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## CORPORATE TAX PLANNING

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### FINANCING FOREIGN AFFILIATES: AN OVERVIEW OF THE CANADIAN PROPOSALS AND THE RULES IN SELECTED COUNTRIES

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This article discusses the policy aspects of the March 2007 federal budget proposals and the May 2007 revised proposals concerning the deductibility of interest expense relating to certain foreign investments. It also provides an overview of recent developments concerning the measurement and taxation of foreign income in a number of other countries.

Readers should note that this article was submitted for publication in mid-September 2007. Soon after, on September 21, 2007, the Canadian and us governments concluded their negotiations on the fifth protocol to the Canada-us income tax convention, which will amend the treaty provisions on source-country taxation of certain interest income. Then, on October 2, 2007, the Department of Finance released draft legislation to implement the new interest deductibility rules, followed by a notice of ways and means motion tabled in the House of Commons on November 13, 2007. These developments are noted but not discussed in detail in the article.

**KEYWORDS:** INTEREST DEDUCTIBILITY ■ FINANCING ■ FOREIGN AFFILIATES ■ DOUBLE DIP ■ ARBITRAGE ■ INTERNATIONAL TAXATION

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**CONTENTS**

Introduction	677
Recent Canadian Proposals Affecting Outbound Investment	677
The March 19, 2007 Budget Proposals	677
Observations on the Budget Proposals	680
Should the Proposals Have Been Expected?	681
The Revised Proposals	686
Observations on the Revised Proposals	688
Taxation of Outbound Investment in Other Jurisdictions	693
United States	693
United Kingdom	698
Australia	703
New Zealand	706
The Netherlands	708
Germany	709
Implications for Canada of Developments in Other Countries	710

**INTRODUCTION**

This has been a very eventful year for multinational enterprises, with Canada and other countries rethinking their approach to the taxation of foreign business investment. Canada is proposing to restrict interest deductibility on borrowings that can be traced to certain foreign investments by domestic companies, and several other countries are seriously considering changes to their legislation, including (but not limited to) the rules for deducting interest expense. The purpose of this article is to provide an overview of these developments and to consider how the Canadian approach, as reflected in the new interest deductibility proposals, compares with initiatives in other countries.

Because of space constraints, it is impossible to include in this article all the relevant developments worldwide. Here I will focus mainly on Canada and the original members of the Joint International Tax Shelter Information Centre—the United States, the United Kingdom, and Australia. I will also review some recent developments in New Zealand, the Netherlands, and Germany.

**RECENT CANADIAN PROPOSALS AFFECTING  
OUTBOUND INVESTMENT****THE MARCH 19, 2007 BUDGET PROPOSALS**

The March 19, 2007 federal budget announced a set of proposals that sent shock waves through the Canadian tax and business communities. The government proposed to deny the deduction of interest and certain other financing costs in respect of borrowed funds that could be traced to any investment in a foreign affiliate. Interest on money borrowed to invest in a foreign affiliate is currently deductible, even if dividends from the affiliate are paid from exempt surplus and exempt from tax in Canada. Exempt surplus dividends are generally paid out of the active business

earnings of a foreign affiliate located in a country with which Canada has entered into a tax treaty.<sup>1</sup>

In the government's view, as stated in the budget documents, the existing interest deductibility regime

creates a mismatch between income and expenses, and allows the interest deduction to shield other income (such as Canadian-source business income) from tax. As a result, the system may provide an incentive for taxpayers to locate debt in Canada while earning income in a foreign jurisdiction.<sup>2</sup>

The proposed rules were very far-reaching, applying to all debt and equity investments in foreign affiliates. Anti-avoidance rules were proposed that appeared to limit the opportunities to refinance Canadian assets and use the proceeds to fund foreign investments.

The disallowed interest expense would be pooled and carried forward, and could be deducted to the extent that the taxpayer recognized taxable income from the investment through foreign accrual property income (FAPI), interest on indebtedness owed by the foreign affiliate, or taxable capital gains from the disposition of shares or debt of the foreign affiliate. In practice, the interest would rarely be deductible, since the interest could not be deducted until the taxable income from the investment exceeded the non-taxable income, such as exempt surplus dividends and deductions for foreign accrual taxes.

