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Enhancing Canada's International Tax Advantage

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In his speech to the Canadian Tax Foundation Prairie Conference in Calgary on May 25, 2009, Nick provides his perspective on the background behind the creation of the Advisory Panel and the environment it faced in its deliberations and in making its recommendations. He also highlights the principles articulated in the final report that should guide tax policy makers in making changes to Canada's international tax system and discusses how the principles support the recommendations made by the Advisory Panel.

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Advisory Panel on Canada's System of International Taxation Final Report: Enhancing Canada's International Tax Advantage¹ —A Panel Member's Perspective

Nick Pantaleo, FCA

Good afternoon. I am grateful to the Canadian Tax Foundation for inviting me to speak to you today to offer my perspective on the Advisory Panel's final report. Hopefully, many of you have had the opportunity to read the final report or at least to read the executive summary and are familiar with the Panel's recommendations.

A summary of the recommendations is included in your handout.² I do not plan on reviewing each recommendation this afternoon; instead, I intend to provide some personal observations setting out the background that led to the creation of the Panel. I will also discuss the environment the Panel faced in our deliberations and in making our recommendations, and the environment the government faces as they ponder the report and the Panel's recommendations. As well, I will devote some time to the underlining principles articulated in the final report that support our recommendations and that are intended to guide tax policy makers in making changes to Canada's international tax system now and in the future.

Background

The Minister of Finance, Jim Flaherty, announced the creation of the Advisory Panel in late November 2007. The Panel's mandate was to recommend ways to:

- first, improve the competitiveness, efficiency and fairness of Canada's system of international taxation; and
- second, minimize compliance costs for business and facilitate the administration and enforcement by the Canada Revenue Agency ("CRA").

It was a broad mandate. To meet our planned deadline of making recommendations in about a year, the Panel focused on how Canada's international tax rules affect Canadian businesses investing in foreign markets and how the rules affect foreign businesses investing in Canada.

A third aspect of our mandate was to "develop practical and readily-applicable changes" to Canada's international tax system. As will be evident from my remarks this afternoon, this part of our mandate would be fundamental in terms of *how* we would carry out our deliberations and *what* we would eventually recommend.

The Panel was a "mixed" Panel with its members drawn from the Canadian business community, professional tax advisory firms and the tax policy research field. The announcement of the Panel followed a promise made by the Minister in his March 2007 budget to create "an advisory panel of tax experts to undertake further study and consultations, with a view to identifying additional measures to improve the fairness of Canada's system of international taxation." This turned out not to be a panel of tax experts. It was not a tax technical panel. As a result, the announcement of the Panel was greeted with some apprehension within the tax community. In the end, I trust, such apprehension proved to have been misplaced.

In my view, the Panel had sufficient tax technical expertise available to it. First, certain members of the Panel had significant experience in international tax and tax policy – in particular, Kevin Dancey, Jim Love and me.

Second, the secretariat set up to provide technical assistance to the Panel was lead by Brian Mustard, an international tax services partner with KPMG, and included representatives from the Departments of Finance and Justice and from the CRA.

Finally, the Panel reached out in the course of its deliberations to tax practitioners and to tax academics throughout the country and from around the world to benefit from their expertise and experience in the relevant areas.

1. Advisory Panel on Canada's System of International Taxation, *Final Report: Enhancing Canada's Competitive Tax Advantage: A Consultation Paper Issued by the Advisory Panel on Canada's System of International Taxation* (Ottawa: Department of Finance Canada, December 2008).

2. See Appendix A.

Aside from all of that, I believe the diverse makeup of the Panel – and not being a panel of tax experts – proved to be its strength. But perhaps more importantly, the international business experience a number of the Panel members brought to the table provided us with something that often tax practitioners accuse tax policy makers of not having – indeed, it is something tax practitioners are at times themselves accused of not having – which is an appreciation or an understanding of the realities of carrying on business in today’s global economy over which tax policy and tax rules govern. This understanding, I believe, is evident throughout the discussion in our consultation³ and final reports and is reflected in the principles we articulate. This had to be the case for us to “develop practical and readily-applicable” recommendations.

We clearly recognized that there would be a need to address technical matters, as we did, for example, with respect to our recommendation to exempt certain capital gains arising on the sale of shares of foreign affiliates. And we knew more would be needed. However, not being a tax technical panel, we were able to take a more principle-based, rather than rules-based, review. This allowed us to focus and deal with specific issues and problems.

Why was there a need for the Advisory Panel?

The announcement of the Panel in the March 2007 was a surprise to many, but perhaps not as surprising as the changes to our international tax system, which were announced at the same time, each of which was a departure, and in a couple of instances, a very significant departure from Canada’s international tax policy.

As a reminder, these initiatives were:

- first, to eliminate withholding taxes with respect to cross border, arm’s length interest payments;
- second, to sign the Canada-US protocol to, among other things, eliminate cross-border withholding tax on non arm’s length interest payments;
- third, to extend the exemption under our foreign affiliate regime to active business income earned in countries with which Canada had entered into a Tax Information Exchange Agreement (or TIEA); and
- finally, to restrict the deductibility of interest on funds borrowed to invest in foreign affiliates, which, in May 2007, was modified under the Anti-Tax Haven Initiative and subsequently enacted as section 18.2, to deny the deductibility of interest if these funds were eventually used in certain offshore, double dip financing structures.

Looking back to that time, I believe there were compelling reasons for creating the Panel, not the least of which was, as the Minister stated, to determine what other changes might be needed and inevitably to assess the appropriateness of the March 2007 proposals dealing with expanding the exemption system and restricting the deductibility of interest. In addition, at the time and still today, a significant amount of draft legislation in the foreign affiliate and the Foreign Investment Entity and Non-Resident Trust areas is outstanding. Incredibly, the origins of some of this draft legislation date back 10 years. Throughout this period, stakeholders – the government, including Finance and the CRA, taxpayers, and advisors have had to deal with the uncertainty of not knowing what tax rules are applicable to some of their international transactions. Moreover, these are enormous pieces of legislation that would add considerable complexity to the rules in these areas.

