It is reasonable that income derived by a CFC from related party transactions should be exempt if that income is a reflection of genuine business activity in the CFC's local market. Even so, care must be taken in designing a test which cannot be easily manipulated.

Interaction with transfer pricing rules

4.27 A key issue is how the base company income concept interacts with a country's transfer pricing rules. Transfer pricing applies to transactions between related parties and seeks to determine correct prices with precision on a transaction by transaction basis. The base company rules apply to a wider set of circumstances, to groups of transactions, and have an anti-avoidance purpose. Base company income rules are generally viewed as a necessary reinforcement of the transfer pricing rules.

4.28 Take the example of NZ Co, a New Zealand-resident company which manufactures goods costing $10 (see figure 4). NZ Co sells the goods to its CFC, resident in a low-tax jurisdiction, for $11. The CFC then sells the goods to unrelated third parties for $20.

FIGURE 4
Example of base company income



4.29 One dollar of the profit from the sale is sourced in NZ Co, and $9 in the CFC. However, assume very little activity took place in the CFC to justify the profit sourced there. Say, for example, the arm's length consideration for the supply by NZ Co to its CFC is determined to be $17. The result of the application of the transfer pricing rules, then, is that $7 of the profit will be taxable in NZ Co (and $3 in the CFC). Under the CFC rules, however, all the income derived by the CFC ($9) would be base company income and taxable on attribution to NZ Co in New Zealand.

4.30 The appropriate interaction between the base company income concept and New Zealand's transfer pricing rules will have to be determined.

Special cases – passive in form but with activity

4.31 The approach that New Zealand takes to various boundary issues should have regard for the New Zealand business environment. There may be times when it is appropriate for the new rules to depart from international norms. On the one hand, this may give rise to concerns that an over-cautious approach could inhibit the establishment of some new offshore activity that might otherwise develop. There are risks, however, associated with instituting an exemption that tries to anticipate changes to the current business environment. This section explores the question of when it might be appropriate to limit the active income exemption, recognising, however, that the active/passive boundary will need to evolve over time as New Zealand business conditions change.

4.32 One issue on which New Zealand might depart from international norms is whether a CFC that is actively engaged in the business of earning a category of income that is typically passive (the classic example being interest earned by banks) should qualify for the active exemption. This issue is particularly problematic and is dealt with by countries in different ways for different types of passive income.

4.33 This section examines areas where businesses which arguably are active earn income which is passive in form. The question is whether the active income exemption should be extended to them.

Banks and financial institutions

4.34 In the case of banks and other financial institutions, interest often would constitute active business income and should therefore be excluded from the definition of passive income. The problem is that interest earned by a CFC of a bank might be passive in nature. Therefore treating all interest of a bank as active income creates potential for an erosion of tax revenues because banks can be established in low-tax jurisdictions with minimum capital or presence in that jurisdiction.

4.35 For example, a bank could put a portfolio of its loans to non-residents into a CFC, effectively moving such loans out of the domestic tax base. Identifying such arrangements can be difficult, particularly if the CFC carries on some legitimate active banking business of its own.

4.36 A few countries attribute income derived by banks and other financial institutions. For instance, in Denmark, the CFC rules are targeted at income from financial activity (including insurance). An entity will be a CFC if its financial income is in excess of 33 $^1/_3$ percent of its gross income or its financial assets are in excess of 33 $^1/_3$ percent of its total assets.

4.37 Other countries provide exemptions for interest earned by banks. Australia exempts interest derived by financial institutions in principle, although such interest might still be attributable if it falls into the definition of base company income. Similarly, the United Kingdom exempts CFCs dealing in banking, deposit-taking, money-lending or similar activities in principle, but requires them to satisfy a complex capital structure test (as well as satisfying minimum presence and effective management requirements) in order to be eligible for the active business exemption.

4.38 If New Zealand had a local retail banking industry that operated offshore through CFCs there could be merit in extending the exemption to interest earned by these CFCs. However, it is difficult to design an appropriate exemption in anticipation of such an industry development. Moreover, there is a fiscal risk that such an exemption would be used to exempt interest not intended to be covered by the exemption. It is possible that the problems associated with attempting to design and institute a suitable exemption in a vacuum outweigh any potential benefits from providing such an exemption.

Inter-affiliate financing

4.39 Multinational groups will often be organised in such a way that one subsidiary operates as an intra-group financial centre, with loans from third parties channelled through the subsidiary to other group members. Those subsidiaries can be used to consolidate financial expertise in one specialist centre and manage intra-group financing transactions. In such situations, they might receive interest payments from other members of the group which are then consolidated and used to pay interest on the loans from third parties.

4.40 Without an exception to the general rule, those subsidiaries would be considered to be earning passive income and potentially taxed in New Zealand.

4.41 To relieve this taxation, it is sometimes suggested that the treatment of income received by a CFC from a related party borrower should be dependent on the origin of that income. Under this principle, interest that is received by a CFC from a loan to a related party borrower and deducted against active income of the borrower should be treated as active income of the recipient CFC.

4.42 The United States has an exclusion from passive income for inter-affiliate financing if certain "same country" (and other) conditions are met. Other countries (including Australia) always treat interest on loans to related parties as passive income. Implementing an inter-affiliate financing exception would necessarily be complex, given the fungibility of money and the complexity of intra-group financial arrangements. As such, the government does not favour exempting interest derived from inter-affiliate financing from accrual taxation.

Income from insurance

4.43 Many countries consider the insurance industry to be another special case. As with banks and other financial institutions, countries vary in the way they treat the business of insurance.

4.44 The United Kingdom's rules, in broad terms, provide that a CFC whose main business is insurance cannot be eligible for exemption unless less than 50 percent of its business is derived from the risks of related parties. Japan's rules also require a CFC whose main business is insurance to conduct more than 50 percent of such business with unrelated parties for the CFC to be eligible for exemption. In Canada, income from insurance is *prima facie* attributable, but will qualify for exemption, if not related to the insurance of Canadian risks, if the CFC's business is conducted principally with arm's-length persons and more than five individual employees are employed full-time in the active conduct of the business. Australia has special rules for calculating the passive income of life assurance and general insurance CFCs. The effect of these rules, in broad terms, is to require attribution for income from assets held to meet liabilities on policies held by associates or Australian residents or that are in excess of the assets required to meet the liabilities referable to policies. Income from insurance can also fall within the definition of base company income in certain circumstances.

4.45 Concerns particularly arise when companies use offshore captive insurance companies to provide "insurance" for their operations. As the premiums for such insurance are deductible against domestic income, such companies can be used to shift income out of the domestic tax base.

Management of real and other property

4.46 There is an argument that rent derived by a company actively engaged in owning and managing commercial property should be excluded from attribution. Similarly, royalties derived by a company engaged in owning and managing intellectual property could be said to constitute active business income and, arguably, should be excluded from attribution.

4.47 Countries vary in the way they treat rents and royalties derived from active management in their CFC rules.

4.48 The United Kingdom takes a strict approach and treats rent and royalties as always passive: a CFC whose main business is holding intellectual property or leasing any property or rights will not qualify for exemption.

4.49 The United States treats rents and royalties as active if they are:

- derived by a CFC in the active conduct of a business, if derived from unrelated parties; or
- for the use of property within the CFC's jurisdiction, if derived from related parties.

4.50 Australia provides an exemption for property in the same jurisdiction as the CFC. However, to be exempt, a substantial part of the rental income must be attributable to the provision of labour-intensive property management services in connection with the land by the CFC. Australia also provides an exemption for royalties received from unrelated parties if derived in the course of carrying on a business and either the property or right in respect of which the royalty is consideration originated with the CFC, or the CFC substantially develops, alters, or improves the property or right for which the royalty is paid.

4.51 While there is a conceptual argument to exempt rents and royalties that are actively managed, it would be extremely difficult to administer a boundary that has the more general "active business" exemptions used in the United States and Australia. (There is already concern that intellectual property is being moved offshore to reduce New Zealand taxation.) It would appear preferable to follow the United Kingdom's approach and treat all rent and royalties as passive.

Submission points

Submissions are sought on the following matters, in particular:

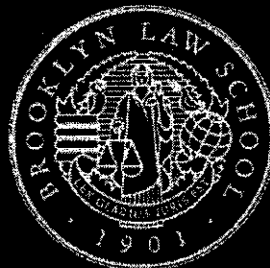
- whether positively defining passive income, with active income defined by default as the remainder, is appropriate;
- the appropriate scope of the definition of "tainted income":
  - the list of passive income to be included (interest, dividends, royalties and rent);
  - treatment of a CFC which is actively engaged in the business of earning a category of income that is typically passive; and
  - extent of base company rules.

BROOKLYN JOURNAL OF INTERNATIONAL LAW

VOLUME XXVI 2001 NUMBER 4

FROM THE BOTTOM UP: TAXING THE INCOME OF FOREIGN CONTROLLED CORPORATIONS

H. David Rosenbloom



PANEL III: U.S. MULTINATIONAL AND INTERNATIONAL COMPETITIVENESS

PRINCIPAL PAPER

FROM THE BOTTOM UP: TAXING THE INCOME OF FOREIGN CONTROLLED CORPORATIONS

*H. David Rosenbloom**

I. INTRODUCTION

From time to time I have occasion to offer advice in regard to other countries' income tax systems, and therefore to think about income taxation in general, but very practical, terms. For the most part these assignments concern developing countries with so-called emerging economies. I never have sufficient time to understand fully the context in which the tax system must operate in these countries, but I do my best to learn about the problems and issues that others more familiar with the territory have identified, and I attempt to tailor my comments to the circumstances as I come to understand them. Clearly there is no single income tax system that fits the needs of all jurisdictions. The principal supports of the local economy, the country's history with taxation, the question whether the

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country is, or could eventually become, a capital exporter as well as an importer, its tax and general economic relationships with other countries, all enter into the calculus of what might be appropriate in any given case.

There do seem to be some constants, however. Any country that has a government must find a means of paying for that government and that means, however implemented in rules and actions, usually will require some form of mandatory contribution from the public. It is not necessary that any such concept as tax law, or even law, exist for this purpose. A country that borrows, or that prints money to pay expenses, or some combination of these options, would still impose a "tax" in a broad sense of that term, because the effects of these actions would have a cost that the populace of the country would be required to bear. In this sense, running large deficits, tolerating inflation, paying interest out of public resources—all of these involve taxation. Thus, a "tax reduction" that contributes to deficits or inflation merely shifts the burden from one set of "taxpayers" to another.

If there is to be a formal tax system in a country—and most countries clearly believe (though not always for clearly articulated reasons) that they should have such a system—there are additional constants irrespective of where in the world the question is posed. For one thing, the system should have as little adverse effect as possible on other interests deserving of government encouragement or protection. Taxes are, by definition, undesirable insofar as the person called upon to pay them is concerned. It is obvious that the incidence of taxation—the combination of circumstances that give rise to an obligation to pay tax—is burdened by the tax, and to that extent disadvantaged, discouraged. Since most countries impose taxes upon some form of economic activity, and since a rational nation has an interest in supporting economic activity of persons subject to its taxing jurisdiction, the nation generally will wish to impose its tax with as much care as possible to preserve maximum room for that activity, given the necessity of the tax. This may be difficult in particular situations, but the general directive is clear: As between two taxes having the same effect, the one that interferes less with economic freedom is to be preferred. More broadly, it could be argued that general freedom of decision-making is a "good" meriting government protection, and taxes therefore should be

imposed with as much leeway as possible for such freedom. Such considerations are commonly referred to as "efficiency."[1] Professor Gergen invokes instead, and probably more fittingly, "the natural law of the parasite: Do the least damage to the host in extracting sustenance from it."[2]

A second desirable feature in a tax system, no less important than efficiency, is what some refer to as "equity." This condition obtains when persons who stand in the same place insofar as the relevant target of tax is concerned are treated similarly by the tax regime. The point is important because tax systems in countries that are not totalitarian ultimately depend, to a large extent, upon the (sometimes grudging) consent of the taxed. If the system does not operate in an equitable way, that consent is difficult to acquire and more difficult to retain, with the result that those subject to the system will devote greater energy to frustrating, avoiding, or evading it. Such actions, in turn, render the system more difficult to administer and enforce in an equitable way which, in turn, only will add to the frustration of persons subject to the regime. For this reason, equity is needed in a tax system for the most pragmatic of reasons, to permit the system to function.

The term "equity" is sometimes also used to describe a progressive system of taxation, in which persons who have more resources from which to contribute to government revenues, or perhaps who have benefited more from government actions supported by such revenues (often the same folks), should contribute more than others by paying a higher amount. I do not disagree with this view, but it seems a different matter from the proposition that those persons standing relevantly in the same place should be treated (more or less) the same by the tax regime. One could envision a tax system without progressivity, a debatable subject in its own right. That subject may not be intrinsic to thinking about the "fundamentals" of taxation, and I propose to leave the matter

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1. *See, e.g.*, DAVID F. BRADFORD, AND THE U.S. TREASURY STAFF, BLUEPRINTS FOR BASIC TAX REFORM 1-3, 2 (Tax Analysts 2d ed. 1984).

2. Mark Gergen, The Common Knowledge of Tax Abuse, Paper presented to the Ernst & Young Tax Policy Seminar at Georgetown University (Sept. 22, 2000) (on file with author). This recalls Colbert's "art of plucking the goose so as to get the largest possible amount of feathers with the least possible squealing." GEORGE ARMITAGE-SMITH, PRINCIPLES AND METHODS OF TAXATION 36 (John Murray ed., 1907).

here—and, as explained in more detail below, take no detailed position (for the moment) on the topic of corporate integration, which could be viewed as an element of progressivity.

The third fundamental characteristic of a sound tax system is "simplicity," which means favoring the less complex over the more complex to the extent a choice is available. Simplicity, like efficiency but perhaps not quite like equity, is a general goal, not capable of being attained in anything resembling a pure state. It is valuable in its own right and also because it contributes to other aspects of a well-functioning tax system: Administrability (the capability of government officials themselves to understand the relevant rules and see to their implementation in practice); and transparency (the ability of the public to understand the rules, so that obligations are clear and the companion goals of efficiency and equity can be evaluated and intelligently discussed). If the tax system cannot be understood and administered, then in actual practice it may become something very different from what its authors envisioned. And while they go on finely spinning rules, some other regime for raising taxes comes to operate in practice.[3]

Perhaps it is years of working with and under the U.S. tax system that leads me to place a special premium on simplicity in matters of taxation. There are too many rules in that system, and the complexity of those rules impedes assessment of their merits on other grounds. Furthermore, there is all too little consideration by the creators of U.S. tax legislation of what and who will be involved in translating tax laws into working reality. For these reasons, simplicity and administrability of rules hold a special place for me. Efficiency, equity, and simplicity are all virtues in matters of taxation, but the greatest of these virtues is simplicity.

Advising other countries on tax matters, I try to take all of these factors into account. This is, of course, no easy task, since not only are efficiency, equity, and simplicity all abstract concepts subject to considerable doubt and interpretation when applied in the evaluation of specific provisions, but the factors

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3. This long has been the case in the United States, where, in my experience, there are in force two parallel systems of taxation having at best only a resemblance—one, enacted in Washington and the other as applied by the Internal Revenue Service in the "field," in (for example) San Jose, Des Moines, and Cleveland.

actually conflict with one another when any of them is pursued with a single mind. Clearly, the goal of simplicity is best served by rules that do "rough justice" in the sense of assimilating different inputs into categories—persons, circumstances, amounts, etc.—even though it is known, indeed obvious, that there are differences within the categories and that item A is not at all the same as item B, but only similar to item B in a particular way. The call of equity may be strong in these circumstances. Does not each item deserve its own rule, or subrule, or exception? An affirmative response translates into discarding a key element of simplicity.

The same conflicts are present with respect to efficiency, though they may be more subtle. There are circumstances where a simpler rule or one that responds more closely to considerations of equity pulls in a direction that may not be the most efficient. Thus, in weighing the implications of efficiency, equity, and simplicity, it is necessary to engage in a constant process of judgment, revision, and compromise. The overall system will be an amalgamation of the disparate results of this process.

Recently, I had occasion to think about all this in a context that was unusual for me. The country in question had not only agricultural and mineral sectors, but a substantial manufacturing base. It was not only a capital importer, but a nation of real wealth, with substantial capital exports and possibilities for more. It was relatively modern, with a reasonable number of highly educated residents. Yet, its tax system was underdeveloped as a result of historical factors which, perhaps, were on the wane. In other words, here was a country with a need for a modern tax system. There were certain unusual factors that might impede movement from the existing—quite old, quite odd—system to one that appeared capable of working better in the future. The transition might be painful, and there were problems stemming from a large indigent population and substantial disparities in the distribution of wealth. Nevertheless, here was a chance to concentrate upon sensible taxation in a complex country, and to develop proposals that might not be weighted down by years of politics, inattention, habit, or ignorance.

A. *Explanations, Disclaimers, Excuses, Apologies, Etc., Etc.*

By now even the inattentive reader may have realized that the author is neither an economist nor someone who approaches taxation from the perch of high theory in any other discipline. I am interested in what works, in practice, on the ground. My only qualification to be writing at all is that I have worked on tax matters for nearly 35 years in the private sector, government, and the classroom, and have witnessed at close quarters the operation of many of the world's tax systems. Some of my notions may function better in practice than in theory.

The starting point for this paper is a hunch that a good deal of the current U.S. debate about subpart F is misplaced: It is either focused upon what happened in the distant past (1961-1962, to be precise), or about what occurred to produce the numerous *ad hoc* adjustments over the years to the original understanding, or about anecdotal evidence of the difficulties U.S. companies face in operating under the strictures of U.S. law, particularly in competing against companies from other countries that are not subject to similar regimes, or about the implications of banalities such as "capital export neutrality" and "capital import neutrality." The debate has been heating up (again) in recent years.[4] It seems to me, however, that debating on the basis of what originally was contemplated or not contemplated is not likely to be fruitful, since we are not speaking of a constitution but a set of tax laws, a quite different proposition. Tax laws (not subpart F in particular, thank goodness) are probably the most important laws in the United States as a practical matter, but there is no obvious reason why, in revising them, we should be saddled today with the "intention of the framers." Anything is possible and worthy of consideration. It would be foolish to operate on the assumption that what may or may not have been right in the early

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4. *See, e.g.*, NATIONAL FOREIGN TRADE COUNCIL, THE NFTC FOREIGN INCOME TAX PROJECT: INTERNATIONAL TAX POLICY FOR THE 21ST CENTURY (1999). Largely as a result of the strong public and congressional reaction to Notice 98-11, 1998-1 C.B. 433, involving "hybrid branches," and its aftermath, the U.S. Treasury announced on December 11, 1998, that it would study "the extent to which changes in our anti-deferral rules are warranted." *Id.* The Treasury's report, "The Deferral of Income Earned Through U.S. Controlled Foreign Corporations," was issued in December 2000.

1960s should have substantial force in the new century. Lengthy reports are not needed to demonstrate that the world has changed since 1962.

Reasoning from practical application of present-day rules is even worse. The "truth" about competitive and other effects of the rules is elusive, changing, unverifiable, and unknowable. Something of interest probably can be gleaned from the decibel level of corporate complaints at any given time, but that something is not likely to tell us that today's rules should be any better than what some congressman thought in 1962. Moreover, the evident self-interest of participants in the debate renders it difficult to credit the complaints without independent and objective evaluation.

Perhaps it would make sense to consider the subject from a different perspective. Instead of thinking about how the past is apt to resemble the future, perhaps it would be useful to begin with a blank page and ask what would constitute sound and appropriate treatment of the income of foreign controlled corporations as a matter of general tax policy. In other words, maybe the United States should be viewed as a candidate for true tax reform.[5]

Approaching the topic from this vantage point, I mean no disrespect for the substantial scholarship that has been devoted over the years to the question whether, and how, the United States should tax income earned by foreign corporations controlled by U.S. persons.[6] That scholarship is formidable, and offers numerous insights into both the ways in which the stat-

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5. The term "true tax reform" is employed in contradiction to the "tax reform" label that Congress routinely slaps on tax legislation, as in 1969, 1976, 1982, and 1986.

