

Tax Memo

Enhancing Canada's International Tax Advantage

Final Report of the Advisory Panel on Canada's System of International Taxation

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Overview

The Advisory Panel on Canada's System of International Taxation released its long-awaited final report on December 10, 2008. The report offers seventeen main recommendations, which, together with ancillary recommendations and suggestions, are intended to be "pragmatic, balanced and actionable advice to the Minister of Finance toward improving Canada's international tax system for the benefit of our country."¹

The Panel's recommendations to improve Canada's system of international taxation include:

- Adopting a full exemption system for both:
 - foreign-source active business income earned by foreign affiliates; and
 - capital gains and losses realized on the disposition of shares of a foreign affiliate (when the shares derive all or substantially all of their value from active business assets).

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), paragraph 1.14.

- Eliminating the tax treaty and Tax Information Exchange Agreement (TIEA) requirement for exempting active business income earned by foreign affiliates.
- Reducing the overlap and complexity of the current foreign accrual property income (FAPI) and the proposed foreign investment entity (FIE) and non-resident trust (NRT) regimes.
- Repealing section 18.2 (which is directed at certain “double-dip” financing structures).
- Retaining the current thin capitalization regime, but reducing the allowable debt-to-equity ratio from 2:1 to 1.5:1.
- Curtailing tax motivated “debt-dumping” transactions by foreign-controlled Canadian companies by enacting specific anti-avoidance rules.
- Considering bilateral reduction of withholding tax rates.
- Reducing the compliance burden on Canadian companies with respect to cross-border services.
- Improving communication with taxpayers.

The Panel's recommendations would modernize Canada's current international tax system to reflect current global business practices and make it competitive relative to tax systems in other jurisdictions. They would also reduce unnecessary complexities in a number of areas, thereby relieving the compliance and administrative burden of taxpayers and the Canada Revenue Agency (CRA), and permitting the CRA to focus their 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 will likely be well received by businesses and CRA.

However, given the current economic and political climate, it is uncertain whether much can be accomplished with respect to these recommendations before the next federal budget, scheduled for January 27, 2009. Nevertheless, the current Minister of Finance did establish the Panel and it would be reasonable to expect him to refer to it and its recommendations in the budget. At a minimum, we would expect some statement indicating the approach the government intends to take to respond to the

recommendations. It is also reasonable to expect that any proposed changes to the rules would be circulated for public consultation.

Background

The Panel's report is the first focused review of Canada's international tax system since the early 1970s.²

The Minister of Finance announced the creation of the Panel in late November 2007. Its mandate was to recommend ways to improve the competitiveness, efficiency and fairness of Canada's system of international taxation, minimize compliance costs for Canadians and facilitate administration and enforcement by the CRA. 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.

The members of the Panel were drawn from the Canadian business community, professional tax advisory firms and the tax policy research field, and included Nick Pantaleo, FCA, the lead partner of PricewaterhouseCoopers' Canadian National Technical Services group.³

In April 2008, the Panel released a discussion document entitled *Enhancing Canada's International Tax Advantage*.⁴ The document set the context for consultation with a series of questions and a call for submissions. From April to July 2008, the Panel had a series of consultations and round table discussions with many business groups, industry associations, economists and tax advisers across Canada. In addition, the Panel conducted a program of research to supplement its review, including a review of the tax systems of Canada's major competitors to benchmark Canada's system against international norms. The Panel met with officials from the CRA and the Department of Finance as well as officials with the tax authorities of the United States, the United Kingdom and other countries.

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2. The Report of Technical Committee on Business Taxation of 1998 (the “Mintz Committee” or “Mintz Report”) reviewed the international tax system but as part of a broader review of the Canada's entire system of business taxation.
 3. See www.pwc.com/ca/cnts for information about the Canadian National Technical Services group.
 4. 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).

Principles for Guiding Canada's International Tax Policy

The Panel embraced the view that inbound and outbound foreign direct investment is important to the Canadian economy. Both have grown significantly in recent years. However, it observed that:

"Canada's declining FDI (foreign direct investment) share reinforces the competitive nature of the world economy and highlights the need to consider carefully any international tax changes that impede the ability of Canadian businesses to compete."⁵

Pointing out that setting international tax policy entails trade-offs and practical constraints, the Panel states that its principles and recommendations attempt to strike a balance between protecting the Canadian tax base and ensuring that Canada's international tax system does not impede cross-border business investment. The Panel articulates six principles that it states should guide Canadian international tax policy makers in the future.

1. Canada's international tax system for Canadian business investment abroad should be competitive when compared with the tax systems of our major trading partners.
2. 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.
3. Canada's international tax system should include appropriate safeguards to protect the Canadian tax base.
4. Canada's international tax rules should be straightforward to understand, comply with, administer and enforce, to the benefit of both taxpayers and the CRA.
5. Full consultation should precede any significant change to Canada's international tax system.
6. Canada's international tax system should be benchmarked regularly against the tax systems of our major trading partners.

In the Panel's view, "an international tax system that is consistent with these principles will be competitive, efficient and fair, and deliver predictable and certain results. The system will also be less costly for all businesses to comply with and easier for the CRA to administer and enforce."⁶

5. Supra, footnote 1, paragraph 2.17.

6. Ibid., paragraph 3.4.

PwC Commentary

The Panel makes a positive contribution by articulating principles that should guide policy makers in the future. These principles, particularly those of competitiveness and simplification, form the basis of the Panel's recommendations.

The Panel's Recommendations

The predominant view formed by the Panel is that the Canadian international tax system is a good one that has served Canada well. As such, the Panel's recommendations seek not to reform but rather to refine the existing system. This conclusion is not surprising given the comments made in the Panel's consultation paper.⁷

The Panel described two key directives that emerge from applying the principles described above:

- 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 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.⁸

The Panel makes specific recommendations for improving Canada's system of international taxation. These recommendations are discussed below, under the following headings:

- A. Taxation of Outbound Direct Investment**
- B. Taxation of Inbound Direct Investment**
- C. Non-Resident Withholding Taxes**
- D. Administration, Compliance and Legislative Process**

7. Supra, footnote 4.

8. Supra, footnote 1, paragraph 3.31.

A. Taxation of Outbound Direct Investment

Recommendation 4.1:

Broaden the existing exemption system to cover all foreign active business income earned by foreign affiliates.

