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Canada's System of
International Taxation

Examining Policy Options for the Taxation of Outbound Direct Investment

Arthur J. Cockfield

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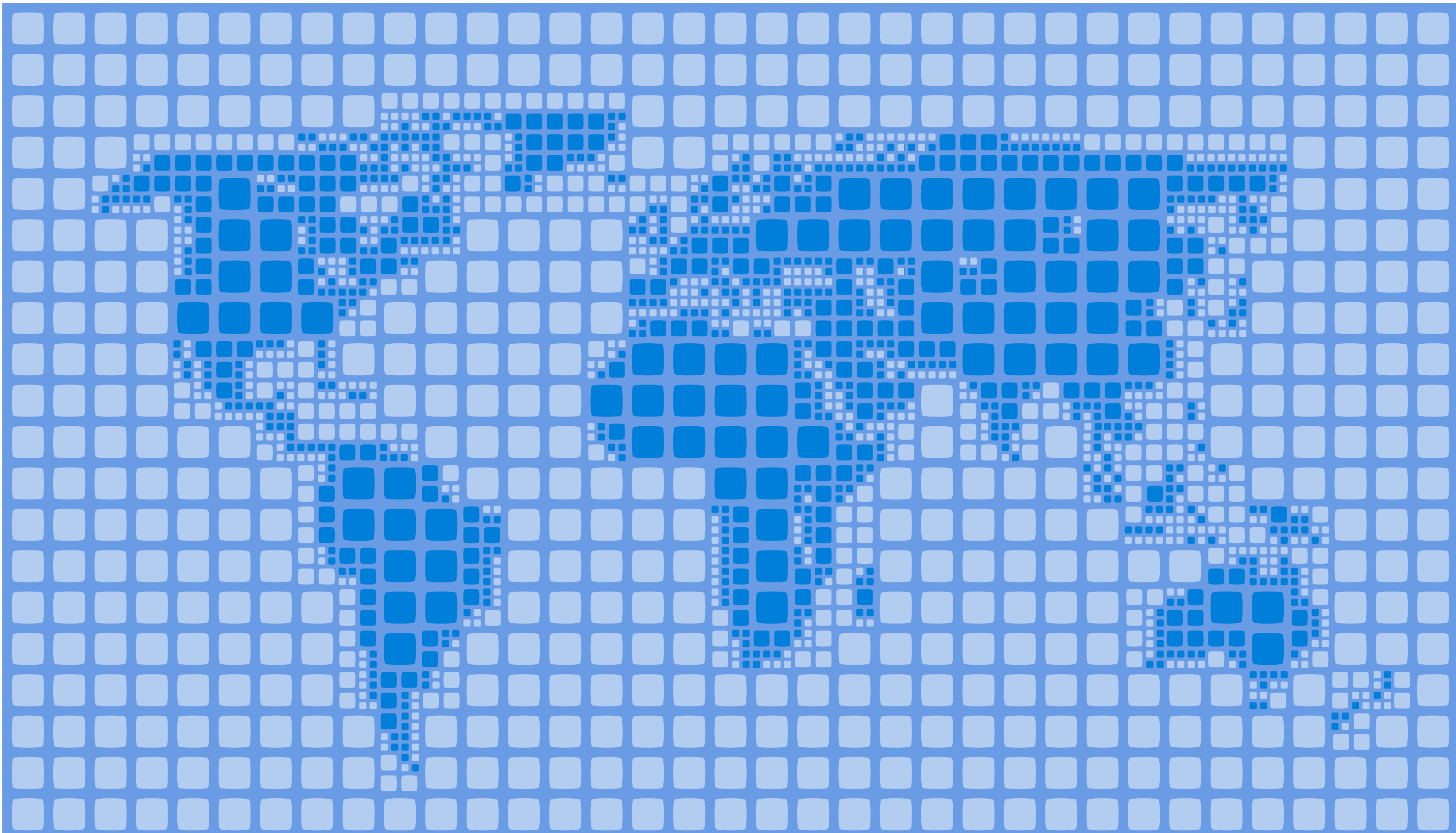

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1. Introduction

1.1 Context: Impetus from 2007 federal budget

Canada's international tax system has maintained a similar approach with respect to the taxation of outbound direct investment since the 1970s although complex tax rules were subsequently added to support the system's main policy goals. In the 2007 federal budget, the government indicated that it was time to consider ways to improve the fairness and international competitiveness of Canada's international tax system. On November 30, 2007, the Minister of Finance appointed the Advisory Panel on Canada's System of International Taxation (the "Advisory Panel") to review this system and to provide recommendations in a report to the Minister of Finance.

1.2 Mandate of the Advisory Panel

According to the Minister of Finance, the Advisory Panel's objectives are to:

- improve the fairness, economic efficiency and competitiveness of Canada's system of international taxation, as outlined in *Advantage Canada*;[1]
- minimize compliance costs for business and facilitate administration and enforcement by the Canada Revenue Agency (CRA); and
- develop practical and readily-applicable changes, taking into account existing rules and tax treaties as well as fiscal implications.

In April 2008, the Advisory Panel published a Consultation Paper entitled *Enhancing Canada's International Tax Advantage*.[2] The Advisory Panel indicated that its recommendations will:

- aim to improve the competitiveness, efficiency and fairness of Canada's system of international taxation, minimize compliance costs for businesses, and facilitate administration and enforcement by the CRA;
- attempt to propose changes that can be practically implemented and that will increase the certainty and simplicity of Canada's system of international taxation for large, medium-sized and small businesses;

1 See Canada, Department of Finance, *Advantage Canada: Building a Strong Economy for Canadians* (Ottawa: Department of Finance, 2006), proposing, among other things, to reduce taxes for all Canadians and establish the lowest tax rate on new business investment in the G7; reduce taxes on savings, including capital gains, to make them more competitive with the tax treatment of savings in other countries; and be open to trade and foreign investment so goods, services and technologies flow freely into Canada and Canadian firms have ready access to foreign markets to compete with the best of the world.

2 See Canada, Advisory Panel on Canada's System of International Taxation, *Enhancing Canada's International Tax Advantage* (Consultation Paper) (Ottawa: Department of Finance, 2008) at 1-2.

- take into account the revenue impact of any proposal; and
- accord with the Competition Policy Review Panel's goals to (a) promote Canadian direct investment abroad, and create the domestic conditions to foster the development of Canadian businesses; and (b) maximize Canada's attractiveness as a destination for talent, capital and innovation.[3]

1.3 Outline of this report and main conclusions

This report provides background research to assist the Advisory Panel with its deliberations. More specifically, the objective of this report, provided by the Advisory Panel, is to assist with the identification and assessment of options for accessing a broader or full exemption tax system with regard to the taxation of outbound direct investment, if Canada were to move in such a direction.

The report is organized as follows. Part 2 provides a general assessment of advantages and disadvantages, discussed within the academic and policy literature, of the two main approaches to taxing outbound direct investments: worldwide and exemption tax systems (relevant terms and concepts are defined and explained in Section 2.1). Part 3 sets out a general assessment of rules for taxing outbound direct investments in 10 selected countries — the United States, the United Kingdom, France, Germany, Italy, Japan, Australia, Sweden, the Netherlands, and Hong Kong. With the exception of Japan, all of the selected countries have moved, or are considering a move, to an exemption tax system. Part 4 offers a general assessment of the policy impact if Canada were to move to a *full hybrid exemption tax system* that reforms tax laws and policies so that all foreign source active business income is exempt from Canadian tax. Part 5 concludes with a brief discussion of possible reform approaches.

The report's main conclusions are:

- there is an ongoing academic debate about the value of worldwide and exemption tax systems although globalization may be constraining the policy option to develop or perfect worldwide tax systems so that they effectively tax all profits generated by outbound direct investment;
- a review of reform efforts underway or under consideration in the selected countries suggests that, at least for the identified trade and investment partners, there is a policy trend where countries are increasingly considering the adoption or broadening of exemption tax systems, which provides a number of lessons for the Canadian government should similar reforms be undertaken;

3 In 2007, the Minister of Industry and the Minister of Finance formed a Competition Policy Review Panel to, in part, "review key elements of Canada's competition and investment policies to ensure that they are working effectively, allowing us to encourage even greater foreign investment and create more and better jobs for Canadians." See Canada, Industry Canada, *Press Release: Canada's New Government Creates Competition Policy Review Panel* (Ottawa: Industry Canada, July 12, 2007). See Canada, Competition Policy Review Panel, *Compete to Win: Final Report* (Ottawa: Public Works and Government Services Canada, June 2008) at 65-66, 128, recommending that the Advisory Panel should give particular attention to tax competitiveness issues, as well as interest deductions limits with respect to foreign acquisitions.

- if Canada were to move to a full hybrid exemption tax system, a reform agenda could include some or all of the following features (each with its own costs and benefits):

  (a) abolish taxable surplus;

  (b) exempt from tax all repatriated dividends from foreign affiliates engaged in active business as well as partial or full capital gains relief on sale of shares in such foreign affiliates;

  (c) simplify and/or merge the foreign source passive income regime (controlled foreign affiliates, foreign investment entities, non-resident trusts); and/or

  (d) strengthen anti-avoidance rules and cooperation between the CRA and foreign tax authorities.

An integrated reform agenda that seeks to address most or all of these concerns may best promote reduced compliance and enforcement costs while protecting the tax base, and may be better-suited to achieve the Advisory Panel's goals. Alternatively, a selective reform agenda could maintain most of the elements of the current system while trying to reform specific areas of concern. For example, the abolishment of taxable surplus alone could promote significant simplification and would move the Canadian system more formally to one that exempts from tax all foreign source active business income.

2. Worldwide versus exemption tax systems: Identifying the key arguments

One of the most scrutinized issues within international tax policy discussions involves the decision to tax the worldwide income of outbound direct investment, or to exempt this income from tax.[4] This Part identifies the key arguments that academics and other policy analysts have advanced to support either system. It begins with Section 2.1 by setting out definitions for certain relevant international tax terms and concepts while Section 2.2 reviews traditional evaluative criteria used to guide international tax reform efforts.[5] Section 2.3 explores the historical acceptance by many international tax scholars of worldwide taxation along with the purported advantages of this approach while Section 2.4 discusses the professed advantages of exemption tax systems. Section 2.5 overviews the impact of globalization on tax policy as well as a more recent view that maintains governments should, as the theoretically most attractive option, improve their worldwide tax systems by adopting measures such as full accrual taxation for active business income generated by outbound direct investments or, as the second best option, move to an exemption tax system with "tight" rules to protect the tax base.

2.1 Definitions

For international tax purposes, taxpayers are typically classified as either a *resident* or a *non-resident*. With respect to outward direct investment, Canada and other countries, under the general rule, tax their residents on their worldwide income. Worldwide income is comprised of both *domestic source income* (that is, income from economic activities that originate in the home or source country) and *foreign source income* (that is, income that is generated from activities in host or residence countries where resident taxpayers have chosen to invest or operate). With respect to inward direct investment, Canada only taxes non-residents on their (Canadian) domestic source income.

For purposes of this report, a *pure worldwide taxation system* is one that seeks to tax the domestic and foreign source income of resident taxpayers derived from their outbound investments and transactions. A pure worldwide taxation system includes two necessary elements. First, tax rules should tax on a current basis all foreign source income, whether or not it has been repatriated back to the home country (that is, the rules would seek to end deferral of foreign

4 For a small sample of works in this area, see, e.g., Klaus Vogel, "World vs. Source Taxation of Income – A Review and Re-evaluation of Arguments (Part III)" (1988) 11 Intertax 393; Donald J.S. Brean, "Here or There? The Source and Residence Principles of International Taxation" in Richard M. Bird and Jack M. Mintz eds., *Taxation to 2000 and Beyond* (Toronto: CTF Paper no. 93, 1992) at 303; Stephen E. Shay, J. Clifton Fleming, Jr. and Robert J. Peroni, "The David R. Tillinghast Lecture 'What's Source Got to Do With It?' Source Rules and U.S. International Taxation" (2002) 56 Tax Law Review 81. Certain observers maintain that the ongoing debate may be potentially misleading. See Richard M. Bird and J. Scott Wilkie, "Source vs. Residence-based Taxation in the European Union: The Wrong Question" in Sijbren Cnossen ed., *Taxing Capital Income in the European Union: Issues and Options for Reform* (Rotterdam: OCFEB, 2000) at 78, 81, 91 (noting that residence and source principles are not, even in theoretical terms, alternatives and, at best, constructs to guide the relative desirability of emphasizing one approach over the other).

5 For a more detailed introduction to guiding principles and concepts such as worldwide and exemption taxation, see Jinyan Li, Arthur Cockfield and J. Scott Wilkie, *International Taxation in Canada: Practices and Principles* (Toronto: LexisNexis, 2006) at 10-21 (International Taxation).

source income when this income is generated by a foreign affiliate). Second, tax rules should provide for a tax refund to a resident taxpayer when it pays a higher foreign tax rate on foreign source income when compared with the domestic tax rate on this income. A *pure exemption tax system* (sometimes referred to as a territorial system) is one that exempts from taxation all of the foreign source income of resident taxpayers.

In practice very few countries have chosen to adopt a pure worldwide or exemption tax system (the analysis in Part 3 suggests that only Hong Kong has implemented an almost pure exemption tax system while none of the selected countries deploy pure worldwide tax systems). Instead, governments deploy a spectrum of tax systems that emphasize the worldwide or exemption approach. A *hybrid worldwide tax system* is one that emphasizes the taxation of domestic and foreign source income of resident taxpayers while also providing for exemption of foreign source income in some circumstances (for example, permitting the deferral of taxation until profits within foreign affiliates are repatriated to the parent company based in the home country). The United States is an example of a country that deploys a hybrid worldwide tax system.

A *hybrid exemption tax system* is one that exempts from taxation foreign source income in many circumstances while taxing this income in other circumstances (for example, by providing for current or accrual taxation of foreign source passive income). As discussed in Section 4.1, Canada has deployed its "modern" hybrid exemption tax system since 1976. Under current rules, Canadian tax laws generally exempt from Canadian taxation any active business profits generated within a foreign affiliate based in a tax treaty partner or a country that has negotiated a comprehensive tax information exchange agreement (TIEA) with Canada (a "TIEA partner"). As subsequently discussed, the Canadian system has over time evolved, effectively, into a *full hybrid exemption tax system* that exempts from taxation all sources of foreign active business income (see Section 4.1.2).

The departures from ideal or pure forms of worldwide or exemption tax systems are based in part on the fact that traditional international tax rules offer different tax treatment depending on whether cross-border income is characterized as active or passive in nature. Active income is income derived from the entrepreneurial pursuit of cross-border investments such that investors can influence the returns on these investments. For example, a resident taxpayer could open up and manage a retail shoe outlet in a foreign country — the income generated within the retail outlet would normally be characterized as active income. Passive income is normally associated with situations where a taxpayer "passively" enjoys returns on its investment through royalties, interest, rents or other passive income streams. Passive income can be very mobile in the sense that taxpayers can shift the location where this income ostensibly originates. By way of example, a resident taxpayer could purchase, for temporary business reasons, a government bond issued by a foreign country — the cross-border interest income generated by this investment would be characterized as passive income. Once a favourable interest rate is identified, the resident taxpayer could choose to locate this investment in the country that imposes the lowest tax burden on this income.

For this reason, most other countries that deploy hybrid exemption tax systems generally only exempt from taxation (a) dividends repatriated to the residence country from a related foreign subsidiary; and (b) the sale of shares of a related foreign subsidiary (under certain conditions such as the need for the foreign subsidiary to be engaged in an active business). Under the general approach, all other forms of income are subject to current worldwide taxation (see Part 3).

2.2 Guiding principles

While there is an ongoing scholarly debate surrounding appropriate criteria, the traditional approach is to divide international tax policy goals into concerns about economic efficiency and concerns that focus more explicitly on justice or fairness among citizens or nations.[6]

With respect to efficiency concerns, analysts sometimes examine whether tax systems distort cross-border investment decision-making, impeding *tax neutrality*. A tax is considered to be neutral if it does not distort private cross-border investment decision-making. There are notable differences among countries in terms of tax bases, tax rates and liability to tax. In a closed economy, these differences would not matter because trade and investment takes place within individual countries. In the reality of open economies, however, national tax systems interact when trade and investment activity crosses borders.

As a result of this interaction, different tax burdens may be imposed on cross-border investments, hence affecting the after-tax returns on these activities. Investment decisions may be influenced by tax affecting the amount and direction of the investment patterns, including what types of asset investments are undertaken (for example, buildings instead of machinery), which industry to choose from (for example, industrial manufacturing instead of services), and how these investments are financed (for example, debt instead of retained earnings). Different national tax systems that impose different tax burdens on international transactions provide a tax incentive to engage in *income shifting*, a form of international tax planning where taxpayers structure their activities to shift income — paper profits — from relatively high tax jurisdictions to relatively low tax jurisdictions so that the cross-border transactions will attract a lower overall tax liability. Income shifting strategies, at times, reduce tax revenues that would otherwise be enjoyed by relatively high tax jurisdictions like Canada. Much of the technical complexity surrounding outbound direct investment tax rules springs from policy efforts to inhibit income shifting so that the residence (home) country can tax an appropriate share of profits from international transactions.

6 Richard A. Musgrave, *Fiscal Systems* (New Haven: Yale University Press, 1969) at 243-252, noting that the concepts of equity and efficiency are inter-related; Michael J. Graetz, "Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies" (2001) 26 Brooklyn Journal of International Law 1357 at 1362, arguing that traditional international tax principles may inhibit sound policy analysis.

In addition to promoting revenue losses in some circumstances, different national tax systems may distort investment decision-making as entrepreneurs and investors respond to incentives or barriers caused by the interaction of two different national tax regimes. These tax barriers or incentives lead to an allocation of investments and resources in a manner that is not considered to be economically efficient. Such distortion can harm the economy of one country by diverting resources to another. Moreover, because resources are allocated for tax reasons instead of purely economic ones then these resources, including capital, are not being deployed as productively as they otherwise could be. In turn, reduced capital productivity may reduce overall economic welfare or living standards that might otherwise be enjoyed by individuals. For this reason, taxes on cross-border activities should distort investment decision-making as little as possible (while recognizing that some distortion will persist as long as countries around the world refuse to adopt the same tax rates and tax systems).

There is a further refinement with respect to evaluating the potential distortionary impact of a national tax system: analysts ask whether a tax system promotes *capital export neutrality* (CEN) or *capital import neutrality* (CIN). CEN is achieved if a taxpayer's choice between investing at home or in a foreign country is not influenced by taxes. This can be accomplished by a pure worldwide taxation scheme that seeks to tax the worldwide income of its residents, whether or not foreign source income is repatriated back to the home country: in these circumstances resident taxpayers pay the same tax burden on domestic or foreign investments, removing tax as an influence of cross-border investment decision-making.

CIN is achieved when companies operating in foreign countries are placed in the same tax position as their local competitors. At times, analysts suggest that CIN hence encourages a level tax playing field so that companies (and their investors) will be in a better position to compete against each other. The goal of CIN could be promoted by the adoption of a pure or hybrid exemption tax system that exempts from taxation active foreign source income.

Additional efficiency goals include the promotion of low tax administration and enforcement costs for tax authorities and low compliance costs for multinational firms. Simple rules that taxpayers can follow and tax authorities can enforce promote international trade and investment by reducing costs associated with tax systems.

More recently, the goal of *capital ownership neutrality* (CON) and *national ownership neutrality* (NON) have been introduced as possible alternative guiding principles: instead of focusing on how tax affects cross-border investment decision making as per CEN and CIN, the focus has been placed on how tax affects the access to assets by multinational corporations that can utilize these assets. Under (the unfortunate acronym) CON, tax systems should be designed to be neutral regarding which corporations own and exploit assets (for example, a patent for a technology service) so that corporations that can exploit these assets most efficiently will be willing to pay the most to own these assets.[7] NON promotes national welfare by focusing on

7 See Mihir A. Desai and James Hines Jr., "Evaluating International Tax Reform" (2003) 56:3 National Tax Journal 487, arguing that, under CON and NON, the United States should move toward an exemption tax system to maximize national and global welfare.

the efficiencies derived from the ownership of business assets within a particular country. CON and NON have been used to support the use of hybrid exemption tax systems that exempt active foreign source business income from domestic tax.[8]

From a fairness perspective, the concept of *inter-nation equity* is sometimes used to guide the formulation of international tax rules.[9] This equity concern often centers on whether a tax system promotes a "fair" sharing of the international tax base. Governments have traditionally maintained that they should enjoy revenues from taxing value-adding economic activities within their borders.[10] This view is supported by theoretical justifications such as the benefit principle that maintains taxpayers should pay taxes for benefits (for example, roads and hospitals) provided by governments.[11]

Equity is also used to evaluate whether international tax rules and policies encourage a fair distribution of the tax burden among taxpayers of a particular country. As subsequently explored, worldwide tax systems help to preserve *vertical equity* and the progressive tax system whereby individuals with more income should pay higher tax burdens. Moreover, worldwide tax systems may also promote *horizontal equity* (that is, similarly situated taxpayers should be taxed the same way) by taxing taxpayers with domestic sources of income only in the same way as resident taxpayers with both domestic and foreign sources of income (see Sections 2.3.1 and 2.3.2).

A non-traditional evaluative criterion explores how tax sovereignty concerns drive the adoption of different international task policy options: prospective international tax reform that unduly constrains a government's sovereign ability to develop tax policy as it wishes to pursue domestic economic and social agenda (including how much taxes should be raised and who should bear the tax burden) may not be an acceptable reform option.[12] In other words, because governments derive "value" from maintaining control over their tax systems then international tax reform that reduces this control may be unacceptable, or at least politically infeasible, to these governments. For this reason, to promote optimal international tax policy, policy analysts sometimes try to balance the economic benefits derived through promoting international investments with other factors such as globalization that may encourage and/or constrain tax reform (see Section 2.5).

8 Ibid.

9 For a discussion, see, e.g., Peggy B. Musgrave, *United States Taxation of Foreign Investment Income: Issues and Arguments* (Cambridge: Harvard Law School, 1969).

10 After reviewing the tax and treaty systems that arose prior to the 1920s, the authors of an early report noted that source taxation of business profits generated by foreign investors was "the main instinct" of governments. See Professors Bruins, Enaudi, Seligman and Sir Josiah Stamp, "Report on Double Taxation Submitted to the Financial Committee" (Geneva: League of Nations, 1923) (Group of Four).

11 Ibid. at 18-22, proposing a theory of "economic allegiance" whereby "a part of the total sum paid according to the ability of a person ought to reach the competing (tax) authorities according to his economic interest under each authority."

12 See Richard M. Bird, "Shaping a New International Tax Order" (1988) Bull Int. Fisc. Doc. 292; H. David Rosenbloom, "Sovereignty and the Regulation of International Business in the Tax Area" (1994) 20 Can.-U.S. L. J. 267; Arthur J. Cockfield, "Tax Integration under NAFTA: Resolving the Conflict between Economic and Sovereignty Interests" (1998) 34 Stanford J. Int. L. 39 at 55-59.

2.3 The historical acceptance and advantages of worldwide taxation

The decision whether countries should try to tax the worldwide income of their residents or whether they should only tax profits derived from economic activities that originate within their borders was considered by a highly influential report commissioned by the League of Nations. In this report, a group of four economists (the so-called "Group of Four") scrutinized these policy options while examining the general features of an optimal international tax system.[13]

The economists accepted that the worldwide taxation of outbound direct investment was a necessary element of a nation's tax system principally to ensure that progressive income taxes could be applied to international income.[14] Under progressive income taxation, heavier tax burdens should be applied to higher levels of income. As a result, the Group of Four recommended to the League of Nations that governments adopt a worldwide taxation system where, ideally, tax treaty partners would agree to forego taxing any source-based profits. In addition to supporting progressive income taxation, the proposed scheme was thought to be the most administratively feasible way to eliminate international double taxation.[15] Instead, the League of Nations ultimately adopted model tax treaty provisions that would support the worldwide taxation of income, but called for resident countries to provide tax credits or tax deductions to relieve double taxation.[16]

Subsequent model treaties enshrined both the primary right of source countries to tax most profits generated within their borders and the secondary right of the residence country "to tax the taxpayer's entire income even when it is taxable, in part or in whole, in the other country."[17] The OECD model tax treaty, first put in place in 1963, was closely based on these earlier League of Nations model treaties. The modern tax treaty network, including treaties negotiated by Canada, arose out of these efforts, continuing to emphasize the right of nations to tax the worldwide income of their residents along with the provision of relief for international double taxation.

Since the work of the League of Nations, scholars have examined in detail the merits of a worldwide tax system. This Section briefly identifies the key arguments in favour of worldwide taxation. The analysis concentrates on arguments that follow concerns surrounding equity and efficiency noted earlier.

13 Group of Four, supra note 10.

14 Group of Four, supra note 10 at 18, 20.

15 Ibid. at 48-51.

16 See Technical Experts to the Financial Committee of the League of Nations, "Double Taxation and Tax Evasion: Report and Resolutions" (Geneva: League of Nations, 1925) at 31-32 (Technical Experts); League of Nations, Fiscal Committee, "Report to the Council on the Fourth Session of the Committee" (Geneva: League of Nations, 1933) at 3-4, 6, proposing model treaty provisions that provide for the worldwide taxation of business income along with credits or deductions to relieve international double taxation.

17 See League of Nations, Fiscal Committee, "London and Mexico Model Tax Conventions: Commentary and Text" (Geneva: League of Nations, 1946) at 29. While the so-called Mexico and London model treaties of the 1940s differed significantly in their approach to taxing cross-border business profits — the Mexico model enabled source-based taxation of non-residents that conduct activities other than "isolated or occasional transactions" while the London model required the presence of a permanent establishment prior to the exertion of source-based taxation — both model treaties contained the same article surrounding the right of residence countries to tax worldwide income. Ibid. at 13-14.