6. The past few years have witnessed an array of substantial and thoughtful legal writings devoted to this topic. *See, e.g.*, Melvin S. Addess et al., *The Erosion of Deferral After the 1993 Act*, 47 TAX LAW 933 (1994); Stephen E. Shay, *Revisiting U.S. Anti-Deferral Rules*, 74 TAXES 1042 (1996); Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Tax Rules*, 51 U. MIAMI L. REV. 975 (1997); Stuart Leblang, *Deferred Gratification: A More Rational Approach for Taxing U.S. Multinationals*, 27 TAX MGM'T INT'L J. 78 (1998); J. Clifton Fleming et al., *Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income*, 52 SMU L. REV. 455 (1999); Roseanne Altshuler, *Recent Developments in the Debate on Deferral*, 87 TAX NOTES 255 (2000); J. Clifton Fleming et al., *Deferral: Consider Ending It, Instead of Expanding It*, 86 TAX NOTES 937 (2000); Keith Engel, *Tax Neutrality to the Left, International Competitiveness to the Right, Stuck in the Middle with Subpart F*, U. TEX. L. REV. (forthcoming 2001).

ute developed and the alternatives that have been considered and rejected (sometimes by repeal, after enactment) along the way. It is interesting to consider the relevance of arguments made forty years ago for the world of the twenty-first century. Further, I can not categorically reject the methodology of attempting to determine "how should subpart F be altered to fit the needs of today?" My approach, however, is different. I propose to think about constructing a tax system, using building blocks, experimenting and rejecting, in much the same process I would employ (have employed) in counseling other countries. This methodology offers the possibility of opening for discussion propositions that might be viewed as too certain or immutable to merit comment in the context of the existing system. That, in and of itself, has to be salutary.

Of course, the economic system of the United States is complex, and rethinking the enterprise is a Herculean proposition. Many adjustments are doubtless needed in attempting to transfer rules developed for other jurisdictions to the U.S. context. Moreover, there is no way of "unlearning" our experiences with the present statute and every reason to believe that the forces that shaped it will continue to operate on whatever might stand in its stead. Nevertheless, it seems possible that we are unduly intimidated by the monster that lies before us. It may not have to look like that.

I approach the subject with few illusions. Ultimately, how U.S. income tax will apply to income of foreign corporations controlled by U.S. persons will be subject to the same political forces that have always determined the outcome of the discussion (though that outcome varies from time to time, as the political forces themselves mutate). However, it even may be useful to note that the debate *is* political, that subpart F is neither going to be expanded into a complete repeal of deferral nor itself repealed on the basis of which view is "right." The question is who has the votes, not which side is "right." In these circumstances the notion of "starting over" as a basis for considering changes in this important body of law may seem ludicrous. On the other hand, there are few things more risible than the rules presently on U.S. books.

II. RESIDENCE-BASIS TAXATION AND ITS CONTENTS

There are two well-recognized and internationally accepted "jurisdictional" bases for an income tax: source and residence. Source-basis taxation depends, more or less, on the proposition that the country where income originates has a legitimate claim to tax that income. Residence-basis taxation relies on the notion that the country where the taxpayer resides legitimately may impose tax in order to support the normal government activities that residents enjoy.

Most countries rely on both source taxation and residence taxation for their income tax base, and there is really no need to choose between these two jurisdictional grounds. A "mixed" system is common, justifiable, and reasonable. What is more important, for this paper, is that residence-basis taxation is hard to quarrel with as a matter of tax policy. Such taxation certainly is equitable, since it treats equally taxpayers having similar amounts of income, irrespective of where that income was derived. In contrast, a system that relied exclusively on source-basis taxation would favor residents benefiting from foreign-source income, a benefit that modern technology and communications make much easier to achieve than in years past.

From the standpoint of efficiency, there is no obvious gain in an exclusively source-based system because a government's interest in favoring foreign-source income is difficult to rationalize. Most countries may be thought to have the converse interest—favoring domestic income over foreign, so that the domestic use of capital may work to produce non-tax benefits in the form of economic activity and employment. And, from the standpoint of simplicity, there is nothing inherently complex in defining who is a resident, although there are competing definitions from which to choose and it would be easy to devise others.[7]

In short, it is possible, without much effort, to defend the residence basis as a jurisdictional ground for income taxation.

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7. The United States, idiosyncratically but understandably in light of twentieth century events, views citizens as enjoying many of the same government-funded benefits as residents and, therefore, effectively treats U.S. citizens the same as residents for purposes of jurisdiction to tax. That is a fine point for present purposes.

It fits nicely within all criteria of a good and proper income tax, does no violence to international understandings, and probably should be used by any country that has a formal income tax. The most common objection—that the worldwide taxation implied by residence basis jurisdiction creates difficult problems for tax administration because income sources outside the country cannot be easily verified—has validity. But the desirable features of residence taxation and the undesirable implications of an exclusively source-based system argue strongly in favor of making the attempt. The results of not doing so will be distortions in the patterns of income-producing activity and dramatic inequality among taxpayers having similar amounts of economic income.

Taxing on a residence basis does, however, definitely imply taxation of global income, "from whatever source derived" in the resounding words of section 61 of the U.S. Internal Revenue Code. If less than all worldwide income is taxed to residents—or, more specifically, if residents are taxed only on some geographically limited slice of that income—the result is something less than true residence-basis taxation but rather (depending on how the slice is defined, though it generally would be limited to some version of domestic source) an expanded version of source taxation. Residence-basis taxation ultimately is based on the proposition that geographic distinctions among income flows are irrelevant.

There is nothing inherent in the concept of residence-basis taxation that speaks clearly to the question of how to tax income of foreign controlled corporations. However, two attributes of such corporations are more eloquent. First, corporations are a complicating factor. Their presence in a tax system requires rules of many different sorts—not least troublesome of which is identifying exactly what a corporation is.[8] Respect for the corporation as an entity separate from its controlling shareholders leads to difficult questions about when income enters or leaves corporate solution, the need to police intercorporate dealings, and inevitable ambiguities in assessing the

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8. The United States virtually has thrown in the towel on the point, having adopted rules that generally permit corporate status to be elected by merely "checking the box." *See* Treas. Reg. § 301.7701-2, -3 (as ammended in 1999). The prior rules based the definition on a weighing of "factors" that, over time, became increasingly arcane, abstract, and ephemeral.

relationship between the corporation and those who control it.

Second, the only persons a country has available to tax are, in the final analysis, individuals. Corporations, trusts, and more exotic types of entities are all pieces of paper—legal constructs, adopted at one time or another for one purpose or another. Without disparaging those purposes or those times, the results need not be accepted for all purposes. The existence of the constructs holds many legal implications, but those implications exist exclusively at the sufferance of laws and lawmakers and, in that sense, the constructs are not "real." Insofar as taxation in particular is concerned, there is no compelling reason why those implications must be respected. It is possible to make a reasoned and independent judgment whether to accept and respect the legal constructs *in tax matters*.

This paper is focused on taxation of the income of foreign corporations controlled by resident taxpayers. One of the building blocks I would propose for such taxation is disregard of the corporate form, because the benefits of accepting that form in a control situation—treating it as an entity separate from those who control it and potentially representing a taxpayer in its own right—do not seem compelling. The corporate form is easily obtained and insubstantial. Especially in today's world, there are few inhibitions to adopting or discarding it in any geographic location. The costs of maintaining the form in existence are insignificant. There is no difference in substance between a single controlled corporation and twenty such corporations. In the United States, as a result of the check-the-box regime, the form easily can be made transparent (non-existent) in one jurisdiction but opaque in another. The decision whether to operate in corporate form is, for the controlling shareholder, simply an election.[9]

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9. The point was made clearly and irrefutably by Sidney I. Roberts, *From the Thoughtful Tax Man*, 40 TAXES 355 (1962):

> If a taxpayer had foreign income and decided he did not want to pay tax on that income, he went to the Wizard of Og to secure a Talisman.
>
> Now you would have thought that the road to Og was long or difficult or expensive. Not so! You would draw your Charter pretty much as if you were forming the ordinary garden-variety corporation, say, in Delaware or New York. Then you would mail it to counsel in Og and for $500 he would arrange to have affixed the Talisman, which was merely a red seal symbolizing that you were incorporated under the laws of Og. In other respects, this corporation could operate in much the same places

Without being absolute on the subject, I think elections in tax matters are suspect. They arguably promote efficiency through the element of taxpayer choice, and in some cases may do no serious violence to the goal of equity. But they are not simple. By definition elections require the development of at least two sets of rules where, but for them, one would have served. Moreover, elections may become a threat to equity because, although they begin by allowing different results for situations that taxpayers, at their option, deem different, they commonly end up distinguishing between situations that are similar.

A foreign corporation represents an election by controlling shareholders in the residence country not to recognize income and loss, or credits, currently. The shareholder facing positive income and relatively low credits may be expected to make the election and thus not recognize the income or claim the credits. A shareholder anticipating losses usually will make the contrary election, because losses have a current value that the taxpayer will not wish to defer. But the situation may change. The foreign corporation that suffered losses begins to earn income; the one that anticipated income endures difficult years. Residents now in similar situations continue to be treated differently. If the tax system opts to address this inequity, it will adopt rules, invariably complex, for permitting the election to be reversed.

Nor is the election limited to recognition versus non-recognition, current taxation versus deferral. That is merely a starting point. When a resident shareholder chooses to earn income through a foreign controlled corporation, the election to defer income opens up a panoply of further elections because non-recognition of current income of a foreign corporation historically has implied an optional regime for when and how much recognition will occur at subsequent times. Since income is apt to be a driving force under other provisions of the tax regime—for example, the limitation on certain deductions or

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> and with much the same people as if it were a Delaware or a New York corporation. But because of the Talisman affixed to its Charter—which nobody but the lawyers ever so much as looked at or noticed—the laws of this Kingdom specified that a corporation with this Talisman paid no tax on its foreign income.

Id. at 365.

certain credits, including the foreign tax credit—these other provisions also become elective in substantial part. The result is additional rules to govern or restrict these secondary elections.[10]

This is not to condemn elections in all instances—there are few such black letter postulates in the business of developing a tax system. But tax choices having no non-tax consequences are problematic. Taxes are, and are meant to be, compulsory. To the extent elections introduce elements subject to the taxpayer's control, they tend to undermine the compulsory nature of the system and produce unfairness and inequity, in the basic sense of treating similar persons differently.

The notion of residence-basis taxation without respect for the corporate form is not radical in situations involving foreign corporations and control. The U.S. rules relating to the "deemed paid foreign tax credit" long have applied to corporate residents owning 10 percent or more of the voting stock of a foreign corporation.[11] These "indirect credit" provisions, which apply at ownership levels much lower than control, are at odds with the concept that the foreign corporation is separate from its shareholders. If the corporation is in fact separate, why is a credit allowed to the shareholder for taxes paid by the separate entity? In fact, the indirect credit provisions recognize that the foreign corporation is separate only in a formal or legal sense. In the context of a regime for avoiding international double taxation, it has seemed appropriate to cut through such formalities and allow a credit for taxes incurred by *the enterprise* on foreign income-producing activities. The gross-up of section 78, which prevents *the enterprise* from simultaneously benefiting from a credit and a deduction for foreign taxes paid completes the picture: The shareholder is called upon to recognize the income out of which the foreign tax was paid, making clear that both income and tax "really" belonged to the shareholder in the first place.[12]

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10. Thus, the deferral regime in the United States fueled elections under the allocation and apportionment rules of Treasury Regulation section 1.861-8, which depended on the amount of current income recognition. These secondary elections came to be seen as excessively generous, and were eventually circumscribed (in part) by additional rules and limitations.

11. *See* I.R.C. §§ 902, 960 (1988).

12. The United States restricts the indirect credit to *corporate* shareholders, a restriction that derives from the classical system of taxation of corporate earnings.

There are two important offshoots of the suggestion of corporate transparency, each representing something of a diversion, but each worthy of note. First, the suggestion pertains to control situations, not necessarily to other instances of income earned through foreign corporations. This is because control situations are fundamentally different from situations in which the shareholder lacks control. The proposed rationale for disregarding the corporate form for controlling shareholders is that, taxes aside, the corporate form amounts to a simple election. In a world where limited liability companies are common, it is no longer necessary to adopt the corporate form even for the purpose of limiting liability. But it is only in situations involving control that the election is without non-tax consequences; in other circumstances the corporate form represents a structural choice having potentially important effects beyond taxation. In a case of control, the shareholder elects whether to operate directly or in a form that the tax laws may view as separate from him. In the absence of control, the shareholder may or may not engage in income-earning activities through a corporate vehicle, but the decision to employ that vehicle involves a surrender of decision-making authority to other persons, or at least a sharing of such authority. For this reason, the suggestion that the corporate form be disregarded or viewed as transparent in a control situation does not necessarily imply disregard of that form in other situations. Of course, an underlying assumption here is that it is possible through suitable definitions to distinguish control from non-control. Except at the margin, where all cats are grey, that assumption does not seem unreasonable.

Second, disregarding the corporate form when that form is foreign need not hold implications for corporate integration within the residence country. The so-called classical system involves taxation at the corporate level and again at the shareholder level. That system does not have to depend upon the "person-hood" of the corporation; it can be defended as an imperfect element of progressivity, without holding any implications for the separateness of corporation from shareholder except in the practical sense that a corporate-level tax requires some understanding of what a corporation, and the corporate tax base, are. On this view, the corporation is simply a convenient place to situate a second tax on certain earnings. Although the classical system doubtless has underlain at least

some thinking about taxing the income of foreign corporations, questioning the substantiality of such corporations does not necessarily imply dispensing with the corporate tax at home. Corporate residents represent a well-known and long-understood type of taxpayer, and on these grounds alone a very different matter than foreign corporations. The U.S. check-the-box regime, with its distinctions between U.S. and foreign corporations, appears to make a distinction of precisely this sort.

In sum, viewing the foreign control situation as an insubstantial election, or series of elections, says nothing compelling about corporations in other contexts, where they do not function as an election and hold substantially different consequences for the residence country tax base. A tax system could function without accepting the separateness of the foreign controlled corporation from its controlling resident shareholders while continuing to view both non-controlled foreign corporations and domestic corporations as independent and separate taxpayers or potential taxpayers.

The proposition that there may be no difference between income earned by a resident through a foreign controlled corporation and income earned by the resident directly is not the end of the matter, however. That proposition serves to simplify and may induce clear thinking about taxing the income of foreign controlled corporations, but it does not dictate the tax rules to be adopted. Residence-basis taxation implies taxation of worldwide income, but there are considerations of international comity and double taxation that also bear importantly on the subject. Those considerations are important without regard to the separateness of the corporate form, and quite apart from notions of global neutrality or competitiveness, the main linchpins of the arguments that have been advanced in the United States against, and for, deferral.[13] Comity and double taxation draw the debate away from these abstract and elusive subjects, and into the distinct area of how best to deal with impediments to international commerce. The topic is integral to the taxation of foreign controlled corporations and, as a practical matter, cannot be shunted aside for separate consideration.

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13. *See* Engel, *supra* note 6.

III. The Problem of International Double Taxation

It may be a basic tenet of residence-basis taxation that the tax base should include all income irrespective of source, but it also is indisputable that source-basis taxation exists commonly in the world; indeed, most countries have such taxation in their laws. The residence country may conclude—as countries around the world decades ago similarly concluded—that it is excessive for two taxing jurisdictions to impose the same type of tax (income) simultaneously on the same base; one because it sees itself as the origin of that base and the other by reason of its claim on the person of the taxpayer.[14] Traditionally, the claim of the source country comes first, with the residence country assuming the responsibility of alleviating double taxation because it is in the best position of any country to do so. This responsibility may be discharged by a system allowing credit for income tax imposed by the source country, by exempting income earned in the source country, or by some combination of these methods. The United States, of course, has a well-developed foreign tax credit system.

In an industrialized and tax-sophisticated country the inherent logic of such a system threatens to engulf it. This leads to a regime that is either terribly naive or terribly complex—and neither attribute is, ultimately, tolerable. A theoretically proper foreign tax credit system would allow credits for qualifying foreign (source country) tax on each item of income subject to tax in both the source country and the residence country, and prevent foreign taxes in excess of the residence country tax on any item to be used to offset the residence country tax on other items. There appears to be no principled justification for mitigating double taxation through cross-crediting, allowing the foreign country's "excess" tax on certain income to reduce residence country tax on other income. And yet, the "per item" approach, clearly, is impractical. Multinational enterprises cannot be expected to subdivide income into bite-sized pieces for the purpose of determining whether a credit is available. Even if they could, tax administrations cannot be expect-

14. This is distinguishable from a revenue-sharing situation, in which similar taxes are imposed at national and subnational levels within a single jurisdiction. There are various reasons born of history and practice why the same concern for "double taxation" need not apply with equal force in both situations.

ed to police the resulting determinations. There also lurk questions about the meaning of an "item," the problem of taxes imposed on the same "item" in different years, and the difficulty of determining how much foreign tax has been applied to each item (since foreign countries will not itemize their taxes so that items perceived as separate by the residence country are taxed separately by the country of source). These problems are overwhelming. For good reason, the per item approach has never been employed by any country.

The next best solutions, like most next best solutions in tax matters, carry far from the optimum. They all involve compromises and limited cross-crediting: Allowing excess source country foreign tax on certain items as a credit against residence tax on other items. The cross-crediting may be geographically general (worldwide) or specific (country-by-country). It may involve various categories of items, which in turn may be grouped on a worldwide basis or according to some other geographical or other delineation. The possibilities are numerous. The results will be a series of limitations on the credit in a way, and to an extent, that policy-makers conclude (for the moment) is reasonable.

Taxpayers, of course, will wish to have as few categories as possible apply to themselves, irrespective of what categories may be created. The important thing for a resident taxpayer is that, in its particular situation, foreign taxes giving rise to potential credits not be disassociated from income categories on the basis of which the credit limitation is computed. The fewer the applicable categories of taxes and income, the better the taxpayer will fare.

In such a regime, it is clear that accepting foreign corporations as entities separate from shareholders constitutes a complicating factor of enormous proportions. When foreign corporations are viewed as separate from shareholders and credits are allowed for foreign taxes imposed on the corporations and "deemed paid" by resident shareholders, logic and integrity suggest that the limitation be refined. An item of income must be assigned a category for purposes of the limitation regime when it enters into the tax return of the resident shareholder. The same holds true for foreign taxes eligible for credit. If the residence country wants to forestall manipulation of its system, taxpayers must be precluded from altering limitation categories by transactions with themselves (that is, transac-

tions involving related, commonly controlled, foreign corporations) after the income has been earned by a foreign affiliate, but prior to the time when it becomes taxable, and credits available, in the residence country. If each corporate form represents a person for tax purposes and no tax applies to the current income of foreign corporations, separate corporations are relatively free to transact business with each other and, potentially, adjust credit limitation categories to their benefit. It is, therefore, necessary to establish rules to "trace" income and credits back from the time when they are reported on the resident's tax return to the moment when they first became available to the enterprise, that is, when they were first taken into account for tax purposes by a foreign corporation that constitutes part of the enterprise.

As current U.S. law amply demonstrates, a regime for "basketing" income and foreign taxes is complicated enough. However, complications are turbo-charged by the elaborate rules needed to "look through" transactions between and among foreign corporations.[15] Additional rules are necessary for handling losses and deficits within categories, both during the period when income and credits remain in foreign corporate solution before reaching the resident's return and as of the moment when one or more of the categories on the return are themselves negative. Losses in a category may be provisionally applied to reduce other categories,[16] without actually moving into those other categories, or they actually may shift over, "borrowed" by other categories, subject to rules for eventual repayment to the category whence they came.[17] It is a separate question whether foreign taxes associated with the loss category should move as well.[18]

To determine the amounts, positive or negative, in the categories, it is necessary to provide for the allocation and apportionment of deductible expenses, both while income remains in foreign corporate solution and when income and credits arrive on the residence country tax return.[19] Conceptually and logically (if not politically) unassailable, this detailed,

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15. *See* I.R.C. § 904(d) (1989).
16. *See* I.R.S. Notice 88-71, 1988-2 C.B. 374, 375.
17. *See* I.R.C. § 904(f)(5) (1989).
18. *See* Treas. Reg. § 1.904-6 (1989).
19. *See* Treas. Reg. § 1.861-8 (1989).

judgment-laden process results in "stealth" deductions assigned to limitation categories but which may be totally unknown in the foreign jurisdiction that imposes tax. The effect is a regime for avoiding international double taxation that floats free, with only a tenuous connection to what is occurring in the source country.[20]

The problem is not simply that this tangle of rules is complex, much less that it is illogical or unnecessary. The rules fit together nicely in a rational unfolding of the basic notion that the foreign tax credit should be limited so as to preclude "excessive" cross-crediting or the use of credits to offset tax on income from within the residence country. It is certainly unclear where in this unfolding the proponents of the rules strayed from the necessary and rational. Nor is the problem simply that the limitation may have been spun too fine for its own good. The more serious point is that the complexity is bound to engender inequality of treatment among taxpayers. A great deal clearly escapes audit attention, and the odd case that becomes a discussion with tax authorities tends to produce (in me, at least) a nagging feeling that many others, indistinguishable, must surely pass without drawing attention.