Recommendation 4.2:

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

The Panel concludes that Canada's system already largely exempts foreign active business income earned by foreign affiliates because minimal Canadian tax is collected on dividends paid by foreign affiliates to their Canadian shareholders.⁹ The Panel feels that Canada should formally adopt a broader exemption system for foreign active business income earned through foreign affiliates for the following reasons:

- A broader exemption system would be simpler, reducing the compliance burden (i.e., in tracking "surplus" balances of foreign affiliates) for Canadian businesses and the administrative burden for the CRA.
- Broadening the exemption system would be revenue-neutral for the government, because dividends from foreign affiliates are rarely taxed under the current regime.
- A broader exemption system could facilitate repatriation of foreign profits, generating economic benefits for Canadian businesses and their owners.
- The Panel's benchmarking research showed that taxing active business income at its source is consistent with the tax policies (or policy direction) of most other industrialized nations.
- Concerns that formally adopting a broader exemption system would cause a migration of jobs or investment from Canada are not well supported.¹⁰

More important is the Panel's statement in paragraph 4.21 of the report:

"The Panel believes that the exemption of foreign active business income earned by a foreign affiliate

9. Ibid., paragraph, 4.28 – 4.32 where it is noted that of the total amount of exempt and taxable surplus dividends, 92% is paid from exempt surplus and the likelihood that Canadian tax is paid on taxable surplus dividends is low.

10. Ibid., paragraphs 3.13 – 3.15 of the report.

*should be viewed as the norm for Canadian tax purposes.*¹¹ *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.*

This view appears to underpin much of the Panel's analysis and is the basis for a number of its other recommendations with respect to the taxation of outbound investment.

The implication of recommendations 4.1 and 4.2 is that all dividends from foreign affiliates would be exempt from Canadian income tax, while certain passive income would be taxed on a current basis. The exemption for active business income earned by a foreign affiliate would no longer depend on whether the income is earned in a treaty or TIEA country. The Panel considered it inappropriate to preclude businesses from taking advantage of the simplicity and other benefits of a broader exemption system merely because a non-Treaty country chooses not to negotiate a TIEA with Canada. The Panel also considered it inappropriate for active business income to be FAPI if Canada does not enter into a TIEA with a country within five years of starting negotiations, because doing so would put an unfair onus on businesses to influence the local government to secure a TIEA.

The Panel also considered the treatment of existing exempt and taxable surplus balances at the time of the change to a broader exemption system. The Panel supports a complete amnesty from Canadian tax for accumulated taxable surplus balances of affiliates whose shares are excluded property. Further consideration would have to be given to transitional rules for affiliates whose shares are not excluded property.

11. Under this view, the exemption of dividends from foreign active business income would not be considered a tax preference or "tax expenditure." The Department of Finance Canada report, *Tax Expenditures: Notes to the Estimates/Projections – 2004* (Ottawa: Public Works and Government Services Canada, 2004, at p. 7) describes tax expenditures as special tax rates, exemptions, deductions, rebates, deferrals and credits that have an impact on government revenue (that is, they have a cost) and reflect the government's policy choices. The report states that to define tax expenditures, it is necessary to establish a "benchmark" tax structure that applies the relevant tax rates to a broadly defined tax base — for example, personal income, business income or consumption. Tax expenditures are then defined as deviations from this norm.

PwC Commentary

These recommendations should be welcomed by taxpayers and tax practitioners.

A Change in Policy?

Some may view the adoption of a full exemption system for active business income earned by a foreign affiliate as one of the most significant of the Panel's recommendations. This change would amount to an abandonment of Canada's right to tax foreign active business income of a corporation resident in Canada when that income is earned through foreign affiliates. At first glance, this may appear contrary to the existing tax policy underlying Canada's foreign affiliate rules.

Under current tax policy, Canada maintains the right to tax a corporation resident in Canada on its world-wide income. However, to promote the competitiveness of Canadian business in the international market place, Canada currently defers the taxation of foreign active business income earned through a foreign affiliate until that income is received in Canada by way of a dividend payment. When the dividend is ultimately received in Canada, it is included in computing the Canadian taxpayer's income for tax purposes and a deduction may be taken based on the nature and source of the foreign income out of which the dividend was paid. However, practically speaking, Canada has already been operating under a territorial system for taxing foreign active business income for the reasons given by the Panel. In this respect, the movement to a full exemption system for taxing active business income earned by foreign affiliates may not represent a significant change in policy.

While the Panel correctly argues that linking access to the exemption system to the signing of TIEAs makes no sense from a policy perspective, acceptance of recommendation 4.2 may depend on whether the Department of Finance believes it can entice other countries to negotiate TIEAs without this added leverage. We believe this should be possible, because countries such as Australia and New Zealand have successfully negotiated TIEAs with low tax jurisdictions.

Recommendation 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.

The Panel recommends that the exemption system be extended to capital gains realized by Canadian corporate shareholders on the dispositions of foreign affiliate shares and to capital gains realized by foreign affiliates on the sale of shares of other foreign affiliates, if, in either case the shares of the disposed affiliate derive all or substantially all of their value from assets used or held principally to earn active business income. The Panel reached this conclusion for the following reasons:

- Exempting capital gains arising on the sale of shares of a foreign affiliate is appropriate because the affiliate's income would also be exempt from Canadian tax. This treatment is consistent with the view that foreign active business income should be exempt from Canadian income tax.
- The Panel's benchmarking research confirms that most countries that exempt dividends received from a foreign affiliate from domestic taxation also exempt the capital gain realized on a disposition of the shares of the foreign affiliate.
- Little tax revenue would be at risk if capital gains realized on dispositions of foreign affiliate shares were exempt.¹²

The Panel acknowledges that exempting gains on the sale of foreign affiliate shares while taxing gains on the sale of Canadian company shares may appear inconsistent but suggests that this difference can be accepted on the grounds that the current rules are out of step with those of most other countries that also have an exemption system.¹³ Moreover, this approach would result in a much simpler system for businesses and the CRA. It could eliminate another aspect of surplus tracking, including the need for subsection 93(1) elections and the need for the proposed foreign affiliate amendments directed at preventing taxpayers from creating exempt surplus inappropriately in certain types of inter-affiliate transactions.

