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TAX HAVENS

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TAX HAVENS

INTRODUCTION

International capital mobility – the ability of investors to move money, machinery and plants from one jurisdiction to another quickly and without impediment – is a defining feature of an increasingly global economy.(1) Theoretically at least, international capital mobility enhances total economic wellbeing, allowing investment to move from less to more productive areas, thereby increasing total economic output. Foreign direct investment (FDI)(2) in plants, machinery, equity and debt is an especially important component of global capital flows,(3) enabling companies to grow by developing economies of scale through expansion into new markets and by transferring jobs, skills and technology to recipient countries.

For tax authorities – ministries of finance and treasury offices – these ever-increasing capital flows pose a challenge rooted in a tension between the fact that multinational firms operate internationally while tax authorities operate nationally.(4) Two major problems

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(1) In 2002, worldwide inflows of foreign direct investment (or FDI, defined below) totalled US$651 billion, bringing the inward FDI stock to US$7.1 trillion, up from US$700 billion in 1980, a ten-fold increase in a little more than 20 years. For details, see United Nations Conference on Trade and Development, http://globstat.unctad.org.

(2) The International Monetary Fund defines foreign direct investment as an investment that "allows an investor to have a significant voice in the management of an enterprise operating outside his own economy." Source: C. Lajule, *Foreign Direct Investment: A Driving Force in Economic Globalization*, Statistics Canada, Research Paper No. 67F0001MIB01020, Ottawa, 2001. According to Statistics Canada, foreign direct investment "reflects a significant influence in the other enterprise and does not need to be as intense as controlling investment." Ownership of more than 50% of the voting equity typically establishes a controlling interest. Direct investment "is measured as the total of the equity, including reinvested earnings, as well as long-term and short-term claims of the direct investor in the enterprise."

(3) Global capital flows are generally defined to consist of FDI plus factor payments, i.e., the flows of interest and dividend payments that result from FDI. In the balance of payments, FDI is counted under the "capital account," while factor flows – interest and dividends – are counted as part of the current account.

(4) This point is emphasized by Jinyan Li, a well-known expert in international taxation, in her 2003 book *International Taxation in the Age of Electronic Commerce: A Comparative Study*, Canadian Tax Foundation, Toronto, 2003.

arise from this tension. First, at least some capital flows may be motivated by a desire to avoid taxes,[5] something that can be done by moving funds to countries known to be tax havens where income or profit tax rates may be low or non-existent.[6] Second, no two countries share the exact same income/profit tax rules or information disclosure requirements, a situation that makes it difficult to find out exactly who sent what money where and how and, most importantly of all, to enforce national tax rules. By exploiting these differences, companies can sometimes end up paying little or no income or profit taxes at all.

Because Canada is a small, open economy, Canadian tax officials have long been concerned about the impact of international capital flows on tax revenue. As of the end of 2003, the value of foreign direct investments held by Canadian firms was almost $400 billion, a four-fold increase over the 1990 year-end value.[7] The largest recipient of Canadian FDI is the United States, where Canadian enterprises have investments valued at $164.9 billion, followed by the United Kingdom ($40.7 billion) and Barbados ($24.7 billion)

Table 1: Top Twelve Recipients of Canadian FDI

Country	Value of Canadian FDI, 2003 C$ billion
United States	164.9
United Kingdom	40.7
Barbados	24.7
Ireland	18.2
France	11.6
Bermuda	10.8
Netherlands	10.7
Cayman Islands	10.6
Hungary	9.4
Japan	9.1
Bahamas	8.8
Germany	7.8

Source: Statistics Canada, Canadian Direct Investment Abroad, CANSIM Table 376-0051.

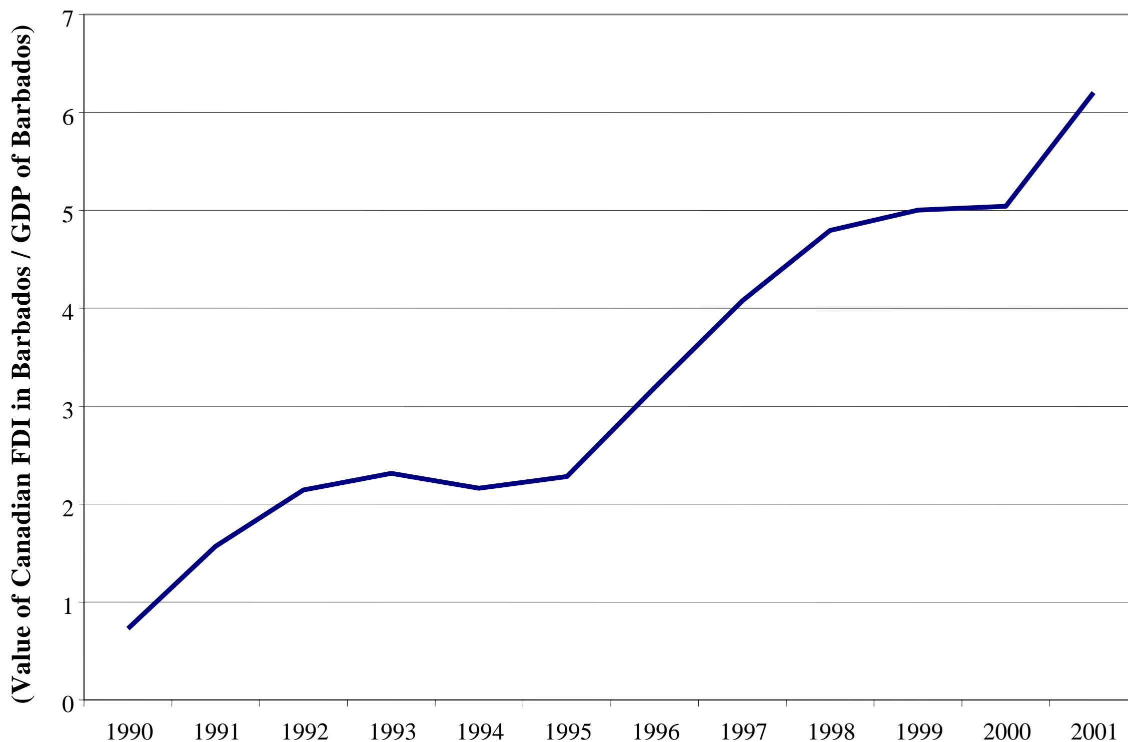
(5) D. W. Conklin, and D. A. Robertson, "Tax Havens: Investment Distortions and Policy Options," *Canadian Public Policy*, Vol. 25, No. 3, 1999.

