Canada's International Tax System
Panel Discussion

Arnold, Duff, Tremblay,
Williamson

Discussion Outline

- Exemption system; capital gains exemption; surplus calculation
- Interest deductibility; including inbound thin capitalization and "debt dumping"
- Deeming rule (S. 95(2)(a)(ii), etc.)
- FAPI (including a discussion of base erosion rules with comments on FIEs and NRTs)
- Treaty shopping
- Process for developing tax policy

Exemption System

- Widespread support for exemption system, which involves little change from current system
- TIEAs rightly regarded as separate issue, but good reasons to encourage information sharing
- Expanded exemption system increases pressure on
  - foreign affiliate definition
  - anti-deferral rules
  - base erosion and transfer pricing rules
  - interest (and other expense) allocation rules

Exemption System – Eligible Entities

- Advisory Panel: review FA definition, consider extending to other foreign entities, but not branches
- Current threshold is low (Technical Committee)
- Threshold should be a requirement of substance, not mere formality (Arnold)
- 10% votes and value more compatible with international norms
- Extension to branches logical but complicated

Exemption System / Anti-deferral rules

- Full exemption system means FAPI of non-controlled FAs could escape Canadian tax
- Advisory Panel: review and consult on how to reduce overlap and complexity while ensuring that all foreign passive income currently taxable in Canada
- Consider extending FAPI rules to apply to non-controlled FAs
- Could simplify or eliminate need for surplus accounts

Exemption System – Capital Gains

- Logical where gain represents ABI or expected ABI that would be exempt from Canadian tax
- Inappropriate where gain represents FAPI of non-controlled FA or unrealized gain in value of non-excluded property
- Capital gains stripping problem if dividends exempt and gains partly taxable
- Possible solutions
  - extend FAPI rules to non-controlled FAs
  - retain surplus accounts and section 93
  - deem FAs whose shares are sold to have disposed of all assets prior to sale at FMV

Exemption System – Capital Gains

- Arguably inconsistent to exempt gains on sale of FA shares but not shares of Canadian corporations (particularly where gain represents increase in value of a FA)
- Consider consequential changes: capital dividends, refundable tax, loss limitations
- Added pressure on inbound interest deductibility rule – if proposal is to deny interest related to "bad" foreign investments

Interest Deductibility — Outbound

- Advisory Panel: no restrictions on deduction of interest
- 3 reasons:
  1) Other countries allow unrestricted interest deduction
  2) "Canada's tax system should not create disadvantages for Canadian businesses when they compete abroad"
  3) Now is not the right time

Interest Deductibility — Outbound

- If foreign dividends from foreign affiliates and capital gains on shares of foreign affiliates are exempt, interest should not be deductible
- Interest deduction is a subsidy for foreign investment — bizarre
- Difficult to justify, but should be discussed openly as a subsidy

Interest Deductibility — Outbound

Possible Restrictions:

- Tracing doesn't work
- Interest allocation rules
- Outbound thin capitalization rules
- Earnings-stripping rules
- Pragmatic purpose: get Canadian corporations to move debt offshore

Interest Deductibility — Inbound

- Advisory Panel: thin capitalization rules are "sound in principle and appropriate in scope"
- Debt/equity ratio should be reduced to 1.5:1
- Rules should be extended to partnerships, trusts, and branches
- Rules should not take into account unrelated-party debt and guaranteed debt
- Anti-avoidance rule to deal with debt dumping

Interest Deductibility — Inbound

- Thin capitalization rules need to be tightened
- Problem is exacerbated by elimination of withholding tax on interest
- Unrelated-party debt should be taken into account

Inter-Affiliate Financing

- Advisory Panel: retain 95(2)(a)(ii) as is and repeal 18.2
- Reasons:
  - preserves underlying character of ABI in global context
  - outbound financing arrangements available in other countries (U.S. check the box and look through rule, UK entity-based regime)
  - competitiveness
  - minimization of foreign taxes irrelevant from Canadian perspective

Inter-Affiliate Financing

- Concerns
  - underlying character concern legitimate, but need to distinguish business from tax-motivated structures – same country or listed country limitation
  - appropriate treatment linked with broader restrictions on interest deductibility
  - “tax efficient” financing can be economically inefficient and upsets level playing field for inbound investment
  - current trend is to limit opportunities for outbound financing arrangements: US dual consolidated loss rules, UK anti-arbitrage rules, Fifth Protocol, sunset on U.S. look-through rule, Obama proposals to eliminate check the box
  - reciprocity suggests Canadian cooperation

FAPI (base erosion)

- AP: Paragraph 4.123 – Base erosion rules OK for Canadian debt obligation, Canadian leasing and insurance of Canadian Risks
- Not ok: sale of foreign goods to Canco by CFA/FA where goods not originated solely in it's jurisdiction
  - Transfer pricing (ITA 247) to be guardian of Canadian FISC
  - AP: "more can be done" – not sure what they want done (better ABI definition?).
  - If go with full ES system/territorial system, huge pressure on TP rules. AP saw TP issues (4.122)
  - 4.125: if FAPI applies to non-CFA "consider how rules should apply differently": What they are focusing on?
  - RGT: hard to see how will <u>not</u> be revenue loss. TP yields a range of values. So taxpayers will aim high on sales to Canadian parent. Cases will be settled in the middle-means loss of Canadian revenue. Real issue is whether business benefits outweigh loss.