Certainly many, myself included, believed that a “reality check” was in order to determine whether directionally this was taking the Canadian system where it should go, and as well, to determine whether the increased compliance burden to taxpayers – in particular, small and medium size enterprises – and the increased administration and enforcement burden on CRA is commensurate with the integrity risk to the tax system that the measures are intended to eliminate.

Perhaps the most compelling reason for the Panel, however, was that Canada was falling behind most countries in taking a focused review of its international tax system. Many countries had already conducted or were in mist of reviewing their international tax systems – a review that had prompted a number to make changes to their existing system from general refinements to those, for example, in Australia, the UK, New Zealand and more recently Japan, which resulted in fundamental changes regarding the taxation of foreign source income. With one recent exception, that being the U.S., the focus of proposed reforms in other jurisdictions has been to enhance the competitiveness of their domestic companies operating in global markets while at the same encouraging inbound investment, in

3. Advisory Panel on Canada’s System of International Taxation, *Enhancing Canada’s Competitive Tax Advantage: A Consultation Paper Issued by the Advisory Panel on Canada’s System of International Taxation* (Ottawa: Department of Finance Canada, April 2008).

particular, by reducing corporate income tax rates, though not at the expense of inappropriate erosion of the domestic tax base.

Reform or Tinkering – What Does Canada Need?

The Panel's undertaking would be the first focused review of Canada's international tax system since the early 1970s; this also suggested that Canada was due for a review. The Report of The Technical Committee on Business Taxation of 1998 did review the international tax system but as part of a broader review of the Canada's entire system of business taxation, although a number of its recommendations in the international tax area were adopted over a period of time.

Notwithstanding the length of time that has transpired since the last detailed review of Canada's international tax system, it was evident early on to the Panel that our task would not be to initiate tax reform anywhere near the magnitude of that which preceded the inception of the current system. In any event, that was not going to be necessary because we quickly concluded that Canada's current international tax system is a pretty good one, and that there was no need for radical changes, in particular in the outbound context where the essence of international tax reform in other jurisdictions was actually to bring their systems more closely in line with Canada's. Our April 2008 consultation paper reflected this view.

With respect to the taxation of foreign active business income earned through foreign affiliates, the Panel did not believe that it was necessary to again reconsider alternatives to the exemption system, particularly where those changes would be at odds to international norms and would put Canadian companies, especially smaller and medium-size companies, at a competitive disadvantage relative to their global competitors. Certainly, the Panel did not hear a dissenting view during our deliberations. This was not to suggest the Canadian system was perfect. But perfection is not the standard by which international tax rules can or should be measured. The Canadian system never aspired to such an impossible standard, nor should it.

International tax rules have to accommodate a variety of often conflicting objectives such as capital export and capital import neutrality and tax efficiency, simplicity and administration considerations that are never easily reconciled. Still, as with any tax system, from time to time it is necessary to:

- look objectively and critically as to how the system stacks up relative to what other countries are doing;
- consider how or where the system has become too loose and how or where it has become too tight, too restrictive, and too complex; and
- evaluate the extent to which the current system has kept up and accommodates how businesses conduct and structure themselves in today's global and digital economy.

To re-examine and affirm the underlying principles of the system to ensure they give sufficient guidance to the tax policy makers in today's environment to ensure the system is working for the betterment of Canadian companies operating abroad as well as to encourage foreign investment in Canada, for the collective benefit of all Canadians.

Importance of Foreign Direct Investment to Improving the Welfare of All Canadians

The Panel embraced the view that inbound and outbound foreign direct investment is important to the Canadian economy. Canada is too small a country to adopt insular or protectionist policies that restrict its accessibility to foreign capital, technology and knowledge. On the other the hand, its size necessitates that Canadian companies expand globally earlier than their global competitors to achieve economies of scale.

The Panel described in its final report how both inbound and outbound investments are needed to improve the welfare of all Canadians by creating faster growth, greater employment, higher living standards and additional tax revenues for governments. While both have grown significantly in recent years, the Panel observed that Canada's share has declined. Indeed, some would argue that Canada's foreign direct investment is not impressive by global standards. This was not to suggest that our current international tax system is at fault; Canada has traditionally pursued an open economy and its system of international taxation has reflected this pursuit. But it does reflect the changing dynamics of the global economy and the emergence of developing countries such as China, Brazil and India as competition for Canadian companies. Specifically, the Panel noted in its report that some of these new competitors are aggressively seeking capital in global markets, while others have substantial amounts of capital to invest.

This reinforced the competitive nature of the world economy and highlighted to the Panel the need to avoid changes to our international tax rules that impede the ability of Canadian businesses to compete.

Principles to Guide Canadian International Tax Policy

The Panel made a very clear and deliberate attempt to articulate principles it believed should guide Canada in formulating its international tax policy and in making changes to the system today and in the future.

The Panel's recommendations are pragmatic ones, reflecting the Panel's belief that while Canada's current international tax system is a good one, it does require some improvements. The recommendations were developed with reference to these principles. They are aimed at improving Canada's tax system by delivering predictable and more certain results and by enhancing the competitiveness of Canadian businesses by not impeding cross-border business investment while protecting the Canadian tax base.

Two key directives emerge from applying these principles. The first directive is that the federal government should maintain the existing system for the taxation of foreign-source income of Canadian companies and extend the existing exemption system to all active business income earned outside of Canada by foreign affiliates. The second directive is that the federal government should maintain the existing system for the taxation of inbound investment and adopt targeted measures to ensure that Canadian-source income is properly measured and taxed. There is no hiding the fact that the principles we articulate led us to recommend some measures that are at odds with those recently advanced by the government – for example, the enactment of section 18.2. But that was not always the case.