(6) The definition of a tax haven is discussed at length below.

(7) The stock of FDI is measured as the value of the foreign direct investments on the balance sheets of the recipient entities that have accumulated through time. This book value reflects more than just the sum of incremental investment flows. Differences between the market value and book value of direct investment transactions, as well as other revaluations, exchange rate fluctuations, and corporate reorganizations all contribute to fluctuations in the book value of direct investments over time.

While Canadian investments in the United States and the United Kingdom can be easily explained because of Canada's strong economic ties and long-standing political relationships with these two countries, the extent of Canadian direct investments in, for example, Barbados is less obvious. Barbados is a small Caribbean island state with a population of only 270,000, or roughly twice the population of Prince Edward Island. Its gross domestic product in 2001 was US$2.7 billion.(8) In 2003, Canadian exports of goods and services to Barbados were less than $46 million.(9) Yet, between 1990 and 2003, Canadian FDI into Barbados increased from $1.5 billion to $24.7 billion, driven by an increase in FDI flows.(10) The value of Canadian direct investments in Barbados now surpasses the gross domestic product (GDP) of Barbados by a factor of 6, as shown in Figure 1 below.

Figure 1
Canadian FDI in Barbados Relative to That Country's GDP



Source: Statistics Canada, Canadian Direct Investment Abroad, CANSIM Table 376-0051; World Bank, *World Development Indicators*, CD-ROM, 2003.

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(8) World Bank, *World Development Indicators*, CD-ROM, 2003.

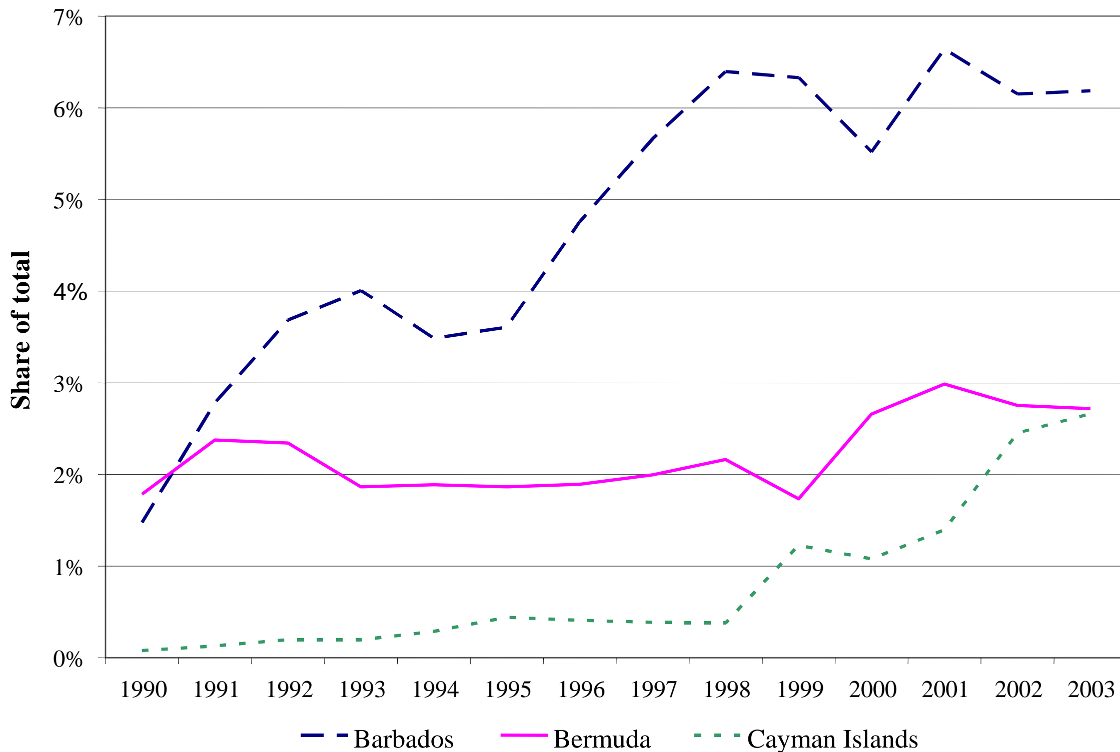
(9) By contrast, exports to the United States account for 88% of Canada's total exports; see Statistics Canada, CANSIM Table 227-0001.

(10) Statistics Canada, Canadian Direct Investment Abroad, CANSIM Table 376-0051.

Similar increases in outbound Canadian FDI to other small Caribbean countries such as Bermuda and the Cayman Islands also took place in the 1990s. Figure 2 shows how those two countries and Barbados have commanded an increasing proportion of Canada's total outbound FDI.

