International Taxation

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Introduction

International taxation is, by its very nature, one of the most complex and difficult areas in any business tax regime – for policy makers, tax administrators and taxpayers alike. A business carrying on activity in multiple jurisdictions is subject to a myriad of taxes and other levies on its various sources of income, and tax rules related to international income – both in design and application – are extraordinarily complex in many jurisdictions. This is a particular concern when, increasingly, small and medium-sized businesses, often lacking internal tax expertise, are expanding into foreign markets and must comply with the rules. The challenge for policy makers is that Canadian tax rules must take account of disparate rules across many jurisdictions, having regard to the significant potential impact that Canadian rules can have on domestic economic growth, job creation and protection of the tax base.

The issue is not a new one; historically, Canada has been a large capital importer and has placed a relatively heavy reliance on foreign investment. However, as noted in Chapter 3, Canada is now a significant capital exporter as well. The stock of foreign direct investment into Canada is substantial, and amounted to approximately $170 billion in 1995 or 20 percent of assets held by Canadian businesses.[1] However, the stock of outbound foreign direct investment by Canadians is also significant (approximately $140 billion in 1995 or 18 percent of total assets held by Canadian businesses), and is rising faster than inbound investment.

Today's global economy is characterized by the ongoing liberalization of trade policies and increasing transborder flows of goods, services, capital and technology. As the world economy becomes ever more integrated, and as business becomes increasingly mobile, the requirement that Canadian tax rules keep pace with international trends increases in importance.

In this Chapter, we provide an outline of some fundamental concepts of international taxation, and an examination of the major policy issues in this area, with a prime focus on foreign direct investment.

Competing Objectives for International Tax Policy

Tax policies related to inbound and outbound investment are driven by two important objectives: domestic economic growth and job creation on the one hand, and protection of the Canadian revenue base on the other. The Committee recognizes that there are often tensions between these two objectives, and there are many situations where there are no obvious "right" or "wrong" answers. A major constraint is the need to balance domestic considerations against international realities over which Canada has little control. For example, Canadian tax policies that are more onerous than those of other countries can have the effect of discouraging Canadian business activity and, as a result, can dampen domestic economic growth and job creation. Another constraint when examining Canada's

international tax policy is a pragmatic one: experience under the tax systems of other countries indicates that relatively little domestic tax revenue is raised from outbound foreign direct investment, irrespective of the nature and scope of the particular tax regime that is in place.

Against this background, this Chapter sets out concepts of international taxation that are fundamental to understanding the issues, examines the major policy issues related to inbound and outbound investment, and finally, details its conclusions. Throughout the discussion, a major theme prevails: it is the Committee's view that as a matter of general principle, Canadian tax rules should strike a balance between facilitating international trade and investment, and protecting the Canadian domestic tax base.

Canada derives considerable benefit from the presence of Canadian-based multinationals, and we believe that Canada's tax policy should accommodate the expansion of such companies, and their foreign investments, but on terms that are fair to Canada. It is also important that Canada continues to attract foreign investment, with foreign and domestic investors being placed on a similar footing. The Committee believes that if our proposals – to lower corporate income tax rates to make them competitive with those of our major competitors, offset by a broader tax base, which includes international tax measures where appropriate – were to be adopted, the result would be increased domestic investment and job creation, greater fairness and better protection of Canada's domestic tax base.

Fundamental Concepts for the Taxation of International Income

Multinational businesses are important to the Canadian economy. Many Canadian businesses operate throughout the world by investing in foreign operations; similarly, foreign enterprises operate here. Also, investment outbound from Canada can contribute to economic growth and job creation at home.[2] For example, Canadian-owned multinationals often rely on domestic sources of supply, and Canadian managerial talent and operational efficiency, to develop export markets for Canadian products and services.

Investment outside Canada by Canadian multinational businesses can therefore have significant spinoff effects, which contribute directly and indirectly to increased economic activities here. Further, as international trade in goods, services, capital and technology grows, and as both foreign and domestic markets open up to international competition, many Canadian businesses have found that they must expand abroad in order to achieve the necessary size to be efficient in production. In a number of industries, only large multinational enterprises have the ability to be truly competitive in global markets.

As for inbound investment, foreign multinationals operating in Canada provide capital, management and expertise for the development of key sectors of the economy, thereby also contributing to Canada's economic well-being. Inbound investment can also provide important spin-offs for Canadian-owned businesses that supply products and services to foreign multinationals operating here. Foreign companies also have access to financial markets in their home countries, often providing pools of cheaper capital for Canada.

The tax system of the host country where the business is carried on can have an important impact on both domestically owned and foreign-owned multinational operations. Although taxes are not the only factor that influence business decisions, the evidence is clear that they affect decisions of multinationals to invest at home and abroad.[3] In examining Canada's tax system, the Committee concluded that taxation of investment in Canada has had a significant impact in discouraging investments from being made in Canada by both Canadian-owned and U.S. companies.[4]

Canadian tax rules also influence the way in which investments are structured and whether the Canadian domestic tax revenue base is adequately protected. For example, as pointed out in Chapter 3, there has been a tendency for multinational businesses to shift debt financing and associated interest expense into Canada, thereby eroding the tax base.[5] The contrast between multinational and domestic-only businesses in this regard is striking: Canadian multinational businesses have increased their debt as a proportion of assets from 36 percent in the period 1986 to 1988, to 43 percent in the period 1992 to 1994, and foreign-controlled businesses have increased their debt as a proportion of assets from 20 percent to 26 percent in these same periods. In comparison, Canadian-controlled businesses without foreign affiliates slightly reduced their debt financing as a proportion of assets from 33 percent to 32 percent for these periods.

The growth and size of inbound and outbound investments thus raise two important tax policy issues for Canada: the need to strive for a tax system that is neutral for all businesses, foreign or domestically owned; and the requirement that governments protect their tax revenue base in order to support public-sector activities.

Neutrality in Tax Treatment for Businesses in Canada

Neutrality – the equal treatment of businesses in similar circumstances – results in both economic efficiency and fairness. It fosters international commerce and the flow of capital, by not interfering with the decisions of multinational businesses, and it contributes to economic growth and job creation by permitting businesses to seek economic opportunities for investments without being unduly influenced by taxation. As a principle, neutrality, in its fullest sense, implies that:

- Canadian businesses bear similar amounts of taxes on domestic and foreign investments;
- Canadian businesses operating in foreign jurisdictions bear similar amounts of taxes on their foreign investments as competitors operating in those jurisdictions; and
- foreign-owned businesses operating in Canada bear similar amounts of tax as Canadian-owned businesses operating in Canada.

As a practical matter, however, neutrality is a difficult principle to apply at the international level, since different jurisdictions choose taxes with varying rates and bases. The result is that all three conditions described above cannot be achieved simultaneously. For example, if foreign tax burdens are less than Canada's, payment by Canadian multinationals of taxes at the Canadian rate on their foreign investments may ensure tax neutrality between domestic and foreign investments, but at the same time, cause Canadian businesses to be more highly taxed than companies operating in foreign jurisdictions. Neutrality in the international context, therefore, can never be absolute. The best possible policy objective for Canada is to minimize economic distortions as much as possible.

Neutrality at the International Level

Varying concepts of neutrality are employed when assessing issues of international taxation. Several of the most important include the following:

Global Versus National Neutrality

Global neutrality implies that businesses should pay similar rates of Canadian and foreign tax on income derived from investments in Canada or abroad and regardless of the nationality of the owner operating in Canada. Under global neutrality, foreign taxes paid by businesses would be credited against Canadian taxes owing, so that the total rate of foreign and Canadian tax on income paid on foreign investments is no greater or less than on domestic investments. Similarly, foreign governments would allow their resident multinationals to credit Canadian taxes against the foreign governments' taxes owing on income derived from Canada.

The concept of global neutrality can be contrasted with national neutrality. National neutrality implies that domestic taxes should apply at the statutory rates of the investor country, irrespective of the geographic source of the income, and that foreign income taxes should only be deductible, in the investor country, as an expense of doing business in another country, rather than being treated as a credit against taxes. With deductibility, however, there is an element of double taxation that results in higher taxes on foreign compared to domestic operations. This can impede the efficiency of Canadian multinational businesses.

Most countries have accepted the concept of global neutrality, in that they allow foreign income taxes to be credited against domestic taxes on income earned abroad, or by exempting foreign income from further taxation in the home country when profits are repatriated in the form of dividends. Given Canada's desire to foster trade in international markets, the Committee believes that global neutrality for Canadian businesses is a more appropriate principle to follow.

Capital Export Neutrality

Capital export neutrality is achieved when foreign-source income is subject to the same effective rate as Canadian domestic income. This leaves Canadian multinationals indifferent, from a tax perspective, as to whether they invest in the Canadian domestic market or in foreign markets. In theory, capital export neutrality implies that Canadian tax would be paid on income taxed at lower rates abroad or, alternatively, result in the provision of refundable Canadian credits to bring down foreign taxes to the level of Canadian tax.

Capital Import Neutrality

Under capital import neutrality, a foreign investor is subject to tax at the same level as domestic companies in the country in which the business is carried on, contributing to international competitiveness by ensuring that foreign-source income is taxed in a particular country at the same rate as income earned by businesses owned by residents of that jurisdiction. From a Canadian perspective, capital import neutrality also implies that Canadian taxes on inbound investment should be similar to those on domestic-owned businesses – there should be no discrimination between foreign and domestic businesses.

Conflicting Demands of Neutrality

These various "neutralities" can conflict with each other. In particular, international competitiveness for Canadian businesses operating abroad can conflict with capital export neutrality, since it implies that domestic and foreign investments of Canadian multinationals may be taxed at different rates. The Committee recognizes that there are conflicts between capital export and capital import neutrality when foreign taxes are less than Canadian tax on income earned from abroad. An appropriate balance must be achieved. Canada derives benefits from the operation of multinationals here. The full application of capital export neutrality could impair their competitiveness abroad or, even worse, discourage companies from operating here. On the other hand, if Canadian businesses earn income that bears little or no tax in foreign jurisdictions, multinationals may be encouraged to locate production in foreign jurisdictions.

Fairness and Revenue Protection

The unavoidable outcome of taxing multinational businesses is that Canada is obliged to share the tax revenue raised from their activities with other national governments. Taxes paid by multinationals to Canadian governments contribute to meeting the cost of public activities that benefit all of us, including Canadian and foreign-owned businesses operating here. It is in Canada's interest, therefore, to protect its share of the tax base of income earned by Canadian and foreign multinationals from operations in Canada.

The sharing of tax revenues among national governments raises the issue of fairness – jurisdictions, either of source (where the production or delivery of goods and services takes place) or of fiscal domicile (where the business enterprise is resident or incorporated), are both entitled to tax the income earned by the enterprise. The country of source taxes the income earned in its jurisdiction to ensure that foreign businesses operating there share in the cost of public goods and services. The country of domicile may also choose to tax the foreign-source income of its residents to ensure that they pay a similar level of tax on all sources of income, domestic or foreign, in the interests of efficiency and fairness. In this event, and consistent with neutrality, a credit for foreign income taxes is often provided to recognize that such income has borne tax elsewhere and should not be subject to double taxation.

Challenges in Implementing the Principles of Neutrality and Revenue Protection

While the Committee regards both neutrality for Canadian businesses and revenue protection as crucial to economic growth and job creation, we are also aware of the difficulties inherent in implementing policies that will achieve these goals. National governments have varying revenue requirements and different views on what constitutes an appropriate sharing of business taxes. Every government chooses its own tax levels and tax mix, as well as the rules for defining what income is subject to tax. In the absence of worldwide uniform corporate taxation, full neutrality for all businesses operating in all countries is impossible to achieve. What Canada can do, however, is be fully aware of the impact its system has on international business, and take measures to ensure that Canada and Canadians benefit to the greatest extent possible from these economic activities.

For example, high levels of tax (relative to other jurisdictions) on foreign and domestic investments can affect the competitiveness of Canadian multinationals, and can reduce the economic benefits that Canadians derive from the Canadian multinational's activities. Similarly, high levels of Canadian tax on foreign businesses operating in Canada can discourage investments here. Also, international tax structures that result in the erosion of the Canadian tax base – for example, a tendency to borrow in Canada for foreign direct investment, rather than in the foreign country in which the investment is being made – can result in the need to increase taxes on other taxpayers or reduce public expenditures.

