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Auditor General of Canada

to the House of Commons

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Chapter 11

Other Audit Observations

Office of the Auditor General of Canada

The December 2002 Report of the Auditor General of Canada comprises 11 chapters, Matters of Special Importance—2002, a Foreword, Main Points, and Appendices. The main table of contents is found at the end of this publication.

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Chapter

11

Other Audit Observations

The work that led to other audit observations was conducted in accordance with the legislative mandate, policies, and practices of the Office of the Auditor General of Canada. These policies and practices embrace the standards recommended by the Canadian Institute of Chartered Accountants.

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Other Audit Observations

Main Points

11.1 This chapter fulfils a special role in the Report. Other chapters normally report on value-for-money audits or on audits and studies that relate to operations of the government as a whole. Other Audit Observations discusses specific matters that have come to our attention during our financial and compliance audits of the Public Accounts of Canada, Crown corporations, and other entities, or during our value-for-money audits or audit work to follow up on third-party complaints. Because these observations deal with specific matters, they should not be applied to other related issues or used as a basis for drawing conclusions about matters not examined.

11.2 During a hearing this year, the Standing Committee on Public Accounts requested that we continue to bring to Parliament's attention previous observations that have not been resolved. In this report, four of the audit observations were previously reported and have been indicated as such.

11.3 This chapter covers new issues:

- Executive compensation in Crown corporations—Compensation needs to be more transparent.
- Royal Canadian Mounted Police—Canadian Firearms Program—Information to screen applicants for firearms licences may not be accurate.
- Indian and Northern Affairs Canada—The food mail program: A key component of this program has never been fully reviewed.

11.4 The chapter also covers issues previously updated:

- Department of Finance—Tax arrangements for foreign affiliates have eroded Canadian tax revenues of hundreds of millions of dollars over the last 10 years.
- Park Downsview Park Inc.—An urban park is being created without formal approval by Parliament.
- Atomic Energy of Canada Limited—The government has approved Atomic Energy of Canada Limited's five-year corporate plan for the first time since 1994–95.
- Employment Insurance Account—No explanation was provided to Parliament for a surplus reaching $40 billion.

Executive compensation in Crown corporations

Compensation needs to be more transparent

In brief

Our review indicated inconsistencies in how the federal Crown corporations manage the overall compensation for their executives. The Privy Council Office and the Treasury Board Secretariat need to provide clear guidance to Crown corporations to ensure that their compensation practices are based on established principles that are clearly understandable by the stakeholders involved. The government needs to adopt disclosure practices to increase transparency.

Background

11.5 Crown corporations have more freedom than federal departments and agencies with regard to compensation packages they give to their executives. As part of our annual financial audits, our Office examined how Crown corporations handled executive compensation. We examined 43 Crown corporations over a three-year period by reviewing some each year. In the government's view, Crown corporations are established at arm's length from the government. They have their own corporate governance structure. They are expected to be competent to run their own affairs. The Crown Corporation General Regulations provide some direction concerning remuneration and benefits for the chief executive officers. The remuneration for the chief executive officers is managed centrally in the majority of cases.

11.6 Executive compensation comprises salaries, pensions, performance pay, termination benefits, and other benefits such as annual leave, short- and long-term disability insurance, life insurance, health and dental plans, social or recreational club memberships, and the use of company vehicles. We examined only the compensation of chief executive officers or presidents, and those one level below them—typically vice-presidents.

11.7 The purpose of our review was to determine whether executive compensation in federal Crown corporations is understandable, transparent, and consistent with the public sector values of prudence and probity. We expected to find complete and accurate information that was readily available, and a set of clear laws, regulations, and rules to adequately guide Crown corporations. We also expected to find that each Crown corporation would follow the rules that apply to its own situation. One method of increasing openness or transparency is by revealing or disclosing more information. We examined disclosure practices in other jurisdictions.

Prudence and probity—Two values that are the building blocks for good accountability.

Authorities governing compensation

11.8 The remuneration of the chief executive officer or the president of a federal Crown corporation is fixed by the Governor in Council, at a salary range that is recorded publicly in an order-in-council. Although this means that the chief executive officer's salary range is known, the actual salary level and other benefits are not. That is considered to be personal information. Nor is the compensation of vice-presidents disclosed. Crown corporations

that are subject to the *Privacy Act* are prevented from disclosing personal information.

11.9 There are different rules governing the compensation of chief executive officers and vice-presidents. A number of laws or regulations apply to chief executive officers: the *Financial Administration Act*, the law governing each corporation, and the Crown Corporation General Regulations. The *Financial Administration Act* requires that the Governor in Council set the rate of remuneration. The Regulations define remuneration for the purposes of the *Financial Administration Act* to mean a salary, a fee, an allowance or any other form of monetary compensation, except monetary compensation payable under the provisions of a registered pension plan. The *Financial Administration Act* further specifies that the board of directors of a corporation has the authority to provide any benefits other than remuneration to the chief executive officer at any time. The Crown Corporation General Regulations require that when additional benefits are provided, the corporation must advise the responsible minister and the Clerk of the Privy Council within a specified length of time.

11.10 For compensation of vice-presidents, the laws that govern a corporation normally give the board of directors overall administrative responsibility. The governing legislation also allows a board of directors to delegate administrative authority to the committee responsible for human resource management or to the executive committee, which are subcommittees of the board. As an alternative, the chief executive officer may be charged with the responsibility for compensation of all of the corporation's employees, including vice-presidents.

11.11 In 1997, the President of the Treasury Board asked the Advisory Committee on Senior Level Retention and Compensation to examine compensation of senior public servants in departments and agencies. The President also asked the Committee to review compensation for the chief executive officers appointed to Crown corporations by the Governor in Council. For the corporations we examined, the Committee recommended a salary range of $113,200 to $325,200 for chief executive officers and a performance pay range of 10 percent to 20 percent of the salary, effective April 2001. However, the Committee excluded compensation of vice-presidents from its review because employee compensation is outside its mandate.

Issues

Notifying responsible authorities

11.12 A corporation's board of directors can set any benefits other than remuneration for the chief executive officer, in accordance with the Crown Corporation General Regulations. However, the Regulations provide little guidance on the principles that boards are to apply. For instance, the Regulations state that benefits shall not exceed the total or aggregate value of standard benefits for chief executive officers in other corporations in the public and the private sectors that carry on similar activities. We found that neither the Privy Council Office nor the Treasury Board Secretariat has provided clear guidance to Crown corporations on how to establish standard

benefits or how to determine which of their activities are similar to those of private sector corporations.

11.13 The Regulations further state that when a board of directors provides benefits to a chief executive officer, the corporation must report them to the responsible minister and to the Clerk of the Privy Council. We noted that three Crown corporations neglected to do that. The three Crown corporations notified the Privy Council Office when we brought this issue to their attention.

11.14 Most Crown corporations do not have their own pension plan. Their employees are subject to the same public service superannuation plan as the public service employees. We found that practices varied in the larger, more commercial corporations that have their own pension authority. A number of corporations had supplementary pension plans for executives, usually approved by the board of directors. Pension benefits are an important part of the overall compensation.

Rationale for pay inversion is not clear

11.15 Pay inversion occurs when the combined total of salary and performance pay paid to a subordinate employee is greater than what is paid to his or her supervisor. The Advisory Committee on Senior Level Retention and Compensation noted in its 2000 report that situations of pay inversion exist in some larger Crown corporations. Our review confirmed these findings.

11.16 In August 2002, the Committee noted that in a few corporations, the vice-presidents are paid more than the chief executive officers. It also observed that the chief executive officers' total compensation lags behind that of comparable positions in the total Canadian markets. The Committee concluded that a fundamental review of the compensation policy for chief executive officers needs to be undertaken. We support the Committee's recommendation for such a review.

11.17 We noted significant inversions in pay for the positions of chief executive officers and vice-presidents in a small number of Crown corporations. In these cases, the vice-presidents' salary and performance pay were significantly higher than the total amount of the chief executive officers' salary and performance pay combined.

11.18 The inversions generally occur because the vice-president's performance pay varies, with no predetermined limit on the total amount that can be given. However, the chief executive officer's performance pay is a percentage of the salary at a rate fixed by the Governor in Council on the recommendation of an external review committee. We understand that the use of variable performance pay as a significant component of overall compensation is common in the private sector.

11.19 Depending on a Crown corporation's particular strategy to recruit and retain staff, pay inversions may be appropriate. Currently there are no guidelines governing pay inversions. Although the Treasury Board Secretariat

is responsible for applying the *Financial Administration Act* to Crown corporations, it provides little guidance on compensation at levels below the chief executive officer. There is no predetermined limit on total compensation for the position of vice-president of a Crown corporation on a government-wide basis.

11.20 The Advisory Committee on Senior Level Retention and Compensation recommended salary and performance pay levels for chief executive officers in 2001 and 2002. However, we noted that the Privy Council Office has not provided guidance to Crown corporations on suitable comparisons from the private sector of overall benefits other than remuneration for chief executive officers.

Disclosure practices in other jurisdictions

11.21 We believe that releasing information about executive compensation by Crown corporations can increase openness with the public. Disclosure practices can vary in different jurisdictions depending on the legislation or regulation in effect. Currently in Canada, the salary range of the chief executive officer of Crown corporations is disclosed to the public. However, the actual salary or other forms of compensation such as the pension entitlements, termination benefits, or other benefits are not disclosed because they are personal information. As well, there is no disclosure of executive compensation for levels below the chief executive officer. However, we noted that the Canada Pension Plan Investment Board disclosed detailed information about executive compensation in its annual report as required by the Canada Pension Plan Investment Board Regulations. This organization is not subject to the *Privacy Act*.

11.22 We examined disclosure practices of executive compensation in Crown corporations within provincial governments. By legislation, some provinces are required to disclose it; other provinces are not. Ontario, for instance, releases information to the public about the total compensation for executives and employees whose earnings are above $100,000. Ontario's *Public Sector Salary Disclosure Act, 1996* covers city and other local governments, universities, colleges, school boards, hospitals, and Crown agencies. Most Crown corporations in Ontario, except for commercial corporations, are required to disclose the information.

