Advisory Panel on Canada's System of International Taxation

Review and Commentary on Recommendations Affecting Inbound Tax Provisions

International Fiscal Association (Canadian Branch)
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Review of Advisory Panel Recommendations Affecting Inbound Tax Provisions Outline

- Thin Capitalization – Recommendations 5.1 and 5.2
- "Debt-Dumping" – Recommendation 5.3
- Treaty Shopping
- Non-resident withholding taxes – Recommendations 6.1 and 7.3

2

Advisory Panel Recommendations: Thin Capitalization

- **Recommendation 5.1:** Retain the current thin capitalization system, and reduce the maximum debt-to-equity-ratio from 2:1 to 1.5:1
- **Recommendation 5.2:** Extend the scope of the thin capitalization rules to partnerships, trusts and Canadian branches of non-resident corporations
- ie) extend application to unincorporated organizational forms but continue to leave third-party debt (whether or not guaranteed) out

3

Advisory Panel "Quasi-Recommendations": Thin Cap

- Consider recharacterization of non-deductible interest as a dividend
- Consider extension of scope of back-to-back loan rule
- No change to definition of specified non-resident

4

Thin Cap as Transfer Pricing/Interest Sourcing Limitation

- Alternative conceptualization of thin cap as a transfer pricing overlay with a sourcing aspect ie) outer limit on sourcing of external debt
- Application to intra-group debt becomes a secondary function in the context of inbound FDI
- Empirical evidence of substitutability of location of arm's length borrowing with use of guarantees and other support
- Differences in local and non-local capital markets

5

Inbound FDI: Taxing Location-Specific Profits

- National welfare maximization - maintenance of tax base = location-specific rents
- NZ first to make conceptual leap to apply as outer limit on sourcing of external debt and intra-group debt
- Thin cap as asset apportionment with a safe harbour
- Avoid difficult issue of the status of guaranteed debt
- Trend in country practice = benchmarking?

6

Generalized Rule of Non-Deductibility

- Competing alternative in context of inbound FDI - generalized rule of non-deductibility for intra-group debt
- Effectively prohibits sourcing of intra-group debt
- Limit thin cap to sourcing of external debt
- Generalized rule of non-deductibility over-inclusive if location of external debt is not perfectly substitutable
- Significance of the non-discrimination principle?

7

Role of Thin Cap Applied to Intra-Group Debt

- Target the tax-driven use of intra-group debt = conversion of external equity to tax-deductible intra-group debt
- Permit sourcing of external debt either directly or indirectly through the use of intra-group debt up to safe-harbour
- Location of external debt is not perfectly substitutable unless can use intra-group debt
- But focus on related-party debt permits conversion of external equity to tax-deductible intra-group debt
- Also substitutability of external group debt in response to tax rates subject only to debt-dumping rule

8

Safe-Harbour Leverage Ratio

- Worldwide consolidated leverage ratio of group = asset apportionment
- First-best expression of the arm's length standard as the outer limitation on the sourcing of external debt?
- Function as a target-effective screening for the tax-driven use of intra-group debt = conversion of external equity
- Looseness in specified safe-harbour ratio = looseness in application of arm's length standard

9

One-Size Fits All Ratio

- Use of one-size-fits all ratio with "fact-specific" arm's length out in context of inbound FDI
- Exception for financial sector with extension to "near banks"
- Use of "uplift" provision
- Permit reduction of effective source-country rate in context of inbound FDI as tax competition mechanism

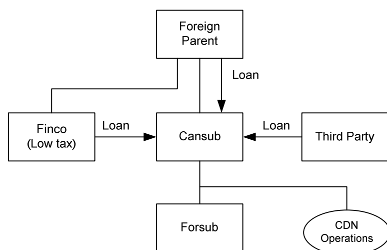
10

Limitations

- Thin cap only addresses stripping of normal returns and a portion of the return to risk-taking on equity
- Use of debt substitutes
- "Black hole" of intra-group royalties and stripping of supernormal returns

11

Recommendation 5.3: Curtail tax motivated debt-dumping by a foreign controlled Canadian company … while ensuring bona fide business transactions are not affected



System design features that permit tax base erosion

- Exemption system
- Debt/equity classification based on legal form
- Thin cap rule not covering third party or guaranteed debt
- Capital gains exemption on active foreign affiliate shares (recommended)
- Reduction/elimination of withholding tax on interest and dividends

Lower Canadian corporate tax rate is an inadequate counter balancing measure on its own.

12

Anti-Avoidance Targeted at Debt-Dumping Dutch Experience and Recent Developments

- Debt/equity – economic substance classification principles
- Thin capitalization rule – 3:1 (related party debt only)
- Tainted transaction – interest on related party debt incurred in connection with a share acquisition not deductible unless:
  - Taxpayer can demonstrate business purpose for both the loan (debt) and share acquisition, or
  - Creditor subject to at least 10% effective tax rate
  - Beginning in 2008, no interest deduction if tax inspector can show no business purpose for the loan or share acquisition
    - No longer a 10% ETR safe harbour – greater than 10% ETR in creditor only shifts burden to tax inspector
- New proposal expected this summer to eliminate uncertainty of business purpose test.