The Panel points out that more study is needed in this area. Although the "safe income" of a Canadian corporation would still have to be calculated, the Panel suggests that this could be done more simply by reference, for example, to financial statements. The current anti-avoidance rule in subsection 55(2), with respect to dividend stripping, might also have to be extended to foreign affiliates.

12. Supra, footnote 1, paragraph 4.52.

13. Australia has in place a similar system that taxes gains on sales of domestic company shares while exempting gains on sales of foreign affiliate shares.

In addition, the definition of “excluded property” would have to be reviewed. The definition must be robust enough to ensure the exemption from capital gains taxation does not occur in inappropriate circumstances. The Panel notes that consideration could be given to requiring the vendor to own the foreign affiliate shares for a certain period, to ensure the investment is not merely a passive investment. As well, the current definition could be modified to take a more consolidated approach given that currently, depending on the circumstances, a small amount of non-excluded property assets could have a cascading effect and result in the shares of a higher-level affiliate in a group not being excluded property. On the other hand, a chain of foreign affiliates could have excess passive assets when viewed on a consolidated basis, yet the shares of the top-tier affiliate may still satisfy the excluded property test.

PwC Commentary

This recommendation should also be welcomed by taxpayers and tax practitioners.

A Change in Policy?

The adoption of a full exemption system for all capital gains and losses realized by a corporation resident in Canada or its foreign affiliates on shares of a foreign affiliate (when the shares derive all or substantially all of their value from active business assets) would be a significant change to Canada’s existing tax policy.

Under current tax policy, Canada defers the taxation of capital gains realized by a foreign affiliate on the disposition of excluded property shares until that income is received in Canada by way of a dividend payment. Capital gains realized by a Canadian resident corporation on the disposition of foreign affiliate shares are taxed currently at capital gains rates. Although any capital gain realized can be reduced to the extent of cumulative unremitted active business earnings¹⁴, any gains in excess of this amount have always been subject to tax in Canada (either when realized if a resident of Canada or when the proceeds are ultimately repatriated if a foreign affiliate). Under these recommendations even gains in excess of cumulative active business earnings would be exempt from tax. Again, practically speaking, given that many Canadian corporations hold shares of their foreign affiliates through foreign holding companies and defer

repatriating proceeds of disposition, this change may not affect current tax revenues significantly.

Anticipating the Reaction of the Department of Finance

Recommendations 4.1 and 4.3 of the Panel should come as no surprise to officials of the Department of Finance. They are well aware of the international norms in this area and have probably been considering this option as part of their own reviews. Therefore, we expect these recommendations will receive serious consideration. However, the Minister of Finance and officials of the Department of Finance will have to consider the financial and political implications of adopting the recommendations. The many factors to consider include:

- the recommendations possibly being perceived as an incentive for investing outside Canada;
- the recommendations putting additional pressure on the existing anti-avoidance rules designed to protect the Canadian tax base; and
- the inconsistency between exempting gains on the sale of foreign affiliate shares while taxing gains on the sale of Canadian company shares.

Finance officials will have to satisfy themselves in some fashion that the benefits of adopting these recommendations exceed the real (or even perceived) costs associated with them.

Other Considerations

There are several policy and technical issues that will have to be considered when determining whether to adopt these recommendations, including:

- Will the exemption system be expanded to cover foreign exchange gains and losses on the disposition of excluded property or will foreign exchange gains and losses need to be separately addressed? For example, consider a taxpayer that disposes of a share of a foreign affiliate (realizing a capital loss at least partially relating to foreign exchange movements) and uses the funds to settle a debt used to acquire the share (realizing a foreign exchange gain). Will the taxpayer be denied the capital loss under the exemption regime and pay tax on the foreign exchange gain? Will the exemption regime be expanded to include foreign exchange gains and losses realized on debt used to fund the acquisition of excluded property?
- Even with the movement to a full exemption system, taxpayers will be required to track certain foreign affiliate tax attributes (adjusted cost basis information for example) to correctly calculate FAPI in the future if

14. This is effected automatically pursuant to the provisions of subsection 93(1.1) or electively pursuant to subsection 93(1).

the asset disposed of is not excluded property at the date of disposition. This raises other questions, such as whether the cost base of shares of a foreign affiliate held by another foreign affiliate should be reduced by dividends that, under the current system, would be deemed to be “pre-acquisition surplus” dividends?

- The Panel suggests that a holding period may be appropriate to access the exemption system, to ensure shares are not merely held as passive investments. Consideration will have to be given to special rules to ensure that holding-period requirements do not unfairly restrict a taxpayer’s ability to undertake reorganization transactions.

Effect on Proposed Foreign Affiliate Amendments

Some taxpayers currently plan their tax affairs based on proposed amendments or even technical proposals provided in comfort letters issued by officials of the Department of Finance. If implemented, the Panel’s recommendations would render many of those outstanding proposals unnecessary, at least going forward.

Even if not all of the Panel’s recommendations are implemented, it is hoped that its report will prompt a re-evaluation by the Department of Finance of the necessity of those outstanding proposals. The significant complexity the outstanding proposals would add to the foreign affiliate rules seems contrary to the guiding principles espoused by the Panel.

Recommendation 4.4:

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

Given the Panel’s recommendation to broaden the exemption system to cover all dividends from active business income and capital gains on dispositions of shares of foreign affiliates that are excluded property, the Panel suggests that the current ownership threshold may require review, especially in light of the thresholds in place in other countries.