As noted, Canada has historically been reliant on significant levels of foreign direct investment from other countries. While high levels of Canadian tax can impair the flow of capital to Canada, low levels of Canadian tax on Canadian income may be offset by higher taxes paid by foreign parent corporations to their foreign governments where the foreign country applies the credit system, as do the United States, the United Kingdom and Japan. The interaction of the Canadian tax system with those of other countries is thus an important factor to keep in mind when developing Canadian policies for the taxation of inbound investment.

Despite recognition that neutrality is, in theory, a desirable objective, most, if not all, countries have elements within their tax systems that create economic distortions. As well, every government seeks to protect what it regards as its rightful share of the revenue base. In this regard, Canada is faced with the same constraints as its neighbours and trading partners: the Canadian tax regime must balance the goals of neutrality and revenue protection while being neither overly generous nor restrictive vis-à-vis the tax systems of other countries.

What Income is Liable to Canadian Federal Income Taxation?

Canadian federal income tax is generally levied on the worldwide income of persons resident in Canada (subject to credit or deduction for foreign taxes in respect of foreign-source income), and on certain Canadian-source income of non-resident persons. However, a Canadian corporate shareholder is generally not taxable on dividend income received as a result of foreign direct investment in countries with which Canada has entered into a tax treaty.

As discussed in Chapter 2, business and investment income may be earned by corporations, individuals, trusts or partnerships. A corporation is generally considered to be resident in Canada if it is incorporated in Canada, or if its central management and control is located here. The residence of an individual is a question of fact, but includes an individual who is living in Canada on a permanent basis. The residence of a trust is generally determined by the residence status of its trustees. Finally, a partnership is an entity that flows through its income to its partners, rather than a taxpayer itself.

A non-resident of Canada is subject to tax on certain Canadian-source income, under one of two regimes. First, a non-resident who is employed in Canada, carries on business in Canada or disposes of certain types of Canadian property, is subject to tax on net income from these sources, based on the general Canadian tax rates. Second, non-residents may be subject to withholding tax at a flat rate with respect to certain types of income, generally of a passive nature, such as interest, dividends, rents and royalties that are paid or credited by persons resident in Canada. The rate of tax on such income is 25 percent, generally on the gross amount paid or credited. As discussed further below, this rate is often reduced under tax treaties, and such treaties may also reduce the tax liabilities of non-residents carrying on business in Canada or deriving other taxable income from this country.

These Canadian rules establishing liability for tax are generally consistent with those followed by other major countries, although the detailed rules do, of course, vary considerably across countries.

The Role of International Tax Treaties

The bilateral income tax conventions (usually referred to as tax treaties) that Canada has entered into with other countries play an important part in facilitating cross-border trade, income and capital flows, and generally result in a more globally neutral tax regime for investment and business transactions between Canada and its treaty partners. Canada has one of the most extensive tax treaty networks in the world, with about 60 treaties in force, and a number of others under negotiation.

Tax treaties modify the taxation of cross-border income in a number of significant ways, primarily to reduce double taxation. For example, a resident of a treaty country is generally not taxable on income from a business carried on in the other country, unless the business is carried on through a fixed place of business. To minimize the potential for double taxation, countries may agree to either provide a credit for foreign income taxes, or an exemption for dividends received from foreign direct investment in the other country.[6] Also, under most treaties, capital gains realized by residents of one country from assets in the other are generally exempt from tax in that other country, except for real property interests and certain other assets. Most treaties provide for significant bilateral reductions in the rate of withholding tax applicable to income such as interest, dividends, rents and royalties that are paid to residents of the other country. Tax treaties also provide for an exchange of information between the revenue authorities of the two countries to assist in administration and enforcement, as well as dispute-resolution procedures to resolve issues of double taxation, including cross-border transfer pricing issues.

While Canada has tax treaties with almost all of our important trading and investment partners, we have generally not negotiated treaties with tax havens (generally those countries without significant domestic income taxes). However, a number of countries with which we have treaties have domestic systems that do not tax some sources of income, or do permit some types of income or entities to be taxed more favourably than the domestic norm.

Taxation of Foreign Income of Canadian Investors

In this section, we review and examine the alternatives for taxation of foreign-source income earned by Canadian-based multinational businesses from foreign direct investment. Such income is generally subject to tax in the foreign country; however, the home country of the investor will often also assert a right to tax the same income. The difficult policy issues to be addressed include the extent to which double taxation is to be avoided, as well as whether, and to what extent, restrictions should be placed on deductions incurred in the investor's home country that relate to business activities carried on abroad. After an analysis of these issues, we then turn to the taxation of passive income from foreign investment.

Accrual, Deferral and Exemption Methods

There are various alternatives for the recognition of income earned in an investor's home country from foreign direct investment. For example, active business income earned by a foreign subsidiary of a parent company could be taxed on a current basis in the home country (the **accrual** method). As a second alternative, income could be recognized as it is distributed as dividends to the parent company and subject to tax in the home country at that time. This approach, referred to as the **deferral** method, results in the recognition of taxable income in the home country being deferred as long as profits are retained or reinvested abroad. A third alternative is to **exempt** income earned abroad from home taxation, meaning that income will only bear foreign tax. The tax systems of many countries incorporate elements of all three methods, adopting the approach considered most appropriate to the particular nature of different sources of income.

To avoid double taxation of income, countries have generally followed either the deferral method with a credit, or the exemption method. Under the deferral method with credit, which is consistent with capital export neutrality, countries such as the United States, the United Kingdom and Japan tax business income from foreign direct investment, and then provide credit for qualifying foreign taxes up to the amount of their domestic tax liabilities. Under this method, such income is, in theory, ultimately subject to tax at the greater of the statutory rates of the foreign jurisdiction(s) and that of the home country of the investor. Under the exemption method, income derived from foreign direct investment is exempt from taxation in the home country and thus only subject to tax in the country where the investment takes place. The exemption method can be viewed as proxy for the deferral method with credit, 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. Alternatively, the exemption method can be viewed as encouraging international competitiveness, by ensuring that home country investors operating in foreign jurisdictions bear similar tax to businesses owned by residents of that jurisdiction, consistent with capital import neutrality.

An Overview of the Present Canadian System[7]

The Canadian system, consistent with most countries, contains elements of all of the three methods described above. Foreign branch income is taxed on an accrual basis, as is "foreign accrual property income" (FAPI), both with relief for foreign taxes. In the case of the earnings of foreign branches of Canadian companies, accrual taxation is consistent with the basic principle that the world income

of Canadian residents should be taxed in Canada. In the case of FAPI – which, as described below, includes passive investment income of foreign affiliates – accrual taxation serves to protect the Canadian tax base, by preventing Canadians from shifting mobile passive income to low tax jurisdictions. On the other hand, dividends received by a Canadian corporate shareholder out of active business income of a foreign affiliate are only subject to recognition in Canada as received, and Canada uses both the exemption and deferral methods in this regard.

A foreign affiliate is generally defined to be a foreign corporation in which the Canadian taxpayer owns, directly or indirectly, at least 10 percent of any class of shares (or more specifically, at least 1 percent of any class of shares, provided the taxpayer, together with related persons, owns, directly or indirectly, at least 10 percent of any class). Active business income earned by a foreign affiliate in a treaty country is included in what is called exempt surplus, and dividends out of exempt surplus paid to a Canadian corporate shareholder are deductible in computing its taxable income, irrespective of the foreign tax burden that has been incurred. Active business income earned by a foreign affiliate in a non-treaty country is included in taxable surplus and, where a dividend is received by a Canadian corporation out of taxable surplus, deductions (adjusted so as to be equivalent to a credit) are available with respect to both the underlying foreign tax applicable to the earnings being distributed, as well as any foreign withholding tax applicable to the dividend.

Canada's approach is consistent with those of other major investor countries. Japan, the United States and the United Kingdom have opted for the deferral method with a credit in respect of income remitted from foreign subsidiaries. However, many other countries, particularly in Europe, use the exemption method. Certain countries, such as Australia and Germany, operate both systems, as does Canada. Canada provides exemption in the case of dividends received by foreign affiliates in treaty countries, and uses the deferral method with the equivalent of a credit in the case of dividends from foreign affiliates in non-treaty countries.

Alternatives for Consideration

In common with other countries, Canada generally recognizes the active business income of foreign affiliates when it is received as dividends. An alternative would be for Canada to adopt the accrual system, whereby income from all foreign direct investment (whether earned by foreign affiliates or by foreign branches) would be taxable in Canada on a current basis, with credit given for any applicable foreign tax. While this would ensure that domestic and foreign-source income was taxed currently at comparable rates, it would put Canadian business enterprises at a major competitive disadvantage vis-à-vis all of Canada's major trading competitors, none of which has adopted this approach. For this and other reasons, it is the view of the Committee that accrual taxation of all sources of income is not a viable option.

Other methods that might be considered as alternatives to the existing Canadian regime are described below.

The Full Exemption Method: Canada could implement a full exemption system, under which all dividends received by a Canadian corporate shareholder out of the active business income of a foreign affiliate would qualify for exemption, irrespective of whether the business operations were carried on in a treaty or non-treaty country. Such a change might be based, in part, on the fact that Canada has a very extensive tax treaty network, which includes virtually all of our major trading and investment partners. With the exception of industries that operate primarily in developing countries, a very significant portion of active business income of foreign affiliates already constitutes exempt surplus. Also, dividends are rarely paid to Canadian corporate shareholders out of taxable surplus, if this would result in additional Canadian tax. Implementing a full exemption system should accordingly result in little loss of Canadian tax revenue, while significantly reducing administrative and compliance costs, by eliminating the requirement to maintain detailed computations of exempt and taxable surplus balances.

One significant problem, however, is related to capital gains. If Canada were to adopt a complete exemption system, under which both dividends from foreign affiliates, and capital gains from the disposition of shares of foreign affiliates, were exempt from tax in Canada, there would be an incentive to seek opportunities for investments in foreign markets with potential for capital appreciation, to the detriment of similar investment opportunities in the Canadian domestic market. If, on the other hand, capital gains from the disposition of shares of foreign affiliates did not qualify for exemption, there would be a continuing requirement to maintain detailed computations of surplus balances of foreign affiliates (or to enact complex anti-surplus stripping provisions to prevent capital gains from being turned into exempt dividends), which would eliminate much of the simplification that would otherwise be achieved by full exemption. Finally, it might be argued that a complete exemption system, even for dividends, is overly generous, when compared with the regimes of many of Canada's major trading and treaty partners.

The Deferral Method with Crediting: As an alternative to the exemption approach, Canada could follow a full deferral method with crediting, under which all active business income earned by foreign affiliates would be included in taxable surplus. All dividends would be taxable when received by Canadian corporate shareholders, with relief in respect of applicable underlying foreign taxes and withholding taxes. Under the deferral method, relief for foreign taxes might be computed on a global basis; alternatively, more detailed rules could be put in place requiring separate calculations for specific sources of income.

It can be argued that converting to a full deferral system would not add significant additional complexity to the Canadian tax system. Canadian corporate taxpayers have been required, since 1972, to maintain computations of surplus account balances. Accordingly, and after a transitional period, all active business earnings might flow solely into the taxable surplus account. However, experience in other countries that operate under the deferral with credit method has proven that the rules do, invariably, become extraordinarily complex, resulting in a significant increase in administrative and compliance costs.[8] While it is true that Canadian rules for the computation of taxable surplus have been in place for many years, taxable surplus dividends are rarely paid to Canada and, if Canada implemented a full deferral with credit method, the rules would have to be considerably more intricate and sophisticated than they are at present, including dealing with important differences in the timing of the recognition of income in foreign countries and Canada.

It is unlikely that the implementation of a deferral with credit method would, by itself, result in any significant revenue gain to the Canadian treasury. Experience under the tax systems of other countries, notably the United States, indicates that relatively little domestic tax is raised with respect to active business income from foreign direct investment under the deferral systems.[9] Corporations simply tend not to repatriate foreign earnings if the action involves significant domestic tax, or implement planning measures to maximize the availability of foreign tax credits. Finally, entitlement to benefits under the exempt surplus system is embedded in Canada's tax treaty network, and abandoning the system in favour of the deferral with credit method might require either a renegotiation of many of Canada's tax treaties, a process that would take many years, or a change to Canadian domestic legislation, which would effectively override Canada's existing treaty obligations.

