



Reflections on the Advisory Panel's Outbound Tax Recommendations

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- Geoffrey Turner
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Key Considerations

- What did the Panel recommend and why?
- What choices are there and why are they relevant?
- What has been done?
- The business point of view

3

Overview of Discussion

- Heather
 - Taxation of active business income
 - Interest deductibility – 18.2, UK and US proposals
- Geoffrey
 - Capital gains from FA share dispositions
 - Capital gains / FAPI tradeoffs
- Michael
 - Practical implications
 - What have we learned?

4

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- Taxation of active business income
 - Interest deductibility – 18.2, UK and US proposals

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5

Taxation of Active Business Income – What was the Panel Concerned About?

- Competitiveness of Canadian business
- What other countries are doing
- Complexity – tracking surplus
- Effectiveness – TIEA/DTC linkage, taxable surplus

6

Taxation of Active Business Income – What did the Panel Recommend?

- Broaden existing exemption system to cover all foreign ABI
- De-link exemption system and FAPI from TIEA status

7

Taxation of Active Business Income – What Are Other Countries Doing?

Recent developments:

- United Kingdom
- Japan
- United States – will it become the outlier??

8

Taxation of Active Business Income

– Obama Proposals and Economic Myths

- Obama proposals attempt to increase U.S. taxes on foreign investment
 - Mechanic is deferred expenses rather than repeal of deferral
- President Obama, May 4, 2009:
 - “The tax code says you should pay lower taxes if you create a job in Bangalor”
 - View that “tax subsidies” are causing U.S. job losses
- Trade off between low tax rates on foreign income and domestic jobs?

9

Taxation of Active Business Income

– Obama Proposals and Economic Myths

- Assumes that a home country multinational has fixed dollars, and these dollars can be spent either at home *or* abroad
- Therefore, multinationals invest in low-taxed foreign businesses as a substitute for higher-taxed domestic investment
- Theory based on assumptions that multinational corporations:
 - are the relevant taxpayers;
 - are the main vehicles for the cross-border transfer of capital; and
 - make location decisions based on tax rate differentials

10

Taxation of Active Business Income – But Theory Supports Territorial Tax

- Devereux – outbound investment does not crowd out domestic investment - investments financed at the margin by inbound portfolio investment
- Desai – productivity differences between firms; cross-border capital flows from direct holdings of portfolio investments; outbound FDI funded by domestic investment and/or new inbound investment
- Molnar, Pain & Taglioni – no clear evidence that foreign investment negatively correlated with domestic employment
- Policy prescription - territorial taxation maximizes economic welfare

11

Taxation of Active Business Income – Simplification

- Elimination of distinction between taxable and exempt surplus provides welcome system simplification
- Need to ensure any steps taken to deal with base erosion / anti-avoidance concerns do not lead to new sources of complexity

12

Active Business Income

What Actions Have Already Been Taken?

- No formal response to the Panel's recommendations to broaden exemption system
- De facto exemption system is being broadened through the negotiation of new TIEAs
- Next steps?

13

Interest Deductibility (Outbound)–

What was the Panel Concerned About?

- Competitiveness
- Consistency with international norms
- Protecting the Canadian tax base
- Impact of the current global financial crisis

14

Interest Deductibility (Outbound)– What Did the Panel Recommend?

- There should be no restrictions on the deductibility of interest expense incurred by Canadian companies to invest in foreign affiliates
- Repeal section 18.2

15

Interest Deductibility (Outbound) – Section 18.2

- Focus of section 18.2 was misplaced
 - Target of section 18.2 was reduction in foreign tax rate
 - No coherent policy rationale
- Compliance burden and uncertain application (double tracing)
- Avoidable
- Widespread support for repeal

16

Interest Deductibility (Outbound) – Exemption System and Restricted Expenses?

