Statement

of

TAX EXECUTIVES INSTITUTE, INC.

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on

Pre-Budget Consultations

submitted to

HOUSE OF COMMONS
STANDING COMMITTEE ON FINANCE

August 5, 2011

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Tax Executives Institute (TEI) is pleased to participate in the pre-budget consultations that the Standing Committee has scheduled in order to gather input from across the country. In addition, TEI commends the government for its commitment to return to a balanced budget position by 2014-2015 through targeted savings from its *Strategic and Operating Review* initiative. In connection with the 2012 Budget, TEI offers the following recommendations to foster economic growth and job creation, promote a favourable business environment for investments in Canada, and ensure a high level of innovation and productivity. We believe the implementation of our recommendations will spur economic efficiency, improve tax administration, and enhance the competitiveness of Canada's business tax system to ensure shared prosperity and a high standard of living for all.

Background

Tax Executives Institute is the preeminent worldwide association of business tax professionals. Founded in 1944, TEI's 7,000 members work for 3,000 of the largest companies in Canada, the United States, Europe, and Asia. TEI's membership includes representatives from a broad cross-section of the business community, with members employed in all major industries and sectors of the economy. In that sense TEI is unique — we do not represent a particular group or industry. Canadians make up approximately 10 percent of TEI's membership, with our Canadian members belonging to chapters in Montreal, Toronto, Calgary, and Vancouver. In addition, many non-Canadian members work for companies with substantial Canadian operations, investments, and employees.

Executive Summary

TEI urges the Canadian government to maintain or enhance the international competitiveness of Canada's business tax structure by:

- Ensuring the Department of Finance completes its study on the taxation of corporate groups announced in the 2010 Budget Message and develops a workable tax loss- and attribute-transfer system for corporate groups in Canada.

- Implementing the recommendations of the Advisory Panel on Canada's System of International Taxation, including —
  - Eliminating withholding taxes under Regulations 102 for non-resident employees and 105 for cross-border services;
  - Adopting a broader exemption system for the earnings of foreign affiliates (FAs).

Implement a Loss-Transfer System for Corporate Groups

Federal budgets enacted during the past decade have focused on making Canada's business tax structure one of the most competitive in the world. To a large extent, the government has succeeded. By reducing the federal corporate income tax rate from 21 percent to 15 percent by 2012, Canada has made great strides in increasing Canada's attractiveness for both foreign and domestic business investors. Increased capital investments in Canada, in turn, have spurred productivity, promoted employment, and enhanced the prospects for sustainable economic growth. By staying the course with the scheduled rate reductions through the global recession, the government sent a strong signal to the capital markets about its commitment to enhancing the competitiveness of the Canadian business tax system, thereby blunting the severity of the recession on Canada and promoting a recovery more rapid than any other G-7 nation.[1]

Canada, though, must remain vigilant about maintaining its economic advantage, especially as other countries review their fiscal positions, restructure their corporate income tax systems, implement rate reductions, and make other changes lowering marginal effective corporate income tax rates. In addition to staying the course on the income tax rate reductions, the government must assess the tax base to evaluate the competitiveness, effectiveness, and relative burden of the tax system. Indeed, all aspects of the tax system must be considered and, in respect of tax loss utilization for corporate groups, the current system is regrettably deficient because it is too restrictive, subject to significant administrative uncertainty, and imposes unnecessary costs on taxpayers seeking to avail themselves of Canada Revenue Agency's (CRA's) administrative concessions for federal loss transfers.[2]

Thus, TEI welcomed the 2010 Budget Message announcing the government's commitment to explore changes to Canada's system of taxing corporate groups and was pleased to participate in the November 2010 consultation initiated by the Department of Finance. As explained in April 8, 2011, comments to the Department of Finance, implementing an efficient system of group taxation will provide a more competitive tax environment for businesses in Canada, thereby fostering economic growth and generating additional employment. Indeed, more than two thirds of OECD countries — including major Canadian trading partners such as the United States, the United Kingdom, Australia, and Germany — provide some form of group taxation or loss-transfer regime in their legislative or regulatory schemes for business taxation. Canada is currently the only G7 country that does not have such a feature.

While Canadian corporate groups can structure transactions today or make use of CRA's administrative concessions to transfer a tax loss to a profitable group member, such tax planning techniques require corporate groups to incur significant administrative costs and delays utilization of the loss. Moreover, regulatory or business constraints prevent some groups from structuring a tax loss transfer or making use of the administrative concessions thereby resulting in a permanent inability to utilize the loss. Permitting corporate groups to immediately offset profits and losses (and share other tax

[1] *See Canada's Global Economic Leadership: A Report to Canadians,* Department of Finance Canada (June 2010).