The government's recent change to extend the exemption system to countries with which Canada has entered into a TIEA made it easier for the Panel to recommend that Canada move to a territorial system. The government's announcement in the 2007 budget was a bold initiative and, in my view, would have been the highlight of that budget if not for the interest deductibility proposal. To me, the significance of extending the exemption system to countries with which Canada had signed a TIEA is that ended any pretense that the exemption system for taxing foreign active business income earned through foreign affiliates was still, if it ever was, a proxy for a foreign tax credit system.

Recommending that Canada move to a territorial system for taxing foreign business income in turn made it easier for the Panel to recommend that there be a fresh look at or rethink of the scope and interaction of our anti-deferral regimes – i.e., the FAPI, FIE and NRT regimes.

The first principle is:

Canada's international tax system for Canadian business investment abroad should be competitive when compared with the tax systems of our major trading partners.

In the Panel's view, an overriding principle guiding Canada's taxation of outbound direct investment should be to ensure that the Canadian tax treatment of foreign-source business income does not disadvantage Canadian businesses investing abroad when compared with their foreign competitors. Achieving this goal can be accomplished by not exposing Canadian businesses to costs in relation to their foreign business income that their foreign competitors are not required to incur. This principle is not new to our current system.

It was evident in the tax policy discussion at the time of and subsequent to the adoption of the existing foreign affiliate rules of a conscious concern to balance fair taxation of the domestic and foreign income of multinational corporate groups, while supporting the competitiveness of Canadian multinational businesses.

While some question whether this is an appropriate guiding principle for formulating international tax policy, as a practical matter, I believe such a debate has been rendered to be academic because the fact of the matter is that concerns about competitiveness have played an important role in recent years in shaping international tax policy. In the last few years, countries such as the United Kingdom, Australia, New Zealand, Sweden, Germany and Italy have published government reports that try to assess whether their international rules are competitive with those in place elsewhere.⁴ Can a small open, trading nation like Canada realistically afford to be the odd one out in this respect? The Panel did not think so.

4. The U.S. has also issued such reports in the past (see, for example, Department of Treasury, Office of Tax Policy, "Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century"). Although recent White House tax proposals seem

Where does this lead us? A recent report of the OECD concluded, “international competitiveness considerations weigh heavily and effectively towards no or only limited home country taxation of foreign profits.”⁵ Hence, our recommendation that Canada formally move to a full exemption system for taxing foreign business profits earned through foreign affiliates. But if the objective is to ensure that our tax rules do not impede Canadian businesses from being competitive in global markets, then this principle requires that we understand and accommodate how businesses structure their global operations; how they manage their supply chains and allocate its various stages in the most productive and cost-efficient manner throughout the world.

Thinking in this manner means reflecting, for example, on the role of base erosion rules⁶ in the modern business environment: do they place Canadian businesses at an unnecessary competitive disadvantage and do the rules actually impede the development of modern domestic business infrastructures that these rules were originally intended to protect; infrastructures that in a large part are being created by small and medium-size companies? The Panel believed that these rules and the investment business definition needed to be revisited for this reason.

Considered in this manner, is paragraph 95(2)(a) of the Act really just a “loophole” in our law that permits Canadian companies to shift foreign business income to lower tax jurisdictions, which is the reason the check-the-box-rules are currently under attack in the U.S.? Or has 95(2)(a), consciously enacted 35 years ago, turned out to be an inspired initiative that accommodates modern business practices of having different ownership and management structures throughout the world and not just within a single jurisdiction?

The Panel believes that the provision is as important as ever for Canadian businesses, and measures that would limit its application, which to my mind was the real consequence of section 18.2, should be avoided.

As for interest deductibility, the Panel recommended not restricting interest deductibility on funds borrowed in Canada to invest in foreign affiliates – other countries allow this – and so should Canada, as a matter of benchmarking and competitiveness. This is especially important in today’s economic environment. It has been a constant feature of our rules since the early 1970s and appropriately so. As we noted in our report:

“Canadian businesses need flexibility in raising capital and structuring the financing of their foreign acquisitions and expansions to be competitive with businesses based in other countries. In the Panel’s view, this pragmatic concern is of much greater weight than any theoretical basis for denying interest deductions on money borrowed to invest in foreign companies or in respect of outbound financing arrangements.”⁷

The second principle is:

Canada’s international tax system should seek to treat foreign investors in a way that is similar to domestic investors, while ensuring that Canadian-source income is properly measured and taxed.

Foreign direct investment brings significant benefits to the Canadian economy. While competitiveness is an important feature of an outbound international tax system, domestic competition is also important to Canada’s inbound regime and it is necessary that the government continue to take action to ensure Canada remains an attractive destination for foreign investors. The Panel endorsed the government’s efforts to reduce the Canadian corporate tax rate as being very important in this regard.

A level playing field for the taxation of Canadian-source income is a key concern of Canadian businesses. Foreign entities doing business in our country should pay Canadian tax on what is properly considered Canadian-source income. Although no playing field can ever be perfectly level, the Panel believes that creating the conditions to ensure that Canadian and foreign businesses investing in Canada compete on similar footing should be a key consideration of the government in setting Canada’s tax policies regarding inbound direct investment.

to contradict this direction, it is not clear such proposals will be enacted or that they are part of international tax reform in the U.S. or simply part of the U.S.’s current crackdown on abusive tax avoidance and evasion.

5. See discussion in OECD, *Tax Effects on Foreign Direct Investment – Recent Evidence and Policy Analysis*, OECD Tax Policy Studies no. 17, 2007, at page 17.

6. In Canada’s tax system, these rules include paragraphs 95(2)(a.1)-(a.4) and (b) of the Income Tax Act (Canada) (“the Act”).

7. *Supra*, footnote 1, paragraph 4.166.

This brings us to our third principle:

Canada's international tax system should include appropriate safeguards to protect the Canadian tax base.

Canada must have robust rules to protect the Canadian tax base to ensure Canadian source income is properly measured and taxed. This principle has implications for setting Canada's outbound and inbound tax rules.