The Panel also suggests that consideration be given to amending the definition of “foreign affiliate” of a taxpayer resident in Canada to include any non-resident entity when the taxpayer and related persons hold equity

interests in the entity that would be the equivalent of an interest in a foreign affiliate if the entity were a corporation and its equity interests were shares.

The Panel suggests no fundamental changes to the taxation of active business income earned by foreign branches of Canadian companies. While it acknowledges that conceptually the extension of the exemption system to foreign branch income seemed appropriate, the Panel feels the practical difficulties currently outweigh the benefits.

PwC Commentary

The Panel’s suggestion that certain non-resident entities other than corporations may be deemed in certain cases to be foreign affiliates is consistent with recommendation 4.5 (discussed below) and could ensure that particular non-resident business trusts are not caught by the non-resident trust rules.

Support appears to be strong for the notion that the exemption system should be extended to foreign branch active income. However, complex rules would have to be drafted to deal with passive income of the branch and perhaps payments received from the foreign branch. Current demand for this change does not seem sufficient to justify the cost and additional complexity.

Recommendation 4.5:

In light of the Panel’s recommendations on outbound taxation, review and undertake consultation on how to reduce overlap and complexity in the anti-deferral regimes while ensuring all foreign passive income is taxed in Canada on a current basis.

The Panel hopes to take advantage of the fact that Bill C-10, which included the recent version of the proposed FIE and NRT rules, lapsed in the fall when the general election was called for October 14, 2008, and calls for the government to undertake a fresh review to coordinate the FAPI, FIE and NRT regimes. Such a review should aim to ensure all passive income is taxed on an accrual basis and focus the scope of these rules so they do not impede bona fide commercial business transactions.

“The Panel believes that 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

the Panel's recommendations and the principles in Chapter 3 regarding the international taxation of outbound investments by Canadian businesses.”¹⁵

The challenge under a broader exemption system as proposed by the Panel is how to deal with passive income earned by non-controlled foreign affiliates. Consistent with their view that “all passive income is taxed on an accrual basis,” the Panel considered whether the existing FAPI regime should be extended to tax passive income of all foreign affiliates on an accrual basis, while applying the FIE regime only when the non-resident entity is a FIE but not a foreign affiliate. The bright-line distinction would eliminate overlap between the FAPI and FIE regimes by narrowing the scope of the FIE regime to entities that are not foreign affiliates and thereby eliminate much of the complexities inherent in the proposed FIE rules, which have almost universally been denounced by taxpayers and tax practitioners.

The Panel acknowledges that this approach is easier to apply with respect to controlled foreign affiliates because Canadian taxpayers typically control or influence the affiliate's investment in passive-type activities, including the timing of the repatriation of such income derived from such activities. As well, they are also in a better position to access the information needed to compute an affiliate's FAPI. However, Canadian investors in non-controlled foreign affiliates might not be able to obtain such information, or control or influence the level of investment in passive activities and the repatriation of the resulting income.

The Panel suggests that if the FAPI regime were extended to all foreign affiliates, the manner in which the FAPI rules apply to controlled and/or non-controlled foreign affiliates may have to be modified to deal with these practical difficulties. For instance, there could be a possible exemption from FAPI if the entity was subject to a certain level of foreign tax or if it was earned in a certain designated country. As well, non-controlled foreign affiliates could be exempt from certain FAPI rules, such as the base erosion rules.

PwC Commentary

Any recommendation focused on reducing the overlap and complexity inherent in Canada's current anti-deferral regimes should be well received by all stakeholders. The movement to a full exemption regime and the related need to review the scope of Canada's FAPI regime would

15. *Supra*, footnote 1, paragraph 4.103.

create a perfect opportunity to better coordinate the various regimes and significantly reduce the complexity of the rules.

Recommendation 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.

In the Panel's view:

“Canada's base erosion rules and the ‘investment business’ definition should not target income arising from activities that are carried out for bona fide business reasons, enhance the competitiveness of Canadian companies in the global marketplace and do not aim to erode the Canadian tax base.”¹⁶

The Panel identifies circumstances in which the base erosion rules hurt Canadian companies trying to carry on business in the most efficient and cost-effective way possible and undermine their ability to compete with foreign companies not affected by these rules.¹⁷ While acknowledging that relieving provisions have been introduced in recent years to prevent some of these types of income from being treated as FAPI, the Panel believes more should be done.

On the other hand, the Panel does not accept that the base erosion rules are unnecessary in light of Canada's transfer pricing rules because of the administrative challenges these rules pose. Instead, it believes that “[w]ell-designed and properly focussed base erosion rules complement the transfer pricing rules and provide certainty about the types of income that should be subject to Canadian tax, without adversely affecting the global competitiveness of Canadian businesses.”¹⁸ For this reason, the Panel concludes that base erosion rules which target income derived from Canadian debt obligations, Canadian leasing activities and the insurance of Canadian risks are appropriate and should be retained.

With respect to the definition of “investment business,” the Panel notes that certain tests providing exceptions from the investment business rules can be difficult to meet, causing otherwise active business income to be treated

16. *Ibid.*, paragraph 4.121.

17. See *Ibid.*, paragraph 4.117 of the report. Based on these examples, it is clear that the Panel was focusing on the broad impact of paragraphs 95(2)(a.1) and 95(2)(b).

18. *Ibid.*, paragraph 4.122.

as FAPI.¹⁹ In particular, the Panel refers to real estate development, leasing, management and other global businesses linked to real property that tend to be carried on in multiple foreign entities for non-tax reasons. The Panel notes that this result is particularly disconcerting because if all the relevant entities in a corporate group were treated as one taxpayer, in many cases there would be no doubt that the taxpayer would be considered to be carrying on an active business.