11.23 We also examined disclosure practices in private and public sectors in other countries. For public sector organizations similar to Crown corporations, disclosure is required in the United States, Australia, and New Zealand. In the United Kingdom, only certain organizations that raise part of their funding in the private sector are required to disclose information. In the private sector, we found more consistent disclosure. Specifically the securities regulators in Canada and in the United States require that compensation for key executives of publicly traded companies must be disclosed to the public. The disclosure includes overall compensation rather than just salary. If the Crown corporations wish to align compensation practices in part with those of the private sector, then in our view they should also adopt their disclosure practices.

Conclusion

11.24 As part of the public sector, Crown corporations need to follow a more consistent and transparent approach to executive compensation. We found the Crown Corporation General Regulations to be too general to apply in these circumstances. In our view the comparison between the public and private corporations needs to be clarified through guidance. The Advisory Committee on Senior Level Retention and Compensation recommended salary and performance pay levels for the chief executive officers.

11.25 **Recommendation.** The Privy Council Office and the Treasury Board Secretariat should clarify the principles that govern compensation for both chief executive officers and vice-presidents, including the issue of pay inversion. They should also monitor the practices of Crown corporations and ensure that they are consistent with the governing authorities.

11.26 **Recommendation.** The Privy Council Office and the Treasury Board Secretariat should provide more integrated guidance to compare executive compensation in Crown corporations against those in private sector corporations. For example, they could develop more guidance for comparable benchmarks to determine which activities are similar to those of the private sector corporations.

11.27 **Recommendation.** In addition to providing guidance, the federal government should adopt disclosure practices for executive compensation, taking into account similar practices in other jurisdictions, with the view to increasing transparency.

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Royal Canadian Mounted Police—Canadian Firearms Program

Information to screen applicants for firearms licences may not be accurate

In brief

As part of the Department of Justice's Canadian Firearms Program, the Royal Canadian Mounted Police (RCMP) operates a database of about four million records called the Firearms Interest Police. Chief Firearms Officers use this database to help screen applicants for firearms licences. The RCMP provides about 1 million of these records. The RCMP told us that while it believes that the database has significantly improved public safety, it remains concerned about the reliability of the information it provides to the database. This matter came to our attention as part of our follow-up to our study of challenges to the criminal justice system, reported to Parliament in our April 2002 Report, Chapter 4.

Background

11.28 The Department of Justice's Canadian Firearms Program requires that the Chief Firearms Officers screen applicants for firearms licences in order to help ensure public safety. The Officers use the Firearms Interest Police database to help screen applicants.

11.29 The RCMP indicates that over 900 police agencies contribute information to the database. It contains information on individuals who have had contact with the police, including those that have been charged with an offence. The RCMP provides about 1 million of the records in the database. These records are extracted from the RCMP's Police Information Retrieval System database. The RCMP reviewed the quality of the records it provides. The data supplied by other police agencies were not reviewed.

Issues

11.30 In November 1998 and March 2000, the Senior Executive Committee of the RCMP was informed that officers responsible for the RCMP's contributions to the Firearms Interest Police database had serious concerns about the accuracy and completeness of the information. We reviewed RCMP files and made other inquiries to confirm the significance of these concerns.

11.31 An April 2001 RCMP review of data quality stated that

- persons are known to be in the database who should not be, and thus could be denied firearms licences or have their eligibility reviewed; and
- some persons who should be in the database are not and these individuals could be issued licences and subsequently use firearms to commit a violent offence.

The review concluded that a tragic incident could arise as a consequence of the poor data quality and that the RCMP therefore faces serious legal risks.

11.32 In 2002, the RCMP further indicated that the quality of the data was still questionable.

Conclusion and recommendation

11.33 The RCMP's concerns about the data are based on the limited reviews it has conducted. If what these RCMP reviews show is representative of the risks that the database presents, then remedial action must be taken immediately. However, to be effective, such action must be based on an urgent systematic identification of the problems in the database and potential solutions.

Royal Canadian Mounted Police's response. The Royal Canadian Mounted Police (RCMP) is aware of the concerns about the quality of some data in its Police Information Retrieval System and its impact on the Canadian Firearms Program. The RCMP considers public safety to be paramount. For this reason, the RCMP is committed to ensuring that individuals who do not meet the legal requirements to be issued a firearms licence are identified through proper information sharing.

The RCMP recognizes that effective information sharing for the purposes of the Canadian Firearms Program is critical, and that this is dependent on the integrity of the data contained in police information systems, including those of the RCMP. The RCMP has implemented a number of remedial measures to address data quality issues. These include a record disclosure and verification process, system-level error detection and reporting mechanisms, enhanced system user awareness regarding data quality issues, development of additional data quality reviewer expertise, progress and compliance monitoring, and an increased level of accountability on the part of contributors to RCMP systems for their data quality.

The RCMP opens 2.9 million operational case records per year, from over 750 locations throughout Canada. The measures specified to address data quality in the RCMP's Police Information Retrieval System are already proving to be effective.

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Indian and Northern Affairs Canada

Food mail program: A key component of this program has never been fully reviewed

In brief

Since the late 1960s, the federal government has been subsidizing Canada Post's costs of sending nutritious perishable food to Canada's North by air. The objective of the food mail program is to increase the level of nutrition in the diets of those living in the North, all within a reasonable cost to the government. Users of the program must arrange with wholesalers to send food that is eligible under the program to Canada Post facilities at one of the 20 designated entry points. Canada Post then assumes the responsibility for flying the perishable food to any one of 140 communities in the North within 48 hours.

Yet Indian and Northern Affairs Canada has never reviewed the impact of the entry points on the effectiveness of the program. There have been calls for such a review because more southerly cities might prove to be more efficient. This is particularly true for entry points such as Val-d'Or, Happy Valley-Goose Bay, Yellowknife, and Churchill. We are proposing that Indian and Northern Affairs Canada conduct such a review.

Background

11.34 Since Aboriginal people in the North have faced many changes in their lifestyle, they are no longer able to obtain all of their food from the land and sea. This gives increasing importance for the need for nutritious foods at an affordable price.

11.35 While there are a variety of ways to meet that need, such as educating Northerners about what constitutes a nutritious diet and working to increase their income, keeping the cost of nutritious foods low contributes to the nutrition of Northerners. It is therefore important that nutritious food from the South be shipped at an affordable price to all of the 140 northern communities.

11.36 In the late 1960s, the federal government determined that by subsidizing the costs of mailing food to the North, it could improve the nutrition and health of Northerners. With that in mind, the government introduced the Northern Air Stage Program, generally known as the "food mail program." The program is intended to provide a subsidized rate to mail fresh nutritious foods and other essential items to the North.

11.37 In 1989, Indian and Northern Affairs Canada undertook a review to determine what role, if any, the government should continue to play in the program. The review pointed to the program's importance in both decreasing the cost of perishable nutritious food and increasing its consumption. At a parliamentary committee hearing in 1998, the Department informed committee members that while the consumption of nutritious food had increased since the program began, it was still below recommended levels—particularly the consumption of fruit, vegetables, and dairy products in isolated communities.

11.38 In 1996, the government agreed to continue the program but with a yearly cap of $15.6 million. For the most part, the program stayed within that budget up to 1999–2000. But in 2001–02, spending grew to $24.5 million. This was brought on by increased demand for the program as well as increased costs due to the contract that Canada Post had with its carriers. The Department funded the additional costs by using Supplementary Estimates to reallocate money from elsewhere in the Department.

11.39 The program is still delivered by Canada Post through an airport-to-airport subsidized postal freight service for communities that do not have year-round access by road. When the program began, it was limited to northern Quebec and Ontario. Today, about 90,000 people are eligible for the program in some 140 communities—in virtually all of Nunavut and parts of northern Quebec, Labrador, Ontario, Alberta, Saskatchewan, Manitoba, the Yukon, and the Northwest Territories. In 2001–02, these communities received about 10 million kilograms of food; Nunavut and northern Quebec received about 60 percent and 30 percent respectively of that total shipment.

11.40 The entry points where food must be delivered for shipment to the north are limited to 20 designated communities with airports. For example, Val-d'Or serves all of Baffin Island and northern Quebec, while Happy Valley-Goose Bay in Labrador serves northern and central Labrador, and Churchill serves the Keewatin (Kivalliq) area. Exhibit 11.1 shows a map of Canada illustrating some of the entry points and communities served by the program.

How the program works

11.41 Although Indian and Northern Affairs Canada sets the policy for the program, Canada Post delivers it on a day-to-day basis. How a Northerner in a designated community actually receives subsidized goods is described in Exhibit 11.2.

Issues

Location of entry points and the effect on food quality and choice

11.42 We believe that this program contributes to the nutrition of Aboriginal people and others in the North by keeping the price of fresh nutritious foods affordable. We also found that the people involved in delivering this program are committed to its success and believe that the program really matters.

11.43 However, we also discovered that no systematic review had ever been done to assess whether changing the entry points would make the program more effective.

11.44 A 1996 study conducted by Indian and Northern Affairs Canada revealed that many northern merchants and consumers have suggested that access to more southerly entry points would have a positive impact on the quality and choice of food. For example, Montréal or Ottawa should be considered as a possible alternative to Val-d'Or; Winnipeg or Thompson, Manitoba, should be considered in addition to, or instead of, Churchill. We would have expected to find a review of major entry points but were unable to do so.

Exhibit 11.1 Food mail program—Some of the entry points and final destinations

11.45 The Department conducted a survey about food quality in 2001, which revealed that there was a lack of quality and variety of fresh and frozen perishable foods in Labrador. Customers have clearly and repeatedly said that they were not satisfied with the quality of the products sold in their communities. They were also dissatisfied because they believed these products were too expensive. At the same time, the retailers who responded to the survey said that there were no serious problems with the products sold in their stores. According to them, these products were of good quality and there was a large variety of fresh and frozen perishable foods made available to their customers at all times. A key finding of this survey was the gap between the views of customers and retailers about the quality of the food.

11.46 During the course of conducting price surveys, the staff of the Department also found that food quality can sometimes be poor, particularly in smaller communities in Labrador and Nunavut. Although the Department and Canada Post work with wholesalers and retailers to improve the packaging and storing of food, they have made no effort to determine whether having food shipped from more southerly cities would improve the quality of food.

