IFA Seminar 2012

Review of Global CFC Developments: Policy Choices and Practical Implications

Steve Suarez:

Good morning, my name is Steve Suarez. I'm a partner in the Toronto office of Borden Ladner Gervais LLP, and I have the privilege of acting as the moderator for this morning's panel entitled "Global CFC Developments: Policy Choices and Practical Implications."

With me today are three well known individuals who will share with us their unique perspectives on recent developments in CFC taxation in Canada, the United Kingdom and the United States.

First of all, we are joined by **Edward Troup**. Edward has been Director-General Tax and Welfare at Her Majesty's Treasury since 2010. He was previously Director, Business and Indirect Tax at Her Majesty's Treasury, after a career as a corporate tax partner at City law firm Simmons & Simmons and, from 1995 to 1997 as Special Adviser on tax to the then Chancellor of the Exchequer, Kenneth Clarke.

Next, please welcome **Pamela F. Olson**, the deputy tax leader and the Washington National Tax Services practice leader at PricewaterhouseCoopers LLP. From 2001 to 2004, Pam served first as Deputy Assistant Secretary for Tax Policy and, starting in 2002, as Assistant Secretary for Tax Policy at the U.S. Department of the Treasury where she had supervisory responsibility for providing policy analysis and recommendations for all domestic and international issues of federal taxation. Prior to joining Treasury, Pam was a partner in the Washington, D.C. office of the law firm Skadden, Arps, Slate, Meagher & Flom LLP, and returned to Skadden in 2004, leading Skadden's Washington Tax Group in 2010 and 2011. Pam has also served in the Chief Counsel's office at the Internal Revenue Service.

Finally, I am pleased to welcome **Nick Pantaleo**, the President of the Canadian branch of the International Fiscal Association and a member of the Executive Committee of IFA Central. Nick is a tax partner in the Toronto office of PricewaterhouseCoopers LLP and the leader of the firm's Canadian National Tax Services group. We all know Nick from his many papers and presentations to the Canadian tax community, including at the Canadian Tax Foundation, IFA, and Tax Executives Institute. In December 2007, Nick was appointed to serve as a member of Finance Minister Jim Flaherty's Advisory Panel on Canada's System of International Taxation.

Focus of discussion (slides 3-4)

Today's panel will examine some of the choices we face in designing an effective system for the taxation of controlled foreign corporations or CFCs. There are a variety of competing objectives that a CFC taxation system may have, and the choices to be made amongst them have a major impact on business transactions. In particular, today's panel will examine how different countries have approach the challenge of protecting the domestic tax base while facilitating global competitiveness and attracting economic activity.

Background (slides 5-9)

Let's begin with a brief look at the high-level choices.

Under a **worldwide** or **accrual** system of taxation, a country taxes both the domestic and foreign-source income earned by its residents, directly or indirectly, as it accrues, with a credit given for foreign taxes paid in the country of source.

Conversely, under a **territorial** or **full exemption** system, foreign source income is exempt from domestic taxation in the country of residence, both when earned *and* when a dividend is paid to domestic corporate shareholders. No credit or deduction is given for foreign taxes paid in the source country. In most countries employing this system of CFC taxation, full exemption status is limited to foreign active business income, not passive income.

Finally, in a **deferral with credit system**, foreign-source income (usually active business income) earned through a foreign entity (generally a corporation) is deferred until repatriated back to the home-country taxpayer in the form of a dividend from the foreign entity, with a credit provided for foreign taxes paid on such income.

Slide 6 summarizes the approach of our three subject countries to CFC taxation.

Following recent changes, the U.K. has essentially adopted a territorial regime, with a hybrid system for passive income. Generally speaking, Canada is a worldwide system for passive income (referred to as **foreign accrual property income** or FAPI), a territorial system for active business income in a tax treaty/TIEA country, and a deferral with credit system for active business income in non-treaty/TIEA countries. Sales of CFCs are either fully taxed (if the vendor is a Canadian resident) or Canadian tax is deferred until repatriation and partially exempted (if the vendor is a foreign affiliate). The U.S. has a deferral with credit system for taxing active business income, and a worldwide taxation system on passive income and gains from the sale of CFCs.

Slide 7 provides some interesting economic statistics about the Canada, the U.K. and the U.S.. Noteworthy is how much smaller a proportion of GDP exports are in the U.S. (12.5%) compared to the U.K. (29.4%) or Canada (34.3%). It is important to be cognizant of the fact that not all countries have the same needs or face the same pressures, and in an export-heavy economy like Canada there is greater pressure to be globally competitive than in a country like the U.S.. This is reinforced by the numbers on slide 8, which shows the U.K.'s dramatically higher rate of foreign ownership of domestic corporations.

Finally a little bit of commentary on corporate income tax generally as a percentage of total taxation and a percentage of GDP is shown on slide 9.

Canada is a little bit different than the other two countries in that corporate tax revenue as a percentage of total taxation has actually stayed relatively constant, which is interesting in the context of the system where corporate tax rates have steadily declined in recent years at the both

the federal and provincial levels. This is in contrast to what has happened in the U.S. and the U.K. where corporate tax revenue have dropped significantly. I suspect this is a reflection of effect the financial crisis has had on corporate income tax revenues. Also, the U.S. numbers show the effect of a high degree of business activity now taking place outside of the corporate context; that is to say through trusts, partnerships, LLCs, and other tax pass-through entities.