The budget also included proposals to restrict the scope of paragraph 95(2)(a) of the Income Tax Act<sup>3</sup> ("the deeming rule") to circumstances in which the payer of interest and certain other amounts is a foreign affiliate in which the Canadian taxpayer has a qualifying interest (generally 10 percent ownership of the affiliate based on votes and value).<sup>4</sup> This would prevent the earning of exempt surplus on certain payments from related companies in which the Canadian taxpayer has either no, or an

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1 Taxable surplus dividends are generally paid out of a pool that includes the active business earnings of a foreign affiliate resident in or carrying on business in a country with which Canada does not have a tax treaty, and certain other amounts, such as one-half of capital gains on a disposition of shares of another foreign affiliate. Taxable surplus dividends may be subject to tax in Canada, depending on the level of foreign tax associated with the underlying earnings and the payment of the dividend.

2 Canada, Department of Finance, 2007 Budget, Budget Plan, March 19, 2007, 420.

3 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act. Paragraph 95(2)(a) is a longstanding rule that allows payments from one corporation to another that would otherwise be treated as income from property in the hands of the recipient (and included in FAPI) to be characterized as active business income if the amount paid is deductible in computing the active business income of the payer. If certain other requirements are met, the income will also be included in the exempt earnings of the recipient.

4 Paragraph 95(2)(m).

insignificant, ownership interest, and it would further tighten the rules designed to discourage so-called second-tier finance companies.<sup>5</sup>

Conversely, and perplexingly, the budget proposed to relax the rules that restrict exempt surplus treatment to the earnings of foreign affiliates resident in and carrying on business in countries with which Canada has concluded a tax treaty. If a country with which Canada has not concluded a tax treaty is willing to sign a tax information exchange agreement (TIEA) with Canada, a foreign affiliate resident in or carrying on business in that country will be able to earn exempt surplus, opening up the possibility of locating a financing affiliate or similar company in a pure tax haven such as the Cayman Islands. This proposal is difficult to reconcile with the criticism over the years, from the auditor general and others, of the ability of certain tax-privileged entities to earn exempt surplus in a low-tax treaty country such as Barbados.<sup>6</sup> Although the rationale for the proposal is not exactly clear, it may be motivated by a desire to gain information to help combat evasion of Canadian tax by individual investors. If it is enacted, it will add to the case for eliminating the category of taxable surplus altogether and moving to an exemption system for all dividends from foreign affiliates. In that event, the only remaining role for the taxable surplus system would be to impose a possible residual Canadian tax on the disposition of shares and partnership interests that are excluded property and on FAPI earned or realized by non-controlled foreign affiliates.<sup>7</sup>

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5 A second-tier finance company structure was the subject of the decision in *Univar Canada Ltd. v. The Queen*, 2005 DTC 1478 (TCC). Typically in this kind of structure, a Canadian subsidiary of a foreign parent company (“Cansub”) uses excess cash or borrowed funds to invest in the equity of a subsidiary (“Foreign Sub”) in a low-tax jurisdiction that has a tax treaty with Canada. Foreign Sub loans the funds to other foreign related companies—usually, subsidiaries of the foreign parent. The interest income of Foreign Sub is included in exempt surplus because of the deeming rule, which (subject to the budget change) allows interest paid by related foreign companies to be characterized as active business income of the recipient. The Canada Revenue Agency continues to attack such structures under section 245 (the general anti-avoidance rule) and paragraph 95(6)(b) of the Act, despite the Crown’s loss in *Univar*. Such structures are no longer tax-efficient in the form described because of the introduction of subsection 17(2) of the Act (applicable to taxation years after 1999). Generally, subsection 17(2) deems a Canadian parent company to have an income inclusion at a prescribed rate under subsection 17(1) if the loan can reasonably be considered to have been made because of a transfer of property by the Canadian parent company to the subsidiary. However, section 17 does not apply if this causal connection does not exist or, pursuant to the exception in paragraph 17(3)(a), if the Canadian company controls the borrower (subject to the anti-avoidance rule in subsection 17(14)). Therefore, the proposed tightening of paragraph 95(2)(a) would affect some structures.

6 See, for example, the auditor general’s 1992 and 2002 annual reports, *infra* note 10 and the accompanying text; Brian J. Arnold, “Unlinking Tax Treaties and the Foreign Affiliate Rules: A Modest Proposal” (2002) vol. 50, no. 2 *Canadian Tax Journal* 607-29; and Angelo Nikolakakis, “Exempt Surplus: What’s the Problem? A Reply to Brian Arnold” (2002) vol. 50, no. 4 *Canadian Tax Journal* 1354-77.

