Standing Committee on Finance (FINA)

Pre-budget consultations 2012

Tax Executives Institute, Inc.

Responses

1. Economic Recovery and Growth

Given the current climate of federal and global fiscal restraint, what specific federal measures do you feel are needed for a sustained economic recovery and enhanced economic growth in Canada?

As the preeminent association of in-house tax executives worldwide, Tax Executives Institute (TEI) urges the Canadian government to enhance the international competitiveness of Canada's business tax structure by: • Ensuring that the Department of Finance completes the 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. Although the provinces have expressed concerns about potential loss-shifting that may occur under a group taxation system, we believe the federal government can ameliorate those concerns through proper system design. As important, a formalized group taxation system will mitigate the uncertainty of undertaking permitted loss-sharing transactions pursuant to Canada Revenue Agency's (CRA's) current policy on administrative concessions. As a result, taxpayers will obtain greater certainty about their tax results and the interprovincial tax effects of loss- or attribute-sharing that occurs currently will be more transparent to the provinces. • Eliminating withholding taxes under Regulations 102 for non-resident employees and under Regulation 105 for cross-border services and implementing a certification system whereby non-residents would certify whether the services or employment income is treaty exempt. • Amending the August 2011 Foreign Affiliate upstream loan provisions and modifying the Foreign Affiliate Dumping proposals set out in the 2012 Budget to avoid either creating a Canadian "cash trap" or imposing an effective tax increase for foreign investors.

2. Job Creation

As Canadian companies face pressures resulting from such factors as uncertainty about the U.S. economic recovery, a sovereign debt crisis in Europe, and competition from a number of developed and developing countries, what specific federal actions do you believe should be taken to promote job creation in Canada, including that which occurs as a result of enhanced internal and international trade?

By reducing the federal corporate income tax rate, Canada has increased its attractiveness for both foreign and domestic investors. Increased capital investments in Canada, in turn, have spurred productivity, promoted employment, and facilitated sustainable economic growth. Canada, though, must remain vigilant about maintaining its economic advantage, especially as other countries restructure their corporate income tax systems, implement rate reductions, and lower marginal effective corporate income tax rates. In assessing Canada's tax system, the government must consider all aspects and, in respect of corporate tax loss utilization, the current regime is too restrictive, is subject to too much administrative uncertainty, and imposes unnecessary costs. Thus, TEI welcomed the opportunity to participate in the Department of Finance's November 2010 consultation on Canada's system of taxing corporate groups. As explained in our April 8, 2011, comments, implementing an efficient group taxation system will improve the tax environment for businesses in Canada, thereby fostering economic growth and generating additional employment. More than two thirds of OECD countries — including major Canadian trading partners such as the United States, the United Kingdom, Australia, and Germany — provide a 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. Permitting corporate groups to immediately offset profits and losses (and share other tax attributes) will improve corporate liquidity and reduce borrowing costs for the corporate group. As this Committee acknowledged in its 2011 hearings, experience shows that, following a financial crisis, economic stagnation may occur as credit markets tighten. And improving corporate liquidity remains vital. An annually elective tax loss-transfer system similar to that used in the United Kingdom will be the simplest and most flexible to adopt, requiring the fewest modifications to the Income Tax Act to implement. The provinces have expressed concerns about potential loss shifting under a group taxation system, but those concerns can be ameliorated through proper system design. We urge the government to work with the provinces to develop an acceptable formal loss-transfer system.

3. Demographic Change

What specific federal measures do you think should be implemented to help the country address the consequences of, and challenges associated with, the aging of the Canadian population and of skills shortages?

In today's environment business organizations staff their projects based on global skill sets and access to services and know-how is a key aspect of international competitiveness, especially where the skills and knowledge workers are unavailable in the Canadian market. Two Canadian barriers impeding access to service providers in the global services market place are payroll withholding tax for non-resident employees and withholding tax on service providing entities. Specifically, 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 fees paid to non-employees for services, whereas Regulation 102 addresses compensation paid to employees working in Canada. In its December 2008 report, the government's Advisory Panel on Canada's System of International Taxation — which was created to study and recommend measures to improve the competitiveness, efficiency, and fairness of Canada's international tax system — found in respect of Regulation 105 that: • the costs associated with complying are significant, • service providers commonly gross-up their fees to offset the withholding tax, resulting in additional costs to Canadian businesses and hampering their ability to engage skilled workers, • the process for obtaining a waiver of withholding tax from CRA is cumbersome and 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 is not grossed-up by 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 non-residents, as well as Canadian corporations that carry out administrative duties on behalf of related non-resident employers. Thus, the Panel recommended abandoning the withholding tax system and replacing it with a certification system similar to that in the United States. TEI concurs. A certification system based on retaining the current information reporting requirements will maintain CRA's enforcement capability, but shift compliance costs to the certifying party, minimize tax withholding refunded to exempt parties, reduce tax gross-up costs to Canadian payers, and minimize administrative burdens for CRA and business taxpayers alike. TEI urges adoption of the Panel's recommendation.