Let me now turn it over to you Edward to talk about some recent UK developments. The UK has just gone through a relatively fulsome review of its CFC system and the highlights of that process has generated a lot of interest.

Edward Troup:

Thanks Steve. You have some interesting numbers on these slides that give quite a lot of context in terms of where the U.K. has come from.

The U.K. CFC rules go back to 1984.

I illustrate on a later slide the principles that underlie the recent changes to our CFC regime.

I believe that it is fair to say that there were no similar principles upon which our original CFC rules were based, other than the desire to stop the potential tax loss from the outflow of funds following the abandonment of exchange controls in 1979 into so-called “money box” companies.

We made various amendments to our CFC rules in the subsequent 25 years, but they were getting increasingly creaky by the mid 2000s.

UK CFC developments (slides 10-11)

There were quite a lot of drivers around what we have done over the last few years and we are concluding with legislation for our new CFC rules in a Finance Bill that is going through Parliament as we speak.

The numbers on the previous slides, in particular, that 40 percent of the U.K. listing of corporate shares are held by non-U.K. residents and that the U.K. is an small, open economy reliant on exports and imports, reveal that an awful lot of our economic growth is dependent on foreign capital being invested in and through the U.K.. Hence, trying to operate a worldwide system in those circumstances was proving increasingly difficult.

As a result, the changes summarized on slide 10 - the introduction of a dividend exemption in 2009, the “opt-in” exemption for foreign branches within the last year and the new CFC rules – reflect our realization that the U.K. is no longer the imperial power that allowed us at one point to tax whoever we liked, wherever they were. If we want to attract investment, then we have to just tax what goes on in the U.K. or activity that has a connection with the U.K..

You will see at the bottom part of slide 10 that the key features of the new regime are to define artificial diversion of profits. In other words, we start not from the approach that if the profits

were owned or earned by a U.K. corporation, then they should be subject to tax in the U.K., subject to specific exclusions. Instead, we look to tax in the U.K. only those profits that have sufficient connection with the U.K. to justify us reaching out and taxing them.

It should be recognized that to a certain extent, we are making a virtue out of a necessity because a constraint that we have in contrast to the U.S. and Canada is that we are part of the European Union and are subject to EU rules.

Our CFC rules, as they stood when they were first introduced in 1984, almost certainly in the light of subsequent jurisprudence, would be contrary to the principles of the European Treaty. We therefore had to move to a set of CFC rules which were consistent with EU rules and jurisprudence and the latter shows that the artificial diversion of profits outside your jurisdiction is an appropriate basis for leveling domestic tax on such income.

Slide 11 gives a little bit more background to our changes.

It starts off by revealing that the UK's aim is to create the most competitive corporate tax regime in the G20. Today, many countries justify changes to their corporate tax system as being "competitive". Often times, though, this is characterized as the "race to the bottom".

I honestly and completely rebut that as describing the nature of the U.K. changes.

But it does raise an interesting question which is, "What is a competitive tax regime?" and "What should a corporate tax regime do in order to allow its multi-nationals to stay there, to stay in the game and to attract genuine overseas business?"

It is quite interesting to think about that as we go through and look at the developments in the jurisdictions we are talking about today.

The rest of the slide sets out a little bit more about what we have done in recent years.

In 2010, the government set out a roadmap or framework for what ought to be done with our corporate tax regime more generally and in regards to our CFC regime, we have been quite explicit that we want to make the corporate tax system more competitive.

But the CFC rules are there to protect the U.K. tax base and so inevitably they are to some extent a dampener on business because they restrict U.K. businesses ability to do what they like. And as I have said, the rules have to comply with the EU Treaty.

One of the features that is an advantage of the U.K. system is that we have quite a degree of control within Treasury over tax legislation, in contrast, say, to the U.S. where the checks and balances of the political system makes it more difficult for the administration to enact what it wants.

There are risks in a more centralized system. But I am quite proud of what we have done in the U.K. over the last few years to actually bring these potentials forward, not with complete

unanimity but with a very high degree of consensus and with a very high degree of consultation.

If you are sorry enough to be following us on our website you have seen that we have been putting out quite a flurry of extensive documents over a very prolonged period of time as part of this process.

But I think that is important and I think it means that what we are enacting will stick. It may not last 25 years, but it will outlast me anyway!!

Nick Pantaleo:

I am not intending to dwell on the specific points described on slide 12 because for many here today these are all things that you are well aware of. But I do have three observations that I want to make about this slide and the next one in comparison to the recent U.K. and U.S. developments that are summarized on slides 10 -11 and 14 -15.

The first is that as much as it is common practice for Canada to compare itself in many respects with the U.S., I submit that when it comes to benchmarking ourselves for comparative purposes in terms of what the Canadian system for taxing foreign source income could or should be, we should pay more attention to what is going on in countries like the U.K..

If we go back to the financial data presented in slides 7 -9, it is evident that Canada has much more in common with the U.K. when it comes to this discussion.

