Taxing Foreign Business Income

Nick Pantaleo and J. Scott Wilkie

Nick Pantaleo, CA. International tax services partner, PricewaterhouseCoopers, Toronto. BComm, University of Toronto. Lecturer, Canadian Institute of Chartered Accountants international tax course. Former lecturer, Institute of Chartered Accountants of Ontario School of Accountancy and Society of Management Accountants. Co-editor, International Tax Planning feature, *Canadian Tax Journal*. Frequent speaker on international taxation matters for the Canadian Tax Foundation, Tax Executives Institute, and CCH Canadian Limited. Recipient of the 1997 Douglas J. Sherbaniuk Distinguished Writing Award, presented annually by the Canadian Tax Foundation.

J. Scott Wilkie. Tax partner, Ogilvy Renault, Toronto. Adjunct professor of international taxation, Osgoode Hall Law School, York University. Governor, Canadian Tax Foundation. Chair, National Tax Section, Canadian Bar Association (CBA); joint chair, Joint Committee on Taxation of the CBA and the Canadian Institute of Chartered Accountants. Member and treasurer, Canadian Branch Council, International Fiscal Association; member, International Advisory Council, International Bureau of Fiscal Documentation. Frequent speaker and writer on many income tax subjects, particularly in the international area. Co-author of *Transfer Pricing Strategies in a Global Economy* (International Bureau of Fiscal Documentation).

Introduction

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

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

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

International Taxation and Contemporary Business Activity

Interjurisdictional Income Allocation and Foreign Tax Credit

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

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

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

(The footnote is continued on the next page.)

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

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

The Committee's Recommendations: Tax Policy Themes

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The Report: Policy Directions

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Taxation of Foreign Income of Canadian Investors

General

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

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

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

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

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

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

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

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

Canadian Taxation of Foreign Active Business Income: A Territorial System

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

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

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

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

The Accrual Method

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

Full Exemption System

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

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

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

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

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

Deferral Method with Credit

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

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

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

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

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

The High-Tax Method

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

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

The Committee's Overall Assessment

On balance, the committee concludes that the present system of

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

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

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

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

The Recommendations: Outbound Investment

Definition of Foreign Affiliate

Recommendations

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

Background

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

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

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

[26] Ibid.

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

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

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

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

Discussion

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

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

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

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

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

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

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

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

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

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

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

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

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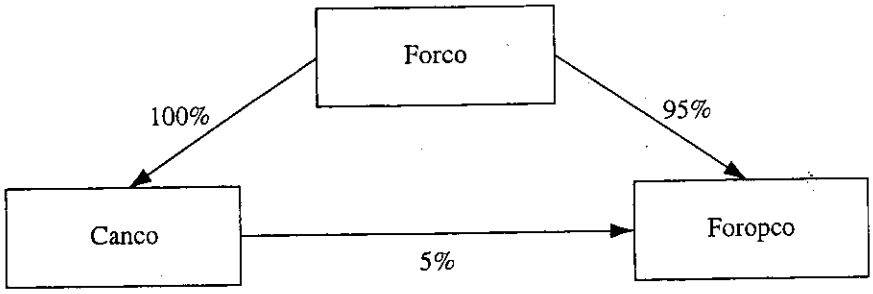
[33] Paragraph 95(6)(b) applies to an acquisition or disposition of shares if the principal purpose is the avoidance, reduction, or deferral of amounts payable under the Act. If the principal purpose test is met, the shares are deemed not to have been acquired or disposed of, and previously unissued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

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

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

Figure 1



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

Interest Deductibility: Financing Foreign Direct Investment

The Committee's Recommendations

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

Background

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

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

Discussion

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

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

Interest Deductibility and Foreign Tax Credit

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

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

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

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

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[37] Ibid.

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

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

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

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

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

Determining Interest Related to FDI: The Tracing Method

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Other Possible Methods To Determine Interest Related to FDI

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

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

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

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

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

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

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

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

Protecting the Revenue Base

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

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

Recovering Lost Interest Deductions

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

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

Small Business Tax Harbour

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

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

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

Practical Effects: Theoretical Issues

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

FAPI Exemption for Interaffiliate Transactions

Recommendations

- The FAPI exemption for interaffiliate transactions should be maintained.

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

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

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

Background

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

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

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

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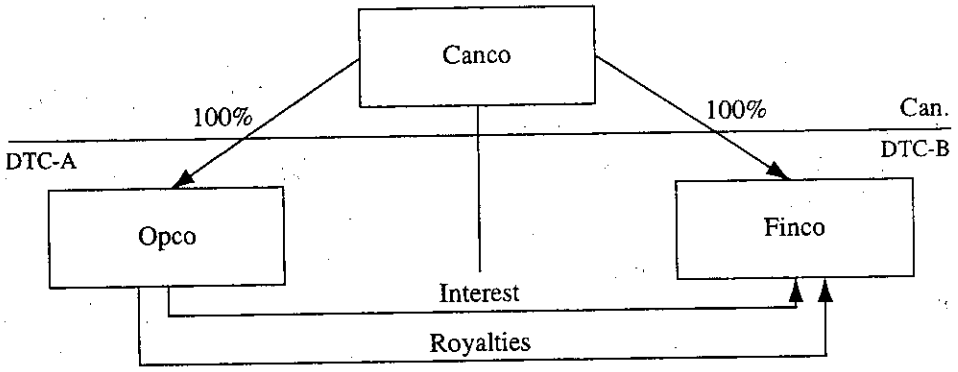
[55] Income that would otherwise be income from property may also be deemed to be active business income if the conditions found in subparagraph 95(2)(a)(i), (iii), or (iv) are met.

Figure 2



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

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

Discussion

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

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

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

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

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

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

Tax-Privileged Entities

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Second-Tier Financing Structures

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

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

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

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

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

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

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

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

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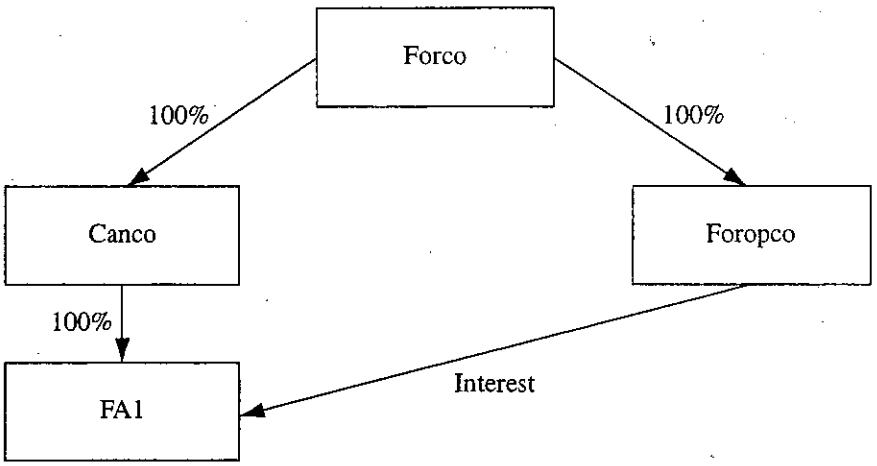
[64] Revenue Canada has indicated that it will challenge such structures using the general anti-avoidance rule found in section 245 (see Wayne Adams, "The General Anti-Avoidance Rule (GAAR) Committee," in *Report of Proceedings of the Forty-Seventh Tax Conference*, 1995 Conference Report (Toronto: Canadian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

Figure 3



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

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

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

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

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

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

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

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

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

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

Conclusion

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

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

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

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

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

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

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

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

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

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

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

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

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

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