Exhibit 11.2 How the program works

- The program starts with a retailer, or in some instances, an individual consumer living in a designated northern community like Iqaluit or Pond Inlet, who wants to purchase an item that is eligible for a subsidy. (Designated communities and eligible products are listed in a food mail program guide from Indian and Northern Affairs Canada on its Web site at http://www.ainc-inac.gc.ca/ps/nap/air/index_e.html
- The retailer places the order with a wholesaler in the South (for example, Montréal or Edmonton) who has a contract with Canada Post to supply food or eligible products under the food mail program.
- The wholesaler must deliver the item from his or her warehouse to one of 20 designated Canada Post entry points, which are located at the airports in those communities, for example, Val-d'Or, Happy Valley-Goose Bay, Churchill, or Inuvik. Generally this is done by road or rail. In the case of Val-d'Or, food takes between 5-7 hours by road from Montréal; for Happy Valley-Goose Bay, it takes up to 60 hours from Montréal by road.
- When the item is delivered to the entry point, there are limitations regarding weight, size, and packaging quality. (These are all described in the food mail program guide.)
- Canada Post randomly checks the content of packages to be sure that the items are eligible under the program. There are a number of classes of eligible products. While they all receive the same subsidized rate per package, there are three different per-kilogram rates—$0.80, $1.00, and $2.15, depending on the specific product and destination.
- Canada Post then takes responsibility for delivering the product to one of the 140 final destinations from one of 20 entry points. It guarantees that the item will be delivered to any of these eligible communities in the North within 48 hours for perishables and 72 hours for non-perishable foods.
- All shipments must be picked up at the airport within 15 minutes of the time that the aircraft arrives. The carrier must notify the retailer or individual person who placed the order when the plane is scheduled or anticipated to arrive.
- The retailer or individual pays the wholesaler the full cost for the item. This includes the cost of packing the product for delivery, the cost of getting it to the entry point, and the subsidized rate that Canada Post charges for the service.
- The federal government pays Canada Post the difference between the subsidized rate and the rate that would be charged if there was no subsidy.

Location of entry points and relationship to overall program budget

11.47 The rationale for selecting the entry points was that the air distance from the entry point to the individual northern communities served was the shortest possible. The presumption was that road and rail travel to the entry point was cheaper and therefore the cost to the consumer would be the lowest possible, given the amount the federal government was willing to commit to the program.

11.48 Since the program began, there has not been any assessment of this concern. Yet it is a simple fact that planes are not constrained by the location of roads. Take, for example, a shipment of food going to Iqaluit. At this time the food often travels from Montréal to Val-d'Or, which takes about five to

seven hours by road. Then the package is flown from Val-d'Or to Iqaluit. Yet the air distance from Montréal to Iqaluit is just 220 kilometres longer than from Val-d'Or to Iqaluit. Alternatively, the food could be flown from Ottawa to Iqaluit, an air distance of 260 kilometres further than from Val-d'Or to Iqaluit.

11.49 In fact for parcels that do not qualify under the food mail program, Canada Post charges the same rate to Iqaluit, no matter whether the parcel originates in Ottawa or Val-d'Or. This means that shipping such packages from Ottawa to Iqaluit rather than trucking them to Val-d'Or is not more expensive when using regular Canada Post and it saves at least five to seven hours. The same would apply to parcels from Montréal to Iqaluit versus Val-d'Or to Iqaluit. Furthermore, the planes that are used to transport food from Val-d'Or to the North using this program all originate in Ottawa. Whether or not it is less expensive to transport the food from Ottawa directly to the northern communities is based on a number of assumptions. One of these is having enough food storage facilities in Ottawa to handle the increased amount of food mail through that centre. Improving the quality of the food that arrives in the North would depend on factors such as whether the delay at the Ottawa airport is longer or shorter than the delays now faced at the Val-d'Or airport.

11.50 We have also been told that if other entry points are opened in larger centres, it could lead to an increase in the use of the program. The dilemma that officials face is that this program has a budget that is capped at $15.6 million.

Location and impact on community

11.51 When the program began, Val-d'Or and Montréal were selected as the entry points for northern Quebec and the Baffin region. However, Montréal was dropped in the mid-1980s. As the program grew, other entry points were selected. Today, an infrastructure has grown around the food mail program in its major locations. This includes the growth of businesses associated with the program and the hiring of staff to manage it. We recognize changing an entry point or opening up additional entry points, which may compete for the same shipments, would have an effect on these infrastructures which have already built up at the existing entry points. These impacts should be considered during the review.

Conclusion

11.52 Low food prices have a great effect on the decision by Northerners to buy nutritious food. The food mail program clearly makes it easier for them to buy fresh nutritious food at reasonable prices. But how effective the locations of the entry points are to the overall quality and price of nutritious foods, as well as the cost to Indian and Northern Affairs Canada, has never been reviewed.

11.53 We believe that the Department has sufficient reason to assess how effective the locations of the major entry points are, particularly Val-d'Or, Happy Valley-Goose Bay, Churchill, and Yellowknife. Interviews and surveys done by program officials all point to the fact that the entry points and the

quality and nutrition levels of the foods being sent to the North through this program are related. Officials and users of the program have told us that having entry points in more southerly locations might be better if it leads to a greater choice in food. More competition could lead to an improvement in quality, which may in turn lead to a corresponding increase in the use of the program.

11.54 However, all the evidence we could gather is either informal or a matter of opinion. We could not find any systematic review of the effect that changing the entry points would have. We did, however, find that officials had discussed such a review over a number of years, but nothing had materialized.

11.55 **Recommendation.** Indian and Northern Affairs Canada should undertake a review of the location of its major entry points.

11.56 Such a review should focus on whether the existing points are the most effective in terms of contributing to the overall levels of nutrition in the North. That review would look not only at the financial costs and benefits associated with existing and alternative locations, but also the less tangible, but equally important issues such as quality, freshness, variety of foods, and how long it would take to deliver the food items from entry points located farther south.

Department's response. The goal of the food mail program is to provide good-quality, affordable, nutritious food to isolated northern communities. This program is an important element in our continuing efforts to improve the health of northern communities.

Action was taken in 2001 to address the issue of Inuvik as a food mail entry point, by reducing the rate charged for shipping perishable food from this remote entry point to other communities in the Beaufort-Delta region. The Department will continue to examine alternatives, on a case-by-case basis, where there is clear evidence that the existing entry points are adversely affecting the quality or price of foods in northern communities. As resources permit, the Department will also consider requests for designating additional entry points from stakeholders or other levels of government.

The primary focus of the Department will continue to be on enhancing program effectiveness under the existing network, including improving food quality under the Food Mail Quality Assurance Initiative being phased in across the system, seeking the funds necessary to avoid postage rate increases for food mail service, and implementing pilot projects in selected communities to assess the impact of rate reductions for the most critical perishable foods, combined with nutrition education and retail promotion of healthy foods.

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Department of Finance

Tax arrangements for foreign affiliates have eroded Canadian tax revenues of hundreds of millions of dollars over the last 10 years

In brief

In 1992, we expressed concern that tax arrangements for foreign affiliates resulted in hundreds of millions of dollars in reduced tax revenues. Following our Report, the House of Commons Standing Committee on Public Accounts held hearings and made recommendations to the Department of Finance Canada in 1993. While legislative changes have been made, we are still concerned. The Minister of Finance's Technical Committee on Business Taxation also examined the issues and reported on them in 1997.

The report of the Technical Committee noted that Canada's rules have allowed foreign-owned multinationals to shift debt into Canada and have encouraged tax planning mechanisms that erode Canadian tax revenues. We observed transactions where foreign-owned Canadian corporations incurred over $3 billion of debt to finance investments in third countries. The interest on that debt is deducted from Canadian income before taxes. It results in a loss of revenue for both federal and provincial governments.

We also observed a transaction, for example, where a foreign affiliate of a foreign-owned Canadian corporation was used to move $500 million in capital gains from Canada to Barbados tax-free. In 2000, Canadian corporations received $1.5 billion of virtually tax-free dividend income from their affiliates in Barbados (compared with $400 million in 1990). We noted that Barbados and Malta changed their tax rules to bypass our law—to accommodate foreign affiliate investments. Tax arrangements for foreign affiliates continue to erode Canadian tax revenues.

Background

11.57 In 1992 we reported on tax arrangements for foreign affiliates of Canadian corporations. We were concerned about the following issues:

- the rules for deducting interest;
- tax-exempt dividends from foreign affiliates;
- taxable dividends from foreign affiliates; and
- the rules for foreign accrual property income (passive income such as interest).

11.58 Following our Report, the House of Commons Standing Committee on Public Accounts held several hearings. On 23 April 1993, the Committee issued its report and in 1995 a number of legislative changes were made. The 1997 report of the Minister of Finance's Technical Committee on Business Taxation also dealt with the issues we previously reported on.

11.59 This audit observation follows up on our 1992 concerns.

Issues

Interest deductibility

The concerns we had in 1992

11.60 When a Canadian corporation carries on business outside Canada through a foreign affiliate, the interest expense charged on the money borrowed to invest in the operations of the foreign affiliate can be deducted in Canada (interest deductibility). However, the related income is usually taxable only in the foreign jurisdiction.

11.61 We were concerned about this because deducting interest from a business's income in Canada reduces Canada's tax revenues, but the income related to that interest is not usually taxed in Canada. The related income may be received as a tax-exempt dividend and it may never be subject to any Canadian tax.

The Public Accounts Committee was concerned about interest deductibility rules

11.62 The House of Commons Standing Committee on Public Accounts noted that being able to deduct interest expenses without being able to tax the related income earned through the foreign affiliate gives cause for concern. This is particularly so because some taxpayers are using the rules to obtain an interest deduction for the same investment in two or more different jurisdictions. This type of transaction is a "double-dip" financing structure (Exhibit 11.3).

Exhibit 11.3 Double-dip financing structures

A company can significantly reduce its effective rate of borrowing with a type of arrangement referred to as a double-dip financing structure. These structures allow taxpayers to obtain at least two interest deductions on the amount of money borrowed.