2.3.1 Supporting progressive tax systems and vertical equity

As mentioned, the earliest advocates for worldwide taxation considered this approach to be a necessary element for the imposition of taxes on a taxpayer's "ability to pay taxes" (reflected by their worldwide income) and the preservation of a progressive income tax system.[18] This was particularly important for times when the individual income tax systems of many countries were beginning to develop multiple tax brackets for different levels of income. For example, by 1950 Canada had 10 marginal federal tax rate brackets with a spread of 45 percent between the lowest and highest bracket and in 1970 Canada had 14 brackets with a spread of 64 percent.[19]

Since the 1980s, many countries, including Canada, have reduced the number of tax brackets and flattened the spread between the highest and lowest brackets. In 2008, Canada has four federal brackets ranging from rates of 15 to 29 percent, providing a spread of 14 percent. Despite the flattening of tax rates, many tax policy analysts continue to call for the maintenance of a progressive tax system, at least for individual taxpayers, to promote vertical equity.[20]

The lowering and flattening of rates is more apparent for corporate income taxes. In 1951, for instance, Canada imposed a 15-percent federal corporate income tax on the first $10,000 of income and a 45.6 percent rate for excess amounts of income (or, with a 1951 Ontario provincial income tax rate of five percent, a total federal/Ontario rate of 50.6 percent for income above $10,000).[21] Canada now has a 2008 federal corporate income tax rate of 19.5 percent for large corporations, and this rate is scheduled by the government to drop to 15 percent by 2012 (or, assuming a 10-percent provincial rate will apply, a combined federal and provincial rate of 25 percent). At one time, the taxation of the worldwide income of corporations was thought necessary to reach their total income and preserve progressive taxation.[22] The fact that many countries have reduced and flattened rates for corporate income taxes may have reduced the need to apply progressive tax rates on the worldwide income of corporate taxpayers. The "ability to pay" argument may also be less relevant in situations where many of the multinational firms' shareholders are resident of foreign countries.[23]

18 See also Robert A. Green, "The Future of Source-Based Taxation of the Income of Multinational Enterprises" (1993) 79 Corn. L. Rev. 18 at 29-30.

19 For background, see James B. Davies and Tunseng Zang, "Measuring Marginal Income Tax Rates for Individuals in Canada; Averages and Distributions over Time" (1996) 29:4 Can. J. Econ. 959 at 961.

20 See, e.g., Neil Brooks and Thaddeus Wong, "The Social Benefits and Economic Costs of Taxation: A Comparison of High- and Low-Tax Countries" (Toronto: Canadian Centre for Policy Alternatives, 2006), discussing how countries with high taxes on individuals support national social and economic objectives.

21 See J. Harvey Perry, *Taxation in Canada* (Toronto: Univ. of Toronto Press, 1951) at 33.

22 As the Group of Four noted in 1923, while tax systems often subject business entities and individuals to different forms of taxation, "(t)is distinction, however, must not prevent recognition of the fact that all taxes are ultimately paid by persons... That is to say, the taxes, though measured by things, eventually fall upon persons and ought to fall upon them in the aggregate according to the total resources of the individual, leading to progressively larger sums being paid by people who are richer." See Group of Four, supra note 10 at 18.

23 See, e.g., United Kingdom, HM Treasury and HM Revenue and Customs, "Taxation of the Foreign Profits of Companies: A Discussion Document" (London: HM Treasury, 2007) at 9, indicating the case for not taxing foreign dividends on a UK corporate recipient increases as the level of foreign ownership of UK companies increases.

2.3.2 Protecting taxpayer morale and the self-assessment system

An important goal of a worldwide tax system is to promote equal tax treatment between resident and non-resident taxpayers. Under the horizontal equity principle referenced above, similarly-situated taxpayers ought to be taxed in a similar manner. Consider a corporate taxpayer A in country A with $100 in domestic source active income that is fully taxed on this income by country A. Taxpayer B within country A has $50 of domestic source active income and $50 of foreign source active income. If country A exempts all active foreign source income from taxation then taxpayer B may be able to structure its activities so that the $50 of foreign source income is taxed at a low or nil rate by a foreign government. The shareholders of taxpayer A may not consider this to be a fair outcome and hence might be reluctant to pay their full share of taxes because taxpayer A does not receive the same tax break as taxpayer B.

A policy concern exists that this differential treatment could demoralize taxpayers who are not eligible for this preferential tax treatment. A reasonable Canadian taxpayer — let us call her "the woman on the Ajax GO Train", a term that can stand in for the reasonable English taxpayer referred to by English and Canadian tax court judges as "the man on the Clapham omnibus"[24] — might be puzzled by the creative tax planning that appears to favour firms with resources that enable, effectively, a zero (or negative) tax rate on foreign source income. If the woman on the Ajax GO Train owns a business she might additionally be upset that her own local business cannot, for example, access debt capital on a similarly tax-favoured basis (see also Section 4.3.5). The income tax system in Canada and other countries is based to large extent on the self-assessment approach whereby taxpayers are supposed to accurately disclose their earnings. The perception of equal treatment between domestic and foreign source income may protect taxpayer morale and induce taxpayers to comply with their legal obligation to properly self-assess their income.[25]

2.3.3 Promoting international economic interests

As mentioned, worldwide taxation promotes the goal of capital export neutrality (CEN) by striving to impose the same tax burdens on domestic and foreign investments (hence eliminating tax as a motivating factor to invest abroad). Under the traditional view, CEN promotes international wealth maximization as entrepreneurs make cross-border investment decisions on the basis of "real" economic factors such as the need for a skilled work force, and not for tax reasons. This is thought, in turn, to promote capital productivity where capital is directed to its most productive uses, ultimately enhancing global wealth and overall standards of living.

Worldwide taxation may also inhibit tax competition among governments, and corresponding policy concerns such as "races to the bottom", because firms face the same tax burden whether they invest at home or abroad (hence foreign tax incentives should not be appealing). Under the race to the bottom scenario, countries may increasingly compete with their tax systems to attract foreign capital. This process could lead to two problems. First, as countries lower their tax burdens on cross-border capital they may lose revenues and become unable to fund

24 See e.g., Justice Bowman in *Klotz v. The Queen*, (2004) 2 CT.C. 2892 (T.C.C.), affirmed (2005) 3 C.T.C. 78 (F.C.A.).

25 See Shay, Fleming and Peroni, supra note 4.

needed public goods and services. Second, as countries lower tax burdens on mobile factors of production such as capital they may need to raise tax burdens on less mobile factors such as workers, potentially leading to a more regressive tax system.

2.3.4 Promoting national economic interests

Worldwide tax systems also arguably promote national economic interests by removing the tax incentive to invest abroad. A business that can access a relatively lighter tax burden in a foreign country might be motivated to open a new business in this country instead of starting it up at home. These activities may lead to lower investment and employment in the home country.

Exemption tax systems can also provide incentives to shift income and assets abroad so that a resident taxpayer can nominally create more exempt foreign source income. Tax experts from the League of Nations, for example, argued in 1925 that residency rules could be developed to inhibit abusive tax planning so that "businesses will be prevented from nominally transferring their headquarters to a place where taxes are lower."[26] In particular, exemption tax systems provide incentives to increase the allocation of expenses to income in high tax countries so that the tax deductions are taken in the country of residence and income is increased in low tax host countries, reducing tax revenues in the high tax residence country. A worldwide tax system arguably inhibits income shifting because foreign source income will eventually be taxed upon repatriation thereby removing tax incentives to shift income to low tax countries.

2.4 Advantages of exemption tax systems

Over time, international tax scholars have provided increasing support for tax systems that offer partial or full tax exemptions of foreign source active business income derived from outbound direct investments. While acknowledging the theoretical attractiveness of pure worldwide tax systems, there has been scholarly disenchantment with the fact that the necessary elements for such a system to encourage positive economic outcomes seem difficult or impossible to achieve: "The residence principle is on the wane as a means of promoting capital export neutrality, of achieving equity within the residence country, or of raising revenue for residence countries."[27]

A theoretically "pure" worldwide tax system would seek to abolish deferral of taxation of foreign source income as well as provide tax refunds for higher taxes paid to foreign countries. In practice, neither option has ever been adopted by any government (New Zealand, which has adopted the most "pure" worldwide tax system permits deferral for select countries and, in any event, has introduced tax legislation to reform this system into a hybrid exemption tax system; see Section 2.5.2). While advocates of worldwide taxation sometimes call for the end of deferral, even the staunchest defender of this system does not support tax refunds as this reform would effectively substitute a foreign country's tax rate for the one adopted by the residence country, potentially creating significant revenue shortfalls.

26 See Technical Experts, supra note 16 at 21, proposing that firm residency status be based on the place of effective management to inhibit abusive tax planning.

27 See Brean, supra note 4 at 330.

In addition to academic worries about the effectiveness of worldwide taxation, governments have also tempered their views on the desirability of maintaining or developing worldwide tax systems. The Canadian exemption tax system that dates back to 1949 was apparently once considered unique among capital exporting nations, leading the author of a study to lump Canada into a category with well-known tax havens such as Bermuda, Liberia, the Netherland Antilles, and Liechtenstein (see Section 4.1.1).[28] As subsequently discussed in Part 3, the modern Canadian hybrid exemption tax system can be increasingly portrayed as the international norm as other countries have initiated, or are in the process of initiating, reforms that move their international tax regimes closer to the Canadian approach.

This section overviews the equity and efficiency arguments in favour of a pure or hybrid exemption tax system.

2.4.1 View that worldwide taxation leads to few (or negative) revenues

A goal of worldwide taxation is to preserve vertical and horizontal equity by imposing the same tax burden on domestic and foreign sources of income. In practice, countries that deploy worldwide taxation have found that they collect few revenues from trying to tax active foreign source income.[29] As a result, hybrid worldwide tax systems arguably fail to achieve these important tax policy goals.

For instance, the United States, which deploys a hybrid worldwide taxation system, raised only about $18.4 billion in 2004 from taxing corporate foreign source income — at most 20 percent of this amount was derived from taxing dividends paid by foreign subsidiaries to their U.S. parents.[30] There are three main reasons put forward to explain this outcome. First, the U.S. system permits deferral of taxation of foreign source income until this income is repatriated back to the United States (see also Section 3.1.1).[31] Due to the time value of money, deferral may mean that, effectively, no tax is assessed on this foreign source income as long as repatriation is deferred long enough.[32] Second, the U.S. system permits cross-crediting of foreign tax credits to reduce taxes owed on domestic source income (discussed below). Finally, corporate taxpayers can change their residency in the United States by changing their place of incorporation, providing

28 See William J. Gibbons, *Tax Factors in Basing International Business Abroad* (Cambridge: Harvard Law School, International Program in Taxation, 1957), as cited by J. Harvey Perry, *A Fiscal History of Canada—The Postwar Years* (Toronto: CTF Canadian Tax Paper no. 85, 1989) at 1033.

29 See, e.g., United Kingdom, supra note 23; Alex Easson, *International Tax Reform and the Inter-nation Allocation of Tax Revenues* (Wellington: Victoria University Press, 1991) at 14, supporting exemption tax systems for active business profits on equity and efficiency grounds; Brean, supra note 4 at 314, noting that more recent empirical evidence suggest that worldwide taxation of foreign source income does not raise significant tax revenues.

30 See Office of Tax Policy, U.S. Department of the Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century* (Washington: Dec. 20, 2007), at 57.

31 See United States, Staff of J. Comm. on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (Washington: Joint Committee on Taxation, 2005) at 188-189, noting that, by maintaining deferral indefinitely, U.S. taxpayers achieve results that are economically equivalent to 100-percent exemption of income with no corresponding disallowance of expenses allocable to the exempt income.

32 Taxpayers sometimes use tax havens to legally defer or illegally evade income tax liabilities, resulting in revenue losses to the high tax jurisdictions like the United States. These losses may be increasing. See, e.g., Martin A. Sullivan, "Economic Analysis: Latest IRS Data Show Jump in Tax Haven Profits" (2004) *Tax Notes 151*, discussing a 64-percent increase in profits allocated to low tax jurisdictions by U.S.-based multinational firms from 1998 to 2000.

an incentive for some U.S.-based multinational firms to take up residency in more leniently taxed jurisdictions: if the change is effective, the now non-resident firm will only be subject, under U.S. tax law, to taxation on its (U.S.) domestic source income.

As a result of these features, U.S. taxpayers can often structure their foreign activities so that foreign source income is effectively subject to a negative tax (that is, the worldwide tax rules that strive to tax foreign source income actually reduce the tax burden on domestic source income). For example, U.S. taxpayers can "cross-credit" by using foreign tax credits arising from high-taxed foreign source income (for example, foreign taxes paid on active business income that is repatriated by way of dividend) to offset other lower-taxed foreign source income (for example, royalties). If earnings that have been repatriated by a foreign affiliate have been taxed at a rate that exceeds the U.S. rate then the "excess" foreign tax may be used to offset U.S. tax on the other low-taxed foreign source income. The phenomenon of achieving zero or negative tax on foreign source income has been labeled "self-help territoriality" in that U.S. residents have managed to structure their activities in such a way to transform the ostensible U.S. worldwide tax system into an exemption tax system.[33]

Certain observers have suggested that these outcomes reflect deficiencies within the U.S. system that could be addressed through reform that promoted a pure worldwide tax system. For instance, proposals have been issued to reform the U.S. system so that it taxes on a current (or accrual) basis all foreign source income, whether or not this income has been repatriated to the United States.[34] As explored below in Section 2.5, while these proposals may be attractive from a theoretical perspective, the forces of globalization now likely constrain this policy option for Canada and most other countries.

It bears mentioning that hybrid exemption tax systems that seek to tax certain active or passive foreign source income may also fail to collect significant revenues. For example, under the Canadian hybrid exemption tax system, active income generated in foreign affiliates based in non-treaty partners and non-TIEA partners (that is, income allocable to a "taxable surplus" account) is subject to Canadian tax when repatriated from the foreign affiliates to Canada: Canadian tax laws then generally provide a foreign tax credit for foreign taxes paid on the underlying foreign source income (see Section 4.1.2).

According to the Department of Finance, only roughly $1.3 billion in taxable dividends were distributed back to Canada in 2005 although currently available data did not permit a reliable estimate of the Canadian tax, if any, paid on these dividends.[35] Because the Canadian system appears to collect few or no revenues from taxing repatriated profits, movement toward a full hybrid exemption tax regime in Canada may be able to reduce complexity without losing any material revenues (see Section 4.2.3).

33 See Office of Tax Policy, supra note 30 at 55, 57.

34 See, e.g., Lawrence Lokken, "Territorial Taxation: Why Some U.S. Multinationals May be Less than Enthusiastic about the Idea (and Some Ideas They Really Dislike)" (2006) 59 SMU Law Rev. 751; James R. Repetti, "Will U.S. Investment Go Abroad in a Territorial Tax: A Critique of the President's Advisory Panel on Tax Reform" (2007) 8 Fla. Tax Rev. 303; Paul R. McDaniel, "Territorial vs Worldwide International Tax Systems: Which is Better for the U.S.?" (2007) 8 Fla. Tax Rev. 283.

35 Under Canadian tax law, residents are entitled to take foreign tax credits on dividends distributed out of the taxable surplus account of foreign affiliates, hence it is difficult to estimate the amount of taxes, if any, paid on these dividends. See Consultation Report, supra note 2 at 14, citing Department of Finance analysis.

2.4.2 Enhance worldwide economic efficiencies

Exemption tax systems promote the goal of CIN, discussed above, by ensuring that taxpayers compete on a level tax playing field. If CIN promotes enhanced levels of cross-border investments and related economic activities then multinational firms may become more productive, promoting heightened levels of wealth and higher global standards of living. As a result, some observers assert that CIN will ultimately maximize global welfare by leading to heightened levels of firm competition and resulting efficiencies achieved through this competition.[36] Others maintain that exemption tax systems may be better suited to deal with contemporary international tax issues such as the taxation of mobile capital, tax competition among nations, and protecting the integrity of domestic tax bases in open economies.[37]

Does CEN or CIN promote global wealth maximization? As more recently argued, there is little empirical evidence to confirm either perspective. Within international economics, there remains much uncertainty, for instance, surrounding how taxpayers react to tax changes for cross-border investments (in part because tax is only one factor of many that motivates cross-border investment decisions).[38] Other sources of empirical uncertainty surround the supply of capital (whether it comes from domestic sources or whether the rate is fixed by global capital markets), how multinational firms structure their activities (in particular, the location of intangible assets), as well as how investors respond to worldwide or exemption tax systems.[39]

Similarly, the introduction of relatively new guiding principles, capital ownership neutrality (CON) and national ownership neutrality (NON), has been criticized as lacking a sufficient empirical foundation.[40] This recognition of the uncertainties surrounding the design of optimal international tax rules may have reduced academic and policy support for worldwide taxation by deflating one of its traditional main supporting arguments, namely that CEN promotes international welfare.

36 See, e.g., Vogel, supra note 4.

37 See, e.g., Brean, supra note 4 at 305, noting that "source taxation is on the rise" in part because source taxation, and not residence taxation, offers greater promise to confront challenges presented by increasingly interdependent economies.

38 For discussion, see, for example, Arthur J. Cockfield, "Purism and Contextualism within International Tax Law Analysis: How Traditional Analysis Harms Developing Countries" (2007) 5 eJournal of Tax Research 199 at 202-213, reviewing theoretical, empirical and behavioural complexities within international tax economics.

39 See Rosanne Altshuler and Harry Grubert, "Where Will They Go if We Go Territorial? Dividend Exemption and the Location Decisions of U.S. Multinational Corporations," (2001) 54 National Tax Journal 787 at 807, noting that the empirical evidence is inconclusive with respect to whether location decisions would be significantly changed if the U.S. moved to a hybrid exemption tax system; Ruud A. De Mooij and Sjef Ederveen, "Taxation and Foreign Direct Investment: A Synthesis of Empirical Research" (2003) 10 Int'l Tax and Public Finance 673 at 690, concluding that there is no evidence to support the view that investors from hybrid worldwide tax system countries are less responsive to taxes when compared to investors from hybrid tax exemption system countries; Office of Tax Policy, supra note 30 at 56-57, noting that this empirical uncertainty reduces the value of guiding principles such as CEN and CIN as both depend on assumptions that may or may not be accurate.

40 See Mitchell A. Kane, "Ownership Neutrality, Ownership Distortions, and International Tax Welfare Benchmarks" (2006) 26:1 Virginia Tax Review 53.

2.4.3 Enhance national economic success

Proponents of exemption tax systems sometimes maintain this approach supports the competitiveness of their multinational businesses that will be able to compete more effectively in the global marketplace unconstrained by domestic tax factors. Domestic economic interests, under this view, are often supported when tax does not act as disincentive for businesses to expand abroad. Businesses operating in foreign markets may become more efficient due to enhanced levels of competition and may provide other benefits to the home country such as technology transfers or new management techniques.[41] In addition, they note that hybrid worldwide systems that permit deferral provide a tax disincentive to repatriate foreign source income because this income will be taxed upon repatriation, hence potentially harming the ability of home-country firms to access needed capital so that they can compete effectively with others.

Critics of this view maintain that the use of the "competitiveness" concept is not grounded in any substantive tax policy content, and should not therefore be used as a guiding principle to develop international tax policy.[42] For example, supporting a competitive tax regime does not tell us anything about the appropriate amount of tax firms ought to pay on their foreign source income, in part because firm competitiveness is founded on many factors other than tax: one could even argue that a tax system should impose a negative tax on foreign source income to promote firm competitiveness (in other words, under the competitiveness criterion it is possible to argue that a tax system should subsidize the efforts of Canadian firms to expand to foreign markets).

Alternatively, the "competitiveness" concept can be portrayed as related to the traditional international policy goal of encouraging capital import neutrality (CIN). If one accepts that the two concepts are related, an appropriate tax rate for foreign source income is zero (under CIN), but a positive or negative rate would unduly distort cross-border investment decision-making by offering tax disincentives or incentives to invest in foreign countries, inhibiting national and international welfare (see Section 4.3.1).

In any event, concerns about tax competitiveness have played an important role in recent years in shaping international tax policy. In the last few years, countries such as the United States, the United Kingdom, Australia, New Zealand, Sweden, Germany and Italy have published government reports that try to assess whether their international tax rules are "competitive" with those in place elsewhere (see Part 3). Tax competitiveness concerns have also traditionally shaped Canadian policy views to exempt most forms of foreign source active income from taxation (see Section 4.1.1). Moreover, the Advisory Panel was provided with an explicit mandate to consider ways to enhance Canada's competitiveness vis-à-vis its main partners in part by proposing reforms to ensure that the tax rate on new capital is the lowest in the G7 (see Section 1.2). Accordingly, Part 3 considers reform efforts in selected countries to see whether the Canadian international tax regime can be portrayed as "competitive" with these countries by attempting to assess whether the Canadian regime imposes relatively favourable tax treatment on outbound direct investment.

41 For a general assessment of the perceived advantages of outbound direct investment, see Alex Easson, *Tax Incentives for Foreign Direct Investment* (The Netherlands: Kluwer Law International, 2003), at 12-19.

42 See, e.g., McDaniel, supra note 34 at 301.

2.4.4 Support for simpler rules

Worldwide tax systems require complex tax laws and policies to ensure that foreign source income is subject to tax. These rules include foreign tax credits, foreign tax credit limitations and expense allocation rules, promoting high compliance costs for taxpayers and high administrative costs for tax authorities.[43] Advocates of exemption tax systems sometimes maintain that these systems require fewer and less complex rules as they strive to only identify and tax domestic source income.[44]

These observations have been challenged on the basis that even a pure exemption tax system would require complex rules to ensure that an appropriate amount of tax was levied on domestic source income: governments would still need to discern how much foreign source income was being generated by the taxpayer to see whether their tax rules were being adhered to.[45] For instance, under an exemption tax system a taxpayer may have an incentive to engage in transfer pricing strategies that shift profits to the relatively lighter taxed country. To ensure that a country's transfer pricing laws were being followed, tax authorities would need to access information about the international income provided to foreign governments. In other words, tax authorities need to carefully scrutinize foreign source income to ensure that an appropriate share of the domestic profits from a cross-border transaction are being taxed by a hybrid exemption tax system. Importantly, government reports suggest that taxpayers can engage in tax planning within both hybrid exemption and hybrid worldwide tax systems that leads to significant revenue losses.[46]

In any event, it is clear that complexity is inherent in the design of at least certain exemption tax systems: the Canadian hybrid exemption tax system is arguably the most complex statutory scheme in all of Canadian law (see Section 4.2.1). This complexity is on the rise as a result of recent reforms such as the new rules that strive to prevent taxpayers from generating

43 But see Robert J. Peroni, "Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules" (1997) 51 U. Miami L. Rev. 975, indicating that reform of the U.S. hybrid worldwide tax system could lead to simpler rules and reduced compliance costs.

44 See, e.g., United States, Report of the President's Advisory Panel on Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (Washington: President's Advisory Panel, 2005) at 105; Sijbren Cnossen, *Reform and Harmonization of Company Tax Systems in the European Union* (Rotterdam: Erasmus University Research Memo no. 9604, 1996) at 26-27, concluding that cross-border business taxes in Europe should continue to be founded on the source entitlement principle, in part because it requires less administrative cooperation among tax authorities; Brean, supra note 4 at 309; Staff of Joint Committee, supra note 31 at 134.

45 See Brian Arnold, Comment, in Richard M. Bird & Jack M. Mintz (eds.), *Taxation to 2000 and Beyond* (Toronto: CTF Paper No. 93, 1992) at 337, 342; Michael J. Graetz and Paul W. Oosterhuis, "Structuring an Exemption System for Foreign Income of U.S. Corporations" (2001) 44 National Tax Journal 771 at 784, concluding that much of the complexity of an exemption system occurs in the scope and treatment of non-exempt income hence virtually all of the questions in a hybrid worldwide tax system must be addressed in a hybrid exemption tax system; Lokken, supra note 34 at 771, claiming that proponents of simplification sometimes err by comparing imperfect hybrid worldwide tax systems with idealized pure exemption tax systems; McDaniel, supra note 34 at 291, concluding that virtually all elements that make worldwide tax systems complex would be present in an exemption system.

46 See, e.g., Canada, Office of the Auditor General, *Report of the Auditor-General of Canada* (Ottawa: Auditor General, 2001) at 7.85-7.89, discussing how Canadian multinational firms deployed trust structures, under the Canada-Barbados tax treaty, to shift over $800 million in capital gains to the Barbados; United States Senate, Minority Staff of the Permanent Subcommittee on Investigations, *U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals* (Washington: U.S. Senate, 2003) at 8, describing how a small sample of taxpayers had managed to reduce federal tax revenues by $1.4 billion through the use of tax shelter arrangements.

dividends free of Canadian tax (that is, dividends out of "exempt surplus" accounts of foreign affiliates) through tax planning via related party transactions. As explored in Part 4, while a certain amount of technical complexity appears unavoidable, there may be opportunities to simplify Canadian rules should the government choose to modify its current hybrid exemption tax system.

2.5 The impact of globalization and recent views

This section reviews how the forces of globalization constrain the international tax policy choices available to governments along with a discussion of a more recent academic view that strives to take greater account of the deficiencies associated with existing hybrid worldwide tax systems.

2.5.1 Accounting for the changing global environment

Globalization today stands for the proposition that, as a result of legal, technological and other developments, the world is tied together economically (and in other ways) like never before. According to one view, the main relevant features of globalization with respect to the taxation of international investments are:[47]

- the increased activity of multinational companies;
- the internationalization of the way in which these companies organize their business;
- the increase in the number of countries acting as both importers and exporters of investment capital;
- the increased complexity of cross-border transactions; and
- the shrinking of geographical constraints to international business activities as a result of the information and communication technology revolution.

With respect to legal developments, over the past half century countries have agreed to reduce or eliminate tariff and non-tariff barriers to cross-border trade and investment. With respect to technological developments, information technology changes in particular have reduced communication costs and have promoted new forms of international business such as component manufacturing by related companies located in different countries.[48] These processes have encouraged a gradual growth of direct investment throughout much of the world. As noted by the Consultation Report, flows of direct investment by Canadians to foreign countries and by foreigners to Canada, as well as the stock of direct investment abroad held by Canadians and by foreigners in Canada, have steadily increased since the 1970s.[49] For example,

47 See A.J. Easson, *Taxation of Foreign Direct Investment: An Introduction* (London: Kluwer Law International, Series on International Taxation no. 24, 1999), at 156-157.

48 See, for example, Arthur J. Cockfield, "Reforming the Permanent Establishment Principle through a Quantitative Economic Presence Test," (2003) 38 Canadian Business Law Journal 400.