4. Productivity

With labour market challenges arising in part as a result of the aging of Canada's population and an ongoing focus on the actions needed for competitiveness, what specific federal initiatives are needed in order to increase productivity in Canada?

On August 19, 2011, the Department of Finance released legislative proposals (hereinafter "the 2011 proposals") to amend the foreign affiliate rules in the Income Tax Act. The Explanatory Notes to the 2011 proposals state that "section 90 is being significantly expanded to provide, among other things,

specific rules for dividends from foreign affiliates and to address avoidance techniques involving so called ‘upstream loans’.” Regrettably, the proposed upstream loan rules introduce inordinate complexity into the tax system, increase the cost of funding to Canadian companies, and represent an overbroad response to the issues the Department of Finance is seeking to remedy. The proposals also overlap with current anti-avoidance provisions. In addition, the rules are so broad that “downstream” and brother-to-sister company loans are caught in addition to “upstream” loans of low-taxed foreign affiliate surplus. Finally, there are technical flaws in the upstream loan proposals that TEI addressed in a letter to the Department of Finance on October 19, 2011. Standing alone, the upstream loan provisions are a drag on the financing and competitiveness of Canadian companies (whether or not headquartered in Canada) and Canada’s capital and financial markets. Taken together with the foreign affiliate dumping proposals discussed in the next response (Other Challenges), the upstream loan provisions create a cash trap and effectively increase the corporate tax rate for foreign investors in Canada. The upstream loan provisions should be significantly narrowed. This action, accompanied by a revision of the 2012 anti-dumping proposal (see TEI’s responses to the next question), will prevent abusive debt-dumping transactions while ameliorating the severe cash restrictions imposed on companies. It will also enable companies to raise capital in Canada and on-lend the proceeds within the corporate group. In addition to generating net tax revenues for Canada, such amendments will enhance Canadian capital markets industries, generate additional investment opportunities for Canadian investors, and increase Canada’s attractiveness in the global capital markets — in line with the goals set out in Advantage Canada.

5. Other Challenges

With some Canadian individuals, businesses and communities facing particular challenges at this time, in your view, who is facing the most challenges, what are the challenges that are being faced and what specific federal actions are needed to address these challenges?

The 2012 Budget proposes to curtail “foreign affiliate dumping” transactions. Regrettably, the interaction of this anti-dumping proposal with the upstream loan provision in the 2011 foreign affiliate proposals and Act subsection 15(2) will restrict foreign-owned Canadian companies’ abilities to manage and invest cash and will be viewed as increasing the effective tax rate from 25 to 30 percent or more depending on the withholding tax rate. Taken together, the proposals partially reverse the last 10 years of corporate income tax reductions and contravene the propositions in Compete to Win that (a) “raising Canada’s overall economic performance through greater competition will provide Canadians with a higher standard of living” and (b) in “the new world economy, Canada must be ready to keep pace with change and develop a global mindset that is open to two-way trade, investment and talent.” (See Compete to Win, at p. 1 and 13, respectively.) The anti-dumping proposal is intended to address “abusive” transactions but it counterproductively overreaches. The Advisory Panel expressly found that not all transactions are offensive, and it supported business expansion through investments in non-resident businesses, related-party borrowings, and guaranteed debt to finance non-Canadian investments. As important, the proposal’s excessively stringent business purpose test would set Canada’s tax system apart from its principal trading partners and adversely affect foreign investors’ views of Canada’s attractiveness. TEI’s June 6, 2012, letter to the Department of Finance makes recommendations to restrict abusive transactions (without increasing a foreign-owned group’s tax rates) by: • Amending subsection 15(2), the proposed upstream loan rules, and the proposed foreign affiliate dumping rules to permit Canadian subsidiaries of non-resident corporate parent groups to lend surplus cash upstream and downstream to related parties free of withholding tax as long as the loans generate net positive taxable income in Canada. • Revising proposed paragraph 212.3(l)(c) to permit a foreign-owned Canadian company to hold fully participating investments in a controlled foreign affiliate that carries on an active business. • Deeming the bona fide business purpose test satisfied where the terms and conditions of a transaction are essentially the same as transactions entered into by parties dealing

at arm’s length. • Correcting the proposal's technical flaws, including the excessively stringent business purpose test.