From an outbound perspective, the implications of moving to a territorial system for taxing foreign active business income of foreign affiliates, including the exemption from Canadian income tax of capital gains arising on the disposition of shares of foreign affiliates if all or substantially of its assets are used or held to earn active business income, is that certain foreign passive income be taxed in Canada on a current basis. The Panel concluded that there was simply no good policy reason to favour foreign over domestic passive income. Accordingly, Canada would continue to need robust anti-deferral regimes to prevent the offshore accumulation of passive income. It will also have to strengthen its rules and its enforcement of its transfer pricing regime and closely monitor the migration of intellectual property from Canada.

From an inbound perspective, the Panel considered alternatives to the current Canadian thin capitalization regime. In particular, it reviewed the so-called "earnings stripping" rules employed by countries such as the U.S., Germany and Italy. It also considered the "arm's length" approach employed by the U.K. As well the Panel considered whether third-party and guaranteed debt should be incorporated into Canada's thin capitalization rules, including whether to extend such rules to all domestic companies, regardless of whether these companies own foreign affiliates.

The Panel resisted following certain countries in proposing general thin capitalization rules, for a couple of reasons. We certainly were not going to pursue such a proposal without first having the opportunity to consider the implications of purely domestic, highly leverage buyouts by pensions and other tax-exempt entities. Moreover, it would introduce mind boggling complexity, contrary to our fourth principle (which I will introduce in a moment), without necessarily gaining any greater assurance of achieving the right objective. In the end, the Panel concluded "Canada's current approach...is sound in principle and appropriate in scope. The approach is transparent and relatively simple to enforce and the Panel believes it should be maintained."⁸ The Panel made recommendations 5.1 and 5.2 to strengthen the current thin capitalization rules and to ensure the system remains effective in protecting Canada's tax base.

As part of the Panel's mandate, it was asked to review issues related to so-called "debt-dumping" with respect to foreign-controlled Canadian corporations. The Panel reveals that the term "debt dumping" could be used to describe different types of circumstances where a Canadian company, whether or not it is foreign owned or controlled, is highly leveraged. In paragraph 5.51 of the report the Panel states "[c]onsistent with Recommendation 4.7, the Panel does not believe that interest expense should be restricted in situations where a Canadian company borrows to make a foreign investment with ordinary business motives. In the Panel's consultations, however, it was widely agreed that one particular type of debt-dumping transaction raises significant tax policy concerns." This type of transaction is depicted in slide 21 in Appendix A. Believing that recommendation 5.1 and 5.2 would not be enough to discourage these type of transactions, the Panel concluded that Canada needs to supplement its thin capitalization rules with a specific anti-avoidance rule to address them. Consistent with its principles, the Panel recommends that such a rule be "robust, easy to administer, and narrowly targeted to ensure it does not impede acceptable business transactions that benefit the Canadian economy."⁹ This is consistent with what the Panel heard during our deliberations about avoiding having a broad based provision to deal with a specific type of problem.

Another significant area affecting the Canadian tax base is withholding tax. While the Panel expressed its support for Canada to continue to reduce its withholding taxes, consistent with what is generally happening elsewhere in the world, we cautioned that this needed to be done carefully and with a full appreciation for the benefits it would bring to Canada recognizing the current revenue it generates.

The fourth principle is:

Canada's international tax rules should be straightforward to understand, comply with, administer and enforce, to the benefit of both taxpayers and the CRA.

8. Supra, footnote 1, paragraph 5.29.

9. Supra, footnote 1, paragraph 5.54.

Personally, I have a soft spot for the quote from David Rosenbloom found in your materials on slide 12, in particular, the following statement: “Efficiency, equity, and simplicity are all virtues in matters of taxation, but the greatest of these virtues is simplicity.” It seems, though, the more we speak of simplifying the international or any other part of the Canadian tax system, it just gets more and more complicated for taxpayers, for the CRA and for the drafters of tax policy. Let’s be clear: “Simplicity” is not intended to mean “simplistic.” Rather it means avoiding complex rules where possible, without sacrificing the main tax policy objectives of the tax system, in the interest of tax legislation that is understandable and relatively easier to apply and administer – a task that is certainly made easier if such policy is properly articulated and understood.

The recommendation to move a territorial system, at a conceptual level, is a significant tax policy change for Canada. At a practical level, many, the Panel included, would submit it is not so significant a change.

For the reasons articulated in our report, the current system generates little if any Canadian tax revenue with respect to dividends paid by foreign affiliates to their Canadian shareholders. Yet, under the current rules, taxpayers have the significant time consuming and costly burden of tracking “exempt” and “taxable” surplus balances. This is a significant cost to taxpayers, in particular, small and medium size companies. As important, taxpayers find it challenging, if not impossible, to maintain accurate and current surplus balances for a number of reasons, which we articulated in our report.¹⁰ Finally, taxpayers have to spend time reviewing and explaining their calculations to the CRA while the CRA in turn is obliged to spend hours reviewing the calculations, essentially in the hope that a taxpayer made an error and paid a taxable surplus dividend with little or no underlying foreign tax. There is surely a better use of the CRA’s limited resources than to chase such a low area of risk to the Canadian treasury. Their time would be best directed to training their people to better understand and review for FAPI and transfer pricing risks.

Speaking of FAPI: Consistent with our third principle, the Panel did not believe there should be any controversy over the need for FAPI rules. But while the FAPI rules are generally understood, the Panel heard many complaints about their complexity, particularly in terms of how they interact with the proposed FIE and NRT regimes.

The Panel believes our recommendation to adopt a broader exemption system raises questions about the scope and interaction of Canada’s existing anti-deferral regimes. In particular, the Panel believes that the FIE and NRT rules should be reconsidered to ensure that their need and scope are consistent with our principles and our recommendations regarding the taxation of outbound investments by Canadian businesses. The Minister in his January 2009 budget proposed that in light of the government receiving a number of submissions, including the Panel’s recommendations, it will review the existing proposals before proceeding with measures in this area.