The High-tax Method: An additional alternative is a hybrid of the deferral and exemption approaches which would maintain the existing distinction between active business income earned in treaty and non-treaty countries, but would add an additional requirement that income earned in a treaty country would only be included in exempt surplus if the income met a "high-tax" requirement. For example, there might be a requirement that the income bear an effective tax rate equal to a certain, prescribed amount, or a rate equal to a certain percentage of the Canadian corporate income tax rate.

Under the hybrid approach, the nominal or statutory rate in the foreign country should presumably not be relevant, as this would not reflect the actual tax burden that the income in question has borne. Rather, what would be important is the effective tax rate (taxes divided by income) that each particular foreign affiliate is actually paying on its various sources of income. As a result, and similar

to the deferral with credit method, complex rules would be required for purposes of determining both the income base (either under Canadian tax rules, foreign tax rules, or some combination) and the amount of taxes being paid. These rules would have to deal with various issues such as the impact of loss carry-overs, whether computations are to be done on a company-by-company or on a group basis, the impact of tax credits and other foreign tax incentives, and foreign exchange issues. Perhaps most importantly, a high-tax approach limits the ability of Canadian taxpayers to aggregate taxes paid on all sources of foreign business income, as is the case under a deferral with credit method with a global tax credit. This would place Canadian companies at a disadvantage relative to competitors from countries such as Japan, the United States and the United Kingdom, which allow more flexibility for companies to average low- and high-taxed sources of income.

In summary, with only modest anticipated revenue gains to the Canadian treasury, the high-tax method could put Canadian multinationals at a competitive disadvantage and could result in substantial additional complexity.

Conclusions and Recommendations

On balance, it is the Committee's view that the existing regime – providing exemption in the case of active business income earned by foreign affiliates in treaty countries, deferral with credit in the case of such income earned in non-treaty countries, and accrual with credit or current taxation with respect to income earned by foreign branches and FAPI – is fundamentally sound and should be maintained. The alternatives in the form of a total deferral system or a hybrid, high-tax system, would introduce significant new complexity and would discourage some foreign direct investment by Canadian multinationals, with little anticipated revenue gain for Canada. At the same time, however, the Committee believes that there are certain elements of the existing system that weaken its integrity and should be addressed.

RECOMMENDATION

It is the Committee's view that the ownership threshold for access to the exempt and taxable surplus system (generally, direct or indirect ownership of at least 10 percent of any class of shares of the foreign affiliate by the Canadian taxpayer and/or by related parties) is low, both in absolute terms and by international standards. For example (and subject to the possible application of a specific anti-avoidance provision), the ownership of at least 10 percent of a special class of preferred shares, even if *de minimis* in amount, is sufficient to allow access to the system. This may allow certain tax avoidance arrangements, where taxpayers can invest in preferred shares and can access the exempt surplus of otherwise unrelated taxpayers.

We recommend that the present definition relating to foreign affiliates be strengthened, so that only foreign companies in which Canadian corporations have a significant equity interest can be considered as foreign affiliates.

For example, the ownership threshold might be increased to require the ownership (either directly or indirectly, and by the Canadian taxpayer and/or by related parties) of at least (i) 10 percent of shares having full voting rights under all circumstances, and (ii) 10 percent by value of all outstanding shares. At the present time, there is an interrelationship between the rules defining foreign affiliates, and those defining controlled foreign affiliates that are subject to the FAPI rules. The Committee does not consider it appropriate to loosen the scope of the FAPI rules. We suggest, therefore, that the present definition related to controlled foreign affiliates be maintained.

A second weakness in the current regime concerns the manner in which income from foreign affiliates is treated. The exemption method can be argued to act as a proxy for the more complex credit method, on the assumption that the income of the foreign affiliate has borne foreign taxes at rates roughly equivalent to the Canadian rate (although the exemption method can also be viewed as encouraging international competitiveness under the principle of capital import neutrality). However, with the increasing expansion of the Canadian tax treaty network, more and more situations are arising – typically in the context of interaffiliate transactions involving the receipt of passive income such as interest, rents and royalties – where income earned in treaty countries is subject to low effective tax rates under special rules applicable to such income. It is the Committee's view that permitting exempt surplus treatment for such income tends to encourage tax-planning mechanisms that erode the Canadian tax base. Accordingly, we recommend later in this Chapter that interaffiliate income earned by certain low-tax entities in treaty countries be included in taxable surplus.

Interest Expense Related to Foreign Investment of Canadian Investors

Background

Prior to the tax reform of 1972, interest on funds borrowed by Canadian corporations to invest in both Canadian and foreign subsidiaries was non-deductible. Taxpayers used tax-planning techniques to avoid the application of the rule (for example, "cash damming," with cash from operations being accumulated in a separate account and ultimately being used to make investments in Canadian or foreign subsidiaries, and with borrowed funds being used to pay day-to-day operating expenses). At times, such planning was effective, although the rule did have the effect of reducing borrowings in Canada.

Since the 1972 reform, interest has been deductible by Canadian companies on funds borrowed to invest in both domestic companies and foreign affiliates. At the time, it was argued that this modification to the rules would put Canadian companies in the same position as foreign corporations in claiming interest deductions to invest in other companies. While interest deductibility resulted in a significant reduction in the Canadian tax revenue base, it also resulted in a significant decrease in the after-tax cost of such borrowing, and allowed Canadian corporations to be more competitive in making investments, both in Canada and abroad.

Other Countries' Approaches

There is no international norm with respect to deductibility of interest on funds borrowed for foreign direct investment. Some countries (such as Canada) provide for full interest deductibility, while others have direct or indirect limitations. For example, Australia and the Netherlands deny interest deductibility on funds traceable to foreign direct investment, if the dividends from the investment qualify for the exemption method. In certain European jurisdictions, interest expense is effectively denied in a particular year, but only to the extent of exempt dividends received in that year. Finally, some countries, such as the United States, require the apportionment of interest expense between domestic and foreign-source income using a formula approach, where the amount of interest expense allocable to foreign-source income, while still deductible, serves to reduce the entitlement to foreign tax credits.

Alternatives for Consideration

As discussed earlier, while Canada uses both the exemption and deferral methods (exempt and taxable surplus) in respect of foreign direct investment by Canadian corporate shareholders, in practice, dividends are rarely received out of taxable surplus; thus the exemption system is the norm.

Under the exemption system, income repatriated as dividends to Canada bears no domestic tax, meaning that such income is only subject to foreign tax. Against this background, it is arguable that, as a general proposition, the tax system of the foreign country in which the business activities are carried on (and not the home country from which the investment is made) should bear the preponderance of the cost of financing the foreign business activities.

On the other hand, it can be argued that by restricting the exemption system to tax treaty countries (and assuming that Canada would only negotiate tax treaties with countries that impose a reasonable level of taxation), the exemption system serves as a proxy for foreign taxes that have been paid, and is also consistent with capital import neutrality. This suggests that interest deductibility in Canada should not be objectionable from the viewpoint of global neutrality. Furthermore, exempt surplus may be ultimately taxed in Canada when it is distributed as dividends to individuals or realized as capital gains.

Why Businesses Shift their Borrowing Costs to Canada

In addressing the clear differences between these two views on interest deductibility, it must be kept in mind that Canadian corporations frequently have a choice as to whether to borrow funds in Canada for foreign investment, resulting in interest deductions to the Canadian corporation itself, or to cause the foreign affiliate to borrow the required funds. Financing choices are influenced by a number of non-tax considerations; however, tax issues are often critical to the decision as to whether the funds should be borrowed by the parent company or by the foreign affiliate. As noted above, in recent years, and for a number of reasons, it appears that a disproportionate amount of borrowed funds has been incurred in Canada rather than abroad, resulting in a significant reduction of the Canadian domestic revenue base. As discussed earlier in this Chapter and Chapter 3, Canadian multinationals have significantly increased their borrowings of debt in Canada since the period 1986 to 1988. The Committee sees a number of factors leading to this trend.

First, and as discussed in Chapters 2 and 3, the combined federal and provincial corporate income tax rate for non-manufacturing activities in Canada is above the corresponding tax rate in a number of other countries. This creates an incentive for Canadian corporations to incur interest expense in Canada, where a current deduction may be obtained against income taxed at relatively high rates, leading to an increase in debt financing of multinational operations in Canada.

Second, many tax treaty countries provide domestic tax incentives that can often significantly reduce the tax burden in the foreign country. As the amount by which the Canadian rate exceeds those of other countries' increases, so does the incentive to claim interest deductions in Canada.

Third, tax changes introduced by other countries in recent years, most notably the United States, have tended to restrict the deduction of interest costs relating to foreign investment, inducing U.S. and other foreign corporations to shift such costs to their subsidiaries in other jurisdictions such as Canada.

Finally, funds may be borrowed in Canada to invest in a foreign affiliate in situations where losses are expected in the affiliate, such that the foreign affiliate will not be in a position to obtain an immediate deduction for the interest expense.

Weighing Alternatives – Factors to be Considered

In considering possible solutions to tax base erosion, the Committee is fully aware of the potential adverse impact on the amount of foreign direct investment by Canadian companies that could result from a restriction of interest deductibility. We pointed earlier to a number of studies that suggest that foreign direct investment has a beneficial effect on the investor country. It can be legitimately argued that interest deductibility is a reasonable price for Canada to pay to allow Canadian multinationals to continue to expand and compete in the global marketplace. A case can also be made, however, for

the view that a restriction of interest deductibility would affect, for the most part, the manner in which foreign investment is financed, rather than its absolute amount. For example, in most cases, funds that might otherwise have been borrowed by a Canadian parent corporation could be borrowed directly by its foreign affiliates (supported, if necessary, by a parent company guarantee).

The Committee weighed the arguments, and evidence for and against interest deductibility on funds borrowed to invest in foreign affiliates. It is our view that the current rules have resulted in a substantial erosion of the Canadian domestic revenue base, and that other Canadian taxpayers are paying more tax to make good on the shortfall. We are convinced that lower corporate income tax rates, offset by a broader tax base, including measures relating to the taxation of foreign-source income, where appropriate, will encourage domestic investment in job creation, improve fairness, and protect the Canadian domestic revenue base. A restriction of interest deductibility on funds borrowed to invest in foreign affiliates would be one such international tax measure. We also believe that, generally, the tax system of the foreign country in which the business is being carried on should bear the preponderance of the cost of financing the foreign business activities.

For these reasons, the Committee later recommends that interest expense be restricted on borrowed funds related, directly or indirectly, to investments in foreign affiliates. We appreciate that such a rule could, in certain circumstances, penalize small start-up companies, which will only be able to obtain financing directly in Canada, and we accordingly also recommend an exemption for up to $10 million of borrowings related to investments in foreign affiliates, to be shared among members of an associated group.

In arriving at its conclusion that interest expense should be restricted, the Committee considered an alternative approach of continuing to allow full interest deductibility on all borrowed funds used to invest in foreign affiliates and, at the same time, converting to a total taxable surplus regime (the deferral with credit method), described further above. Under such an approach, it would be most appropriate for interest expense to be allocated between foreign and domestic-source income for purposes of computing foreign tax deductions available in Canada, consistent with the system used in the United States. However, this alternative would, of necessity, involve a long and difficult transitional period, and would result in a regime for the taxation of foreign-source income that would be both exceedingly complex, and could act as a severe impediment to taxpayers seeking to invest and expand in foreign markets.

Restricting Interest Expense Deductibility: Methods of Allocation

If, as we propose, rules are introduced to restrict interest expense on funds borrowed in Canada to invest in foreign affiliates, an important issue to be resolved is the method to be used for determining the amount of expense attributable to foreign (as opposed to domestic) investment. The Committee examined four alternative approaches: tracing; a Canadian domestic allocation formula; a modified domestic allocation formula incorporating a "safe-haven" for up to a certain amount of Canadian borrowings; and a worldwide allocation formula. Each, together with its perceived advantages and disadvantages, is set out below.

Tracing

Under tracing, any Canadian taxpayer borrowing to invest in foreign affiliates, whether directly or indirectly through one or more Canadian subsidiaries or affiliates, would be subject to a restriction of the related interest expense. This method would be consistent with general Canadian income tax principles, and avoids many of the arbitrary results, distortions and complexities that can arise under the various allocation methods.

The rule would be broadly drafted, and would include borrowings that can reasonably be considered, having regard to all of the circumstances, to have been used to assist, directly or indirectly, another person to make the foreign direct investment. Additional anti-avoidance provisions would be required to deal with tax-planning techniques that sought to avoid the rule, such as cash damming.