First of all, economically, Canada is closer in size to the U.K. with the Canadian economy only being about 60 percent that of the U.K., although I have also seen numbers that suggest it could be as high as 70 percent. That is in comparison to, say, ten years ago, when the Canadian economy was less than half the size of the U.K. economy. So we certainly have narrowed the gap over the last number of years between us and the U.K., but not so much vis-a-vis the U.S..

Also, the U.K. and Canada both have very open economies with both imports and exports representing 30-36 percent of each country's GDP. This reflects the countries' strong dependence on foreign inbound and outbound investment for economic growth. Contrast that to the U.S. whose numbers are less than half of that of the U.K. and Canada, although apparently its numbers have tripled over the last 30 years.

An important implication of having an open economy, and this is certainly something that members of the Advisory Panel on Canada's System of International Taxation were well aware of, particularly given the pace of globalization, is that there are practical constraints on a country's ability to impose corporate taxes on foreign business income.

The second observation I would make is that recent developments in Canada are certainly not as dramatic, in comparison to what has or is taking place in U.K.. There is a good reason for this, which is that Canada has long had many of the competitive features in its system for taxing foreign source income, particularly business income, that the U.K., and indeed countries like Australia and New Zealand, have aspired to over the last 10 years.

Features, such as our look-through rule in paragraph 95(2)(a) of our Income Tax Act, a provision that has been the source of much discussion and controversy, but one that almost forty years after its enactment has turned out, I submit, to be an inspired initiative that really accommodates today's modern business practices by recognizing that cross-border businesses is conducted across national boundaries and not just within a single jurisdiction. Indeed, it even seems the Obama administration is prepared to keep the look-through rule in the U.S. in place, at least for the time being.

Still, there seems to be a preoccupation to tinker, and sometimes to more than tinker, with our system in ways that at times have been controversial and not entirely consistent with current international norms in spite the fact that the Advisory Panel in 2008 and the Mintz Committee fourteen years ago had concluded that the Canadian system was a good one and has served Canada well.

In fact, a number of what some would refer to as recent positive developments turn out to be reversals or the abandonment of certain initiatives that eventually proved to be unworkable or just inappropriate.

For example, there was the abandonment of the Foreign Investment Entity proposals after ten years of trying.

Extending the exemption system in 2007 to active business income earned by foreign affiliates in countries with which Canada has entered into a Tax Information Exchange Agreement was a very positive development, but it was overshadowed at the time by the now abandoned restrictions on interest deductibility. Even now, with Canada having signed or about to sign over 130 tax treaties and TIEAs, one can't help but wonder why it is still necessary to have these conditions for a foreign affiliate to earn exempt foreign active business income.

Most of the 2002 and 2004 proposed changes to the foreign affiliate rules were abandoned in 2011. This is seen as being another favourable development, although it still leaves in its wake a broad anti-avoidance rule to prevent the artificial creation and duplication of surplus.

Moreover, as was discussed in the previous panel, among other things the 2011 proposals create another surplus account and also propose to restrict foreign affiliates' ability to make upstream loans.

I find these latter developments to be particularly troublesome. They are contrary directionally to the recommendations of the Advisory Panel. In addition, as many have pointed out, the U.S. system has long tried to use its Subpart F rules to, in effect, force repatriation when profits are no longer needed in a foreign business. But this has clearly not resulted in increased repatriation. Instead, it has resulted in companies retaining excess earnings in their foreign affiliate structures and distorting their investment decisions.

I do not have a great explanation for this type of tinkering. It could be partly attributable to the government's reluctance or uncertainty about pulling the trigger and moving Canada more

completely to an exemption system. Therefore, there is a perceived need to preserve the integrity of the current rules and policies adopted in the 1970s, which fundamentally is based on a worldwide system of taxation.

I suppose that there is also some discomfort with our fairly generous interest deductibility rules. However, the recent foreign affiliate dumping proposals will largely prevent Canadian companies that are foreign controlled from benefiting from such rules. In my view, that is a pretty significant development because the proposal is essentially a warning that Canada's foreign affiliate system is reserved for companies that are not foreign controlled.

My last observation on recent developments is to reflect of the tendency and the apparent intention for Canada to make changes on a piecemeal basis or "incrementally", as the government has stated in recent budgets.

I believe there to be some drawbacks to this approach - not just because it does not help to get things done on a timely basis, but more importantly because it really does not allow for a complete discussion and debate about what the system should be as a whole.

Looking at slide 13 reminds us of what I always thought was the most important contribution made by the Advisory Panel, which was to articulate six principles that we thought should guide future tax policy tax changes in the international arena.

These principles have not received a lot of publicity. But as a member of the Advisory Panel, I was heartened when I read the Corporate Tax Reform document published by the U.K. Treasury in 2010. That document articulated principles for the reforming the U.K. corporate tax system, which Edward has described on slide 11. If you compare the U.K. principles to those articulated by the Advisory Panel two years earlier, you will see that they are almost identical!

If Canada is indeed going to continue to proceed to make changes to our system of taxing foreign source income on an incremental basis, to enhance certainty, promote greater transparency and ensure that in the end there is a coherent framework that underlies the system, it would far more preferable if it did so pursuant to an established set of principles, such as those described on slide 13.