49 See Consultation Report, supra note 2 at 3-4, citing Statistics Canada data.

the total amount of direct investment from and to Canada increased by roughly 500 percent between 1986 and 2007.[50] As barriers fell, international trade was also on the rise: Canada is now the second most trade intensive country in the G7 with total trade equalling roughly 70 percent of gross domestic product.[51]

The reduction in barriers along with the ongoing intertwining of national economies has led to three important international tax policy concerns.[52] First, while there is an ongoing debate about the impact of tax on international investment decision-making, there is a general view that direct investment decisions are increasingly sensitive to national tax differences.[53] This view may support the apparent increased policy attention paid to the "competitiveness" of national tax regimes (see Section 3.1). Second, studies increasingly show that the substitution of intra-group equity and debt financing, as well as the location of external debt, occurs in situations of perfect (or near perfect) substitutability. As a result, multinational firms may be in a better position to take advantage of national tax differences, with financing in low or nil tax jurisdictions, to lower their global tax liabilities. Finally, studies also appear to increasingly demonstrate that outbound direct investment is a complement of (and not a substitute for) domestic investment. As a result, tax reform that makes outbound direct investment more costly (by lowering after-tax returns on this investment) may have an adverse impact on domestic investment (see Section 2.2).

In addition, the types and structures of international investments appear to be changing. For instance, a rising proportion of outbound and inbound direct investments are made by tax-exempt corporations, including sovereign wealth funds.[54] Because the majority of listed shares are held by tax-exempt entities, most of the repatriated dividends get paid out to individuals as pension, bank interest or insurance proceeds and national tax systems may not fully account for this fact.[55]

Statistics surrounding direct investment destinations also suggest that tax planning through foreign affiliates based in low or nil tax jurisdictions may be playing an increasing role in the structuring of foreign direct investments: in 2007, 16.5 percent of the total Canadian direct outbound investment was placed in the Barbados, Bahamas, Bermuda and the Cayman Islands,

50 See Statistics Canada, *The Daily* (May 6, 2008), indicating that foreign direct holdings in Canada reached roughly $500 billion in 2006, an increase of 14.4 percent from the previous year.

51 See Competition Review Panel, supra note 3 at 86.

52 For an accessible overview of the interaction between tax and inbound and outbound direct investments, see OECD, *Tax Effects on Foreign Direct Investment: Policy Brief* (Paris: OECD Observer, 2008).

53 See, e.g., Joosung Jun, "U.S. Tax Policy and Direct Investment Abroad" in Assaf Razin and Joel Slemrod ed., *Taxation in the Global Economy* (Chicago: University of Chicago Press, 1990) at 55, 56, concluding that United States tax policy towards domestic investment can have a significant effect on U.S. direct investment abroad by influencing the relative after-tax rate of return on investments in the United States and abroad; Joel Slemrod, "Tax Effects on Foreign Direct Investment in the United States: Evidence from a Cross-Country Comparison" in Assaf Razin and Joel Slemrod ed., *Taxation in the Global Economy* (Chicago: University of Chicago Press, 1990) at 79, 93; Alan J. Auerbach and Kevin Hassett, "Taxation and Foreign Direct Investment in the United States: A Reconsideration of the Evidence" in Alberto Giovannini, R. Glenn Hubbard and Joel Slemrod eds., *Studies in International Taxation* (Chicago: University of Chicago Press, 1993) at 119, indicating that attributing most of the increase in FDI in the United States after the mid-1980s to TRA86 is not likely correct.

54 See Consultation Report, supra note 2 at 4.

55 For a discussion of the international implications for tax-exempt investors, see Alex Easson, "Company Tax Reform and the Inter-Allocation of Tax Jurisdiction" in Rick Krever and John Head ed., *Company Tax Systems* (Australia: Australian Tax Research Foundation, 1997) at 285, 290-294, discussing how imputation systems do not generally account for tax-exempt investors.

up from 5.4 percent in 1997. The Barbados is now the third most popular country for Canadian direct investments after the United States and the United Kingdom.[56] These countries are sometimes characterized as tax havens or low tax jurisdictions and they would typically act as bases for investments in other high tax countries where most of the value-adding economic activities take place. In addition, Ireland is the fourth largest destination for Canadian direct investors,[57] which may be attributable in part to the fact that Ireland maintains a relatively lenient corporate income tax system with a general rate of 12.5 percent. The country with the third largest group of direct investors in Canada (after the United States and the United Kingdom) is now the Netherlands,[58] which may be explained by the fact that this country is often used as a corporate base for tax planning purposes.

As countries increasingly engage in cross-border trade and investment, they need to ensure that their tax rules do not unduly inhibit or distort direct investment activities, while ensuring that the domestic tax base is protected against aggressive planning activities that can strip away revenues from relatively high tax countries.[59] Yet as countries become tied together more and more, they now have fewer options to reform their tax rules, which constrains their sovereign ability to develop these rules.[60] This is particularly so for relatively small players in the global capital markets like Canada that must often pay close attention to the ways their tax systems interact with those of larger trade and investment partners to ensure that these systems do not inhibit cross-border investments while protecting the domestic tax base.[61]

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56 See Statistics Canada, supra note 50. For analysis of recent trends for Canadian outbound direct investment, see Jean-Pierre Vidal, *La concurrence fiscale favorise-t-elle les planifications fiscales internationales agressives?* (Draft, 2008) (concluding that the tax regimes of tax havens may influence tax planning by Canadian multinational firms).

57 Ibid.; see also Altshuler and Grubert, supra note 39 at 791, using empirical evidence to show that Canada has a relatively larger share of direct investments in Ireland when compared to the United States, which might be attributable to tax planning that takes advantage of Canada's hybrid exemption system.

58 See Statistics Canada, supra note 50.

59 To support equity and efficiency tax policy goals, the phenomenon of globalization has led some observers to propose reforms to a nation's tax system to account for the fact that capital (particularly portfolio investments) is more mobile. Under one approach, progressive rates are imposed on labour income along with a lower flat rate for capital (for example, the system in place in Nordic countries) or to account for global environmental pressures through tax reform. Consideration of these reform efforts, however, appears to be outside of the Advisory Panel's mandate as the reforms would require significant changes to domestic tax laws that do not have international aspects — for example, a Nordic-like tax system imposes a low flat rate on domestic investment income earned by individuals. For proposals surrounding the dual income tax, see Robin Boadway, "Income Tax Reform for a Globalized World: The Case for a Dual Income Tax" (2005) 16 Journal of Asian Economics 910. For proposals that seek to address global environmental problems, see Jack Mintz and Nancy Olewiler, *A Simple Approach for Bettering the Environment and the Economy: Restructuring the Federal Fuel Excise Tax* (University of Ottawa: Institute of the Environment, 2008); Thomas Courchene and John R. Allan, "Climate Change: The Case for a Carbon Tariff Tax" *Policy Options* (March 2008) at 59.

60 See Jack M. Mintz, "Is National Tax Policy Viable in the Face of Global Competition?" (1999) 19 Tax Notes Int'l 99; Reuven S. Avi-Yonah, "Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State" (2000) 113 Harvard Law Review 1573; Charles E. McLure Jr., "Globalization, Tax Rules and National Sovereignty" (2001) Bull. Int'l Fisc. Doc. 328 at 334-338; Joseph H. Guttentag, "Key Issues and Options in International Taxation: Taxation in an Interdependent World" (2001) Bulletin for International Fiscal Documentation 546; Duncan Bentley, "International Constraints on National Tax Policy" (2003) 30 Tax Notes International 1127; Walter Hellerstein, "Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective" (2003) 38 Ga. L. Rev. 1.

61 See Arthur J. Cockfield, *NAFTA Tax Law and Policy: Resolving the Conflict between Sovereignty and Economic Interests* (Toronto: University of Toronto Press, 2005) at 87-102 (NAFTA Tax Law and Policy).

2.5.2 A new view

The recognition of constraints imposed on tax policy by globalization along with scholarly dissatisfaction with current hybrid worldwide tax schemes has led to what may be characterized as a "new" view by certain commentators.[62] First, under this new view, a pure worldwide tax system remains theoretically the most attractive option to address equity and efficiency goals within international tax law and policy. Countries that have the flexibility to do so should adopt pure worldwide taxation systems by reforming their tax laws (for example, by eliminating deferral of taxation of foreign source active business income). Second, countries that are unable to perfect their worldwide tax systems should move to adopt a "tightened" hybrid exemption tax system with rules to ensure that the domestic income tax base remains protected. In other words, countries should adopt a pure worldwide tax system or, if this proves infeasible, design an effective hybrid exemption system. An assessment of economic and political constraints may help to determine whether countries should adopt the first or second approach.

As explored in Part 3, all of the major government studies from the selected countries favour the development of hybrid exemption tax systems. In addition, other countries appear to be following a similar course. In July 2008, New Zealand introduced tax legislation to transform its (almost) pure worldwide tax system into a hybrid exemption system.[63] New Zealand policy makers have pushed for this reform under the view that, during a time when national economies were being increasingly tied together, its worldwide system scared off potential foreign investors and may have inhibited domestic economic growth. Globalization may have progressed to the point where even the largest capital markets are constrained in their reform efforts. This is evidenced by the increasing attention paid within the United States to the role of tax as a potential inhibitor of cross-border investments. In 2007, the Office of Tax Policy of the U.S. Treasury Department released a report to improve the competitiveness of the U.S. tax system. After noting that over half of OECD countries have implemented hybrid exemption tax systems, it recommended that the United States consider the adoption of some form of exemption tax system (see also Section 3.1.1).[64]

While there remain theoretically attractive aspects of pure worldwide tax systems, there appears to be little policy support for such a move within Canada (which would, in any event, represent a significant departure from the traditional Canadian approach). This new view hence appears consistent with the objective of the Advisory Panel to explore the contours of a broader or full exemption tax system for Canada.

62 See J. Clifton Fleming Jr. and Robert J. Peroni, "Exploring the Contours of a Proposed U.S. Exemption (Territorial Tax System)" (2006) Tax Notes Int'l 217 at 219-220, 230-232, describing how a well-designed exemption tax system would be preferable over the current U.S. hybrid worldwide approach, but that a pure worldwide tax system remains theoretically the most attractive option; J. Clifton Fleming, Jr., Robert J. Peroni, and Stephen E. Shay, "Some Perspectives from the United States on the Worldwide Taxation vs. Territorial Taxation Debate" (Draft, 2008).

63 See New Zealand, Minister of Finance and Minister of Revenue, *Press Release: Tax Reform to Help New Zealand Companies Compete Overseas* (Wellington: The Treasury, 2008).

64 See Office of Tax Policy, supra note 30 at 1-2, 12-16, 46, discussing how it is now "imprudent for the United States, or any other country, to enact tax rules that do not take into account what other countries are doing." This position appears to be a departure from certain earlier works that maintained that new ways of conducting remote businesses, promoted by globalization and information technology developments, called for a greater adherence to the worldwide taxation of residents. See United States, U.S. Dept. of the Treasury, Tax Policy, *Selected Tax Policy Implications of Global Electronic Commerce* (Washington: Department of Treasury, 1996) at 18-19.

3. Identifying key trends in hybrid exemption tax systems

To assist with background research, the Advisory Panel commissioned the preparation of benchmark reports by independent experts to assess the 2008 tax rules for outbound direct investment within 10 selected countries.[65] The selected countries were six of the G-7 countries — the United States, the United Kingdom, France, Germany, Italy and Japan (Canada is also a member) — as well as four other countries: Australia, the Netherlands, Sweden and Hong Kong. Drawing from the analysis within the benchmark reports, Section 3.1 provides a brief summary of some of the main aspects of the outbound direct investment tax rules for each of the selected countries (see also Table 1). Section 3.2 discusses lessons and implications that can be drawn from the comparative analysis with respect to potential Canadian reform efforts.

3.1 Selected country tax rules

3.1.1 United States

The United States deploys a hybrid worldwide tax system with a federal corporate income tax rate of 35 percent for large corporations. U.S. states also levy corporate income tax rates between zero and 12 percent. Under the general rules, U.S. resident corporate taxpayers are taxed on their worldwide income and capital gains although deferral of tax is permitted for unrepatriated active business income: once remitted, the income is subject to U.S. tax with a foreign tax credit for foreign taxes paid (with a foreign tax credit limitation computed separately for different types or "baskets" of foreign source income). Foreign taxes that exceed this limitation can be carried back one and forward 10 years.

The tax system tries to tax the passive income (and certain active income) of a controlled foreign corporation (CFC) under subpart F of the Internal Revenue Code. Expenses for foreign source income that is exempt from U.S. taxation are generally not deductible. If the foreign source income is deferred, complex rules try to allocate the expense deductions for purposes of calculating the foreign tax credit. For instance, interest expenses are generally allocated on the basis of the relative tax values of foreign and domestic assets. Under another approach, research and development expenses are allocated first to product categories then secondly by either looking at sales or gross income. In addition, the U.S. tax system contains "dual consolidated loss" rules that strive to prevent the consolidation of cross-border income and losses as well as certain double dip structures (while leaving many viable structures that effectively achieve the same result as double dips).

65 See PricewaterhouseCoopers LLP, *Taxation of Foreign Source Income in Selected Countries* (May 2008); Deloitte & Touche LLP, *Tax Treatment of Expense Attributable to Foreign Source Income in Selected Countries* (May 2008); KPMG LLP, *Controlled Foreign Company Taxation Regimes in Selected Countries* (April 2008).

There are additional thin capitalization rules (more typically called "earnings stripping" rules in the United States) that seek to deny excessive interest deductions for inbound loans from related affiliated (where the U.S. corporation's debt-to-equity ratio exceeds 1.5:1). Debt can also be recharacterized as equity under a subjective "substance over form" test that scrutinizes a U.S. corporation's facts and circumstances. While the U.S. does not maintain a general anti-avoidance rule, a number of judicial doctrines, applied by courts, scrutinize the business purpose and economic substance of transactions.

In recent years, reports that scrutinize potential international tax policy fundamental reform have been issued by the congressional staff of the Joint Committee on Taxation, the President's Advisory Panel on Federal Tax Reform, and the Office of Tax Policy (U.S. Department of Treasury). All of these reports call for the development of a hybrid exemption tax system (see also Section 2.5). There has been significant academic and industry opposition to these reforms, which do not appear imminent.

3.1.2 United Kingdom

UK resident corporations are taxed at a general corporate income tax rate of 28 percent on their worldwide income although deferral of tax is permitted until dividends are repatriated from non-resident companies to the UK affiliates. Relief from double taxation is provided through foreign tax credits or, upon election, foreign tax deductions. Excess foreign tax credits can be carried back three years and carried forward indefinitely. In addition, under certain conditions, UK resident corporations can enjoy tax exempt sales of shares of foreign corporations.

Controlled foreign corporation (CFC) rules that strive to tax unrepatriated profits or passive income are restricted to foreign companies located in low-tax jurisdictions, which are countries that charge tax that is less than three-quarters of the UK that would otherwise be levied on the income. There are addition exemptions from the CFC rules, including exemptions for de minimis profits and non-UK tax motivated transactions. The current CFC rules are to be repealed and replaced with rules relating to "controlled companies", which will apply to both UK and foreign controlled corporations.

Certain (fairly informal) rules strive to allocate the deductions of expenses for foreign source income in order to calculate the foreign tax credit once profits are repatriated to the United Kingdom and subject to U.S. taxation. Under the thin capitalization rules, a subjective test is deployed to see whether the loan arrangement would have been entered into between arm's-length parties (a similar approach is also possible under Canadian arm's-length rules found within section 247 of the Income Tax Act although the CRA normally resorts to the specific Canadian thin capitalization rules found within subsection 18(4) to attack excessive interest deductions). Anti-arbitrage rules were introduced in 2005 to restrict deductions involving certain aggressive international tax planning arrangements such as the use of hybrid business entities. In addition, anti-avoidance rules were introduced in 2006 to restrict interest expense deductions for "unallowable purposes."

The UK tax authorities released a report in 2007 that, among other things, recommended movement toward a hybrid exemption tax system for reasons that include: (a) globalization and the increasing ownership of UK multinational companies by non-resident shareholders; (b) the increased deployment of exemption tax systems by other countries; (c) concerns surrounding compliance costs; and (d) the view that this would enhance UK firm competitiveness in global markets.[66] In the summer of 2008, there were ongoing consultations between the UK tax authorities and taxpayers concerning the possible direction of these reforms.

3.1.3 France

France deploys a hybrid exemption tax system that exempts from French tax (which provides for a general corporate income tax rate of 33⅓ percent) most foreign source income. The exemption applies to income generated by an "enterprise operated outside of France", which occurs when: the French resident company operates an autonomous establishment outside of France (similar to the tax treaty concept of permanent establishment in the OECD and UN model treaties); the French company operates outside of France through an autonomous agent (similar to the independent agent concept in the OECD model tax treaty); or the French company has derived income from a complete cycle of commercial operations that has been performed entirely in the foreign country. CFC rules apply for investments in a "low tax country" or a country where it benefits from a favourable income tax regime.

France does not tax 95 percent of the repatriated income of foreign subsidiaries as long as the French parent company owns at least five percent of both the capital and the voting rights of the subsidiary. Relief is also provided for 95 percent of capital gains from the sales of foreign subsidiaries as long as this participation threshold is surpassed, the participation qualifies as a long-term investment, or the shares were acquired through a public offering.

There is no general limitation rule regarding the deduction of expenses for the acquisition or maintenance of a shareholding in a foreign subsidiary. When a repatriated dividend from a foreign subsidiary is exempt from French tax (because the participation threshold has been surpassed), the general rule is to deny a portion of the total expenses of the French parent company (a similar approach is deployed in Germany and Italy). The portion generally equals five percent of the exempt income or gain. French tax authorities determine on a case-by-case basis the allocation of deductions for exempt income, which may also be reviewed by a French court.

Thin capitalization rules apply to partly deny interest deductions that exceed all three of the following tests: (i) a related party debt-to-equity ratio of 1.5:1; (ii) 25 percent of adjusted current profits for the year; and (iii) interest income received from related parties. The rules do not apply if the French company demonstrates that its debt-equity ratio is consistent with industry practices or for de minimis transactions. In addition, while there is no general anti-avoidance rule, French tax authorities apply substance over form tests if they find fraud or abuse of law.

66 See HM Revenue and Customs, supra note 23.

3.1.4 Germany

In 2007, Germany reformed its international tax laws primarily to make them more attractive for domestic and foreign investors: the federal corporate tax rate, for example, was reduced from 25 percent to 15 percent. Germany has enacted a hybrid exemption tax system that exempts from federal German tax dividend income from foreign source income and capital gains on the sale of foreign shares regardless of the participation level or length. However, five percent of the gross dividend or capital gain is added back to the German affiliate's taxable income as deemed non-deductible business expenses, resulting in an effective tax rate of these items of roughly 1.5 percent (that is, 5 percent of the general combined federal and municipal corporate income tax rate of approximately 30 percent). The municipal trade tax applies to repatriated dividends unless the resident company maintains an ownership of 15 percent or more of the share capital of the foreign corporation.

CFC rules strive to tax on an accrual basis certain passive income generated within low tax jurisdictions (that is, the passive income is subject to tax at an effective rate below 25 percent). As a general principle, business expenses that are economically directly related to the earning of tax-exempt income are non-deductible. In 2008, Germany introduced new rules to restrict the deduction of interest expenses. Under the new approach, a taxpayer can only deduct interest expenses up to 30 percent of adjusted profits (calculated by adding back certain charges such as depreciation). The rule does not apply to de minimis transactions, if the taxpayer is not part of a group of companies or the taxpayer shows that the borrower's debt-to-equity ratio is similar to the worldwide groups ratio. A revised general anti-avoidance rule was introduced in 2007 to target transactions that arise only from tax reasons.

3.1.5 Italy

Italian resident corporations are taxed on their worldwide income at a rate of 31.4 percent (27.5 percent corporate income tax and 3.9 percent for a regional tax on productivity) along with foreign tax credits to relieve international double taxation. However, under its hybrid exemption tax system, Italy generally exempts from Italian tax 95 percent of active business income when it is repatriated from a related foreign subsidiary. In addition, 95 percent of the capital gains on the sale of shares in a foreign subsidiary are also exempt from Italian tax. The government's underlying policy for the tax of five percent on dividends and capital gains is to recognize an amount of expenses associated with the ownership of the foreign investment.

Italy does not have a minimum holding percentage to benefit from these exemptions. Rather, certain conditions need to be met to enjoy the benefit, including the need for the corporation not to be based in a tax haven or blacklist country.

Under CFC rules, foreign source income is taxed on an accrual basis if this income originates in a tax haven on Italy's tax haven or blacklist. If a company is not resident in a tax haven country, these CFC rules do not apply, even for passive foreign source income. The Italian government proposed in 2008 to replace the existing blacklist with a white list that identifies (a) countries that allow an adequate exchange of tax information with Italy; and (b) impose a level of taxation similar to that of Italy. The CFC and other rules directed at tax havens and blacklisted countries will extend to all foreign corporations resident in countries not mentioned in the forthcoming white list. The proposed Italian approach is the most similar to the one in place in Canada where tax benefits are conferred on businesses based in tax treaty and TIEA partners (see Section 4.2.2).

Other than the deeming of five percent of expenses to be non-deductible, there are no specific rules that limit the deduction of interest and other expenses relating to the earning of foreign source income. The Italian Ministry of Finance has issued guidance that suggests the allocation of interest and overhead expenses should be determined on the basis of the ratio between foreign revenues and total revenues.

Like Germany, however, Italy replaced its thin capitalization rules in 2008. Under the new rules, interest expenses will be deductible only up to an amount equal to 30 percent of adjusted earnings. Any excess non-deductible interest can be carried forward indefinitely. The new rules envision "virtual consolidation" of the foreign subsidiary of an Italian company so that Italian firms do not face a tax disincentive to acquire a foreign subsidiary.

There are also anti-avoidance rules that limit the deduction of expenses between Italian resident companies and certain non-resident business entities based in tax havens or blacklist countries, unless it can be shown that the non-residents carry on real business activities or that the relevant transactions have a real business purpose.

Italy does not maintain a general anti-avoidance rule although it does have specific anti-avoidance provisions and a more recent tendency for Italian courts to deploy "substance over form" tests to counter abusive transactions.

3.1.6 Japan

Japanese resident corporations are taxed on their worldwide income and foreign capital gains at a large corporation rate of 41 percent along with a foreign tax credit for foreign taxes paid up to a statutory limit. CFC rules strive to tax on a current basis the income generated by related companies based in a tax haven country. There are a number of exemptions to these rules that focus on whether substantive business activities are taking place within the foreign subsidiaries.

Under general expense allocation rules, directly allocable expenses should be allocated to foreign source income while certain expenses must be so allocated. Generally speaking, interest expenses are allocated based on the ratio of the corporation's foreign assets to worldwide assets.

Thin capitalization rules generally restrict interest expenses paid to related foreign subsidiaries to situations where the Japanese resident firm maintains a debt-to-equity ratio of at most 3:1. The rules, however, provide relief when a higher debt-to-equity ratio is within the industry standard. In addition, anti-avoidance rules apply substance over form tests with respect to certain specified domestic and cross-border transactions.

3.1.7 Australia

The general corporate income tax rate is 30 percent. Under Australia's hybrid exemption tax system, certain categories of foreign source income are exempt from tax such as dividends from foreign corporations (as long as the Australian related corporation holds 10 percent or more of the voting shares of the foreign subsidiary) and capital gains on the sale of non-portfolio foreign shares in a foreign corporation that carries on an active business. In addition, Australia introduced in 2005 "conduit foreign income" rules that exempt Australian dividend withholding tax from applying to distributions of parent/subsidiary (direct) dividends to foreign shareholders.

On July 1, 2008, the foreign tax credit system was replaced with a foreign tax offset system that provides greater tax relief for international double taxation. Under the new system, Australian taxpayers can claim a tax offset against Australian tax payable for foreign income, subject to a cap (under the previous rules foreign tax credits were quarantined and could only be used against foreign income of the same class).

CFC rules strive to tax foreign passive income on a current basis. Since July 1, 2008, the Australian rules permit foreign losses to be offset against all domestic and foreign income, a reform that departs from the practices of the other selected countries as well as Canada.

Generally, an Australian corporation cannot deduct expenses incurred for producing foreign tax exempt income. An exception is permitted for interest and other borrowing costs. However, new thin capitalization rules were introduced in 2001 that restrict interest deductions for inbound and outbound loans. These new rules have the following features:

- they apply to all debt, related or unrelated, from both foreign or domestic sources;
- they apply to inbound and outbound investments;
- there are three tests that must be satisfied: an objective safe harbour test broadly based on a 3:1 debt-to-equity test, a worldwide gearing test that looks to the resident company's worldwide debt leverage, and an arm's-length test;
- anti-avoidance rules can classify debt and equity based on economic substance.

Previously, Australia relied on restricting interest deductions that could be traced to outbound investments (similar to section 18.2 of the ITA, enacted in 2007, that seeks to restrict interest deductions for double dip and other "tax efficient" cross-border structures). The government abandoned this earlier approach under the view that it did not effectively restrict abusive interest deductions. Nevertheless, tracing is still required to allocate certain expenses between domestic and foreign source (exempt) income. Under this approach, the income and expense is deemed to arise where the substantial elements of production of income occur, as well as other relevant facts and circumstances.

Finally, Australia deploys a general anti-avoidance rule that applies to transactions entered into with the sole or dominant purpose of obtaining a tax benefit.

3.1.8 Sweden

The corporate income tax rate is 28 percent. Under its hybrid exemption tax system, Sweden exempts from tax any repatriated dividends from foreign subsidiaries as long as the Swedish corporation owns at least 10 percent of the voting rights or where the shareholding is considered held for business reasons. Similarly, the sale of shares in foreign corporations is tax exempt if the resident corporation qualifies for the participation exemption. CFC rules tax on a current basis certain foreign source income that is subject to low rate taxation (that is, below a rate of 15.4 percent) unless the foreign corporation is based in a white list country (and the income has not been specifically excluded from the white list) then a lower rate is permissible. Beginning on January 1, 2008, the Swedish parent corporation is exempt from the CFC rules if the corporation can show that the foreign subsidiary was established for genuine business reasons in a member country of the European Economic Area.