Figure 2

Value of Canadian FDI in Barbados, Bermuda and the Cayman Islands as a Percentage of Total Canadian Outward FDI Stock



Source: Statistics Canada, Canadian Direct Investment Abroad, CANSIM Table 376-0051.

What these three countries have in common is that they have been identified as tax havens by the Organisation for Economic Co-operation and Development (OECD), the implication being that at least some portion of the flow of funds to these and other tax havens is motivated by tax avoidance or tax evasion considerations.(11) These three countries, along with other well-known tax havens, also have come under the scrutiny of the Office of the Auditor General of Canada, which in two separate reports spaced 10 years apart concluded that weak

(11) In the taxation literature, tax avoidance is defined as a strategy to minimize an individual's or a corporation's taxation bill by employing taxation law to the fullest extent possible. Tax evasion, however, is characterized as illegal efforts to minimize a tax bill.

Canadian tax rules – and specifically the rules governing transfers of funds between Canadian companies and their foreign affiliates – had cost the federal government hundreds of millions of dollars in lost tax revenue.(12)

This publication reviews some of the key problem areas identified by the Office of the Auditor General of Canada in the 1992 and updated 2002 reports. It then reviews the Department of Finance response to these concerns, as well as possible policy actions that could be taken to collect some of the potential tax revenue. First, however, it will take a closer look at the definition of a tax haven, and then briefly review some key tax principles that shape most discussions about the taxation of international capital flows.

TAX HAVENS DEFINED

The OECD defines a tax haven as any jurisdiction that "has no or nominal taxation on financial or other service income and offers or is perceived to offer itself as a place where non-residents can escape tax in their country of residence."(13) Other criteria include a lack of transparency and minimal information transfers with other states. In 2000, the OECD published a list of 35 countries that qualified as "tax havens" according to its 1998 inaugural study of "harmful tax competition." The list is reproduced in Appendix A.(14)

Others define tax havens more loosely. David Conklin and Darroch Robertson define a tax haven as "any jurisdiction that imposes a lower tax on corporate income than does the jurisdiction from whence the foreign direct investment originates, or the jurisdiction in which the investment is ultimately made."(15) In its 1966 report, the landmark Royal Commission on Taxation (better known as the Carter Commission) defined tax havens as "countries through which income can be channelled at little or no tax cost."(16)

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(12) *Report of the Auditor General of Canada*, 1992, Ch. 2, lead-up sentence to paragraph 2.28; and *Report of the Auditor General of Canada*, December 2002, Ch. 11, p. 29, paragraph 11.113.

(13) OECD, *Towards Global Tax Co-operation*, 2000, p. 10, paragraph 7, available at: http://www.oecd.org/dataoecd/9/61/2090192.pdf. See also footnote 4 on the same page for details.

(14) Subsequent to its 2000 report, the OECD broke up the tax-haven category into "cooperative" and "non-cooperative" tax havens. The OECD defines a cooperative jurisdiction as any tax haven that agrees to "improve transparency and establish effective exchange of information for tax matters" with OECD member countries. Non-cooperative tax havens make no such promise. As of December 2003, there were only five non-cooperative tax havens remaining, namely: Andorra, Liberia, Liechtenstein, the Marshall Islands and Monaco. For details, see: OECD, "Work of Participating Partners," at: http://www.oecd.org/document/48/0,2340,en_2649_33745_29874096_1_1_1_1,00.html.

(15) Conklin and Robertson (1999), p. 334.

(16) Royal Commission on Taxation, Ch. 26, p. 483.

FIVE KEY TAX PRINCIPLES

The federal tax system is ultimately designed to generate revenue for the federal government so that it can provide services for Canadians. In their effort to generate tax revenue from international capital flows, policy makers are normally guided by five tax principles designed to minimize inequity to taxpayers and disturbance to the private-sector economy. These five principles are in addition to more generic or general concerns about tax efficiency (the notion that the tax system should not favour one sector of the economy over another), horizontal equity (the notion that entities in similar economic circumstances should be taxed similarly) and vertical equity (the notion that taxes should reflect in some measure the ability to pay). The five international tax principles are:

- **Avoid Double Taxation –** Double taxation is seen as not only unfair but potentially harmful for economic growth to the extent that it discourages income-generating investment activity.

- **Tax Worldwide Income –** Residents, whether corporations or individuals, must report and pay taxes on their *worldwide* income, not just the income they earn in Canada. As discussed below, this tax principle is the basis for many of the Office of the Auditor General of Canada's concerns about taxation policy as it affects foreign affiliates.(17)

- **Strive for National Neutrality –** Canada's tax system should be internationally competitive. In other words, the foreign operations of Canadian firms should face similar tax rates as their competitors in that foreign country. In the absence of national neutrality, the foreign operations of Canadian firms would be disadvantaged because they would be required to pay (presumably) higher Canadian taxes than their competitors.

- **Strive for Global Neutrality –** Canada's tax system should be neutral; the tax system should neither encourage nor discourage outbound foreign investment by Canadian taxpayers. In other words, investment decisions should not be made on the basis of different tax rates in different countries. This is the idea that a country "would like to tax income earned abroad at the same effective tax rate as income earned domestically in order to leave corporations indifferent, from a tax perspective, as to whether they invest domestically or abroad."(18) A tax structure that did *not* account for the difference between Canadian and foreign taxes could unfairly benefit multinational Canadian firms relative to domestic competitors that operate only in Canada.(19)

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(17) The two major exceptions are: 1) up to $80,000 of foreign-source employment income for an individual employed in qualifying activities for more than six months; and 2) income from offshore banking centres. (See Appendix B.)

(18) Conklin and Robertson (1999), p. 335.

(19) To see why, imagine a situation with two Canadian companies. Suppose that company A operates solely in Canada and faces a marginal tax rate of 22%. Company B operates in Canada and abroad.

