International Aspects - - I

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International Tax Provisions

On the international tax provisions—those relating to the taxation of foreign income and of non-residents—falls the responsibility of preserving the integrity of the domestic tax system and, at the same time, of accommodating that system to the range of different tax systems of other countries. The proper discharge of this responsibility assumes somewhat greater importance in Canada than elsewhere because of the openness of the Canadian economy and the extent of its dependence on international trade and foreign investment.

Non-Residents

For the foreseeable future, Canada's capital requirements will continue, as they have in the past, to exceed the level of domestic savings. Canada must therefore continue to attract foreign investment. The tax system in general, and the international provisions in particular, cannot ignore Canada's dependence on foreign investment.

Ideal, non-resident provisions would encourage the foreigner to invest in Canada, in a form acceptable to Canada, but in a manner that would not grant him a preferred tax position in any way over the Canadian investor in Canada.

The ideal is unattainable. But non-resident provisions can achieve a less ambitious object of providing for fair treatment of the foreign investor without, at the same time, opening opportunities for abuse. This objective can best be approached, not unilaterally by Canada, but in concert with other countries.

The White Paper proposes to follow the example set by most other developed countries. It opts for two international tax systems for non-residents—a tax treaty system and a statutory system. Bilateral tax treaties have emerged and expanded rapidly in response to the need for a flexible mechanism by which different tax systems can be reconciled. Such treaties have as their object the alleviation of over-

lapping international taxation which, at current levels throughout the world, can constitute a serious fiscal impediment to international capital mobility and foreign trade.

In treaty negotiations, Canada would seek to induce other developed countries to dismantle any fiscal barriers standing in the way of investment in Canada. In exchange, Canada would be expected to offer appropriate concessions. The advantage of the treaty mechanism is that it is flexible—the concessions can better be tailored to particular circumstances and confined to those persons they are intended to benefit.

Few persons have taken issue with the "two-system" approach adopted in the White Paper. Some apprehension has been expressed on the part of non-residents, stemming in large measure from uncertainties—concerning the system itself, concerning the particular countries with which there will be treaties and concerning the concessions Canada will be prepared to make.

There is little that can be said at this time to dispel the uncertainty except to observe that the expressed intention to place a high priority on the expansion of Canada's treaty network implies a willingness on Canada's part to adopt a reasonable attitude in treaty negotiations.

It has become one of the popular games people play to speculate on the extent to which Canada's future treaties will depart from the international norm as reflected in the *pro forma* tax convention adopted in 1963 after protracted study by the Fiscal Committee of the O.E.C.D. In any such speculation, several factors seem relevant.

First, the O.E.C.D. treaty is a consensus agreement. It emerged more as a collection of compromise solutions to practical problems of international taxation than as a codification of any fundamental principles founded on a need for international fiscal harmonization.

Second, the draft convention reflects a bias that exacts tax reductions from the "country of source" of income in favour of the "country of destination". It is not therefore surprising that the capital-importing countries (and particularly the less-developed countries), take exception to some of the provisions that, at least in revenue terms, would not represent reciprocal concessions.

Third, most other countries have a wide selection of devices outside of their tax systems which can be used to protect their taxes—e.g., currency controls, investment regulations, corporation laws and other restrictions which enable the authorities to dictate the terms on which international investment will be accepted. Many European countries and most of the less-developed nations, for example, use such controls to prescribe limits to the royalties and management fees that may be charged within the multi-national business complex, to protect against thin capitalizations, or to ensure that local capital is given an opportunity to "take a piece of the action". The relative freedom from such controls in Canada places a correspondingly heavier burden on the tax system to police the national interest.

Fourth, the O.E.C.D. treaty reflects the influence of the tax systems of member countries in the 1950's and early 1960's, when the "fruit-of-the-tree" concept of income and the "separate identity" concept of the corporate tax prevailed. As these concepts gradually erode, the standard treaty prescriptions change.

The point of the last observation is to emphasize that the players of the treaty guessing game ought not to ignore the process of evolution evidenced in recently

negotiated treaties of the developed and less-developed countries. Significant treaty developments are taking place. Polite society no longer considers it outrageous, or a flagrant violation of established international fiscal morality, to refer to the possibility of taxing the share gains of non-residents.

Foreign Income

Much, but by no means all, of the criticism of the proposals relating to the taxation of foreign income centres on the demise of the blanket exemption privilege now enjoyed by Canadian corporations in respect of dividends from direct investments abroad.

The proposed substitution of a U.S./U.K.-style gross-up-and-credit system for dividends in non-treaty circumstances seems to have few supporters among academic purists. They argue on neutrality grounds that even the American system is too generous.

President Kennedy, in his 1961 tax message to the U.S. Congress, took the position that neutrality required all foreign income, including the earnings of American-controlled foreign corporations (whether repatriated or not), to bear an effective tax burden at least equal to that imposed in the United States. The Treasury proposal to eliminate the so-called "deferral privilege" was rejected by the U.S. Congress after extended debate for a variety of reasons, perhaps the most important being that it would result in a more onerous regime than that in effect in other countries and would, therefore, place U.S. business at a competitive disadvantage abroad.

The "competitive disadvantage" argument, rather than any neutrality argument, generally underlies the criticism, by others, of the White Paper proposals: "Widgets Canada cannot compete with Widgets Europe unless it can enjoy the same tax-exempt privileges on foreign earnings." This objection is often accompanied by the lament that "the disadvantages from the point of view of administration and compliance are likely to be wholly incommensurate with any benefits gained in terms of additional revenues and curtailment of abuse".