Treating foreign-controlled corporations as transparent is no panacea. This step would not dispense with the need to deal with cross-crediting and determining net income in individual credit categories. Further, the "deemed paid" credit rules—and all they require in the name of defending purity of the limitation categories—still would have room for operation in noncontrol situations. Respecting the separateness of foreign corporations magnifies the conundrum of limitation, but the origins of that conundrum lie in the foreign tax credit regime itself.

The tax policy choices that have been the object of the obsessively intricate U.S. rules are inherent in the laws of any nation that employs a credit as the means of alleviating international double taxation. Those choices seem to lead to any of three conceivable results: large dollops of electivity; rules so generous on the issue of cross-crediting as to make elections virtually unnecessary; or a fiendishly complex, ultimately self-

20. For a particularized example, see United States v. Goodyear Tire & Rubber Co., 493 U.S. 132 (1989).

defeating, series of provisions designed to police the limitation categories and the rest of the regime.

Exemption may offer a better alternative. In considering that possibility it is worth taking note that most substantial business activities occur in countries with formal and serious tax systems. The amount of "residual" residence country tax to be derived after a foreign tax credit is allowed with respect to income from such activities is small. A credit system in these circumstances operates prophylactically, to protect the residence country tax base. Viewed from that perspective, however, the system may be extravagant. It costs the residence country a great deal in terms of compliance, tax administration, efficacy and honesty of the rules. Weighing such costs, a residence country might conclude that an exemption carefully trained upon the principal sources of international double taxation would be an improvement.

The residence country might also note that all taxing jurisdictions in the world are not equal, and there is no reason to treat them as if they were. Even as a political matter, it is unclear that equality should be the norm. If France and the Cayman Islands are viewed *in pari passu* insofar as residence-country taxation is concerned, it inevitably will be necessary to adopt rules not needed for France because the same rules must contend with the Caymans. For such reasons, tax policy addressing foreign income earned by residents can and should contain means of distinguishing between jurisdictions anticipated to impose substantial income tax and those that will not. The aim is not necessarily to find a match for residence country rules but, more modestly, to identify jurisdictions that have comprehensive rules of income taxation. The possibility of exemption should be reserved for such jurisdictions.

It is not, of course, enough for the residence country to make a distinction among countries and leave the matter there. That country would have to remain vigilant and adopt a dynamic method for distinguishing between the Frances of the world and the Caymans. Any jurisdiction may find it necessary/expedient/profitable to convert to low-tax status, either in whole or in substantial part. Countries that previously have been oblivious in matters of taxation suddenly may perceive gold in haven status and embark on programs intended to attract investment from residence countries. Or, more subtly, France may decide for any number of reasons that Alsace (for

example) should become a special enterprise zone, with privileged tax rules. Without proceeding so far as a new view of the national tax system, and perhaps for reasons other than those that induce a nation to turn itself into a fiscal paradise, geographical or industrial or other distinctions may be adopted that have the result of precluding application of "normal" tax rules. This, too, would be problematic from the standpoint of the residence country.

For such reasons, the residence country will not want simply to prepare a list, include France (or, conversely, the Caymans), and rely on the list for operation of its rules. The subject requires periodic revisitation, and current information about both actual practices and new developments.

The best tool for this purpose is the residence country's tax treaty network. A sensible country will use this network, in combination with its internal law, to advance its national tax policy goals. If an element serving those goals is distinguishing between France and the Cayman Islands on a dynamic basis, and perhaps making distinctions within France as well, the treaties readily lend themselves to the task. They can be used with precision, changed rapidly, offer the possibility of ascertaining current information, and ought to be the instrument of choice for identifying, on an ongoing basis, those jurisdictions where an exemption system could apply.

There are some risks, particularly in the discretion that must be vested in government officials charged with tending the treaty network, but they do not seem so huge as to be unbearable. The suggestion is not that compiling a list of countries qualifying for exemption be left entirely to the treaty program, but that the program be employed to prepare, review and, if necessary, change the list. Nor is reliance on the treaties inconsistent with oversight and correction by the legislature. The treaties are not the only means of establishing and reviewing the sort of list that has been described, but some means of distinguishing among jurisdictions is indispensable.

Normal business income in countries appearing on the list of exemption jurisdictions does not appear to require a foreign tax credit system. If exemption was instead employed for the core case—business income attributable to a substantial presence within such countries—there is a potential for real improvement in the tax system, judged in terms of efficiency, equity, and simplicity.

Under the proposal, manufacturing income earned in France would not be taxable in the residence country, either when earned or when repatriated. Sales income in France, even from sales into Germany, similarly would be exempt, provided the income was linked with activities carried on in France. The so-called "base company" concept should not be controlling in this context, as the "high tax exception" of subpart F recognizes in a different way.[21] That exception, however, mechanical and static, is not equivalent to exempting income in the first instance. The exemption would apply not only to income earned directly by the resident taxpayer but, since foreign controlled corporations would be transparent, to all foreign corporations subject to the taxpayer's control, wherever organized and wherever managed and controlled, at whatever tier in the chain of ownership.

Would some income escape taxation? Certainly. In some instances income would qualify for exemption under the proposal yet not be taxed by the source country. In others, the source country's tax rate would be low enough that potential residual taxation in the residence country would be foregone. Would there be tax planning opportunities for professionals and tax directors in the residence country's businesses? Surely. Exemption is a powerful magnet and residence country taxpayers would pay close attention to it. The question, however, is not whether the proposal places a hermetic seal on income that might, in the abstract, be subject to tax in the residence country, but whether costs of the described nature will be so large as to result in assaults on the goals of efficiency, equity, and simplicity, particularly by comparison with the system presently in force in the residence country. Seepage exists in the most detailed tax system, and no approach to taxing the income of foreign controlled corporations is capable of preventing it. Aiming for perfection will, inevitably, fall short of the mark with respect to persons determined to avoid tax while (at best) inconveniencing everyone else.

To be sure, the proposal (like any other dealing with this subject) calls for important definitions, such as what is control, what is business income, and when is such income to be viewed as earned through a substantial presence in a listed

21. *See* I.R.C. § 954(b)(4) (1989).

foreign country? Each of these crucial concepts merits careful consideration, but it is relatively easy to identify starting points.

For "control," it is tempting to recur to the definition used in the transfer pricing area—"any kind of control, direct or indirect, whether legally enforceable or not, and however exercised or exercisable."[22] The vagueness of the phrase may rule it out as a sole test, however. The "safe harbor" that lies at hand is direct or indirect holding of a majority of either vote or value.[23] Shareholders not within the control group,[24] even if substantial, should be treated separately, since notwithstanding the size of their holdings it cannot be said that the foreign corporation represents, for them, merely an election.

For "business income" the leading definition is probably the treaty concept of business profits. This would include passive income recharacterized in accordance with the circumstances in which it is earned. The residence country would have to make a judgment, in developing its exemption list, whether such income likely would be subject to tax in foreign countries. Incidental income is going to be the focus of planning activity, and in jurisdictions where such income is apt to escape tax, adjustments to the list would be indicated.

To determine when income is earned through a substantial presence in a foreign country, the concepts of permanent establishment and attribution seem appropriate. These concepts are used around the world as a result of the international web of tax treaties and therefore, in most jurisdictions, offer the hope that they truly will identify cases in which the source country will tax. Although the precise contours of the permanent establishment concept are not crisp and a number of fact patterns (more numerous, no doubt, by reason of the e-commerce phenomenon) are bound to require interpretation, any competing concepts (for example, the "trade or business" and "effectively connected" standards employed for inbound taxation in the United States)[25] are unlikely to achieve wide acceptance and could be idiosyncratic in application. The notion of business

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22. Treas. Reg. § 1.482-1(i)(4) (1989).
23. *See* I.R.C. § 957 (1988).
24. Constructive ownership rules would, of course, be used for this purpose, though the rules of I.R.C. Code section 958 usefully could be rationalized.
25. *See* I.R.C. § 864(b), (c) (1989).

profits attributable to a permanent establishment has a clear basic meaning, one that receives endorsement and interpretation through ongoing work of the Organization for Economic Cooperation and Development (OECD). So the suggestion is that business income attributable to a permanent establishment in designated countries would be exempt in the residence country. Permanent establishment would be defined by law in a general way—for example, adopting the OECD concept—though the definition could be adjusted by negotiation with individual treaty partners.

The residence country would be the arbiter of these definitions, since the rules would represent its domestic law, even though the terms are borrowed from the treaties. There might, of course, be instances where the law of the residence country would pose a question not asked by the source country for purposes of its own taxation, for example whether a controlled corporation considered by France to be a resident had a permanent establishment in France. France, taxing corporations on a residence basis, might not have any interest in the inquiry. There also might be jurisdictions, even designated jurisdictions, that do not tax at source all income that, in the eyes of the residence country, is attributable to a permanent establishment in those jurisdictions. If there likely is not to be a source country tax on a clearly envisioned class of income—the operative word here is likely, not certain—adjustments to the list, as suggested above, should be made. In particular, a source country exemption for foreign income attributable to a permanent establishment in that country cannot be accepted in this regime. Systemic holes in a tax system are like the drain in a bathtub; the fact that they are limited in diameter is of little importance.

As for the Caymans, as for income from Alsace, the implications of the proposal are current tax in the residence country and a deduction for foreign taxes imposed on such income. Like the proposed exemption, this rule would apply regardless of whether income was earned directly or in foreign controlled corporate solution, and irrespective of how many layers of foreign controlled corporations were interposed between the resident and the income. The taxpayer that finds itself in a position in which it does not derive maximum benefit from the tax regime can obtain that benefit by removing itself from that position. Relieving international double taxation is a worthy

goal for a residence country, but that goal need not be pursued in exactly the same way in every country in the world.

My inclination would be to favor a similar approach to passive income, not qualifying as business profits. It has never been clear why a foreign tax credit should be made available for such income. The earning of income from portfolio investments in a source country is clearly in the economic interests of that country, which finds itself in a conflict. It wants and needs the investments, but the earnings are a natural part of its tax base. The result is likely to be a modest regime of taxation, with exemption perhaps for particularly favored investment forms. The residence country does not have a strong interest in wading into this conflict and making life easier for the source country by shouldering the burden of whatever tax the latter country chooses to impose. (The existence of a foreign tax credit regime that is likely to be misunderstood in the source country probably contributes to a higher level of source country tax than would otherwise be the case.) A deduction for foreign taxes imposed on income not qualifying as business profits attributable to a permanent establishment would treat such income in the same manner as if it was earned in the residence country and subject to taxation at the sub-national level.

It is true that not every residence country will be prepared to contemplate this binary view of the world, with an "exemption zone" carved out from a general rule of current taxation and no foreign tax credit. Much will depend upon the extent of the foreign activities carried on by residents of the particular country. Especially if those activities are likely to be widely dispersed, it may be necessary to interject a direct foreign tax credit, subject to some form of limitation to control cross-crediting, for certain situations. Ideally, this "third way" would be limited to business profits and activated solely by means of negotiated treaties. There would, of course, be a cost in terms of complexity. But if the residence country could achieve at least elimination of the deemed paid credit, gains for the cause of simplicity still could be substantial.

Even with neither foreign tax credit nor exemption for income earned in the Cayman Islands or (on the previous hypothetical) Alsace, a deduction would be allowed since there is no reason to treat such income more harshly than income earned within the borders of the residence country. The same

rule would apply to business profits from a listed country but not attributable to a permanent establishment. Source rules still would be needed, if only to govern source-basis taxation in the residence country. But the focus on income attributable to a permanent establishment would diminish the importance of such rules in the case of residence-basis taxation.

Income earned by foreign corporations in a non-control situation—either the corporation is not controlled by any one shareholder or controlling group of shareholders or the residence country taxpayer is not part of the control group—presents a different question. The proposal relating to control situations does not indicate how best to deal with the problem of international double taxation when control is lacking, and that subject is not the focus of this paper. Nevertheless, the subject is so closely related to the case of foreign control that a few observations are warranted.

The case for non-transparency of the corporate form finds support here in an eminently practical consideration—the residence country will not wish to place taxpayers in a position where they may be without sufficient information to comply with the law. That is probably a sufficient basis for general acceptance of the separateness of the non-controlled foreign corporation from its shareholders. On the other hand, if income earned through a non-controlled foreign corporation is not taxed currently to resident shareholders, there will be avoidance possibilities that would justify a regime akin to the U.S. rules relating to passive foreign investment companies.[26]

A greater problem pertains to business profits attributable to permanent establishments. Suppose a residence country taxpayer enters into a joint venture with an independent party from another country to carry on business in corporate form in an exemption jurisdiction that imposes a substantial income tax on earnings of the venture. It might be reasonable to provide for exemption of dividends from such foreign corporations, at least (in a classical system), insofar as *corporate* recipients in the residence country are concerned. Further, there is no obvious justification for a minimum threshold of ownership,

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26. *See* I.R.C. §§ 1291-1298 (1989). The word "akin" is used advisedly. It is hard to imagine a rational residence country intentionally replicating the passive foreign investment rules (PFIC), but there are doubtless simpler ways of targeting non-business income earned through foreign entities.

like ten percent of voting stock as employed in the United States to govern the deemed paid foreign tax credit.[27] In the case of income that would qualify for exemption if earned directly by the resident or through a foreign controlled corporation, the circumstance of non-control is not a reasonable basis for withholding double taxation relief. Nevertheless, exemption would have to be conditioned on availability of sufficient information to allow residence country tax authorities to verify the nature of the income; in the absence of such information, taxation would attach to the dividends received, with a deduction for foreign taxes imposed on the dividends. A direct credit might be considered, but in no event would a deemed paid credit be available; a foreign corporation would not be both separate from its shareholders and not separate at the same time.

To the extent of exemption, whether in a control or non-control situation, expenses incurred by the resident would be denied deductibility based on an appropriate allocation and apportionment to exempt foreign income. This would not be simple, but the allocation and apportionment rules presently in place in the United States, for example, serve an essentially similar purpose.

IV. Pressure Points

When the building blocks are assembled, the resulting system relieves foreign business income from residence-basis taxation, but in the name of alleviating international double taxation, not protecting import neutrality or promoting competitiveness. The system is precise, subject to the scrutiny and control of residence country tax authorities, and flexible. Exemption is afforded to income earned through substantial activities in designated jurisdictions. Other income—passive income not constituting business profits, business profits not attributable to a permanent establishment, income from jurisdictions not designated on the list—is taxed currently, whether earned directly by a resident or through foreign controlled corporations. A direct foreign tax credit for taxes imposed on the resident might be allowed in some of these instances, but the general rule would be deduction only.

27. *See* I.R.C. § 902 (1989).

In such a regime, the foreign tax credit would have relatively little scope for application. The rules relating to transfer pricing also would have reduced importance, particularly if the definition of control is borrowed from the transfer pricing area, though similar rules would be needed to govern the concept of attribution to a permanent establishment. More prominent would be the determination of what is a permanent establishment and what income is business profits. These are concepts that must be applied by countries around the globe in their role as source-basis taxing jurisdictions, and that are relatively familiar from decades of application in an international context.

The result would favor business investment and business earnings in major trading partners of the residence country. There would be no concept of "base companies," and no traps for the unwary in the rules relating to international double taxation. On the other hand, it would be more difficult to use foreign corporations to squirrel away passive income without tax, and there would be no special incentive to retain earnings in foreign corporate solution.

Without doubt there are many fault lines in the proposal, and experience would surely bring these to the attention of tax authorities. Several important issues, however, do not require such experience and can be identified now.

As suggested, rules similar to those that govern transfer pricing would be required to regulate the issue of what income is attributable to a permanent establishment. There does not appear to be any reason, however, why those rules need be any more complex than a transfer pricing regime. In addition, since the system is based on the notion of avoiding international double taxation, it may be possible to build upon the views of the source country, at least to some extent. This should not go so far as a "subject to tax" test, which would tend to embroil residence country tax administrators in the unhappy task of understanding laws of the source country as applied on a case-by-case basis. A lesser standard—for example, a requirement that the taxpayer demonstrate consistency of factual representations in both countries—might not be nearly so difficult to administer. The test would not conclusively establish attribution, but might be a necessary condition for such a claim.

The residence country also would have to address transfers of appreciated property to a permanent establishment in a

country qualifying for exemption. Such transfers should give rise to immediate taxable gain, regardless of whether the asset in question is "purchased" by the permanent establishment. There thus would be a "price" for entering the exemption zone with assets that had acquired value outside it. Alternative approaches would place too much pressure on the question of what is, and what is not, attributable to the permanent establishment. Other conceivable responses to the "transfer in" issue likely would prove dauntingly complex in practice.

The proposal would result in a "misallocation" of tax revenue in some instances, particularly when deductible expenses have been incurred outside the exemption zone and a not yet highly appreciated asset is transferred into that zone. The proposal accepts the resulting misallocation as a fact of life, given the concept of an annual accounting period. Similar mismatches inhere in any system that allows current deductions for expenses, like research and development costs, that produce future value. My inclination would be not to attempt to police the mismatch through detailed rules governing the transfer to the exemption jurisdiction,[28] but instead to rely upon a combination of an immediate tax upon gain and the expected tax in the source country to inhibit transfers having little business purpose.

Finally, perhaps most importantly, the proposal draws a sharp line between designated jurisdictions where exemption could apply and everywhere else. The resulting difference in treatment would place continual pressure upon the residence country to expand its list of exemption jurisdictions. Clearly, not every jurisdiction is either a France or a Cayman Islands. How is the residence country to treat Morocco or Brazil? Hungary? Gabon? Nations have different views about taxation, different capabilities for implementing a tax system, different economic attractions for the resident. Some pressure would be relieved if it was determined to allow a direct foreign tax credit in specific situations, preferably through treaty negotiations. But with every agency in the residence country doubtless viewing itself as a custodian of tax policy, it may be difficult to keep the exemption list to its intended purpose. Nevertheless, there are substantial dangers in loosening the grip. *In concept*

28. *See* I.R.C. § 367 (1988).

the list should include only foreign countries that have full-blown, purposively administered, income tax systems, and which can be trusted, in most cases, to impose tax on persons having a substantial nexus with their soil. That does not necessarily imply a restriction to OECD members (or, for that matter, inclusion of all OECD members), but the criteria for inclusion should be high. It would be strange indeed for a residence country, dubious of its ability to administer such criteria, to opt instead to place all foreign taxing jurisdictions on the same plane and structure its rules for foreign income accordingly.

V. CONCLUSION

There is no way to drain complexity from the regime of a modern capital-exporting country for taxing income of foreign corporations controlled by residents. The history of this subject contains many lessons. But, the lessons are themselves in conflict and ultimately unclear; some do not find concrete expression in existing rules of law. Considerations of economic encouragement or discouragement do not point clearly to any particular solution; and, in any event, the *tendency* of a given rule to induce or discourage certain behavior is often a weak foundation on which to create a superstructure of more detailed rules. What is left, at the end of the day, is the need to deal with international double taxation and to protect the residence country's tax base. The proposals sketched above, involving a limited exemption for business profits attributable to permanent establishments in certain specific foreign countries, aims at these objectives.

Any country—the United States, for instance—having a different set of rules presently in place for taxing the income of foreign controlled corporations would have to address many transitional issues in passing to the proposed regime. The treaty network would have to be studied with a view, eventually, to reworking it to accommodate the proposal. All that is no doubt of great technical and political complexity. But it is a separate subject.

An Initial Observation I

- An international debate is in progress about when and to what extent a tax jurisdiction should have and retain primary jurisdiction to tax manifestations of business income somehow connected with it and when it reasonably should expect other countries to recognize this entitlement by excluding such income from their tax bases or providing credit for tax levied on that income

Viewpoints

Why Not Des Moines?

A Fresh Entry in the Subpart F Debate

by H. David Rosenbloom

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After the 15 July hearings on "U.S. Tax Policy and Its Effect on the International Competitiveness of U.S.-Owned Foreign Operations," U.S. Senate Finance Committee Chairman Charles E. Grassley, R-Iowa, posed the following written questions to witnesses:

> Company X manufactures widgets in the United States for sale in the United States and abroad. It forms a subsidiary, Y, in a zero-tax jurisdiction such as Bermuda to serve as a trading company. Y hires 200 persons in Hamilton. Widgets are sold by X to Y for 100, and Y resells the widgets, without changing them, for 125 to unrelated parties in the United States and the rest of the world. The transfer price from X to Y is defensible. The 25 earned by Y is attributable to economic functions that Y performs in Bermuda. Should the United States tax that 25? Why or why not?