- **Strive for Simplicity –** To be effective, a tax system should avoid undue complexity for both taxpayers and tax administrators. Simplicity for the taxpayer encourages compliance; simplicity for the tax administrator eases the process of ensuring compliance. Sometimes, however, the simplicity principle is at odds with other principles such as competitiveness and neutrality.

PROBLEMS WITH THE FOREIGN AFFILIATES RULES

In her 2002 report, the Auditor General of Canada identified five areas of concern with respect to the federal government's foreign affiliates tax rules.[20] To simplify the exposition, these five areas of concern are condensed into the two major categories discussed below.

A. The Problem with Interest Deductibility

Canadian tax law allows corporations to deduct incurred interest expenses against taxable income. This deduction, first introduced in 1972, is permitted regardless of whether interest is incurred to fund projects domestically or abroad through foreign affiliates.[21] Moreover, unlike several other countries which impose limitations on interest deductibility, Canadian tax rules allow for *full* deductibility of interest on funds borrowed to invest in foreign affiliates, with few exceptions.[22] A Canadian corporation that borrows to invest in a project

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(cont'd)

Like company A, company B's Canadian income is taxed at 22%. Suppose that company B's foreign income, however, is taxed at 15%. If both firms have similar total sales and similar before-tax profit margins, company B will have higher after-tax profits than company A. This competitiveness concern is also at play in the case of a foreign company based in a low-tax jurisdiction but with Canadian operations. While its Canadian-source income is subject to Canadian taxes, it still benefits from the low-tax regime in its home country to the extent that this low-tax base allows it to subsidize its Canadian operations.

(20) Appendix C presents an overview of Canada's foreign affiliates rules, in graphic form. Note also that this discussion relates exclusively to corporate activities. Individuals holding shares in foreign companies, regardless of the size of the investment, must include all dividends in their income. They are entitled to a tax credit worth up to 15% of taxes paid in the foreign jurisdiction, after which they may deduct any taxes paid to that jurisdiction.

(21) Recent legislative amendments for tax years beginning after 1999 stipulate that Canadian firms must control (own 50% or more of voting shares) their foreign affiliates in order to benefit from interest deductibility.

(22) Conklin and Robertson (1999).

undertaken by its foreign affiliate is therefore able to deduct the full interest expense in Canada even though the firm may, under certain circumstances (discussed in the next section), be able to repatriate the income resulting from the foreign investment tax-free.

To illustrate how this works in practice: the Auditor General's 2002 report offered the example of a foreign-owned Canadian company that borrowed more than $800 million in Canada to invest in a Barbados subsidiary. The interest expense of $100 million was deducted from the Canadian company's Canadian taxable income. The related income of the Barbados subsidiary was eventually repatriated to Canada as a tax-exempt dividend, a process discussed in more detail in the next section.

As a result of these interest deduction rules, there has been a tendency by some multinational firms to engage in a strategy called "debt shifting." The Technical Committee on Business Taxation (better known as the Mintz Committee), which was set up by the Department of Finance in the mid-1990s to review Canada's corporate tax system, found evidence that Canada's tax rules encourage foreign-owned multinational corporations to shift debt into Canada in order to deduct interest expenses in Canada in a way that ultimately erodes Canada's tax revenues. The associated investment, however, typically occurs in a third country, as do the jobs. The Auditor General's 2002 report echoes this finding.

The logic behind debt shifting is straightforward. Because interest is deductible from taxable income in Canada regardless of where the loan is used, it is more advantageous to a multinational corporation to borrow and incur interest expenses in a relatively high-tax jurisdiction such as Canada to minimize its overall (global) tax bill. By borrowing in Canada instead of in a country where taxes are lower, a multinational firm can fund its foreign affiliate(s) in a low-tax country (or countries) while minimizing its overall tax bill. Reallocating debt from a low-tax jurisdiction to a high-tax jurisdiction allows a multinational corporation to take advantage of the interest deduction in the high-tax jurisdiction (i.e., interest is deducted at a higher marginal rate, so the savings are larger).

To gauge the extent of the debt shifting problem, Vijay Jog and Jianmin Tang compared the debt-to-asset ratios of companies (both Canadian-controlled and foreign-controlled corporations operating in Canada) with and without foreign affiliates. For the years 1984 to 1994, they found a consistent increase in the debt-to-asset ratio of companies with foreign affiliates that is not observed in companies with no foreign affiliates. Jog and Tang conclude

that as a result "the taxes paid by the foreign-controlled corporations, as well as those Canadian-controlled corporations with foreign affiliates have declined significantly relative to their underlying operating earnings."[(23)]

Canada's tax rules on capital flows also make it relatively easy for a multinational corporation to obtain two deductions for the same loan – a process known as "double-dip" financing. Consider, for example, a multinational company based in Canada that wants to invest in one of its U.S. affiliates. The company borrows $1 billion in Canada. The company deducts the interest expense on this loan against its taxable income in Canada. This is the first deduction. The company invests the $1 billion in its affiliate located in Barbados, with whom Canada has a tax treaty. The Barbados affiliate in turn lends $1 billion to the U.S. affiliate. The U.S. affiliate in turn deducts the interest it pays to the Barbados affiliate from its U.S. taxable income, which becomes the second interest deduction. Because Barbados offers preferential tax rates for certain foreign investments and businesses, the interest income received by the Barbados affiliate is taxed at a very low rate, if at all. And because, under Canadian tax law, the interest income received by the Barbados affiliate is considered "active business income" – i.e., income earned by a foreign affiliate from its day-to-day sales operations[(24)] – it can ultimately be repatriated to Canada as a tax-free dividend.