7 See Nick Pantaleo and J. Scott Wilkie, “Are the Surplus Rules Surplus?,” course materials presented at the International Fiscal Association (Canadian branch) 2007 Travelling Lectureship in February and March 2007. See also Robert Couzin, “Canada’s Fiscal Competitiveness,” in

The government announced that an advisory panel of experts (“the expert panel”) would be created to review the fairness of Canada’s system of international taxation and recommend additional measures to be included in the 2008 budget. It did not appear, however, that the expert panel would be asked to consider or comment on the appropriateness of the budget proposals.

### Observations on the Budget Proposals

The proposals as originally formulated would have resulted in the disallowance of several billion dollars of interest expense and, in so doing, would have increased significantly the after-tax cost of capital for Canadian companies seeking to expand outside Canada. Canadian businesses expressed strong concern that the proposed changes to the current rules would remove a key source of fiscal competitiveness for Canadian companies.<sup>8</sup>

Although positioned as an anti-tax-haven initiative, the proposals were in no way targeted to money borrowed to invest in tax haven countries. In fact, they would apply equally to foreign affiliates located in countries (such as the United States) with a tax rate equal to or exceeding Canada’s. Income earned in such countries would not generally be subject to tax in Canada even if Canada had a credit system rather than an exemption system for taxing most foreign income, since foreign tax credits would eliminate the need to pay tax on the income in Canada in any event.

The proposed amendments would have had a significant impact on the ability of Canadian companies to compete in the context of foreign acquisitions; for example, they would have disallowed the deduction of interest on money borrowed by a Canadian company to buy a foreign competitor, wherever based. I understand that the Department of Finance intended that the amendments would also apply to deny a portion of the interest expense on a borrowing used to buy a Canadian competitor if the Canadian target company had any foreign operations. As discussed below, a Canadian company seeking to expand its operations would be at a disadvantage relative to competing bidders based in other countries, which generally allow the deduction of interest in such circumstances.<sup>9</sup>

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*International Tax Seminar, May 9, 2005 Toronto Ontario, May 8, 2006 Montreal Quebec* (Kingston, ON: International Fiscal Association (Canadian branch), 2007), 2:1-18, at 2:15. While a detailed discussion of Canada’s exemption system is beyond the scope of this article, it is clearly time to reconsider the exempt surplus and taxable surplus distinction, particularly in light of the complexity entailed by recent proposals to restrict the creation of exempt surplus and force the recognition of taxable surplus by deeming distributions of surplus to occur on liquidations, redemptions, and other transactions (the suspended surplus proposals contained in the February 27, 2004 draft legislation, and the foreign paid-up capital proposals that are expected to be introduced on the basis of Department of Finance statements and comfort letters).

8 Letters of concern were sent to the minister of finance by the Canadian Chamber of Commerce and the Canadian Council of Chief Executives, among other business groups.

9 As will be discussed below, some countries impose limitations on the deductibility of interest in such cases; a blanket denial is not the norm. Australia, for example, changed its rules in 2001 to eliminate that feature of its tax system.

The proposals set out only very limited grandfathering and transitional rules. It was estimated that these changes would raise \$10 million in the government's 2008 fiscal year and \$40 million in 2009, suggesting that the measures were almost inconsequential. It was clear from the reaction of Canadian companies and their advisers that the estimates should have been much higher than those presented.

### Should the Proposals Have Been Expected?

The most fundamental change to the taxation of foreign investment since the tax reform of 1972 was introduced with no consultation and no study—at least, no current study that has been publicly released. It is true (as noted in the budget documents) that the deductibility of interest expense in such circumstances was raised as an issue by the auditor general in 1992 and 2002,<sup>10</sup> and was addressed in a study leading to similar proposals by the Technical Committee on Business Taxation (“the Mintz committee”) in 1998.<sup>11</sup> Given this background, perhaps the government believed that the proposals would not be a surprise and did not require advance public consultation.

In 1992, the auditor general's report raised a number of concerns about the tax rules applicable to foreign affiliates, including interest deductibility, the ability to earn exempt surplus in low-tax treaty countries, and the lack of a definition of active business income for the purpose of determining FAPI. The report famously declared, “In our view, it is reasonable to conclude that hundreds of millions of dollars in tax revenue have already been lost and will continue to be at risk.”<sup>12</sup>

However, the Department of Finance has—until now—always been a staunch defender of interest deductibility in this context.<sup>13</sup> In reply to the auditor general's

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10 Canada, *Report of the Auditor General of Canada to the House of Commons 1992* (Ottawa: Supply and Services, 1992); and *Report of the Auditor General to the House of Commons 2002* (Ottawa: Office of the Auditor General of Canada, December 2002).