Those are good questions. And this is an excellent way to relaunch a debate on what should be done to, or about, the main U.S. antideferral statute, subpart F of the Internal Revenue Code. The statute clearly shows age. What revisions should be considered in the name of international competitiveness?

The debate needs to be relaunched because, although there has been a great deal of recent discussion about subpart F, much of it has soared above and beyond the ostensible subject. It has approached subpart F from perspectives that are historical and perhaps oxymoronic (what was Congress *really* thinking in 1962?), economic (is capital export neutrality reconcilable with — or preferable to — capital import neutrality?), and philosophical (how can we best advance the cause of global welfare? U.S. welfare?). What happened to practical? That is where the debate should focus, and that is why Chairman Grassley's questions are so good. They portray what is at stake.

The questions imply, fairly, that the subpart F debate is really about tax havens. The statute does not impose a serious impediment to investment in, or income derived from, the high-tax countries that are the locus of most U.S. foreign investment, such as Germany, Japan, and the United Kingdom. An effective rate of 31.51 percent or higher puts income beyond the statute's reach. Subpart F may intrude in those countries at the margin, and perhaps occasionally more deeply, but the overall limitation on the foreign

tax credit goes a long way — some might say too far — to alleviate the pain of residual U.S. tax on income from an active business in Munich.

Some countries are not high-tax countries, but are not tax havens either. My own preference would be to take a benign view of these situations as long as a real tax system is in place. But I must acknowledge, sadly, that my view is not the law, and subpart F can surely have an effect here as well. Nevertheless, the real prize in subpart F "reform" lies in the low- or no-tax countries, the tax havens of the world. U.S. companies would be pleased to be able to establish the sort of structure described in Chairman Grassley's questions — with a slice of the combined income from manufacture and marketing "hived off" to a jurisdiction where taxes are low or nonexistent.

Checking the box to render all foreign affiliates part of one large corporation for U.S. tax purposes does not obviate the branch rule, and although contract manufacturing may sometimes undermine the rule, it also may not.

Of course, the subpart F debate is not really about subpart F as a whole, sections 951 through 964 of the Internal Revenue Code. Those sections represent the most far-reaching of six or seven U.S. regimes (depending on how one counts the passive foreign investment company/qualified electing fund rules) aimed either directly or glancingly at deferral — the nonimposition of current U.S. tax on the foreign income of controlled foreign corporations. No one (I think — I hope) maintains that passive investment income should qualify for deferral, for reasons that are obvious: That income can be earned by anyone and, in the absence of an antideferral statute, can and would be stuffed into a foreign corporation by anyone and everyone. There is room for argument about what income is passive, but in the area where the argument has been most heated — financial services income — powerful lobbies have succeeded (appropriately, in my view) in distinguishing most of their activities as nonpassive and outside the scope of the subpart F regime. It is also true that the statute regards moving funds around within a foreign group as passive, but the check-the-box rules, and particularly their disregarded entity corollary, have made it easy for taxpayers to do as they wish in this regard without interference.

Nor — and I confess to venturing now into areas that derive more from experience than analysis — is the subpart F discussion focused on base company oil-related income, base company shipping income, or even base company services income. No doubt those categories produce their share of aggrieved taxpayers, but the categories are industry-specific (in the case of oil-related and shipping income), applicable to relatively few taxpayers even within the designated industry (oil-related income), or, if broadly applicable, infrequently enforced by the Internal Revenue Service (services).

Finally, for reasons that are unclear, the discussion in recent years has not extended to the aspect of subpart F that seems to operate most effectively — the provision that earnings of a controlled foreign corporation, when invested in the United States, are taxable to U.S. shareholders as if the earnings had been distributed to them.

If much of subpart F has not been the subject of intense and widespread discussion, and a large share of foreign income and investment lies outside the statute's purview, what has the core discussion been about? Sales. The subpart F regime pertaining to foreign base company sales income — income earned by a controlled foreign corporation either buying from or selling to a related person, with both manufacture and consumption outside the country of the CFC's incorporation — retains vibrancy. In the case of products manufactured abroad, this is largely attributable to the "branch rule." Checking the box to render all foreign affiliates part of one large corporation for U.S. tax purposes does not obviate the branch rule, and although contract manufacturing may sometimes undermine the rule, it also may not. The courts — stalwart guardians of international tax principles — will have to tell us. In any event, for products manufactured in the United States with no further manufacture abroad, contract manufacturing will be of no help.

Thus, it seems that the rubber, insofar as subpart F is concerned, hits the road principally in the area of base company sales income. That is why Chairman Grassley's questions resonate. They present a fair view of how prototypical base company sales are made. They are modeled on the facts in *Dupont* (*E.I. Dupont de Nemours & Co. v. United States*, 608 F2nd 445 (Ct.Cl. 1979)), a transfer pricing case involving years before the effective date of subpart F. It cannot seriously be contended that the questions, though simplified, are unrealistic, or that in the absence of subpart F companies would not operate in the way reflected in the questions, or that the questions fail to arrive at the nub of the issues. Under subpart F, the 25 earned by Y is now taxable to X. Without the base company sales rules, this income would be taxable only when repatriated to X in the United States. And that, of course, may be never, for all practical purposes.

It is perhaps wise at this point to spend a couple of sentences on transfer pricing. Most knowledgeable observers believe that this is a malleable subject and that in the absence of the foreign base company sales rules, the 25 earned by Y could easily grow to 50 or more. Presumably that would occur by contriving to situate intangible values and other footloose elements of the manufacturing and marketing cycle in Y. Some, alleging faith in the transfer pricing regime — and, more importantly, in the ability of tax administrators to enforce that regime — say the 25 is overstated and that the real number is closer to 5.

The controversy does not matter much, however. Whatever the transfer pricing rules and however talented those charged with enforcing them, there is a slice of income that will properly reside in the base company. Elimination of the foreign base company rules may not be important if that slice is small enough, but it is hard to believe the transfer pricing regime could ever confine the slice that narrowly.

If that conclusion is right — and the rest of this essay proceeds on the assumption that it is — Chairman Grassley's questions are realistic and fair. Should the United States tax the income that comes to repose in Bermuda? We tax it now. Should we continue to do so? Why or why not? *Any discussion of subpart F or the need for reform that fails to address these questions is not participating in the debate.* The questions are clear. They are realistic. They are central to subpart F. They deserve answers.

Not that the answers are easy. In the first place, the functions that generate income in Bermuda are real. In Chairman Grassley's questions, there are really employees in Hamilton — not likely to be Americans, because Americans generally are not enthusiastic about living and working outside the United States — but nevertheless real employees. There is a slice of income in Bermuda because something significant is occurring in Bermuda.

Secondly, those who argue against subpart F in the name of competitiveness have a point (a better point by far than the one made by those arguing complexity, whose aim would be better trained on the foreign tax credit). Many, possibly all, of our major trading partners would not tax the 25 of income if X was a resident of their countries. In that respect the United States may well treat its multinationals less favorably than competitor nations treat theirs. (Whether it makes sense to compare particular aspects of tax systems while disregarding the overall context in which those aspects fit is a fair question but, because it is hard to answer, one that is generally ignored.) So a company resident in, say, the United Kingdom might be able to establish a base company of the sort described in Chairman Grassley's questions and use that company to reduce worldwide taxation on products sold into Switzerland or Japan. Or, for that matter, the United States.

Although the competitiveness concern is rarely spelled out, presumably it runs something like this: A firm that benefits from tax exemption of a distinct slice of its manufacturing and marketing income is in a position to reduce ultimate prices and garner a greater share of the market. Alternatively, that firm can provide a greater return to investors and enjoy an advantaged position in seeking capital. A firm in a position to achieve either of these goals is likely to fare better than competitors. And that conclusion holds not only when firms are competing in foreign markets, but also when the competition takes place in the United States.

Allowing exemption to domestic companies engaged in base company activities would appear to represent not only a logical but a necessary extension.

Advocates for terminating deferral thus have a long hill to climb. They must defend taxation of the 25 in Chairman Grassley's questions in the face of evidence that other countries would not impose tax in parallel circumstances and the argument — if not perhaps incontrovertible proof — that Y will be able to justify the 25 under a transfer pricing analysis only if it is performing real economic functions. Those advocates attempt to climb that hill on the basis of policy goals that range from protecting the U.S. tax base to backstopping the transfer pricing regime, to preventing the loss of U.S. jobs, to avoiding the creation of incentives that favor foreign investment over investment at home.

This rapid and truncated recitation of the policy arguments against deferral is not intended to denigrate those arguments. They are powerful and deserve thorough consideration. The discussion of subpart F has consisted for the most part of weighing those arguments against the competitiveness concern — the notion that tolerance of base companies implies undesirable exemption for income that would otherwise be subject to current U.S. taxation against the threat to U.S. competitiveness of taxing income of the base company under an antideferral regime.

The policy arguments might be blunted to some extent if it could be shown that the exempted income would not otherwise be earned in the United

States. It may be that, with subpart F in place, the income is now assigned to the country of sale, not the country of manufacture. On the other hand, it seems reasonable to believe that elimination of the foreign base company rules would attract at least some activity either from the United States or otherwise subject to current U.S. taxation into the low-tax jurisdiction. Is that consequence not implicit in the argument that subpart F interferes with competitiveness — that competitors are able to achieve exemption for income that, when earned by U.S. controlled companies is subject to U.S. taxation?

In any event, assuming that competitiveness requires that a slice of income — however defined, however measured — be exempted from U.S. taxation, the next inquiry is why that exemption should be available only when economic functions are carried on outside the United States. Proponents of a change to subpart F argue only for that. They would rescind the foreign base company rules and allow the Duponts of the world to recur to the use of those companies, with a slice of income coming to rest in a low-tax jurisdiction, just as in Chairman Grassley's questions.

Why, however, should U.S. companies be required to situate economic functions abroad to achieve a desirable result? It is hardly obvious that there is a national interest in providing an otherwise justifiable tax benefit only when U.S. persons operate through foreign investment and a foreign corporation. If exemption is warranted, why stop with abolition of the foreign base company rules? U.S. companies are allegedly encountering serious competitiveness problems that arguably deserve a solution — but why is it the right solution to exempt income from operations in Hamilton? Why only Hamilton? Or Singapore? Or Nassau? Or Zug? Why not Des Moines?

Assuming an exemption for base company income is justified by a competitiveness concern, there would be less distortion in our tax system if the slice of income accruing to the base company could be earned without U.S. taxation regardless of whether the base company is foreign or domestic. That would answer the charge that U.S. tax policy is driving jobs out of the country, and it is hard to see how proponents of competitiveness could object it. Indeed, because the competitiveness argument applies to sales into the United States and sales from the United States for consumption abroad, allowing exemption to domestic companies engaged in base company activities would appear to represent not only a logical but a necessary extension.

So here is the concept: exemption not only for foreign but for domestic base companies, corporations incorporated in the United States that buy a product from or sell it to related parties. To parallel the reach of subpart F, the exemption should extend to situations involving manufacture or ultimate sale (but possibly not both) in the United States, since subpart F does not reach income from manufacture or sale in the country of incorporation. The middleman function would thus qualify for U.S. nontaxation, wherever it is located. It is true that the contours of that function might be expected to vary by industry and, indeed, with the creativity of each affected company, but none of this is dramatically different from the situation of foreign base companies. If foreign companies qualify for the exemption, why should similar domestic companies not also qualify? This would further national goals (nondistortion, U.S. employment) while doing no violence to the goal of subpart F reformers to bring the statute into the 21st century.

And so I ask again: Why not Des Moines? ✦

Throw Territorial Taxation From the Train

by Edward D. Kleinbard

Edward D. Kleinbard makes the case against a territorial taxation regime.

Throw Territorial Taxation From the Train

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This report reviews the case for replacing the Internal Revenue Code's complex rules for taxing foreign direct investment with a territorial tax system. The report acknowledges that a territorial system offers one unambiguous advantage over current law, which is that it removes U.S. tax frictions on repatriating foreign profits. The report argues, however, that a territorial tax system would vastly exacerbate cross-border transfer pricing problems by rewarding successful transfer pricing gamers as "instant winners" of the tax lottery. In light of the overwhelming evidence of pervasive transfer pricing problems today, Kleinbard argues that this alone is sufficient reason not to move to a territorial tax system. Kleinbard also argues that other purported advantages of territorial systems, including simplicity and a more competitive tax environment for U.S. multinationals, are overstated.

Kleinbard believes a "full-inclusion" tax system also would eliminate the tax frictions on repatriating foreign earnings, and would genuinely be simpler than current law (in contrast to a territorial tax system). Importantly, he further argues, U.S.-based multinationals would have little reason to pursue aggressive transfer pricing tax strategies in a full-inclusion environment (again in contrast to a territorial tax system). Without more, however, a full- inclusion solution would be profoundly anti-competitive. Kleinbard shows how his business enterprise income tax proposal (first discussed in *Tax Notes,* Jan. 3, 2005, p. 97) addresses the competitiveness problems of a full-inclusion system, in large measure by enabling the tax rate imposed on U.S. firms to be substantially reduced and the foreign tax credit rules to be simplified.

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I. Introduction

Territorial income tax systems are designed to exempt the "active" income of a U.S. firm's foreign branches or foreign subsidiaries from U.S. income tax when that income is repatriated to the United States. Territorial tax proposals are the current darling of many international tax reform recommendations, including those made in late 2005 by the President's Advisory Panel on Federal Tax Reform.[1]

This report advances three related arguments regarding the taxation of foreign direct investments by U.S. firms. The first is that territorial income tax proposals are a terrible idea. Once the actual implementing rules of a realistic territorial tax system are understood, territoriality cannot be recommended, even on the grounds advanced by that idea's proponents.

The report's second argument is that a *properly constructed* implementation of a "full-inclusion" income tax system for outbound investments (that is, an income tax that imposes current U.S. residual tax on income earned by a U.S. firm's foreign branches or subsidiaries, regardless of whether that income is "active" or "passive") can be pro-competitive, economically neutral in application, and infinitely more administrable than a territorial tax system. A properly constructed income tax satisfies four conditions: Its statutory tax rates are close to the low end of the range of rates employed by the major trading partners of the United States; it permits firms to claim foreign tax credits to the greatest extent compatible with protecting the fisc from the erosion of the domestic tax base; it permits the deductibility of foreign losses with no more restrictions than are imposed on the use of domestic losses; and it does not prefer outbound portfolio investment to outbound direct investment (or vice versa) by effectively imposing (for example) a "deferral regime" on one and a "full-inclusion system" on the other.

The third argument advanced by this report is that just such a properly constructed full-inclusion tax system has already been proposed. It is the business enterprise income tax, or BEIT -- a comprehensive business income tax reform proposal that I first presented in an article published in January 2005 and have continuously refined since then.[2]

To this author's infinite dismay, many readers of this report will not yet be familiar with the BEIT. Part II therefore takes matters out of order by quickly summarizing the BEIT's basic features. Part III then returns to the logical flow of the presentation by describing why the United States should not adopt a territorial tax system. Finally, Part IV demonstrates how the BEIT (in particular), or a more modestly overhauled version of the current income tax (as a second best), advances competitiveness, economic neutrality, and sound tax administration regarding foreign direct investment.

Two other introductory matters need to be addressed. First, for the avoidance of doubt, the arguments that follow are not a disguised attack on big business, multinational enterprises, or the pursuit of money. To

the contrary, the BEIT is intended to advance the competitiveness of American businesses and the economic neutrality of the tax system, thereby eliminating many distortions that the current income tax system introduces into commercial and financial decisionmaking.[3]

Second, this report advocates a full-inclusion tax system for foreign direct investment by *all* U.S. firms, as part of the larger overall restructuring of the U.S. system for taxing business enterprises and business capital outlined below. In the absence of that sensible development, all active income of U.S. firms should be treated consistently, which is to say that income should be eligible for deferral. In particular, there is no justification for singling out the active international income of U.S.-based financial service firms for a more punitive tax regime than that enjoyed by the rest of the U.S. economy. Accordingly, while it is to be hoped that the BEIT becomes law, if fundamental business tax reform were not to occur, the case for making the "active financing exception" of section 954(h) and 954(c)(2)(ii) permanent would be persuasive, both as a matter of fairness and to prevent distortions in cross-industry investment over time.

II. The BEIT in a Nutshell

The business enterprise income tax's individual proposals comprise an integrated package of reforms that rely on traditional income tax concepts but produce a more efficient and neutral system for taxing the returns to capital invested in private businesses. This part summarizes the BEIT's principal operating rules. The papers cited in note 2 describe the reasoning behind the rules and compare the BEIT with other income tax reform packages, particularly Treasury's 1992 "comprehensive business income tax" (CBIT) proposal.

A. Overview

The BEIT superficially resembles the current corporate income tax, but the underlying architecture has been completely overhauled. The result is a tax system that is economically neutral (returns to capital are burdened consistently) and that has much lower corporate (now "business enterprise") tax rates than current law's 35 percent corporate rate. The working hypothesis is that the new business enterprise tax rate can be in the range of 25 percent to 28 percent and that the system can remain revenue neutral compared with current law.

The BEIT abandons current law's multiple and frequently elective tax regimes (each turning on largely formal differences from the others) with a single set of tax rules for each stage of a business enterprise's life cycle:

1. Choosing the form of business enterprise.

2. Capitalizing the enterprise.

3. Selling or acquiring business assets or business enterprises.

As a result, under the BEIT, every form of business enterprise - - sole proprietorship, partnership, or corporation -- is taxed identically and every investor in a business enterprise is taxed identically on his investments, regardless of the label placed on an instrument as debt, or equity, or anything else. The BEIT thus moves the income taxation of business enterprises closer to the ideal of a *featureless tax topography* -- an environment in which there are as few special tax rules, exceptions to those rules, and antiavoidance glosses on the exceptions to the rules as is practical.

The centerpiece of the BEIT is a *comprehensive* and *coordinated* system for taxing time value of money returns, through the BEIT's cost of capital allowance (COCA) system. Under the COCA regime, a business enterprise deducts a time value of money return on all capital invested in its business (whether denominated as debt or equity) and investors include in income every year a time value of money return on their

investments in financial capital (regardless of cash receipts). Investor-level calculations are based on an investor's cost basis in an instrument and thus do not require mark-to-market valuations or other financial information beyond simple arithmetic. The COCA system relies on the BEIT's other operating rules as a platform from which to apply the COCA calculations.

The fundamental theme of the COCA system (in conjunction with the BEIT's other rules) is to tax "economic rents" (the supersized returns attributable to unique commercial ideas or market positions) and risky returns entirely (or nearly so) at the business enterprise level and to tax time value of money returns once (and only once) at the investor level. The COCA system thus achieves both *integration* (that is, the elimination of double tax on corporate profits) and a consistent and accurate measure of income.

B. Specific Rules

The following bullets describe the principal components of the BEIT as applied to large business enterprises. (There are special rules for small businesses not summarized here.)[4]

- Taxation of all business enterprises, regardless of form (for example, sole proprietorships, partnerships, or corporations), as separate taxable entities. Entrepreneurs thus are free to choose whatever form of business organization they wish, but that choice has no collateral tax consequences. The basic tax system looks much like today's corporate income tax, in that the entity tax roughly follows current rules for taxing corporations, subject to the major modifications described below. Also, investors are taxed under the new COCA system on their investment returns. The BEIT thus preserves a two-level tax system, which minimizes transition revaluations of financial assets. The two levels of tax, however, are for the first time coordinated and integrated.
- Substantially lower enterprise-level tax rates (working hypothesis: 25 percent to 28 percent) than the current corporate income tax rate (35 percent).
- Broadening of the business tax base by reforming some important but technical business tax accounting rules and industry-specific preferences (for example: last-in, first-out inventory accounting; like-kind exchanges; or percentage depletion). The largest base-broadening component, however, is the COCA system for taxing returns on investment, as described below.
- Adoption of the COCA system for taxing time value of money returns to investors and deducting the cost of capital by issuers. The basic theme of the COCA system (in conjunction with all the other rules described below) is to tax economic rents and risky returns at the business enterprise level and to tax time value of money returns on a current basis at the investor level. The critical difference between COCA and current law is that COCA taxes investors on a current basis on an expected time value of money return on *all* forms of financial capital invested in businesses, whether called debt or equity, without regard to cash receipts. That current income inclusion is determined by straightforward arithmetic, not observed market valuations for assets. The COCA system is described in a bit more detail a few paragraphs below.
- Mandatory "super tax consolidation" for affiliated enterprises. (All subsidiaries are treated as part of the parent company, as in financial accounting, rather than the hodgepodge consolidated return tax rules we have today.) Consolidation in general would be measured at the 50 percent level and would be measured by reference to all of a company's long-term financial instruments (with tiebreaker rules to prevent multiple consolidations). The rule both eliminates substantial complexity and serves as a foundation for the COCA system.
- As described in more detail in Part IV, the extension of the "super-consolidation" rules to international income. As a result, the BEIT eliminates the "deferral" of active foreign income from current U.S. tax.[5] (The BEIT in this respect is the perfect mirror image of a territorial system.) At the same time, the BEIT contemplates (1) eliminating the allocation of U.S. interest expense (now COCA deductions) against foreign income -- the principal source of "excess FTC" problems for U.S. multinationals -- and (2) lowering the tax rate on global income. Finally, global super-consolidation also means that foreign losses will become currently deductible in the United States, thereby restoring neutrality to the U.S. tax analysis of foreign direct investments.