While Sweden does not have any thin capitalization rules, all related party loan and other transactions must be at arm's length (the transactional arm's-length rule for transfer pricing purposes appears to similarly apply to cross-border loans in all of the selected countries as well as Canada). In addition, a general anti-avoidance rule can be applied to transactions that are designed to provide the Swedish taxpayer with an improper tax benefit.

Swedish multinational firms can additionally deduct interest expenses to finance related subsidiaries that generate exempt income. The Swedish Tax Agency has challenged similar cross-border structures under anti-avoidance laws, but Swedish courts have ruled that the laws did not apply. The Swedish Tax Agency has announced it will investigate whether the anti-avoidance laws need to be reformed.

3.1.9 Netherlands

Under the Dutch hybrid exemption tax system, qualifying dividends (where the Dutch parent company hold five percent or more of the nominal paid-up capital in a domestic or foreign company) and capital gains from the sales of shares in foreign subsidiaries are exempt from Dutch tax. The general corporate income tax rate for large corporations is 25.5 percent.

While the Netherlands does not have general CFC rules, low-taxed foreign subsidiaries with assets of more than 90-percent portfolio investments and in which the Dutch taxpayer holds at least 25 percent have to be valued at fair market value. In a similar way to Canada's "mark-to-market" rules for foreign investment entities, any increase in value in the low-taxed subsidiary must be included in income.

There appear to be few restrictions on deductions for expenses attributable to exempt foreign source income (although interest expenses for foreign branches must be allocated for foreign tax credit purposes). Anti-avoidance rules permit the recharacterization of debt as equity if the underlying purpose of the transaction was to generate the interest deduction to a related party. There are exemptions to this anti-avoidance rule if the taxpayer can establish that the transaction was entered into for sound business reasons or the interest income was taxed at a rate of at least 10 percent.

Thin capitalization rules seeks to restrict excess interest deductions where the debt-to-equity ratio of the Dutch borrower exceeds a ratio of 3:1 (alternatively, the restriction applies if the Dutch company's ratio is less than the maximum ratio for the related international group of companies). Dutch tax laws also incorporate a general anti-avoidance rule that permits tax authorities to challenge transactions where their primary purpose is the avoidance of tax and they frustrate the spirit and purpose of the tax law.

3.1.10 Hong Kong

Beginning on April 1, 2008, Hong Kong deployed a corporate income tax rate of 16.5 percent. Out of all of the selected countries, Hong Kong has chosen to implement the closest tax system to a pure exemption tax system: all active and passive foreign source income (whether remitted or not) is exempt from Hong Kong tax. In addition, Hong Kong does not have CFC rules.

Expenses attributable to foreign source income are generally not deductible by the related company in Hong Kong. The underlying policy is that only expenses incurred to earn taxable profits in Hong Kong should be deductible — arm's-length payments for overhead and certain other cross-border expenses are permissible. Informal tracing rules or, alternatively, allocation formulas may be used by taxpayers to distinguish between expenses incurred for the production of domestic and foreign source income.

While there are no thin capitalization rules, certain anti-avoidance rules apply to restrict the deduction of interest expenses unless a taxpayer can meet one of the tests that try to ensure the interest income was taxable in Hong Kong or there is a substantive business reason for the loan. There are additional general anti-avoidance rules.

Table 1
Summary of Outbound Direct Tax Regimes (2008)

	Hybrid exemption system	Hybrid worldwide system	Corporate tax rate (percent)	Participation threshold for dividend exemption	Deduct interest expenses for exempt income	Thin Capital-ization rules	Exempt capital gain on sale of foreign shares	GAAR
Canada	X		29.5 [(a)]	10 percent any equity; 1 percent Cdn shh.	yes: single dips only	yes	no[(b)]	yes
United States		X	40 [(c)]	n/a	n/a	yes	no	no
United Kingdom		X	28	n/a	n/a	yes	yes	no
France	X		33 1/3	5 percent voting shares/share capital	yes: denial of 5 percent	yes	yes	no
Germany	X		30 [(d)]	none[(e)]	yes: denial of 5 percent	no	yes	yes
Italy	X		31.4	none[(f)]	yes: denial of 5 percent	no	yes	no
Japan		X	41	n/a	n/a	yes	no	no
Australia	X		30	10 percent voting shares	yes	yes[(g)]	yes	yes
Sweden	X		28	10 percent voting shares	yes	no	yes	yes
Netherlands	X		25.5	5 percent paid-up capital	yes	yes	yes	yes
Hong Kong	X		16.5	no	yes	no	yes	yes

n/a = not applicable

Notes:

(a) The 2008 federal corporate income tax rate is 19.5 percent (to be reduced to 15 percent by 2012). Assumes a provincial corporate income tax rate of 10 percent.

(b) Canada provides partial capital gains relief on these sales to the extent that the foreign affiliate has undistributed profits (more technically, exempt surplus).

(c) The 2008 federal corporate tax rate is 35 percent for large corporations. Assumes a state corporate income tax rate of five percent.

(d) The 2008 federal corporate income tax rate is 15 percent. Assumes a municipal corporate income tax rate of 15 percent.

(e) While the federal system does not impose a participation threshold to exempt repatriated dividends, the municipal trade tax will apply to these dividends unless the German resident corporation maintains an ownership of 15 percent or more of the share capital of the foreign corporation.

(f) Under proposed tax laws, dividends that do not come from white list countries will not enjoy tax exemption.

(g) While all of the other identified thin capitalization rules restrict interest deductions for inbound loans, the Australian rules additionally restrict deductions for outbound loans.

Source: PricewaterhouseCoopers LLP, *Taxation of Foreign Source Income in Selected Countries* (May 2008); Deloitte & Touche LLP, *Tax Treatment of Expense Attributable to Foreign Source Income in Selected Countries* (May 2008); KPMG LLP, *Controlled Foreign Company Taxation Regimes in Selected Countries* (April 2008).

3.2 Implications for Canada

The previous discussion provides lessons for potential Canadian reform efforts with respect to the taxation of outbound direct investment. The following comparative observations are necessarily of a very general nature due to the complexities associated with each of the tax regimes as well as the fact that a number of these regimes are undergoing or have undergone significant reform in recent years. The devil, as they say, is in the details and each tax regime incorporates complex rules that, along with distinct civil or common law principles of tax statute interpretation and judicial anti-avoidance doctrines, enable or inhibit international tax planning strategies that ultimately play a significant role in determining the final tax bill on foreign source income derived from outbound direct investment.

First, all of the government reports from the selected countries that have scrutinized fundamental international tax reform have supported movement toward, or broadening of, hybrid exemption tax systems. While there appears to be ongoing academic support for worldwide taxation, the increasing government support for hybrid exemption tax systems suggests that policy support for worldwide taxation is diminishing. Two traditional hybrid worldwide tax countries, the United States and the United Kingdom, are considering reforming their tax regimes into hybrid exemption tax systems although U.S. reforms do not appear to be imminent.

Second, the general approach of the current Canadian hybrid exemption system appears consistent with, or in advance of, many of the trends identified within the selected countries: the Canadian system can be portrayed as "competitive" with its G-7 counterparts in that, generally-speaking, this system appears to impose comparable or more favourable tax treatment for outbound direct investment (see Section 2.4.3 for a discussion of the usage of the competitiveness criterion to guide policy analysis). While the survey reveals a diversity of possible approaches, seven of the 10 selected countries offer tax exemption for dividends repatriated from foreign affiliates, providing similar tax relief to the Canadian system (the United Kingdom, the United States and Japan maintain worldwide tax systems that tax repatriated dividends along with relief for double taxation). All of the hybrid exemption tax regimes provide, effectively, zero tax rates on dividend income repatriated from related foreign business entities: with the exception of Hong Kong, all of the regimes impose worldwide taxation on most other sources of foreign income (with some exceptions such as exempting passive income taxed in high tax host countries).

Canadian tax law now provides an exemption for dividends received from related corporations based in tax treaty and TIEA partner countries although no TIEAs have been signed as of yet (see Section 4.1.2). As a result, Canada no longer ties exemption eligibility to the need for the non-resident to be based in a country with a comparable tax system (or a minimum tax rate). Australia, France, Germany and Sweden similarly do not maintain "low tax kick-outs" that remove the exemption benefit for dividends repatriated from related companies based in low or nil tax jurisdictions. In contrast, Italy has recently proposed laws that would deny the dividend exemption if the foreign affiliate was based in a country that did not maintain effective tax information exchanges with Italy and maintains a low tax regime.

One area Canada appears out of step is with respect to participation thresholds: Canada, with a general group participation threshold of at least 10 percent of *any* shares of the foreign corporation (the Canadian resident, itself, generally must own one percent), has a lower participation threshold when compared to the other selected countries. Out of the remaining hybrid exemption tax systems: Sweden and Australia mandate a minimum threshold of 10 percent of voting shares; France mandates a minimum threshold of at least five percent of both share capital and voting rights; the Netherlands maintains the need for at least five percent of the firm's paid-up capital. Italy does not have a participation threshold, but denies the dividend exemption to, under a proposal, investments outside of white listed countries. Germany does not have a participation threshold for its federal tax dividend exemption, but, like Italy and France, denies five percent of total deductions to the related foreign corporation. The absence of a Canadian low tax kick-out along with the low participation threshold for dividend exemptions provides more favourable tax treatment for outbound direct investment when compared to the other selected partners. If Canada moves more formally to a full hybrid exemption tax regime, it may need to revise certain policies such as the low participation threshold to protect its domestic tax base (see Section 4.3.2).

Importantly, the European Union countries under scrutiny (France, Germany, the United Kingdom, Italy and Sweden) provide additional relief for the taxation of foreign source income emanating from other EU countries (such as no withholding taxes on parent/subsidiary dividends):[67] unlike the situation in Europe, the North American Free Trade Agreement does not provide for, or motivate, similar tax relief for firms based within North America.[68] In addition, eight of the selected countries (the United States and Japan are the exceptions) provide capital gains exemptions for sales of foreign shares under certain circumstances (such as the need for the foreign corporation to have been engaged in an active business). This approach provides greater tax relief than the Canadian rules that permit tax relief only to the extent there are undistributed profits within the foreign affiliate (see Section 4.3.3).

The Canadian hybrid exemption tax system appears to compare less favourably, in some circumstances, with the selected non-G-7 countries. Australia generally permits interest deductions for foreign ventures (subject to thin capitalization rules imposed on inbound and outbound direct investments) unlike the recently introduced tax rules in Canada that seek to deny interest deductions for double dip structures: in addition, Australia, unlike Canada, does not apply a withholding tax to parent/subsidiary (direct) cross-border dividends in many instances and permits cross-border loss offsetting. The Swedish system appears comparable to the Canadian system although it has a slightly lower tax rate (see below), provides more exemptions from its CFC regime, and does not appear to restrict financings of foreign affiliates to the same extent as Canadian rules. The Netherlands' hybrid exemption tax system has a number of features that provide tax relief for international investments (in part because this

67 This relief is derived in part from EU Directives such as the Parent-Subsidiary Directive that prohibits the imposition of withholding taxes on direct dividends (see Commission for the European Communities (2004), Council Directive 90/435/EEC). Importantly, and unlike the situation in North America, the European Court of Justice plays an important role in shaping the international tax policies of EU member states in situations where these policies violate EU principles such as non-discrimination. For review, see Ruth Mason, *Primer on Direct Taxation in the European Union* (Minnesota: Thomson/West: St. Paul, 2005).

68 See NAFTA Tax Law and Policy, supra note 61 at 105-127.

country has historically been used as a base for these investments). Unlike Canada, Hong Kong does not try to tax foreign source passive income or maintain complex CFC and thin capitalization rules.

Third, a review of the general corporate tax rates deployed by the selected countries shows that, in 2008, Canada had the second lowest corporate income tax rate (after the United Kingdom) within the G-7. Of the remaining four countries, three (Sweden, the Netherlands and Hong Kong) currently impose lower corporate income tax rates than Canada. The Canadian government has scheduled further rate reductions so that, in 2012, the Canadian rate should be 25 percent (assuming a 10-percent provincial corporate income tax rate applies). Assuming that the other G-7 countries do not reduce rates during this time, this would provide Canada with the lowest corporate income tax rate within the G-7, which is consistent with the government's goal set out within the *Advantage Canada* report, and incorporated into the mandate of the Advisory Committee (see Sections 1.1 and 1.2). Corporate income tax rates have been trending downward in most of the selected countries and the Canadian government will need to pay ongoing attention to these developments.

Importantly, corporate income tax rates determine only a part of the total tax burden facing marginal cross-border direct investments. Other aspects of the tax system such as the ability of taxpayers to write-off equipment depreciation as well as non-tax factors such as interest and inflation rates also contribute to the ultimate tax burden paid by taxpayers on cross-border investments. Moreover, taxes on individual investors, in addition to corporate taxes, ultimately must be taken into consideration when scrutinizing overall tax burdens on cross-border capital. Marginal effective tax rate (METR) studies strive to take into account these various factors, and the results reflect a rough estimate of the tax burdens faced by investors for each additional dollar for cross-border investments. Once these METRs are generated, they can be compared with the METRs facing investors in other countries to see whether a particular national tax system imposes relatively higher or lower tax burdens.[69]

One study indicates that, in 2006, Canadian investors faced significantly higher overall tax burdens when compared to other investors: Canada had the second highest overall METR on cross-border investments (after Germany) of the G-7 countries.[70] When only taxes paid by corporations are taken into account, however, another recent study shows that 2007 tax burdens on capital, on average, are lower in Canada in certain circumstances: Canada had the second lowest average (for manufacturing and services) METR in the G-7 after the United Kingdom and a slightly lower average METR of 30.9 percent when compared to the weighted average of 31.5 percent for the average METR for all of the OECD members.[71] On the other hand, this study also showed that Canada imposed the 11th highest average METR on capital out of the 80 countries surveyed.

69 METR studies suffer from certain drawbacks such as the need to incorporate (potentially unrealistic) assumptions to calculate the comparative METR. In addition, METR studies generally do not account for tax planning strategies that can have a significant impact on global tax liabilities. As such, METRs can only serve as rough guides to the possible influence of tax on cross-border investment decision-making. See NAFTA Tax Law and Policy, supra note 61 at 76-80.

70 See United States, Department of Treasury, *Treasury Conference on Business Taxation and Global Competitiveness: Background Paper* (Washington: 2007) at 40.

71 See Jack M. Mintz, "2007 Tax Competitiveness Report: A Call for Comprehensive Tax Reform" (2007) C.D. Howe Institute Commentary No. 254, at 9-10.

Fourth, a key area of policy focus for countries that have moved to an exemption tax system appears to be the appropriate tax treatment of interest expenses related to the acquisition or maintenance of a shareholding in a foreign subsidiary. In particular, the treatment of these expenses is subject to three general approaches: (i) certain countries deny deductions for interest and other expenses related to such acquisitions or maintenances (such as the U.S. approach for foreign tax credit calculation purposes or the proposed U.K. approach: see Section 4.3.5); (ii) other countries (France, Germany, Italy) permit interest and other expense deductions, but deny a portion (five percent) of the deductions to the resident parent corporation; (iii) others permit interest deductions subject to certain anti-avoidance rules (Australia, Sweden, the Netherlands, and Hong Kong). Also notable is that, in part as a result of legal pressures applied by the European Court of Justice, certain European Union countries such as Germany and Italy have abandoned their thin capitalization rules in favor of rules that restrict interest deductions for domestic and foreign ventures to a specified percentage of adjusted earnings.

Canada permits interest deductions that generate exempt foreign source income although new tax laws seek to inhibit these deductions for certain cross-border structures such as double dips (see Section 4.3.5). The current rules in Canada appear to be more favourable than the rules in France, Germany, Italy, Japan, and the United States that seek to either restrict interest deductions or ensure that a portion of the deduction is denied. Other countries such as Australia, Sweden, the Netherlands and Hong Kong appear to offer more favourable treatment as they do not seek to inhibit double dip and other cross-border structures through specific legislation such as new section 18.2 of the ITA. This comparative perspective is complicated by the fact that thin capitalization rules in certain countries as well as other anti-avoidance laws may restrict the use of certain cross-border structures to a greater extent than currently occurs in Canada. For example, Australia deploys thin capitalization rules that restrict inbound and outbound financings (unlike the Canadian approach that only restricts inbound financings) that may have a more significant impact at inhibiting excessive interest deductions (see Section 4.5.3)

Fifth, the tax regimes in the selected countries — whether hybrid worldwide or exemption tax systems — appear to incorporate significant technical complexity. This complexity leads to compliance uncertainty and the need to devote more resources to ensure firms comply with all relevant tax laws, policies and practices. In addition, this complexity results in significant enforcement costs for tax authorities. The Hong Kong pure exemption tax system appears to be the least technically complex system (for example, there are no CFC or thin capitalization rules), but such a regime is not appropriate or feasible for countries like Canada with large economic sectors outside of the financial and service sectors. A certain amount of technical complexity may not be an avoidable feature of even a well-designed hybrid exemption tax system (see Sections 2.4.4, 4.2.1 and 4.3.1).

4. Exploring Reform Options

This Part provides general observations concerning the policy implications should Canada move to a full hybrid exemption tax system. It begins with a discussion of the evolution of Canada's hybrid exemption tax system that, initially, provided tax relief only for foreign affiliates based in countries with comparable tax regimes, but over time has expanded, effectively, into a full hybrid tax exemption system that exempts from Canadian tax all foreign sources of active business income. Next, the section explores reform options to promote tax simplification within a *streamlined full hybrid tax system*, including: (i) abolishing taxable surplus; (ii) design features with respect to exempting from Canadian tax repatriated dividends and capital gains from selling shares in foreign affiliates as well as the treatment of expenses that generate tax-exempt foreign source income; (iii) design features with respect to the foreign accrual property income (FAPI) regime and related regimes that seek to tax foreign source passive income on an accrual basis; and (iv) design features of certain anti-avoidance rules such as transfer pricing rules, thin capitalization rules, anti-arbitrage rules and the general anti-avoidance rule (GAAR) as well as potential enhanced administrative cooperation between the CRA and foreign tax authorities. Many of these issues were identified or discussed by the Advisory Panel in its Consultation Report.[72]

4.1 The evolution of Canada's tax rules for outbound direct investment

4.1.1 A brief history of the exempt surplus rules

In the early years of Canada's tax system, Canadian residents, including corporate taxpayers, were required to pay tax on their worldwide income along with a limited foreign tax credit to relieve international double taxation. From 1938 to 1949, the basic approach of worldwide taxation was maintained although Canadian corporations were permitted to receive dividends from wholly-owned subsidiaries on a tax-exempt basis under certain circumstances.[73]

From 1949 to 1951, Canada's international tax laws were reformed into an exemption tax system where repatriated dividends were exempt from Canadian tax as long as the Canadian resident corporation maintained more than 25 percent of the voting control. According to a contemporary account, the rules were changed to an exemption system largely due to concerns about tax complexity:

> In the case of dividends received by a Canadian corporation from a controlled foreign subsidiary, the Canadian tax credit provision was extremely complicated until the budget of 1949… A 1949 amendment to the tax law entirely eliminated (the) complicated tax credit calculation and substituted in its place the right to exclude from Canadian income all dividends received from a controlled subsidiary. A further step was taken in the 1951 budget with the extension of this privilege to dividends from companies which more than

72 See Consultation Report, supra note 2.

73 For a discussion of historical practices, see, e.g., R.J. Dart and R.D. Brown, "Taxing International Income—A Canadian Perspective" (1976) 24(2) Can. Tax J. 144 at 145-147.

> 25 per cent of the shares are owned. In effect this change extends to foreign dividends the general practice in respect of inter-company dividends in Canada, except for the limitation in the foreign field for the degree of ownership.[74]

To reduce tax avoidance and to ensure that foreign source income is taxed at progressive rates, the 1967 report of the Royal Commission on Taxation (the so-called Carter Commission Report) recommended the repeal of the 1949 rules and subsequent Canadian tax laws that exempted foreign source income from taxation.[75] Taking into consideration factors such as the need to ensure that the Canadian tax system does not inhibit outbound direct investment as well as "a more pragmatic approach in the international field than in domestic taxation," the Royal Commission ultimately recommended that, for outbound direct investments where Canadian residents maintain at least 10-percent ownership of voting shares (down from the 25-percent requirement in place at the time to qualify for exemption), repatriated dividends from foreign affiliates will be exempt from tax if the foreign income tax were paid at a rate of at least 30 percent. In addition, to reduce compliance costs it was recommended that foreign source income derived from the United States or the United Kingdom should be deemed to be taxed at a rate of at least 30 percent. Where foreign income was taxed at a rate of less than 30 percent, the difference between the lesser rate and 30 percent would apply to tax the foreign earnings on an accrual basis.[76]

While this recommendation was never implemented, the Royal Commission's report provided the policy basis for tying the dividend exemption to the need for foreign source active business income to take place in a tax treaty partner (i.e., a foreign country with a comparable tax regime) that became part of Canada's modern tax policy approach to taxing outbound direct investment.

In 1969, the Canadian government released a White Paper on tax reform. The government proposed that, where Canadian residents maintained a 25-percent interest in foreign corporations, the repatriated dividends would continue to be exempt from Canadian tax in certain circumstances. A controlled foreign corporation (CFC) regime to be called the foreign accrual property income (FAPI) regime was proposed to tax a controlled foreign affiliate on its passive income, mainly to counter fears over tax avoidance. After 1976, the dividend exemption would only apply with respect to these foreign corporations if they were based in tax treaty partner countries, providing the statutory basis for the exempt surplus account rules that persist to this day.[77] The government rejected the Royal Commission's proposal for partial accrual taxation of foreign source income in favour of an exemption system that was still tied to the need for a foreign tax system that would levy comparable tax burdens on this income: in 1972, for instance, Canada had tax treaties with only 16 countries, most of which were high tax countries.

74 See Perry, supra note 21 at 97-98.

75 See Canada, Office of the Auditor General, *Report of the Royal Commission on Taxation, vol. 4* (Ottawa: Queen's Printer, 1967) at 617, 628, as reprinted in part in (1967) 15(2) Can. Tax J. 190 at 192.

76 While generally lauding the Carter Commission Report "as a landmark in taxation," Richard Musgrave disagreed with the partial dividend exemption and called for accrual taxation of all foreign source income mainly to promote cross-border tax neutrality. See Richard A. Musgrave, "An Evaluation of the Report" (1967) 15(4) Can. Tax J. 349 at 367-368.

77 The legislation was delayed and draft regulations that created the foreign affiliate/exempt surplus regime were not issued until June 5, 1975 to apply to taxation years beginning in 1976.

A contemporary observer noted that the exemption for repatriated dividends out of corporate affiliates based in treaty partners was motivated mainly by the desire to maintain administrative simplicity:

> In opting for the tax exemption system for "controlled" foreign corporations in treaty countries, the government has accepted the need for a system which would be relatively simple to administer and which would not impose upon the Canadian corporation or its subsidiaries unduly onerous reporting and recording requirements with respect to the foreign operations.[78]

Because Canada had so few tax treaties at the time, it was assumed that the foreign tax credit would take on greater importance to provide double tax relief in situations where profits were repatriated from corporations based in non-tax treaty partner countries. Despite efforts to encourage simple rules, the new international tax laws did not escape criticism from some quarters. After reviewing the need to form highly complex tax laws to ensure foreign direct and indirect credits apply to the appropriate surplus accounts to be maintained by foreign affiliates, one observer indicated: "Whether this result comes about through oversight or fiscal masochism is immaterial; what we should be asking ourselves is whether we can afford to adopt policies whose effects will be so detrimental to our own interests."[79] After reviewing the 1975 draft legislation that introduced the foreign affiliate surplus accounts, the same observer noted presciently, "Reform has razed (the pre-1973 exemption) structure of classic simplicity, and erected in its ashes one of baroquian complexity."[80]

This brief historical detour shows how the modern foreign affiliate system arose from policy objectives that included the desire to promote administrative simplicity and reduce tax barriers to international investments as well as the view that foreign source income should be subjected to roughly similar tax treatment as provided through the Canadian tax regime. In particular, the early dividend/treaty exemption system appears to have been designed as a kind of proxy for the foreign tax credit system associated with worldwide taxation where Canada would otherwise grant credits to its residents for foreign taxes paid in treaty partner countries. By the late 1990s, the Report of the Technical Committee on Business Taxation concluded that the general approach of Canada's hybrid exemption tax system effectively promoted Canadian economic policy goals.[81]

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78 See George T. Tamaki, "The White Paper: Taxation of Foreign Source Income" (1970) 18(2) Can. Tax J. 142 at 143.

79 See James Scott Peterson, "Canada's Foreign Tax Credit System" (1971) 19(2) Can. Tax J. 89 at 98. Opposition was also mounted against the perceived over-complexity of the proposed FAPI regime. See H. Arnold Sherman, "How to Kill a Mouse with an Elephant Gun or Foreign Accrual Property Income: Some Problem Areas" (1972) 20(5) Can. Tax J. 397.

80 See James S. Peterson, "Canada's New Tax Treaties" (1975) 23(4) Can. Tax J. 315 at 316.

81 See Canada, Department of Finance, *Report of the Technical Committee on Business Taxation* (Ottawa: Dept. of Finance, 1997) at 6.7-6.11, concluding that the hybrid exemption system "is fundamentally sound and should be maintained."

4.1.2 Current rules: toward a full hybrid tax exemption system

This Section provides an overview of the current tax rules for outbound direct investments and shows how these rules have evolved to the point where virtually all foreign source active business income is now exempt from Canadian tax.[82]

The general approach

Canada's hybrid exemption tax system for taxing outbound direct investment essentially comprises two taxation regimes:

1. dividends from active income earned by foreign affiliates based in treaty partner countries or a country that has negotiated a comprehensive tax information exchange agreement (TIEA) are effectively exempt from Canadian tax when distributed to Canadian resident shareholders;[83] and

2. a Canadian resident shareholder must currently include in income his/her/its appropriate share of passive income (more specifically, foreign accrual property income or FAPI) earned by a controlled foreign affiliate (CFA), whether or not this income is distributed by the CFA[84] (for more discussion of the FAPI rules, see Section 4.4).