Pamela Olson:

I am hoping that the U.S. will take a page out of Canada's and the U.K.'s playbook.

The basic framework of the U.S. international tax system has largely been in place for about fifty years.

The basic system was enacted as a worldwide tax system with tax paid on repatriation. Shortly thereafter, the U.S. Congress realized that it had to give tax credits for taxes paid on foreign operations if it didn't want to discourage foreign trade and investment.

That regime stayed in place until 1962. Then a lot of reforms to the tax system were enacted in

the form of our Subpart F rules, which place restrictions on the ability to defer U.S. taxation of foreign income.

In 1986, the U.S. adopted a number of reforms as part of overall individual and corporate tax reform. Many of the changes made in 1986 on the international side may have been seen at the time, but certainly over time came to be seen, as changes that were less about good policy than about raising revenue to hit a budget target because the Congress and the President had committed to doing tax reform on a revenue neutral basis.

We labored under those rules until 2004.

In 1997, we made a significant regulatory change, which was the adoption of **check-the-box-rules** and making those check-the-box rules applicable to foreign entities. That clearly paved the way for a whole lot of the tax planning that U.S. companies have undertaken since their adoption.

My personal view is that much of the tax planning that has occurred would have occurred with or without the check-the-box rules and their application to foreign entities because firms operating internationally were becoming very adept at finding foreign entities that could be treated as partnerships under our partnership classification rules and as corporations in the local country. The check-the-box rules merely sped up a process that was already well underway and facilitated the planning that was being done, which may have had the effect of undermining our Subpart F rules.

There were Treasury notices issued shortly after the check-the-box rules were applied to foreign entities that tried to carve back their application to foreign entities, but the notices were beaten back by Congress.

There was also a 2009 Obama Administration Budget proposal that would have restricted the check-the-box rules that was not well received. Actually, none of the Obama budget proposals have been met favorably on Capital Hill, including when the Democrats were in control of Congress, but that one in particular met with a lot of criticism and the Obama Administration abandoned it in subsequent Budgets.

The U.S. did scale back in 2004 a lot of the revenue raising provisions that were enacted back in 1986.

Then, in 2006, the U.S. enacted the CFC look-through provision that Nick mentioned. In 1997, the U.S. enacted an active finance exemption from the Subpart F rules. Both the active finance exemption and the CFC look-through provision are temporary provisions. I think neither has been extended for more than three or four years at a time and both have generally been extended only on a year to year basis, which of course makes it somewhat difficult to plan.

The most critical point right now about the U.S. tax system is that corporate tax rates have been falling around the globe while the USA tax rates have stayed high. We now are in sole possession of first place among OECD countries -- for having the highest corporate tax rates --

and the high rates relative to the rest of the world have created a significant dividend lockout effect. The lockout effect is pretty clear when you look at the financial statements of U.S. headquartered multi-nationals and you see very large sums of money that are listed as permanently reinvested abroad. The numbers are well over a trillion dollars right now, which is a good measure of the high corporate tax rates lockout effect.

There was temporary relief from the lockout effect in 2004 in the Homeland Investment Act, which was part of the 2004 legislation. The Homeland Investment Act provided a temporary incentive for companies to repatriate foreign profits. Companies were allowed to bring back foreign dividends with an 85 percent dividends received deduction. So basically a 5 ¼ percent rate applied to those foreign profits. There have been calls for a reprise of that proposal a number of times over the course of the last few years but it has been resisted heavily by the Obama Administration. It has also been resisted by some Republicans and by a number of congressional Democrats.

Congressman David Camp has proposed the concept of a reprise of the Homeland Investment Act as part of paying for a move from the U.S.'s worldwide system to a territorial system. I would not expect, unless some economic catastrophe befalls us over the course of the next year or so, to see such a proposal enacted in any form other than as part of a large corporate tax reform proposal.

Corporate tax reform is being discussed a lot in the U.S. currently. It has been proposed by the Obama Administration, although some might say that the proposals made by the Administration are not really corporate tax reform. The Administration's proposals are less a framework for reform than a patchwork of proposals addressing a number of issues that the Administration has identified as problems in the tax system. There is nothing comprehensive about the proposals; nor is there an underlying framework that is obvious from the proposals.

There are a number of Congressional proposals as well.

The chairman of the House Ways and Means Committee, which is the committee where all tax legislation must arise, released a draft corporate tax reform bill for discussion. It would reduce the federal corporate rate to 25 percent so when combined with state rates it would bring the U.S. combined rate under 30 percent, which would be a major improvement over where it stands today.

Chairman Camp would also move the US to a territorial system. His draft bill includes very detailed rules for what a territorial system would look like.

Senator Enzi, who sits on the Senate Finance Committee, has introduced similar legislation that would move the U.S. from worldwide taxation to a territorial system, but with a few different provisions.

There has also been comprehensive tax reform legislation introduced by two senators, a Republican and a Democrat, including international reform that would go in the exact opposite direction of Chairman Camp's and Senator Enzi's territorial proposals. Their legislation would

repeal deferral and keep a worldwide system. The repeal of deferral in a worldwide system would allow the corporate tax rate to be reduced to the low 20s while keeping the legislation revenue neutral.