Clearly there is no way to reconcile the differences of opinion between those who view the proposals as too generous or as having too diluting an effect on the incentive provided within the system for increased Canadian investment by Canadians, and those who believe the proposals fail to recognize the practical problems of multi-national corporations.

The latter critics generally express doubts that Canada's treaty network can in fact be extended to cover more than but a few of the less-developed countries. Many such countries do not now enter into bilateral treaty relationships with developed countries. And the point is further made that it is inappropriate for Canada, as a developed country, to adopt a system of taxing foreign income that effectively frustrates the incentives given by less-developed countries in their effort to attract much-needed foreign investment.

If tax preferences are to be given to investment in less-developed countries there is good reason to do this on a bilateral treaty basis rather than by the unilateral blanket extension of preferences to all foreign investment. The country-by-country approach has the advantage of flexibility—more effective incentives can be given where appropriate, with greater assurance that they will, in fact, benefit *bona fide* foreign investment.

The prospects for the success of Canada's efforts to conclude tax treaties with less-developed countries remains a matter of conjecture. Much will depend on the attitudes of less-developed countries and on Canada's negotiating demands.

The White Paper indicates a willingness on the part of the government to exempt from corporate tax dividends received on direct investments in treaty countries. The exemption privilege—which is a generous form of tax sparing—would of course be included in any treaties with developing countries. A number of European countries have not insisted in treaty negotiations that the less-developed countries yield those reciprocal concessions ordinarily reflected in treaties between developed countries. Their principal objective appears to be to obtain "most-favoured-nation" treatment—to ensure that the less-developed country treats their taxpayers on an equal tax footing with investors and exporters from other developed countries.

If Canada were to adopt a similar approach in negotiations with the L.D.C.'s, it seems reasonable to expect that Canada's treaty program could proceed fairly quickly once the reform is implemented. In the meantime, the uncertainty concerning the countries with which successful treaty negotiations will take place has the unfortunate effect of making it difficult for Canadians properly to assess the tax implications of proposed investments abroad.

The government is concerned with this problem. In his appearance before the parliamentary committee, the Minister of Finance indicated that he was giving serious consideration to a supplementary proposal designed to overcome the negative effect that such uncertainty might have on Canadian investment overseas.

Conclusion

A country sees the bilateral tax treaty as a means of gaining access to foreign capital and/or export markets. While these are not the only treaty objectives, they are important ones. If these objectives cannot be achieved, a compelling reason for having a treaty is missing.

It should be recognized that a treaty represents a negotiated agreement, settled in the ordinary course of hard bargaining. This means that to get meaningful concessions from other countries, Canada must stand ready to yield concessions in return. The success of Canada's treaty program depends, to a large extent, on its willingness to offer preferential treatment to non-residents and to foreign investment in treaty circumstances. Canada's willingness to do so is openly acknowledged in the White Paper.

It would be a mistake to assume that the proposals relating to non-residents and foreign income are simply bargaining ploys to be given away in treaty circumstances. The international provisions are designed with a view to protecting the domestic tax system. And the restriction of certain privileges to treaties forms an important element in that protection.

The overall tax system is designed to:

(1) ensure that the domestic operations of Widgets Canada and of Widgets Foreign bear their appropriate share of the Canadian tax burden;

(2) ensure that the foreign operations of Widgets Canada bear an appropriate burden;

(3) provide Widgets Canada with an incentive to expand its domestic operations, but in a way that does not prevent it from expanding abroad and does not render it uncompetitive with Widgets Foreign abroad; and

(4) ensure that Widgets Foreign is not discouraged from investing in Canada and from expanding its Canadian operations.

The overall system is also designed to:

(5) ensure that the shareholders of Widgets Canada, both resident and non-resident, bear an appropriate share of the tax burden;

(6) ensure that the Canadian shareholders of Widgets Foreign bear an appropriate tax; and

(7) encourage Canadians to acquire shares of Widgets Canada and to ensure that Canadians are not at a disadvantage over foreign investors in bidding for such shares.

A provision designed to achieve one particular objective may frustrate another. A blanket dividend exemption privilege, for example, designed to protect the competitive position of Widgets Canada abroad may:

(8) encourage Widgets Canada to expand abroad rather than in Canada;

(9) encourage Widgets Canada to serve export markets out of foreign rather than domestic production;

(10) may frustrate Canada's efforts to obtain tax treaties abroad; and

(11) serve as a shelter to reduce the tax on income from other than *bona fide* operations abroad.

In the final analysis, the international provisions inevitably involve compromises to achieve an appropriate overall balance. In my view, the government's proposals achieve a reasonable balance.

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The White Paper and U.S. Investors

The opportunity to discuss the implications of the tax proposals in the White Paper with this group is a real privilege. Although I am from below the border, I am pleased to see present many I consider friends.

The proposals for tax reform contained in the recent White Paper have a significantly greater effect on Canadian residents than on U.S. investors and non-residents generally. I commend the time span which has been allowed for discussion and study of the reform proposals since the publication of the Carter *Report* over three years ago.

As most of you know, President Nixon announced the outlines of tax reform proposals in April of last year and the legislation was enacted in December. The final law is far different from the initial proposals. Already it is clear that amendments will be required to avoid unanticipated penalties and benefits.

As in the U.S., the Canadian proposals are stated in general terms and advance broad objectives. It is easy to interpret such statements in accord with one's own preconceived ideas. From our experience it would be highly desirable to have the proposed statutory language also exposed for a period of examination. This would allow time for clarification of ambiguities and definitions.