So where does this leave us? The challenge in any move to territorial system or even a fuller exemption system is what to do about passive income earned by entities and foreign affiliates that are not controlled foreign affiliates. Specifically, to what extent should they be covered by the FAPI or the FIE rules or both? What role should the NRT regime play? FAPI is the anti-deferral regime that is best known and best understood, not just by taxpayers and tax advisors but by the CRA. The FIE regime is not. This is important. In fact, I submit that it is of paramount importance because taxpayers and the CRA cannot comply with, administer or enforce a law they do not understand. The Panel made recommendations and offered some direction as to how the FAPI regime could be “modernized” to accommodate modern business practices and reduce the level of complexity and compliance burden associated with these rules. Along with these changes, the FAPI regime could be extended to tax passive income earned by non-controlled foreign affiliates.

There are concerns with this suggestion. These concerns focus on the lack of information available to taxpayers to determine FAPI of non-controlled foreign affiliates and whether, in light of the broad definition of “controlled foreign affiliate” in subsection 95(1) of the Act, it is likely that Canadian companies are attempting to avoid Canadian tax in non-controlled situations. These are legitimate concerns, especially keeping in mind the fourth principle about keeping the system simple and easy to administer and enforce. These concerns may be overcome, for example, as the Panel suggests, by eliminating the base erosion rules for non-controlled foreign affiliates and/or by having a high tax exemption from FAPI, say, for foreign affiliates in the US and the UK. This would likely cover most of Canada’s foreign affiliates.

10. Supra, footnote 1, paragraph 4.25.

In the alternative, is it better to have the FIE regime apply to non-controlled foreign affiliates? Most of what we heard about the complexity of the anti-deferral regimes was directed at the FIEs and NRT proposals. Extending the FAPI regime to non-controlled foreign affiliates with the above mentioned modifications, coupled with our suggestion to expand the foreign affiliate definition to include trusts and partnerships, which could take them right out of the FIE and NRT regime, could significantly pare down the scope of the FIE proposed rules. Paring down the scope of the FIE rules could then result in consideration being given to eliminating the mark-to-market and accrual aspects of these proposals. After then allowing for the exceptions in the current proposals (for example, with respect to foreign interests traded on designated stock exchanges), it is not unreasonable to then think about eliminating the FIE proposals in their entirety and having instead very specific anti-avoidance provisions – perhaps a modified version of current section 94.1 that deems the holding of an offshore interest to be tax motivated in certain circumstances. It would probably also be necessary to retain some of the proposed provisions to deal with tracking interests or insurance policies or the like.

Interestingly, the Australians have recently decided to go this route and, ironically, have referred to Canada's existing section 94.1 as a model to follow. The NRT rules could similarly be reconsidered in light of the Panel's recommendations and the principles we articulated.

Moving certain entities, such as commercial trusts, over to the FAPI regime is an easy one. Given the huge downside to falling into these rules, the government should ensure we properly define "exempt foreign trusts." that we narrow down what is considered to be a "contribution" and that taxpayers have appropriate remedies to address, in particular, double taxation issues.

The fifth principle is:

Full consultation should precede any significant change to Canada's international tax system.

I do not believe there is any greater threat to the integrity of any tax system than having rules that are too difficult for taxpayers to understand and to comply with and for the revenue agency to administer and enforce.

Applying the fourth principle is a way of avoiding this problem. The other is to have a more open and productive consultation about proposed changes. Open consultation will increase overall understanding and the certainty of our tax rules and avoid unintended consequences for Canadian businesses.

Consultations should be held regarding possible tax policy changes, with a reasonable period of time allowed for study and comment on the potential impact of a proposed rule before they are intended to take effect. The draft foreign affiliate rules are a good example of the consequences to introducing draft legislation in the absence of prior consultation – Finance now has an almost impossible task of reconciling these proposals with the Panel's recommendation while at the same addressing multiple transitional rules to deal with several versions of the draft legislation as well as already promised proposed changes to such drafts. The result has been significant uncertainty for taxpayers – again, a disproportionate burden of which falls upon small to medium-size companies – and for the CRA.

The last principle is:

Canada's international tax system should be benchmarked regularly against the tax systems of our major trading partners.

Many countries are considering or are already changing their tax systems to compete for capital, jobs and growth. Canada's tax policy must anticipate continuous change in the global environment and retain the flexibility to adapt accordingly.

Regular benchmarking can help ensure Canada's system of international taxation stays in step with or ahead of international norms. We do not want to lag behind other countries and we do not necessarily always want to lead, notwithstanding that our track record in the later respect is pretty good.

Looking Ahead

In my remaining minutes I want to allude to one aspect of our report that has not received a lot of attention. It is something that I had hoped would have received more attention in our deliberations and generated a bit more discussion during our consultations.

In our *Looking Ahead* chapter, we referred to “Neutrality Among Substitutable Economic Returns.” We noted that, tax considerations aside, shareholders are generally indifferent to the manner in which they derive their return from a subsidiary. In other words, if the tax treatment was identical, a shareholder would be indifferent as to the form of their return; i.e., as dividends, interest, royalties or some other return. The Panel suggests that the Canadian government explore this concept to assess whether there is some merit to harmonizing the treatment of different returns from foreign affiliates.

For example, interest received by a Canadian company from a foreign affiliate is taxable in Canada while all dividends from foreign business income of the affiliate will be exempt, assuming the government accepts the Panel’s recommendations. This suggests that a Canadian company would have a preference for using equity to finance its foreign affiliates because returns on equity are exempt from Canadian tax.

However, this is not necessarily the case. If the Canadian shareholder only uses equity to finance a foreign affiliate, the affiliate generally will not be able to obtain a deduction for the payment of dividends and its foreign taxable income and tax liability will not be reduced by the return paid to the shareholder. Therefore, Canadian companies, like their foreign competitors, will organize and finance their affiliates using intermediary entities to reduce the foreign tax payable by the affiliate on its foreign business income to maximize the returns that can be repatriated to Canada in the form of tax exempt dividends. The Panel follows this analysis by raising the question as whether it is necessary for Canadian companies to set up complicated and costly offshore holding and financing structures to achieve this result. Instead, should consideration be given to exempting or reducing the Canadian tax burden on such interest and, for that matter, royalties and similar returns from its affiliates? This could encourage Canadian companies to carry out more financing, leasing and licensing functions in Canada rather than in foreign jurisdictions.