The first regime deals with the taxation of dividends received by Canadian residents from foreign corporations under section 113 of the ITA. Because the foreign corporation paying the dividends may earn both FAPI and active business income and FAPI has already been taxed in Canada, section 113 differentiates dividends based on the nature of the underlying foreign income. The income, as it is earned, is tracked under elaborate tax accounting (that is, "surplus") rules contained in Part LIX of the Income Tax Regulations.[85]

Active business income earned by a foreign corporation resident in a treaty country generates "exempt" dividends which are effectively tax-free to corporate shareholders. "Active business income" is residual income exclusive of FAPI. It typically includes income from manufacturing, processing, transportation, services, and other activities that involve a high level of involvement of people. It also includes intra-group payments of property income, such as rents, royalties and interest (see Section 4.3.5).

Other types of income, including FAPI and active business income earned by foreign corporations in non-treaty and non-TIEA countries, generates "taxable" dividends (or dividends that come from the foreign affiliate's taxable surplus account). Taxable dividends are taxable in Canada, but foreign taxes paid in respect of the income are credited against Canadian tax.

82 Sections 4.1 and 4.2 draw from an earlier co-authored work. For a more extensive discussion of Canada's tax rules governing the treatment of foreign affiliates, see International Taxation, supra note 5 at 199-231.

83 See s. 113(1)(a) of the ITA. More technically, the Canadian corporate affiliate is permitted to take a full deduction for the repatriated dividend, which effectively reduces the Canadian tax on such dividend to zero.

84 See s. 91 of the ITA.

85 See ITA Regulations s. 5900 and s. 5901.

A distribution made by a foreign affiliate to its shareholders which exceeds the amount of exempt surplus and taxable surplus is considered next to come out of "preacquisition surplus" and in effect to be a return of the shareholder's investment to the extent of the original invested amount and deductible in computing a corporate shareholder's taxable income.[86] Any distribution in excess of that amount is generally considered to be a capital gain.[87]

The first and second regimes are integrated to ensure that FAPI is not subject to double taxation under the ITA when FAPI is earned, and again when FAPI is distributed to Canadian shareholders by way of dividends or when the shareholder realizes capital gains from the sale of the foreign affiliate's shares.

The impact of an expanding tax treaty network

In 2007, the federal budget proposed to link TIEA partners to the exempt surplus regime: laws were subsequently passed to accomplish this objective (see Section 4.2.2).[88] At first glance, this budget proposal appears to be a significant departure from the traditional approach. As indicated above, since 1976 the tax free repatriation of dividends from foreign affiliates was linked to the need for this foreign affiliate to be based in a tax treaty partner (that historically had a similar tax regime to the Canadian one). Canada now has over 80 tax treaty partners. The upside of this extended treaty network is that it likely facilitated outbound direct investment as Canadian residents could expand into more foreign markets while benefiting from the tax relief provided by tax treaties.

While the majority of treaty partners appear to maintain roughly similar tax regimes to the Canadian one, there are now a number of exceptions. For instance, Canada now has treaties with countries with low corporate income tax rates (for example, Ireland, a tax treaty partner, imposes a general corporate income tax rate of 12.5 percent) or very low rates (for example, the Barbados, a tax treaty partner, maintains progressive corporate income tax rates between one percent and 2.5 percent for international business companies). Other treaty partners may have tax regimes that, in broad outline, ostensibly resemble the Canadian regime, but in fact offer special tax breaks and incentives for international investments unlike Canada: China serves as one example of a Canadian treaty partner that has traditionally enacted a host of tax incentives, including tax holidays that impose no taxes for stipulated periods, for inward direct investment (in 2008, China reformed its tax system to reduce the amount of special tax incentives for cross-border investments). By 1992, analysis by the Department of Finance and (then) Revenue Canada indicated that 23 percent of exempt dividends were received from treaty partner countries with low tax rates.[89]

86 See s. 113(1)(d) of the ITA.

87 See s. 40(3) of the ITA.

88 See ITA Regulation s. 5907(1), *Notice of Ways and Means Motion*, March 19, 2007, at 31.

89 See Canada, Office of the Auditor General, The Standing Committee on Public Accounts, *Report to the House, 12th Report* (Ottawa: Queen's Printer, April 23, 1993).

As Canada's tax treaty network expanded, it undercut the intent of the modern system to link the exempt surplus regime to foreign affiliates based in comparable tax jurisdictions. It is thus probably more accurate to say that, under an expanding treaty network, there has been a gradual departure from the original intent of the modern system that was accelerated by the 2007 TIEA proposal. In effect, the expanding network and TIEA linkage has returned Canada to its "pre-modern" position of exempting virtually all forms of foreign source active business income. There are two possible responses to this development: (1) Canada could return to the approach in 1976 by, say, reforming the rules to only permit exempt dividends in situations where the foreign affiliate is based in a relatively high tax country; or (2) abolishing taxable surplus and move more formally to a hybrid exemption system that exempts from Canadian taxation all repatriated dividends regardless of where the foreign affiliate is based.[90]

4.2 Abolishing taxable surplus

Because Canada's outbound direct tax regime has evolved, effectively, into a full hybrid tax exemption system, it calls into question the need to maintain separate surplus accounts for different types of foreign source active business income. As mentioned above, a second kind of surplus called "taxable surplus" comprises foreign accrual property income (FAPI) as well as business income earned in jurisdictions and by foreign affiliates that are resident in jurisdictions with which Canada has not concluded a tax treaty or TIEA. Similar to "exempt surplus", "taxable surplus" is the result of the application of a number of other tax accounting concepts including "taxable earnings" and equivalent loss computation rules. Dividends paid by a foreign affiliate are considered to originate in "taxable surplus", generally after their capacity to be paid from "exempt surplus" has been fully exhausted although in certain circumstances elections may be made to transform what would otherwise be an "exempt surplus" dividend into a "taxable surplus" dividend in order, for example, to maximize the application of various tax preferences, including losses and the application of other tax accounts, that would otherwise be wasted.

This section discusses how the abolishment of taxable surplus could reduce tax complexity along with correspondingly lower compliance costs for taxpayers and lower enforcement costs for the CRA. In addition, the section discusses how the new TIEA rules could protect against revenue losses if the exemption tax system is opened up to all dividends repatriated from foreign affiliates (although TIEAs may be better suited to guard against tax evasion via international portfolio investments, and not direct investments): steps will need to be taken to ensure that the new TIEAs promote the effective — that is, efficient and fair — sharing of tax information between the CRA and TIEA partners.

90 For proposals to introduce a "low tax kickout" feature to the foreign affiliate rules, see Brian J. Arnold, "Unlinking Tax Treaties and the Foreign Affiliate Rules: A Modest Proposal" (2002) 50(2) Can. Tax J. 607 at 618. For views on reforming the system to exempt all repatriated dividends from Canadian tax, see Angelo Nikolakakis, "Exempt Surplus: What's the Problem? A Reply to Brian Arnold" (2002) 50(4) Can. Tax J. 1354 at 1370, concluding that a full hybrid exemption system is preferable in part because "there is not much difference between having no-treaty-country requirement and having a treaty with virtually every relevant foreign jurisdiction."

4.2.1 Reducing tax complexity

At over 2,000 pages, Canada's Income Tax Act is without question the most complex statutory scheme in the country. In an earlier review of Canada's tax rules governing outbound direct investment, we maintained that this system is the most technically complex part of Canadian tax law.[91] In other words, the legal regime surrounding this system arguably provides for the most technically complex laws in Canada. By way of crude example, a portion of the rules within Canada's hybrid exemption tax system (found within section 95 of the ITA that sets out the FAPI rules), along with proposed amendments, supporting rules and Department of Finance comfort letters goes on for 162 single-spaced pages.[92] In comparison, the entire Canada Business Corporation Act, itself a fairly complex statutory regime, is 128 single-spaced pages long.[93]

The complexity of the outbound tax system is attributable to the fact that the foreign affiliate system adopts numerous terms, deeming rules, and notional accounting rules to implement the underlying policies and principles. Despite its simple objectives, the foreign affiliate system depends on elaborate tracking mechanisms with respect to income of foreign affiliates and persons who are, from time to time, their shareholders. The purpose of this tracking is, among other things, to ensure that shareholders are taxed to an appropriate extent on FAPI as it is earned, that when distributions are made previously taxed FAPI is not further included in income and subject to taxation, that active business earnings that are exempt continue to be available, as a pool, to support distributions to shareholders who were shareholders of the foreign affiliate when the income was earned and finally that underlying tax borne by taxable earnings is fully creditable against the Canadian tax liability that would otherwise arise when taxable surplus distributions in the form of dividends are made to Canadian shareholders.

The rules also reflect the fact that a shareholder's ownership in a foreign affiliate may be altered by reorganizations of interests in the foreign affiliate, such as share-for-share exchanges of foreign affiliate shares for other foreign affiliate shares, windings up, amalgamations and other mergers of foreign affiliates, infusions of new capital in foreign affiliates and other changes. A number of complex changes to the ITA are proposed as part of continuing amendments to the foreign affiliate system (see below). The effect of these changes is expected to expand the circumstances in which corporate reorganizations may take place without generating FAPI but also to limit the circumstances in which internal reorganizations of property and undertakings by foreign affiliates can create additions to exempt surplus that can be used to reduce Canadian tax on what would otherwise be taxable distributions to Canadian shareholders.

91 See International Taxation, supra note 5 at 203.

92 See Tax Net Pro, s. 95 — Determination of certain components of foreign accrual property income, including amendments in Bill C-10 (Second Senate Reading, Dec. 4, 2007) online: www.taxnetpro.com.

93 See Consolidated Canada Business Corporations Act and Regulations (Toronto: Carswell, 2004).

Elaborate analysis and criticism of the system have been issued by a number of observers.[94] A summary of these views suggests that the complexity of Canada's hybrid exemption system raises the following policy concerns:

(a) *Over-inclusive tax rules*: Because the rules are so complex, they may at times sweep into the tax net foreign source income that the rules arguably never intended to catch. If this is the case, Canadian taxpayers will pay an "unfair" (that is, unintended when the tax laws were initially put in place) amount of tax, potentially discouraging international investments and operations. Moreover, the complexity may lead to double taxation, again discouraging outward direct investment.

(b) *Under-inclusive tax rules*: The complex rules may be encouraging aggressive avoidance strategies that take advantage of the interpretational ambiguities within the rules. For example, multinational firms engage in tax planning to reduce the nominal amount of taxable surplus that is repatriated to Canada and is subject to tax (see Sections 2.4.1 and 4.2.3). The "return" on maintaining the taxable surplus rules appears to be quite low (or nil) for the Canadian government.

(c) *High compliance costs*: The complex rules promote high compliance costs for taxpayers who must pay tax advisors to ensure that they are complying with all relevant tax laws.

(d) *High enforcement costs*: The CRA must devote significant resources to try to enforce the system. For example, the most recent round of proposed technical amendments to the foreign affiliate system began in 2002 (with more reforms introduced in 2004), and are ongoing to this day. This lengthy reform process promotes planning uncertainty and raises enforcement costs for the CRA and compliance costs for taxpayers who must account for both the current rules as well as proposed rules that may have a retroactive effect.

In summary, Canadian rules governing outbound direct investments could be simplified by abolishing the taxable surplus concept. The most significant reduction in complexity will be related to the removal of the need to calculate surplus amounts pursuant to Part LIX of the Regulations. While there would remain a need to properly measure domestic and foreign source income as well as active and passive forms of this income, in many circumstances these measurements will be accomplished more directly by using the accounting and legal rules in place in countries where Canadian foreign affiliates are based. The CRA has accepted earlier case law pronouncements where foreign law determines whether a proper dividend was issued by foreign affiliates and only in the absence of such foreign law Canadian legal views apply (that is, the need for a pro rata distribution of profits among shareholders).[95]

Abolishing taxable surplus would move the Canadian system more formally to a full hybrid tax exemption system that seeks to exempt from tax all foreign sources of active business income. As subsequently discussed, the new TIEA rules afford some protection to the tax base

94 See, e.g., Eric Lockwood, Michael J. Maikawa and Nick Pantaleo, "Proposed Technical Amendments to the FAPI and Foreign Affiliate Rules" (2000) 48 Can. Tax J. 456; Brian J. Arnold, "An Analysis of the 1994 Amendments to the FAPI and Foreign Affiliate Rules" (1994) 42 Can. Tax J. 993.

95 See, for example, *Cangro Resources Ltd. (in Liquidation) v. MNR*, 67 DTC 582 (TAB).

should taxable surplus be abolished. Additional reforms that could protect the tax base include revised minimal participation thresholds for the dividend exemption (see Section 4.3.1), more formalized expense allocation rules (see Section 4.3.3), and revamped anti-avoidance rules (see Section 4.4) along with certain other steps such as increased cooperation between the CRA and foreign tax authorities (see Section 4.5.4).

Even without taking these additional reform steps, the abolishment of taxable surplus would simplify and streamline the foreign affiliate system to a significant extent. FAPI could remain taxable on a current basis (with relief for foreign taxes paid on such income) while all foreign source active business income (essentially exempt surplus) would be exempt from Canadian tax whether or not it was repatriated by way of dividend. This could be accomplished by maintaining most of the other existing features of the foreign affiliate system although certain aspects such as participation thresholds in foreign affiliates to trigger the tax exemption may need to be revised (see Table 2).

Table 2

Reform Option Summary: Abolishing Taxable Surplus Only

Exemption from Canadian tax:	All foreign source active business income and, potentially, related capital gains from share sales, regardless of jurisdiction
Subject to Canadian accrual taxation:	Foreign accrual property income (FAPI)

4.2.2 Protecting the Tax Base with TIEAs

The fact that the intent of the modern system has been undermined by an expanding treaty network may have called for a new approach to taxing foreign source income. In its Notice of Ways and Means motion that introduced the new tax laws to link TIEAs to the exempt surplus regime, the government noted that: "This will give Canadian firms more scope to expand internationally, especially into new and emerging markets, without our tax system imposing additional costs that could reduce their competitiveness, while also maintaining tax fairness. It will also encourage non-treaty jurisdictions to join in the efforts of Canada and our treaty partners to control international tax evasion."[96] Enhanced tax information exchanges, it was thought, would assist with enforcing the new rules that sought to trace interest and other deductions to the earning of exempt foreign source income. This perspective is consistent with the ongoing work of the OECD to encourage heightened information sharing to inhibit aggressive international tax avoidance as well as tax evasion.[97] The following analysis discusses how broader access to dividend exemptions raises the risk of revenue losses resulting from tax planning involving tax havens as well as ways to address this risk through, among other things, accrual taxation of foreign profits based in "non-qualifying" (or "blacklist") countries that refuse to cooperate with TIEA negotiations.

96 See Canada, Department of Finance, *The Budget Plan 2007* (Ottawa: Queen's Printer, March 19, 2007), "Foreign-Source Business Income: Exempt Surplus", at 243.

97 See, e.g., OECD, *Tax Co-operation: Towards a Level Playing Field: 2006 Assessment by the Global Forum* (Paris: OECD, 2006).

Tax havens and the risk of revenue losses

If the government decides to abolish taxable surplus (or negotiate TIEAs), the main risk to the Canadian tax base appears to arise from the fact that Canadian corporations are permitted interest deductions for the financing of shares in foreign affiliates that generate exempt foreign source income. In addition, other tax planning strategies with foreign affiliates based in tax havens may contribute to revenues losses. Perhaps more importantly, TIEAs could assist with inhibiting tax evasion through international portfolio investments by Canadian individuals as there is evidence that these individuals are increasingly illegally shifting their income to tax havens without disclosing these accounts to the CRA.[98]

The TIEA proposal, however, appears to have been linked with the outbound direct investment tax rules: in both the 2007 federal budget as well as the Notice of Ways and Means motion introducing the new tax laws, the TIEA proposals were linked to earlier efforts to inhibit any interest deduction related to generating foreign source income that is exempt from Canadian tax: "The resolution of the problems around the deductibility of interest used to fund untaxed income provides an opportunity to de-link the exemption from the presence of a tax treaty."[99] As subsequently discussed, the federal government eventually amended this interest deduction proposal so that the new tax laws only inhibit deductions that are part of double dip and certain other cross-border tax structures (see Section 4.3.5). While the government has altered its policy with respect to interest deductions, it has not yet revisited the TIEA proposals that were linked to the earlier approach.

Should the government proceed with TIEA negotiations (or reforms to promote a full hybrid tax exemption system), a danger of revenue loss arises as a result of "single dips" that continue to permit Canadian residents to take interest deductions for payments to foreign affiliates that result in exempt foreign source income. The need for a treaty partner previously inhibited, at least to a certain extent, single dips to finance foreign ventures. Now the gate would be left more open, and Canadian corporate taxpayers can pick and choose the most favourable tax haven (for example, one with a zero corporate income tax rate and a lax financial regulatory regime) to act as a base for a financing affiliate.

In addition to these interest deductions, extending the dividend exemption to all foreign source active business income may provide incentives for Canadian residents to engage in other forms of tax planning that lead to revenue losses. The Canadian experience with its treaty with the Barbados is instructive. While the Barbados is technically a low tax jurisdiction and not a tax haven (due to its corporate income tax rate of up to 2.5 percent), the Canada-Barbados treaty has been a popular planning device for many Canadian-based multinationals as well as for individual Canadians. As noted, the Barbados is now the third largest destination for Canadian outbound direct investment after the United States and the United Kingdom: Canadian multinational firms sometimes use the Barbados as a base for holding companies for related businesses located in other foreign countries where the firms engage in value-adding economic activities. The Auditor General of Canada reviewed in her 2001 report several different planning

98 See, for example, Karen Howlett and Paul Waldie, "Lure of Tax Havens Proving Irresistible", *The Globe and Mail* (June 9, 2003), at B1 (citing a study that indicates Canadians invested in 2001 an estimated $44.6 billion in tax haven countries, which represents an 891-percent increase from 1988).

99 Ibid.

structures between Canadian and Barbadian foreign affiliates that led to significant revenue losses to the Canadian treasury (see Sections 2.5.1 and 4.5.1). As a result of this report as well as other government reports, the CRA formed a special international tax audit branch called the Barbados Project that focuses in part on reviewing public records to determine whether Canadians act as directors for Barbadian companies.

As previously discussed, outbound direct investment appears to be increasingly accomplished through cross-border planning structures that deploy foreign affiliates based in low or nil tax jurisdictions such as the Barbados, the Bahamas, Bermuda and the Cayman Islands (see Section 2.5.1).

To promote compliance and to protect the tax base, Canadian residents with outbound direct investments could be subjected to new documentation requirements that force them to more fully disclose foreign earnings: TIEAs could assist with determining whether inaccurate reporting has taken place. An idea discussed elsewhere is to require these residents to file with their tax return a schedule disclosing their consolidated worldwide revenues and income before taxes, as reported in the firms' financial statements: the schedule will additionally disclose the proportion of domestic and foreign source revenues and income.[100] In addition, resident firms could be required to reconcile the consolidated revenues and income reported on their financial statements with the taxable income reported on their tax returns. This approach could also assist with CRA audits of transfer pricing practices (see Section 4.5.1). A drawback of this approach is that it might increase compliance costs for taxpayers as current laws do not mandate consolidated reporting.[101] On the other hand, medium- and large-sized multinational firms should presumably already be preparing this reporting for internal management purposes to determine whether their international investments are generating expected returns. Accordingly, the rule could provide for a de minimis exemption for firms with, say, less than $1 million in global revenues.

As we will now turn to, the new TIEA laws may help to inhibit abuses although tax information exchanges with tax havens can often be problematic.[102]

Inhibiting tax planning abuses with TIEA partners

Effective tax information exchange involves two elements: an efficient and fair sharing of tax information among two or more tax authorities.[103] Efficient sharing entails tax rules that promote low compliance costs for taxpayers and ease of administration and enforcement by tax authorities. Fair sharing respects the rights of taxpayers, including privacy rights, solicitor/client confidentiality rights and rights to maintain trade secrets, when tax information is transferred across borders. This is of particular importance in the digital era when Canadians worry about the privacy implications surrounding electronic cross-border transfers of their personal

100 See Report of the President's Advisory Panel, supra note 34 at 244.

101 It bears mentioning that current tax laws nevertheless appear to accept limited consolidation of global earnings by permitting intra-group trading in certain circumstances (see Section 4.3.4).

102 For background, see Sara K. McCracken, "Going, Going, Gone … Global: A Canadian Perspective on International Tax Administration Issues in the "Exchange-of-Information Age"" (2002) 50 Can. Tax J. 1869; Michael Keen and Jenny E. Lithgart, "Information Sharing and International Taxation: A Primer" (2006) 13(1) International Tax and Public Finance 81.

103 See Arthur J. Cockfield, "Protecting Taxpayer Privacy Rights under Enhanced Cross-border Tax Information Exchanges: Toward a Multilateral Taxpayer Bill of Rights" (Draft, 2008).

information.[104] Critics of the OECD emphasis on TIEAs suggest that tax information sharing between developed countries and tax havens (or developing countries) has not worked well in the past.[105] Before the Canadian government proceeds with negotiating TIEAs and extending dividend exemptions based in TIEA partners, it will need to develop laws and policies to promote the effective sharing of tax information.

Recharacterizing non-TIEA income in blacklist countries

If Canada negotiates a TIEA and imposes obligations on another country without extending any reciprocal benefits, the TIEA partner may only pay lip service to the agreement and refuse to meaningfully enforce it. While TIEAs do not typically contemplate the exchange of reciprocal benefits (unlike tax treaties), the Canadian government should explore ways to offer "carrots" to TIEA partners to encourage cooperation and enforcement of the agreement.

In fact, the current rules contain an incentive for the effective exchange of cross-border tax information. Under these rules, when the Canadian government approaches a foreign government and requests the negotiation of a TIEA, a deadline of five years is imposed on the negotiation process. If the parties are unable to reach agreement then income generated within foreign affiliates based in the ostensible TIEA partner will not be allocated to exempt surplus, but will rather be drawn from taxable surplus and hence subject to current Canadian tax along with foreign tax credits. New rules may also need to be introduced to account for this recharacterization process so that previously untaxed amounts will be taxed once a foreign country is blacklisted. Supporting rules may need to be developed to prevent abuse where foreign affiliates are wrapped-up or continued in other countries prior to a determination of the appropriate tax treatment of income generated within the foreign affiliates.

Should the government abolish taxable surplus, it should consider aggressively pursuing TIEA agreements. Non-cooperative foreign countries will be sanctioned in the sense that these countries will not be eligible to attract Canadian tax benefits associated with the exemption system: assuming taxable surplus is abolished, the income should be treated as passive in nature (under FAPI or a merged system for passive foreign source income) and taxed on a current basis. In other words, the new TIEA laws envision a kind of blacklist for uncooperative tax havens (the new tax laws use the appropriately polite Canadian term "non-qualifying countries"). A similar approach is to be deployed by Italy: under a 2008 budget proposal, the dividend exemption regime will apply (and the CFC regime will not apply) if: (a) there is an effective exchange of tax information; and (b) the CFC is based in a white list country with a "non-noticeably lower level of taxation" although specific criteria has not yet been enacted (see Section 3.1).

104 From 2004 to 2006, the Queen's Surveillance Project, acting through the Globalization of Personal Data project, prepared and commissioned an international survey of over 7,000 residents of eight countries (Canada, the United States, China, France, Spain, Hungary, Mexico and Brazil). A majority of Canadians polled expressed privacy concerns in a number of different areas, including when personal information is transferred across borders. See Ipsos Reid, "Summary Report: Globalization of Personal Data International Survey" (Nov. 2006), online: Queen's University www.queensu.ca/sociology/Surveillance/?q=research/intl_survey.

105 See Alex Easson, "Harmful Tax Competition: An Evaluation of the OECD Initiative" (2004) 38 Tax Notes International 1037. See also United States, Department of Treasury, *IRS Revenue Bulletin 2007-18* (Washington: Government Printing Office, April 30, 2007), discussing problems associated with the U.S.-Cayman Islands TIEA.

Another policy concern results from the uncertainty surrounding the potential negotiation of qualifying TIEAs with Canada: this uncertainty may make certain Canadian firms more reluctant to create cross-border structures involving business entities based in potential TIEA partners, possibly inhibiting some outbound direct investment. The five year countdown may enhance planning uncertainty as years may go by before a recharacterization takes place (or not) along with potentially significant tax bills for Canadian residents. It may also be difficult to recapture untaxed amounts that will be subject to taxation after the five year countdown is over, assuming the recharacterization takes place. A shorter countdown period of, say, one to three years may be preferable.

Joint audits and scrutiny of foreign legal system and government practices

Assuming a foreign government is willing to enter into a comprehensive TIEA with Canada, steps will need to be taken to ensure that the provisions within the TIEA will be enforced in a meaningful way by the foreign tax authorities.

Tax havens and other developing countries may not have income tax systems and hence there is no record-keeping requirement. In particular, there may not be any law that mandates the collection of relevant information by financial intermediaries. To encourage effective sharing, TIEA partners must adopt laws to force financial institutions to provide information to the foreign government, which is contrary to the bank secrecy laws that are often legislated by tax haven governments (for example, it may be a criminal offence for a bank employee to divulge confidential financial information to any third parties).

Assuming the TIEA partners have adopted transparency laws for their tax regimes, reforms to Canadian tax laws could also call for the need for the CRA to audit the TIEA partners' law, policies and practices to see whether effective sharing is taking place (or will take place). A country that failed this audit, even after a TIEA was entered into, would not enjoy the benefits associated with Canada's exemption system and could be added to the blacklist.

Another possible approach would involve the insertion of a provision in the TIEA that contemplates significant cooperation between the CRA and the TIEA partner's tax authorities, including joint audits and permitting tax examiners to depose witnesses in each other's country. The 2007 Fifth Protocol changes to the Canada-United States tax treaty provisions surrounding administrative cooperation could serve as a template for this approach (see Section 4.5.4).

Miscellaneous TIEA provisions to support effective sharing

In 2002, the OECD developed a non-binding model tax information exchange agreement (the "OECD model TIEA") to encourage transparency and to set standards for the exchange of this information: this model treaty can serve as a starting point to develop a model TIEA for Canadian purposes. In some cases, this model may be inappropriate. For instance, a typical exchange of information provision within a Canadian tax treaty contemplates three types of information exchange: on request, spontaneous and ongoing. To protect against so-called fishing expeditions, the OECD model TIEA only contemplates the exchange of tax information on specific request with an identifiable taxpayer — this approach may unduly inhibit efficient exchanges.