The Obama Administration and the Congressional territorial proposals all include anti-base erosion provisions, which have caught some of the business community by surprise. It was expected from the Administration, but not from Republicans in Congress. A careful reading of the press, however, should have suggested that both Republicans and Democrats would see a need to consider anti-base erosion proposals.

It is interesting that there is no formal consultation process in the U.S. with the business community. Chairman Camp did put out his corporate tax reform proposal in draft form specifically requesting comments on a number of features. But when I listen to the U.K. or Canada talk about their consultation processes, I must admit that I am envious.

Chris Wales, who is one of my colleagues in the U.K., recently completed a study on tax policy making around the globe. One of his comments when he presented his paper a couple of months ago was that the U.S. has such a marvelous system for developing tax policy and yet produces such poor results.

Nick Pantaleo:

We now want to shift our focus by taking a look at some of the pressure points that we see applying to current CFC rules broadly, but obviously more specifically to the systems in place in the three countries.

Slide 16 is a point of reference for your background as to some of the key features with respect to the CFC systems in place currently in the U.K., Canada and the U.S..

From a Canadian perspective, slide 17 identifies a few points. I do not have time to go through each of them but I do want to highlight a couple of them.

First off, certainly the Advisory Panel believed that its recommendation to adopt a broader exemption system raised questions about the scope and the interaction of Canada’s anti-deferral regimes, which of course includes the FAPI rules, Foreign Investment Entity rules and the non-resident trust rules.

The challenge that Canada faces in taking such a direction is what to do about passive income that is earned by entities and foreign affiliates that are not controlled foreign affiliates because of course it is controlled foreign affiliates on which these rules really have an impact.

With the abandonment of the FIE rules in 2010, one consideration might be to extend the FAPI regime to passive income that is earned by non-controlled foreign affiliates. For many, this seems logical: if the foreign active business income of such entities is exempt, shouldn’t its passive income be taxable in Canada?

There are issues with this particular suggestion, not the least of which concerns the possible lack of available information for taxpayers to determine the FAPI of non-controlled foreign affiliates. This is a legitimate concern in my mind, especially keeping in mind the fourth principle articulated by the Advisory Panel about keeping the system relatively simple and easy to administer and enforce.

The Advisory Panel did suggest in our report that there may be ways of dealing with this from a practical prospective by eliminating the application of base erosion rules to non-controlled foreign affiliates. Or by having some sort of high tax exemption from FAPI, say, for foreign affiliates in countries like the U.S. and the U.K., which would likely cover the vast majority of Canada's foreign affiliates.

Edward Troup:

As Nick says, looking at pressure points is just an excuse to say where we are but I think what is quite interesting about this is that this is an area of tax policy where there is always going to be pressure because CFC rules are there effectively to stop corporations from moving their profits offshore.

CFC rules do restrict their freedom, but they are necessary for the protection of the corporate tax base, for as long as we have a corporate tax base.

Rumours of the death of the corporate taxes have been greatly exaggerated. The graph earlier shows how sustainable corporate taxes have been at around 2 or 3 percent of the GDP across the developed world. This is quite interesting and given the fiscal situation many countries are facing, I do not think that corporate income taxes are going to go quickly. So we will need to protect that base.

I'd like to think that while our new rules have not done away with the pressures, and while some aspects of the new rules will need to be further refined, we have at least engaged with those pressures and we have come up with some answers.

Through a proper review process that included significant consultation, we now have the ability to explain our CFC regime, which is something we could not easily do with the CFC regime we replaced.

CFC Pressure Points – U.K. (slide 18)

There is the pressure to achieve consistency between subsidiaries and branches, which is easy to say, but actually quite difficult to achieve. We have done that.

Given our territorial system, we have adopted a CFC regime that defines the artificial diversion of profit. We have done this through what we call, "The Gateway". However, in a sense, it is sort of a way of getting out; not a way of getting in.

The Gateway looks at whether there is active U.K. involvement in the overseas company as well

as whether the capability of the overseas company is such that without the U.K. parent it could still operate. It also looks at tax motives and tax purpose.

We floated a proposal about two or four years ago to in a sense ignore the entities and just look for overseas income there was owned by the group. But, administratively, it was decided to be unworkable. So, we went back to an entity based approach.

Dealing with offshore finance companies has always proven to be difficult. So, we decided on a blanket 75 percent exemption for finance company income, effectively resulting in income earned by such entities being subject to a 5.5 percent rate of tax or one quarter of the U.K. rate in 2014. I think this to be a pragmatic approach to such entities. It will be very interesting to see how it actually pans out and what the behavioral response to this will be over time.

Nick Pantaleo:

Going back to slide 17**,** I have always thought that Canada, unlike a number of jurisdictions such as the U.S., but not necessarily now the U.K., was unique in that the level of foreign tax is not a criteria or condition on whether income earned by a foreign affiliate is active business income and therefore exempt from Canadian tax. Essentially, where the income is earned in a treaty or in a TIEA country, we cede taxing rights to that country in situations where that income is earned through foreign affiliates, and it is irrelevant whether that country exercises that right or not or at what level.