- Repeal of all tax-free organization/reorganization rules, and their replacement with a much simpler "tax-neutral" acquisition system in which *all* acquisitions of business assets or business enterprises --- basically, all incorporation transactions, or all entries to or exits from a super-consolidated group --- are treated as taxable asset acquisitions. The seller's tax rate, however, differs across the different asset classes that it transfers, depending on the present value to a taxpaying buyer of the step-up in the tax basis of the various assets acquired. The result, from the point of view of the tax system as a whole, is close to that of entirely tax-free transfers (at least at the business enterprise level), but with important technical and administrative advantages.

The COCA system is the centerpiece of the BEIT's ability to measure and tax returns to capital, but the COCA cannot be implemented in a logical fashion without the other reforms summarized above. Nonetheless, because of the COCA's central role, it is useful to outline how it would be implemented.

An investor's COCA income calculation for a year is simply the relevant rate of return for the year (as published by the IRS) multiplied by the taxpayer's tax basis in his financial investments.[6] That amount -- termed the minimum inclusion -- is includable in income regardless of whether it is paid currently by the issuer to the investor. Cash received from the issuer is tax-free to the extent of current or prior minimum inclusion accruals. The COCA rate will be published regularly by the IRS (just as the applicable federal rate is today) and will be set by reference to the one-year Treasury note rate (for example, one-year Treasuries plus 1 percent).

In the COCA environment, issuers deduct each year, in lieu of current law's interest deductions, a uniform cost of capital allowance equal to the same COCA rate multiplied by the aggregate tax basis of their assets. Thus, an equity-funded issuer obtains exactly the same COCA deduction as does a debt-funded issuer, regardless of the coupons paid on its financial capital.

Under the COCA system, losses from sales of financial assets are currently deductible against ordinary income (to the extent of prior time value of money inclusions on those assets). The result is a more economically neutral investment environment than that provided by current law's capital loss limitation rules.

As currently contemplated, the COCA system would impose a *small* (10 percent to 15 percent) additional tax on an investor's gains beyond time value of money returns. That incremental tax is not compelled by the logic of the system, but rather is suggested in response to traditional fairness and ability-to-pay concerns.

Depreciation methods are unaffected by the COCA system, but the interaction of the COCA rules and depreciation at the business enterprise level has the effect of neutralizing the present value to the government of a firm's tax obligations regarding the capitalization/depreciation methods that it might employ: Faster depreciation means less remaining tax basis in business assets and smaller COCA deductions for the future.

While the COCA system does require some record keeping and arithmetic, it is feasible, in ways that "accruals" (universal mark-to-market) taxation and other ideal systems are not. The COCA's allocation of the incidence of tax between investors and issuers is technically superior to Treasury's 1992 CBIT proposal to tax all time value of money returns solely at the business enterprise level.[7]

The COCA system is intended to coexist with broad savings incentives similar to current law and the President's Advisory Panel on Federal Tax Reform's proposals. As a result, the COCA system adds progressivity to the tax code because its burden falls on only the wealthiest taxpayers (as the only taxpayers with significant financial investments not sheltered by tax-deferred savings plans).

III. Why U.S. Should Reject Territorial Tax Solutions

A. Practical Implementations of Territoriality

Territorial tax systems seek to exempt from U.S. income tax the active foreign income of branches or subsidiaries of U.S. firms when that income is repatriated to the United States. Three principal reasons usually are advanced for preferring a territorial tax system as the basis for taxing the international income of U.S.-based multinationals. First, by exempting foreign income from any incremental U.S. taxation, territorial solutions are said to improve the international competitiveness of U.S. firms.[8] Second, territorial systems are said to promote goals of economic neutrality, in particular by eliminating current law's bias in favor of keeping low-taxed foreign income offshore, rather than repatriating it, simply to avoid incremental U.S. repatriation tax costs.[9] Third, territorial tax solutions are thought to be simpler than current law because, in particular, they do away with the FTC in respect of active foreign income.[10]

A practical territorial tax system requires several design elements that critically affect the validity of those claims. First, there appears to be a consensus among tax theorists that a territorial solution in practice would apply only to active foreign income; as the price for exemption from U.S. tax, that active income of course would not bring with it an FTC for any non-U.S. taxes that burdened that income.[11] Active foreign losses would not offset domestic taxable income; that is, in effect, the mirror image of domestic exemption for active foreign income.[12] Interest, royalties, or other deductible flows paid by a foreign affiliate to its U.S. parent would be fully taxable in the United States because that income would not have been subject to foreign tax. Further, current law's subpart F regime generally would be retained for passive/mobile income.[13] The FTC system in turn would apply as it does today for any such nonexempt income.

One important implementation issue that is not explicitly discussed in most of the literature is what the treatment should be for "stripping" payments (deductible interest or royalties, for example) paid by one foreign affiliate of a U.S. firm to another foreign affiliate.[14] Thus, if a German subsidiary pays royalties to an Irish sister company for the use of intangible assets owned by the Irish company, and those payments reduce German (high- tax) active foreign income, should the receipt of that deductible flow in (low-tax) Ireland be treated as active income or instead as passive/mobile income that is ineligible for the territorial regime? Until the adoption of section 954(c)(6) a few months ago, the answer under current law would have been that the Irish affiliate's income was subpart F income.[15] Today, section 954(c)(6) would treat the income as retaining the active income character that it had in the hands of the German payor -- at least for the three years that section 954(c)(6) is scheduled to apply. So one could say that recent tax policy points in every possible direction on this critically important question that goes to the heart of the utility and fairness of a territorial tax system.

Finally, most territorial tax systems that have been seriously studied in the United States to date have included a provision to allocate interest expense incurred in the United States, and in some cases other classes of domestic expenses, against foreign "exempt" income (which, of course, is not necessarily exempt in a global sense and which may in fact have borne foreign tax at rates as high as or higher than the U.S. rate).[16] Most commentators agree that some sort of sensible interest expense allocation rule, or some comparable provision (for example, an efficacious "thin capitalization rule" that would prevent the overleveraging of U.S. operations), unquestionably is required in the context of a territorial foreign tax system to protect the *domestic* tax base. In the absence of such a rule, analysts fear that U.S. firms would overleverage their U.S. operations to the point where they "zeroed out" their U.S. tax liability on their domestic operations and would service that debt with tax-exempt (from the perspective of the United States) foreign-source income.[17]

That last concern demonstrates in turn the critical importance of the treatment of interaffiliate stripping transactions, as described above. If one is confident that foreign income will bear a tax burden comparable to that of the United States, the case for domestic interest expense allocation rules becomes more attenuated. Conversely, if one believes that foreign-to-foreign income stripping to reduce foreign tax burdens is appropriate, the need to protect the domestic tax base becomes more urgent. (Of course, if one believes that foreign tax rates are highly likely to be comparable to those of the United States, one can

fairly question the need to adopt a territorial tax system at all, as doing so would not reduce tax burdens or in practice significantly change repatriation policies.)

The remainder of this part demonstrates that practical implementations of territorial tax systems are anything but simple. For example, as described above, territorial tax systems in practice inescapably require two parallel tax regimes, one comprising current law (for passive/mobile income) and the other the territorial scheme. With those two parallel regimes come difficult coordination and line- drawing issues. Similarly, territorial tax systems are usually scored as revenue generators once ancillary expense allocation or comparable rules are considered. And while it is true that a territorial tax system removes current law's distorting effects on firm repatriation policies, the irony is that so too does a full-inclusion system. At the same time, territorial tax schemes introduce important new distortions, of which the most important by far is the pressure those schemes put on our transfer pricing systems. The next sections therefore turn to transfer pricing and its relationship to the choice of a foreign direct investment tax regime.

B. The Critical Importance of Transfer Pricing

Transfer pricing issues (that is, efforts by firms, whether U.S. or foreign-based, to reduce their U.S. tax liabilities by shifting U.S. profits to low-taxed non-U.S. affiliates) are the most important challenge today to the administration of the international tax provisions of the code. That observation is consistent as an anecdotal matter with the issues that many practitioners see in their practices.[18] More usefully, that observation also is consistent with objective data.

The IRS now confronts transfer pricing cases involving staggering sums of money. For example, the IRS recently announced the settlement of a tax case against Glaxo- SmithKline in which the pharmaceutical company agreed to pay the IRS $3.4 billion (including interest) for tax deficiencies relating to a 12-year period (and concurrently agreed to abandon a $1.8 billion tax refund claim), all as a result of its transfer pricing practices.[19] Similarly, Merck & Co. recently revealed that it is contesting similar transfer pricing (and other) cases, in which the tax claims against it by the IRS and the Canadian tax administration total some $5.6 billion.

In a recent and sophisticated paper, Dr. Harry Grubert of the Treasury Department and Prof. Rosanne Altshuler of Rutgers University (and formerly on the staff of the President's Advisory Panel on Federal Tax Reform) considered in detail the role of intangibles in cross-border transfer pricing.[20] Paraphrasing the work of this academic study (hopefully without excessive violence to the authors' intent), Grubert and Altshuler concluded that:

- The exportation of intangible assets has been a "significant source" of foreign direct investment income; royalties and license fee income received by U.S. companies *tripled* from 1990 to 2004.[21]
- At the same time, royalties paid by foreign subsidiaries to U.S. parent companies "represent *less than half* of the contribution that parent R&D makes to subsidiary income."[22]
- The data suggest that low-tax countries "are becoming much more important destinations for U.S.-produced intangible assets"; in this connection, "the share of total affiliate royalties accounted for by Ireland and Singapore doubled between 1994 and 1999."[23]
- "Pre-tax profits in relation to sales are almost three times higher in Ireland on average than the group mean. These 'excess' profits presumably reflect the fact that very valuable intellectual property is located in Ireland and the royalties paid back to the United States, while significant, do not fully reflect its contribution."[24]

A recent economic analysis by Martin Sullivan reaches similar conclusions.[25] Sullivan concludes, for example, that while foreign affiliates of U.S. multinationals in the aggregate earned a 7.2 percent return on sales in 2004, Irish subsidiaries had more than twice that profitability -- 14.8 percent. By contrast, the unweighted average of the returns on sales realized by subsidiaries in Europe's larger economies was much lower than the all-countries aggregate figure -- roughly 4.2 percent.[26]

An important *Wall Street Journal* article from November 2005 gives life to those dry statistics by describing in detail Microsoft's use of "cost-sharing agreements" with an Irish subsidiary to develop and exploit Microsoft's core intellectual property.[27] According to that article, Round Island One, Microsoft's intellectual property holding company in Ireland, earned nearly $9 billion in gross profits in 2004, and roughly $2.4 billion in taxable income, by exploiting intangible assets to which it acquired ownership by virtue of its cost-sharing agreements with its U.S. parent.[28]

To be clear, I do not mean to suggest that Microsoft's arrangements with its Irish subsidiary violate the requirements of the extensive arm's-length transfer pricing regulations governing cost-sharing agreements. That is the purpose of the IRS examination process, to which I am a complete outsider. I do think it fair, however, to point to *The Wall Street Journal* article and the academic paper discussed above to illustrate the magnitude of the intangible property transfer pricing issue and its importance to tax administration.

I also believe it fair to draw from all of the above the inference that the IRS is shouldering a near-impossible burden in that area, for two reasons. First, the accurate valuation by outsiders of intangible assets like Microsoft's proprietary "crown jewel" software is nearly impossible, because the assets themselves are incredibly complex and because in practice genuinely comparable third-party transactions almost never exist. (That is, major software companies rarely enter into cost-sharing agreements with third parties to develop new versions of their crown jewel intangible assets.) Yet the arm's-length transfer pricing cost- sharing regulations require just such an inquiry, to measure "buy-in" payments for the existing intangible assets that form the basis for a cost-sharing agreement.[29]

Second, the entire premise of our transfer pricing rules -- that related parties should deal with each other for tax purposes at the prices and on the terms at which third parties would engage in comparable transactions -- is unachievable, particularly when applied to high-value intangible assets held by multinational enterprises. There is abundant literature to support the proposition that multinational enterprises thrive in the world economy precisely because the economy is increasingly global and because multinational enterprises can muster *tightly integrated* global resources to take advantage of that fact.[30] The paradigmatic example of the integrated global strategies of modern multinational enterprises, of course, is the worldwide exploitation of a common pool of high- value intangible assets.

Arm's-length transfer pricing tends to deny (or perhaps misallocate) the synergies that flow directly from the globally integrated activities that explain the success of multinational enterprises in the first place. As applied to intangible assets, arm's-length transfer pricing requires us to pretend that a multinational group does not in practice control a single common pool of intangible assets with worldwide application, but rather comprises essentially independent enterprises negotiating with each other as if trade barriers to the direct global exploitation of those intangible assets still existed.[31]

As a result, the arm's-length transfer pricing principle at its core presupposes a business model that is fundamentally inconsistent with the business strategies of multinational enterprises that possess high-value and globally relevant intangible assets. When the tax model that we have created is so fundamentally agonistic to business realities, the administration of the tax system can never be wholly successful.

C. Territoriality and Transfer Pricing

Changing to a territorial tax system would greatly exacerbate the importance of transfer pricing issues. The reason is simple. Under current law, the principal "reward" for successfully gaming our transfer pricing rules is the accumulation of profits in a foreign subsidiary, presumably located in a low-tax jurisdiction.[32] To collect that reward, however, a U.S. firm must keep those earnings offshore indefinitely. *Territorial tax systems, by contrast, reward successful transfer pricing gamers as "instant winners"* by enabling the successful U.S. firm to recycle immediately its offshore profits as tax-exempt dividends paid to the U.S. parent.[33]

That concern is widely shared, and has been identified as a topic of concern by the staff of the Joint Committee on Taxation and other authors who have described or proposed possible territorial tax systems.[34] The principal difference between my views and the views of these other observers is that they typically conclude that the administration of our existing arm's-length transfer pricing rules simply will require greater vigilance in a territorial tax system.[35] By contrast, I believe that it is unrealistic to expect that enhanced administration can ever adequately address the transfer pricing challenge that modern tightly integrated multinational enterprises possessing high-value intangible assets would pose to a territorial tax system.

D. Competitiveness and Economic Neutrality

In recent years, many observers have described how the rapid evolution of the global economy has compelled U.S. tax policymakers to become increasingly sensitive to issues of international competitiveness. For example, Glenn Hubbard, the dean of the Columbia Business School and former chair of the president's Council of Economic Advisers, recently testified before the House Ways and Means Committee on precisely that topic. Hubbard identified several important themes relating to the changing competitive landscape in his testimony, including the increasingly integrated nature of the global economy, the enormous rise in international capital flows (which include cross-border portfolio investments), and the shift over the last several decades from the United States' role as the world's largest exporter of capital to its current status as the world's largest capital importer.[36]

Hubbard rightly draws from these facts the conclusion that U.S. international tax policy norms from, say, 1962, do not necessarily serve the interests of the United States in 2006. The same underlying questions remain relevant, however: What principles should we in fact adopt as our international tax policy norms in the new world economy? And how can we measure different tax proposals against those norms?

It is the traditional practice in discussions of international tax policy choices to begin to address those questions by laying out the principle of "capital export neutrality" -- that a U.S. multinational firm should face the same tax burden on a new investment wherever in the world that investment might be made -- and the principle of "capital import neutrality" -- that a U.S. multinational firm should bear the same tax when competing in a foreign market as its local competitors face.[37] To those can be added at least two other widely discussed "neutralities" - - "national neutrality" and "capital ownership neutrality."[38]

The traditional discussion then goes on to demonstrate that it is not fully possible to satisfy both capital export neutrality and capital import neutrality simultaneously in the real world.[39] At the same time, most analysts acknowledge that, all other things being equal, maintaining capital export neutrality would be desirable, and, by the same token, so would maintaining capital import neutrality. Finally, every traditional discussion concludes by asserting that whatever policy is being proposed represents a fair balancing between those two irreconcilable objectives, in every case based largely on the author's preexisting intentions. No wonder our international tax policy is muddled!

In a refreshing break from that familiar presentation, Grubert and Altshuler implicitly conclude that the traditional "Battle of the Neutralities" (as I term the process) is an essentially sterile exercise that by itself cannot usefully guide tax policymakers in shaping the international tax policy norms of the United States.[40] Instead, they urge policymakers to focus on the *behavioral distortions* among taxpayers (and, to a lesser extent, governments) that flow from current law and to evaluate reform proposals by reference to their success in mitigating the distortions:

What reform within an income tax can hope to accomplish is to eliminate unnecessary waste and the possibility of extremely high or low tax burdens that are not justified under any standard. Then we can at least be sure that we are moving toward the optimum without overshooting it and running the risk of making things worse.

International tax systems can act on many behavioral margins in addition to the choice of location. The current tax system induces a number of behavioral responses that both waste resources and lead to inappropriate incentives to invest tangible and intangible capital in various locations. These include strategies to avoid the U.S. repatriation tax on dividends, to shift debt from high-tax to low-tax locations, and to shift income to low-tax locations by distorting transfer prices or paying inadequate royalties. Besides directly wasting resources, these strategies can lead to inefficient choices between related party and arms' length transaction and a distribution of tangible and intangible assets that cannot be justified on any conceptual basis.

In our evaluation of the distortions that may be eliminated by some of the reform proposals, we focus on how the proposals affect (1) the location of tangible capital, (2) the location of intangible capital, (3) the repatriation decision, (4) financing decisions, (5) income shifting, (6) incentives to lower foreign tax burdens, (7) export decisions and (8) host government decisions regarding the taxation of U.S. companies.[41]

I submit that reviewing the effect of current law or any tax reform proposal on the eight criteria listed immediately above is a far more productive exercise than continuing the sterile "Battle of the Neutralities" that has dominated much of the policy discussion to date.

It also unfortunately follows from the above that it is absolutely necessary in evaluating any international tax reform proposal to wade into the technical details of how that proposal will be implemented. That is, it turns out that an international tax reform proposal must be *specified* and *analyzed* in detail, if one is to predict with any degree of accuracy how the behaviors of differently situated taxpayers will be affected by the proposal, and, therefore, what distortions in economic activity might follow.[42]

E. Consequences of Territorial Systems

This section considers the economic and competitiveness consequences of adopting a practical territorial tax system for taxing foreign direct investment. It turns out that when one applies the metrics proposed in the previous section to realistic implementations of territorial systems, the analysis becomes surprisingly complex and the answers not at all intuitive.

A territorial tax system unquestionably would reduce distortions inherent in the current code in one important respect, which is that it would eliminate the barriers to repatriation that current law imposes. As observed earlier, a U.S. firm today must "earn" the tax benefit of deferral through patiently deploying its active foreign profits outside the United States, even if the highest and best use of those funds would be in a domestic application.[43] As a result, current law encourages the wasteful accumulation of profits abroad, and in some cases the wasteful investment of those profits in the expansion or acquisition of "active" businesses, solely to preserve the continuing benefits of deferral. A territorial tax system eliminates tax considerations from the repatriation decision and therefore removes this significant economic distortion of current law.

Many advocates of territorial tax systems also believe it to be self-evident that territoriality will enhance the competitiveness of U.S. firms by eliminating residual U.S. income tax. Those proponents view territorial tax systems as the paradigmatic implementation of capital import neutrality themes. The revenue implications of practical territorial tax systems, however, are more ambiguous than those advocates might expect.