Investment Business

- Literal CRA interpretation of 95(2)(a)(i) coupled with five employee requirement
  - "If income had been earned by FA_1", (instead of FA_2) would be ABI
  - e.g. Real estate in US; class action lawsuits and general liability concerns means separate subs for each project
  - Need to test foreign groups as one company where activities are related (as AP points out)
  - CRA could get there if wanted to interpret reasonably

FIEs and NRTs

- Not Salvageable
  - Need to start over
  - Drafting is simply too bad conceptually and technically
- FIE: If FAPI applies to FA, then much narrower scope
  - Go with purpose test
  - Probably need "tracking" rule
  - Impute return like old 94.1 unless election to pay on actual earnings
- NRT: deemed residence concept unacceptable and commercially disastrous
  - Limit taxation impact to Canada/Canadians
  - Extraterritoriality of proposed rules repugnant
- Overlap
  - Avoid and if must, then definitions must at least be consistent as between FAPI, FIE and NRTs
- Do not see evil of sheltering passive income with active losses
  - really did lose money
  - a buck is a buck
- Tolerate some slippage

Treaty Shopping

- AP: "Adequate Resources and Tools in Tax Treaties and Domestic Law and International Jurisprudence but Government should continue to monitor developments"
- Prevost – Beneficial Owner – Taxpayer Won despite bad facts
- RMM Canadian Enterprises 97 DTC 302 – Surplus strip – Crown won
- MCA 94, 96 Royalties ("collection agent"): taxpayer won
- Crown Forest SCC 1995 Treaty Shopping: Not improper but not to be encouraged by judicial interpretation of existing agreements
- Union of India (Indian Supreme Court)
  - If want to limit treaty benefits beyond residency requirement, say so with LOB clause
- Smallwood Estate – UK High Court Ch. Division
  - Trust moved to Mauritius to use capital gains article – Taxpayer won (on appeal)
- Indofood (non-tax UK court): right to redeem bonds early
  - "Beneficial owner" case won by Crown on appeal
  - Presume big part of Velcro case
- Velcro – back to back royalty?

Treaty Shopping

- MIL 2006 TCC
  - Paragraph 72: nothing inherently improper in selecting one foreign regime over another. "(referring to" dicta in Crown Forest SCC)
  - Paragraph 74: "MIL's reliance upon a treaty provision…cannot be viewed as being a misuse or abuse. Canada if concerned,…instead of applying ITA 245 should seek recourse by attempting to renegotiate selected tax treaties."
- MIL F.CA 2007
  - Paragraph 5 – "We are unable to see in the specific provisions of the ITA and the treaty…Interpreted purposively and contextually and support for the argument that the benefit obtained by MIL was an abuse or misuse of the object and purpose of any of those dispositions."
  - Paragraph 7 – If the object of the exempting provision was to be limited to…it would have been easy enough to say so.
  - Paragraph 8 – To the extent that Crown argues that the treaty should not be interpreted so as to permit double non-taxation, the issue raised by GAAR is the incidence of Canadian taxation, not the foregoing of revenues by the Lux fiscal authorities.

Treaty Shopping

- US LOB
  - XXIXA(7): GAAR – context is different because of existence of XXIXA (1) – (6)
- OECD Art1: Commentary
  - MIL:1997 Facts: TCC rejected use of later (2003) commentaries (Canada – Lux treaty concluded 1990)
  - relied on Paragraph 7 OECD commentary 1977: "Such states will wish, in their bilateral double taxation conventions, to preserve the application of a provision of this kind contained in their domestic laws."
  - Canada – US: (after 5th protocol)
    - MIL's application probably is limited vis à vis US
  - Canada – country X treaties:
    - MIL applies (subject to OECD Model Commentary in play <u>when relevant treaty entered into</u>)
- As pointed out by many, US taxpayers can use third country company e.g. Lux, Neth to avoid IV(7)(b) impact on ULCs.
  - Query: Is that abusive treaty shopping? Does it matter that earnings/dividends received by Lux/Dutch Co already taxed in Canada and application of IV(7) results in double tax?

Treaty Shopping

NRTs

- Julien Sept 2008 Art IV(3) - no order granted to force CRA to negotiate (Unenacted ITA 94)
- RCI Trust 2009 (ITA 116) : Deemed residence not “a criterion of a similar nature”. Barbdos Trust with indirect Cdn beneficiary. Fed Ct ordered CRA to determine whether shares treaty exempt property but based on trust being solely Barb resident

Tax Policy and Legislative Process

- Current process is flawed
  - lack of consultation on policy issues
  - unacceptably long delays in enactment
  - quality of legislation
  - Finance is under-resourced
- Advisory Panel’s recommendation: government should make every effort to achieve more transparency

Tax Policy and Legislative Process

- Tax policy process should be improved
- Finance should conduct its own internal review
- There should also be an external review
- Reviews should propose changes and be made public
- Canadian Tax Foundation Committee to study the process

Tax Policy and Legislative Process

- Finance should issue consultative documents on all major reforms
  - Advisory Panel is not consultation
- consultation should occur throughout tax policy and legislative process
- Finance should adopt a formal policy concerning consultation

Tax Policy and Legislative Process

- Tax Policy Review Board should be established to supplement tax policy work done by Finance
- Quasi-independent from Finance and CRA, but close co-operation is required
- Issues referred to Board by Finance
- But sufficient resources and authority to carry out projects on its own

Tax Policy and Legislative Process

- Finance lacks sufficient human resources, especially in the international area
- Separate international tax unit should be established
- Parallel to Business and Personal Income Tax Divisions
  - should include tax treaties unit