Example of a transaction

Company A, which is Canadian, borrows $275 million. The interest on the $275 million reduces Canada's tax base because "A" writes this expense off against its Canadian income before taxes. This is the first interest deduction.

Company A then invests the $275 million in shares of its Barbados and Netherlands subsidiaries. These subsidiaries then loan the $275 million to a United States subsidiary of "A." The U.S. subsidiary deducts the interest it pays to the Barbados and Netherlands subsidiaries from its U.S. income. This is the second interest deduction. Even though the Barbados and Netherlands subsidiaries receive interest income from the U.S. subsidiary, they will pay little or no tax on that income because of low tax rates in Barbados and the Netherlands.

Under Canadian tax law, the interest income, which is passive income that the Barbados and Netherlands subsidiaries receive from the U.S. subsidiary, is redefined as active business income. Because it is considered active business income it can be received in Canada as a tax-free dividend (paragraphs 11.79, 11.80, 11.81).

Source: Canada Customs and Revenue Agency

11.63 The Committee recommended in 1993 that the Department of Finance study in depth the problem of deducting interest charges before making changes to the tax laws. The Committee also recommended that the

Department send the results of the study to them for review. The Department has not yet completed its study. However, the Minister of Finance's Technical Committee on Business Taxation examined the issue and reported on it in 1997.

11.64 While double-dip financing structures may allow Canadian multinationals to expand and compete in the global marketplace, they also provide the same incentive to foreign-owned multinationals.

11.65 Double-dip financing structures encourage foreign-based multinationals to shift debt into Canada from a country with lower tax rates. However, to get the two interest deductions—one in Canada and one in a foreign jurisdiction—the investment and related jobs must be located outside Canada.

11.66 The Canada Customs and Revenue Agency is pursuing a number of cases involving foreign-owned Canadian corporations that borrowed money and invested it in a newly created corporation in a tax haven, (which is often Barbados). The tax haven corporation then lent the funds to another non-resident corporation in the group. In 12 of these cases the foreign-owned corporations put a total of $1.1 billion of debt in their Canadian subsidiaries to finance foreign investments. As the Canadian subsidiaries deduct the interest charges from their taxable income, the interest expense on the debt reduces Canadian tax revenues.

Debt shifting by foreign-controlled corporations resulted in reduced tax revenue

11.67 The 1997 report of the Minister of Finance's Technical Committee on Business Taxation noted that there had been a tendency for foreign-controlled multinational businesses with Canadian subsidiaries to shift debt financing and the associated interest expense into Canada. It stated that the current rules had resulted in a major decrease in Canadian tax revenues. Research done for the Technical Committee estimated that this tax revenue shortfall was $3.5 billion in 1994, the last year for which data were available to researchers.

11.68 This tax revenue shortfall results from interest charges on the debt of foreign-controlled Canadian corporations to finance their investments both in Canada and in third countries. The research done for the Technical Committee did not quantify the portion of the tax revenue shortfall related to financing investments in third countries.

11.69 We observed that in three transactions foreign-owned Canadian corporations incurred $2.1 billion in debt to finance investments in third countries (Exhibit 11.4). In addition, the Canada Customs and Revenue Agency is pursuing cases where foreign-owned corporations put over $1.1 billion in debt in their Canadian subsidiaries to finance foreign investments (paragraph 11.66).

11.70 Our review indicated that the tax revenue shortfall that results from interest charges on the debt of foreign-controlled Canadian corporations to finance investments in third countries would amount to hundreds of millions of dollars over the last 10 years.

Exhibit 11.4 Shifting debt into Canada

Examples of how the Canadian tax system financed a non-resident's foreign operations

In each of these examples, the Canadian company may never pay tax on the income earned from its offshore investments because of the current rules.

- A United States company loaned its Canadian subsidiary about $1 billion. The Canadian subsidiary then invested the funds in a foreign company. The interest that the Canadian company paid on the $1 billion loan reduced Canadian tax revenues because it is deducted from the Canadian company's Canadian income before taxes.
- Canadian company A, a subsidiary of a U.S. company, borrowed $300 million. This $300 million plus $100 million of cash it already had, were invested in $400 million of shares of Canadian company B. "B" then invested the $400 million in shares of a Bermuda company. The interest which "A" paid on its loan reduced Canadian tax revenues because it is deducted from its Canadian income before taxes. Furthermore, if the cash amount of $100 million had stayed in Canada, the interest income which "A" would have earned, would have been taxed in Canada.
- A foreign-owned Canadian company borrowed over $800 million to invest in a Barbados subsidiary. The related interest expense of $100 million reduced Canadian tax revenues because it is deducted from the Canadian company's Canadian income before taxes.

Source: Canada Customs and Revenue Agency

11.71 The Technical Committee recommended that the *Income Tax Act* restrict the amount of interest expense that a Canadian corporation can deduct on borrowed funds related, directly or indirectly, to investments in foreign affiliates.

Court decision hampers the Canada Customs and Revenue Agency's ability to challenge certain financing arrangements

11.72 Until recently, the Agency did not allow taxpayers to claim an interest deduction on borrowed funds used to earn foreign source income through a foreign affiliate in limited circumstances. Some of the reasons it restricted this were because

- the overriding economic purpose of the loan was not to earn income,
- the taxpayer's primary purpose was to make a capital gain, or
- there was no possibility that the taxpayer would receive dividends that were more than the total cost of the interest.

11.73 As a result of a recent Supreme Court of Canada decision, the Agency can no longer challenge these types of arrangements.

Legislation was recently amended

11.74 Legislative amendments for tax years beginning after 1999 restrict the ability of foreign-owned multinationals to channel funds through Canada to foreign corporations that are not controlled foreign affiliates of their Canadian subsidiaries. However, there is still an incentive for Canadian

subsidiaries of foreign-owned multinationals to borrow in Canada to finance offshore investments where the Canadian corporation has controlled foreign affiliates. A controlled foreign affiliate is one in which a corporation owns more than 50 percent of the voting shares.

Tax-free dividends from foreign affiliates

The concerns we had in 1992

11.75 We pointed out that the rules allow a Canadian corporation to receive tax-free dividends out of active business income earned by some of its foreign affiliates. The foreign affiliate had to be resident in one of the countries listed or designated in the Income Tax Regulations, and the active business income had to be earned there. The dividends paid by the foreign affiliate to the Canadian corporation were not subject to Canadian tax, on the basis that the underlying income was taxed by a foreign state at a rate similar to the Canadian rate.

11.76 We were concerned that a number of the designated countries had low tax rates or were tax havens. This would have allowed income from those countries to enter Canada tax-free even though that income had likely not been subject to tax at a rate similar to the Canadian rate.

11.77 Also, a foreign affiliate resident in a tax haven country, not designated in the Income Tax Regulations, could have been considered to be resident in a designated country through a technical rule. In this case, its dividends could be passed on to its Canadian affiliate without being subject to Canadian tax, even though the affiliate's income had not been subject to foreign tax at a rate similar to Canadian rates. For example, the technical rules allowed Canadian corporations to incorporate subsidiaries in tax havens such as Bermuda and Panama but have the central management and control of the corporation exercised in a treaty country such as the United States. Such a foreign affiliate could pass on dividends to a Canadian corporation on a tax-free basis, because it was assumed that the income was subject to tax in the treaty country. However, in reality neither the treaty country nor any other country taxed the income.

The Public Accounts Committee recommended a review of the rules

11.78 In its report of 23 April 1993, the Public Accounts Committee recommended that the Department of Finance assess the merits of being able to bring back to Canada all income from subsidiaries operating in tax havens on a tax-free basis. As noted in paragraphs 11.82 to 11.87 the legislative changes made in 1995 did not solve the problem. The 1997 report of the Minister of Finance's Technical Committee on Business Taxation examined the rules and recommended further changes to them.

The Technical Committee on Business Taxation found that tax arrangements erode the tax base

11.79 The Technical Committee noted that there is a rule that allows investment income to be re-characterized as active business income (this can

arise through interaffiliate transactions). This rule encourages tax-planning mechanisms that erode Canada's tax base because dividends paid by foreign affiliates in designated countries from this re-characterized income (which may have been subjected to little or no tax) can then enter Canada tax-free (Exhibit 11.3).

11.80 The Technical Committee provided the following example. Canada has a tax treaty with Barbados, a country with a general corporate income tax rate of 40 percent. Special-status entities such as Barbados International Business Corporations, which are taxed in Barbados at preferential rates of 1 percent to 2.5 percent, can pass dividends on to Canada on a tax-free basis. This is equally true of certain tax-favoured entities in other treaty jurisdictions, which include Cyprus, Israel, Jamaica, and Luxembourg. Most typically, income earned by such entities occurs as a result of a double-dip financing structure, which was discussed earlier. For example, many financing structures involve a Canadian corporation borrowing in Canada to invest in a related finance company in a tax haven. In turn, the finance company lends the same capital to another foreign affiliate in a higher-tax jurisdiction.

11.81 The Technical Committee recommended that the government revise the rules and/or aggressively pursue a policy of renegotiating its existing treaties to prevent tax-privileged entities in treaty countries from enjoying the benefits of the rules that allow income from interaffiliate transactions to enter Canada tax-free. The treaties have not been renegotiated and changed.

Legislative amendments did not solve problem

11.82 **1995 general rule addresses the problem.** Under a general rule introduced in Canada in 1995, a dividend from a foreign affiliate could be received in Canada tax-free only if the foreign affiliate was resident in a designated treaty country both for purposes of Canadian law and for purposes of the treaty between Canada and that country. Under Canadian law a corporation is resident in a country if its central mind, management, and control are located in that country.

11.83 The explanatory notes to this 1995 general rule state that the change is a "simple means for **eliminating double taxation** on foreign business income earned by a foreign affiliate" [emphasis added]. In other words, Canada will not tax dividends received by a Canadian corporation from a foreign affiliate if that income was taxed by a foreign state.

11.84 For example, the Canada–Barbados tax treaty excludes Barbados International Business Corporations that are taxed at a very low rate from enjoying the benefits of the treaty. As a result, under the general rule dividends received from these corporations would be subject to tax in Canada.