[2] Even though CRA permits related parties to transfer losses through various techniques, the tax result in any particular case depends upon the agency's exercise of administrative discretion and that engenders a degree of uncertainty for taxpayers.

attributes) will improve corporate liquidity and reduce borrowing costs for funding the payment of profitable group members' tax liabilities. As the Committee acknowledged in announcing these hearings, experience shows that, following a financial crisis, economic stagnation may occur as credit markets tighten. This means improving corporate liquidity is especially critical.

In addition, the inability to immediately offset losses (*i.e.,* without using a statutory reorganization transaction or employing CRA's administrative concessions) deters investments because companies often measure returns on investment and internal rates of return on an after-tax, present-value basis. To improve the neutrality and equity of the tax system, corporate groups should be treated as an economically integrated unit with free transferability of profits, losses, and other tax attributes.

Finally, adoption of a formalized corporate group taxation system will reduce administrative costs for governments and taxpayers alike. With a group taxation mechanism, taxpayers will be able to transfer losses and other attributes in an efficient, straightforward fashion without incurring the substantial transaction costs and legal and accounting fees incurred today. As important, CRA will be able to redirect the resources it currently devotes to issuing advance income tax rulings and auditing transactions undertaken for loss-utilization purposes.

The full details of a group loss-transfer system that TEI recommends are set forth in our submission to the Department of Finance. In summary, we believe the adoption of an annually elective tax loss- (or attribute-) transfer system similar to that used in the United Kingdom will be the simplest and most flexible to adopt and will require the fewest modifications to the Income Tax Act to implement. Attributes that should be part of the system include non-capital losses, capital losses, carryovers of such amounts, and — either immediately or a phased-in basis as revenue considerations permit — investment and other tax credits. Other important design parameters for a group taxation system include: establishing a threshold for common ownership for eligible groups of more than 50 percent but no greater than 80 percent; requiring a common parent corporation; and requiring that members be part of a group throughout the taxation year in order to transfer losses or attributes among eligible members. TEI would be pleased to consult further with the Standing Committee and the Department of Finance on the myriad details of an administrable loss-transfer system.

Enhance the International Competitiveness of Canada's Business Tax Structure

In November 2007, the government created an Advisory Panel on Canada's System of International Taxation (hereinafter "the Advisory Panel") to study and recommend measures to improve the competitiveness, efficiency, and fairness of Canada's international tax system. The Advisory Panel released a consultation paper in April 2008, and TEI is pleased to have participated in those consultations. We are also pleased that the final report on *Enhancing Canada's International Tax Advantage* issued in December 2008 (hereinafter "the Report") endorses recommendations that TEI made to the Panel (and, indeed, previously made to the Standing Committee).

Although the government has adopted several of the Advisory Panel's recommendations — such as abandoning the proposed foreign investment entity and non-resident trust legislation and repealing rules under section 18.2 that severely restricted the deductibility of interest attributable to financing foreign affiliates — other recommendations remain outstanding that would significantly enhance Canada's business tax system. TEI endorses the following:

A. *Withholding Taxes under Regulations 102 and 105.* In today's environment, business organizations staff their projects based on global skill sets rather than looking solely to the resources available within their home jurisdiction. Thus, access to individuals with key skills and know-how is

another key aspect of international competitiveness, especially where those skills or know-how are unavailable in the Canadian market.

Sections 105 and 102 of the Income Tax Regulations impose withholding tax on payments for services rendered in Canada by non-residents. Regulation 105 covers situations where a fee is paid to a non-resident for services rendered in Canada while regulation 102 addresses compensation paid to an employee who is working in Canada. Under regulation 105, payments to non-residents for services rendered in Canada are subject to withholding tax at a rate of 15 percent. Under regulation 102, non-resident employers have obligations similar to those of Canadian resident employers to withhold, remit, and report amounts in respect of remuneration paid to an employee who renders services in Canada on behalf of the non-resident employer. If a foreign-service provider can show, before performing the services in Canada, that the amount to be withheld is more than the ultimate Canadian income tax liability, the provider may apply for a waiver of withholding tax under regulation 105. Similarly, under regulation 102 an employee may apply for a waiver of withholding tax.