One disadvantage of tracing is that past experience with the enforcement of rules governing the disallowance of interest indicates that taxpayers will seek to construct mechanisms aimed at making borrowings that relate to a direct or indirect investment in a foreign affiliate, appear to be traceable to an investment for which the interest expense is deductible. Also, under tracing, it will be difficult – even with elaborate anti-avoidance rules – to overturn arrangements whereby a Canadian taxpayer borrows to invest in Canadian domestic operations and, in separate transactions, uses existing equity to finance foreign direct investment.

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.

Bearing in mind these limitations, it 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.

Canadian Domestic Allocation Formula

Under a Canadian domestic allocation approach, the amount of a Canadian corporation's indebtedness that is considered to support foreign direct investment, is based on the ratio of foreign assets to total assets. For example, if a Canadian corporate taxpayer has $50 of Canadian assets and $50 of foreign direct investment (total assets of $100), supported by $70 of third-party debt and $30 of equity, 50 percent of the debt would, under an allocation formula, be considered to support the foreign direct investment. Accordingly, interest on indebtedness of $35 would be subject to restriction.

Formula allocation is based on the argument that money is fungible, and that all funds borrowed by a business enterprise should be regarded as effectively supporting its total assets at any point in time. There are, however, a number of major disadvantages to employing such a system, including the following:

- The domestic allocation approach ignores the extent to which foreign operations have themselves been capitalized through third-party borrowings.
- In common with any formula allocation, the domestic allocation approach will inevitably lead to undesirable economic results. For example, consider a Canadian business enterprise with 50 percent of its assets invested in Canada and 50 percent invested in foreign affiliates. If the enterprise decides to borrow to make a new investment in Canada, approximately 50 percent of the related interest expense would, under the allocation method, be restricted. Such a rule could accordingly discourage borrowings for Canadian domestic investment, where a Canadian business enterprise already has a significant proportion of its assets invested in foreign affiliates. On the other hand, if the same enterprise decides to borrow to invest in a foreign affiliate, approximately 50 percent of the interest expense would be allowed in Canada and, to this extent, the Canadian tax system would continue to provide a benefit in the form of partial deductibility of interest expense on funds borrowed to invest in foreign affiliates.
- To be effective, the formula method must be employed on the basis of a corporate group (and not on a taxpayer-by-taxpayer basis), and would require a compulsory consolidation for purposes of calculating all of the assets and borrowings of the corporate group, as defined. In the absence of

such consolidation, the formula method would be largely ineffective, and, with appropriate tax planning, little if any interest expense would ever be subject to disallowance. For example, if a Canadian parent company borrowed funds and invested in share capital of its 100 percent-owned Canadian subsidiary, with the Canadian subsidiary then investing in a foreign affiliate, the Canadian parent company would have used the funds for a qualifying purpose (to invest in another Canadian corporation), and the interest expense would be fully deductible.

- The consolidation rules that would be required under the formula allocation approach would, without question, add a significant amount of complexity to the Canadian tax system, with the attendant increase in administrative and compliance costs. In addition, defining the ownership threshold of the corporate group would itself lead to anomalous results. If the ownership threshold is relatively high, there would be situations where the rules would not apply. For example, assume that the defined ownership threshold is 90 percent, and assume further that a Canadian corporation borrows to invest in an 80 percent-owned subsidiary, with the subsidiary using the funds to invest in a foreign affiliate. As a result of the fact that the subsidiary does not form part of the corporate group as defined, none of the interest expense would be restricted. This contrasts with the tracing method, where the borrowings would have been considered to have been used, directly or indirectly, to assist another person to invest in a foreign affiliate, resulting in a restriction of all of the interest expense. To address this situation, one could set the threshold level for purposes of defining a corporate group relatively low. However, this option has its own shortcomings. In particular, under any corporate group approach, the borrowing and investment decisions of one member of the group might have an adverse impact on the interest deductions available to another; and, the lower the ownership threshold, the greater the possibility that the interests of minority shareholders could be adversely affected.
- The basis on which Canadian domestic assets and foreign assets would be measured must also be defined – does the system employ accounting values, tax values or fair market values? The use of accounting values is the simplest approach but could yield anomalous results. In the United States, interest allocation rules include an election to prepare calculations based on current fair market value, but the result is even further complexity.

For all of the reasons described above, the Committee is of the view that, in addition to introducing additional complexity to the Canadian tax system, a domestic allocation formula would inevitably produce results that are both uncertain and arbitrary, and would, in some circumstances, unduly increase the cost of both foreign and domestic investment by Canadian multinationals. We do not believe that a domestic allocation formula is a viable alternative, particularly in the context of a regime such as Canada's, which relies, to a great extent, on the exemption method, and where disqualified interest would be non-deductible (unlike the United States, where the deferral method is used, and where disqualified interest remains deductible but serves to potentially reduce foreign tax credits otherwise available).

Modified Domestic Allocation Formula

In order to address certain of the anomalies that might result from the domestic allocation method, a modified allocation formula could be devised. Such a formula might have two parts. First, a Canadian corporate group would be allowed to deduct interest on borrowing up to a certain prescribed amount of its total Canadian domestic assets. For example, using a 2-to-1 debt/equity ratio as a hypothetical "safe harbour," interest on indebtedness of a Canadian corporate group would be allowed under all circumstances, up to 66⅔ percent of the amount or value of Canadian domestic assets. Second, any interest expense incurred by the Canadian corporate group in excess of the original base would be subject to the domestic allocation method described above, taking into account both the indebtedness already allowed in Canada and the Canadian domestic assets financed by such borrowings,

both of which would be excluded from the calculation. The overall impact is that indebtedness up to a percentage of Canadian domestic assets would be allowed in full, while any excess indebtedness would be subject to the application of the formula allocation method.

The main advantage to this modified approach is that the safe harbour would permit full deduction of interest up to a reasonable amount, so that for corporate groups falling within the safe harbour range, there would be no adverse economic effect of incurring additional indebtedness to finance new Canadian investment. Its major disadvantage is a level of complexity in design and application similar to that which would likely result from the general domestic allocation method. The modified approach gives rise to two additional concerns. First, there would still be an inducement for Canadian corporate groups that fall below the safe harbour limit to put more borrowings in Canada. Second, for corporate groups operating in business sectors that generally require higher amounts of financial leverage (real estate and certain other industries), there might be difficulty in meeting the safe harbour exception, and consideration would have to be given to industry-specific exceptions, introducing yet more complexities.

Worldwide Allocation Formula

Under worldwide consolidated allocation, the corporate group would be defined with reference to both Canadian domestic taxpayers and foreign affiliates, and worldwide debt would be considered to support foreign assets, based on the ratio of worldwide foreign assets to worldwide total assets. The formula would produce an amount of consolidated debt considered to support foreign assets and, to the extent that foreign affiliates of the consolidated group had third-party borrowings equal to or in excess of this amount, there would be no restriction in Canada. However, to the extent that the amount of debt considered to support foreign assets under the worldwide allocation formula exceeded the amount of third-party borrowing incurred by foreign affiliates, any excess would be considered to have been borrowed in Canada to support foreign investments, and the interest on such excess would be restricted.

From the theoretical perspective, the worldwide formula allocation method is clearly better than the domestic allocation methods described above, in that it recognizes the extent to which debt has been incurred by foreign affiliates. However, the method appears to be so extraordinarily complex that, for all practical purposes, it is virtually unworkable. For example, the existing ownership threshold for foreign affiliate status is, in general terms, the direct or indirect ownership interest of at least 10 percent of any class of shares. The Committee has concluded that in such a context, there would be many circumstances in which any attempt to prepare consolidated worldwide calculations would be effectively impossible.

Restricting Interest Deductibility: Alternative Tax Treatments

Once a method is adopted to identify borrowings related to investments in foreign affiliates, the next step is to decide what treatment should apply to interest expense on such indebtedness. Again, the Committee examined different approaches. For example, any such interest expense could be unconditionally denied, or denied only to the extent of exempt surplus dividends received in the particular year or within a prescribed carry-over period (an approach that would obviously have a negative implication on repatriation). Another approach would be to restrict the interest expense, with deductibility being initially denied, but then being reinstated if the investment in the foreign affiliate results in taxable income in that year, or in a prescribed carry-over period.

As is usual in international taxation, no perfect solution emerges, especially in the context of Canada's current tax regime which employs elements of the accrual, exemption and deferral methods. Any rules that sought to allocate interest expense between "qualifying" and "non-qualifying" foreign

affiliates (for example, foreign affiliates in treaty versus non-treaty countries) would be complex, arbitrary, and unworkable in many situations, particularly given that foreign affiliates can earn varying amounts of exempt and taxable surplus from different sources and different jurisdictions on a year-to-year basis.

On balance, however, an initial denial of interest deductibility appears to the Committee to be appropriate in the context of Canada's broad exemption system, where dividends from foreign affiliates to Canadian corporate shareholders are predominantly paid out of exempt surplus, and where taxation is accordingly restricted to income taxes paid in the foreign jurisdiction in which the business activities are carried on. To the extent that taxable surplus dividends are ultimately received by the Canadian corporation, we believe that it is appropriate to then allow an amount of interest to be deducted, equal to the net inclusion in taxable income (in other words, net of deductions in respect of foreign taxes), on the basis that the interest expense should then be regarded as having been incurred to earn income subject to tax in Canada.

A refinement to this alternative would be to limit the amount of deductions in respect of foreign taxes, by incorporating into the formula for foreign-source income, an allocation of all or a portion of the restricted interest now being allowed as a deduction. However, such an approach would introduce its own set of complex allocation problems, with little anticipated revenue gain to the Canadian treasury.

Under our approach, we suggest that any disallowed interest in respect of an investment by a Canadian corporation in the shares of a directly held foreign affiliate be disallowed and added to the tax basis of those shares. The disallowed interest would also be accumulated and be eligible for carry-over, to be offset against any net taxable dividends received on the shares of that affiliate (and would then be deducted from the tax basis of the shares). The Committee considered other approaches, including the alternative of allowing an offset for disallowed interest against net taxable dividends received from, or capital gains realized on, the shares of any foreign affiliate. However, we concluded that this option would be overly generous.

It is the Committee's view that FAPI, in contrast, requires a different approach than does other taxable surplus. The FAPI rules are primarily anti-avoidance provisions, which include in taxable income, investment or passive income that could have been earned in Canada rather than abroad or which otherwise erodes the Canadian revenue base. 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. Also, if the cumulative disallowed interest expense balance was available for offset against FAPI, there would be a significant incentive for any Canadian taxpayer who had such balances to establish foreign affiliates for the express purpose of earning FAPI. The FAPI inclusion would simply be offset by the release of a corresponding amount of disallowed interest.

Summary and Recommendations

As set out above, there are a number of competing, and often contradictory, policy objectives and technical issues related to interest expense on funds borrowed to invest in foreign affiliates. These include economic efficiency, international competitiveness, complexity and protection of the Canadian domestic revenue base. As stated earlier, however, the Committee believes that lower corporate income tax rates proposed in our Report, supported by base broadening measures (including international tax measures, where appropriate) will produce a net benefit to Canada. Further, and as a general rule, we believe that the tax system of the foreign country in which the business activities are carried on (and not that of the home country from which the investment is made) should bear the preponderance of the cost of financing the foreign business activities.

With these overall principles in mind:

RECOMMENDATIONS

The Committee recommends that interest expense of Canadian taxpayers on indebtedness incurred to invest in foreign affiliates should be disallowed.

This disallowance should also apply to individuals, to the extent that funds are borrowed to invest in foreign affiliates of the individual through Canadian corporations.

The tracing method should be used for purposes of identifying the amount of indebtedness allocable to investments in foreign affiliates.

This should include interest on funds borrowed by a taxpayer, which can reasonably be considered to have been used, directly or indirectly, to assist another person to make an investment in a foreign affiliate of the taxpayer; other anti-avoidance provisions should be incorporated as discussed above.

Interest expense that is disallowed should be added to the tax basis of the shares of the relevant foreign affiliate, and accumulated in a "disallowed interest account."

To the extent that dividends are received on those shares out of taxable surplus, an amount equal to the lesser of the accumulated balance in the disallowed interest account, and the net inclusion in taxable income should be allowed as a deduction (and deducted from the tax basis of the shares). Accumulated balances in the disallowed interest account should not be available, however, for offset against FAPI.

