Reform of International Tax: Canada, Japan, United Kingdom and United States

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General Perspective

- Canada has a small open economy with a relatively large amount of inbound and outbound international direct investment
- Canada's economy has a large trade component--over 75% of trade occurs with the United States
- Major sectors include natural resources, financial services, and manufacturing
- Canada has a competitive business tax regime:
  - Combined federal/provincial corporate tax rates around 25%
  - Generally no taxes on corporate capital
  - Mostly, no sales tax on business inputs: VAT-like system in most provinces
- Canadian tax policy has generally aimed to provide resident corporations with a competitive regime for outbound investment

Outbound Investment Taxation in Canada: Historical Perspective

- Pre-1972 Tax Reform: simple dividend exemption system
- Dividends received from foreign corporation by resident corporation were exempt from tax where 25% shareholding
- No deductibility of interest on debt used to acquire foreign corporation shares paying exempt dividends
- No taxation of capital gains on shares
- No CFC regime
- Limited bi-lateral tax treaty network

Outbound Investment Taxation in Canada: Current System

- 1972 Tax Reform created a hybrid system using both the exemption method and the tax credit method for dividends received from a foreign corporation by a resident corporation
  - Exemption depends on location of business earnings in a treaty jurisdiction
- Removed the restriction on interest deductibility on debt used to acquire shares paying exempt dividends
- Introduced a CFC regime (“FAPI” rules) for foreign passive income
- Signalled a major initiative to expand Canada’s bi-lateral tax treaty network
  - Canada now has tax treaties with approximately 90 other countries
- Over last 30+ years there has been a steady stream of changes to the system, including addition of many complex technical rules

Outbound Investment Taxation in Canada: Recent Policy Developments

- 2007 Budget: Proposed restriction on interest deductibility on debt used to acquire foreign corporation shares paying exempt dividends
- 2007 Budget: Introduced policy to use "exemption" to encourage negotiation of Tax Information Exchange Agreements
- December 2008 Report of the Advisory Panel on Canada's System of International Taxation
  - Canada's system "... is a good one that has served Canada well..."
  - Reform not needed, but improvements recommended
- 2009 Budget: Withdrawal of revised restriction on interest deductibility
- 2010 Budget: Withdrawal of Foreign Investment Entity proposals and substantial revision to Non-Resident Trust proposals (from 1999 Budget)

Outbound Investment Taxation in Canada: Policy Issues

- Continued utility of the hybrid system—i.e. tax credit method—in view of large extension of bi-lateral tax treaty network
- Interest deductibility on debt used to acquire shares of foreign corporations paying exempt dividends
- Treatment of capital gains on shares of foreign affiliates disposed of by resident corporation
- Base erosion relating to delineation of foreign business income from foreign passive income, particularly income from financial activities and IP