

FINAL REPORT — EXECUTIVE SUMMARY

# Enhancing Canada's International Tax Advantage

Advisory Panel on Canada's System  
of International Taxation

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Distribution Centre  
Department of Finance Canada  
Room P-135, West Tower  
300 Laurier Avenue West  
Ottawa, ON K1A 0G5  
Tel.: 613-995-2855  
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# Introduction

1 Canada's system of international taxation is important to our country's competitiveness. At the global level, competitiveness is crucial to attracting high-value activities, spurring innovation, and creating skilled jobs. Establishing Canada's competitive advantage is part of the Government of Canada's strategic policy, as set out in *Advantage Canada*,<sup>1</sup> its long-term economic plan. Improving the international tax system will enhance Canada's advantage to the benefit of all Canadians. For this reason, the Minister of Finance established the Advisory Panel on Canada's System of International Taxation in November 2007.

## Our mandate

2 The Panel's mandate was to recommend ways to improve the competitiveness, efficiency and fairness of Canada's system of international taxation, minimize compliance costs, and facilitate administration and enforcement by the Canada Revenue Agency (CRA). The Panel members were drawn from the Canadian business community, professional tax advisory firms, and the tax policy research field. The chair and vice chair of the Panel are Peter C. Godsoe, OC, and Kevin J. Dancey, FCA. Also on the Panel are James Barton Love, QC, Nick Pantaleo, FCA, Finn Poschmann, Guy Saint-Pierre, CC, and Cathy Williams.

## Our approach

3 Canada is on its way to achieving the lowest effective tax rate on new business investment in the G7 and is "open to two-way trade, investment and talent,"<sup>2</sup> as encouraged by the Competition Policy Review Panel. With this context in mind, the Panel focused primarily on how Canada's international tax rules affect Canadian businesses investing in foreign markets (the "outbound" tax rules) and how they affect foreign businesses investing in Canada (the "inbound" tax rules).

4 Released in April 2008, the Panel's consultation paper<sup>3</sup> framed the issues and asked questions; numerous submissions were received in response. To obtain a wide range of views, the Panel held meetings across Canada with businesses, industry groups, economists and tax advisors, as well as officials from the Department of Finance and the CRA. The Panel also undertook a research program to supplement its consultations and deliberations.

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1 Department of Finance Canada, *Advantage Canada: Building a Strong Economy for Canadians* (Ottawa: Public Works and Government Services Canada, 2006).

2 Competition Policy Review Panel, *Compete to Win* (Ottawa: Public Works and Government Services Canada, June 2008), at p. 13.

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

- 5 Our views and recommendations have been shaped by the submissions we received, by our deliberations, consultations and research, and by our experiences.
- 6 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 improve our existing system.
- 7 Although the Panel's mandate did not specify that our recommendations should be fiscally neutral, the Panel considered how they could affect Canada's tax revenues. In considering the fiscal impact of our proposals, the Panel recognized the importance of promoting competitiveness and the responsibility of sustaining Canada's tax revenues, especially in light of the current economic climate. We believe the consequences of our recommendations, taken together, should not result in any net fiscal cost to the government.
- 8 The Panel's goal is to offer pragmatic, balanced and actionable advice to the Minister of Finance toward improving Canada's international tax system for the benefit of our country.<sup>4</sup>

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<sup>4</sup> The Panel's final report, *Enhancing Canada's International Tax Advantage*, is available at: [www.apcsit-gcrf.ca](http://www.apcsit-gcrf.ca)

## The Current Environment

- 9 The global landscape is changing quickly. Current events show how swiftly capital markets can change and influence industrial and commercial activity, and how adaptable Canadian companies need to be in response. As a relatively small trading nation, Canada has historically pursued an open economy; its system of international taxation reflects this pursuit.

### **Cross-border investment and tax policy**

- 10 Cross-border business investment has become central to the world economy. Global two-way trade is important to Canada’s prosperity, as it is to that of other countries. New competitors are emerging, notably from developing economies. Some of these new competitors are aggressively seeking capital, while others have substantial amounts of capital to invest. Canadian businesses need to be able to compete with them for investment on both the outbound and inbound fronts.
- 11 Direct investment by Canadian businesses abroad is associated with efficiency gains and greater productivity. Such benefits may arise from the ability to achieve scale economies and greater specialization, set up global supply chains, and access foreign technologies. Although a common worry among some Canadians is how Canadian direct investment abroad affects Canadian employment, the Panel found no clear evidence that such investment leads to the export of jobs or increases unemployment in a capital-exporting country like Canada.
- 12 Investment by foreign businesses in Canada adds to the stock of capital invested in Canada, resulting in faster growth, greater employment, higher living standards, and additional tax revenues for governments in Canada.
- 13 To support Canadian business investment abroad, attract foreign business investment at home, and strengthen our open economy, tax policy must keep pace with global trends. The significance of two-way trade and the need for a complementary system of international taxation are central to the Panel’s recommendations.

# Principles for Guiding Canada's International Tax Policy

- 14 The Panel acknowledges that setting international tax policy entails trade-offs and practical constraints. In the Panel's view, Canadian international tax policy makers should be guided by the following principles:
- 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.
- 15 We believe that 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.
- 16 The Panel believes that mutual responsibility and cooperation among businesses, tax advisors and government will strengthen our self-assessment system and help to achieve efficiency and simplicity within Canada's system of international taxation. Applying the above principles, in a spirit of cooperation and mutual respect, would offer Canada an opportunity to distinguish itself from other countries and enhance its international tax advantage.

## Our Recommendations

- 17 The Panel has designed an integrated package of specific recommendations for improving Canada’s system of international taxation in the following areas: outbound and inbound tax rules, non-resident withholding taxes, and administration, compliance and legislative process.
- 18 Two key directives emerge from applying the Panel’s principles:
- 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.
- 19 These principles and the recommendations in our final report are pragmatic ones, reflecting the Panel’s belief that Canada’s current international tax system is a good one that requires only some improvements.

## List of Recommendations

The Panel's recommendations to the Minister of Finance are listed below. Recommendation numbers correspond to the chapters in which they are discussed in the Panel's final report *Enhancing Canada's International Tax Advantage*.

### 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.

**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.

**Recommendation 4.4:** Review the "foreign affiliate" definition, taking into account the Panel's other recommendations on outbound taxation, the approaches of other countries, and the impact of any changes on existing investments.

**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.

**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.

**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.

## 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.

**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.

## 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.

## 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.

**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.

**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.

**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.

**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.