To prevent small start-up 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, we recommend an exemption for up to $10 million of accumulated indebtedness related to investments in foreign affiliates (with the exemption to be shared among members of a an associated group).

Indebtedness incurred or committed to under existing rules should be exempted from the new regime or be eligible for a generous transition period.

Grandfathering or transitional provisions are particularly significant in this area, having regard to the fact that taxpayers have made significant borrowing and investment commitments based on existing rules.

Deductibility of Other Expenses Related to Foreign Direct Investment

While the single, major expense incurred in Canada in respect of investments in foreign affiliates is, in most circumstances, interest expense, there are other costs incurred by Canadian business enterprises that relate to foreign direct investment. These include the costs of Canadian management personnel, certain accounting and legal costs, and support services. To the extent that such costs and expenses are custodial in nature (and thus properly the costs of the Canadian taxpayer rather than its foreign affiliate), it is arguable that such costs should be subject to the same general restriction as might apply to interest expense incurred for foreign direct investment.

On the other hand, custodial expenses are fundamentally different from interest expense. If they were to be disallowed, taxpayers might be induced to relocate management personnel out of Canada and into foreign markets. Moreover, disallowing custodial expenses incurred in Canada would result in double taxation, given that such expenses would not be deductible in the foreign country. Finally, the Canadian economy benefits from inbound foreign direct investment, and from the associated custodial expenses incurred outside of Canada by foreign parent companies.

It is the Committee's view, therefore, that while Revenue Canada should continue to be vigilant in ensuring that all costs borne in Canada for services incurred for the benefit of a foreign affiliate are charged to it, there is no compelling reason to change the Canadian tax law related to other expenses that are custodial in nature.

Foreign Accrual Property Income

Any Canadian taxpayer, individual or business, that has an interest in a "controlled foreign affiliate," may be taxed on an accrual basis where such affiliates earn certain types of income, including passive income such as interest and portfolio dividends, as well as prescribed amounts where the corresponding deduction erodes the Canadian tax base. These are the FAPI rules. As an anti-avoidance regime, the FAPI rules are intended to be prophylactic, and as such, they safeguard the Canadian tax base by preventing taxpayers from diverting income abroad. As a result, the FAPI regime can be said to be most effective when little if any FAPI is, in fact, being earned by foreign affiliates of Canadian taxpayers.

Countries vary in their approaches to this type of income; the United States, for example has extremely detailed and complex rules while certain other countries have rules that are extremely limited in scope. Tax policy considerations in this area accordingly involve difficult issues as to the appropriate nature and scope of such rules. Income to be attributed needs to be defined broadly enough to protect the domestic revenue base, but without casting too wide a net, such that the rules hamper the ability of Canadian multinational businesses to compete in the international marketplace.

Background

A controlled foreign affiliate of a taxpayer resident in Canada is defined, in general terms, as a foreign affiliate of the taxpayer that is controlled by the taxpayer (alone or with persons with whom the taxpayer does not deal at arm's length), or by the taxpayer and/or not more than four other persons resident in Canada (whether or not related to the taxpayer). To be defined as a controlled foreign affiliate, a foreign company must first be a foreign affiliate of the Canadian taxpayer. Earlier in this Chapter, the Committee recommends that the ownership threshold to qualify as a foreign affiliate be increased, to require a more significant equity interest in the relevant foreign affiliate for access to the exempt and taxable surplus system. However, the Committee also recommends that the existing (and lower) threshold continue to apply for purposes of the definition of controlled foreign affiliate, to prevent an erosion in the amount of income, potentially subject to the FAPI rules, that would otherwise result.

Taxpayers resident in Canada must include their proportionate amount of any FAPI earned by a controlled foreign affiliate in income on a current basis (subject to deductions equivalent to credits in respect of underlying foreign tax), whether or not the income is distributed by the affiliate as dividend payments. These rules apply to Canadian-resident individuals as well as corporations, and to affiliates in treaty as well as non-treaty countries. The allocable amount is based on the taxpayer's participating percentage (as defined) in the foreign affiliate, determined at the end of each taxation year of the affiliate. FAPI includes an affiliate's income from property and businesses other than active businesses, and taxable capital gains from dispositions of certain property (generally, a property that is not used or held for the purpose of gaining or producing income from an active business).

The definition of FAPI was substantially expanded in scope by the 1995 foreign affiliate amendments, and there are various sources of active business income that are, in fact, characterized as FAPI. In addition to property income, which is purely of a passive nature, FAPI includes income from an investment business unless the affiliate employs more than five employees (or their equivalent) full-time in the active conduct of the business, as well as specified types of income earned by a foreign affiliate, where the corresponding deduction erodes the Canadian tax base. There are also certain relieving provisions, which provide specific exceptions in the case of income that would otherwise be characterized as FAPI, but which arise from payments and other transactions between different foreign affiliates of the same Canadian taxpayer (generally referred to as "interaffiliate transactions").

Interaffiliate Transactions

As noted above, the 1995 amendments to the foreign affiliate rules significantly expanded the scope and definition of FAPI. The Committee is aware, however, of some suggestions that the FAPI provisions be even further expanded, by repealing or severely restricting the exemption provided by the rules related to interaffiliate transactions. We examine the issues relating to interaffiliate transactions below.

Background

Under the FAPI rules, income received by a foreign affiliate of a Canadian taxpayer, and paid by another foreign affiliate of the taxpayer (or by a related, non-resident corporation), is treated as active business income (rather than FAPI), provided the amount reduces active business income of the payor (and other prescribed tests are met).[10] In addition to being exempt from FAPI, income from such interaffiliate transactions is included in exempt surplus provided, in general terms, that the payments reduce exempt surplus of the payor, and are received by an affiliate in a tax treaty country. The rules, accordingly, characterize such income, which would otherwise often be considered passive in nature, both as active business income and, in many circumstances, as exempt surplus.

Exempt Versus Taxable Surplus Characterization

As discussed earlier in this chapter, the exemption method for active business income earned by foreign affiliates in treaty countries can be argued to be based, in part, on the assumption that the income of the foreign affiliate has borne taxes somewhat equivalent to the Canadian tax rate. However, many countries with which Canada has negotiated tax treaties provide rules that allow certain activities or entities to be taxed at rates well below domestic norms. Under Canadian rules, such income qualifies for exempt surplus treatment, even if the entity in question is specifically denied benefits under the treaty.

For example, Canada has a tax treaty with Barbados, a country that has a general corporate income tax rate of 40 percent. Special-status entities such as Barbados international business corporations (IBCs), which are taxed in Barbados at preferential rates of 1 percent to 2½ percent, are specifically

denied treaty benefits, but remain eligible for exempt surplus treatment. This is equally true of certain tax-favoured entities in other jurisdictions, including Cyprus, Israel, Jamaica and Luxembourg. Most typically, income earned by such entities arises in the context of interaffiliate transactions involving offshore financing and similar arrangements, and where the income is passive in nature. It can be argued that this tends to encourage tax-planning mechanisms that erode the Canadian tax base, particularly where the interaffiliate payments relate to amounts that are deductible in Canada. For example, many finance structures involve borrowing in Canada to invest in an offshore, captive finance company, with the finance company, in turn, lending to another foreign affiliate in a higher-tax jurisdiction.

As a general principle, the Committee believes that Canada should not unilaterally seek to claw back general incentives implemented by its treaty partners, involving active business activities carried on in their jurisdictions. However, income from interaffiliate transactions often involves minimal, if any, direct job creation in the foreign country.

For these reasons, the Committee recommends below that the government revise the rule that extends exempt surplus characterization on interaffiliate payments, for income earned by entities that are expressly denied benefits under Canadian tax treaties. Such income would accordingly be included in taxable surplus of the recipient affiliate (even if the payment reduces exempt surplus of the payor affiliate), consistent with the treatment that applies with respect to such income earned by affiliates in non-treaty countries. We also urge the government to aggressively pursue a policy of renegotiating its existing treaties, to ensure that other tax-privileged entities in treaty countries are denied access to the exemption system with respect to interaffiliate transactions that would otherwise be passive in nature.

Exemption from FAPI

It has been suggested that the exemption from FAPI for interaffiliate payments (where the corresponding deduction reduces active business income of the payor affiliate) should be repealed altogether, on the basis that, as discussed above, the exemption tends to encourage tax-planning arrangements which erode the Canadian tax base. On the other hand, the interaffiliate exemption, in and of itself, simply ensures that the active business of one foreign affiliate of a Canadian taxpayer is not, as a result of deductible payments (such as interest, rents and royalties) characterized as FAPI in the hands of the recipient affiliate. The exemption from FAPI therefore facilitates interaffiliate payments, where consolidation of the income of a foreign affiliate group might not otherwise be possible. There are, for example, many situations in which multi-tier structures are required for regulatory and other non-tax reasons (for example within the United States and the European Union).

In addition, there are many situations involving interaffiliate payments such as royalties, interest and various other running expenses, where any fundamental change to the provision would be singularly inappropriate. We also recognize that the exemption allows Canadian businesses to compete more effectively in the global marketplace with the multinationals of certain other countries that can often benefit from similar provisions.

The Committee's recommendation (discussed earlier in this Chapter) with respect to the restriction of interest expense on funds borrowed to invest in foreign affiliates will help to protect the Canadian domestic base erosion from financing transactions. If in addition to this measure, and to the recommendation to repeal the rule that extends exempt surplus status to interaffiliate payments earned by entities denied treaty benefits, the exemption from FAPI for income from interaffiliate transactions were to be eliminated, the cumulative impact of these changes could significantly impair the international competitiveness of Canadian businesses.

Conclusions and Recommendations

In the Committee's view, the FAPI regime – including the extent and scope of the definition of FAPI – is generally sound, and since the expansion of the FAPI rules as part of the 1995 foreign affiliate amendments, operates effectively to protect the Canadian revenue base. However, there are still certain areas in which the system should be tightened.

RECOMMENDATIONS

We recommend that the FAPI exemption for interaffiliate transactions be maintained, but that such payments be included in taxable surplus where the income is received by an entity that, while located in a tax treaty jurisdiction, is expressly denied benefits under that treaty.

As a result, such income would be treated in the same manner as income from interaffiliate transactions earned by entities in tax havens, which do not have tax treaties with Canada.

We recommend that the government 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.

In addition to the FAPI exemption for interaffiliate payments, exemption from FAPI applies in respect of income received by a foreign affiliate of a Canadian taxpayer, where it is paid by a non-resident corporation that is not a foreign affiliate of the Canadian taxpayer, provided the payor is a non-resident corporation to which the particular affiliate and the Canadian taxpayer are related. This provision has encouraged the implementation of a number of so-called "second-tier" financing transactions, which may erode the Canadian domestic tax base, in situations where a foreign parent company controls the Canadian corporation, and where the Canadian corporation has little if any economic interest in the foreign operations being financed.

The Committee recommends that the provision that provides FAPI exemption for payments from related non-resident corporations that are not foreign affiliates of the Canadian taxpayer, be revised to exclude situations in which related party status arises solely as a result of share ownership by foreign parent companies outside Canada.

Finally, the Committee is concerned by reports that significant amounts of Canadian assets are being invested in a variety of foreign trust structures, and in circumstances where positions are being taken by Canadian taxpayers and their advisors that income earned by the foreign trusts fall outside the ambit of the Canadian FAPI provisions. These transactions undermine the integrity of (and confidence in) the Canadian tax system. The new foreign reporting requirements should assist Revenue Canada to identify situations in which these transactions are taking place.

The Committee recommends that foreign trust structures identified by Revenue Canada be challenged in the courts, in circumstances in which the trust income may be subject to the FAPI rules, and that, if such challenges prove to be unsuccessful, appropriate amendments be made to the tax legislation.

Later on in our Report (Chapter 10), the Committee also recommends the introduction of expanded civil penalties on gross negligence of tax advisors and promoters – penalties that we believe should also apply in the foreign trust area.

Offshore Investment Funds

As noted, the FAPI rules only apply in respect of controlled foreign affiliates of a Canadian shareholder. As a result, and consistent with the approach that has been adopted in certain other countries that have adopted anti-avoidance provisions similar to the FAPI rules, they do not apply to shares of foreign entities that are widely held by residents of Canada, such as offshore mutual funds and unit trusts or in other foreign entities. Accordingly, the offshore investment fund rules (which were introduced in 1984) serve as a backstop in these situations.