While elaborate analysis of appropriate provisions is beyond the scope of this report, the following sets out a few thoughts for consideration. To support effective sharing, TIEAs should include provisions that: (a) expand coverage to different types and levels (e.g., subnational) of taxes; (b) do not contemplate "dual criminality" (i.e., provisions that indicate tax information exchanges will only take place if the conduct being investigated, and which gives rise to the information request, would constitute a crime under the laws of the requested country); (c) do not contemplate the need for a "domestic tax interest" (i.e., situations where the requested country will only provide tax information that it normally collects for its own domestic tax purposes); (d) tie into existing multilateral agreements such as the Council of Europe and OECD *Convention for the Mutual Assistance in Tax Administration*; (e) require Canadian resident taxpayers to disclose their taxpayer identification numbers to foreign tax authorities (i.e., the Business Identification Number for business taxpayers and the Social Insurance Number for individual taxpayers) so that the CRA can identify resident taxpayers with investments in TIEA partners; and (f) protect privacy and other taxpayer rights enjoyed by Canadians (and set out within the CRA's *Taxpayer Bill of Rights*) when their tax information is transferred to foreign governments.

4.2.3 Maintaining revenue neutrality

As part of its mandate, the Advisory Panel plans to account for the revenue implications of possible reform efforts (see Section 1.2). As previously touched on, Canada's current hybrid exemption tax system collects few to no tax revenues from taxing outbound direct investment (see Section 2.4.1). In 2005, $1.3 billion in taxable dividends were distributed by foreign affiliates to their Canadian parent companies. Using available data, the Department of Finance was unable to measure whether any Canadian taxes were owed on these distributions. Because the Canadian parents are eligible for foreign tax credits for these remitted dividends, it is likely that few to no taxes were paid on the remittances (in part because tax planning would generally call for no distributions unless and until any potential Canadian taxes owed can be "soaked up" by foreign tax credits). To the extent that the current regime is discouraging Canadian parents from repatriating funds, abolishing taxable surplus could foster domestic economic growth as these parent companies would more likely bring back the monies for investment in their Canadian business operations.

Assuming (unrealistically) that the remitted dividends were fully taxed at a combined federal/provincial corporate income tax rate of 30 percent, Canada collected at most $390 million through this system. By comparison, the Canadian corporate income tax system raised roughly $30 billion in the 2004/2005 fiscal year. The Canadian withholding tax imposed on parent/subsidiary (direct) dividends from Canadian corporations to their U.S. affiliates collected roughly $1 billion in revenues in 2005.[106]

106 See Consultation Report, supra note 2 at 39.

There appears to be few tax dollars at risk should taxable surplus be abolished. The most likely scenario is that this reform will be revenue neutral and will not create new tax bills or savings for most multinational taxpayers based in Canada.

There are at least two counter-arguments to this perspective. First, the current rules may be defective and permit too much leakage from amounts that should be otherwise allocated to taxable surplus: the proposed amended rules that seek to inhibit the use of certain inter-affiliate transactions to generate exempt surplus may, under this view, work more effectively resulting in the collection of more tax revenues. Given the reality of the ongoing "cat and mouse game" whereby the CRA and the Department of Finance react to perceived loopholes exploited by a taxpayer's planning strategies, it seems unlikely that the new rules will materially enhance revenues: the more likely scenario is that any new rules will, at best, forestall possible revenue losses associated with this tax planning.

A second counter-argument is that, while taxable surplus does not bring in any material revenues, the system serves to protect the domestic tax base against possible erosion as it only extends the dividend exemption to treaty partners (as no TIEAs have been negotiated to date). Abandoning taxable surplus, under this view, will open up more avenues for aggressive tax avoidance that will lead to negative taxes being increasingly imposed on foreign source income along with additional revenue losses. As discussed in the preceding section, this second point carries more weight and prospective tax reform will need to plug any new "holes" that are opened up by abandoning taxable surplus.

4.3 Moving to a streamlined full hybrid tax exemption system

This section discusses guiding principles as well as the basic elements of a full hybrid exemption tax system, which is a system that seeks to exempt all active business foreign source income from tax while taxing on a current basis all other foreign sources of income.

4.3.1 Guiding principles revisited: the zero tax rate principle

Should the Canadian government proceed toward a full hybrid exemption tax system, a possible guiding principle would be to structure the system so that foreign source active business income is subject to, effectively, a zero tax rate, but not a negative or positive rate (the "zero tax rate principle"). A negative tax results from situations where tax rules permit cross-border structures that allow the material reduction of Canadian tax on the portion of domestic source income from an international transaction: in other words, the tax rules that govern foreign source income derived by outbound direct investment actually reduce the tax burden on domestic source income in a significant way. This outcome does not generally occur when Canadian residents deduct expenses for intra-group payments that are subjected to comparable tax by trade and investment partners as the active business generally takes place in foreign jurisdictions that impose comparable corporate income taxes. The zero tax rate principle, however, will be violated when an expense is deducted in Canada to generate exempt foreign source active business income that is never subjected to tax (or subjected to

a very low tax rate) by a foreign government (for example, the inter-affiliate financing exception recharacterizes passive interest income to be tax exempt dividend income and thus violates the zero tax rate principle: see Section 4.3.5).[107]

The zero tax rate principle is supported by the traditional tax policy goal of pursuing capital import neutrality (CIN) with respect to the tax treatment of outbound direct investment so that firms can compete in foreign markets on a level tax playing field: under this view, negative or positive rates on foreign source income distort investment decision-making in a way that is considered to be economically inefficient as it would encourage Canadian entrepreneurs, investors and other risk-takers to divert their resources across borders for tax reasons instead of trying to beat their domestic and foreign competitors by, say, building better widgets (see Sections 2.2 and 2.4.3). A tax system that interferes as little as possible with these cross-border investment decisions should integrate the Canadian economy to a greater extent with the global economy and promote long term economic growth.

A review of the hybrid exemption tax systems in Part 3 suggests that such a system should be comprised of the following elements:

(a) a tax exemption for repatriated dividends from foreign affiliates (following the policy goal of CIN);

(b) a tax exemption or partial tax exemption for sales of shares of foreign affiliates (following the policy goal of CIN);

(c) accrual taxation of foreign source passive income (following the policy goal of capital export neutrality or CEN);

(d) allocation and transfer pricing rules to restrict resident country deductions for foreign source exempt income to ones that approximate arm's-length market transactions;

(e) anti-avoidance rules to guard against attempts to blur the boundary between foreign source active business and foreign source passive income;

(f) base erosion rules to protect against attempts to ostensibly produce foreign source active business income with minimal economic activity to shift profits out of the residence country; and

(g) access to tax information provided to, or derived from, foreign governments to assist with audits of resident taxpayers.

107 For example, under the intra-group trading provisions, Canadian residents are permitted to take deductions for certain properties traded among related affiliates — a foreign affiliate could be based in a country with an effective corporate income tax rate that is lower than the Canadian rate, hence generating an overall tax savings by deducting the expense in Canada with its relatively higher rate, but this outcome will not violate the zero rate principle as it will not generally lead to a significant reduction in domestic tax revenues (see Section 4.3.4). As long as countries maintain different tax rates and tax bases, complete neutrality with respect to the tax treatment of cross-border payments is not possible (see Section 2.2).

4.3.2 Treatment of repatriated dividends

Countries that deploy hybrid exemption tax systems incorporate tax rules to ensure that only qualifying investments in foreign corporations will be exempt from domestic tax.

In Canada, the dividends regime as well as the exempt surplus rules apply only to foreign affiliates. A "foreign affiliate" of the Canadian shareholder means, generally, that the Canadian resident, alone or together with other related persons (who may not be Canadian residents), must own at least 10 percent of the shares of a class or series of the foreign corporation and the Canadian resident, itself, generally must own one percent.[108] The shareholder may be an individual, a corporation or any other person or organization that is recognized for purposes of computing income under the ITA, including a partnership.

As a number of observers have noted, this participation threshold is low when compared with counterparts in many other countries.[109] First, most hybrid exemption tax systems require ownership of voting shares (such as common shares) and not just any class of equity. For example, Canadian shareholders can purchase preferred shares in foreign affiliates, which may not provide any control over the foreign affiliate:[110] while technically an equity instrument, preferred shares resemble debt instruments in that they often grant holders the right to a fixed return.

Second, the one-percent Canadian ownership threshold is comparatively less than certain trade partners (see Section 3.2. and Table 1). For example, Australia and Sweden require at least 10-percent ownership of voting shares. France requires at least five percent of voting shares and capital while the Netherlands requires at least five-percent ownership of the paid-up capital of the foreign shares.

In contrast, Italy does not maintain any participation threshold although, as mentioned, dividends distributed from related corporations based in blacklist countries will not be exempt from Italian tax. In addition, Germany does not maintain any participation threshold for exemption from its federal tax although there is a requirement of 15-percent ownership of the share capital of the foreign affiliate for exemption from the municipal tax (which carries tax rates that approximate or exceed most Canadian provinces).

Should Canada move toward a full hybrid exemption tax system, the government may need to revise the participation threshold. If Canada plans to aggressively negotiate TIEAs along with a blacklist of non-cooperative tax havens, one could argue that the existing threshold will suffice because dividends distributed from foreign affiliates located in blacklist countries will not qualify for the dividend exemption.

108 See s. 95(1) of the ITA.

109 See, e.g., Technical Committee on Business Taxation report, supra note 81, at 6.10.

110 Certain classes of preferred shares provide for indirect control by allowing the preferred shareholders to vote for (and replace) directors of foreign affiliates when the affiliates do not distribute their preferred dividends by stipulated dates.

Given the traditionally low threshold in Canada, another view could maintain that a requirement of five percent of voting shares and/or share capital may be appropriate as this relatively low threshold would still represent a significant increase. Alternatively, a higher requirement of, say, 10 percent of voting shares and/or share capital may provide greater protection against tax base erosion, and would arguably better reflect situations where Canadian shareholders can exert at least some control over their foreign affiliates. This higher threshold could be linked to the application of the FAPI regime (see Section 4.4.2).

4.3.3 Treatment of sales of shares of foreign affiliates

Examining reform options

There are three general approaches deployed by governments to tax the sales of shares of related foreign corporations (see Part 3 and Table 1). First, governments (such as Japan and the United States) can fully tax any capital gains that results from such sales. Second, governments can provide limited capital gains relief to the extent that the related foreign corporation has undistributed profits. Third, governments can exempt from tax any such capital gains under certain conditions such as the related foreign corporation was engaged in the conduct of an active business: eight of the 10 selected countries appear to deploy this approach.

Canada deploys the second approach. Under the Canadian approach, when a resident corporation sells shares in a foreign affiliate, it generally must pay tax on any capital gains attributable to appreciation in the shares. Relief, however, is provided to the extent the foreign affiliate has undistributed exempt surplus (i.e., mainly accumulated profits derived from the pursuit of an active business): the capital gain will be reduced to the extent of these profits.[111] The rules were designed in part to recognize the fact there may be situations where the affiliate cannot repatriate this exempt surplus through dividends prior to the sale of the shares (for example, the foreign affiliate may not have sufficient cash on hand to pay out the dividends).

The realistic reform alternatives for Canada are to either maintain the current rules or create new rules that provide for an exemption of capital gains from sales of foreign affiliate shares to the extent that all or substantially all of the assets of the foreign affiliate were deployed in an active business.

Advantages of exempting capital gains

By moving toward the second regime, a certain amount of simplification could be achieved. As noted by the Technical Committee on Business Taxation, if the current capital gains system was maintained under a full hybrid exemption system then either something similar to the taxable surplus rules would need to be maintained or anti-earnings stripping rules would need to be developed to discourage capital gains from being converted into exempt dividends.[112] If the exemption were restricted to sales of shares of foreign affiliates carrying on an active business,

111 See s. 93 of the ITA.

112 See Report of the Technical Committee, supra note 81, at 6.8-6.9.

rules would need to be developed to inhibit situations where the exemption improperly results from situations where the foreign affiliate's underlying business is really of a passive or mixed passive/active nature.

To promote more consistent practices with its competitor nations, Canada could develop rules so that the sales of foreign affiliates carrying on active business will be exempt from Canadian tax.[113] This reform would make the Canadian outbound direct investment tax regime more internally consistent as it would promote capital import neutrality (CIN) to a greater extent, which is consistent with the view that foreign source active business income should be taxed on this basis (see Section 4.3.1). Under conventional finance theory, a share price reflects the present value of the firm's expected future profits.[114] As long as the firm is engaged in an active business then the entire share price should reflect expected future active business income, which should call for the same tax relief as provided to dividends distributed by the foreign affiliate to its Canadian corporate affiliate. Accordingly, exempting the sales of shares of foreign affiliates from capital gains tax would reduce distortions caused by the current inconsistent tax treatment and would better enable Canadian resident firms to expand abroad. In addition, by removing the capital gains tax, Canadian firms may be more willing to sell shares in their foreign affiliates, potentially using the monies derived from these gains to fund domestic business operations, which in turn should promote domestic economic growth.

Disadvantages of exempting capital gains

The capital gains exemption, however, raises certain policy concerns. Like the exemption of any foreign sources of income from Canadian tax, this capital gains relief for the sale of foreign shares would violate horizontal and vertical equity because the sale of shares for domestic firms is generally taxed (see Sections 2.2, 2.3.1 and 2.3.2). Moreover, this capital gains relief will violate the principle of capital export neutrality (CEN) by providing for a lighter tax burden on foreign source income when compared to domestic source income: this may encourage investment in businesses outside of Canada as subsequent sales of these businesses will attract the tax break. As discussed, CEN may not be an appropriate guiding principle for the taxation of outbound direct investment within an exemption tax system (see Sections 2.2 and 4.3.1).

Let us bring back, for a moment, our standard for the reasonable Canadian taxpayer — the woman on the Ajax GO Train — to hear how she might react to this reform effort (see Section 2.3.2). If the woman on the Ajax GO Train owns a large Canadian business she would not be pleased by this development. As an entrepreneur and risk-taker, she will wonder why the Canadian government wants to provide tax breaks to owners of foreign corporations. She may not find arguments about tax competitiveness particularly persuasive as she will wonder how this reform is helping her compete against her own domestic and foreign business competitors.

113 The Canadian rules, under the proposed amendments, already envision a similar approach when a foreign affiliate sells shares in another foreign affiliate. Excluded property includes capital gains resulting from the foreign affiliate's sale of shares of corporations, all or substantially all of the property of which is excluded property — in other words like corporations engaged in an active business. The rules, however, only permit deferral of the capital gains tax arising from such sales.

114 See, for example, William A. Klein and John C. Coffee, Jr., *Business Organization and Finance: Legal and Economic Principles* (New York: Foundation Press, 2nd ed., 2000), at 314.

There are several possible responses to these concerns. First, the sale of shares in small Canadian businesses is already free of capital gains tax of up to $750,000 (for sales of shares of "qualifying small business corporations") and Canadian small business corporations are subject to reduced corporate income tax rates (the 2008 federal rate is 11 percent on the first $400,000 of active business income): the woman from the Ajax GO Train may have benefited from this tax subsidy to help grow her business (or an earlier business). Second, the Canadian tax system contains a number of rules that favour investors in Canadian businesses (and discriminate against owners of foreign businesses), which may have already benefited her.[115]

Third, it is unclear whether Canadian residents are paying significant capital gains tax on the sale of shares of their foreign affiliates: by engaging in tax planning (such as merging the foreign affiliate with another so that any accrued gains are "rolled-over" and, at times, can be repatriated on a tax exempt basis out of the newly-merged foreign affiliate's exempt surplus account), Canadian firms structure their activities in such a way to avoid paying this tax, effectively permitting them to receive the same tax relief as occurs under the exemption regimes of the eight selected countries. There does not appear to be any reliable estimate of revenues collected, if any, on sales of shares in foreign affiliates. To the extent that the current regime does not raise material capital gain tax revenues, it calls into question the need for the current approach or, alternatively, calls for reforms to achieve the apparent objective of the current rules. On the other hand, if firms are currently engaging in tax planning to achieve, effectively, capital gains exemptions on the sales of their foreign affiliates then broadening the exemption will not materially affect their behaviour. If this is the case, it calls for maintaining the current regime because providing full capital gains relief will not change cross-border investment decision-making while potentially opening up avenues to avoid payment of Canadian taxes.

Other possible reforms

To provide the woman on the Ajax GO Train with further assurances, a rule could be designed to permit an exemption of Canadian capital gains taxes only to the extent that the sale attracted a minimal level of taxation elsewhere: as suggested below a possible solution would be to create a rule that mandated a foreign taxation level of say at least half of the Canadian tax rate to be eligible for the full Canadian tax exemption (see Section 4.4.5). Alternatively, rules could specify that a certain percentage of the capital gain will remain taxed in Canada: Germany, France and Italy provide for the taxation of five percent of the capital gain. In addition, the Canadian government could review ways to provide more relief for the sale of shares in Canadian domestic businesses to reduce equity and efficiency concerns. For example, a Nordic-like tax system that provides tax relief for investment income, including capital gains, could further reduce the capital gains burden on sales of domestic and foreign shares.[116]

115 See Brian J. Arnold, *Tax Discrimination Against Aliens, Non-Residents and Foreign Activities: Canada, Australia, New Zealand, the United Kingdom, and the United States* (Toronto: Canadian Tax Foundation Canadian Tax Paper No. 90, 1991), noting that the Canadian system imposes more discriminatory tax treatment against foreign investors when compared to the selected countries.

116 For a discussion of this approach, see Boadway, supra note 59.

4.3.4 Deductions for expenses other than interest

Because all foreign source active business income will be exempt from Canadian taxation under a full hybrid exemption tax system, there may be a need to strengthen the tax rules that try to inhibit the ability of taxpayers to deduct related company expenses in Canada to shift domestic source income to foreign source income. The ITA contains fairly informal "source rules" that try to determine where income and deductions should take place. For Canadian residents, source rules also set limits on the availability of foreign tax credits as well as the application of certain anti-avoidance rules.

Active business income is generally sourced to the jurisdiction where the economic activities took place that gave rise to this income. For passive income, the source of income is generally allocated to the residence of the person paying the income: the payer's residence is used as a proxy for the economic activities that generates this passive income. With respect to this passive income, there are additional rules — base erosion tests — that seek to ensure that passive income is allocated to the proper jurisdiction. Under these tests, the source of interest, rents and royalties is determined by the country whose tax base is eroded by the payer's deductions of the payments in computing taxable income.[117]

With respect to the deduction for expenses (other than interest) Canada could pursue one of several avenues (see Section 3.1 and Table 1):

(a) denial of all expense deductions that result in exempt foreign income;

(b) permit all deductions without restrictions;

(c) permit full intra-group deductions along with anti-avoidance rules to try to ensure that there is a corresponding inclusion of the expense in the revenues of the foreign affiliate engaged in an active business (which would generally occur within a country with a comparable tax system); or

(d) permit deductions, but restrict availability of the dividend exemption (France, Italy, and Germany permit 95 percent of the dividend to be free of domestic tax).

Canada currently deploys the third option as rules permit intra-group trading of certain expenses like rents, royalties and interest by deeming this income that would otherwise be FAPI to be active business income of the recipient affiliate because it is received from another member of a corporate group that deducts the payment from its active business income.[118] The fourth option is more straightforward, but arbitrarily taxes a percentage of remitted dividends even if all of the expense deductions went toward active business operations in high tax foreign countries.

117 For example, the payment of interest by a Canadian branch of a foreign bank is treated as domestic source income even though the payer is a non-resident. See s. 212(13.3) of the ITA. In another example, the payments of rents, royalties and interest paid by any non-resident person who deducts the payments in computing taxable income from business activities in Canada are deemed to be paid by a Canadian resident, and thus create domestic source income. See s. 212(13.2) of the ITA.

118 See s. 95(2)(a) of the ITA.

In addition, special rules may need to be developed to ensure that overhead fees are properly allocated between the Canadian multinational firm and its foreign affiliates. The rules could disallow overhead deductions to the Canadian firm to the extent they exceed a proportion of the deductions taken by foreign affiliates. This could help to ensure that such expenses are not taken to unfairly reduce taxable profits in Canada. Canadian rules currently strive to prevent abuse in this area by imposing a withholding tax on management fees paid to non-residents although this withholding tax does not generally apply if there is a tax treaty.[119] Other rules guard against abuse to the extent that the management fee is unreasonable or the fee is not for any identifiable services performed by the non-resident: the portion of the payment deemed to be unreasonable can be taxed as a shareholder benefit.[120]

In addition, Canadian transfer pricing rules that mandate the need to charge related parties fair market prices for exchanges of goods, services and financing may inhibit efforts to improperly take deductions in Canada to shift profits to low or nil tax jurisdictions (see Section 4.5.1). The fact that Canadian corporate tax rates are now lower than many trade and investment partners may also inhibit certain income shifting strategies (see Section 3.1). Countries with higher tax rates provide greater benefits for tax deductions (as they reduce taxable income to a greater extent) hence there is a tax incentive to shift expense deductions, especially interest, to the high tax rate country (and away from the lower tax rate country).[121] By keeping corporate tax rates lower than close trade and investment partners, the Canadian regime removes this incentive.

4.3.5 Deduction of interest expenses

Exploring reform options

The comparative review in Part 3 revealed different possible approaches with respect to interest deductions for the generation of foreign source exempt income (see Section 3.2 and Table 1). First, countries can deny all such deductions (as per the U.S. and Japanese approach with respect to determining foreign tax credit limits although as discussed below, the U.S. has legislated temporary relief in this area). Second, countries can try to limit the interest deductions to prevent perceived abuses (as per the Canadian approach discussed below). Third, countries can permit such deductions, but provide for thin capitalization rules for inbound and outbound loans and/or limited anti-avoidance rules (as per current Australian rules).[122] Fourth, countries can permit such deductions but provide for earnings stripping rules that indicate interest can only be deducted to a stipulated percentage of adjusted earnings in domestic corporations as well as their foreign affiliates (as per Germany and Italy). Under the German approach, the rule does not apply to de minimis transactions, if the taxpayer is not part of a group of companies or the taxpayer shows that the borrower's debt-to-equity ratio is similar to the worldwide group's ratio.

119 See s. 212(1)(a) of the ITA. Article XIII of the Canada-Barbados tax treaty somewhat unusually provides for a 15 percent withholding tax on management fees.

120 See s. 15(2) of the ITA. s. 56(2) may also assess a tax in situations where the payment is deemed to be an indirect payment to the Canadian shareholder.

121 See Vijay Jog and Jianmin Tang, "Tax Reforms, Debt Shifting and Corporate Tax Revenues: Multinational Corporations in Canada" (1998) Technical Committee on Business Taxation Working Paper 97 at 14; Roy D. Hogg and Jack M. Mintz, "Impacts of Canadian and U.S. Tax Reform on the Financing of Canadian Subsidiaries of U.S. Parents" in Alberto Giovannini, R. Glenn Hubbard and Joel Slemrod eds., *Studies in International Taxation* (Chicago: University of Chicago Press, 1993) at 47.

122 See United Kingdom, *Taxation of the Foreign Profits of Companies*, supra note 23 at 25-26.

Only the first option respects the zero rate principle noted previously. The other approaches violate the zero rate principle by permitting, effectively, a negative tax rate on foreign source active business income in some circumstances.

Recent Canadian reforms: accepting the need for single dips

In fact, the Canadian government recently proposed to deny interest deductions for exempt foreign income, which requires a brief detour into the ongoing Canadian policy debate surrounding single and double dip financings. In the 2007 federal budget, the government initially proposed to deny interest deductions for any interest expense that could be traced to earning exempt foreign source income. In its original proposal, the Department of Finance noted that this reform had been discussed earlier by the Technical Committee on Business Taxation as well as the Auditor General of Canada.[123] The main opposition to this reform came from the view that this step will make Canadian companies less competitive than their foreign counterparts as an elimination of tax-favoured foreign financings will raise the cost of capital for cross-border ventures. In May 2007, the government amended the earlier proposal to only target interest expenses attributable to more aggressive "double dip" and certain other "tax efficient" financing structures. This proposal, which provides for a transition period to 2012, was set out in draft legislation on October 2, 2007 and enacted as new section 18.2 of the Income Tax Act on December 14, 2007.

Under current rules, Canadian corporations are generally permitted to take interest deductions for the earning of exempt foreign source active business income — this income may be generated and taxed in countries with comparable tax systems.[124] Under a more important rule, however, Canadian corporations can take the interest deductions to purchase shares in a foreign financing affiliate that is not based in a country where the active business is taking place — this rule effectively permits interest deductions even though the interest income will likely never be subject to tax.[125] This second rule permits what is sometimes referred to as a single dip as the Canadian debtor corporation deducts the interest and lowers its tax bill while the corresponding income inclusion in the foreign affiliate is free of tax (assuming the affiliate is located in a country without a corporate income tax). The interest income is recharacterized as active business income and hence does not fall within FAPI. As a result, Canadian corporations can continue to deploy single dip structures that permit Canadian parent corporations to take interest deductions to generate exempt foreign source income although, assuming the new rules work effectively, they will no longer be able to receive the greater tax benefits offered via double dips.

123 See Canada, Department of Finance, *2007 Federal Budget* (Ottawa: Queen's Printer, 2007) at 241-242.

124 Paragraph 95(2)(a)(ii) generally deems certain receipts by foreign affiliates to be active business income even if the payments take the form of property income. For example, a foreign affiliate of a Canadian taxpayer might loan money to another foreign affiliate of the taxpayer which uses the money in conducting manufacturing activities. The interest paid by the borrower will be treated as "deemed active business income" of the lender foreign affiliate, provided that it is deductible in computing its "earnings" within the meaning of s. 5907(1) of the Regulations. Deemed active business income also includes income generated from factoring certain trade accounts receivable (s. 95(2)(a)(iii)) and dealings in certain "indebtedness" (s. 95(2)(a)(iv)), generally where these financial obligations arose in business conducted by the vendor of these receivables.

125 Clause 95(2)(a)(ii)(D) provides for circumstances in which the financing affiliate does not itself conduct an active business and requires the financing for purposes of acquiring the shares of the affiliates that conduct the active business (which are typically based in another high tax country).