B. The Problem with Tax-Free Dividends from Foreign Affiliates

Under Canadian tax law, Canadian corporations can receive tax-free dividends paid out of active business income earned by foreign affiliates resident in countries with which Canada has a tax treaty. This tax exemption is grounded in a desire to avoid double taxation, with a presumption that Canada's tax treaty partners have comparable corporate and individual tax rates – otherwise, they would not be tax treaty partners. However, this is not necessarily the case.[(25)] Canada has tax treaties with 3 of the 36 countries identified as tax havens by the OECD, namely Barbados, Cyprus and Malta.

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(23) V. Jog and J. Tang, "Tax Reforms, Debt Shifting and Corporate Tax Revenues: Multinational Corporations in Canada," Working Paper 97-14, prepared for the Technical Committee on Business Taxation, February 1998.

(24) A glossary of key foreign affiliates terms is provided at the end of this document.

(25) Canada has a general policy of not entering into tax treaties with countries that are known to be tax havens. There have been instances, however, when a country with which Canada has previously

The opposite of active income is "passive income," which is income derived from investments in bonds, rental units and other investments that do not involve much or any day-to-day oversight. Under the *Income Tax Act*, passive income is subject to federal taxes on what is known as an "accrual basis," i.e., as the income is earned. The so-called foreign accrual property income (FAPI) rules ensure that taxpayers report and pay Canadian taxes on a certain amount of their accrued income each year,[26] rather than waiting for the income to be distributed back to the Canadian corporate shareholder.[27]

In his 1992 report, the Auditor General of Canada expressed concern that the "active income" category was being abused because some of Canada's tax treaty partners impose low or no taxes on active business income earned by Canadian foreign affiliates. This practice becomes especially problematic in the context of double-dip financing, which was discussed earlier. The Auditor General also pointed out that, in some cases, even Canadian-owned foreign affiliates operating in *non*-tax treaty countries could, through a technical rule, repatriate dividends tax-free.

> For example, the technical rule 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.[28]

(cont'd)

concluded a tax treaty changed its tax laws after the treaty had been signed in order to attract foreign investment. Barbados and Malta did this in the mid-1990s. The Netherlands, Switzerland, Luxembourg, Ireland, Cyprus, Belgium and Hungary, all of which have concluded tax treaties with Canada, also offer preferential tax rates for some forms of income or corporate entities.

(26) In order to avoid double taxation, the *Income Tax Act* provides for tax credits designed to neutralize any taxes paid in the foreign countries where the foreign affiliate income was earned.

(27) Before the introduction of the FAPI rules in the early 1970s, firms would time the disbursement from their foreign affiliates in such a way as to minimize their tax costs.

(28) *Report of the Auditor General of Canada*, 2002, Ch. 11, paragraph 11.75.

It is important to note that the FAPI rules apply only to *controlled* foreign affiliates.[(29)] They can therefore easily be skirted by ensuring that the shares of a foreign corporation are widely owned by Canadian residents through offshore mutual funds and unit trusts. These funds allow Canadian taxpayers not only to defer their taxes (until dividends are paid), but also to convert ordinary income (such as interest) into capital gains on the disposal of their investment.[(30)]

Analysis by the House of Commons Public Accounts Committee and the Mintz Committee agreed with the Auditor General's 1992 argument that something should be done to minimize this kind of tax avoidance. In 1995, the federal government acted on these recommendations and introduced rules stipulating that Canadian-owned firms could receive tax-free dividends from a foreign affiliate only if the foreign affiliate was considered "resident" in the designated treaty country under the tax treaty itself *and* under Canadian tax law. Canadian law states that a corporation is resident in another country only if its central mind, management and control are in that country. In other words, the rule change was designed to prevent the use of postal-box shell companies to avoid Canadian taxes.

The effectiveness of the new rules was limited, however, by two important exceptions. The first exception allowed dividends from Barbados International Business Corporations (BICS) and other similar corporations to qualify for tax-free treatment, despite the special tax rates enjoyed by these institutions.[(31)] The second exception allowed tax-free dividends to flow from a Canadian-owned U.S. limited liability corporation[(32)] that conducts the bulk of its activities outside the United States, possibly in a tax-haven country. As a result of these two exceptions and changes in the laws in some tax-haven countries themselves,[(33)] the

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(29) A controlled foreign affiliate is a foreign affiliate owned directly or indirectly by five or fewer Canadian residents. A foreign affiliate is, in turn, a corporation, not resident in Canada, in which a Canadian corporation owns at least 1% of the shares of any class, and the corporation and related persons own at least 10%.

(30) Section 94.1 of the *Income Tax Act* attempts to deal with this problem by requiring investors in such funds to include in their statement of income a notional amount equal to what it cost to purchase the mutual fund shares, multiplied by a prescribed interest rate. This so-called anti-avoidance rule has not, however, been very effective, and the Department of Finance is attempting to modify the legislation to improve its efficacy.

(31) In Barbados, BICS income is taxed at a rate of between 1% and 2.5%.

(32) This corporation would be managed and controlled in the United States.

(33) According to the Auditor General of Canada, some of Canada's insurance companies were concerned that the 1995 changes would jeopardize the tax-free status of dividends from their Barbados subsidiaries, which paid no tax but instead were charged a $5,000 licence fee. As a result, Barbados changed its laws in order to convert the fee into a tax, which was set at 0% for the first 15 years, 2% on the first $250,000 of income for subsequent years, and 0% on any excess income.

Auditor General of Canada noted in her 2002 report that since 1992, "…little has changed. Tax havens continue to attract Canadian money."