Similarly, FAPI identifies specific categories of income as opposed to being concerned about where the income is principally earned or whether and to what extent it has been subject to foreign tax.

I believe these to be strengths of the Canadian system but one of the pressure points is that this could lead to double non-taxation. Is this a problem?

Certainly if you read things coming out of the OECD: they think so, particularly when you read the recent OECD report on hybrid entities and instruments. The reaction you get is a fear that if businesses continue to ignore what governments believe is their right to collect at least a single level of tax on business income, then governments could fight what they perceive to be double non-taxation with some form of unilateral action that could result in multiple taxation.

Edward Troup:

We have consciously stepped back from being so worried about double non-taxation.

From a policy prospective, I think that this does represent the shift over the last few years. In designing our CFC rules, we have become less worried about the fact that there may be income out there that is untaxed and more concerned about an actual erosion of the U.K. tax base.

The specific example which became the focus of debate five or six years ago was the use of overseas finance companies to erode the tax base of German subsidiaries of U.K. companies. At

the time, Germany had a very high corporate tax rate and there was a very strong incentive to use financing structures to shift profits out of Germany to a lower tax jurisdiction.

The Inland Revenue at that time was very anxious to use the CFC rules and they then started to tax that income. There was a huge amount of resistance from U.K. companies who were upset that Inland Revenue was effectively trying to counter their attempt to manage their German tax bill. That was not something U.K. companies believed Inland Revenue should be doing. Eventually, that argument prevailed in the U.K..

Pamela Olson:

That argument has not prevailed in the U.S.. I am not sure whether it ever will, but perhaps at some point.

We actually went, fifteen years ago, in the opposite direction. Under the Clinton Administration, the Treasury Department was concerned that the ability of U.S. companies to erode foreign tax bases provided an incentive for companies to migrate their operations and jobs outside of the U.S..

This is consistent with the capital export neutrality economic theory, which suggests that the same rate of tax should apply to operations in the U.S. and operations abroad, and that was sort of the guiding principle under the Clinton Administration.

That theory laid behind a lot of the work that the U.S. encouraged the OECD to take on during the 1990s, such as the harmful tax practices project, though arguably the OECD has backed off from that work a bit in recent years.

Going back to the earlier slide on the size of the U.S. market, we tend to think that what's good for the U.S. has got to be good for the rest of the world and that we only need to look at what is going on in the U.S. to set our rules. The dominance of our market has affected a lot of our thinking about what our rules should be.

There is a growing recognition that the world has changed since 1962 when we enacted the Subpart F rules. We were dominant in the world economy back then. We may still be number one, but we are not nearly as dominant today as we were then in terms of the number of multinational companies headquartered in the U.S., our share of world exports, and our share of global investment.

We have to adapt to a changed world and recognize the importance of other economies and global trade. That ought to mean that we pay more attention to what's legitimately within our own tax base and worry about the erosion of our own tax base, but stop worrying about whether U.S. companies are eroding the German tax base or the U.K. tax base or the Canadian tax base.

We are not there yet but as part of our corporate tax reform discussion, that issue is going to be front and centre.

Steve Suarez:

We will now move to the last segment of our discussion.

Slide 21 has an interesting quote from the U.K. Chancellor of the Exchequer, George Osborne, from earlier of this year: "Our new controlled foreign corporation rules will be legislated for in the coming finance bill and will stop global firms leaving Britain as they were and encourage them to start coming here."

Historically, CFC systems were designed to preserve the domestic tax base. This quote suggests that a CFC system could potentially be a competitive advantage in terms of generating business activity and attracting to a country activity that would not otherwise occur there.

The UK example is interesting in this regard and I get the sense that in the UK that the question has shifted from, "why should we exempt this income" to "why should we tax this income?" And it really reflects an important shift in thinking that countries should be carefully reflecting on.

In the context again of this last segment, "Competitiveness versus Protecting the Tax Base, Which One Trumps?", what one is saying in engaging in this debate is, you do want to protect your tax base and prevent double taxation, but do so in a way that does not inhibit the current globalization of business that could attract activity to your country that you would otherwise perhaps not have.

The pressure points in this regard are listed on slide 20. I think the way that the UK has considered them in the course of revamping its CFC regime is instructive, and what I would like to do now is turn it back over to the panel to talk about some of the issues in our respective countries.

Edward Troup:

Steve made the point that the debate has become more about what you tax versus what you don't and it comes back to something he said earlier about corporate taxation.

Any economic analysis would conclude that tax on corporate income is less efficient economically than, for instance, taxing consumption.

The challenge, particularly at the moment but it will always be for the policy makers, is how do you tax corporate income in a way that minimizes the inefficiency? I think the debate that has gone on in the UK, and that is going on globally, has brought a lot of the aspects of that out.

I've listed on slide 22 some of the factors and I've referred to the challenge.

Are we actually being competitive or are we being predatory?

Clearly we are not being predatory.

As for the statement by George Osborne, I do not think any business would say that having a set of CFC rules makes a country competitive – they would say that it would be much more competitive if you did not have any CFC rules.

But the context, of course, is that amongst the developed countries where global businesses want to base themselves, what is the right balance of CFC rules with the rest of the tax system to make sure that the allocation of resources, investment, employment, and research and development is most efficient - not just for that country but for the global economy?