- Some have suggested that a *quid pro quo* for a broadened exemption system is restricted interest expenses
- But there would be a significant economic cost:
 - Increased taxes on *both* domestic and foreign investment
 - Discourage international expansion and growth
 - Discourage domestic expansion and growth
 - Unclear revenue impact
 - Reduction in outbound investment = reduction in domestic investment = reduction in domestic tax revenue?
 - Double taxation if taxable Canadian creditor
 - Incentive to locate expenses – and related income - offshore
 - Impact on Canadian capital markets?

17

Interest Deductibility (Outbound) – Exemption System and Restricted Expenses?

- There is no conceptually correct approach under any system of tracing/allocation:
 - Money is fungible
 - Tracing can be manipulated
 - Allocation involves complex rules with arbitrary results
 - Should tax treatment of creditor be considered?
 - Effectiveness - ability of companies to overcome restrictions?
- Enormous compliance burden

18

Interest Deductibility (Outbound) - UK Debt Cap Rules

- Scaled down version of worldwide debt cap (WWDC) rules announced in April:
 - Original proposals were modified to respond to business concerns
- General concept:
 - UK corporate tax deductions for financing costs cannot exceed consolidated group's worldwide external financing costs
 - Main target unclear – UK tax base erosion - upstream interest-bearing loans from overseas subsidiaries to UK parent?
 - Rules supplement transfer pricing, thin cap

19

Interest Deductibility (Outbound) - UK Debt Cap Rules – Impact?

- View that still uncompetitive – more likely to affect UK headed groups than foreign companies with UK operations
- Significant compliance burden – UK groups need to monitor finance costs of the wider worldwide group; difficult to forecast availability of UK interest relief
- Gateway test – WWDC n/a if UK net debt no more than 75% worldwide group's external gross debt
- Exceptions for financial services companies – details not yet worked out
- Preliminary, informal analysis suggests that WWDC may have little actual impact

20

Interest Deductibility (Outbound)– The Obama Proposals

- Proposal - deduction of domestic expenses (other than R&D expenses) allocated to foreign source income will be deferred until the foreign income is taxed in the United States
- Allocation methodology likely depends on type of expense:
 - Interest expense – assets
 - Other expenses – revenues/other
- Unclear how and when deferred expenses will be recognized
- Complex interaction with changes to U.S. FTC system
- If proceed, U.S. companies with foreign operations will have increased costs of doing business both abroad and domestically
- Proposals inconsistent with recent recommendations to move to territorial tax system

21

Interest Deductibility (Outbound)– Will the Obama Proposals be Implemented?

- Chairman Rangel: These proposals are “another strong step toward fulfilling the administration’s promise to strengthen opportunities for investment and job creation here in the U.S.”
- Chairman Baucus: More study is needed to see how American companies will be influenced by the suggested policies. “I want to make certain that our tax policies are fair and support the global competitiveness of U.S. businesses”

22

Interest Deductibility (Outbound)- What Actions Has the Government Taken?

- Section 18.2 repealed

23

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- Capital gains from FA share dispositions
 - Capital gains / FAPI tradeoffs

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24

Capital Gains from FA Share Dispositions

Panel's Recommendation:

- "Extend the exemption system to capital gains and losses realized on the disposition of shares of a foreign affiliate where the shares derive all or substantially all of their value from active business assets."

25

Capital Gains from FA Share Dispositions

Implications:

- Where vendor is FA selling excluded property FA shares, relinquish potential Canadian taxation of the 50% of gain currently included in taxable surplus
- Where vendor is Canco selling excluded property FA shares, relinquish Canadian taxation altogether

26

Capital Gains from FA Share Dispositions

Arguments for full exemption:

1. Capital gain on excluded property FA shares is substitute for exempt active business income
 - Capital appreciation represents present value of FA's future active business earnings
 - FA could sell assets (excluded property) and pay exempt dividend

27

Capital Gains from FA Share Dispositions

Arguments for full exemption:

2. Simplification of FA system
 - Permits elimination of all surplus accounts
 - Elimination of s. 93 elections
 - FA reorganization rules simplified

28

Capital Gains from FA Share Dispositions

Arguments for full exemption:

3. Tax cost to government may not be significant
 - Many FA share sales made by FA holding companies, i.e. lower tier, not direct from Canada
 - Taxable surplus from 50% taxable capital gain rarely repatriated to Canada as dividend

29

Capital Gains from FA Share Dispositions

Arguments for full exemption:

4. Benchmarking
 - Many countries with exemption for FA dividends also exempt capital gains
 - Participation exemptions

30

Capital Gains from FA Share Dispositions

Issues with full exemption:

1. Reconcile taxable sale of Canadian companies with tax-exempt sale of FA shares
 - Preferential treatment for foreign investments
 - Politically acceptable?