THE DEPARTMENT OF FINANCE RESPONSE

The Department of Finance has, for the most part, rejected criticisms of the foreign affiliates rules, arguing that in a fast-changing global economy, any change in the tax regime will simply induce changes in tax avoidance behaviour. In its response to the Auditor General's 1992 report, the Department argued, for example, that the interest deductibility tax rules are designed in part to encourage "international competitiveness" and are in line with the "economic realities of the international marketplace."(34) Without such accommodating rules, the argument goes, Canadian companies could find it difficult to compete internationally, and Canada would therefore risk losing some of its most successful multinationals to those countries with more generous taxation regimes. In short, the Department claimed that it is too costly and complicated to stop this kind of behaviour. Commenting on the Auditor General's 1992 report and the Department of Finance's response to that report, the House of Commons Standing Committee on Public Accounts characterized the Department's response as "almost arrogant." The Public Accounts Committee also offered broad support for the Auditor General's concerns.(35)

In response to the Auditor General's 2002 report, the Department of Finance took a somewhat more conciliatory approach, saying it would continue to monitor and assess Canada's tax treatment of interest expenses incurred to make investments in foreign affiliates. It argued, however, that Canada is becoming a relatively less attractive jurisdiction for multinationals looking to take advantage of valuable interest deductions on debt financing, primarily because corporate tax rates have been reduced considerably at both the federal and provincial levels.(36) The Government of Canada's five-year corporate income tax reduction plan introduced in Budget 2000, in conjunction with "significant" reductions in provincial corporate income tax rates, could bring Canadian corporate tax rates below those in the United States by 2006. It remains to be seen whether these corporate tax cuts will have the anticipated effect.

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(34) *Report of the Auditor General of Canada*, 1992, Ch. 2.

(35) Standing Committee on Public Accounts, *Twelfth Report*, available as Appendix C of the 1993 *Report of the Auditor General of Canada* at http://www.oag-bvg.gc.ca/domino/reports.nsf/ html/93appce.html.

(36) *Report of the Auditor General of Canada*, 2002, Ch. 11, Department's Response.

Finally, in its annual *Report on Plans and Priorities*, the Department of Finance typically sets "Improvements to the Tax System" as one of its key policy objectives for the coming years. Finance Minister Ralph Goodale has sounded a similar theme, noting in Question Period that "in relation to the tax treaties with certain countries around the world, those are matters that we need to constantly review in the context of the integrity of our tax system and the fairness to all taxpayers. They must all pay their fair share and I will examine that as I prepare my next budget."(37)

POSSIBLE POLICY RESPONSES

Over the years, a number of analyses have proposed changes to Canada's tax system that would address the Office of the Auditor General's concerns – which, it should be noted, have been around for more than 50 years. Some more general proposals recall the Carter Commission's suggestion in its 1966 report, namely, an end to the practice of exempting foreign affiliate dividends – regardless of the source – from Canadian income and profit taxes. Under the Commission's proposal, which included a system of gross-up and tax credits, Canadian firms and shareholders would have always ended up paying Canadian-level taxes on foreign-source income.(38) The proposal essentially gave priority to simplicity and global tax neutrality at the expense of national neutrality. The Commission felt that national neutrality was simply not feasible in an unequal world of creditors and debtors, trade barriers of all kinds, and different national preferences for public goods. Put differently, the potential benefit of closing what the Commission saw as a "major loophole" outweighed the potential cost of hurting the competitiveness of Canadian firms operating abroad.(39)

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(37) Hansard, 4 February 2004, No. 3, between 14:25 and 14:30. See: http://www.parl.gc.ca/37/3/parlbus/chambus/house/debates/003_2004-02-04/han003_1425-E.htm.

(38) Specifically, the Carter Commission argued that dividends from foreign affiliates should be "grossed-up" by 30% and that Canadian investors should be allowed to claim a foreign tax credit worth the same amount. "Gross-up" rules are used to ensure that taxes are applied on total taxable income. See: Royal Commission on Taxation, Ch. 26, p. 486.

(39) As noted earlier, Canadian firms with operations in lower-tax countries might have been put at a competitive disadvantage to the extent they were forced to compete with non-Canadian firms not required to pay Canadian taxes in these lower-tax countries.

Others have proposed less sweeping changes. The Mintz Committee, for example, proposed that the *Income Tax Act* be amended to limit[40] the amount of interest expense that a Canadian corporation can deduct on borrowed funds related to investments in foreign affiliates,[41] the idea being that the Canadian tax base should not be eroded when funds raised in Canada are used offshore.[42] Conklin and Robertson echo the recommendation of the Mintz Committee, amending it slightly to suggest that the interest deduction could be allowed, but only against repatriated foreign profits. Similar strategies are used in Australia, the Netherlands, and the United States.

The Mintz Committee also recommended policy changes to address potential abuses related to inter-affiliate transactions, whereby one foreign affiliate transfers funds that would otherwise be classified as passive to another foreign affiliate, where they are often regarded as active income and taxable surplus for Canadian income tax purposes. Consequently, any dividends paid out of this taxable surplus are tax-exempt in Canada. Specifically, the Mintz Committee (p. 6.22) recommended that the *Income Tax Act* be changed so that inter-affiliate transactions be included in taxable surplus "where the income is received by an entity that, while located in a tax treaty jurisdiction, is expressly denied benefits under that treaty." It also recommended that Canada renegotiate tax treaties where this is a problem.

CONCLUSION

As noted at the beginning of this paper, the Office of the Auditor General of Canada has estimated that the use and misuse of the foreign affiliates rules have cost the federal

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(40) Until such time as Canada's tax laws are changed, the Canada Revenue Agency is essentially precluded from challenging interest deductions claimed by multinational companies operating in Canada. The Supreme Court of Canada recently ruled that the Agency cannot challenge interest deductions on funds used to earn foreign-source income even in the case where "there was no possibility that the taxpayer would receive dividends that were more than the total cost of the interest." See: *Report of the Auditor General of Canada*, 2002, Ch. 11.