13

Anti-Avoidance Targeted at Debt-Dumping French Approach and Experience

- No specific anti-avoidance provision for affiliated party financed share acquisitions – general avoidance (abuse of law) provisions govern
- If business purpose, abuse of law provisions will not apply
  - Establishing a French holding company for Europe or managing a multinational business from France likely a sound business purpose; simply acquiring common or preferred shares likely not
  - If abuse found – downside penalties severe
- Other sources of planning/”looseness” in system
  - Affiliated person interest permitted up to 25% of adjusted earnings
  - Back to back loans
  - Increase Frenchco’s net equity
  - Excess interest can be carried forward, subject to amortization
  - Exception if global debt/equity greater than thin cap limitation (seldom used).

14

Anti-Avoidance Targeted at Debt-Dumping Recent Developments in Sweden

- Effective January 1, 2009 Sweden adopted a rule broadly modeled on the Dutch anti-avoidance rule, except:
  - No requirement to take account of loss carry-forwards in determining ERT in creditor entity
  - 10% counterbalancing tax exception is a safe harbour
  - Does not apply to external share acquisitions
  - Only applies to share transactions (Dutch rule also applies to debt incurred to finance various types of equity distributions)
- Swedish rule also contains exemption where transactions mainly motivated by business reasons
- Whether Swedish Tax Agency's guidance consistent with law is unclear

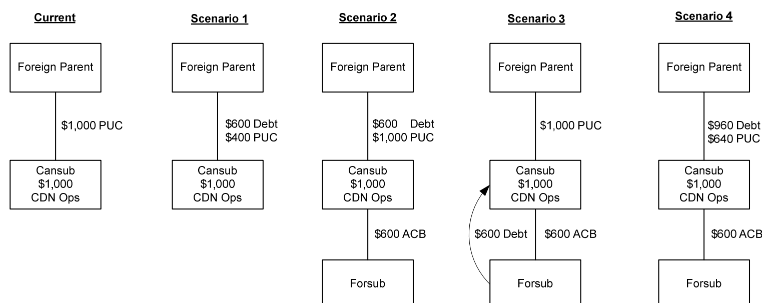
15

Anti-Avoidance Targeted at Debt-Dumping Canadian Context

- Absent broader thin cap reform, targeted approach preferred
- Difficult balancing act between designing a rule that is not over-inclusive (discriminatory and barrier to inbound capital), yet effective
  - Recent experience/developments in Netherlands and Sweden not compelling; French system seems stable – each approach must be assessed in broader context
  - Something in between a s.95(6) type rule and the GAAR without s.245(4)?
  - Tracing/linking the financing to the share acquisition
  - Assessing business purpose – for the financing, the share acquisition or the transaction?
  - Swedish "mainly" threshold is 75% - compare to primarily/principally tests in Canada (assessing qualitative and quantitative factors)
  - Broad range of circumstances in which Cansub acquires foreign affiliates.

16

Anti-Avoidance Targeted at Debt-Dumping Scenario Analysis



- 1.5:1 safe harbour – same treatment for Scenario 1 and 2?
- Same treatment between Scenario 1 and 3 – thin cap and FAPI protect the base in 3?
- Extent of problem in 4 - $960 vs excess $360?
- Integrating a targeted debt dumping rule with existing scheme, incl. 15(2), 17(1), 18(4), 95(1), (2), and (6), and 245(2).

17

Treaty Shopping

- **Conclusion** – "Canada has adequate resources and tools in its tax treaties and domestic law and international jurisprudence to police treaty shopping. However, the government should continue to monitor developments in this area."
- **Observations**
  - What tools:
    - MIL; Prevost?
    - LOB Article in US Treaty
  - Withholding taxes on interest, dividends, royalties
  - Capital gains largely exempt, except real property.

18

Advisory Panel Recommendation: Non-Resident Withholding Taxes

- **Recommendation 6.1:** Consider further reducing withholding taxes bilaterally in future tax treaties and protocols to the extent permitted by the government's fiscal framework and its agenda regarding additional corporate tax rate reductions.

19

Recommendation "Qualified"

Case For:

- Remove obstacles to cross border capital flows (potentially serious during times like recent financial crisis)
- Canada should follow global trend toward reduction/elimination of withholding taxes
- Favorable impact on Canadian capital exporters
- Potential for lower costs for Canadian business inputs (financing, technology)
- Positive impact on Inbound Capital Flows – Increased foreign investment
- Eliminate distortive impact on multinational capital flows

20

Recommendation “Qualified”

Case Against:

- Potential risk to tax base
- Fiscal cost not insignificant
- Lack of clear empirical data re impact of wh tax on investment decisions
- Panel informal business survey indicated preference for income tax reductions

21

Advisory Panel Recommendation: Non-Resident Withholding Taxes

- **Recommendation 7.3:** Eliminate withholding tax requirements related to services performed and employment functions carried on in Canada where the non-resident certifies the income is exempt from Canadian tax because of a tax treaty.

22

Recommendation Will Benefit Canadian Business

- Current system is not workable given current global mobility in services and labour. Reg 105 is barely manageable; Reg 102 is impossible for most multinationals.
- Waiver process not feasible in most cases.
- Large compliance burden, exposure and real incremental cost to Canadian business
- Recommendation has wide support from business community. Have reached out to both Finance and CRA to provide leadership in moving this forward.

23