Offshore investment fund rules address situations in which Canadian taxpayer has an interest in a foreign entity that does not qualify as a controlled foreign affiliate, where the interest in the foreign entity derives its value primarily from portfolio investments, and where one of the main reasons for the taxpayer acquiring or holding the interest in the property is to reduce Canadian tax. If the rule applies, the Canadian taxpayer must include in income a notional amount equal to the designated cost of the investment (as defined) multiplied by a prescribed rate. This prescribed rate may of course be greater or less than the actual income earned by the foreign entity and attributable to the interest of the Canadian taxpayer. The rule is arbitrary and, where it applies, can result in a significant penalty to the Canadian taxpayer. However, as an anti-avoidance provision, this result is not necessarily inappropriate. While the offshore investment fund rules could be revised, so that they would operate on a more specific and targeted basis, such changes would not necessarily provide any additional protection to the Canadian domestic tax base.

There appears to be little income being reported by taxpayers or assessed by Revenue Canada under the offshore investment fund rules. This could result from the fact that the rules have had their desired effect, and that offending, portfolio investments are not being made. However, the Committee is concerned that certain transactions are occurring that may fall within the ambit of the rules, but where the income is neither being reported nor assessed. We suggest that Revenue Canada review investments in foreign entities and aggressively apply the offshore investment fund provisions as appropriate.

Taxation of Income of Non-resident Investors

Introduction

As noted earlier in this Chapter (see inset entitled "What Income is Liable to Canadian Federal Income Taxation?"), non-residents are taxable in Canada on Canadian-source employment and business income, on the disposition of certain types of Canadian property, and on the receipt of specified property income (including dividends, interest, rents and royalties) paid or credited by persons resident in Canada. International tax treaties modify these rules on a bilateral basis, generally restricting the right of one country to tax income earned by a resident of the other, so as to facilitate trade and investment, and reduce the potential for double taxation. Also, treaties generally provide for significant reductions in the rate of withholding tax applicable to income such as dividends, interest, rents and royalties, paid to residents of the other country.

With respect to inbound investment, it is the Committee's view that tax policy in this area should work toward two goals: that foreign investors in Canada should, to the extent practical, be on an equal footing with Canadian domestic investors operating in the Canadian marketplace; and that the Canadian treasury obtain its fair share of tax revenue derived from businesses carried on in Canada. Achieving a fair balance between the two includes determining an acceptable level of rates of withholding taxes applied on property income paid to non-residents of Canada, and an appropriate scope of the thin capitalization provisions.

In this section of the Report, after commenting on tax policy objectives related to inbound investment, the Committee reviews the issues noted above, as well as the exemption for interest payments on arm's-length indebtedness and the status of non-resident-owned investment corporations.

Finding a Balance Between Attracting Foreign Capital and Protecting the Revenue Base

As discussed earlier, there are a number of sometimes competing tax policy objectives related to inbound investment. Primary among these are the need to attract foreign capital and know-how to Canada, so as to benefit our economy, and the simultaneous requirement to prevent erosion of Canada's tax revenue base. The conflicting pressures are not easily resolved.

One means of protecting the revenue base is to impose high rates of withholding tax on interest and other deductible amounts paid to non-resident investors. However, such taxes may impede cross-border income and capital flows, and act as a tariff on the importation of capital or knowledge, contrary to neutrality principles. This is particularly the case when such taxes are not fully creditable in the home country of the non-resident. Such situations often arise, since Canadian withholding tax generally applies to gross income (and without reference to related, deductible expenses), but with tax being computed in the home country based on net income after expenses. Withholding taxes can be shifted onto Canadians, to the ultimate detriment of the national economy. For example, withholding taxes on interest are frequently shifted to the borrower, thereby increasing the cost of foreign capital to domestic business enterprises. Similarly, with respect to royalties, withholding tax can increase the cost to domestic business enterprises of accessing foreign technology, representing a tariff on knowledge.

Pulling in the other direction, however, are some equally compelling realities. Withholding taxes on deductible payments such as interest, rents and royalties are an important element in protecting the Canadian domestic revenue base, and represent significant revenue to the Canadian treasury – almost $1.7 billion in 1995.

Foreign Portfolio Versus Foreign Direct Investment

In reviewing the treatment of inbound investment, the Committee remained cognizant of the need to differentiate between foreign portfolio investment and foreign direct investment, particularly with respect to withholding taxes and thin capitalization provisions. Foreign direct investment is generally regarded as an investment by a person with an equity ownership in a business enterprise of at least 10 percent. In practice, this level of ownership interest will often be sufficient to allow the non-resident investor to have influence on the borrowing and investment decisions of the business entity. A foreign direct investor often looks to the rate of return of the business enterprise itself, with a view to deriving income, either in the form of dividend payments, or by capital appreciation realized on an ultimate divestment of the ownership interest. A foreign portfolio investor, on the other hand, will generally have little, if any, control over the borrowing and investment decisions of the business enterprise, and is primarily interested in the return on the shares or indebtedness owned, rather than the underlying performance of the business enterprise itself.

Withholding Taxes

Background

While the general withholding rate is 25 percent under Canadian domestic tax law, under our bilateral tax conventions this rate is almost always reduced. Canada has historically been, and continues to be, a significant importer of capital – both foreign direct and portfolio investment – and has in the past, accordingly, tended to seek higher rates of withholding rates in its tax treaties than many of our major trading and treaty partners.

The OECD Model Tax Convention sets out a uniform basis of withholding tax rates in respect of different sources of income. The Model Convention is intended to act as guidance to member countries in negotiating bilateral tax treaties, but is not binding. The Model Convention suggests a 5 percent dividend withholding rate in the case of foreign direct investment, 15 percent for dividends on foreign portfolio investment, 10 percent on interest and no tax on royalties. In the past, Canada generally sought higher rates in its treaties than suggested in the Model Convention – often 15 percent for dividends (whether direct or portfolio), 15 percent for interest, and 10 percent for royalties.

More recently, however, Canada has taken a different approach in its treaty negotiations, and Canada's position with respect to treaty withholding rates now conforms more closely to the OECD Model Tax Convention. The 1992 and 1993 federal budgets announced Canada's willingness, in its tax treaty negotiations, to reduce the withholding tax rate on direct dividends to 5 percent, and to eliminate withholding tax for royalty payments made for the use of computer software and in respect of rights to use certain patented information or information concerning scientific experience. Canada has now negotiated a number of new treaties, or protocols to existing treaties, which incorporate these reduced rates, as well as a 10 percent withholding tax rate for interest payments.

It is the Committee's view that the present Canadian position with respect to the level of withholding taxes under bilateral tax treaties is consistent with international norms, strikes an acceptable balance between the competing goals of global neutrality and protection of the Canadian revenue base, and, accordingly, requires no modification at the present time.

Exemption for Interest Payable on Arm's-length Indebtedness

Under Canadian domestic tax law, interest payable by a corporation resident in Canada to a non-resident person with whom the corporation is dealing at arm's length is exempt from withholding tax, if certain conditions are met. The exemption generally applies if, under the terms of the obligation, the Canadian corporate borrower may not be obliged to pay more than 25 percent of the principal amount of the obligation within five years from the date of issue of the indebtedness, except in the event of a failure or default under the terms of the agreement. This exemption was introduced as a temporary measure in 1975, to allow Canadian corporate borrowers increased access to international capital markets. The exemption was extended on several occasions, until it became a permanent feature of the Canadian tax system in the 1988 federal budget.

As noted earlier, withholding taxes on interest payments tend to be shifted to the borrower, thereby increasing the cost of capital. The exemption for interest payable on arm's-length indebtedness provides Canadian businesses with increased access to global financial markets at competitive interest rates. The Committee supports the exemption, but has two recommended changes.

RECOMMENDATIONS

The Committee recommends that the withholding tax exemption for interest payments to arm's-length non-resident lenders be extended to all indebtedness, regardless of its term.

We see little compelling rationale for limiting the exemption to longer-term debt. While it can be argued that restricting the exemption in this manner may provide some degree of control over monetary conditions or may facilitate the regulation of Canadian financial institutions, in today's global environment, such arguments have little validity.

We also recommend that the exemption be denied in circumstances involving back-to-back transactions and similar financial support arrangements, in the same manner as discussed below under the thin capitalization provisions.

At present, there is no provision in the income tax rules that specifically denies the exemption in situations involving back-to-back loan arrangements by non-resident investors through third-party, financial intermediaries, or similar arrangements. While the exemption does require that the Canadian borrower and the financial institution deal at arm's length, at present the issue of whether otherwise unrelated parties are dealing at arm's length with respect to a particular transaction has to be determined in each case, thereby introducing uncertainty and complexity.

Rules Applying to Thinly Capitalized Businesses

Background

A business is said to be thinly capitalized when it is financed with a relatively high proportion of debt in relation to its equity base. In the absence of legislative restrictions, foreign investors seeking to minimize taxes associated with an investment in Canada would tend to invest a disproportionate amount of debt (as opposed to equity) in Canada. The interest expense reduces income otherwise subject to tax in Canada. By thinly capitalizing a Canadian business enterprise, a foreign investor can receive a greater proportion of its return in the form of deductible interest payments (generally subject to a 10 percent treaty withholding rate), rather than dividend payments out of after-tax income. The purpose of thin capitalization rules is to prevent this type of erosion of the domestic tax base in the country in which the business enterprise is being carried on.

Canada was one of the first countries to introduce thin capitalization rules, under which interest payable on indebtedness owing to certain non-residents is disallowed, to the extent that the amount of such indebtedness exceeds three times equity.[11] These rules were introduced in 1972 and, with minor modifications, have remained in place since that time. After describing the Canadian rules as well as international comparisons, this portion of the chapter reviews the efficacy of the rules and possible alternative approaches.

Canadian Thin Capitalization Rules – An Overview

Canada has a statutory thin capitalization rule of 3 to 1. This rule disallows interest that would otherwise be deductible, and that is paid by a corporation resident in Canada to a specified non-resident, as defined, where such indebtedness exceeds three times equity. For this purpose,

a specified non-resident includes a non-resident shareholder who, either alone or together with other persons with whom it does not deal at arm's length, owns 25 percent or more (votes or value) of the shares of the Canadian corporation; a specified non-resident also includes any other non-resident persons that deal at non-arm's length with such shareholders.

For purposes of applying the 3 to 1 debt/equity ratio, equity is generally defined to be the aggregate of: (i) the retained earnings of the Canadian corporation on an unconsolidated basis, (ii) the amount of surplus contributed by specified non-resident shareholders of the corporation; and (iii) the corporation's paid-up capital, to the extent that the capital stock is owned by specified non-resident shareholders. Indebtedness is generally defined as the greatest amount of interest-bearing debt owing to specified non-residents at any time in the year.

For example, if a Canadian corporation had $100 of equity and interest-bearing indebtedness of $400 owing to specified non-residents, $100 of the $400 of debt will be treated as being in excess of the allowable limits, and therefore, 25 percent of interest paid for the year to specified non-residents would be disallowed. On the other hand, if the greatest amount of interest-bearing indebtedness to specified non-residents at any time in the year is restricted to an amount of $300, there will be no disallowance.

To the extent that interest expense is disallowed as a result of the thin capitalization formula, double taxation will often result. The interest remains subject to Canadian withholding tax, and will often also be taxable in the home country of the foreign investor. The rules are therefore prophylactic in nature, and are intended to apply to financing that is provided by non-resident shareholders in closely held situations. Canadian corporations in these situations generally carefully monitor their debt/equity ratios to ensure that there is no disallowed interest expense.

Other Countries' Approaches

There is no single, common standard with respect to the application of thin capitalization rules, and the approaches of different countries vary widely, both in concept and in detail. As noted, Canada introduced a thin capitalization rule in 1972, and was one of the first countries to do so. Increasingly, other countries have implemented thin capitalization rules, particularly since the late 1980s. Many countries follow the same type of objective formula approach as does Canada, with the majority using the same statutory debt/equity ratio of 3 to 1 as Canada. More recently, however, lower debt/equity ratios of 2 to 1 are being adopted.