11.85 This general rule also does not allow dividends from corporations that are flow-through or transparent entities to enjoy tax-free dividend treatment. Flow-through or transparent entities are ones whose owners pay tax on the income earned by the entity, rather than the entity paying the tax. As a result,

dividends paid from income that is not taxed in another country would not enjoy tax-free treatment on entering Canada.

11.86 **Two special rules provide exceptions to the 1995 general rule.** Two special rules were also introduced in 1995 that provide exceptions to the general rule. One allows dividends from Barbados International Business Corporations and other similar corporations to qualify for tax-free treatment. This is exactly what was happening in 1992 when we raised our initial concerns.

11.87 The other special rule allows a Canadian corporation to establish a United States limited liability corporation (a flow-through entity) that is managed and controlled in the U.S. but carries on business activities outside the United States. Dividends from this type of entity, which may not be subject to tax in another country, can enjoy tax-free treatment on entering Canada. This is essentially what was happening before 1995 and what the 1995 general rule was designed to stop.

11.88 This means dividends from, for example, Barbados International Business Corporations can qualify for tax-free treatment in Canada. However, dividends from foreign affiliates that are resident in countries with which Canada does not have a treaty, and that are subject to a significantly higher rate of tax than foreign affiliates in Barbados, do not enjoy the same tax-free treatment.

11.89 **Barbados changed its law in response to the 1995 amendments.** Canadian insurance corporations were concerned that as a result of the 1995 amendments, dividends from their Barbados subsidiaries would not continue to qualify for tax-free treatment. This was because corporations incorporated under the Barbados *Exempt Insurance Companies Act* were not liable for Barbados tax, but paid a $5,000 annual licence fee.

11.90 To get around the problem, the *Exempt Insurance Companies Act* was amended to provide that corporations incorporated in Barbados under the Act were deemed to be resident in Barbados and the $5,000 annual licence fee was converted to a tax. The new tax rate was set at 0 percent for the first 15 years, 2 percent on the first $250,000 of income for subsequent years, and 0 percent on any excess income. If tax is not payable in any year, the licence fee is payable.

11.91 **Malta changed its tax rules to bypass our law.** The Canada–Malta treaty, which came into force in 1987, contains an anti-avoidance provision denying offshore corporations of Malta the benefits of the treaty that would exempt them from Canadian tax on a capital gain. This is because offshore corporations are exempt from taxation in Malta and they should also not be exempt from Canadian tax on any capital gain on the sale of taxable Canadian property. The gain would be subject to a 33.33 percent Canadian withholding tax.

11.92 In 1994, subsequent to entering into the treaty with Canada, Malta changed its rules for offshore corporations. They became subject to tax at the

full rate and became eligible for a tax refund on dividends they paid to their offshore shareholders. Therefore, offshore corporations of Malta can still be exempt from taxation in Malta. However, they are now claiming that because they are now subject to taxation in Malta, the anti-avoidance provision in the Canada–Malta treaty does not now apply to them.

11.93 The Canada Customs and Revenue Agency now considers Malta a tax haven for non-resident shareholders. Non-resident shareholders incorporate a corporation in Malta to hold and dispose of taxable Canadian property to avoid Canadian withholding tax. The Agency is challenging this type of arrangement. Millions of dollars of tax revenue are at risk.

11.94 **Administrative action cannot address the Department of Finance's concern.** In 1992, the Department of Finance advised us that where there is a concern that income earned by a foreign affiliate in a tax haven country is brought back to Canada tax-free, the arrangement should be challenged by the Canada Customs and Revenue Agency on the basis of either the specific rules in the *Income Tax Act* or the general anti-avoidance rule.

11.95 However, in addition to Barbados, other countries that are designated treaty countries can be used effectively to earn income that is exempt from tax or taxed at a low rate. For example, Belgium, Cyprus, Hungary, Ireland, Luxembourg, Malta, the Netherlands, and Switzerland are all designated treaty countries. But these countries have aspects of their tax systems that provide preferential rates of tax for certain types of income or entities. This allows Canadian corporations to continue to receive dividend income from these countries, on a tax-free basis even though that income was either not subject to tax, or was taxed at a very low rate.

11.96 **An indication of the magnitude of the problem.** Although Canada amended its rules in 1995, little has changed. Tax havens continue to attract Canadian money. For example, Statistics Canada reports that Canadian direct investment in Barbados has increased from $628 million in 1988 to $23.3 billion in 2001—over a 3,600 percent increase. Exhibit 11.5 shows information on Canadian direct investment abroad for 2001 and 1990.

11.97 Information provided to us by the Canada Customs and Revenue Agency shows that in 2000, Canadian corporations received $1.5 billion in dividends from corporations in Barbados. Income defined as active business income and earned in Barbados can enter Canada tax-free. Although this income is not taxed in Canada, when it is paid to Canadian individual shareholders they receive federal and provincial dividend tax credits on it.

11.98 To determine the extent of Canadian involvement in Barbados International Business Corporations, the Canada Customs and Revenue Agency obtained information from Barbados. The Agency identified 3,500 Barbados International Business Corporations. Of those 3,500 corporations, 1,700 had Canadian directors. Exhibit 11.6 provides examples of how capital gains were moved out of Canada to Barbados.

Exhibit 11.5 Canadian direct investment abroad

Top 10 countries for investment in 2001	Invested in 2001 ($billions)	Invested in 1990 ($billions)	Increase (percentage)
United States	198.4	60.0	231
United Kingdom	38.3	13.5	184
Barbados	*23.3*	*1.5*	*1,453*
Netherlands	*10.9*	*1.5*	*627*
Bahamas	*7.9*	*2.0*	*295*
Bermuda	*7.5*	*1.8*	*317*
Ireland	*7.4*	*1.3*	*469*
Japan	6.4	0.9	611
Chile	5.6	0.3	1,767
Brazil	5.6	1.7	229
Total amount invested in all other countries	87.1	13.9	527
Total amount invested abroad for all countries	398.4	98.4	305

Note: Countries in italics are often referred to as tax havens. Certain dividends from Barbados, the Netherlands, and Ireland can enter Canada tax-free.

Source: Statistics Canada

Exhibit 11.6 Tax planning mechanisms continue to erode Canadian tax revenues

Moving capital gains to Barbados

- A Canadian subsidiary of a multinational foreign corporation owns shares in a foreign subsidiary that costs $1 billion and are worth $1.5 billion. The shares of the foreign subsidiary were transferred on a tax-free basis from the Canadian subsidiary to its Barbados subsidiary so that the tax cost of the shares to the Barbados subsidiary was $1 billion. The Barbados subsidiary then resold the shares for $1.5 billion to another Barbados subsidiary and realized a $500 million gain, but paid no tax on it. The $500 million capital gain moved from Canada to Barbados tax-free.

  The $1.5 billion was then loaned to a related Netherlands company. The Netherlands company paid interest of $100 million to $200 million a year on the loan. The interest was subject to Barbados income tax at 1 to 2 percent. The Barbados subsidiary paid dividends to the Canadian company that are tax-exempt in Canada. The Canadian company reinvested the funds in the Barbados subsidiary.

- A non-resident owned property that the Canada Customs and Revenue Agency determined was taxable Canadian property. If the property is sold it would result in a $750 million capital gain that would be subject to tax in Canada. The non-resident became a resident of Barbados. The property was sold but the gain may be exempt from Canadian tax under the Canada-Barbados tax treaty. The gain was not subject to tax in any other country. The Agency has been reviewing this transaction for over a year.

Source: Canada Customs and Revenue Agency

Taxable dividends from foreign affiliates

The concern we had in 1992

11.99 In 1992, Canada taxed dividends that a Canadian corporation received from foreign affiliates that were resident in a country not designated in the Income Tax Regulations. Canada also taxed dividends received from foreign affiliates resident in designated countries if the dividends were received from investment income rather than from active business sources. In addition, Canada allowed a tax credit to Canadian corporations for foreign taxes paid by the foreign affiliate or foreign taxes withheld from the dividend. In situations where the foreign affiliate's income was taxed at a lower rate than Canadian tax rates, Canadian foreign affiliates often deferred the distribution of dividends to avoid paying Canadian taxes.

11.100 We were concerned that a number of schemes had been devised to get this type of income into Canada on a tax-free basis. For example, it is possible to repatriate funds to Canada in ways other than through the payment of dividends.

Legislative changes did not solve the problem

11.101 Although the rules were modified in 1995 it is still possible for a foreign affiliate to simply loan funds to its Canadian parent rather than pay a dividend that would be subject to Canadian tax.

Foreign accrual property income

The concern we had in 1992

11.102 The foreign accrual property income rules that deal with passive income such as interest are a key anti-avoidance element of the current system. The rules are intended to discourage Canadian residents from shifting investment income, such as interest, to controlled foreign corporations. This is done by taxing the Canadian shareholders on the investment income of the controlled foreign affiliate as it is earned, rather than waiting for it to be paid to them in the form of a dividend.

11.103 A key concern we had in 1992 was that the *Income Tax Act* did not define active or passive income in the context of the foreign accrual property income rules.

The Public Accounts Committee asked for the rules to be tightened

11.104 The Public Accounts Committee recommended that the law be amended to

- clarify what constitutes active business income,
- prevent Canadian corporations from importing the tax losses of their foreign subsidiaries into Canada, and
- ensure that the rules protect the integrity of Canada's tax base.

Legislation was amended

11.105 These rules were amended in 1995. "Active business" was defined and the rules were changed to prevent Canadian corporations from writing-off the tax losses of their foreign subsidiaries against Canadian income.

11.106 Certain businesses are exempt from the foreign accrual property income rules if they have more than five full-time employees. The qualifying businesses are financial institutions, trading or dealing in securities or commodities, real estate development, lending money or licensing property, and the insurance or reinsurance of risks.

The Technical Committee on Business Taxation recommended tightening the rules

11.107 As previously noted (paragraph 11.81), the Technical Committee recommended in 1997 that the government tighten even further the investment income rules and/or aggressively pursue a policy of renegotiating the provisions of its existing treaties that allow investment income (that can arise through interaffiliate transactions) to enter Canada on a tax-free basis.