Why must Canadian companies establish offshore treasury and research development centers? Why Bermuda? Why Barbados? Why not... Kenora?¹¹

I believe the most compelling and intriguing aspect of this proposal is how it could enhance the development of “centers of excellence” in Canada in the information, technology and other knowledge base industries.¹²

Some maintain that Canada’s overall investment in R&D is not enough; not by global standards. But how can this be increased or improved? The government effectively provides an annual subsidy, to the tune to \$4 to \$5 billion dollars, through various tax incentives, to encourage R&D activities in Canada. How much more can it realistically afford to invest in this area and what is the best way to do so? I had an interesting discussion on this topic with a senior tax person of a Canadian subsidiary of a large, global company. He indicated that the current Canadian R&D tax incentives were not enough to make him go to the “global table” to request additional R&D be done in Canada by the Canadian subsidiary. However, he would certainly do so if the Canadian subsidiary were able to commercialize products developed as a result of such R&D and with the resulting income being subject to a significantly lower rate of tax, similar to that imposed by a number of countries. I thought this was a revealing comment.

Should we not be considering how our international tax system can encourage increased development and commercialization of intellectual property in Canada? Part of the answer to attracting increased investment in this area may be to reduce significantly the rate of Canadian tax on royalties and licensing fees received from outside Canada from the exploitation of intellectual property developed in Canada, as well as reducing significantly the rate of tax on gains from the disposition of such property. This approach would encourage Canadian companies that may

11. This description is taken from H. David Rosenbloom, “Why not Des Moines? A Fresh Entry in the Subpart F Debate” (2003) vol 32. no. 10 *Tax Notes International* 895-98. See also, Brian J. Arnold, **Reforming Canada’s International Tax System: Toward Coherence and Simplicity**, Canadian Tax Foundation, Canadian Tax Paper no. 111, page 133.

12. For an interesting perspective on this topic, see submission to the Advisory Panel by Mr. W. Geoff Beattie, President of The Woodbridge Company Limited at <http://apcsit-gcrctf.ca/05/sbrmms-eng.html>.

otherwise move or migrate their IP and related assets outside Canada to retain such property, together with related offices and jobs in Canada.

As a footnote, the Panel identified migration of IP out of Canada as an area of concern and one we encouraged the government to monitor closely, including what other countries are doing in this area. Indeed, this is an area of current tax planning that is not for the faint of heart as it is attracting increased audit attention by the CRA.

As important, should our international tax system not also encourage Canadian companies that acquire IP outside of Canada to migrate that property to Canada for purposes of further development in Canada and to commercialize it from Canada? This could be further encouraged by permitting a more generous writeoff of these purchases of IP, something a number of countries, most recently, Ireland, are doing. It is unclear how much tax revenues Canada currently generates from taxpayers licensing globally their IP developed in Canada.

The question that needs to be studied further is whether reducing the tax burden on this income would actually create a higher tax base, not just in the corporate tax area, but in other areas that would benefit from the increased activity that could be generated – for example, additional infrastructures that would be created and the related increased level of employment. Not to mention the other benefits associated with centers of excellence, in particular, retaining and attracting highly skilled workers – scientists, engineers, and so on. A pipe dream? By Canadian standards – maybe.¹³ Clearly, more thought and review would be necessary. But other countries are increasingly turning to targeted tax incentives they wish and need to encourage. The OECD has indicated in one of its reports:

“Certain countries prefer to explicitly target tax relief with the aim of encouraging additional FDI at a lower cost in terms of foregone tax revenue. Targeting mobile activities is regarded by some policy makers as an attractive option....there are indications that policy considerations including the mobility of capital and business calls for more lenient home country treatment are leading many if not most countries towards more lenient treatment, not less, across a broader set of income types, because other countries are doing the same.”¹⁴

This may indeed be “looking ahead”; something for “future consideration” – but to many, the future is now.

Conclusion

In conclusion, the Panel’s recommendations are intended to modernize Canada’s current international tax system to reflect current global business practices and make it competitive relative to tax systems in other jurisdictions.

The recommendations are also intended to reduce unnecessary complexities in a number of areas to relieve the compliance and administrative burden of taxpayers and the CRA, and permit the CRA to focus its limited resources in areas that have a greater potential for detecting inappropriate tax avoidance. These benefits, along with the Panel’s assessment that its recommendations “should not result in any net fiscal cost to the government,” are compelling reasons for the federal government to seriously consider moving forward with the Panel’s recommendations. While not every recommendation may gain acceptance by all stakeholders, overall, the Panel’s recommendations should be well received by businesses and the CRA.

The government has already announced the repeal of section 18.2 and its intention to review the proposed FIE and NRT rules as a result of the Panel’s recommendations.

The government is expected to give consideration to the Panel’s other recommendations and hopefully additional changes to Canada’s system of international taxation the rules will be circulated for public consultation in due course.

Our work is not yet done.

13. However, see provincial tax incentives offered to companies registered under British Columbia’s International Financial Activity program (see www.ifcbc.com).

14. See *supra*, footnote 5, pp. 16-23.

Appendix

PowerPoint® Presentation

Advisory Panel on Canada's System of International Taxation

Final Report: Enhancing Canada's International Tax Advantage

By Nick Pantaleo, FCA

May 25-26, 2009 Prairie Provinces Tax Conference: Canadian Tax Foundation



Advisory Panel on Canada's System of International Taxation

Final Report: Enhancing Canada's International Tax Advantage



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Advisory Panel's Mandate

Improve the fairness, economic efficiency and competitiveness of Canada's system of international taxation, as outlined in *Advantage Canada*;

Minimize compliance costs for business and facilitate administration and enforcement by the Canada Revenue Agency; and

Develop practical and readily-applicable changes, taking into account existing rules and tax treaties as well as fiscal implications.