The Panel strongly supports the retention of paragraph 95(2)(a).²⁰ The Panel notes that a number of countries, including the United States, have such a provision in their tax laws. Notwithstanding that some of these countries, such as Australia and New Zealand (under current proposals), restrict their rules to inter-affiliate payments within a particular country, the Panel concludes that such a restriction ignores the reality that businesses are often not conducted within a single country or entity. Moreover, consistent with the Panel's view that Canada tax foreign source business income earned by foreign affiliates on a territorial basis, the Panel adds:

"...how Canadian multinationals structure their foreign operations within or between foreign jurisdictions to minimize foreign income tax on their active business earnings should be irrelevant from a Canadian tax perspective."²¹

Finally, the Panel recommends increasing the current FAPI de minimis rule of \$5,000 per controlled affiliate. In addition, it suggests that consideration be given for a de minimis rule for the FIE and NRT regimes.

PwC Commentary

The Panel's recommendation to review the existing base erosion rules and investment business definition with a goal of ensuring they facilitate modern day business models will be welcome news to companies in many industries. Business models are changing and it is important the Department of Finance consult with the business community as part of this review to ensure any

revised rules allow for bona fide business transactions while still protecting the Canadian tax base.

The Panel's recommendation to increase the current FAPI de minimis threshold of \$5,000 is welcomed, because the current threshold is meaningless for most taxpayers. The addition of a de minimis threshold for the FIE and NRT regimes also makes a lot of sense. These changes should be considered even before any review is completed pursuant to recommendation 4.5.

Recommendation 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 of the Income Tax Act should be repealed.

The Panel acknowledges that one of the more difficult issues in measuring foreign active business income is the treatment of costs incurred by a domestic company that may be considered to relate, directly or indirectly, to the earning of foreign active business income (in particular, interest on funds borrowed to invest in foreign affiliates).

While the Panel recognizes that permitting a deduction for interest expense to earn exempt foreign income may not be consistent with the principle requiring the matching of revenue with expenses incurred to earn that revenue, for competitiveness reasons, the Panel supports such a deduction, which for that reason has been a feature of the current foreign affiliate system since its inception in the early 1970s. The government did introduce a proposal in its March 2007 federal budget to restrict the deductibility of such interest but withdrew the proposal two months later. The Panel also confirmed that few countries have such a restriction. In its summary, the Panel noted:

"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."²²

19. In particular, the test requiring that more than five employees be employed full-time by the affiliate in the conduct of its active business was brought to the Panel's attention.

20. This provision deems income received by a foreign affiliate from another affiliate, which would otherwise be income from property, to be income from an active business if certain conditions are met, including that the income is deducted in computing the active business income of the paying affiliate.

21. Supra, footnote 1, paragraph 4.129.

22. Ibid., paragraph 4.166.

The Panel's endorsement of the repeal of section 18.2²³ may have surprised some observers, because it was not clear that a review of section 18.2 was within the Panel's mandate. Regardless, a number of submissions to the Panel revealed an ongoing opposition to the provision. Indeed, the Panel notes that while some countries have introduced targeted rules aimed at restricting these financing arrangements, many countries still allow deductions.

PwC Commentary

The Panel's recommendation that the government permit a deduction in respect of all interest paid by a corporation resident in Canada in respect of funds borrowed to make investments in the corporation's foreign affiliates is welcome news to all taxpayers.

We agree with the Panel's view that the competitiveness arguments for permitting the deduction are stronger than income and expense matching arguments historically presented by government officials. The Panel correctly notes that few countries have introduced such interest deductibility rules. Canada should not be one of the first, especially considering the current economic environment.

The Panel's position on section 18.2 is not surprising given its strong endorsement of paragraph 95(2)(a), which section 18.2 effectively restricted, and its view that planning to minimize foreign taxes paid by Canadian multinationals should not be relevant for Canadian tax purposes.

B. Taxation of Inbound Direct Investment

Recommendation 5.1:

Retain the current thin capitalization system, and reduce the maximum debt-to-equity ratio under the current thin capitalization rules from 2:1 to 1.5:1.

Recommendation 5.2:

Extend the scope of the thin capitalization rules to partnerships, trusts and Canadian branches of non-resident corporations.

23. Section 18.2 is directed at certain "double dip" financing structures. Beginning after 2011, section 18.2 would deny the deductibility of interest on funds borrowed to invest in a foreign affiliate that can be traced, directly or indirectly, to an inter-affiliate borrowing giving rise to interest income that is deemed to be income from an active business pursuant to paragraph 95(2)(a).

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.

In the end, the Panel concluded that:

*"Canada's current approach has stood the test of time and works well: it is effective, transparent and relatively simple to administer and comply with. ...The Panel believes Canada's current approach should be maintained."*²⁴

The Panel stated that recommendations 5.1 and 5.2 were made to strengthen the current thin capitalization rule and to ensure the system remains effective in protecting Canada's tax base.

PwC Commentary

If one accepts that a thin capitalization rule is necessary, the recommendation to retain the main features of the current system makes sense. The alternatives identified by the Panel – an earnings-stripping rule or an arm's-length approach – are complex. The arm's length approach introduces considerable uncertainty, because a foreign-owned Canadian corporation would be required to provide support that its debt level satisfies an arm's-length standard. The lack of certainty this would introduce would be an unwelcome change.

Many taxpayers owned by foreign multinationals operate at close to the current thin capitalization limit. The proposed reduction in the ratio to 1:5 to 1 would force many taxpayers to either refinance with unrelated lenders or convert a portion of their debt to equity. This refinancing may be expensive in today's debt markets and may raise related Canadian tax issues, such as triggering foreign exchange gains and losses. If these recommendations are acted on, generous transition rules should be considered, especially in light of current market conditions.

24. *Supra*, footnote 1, paragraph 5.7

Continuing to exclude debt guaranteed by a foreign parent is a welcome recommendation. Including guaranteed debt in the computation could result in taxpayers having to refinance existing related party debt. However, these taxpayers may be unable to access debt markets at all, or only at a much higher cost.