In January 2005 the JCT staff proposed a comprehensive territorial tax system, described as a "dividend exemption system."[44] The JCT staff estimated that its territorial system would *raise* $55 billion in tax revenue over 10 years. It is difficult to describe that proposal as self-evidently enhancing the competitiveness of U.S.-based multinational firms if by that phrase one means a *reduction* in total tax burden imposed on the income of U.S. multinationals.

Later in 2005, the President's Advisory Panel on Federal Tax Reform proposed a system similar in broad outline to the JCT staff proposal, although with some differences in detail (particularly regarding expense allocation rules).[45] No official revenue estimate accompanied that proposal. Most recently, Grubert and Altshuler concluded that switching to a territorial system would generate a small revenue gain, but that the revenue estimate was critically sensitive to possible behavioral responses that are difficult to model.[46] Their paper also summarizes earlier work that concluded that a territorial tax system would significantly *increase* the tax burden on investments in low-taxed foreign subsidiaries.[47]

There are two principal factors at work behind those surprisingly effective tax rate results. The first factor is the conclusion reached by the JCT staff and others that a territorial tax system must be accompanied by interest expense allocation rules modeled on current law, as described in Part III.A, with the result that interest expense allocated to tax-exempt income would not be deductible.

The second principal reason why a territorial tax system can raise effective tax rates in some cases is that it eliminates a taxpayer's ability under current law to average down high-taxed foreign income with zero-taxed foreign royalty income (or low-taxed affiliate income). I liken the process to a master distiller blending a perfect tax liqueur, in which the blended product bears tax at precisely 35 percent, so that no residual U.S. tax is due and no excess credits are generated.

More specifically, every territorial tax system that has been seriously studied in the United States would *not* exempt from tax royalty or interest income paid by a foreign subsidiary to its U.S. parent, on the theory that those amounts were deductible abroad and that exempting them from U.S. tax thus would result in those amounts bearing tax nowhere in the world. Under current law, a U.S. parent company's stream of royalty or interest receipts from its foreign subsidiaries nominally constitutes taxable income, but in fact the actual tax liability on those amounts is largely sheltered by the tax "master blender" at each company, who brings up sufficient high-taxed income from other foreign operations to shelter those income streams.

In a territorial system, by contrast, the royalty and interest income would be fully includable in income without offset for any tax credits attributable to exempt income. As a result, a firm's cask of exempt high-taxed income could not be blended with liqueur from a low-taxed cask in a way that would reduce the effective tax rate on the former.

It is for those sorts of reasons, I believe, that Stephen Shay, in his 2006 testimony before the Ways and Means Committee on the theme of international competitiveness, suggested that U.S. multinationals today actually enjoy the best of all worlds.[48] In a similar vein, the National Foreign Trade Council in 2002 undertook a comprehensive review of territorial tax proposals on behalf of a wide range of U.S. multinational firms. That study concluded that the evidence did *not* unambiguously support the claim that a territorial tax system would enhance competitiveness:

While it is true that a territorial system could improve competitiveness and simplicity for some U.S.-based companies with substantial operations abroad, the accompanying reduction in foreign tax credits attributable to exempt income could more than offset that benefit for other such companies. Moreover, the benefit for any significant group of companies would be dependent on the adoption of a broad exemption, a cut back on the existing subpart F rules, and reform of the current expense allocation rules.[49]

It is ironic that some proponents of territoriality may be unaware that the current system often can be used to optimize a U.S. firm's global tax liabilities in ways that a territorial system cannot.[50] Similarly, those proponents might not appreciate the complex and ambiguous effects of a well-designed territorial tax system (that is, one with proper expense allocations or other mechanisms to safeguard the domestic tax base) on a U.S. multinational firm's worldwide effective tax burden.

The previous paragraphs acknowledged that a territorial tax system would eliminate the behavioral distortions attendant on current law's repatriation tax burdens. The probable effect of a well-designed territorial tax system on effective tax rates, however, is not unambiguously pro-competitive, as that term

ordinarily is employed. At the same time, a territorial tax system can exacerbate (or create novel) economic distortions, compared with those that exist under current law. Most importantly, a territorial tax system will encourage multinational firms to express increased enthusiasm for aggressive transfer pricing strategies (particularly relating to high-value intangibles), for the reasons described in Part II.C.[51] Because that topic already has been addressed, the remainder of this section considers some other, less obvious, economic distortions that accompany practical territorial tax systems.

First, a territorial system can be expected to impose radically different tax burdens on the international income of different U.S. industries, largely as a result of different industry norms for debt- to-equity ratios,[52] different levels of reliance on separately identifiable intangible assets (as opposed to goodwill and the like), and different rates of adopting tax-preferred methods of developing global intangibles. For example, if a territorial tax system includes an interest expense disallowance rule modeled on current law's FTC rules allocating domestic interest expense against foreign-source income, U.S. financial services firms (with their high debt-to-equity ratios) will be disadvantaged compared with other industries that are primarily equity funded. Similarly, territorial systems will reward those firms or industries that were early and aggressive adopters of cost-sharing agreements with their foreign subsidiaries, because they will be able to capture the returns of those non-U.S. intangibles as exempt income.

Second, an important potential source of economic distortion is that tax policy can distort investment by portfolio investors as well as direct investors. One example of that phenomenon is the tax-driven differences in the relative attractiveness for a U.S. investor of making a portfolio investment in a U.S. multinational firm (which in turn makes foreign direct investments), compared with making such investments in a foreign-domiciled multinational. The same issue can also arise from the perspective of a foreign portfolio investor considering the same two investments, or a U.S. multinational corporation considering a foreign portfolio as opposed to a foreign direct investment, or even a U.S. portfolio investor considering investing in U.S. multinational firms as opposed to U.S. domestically oriented businesses. In light of the enormous surge in global capital flows, the increased transparency and liquidity of many foreign capital markets, and the ease of global research through online tools, it is absolutely imperative that U.S. international tax policy consider any tax reform proposal's potential for distorting those portfolio investment decisions.[53]

As envisioned by the JCT staff, a territorial tax system would not directly distort portfolio investment decisions between U.S. and foreign portfolio investment opportunities, although of course the ultimate effective tax rates imposed on different firms or different industries in a particular implementation of territoriality might do so. Territoriality would, however, distort the decision to make a portfolio investment rather than a direct investment, because the former (at least in many proposed implementations) would be subject to full double taxation, while a direct investment would not.[54]

The territorial proposal made by the President's Advisory Panel on Federal Tax Reform would introduce still another particularly dramatic economic distortion for portfolio investors, because of the peculiar way in which the panel chose to combine its territorial tax proposal with domestic relief from the double taxation of dividends. Essentially, when viewed from the perspective of the ultimate owners of a business enterprise, the panel's proposal would have dramatically preferred portfolio investment in domestically oriented U.S. firms over portfolio investment in U.S.-based multinational enterprises that bore precisely the same effective global tax rate.

More specifically, the panel's "simplified income tax" (SIT) proposal, apparently following the (erroneous) logic of Treasury's 1992 CBIT proposal, would have imposed a sort of compensatory tax when a U.S. company paid dividends to its U.S. shareholders out of exempt foreign earnings.[55] The result would have been a significantly anticompetitive step backwards for U.S. multinationals in respect of their cost of equity capital.[56] In that respect, then, the panel's SIT proposal would have introduced a distortive double tax on foreign income.

For example, imagine two U.S. corporations, Domestico and Globalco. Domestico earns $100 pretax, entirely from U.S. operations; Globalco also earns $100 pretax, but entirely from operations in Freedonia. Both companies are entirely equity funded.

Under the panel's SIT, Domestico pays $31.50 in tax on its $100 income. Domestico then can distribute the remaining $69.50 to its shareholders as an exempt dividend.

Globalco, by serendipity, also pays $31.50 in income tax on its $100 income, but Globalco makes out the check for its tax payment to the Freedonia IRS. Globalco can repatriate its $69.50 of after- Freedonian-tax profits to the United States, but when it distributes that amount to its U.S. shareholders they will be subject to full ordinary income tax on the distribution, while their brethren who invested in Domestico keep the same $69.50 distribution free of any tax.

A third potential new distortion again relates to the role of income stripping transactions, in their broadest sense. At least some proponents of a territorial tax system use "competitiveness" as a code word for "the lowest possible tax on foreign income that can legally be devised." One can fairly ask, however, whether competitiveness in that sense is truly nondistortive or whether instead a less distorting goal might be to design a tax system that would enable a U.S. firm to compete against local firms in their domestic markets at an effective tax burden that is directly comparable to that faced by those local firms.

Those two thoughts are not identical. We all understand the importance of "check the box" disregarded entities, hybrid instruments, and hybrid entities in U.S. international tax planning today. The difficult question that deserves more debate is whether, if a U.S. firm can employ those arrangements to drive its effective tax rate on its Freedonian operations *below* the rate imposed in law and in practice by Freedonia on its domestic companies, we should applaud that result as enhancing competitiveness or instead decry the result as distorting investment decisions.

That point can be generalized by observing that territorial tax systems in practice inevitably bring with them the prospect of "stateless income" -- income that is taxed nowhere in the world (or, at least, taxed at extremely low rates in a country where the income is not earned). Stateless income is not simply an artifact of transfer pricing abuses, but also arises from decisions as to where to place financial capital within a multinational group (so as to generate interest expense in a high-tax country and offsetting income in a very-low-tax jurisdiction), differences in implementation of different tax systems, hybrid instruments, and hybrid entities. All territorial tax systems struggle with the issue of stateless income.[57]

For example, if a territorial system permits a deductible payment paid by one foreign affiliate out of its exempt income to retain its exempt character when paid to another foreign affiliate, that system will encourage -- indeed, impel -- taxpayers to use affiliate interest, rents, and royalties to strip out earnings from the countries in which that income economically is earned. That leads directly to the phenomenon of stateless income. Conversely, treating all such income as "passive" (and therefore as immediately taxable in the United States) will be criticized as undercutting the purpose of a territorial system. The conflict inevitably will lead both to difficult technical issues (for example, layering rules for determining from which income a deductible interaffiliate expense is paid) and to a political tug of war identical to that which has bedeviled subpart F of the code, as reflected in its various "same country" exceptions, the recent adoption of the temporary provisions of section 954(c)(6), and the even more recent passage by the House of Representatives of a bill to scale back some of the provisions of section 954(c)(6).[58]

The problem of stateless income is not an abstract academic concern. Recent European Court of Justice jurisprudence, for example, suggests that it is becoming difficult for one European Union member state to tax (through subpart F analogies or the like) the income of a subsidiary in another member state, or to protect its tax base from widespread income stripping within the EU (by imposing withholding tax on outbound deductible payments or imposing thin capitalization rules on foreign investments only).[59] The effect of those developments, if combined with a U.S. territorial tax system that treats interaffiliate deductible payments made out of exempt income as retaining its exempt character, would be to ensure that

a large fraction of the income earned by many U.S. multinational groups in the EU would be taxed at no greater rate than that imposed by whichever member state had the lowest rates.[60]

Finally, territorial tax systems are distortive in one unassailable respect, which is that they would bring with them substantial deadweight losses in the form of compliance and similar costs. *A territorial tax system is simpler than current law only in the imaginations of those who have never immersed themselves in the detailed implementation of either.*

More specifically, as described in Part III.A, every territorial tax system that has been seriously proposed in the United States would retain a subpart F construct for passive and mobile income.[61] That subpart F income in turn would be entitled to FTCs, so that all the complexities of current law would be replicated, except that the new system would stimulate new taxpayer impulses, which in turn would require new antiabuse rules.[62] In particular, because FTCs would be useless when attributable to exempt active income, but would remain valuable if allocated against subpart F income, elaborate policing mechanisms (which admittedly exist in more rudimentary form today) would be required to ensure that advanced tax planning tactics could not be used to cause tax credits to migrate (from a U.S. perspective) from active (exempt) income to subpart F income.

Today, subpart F income means the unavailability of deferral; tomorrow, categorizing revenue as subpart F income would mean that the revenue would move from wholly exempt to immediately taxable status. The result would be even greater stress on the divide between active (exempt) income and subpart F income than exists under current law.[63] Similarly, the U.S. law on the "source" of income (and many losses or expenses) is relatively undeveloped, compared with other areas of the code. Those concepts would become critical, however, in defining and policing the scope of a territorial tax system.

IV. 'Full-Inclusion' but Pro-Competitive

A. Transfer Pricing and Repatriation Neutrality

In direct contrast to current law, or to a territorial tax system, a "full-inclusion" U.S. international tax system would greatly attenuate the role of transfer pricing strategies by U.S. multinationals as an affirmative taxpayer device to minimize global tax liability, because all income earned by a U.S. multinational group would be taxed by the United States on a current basis.[64] As a result, any remaining transfer pricing issues for U.S. multinationals would relate primarily to conflicting positions that might be taken by different taxing jurisdictions. A U.S. multinational corporation ordinarily would be a disinterested bystander to any such disputes, except in the limited case in which the foreign jurisdiction's tax rates greatly exceed those of the United States.[65]

In practice, a full-inclusion U.S. international tax system will not eliminate transfer pricing cases involving U.S. multinationals, but it will elevate (or at least relocate) those cases to direct negotiations between affected tax administrations, rather then serial negotiations between a taxpayer and those tax administrations. It is my hypothesis that, with little or no money of its own at risk, a U.S.-based multinational will be both less ingenious in its internal transfer pricing strategies and more forthcoming in dealing with the IRS. By elevating the debate to one between tax administrations, a full-inclusion system also will increase the likelihood that all affected tax administrations will work from a common understanding of the facts and that 100 percent of the taxpayer's income -- neither more nor less -- will be accounted for.

Because a full-inclusion system would materially dampen current law's incentives for multinational corporations to embrace transfer pricing strategies with excessive enthusiasm, such a system would remove significant tax-induced distortions in corporate behavior attributable to transfer pricing gamesmanship. The data marshaled by Grubert and Altshuler and in other academic papers are just too powerful to ignore: It cannot simply be the luck of the Irish, for example, that explains the extraordinary and systematic

profitability of Irish subsidiaries of U.S. firms. A full-inclusion tax model is the only approach that directly addresses this critical problem.

Of course, a full-inclusion U.S. tax system does not eliminate the incentives of *foreign*-owned multinationals to engage in U.S. tax transfer pricing planning, as the recent example of GlaxoSmithKline, described in Part III, illustrates. But, by enabling the IRS to concentrate nearly all of its transfer pricing resources on inbound investments by foreign multinationals, the full-inclusion system would indirectly improve compliance in that direction as well.

"Repealing deferral" also would enhance competitiveness directly in the same important respect that adopting a territorial tax system would, which is that without deferral, U.S. firms' repatriation policies would reflect the highest and best use of their cash surpluses, rather than tax rate arbitrage. Ironically, the most unambiguous economic argument for adopting a territorial tax system - - the elimination of tax considerations in firms' decisions whether to repatriate offshore profits -- is a feature that territoriality shares with its mirror image, a full-inclusion system.

A full-inclusion system also would eliminate the distortions attendant on policing the boundaries of a territorial tax policy. As described in Part III, the serious proposals for territorial tax systems for the United States suspend the availability of the FTC for exempt (active) income, but preserve the FTC, and all its attendant limitations, exceptions, and qualifications, for subpart F (passive) income. That requires drawing clear lines between the two categories of income, as well as even more elaborate mechanisms than exist under current law to ensure that uncreditable foreign taxes associated with active (exempt) income do not, through advanced tax planning, migrate over to a taxpayer's subpart F income (where those taxes would become valuable as credits). By dispensing with the sharp demarcation between exempt (active) and subpart F (passive) income, full- inclusion systems eliminate the need to police the border between uncreditable foreign taxes associated with exempt income and creditable foreign taxes associated with subpart F income.

Notwithstanding these attractive features of any full-inclusion system, simply "repealing deferral" by itself is likely to be profoundly noncompetitive. First, current U.S. corporate income tax rates are much too high, relative to those of our important trading partners.[66] Second, without modification, our current FTC system, and in particular its interest expense allocation rules, would leave too many companies with "excess" FTCs, which in this context means that their global effective tax burden would be even higher than the (too high) nominal U.S. corporate tax rate. Third, most proposals to repeal deferral have been inconsistent with the economic neutrality that the proposal purports to espouse, in that the repeal of deferral is not accompanied by an ability on the part of the U.S. parent to deduct losses incurred by foreign operations.[67] Fourth, proposals to end deferral for direct investments ordinarily drive a wedge between the tax burden imposed on direct investments and the burdens imposed on portfolio investment, because the latter means of employing capital in a foreign business would still enjoy the benefits of deferral.

While it follows from the above that simply repealing deferral would be anticompetitive, it remains the case that a full-inclusion system, like a territorial system, would eliminate current law's important distorting effects on firms' repatriation decisions. Full- inclusion systems also dampen the incentives found in current law (which would be *exacerbated* by territorial tax systems) for multinational corporations to engage in overenthusiastic transfer pricing strategies. And finally, the adoption of a full-inclusion system would eliminate current law's incentives for U.S. multinationals to game the boundary between exempt and subpart F income and to cause the migration of high effective foreign tax rates to subpart F income, all for the purpose of minimizing global tax liabilities.

In light of those attractive elements of a full-inclusion system, the intriguing question is, can a full-inclusion system be designed that retains those desirable features, but is pro- competitive as well? I believe that a review of how the BEIT would apply to outbound investments demonstrates that the question can be answered in the affirmative.

B. Application of BEIT to Outbound Investment

From an internationalist's perspective, the BEIT can be seen in large measure as the perfect mirror image of a territorial system. The international aspects of the BEIT begin with the "super tax" consolidation described in Part II, above. That idea is intended to apply globally. As a result, the BEIT treats foreign subsidiaries as if they were branches. The most obvious consequence of that, of course, is the end of deferral (and with it, the need to maintain rules to distinguish between active income and subpart F income). Another immediate consequence is to vastly attenuate the relevance to the United States of transfer pricing issues for outbound investments, for the reasons already described. Global consolidation also means that foreign losses will be deductible in the United States as those losses are incurred, thereby restoring true neutrality in application when compared to current law, and to many proposals over the years to "end deferral."

The BEIT divides all investments in business enterprises into two categories: controlling interests (which trigger the super- consolidation rules referenced earlier) and other interests (which give rise to current taxable income, through the minimum inclusion mechanism). As a result, current law's concept of a controlled foreign corporation that is controlled by, say, three unrelated U.S. investors in equal proportions would no longer exist. Similarly, the hope is that current law's passive foreign investment company rules also would no longer be required. In each case, investors will include annually their minimum inclusion amounts (without regard to cash distributions), just as they would with investments in U.S. firms.

Without more, the BEIT's international aspects could fairly be described as economically neutral regarding transfer pricing, repatriation decisions, and the location of risky investments, but probably on balance still anticompetitive. The BEIT contains two other critical design elements, however, that revise that calculus to yield a system that fair-minded business people should agree is pro- competitive. The first, and most important, is *lower tax rates* -- as mentioned above, 28 percent is the goal, but 25 percent (if affordable) would be even better -- financed through systematic base broadening.[68] The second design element is the repeal of the allocation of domestic interest expense (now COCA) expense deductions against foreign income for purposes of calculating a U.S. business enterprise's allowable FTC for its international operations, for the reasons described below.

As previously described, sensible territorial tax proposals must incorporate an interest expense allocation system (or some equally painful alternative, such as an efficacious thin capitalization regime). The reason, of course, is that the failure to do so would mean that territoriality would quickly lead to a zeroing out of the U.S. *domestic* business tax base, by borrowing money (and deducting the resulting interest expense) domestically and supporting the attendant interest deductions with exempt cash flows from equity- financed foreign investments.

The BEIT abandons interest expense (now COCA expense) allocations for two reasons. First, by virtue of the "true" consolidation of foreign income, there is no income that is exempt or indefinitely deferred anywhere in the BEIT system. As a result, there is no urgent need to protect the U.S. tax base by ensuring that domestic interest expense is not ultimately serviced from deferred or exempt income.

The second, and ultimately more powerful, reason why domestic COCA expense need not be allocated against foreign income under the BEIT is that the purpose of the COCA deduction in the BEIT is different from today's interest expense deduction. In the BEIT, the COCA deduction exists to achieve a form of business enterprise- investor *integration* and applies across the board to all forms of financial capital invested in a business. As such, the COCA deduction is not an "expense"; it is an income allocation device.

