2001 International Tax Seminar

Learning the Ropes for Going Global

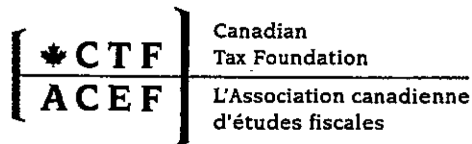
2

Thursday, February 8

9:00 am What Is the Problem with Offshore Income?

- Underlying tax policy issues regarding the taxation of offshore income
- Development of Canadian rules
- The impact of domestic tax changes in light of international trends
- Equitable treatment between residents and non-residents

Wallace G. Conway and J. Scott Wilkie



February 8-9
Hyatt Regency Hotel, Calgary

Canadian Tax Treaties

- Facilitate International Trade and Investment
  - Relief from double taxation
  - Information sharing
  - Dispute resolution
- Generally Follow the OECD Model

Canada's tax treaty network has important implications both for the taxation of foreign source income of residents of Canada and for the taxation of Canadian source income of non-residents. The fundamental purpose of tax treaties is to facilitate international trade and investment by eliminating the double taxation of income from international transactions. Information sharing is also important.

A Tax treaty may allocate the right to tax certain income of a taxpayer exclusively to the country of residence of the taxpayer. It may also provide for the taxation of income of a taxpayer in both countries that are party to the treaty, but require the country of residence to give relief for the taxes levied by the country of the income source.

Canada's tax treaties generally follow the pattern established by the Model Tax Convention on Income and on Capital of the OECD.

Canada's International Tax System - Tax Policy

- Tax Equity and Neutrality
  - Residents compared to residents - income from all sources
  - Non-residents compared to residents - Canadian source income
  - Domestic compared to foreign source income (timing issues)
  - Relief from double taxation
  - Domestic compared to foreign investment

Tax equity and neutrality are the basic reason that residents of Canada are required to pay tax on their income from all sources, including foreign sources to remove any disincentive for investing in Canada. Tax Equity and neutrality also require that that double taxation of foreign source income be eliminated in order to provide for a fair tax result and remove what would otherwise be a disincentive for foreign investment. Timing of recognition of foreign source income also affects tax equity and neutrality.

There are two theoretical views of international neutrality - capital import neutrality and capital export neutrality. Capital export neutrality would be achieved by subjecting foreign source income earned by residents of Canada and their foreign entities to Canadian tax on an accrual basis and providing an unlimited refundable foreign tax credit for foreign taxes on foreign income. Capital import neutrality would be achieved by by exempting residents of Canada from Canadian taxation on their foreign source income and taxing non-residents on their Canadian source income on the same basis as residents.

Elements of both types of international neutrality exist in the Canadian system. Canada taxes income from all sources and provides relief from double taxation. Canada also taxes income of foreign entities of residents of Canada. On the other hand, tax deferral is permitted in respect of foreign active business income earned by foreign affiliates.

Canada's International Tax Regime - Objectives

- Tax Base Protection
- International Competitiveness
- Investment Neutrality
- Administration and Compliance

Tax base protection has been important because Canadian tax rates have historically been higher that the rates of other countries. Therefore, taxpayers are interested in shifting revenue outside and expenses inside Canada. Even with the announced rate decreases in Canada, tax base protection will remain an issue because of the existence of tax haven regimes.

International competitiveness is important in a global economy. Canadians must be able to compete effectively in the international market place with their foreign based competitors. Preserving international competitiveness does not mean exempting foreign income from Canadian taxation. Tax deferral may however be warranted.

Investment neutrality is important to the Canadian economy. Foreign investment must not be favoured over Canadian investment. Incentives to invest outside Canadian are generally detrimental to the growth of the Canadian economy and need to be removed from the Canadian tax system. As well, domestic investment of non-residents should receive the same tax treatment as domestic investment of residents. At the same time it would be inappropriate for Canada to provide incentives for non-residents to invest in Canada that are not available to residents.

Tax compliance and administration are always a problem because of the difficulty in gathering information and the complexity of the rules. Significant costs are associated with the international tax system.

Canada's International Tax System - Global Context

- Small Open Economy of Canada
- Tax Treaties and International Norms Influence Canadian Tax Policy.
- International Co-operation Required to Deal with International Tax Issues.

As a capital exporter, Canada has an interest in ensuring that

- it does not discourage foreign investment by Canadian residents,
- it gets a fair share of the tax revenues from that foreign investment, and
- cross-border transactions are not used to erode the Canadian tax base.