The rules are still being exploited

11.108 As recommended by the Public Accounts Committee, the rules were amended to protect the integrity of Canada's tax base. However, a number of problems still exist, including the following:

- The rule requiring five full-time employees, which can exempt a corporation from the foreign accrual property income rules, is difficult to administer. In testimony before the Public Accounts Committee, an official of the Department of Finance stated that it would be inappropriate to apply the five full-time employee test for purposes of the foreign accrual property income rules, because it would enable some income that should clearly be categorized as investment income to be easily reclassified as active business income.

  The five full-time employee rule favours large multinational corporations for which the cost of six full-time employees may be insignificant compared to the tax benefits gained by avoiding the foreign accrual property income rules. Moreover, it is difficult to determine which corporations qualify under this rule, or which do not. It is difficult to determine if employees are employed actively in the business. The standard for full-time employment is low; one case held that four hours per day was sufficient. Also, the law permits partnerships and other arrangements to be used to satisfy the five full-time employee requirement.

- Taxpayers are joining together to establish tax haven corporations. Each taxpayer could own less than 10 percent of the tax haven corporation to avoid the rules that deal with the reinsurance of Canadian risks. The effect of this scheme is to divert income that should have been taxed in Canada to a tax haven corporation. The Agency is presently reviewing a scheme involving 400 Canadian businesses involved in moving income

to the Cayman Islands and Barbados. Insurance corporations were created in those tax havens to reinsure Canadian risks, to contravene the intent of the foreign accrual property income rules.

- Large multinational corporations have structured their international operations to avoid paying tax on investment income earned offshore. This is done by having a Canadian corporation in the group own 50 percent of the voting shares of the foreign corporation. The foreign corporation is not a controlled foreign affiliate because control requires the ownership of more than 50 percent of the voting shares. The foreign accrual property income rules are avoided because only controlled foreign affiliates are subject to them.
- The law does not contain detailed rules with respect to relationships between corporations, trusts, and partnerships to prevent taxpayers from splitting ownership among related or non-arm's length parties. In these circumstances it is a question of fact whether or not a trust or partnership is dealing at arm's length with a corporation. If the trust or partnership is dealing at arm's length with a corporation, the foreign accrual property income rules may not apply.
- A controlled foreign affiliate of a Canadian corporation can earn business income that avoids the foreign accrual property income rules even though the affiliate receives substantial assistance from its parent in earning the income. For example, a controlled foreign affiliate can carry on an active business outside Canada and enter into a management contract with its Canadian parent to manage the business. If the business is carried on directly by the Canadian corporation, it would be subject to Canadian tax. However, because the Canadian corporation is carrying on the business indirectly rather than directly, it is not subject to Canadian tax.
- The investment income rules are intended to prevent a Canadian corporation from setting up an offshore insurance corporation, which it controls, to insure its Canadian risks. Since the premium paid in respect of the risk is deductible in computing Canadian taxable income, this leads to an erosion of Canadian tax revenues—income is being shifted to a related offshore insurance corporation. Corporations, such as financial institutions, are avoiding the rules by exchanging comparable risk portfolios with foreign insurers.

11.109 Although changes have been made to the rules, the foreign accrual property income rules continue to be exploited, which puts tax revenues at risk.

Conclusion

11.110 Ten years have passed since we first expressed concern that tax arrangements for foreign affiliates cost hundreds of millions of dollars in reduced tax revenues. In response to our Report, the House of Commons Standing Committee on Public Accounts held hearings and made recommendations to the Department of Finance in 1993. The Minister of Finance's Technical Committee on Business Taxation also examined the issues and reported on them 1997.

11.111 We observed that in the three transactions shown in Exhibit 11.4, foreign-owned Canadian companies incurred $2.1 billion of debt to finance investments in third countries. In addition, the Canada Customs and Revenue Agency is pursuing a number of cases involving foreign-owned Canadian companies that borrowed money to finance foreign investments. Twelve of these case involved $1.1 billion of debt. The Minister of Finance's Technical Committee on Business Taxation also noted that Canada's rules have allowed foreign-owned multinational businesses to shift debt into Canada and have encouraged tax-planning mechanisms that erode Canadian tax revenues.

11.112 We also observed that in a transaction shown in Exhibit 11.6, a foreign affiliate of a foreign-owned Canadian corporation was used to move $500 million of capital gains from Canada to Barbados tax-free. Information provided to us by the Canada Customs and Revenue Agency shows that in 2000, Canadian companies received $1.5 billion of virtually tax-free dividend income from their affiliates in Barbados (compared with $400 million in 1990). In paragraph 11.108 we showed how the foreign accrual property income rules continue to be exploited.

11.113 In our view, tax arrangements for foreign affiliates have eroded Canadian tax revenues of hundreds of millions of dollars over the last 10 years.

11.114 **Recommendation.** To protect the integrity of the tax base, the Department of Finance should obtain and analyze current information to reassess the tax revenue impact and the rationale of

- allowing foreign-owned Canadian corporations to deduct interest on borrowed funds related directly or indirectly to investments in foreign affiliates, and
- allowing tax-privileged entities in treaty countries to bring income into Canada tax-free.

11.115 **Recommendation.** The Department of Finance should reassess the rules related to foreign accrual property income and taxable dividends in order to protect the integrity of the tax base.

Department's response: The Auditor General, in her December 2002 Report, expresses a number of observations with respect to Canada's system of taxation of foreign source income and foreign affiliates. These observations, which follow similar observations made in the Auditor General's 1992 Report, are of two types. First, the Auditor General raises issues regarding the policy underlying some of the most significant aspects of the current system. Second, the Auditor General expresses concerns that certain tax arrangements entered into by Canadian taxpayers may contravene the policy intention of the current system.

With respect to the policy issues raised regarding Canada's system for taxing foreign source income and foreign affiliates, the Department expressed the general view in response to the 1992 Report that "the existing foreign affiliate regime accurately reflects the policy intention of Parliament and provides for

the taxation of all income that is intended to be subject to Canadian income tax." Since 1992, the government has enacted several amendments to the law, which specifically address a number of issues raised by the 1992 Report of the Auditor General. In particular, these amendments have strengthened and clarified the foreign accrual property income or FAPI rules, which prevent the use of controlled foreign affiliates to avoid Canadian tax. In broad terms, the current Canadian income tax system provides for the exemption of certain types of foreign source income from taxation, the deferral of taxation for other types of foreign source income until repatriated to Canada, and the taxation on an accrual basis of certain passive foreign source income whether repatriated or not. This system is complex and necessarily involves making distinctions in the definition of the different types of income and their respective tax treatment. As a result, the system is continually under review by the Department in order to ensure that it continues to achieve a reasonable balance of policy objectives.

It is also important to note that there is an interaction between this system of taxation of foreign source income and the taxation of Canadian source income. The government has made significant changes to the general structure of the income tax system since 1992 that are relevant to issues raised by the Auditor General, but that are not referred to in this chapter. In particular, the government has implemented a five-year tax reduction plan that will significantly lower the federal corporate statutory income tax rate. Also, a number of provinces are making significant reductions in provincial corporate income tax rates. The net result of these changes will be that Canada will have on average a five percentage-point lower corporate tax rate (including capital taxes) than the United States by 2006.

This significant reduction of corporate tax rates will change the tax effects of placing debt financing in Canada. This is a reversal of the situation underlying the studies referred to in this chapter. As a result of this change, Canada will become a relatively less attractive jurisdiction for multinationals to locate their debt financing and interest expenses.

With respect to specific tax arrangements entered into by Canadian taxpayers as discussed in this chapter, it is important to note that the use by taxpayers of international tax arrangements evolves with changing circumstances and is thus the subject of continuous monitoring by both the Department and the Canada Customs and Revenue Agency. When specific issues are identified, analysis is performed and amendments are recommended in order to curtail abuse of the law and its intent. This process usually involves consultation with interested stakeholders. This helps to ensure that such amendments are properly targeted, sustainable over time, in keeping with international norms, and not inappropriately detrimental to the international competitiveness of Canadian multinationals.

As a result of this process, several amendments to Canada's *Income Tax Act* have been implemented since 1992 that strengthen the existing anti-avoidance measures in the legislation or provide new legislative tools to challenge abusive arrangements. As noted in this chapter, the FAPI rules,

which deal with the shifting of passive income to foreign jurisdictions by Canadian residents, were the subject of substantial modifications in 1995 and have continued to be reviewed and improved since that time. The effect of these changes to the legislation has been to make the FAPI rules more effective in protecting the Canadian tax base by more precisely defining passive income that is subject to Canadian taxation as it is earned, active business income that may be subject to taxation on its repatriation to Canada by way of dividends paid to Canadian residents, and the situations under which such passive income arises. As also noted in this chapter, Canada's *Income Tax Act* has recently been amended in order to restrict the inappropriate channelling of funds through Canadian subsidiaries to third countries. The effect of these modifications to the legislation has been to make these rules more effective by ensuring that they apply in cases where funds are transferred to subsidiaries in third countries through the use of back-to-back transfer arrangements and the use of special types of entities such as partnerships and trusts.

Furthermore, the government has taken action in four areas that, although not noted in this chapter, are important in reducing the detrimental impact on the Canadian tax base of tax arrangements using tax havens. First, new foreign reporting requirements were implemented in 1996 requiring Canadian taxpayers to provide detailed information regarding their foreign sources of income and their use of foreign entities in earning such income. These new reporting requirements have already provided the Canada Customs and Revenue Agency with important information in relation to non-resident trusts, foreign affiliates, and FAPI. The Canada Customs and Revenue Agency has indicated that this information has improved its ability to manage compliance by allowing it to scrutinize substantial foreign investments held by Canadian taxpayers.

Second, improved transfer-pricing rules were enacted in 1997 to counter the potential for cross-border shifting of income through the manipulation of transfer prices in transactions between related companies. Transfer-pricing provisions of the income tax system are of increasing importance in a world where corporate tax planning strategies also have become globalized. As a result of these changes, Canada's transfer-pricing legislation is fully in line with international standards and helps ensure that an appropriate amount of profit is reported and taxed in Canada.