Some countries use a more subjective approach. For example, in the United Kingdom, amounts paid to non-resident investors are generally recharacterized as dividend distributions, and not deductible interest, where (i) the borrower is a 75 percent-owned subsidiary of the lender, or both the borrower and lender are 75 percent-owned subsidiaries of a third company, and (ii) all or any part of the payment would not have been made had the parties been dealing at arm's length. When applying this rule, the U.K. revenue authorities generally consider both the debt/equity ratio, and the amount of "interest coverage" (defined as the extent to which projected earnings or cash flow would be sufficient to satisfy interest expense obligations).

The United States has a unique approach that includes both subjective and objective elements. Under the U.S. legislation, debt may be reclassified as equity in thinly capitalized situations. In addition, the United States adopted an objective test in 1989 referred to as the "earnings stripping rule," which generally applies to a corporate group that has a debt/equity ratio in excess of a safe harbour amount of 1.5 to 1. Subject to this safe harbour, interest on related-party loans is defined to be "disqualified interest," if the recipient of the interest is not subject to U.S. tax, or is subject to tax at less than the U.S. non-treaty rate of 30 percent. The regulation applies whether the recipient is a foreign or domestic investor (for example, a U.S. domestic, tax-exempt entity, which is related to the payor). Disqualified interest is disallowed to the extent that the U.S. corporate group has excess interest expense as defined, and any disallowed interest may generally be carried forward indefinitely.

Certain other countries adopt a substance over form principle, whereby loan capital provided by a shareholder can, under certain circumstances, be considered as equity (for example, where there are no fixed provisions for repayment, or payment of interest is dependent on profits). In other countries, excessive loan financing of a subsidiary company may be subject to general abuse of law concepts (although, in such countries, there appears to have been little significant practical application of the concept in thin capitalization situations). Finally, certain countries have no restrictions whatever.

Canadian Thin Capitalization Rules – An Assessment and Alternatives

Objective Versus Subjective Approaches: The Canadian objective approach, which uses a fixed debt/equity ratio, is, of course, inflexible and somewhat arbitrary. For example, it does not account for different debt/equity ratios that apply in certain industries or between businesses in the same industry. The advantages to the objective approach, however, are significant: the rules are simple to understand and apply, and are generally effective in protecting the domestic revenue base. Subjective approaches tend to increase uncertainty, as well as administrative and compliance costs.

Earnings-based Methods: Another alternative would be to maintain an objective calculation with an income or profits-based test instead of one using a fixed debt/equity ratio – similar to that which applies in the United States under the earnings stripping rule. However, unless the Canadian approach is modified so that the rules apply to interest (and possibly other non-deductible expenses) paid to a broader category of taxpayers such as Canadian domestic investors (as discussed in Chapter 7 of this Report), we do not favour adopting an earnings-based approach. Earnings-based methods, such as the U.S. earnings-stripping rule, are considerably more complex than thin capitalization rules based on a fixed, debt/equity ratio. In addition to a significant increase in administrative and compliance costs, this complexity can also lead to uncertainty in determining the acceptable level of indebtedness, and the extent to which interest expense may be disallowed in any particular year.

Possible Application of Thin Capitalization Provisions to Non-corporate Borrowers: The Canadian thin capitalization rules only apply to corporations that are resident in Canada, and not to other forms of business enterprises, such as Canadian branches of foreign corporations, or to partnerships or trusts. This creates an opportunity for domestic base erosion through the use of such entities. On the other hand, the extension of the thin capitalization rules to Canadian businesses other than Canadian-resident corporations would result in legislative complexity. Rules would be required to define the non-resident stakeholder to which the rules apply, as well as the allocation of equity to such stakeholders, and it is likely that separate rules would be required for each category (Canadian branches of foreign corporations, partnerships and trusts). With respect to discretionary trusts, it may be difficult or impossible to determine amounts attributable to particular beneficiaries.

Back-to-back Arrangements and Guaranteed Debt: A non-resident investor can lend to a Canadian business directly or indirectly using third-party financial institutions or other intermediaries. For example, in the extreme situation (and in the absence of any countervailing rules in the tax legislation), a non-resident investor might make a loan to a third party, with the same amount then being lent by the third party to the Canadian business. In other back-to-back arrangements, the tracing may be less direct. For example, the non-resident investor may undertake, as part of its commercial relationships with a third party (often a financial institution) to leave certain amounts on deposit with it, which may or may not correspond with the amount of the loan that the third party makes to the Canadian business. As another example, the non-resident investor may guarantee the

loan made from a third party to the Canadian business, with the guarantee being supported by a pledge of assets or other security, or possibly simply by the credit rating of the non-resident investor. There is, therefore, a continuum of foreign investor support that could apply, some of which are clearly tax-motivated and seek to avoid the application of the thin capitalization provisions, and others that may be entered into primarily for commercial reasons.

Again, the approach to back-to-back arrangements, and to guaranteed debt, varies among countries. The Canadian thin capitalization provisions deal with the most egregious type of tax planning. In general terms, they provide that where a loan has been made by a specified non-resident shareholder to another person, on condition that a second loan be made by any person to a corporation resident in Canada, the lesser of the amount of the first and second loan is deemed to be subject to the thin capitalization provisions. This rule does not appear to apply, however, in situations where a specified non-resident places funds on deposit with a third party, and where the third party makes a loan to the Canadian business in a different amount, and subject to different terms and conditions. Finally, third-party debt that is only guaranteed by a specified non-resident is clearly outside the application of the Canadian thin capitalization rules.

While it is clear, from a tax policy viewpoint, that back-to-back financing should be addressed by thin capitalization rules, the treatment of guaranteed debt is not as evident. Debt guarantees by related foreign parties can be regarded as a means of circumventing thin capitalization rules, and a number of countries have included such guaranteed debt in the thin capitalization provisions. On the other hand, the inclusion of guaranteed debt might often disrupt normal commercial financing arrangements. For example, there may be situations where a Canadian business enterprise does have sufficient borrowing capacity, or where a lender will nonetheless request a parent company guarantee (normally, a lender will seek the greatest amount of security possible). There are also a large number of circumstances where a Canadian borrower and related foreign parties will enter into joint financing arrangements, which could include, for example, cross-guarantees by each party of the other's indebtedness.

Conclusions and Recommendations

In general, the Committee is of the view that the thin capitalization rules are working well, and are not a major impediment with respect to the day-to-day operations of Canadian businesses. The rules are simple and effective, and the paucity of jurisprudence with respect to the rules suggests that disputes with the Canadian revenue authorities have been rare, notwithstanding the fact that the rules have been in place for more than 25 years. The Committee would not favour technical revisions to create a system that is purer from a theoretical viewpoint, but that adds complexity to the tax legislation with little benefit to either taxpayers or the tax administration. Accordingly, the Committee favours the fixed, debt/equity ratio approach, in lieu of subjective or earnings-based methods. The Committee also sees little merit in technical modifications to the rules dealing with the definitions of equity and indebtedness (such as a global debt/equity ratio that might focus on the total borrowing capacity of the Canadian business enterprise, or on the measurement of equity or debt attributable to the specified non-resident).

RECOMMENDATIONS

The Committee is of the view, however, that the existing rules should be strengthened in certain areas, following appropriate transitional notice, to provide further protection of the domestic revenue base, generally without undue interference with ordinary, commercial transactions.

The Committee recommends that the existing ratio of 3-to-1 should be revised to 2-to-1, as a closer proxy for financing that would generally be available in an arm's-length context.

While some countries allow somewhat higher debt/equity ratios for companies operating in specific industry sectors (financial institutions, for example), these exceptions have not applied to date in Canada, and there is little evidence that higher industry averages are in fact required.

The thin capitalization rules should be revised so that they apply, not only to investments in Canadian corporations, but also to Canadian branches of foreign corporations, and to partnerships and trusts.

While this will result in additional complexity, it is important that the domestic revenue base be protected. In situations involving discretionary trusts where the relevant beneficial interest of each beneficiary cannot be determined, the thin capitalization rule could apply to all debt attributable, directly or indirectly, to non-resident beneficiaries.

The existing provisions with respect to back-to-back arrangements using third-party intermediaries should be strengthened to include all indebtedness (such as amounts on deposit) between a specified non-resident and a third party, where all or a portion of the amount may reasonably be considered to have been loaned or transferred, directly or indirectly, by the third party to a Canadian business.

The rationale for the possible inclusion of third-party debt guaranteed by a "specified non-resident" is, in the Committee's view, not as compelling. On balance, we propose that guaranteed debt not be included in the thin capitalization provisions at this time, but suggest that the issue be reviewed periodically by the government to identify possible abuses.

Non-resident-owned Investment Corporations

Introduction

A non-resident-owned investment corporation (NRO) is a special-purpose vehicle, eligible for special tax treatment. The NRO regime is a holdover from the 1948 *Income Tax Act*, and seems to have been originally introduced to provide non-resident investors (whether direct or portfolio) with the same Canadian tax result, whether they invested in Canada directly, or through a Canadian subsidiary company. In recent years, however, it appears that NROs have often been used primarily for tax-planning purposes.

Analysis of Current NRO Rules

An NRO is, in general terms, a company incorporated in Canada that elects to be taxed as an NRO, and complies with various conditions, including the following:

- All of its issued shares and indebtedness are owned by non-residents of Canada.
- Its income for each taxation year is derived from prescribed sources, including interest, rents and royalties.
- Not more than 10 percent of its gross revenue for each taxation year is derived from rents.
- Its principal business is not the making of loans or trading or dealing in bonds, shares, debentures, mortgages, notes or similar property.

Various special rules apply for purposes of computing the income of an NRO, and it is then taxed at a flat rate of 25 percent on such income. The 25 percent tax is refunded when the income is distributed as dividends to non-residents and, at that time, Canadian dividend withholding tax applies. This means that, ultimately, the final tax payable on most income earned by an NRO is the Canadian dividend withholding tax.

In recent years, it appears that NROs have often been used for tax-planning purposes. For example, if a foreign investor decides to establish or acquire a Canadian corporation, it could form an NRO to provide part of the required capital. An NRO is treated as a non-resident person for purposes of the Canadian thin capitalization provisions discussed above. Assuming, therefore, an investment of $100, the foreign investor might, for example, invest in $25 of equity of the Canadian company and $75 of equity of the NRO, with the NRO using the $75 to acquire indebtedness of the Canadian subsidiary. In this manner, the existing 3-to-1 debt/equity ratio in the thin capitalization provisions have been respected. Interest payments from the Canadian company to the NRO are deductible by it at ordinary corporate rates, and subject to tax at a rate of 25 percent to the NRO. On an ultimate payment of dividends, the 25 percent is refunded to the NRO, and Canadian withholding tax applies.

For the investor, there are a number of potential tax benefits to the type of structure described above. First, the effective Canadian tax rate can, to the extent of deductible interest and royalty payments to the NRO, be reduced from ordinary rates to the special refundable rate of 25 percent, even though the income remains in Canada. This rate will likely be reduced even further, to the applicable dividend treaty rate, when the income is distributed. Second, and depending on the tax regime applicable in the home country of the foreign investor, the investor may be able to defer or eliminate home country taxation. For example, in certain jurisdictions (such as the United States), the payment of a stock dividend is generally not a taxable event. In such circumstances, it may be possible for the NRO to pay stock dividends and reduce the effective tax rate in the NRO from 25 percent, to the dividend withholding rate applicable to NROs under the relevant tax treaty, without any income inclusion in the investor country. Of particular concern to the Committee is the fact that these types of planning alternatives may encourage non-resident investors to transfer indebtedness to their Canadian subsidiaries, in circumstances where this might not have otherwise occurred.

RECOMMENDATION

The Committee recommends the repeal of the NRO provision, subject to a transitional period.

While the NRO could be viewed as a vehicle that encourages both direct and portfolio investment by non-residents in Canadian corporations – thus creating employment and growth in the Canadian economy – the Committee is of the view that the benefits are limited. In the first place, it is not widely used: in 1994, there were less than 100 NROs in existence. Also, it is unclear whether NROs function to attract additional capital to Canada, or whether, in fact, NRO tax planning structures are more often put in place once an investment decision has been made. The existence of NROs may be acting as an incentive to non-resident investors to thinly capitalize their Canadian subsidiaries.

Transfer Pricing

Introduction

Transfer pricing is a term used to describe the price at which goods, services and capital are exchanged between related parties operating in different tax jurisdictions. The design and application of Canadian transfer pricing rules, and their potential impact on the domestic revenue base, is significant. For example, for 1993, related-party, cross-border transactions of $248 billion were reported to Revenue Canada by taxpayers, $166 billion of which was between related parties in Canada and the United States. Considering that Canada raised close to $20 billion in federal and provincial corporate income tax in 1996, even relatively small percentage shifts in income allocable to Canada from related-party transactions have the potential to cause a significant erosion of (or enhancement to) the domestic revenue base.