That in a sense is the challenge, which is why when you look at slide 23, you will see that we have wrestled in the UK with all of the aspects of this and while in a sense the CFC rules are the most difficult, we have also had to think about the other aspects of corporate activity and the other things which attract business activity and investment.

There is a lot of difference between having a very low corporate tax rate, which encourages corporate groups to establish finance companies in such jurisdictions, and a corporate tax system, which encourages, for example, the type of investment that Glaxo Smith-Kline announced after last year's budget in regards to building a £700 million manufacturing plant in the U.K., their first major manufacturing plant in the U.K. in a generation.

You have to look at the various other things as well to which I've already spoken about, in particular, the Gateway, which is the artificial diversion of profits, and the finance company rules, which is a pragmatic approach to how you tax flows of money that by definition are mobile.

I have not really talked yet about intellectual property or IP profits.

Some of the major disputes that the HMR&C have had with businesses in recent years have been with pharmaceutical companies and their claims that they had effectively transferred the ownership of their IP to Netherlands or to Switzerland or elsewhere. Actually, the way we taxed transfers of such property in comparison to Swiss-based, and even in some respects to U.S.-based companies, was looking uncompetitive.

The challenge of how do you capture a proper tax return on the actual property while at the same time not driving a mobile capital asset outside your jurisdiction has been a difficult one.

Our announcement of the introduction next year of the patent box regime, which will give a reduced rate of tax on income derived from royalties on patents and other qualifying property rights, is a response to that challenge.

Now, all of these things make up a competitive tax system.

It is important, I believe, to look at what we are doing with the CFC regime. But to think that they themselves can make a tax system competitive, is wrong. You have to look at all of these

things together along with non tax factors.

Pamela Olson:

Shifting to the US, I like this question -- competitive versus protecting the tax base, which one trumps?

In the U.S., clearly up to this point, protecting the tax base has trumped.

It is not that folks are not talking about competitiveness and are not concerned about competitiveness. Certainly the Obama Administration uses the word a lot. Yet when the Obama Administration uses the word, they seem to believe that the right way to achieve competitiveness is by raising the tax paid by companies doing business outside of the U.S. as opposed to reducing the tax paid by companies doing business in the U.S..

The Administration has endorsed a 28 percent corporate rate, which would be a more competitive rate. But over the course of the last four years, the Administration has also made a number of proposals that would tighten up the rules on the foreign side. These proposals go well beyond protecting the U.S. tax base directly.

What motivates the Administration is not an erosion of profits earned within the U.S. so much as a concern about whether the U.S. is earning a sufficient amount of tax on profits U.S. companies earned abroad.

For example, the Administration has proposed rules that would have required the pooling of foreign tax credits, the immediate effect of which would have been to freeze more profits outside of the US.. That effect eluded the Administration when it put its budget proposals together.

The Administration also proposed deferring U.S. deductions related to foreign source deferred income. That was originally a very broad proposal, but was narrowed. At this point, it is basically limited to interest expense.

The Administration also proposed immediate taxation of "excess returns", which critics viewed as essentially an override of the arm's-length standard, but only in the context of profits earned in a low tax jurisdiction. The Administration's corporate tax reform framework retains those concepts and then adds on the concept of a minimum tax on overseas profits.

Congress, likewise, has focused attention on protecting the tax base. Although as I mentioned, Chairman Camp and Senator Enzi have drafted bills that would move to a territorial system, which would suggest more of a focus on competitiveness.

We have had proposals to deny deferral for so-called runaway plants. If a company closed a plant in the U.S. and invested in one abroad, the profits would be taxed currently. We've had proposals that would require country-by-country reporting.

Chairman Camp included three anti-base erosion proposals in his bill; one of them is the Administration's excess returns proposal. Another is modeled on a Japanese rule that permits territoriality except where the profits are not subject to at least a certain level of foreign tax.

His third base erosion proposal is in the nature of a "carrot combined with a stick". It would permit a lower rate of tax on certain kinds of intellectual property income, whether earned in the U.S. or abroad, if connected to exports.

We also have, as I mentioned earlier, a bill that would repeal our current deferral with credit system and replace it with a full worldwide system.

Looking ahead, what happens with tax reform will depend on what happens in the elections coming up in November. There is no expectation of there being any significant movement in even re-enacting provisions that have expired before we get past the November election. We call the session after our elections the "lame duck" session. Congress has so many things on the deck that it is not going to touch until after the November elections that we have nicknamed this the "mother-of-all-lame-ducks" session.

A lot will depend as well on what happens with the economy. In 2010, it was expected that a lot of the tax cuts enacted in 2001 and 2003 would be allowed to expire, but because the economy was not doing well, the Democrats and Republicans held hands and went ahead and extended all of them.

Our situation obviously is different from the situation of Canada and the U.K. and a number of other jurisdictions. We have favourable geography. We have a lot of natural resources and a fairly large domestic market. That allows us perhaps to be a bit more insular.

But I think there are a growing number of people who believe that we need to recognize that our role in the world economy is changing and that that means we need to look more seriously at what is going on in the world around us and adjust our tax system accordingly.