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Advisory Panel's Process

Panel created by Finance Minister late November 2007

Consultation paper issued April 2008

Meetings, roundtables and discussions with interested parties May to July 2008

Research program

Final Report issued to Minister December 10, 2008

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Advisory Panel Members

Chair – Peter C. Godsoe, OC

Vice-Chair – Kevin J. Dancey, FCA

James Barton Love, QC

Nick Pantaleo, FCA

Finn Poschmann

Guy Saint-Pierre, CC

Cathy Williams

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Final Report – Key Messages

Canada's current international tax system is a good one

Maintain existing inbound and outbound systems

- Broaden exemption system
- Adopt targeted measures to ensure Canadian source income is properly measured and taxed

Six principles to guide Canadian international tax policy development

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Principles to Guide Canadian International Tax Policy

Competitive tax system for Canadians investing abroad

Level playing field for domestic business activity

Protect Canadian tax base

Straightforward tax rules

Open consultation

Regular benchmarking

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Principles to Guide Canadian International Tax Policy

Implementing the principles requires an effective self-assessment system

Effective self-assessment requires businesses, advisors and the government to take responsibility:

- Business and their advisors – Respect spirit and object of tax law and government’s need to protect Canada’s tax base
- Government – Respect that most businesses seek to comply with the law and do not practise inappropriate tax avoidance

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Recommendations Outbound Investment

“The Panel believes that the exemption of foreign active business income earned by a foreign affiliate should be viewed as the norm for Canadian tax purposes. Ours is a territorial view which asserts that such income should not be considered part of Canada’s tax base. This view is consistent with current international norms—and the reality that little Canadian tax is collected on foreign active business income.”

(para 4.21)

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Recommendations Outbound Investment

4.1: Broaden exemption system to cover all foreign active business income earned by foreign affiliates

Comments

- Little tax cost to government
- No compelling evidence would bias domestic investment
- Simpler for taxpayers to comply and CRA to administer and enforce
- Consistent with many other countries (more recently, New Zealand, UK and Japan)

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Recommendations Outbound Investment

4.2: Pursue tax information exchange agreements on a government-to-government basis without resort to accrual taxation for foreign active business income if a TIEA not obtained

Comments

- Unfair to put business in the middle of government-to-government negotiations to enter into TIEAs
- Does not help Canadian companies with investments in countries where not likely to have a tax treaty or TIEA

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Recommendations

Outbound Investment

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

Comments

- Tax cost to government probably not significant
- Simpler for taxpayers and CRA; e.g. no 93(1) elections
- Consistent with many other countries
- Issues: (i) capital gains taxable on sale of shares of domestic companies; (ii) need for holding period? (iii) still need to compute “safe income”; (iv) need for dividend stripping rule; (v) “excluded property” definition needs to be robust and produce fair results

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Simplicity is Not Simplistic: The Rules Are “Real”

“Perhaps it is years of working with and under the U.S. tax system that leads me to place a special premium on simplicity in matters of taxation. There are too many rules in that system, and the complexity of those rules impedes assessment of their merits on other grounds. Furthermore, there is all too little consideration by the creators of U.S. tax legislation of what and who will be involved in translating tax laws into working reality. For these reasons, simplicity and administrability of rules hold a special place for me. Efficiency, equity, and simplicity are all virtues in matters of taxation, but the greatest of these virtues is simplicity.”

- H. David Rosenbloom

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Recommendations Outbound Investment

4.4: Review the “foreign affiliate” definition, taking into account the Panel’s other recommendations outbound investment, the approaches of other countries, and the impact of any changes on existing investments

Comments

- Current threshold out of step with rest of world, particularly if Canada moves to broader exemption system; other countries employ test based on votes and/or capital
- Consider impact on existing investments; transitional rules needed
- Expand definition to include, for example, trusts and partnerships; should take pressure off of FIE and NRT rules

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Recommendations Outbound Investment

4.5: Review and undertake consultation on how to reduce overlap and complexity in the anti-deferral regimes while ensuring all foreign-source passive income is taxed in Canada on a current basis

Comments

- Need to protect Canadian tax base
- In a broader exemption system, challenge is to deal with FAPI of non-CFAs
- Desirable to simplify proposed Foreign Investment Entity and Non Resident Trust regimes and eliminate overlap
- Extend accrual regime to FAPI earned by non-CFA? If so, need to modify FAPI rules? high tax exemption?
- January 2009 Budget: FIE and NRT proposals to be reviewed

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Recommendations Outbound Investment

4.6: Review the scope of the base erosion and investment business rules to ensure they are properly targeted and do not impede bona fide business transactions and the competitiveness of Canadian businesses

Comments

- Base erosion rules needed; transfer pricing not enough
- Need to ensure such rules do not impede current global business models
- Scope of current rules too broad in some circumstances

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Recommendations Outbound Investment

4.7: Impose no additional rules to restrict the deductibility of interest expense of Canadian companies where the borrowed funds are used to invest in foreign affiliates and section 18.2 should be repealed

Comments

- No. 1 issue raised in consultations
- Affects competitiveness of Canadian companies
- Benchmarking suggests full deductibility of interest is consistent with many other countries
- January 2009 Budget: 18.2 repealed

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Recommendations Outbound Investment

Other recommendations/suggestions

- Treat all non-resident entities as foreign affiliates if requisite equity interests owned
- Further study needed before extending exemption to foreign branches
- Do not tax current taxable surplus balances
- Abandon certain proposed foreign affiliate technical amendments
- High tax exemption from FAPI
- Increase the *de minimis* FAPI threshold to \$25,000

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Recommendations Outbound Investment

Other recommendations/suggestions

- Paragraph 95(2)(a) – Inter-affiliate payments
 - No change – key aspect of our competitive system
 - Limiting to “same country” is not consistent with principles
- Simplify foreign affiliate reorganization rules
- No change in treatment of other expenses (other than interest)