The Panel correctly points out that the interest expense disallowed under the thin capitalization rules retains its character as interest. Under the recently enacted fifth protocol to the Canada-U.S. tax treaty a payment of interest to a U.S. resident will be subject to zero withholding tax by 2010, as opposed to a higher 5% rate on dividends. Therefore, a U.S. investor might prefer to substitute non-deductible interest, which would not attract withholding tax for non-deductible dividends that would be subject to withholding tax. This potential withholding tax leakage could be overcome by deeming the disallowed interest to be a dividend. However, in many of Canada's treaties the withholding tax on dividends is less than on interest. Consequently, in jurisdictions other than the U.S. deeming the interest to be a dividend would reduce the withholding tax collected. The Panel encourages the government to review this area.

The Panel also suggested strengthening the back-to-back loan provisions. Generally, the current rules function effectively, so further work in this area may not be necessary.

The Panel did not consider certain difficulties that taxpayers frequently encounter with the current thin capitalization rules. For example, the lack of tax consolidation in Canada makes it difficult to borrow directly into lower-tier subsidiaries, because only the borrower's retained earnings can be used in the calculations. If the Department of Finance decides to amend the current thin capitalization rules, changes to apply the rules on a consolidated basis would be appreciated.

Recommendation 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.

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

observes that the term "debt-dumping" could be used to describe distinct circumstances in which 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."

It went on to describe such transaction as follows:

"The type of transaction in question involves a foreign-controlled Canadian corporation that borrows to acquire preferred shares of another related foreign corporation. In this circumstance, a foreign company ("Parent"), which owns all the common shares of a non-Canadian subsidiary ("ForSub"), loans funds to its Canadian subsidiary ("CanSub"). CanSub uses the borrowed funds to purchase preferred shares of ForSub, for example, from Parent. The arrangement is structured so that dividends received by CanSub on the preferred shares are exempt from tax in Canada. The dividend will be greater than the interest expense on CanSub's borrowing, which is deductible in Canada and reduces CanSub's Canadian tax liability on its profits derived from its Canadian operations."²⁵

Believing that its recommendation 5.1 and 5.2 would be inadequate to discourage these transactions, the Panel concludes that Canada needs to supplement its thin capitalization rules with a specific anti-avoidance rule for this purpose. 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" and identified two alternatives:

- restrict the deductibility of interest paid by a foreign-controlled Canadian corporation in respect of

25. Ibid., paragraph 5.52. The Panel noted that "[t]here are many variations of this basic structure. For example, CanSub could borrow funds from a Canadian or foreign third-party lender rather than directly from Parent. Under another alternative, CanSub could acquire newly issued shares of ForSub directly from ForSub rather than from Parent.

- borrowings used to purchase, directly or indirectly, an equity interest in a related foreign corporation; or
- apply an appropriate level of Canadian tax to the purchase price paid by the foreign-controlled Canadian corporation in respect of the direct or indirect acquisition of the equity interest in the related foreign corporation. For example, the purchase price paid by the Canadian corporation could be deemed to be a dividend subject to withholding tax in Canada.

Essentially, the second approach would extend the application of subsection 212.1(1) of the Act.²⁶ Although enacted as a “dividend stripping” rule, this provision curtails certain related-party transactions that non-residents have used to leverage a foreign-controlled Canadian corporation by transferring to the corporation shares of another Canadian company for non-share consideration.

PwC commentary

The “debt-dumping transaction” example provided by the Panel involves a borrowing to acquire preferred shares, presumably with no potential for participation in the growth in value of the related foreign corporation. It is questionable whether it is appropriate to treat an investment in preferred shares (with no participation beyond a fixed rate of return) the same as an ordinary common share investment, which could generate FAPI, dividends and capital gains in excess of the related interest expense. On this point the Panel stated:

“distinguishing preferred shares from common shares is often difficult in practice. In the Panel’s view, any proposed rule targeting these transactions should cover the acquisition of any equity interest in a non-Canadian affiliate by a foreign-controlled Canadian company.”

This approach may be pragmatic, but it ignores the significant differences in the features of different equity instruments. When considering the scope of any new anti-avoidance rule, some attempt to differentiate acceptable versus unacceptable types of share investments may be appropriate. This is especially apt if the Panel’s

26. Subsection 212.1(1) of the Act deems a dividend to be paid to a non-resident person by a non-arm’s-length Canadian corporation when the Canadian corporation acquires from the non-resident person a non-portfolio interest in another Canadian corporation and the non-share consideration (e.g., cash or debt) for the acquired shares exceeds their paid-up capital.

recommendation regarding the extension of the exemption regime to capital gains is not implemented.

The Panel states as part of its recommendation 5.3 that bona fide business transactions should not be caught within the scope of any new anti-avoidance rule. A difficulty with the recommended approach is how to identify acceptable versus non-acceptable business transactions. For example, is the fact that the Canadian management is responsible for the operations of a foreign subsidiary sufficient to justify the Canadian company’s acquiring the foreign subsidiary, or is there a requirement that the operations of the foreign subsidiary be somehow linked with the Canadian operations? Taxpayers will require considerable guidance in this area.

As to the mechanics of a new anti-avoidance rule targeted at these transactions, the Panel suggests two alternatives. The Panel correctly points out that there are difficulties associated with both of these alternatives and more study and consultation is required.

With the first alternative, the usual problems associated with tracing funds would arise. These are the same problems that taxpayers are currently beginning to struggle with in the context of section 18.2. Depending on how this anti-avoidance rule is implemented, consideration may have to be given to the effect of the non-discrimination clauses in some of Canada’s tax treaties on Canada’s ability to apply the rule.

Rather than restrict the interest deductibility, the second alternative proposed by the Panel will deter “debt-dumping” by charging an up-front tax on the purchase price paid by the foreign controlled Canadian corporation. One benefit of this alternative is that it would apply only prospectively.

Some of the questions the Department of Finance must consider with respect to this alternative include:

- On what base amount should this tax be charged (i.e., the full purchase price or only the portion of the purchase price represented by non-share consideration)? If one considers this tax as a proxy for the tax benefit associated with future interest deductions, perhaps the tax should be charged only on the non-share consideration paid. However, in this case, presumably rules would have to be drafted to track whether paid up capital created on the purchase is used to introduce additional leverage into Canada.
- What rate of tax should be charged? Consideration will have to be given to whether the current 5% rate

applicable to deemed dividends under most of Canada's treaties would act as a sufficient deterrent. Alternatively, perhaps a rate set to approximate the tax benefit associated with future interest deductions would be more palatable.