Third, revised proposals first included in the 1999 federal budget would, if implemented by Parliament, strengthen the rules applicable with respect to non-resident trusts and foreign investment entities in which Canadian residents have an interest. The proposed modifications to these rules, the details of which were set out in draft legislation released on 11 October 2002, are intended to make the income tax system fairer and prevent tax avoidance by taxpayers that invest in or otherwise transfer property to foreign trusts or investment funds. These provisions support the FAPI system and better protect the tax base by ensuring that passive income earned outside of Canada by Canadian residents is taxed in Canada as earned.

Fourth, the Department also participates actively in the work of the Organisation for Economic Co-operation and Development (OECD) to enhance co-operation with other jurisdictions to secure the integrity of our respective tax systems. For example, the OECD reviews and updates on an ongoing basis its Model Tax Convention (which Canada uses as a model to negotiate its own bilateral tax treaties) and its Transfer Pricing Guidelines (which define the standards used for calculating an appropriate amount of income in each jurisdiction in respect of cross-border related-party transactions). The OECD also has a project ongoing that is intended to address some of the issues raised by harmful tax practices with respect to mobile activities that erode tax bases of other countries and distort the location of capital and services.

With respect to the recommendations made in this chapter, the Department of Finance will continue to assess the rationale and operation (including revenue impact) of Canada's system for taxing foreign affiliates and foreign source income, as well as the treatment of expenses incurred to make investments in those affiliates. This analysis will incorporate the most recent information available for this purpose. As part of this process, the Department of Finance will continue to consider appropriate improvements to Canada's system of taxation of foreign source income and foreign affiliates, recognizing that the system serves a number of policy goals, including supporting the international competitiveness of Canadian businesses.

Audit team

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Related audit work

See also Chapter 4, Canada Customs and Revenue Agency: Taxing International Transactions of Canadian Residents.

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Parc Downsview Park Inc.

An urban park is being created without formal approval by Parliament

In brief

For the past two years, we have reported that the Government of Canada has not requested—and accordingly Parliament has not provided—clear and explicit authority for the creation and operation of an urban park being undertaken by Parc Downsview Park Inc. (Downsview Park). Furthermore, Parliament has not authorized the related spending of public funds, estimated to be more than $100 million over the next 20 years.

We also reported that public funds were transferred to Downsview Park without formal approval by Parliament. We concluded that the government should remedy the situation so that the role of Parliament is fully respected.

In the current year we noted that the government has not taken steps yet to correct the situation.

The House of Commons Standing Committee on Public Accounts held a hearing on this issue in April 2002, which was continued in June 2002. Because of the importance of the matter, the Committee adopted a motion to request the Auditor General to continue to advise Parliament and the Committee on Downsview Park.

Background

11.116 Downsview Park was established following the closure of Canadian Forces Base Toronto, which was announced in the government's 1994 Budget. The only reference to Downsview Park was contained in the National Defence budget impact paper referred to in the 1994 Budget, which indicated that "[the] Downsview site will be held in perpetuity and in trust primarily as a unique urban recreational green space for the enjoyment of future generations."

11.117 In April 1997, the government issued an order-in-council authorizing Canada Lands Company Limited (Canada Lands) to set up a subsidiary corporation to develop an urban park. Canada Lands incorporated Downsview Park as a wholly owned subsidiary Crown corporation in July 1998. Members of the board of directors were officially appointed in February 1999 and Downsview Park began operations in April 1999.

11.118 Generally, when a new Crown corporation is established, it receives a mandate from Parliament through legislation establishing a parent Crown corporation. The government chose to set up Downsview Park as a subsidiary of Canada Lands. It then required only an order-in-council to authorize the incorporation of Downsview Park. As we noted in our last two years' reports, except for the payment of $2 million as described below, the government, including Canada Lands, met all applicable administrative and legal requirements in establishing Downsview Park. However, the individual steps taken together had the effect of leaving Parliament out of the decision-making process. The mandate of Downsview Park was not presented to Parliament for review and approval.

11.119 In addition to our concern about the method by which this urban park was created, we reported specific transactions that took place without formal approval by Parliament. Details are as follows:

- In 2000, National Defence paid $2 million to Downsview Park for expenditures related to the development of the park site. In our view, these expenditures were not a valid charge against National Defence's Vote 1, which Parliament had authorized to be used for the Department's operating expenditures.
- In 2001, the Government of Canada undertook a significant transaction whose effect was an infusion of approximately $19 million in cash to Downsview Park for its program activities. We concluded that given the importance of this project and the nature of the transactions, formal approval by Parliament would have been preferable.
- During 2002, Downsview Park used about $4 million, and about $1 million in 2001, from the proceeds of $19 million to fund its operating and capital expenses. At 31 March 2002, the unused balance was approximately $14 million.

11.120 As we have noted in our previous reports, if the government wishes to set up an urban park and invest more than $100 million of public funds in it over the next 20 years, it should have clear and explicit approval from Parliament to do so.

11.121 In addition, it appears that the full consequences of the current corporate structure were not thought out fully when Downsview Park was created. The result is that Downsview Park is facing severe difficulties in carrying out its mandate. For example, as mentioned in our audit observation in 2000, the particular structure used to create the new park was based on the assumption that Downsview Park would be eligible to receive charitable donations and use them to develop the park. Canada Lands was authorized to incorporate Downsview Park Foundation that would solicit charitable donations. Under the *Income Tax Act*, however, the foundation could donate its funds only to a "qualified donee." Downsview Park is not a "qualified donee" for income tax purposes because it was established as a taxable, commercial, for-profit entity. We understand that the current corporate structure has been reviewed by Downsview Park and Canada Lands and recommendations have been made to the government.

11.122 As well, Downsview Park has been working with National Defence, which owns the property, to obtain a long-term land lease to the Downsview lands. This major issue must also be resolved in order for Downsview Park to complete commercial transactions, which are vital to the self-financing mandate of the Corporation.

Issue

11.123 The government has still taken no steps to obtain Parliament's authorization to set up an urban park or to rectify the weaknesses in the structure that have proven to be impediments in implementing the Corporation's objectives and plans.

11.124 We pursued our discussions with corporate management and government officials during the year.

11.125 As mentioned earlier, the House of Commons Standing Committee on Public Accounts held a hearing on this issue in April 2002, which was continued in June 2002. The Committee voted a motion asking the Auditor General to continue to advise Parliament and the Committee on Downsview Park, or any other similar programs, at the discretion of the Auditor General.

Conclusion

11.126 We believe that the information that was provided in the 1994 Budget about the creation of an urban park was not sufficient for Parliament to fully exercise its oversight over the spending of public funds.

11.127 There is a pressing need for the government to finalize its review of the current corporate structure and to remedy the situation so that the role of Parliament is fully respected and Downsview Park is able to carry out its mandate effectively.

11.128 **Recommendation.** The government should urgently take steps to rectify the shortcomings in the structure of Parc Downsview Park Inc. and obtain Parliament's clear and explicit authority for the creation and operation of an urban park being undertaken by Downsview Park.

Government's response. Canada Lands Company Limited and Parc Downsview Park Inc. have taken note of the Auditor General's position regarding the need to involve Parliament in the creation and operation of Downsview Park. We wish to reiterate that, as mentioned by the Auditor General, Canada Lands met all applicable administrative and legal requirements in establishing Parc Downsview Park Inc. We also recognize that the current structure of Downsview Park should be revisited in order to allow it to fully achieve its mandate. Discussions with the government are currently under way to review the situation.

The Department of Transport, responsible for providing independent policy advice to the Minister as Minister responsible for several Crown corporations that include Canada Lands Company Limited and Parc Downsview Park Inc., has noted the observations of the Auditor General with respect to Downsview Park Inc.'s corporate structure and will pursue discussions with central agencies in this regard.

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Atomic Energy of Canada Limited

The government has approved Atomic Energy of Canada Limited's five-year corporate plan for the first time since 1994–95

In brief

The government has approved Atomic Energy of Canada Limited's five-year corporate plan for the first time since 1994–95. The Governor in Council's approval of the 2002–03 to 2006–07 corporate plan in July 2002 meant that the annual accountability requirements of the *Financial Administration Act* related to the corporate plan have now been met for 2002–03. Atomic Energy of Canada Limited and the government expended considerable effort to resolve this long-outstanding issue. The result of this agreement is that the auditors have removed the statement related to this issue from the auditors' report on Atomic Energy of Canada Limited's 2002 financial statements. This statement had been included in the auditors' reports since 1998.

While the approval of the five-year corporate plan is a significant achievement, we continue to urge Atomic Energy of Canada Limited and the government to work together to monitor and address some of the longer-term issues affecting the Corporation.

Background

11.129 As a result of its 1995 Program Review, the government reduced its annual appropriations to Atomic Energy of Canada Limited. The amount was reduced from $170 million in fiscal 1996–97 to $100 million two years later. The government also directed the Corporation to focus its research and commercial activities on the CANDU nuclear power reactor. We indicated in our December 1998 Report, that while the Program Review focussed on government funding for Atomic Energy of Canada Limited, other ongoing issues remained.

11.130 The five-year corporate plan for Crown corporations is the cornerstone of the control and accountability framework in the *Financial Administration Act*. Annual submission and approval of a good five-year corporate plan is necessary to demonstrate that

- the corporation has properly interpreted its mandate;
- the corporation's objectives, strategies, and targets are appropriate and aligned with government priorities;
- its performance objectives provide a strong basis for holding it to account and performance against past targets is reported;
- trade-offs the corporation has made between commercial and public policy objectives are reasonable; and
- there is a need to assess the continued relevance of the corporation's mandate.

11.131 This report describes developments since 1998, the long-term issues that remain, their implications for the Corporation, and the importance of those issues to Parliament.

Issues

Recent developments and long-term issues

11.132 We are pleased to report that the government has approved Atomic Energy of Canada Limited's five-year corporate plan for the first time since 1994–95. The Governor in Council's approval of the 2002–03 to 2006–07 corporate plan in July 2002 meant that the annual accountability requirements of the *Financial Administration Act* related to the corporate plan have now been met for 2002–03. Atomic Energy of Canada Limited and the government expended considerable effort to resolve this long-outstanding issue. The result of this agreement is that the auditors have removed the statement related to this issue from the auditors' report on Atomic Energy of Canada Limited's 2002 financial statements. This statement had been included in the auditors' reports since 1998.