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Recommendations Inbound Investment

- 5.1: Retain the current thin capitalization system, and reduce the maximum debt-to-equity ratio from 2:1 to 1.5:1
- 5.2: Extend scope of thin capitalization rules to partnerships, trusts and Canadian branches of non-resident companies

Comments

- Benchmarking suggests current rules may be marginally more generous - third-party debt not included
- Extending rules to third-party debt would be complicated and could affect bona fide business transactions

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Recommendations Inbound Investment

Thin Capitalization Rules - Other matters considered by the Panel

- Disallowed interest expense under thin capitalization rules
 - Review to ensure taxpayers cannot reduce withholding tax obligations on dividends
- Back-to-back loan arrangements
 - Review to ensure all objectionable arrangements are caught while not capturing bona fide business transactions
- Scope of thin capitalization rules
 - No change to definition of “specified non-resident shareholder”; not raised as issue during consultation

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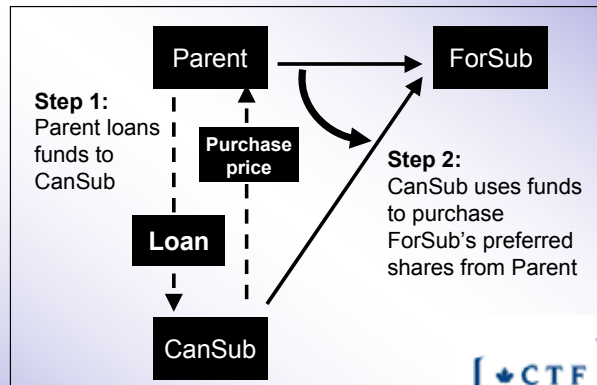


Recommendations Inbound Investment

5.3: Curtail tax-motivated debt-dumping transactions within related corporate groups involving the acquisition, directly or indirectly, by a foreign-controlled Canadian company of an equity interest in a related foreign corporation while ensuring bona fide business transactions are not affected

Comments

- Commonly described debt-dumping transaction
- Two possible approaches:
 - Interest deductibility
 - Deemed dividend
- Ensure bona fide business transactions not affected



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Recommendations Withholding Taxes

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

Comments

- Businesses united in preferring corporate rate reductions
- Reducing withholding is consistent with other countries but could be costly; magnitude of benefits would need to be fully assessed
- Revenue for Canada comes at a cost to CDN companies in respect of withholding taxes they pay to foreign governments

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Recommendations Administration

7.1: Take immediate action to enhance the dialogue among taxpayers, tax advisors and the CRA to promote the mutual responsibility and cooperation required to uphold Canada's self-assessment system

Comments

- Panel concerned about deteriorating relationship between business and the CRA; needs to be fixed

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Recommendations Administration

7.2: Take steps to improve administration of the transfer pricing rules in resolving disputes, centralizing knowledge for better consistency and resolving technical issues

Comments

- Three themes arising from Transfer Pricing Subcommittee report: Dispute Resolution, Centralization and Consistency, and Guidance and Technical Matters

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Recommendations – Transfer Pricing Subcommittee Dispute Resolution

Competent Authority (CA)

- Not be restricted to findings of Appeals Branch and able to negotiate to avoid double taxation
- Separate issues (penalties, interest) from CA cases so can pursue in Appeals Branch
- Appeals Branch hold formal decision in abeyance pending resolution at CA
- Taxpayer should not pay disputed tax liability while CA proceedings are expected or ongoing

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Recommendations – Transfer Pricing Subcommittee Dispute Resolution

Competent Authority (cont'd)

- Deficiency interest not charged on MAP/APA where repatriation can be made within reasonable time
- Negotiate re-characterization cases or allow right to obtain full relief
- Accelerated Competent Authority Procedure should follow OECD and apply to “yet to be audited years”
- Confirm APAs are an extension of mutual agreement procedure and may be subject to the arbitration process (Canada-US treaty)

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Recommendations – Transfer Pricing Subcommittee Other

Penalties

- More guidelines needed on what constitutes “reasonable efforts”
- Raise threshold for small business or start-ups
- Exercise discretion to penalize flagrant cases

Downward Adjustments

- Promote recourse when a request is not acted upon or refused
- Remove “discretion” from 247(10)

General

- Clarify practice of accepting security for both Part I and Part XIII tax assessments
- Ability to file waivers after the normal reassessment period
- Amend 164(3)(c) so interest on Part XIII assessments can be refunded
- Amend 214(3) for clarity that transfer pricing adjustments are deemed to have been paid as a dividend to non-resident shareholder(s)

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Recommendations Administration

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

Comments

- No. 2 issue raised during consultation process
- Reduce compliance and administrative burden and cost of services

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Recommendations Administration

7.4: Eliminate withholding tax requirements related to the disposition of taxable Canadian property where the non-resident certifies that the gain is exempt from tax because of a tax treaty

7.5: Exclude the sale of all publicly traded Canadian securities from notification and withholding requirements under section 116 of the Income Tax Act

Comments

- Reduce compliance and administrative burdens
- Little basis for differentiating publicly traded shares from other instruments such as trust units

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Recommendations Administration

7.6: Develop a comprehensive, long-term plan to optimize tax information collection and set up the information management systems needed to efficiently process and analyze this information

Comments

- Enhance the government's ability to assess the impact of tax changes

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Recommendations Administration

Other matters considered by the Panel

- Transfer pricing
 - Safe harbours
 - Intellectual property transfers
- Consultation during legislative process
 - One of the six principles

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Looking Ahead

Source-based taxation

- More challenging as transactions are conducted electronically and with no fixed place of business

Neutrality among substitutable returns

- Outbound (other returns from foreign affiliates)
 - More countries exempting or reducing tax on interest, royalties; consideration for establishing centers of excellence in Canada?

- Inbound and domestic (allowance for corporate equity)

Tax consolidation

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