(41) It is important to note that the Mintz Committee linked this recommendation to a broader recommendation for lower corporate income tax rates.

(42) See: Tax Executives Institute, "Comments regarding the Report of the Technical Committee on Business Taxation," available on-line at: http://www.taxnews.com/tnn/tei/tei_doc_public.nsf/0/4057b30290b0765585256a73005ebd9c?OpenDocument.

government hundreds of millions of dollars in lost tax revenue. The Mintz Committee estimated that the interest deductibility rules alone cost the federal government about $3.5 billion in lost tax revenue in 1994 alone.(43)

Because Canada is a small, open economy, Canadian tax experts have long expressed concern about the tax implications of increased capital mobility. In its 1966 report, the Carter Commission wrote there were "serious loopholes in the present system that allow some Canadian residents to avoid paying full tax on their income by the utilization of companies in tax-haven countries."(44) The magnitude of the problem appears to have worsened since then, particularly in the 1990s with the sharp increase in outbound FDI to known tax havens such as Barbados.

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(43) It should be pointed out that the Committee's research did not isolate those interest deductions related to loans used to finance foreign affiliates.

(44) Royal Commission on Taxation, Ch. 26, p. 485.

GLOSSARY

Active Business Income: Income earned from a business source, including any income incidental to the business. Active business income approximates operating income, and includes interest income received from a related foreign affiliate provided the income was deducted from the active business income of the debtor.(45)

Canadian Resident Corporation: A company is considered a resident of Canada for tax purposes if its central management and control are located in Canada, or if it is incorporated in Canada.

Foreign Accrual Property Income (FAPI): FAPI consists of income from property, income from investment-type businesses, certain capital gains, and certain business income derived from Canadian sources. FAPI does not include base company sales and services income. It also does not include certain interest, rent, royalties, or other similar payments received by a controlled foreign affiliate from another foreign affiliate or a related non-resident corporation, to the extent that the payment is deductible in computing the payer's earnings from an active business in the country in which it is resident.

FAPI Rules: Rules designed to prevent Canadian residents from diverting passive income to a *controlled* foreign affiliate or from accumulating certain income in such a corporation. The FAPI rules require Canadian residents to pay tax on passive income as it is earned by a controlled foreign affiliate, regardless of whether this income is paid out or not. FAPI rules do not apply to any Canadian shareholder that owns less than 10% of any class of shares of a foreign corporation.

Foreign Affiliate, Controlled and Otherwise:

- A foreign affiliate is a corporation, not resident in Canada, in which a Canadian corporation owns at least 1% of the shares of any class, and the Canadian corporation and related persons own at least 10%.

- A controlled foreign affiliate is a corporation controlled directly or indirectly by five or fewer Canadian residents. A corporation must be a foreign affiliate to qualify as a controlled foreign affiliate.

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(45) The Canada Revenue Agency defines active income as "income earned from a business source, including any income incidental to the business." See http://www.ccra-adrc.gc.ca/E/pub/tg/t4012/t4012-07-e.html for details. Note that active business income does not include income earned from what are called "specified investment businesses" or from "personal services businesses." A specified investment business is "a business with the principal purpose of deriving income from property, including interest, dividends, rents, or royalties," while a personal services business is "a business that a corporation carries on to provide services to another entity (such as a person or a partnership) that an officer or employee of that entity would usually perform. Instead, an individual performs the services on behalf of the corporation."

Foreign Branch: From the perspective of the *Income Tax Act*, foreign branches are reflected in the Canadian company's tax return. The Canadian company is entitled to a foreign tax credit for any income paid to the foreign tax authority by the branch. Standard tax planning strategies recommend that a foreign operation be designated a "branch" during start-up in order to claim foreign losses as deductions on domestic income. Once profitable, the firm is restructured to become a foreign affiliate.

GAAR: General Anti-Avoidance Rule, introduced in 1988 in order to sustain the "spirit of the law" in cases where tax rules were being "misused" (the Auditor General of Canada's term).

Individual: Defined in subsection 2(1) of the *Income Tax Act* as "a person other than a corporation."

Non-Qualified Foreign Affiliates: Foreign affiliates resident in a country not designated in the *Income Tax Act Regulations* (i.e., not a tax treaty country).

Passive Income: Includes interest income and dividends earned from investment portfolios.

Person: Subsection 2(1) of the *Income Tax Act* defines a person as any "body corporate and politic, and also the heirs, executors, administrators or other legal representatives of such person."

Personal Services Income: Personal services income is earned from "a business that a corporation carries on to provide services to another entity (such as a person or a partnership) that an officer or employee of that entity would usually perform. Instead, an individual performs the services on behalf of the corporation."

Portfolio Income: This type of income (dividends, interest, rent, and royalties) is typically included in a Canadian corporation's worldwide income under FAPI, with a tax credit available for any foreign taxes applied on this income. The size of the tax credit is, however, limited to 15% for all income other than real-property income, i.e., income earned from rent. Any foreign taxes in excess of this amount are deductible in computing income, rather than creditable.

Safe Income: Income that is attributable to anything other than the income earned by the corporation.

Specified Investment Income (or Passive Business Income): Specified investment income is income earned from "a business with the principal purpose of deriving income from property, including interest, dividends, rents, or royalties."