31

Capital Gains from FA Share Dispositions

Issues with full exemption:

2. Robustness of excluded property test
 - Holding period?
 - Point-in-time test?
 - Consolidated basis?
 - Anti-avoidance rules for “stuffing” with business assets?
 - Needs to apply to FA shares directly held by Canco

32

Capital Gains from FA Share Dispositions

Issues with full exemption:

3. Safe income / dividend stripping
 - Current rules compute safe income of FA by reference to surplus accounts (s. 55(5)(d))
 - Panel suggests if surplus accounts eliminated, compute FA safe income using financial statements
 - If s. 93 election eliminated, still need s. 55(2) analogue for FA share dispositions

33

Capital Gains from FA Share Dispositions

Issues with full exemption:

4. Source of capital gain income
 - Rationale for exemption is that Canada relinquishes jurisdiction to tax foreign-source active business income – avoid double tax
 - When Canco sells FA share, is capital gain of Canco foreign-source, or Canadian-source?
 - Is a capital gain proxy for active business income, or is it investment income / property income?

34

Capital Gains from FA Share Dispositions

Issues with full exemption:

5. Inconsistency with tax treaty network
 - Tax treaties allocate jurisdiction to tax capital gain from share dispositions to the residence country (unless gain attributable principally to immovable property in the source country)
 - Where Canco sells FA shares, treaty precludes source country taxation, Canada is only country that may tax the capital gain
 - Effect of Canadian exemption is no country taxes the capital gain
 - Canada doesn't need to exempt Canco's capital gain in order to avoid double taxation of that gain

35

Capital Gains from FA Share Dispositions

Issues with full exemption:

6. No taxation of FAPI earned in non-CFAs
 - FAPI in non-CFAs is not caught by s. 91
 - FAPI contributes to increase in value of FA shares
 - If Canada relinquishes taxation of the capital gain when the FA shares are sold, the non-CFA FAPI is not taxed in Canada
 - Panel recognizes problem (4.99 to 4.102)
 - Possible solution is to apply s. 91 FAPI accrual tax to FAs (not just CFAs)

36

FAPI / FIE / NRT Rules

Panel's Recommendation:

- "In light of the Panel's recommendations on outbound taxation, review and undertake consultation on how to reduce overlap and complexity in the anti-deferral regimes while ensuring all foreign passive income is taxed in Canada on a current basis."

37

FAPI / FIE / NRT Rules

Implications:

- Reduce overlap and complexity in the anti-deferral regimes
 - 2009 budget -- government will review FIE/NRT proposals before proceeding with measures in this area
- Ensure all foreign passive income is taxed in Canada on a current basis
 - Affirmation of fundamental principle of FAPI rules
 - Consultations revealed no contrary opinion (4.91)
 - Improvements needed to reduce complexity and compliance costs (especially base erosion rules and investment business rules)

38

FAPI / FIE / NRT Rules

FAPI earned in non-CFAs

- Under Panel's recommendation for full exemption for capital gains on FA share dispositions, non-CFA FAPI might never be taxed in Canada
- "a solution must be found" (4.99)

39

FAPI / FIE / NRT Rules

FAPI earned in non-CFAs

- Lowering FAPI threshold to FAs (accrual tax of FAPI in FAs not just CFA's) difficult to accept:
 - Canadian owners have mere non-controlling interests in FAs
 - No control of FAPI activities
 - No control over repatriation of FAPI to Canada
 - Difficulty obtaining information to comply

40

Capital Gains / FAPI Tradeoff

Policy choices:

1. Extend full exemption to capital gains from FA share dispositions, retain CFA threshold for FAPI
 - Effectively what the Panel recommended
 - But means conceding no Canadian taxation of FAPI earned in non-CFAs
 - Potentially large loophole
 - Could FIE rules be tailored to plug this gap? (but complexity)

41

Capital Gains / FAPI Tradeoff

Policy choices:

2. Extend full exemption to capital gains from FA share dispositions, but apply FAPI rules to all FAs
 - Effectively what B. Arnold recommended
 - Protects Canadian tax base with tightened FAPI rules
 - But this means extending the FAPI accrual system to mere FA interests
 - Likely complexity
 - Compliance issues where non-controlling interests

42

Capital Gains / FAPI Tradeoff

Policy choices:

3. Fully exempt lower-tier FA share dispositions (eliminate taxable surplus), but retain capital gains taxation of top-tier FA share dispositions by Canco, and retain CFA threshold for FAPI rules
 - Top tier capital gains taxation preserved as fallback means of taxing FAPI accumulated in non-CFAs
 - Consistent with tax treaty network
 - Treats Canco capital gain as Canadian-source and/or investment income (not foreign-source ABI)
 - Reap many of the advantages of simplification
 - Avoid problems from reducing FAPI threshold to FAs

43

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- Practical implications
 - What have we learned?

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44

The Three Big Recommendations

1. Repeal anti-tax haven initiative
2. Expand exemption system to all foreign ABI and capital gains; and
3. Simplify accrual taxation of passive income

45

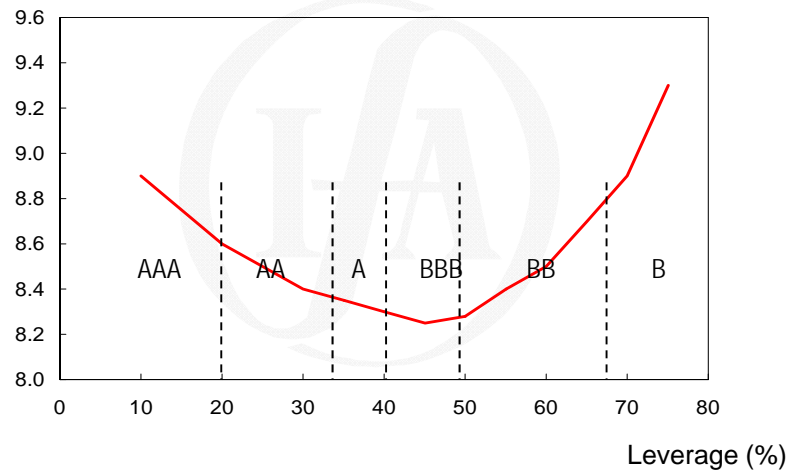
Practical Implications - Interest

- Mission accomplished?
- Tracing sucks, but beats other restricting alternatives:
 - Tracing (linked, flexible, connected, in respect of)
 - Allocating
 - Ordering
 - Caps
 - REOP
 - Fresh start
 - Exceptions
- Remember the killer C's:
 - Currency
 - Credit
 - Cashflow
- Rethink restrictions overall

46

U-Shaped Cost of Capital

Cost of capital (%)



Source: Bloomberg; Reuters

47

Practical Implications – Surplus Expansion

- TIEAs
 - One China, One Treaty....One Way
 - Bi-lateral reforms too uncertain
 - Loose Lips Sink Ships
- Exempt foreign capital gains?
 - Be careful what you ask for
- Transitional considerations:
 - Surplus amnesty
 - Toll charge
 - Other as yet unimagined yet even less palatable alternatives

48

Practical Implications – Accrual Taxation

- Are we there yet?
- Simplification welcome
- Dump NRT rules or create wider exceptions for FIs
- Is existing accrual regime a future frontier?

49

What Did S.18.2 Teach Us About Reforms?

- Need to work together
- Understand the facts
- Simplify the message
- Understand the terrain
- Get the message out
- Work with Finance on big ideas in advance
- More transparency with finance

50