Treaty Shopping

The Panel made no recommendation with respect to treaty shopping, beyond saying that:

*"[w]hile there may be situations in which inappropriate access to tax treaties can arise, the Panel believes that Canada has adequate resources and tools in its tax treaties and domestic law and in international jurisprudence to police treaty shopping. However, the government should continue to monitor developments in this area."*²⁷

C. Non-Resident Withholding Taxes

Recommendation 6.1:

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

Withholding taxes on payments to non-residents are a significant source of government revenue. The report provided figures showing that in 2005, the government collected \$4.3 billion in withholding taxes on dividend, interest, rents, royalties and other payments to non-residents.

The Panel notes the strong consensus in the business community to further reduce or eliminate withholding taxes, which would remove an obstacle to cross border flows of income and capital and would also be consistent with the trend globally. However, no doubt conscious of the fiscal challenge in making up for further reduction or elimination of withholding taxes, the Panel seemed reluctant to endorse such a proposal, unreservedly noting that "[t]he magnitude of the potential economic benefits from eliminating withholding taxes needs to be fully assessed."²⁸

Interestingly, the Panel indicates that, given a choice, most companies and organizations would recommend lower corporate tax rates over lower withholding taxes.

The Panel explains the reason for this preference was likely

*"that reducing the corporate tax rate would benefit all Canadian companies (including small and medium-sized businesses) and help improve the competitiveness of the Canadian economy more broadly. Another possible reason is that a large share of the withholding tax collected in Canada on payments to non-residents may be credited abroad and does not increase the tax burden of non-residents investing in Canada."*²⁹

In the end, the Panel concludes:

"...the Panel believes that further reducing withholding taxes is desirable for Canada. The Panel recommends that the government continue to reduce or eliminate withholding taxes in future tax treaties and protocols to those treaties. However, in recognition of the significant fiscal cost to the government and of the widely-shared preference among businesses for lower corporate income tax rates over lower withholding taxes, future reductions should be implemented as the government's fiscal framework permits, taking into account the government's currently planned reductions in the federal corporate tax rate. The government should also continue to monitor global trends and assess the desirability of eliminating withholding tax bilaterally on a case-by-case basis."

PwC commentary

It is interesting that no information was provided on how much Canadian residents, including Canadian companies, pay in withholding taxes to foreign governments on specific types of payments. The Panel's recommendation to proceed cautiously in reducing or eliminating withholding taxes on non-residents is appropriate. However, the cost to Canadian companies paying withholding taxes to foreign governments should not be overlooked, particularly given the current economic climate and the extent to which these taxes are not creditable in Canada (for example, on exempt surplus dividends received from foreign affiliates). Elimination of withholding taxes in bilateral tax treaties, for example on dividends, could significantly benefit Canadian companies.

27. Supra, footnote 1, paragraph 5.68.

28. Ibid., paragraph 6.9.

29. Ibid., paragraph 6.19.

D. Administration, Compliance and Legislative Process

Recommendation 7.1:

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

The Panel indicates, that during its consultations, it heard negative comments from various perspectives regarding the relationship between businesses and the CRA. The Panel was rightly concerned about these problems and the opposing positions behind them, fearing that:

*"[f]urther deterioration in the relationship could jeopardize the ongoing viability of Canada's self-assessment system, resulting in higher compliance and administration costs as well as more potential for dispute and litigation. Businesses, their advisors and the CRA all have a responsibility to ensure that our self-assessment system works effectively."*³⁰

Although the Panel urges the government to take immediate steps to improve the dialogue, it offers no specific direction on how the government should proceed. However, it does indicate that:

*"improving communication and undertaking more consultation, as we recommend throughout this report, are important first steps toward a more robust self-assessment system. Achieving this goal should promote better compliance, facilitate enforcement, and reduce occasions for dispute."*³¹

Later in its report the Panel elaborates on this theme as a way of improving the legislative process. It writes:

"Open and timely consultation is one of the principles set out by the Panel in Chapter 3. Allowing businesses and their advisers to raise their concerns at the policy design stage would reduce the risk that a new rule would produce unintended and adverse results, making the process more efficient. Consultations at an early stage could also increase the transparency of the legislative process. Transparency is crucial to sustaining a fair and open process for making tax policy in Canada."

30. Ibid., paragraph 7.4.

31. Ibid., paragraph 7.7.

*The Panel encourages the government to make every effort to achieve more transparency. The government should resort to confidentiality only where necessary, for example, where proposed tax policy changes could affect financial markets or commodity prices or where these changes could have a material revenue impact. The government should also provide better public access to information and analysis supporting proposed tax policy changes, such as by publicizing revenue impact estimates."*³²

The Panel also indicates that its recommendations to simplify the system will benefit not only taxpayers, but also the CRA and the Department of Finance. The Panel encourages the government to allocate more financial resources to the CRA and the Department of Finance in the international tax area "to compete for and retain appropriately skilled employees." While the Panel acknowledged the difficult challenge this poses, it encourages the government to consider more interchange programs with the private sector. This would not only improve the skill and experience level of people in the CRA and the Department of Finance, but also improve communication with the taxpayers and their advisers.

Recommendation 7.2:

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

The Panel's review of Canada's transfer pricing regime focused on its administration. To that end, the Panel organized a subcommittee to assist in this review. In its report,³³ the subcommittee makes more than 20 recommendations to improve the process and administration of Canada's transfer pricing rules, with special emphasis on crafting solutions to current issues that will help both businesses and the CRA.