Accordingly, Canada permits deductions for interest expenses even when it is clear that the interest will be taxed at a low or nil rate. This so-called "inter-affiliate financing exception" effectively allows a negative tax rate on foreign source income as it permits the reduction of Canadian tax on domestic source income although the corresponding income will likely never be taxed. Because the Canadian resident corporation takes the deduction for the interest, it can substitute the source country tax rate (with a rate of zero assuming there is no income tax in the country where the financing affiliate is based) for the Canadian tax rate, while bringing back profits through non-deductible dividend payments.

As mentioned, this rule also creates the most obvious risk to the Canadian tax base should the government move to a full hybrid exemption tax system: Canadian businesses would be able to choose any zero tax jurisdiction to set up their financing affiliates, which may lead to revenue losses to the extent that more Canadian corporations pursue this avenue than is currently the case (see Section 4.2.2). Should taxable surplus be abolished, the new rules that seem to promote the adoption of a blacklist (that is, countries that refuse to either negotiate a TIEA with Canada or, as proposed, are unable to meaningfully enforce existing TIEAs) may help to protect the tax base.

In addition, the new rules that strive to inhibit double dips may also forestall possible revenue losses as they would deny interest deductions to the Canadian firm if a second interest deduction (or "second dip") is taken by a related company based in another (typically high tax) country. It also bears mentioning that other tax rules mandate an arm's-length interest rate for cross-border loans[126] and guard against situations where interest payments were incurred to buy foreign affiliates shares where the "principal purpose" is to avoid taxes,[127] as well as thin capitalization rules that deny interest deductions to the extent they exceed a stipulated debt-to-equity ratio within the resident firm (see Section 4.5.3).

Are further reform efforts needed?

Under a perspective that seeks to maintain tax neutrality and conceptual purity within the Canadian international tax system, the current Canadian approach that permits single dips for foreign source exempt income violates the zero tax rate principle for the taxation of foreign source income and reforms are needed to restrict the availability of this deduction.[128] Another perspective would maintain the current Canadian approach is defensible. Most competitor countries appear to limit excess interest deductions, but also permit interest deductions for foreign operations in some circumstances. Those that try to rigorously deny interest deductions may not be able to effectively enforce their rules: the United States, which has developed complex formulary rules to deny interest deductions for foreign credit calculation purposes, has issued temporary "look through" and "active financing" exceptions to these rules that run to January 1, 2009, and may be renewed or made permanent. Finally, the denial of interest relief for double dip structures, which have apparently been deployed by Canadian multinational

126 See s. 17 of the ITA.

127 See s. 95(6)(b) of the ITA. For discussion, see CRA, *Income Tax Technical News* No. 36 (July 27, 2007).

128 This could be accomplished by amending or deleting s. 95(2)(a)(ii)(D).

firms for at least several decades,[129] reflects policy efforts to curtail more aggressive cross-border tax planning structures so that Canadian firms arguably need the remaining relief to compete effectively in the global marketplace (given the fact that most competitor countries provide at least some, or greater levels of, relief).

A final perspective could maintain that Canada should retreat from its recent efforts to inhibit double dips. In support of this view, there does not appear to be similar legislation in place in countries other than the United States or Japan (which, like Canada, still permits viable cross-border structures in many other areas). Critics of the new anti-double dip rules suggest that they may not effectively inhibit double dips in part because the rules rely on attempts to trace the interest payments to the generation of exempt foreign income, a practice that is notoriously difficult to enforce: taxpayers can engage in tax planning to ensure that funds borrowed by members of a corporate group can be formally traced to the earning of revenue in relatively high tax countries — even though the interest escapes taxation in many circumstances.[130] In addition, the new rules may have an over-broad application and frustrate cross-border financing structures other than double dips or the other tax efficient structures that, in the Department of Finance's earlier discussions, seemed to be the policy target of the rules.[131]

Yet, as explored in Part 3, certain countries such as Germany, Italy, France, and Japan have implemented interest deduction restrictions that are not imposed on Canadian-based multinationals. Other countries, such as Australia and New Zealand, have strengthened their thin capitalization rules to restrict interest deductions for both outbound and inbound financings, unlike Canada (see also Section 4.5.3). Should the United Kingdom move toward a hybrid exemption tax system, its tax authorities have proposed new rules to restrict interest deductions where the total interest deduction claimed by the UK resident corporation would be restricted by reference to the group's total consolidated finance costs: if the UK resident has higher financing costs than the overall consolidated finance costs of the entire group then this will act as evidence that the finance costs have been allocated to the UK corporation with the purpose of artificially reducing the group's global tax liability.

In addition, the new European approach deployed by Germany and Italy may not be welcomed by some members of the Canadian business community as it would impose interest deduction restrictions on both domestic and foreign related businesses. Moreover, when looking more holistically at the Canadian tax rules on outbound direct investments, the Canadian system appears to offer comparable or more favourable tax treatment in certain circumstances (see Section 3.2).

4.3.6 Treatment of foreign branches

The focus of this Part has been placed on foreign corporations owned by related Canadian corporations: under Canadian international tax law, foreign corporations are generally treated as non-residents. Canadian businesses can also expand abroad by opening up branches in foreign markets: the assets of the branch, as well as any profits, remain owned by the Canadian

129 See Donald J.S. Brean, *International Issues in Taxation: The Canadian Perspective* (Toronto: CTF, Canadian Tax Paper No. 75, 1984) at 120.

130 See Andrew W. Dunn et al., "Financing Corporate Affiliates: An Overview of the Canadian Proposals and the Rules in Selected Countries" (2007) 55(3) Can. Tax J. 676.

131 See Patrick Marley, "Canada's New Anti-Double-Dip Initiative" (2008) Tax Management International Journal 95 at 98, 100-102.

resident corporation because there is no separate business entity within the foreign country. As a general principle within Canadian international tax policy, tax rules are designed to approximate the tax treatment of foreign affiliates and foreign branches (otherwise, among other worries, taxpayers will be incentivized to choose the most leniently taxed approach even if there are sound business reasons to prefer a particular foreign business entity). Under current rules, Canadian residents must generally pay a branch profits tax at a rate of 25 percent (which is often reduced in tax treaties).[132]

Accordingly, should the Canadian government move to a full hybrid exemption tax system, it may need to ensure that profits enjoyed by foreign branches are exempt from Canadian tax (as well as ensuring that the tax treatment of sales of interests in foreign branches approximates the treatment of sales of shares in foreign subsidiaries). Moreover, steps would need to be taken to preserve accrual taxation over foreign source passive income generated within the branch. This could be achieved by continuing to treat the foreign branch as if it were a permanent establishment in a tax treaty partner country — branch profits will be calculated under the transactional arm's length approach deployed for transfer pricing purposes and then exempted from Canadian tax (see Section 4.5.1).

If branch profits escape Canadian taxation, rules may need to be developed to ensure that all losses derived through the branch will not be permitted to offset domestic source income: losses from foreign affiliates cannot offset domestic source income from related Canadian-based businesses. For outbound direct investment purposes, some Canadian investors start-up businesses in foreign markets through branches — any start-up losses can currently be offset against Canadian profits. If this tax benefit were eliminated, it might inhibit some outbound direct investment. On the other hand, such reform would remove the current non-neutral tax treatment where foreign branches and foreign affiliates attract different rules on cross-border loss offsetting (which may skew investment decisions in an inefficient manner).

4.4 Merging and/or simplifying the passive income system

If the Canadian government decides to pursue a full hybrid exemption tax system, it could reform and merge all of the international tax rules that govern the treatment of passive sources of foreign income or it could reform only the rules directed at outbound direct investments, namely the foreign accrual property income (FAPI) rules. This section discusses these two reform alternatives.

4.4.1 Merging different rules

Over the years, a complex system arose to ensure that foreign sources passive income remain taxed on a worldwide basis, promoting the policy goal of CEN (see Section 2.1). This process became more important as Canadian investors increasingly invested in cross-border investments that generated passive income. As regulatory barriers around the world fell, it also became easier to shift passive investments from one country to another and to substitute different forms of financing for one another (see Section 2.5). As mentioned, FAPI rules generally strive to tax

132 See s. 219 of the ITA.

on a current basis foreign source passive income generated by outbound direct investment. In addition, foreign investment entity (FIE) rules impose accrual taxation on foreign source passive income when there is a lesser degree of ownership and control by the Canadian resident over his/her/its foreign passive investment. Moreover, non-resident trust (NRT) rules similarly strive to tax on a current basis the returns on passive investments generated within foreign trusts.

Emphasis on Capturing Foreign Source Passive Income

The definitions for passive investments and passive income are similar under all three approaches. Consider the approach deployed by the FAPI regime. FAPI does not include active business income, and includes "income from property" and income from businesses other than active business as determined for purposes of the foreign affiliate rules. The basic notion of FAPI is supported by a number of rules, some of which deem what appears formally to be income from property to be active business income, and others deem business income to be inactive business income.

For instance, FAPI includes certain foreign business income that ostensibly resembles active business income, but may reflect an attempt to reduce taxable income in Canada by taking deductions for expenses in the controlled foreign affiliate (CFA). This aspect of the FAPI rules attempts to prevent the "erosion" of the Canadian tax base; these rules are referred to as "base erosion" rules and apply to various kinds of Canadian source income including income from selling property, interest and leasing income, insurance income, and income from providing certain services.[133]

FAPI also includes income from an "investment business", which is a business (other than a business that is defined not to be active in the ITA) carried on principally to earn income from property (interest, dividends, rents, royalties, or any similar returns or substitutes for them), income from insuring or reinsuring risks, income from factoring trade accounts receivable, and profits from the disposition of investment property.[134]

In summary, the approach of the FAPI rules is to define FAPI as exclusive of active business income as well as certain other activities (such as intra-group trading) that are deemed to give rise to active business income. Moreover, complex rules strive to deem what initially appears to be active business income to be passive income because the payments more closely resemble this stream.

The FIE and NRT regimes incorporate similar approaches although, under their detailed rules, a number of important differences remain. For instance, for a non-resident business entity to qualify as a Foreign Investment Entity then more than 50 percent of its property must be an investment property or it is not primarily engaged in a business that is an "active business".

133 See ss. 95(2)(a.1) to (a.4), 95(2)(b); ss. (2.3) to (2.5), and 95(3)) of the ITA.

134 There are certain exceptions that take activities outside of the investment business definition. The exceptions have three aspects. First, the business must be a business conducted primarily with arm's-length persons. Accordingly, in objective terms, the foreign affiliate must be engaged in a degree of competition with foreign enterprises according to circumstances that are external to the corporate group of which the foreign affiliate is a member. Second, the business must be of a particular type: a regulated financial business, a real estate development business, a money lending business, a business of leasing or licensing property, or an insurance business. Finally, in default of a more reliable qualitative way to explain the degree of activity that the foreign affiliate system requires for gaining access to its exemption aspect, directly or indirectly the business must employ more than five full-time employees, either as employees of the affiliate carrying on the business or indirectly through contractual or other means.

In addition to deploying similar approaches to the definition of passive income and deemed passive income, there is significant overlap among the FAPI, FIE and NRT regimes. For example, FAPI includes income computed under the FIE rules with respect to "participating" interests in a FIE owned by a foreign affiliate.[135] The purpose of many of these rules is to ensure that the FIE regime taxes foreign source passive income that escapes taxation from the FAPI regime. In addition, where the NRT or FAPI rules apply, the FIE rules do not generally apply. Nevertheless, the concurrent application of the different regimes adds to complexity.

Reform options

To encourage tax simplification, the three systems could be streamlined and/or merged. As investigated elsewhere, there are essentially three policy options:[136]

(i) Canada could reform the rules to promote more consistent definitions and approaches within the separate foreign source passive income regimes;

(ii) Canada could collapse and merge the three regimes into one regime;

(iii) Canada could collapse the FAPI and FIE rules while keeping a separate regime for NRTs (or at least a separate regime for discretionary NRTs).

The first option would involve a careful scrutiny of the different regimes along with subsequent reforms to promote consistency. For example, the new FIE rules permit Canadian residents to elect among different attribution methods: (a) the prescribed rate approach that looks to stipulated rates of returns on the foreign investments to determine annual taxable income; (b) the mark-to-market approach that looks to actual fluctuations in the value of foreign investments (and taxes on accrued gains even though no funds have been repatriated); and (c) the income accrual approach that tries to assess and attribute the actual underlying income of the foreign entity (this final approach is the one deployed within the FAPI regime).[137] The first two elections are of particular importance when there is an objective market return (for example, a foreign mutual fund may be listed on a foreign stock exchange along with readily obtainable information concerning fluctuations in the fair market value of the fund) and may not be appropriate in situations where a CFA generates foreign source passive income.

To promote consistency, reform could permit Canadian residents that are subject to the Canadian FAPI or NRT rules to make a similar election to follow the prescribed rate approach or the mark-to-market approach (as the third option is already available under FAPI and NRT rules). By permitting Canadian taxpayers to choose among the alternatives, they would have the flexibility to adopt the system that best matched their business needs, potentially reducing compliance costs in situations where the firm would otherwise be forced to adopt attribution rules that are difficult to follow, inappropriate for industry practices, and may serve to arbitrarily and improperly attribute passive income. On the other hand, if this approach was adopted new

135 See s. 95(2)(g.3) of the ITA.

136 See Australia, Board of Taxation, *Review of the Foreign Source Income Anti-Tax-Deferral Regimes: Position Paper* (Jan. 2008) at 11.

137 For discussion, see International Taxation, supra note 5 at 233-246.

rules may also need to be developed to ensure that CFAs do not deploy the elections to reduce taxes that would otherwise be payable if the CFA's foreign source passive income were taxed on an accrual basis, as occurs under current rules.

The second more ambitious option could work as follows. Canadian residents will remain, under the general rule, taxed on their worldwide income.[138] The main exception to the general rule is that Canadian residents will not be taxed on "exempt income" which in turn could be narrowly defined to be dividends repatriated from foreign affiliates as well as, potentially, capital gains from the sales of foreign affiliates.[139] Dividends could similarly be narrowly defined to be pro rata distributions from profits derived through the conduct of an active business: the term "dividend" is undefined in the ITA (although subsection 248(1) provides that a dividend includes a stock dividend). The courts have interpreted "dividend" to be any pro rata distribution from a corporation to its shareholders, unless the distribution is made on the liquidation of the corporation or on an authorized reduction of corporate capital.[140] Under this case law, the Canadian definition only applies as long as there is not any foreign law to make such a determination.

Foreign source passive income could in turn be defined as excluding active source income, and including, but not limited to, foreign source interest, rent, and royalties. This is a similar approach to the current FAPI definition. The main difference from the current approach is that active business income still appears to be defined in a fairly broad manner and is not set up as the one main exception to the general rule that all sources of income are subject to worldwide taxation, which leads to tax planning efforts to ostensibly create active income from what is really passive income. Moreover, by segregating all of the foreign source passive income rules into one area within the Income Tax Act along with legislative statements that these rules serve as anti-avoidance rules, it may assist with efforts to apply the general anti-avoidance rule (GAAR) to situations that appear to involve tax-driven attempts to technically comply with a specific provision of the ITA while at the same time subverting the purpose of the rule (see Section 4.5.2).

Under this approach, additional exceptions to the main rule could be added to address the tax relief offered under each existing regime. For example, exceptions could ensure that deductions for certain intra-group trading as well as interest deductions for foreign financing affiliates would remain permissible deductions despite the fact that they give rise to foreign exempt income (see Section 4.3.5). Other provisions would need to be added to specifically capture passive income such as income from an "investment business" that, on the surface, may appear to be active income.

138 See s. 2(3) of the ITA.

139 Similar reform efforts were conducted in the mid-1990s to come up with fairly restrictive definitions for active business income: the purpose behind these reforms was to try to stop Canadian residents from artificially inflating exempt surplus with foreign income that did not really have an underlying active business. For review, see Arnold, supra note 94; Standing Committee on Public Accounts, supra note 89, indicating that appropriate definitions for " 'active business' would put an end to the tax avoidance schemes that are eroding the Canadian tax base."

140 See *Hill v. Permanent Trustee of New South Wales*, (1930) AC 720 (PC); and *IRC v. Burrell*, (1924) 2 KB 52 (CA), and *Cangro Resources Ltd. (in Liquidation) v. MNR*, 67 DTC 582 (TAB).

The main upside of this more fundamental reform is that it could achieve the greatest amount of simplification. This reduction in complexity would presumably be followed by reduced compliance costs for Canadian taxpayers. The main downside would be that the fundamental reform could open up holes so that, at least temporarily, Canadian residents can structure their outbound passive investments in such a way to reduce their tax liabilities.

With respect to the third option, one perspective maintains that non-resident trust rules should not be merged with the other accrual taxation regimes.[141] Under this view, the CFC and foreign investment entity regimes generally target situations where residents hold fixed interests in foreign business entities. The non-resident trust regimes, in contrast, apply in situations where residents maintain discretionary interests in foreign entities: measuring such interests may require a different approach compared to the rules that strive to measure fixed interests. Accordingly, collapsing the NRT regime with the others may not bring about significant simplification gains.

The Canadian NRT regime has been reformed in recent years so that complex new rules generally apply for tax years after 2006.[142] Under the former approach, if the foreign trust was a discretionary trust then it was taxed on undistributed amounts (by, effectively, deeming such foreign trust to be a Canadian resident taxable on its worldwide income). For non-discretionary trusts (e.g., mutual fund trusts), worldwide income is treated basically as it would be under the FAPI regime. The new approach appears to pursue the same objective along with a variety of supporting rules that act as anti-avoidance rules. Because the old and new NRT rules for discretionary and non-discretionary foreign trusts incorporate a similar approach (i.e., accrual taxation for undistributed or distributed amounts) it may be feasible to collapse the non-discretionary rules in with the FAPI and FIE rules to achieve greater simplification while maintaining a separate regime for discretionary NRTs (see Table 3).

Table 3

Policy Option Summary: Merging the Foreign Source Passive Income Regimes

Foreign affiliates:	Exempt from tax on all foreign source active business income and, potentially, related capital gains from sales of shares, regardless of jurisdiction.
Controlled foreign affiliates:	Taxed on accrual basis under general FAPI rules
Non-controlled foreign affiliates:	Provide for accrual taxation under three reporting options available under FIE rules
Non-discretionary non-resident trusts:	Maintain separate regime

As subsequently explored, instead of merging and/or simplifying the different foreign source passive income regimes, Canadian reform efforts could focus on amending the FAPI regime that targets passive income generated by outbound direct investment.

141 See Australia, Board of Taxation, supra note 136 at 12.

142 For discussion, see Stephen W. Bowman, *Non-Resident Trust Update: Living with the New Section 94*, Conference Report 19:1 (Toronto: Canadian Tax Foundation, 2003).

4.4.2 Definition of controlled foreign affiliate

The benchmark reports, prepared by outside tax experts to assist the Advisory Panel with background research, show a dizzying array of possible approaches for controlled foreign corporation (CFC) regimes (see Section 3.1). The general approach of these CFC regimes follows the Canadian approach under the FAPI rules by trying to tax on a current basis foreign source passive income generated within foreign corporations that are controlled by resident taxpayers, hence promoting the policy goal of CEN for such income (see Section 2.2). This section as well as the following sections overview some of the design choices surrounding: (a) the threshold of ownership of the foreign corporation; (b) the type of control needed; (c) exemptions from compliance with the FAPI rules; and (d) base erosion rules.

Under subsection 95(1) of the Income Tax Act, a controlled foreign affiliate (CFA) is a foreign affiliate "controlled" by the Canadian taxpayer alone or together with non-arm's-length persons, or with certain Canadian resident persons who are wholly unrelated if they form a group of five with the Canadian resident. "Control" means de jure control by being in a position to elect a majority of its directors (typically by owning more than 50 percent of the voting shares). The definition also contemplates collective or group control along with proposed amendments to these rules.[143]

With respect to the ownership threshold, France, Germany, Italy, and the United States have incorporated, under certain conditions, a need for at least 50-percent ownership of the foreign affiliate's voting shares. On the other hand, Japan has an ownership threshold of five percent of voting shares, while Sweden and the United Kingdom have thresholds of 25 percent. Should Canada move toward a full hybrid tax exemption system, it may be advisable to reduce the participation threshold so that the FAPI rules protect against the ability to defer Canadian tax on foreign source passive income. Under one view, greater simplification could be achieved by linking the foreign affiliate dividend exemption to the threshold for controlled foreign affiliates: for example, a 10-percent voting shares threshold could be used for the dividend exemption while, at the same time, triggering the FAPI rules.[144] In other words, there would only be the need to define foreign affiliate thresholds in lieu of the current practice of providing for different thresholds for foreign affiliates and controlled foreign affiliates. If the participation threshold is reduced, relief could be offered via high tax or white list exemptions as well as de minimis exemptions (see below).

Alternatively, it could be argued that there is no real need to reduce the ownership threshold as most other forms of foreign source passive income are captured by the foreign investment entity rules or the non-resident trust rules in situations of reduced ownership.

143 In response to the Federal Court of Appeal's decision in *Silicon Graphics Limited v. The Queen*, 2002 DTC 7112 (FCA), the definition of controlled foreign affiliate is to be amended to clearly include circumstances of indirect control. The *Silicon Graphics Limited* case stands for the proposition that control by more than one person must reflect some common interest or behaviour by them that constitutes them as being in the nature of a group. For example, in determining whether a foreign affiliate is a controlled foreign affiliate certain look-through rules apply to shares held directly by partnerships and trusts, essentially attributing underlying ownership of shares by a partnership or trust to the partners or beneficiaries of the partnership or trust, as the case may be (proposed ss.95(2)(u), (v), and (w)).

144 See David G. Duff, "Taxation of Outbound Direct Investment: Comments on the Advisory Panel on Canada's System of International Taxation Consultation Paper" (Draft, 2008).

4.4.3 *De jure versus de facto control*

As mentioned, the Canadian FAPI rules rely on de jure control (that is, legal control whereby shareholders with more than 50 percent of voting shares have the ability, under general corporate law principles, to elect directors of foreign affiliates who in turn appoint officers to manage these affiliates). Other countries deploy de facto tests (on an objective or subjective basis) that scrutinize whether the resident corporation effectively controls the related foreign corporation by looking at factors such as influence on dividend policy, controlling the appointments of the foreign corporation's directors, and day-to-day management.

There appear to be a number of options available with respect to imposing participation thresholds before the CFC rules kick in: the problem with comparative analysis in this area is that each CFC system has to be viewed in an integrated manner to fully understand the design choices. A country could, for instance, have a low threshold (say five percent of voting shares in the foreign affiliate), but then offer a generous series of exemptions (such as exemptions for all businesses based in relatively high tax countries).

4.4.4 *Transaction- versus entity-based approaches*

The FAPI rules only strive to tax passive income within foreign affiliates (the so-called transaction-based approach) whereas at least certain countries deploy approaches that strive to tax all of the foreign affiliate's income as long as this corporation has too much "tainted" income (the so-called entity-based approach). Other countries that follow the transaction-based approach include Australia, Germany, and the United States. Sweden and Japan, on the other hand, tax all of the income of a foreign affiliate if it is deemed to be subject to low taxation (hence providing exemptions for high tax countries as well as white list countries: see below). France appears to deploy both the transaction- and entity-based approaches.

A drawback of the entity-based approach is that it may bring about fairly punitive results to the extent that foreign corporations are subjected to CFC rules on their foreign source active business income, potentially discouraging outbound direct investments. This may explain why countries that adopt this approach appear to also offer fairly generous exemptions from the application of the CFC rules. For example, the United Kingdom currently deploys the entity-based approach along with an exemption for companies based in countries that have tax rates of at least 75 percent of the UK rate. The UK tax authorities have proposed to move to a transaction-based approach and to eliminate the rate exemption.

4.4.5 *Exemptions from CFC rules*

One area where Canada appears to be increasingly out-of-step with the selected countries surrounds exemptions from CFC rules. Sweden, for instance, recently reformed its CFC regime to exempt related foreign corporations based in high tax countries, which are countries that apply effective tax rates greater than 15.4 percent (i.e., 55 percent of the Swedish tax rate of 28 percent). Sweden also provides for exemptions for businesses based in white list countries that include European Economic Area countries. Japan also provides for a "high tax exception" for foreign affiliates based in countries with effective tax rates greater than 25 percent while,

as mentioned, the United Kingdom's rules (which are currently under review) provide for an exemption where the CFC's effective tax rate is three-quarters or more of the UK rate. Unlike Canada, all of these countries deploy the entity-based approach discussed previously.

These exemptions have the virtue of simplicity. The Swedish approach in particular appears attractive as the exemption for high tax countries will change to the extent the Swedish corporate income tax rate is changed. Canada should consider a similar route by exempting the application of the FAPI rules for all foreign affiliates subject to an effective tax rate that is, say, 50 to 75 percent of the Canadian rate (or tax rates of roughly 15 to 23 percent as current federal/provincial corporate income tax rates equal 29.5 percent). Alternatively, Canada could reform its rules to exempt from FAPI situations where there is a substantial business presence: the test could hinge on the presence of people and/or assets in the foreign country in a similar way to the approach in the base erosion rules within FAPI (see Section 4.4.7). A drawback of these approaches is that, by moving away from full accrual taxation of foreign source passive income (and by violating CEN that is sometimes advocated for this income), Canadian resident taxpayers may engage in strategies to shift their passive investments to countries that provide more lenient taxes on these investments to generate tax savings. To guard against abuse, anti-avoidance rules may need to be developed, which would reintroduce complexity.

In terms of other exemptions, an expansive white list approach is problematic because there may be a time lag where a white list country engages in tax reform that should take it off the list. A limited white list approach may be preferable where Canada exempts foreign affiliates based in its closest trade and investment partners. Obvious candidates would include the United States and the United Kingdom. Less obvious, but still good, candidates would include countries such as Mexico that are tied to Canada through free trade agreements: ideally, North American firms could operate with reduced tax compliance costs so that they would be able to compete more effectively against firms from the European Union and other regions that reduce tax barriers for trade and investment that takes place within their region.[145] Many of the European CFC regimes appear to similarly offer CFC exemptions for businesses based within the European Union or the European Economic Area.