11 Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998), chapter 6. The committee actually delivered its report to the minister in December 1997.

12 *Report of the Auditor General 1992*, supra note 10, chapter 2, at paragraph 2.58. A full discussion of the report and other historical events is beyond the scope of this article; here, I will only review the highlights. Other authors have thoroughly reviewed the 1992 report and the principles underlying the foreign affiliate system. See, for example, Allan R. Lanthier, “Policy or Abuse? The Auditor General's Report” (1993) vol. 41, no. 4 *Canadian Tax Journal* 613-38; and J. Scott Wilkie, Robert Raizenne, Heather I. Kerr, and Angelo Nikolakakis, “The Foreign Affiliate System in View and Review,” in *Tax Planning for Canada-US and International Transactions*, 1993 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1994), 2:1-72.

13 It is of interest to note a suggestion that was made at the Canadian Tax Foundation's 2001 International Tax Seminar, Learning the Ropes for Going Global, held in Calgary on February 8, 2001. A slide presentation by Wallace Conway, from the Department of Finance, and J. Scott Wilkie raised the possibility of limiting the potential for Canadian tax base erosion by allocating interest expense against foreign income for purposes of computing the deduction available under section 113 in respect of dividends received from a foreign affiliate. Wallace Conway has stated that the views presented did not represent the policy of the department at that time.

comments, it strongly defended the foreign affiliate system and, in particular, the interest deductibility rules. After denying the assertion of substantial revenue loss, the department acknowledged that the existing system favoured foreign investment over domestic investment, but stated that this was a conscious policy decision to preserve the ability of Canadian companies to compete internationally. The following extract from the department's response neatly summarizes the competing tax policy objectives at stake:

Canada has had to struggle with two conflicting goals. The goal of economic efficiency argues for a system which preserves capital export neutrality. This is achieved when foreign source income is subject to the same effective tax rate as domestic source income, leaving taxpayers indifferent, at least from a tax perspective as to whether they invest inside or outside of Canada. Conversely, the goal of competitiveness argues for capital import neutrality. This requires that a Canadian investing in a foreign country be subject to tax at the same effective rate as a resident of that country. From a tax perspective, this ensures a level playing field between Canadian and non-Canadian businesses operating internationally.

In a world where countries maintain different tax systems, it is impossible to achieve both capital import and capital export neutrality. Accordingly, Canada has opted for a system that ensures capital export neutrality with respect to certain types of [passive] income and capital import neutrality with respect to other types of [foreign active business] income.<sup>14</sup>

The department had the following specific comments on interest deductibility:

[I]nternational norms are largely responsible for the policy not to specifically restrict the deductibility of interest expense on money borrowed to invest in a foreign affiliate. Ultimately, Canada finds itself in the position of having to balance tax theory with the economic realities of the international marketplace. . . . [T]he government's policy has generally been to favour competitiveness concerns over those of revenue generation.<sup>15</sup>

The deputy minister of finance at the time, David Dodge, along with other Finance officials, subsequently defended the system in hearings called by the House of Commons Public Accounts Committee (PAC):

[T]he existing system as legislated by Parliament in 1972 and then reviewed again at the time of tax reform in 1987 strikes a reasonable balance between a number of complex, and in some cases competing objectives. . . . [O]ur system for taxing foreign-source income is well in line with that adopted by other OECD countries.<sup>16</sup>

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14 Department of Finance response, *Report of the Auditor General 1992*, supra note 10, at 51-52.

15 *Ibid.*, at 52.

16 Canada, *Minutes of Proceedings and Evidence of the Standing Committee on Public Accounts*, 34th Parl., 3d sess., 1991-92-93, issue no. 37, December 8, 1992.

The deputy minister also defended the ability of Canadian corporations to decrease foreign taxes by financing foreign affiliates through intermediaries in Barbados or other low-tax jurisdictions:

[T]here is a very important general international issue here. Because we all have different tax systems and different tax laws around the world, there is an opportunity for the taxpayer sometimes to structure his activities in such a way that no tax is paid on income arising from activity in the country abroad where the activity occurs.

That is a problem with the tax laws of the country abroad. We have similar problems that we try to deal with here to ensure that the appropriate tax is paid to Canada by affiliates of foreign companies operating in Canada, and that's our problem. But if there were no mechanisms whatsoever to flow this [income] around, then every foreign company that wanted to operate in France, for example, would be subject to exactly the same regime. They'd pay some French taxes and they would not pay the tax when it comes home.

