The Foreign Affiliate System in View and Review

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

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

In View and Review

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The International Context

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

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

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

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

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

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

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

[14] See OECD, supra footnote 9.

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

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

The Auditor General's Report: An Opportunity

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

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

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

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

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

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

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

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

The Present Assessment

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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[23] Continued . . .

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

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

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

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

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

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

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

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

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

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

[27] That is, FAPI.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[33] See supra footnote 31.

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

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

The Canadian System for Taxing International Income

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

Inbound Investment

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

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

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

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

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

Outbound Investment

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

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

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

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

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

3) income that

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

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

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

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

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

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

Income Earned Directly

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

Income Earned Through Intermediaries

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

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

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

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

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

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

[45] For example, see section 94.1.

[46] See supra footnote 43.

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

[48] See supra footnotes 43 and 45.

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

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

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

The Foreign Affiliate System Simpliciter

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

A Foreign Tax Recognition Regime

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

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[51] See the discussion immediately following.

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

[53] See Vogel, supra footnote 11.

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

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

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

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

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

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

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

Basic Design Questions

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

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

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

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

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

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

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

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

General System Constraints: International Norms

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

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

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

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

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

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

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

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

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

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

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

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

International Double Taxation

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

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

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

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

International Norms: The "Neutralities"

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

Capital Export Neutrality

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

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

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

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

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

Capital Import Neutrality

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

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

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

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

[63] Ibid., at 408.

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

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

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

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

National Equity

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

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

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

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

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

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

Resolving Conflicts

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

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

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

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

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

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

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

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

The Canadian System in Historical and Policy Perspective

Laying the Foundations: 1917-1971

The Income War Tax Act of 1917

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[78] Ibid.

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

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

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

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

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

(The footnote is continued on the next page.)

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

The Income War Tax Act of 1927

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

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

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

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

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

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

(The footnote is continued on the next page.)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(The footnote is continued on the next page.)

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

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

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

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[94] Continued . . .

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

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

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

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

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

The Income Tax Act of 1948

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

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

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

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

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

(The footnote is continued on the next page.)

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

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

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98 Continued . . .

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

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

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

99 ITA 1948 section 28.

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

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

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

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

The Income Tax Act of 1952

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

Reform Proposals

The Carter Commission

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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[111] Ibid., at 486.

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

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

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

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

[116] Ibid., at 487.

[117] Ibid., at 489.

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

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

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

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

[120] Ibid., at 516.

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

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

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

The White Paper

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

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[122] Ibid., at 516-18.

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

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

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

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

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

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

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

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

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[127] Continued . . .

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Legislative Reform: 1972-1976

Bill C-259

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

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

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

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

(The footnote is continued on the next page.)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

c) most interaffiliate dividends.

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

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

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

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

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

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

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

b) certain interaffiliate dividends.

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

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

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

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

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

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

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

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

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

(146, 147 Continued on the next page.)

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

[146, 147] Continued . . .

tax and Canada should not have any interest in helping to enforce the tax laws of other countries, particularly when other countries did not do so. Canada was seen as being some sort of an international fiscal policeman, a role that was acceptable on the island of Cyprus but definitely not appropriate for the islands of the Caribbean.

3. Investment income that arose incidentally to or was closely related to the operation of an active business in a foreign country. Examples here were income such as occurs through the operation of the DISC legislation in the United States, income arising from the investments that used to be required to be made in Brazilian Government Bonds and income from the affiliate of a foreign corporation formed for the purpose of acquiring the corporation's commercial paper.

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

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

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

[149] See supra footnote 142.

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

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

The Budgets of 1974

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Subsequent Amendments

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

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

165 Section 90 of the Act.

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

167 Paragraph 95(1)(b).

168 SC 1984, c. 45, section 30.

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

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

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

(The footnote is continued on the next page.)

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

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

Evolving International Policy Considerations

The Canadian Policy Evolution

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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[179] Supra footnote 107.

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

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

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

[183] Ibid.

[184] Supra footnote 124.

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

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

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

Responses to the Report

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

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

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

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

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

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

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

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

The dilemma has been described in these terms:

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

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

Policy Direction

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

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

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

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

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

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

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

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

Contemporary Policy Choices

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

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

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

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

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

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

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

[194] Ibid., at 3.

[195] Ibid.

[196] Ibid., at 8.

[197] Ibid., at 10.

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

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

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

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

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

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198 Ibid.

199 Ibid., at 53.

200 Ibid.

201 Ibid.

202 See comments, infra footnote 215.

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

204 Slemrod, supra footnote 67.

205 Ibid., at 115.

206 Ibid.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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[211] Ibid., at 56.

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

Looking Ahead in Canada

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

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

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

Points To Consider

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

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

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

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

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

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

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

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

(The footnote is continued on the next page.)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[221] See "Evolving International Policy Considerations."

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

[223] Including international group financial operations.

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

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

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

Appendix

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

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

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

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

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

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

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

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

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

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

TABLE 26-1

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

Under the Proposals in this Report

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

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

Under the Present Tax System

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

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

(The table is concluded on the next page.)

TABLE 26-1 CONCLUDED

Cash Position of Resident Shareholder	25 per cent marginal rate	50 per cent marginal rate	Cash Position of Resident Shareholder	25 per cent marginal rate	50 per cent marginal rate
Cash dividend	$ 30.35	$ 30.35	Cash dividend	$ 42.50	$ 42.50
Net resident tax rebate	15.18	0.00	Net resident tax paid	2.12	12.75
Net cash	$ 45.53	$ 30.35	Net cash	$ 40.38	$ 29.75

Notes:

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

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

c/ $12.14 = 20 per cent of $60.71

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

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