Surplus

- **Exempt Surplus:** Canadian corporations do not have to pay income taxes on dividends received out of a foreign affiliate's exempt surplus, which is defined as profit earned from *active business income* by a foreign affiliate in a *designated tax treaty country.* The term "exempt surplus" is closely related to the "exempt method" of recognizing income from a foreign affiliate.

- **Taxable Surplus:** Canadian corporations can claim a tax deduction based on the amount of foreign income tax and withholding tax already paid by the foreign affiliate on active business income in a *non-tax treaty country*. The deduction is limited to the dollar amount of the dividend received from the foreign affiliate's taxable surplus. If the affiliate pays no foreign taxes (income or withholding), its Canadian owner cannot claim a deduction. The term "taxable surplus" is closely related to the "deferral method" of recognizing income from a foreign affiliate.

- **Pre-Acquisition Surplus:** A notional source from which a dividend, other than dividends paid out of exempt or taxable surplus, is deemed to have been distributed. This dividend is fully deductible but results in a reduction of the adjusted cost base of the investment in the foreign affiliate, which potentially gives rise to an increase in the capital gain triggered by any future sale of the foreign affiliate shares. The idea here is to avoid attempts to "bleed" the foreign affiliate of its value and subsequently sell the shares at a capital loss which could then be used to offset capital gains.

Taxable Canadian Property (TCP): Canadian assets such as real estate that are not taxed when a taxpayer becomes a resident of another country.

Thin Capitalization: A corporation is said to be thinly capitalized when it has a high proportion of debt relative to equity.

Thin Capitalization Rules: These *Income Tax Act* rules (see subsection 18(4), for example) limit the amount of interest that a corporation may deduct on debt owing to certain "specified" non-resident investors (corporations try to minimize taxable capital in Canada by lending to foreign affiliates). Specifically, interest payable to a non-resident on debt in excess of three times the total of the share capital and retained earnings is not deductible (the so-called 3:1 rule) by the Canadian corporation. Note that share capital + retained earnings + surplus contributed by the non-resident shareholder = equity. Note also that "specified" non-residents are non-residents, either alone or together with non-arm's-length partners, who own 25% or more of a Canadian company's shares.

Withholding Tax: A kind of tax applied almost like a form of collateral to ensure payment of the said taxes. For example, a Canadian company that hires a non-Canadian must collect a 15% withholding tax on any amounts paid to that non-Canadian. Withholding taxes are also charged on RRSP withdrawals and on certain payments to foreign affiliates (section 212 of the *Income Tax Act* sets the Canadian withholding rate for these latter kinds of transfers at 25% unless reduced by a treaty).

APPENDIX A

LIST OF TAX HAVEN COUNTRIES AS DEFINED BY THE OECD

TAX HAVENS	TAX TREATY WITH CANADA?
Andorra	n
Anguilla	n
Antigua and Barbuda	n
Aruba	n
Bahamas	n
Bahrain	n
Barbados	y (under re-negotiation)
Belize	n
British Virgin Islands	n
Cook Islands	n
Dominica	n
Gibraltar	n
Grenada	n
Guernsey	n
Isle of Man	n
Jersey	n
Liberia	n
Liechtenstein	n
Maldives	n
Marshall Islands	n
Monaco	n
Montserrat	n
Nauru	n
Netherlands Antilles	n
Niue	n
Panama	n
Samoa	n
St. Christopher (St. Kitts) & Nevis	n
St. Lucia	under negotiation
Seychelles	n
St. Vincent and the Grenadines	n
Tonga	n
Turks & Caicos Islands	n
U.S. Virgin Islands	n
Vanuatu	n
Sources: http://www.oecd.org/dataoecd/60/11/2664514.pdf http://www.fin.gc.ca/treaties/treatystatus_e.html	

Note: Six other jurisdictions, namely Bermuda, Cayman Islands, Cyprus, Malta, Mauritius, and San Marino, also meet the OECD's tax haven criteria set out in the 1998 Report, but were not included on this list because of political commitments to eliminate harmful tax practices. Canada has tax treaties with Cyprus and Malta and is negotiating a treaty with Mauritius.

APPENDIX B

AN OUTLINE OF THE FEDERAL GOVERNMENT'S TAX TREATMENT OF FOREIGN AFFILIATES

Principles:

1. Canadians are taxed on worldwide income. Exceptions to this general rule include:
   a. up to $80,000 of foreign-source employment income for an individual employed in qualifying activities for more than six months;
   b. income from offshore banking centres;
   c. dividends out of the exempt surplus (i.e., income derived from active business operations) of foreign affiliates of Canadian corporations.

2. Canadians are credited on tax paid abroad (on foreign-source income) because of the desire to avoid double taxation. In some cases, they may receive a deduction for foreign taxes.

3. Normally, Canadian residents are not taxed on income earned indirectly, i.e., income earned by companies in which they hold shares. They are taxed only when they (directly) receive dividends or dispose of their shares in foreign corporations. FAPI and offshore investment fund rules may, however, cause these payments to be made earlier than they otherwise might have been.

4. Foreign Affiliates: Canada uses a combination of an exemption and credit system.

5. Individuals (as opposed to corporations) cannot avail themselves of the dual tax credit/deduction system for dividends from investments in foreign companies. They must include all dividends in their income, although they may avail themselves of a tax credit which applies to foreign corporate tax rates of up to 15%, after which they deduct any remaining taxes.

6. Foreign taxes paid by a foreign affiliate must be allocated between amounts included in taxable surplus and other amounts. No specific rules are provided for this purpose.

7. Dividends paid in excess of exempt and taxable surplus are deemed to be out of pre-acquisition surplus. They are deductible in computing a Canadian corporation's taxable income, but they reduce the cost of the shares of the foreign affiliate.

APPENDIX C

CANADA'S FOREIGN AFFILIATES RULES