Nick Pantaleo:

Just a couple of final comments from me in reflection on points on slide 26.

Edward has spoken about how competitiveness concerns have played an important role in shaping U.K.'s international tax policy. The same concerns have driven reforms in a number of other jurisdictions, such as Australia, New Zealand and Sweden.

In a 2007 study, the OECD concluded, "international competitiveness considerations weigh heavily and effectively towards no or only limited home country taxation of foreign profits."

Frankly, as a small, open, trading nation, can Canada realistically afford to be the odd man out when it comes to ensuring our system is as competitive as that of other countries? Indeed, given our size, I would suggest we have to be even more competitive than the others.

Certainly that was the view of the Advisory Panel when it concluded that an overriding principle

guiding the way we should tax outbound investment by Canadian companies is to ensure that the tax treatment on such income is not disadvantaged; i.e., that Canadian businesses are not disadvantaged by being subject to costs in relation to their foreign business income that the foreign competitors are not required to incur.

This principle is not new to our current system.

It was evident in the tax policy discussion at the time of and subsequent to the adoption of the existing foreign affiliate rules of a conscious concern to balance fair taxation of the domestic and foreign income of multinational corporate groups, while supporting the competitiveness of Canadian multinational businesses.

That is what led the Advisory Panel to recommend that Canada move to a full exemption system with respect to foreign active business income.

To ensure that our tax rules do not impede Canadian businesses from being competitive in global markets, it is important to understand and accommodate how businesses structure their global operations; how they manage their supply chains in the most productive and cost effective manner throughout the world.

This means having to reflect on the role of base erosion rules in the modern business environment: do they place Canadian businesses at an unnecessary competitive disadvantage and do the rules actually impede the development of modern domestic business infrastructures that these rules were originally intended to protect?

In the March 2012 federal budget, the government promised to take steps to alleviate the inappropriate tax cost arising from the application of our base erosion rules to certain transactions undertaken by Canadian banks.

I believe this to be a very positive and significant development. We have not yet seen draft legislation but it is a recognition of the challenge that we have in this area in streaming our base erosion rules so that they don't impede business operations.

Of course, what I am sure a number of other industries are asking at this point is, "What about me?"

So, while this is a step in the right direction, how big a step remains to be seen.

As many have observed, in a world of mobile capital and increasingly mobile labour, companies and many skilled individuals have a choice not just about where to work or where to invest but about where to pay tax. This is a reality governments can no longer afford to ignore and there is no better example of this than the area of R&D and IP development and commercialization.

Clearly governments are struggling with this one, particularly in regards to, as Edward alluded to, how to deal with the migration of IP to lower or more favourable tax regimes.

It is interesting to contrast the approach being taken on one hand by the U.K., with respect to

their patent box regime, and the almost opposite approach being taken or proposed in the U.S. by the Obama administration with respect to the excess returns and dealing with some of what they think is the inappropriate migration of IP and related profits by effectively taxing them as Subpart F income.

I am intrigued about the possibilities of a patent or innovation box, especially so since the U.K. has decided to adopt it for reasons that should resonate with critics that say there is not enough R&D and innovation being done or coming out of Canada and that our productivity is lagging with respect to the U.S. and other major countries.

A question I keeping asking is, "Are Canadian companies not doing enough R&D and innovation or are they just not doing it in Canada?"

If Canadian companies are not doing enough of R&D and innovation in Canada, maybe it is because we have front loaded all the incentives and not paid enough attention to the back end, the commercialization end of the innovation cycle or as my former colleague, Mark Parsons, wrote in a recent CD Howe paper, maybe it is because we have not focussed enough attention on the "pull" factors to encourage the commercialization of developed IP from Canada – which seems to be one of the reasons behind the U.K. move to the patent box.

The Advisory Panel attempted to touch on this but only in a brief way by recognizing that natural factors draw Canadian business investment offshore.

Some respected commentators argue that a territorial approach will lead to increase transfers of profits to low tax jurisdictions in a way that current transfer pricing principles cannot prevent, therefore there is a need for some form of worldwide consolidation or formulary approach to taxation.

I believe alternatives that provide incentives to encourage more or bring or retain such activities in Canada should be explored; put more focus on the "pull" factors such as a patent box.

As Brian Mustard, Scott Wilkie and I hypothesized in a paper we prepared in 2009 for the Canadian Tax Foundation, this approach may have the potential to actually increase the tax base in Canada and not just the corporate tax base.

Edward mentioned that Glaxo Smith-Kline has announced it will build a new £700 million plant in the UK, the first plant in a generation, and that they are attributing this in large part to the new patent box regime. This type of success story is cause for us to stop and think about such a regime in a more deliberate fashion.

Steve Suarez:

Very good. Well, we've hit our time limit. Thanks very much for your attention today and thanks to our speakers for sharing their thoughts on these important issues.

I also want to acknowledge the contributions of three other people who were part of this presentation. Chris Osborne of PwC Canada (who is the secretary of the panel), Matthew

Prescott from PwC US and Carol Johnson from Her Majesty's Treasury all made important contributions to today's panel discussion, and we wish to acknowledge their fine work with our thanks.