In respect of regulation 105, the Advisory Panel found that —

- the costs associated with complying are significant,
- service providers commonly gross-up their fees to offset the withholding tax, which can result in additional costs to Canadian businesses and hamper their ability to engage skilled workers from outside Canada,
- the waiver process is cumbersome and so it is not used as often as it should be, and
- the service provider may suffer reduced or delayed revenues and cash flow problems if the service provider has not received a gross-up from the payer.

The Advisory Panel also determined 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. For example, where a non-resident employee performs employment duties in Canada for just one day, a withholding obligation is placed on the employer. Although a waiver can be obtained if the employee ultimately will not be taxable in Canada, the time delay is often considerable, making the process unhelpful. In practice, it is difficult for non-resident companies to set up a process to withhold and remit various Canadian taxes for what may be small amounts. Moreover, even though CRA recently modified its waiver process under regulation 102, the process remains far too cumbersome. For example, employees are still required to apply for the waiver 30 days in advance of beginning to render services in Canada — a requirement that is not practical in many circumstances. In addition, every non-resident employee must obtain a Canadian tax identification number and file a Canadian income tax return even where a treaty exemption applies. Finally, each non-resident employer must obtain a tax identification number, prepare and submit a Form T-4 (*Statement of Remuneration Paid*) for each non-resident employee (even where there is no withholding because of a treaty exemption), and then cancel the tax identification number in a subsequent year in order to avoid follow-up inquiries from CRA about potential non-filing of tax returns.

To improve access to skilled services, the government should retain the current information reporting requirements for non-resident employees and service providers but repeal the withholding tax requirements under regulations 102 and 105, especially in respect of payments to U.S. employees and service providers. The Advisory Panel Report extensively discusses the pros and cons of the current withholding regimes and recommends that the current system be abandoned and replaced with a certification system similar to that in the United States. As important, the Advisory Panel recommended that the requirement to withhold taxes on services be eliminated where the nonresident service provider

certifies that it would be exempt under a treaty such as the Canada-U.S. Treaty.[3] We concur and urge the Standing Committee to implement its recommendations on withholding taxes as soon as practicable.

More broadly, the Standing Committee should consider creating an advisory panel to review the burdens and costs of business tax compliance with the Income and Excise Tax Acts and to make recommendations for streamlining CRA's administration of both Acts for the benefit of both taxpayers and the government.

B. *Exemption System*

TEI urges the government to consider a broader — even full — exemption system for dividends from foreign investments. A broader exemption would enhance the inherent economic advantages of foreign investments at a significant savings to taxpayers because the costs of complying with the complex foreign affiliate rules to track and report exempt and taxable surplus would be eliminated or substantially reduced. Moreover, the administrative costs to CRA in administering those rules would be minimized. We are pleased that the Advisory Panel, in paragraphs 4.19 to 4.33 of the Report, substantially endorses this view.

In addition, while the government's 2007 budget announcement relating to Tax Information Exchange Agreements (TIEAs) signaled support for a broader exemption system, the expansion of the exemption system is dependent on the negotiation of TIEAs with myriad foreign jurisdictions. Concededly, access to tax information in foreign jurisdictions is crucial for tax administration (and the government's progress in negotiating agreements has been commendable), businesses should not be precluded from benefiting from the simplicity and other gains of a broader exemption system simply because a non-treaty country chooses not to negotiate a TIEA with Canada.[4] The Advisory Panel reached a similar conclusion, stating that "the exemption system for foreign active business income earned by foreign affiliates should no longer be linked to tax treaties or TIEAs. The Advisory Panel believes there are sound reasons to detach the exemption system from tax treaties and TIEAs." Rather than defer the implementation of a broader exemption system or make it subject to the negotiation of TIEAs, Canada should adopt an approach whereby *only* active income earned in "black-listed" countries (*i.e.*, those designated by Canada as uncooperative in supplying information) will generate taxable surplus.[5]

Conclusion

Tax Executives Institute appreciates the opportunity to participate in the pre-budget consultations by the House of Commons Standing Committee on Finance. If you should have any questions about TEI's written statement, we shall be pleased to respond. Please contact either David V. Daubaras, TEI's Vice President for Canadian Affairs at 905.858.5309 (or david.daubaras@ge.com) or Carmine A. Arcari, Chair of TEI's Canadian Income Tax Committee at 416.955.7972 (or carmine.arcari@rbc.com).

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By:

Paul O'Connor
International President

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[3] *See* Recommendation 7.3 of the Report.

[4] *See* paragraph 4.42 of the Report and recommendation 4.2.

[5] *See* paragraph 4.39 of the Report.