As a capital importer, Canada has an interest in maintaining a tax system that

- encourages investment in Canada by non-residents, and
- does not favour foreign investment over Canadian investment by Canadians.

Canada is a country with a small open economy and it must establish its domestic tax rules giving due consideration to the rules of other countries and the international network of tax treaties which governs the relationships among countries' tax systems.

The Organisation for Economic Co-operation and Development ("OECD") has become much more active over the last decade in disseminating information about international tax and promoting co-operation among member and non-member countries. Since many international tax issues are beyond the capacity of any single country to deal with adequately, these multilateral efforts are extremely important. Canada has taken an active role in the OECD and in other international organisations with respect to international tax issues and must continue to do so.

FAPI Rules - Issues

- Excluded Property
  - Promotes foreign holding company structures
  - Canadian tax avoided
  - Inequitable treatment of taxpayers
- Participating Percentage of FAPI of CFA Share
  - Canadian tax avoided
  - Applies only in respect of shares of CFA

If a Canadian resident disposes of the shares of a foreign affiliate, any taxable capital gain or allowable capital loss must be included in computing the taxpayer's income. Relief is available through the making of an election under subsection 93(1) of the Act to treat some or all of the proceeds of disposition in respect of the shares as a dividend.

Taxable capital gains and allowable capital losses from the disposition of shares of foreign affiliates and partnership interests that constitute excluded property areexcluded from FAPI and included in the affiliate's taxable surplus for purposes of the foreign affiliate rules. Since dividends out of taxable surplus are rarely paid to a Canadian corporation, the treatment of taxable capital gains and allowable capital losses arising from the disposition of shares of a foreign affiliate that constitute excluded property is equivalent to the complete exemption of such amounts from Canadian tax.

The treatment of taxable capital gains and allowable capital losses in respect of shares of foreign affiliates and partnership interests as excluded property seems unnecessary and overly generous in light of the availability of the election under section 93(1).

FAPI Rules - Possible Approaches to Issues

- Excluded Property
  - Exclude shares and partnership interests
  - Exclude a sale of all or substantially all of the business assets
  - consider a replacement property rule
- Participating Percentage of FAPI of a CFA Share
  - Apply in respect of shares of foreign affiliates

It is difficult to justify the more favourable treatment of capital gains and losses realised on the disposition of excluded property (such as shares of foreign affiliates) owned by a controlled foreign affiliate of a taxpayer when compared to those realised on the disposition of such property owned directly by the taxpayer.

The existing rules encourage Canadian taxpayers to structure the ownership of their offshore operations through a holding company located in a low tax jurisdiction. The holding company can dispose of the shares of the operating foreign affiliates without any Canadian tax on the resulting gains.

To correct this inequity, the definition of excluded property could be amended to exclude shares of a foreign affiliate and property sold as part of an asset sale where all or substantially all of the assets of a business are sold. The effect of the exclusion of shares of a foreign affiliate from the definition of excluded property will be to exclude interests in partnerships from qualifying as excluded property.

Consideration could be given to providing deferrals to the extent that proceeds are rolled over into acquisitions of replacement excluded property such as active business assets and shares.

In calculating FAPI inclusions, the rules in subsection 91(1) could be made to apply to shares of foreign affiliates.

ABI Rules - Goals and Tax Policy

- International Competitiveness
- Tax Equity and Neutrality
- Tax Base Protection

ABI Rules - Features

- Foreign Affiliate
- Deferral of Taxation of ABI of Affiliate
- Dividend Income from Affiliate
- Tax Relief-foreign withholding tax

(continues)

Investments in foreign affiliates are intended to be investments in foreign corporations over which the taxpayer has some influence and control. A foreign affiliate is a non-resident corporation in which the taxpayer has an equity percentage of at least 1% and the taxpayer or the taxpayer and related persons have an equity percentage of at least 10%.

Exempt surplus consists of income from an active business carried on in a treaty country by a foreign affiliate of a taxpayer resident in a treaty country, dividends out of exempt surplus of other foreign affiliates of the taxpayer, exempt portion of capital gains and taxable capital gains from dispositions of property used or held in an active business carried on in a treaty country.

The exemption for dividends out of exempt surplus is a proxy for a foreign tax credit and the assumption is that foreign taxes at rates comparable to the Canadian rate has been paid on the active business income.

Taxable surplus includes income, dividends and taxable capital gains not included in exempt surplus.