The Statutory and Administrative Framework for Transfer Pricing

Prior to the February 1997 federal budget, Canadian legislation required that transactions between a Canadian taxpayer and a related non-resident take place at the amount that would have been reasonable in the circumstances had the parties been dealing at arm's length. The 1997 budget announced that the legislation would be revised to more closely reflect the OECD guidelines, and new legislation has been proposed to achieve this change. At the time of the writing of this Report, this legislation has not been enacted.

In response to legislative and administrative pressure from the United States (described immediately below) and other countries, the February 1997 federal budget also proposed that taxpayers be required to provide contemporaneous documentation supporting the transfer pricing methodology used, and the imposition of penalties where these documentation requirements were not met or where the taxpayer did not act diligently in establishing transfer prices in conformity with the arm's-length principle. These requirements for contemporaneous documentation, and penalty provisions, are also included in the proposed legislation.

Statutory and Administrative Approach in the United States

The approach is somewhat different in the United States. While the United States endorses the OECD guidelines, U.S. authorities have also legislated detailed and complex transfer pricing regulations, which, for example, authorize the use of the "comparable profits method." Under this method, the profit performance of a particular related party is, in general terms, compared with the profit performance of arm's-length companies performing similar functions.

In recent years, the United States, from both legislative and administrative viewpoints, has adopted a more vigorous approach than most other countries in the area of transfer pricing. In the statutory area, the U.S. transfer pricing regulations require that contemporaneous documentation be available at the time of filing of a U.S. corporate tax return, to support the transfer pricing methodology used;

otherwise, any transfer pricing adjustments that are ultimately sustained may attract penalties of either 20 percent or 40 percent of the amount of the tax adjustment (depending on the amount of tax at issue). From the standpoint of administration, U.S. revenue authorities devote significant resources in reviewing and pursuing transfer pricing issues, often with teams that include, in addition to international tax agents, economists and industrial engineers.

The Committee is aware of concerns that, because of the statutory and administrative framework in the United States, there has been a tendency for businesses to establish transfer pricing practices that result in a greater proportion of income being recorded in the United States than would otherwise be the case. Further, many taxpayers are tending to rely, in whole or in part, on the comparable profits method when developing their transfer pricing policies, in a manner that may not be entirely consistent with OECD guidelines. These phenomena are of special concern to Canada because of the very significant volume of related-party transactions between the two countries and the potential for serious erosion of the tax base.

Conclusions

The existence of penalty provisions and documentation requirements in certain other countries (most particularly the United States), combined with aggressive transfer pricing audit procedures in those jurisdictions, poses a threat to the Canadian tax base. In particular, many businesses may, in the past, have sought to "overcomply" with tax rules in those foreign jurisdictions, to the detriment of the Canadian revenue base. On the other hand, when other countries respond with their own administrative, enforcement and penalty initiatives, taxpayers face the threat of double taxation and an escalating compliance burden.

While it is important that a balance be struck between protection of the domestic revenue base on the one hand, and the compliance cost and potential for double taxation imposed on taxpayers on the other, the Committee is of the view that, having regard to the volume of cross-border transactions with related parties (particularly in the United States) the threat to the Canadian revenue base is significant, and that Canadian legislation and enforcement should ensure that Canada obtains its fair share of the income from related-party, cross-border transactions. A research study on transfer pricing prepared for the Committee and released in December 1996, recommended that Canada introduce penalties for the underreporting of income stemming from transfer pricing manipulation, and that such penalties differentiate between taxpayers who act in good faith as evidenced by contemporaneous documentation, and those who do not.[12] The Committee supports these recommendations, and also endorses the principles that taxpayers should be required to have adequate documentation on a timely basis supporting the transfer pricing methodology used, and that penalties should be imposed if such documentation requirements are not met.

Further, it is the Committee's view that Canadian transfer pricing legislation should incorporate the following elements:

- The level of penalties should reflect the fact that, unlike in certain other countries, interest on taxes is not deductible in Canada.
- Penalties should not apply if the taxpayer provides adequate contemporaneous documentation.
- The penalty should only apply to any net adjustment against the taxpayer, where a taxpayer has both upward and downward adjustments.
- If a taxpayer is in a loss position, the penalty should apply to reduce the taxpayer's loss, rather than require the immediate payment of cash penalties.
- Canadian law relating to transfer pricing should be consistent with the OECD guidelines.

- In other than exceptional circumstances, the actual nature of transactions entered into by taxpayers should not be disregarded or other transactions substituted for them. Such a rule would be arbitrary, and would also lead to double taxation if the tax administration of the other country does not share the same view as to how the transaction should be restructured. The existing general anti-avoidance rule should be sufficient to deal with those exceptional circumstances where it is appropriate to disregard the structure adopted by the taxpayer.

Transactions between Canadian taxpayers and related parties located in low-tax jurisdictions offer particular opportunities to reduce Canadian taxes through aggressive transfer pricing methodologies. The Committee accordingly urges the Canadian revenue authorities to be especially vigilant in reviewing these types of transactions.

Emerging Issues in the Global Marketplace

Owing to their implications for taxation generally, the emerging issues of electronic commerce and international tax competition in the global marketplace are of special interest to the Committee.

Electronic Commerce

The rapid growth of electronic commerce is challenging many of the traditional concepts of income taxation. For example, when goods or services are provided over the Internet, traditional principles and rules may not be sufficient to determine which jurisdiction should have the right to tax all or a portion of the related income.

As noted earlier, a resident of Canada is generally taxed on worldwide income, and a non-resident is taxable on certain types of Canadian-source income, including income from a business carried on in Canada. Income from services is generally sourced to the country in which the services are rendered. However, it can be difficult to determine the source of income where services are offered electronically. Also, the right to tax business income is generally modified by tax treaty, such that a person resident in a country with which Canada has a tax treaty is generally not taxable on income from a business carried on in Canada, unless the business is carried on through a permanent establishment. In the Canada-United States Income Tax Convention, for example, a permanent establishment includes a fixed place of business such as a place of management, a branch or an office. The nature of electronic commerce is such that, in many instances, a traditional physical presence at the point of delivery or sale need not, and in fact does not, exist.

The electronic delivery of information also blurs the definition of what product is being bought or sold, since the traditional product in tangible form may not be present. Frequently, the nature of a transaction will determine its classification for tax purposes, especially with regard to the taxation of royalties. A sale of a tangible good such as a compact disk by a non-resident into a certain country may not give rise to a liability for income tax in that country, but the payment for that tangible good delivered in electronic format might be considered a royalty to use a copyright, and would thereby subject that transaction to tax in that particular country. The U.S. Treasury has proposed guidelines in this area relating to the classification of income involving computer programs.[13]

In addition to tax policy issues created by electronic commerce, the technology also poses challenges to tax administration at the level of compliance and enforcement. Frequently, the audit trail of electronic transactions is difficult for third parties – including tax authorities – to follow. Although electronic records may exist, they are subject to alteration without detection, and third-party paper records to substantiate transactions often are not available. The development of electronic money or payment systems could challenge tax administrations in the same manner as cash transactions, although electronic systems can be designed so as to establish trails and account for the use of such money in a manner similar to credit card transactions. The nature of the technology, however, points to the need for international co-operation on compliance and enforcement.

Governments and their fiscal agents must continue to monitor the potential impacts of global commerce on tax revenues. The challenge for tax authorities is to devise a means of sourcing such transactions to a particular location, either by extending existing principles to encompass electronic commerce or by creating new rules. Alternatively, source-based taxation may become less relevant, and residence-based taxation could become the standard charging provision for income arising from electronic commerce.

The issues of taxation and electronic commerce have an impact on both governments and businesses – the former confront the risk of tax base erosion, and the latter face uncertainty as to taxation of their operations. Several countries are actively studying these issues, work is being undertaken by the OECD, and a task force dedicated to this issue has been formed in Canada. While the potential risks are well identified, the technology continues to evolve and solutions remain elusive. The Committee favours continued debate and analysis of these issues in Canada, within the OECD, and by businesses undertaking electronic commerce.

Tax Competition

As the pace of economic integration in the global economy accelerates, countries have become increasingly aware of their economic interdependence. Governments have learned that business taxation affects investment and jobs, especially when the taxes levied are higher than those found in competing jurisdictions. However, they are also aware that taxes finance public expenditures on goods and services such as education and transportation – important factors that businesses take into consideration when choosing a jurisdiction in which to locate. Given that different countries have varying preferences for addressing these challenges, it is neither expected nor, we believe, desirable that all countries choose the same level of taxes and public expenditures in the face of global economic integration.

However, knowing the sensitivity of investment and jobs to taxes, a number of capital-importing countries have engaged in "tax competition" by establishing special preferences or low-tax entities to attract capital and jobs to their country from other competing jurisdictions. The most common forms of tax competition include tax holidays, tax-free zones and other tax preferences, such as low statutory income tax rates for designated activities, investment allowances, investment tax credits and accelerated depreciation. Capital-exporting countries have found that, as a result, they are losing more than jobs and investment. Relatively low corporate income tax rates also encourage businesses to shift taxable profits from high to low tax-rate jurisdictions, thereby eroding tax bases of those countries that are trying to maintain the integrity of their own corporate income tax regimes.

Aggressive competition by capital-importing countries to attract jobs and capital tends to encourage capital-exporting countries to retaliate by introducing their own tax preferences. The result is a race to the bottom – a short-term strategy for jobs and investments that results in retaliation by other governments to protect their own interests. In the end, each country chooses an inefficient tax structure. For these reasons, some experts have made the case that governments should strengthen co-operation at the international level, in order to curtail the most harmful effects of tax competition.[14] The Committee encourages the government to involve Canada in these international efforts.

Endnotes

1 Foreign direct investment is generally defined, for this purpose, as investment by a person with an ownership interest of at least 10 percent.

2 In two recent and extensive surveys, Lipsey (1995) argues that foreign activities of Swedish multinationals have resulted in more domestic activity and job creation, while Feldstein (1995) has argued that each dollar of foreign investment has resulted in one dollar less of domestic investment by U.S. multinationals. Brean (1997) suggests that there is substantial complementarity between foreign and domestic activities of Canadian multinationals. In work done for the Committee, Altshuler and Cummins have found that foreign and domestic capital investments are substitutes, ignoring scale impacts and competitive conditions in an industry (Altshuler and Cummins (1997), Technical Committee Working Paper 97-4). In our view, there is some complementarity between foreign and direct activities for Canadian businesses.

3 See Hines (1996).

4 See Cummins (1996), Technical Committee Working Paper 96-4, for an analysis of U.S. multinational investments in Canada and the United States, and Altshuler and Cummins (1997), Technical Committee Working Paper 97-4 for Canadian multinational investment in the United States and Canada.

5 See, for example, Jog and Tang (1997), Technical Committee Working Paper 97-14.

6 This relief from double taxation is often provided unilaterally under domestic tax legislation in addition to tax treaty provisions.

7 For a further description of the current Canadian tax treatment of foreign source income, and comparison with treatment in several other countries, see the working paper prepared for the Committee by Arnold, Li and Sandler (1996), Technical Committee Working Paper 96-1.

8 On the cost of compliance with the U.S. foreign tax credit regime, see Blumenthal and Slemrod (1995).

9 Grubert and Mutti (1995) estimate that the United States has even lost revenue from the taxation of foreign source income under the deferral method.

10 The exemption from FAPI for interaffiliate payments and other transactions includes payments received by certain partnerships; certain payments by foreign affiliate holding companies in jurisdictions that have consolidated or combined tax reporting for members of a corporate group; and income derived by a particular affiliate from factoring of accounts receivable, or from loans or lending assets, provided that the accounts receivable, loans or lending assets were acquired by the affiliate from a related non-resident corporation, and other prescribed tests are met.

11 For a detailed discussion, see Williamson and Garland (1996), Technical Committee Working Paper 96-12.

12 See Turner (1996), Technical Committee Working Paper 96-10.

13 Proposed Treasury Regulation 1.861-18, 61 Fed. Reg. 58, 152 (November 13, 1996).

14 See, for example, Tanzi (1995). The European Council of Finance Ministers also recently agreed to a package of measures to address perceived "harmful tax" competition.