If we were to imagine that all business enterprises were 100 percent equity funded, we would not spend much time worrying about allocating the (nonexistent) cost of capital deductions. The COCA result is the same in theory (but superior in many practical respects) to a world in which all interest expense is disallowed or in which (to put things in today's perspective) all firms are 100 percent equity funded. Accordingly, given that under the BEIT we have neither exempt nor deferred income and that we also have

implemented an integrated tax system, there is no convincing reason to treat the device by which we achieve that integration as if it were an old- fashioned interest expense deduction.[69]

I previously observed that portfolio investments have taken on a larger role in cross-border financial flows in recent years. A tax system that produces radically different results for portfolio investments by U.S. households in foreign companies as compared with portfolio investments in U.S. business enterprises (which in turn make foreign direct investments) will prove not to be stable. One important question in that calculus is how to deal with foreign income when distributed by a U.S. business enterprise to its domestic investors.[70]

The BEIT addresses those issues differently than do other proposals. As described in Part II, full consolidation combined with the COCA deduction/inclusion system basically works to tax economic rents and risky returns at the business enterprise level, and time value returns at the investor level. The COCA component of the BEIT achieves neutrality between U.S. portfolio investors investing in either U.S.-based multinational firms or foreign-based firms -- between, say, investing in Exxon or investing in British Petroleum -- by the simple expedient of applying its investor minimum inclusion rules (current inclusion of time value of money returns, regardless of cash distributions) to portfolio investments in foreign companies, just as those new rules apply to domestic portfolio investments. Finally, the BEIT achieves source neutrality at the level of U.S. portfolio investors in U.S. firms with foreign income by not discriminating (through compensatory taxes or otherwise) against different source of enterprise-level earnings when ultimately received by investors.

This report does not generally address the BEIT's approach to taxing inbound investment into the United States, but the above discussion points to an advantage that the BEIT offers in dealing with inversion transactions, or more generally with the phenomenon of new business enterprises being organized as offshore companies for the purpose of shielding foreign direct investments from the reach of U.S. net income tax. Under the BEIT, U.S. portfolio investors will be taxed currently on time value of money returns on their investments through the minimum inclusion mechanism. As a result, organizing a new business enterprise outside the United States will not reduce the immediate U.S. tax burden on U.S. portfolio investors in that enterprise. Of course, the minimum inclusion device does not address the tax savings that might follow (and ultimately be enjoyed by U.S. investors) at the business enterprise level regarding the new enterprise's non-U.S. income if the average tax rate on that income is lower than the U.S. business enterprise rate. (By the same token, the BEIT does not create the problem either. It exists today in an even more dramatic form.) The answer here lies in rethinking the definition of a business enterprise's residence[71] and in the withholding tax burdens that might be imposed under the BEIT for distributions from a U.S. subsidiary to a tax-haven parent company.

The BEIT also attempts to introduce some rough tax neutrality between majority and minority investments by U.S. multinationals in foreign joint ventures. The BEIT's super-consolidation rules are meant to apply to majority-owned affiliates, which would mean, for example, that the income derived by a 51 percent-owned foreign joint venture would be taxed in its entirety by the United States.[72] By contrast, the income earned by a minority-owned foreign joint venture that did not conduct business in the United States would not be subject to U.S. net income tax. Under the BEIT, however, the U.S. multinational investor would be required to include in income each year its minimum inclusion (time value of money) amounts, regardless of cash distributions, as well as any excess distributions it might receive. That rule erodes, at least to some modest extent, current law's cliff effect, in which majority-owned joint ventures are subject to subpart F, and minority-owned ones are not.

Grubert and Altshuler review the economic theory and revenue effect of the international aspects of the BEIT (which their paper -- no doubt sensibly -- renames the "burden neutral" international proposal). They conclude that the BEIT's super- consolidation approach to taxing international investment (along with retention of the FTC system but abandonment of interest expense allocation) "seems to dominate" both current law and territorial tax proposals as a matter of theory.[73] Moreover, they provide some encouraging news about tax rates. To be clear, Grubert and Altshuler do not offer a revenue estimate for the BEIT as a whole. But they do estimate that, if the super-consolidation/FTC provisions described above were grafted

onto current law, the tax rate imposed on the international income of U.S. corporations could come down to 28 percent and the BEIT's international provisions would still be revenue neutral compared with current law.[74]

The principal criticism that can be leveled against the international provisions of the BEIT -- or, indeed, of any full- inclusion system -- is that the system can distort at the margin international investments by U.S. business enterprises. If foreign tax rates are materially lower than those of the United States, it is argued that U.S. firms would have no great incentive to minimize their foreign tax burden. Conversely, if tax rates are very high in a foreign jurisdiction, a U.S. firm at the margin would have an incentive to "average down" its effective foreign tax rate by making its next investment in a low-taxed jurisdiction.[75]

The first objection to a full-inclusion system -- the indifference to actual foreign tax liabilities, if the aggregate effective foreign tax rate is materially lower than that of the United States -- is substantially undercut in a world where the U.S. corporate tax rate has been repositioned at the low end of the rates imposed by the major world economies. That, of course, is a key component of the implementation of the BEIT. Moreover, we have today regulations in our FTC systems that prohibit the crediting of "voluntary" taxes, and, more importantly, so-called soak-up taxes.[76] Those rules in fact work reasonably well. As a result, the United States is largely the beneficiary of a "free rider" phenomenon, in which local firms can be expected to lobby for lower local tax rates, which local subsidiaries of U.S. firms also will enjoy.

The BEIT responds to the second objection to any full-inclusion system -- that, at the margin, a U.S. firm might have an incentive to invest in a very low-tax jurisdiction to average down its overall foreign tax rate to the amount allowable as a credit in the United States -- by eliminating the allocation of U.S. interest expense (now COCA) deductions against foreign income for FTC purposes, for the reasons described above. Current law's interest expense allocation rules are necessary in our deferral system, but they also are the principal source of "excess" FTC problems, and, with them, the incentive for U.S. firms to average down their FTC systems.

Despite the above rebuttals, I acknowledge that even a well- implemented full-inclusion system brings with it the theoretical possibility of some distortions to investment behavior, particularly if U.S. tax rates are so low as to leave many U.S. firms in excess credit positions, even in a world without interest (COCA) expense allocation for FTC purposes.[77] Ultimately, policymakers will not be able to choose a perfect international tax system -- that cannot exist in a world of many sovereign nations with different rates -- but they can endeavor to adopt the least distortive practical design. A territorial tax system brings with it two problems that, for all the reasons described above, are insuperable at a practical level: the policing of transfer pricing and the policing of the divide between active (exempt) and passive (currently taxable) income.[78] Against those overwhelming problems, the objection to a well-designed full-inclusion system -- that it might encourage a firm to invest real capital in a location that makes little business sense, to average down its aggregate foreign tax rate to the U.S. rate -- seems, to this practitioner at least, a remote and speculative concern.

A further potential objection to a full-inclusion system is that it could raise complicated transition issues.[79] That objection, however, could be leveled at any serious modification to the current regime, and many commentators have emphasized the need for altering the international tax rules.[80] My proposal is thus premised on the growing consensus that change is necessary, and with change comes the cost of transition.[81]

Finally, the problem of stateless income (described above in Part III.E), which has become both more urgent and more obvious in recent years, explains my response to another criticism that might be leveled against the particular implementation of a full-inclusion system that I advocate, which is that it is different from the tax systems employed in the other major capital exporting countries. The major European capital exporting countries, in particular, can fairly be said to be in a state of crisis regarding their own territorial tax systems, as a result of the ECJ's approach to the intersection of EU member state cross-border investment rules and EU constitutional concerns.[82] That is an area in which I believe the United States

could lead by example. The result would be both conformity to a new norm and a sharp reduction in stateless income, which is another way to get to a playing field that is fair as well as level.

FOOTNOTES

[1] President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (Nov. 2005), *available at* http://www.taxreformpanel.gov/final-report/ (hereinafter Tax Reform Panel Report).

[2] I presented the bare-bones outline of the BEIT in "The Business Enterprise Income Tax: A Prospectus," *Tax Notes*, Jan. 3, 2005, p. 97 (hereinafter BEIT Prospectus). That outline was expanded in some respects in a presentation made to the President's Advisory Panel on Federal Tax Reform, *available online at* http://www.taxreformpanel.gov/meetings/meeting-05_11-12_2005.shtml (hereinafter BEIT Presentation). Finally, an explanation of the conceptual underpinnings of the BEIT, titled "Designing an Income Tax on Capital," was presented at the Brookings Institution in Sept. 2005 and is scheduled to appear in a volume to be published in 2007 containing the papers from that conference.

[3] The BEIT is an income tax, and therefore by definition accepts one distortion that consumption taxes are designed to eliminate, which is the distortion attendant on taxing future consumption financed through savings more heavily than current consumption. In practice, that distortion will have no effect on the lives or savings of most Americans because the BEIT is intended to coexist with tax-deferred savings plans of the sort embodied in current law or in the recommendations of the President's Advisory Panel on Federal Tax Reform. As a result, under the BEIT the only savings that will be materially burdened by current taxation will be those of the wealthiest Americans because they are the only taxpayers with significant savings that exceed those sheltered by tax-deferred savings plans. The author, at least, believes that the resulting additional progressivity to the individual income tax is consistent with political ideals and practical revenue constraints.

[4] There are also special rules for financial services firms, under which those institutions basically are taxed on a mark- to-market basis (for liabilities as well as assets). *See* BEIT Prospectus, *supra* note 2, at 103-105.

[5] Repeal of the current deferral regime has been recommended before, for example, by Robert J. Peroni, J. Clifton Fleming Jr., and Stephen E. Shay. *See* Peroni, Fleming, and Shay, "Getting Serious About Curtailing Deferral of U.S. Tax on Foreign Source Income," 52 *SMU L. Rev*. 455, 507-519 (1999). They proposed a "passthrough" approach, under which each U.S. person owning stock in a foreign corporation would be required to include currently a pro rata share of the corporation's gross income and expenses in computing its own U.S. tax liability. A U.S. investor also would be permitted to deduct a pro rata share of the foreign corporation's losses, up to the amount of the shareholder's basis of its investment in the stock of the foreign corporation.

When applied to a wholly owned foreign subsidiary, the results reached under the Peroni-Fleming-Shay model would be roughly similar to those obtained under the BEIT. Even in this circumstance, however, there are important differences between the two recommendations. For example, the Peroni-Fleming-Shay approach limits loss use to a U.S. person's tax basis in its investment. Similarly, the Peroni-Fleming- Shay model does not contemplate revising the U.S. interest expense allocation rules for FTC purposes (as does the BEIT in respect of its replacement for interest expense deductions, the cost of capital allowance or COCA).

As applied to minority investments in a foreign corporation, the Peroni-Fleming-Shay model and the BEIT diverge more sharply, because the former applies its passthrough model to all U.S. investors, while the BEIT taxes noncontrolling U.S. shareholders in a foreign company in the same manner that they would be taxed regarding a noncontrolling domestic investment. The BEIT thus attempts to achieve neutrality in

result across domestic and foreign minority investments. The BEIT also is more straightforward to apply for minority investors because it does not require a minority investor to have any knowledge concerning its pro rata share of the foreign company's results.

[6] Special rules not described here ensure that COCA works seamlessly with financial derivatives. *See* BEIT Prospectus, *supra* note 2, at 105-106.

[7] A potential political weakness of the BEIT system is that, at least in its idealized form, the BEIT would explicitly tax current tax-exempt investors on their time value of money returns, but not on excess returns. CBIT also would have currently taxed tax- exempt investors, but would have done so indirectly. A practical implementation of the BEIT is expected to modulate this ideal result.

[8] *See* Testimony of Dean R. Glenn Hubbard, Impact of International Tax Reform on U.S. Competitiveness: Hearings Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, 109th Cong. (2006) (hereinafter Hubbard Testimony) (encouraging policymakers to review "fundamental reforms like a territorial system, with a view to removing biases [in the U.S. international tax system] against the ability of U.S. multinationals to compete globally").

Interestingly, however, the most sophisticated analyses have argued that, by virtue of (1) eliminating the FTC blending strategies described later in this report and (2) disallowing U.S. interest expense allocable to exempt income, a territorial tax system might actually *raise* total taxes on income derived from very-low-taxed jurisdictions. Rosanne Altshuler and Harry Grubert, "Where Will They Go If We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations," 54 *Nat'l Tax J.* 787 (2001). *See also* Part III.E.

[9] *See generally* Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., "Repatriation Taxes and Dividend Distributions," 54 *Nat'l Tax J.* 829 (2001) (finding that repatriation taxes generate annual efficiency losses equal to 2.5 percent of dividends).

For an economic analysis of the changed incentives created through the elimination of a repatriation tax, see generally Rosanne Altshuler and Harry Grubert, "Repatriation Taxes, Repatriation Strategies and Multinational Financial Policy," 87 *J. Pub. Econ.* 73 (2003) (working with a model of a parent and its low-tax affiliate).

[10] *See* staff of the Joint Committee on Taxation, "The Impact of International Tax Reform: Background and Selected Issues Relating to U.S. International Tax Rules and the Competitiveness of U.S. Businesses," JCX-22-06, *Doc 2006- 12053* [**PDF**], *2006 TNT 120-17* Link, at 5 (June 21, 2006). *See also* American Bar Association, "Report of the Task Force on International Tax Reform," 59 *Tax Law.* 649, 786 (2006) (hereinafter ABA Report) ("Irrespective of one's views regarding the broader issues relating to deferral, there is a consensus regarding both the high cost of compliance with, and the ineffectiveness of many parts of, the subpart F rules. As such, the current rules may be viewed as the worst of all worlds: avoidable, but only with significant transaction costs.").

[11] Michael J. Graetz and Paul W. Oosterhuis, "Structuring an Exemption System for Foreign Income of U.S. Corporations," 54 *Nat'l Tax J.* 771, 774 (2001).

[12] Harry Grubert, "Enacting Dividend Exemption and Tax Revenue," 54 *Nat'l Tax J.* 811, 814 (2001).

[13] Graetz and Oosterhuis, *supra* note 11, at 776- 778. *See also* ABA Report, *supra* note 10, at 673 (advocating the modernization of subpart F "if the exemption proposals of either the Joint Committee Staff or the President's Advisory Panel were adopted, since each would retain the subpart F regime").

[14] For example, Harry Grubert and John Mutti contemplate that "the current anti-abuse regime that applies to controlled foreign corporations [that is, subpart F] . . . would also continue in force." Grubert and Mutti, *Taxing International Business Income: Dividend Exemption Versus the Current System* 9 (2001), The AEI Press *available at* http://www.aei.org/docLib/20021130_71546.pdf. This thought could be read as implicitly incorporating all of current law's treatment of related-party interest and royalties (ex-section 954(c)(6)), or it could be read as signaling that the authors simply did not expressly consider the issue.

[15] The IRC contains rules that exempt from the reach of subpart F some "active" royalty income. Those rules require that the foreign affiliate that owns the intangibles in question have developed or added significant value to the intangible, or, in the case of marketing intangibles, have provided substantial services in connection with marketing the product in question. Section 954(c)(2)(A); reg. section 1.954-2(d).

Those exceptions from subpart F do not apply to royalties received from corporate affiliates, other than affiliates that employ the intangibles in question in the country in which the licensor is incorporated. However, royalties paid by a foreign affiliate that itself is treated as a disregarded entity owned by the licensor under the check-the-box rules of reg. section 301.7701-3 do not give rise to income in the United States sense at all, even though those payments are treated as real for foreign tax purposes.

Moreover, in some cases profits from high-value intangibles can readily be converted from royalty streams into operating income beyond the reach of subpart F. Thus, at the cost of building a highly automated manufacturing facility or CD-ROM pressing plant, a foreign subsidiary located in Ireland (for example) could exploit intangibles owned by it in respect of pharmaceuticals or computer software as sales of physical goods, which sales in turn would fall outside of subpart F.

Grubert, *supra* note 12, at 816, attempts to model the revenue impact of the expected migration of royalty streams paid to a U.S. parent as a result of a switch to a territorial system. He does not appear explicitly to break out the separate effect of a change in systems on the behavior of foreign subsidiaries holding high-value intangibles.

[16] Grubert, *supra* note 12, at 814. The interest expense allocation proposals in particular typically apply "worldwide" fungibility principles (as developed in the American Jobs Creation Act of 2004), thereby avoiding the logical errors of prior law's "water's-edge approach," Daniel N. Shaviro, "Does More Sophisticated Mean Better? A Critique of Alternative Approaches to Sourcing the Interest Expense of U.S. Multinationals," 54 *Tax L. Rev.* 353 (2001), but even worldwide fungibility can be criticized as significantly imperfect because it does not treat foreign currency translation losses as, in effect, a component of worldwide interest expense.

[17] Similar arguments have been made regarding other U.S. domestic expenses (for example, "head office" general and administrative expenses, or domestic research and development expenditures), but there is less of a consensus on how those expenses should be treated.

[18] *See* ABA Report, *supra* note 10, at 716 (saying that the current U.S. tax rules encourage "using transfer pricing to shift additional income to foreign corporations subject to low effective tax rates").

[19] IRS News Release IR-2006-142, *Doc 2006-19012* [**PDF**], *2006 TNT 176-6* Link (Sept. 11, 2006).

[20] Harry Grubert and Rosanne Altshuler, "Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income," presented at the Baker Institute for Public Policy on Apr. 27, 2006, *available at* http://bakerinstitute.org/Pubs/conferences/2006_tax_007.pdf (hereinafter Grubert and Altshuler).

[21] *Id.* at 9.

[22] *Id.* at 10 (emphasis added).

[23] *Id.* at 18.

[24] *Id.* at 26.

[25] Martin A. Sullivan, "A Challenge to Conventional International Tax Wisdom," *Tax Notes*, Dec. 11, 2006, p. 951, *Doc 2006-24455 [***PDF***], 2006 TNT 238-6* Link.

[26] *Id.* The percentage figure in the text is the unweighted average of the returns on sales for subsidiaries located in France, Germany, Italy, the Netherlands, Spain, and the United Kingdom.

[27] Glenn R. Simpson, "Irish Subsidiary Lets Microsoft Slash Taxes in U.S. and Europe," *The Wall Street Journal*, Nov. 7, 2005, at A1.

[28] I derived the latter figure by grossing up Round Island's reported tax liability to Ireland of $300 million at the Irish tax rate of 12.5 percent. I ignored in this calculation the $17 million that *The Wall Street Journal* reported that Round Island paid in tax to other European countries (presumably through withholding taxes). If, as I believe to be the case, those payments were creditable in Ireland, Round Island's taxable income actually would have slightly exceeded $2.5 billion in 2004.

[29] *See* reg. section 1.482-7(g)(1)-(7) (establishing rules for "buy-in" payments for preexisting intangible property). It is unusual for a cost-sharing agreement to be an entirely "greenfields" arrangement in which neither party contributes existing intangibles to the project.

Cost-sharing agreements can also be criticized as based on a false premise, which is that each party to the agreement bears the financial risk of the costs it has agreed to shoulder. That premise might be valid in the case of third-party arrangements, but is fundamentally not credible when applied to a U.S. parent and its foreign subsidiary: The subsidiary's "risk" is the parent's risk, and the former's capital comes from (or at the sufferance of) the latter. The combination of such an intragroup cost-sharing agreement and territorial tax systems in practice thus reduces to the U.S. parent's agreement to forgo U.S. tax deductions for a specified fraction of its global development costs, in exchange for obtaining an exemption from U.S. tax for the same percentage of its worldwide income derived from the intangibles covered by the agreement.

[30] *See*, in this regard, Hubbard Testimony, *supra* note 8 ("Multinationals are an intrinsic part of global integration because they represent an alternative means by which nations conduct cross-border transactions. That is, the economic costs of production, transportation, distribution, and final sale may be lower [if] conducted within a single firm than via a series of market transactions. Accordingly, the rise in global integration carries along with [it] an increased volume of transactions for which multinationals have a particular advantage.").

[31] *See* reg. section 1.482-1(b)(1) (stating that a "controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result)"). It is true, of course, that, whether under existing Treasury regulations or by virtue of multilateral advance pricing agreements, intercompany tax transfer pricing arrangements for intangibles or services often rely on various "profit split" methods. Those methods may have the indirect effect of allocating (or misallocating) the benefits of groupwide synergies, but do not do so explicitly, and in any event are not universally required under the "best method" approach. *See* reg. section 1.482-1(c)(1) ("The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others.").

