Government panel looks to give competitiveness a boost

The panel looking into Canada's international tax rules has identified areas that need attention, including the taxation of income from overseas investments and transfer pricing, say Todd Miller and Laura Stoddard of McMillan

Following the various measures introduced in the 2007 Federal Budget and in furtherance of its Advantage Canada economic policy, the Canadian government announced the establishment of an advisory panel in November 2007 to review and make recommendations about Canada's system of international taxation. The panel, which is comprised of various prominent members of the Canadian business and accounting communities, is scheduled to submit its report to the government by December 1 2008.

The panel's mandate is to consider Canadian tax policy in two key areas: investment abroad by Canadian enterprises and investment into Canada by foreign businesses, with particular focus on identifying measures which will improve the efficiency, fairness and overall competitiveness of Canada's international taxation system, including measures that will minimise or eliminate compliance costs for businesses and facilitate the administration of the tax laws by the Canada Revenue Agency (CRA). Although the panel has not been asked to ensure that its recommendations are fiscally neutral, it has indicated an intention to be cognizant of the revenue impact of any alternatives that come before it for consideration.

Outbound taxation

The panel has expressed the view that the taxation of outbound investment will continue to have a significant impact on the ability of Canadian businesses to remain competitive in a rapidly globalising economy (for example, by achieving economies of scale and acquiring new technologies, resources and skills). This is an area that has been the source of some uncertainty and confusion in recent years because of draft legislation some provisions of which, if enacted, could apply as far back as 1995.

Under the current rules, the taxation of active business income earned by the foreign affiliate of a Canadian corporate shareholder is dependent upon, among other things, the residency of the affiliate and location of its business activity. More specifically, if the affiliate is located in a country with which Canada has a tax treaty or, under recently enacted changes, a country with which Canada has a comprehensive tax information exchange agreement (TIEA), the affiliate's income is not subject to immediate taxation in Canada and dividends from the affiliate can be received by the shareholder free of Canadian tax as exempt surplus. If the affiliate is located in a non-treaty/non-TIEA country, there is generally a deferral of Canadian taxation on the income until returned to Canada as a taxable surplus dividend (with a credit available at that time for any foreign taxes paid by the affiliate).

> **The Canadian government has recently implemented several tax-related changes aimed at making Canada a more attractive place to invest**

Finally, under the recently enacted changes, active business income earned by affiliates located in non-TIEA countries who have been requested by Canada to enter into a TIEA but have not done so within a stipulated period of time, will be taxed in Canada on an accrual (that is, when earned) basis.

While the panel's preliminary view is that Canada's foreign affiliate rules with respect to active business income (as described above) need not be changed extensively at this time, it will be considering any modifications that would reduce compliance costs without adversely impacting tax revenues.

In particular, and consistent with similar initiatives in other OECD countries such as New Zealand and the UK, the panel will consider whether Canada should move toward a broader or full exemption system for active business earnings from abroad (including an exemption for active business-related capital gains).

The move would potentially minimise or avoid the need to compute and track the different baskets of foreign affiliate earnings required under the current system and would not, according to some commentators, have significant repercussions on the fisc.

Inbound taxation

The Canadian government has recently implemented several tax-related changes aimed at making Canada a more attractive place to invest, including a reduction in corporate tax rates and an elimination of withholding tax on most arm's-length interest payments to non-residents and on related-party interest payments in the case of qualifying US lenders (to be phased-in under the new protocol to the Canada-US tax treaty). In addition, a recently proposed amendment will reduce the tax reporting burden placed on non-residents who dispose of taxable Canadian property where the disposition is exempt from Canadian tax by virtue of an applicable tax treaty.