The Panel drew three main themes from the subcommittee report:

Dispute resolution—Resolving double taxation involves the interaction of two states and a process that is unique

32. Ibid., paragraph 7.62 -7.63.

33. Transfer Pricing Subcommittee, *The Administration of Canada's Transfer Pricing Rules: Issues and Recommendations* (August 2008), report prepared for the Advisory Panel on Canada's System of International Taxation ("the Subcommittee Report.")

to international tax disputes. Rather than applying the general domestic rules and processes for resolving other tax disputes in the area of transfer pricing, adopting alternative processes may be more appropriate.

Centralization and consistency—Centralizing the expertise of CRA employees in the transfer pricing area and encouraging more knowledge-sharing among the CRA, businesses and advisers should foster mutual understanding and a more uniform approach to transfer pricing issues and audits for taxpayers and the CRA alike.

Guidance and technical matters—Offering more guidance on administration issues and resolving persistent technical issues could improve the application and administration of the transfer pricing rules by both the CRA and taxpayers.³⁴

The Panel properly recognized that moving to a broader exemption system is likely to

*“exert more pressure on the application and administration of Canada’s transfer pricing rules. If more transfer pricing disputes arise as a result, eliminating irritants arising from the current transfer pricing rules is important to ensuring the rules work as smoothly as possible.”*³⁵

The Panel urges the government to consider the recommendations in the subcommittee’s report as a basis for consultations in this area.

The Panel also urges the government to establish safe harbour thresholds for “routine, non-controversial cross-border service charges” to improve the administration of the transfer pricing process.

The Panel encourages the government to monitor developments involving the migration of intellectual property out of Canada to ensure that transfer pricing rules “properly measure Canadian-source income.” Although the Panel evidently did not have empirical evidence or data as to the extent of that migration from Canada, it notes that this is an area of increased focus among foreign governments and that Canada must monitor developments in this area.

34. Supra, footnote 1, paragraph 7.23.

35. Ibid., paragraph 7.22.

PwC commentary

In summary, the Transfer Pricing subcommittee’s recommendations should be welcomed by taxpayers.

They would help reduce some of the current uncertainty associated with the administration of transfer pricing controversies and give taxpayers greater flexibility in choosing a mechanism to resolve disputes and double tax. PricewaterhouseCoopers will be preparing a separate *Tax Memo* dealing specifically with the subcommittee’s recommendations.

Recommendation 7.3:

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

The Panel notes that concerns regarding regulation 105 were raised frequently during its consultations as Canadian businesses expressed frustrations with having to bear administrative responsibility for another person’s tax liability. The Panel heard that:

- the costs associated with complying with regulation 105 are significant;
- service providers commonly gross-up their fees to offset the withholding tax, which results in an additional cost to Canadian businesses and hampers their ability to engage skilled workers from outside Canada;
- the waiver process is cumbersome and so is not used as often as it could be; and
- the service provider may suffer reduced or delayed cash-flow if it does not receive a gross-up from the payer.³⁶

The Panel also heard that because regulation 102 applies to such a broad range of situations, it places a significant administrative burden on the non-residents, as well as Canadian corporations that carry out the administrative duties on behalf of related non-resident employers.

In the Panel’s consultations, businesses indicated that the U.S. certification system for service providers (both employees and contractors) works well and is easier to comply with than the current Canadian system. The Panel anticipated that adopting a similar certification system in Canada would have the following benefits:

36. Ibid., paragraph 7.38.

- a certification system would shift the compliance burden at the withholding stage from the payer to the non-resident;
- Canadian payers would have to withhold less frequently, reducing administration for both businesses and the CRA;
- fewer withholdings would result in fewer gross-ups, reducing costs for Canadian businesses;
- information reported on the non-resident's certificate and by the Canadian payer would maintain the CRA's ability to audit and enforce compliance; and
- the certification process would reduce the need to obtain waivers, eliminating administration for both businesses and the CRA.

PwC commentary

This would be a positive change that would improve a significant administrative headache for both Canadian businesses and the CRA.

Recommendation 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 Canadian tax because of a tax treaty.

Recommendation 7.5:

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

Many non-residents with interests in taxable Canadian property are not taxable on the sale of such property because they are eligible for treaty benefits. Therefore, the section 116 certificate process is an expensive and time-consuming requirement that can create delays and complicate closing transactions, with no net tax revenue for the government. The non-resident must also file a Canadian tax return to claim treaty benefits or to obtain a refund of amounts remitted to the CRA.

Recent changes will streamline the section 116 certificate process, starting in 2009, and will eliminate the need to withhold tax on dispositions of treaty-protected property. Non-residents who dispose of treaty-protected property will not be required to obtain a section 116 certificate or to file a Canadian tax return, unless they do owe Canadian tax for other reasons.

Businesses told the Panel that these measures should be amended to provide greater certainty regarding withholding and remittance obligations. In particular, businesses must determine their obligation to withhold based on "reasonable inquiry" (the meaning of which is unclear). Further, members of partnerships and other non-corporate entities that are eligible for treaty benefits on a look-through basis do not benefit from these changes.

The Panel considered whether the sale of certain Canadian securities (such as units of real estate, royalty and business income trusts or limited partnerships) should be excluded from the section 116 process without the need to determine if gains on those securities are treaty-protected. Currently, only shares listed on certain exchanges and mutual fund trust units are excluded. We agree with the Panel's view that the exclusion should cover the full range of publicly traded Canadian securities.

Recommendation 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.

Perhaps frustrated about the lack of information available in certain areas, the Panel encourages the government to take steps to streamline and optimize its approach to collecting and using taxpayer information in the international tax area. It recommends that the CRA and the Department of Finance collaborate and undertake consultations toward developing a comprehensive, long-term plan to optimize the way taxpayer information is collected and used. The plan should specify:

- what and how much information is required, and for what purposes;
- how, when and from whom the information should be collected;
- how the information should be captured, stored, maintained, validated and distributed; and
- what systems are needed to analyze and make the best use of the information.³⁷

The Panel indicates that, as a first step in this process, it had undertaken an initial review of available options to improve some of the forms and returns used to gather information and had obtained some initial feedback from government and representatives from industry.

37. Ibid., paragraph 7.69.

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