The deduction for dividends out of taxable surplus is determined by grossing-up the foreign tax applicable to the dividend to reflect the before tax income amount of the affiliate on the assumption that tax was paid at the Canadian corporate rate.

ABI Rules - Tax Base and Policy Issues

- Definition of FA (farming in)
- Excess Foreign Tax Relief-Interest Expense Unrestricted
- Excess Foreign Tax Relief - Low Rate Exempt Surplus
- Foreign Investment Bias
- Administrative and Compliance Complexity

The percentage ownership threshold for foreign affiliate status is quite low. A foreign affiliate of a taxpayer resident in Canada is a non-resident corporation in which the taxpayer has at least a 1% equity percentage and the taxpayer together with related persons has at least a 10% equity percentage. A 10% equity percentage in a corporation can be attained by owning 10% or more of the shares of any class, which is relatively easy for taxpayers to satisfy or avoid depending on the desired result.

Tax base erosion arises because Canada permits the deduction of interest in Canada on funds borrowed and invested in foreign affiliates but does not tax the foreign business income paid to shareholders as dividends out of exempt surplus. Also Canada provides for relief from double taxation on foreign income paid by foreign affiliates as dividends out of taxable surplus to shareholders without reducing the relief by the related interest expense. The timing of the deduction of the interest and the recognition of the revenue also results in tax base erosion.

The exemption surplus system was intended to provide relief from double taxation and is a proxy for a foreign tax credit system. It assumes that the foreign tax rate and base of treaty countries are comparable to the Canadian tax rate and base. Canada has entered into tax treaties with a number of countries with tax rates that are much lower than the Canadian rate and tax bases that differ from the Canadian base. Providing exempt surplus where insufficient foreign taxes have been paid erodes the Canadian tax base.

ABI Rules - Possible Approaches to Issues

- Interest Deductibility
  - Match income and expense,
  - Grind relief from double taxation
- Interest Allocation
  - Domestic allocation formula
  - World-wide allocation formula
  - Tracing
  - Administrative approach

(continues)

The tax base erosion that can be attributed to the lack of matching of interest expense and the related foreign income could be addressed by restricting the deduction of such interest or reducing either the foreign income for foreign tax credit purposes or any deduction in respect of dividends from foreign affiliates under section 113 of the Act by the amount of such interest.

Allocating interest for this purpose poses special challenges and there are several options available. An allocation formula approach involves the assumption that a taxpayer's debt is used to support all of the taxpayer's assets or activities proportionately, whereas a tracing approach assumes that it is possible to match a use of funds with the source of the funds and match income and expense.

A domestic allocation formula would operate by treating a portion of a corporation's interest expenses as having been been used to finance foreign investments equal to the proportion that the value of the corporation's foreign assets is of the total value of all the corporation's assets. To prevent avoidance of the rules, the allocation formula would operate on a group basis with all expenses and assets of a related group of corporations resident in Canada being pooled together. A world wide allocation formula differs from a domestic allocation formula in that the group includes all related corporations, rather than being restricted to corporations resident in Canada.

ABI Rules - Possible Approaches to Issues

- Excess Relief From Double Taxation
  - Credit for foreign taxes paid
  - Taxable surplus approach
  - Designated jurisdiction approach
- Foreign Affiliate Definition
  - Qualifying interest approach

Under a foreign tax credit or taxable surplus approach, a taxable surplus system could be adopted. The relief in Canada would then be based on underlying taxes paid and not on the assumption that taxes have been paid at Canadian rates. Since there would only be one surplus pot, simplicity would be achieved. There would be no need to designate or monitor foreign countries tax systems.

Under a designated jurisdiction approach, all dividends paid by foreign affiliates in designated countries would be exempt from Canadian tax. Dividends paid by other foreign affiliates would be taxable with a foreign tax credit as under the taxable surplus system. The current exemption/credit system of the existing rules would be retained but would be based on an entity approach rather than a transactional approach. A country would only be designated if its tax rate and base were approximately equivalent to the Canadian tax rate and base. By denying exempt treatment to other countries, erosion of the Canadian tax base will be prevented. Complexities would arise under this system.

As most of Canada's tax treaties guarantee exempt surplus treatment, Canada would have to renegotiate tax treaties with countries with such treaty provisions.

The definition of "foreign affiliate" could be amended to include only foreign corporations in which the taxpayer, together with all related persons, owns shares with at least 10% of the votes and 10% of the value of the corporation.