[32] Also, a U.S. parent company can employ a related strategy, under which it shelters from U.S. tax the zero-taxed royalty income from foreign subsidiaries paid to the U.S. parent company (and thereby not subject to deferral) with FTCs arising from repatriating very-high-taxed operating income from other foreign subsidiaries. Grubert and Altshuler describe that strategy in detail; their paper estimates that in 2000, royalties received by U.S. parent companies amounted to roughly $45 billion, but that roughly $30 billion of the amount was sheltered from tax by those FTC blending strategies. Grubert and Altshuler, *supra* note 20, at 9-10.

[33] It is true, as Grubert and Altshuler point out, that territorial tax systems disable the popular current strategy of blending zero-taxed foreign-source royalties paid to the U.S. parent by foreign subsidiaries with high-taxed dividend income to shelter those royalties from tax. Grubert and Altshuler, *supra* note 20, at 28-30. Without considering any possible dynamic responses by U.S. multinational firms, the effect of a territorial tax system thus would be to *raise* the effective rate on the exploitation of intangible assets from low-taxed jurisdictions. *Id.* at 29.

One probable dynamic response by taxpayers to a territorial system would be to attempt to understate royalty payments owed to the U.S. parent by foreign subsidiaries. *Id.* at 30. In addition, cost-sharing agreements, in particular, do not ordinarily generate royalty payments to the U.S. parent company beyond any "buy- in" payments required from the foreign subsidiary. That means that, for companies that employ cost-sharing agreements, royalty payments to the United States should decline relative to the value of the intangible assets that the foreign subsidiary owns outright with the passage of time. As royalties paid to the United States decline (in absolute or relative terms), a foreign subsidiary will be able to capture more profits over time as exempt active foreign income.

[34] Staff of the Joint Committee on Taxation, "Options to Improve Tax Compliance and Reform Tax Expenditures," JCS-02-05, *Doc 2005-1714* [**PDF**], *2005 TNT 18- 18* Link, at 195 n.431 (Jan. 7, 2005) (hereinafter JCT Staff I) (noting that an "exemption system may place somewhat more pressure on [transfer pricing rules], thus making it somewhat more important to remedy existing defects in the design and administration of those rules."); Tax Reform Panel Report *supra* note 1, at 242 (stating that "because pressures" to use transfer pricing to minimize taxable income "are more pronounced in a territorial system, it would be necessary to continue to devote resources to transfer pricing enforcement."); Peter Merrill et al., "Restructuring Foreign-Source-Income Taxation: U.S. Territorial Tax Proposals and the International Experience," *Tax Notes*, May 15, 2006, p. 799, *Doc 2006-7791* [**PDF**], *2006 TNT 94-33* Link (arguing that the incentive for transfer pricing gaming will become greater under territoriality); Graetz and Oosterhuis, *supra* note 11, at 772, 775 ("A simpler system would no doubt result if the transfer pricing rules . . . rather than an exclusion from income, could be relied on to constrain tax avoidance [on passive/highly mobile income]"); Sullivan, *supra* note 25 ("The United States should beef up transfer pricing rules to prevent increasing the incentive effect of already favorable tax rates in production tax havens."); ABA Report, *supra* note 10, at 723 ("Transfer pricing would have higher stakes for the taxpayer and the Government and enforcement of the rules would have to be strengthened and, possibly, the rules reviewed.").

[35] *Id.*

[36] Hubbard Testimony, *supra* note 8. *See also* Testimony of Prof. Michael J. Graetz, Impact of International Tax Reform on U.S. Competitiveness: Hearings Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, 109th Cong. (2006) (hereinafter Graetz Testimony) (recognizing "integration of the world economy").

[37] Staff of the JCT, *supra* note 10, at 3, 5, 57-61.

[38] *See, e.g.*, Mihir A. Desai and James R. Hines Jr., "Old Rules and New Realities: Corporate Tax Policy in a Global Setting," 57 *Nat'l Tax J.* 937 (2004).

[39] *See, e.g.*, Michael J. Graetz, "Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies," 54 *Tax L. Rev.* 261, 272 (2001).

[40] The ABA's Task Force on International Tax Reform reaches a similar conclusion in its final report. In its discussion on the different forms of neutrality, the task force states:

The Task Force has not based its analysis on strict application of any one of [the neutrality] principles. None of the principles can be fully achieved by a country unilaterally, and no country applies any of the principles in a pure form. There is not sufficient evidence for the Task Force to conclude that any one of the principles should be determinative in the design of U.S. tax rules. Instead, the Task Force has taken a more pragmatic approach and attempted to evaluate how taxpayers would apply rules in practice and what the incentive effects of rules would be when analyzed in the context of the overall U.S. tax regime.

ABA Report, *supra* note 10, at 681.

[41] Grubert and Altshuler, *supra* note 20, at 16 (enumeration in the last paragraph supplied by this author).

[42] This, in effect, is one major theme of Grubert and Altshuler, *supra* note 20.

[43] The 2005 experience with the one-year 5.25 percent repatriation tax afforded by section 965 illustrates the magnitude of the issue: One estimate put the size of the one-year repatriation flows triggered by that section as in the neighborhood of $200 billion. Grubert and Altshuler, *supra* note 20, at 19. Another $100 billion was expected to be repatriated by the end of 2006. American Shareholders Association, "ASA Repatriation Scorecard" (Mar. 20, 2006), *available at* http://www.americanshareholders.com/news/asa-repats-03-20-06.pdf.

[44] JCT Staff I, *supra* note 34, at 189. The JCT staff proposal in turn was said to be modeled on that of Grubert and Mutti, *supra* note 14.

[45] For a comparison of the two proposals, and a rough revenue estimate for the advisory panel's package, see Merrill, *supra* note 34, at 808-809.

[46] Grubert and Altshuler, *supra* note 20, at 12.

[47] *Id.* at 29. That observation leads to the conclusion, to paraphrase the dry humor of academic articles, that when applied to the lowest-taxed foreign affiliates, a territorial system actually is a step toward capital *export* neutrality.

[48] Testimony of Stephen E. Shay, Impact of International Tax Reform on U.S. Competitiveness: Hearings Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, 109th Cong (2006). The JCT staff made a similar point in 2005: "In many cases, the present-law 'worldwide' system actually may yield results that are more favorable to the taxpayer than the results available in similar circumstances under the 'territorial' exemption systems used by many U.S. trading parties." JCT Staff I, *supra* note 34, at 189.

[49] National Foreign Trade Council, "NFTC Territorial Tax Study Report," at 24 (2002), *available at* http://www.nftc.org/default/tax/Territorial%20Report.pdf (hereinafter NFTC Territorial Report).

[50] For more on the effect of the current system, see ABA Report, *supra* note 10, at 689 ("The current U.S. international rules allow U.S. multinationals to achieve outcomes that are superior to exemption and therefore cannot be justified by reference to [neutrality principles.] These opportunities are a consequence

of structural and technical rules that operate together to afford tax reduction opportunities that almost certainly are unintended.").

[51] *See supra* note 34. *See also* ABA Report, *supra* note 10, at 730 ("The Joint Committee Staff and President's Advisory Panel exemption proposals are deficient on several grounds. The failure to include any requirement that the exempt income be subject to a foreign tax will invite substantial tax avoidance planning and place great pressure on transfer pricing rules.").

[52] Traditional industrial firms, for example, might have debt-to-equity ratios of 1:1, while the financial services industries' debt-to-equity ratios might be on the order of 30:1.

[53] *Cf.* National Foreign Trade Council, *NFTC Foreign Income Project: International Tax Policy for the 21st Century*, at 98-99 (2001), *available at* http://www.nftc.org/default.asp?Mode=DirectoryDisplay&id=162 (hereinafter NFTC Foreign Income Project); Grubert and Altshuler, *supra* note 20, at 6.

[54] Grubert, *supra* note 12, at 813. Michael J. Graetz and Paul W. Oosterhuis observe that many OECD countries that employ exemption systems impose a 10 percent stock ownership threshold for qualification for that regime. Graetz and Oosterhuis, *supra* note 11, at 779. Those authors argue, to the contrary, that portfolio investments by U.S. corporations should be exempt from U.S. tax, without regard to active/passive distinctions. *Id.* They would not extend that result to portfolio investments by households. *Id.* at 780.

[55] *See* Tax Reform Panel Report, *supra* note 1, at 243-244 (stating that under its proposal, "shareholders of U.S. corporations could exclude from income 100 percent of the dividends paid from income of the corporation reported as taxable in the United States," implying that the exclusion would be limited in the case of a corporation that is not taxable in the United States).

[56] CBIT's designers apparently believed that a compensatory tax was appropriate in this case because the code as then drafted (and, indeed, today) did not grant an indirect FTC to individuals. The code does, however, grant the indirect credit to our principal vehicle for conducting business (the corporation). Because the whole purpose of CBIT and other integration proposals is to treat individual stakeholders as if they directly earned their share of business enterprise income, it is far more logical to assume in designing an integrated tax system that a tax credit that has always been available to prevent double taxation of business income should remain available when that business income is taxed only once, rather than twice. Otherwise, one simply substitutes one form of distortive double taxation for another.

The President's Advisory Panel on Federal Tax Reform followed the logic of CBIT in this respect in fashioning the international tax provisions of the panel's "simplified income tax." As a result, that proposal, like CBIT, would introduce a distortive double tax on foreign income.

[57] OECD, *Harmful Tax Competition: an Emerging Global Issue*, at 43 (1998), *available at* http://www.oecd.org/dataoecd/33/0/1904176.pdf. One popular solution, rejected by most, but not all, U.S. proposals, is to limit the benefits of exempt income status in a territorial system to income earned in jurisdictions with specified minimum tax rates, or jurisdictions on a "good" list, or jurisdictions not on a blacklist. *Id.*

[58] In light of the central importance of deductible interaffiliate payments in determining the consequences and scope of a territorial tax system, one would expect extensive discussion of the issue in the literature. Oddly, that does not appear to be the case.

[59] *See, e.g., Cadbury Schweppes PLC & Cadbury Schweppes Overseas Ltd v. Commissioners of Inland Revenue* (Case C-196/04), *Denkavit Internationaal BV, Denkavit France SARL v. Ministre de l'Économie,*

des Finances et de l'Industrie (Case C-170/05), and *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt* (Case C-324/00).

In *Cadbury Schweppes* (decided in Sept. 2006) the court held that differential treatment under "controlled foreign companies" legislation of companies resident in one member state on the basis of the level of taxation imposed on their subsidiaries in other member states is prohibited under European Community law, except to the extent the applicable legislation specifically counteracts wholly artificial arrangements aimed solely at escaping national tax normally due, when the legislation does not go beyond what is necessary to achieve that purpose.

Denkavit (decided in Dec. 2006) held that the imposition by a member state of withholding tax on dividends paid to a parent company in another member state is contrary to EC law when a dividend paid to a parent in the same country would not be subject to the tax. The court also held that the existence of a double tax convention that authorizes the withholding tax, and provides for an FTC for the withheld tax, does not alter that conclusion if the parent company is unable to take advantage of the credit.

In *Lankhorst-Hohorst* (decided in Dec. 2002), the court ruled that thin capitalization rules that apply only to cross-border loan finance without applying to comparable domestic loan finance are contrary to EC law. A new case on cross-border thin capitalization rules is now before the court (*Test Claimants in the Thin Cap Group Litigation v. Commissioners of Inland Revenue* (C-524/04)). The court has not yet issued its ruling but, interestingly, the advocate general's opinion (issued in June 2006) suggested that such rules may in fact be in conformity with EC law in circumstances in which they can be justified on antiabuse grounds and they do not go beyond what is necessary to attain that objective.

Partly in recognition of the increasing number of infringement proceedings being brought, the European Commission has recently announced a series of initiatives to promote coordination between member states in parallel with litigation. The stated objectives of the initiatives are to provide short- to medium-term targeted measures to remove discrimination and double taxation within the Community, to prevent unintended nontaxation and abuse, and to reduce compliance costs associated with taxpayers being subject to more than one tax system. The first two targeted areas identified for coordination are cross-border loss relief and exit taxation. In the long term, the commission believes that a common consolidated corporate tax base is the solution to removing underlying tax obstacles for corporate taxpayers operating in more than one member state. In his announcement of those initiatives, EU Taxation Commissioner Laszlo Kovacs emphasized the problems currently facing member states when he said, "There is an urgent need to improve coordination of national tax rules to allow them to interact more coherently . . . I am convinced that coordination would help member states to prevent unintended non-taxation or abuse and hence avoid undue erosion of their tax base." "Europe Outlines Coordination Plans for Exit Taxes, Cross-Border Relief," *BNA Daily Tax Report* No. 244 at G-4 (Dec. 20, 2006). For more on this recent commission proposal, see http://ec.europa.eu/taxation_customs/resources/documents/taxation/COM(2006)825_en.pdf.

See also Harry Huizinga and Luc Laeven, *International Profit Shifting Within Multinationals: A Multi-Country Perspective*, presented at the European Commission General Directorate Economic and Financial Affairs Workshop on Corporate Tax Competition and Coordination in Europe (Sept. 25, 2006), *available at* http://ec.europa.eu/economy_finance/events/2006/events_workshop_250906_en.htm (modeling income stripping within the EU).

[60] *See, e.g.*, Harry Huizinga, Luc Laevan, and Gaëtan Nicodème, "Capital Structure and International Debt Shifting," presented at the European Commission General Directorate Economic and Financial Affairs Workshop on Corporate Tax Competition and Coordination in Europe (Sept. 25, 2006), *available at* http://ec.europa.eu/economy_finance/events/2006/workshop250906/tax_conf_nicodeme_en.pdf (EU-based multinational groups' capitalizations of subsidiaries reflect international differences in corporate tax rates).

[61] *See, e.g.*, JCT Staff I, *supra* note 34, at 191.

[62] For example, under a territorial tax system a U.S. parent company might try to convert high-taxed *exempt* income into subpart F income, so that those high FTCs could be used to shelter low-taxed subpart F income elsewhere in the system.

[63] *See* NFTC Territorial Report, *supra* note 49, at 19 ("in light of the higher stakes presented by a territorial exemption . . . even greater pressure would be placed on the issues of whether and to what extent types of active business income now subject to subpart F (*e.g.*, foreign base company sales and services income) would be eligible for exemption.").

[64] *Cf.* Peroni, Fleming, and Shay, *supra* note 5, at 514 (under the authors' proposal, "the number of outbound pricing disputes under section 482 should be significantly reduced, thereby lowering taxpayer compliance costs and IRS administration costs. The deferral subsidy encourages U.S. multinational corporations to use intercompany pricing to shift profits to their CFCs operating in tax haven jurisdictions. This passthrough proposal would make such shifts an ineffective tax planning strategy since the profits would be subject to a current U.S. tax in the hands of the U.S. multinational owning stock in the foreign corporation.").

[65] The U.S. firm might hope to either maximize low- taxed foreign-source income, or minimize high-taxed foreign income, but only for the purpose of averaging down that very-high-taxed income to the U.S. rate, to be able to use all of its FTCs.

[66] *See* Sullivan, "On Corporate Tax Reform, Europe Surpasses the U.S.," *Tax Notes*, May 29, 2006, p. 992, *Doc 2006-10099 [***PDF***], 2006 TNT 103-5* Link.

[67] *See* Peroni, Fleming, and Shay, *supra* note 5, at 501-507 (critiquing two such proposals for curtailing deferral).

[68] The COCA system, in particular, is carefully designed, based on 30 years of practice in the area, to be a robust system to capture the time value of money component of financial investments -- the hallmark of an income tax -- on a current basis. As quickly summarized in Part II, the BEIT includes other significant base-broadening components as well. In some cases, that base- broadening flows from the imposition of the "super" consolidation and acquisition rules described earlier. In other cases, it is attributable to the reform of tax accounting rules (for example, the repeal of LIFO inventory accounting and percentage depletion).

[69] The absence of a COCA expense allocation deduction can create the misimpression that FTCs are sheltering U.S. domestic business income, but that result is one of cosmetics, not substance. For example, assume that a company has $100 of invested capital (that is, tax basis in its assets), and that the COCA rate (the company's deduction for its cost of capital) is 5 percent. Further assume that the company earns $12 before its COCA deduction, that half of that amount ($6) is treated by both the United States and Freedonia as income arising in Freedonia, and that this $6 accordingly is taxed in Freedonia. Finally, assume that both the Freedonian and the U.S. tax rate is 30 percent.

The company will pay $1.80 in Freedonian income tax. All of that foreign tax will be creditable in the United States, because the company's pre-COCA foreign income is equal to $6, and the Freedonian tax is no greater than the U.S. tax on that income. The net result will be that the company will have $7 of taxable income and a tentative tax liability of $2.10, but will pay only $0.30 to the U.S. government -- or will it? The "missing" U.S. tax liability has not disappeared at all, but rather has migrated to investors, who will have minimum inclusions equals the COCA rate multiplied by their aggregate tax bases in their investment. Assuming for convenience that their bases also equal $100 (in fact of course, this will not be true, but it is a useful simplifying assumption), they will include $5 of income in respect of their investments, and pay $1.50 in tax. So in total the U.S. fisc collects $1.80, and Freedonia collects $1.80, on the company's pre-COCA income of $12, which reflects a tax split that precisely mirrors the relative domestic and foreign pre-COCA taxable incomes of the company.

[70] For example, Treasury's 1992 CBIT proposal contemplated imposing a compensatory tax on foreign-source income earned by a U.S. firm when that income was distributed as a dividend to its domestic portfolio investors. *See supra* note 56.

[71] *See* JCT Staff I, *supra* note 34, at 178-181 (proposing changes to the current law for determining corporate residency because the law as it now stands "is artificial, and allows certain foreign corporations that are economically similar or identical to U.S. corporations to avoid being taxed like U.S. corporations").

[72] One can imagine special rules to deal with this case if the results reached under the general rule were thought inappropriate. For example, one could have a special rule that raised the affiliation test for foreign entities to 60 percent or 65 percent, provided that the minority interests were themselves not publicly traded and were foreign-owned.

[73] Grubert and Altshuler, *supra* note 20, at 31.

[74] *Id.* at 33 ("the burden neutral rate based on 'static' calculations is about 28%").

[75] *See, e.g.*, Testimony of Prof. James R. Hines Jr., Impact of International Tax Reform on U.S. Competitiveness: Hearings Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, 109th Cong. (2006).

[76] Reg. section 1.901-2(e)(5) ("noncompulsory" taxes); reg. section 1.901-2(c) ("soak up" taxes).

[77] In practice, U.S.-based multinationals are likely to deal with the incentive to "average down" in a much more straightforward manner than by locating *physical* capital in a low-tax jurisdiction. Instead, U.S. firms will average down by financing high-taxed operations with deductible *financial* capital (in the form of loans paying deductible interest) provided by low-taxed affiliates. Complex "solutions" to that sort of taxpayer behavior can be devised -- for example, by imposing special FTC limitations on interaffiliate interest payments, to discourage such cross-crediting. The text, however, points in a different direction, by arguing that the problem is too remote to require a "solution."

[78] To this can be added the practical and political problems in designing a satisfactory interest expense allocation system (or an alternative, like an efficacious thin capitalization solution) to protect the domestic tax base -- and the associated problems of protecting that solution from erosion through years of taxpayer lobbying.

[79] *Cf.* Peroni, Fleming, and Shay, *supra* note 5, at 519-523 (outlining potential transition relief for the authors' proposal for changing the current deferral rules).

[80] *See, e.g.*, JCT Staff I, *supra* note 34, at 189 ("The present-law system thus creates a sort of paradox of defects: on the one hand, the system allows tax results so favorable to taxpayers in many instances as to call into question whether it adequately serves the purposes of promoting capital export neutrality or raising revenue; on the other hand, even as it allows these results, the system arguably imposes on taxpayers a greater degree of complexity and distortion of economic decision making than that faced by taxpayers based in countries with exemption systems, arguably impairing capital import neutrality in some cases.").

[81] For more on transition to the BEIT, see BEIT Presentation, *supra* note 2, at 15.

[82] *See supra* note 59.

END OF FOOTNOTES

Tax Analysts Information
Code Section: Section 954 -- Foreign Base Company Income
Jurisdiction: United States
Subject Area: Tax policy issues
Magazine Citation: Tax Notes, Feb. 5, 2007, p. 547; 114 Tax Notes 547 (Feb. 5, 2007)
Institutional Author: Cleary Gottlieb Steen & Hamilton LLP
Author: Kleinbard, Edward D.
Document Number: Doc 2007-416 [PDF]
Tax Analysts Reference: 2007 TNT 25-65