11.133 The approved corporate plan sets out strategies and plans for the next five years. However, there are activities and projects beyond the five-year period that will require the investment of hundreds of millions of dollars over at least the next 100 years.

11.134 These projects and activities result from the need to clean up wastes and to support the safe functioning of existing applications. This includes the human knowledge and the equipment and facilities to sustain

- the safe and effective use of nuclear power, nuclear medicine, and nuclear technology for industrial and research purposes; and
- the obligations to manage waste products and to decommission facilities employed over the past 60 years in defence, isotope, and power reactor programs.

11.135 There is no consensus between the Corporation and the government on how best to manage these activities, or on which federal department or agency will be financially responsible for them beyond the five-year period. While Atomic Energy of Canada Limited's commercial activities will assist in funding these activities, it is by no means certain that its contribution will provide all of the funding required.

Conclusion

11.136 Atomic Energy of Canada Limited has made considerable progress in settling ongoing issues with the government since our December 1998 Report. As the Governor in Council approved its 2002–03 to 2006–07 corporate plan, the annual accountability requirements of the *Financial Administration Act* related to the corporate plan have now been met for 2002–03. While some work has been completed regarding the long-term direction for the Corporation, we continue to urge Atomic Energy of Canada Limited and the government to work together to monitor and address some of the long-term issues affecting the Corporation.

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Employment Insurance Account

No explanation was provided to Parliament for a surplus reaching $40 billion

In brief

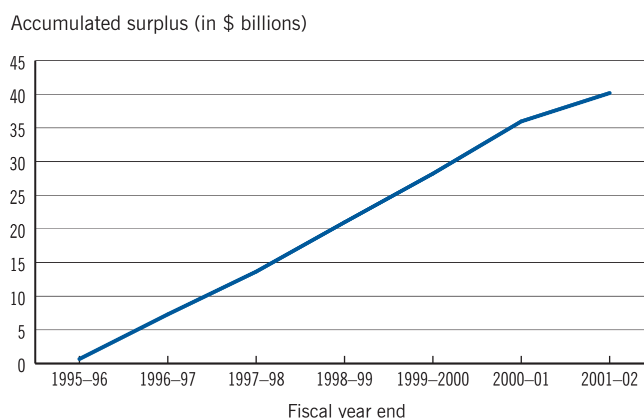
Since 1996, the Employment Insurance Account has collected more revenues than the expenditures it had to pay. These excess revenues are accumulated and shown in the surplus of the Account. The premium rates for 2001 and 2002 were set respectively by the Canada Employment Insurance Commission and by the Governor in Council. In our view, it was Parliament's intent that the Employment Insurance Program be run on a break-even basis over the course of a business cycle, while providing for relatively stable premium rates. However, the accumulated surplus of the Employment Insurance Account increased by about $4 billion in 2001–02 to $40 billion. Neither the Commission nor the government clarified and disclosed what constitutes an adequate level of accumulated surplus, the time required to reach that level, and the factors considered when setting the rates. Therefore, we are unable to conclude that the intent of the *Employment Insurance Act* has been observed in setting the premium rates. The government plans to review the rate-setting process before the 2004 rate is set.

Background

11.137 The Employment Insurance Account is a record of all revenues and expenditures relating to employment insurance programs. Revenues consist mainly of premiums collected from workers and their employers; expenditures include unemployment benefits paid out for job loss, parental leave, and other situations, and the cost of delivering them. It also includes employment benefits and support measures under part II of the *Employment Insurance Act*. An accumulated surplus or deficit in the account is the difference between employment insurance revenues and expenditures over time. Prior to 1996, the way the rate was set had the effect of limiting the amount of surpluses or deficits in the Unemployment Insurance Account, and of forcing premium rate increases or reductions within two to four years after the onset of a recovery or a recession. It also prevented premium rates from staying too low or too high for any extended period. In other words, the amount collected would equal revenues needed to cover program costs over a relatively short period of time. In 1996 this condition was changed to allow surpluses or deficits to accumulate over a longer period of time, provided that revenues covered costs over a business cycle. Since then, the account has been in surplus. The accumulated surplus has grown over the past six years from $666 million in March 1996 to $40 billion in March 2002 (Exhibit 11.7).

11.138 The Employment Insurance Account is consolidated with the financial statements of the Government of Canada. As a result, it has a significant impact on the government's overall financial results. For example, the government's overall surplus in 2001–02 of $10 billion would have been $4 billion lower were it not for the surplus in the Employment Insurance Account.

Exhibit 11.7 The growth of surplus amounts in the Employment Insurance Account



Source: Audited financial statements of the Employment Insurance Account

11.139 Since 1999, we have drawn Parliament's attention to our concerns about both the size and the growth of the accumulated surplus. During 2001–02, the accumulated surplus increased by an additional $4 billion to $40 billion. This is far higher than the maximum that the Chief Actuary of Human Resources Development Canada considered sufficient in his last report, which dealt with Employment Insurance premium rates for 2001. The Chief Actuary estimated that a reserve of $10 billion to $15 billion, attained just before an economic downturn, should be enough to meet the added costs of unemployment benefits. The 2002–03 *Report on Plans and Priorities* for Human Resources Development Canada indicated that the accumulated surplus of the Employment Insurance Account was expected to increase by another $2.3 billion during that fiscal year.

11.140 The House of Commons Standing Committee on Public Accounts recommended in February 2000 that the government disclose to Parliament all the factors used to set the employment insurance premium rates and to determine the appropriate level of the reserve for the Employment Insurance Account. In its response, the government indicated that it would examine the recommendations made previously by the House of Commons Standing Committee on Finance on the subject. The Standing Committee on Human Resources Development and the Status of Persons with Disabilities recommended in May 2001 that it be part of the upcoming review of the process used to set premium rates. The Committee also suggested particular examination areas to be included in the review. The government has not issued any formal response at this time.

Issues

Neither the Commission nor the government clarified or disclosed key factors in setting the employment insurance premium rates.

11.141 Clear goals for government activities is one of the cornerstones of good management practice and accountability to Parliament. This is a key message in the overall management framework that the government set out for itself in its 2000 policy statement, *Results for Canadians: A Management Framework*

for the Government of Canada. In broad terms, the government defines and acts on its goals within the direction and authority that Parliament provides in legislation. It then reports back to Parliament on its performance in meeting those goals and Parliament can hold the government to account. The government's intent is to apply results-based management to all its major activities, functions, services, and programs.

11.142 Administering the revenues and expenditures of the Employment Insurance Account is a significant activity of the federal government. In 2001–02, $19 billion flowed into the account from contributors and $15 billion was spent on benefits and administration. The financial statements of the Employment Insurance Account cover its fiscal year, which runs from the beginning of April to the end of March. Under the *Employment Insurance Act*, the rates for employment insurance premiums are set on a calendar-year basis. As a result, in the fiscal year 2001–02 there were two premiums rates—one for the last nine months of 2001 and another for the first three months of 2002.

11.143 The Canada Employment Insurance Commission set the 2001 premium rate pursuant to section 66 of the Act. This section required that the rate, to the extent possible, ensure that there will be enough revenue over a business cycle to pay the amounts authorized to be charged to the account, while maintaining relatively stable rates. In our view, this meant that employment insurance premiums would equal expenditures over some period of time, including a reserve sufficient to maintain rate stability in an economic downturn. In other words, we believe Parliament's intent was that this program would be run on a break-even basis over the course of a business cycle, while providing for relatively stable rates. The legislation also meant that the Commission had to make certain key decisions—such as how it would apply the ideas of a "business cycle" and "relatively stable rates."

11.144 In May 2001, the Act was amended to suspend section 66, and give the Governor in Council, on the recommendation of the ministers of Human Resource Development Canada and of Finance, the authority to set rates for 2002 and 2003. While section 66 is suspended, the Act provides no criteria to the Governor in Council on how to set the rates. Nevertheless, section 66 comes back into force in 2004. At that time, in our view it is Parliament's intent that the program should be run on a break-even basis again.

11.145 In the interests of accountability, and given Parliament's apparent intent, both past and future, we expected that the Commission and the government would have clarified and disclosed the factors considered in setting the premium rates for 2001 and 2002, the target level for the accumulated surplus, and the time required to reach that level. However, we found that neither the Commission nor the government have done so. As a result, we cannot conclude that the setting of premium rates for 2001 and 2002 observed the intent of the Act.

Status of the government review of the rate-setting process

11.146 When section 66 was suspended, the government announced that it would review the process for setting premium rates. In our view, the review should result in a process that is transparent and objective. In particular, the way that the government interprets the Act needs to be made clear so that Parliament can be assured that its intent is being followed.

11.147 Officials from the Department of Finance have advised us that internal research on the process for setting premium rates is continuing, but that no public consultations have taken place as yet. Much needs to be done before section 66 comes back into force in 2004, and the Canada Employment Insurance Commission must set the 2004 premium rate in the fall of 2003. The government should consider many questions in its review, such as the following:

- What constitutes an adequate reserve and how much time is required to reach that level?
- What are the impacts on premium payers and on the purposes and intent of the Employment Insurance Program in the short and long terms, where the Account balance exceeds the maximum reserve considered sufficient by the Chief Actuary of Human Resources Development Canada?

In view of the growing size of the accumulated surplus, we urge the government to take all the necessary steps to clarify the rate-setting process and to make the process more open and transparent.

Conclusion

11.148 In our view, it was Parliament's intent that the Employment Insurance Program be run on a break-even basis over the course of a business cycle, while providing for relatively stable premium rates. However, the accumulated surplus of the Employment Insurance Account increased by another $4 billion to $40 billion in 2001–02. Neither the Commission nor the government clarified and disclosed what constitutes an adequate level of accumulated surplus, the time required to reach that level, and the factors considered in setting the rate. Therefore, we are unable to conclude that the intent of the *Employment Insurance Act* has been observed in setting the premium rates for 2001 and 2002.

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