Despite these welcome changes, howev-

Advisory Panel on Canada's System of International Taxation

Peter Godsoe, chairman: former chairman of the Bank of Nova Scotia
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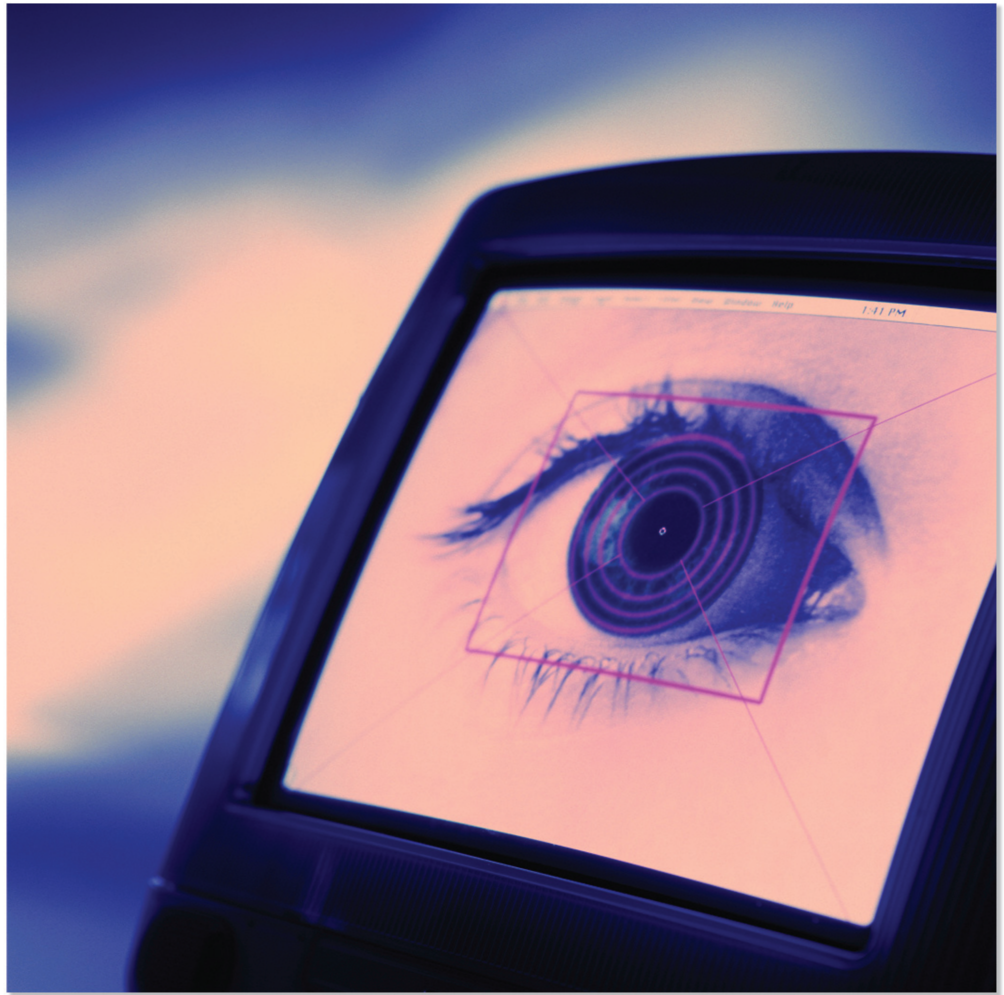
Finn Poschmann: director of research at the CD Howe Institute
Guy Saint-Pierre: former chairman of the Royal Bank of Canada
Cathy Williams: former chief financial officer of Shell Canada

er, many potential barriers and challenges to inbound investment remain. For example, one area that may need to be reconsidered, in the panel's view, is the thin-capitalisation rules which, in their current form, can deny the deductibility of interest expenses in connection with debt owed by a Canadian corporation to its non-resident affiliates, to the extent such debt exceeds the equity of the Canadian corporation by a ratio of greater than 2:1.

In particular, the panel intends to consider whether a modification in this ratio would be appropriate in light of the recent withholding tax and corporate tax reductions and having regard to the potential loss of tax revenue to the Canadian fisc on the one hand versus the potential economic benefits of any incremental inbound investment that might result on the other. One approach potentially meriting consideration is the arm's-length test used in the UK, which does not employ a fixed ratio but instead allows interest paid by a corporation to a related-party lender to be deductible if a comparable corporation could have borrowed the same amount from an unrelated lender.



Advisory panel has its eye on Canada's international tax system

While this company/industry specific approach would obviously have the benefit of better reflecting the commercial realities of a particular taxpayer in comparison to the arbitrary bright-line test contained in the existing thin-capitalisation rules, it could prove difficult to administer in practice.

Withholding taxes

The panel has highlighted the importance from a competitiveness standpoint of regularly benchmarking Canadian withholding tax rates against international norms. In particular, the panel will consider whether the withholding measures relating to interest in the new protocol to the Canada-US tax treaty should be extended to other countries as the relevant treaties come up for re-negotiation.

In addition, the panel will examine whether Canada should negotiate bilateral exemptions for withholding tax on dividends and royalties with its main economic partners, an approach that has been adopted by countries such as Japan and the US.

Administration and enforcement

The panel will consult with taxpayers and the CRA to identify ways to reduce the administrative burdens associated with, among other things, transfer pricing and withholding tax requirements for foreign service providers

One potentially promising development on the transfer pricing front can be found in the new protocol to the Canada-US tax treaty, which introduces a taxpayer/revenue authority binding arbitration process that many expect will result in the revenue authorities taking a more reasoned and pragmatic approach in their transfer pricing reviews of Canada-US cross-border transactions. It is hoped that similar measures will be recommended for other treaties.

Canada imposes a withholding tax of 15% on payments made to non-residents who provide services in Canada. Where the non-resident service provider is not ultimately taxable in Canada (for example, by virtue of an applicable tax treaty) a refund of these withholdings may be sought upon the filing of a Canadian tax return, although significant processing delays are not uncommon.

In recognition of this, the CRA has provided a process for non-residents to seek a waiver of withholding. However, the waiver process is time consuming and can be costly if a taxpayer consults a professional advisor, as is often the case. The panel observes that the current withholding rules present serious obstacles to foreign service providers and to the Canadian companies that require their services. It is hoped that the panel will recommend measures aimed at removing or at least significantly streamlining this compliance burden for the large numbers of service providers who are treaty exempt or whose level of remuneration is relatively low when compared to the costs of compliance.

Waiting for new ideas

While the panel has clearly identified a number of areas in Canada's international tax system potentially in need of change or reconsideration, it acknowledges that there may be others and has accordingly requested written submissions from interested parties. It will be interesting to see what approach is taken by the panel on the topics identified by them and whether any new ideas are generated through the public consultation process.

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