
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 rules⁴ 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

* Tax partner, Davies Ward Phillips & Vineberg LLP, Montreal; sessional lecturer on tax policy, McGill University; and member of the Canadian Bar Association/Canadian Institute of Chartered Accountants Joint Committee on Taxation. I would like to thank David Ward, Nathan Boidman, Stephen Ruby, and Robert Raizenne, also of Davies Ward Phillips & Vineberg LLP, for their helpful comments and suggestions on the manuscript. I nevertheless retain all responsibility for any errors or omissions. This paper is written from the perspective of a tax practitioner—a tax lawyer—with a considerable interest in public policy. I specifically disclaim any professional or other qualification as an economist, a social or political scientist, or an expert in foreign or international relations.

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 out²⁴ 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 *Stuart 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 recognizes⁵⁰ 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 recommended⁷⁰ 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-being⁸⁰—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.