To the extent that there is a limited white list, it might be possible to negotiate reciprocal treatment from foreign countries so that investors from these countries do not have to comply with their own CFC rules when they invest in Canada (which would presumably encourage more inward investment to Canada). A more modest proposal would be to seek this reciprocal treatment when tax treaties are revised with select partners and the exemptions could be incorporated into the revised treaties. Under New Zealand tax law proposals, CFCs based in Australia will similarly be exempt from complying with the new CFC rules.[146] Another interesting feature of the New Zealand proposals is the development of an "active business" test for CFCs. Under the test, a CFC will be considered to be an active business if less than five percent of its gross income is passive income. CFCs that pass the test will not have to attribute any passive

145 See NAFTA Tax Law and Policy, supra note 61 at 175-183.

146 See Hon. Peter Dunne, Minister of Revenue, Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill: Commentary on the Bill (Wellington, NZ: Policy Advice Division of Inland Revenue, July 2008).

income: if the CFC does not pass the test then only its passive income will be attributed to the New Zealand parent corporation (unlike the entity-based tests described previously that seek to tax all foreign source income once sufficient "tainted" income occurs within the CFC).

4.4.6 De minimis rules

Another area for potential reform would be to revise the current rules that exempt de minimis transactions. Canada currently only exempts from taxation situations where the foreign affiliate has passive investments that total less than $5,000. This amount could be revised upward to make it more consistent with the practices elsewhere, providing compliance relief for small- and medium-sized Canadian businesses. For example, after review of de minimis thresholds in Australia, an AUD200,000 (roughly $200,000) threshold was recommended.[147] Under the current United Kingdom approach, the CFC rules do not apply where the profit of the individual CFC is less than £50,000 (roughly $100,000). Similar thresholds may be appropriate for Canadian purposes.

4.4.7 Base erosion rules

A final point surrounds the so-called base erosion rules found within the FAPI rules (see Section 4.1.1). The underlying assumption of the base-erosion rules is that the Canadian tax base is eroded if the taxpayer deflects Canadian-source income to a foreign corporation resident in a low or nil tax jurisdiction. To prevent the base erosion, the deflected income is included in FAPI. More technically, these rules apply to cause certain Canadian domestic source sales income, income from insuring Canadian risks, and certain Canadian domestic source financial and licensing income to be treated in the same fashion as income from an "investment business" and included in FAPI.[148]

While most CFC regimes of the selected countries appear to incorporate similar base-erosion rules, one policy perspective maintains that these rules make it difficult for countries to compete effectively in global markets (as the rules impose resident country tax burdens on foreign source active business income in certain circumstances) and hence should be abolished.[149] If the Canadian rules are properly targeted, however, they serve to protect the domestic tax base against situations where taxable income in Canada is diverted elsewhere to a foreign country where only nominal value-adding economic activities are taking place. Other countries such as the United States contain more complex base erosion rules to protect the tax base. Moreover, under the proposed reforms in the United Kingdom, new rules have been proposed to treat "mobile active income", including certain intangible assets such as brands, as if it was passive income subject to accrual taxation, which would seem to capture broader categories of income when compared with the existing Canadian base erosion rules. Should the Canadian government pursue reform efforts to abolish taxable surplus and move to a full hybrid exemption tax system, there may be additional pressure to maintain or even strengthen the current base erosion rules.

147 See Australia, Board of Taxation, supra note 136 at 62.

148 See ss. 95(2)(a.1), 95(2)(a.2) and s.95(2)(a.3) of the ITA.

149 See Australia, Board of Taxation, supra note 136 at 63.

In other areas, the base erosion rules may be unduly inhibiting outbound direct investment. An area of concern, noted by the Advisory Committee, surrounds whether the base erosion rules should be reviewed to see whether they deal in an appropriate manner with companies that manufacture and source their products from several different jurisdictions.[150]

In summary, there appear to be a number of principled design choices available for CFC regimes. The problem with any comparative analysis is that it is difficult to review aspects of a CFC system in isolation. Moreover, these regimes are very complex and have detailed rules, for instance, with respect to necessary holding periods for shares in CFCs. Having said that, the current Canadian approach seems consistent with practices elsewhere as the FAPI rules provide a comprehensive regime that strives to tax foreign source passive income. Certain areas — such as exemptions and de minimis rules — may need to be revised to reduce compliance costs associated with this complex statutory regime.

4.5 Strengthening anti-avoidance rules

Should Canada move toward a streamlined (or otherwise) full hybrid exemption tax system, it may need to take certain steps to protect the tax base by strengthening transfer pricing rules, anti-arbitrage rules, thin capitalization rules as well as cooperative efforts among the CRA and foreign tax authorities.

4.5.1 Transfer pricing

Because Canada and other countries maintain different tax regimes, taxpayers engage in planning strategies to gain tax benefits. A fairly straight-forward strategy could involve a company in Canada decreasing the price of inter-company transfers of goods being shipped to a subsidiary in a low tax country, thereby shifting accounting profits to the lower-tax country. The company's profits are thus allocated for tax reasons. These sorts of strategies waste businesses resources and divert revenues away from the treasury of the country where the value-adding economic activity takes place. The revenue implications of an appropriate allocation appear to be rising for Canada: in 2005, over 16,000 Canadian corporate taxpayers had foreign related party transactions that totaled over $1.5 trillion.[151]

Tax laws in Canada as well as Canadian tax treaties mandate that related companies should use the market price (or arm's-length price) when they charge for cross-border transfers of goods and services.[152] Forcing these related parties to charge market prices helps to ensure that taxpayers cannot manipulate their profits in such a way that they would not pay their "fair" share of taxes to both countries. Nevertheless, it is often difficult to determine the appropriate arm's-length price that should be charged because, for instance, related companies transfer unique assets (such as patents) and there are no market transactions between unrelated

150 See Consultation Report, supra note 2 at 27.

151 See Office of the Auditor General of Canada, February 2007 Status Report of the Auditor General of Canada to the House of Commons: Chapter 7—International Taxation—the Canada Revenue Agency (Ottawa, 2007), at 1.

152 See s. 247 of the Income Tax Act.

companies that could be used to determine the appropriate price.[153] Taxpayers in Canada and elsewhere often get embroiled in disputes with their tax authorities who assert that these taxpayers have not charged the appropriate transfer prices for their cross-border transactions.

For this reason, the recent introduction of mandatory arbitration for transfer pricing disputes in the Canada-United States tax treaty is a welcome development. This development is particularly important given that roughly ⅔ of all related party transactions with Canada is attributable to intra-firm trade and investment between Canadian and U.S. business entities.[154] Similar arbitration clauses should be pursued with other significant trade and investment partners.

Despite this progress, at least three areas of concern remain surrounding transfer pricing. First, the Canadian government has, unlike the United States, decided to proceed with administrative pronouncements instead of enacting tax laws:[155] these pronouncements are persuasive at best to courts so that a fair amount of uncertainty remains with respect to, for instance, the appropriate transfer pricing methodology (e.g., the comparable uncontrolled price (CUP) method). Tax certainty is an important goal to promote heightened cross-border investments as uncertainty creates reluctance to engage in these activities. The government could help to clear up this problem by legislating aspects of its information circular or at least by making a reference to the OECD's transfer pricing guidelines in its transfer pricing legislation in section 247 of the Income Tax Act.[156] This process would also necessitate a careful review of existing policies and practices, which may need to be tightened up to protect the tax base should Canada move to a full hybrid exemption tax system.

Second, in an environment of heightened audit, enhanced documentation requirements, and the need for more sophisticated tax advice (often by economists and other experts) to discern and protect an appropriate transfer pricing methodology, compliance costs for Canadian firms will invariably rise, potentially inhibiting cross-border investments. As with respect to exemptions for FAPI rules (see Section 4.4.5), the Canadian tax authorities should consider additional cooperative efforts with their foreign counterparts to, for example, reduce or eliminate some of the documentation requirements for highly integrated North American firms (while ensuring that enhanced audit cooperation reduces the risk that reduced reporting requirements will lead to abusive tax planning that erodes the Canadian tax base). Alternatively or in addition, the Canadian government should continue its efforts to apply documentation requirements that are consistent with other tax systems: as a member of the Pacific Association of Tax Administrators, the Canadian tax authorities have entered into an agreement to deploy consistent requirements with the other participating national tax authorities (see Section 4.5.4).

153 For a discussion of recent transfer pricing developments, see Robert Couzin, "The OECD Project: Transfer Pricing Meets Permanent Establishment" (2005) 53 Can. Tax J. 401.

154 See Alan M. Rugman, *Multinationals and Canada-United States Free Trade* (South Carolina: University of South Carolina Press, 1990).

155 See Canada, Canada Revenue Agency, *IC 87-2R International Transfer Pricing* (Ottawa: Finance Canada, 1999).

156 In the past, certain Canadian courts have looked to OECD materials when interpreting provisions within Canadian tax treaties and it may be the case that a court will defer to the views expressed by the OECD in the OECD Guidelines, which have been endorsed by the CRA in the Information Circular, to encourage consistency with the application of transfer pricing rules used in other jurisdictions. For a discussion on the relationship between Canadian transfer pricing rules and the OECD rules, see *SmithKline Beecham Animal Health Inc. v. Canada*, (2002) 4 C.T.C. 93 (FCA). An explicit reference within s. 247 to adherence to the OECD Guidelines would be the preferred route to encourage this approach hence promoting tax certainty.

Finally, more financial and human resources may need to be provided to the CRA so that it can effectively audit a firm's international income. In 2007, the Auditor General of Canada indicated that the CRA, working together with the Department of Finance and the Tax Litigation Department at Justice Canada, needs more resources to access information about a taxpayer's international activities.[157] Moreover, she indicated that the CRA requires higher levels of expertise to conduct international audits of high risk files. The Auditor General also noted that ongoing efforts, such as the 2005 federal budget decision to devote an additional $30 million a year to assist with the Aggressive International Tax Planning initiative, have helped to promote compliance with Canada's international tax regime. Additional resources could be devoted to encourage the negotiation of more timely Advanced Pricing Agreements between the CRA, taxpayers as well as foreign tax authorities.[158]

4.5.2 Anti-arbitrage rules and GAAR

A more recent area of international tax policy controversy surrounds the worry that aggressive international arbitrage will dilute the treasuries of relatively high tax countries like Canada. One response to international arbitrage is the reactive introduction of increasingly complex rules to guard against new planning strategies. This approach is evident in the recent Fifth Protocol changes to the Canada-United States tax treaty that introduce complex new rules to restrict the use of certain "hybrid" business entities, which are businesses that are treated as a taxable entity in one country and as a fiscally transparent entity in another.[159] These exotic business entities, sometimes referred to as "reverse hybrids" or "synthetic hybrids," are used in the Canada-U.S. context to promote tax savings within cross-border financings and holding structures.

In another important reform, Canada agreed to amend the Canada-United States tax treaty to try to stop the abusive use of the treaty to gain benefits without any real economic connection to Canada; the new "limitation of benefits" provision, for example, tries to inhibit "treaty shopping" that occurs when an investor outside of Canada or the United States engages in tax planning to gain access to the benefits of the Canada-United States tax treaty. This represents a policy change from earlier treaty negotiations with the United States as Canada had since 1984 only agreed to a provision that stopped foreign investors from using the treaty to gain access to the U.S. market (i.e., the previous treaty provision only called for unilateral limitations-on-benefits that sought to gain access to the U.S. market). The Canadian government had historically taken

157 See February 2007 Status Report, supra note 151; Sheila Fraser, "Opening Statement to the Standing Committee on Finance: Briefing on Tax Havens and Tax Avoidance" (May 17, 2007), noting that, overall, the CRA's efforts to bolster its international audits are "satisfactory."

158 For a recent discussion of CRA APA processes, see Canada, Canada Revenue Agency, *APA Program Report* (Ottawa: Finance Canada, 2006/2007).

159 New Article IV(7) of the Canada-U.S. tax treaty contains two rules which are highly technical. To illustrate the first rule under paragraph (a), treaty benefits may be limited where, for example, income from Canadian sources is derived by a U.S. resident through a Canadian partnership which is fiscally transparent for Canadian tax purposes and treated as a non-resident corporation for U.S. tax purposes. To illustrate the second rule under paragraph (b), treaty benefits may be limited where, for example, income from Canadian sources is derived by a U.S. resident through a Canadian unlimited liability company (e.g., a Nova Scotia Unlimited Liability Company) treated as a corporation for Canadian tax purposes and a fiscally transparent entity for U.S. tax purposes.

the policy stance that the Canada-United States tax treaty could be used to provide treaty benefits to investors based outside of the United States in order to attract more investments to Canada.

The addition of increasingly complex tax rules in Canadian tax treaties as well as within the Income Tax Act will invariably promote higher compliance costs as resident businesses try to ensure they comply with the new rules. In addition, the CRA must incur significant enforcement costs to police this regime.

Another possible approach would be to revisit the potential for the general anti-avoidance rule (GAAR) under section 245 of the ITA to combat these strategies.[160] In theory, the GAAR should be a suitable rule to guard against tax-driven strategies that seek to comply with the letter of the ITA (or a tax treaty) while at the same time frustrating the purpose underlying the ITA (or treaty) rules. To date, however, the GAAR has proven to be an uneven weapon within the CRA's arsenal to fight aggressive avoidance. Under one view, as a result of the constraints imposed by earlier common law precedents, a number of Canadian courts appear to have restrictively interpreted the GAAR.[161]

Since 2005, the Supreme Court has weighed in on the interpretation of the GAAR.[162] In its two initial cases that reviewed the application of the GAAR to international transactions, the Court emphasized the importance of balancing the need for taxpayers to have certainty, predictability and fairness with the need of the government to counter abusive tax avoidance. Importantly, the Court appears to have focused on subsection 245(4) that indicates the GAAR will only apply if there has been an abuse of the provisions of the ITA or a tax treaty. A two-stage test applies to determine whether an abuse has taken place: (a) determine the purpose of the provisions of the ITA or treaty that confer the tax benefit; and (b) determine whether the avoidance transaction abuses or frustrates that purpose. With respect to the first stage, the purpose of the relevant provision is determined by reference to the text of the provision, the broader context of the ITA as a whole, and extrinsic aids.

While detailed analysis of this issue is beyond the scope of this paper, for the first time the Department of Finance has been provided with an opportunity to design anti-avoidance rules that are consistent with the Court's interpretation of the GAAR. In particular, the Supreme Court has signalled that it will emphasize the scrutiny of the legislative purpose of tax rules "to arrive at the most plausible interpretation of an ambiguous statutory provision."[163] As a result, it may make sense to, for example, clearly delineate within the ITA those parts of the international tax system that are anti-avoidance rules (for example, the FAPI rules or a merged foreign passive income regime) along with statements concerning the anti-avoidance purpose underlying these rules. Should Canada proceed with the simplification and merging of the different foreign

160 For a discussion of the application of GAAR to international transactions, see International Taxation, supra note 5 at 283-307.

161 See, e.g., Daniel Sandler, "GAAR and the Supreme Court of Canada: The Road to Nowhere" in David Chodikoff and Jim Horvath eds., *Advocacy and Taxation in Canada* (Toronto: Irwin Law, 2004) at 430; Jinyan Li, " 'Economic Substance': Drawing the Line Between Legitimate Tax Minimization and Abusive Tax Avoidance" (2006) 54(1) Can. Tax J. 23.

162 *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54 (S.C.C.); *Mathew v. Canada*, 2005 SCC 55 (S.C.C.).

163 See *Placer Dome Canada Ltd. v. Ontario (Minister of Finance)*, (2006) 2006 SCC 20 (S.C.C.), at 23.

source passive income regimes, it could reorganize those aspects of the ITA that are designed as anti-avoidance rules to help Canadian courts identify when tax-driven transactions abuse the purpose of these rules (see Section 4.4.1).

Assuming the GAAR becomes a more effective weapon, it will guard against abusive planning strategies that erode the Canadian tax base and inhibit the need to develop increasingly complex technical rules that strive to address each new aggressive planning structure as it arises.

4.5.3 Thin capitalization

Canada's thin capitalization rules indicate that if a loan is made from a related party based outside of Canada to its Canadian corporate affiliate then this affiliate is only permitted to deduct interest payments associated with interest on debt that is below the specified 2:1 debt-to-equity ratio.[164] In other words, if the Canadian corporate affiliate is too "thinly capitalized" with debt (i.e., its debt-to-equity ratio exceeds 2:1) the rules will deny the deduction of a portion of its interest payment to the foreign related company. The Canadian thin capitalization rules deploy this so-called objective while certain other countries deploy other approaches including more subjective approaches that scrutinize the facts and circumstances of a cross-border loan transaction (see Section 3.1).

As mentioned, thin capitalization rules can also be deployed to guard against perceived abusive tax planning structures such as double dip financing structures (see Section 4.3.5). In fact, Australia previously attempted to inhibit abusive interest deductions for foreign operations through tax laws that tried to trace local interest deductions to the earning of tax exempt income in foreign countries (in a similar way to the new Canadian tax laws that attempt to restrict double dips). After review, this approach was abandoned in favour of reforming the thin capitalization laws as this effort was ultimately thought to be a more effective way to attack the problem.[165]

Several commentators have scrutinized this issue carefully and maintain that an Australian-type "thin capitalization" rule may be more effective at combatting this problem when compared to the approach currently advocated by the federal government.[166] Under the Australian approach, the thin capitalization regime applies, with modifications, to both outbound and inbound direct investment (unlike the Canadian version that only applies to inbound direct investment). Because the rules scrutinize outbound investments and interest deductions taken by related foreign corporations, the rules can be deployed against double dip and other structures that enable two interest deductions on the same (economically) item of income. It also bears mentioning that, in addition to Australia, certain European countries are either abolishing or redesigning their thin capitalization rules so that they offer roughly equal treatment to inbound

164 See s. 18(4) of the ITA.

165 See Australia, Treasury Department, *New Business Tax System (Thin Capitalization) Bill 2001: Explanatory Memorandum* (Canberra: Treasury Department, 2001).

166 See Jack M. Mintz and Alan R. Lanthier, "Seeking a More Coherent Approach to Interest Deductibility" (2007) 55(3) Can. Tax J. 629; Tim Edgar, "Outbound Foreign Direct Investment and the Sourcing of Interest Expense for Deductibility Purposes" (Draft, 2008).

and outbound financing as a result of a European Court of Justice decision.[167] For example, Germany has implemented new earnings stripping rules that apply to financings of domestic and foreign firms in excess of stipulated adjusted earnings along with safe harbor rules (see Section 3.1).

While the development of European- or Australian-like thin capitalization rules may be appealing in the longer run, the new Canadian rules that attack double dip and certain other tax efficient structures may need time to see if they are effectively achieving their goals. Under this view, the Canadian government should monitor the impact of its recent reform efforts and, should this approach prove too unworkable or impose overly burdensome compliance costs on taxpayers, explore reform efforts with respect to Canadian thin capitalization rules, which may ultimately prove to be more effective at attacking the policy problem of excessive interest deductions to fund foreign operations.

4.5.4 Tax cooperation

In recent years, the Canadian government has engaged in a number of cooperative efforts with other governments or their tax authorities. In 2004, Canada signed onto the *Convention on Mutual Administrative Assistance in Tax Matters*; this multilateral agreement promoted by the Council of Europe and the OECD envisions administrative assistance to exchange tax information among national tax authorities (Canada did not sign onto two other parts of the agreement that required assistance to collect foreign tax liabilities or to deliver tax-related documents from other governments). In the same year, Canada also joined the Joint International Tax Shelter Information Centre taskforce (see Section 4.5.2). In addition, Canada participates in the Seven Country Working Group on Tax Havens (along with Australia, Japan, the United States, France, Germany and the United Kingdom) to share research and information on avoidance schemes to reduce the risk to the tax regimes posed by tax havens. The CRA also maintains membership in the Pacific Association of Tax Administrators (along with Australia, Japan, and the United States) that, in 2004, released agreements to promote consistent documentation requirements for transfer pricing purposes as well as consistent mutual agreement procedures and advance pricing arrangements (see Section 4.5.1).

All of these efforts are consistent with the need to cooperate effectively in an era of globalization that is tying together Canada's economy with much of the rest of the world (see Section 2.5).

Additional efforts to cooperate with foreign tax authorities could help to reduce compliance costs while protecting the Canadian tax base. As mentioned, Canada could implement measures to reduce administrative and compliance costs for cross-border investments, including the exemption of taxpayers from compliance with some of the more onerous international tax rules such as the FAPI regime that are mainly designed to counter tax avoidance and tax evasion through the use of corporate bases in low or nil tax countries (see Section 4.4.5). Another important step would be to streamline the documentation

167 For example, in its decision in *Lankhorst-Hohorst* in 2000, the ECJ ruled that, as a result of the EC Treaty, thin capitalization rules cannot impose unequal treatment between resident and non-resident EU companies, leading many EU countries to redesign those rules. In contrast, the one Canadian decision in this area held that the discrimination is permissible under the Canada-U.S. tax treaty. See *Specialty Manufacturing Ltd. v. Canada*, (1998) 1 C.T.C. 2095 (T.C.C.), aff'd (1999) 3 C.T.C. 82 (F.C.A.).

requirements for transfer pricing purposes for North American firms: one set of documents, encouraged by the PATA reforms noted earlier, should suffice to offer evidence to tax authorities that reasonable efforts were made to determine the appropriate transfer prices.

Commentators have also identified a number of problem areas surrounding mergers and reorganizations arising from the different tax rules of Canada and the United States (as well as, potentially, elsewhere).[168] These different rules, at times, can impose income taxes on accrued gains on different types of cross-border corporate formations, reorganizations and liquidations: within each country, the same activities are normally conducted on a tax-free or tax-deferred basis. The existing tax treaty provides only limited relief in this area as capital gains taxes on cross-border restructuring operations often remain prohibitively high, forcing Canadian firms to maintain their existing inefficient structures.[169]

Another idea, explored elsewhere, would be to form a trilateral government institution (perhaps constituted by the three North American tax authorities) to grant case-by-case approval of tax-free or tax-deferred North American mergers and acquisitions.[170] This organization could scrutinize deals and grant tax relief if it felt that the merger would not result in tax avoidance.

This proposal is consistent with a Fifth Protocol change to the Canada-U.S. tax treaty that enhances cross-border audit cooperation by, among other things, (a) permitting tax authorities from Canada or the United States to enter the other country to investigate and depose witnesses as well as joint audits; and (b) expanding tax information sharing to include witness depositions and unedited original documents such as books, papers, accounts and writings. As previously noted, similar provisions within TIEAs would likely encourage a more effective sharing of tax information with TIEA partners (see Section 4.2.2).

These recommendations are also consistent with global international tax trends that are emphasizing administrative cooperation between or among tax authorities to smooth over problems encouraged by the interaction of different national income tax regimes. By focusing on administrative cooperation, governments feel less of a need to harmonize their tax laws and policies with those of other countries, which follows their desire to preserve sovereign control over their tax systems to the greatest extent possible (see Sections 2.2. and 2.5). As long as tax policy remains interwoven with the fabric of society, international tax reforms that alter the amount of taxes collected as well as who pays these taxes will remain important and often politically controversial decisions for governments and their citizens.

168 See Catherine Brown and Christine Manolakas, "Organizations, Reorganizations, Amalgamations, Divisions and Dissolutions: Cross-Border Assets, Double Taxation and Potential Relief under the US-Canada Tax Treaty" (1997) 26 Georgia Journal of International & Comparative Law 311.

169 Article XIII(8) of the Canada-U.S. tax treaty provides that tax authorities "may agree" to try to provide relief for double- or over-taxation of cross-border combinations, but this provision does not mandate such relief nor does it set out a process to expedite the grant of relief, if any.

170 See Michael McIntyre, "Commentary, The Design of Tax Rules for the North American Free Trade Alliance" (1994) 49 Tax Law Review 769.

5. Conclusion

This report reviewed the scholarly and policy arguments marshalled to support worldwide or exemption tax systems as well as policy developments related to the taxation of outbound direct investments within selected countries. While there is an ongoing academic debate about the value of deploying worldwide versus exemption taxation, there has been a policy shift by certain foreign governments who increasingly favour the use of hybrid exemption tax systems that seek to exempt from tax foreign source active business income (reflecting the policy goal of capital import neutrality) while maintaining current worldwide taxation on foreign source passive income (reflecting the policy goal of capital export neutrality). Viewed in this light, the current Canadian approach can be portrayed as consistent with, or in advance of, international policy trends.

Nevertheless, the policy environment is in flux. In particular, in recent years a number of countries (including the United States, the United Kingdom, Australia, New Zealand, Sweden, Italy, and Germany) have considered, or are considering, reforms to their outbound direct investment tax regimes to ensure that they do not impede cross-border investment activities. More specifically, governments are considering reforms that seek to:

- reduce the compliance burden on taxpayers;
- ensure that their international tax systems are sufficiently competitive to encourage levels of international investment that match desired rates of economic growth; and
- minimize the impact of tax on cross-border investment decisions to promote the integration of national economies with global capital markets.

These efforts comport with the Advisory Panel's mandate to review ways to reduce compliance and enforcement costs and to ensure that the Canadian system does not impede international investments while, at the same, protecting the Canadian tax base. Part 4 of this report set out some general observations concerning the possible direction of Canadian reform efforts.

On the one hand, the Canadian government could choose to pursue an *integrated reform agenda* that addressed policy concerns with respect to most of the elements of the tax system for outbound direct investment. This approach could involve comprehensive reform that abolished taxable surplus, reformed the rules to form a streamlined full hybrid tax exemption system that exempted all repatriated dividends from foreign affiliates along with relief for the sale of shares in these affiliates, merged and simplified the foreign source passive income systems, and strengthened certain anti-avoidance rules along with enhanced tax cooperation between the CRA and foreign tax authorities.

The integrated reform approach may be better-suited to achieving the Advisory Panel's goals. The drawback of this approach is that it will necessarily involve an overhaul of existing rules, which will take time and require complex transition rules to help taxpayers adapt to the new system. Should an integrated approach be deployed, it may be necessary to grandfather many existing cross-border structures (as well as, for instance, current participation thresholds for exempt surplus treatment) to promote a smoother transition to the new system.

Alternatively, a *selective reform agenda* could try to tweak specific areas of concern surrounding the surplus rules, the FAPI rules, and elsewhere. This reform approach would take less time, and would result in fewer overall changes to the status quo. For example, significant simplification could be achieved by abolishing taxable surplus while maintaining most of the existing features of the foreign affiliate system. The drawback of this approach, however, is that it may not fully achieve the goals of the Advisory Panel and, in an era of heightened global economic integration, may merely stave off the day where more fundamental reform is required.

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