But there are opportunities to flow income differently, which in fact means that the French government gets less tax revenue on the activity in France, but it does not mean that the Canadian government is in fact losing revenue on that activity. Because . . . structured differently [as an equity investment], we would not get any revenue anyway.

So the real question comes down to this issue. Do we want, let's say Bombardier to be in a position where it cannot avail itself of tax planning opportunities that are available to every other foreign company when operating abroad? . . . For many years, the answer to that question has been no. Our policy has been to work through the OECD, and through other ways, to try to get some better coordination of countries in setting corporate income taxes. But that is a very difficult and not very productive exercise.<sup>17</sup>

The PAC's 1993 report<sup>18</sup> recommended a number of changes to the foreign affiliate rules, most of which were subsequently enacted. The amendments included the restriction of exempt surplus to treaty (rather than listed) countries, a legislated definition of active business income, and a prohibition against reducing FAPI by deducting foreign active business losses. However, on the subject of interest deductibility, while the PAC expressed concern that some taxpayers might successfully use the rules to obtain several interest deductions for the same transaction,<sup>19</sup> it appeared to appreciate the complexity of the issue and recommended caution, suggesting only that the Department of Finance conduct an in-depth study of the problem before making changes to the Act.

In 1996, the department appointed the Mintz committee to undertake an overall study of business taxation, including international taxation, subject to the constraint

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17 Canada, *Minutes of Proceedings and Evidence of the Standing Committee on Public Accounts*, 34th Parl., 3d sess., 1991-92-93, issue no. 38, December 10, 1992.

18 Canada, *Minutes of Proceedings and Evidence of the Standing Committee on Public Accounts*, Twelfth Report to the House, 34th Parl., 3d sess., 1991-92-93, issue no. 48, April 23, 1993.

19 *Ibid.*, at 48:8.

that any measures recommended by the committee would, taken together, be revenue neutral. The committee's report recommended significant tax-rate reductions along with a number of base-broadening measures, including, in the international area, restriction of the deductibility of interest traceable to investments in foreign affiliates and tightening of certain aspects of the exempt surplus rules.<sup>20</sup> These recommendations are similar to the 2007 budget proposals. However, the report also recommended significant grandfathering, a de minimis threshold, and a tax basis adjustment for interest expense—none of which are included in the budget proposals. In addition, the committee considered the tracing method to be superior to other methods of interest restriction, such as various methods to prorate interest expense based on Canadian and worldwide assets and liabilities.

The Mintz committee expressed concern that multinationals, motivated in part by high Canadian tax rates, were shifting debt financing into Canada, thereby eroding the tax base. It also expressed the view that the tax system of the country in which the operations are carried on should bear the preponderance of the cost of financing the activities.

While a number of the Mintz committee's recommendations were accepted over time, the interest deductibility proposal did not receive support from the Department of Finance and was not pursued by the government.

The 2002 auditor general's report followed up on the concerns raised in the 1992 report and concluded that insufficient action had been taken in response to those concerns. It specifically highlighted allowing foreign-owned Canadian corporations to deduct interest on borrowed funds related to investments in foreign affiliates and allowing tax-privileged entities in treaty countries (like Barbados international business corporations) to earn exempt surplus.<sup>21</sup>

In replying to the auditor general's comments, the Department of Finance began by stating that a number of measures had been enacted in response to the 1992 report. In fact, the department has continually introduced amendments to strengthen the integrity of the system over the years despite holding the line on interest deductibility. For the most part, the measures recommended by the PAC in 1993 were implemented, as well as other restrictive changes to the FAPI rules. In addition, the introduction of subsection 17(2) effectively limited the classic second-tier finance

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20 *Supra* note 11. The proposals included an increase in the threshold for foreign affiliate status, restriction of the ability of certain tax-privileged entities resident in treaty countries to earn exempt surplus, and a tightening of the deeming rule in a manner similar to the current budget proposal. In general, though, the report indicated that the existing regime was fundamentally sound and should be maintained. On the inbound side, the report recommended measures to tighten the thin capitalization rules, including a revised 2:1 debt-to-equity ratio. Other recommended thin capitalization measures were proposed in the federal budget of 2000 and then withdrawn. For a detailed discussion of the committee proposals, see Nick Pantaleo and J. Scott Wilkie, "Taxing Foreign Business Income," in *Business Tax Reform*, 1998 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1998), 8:1-44.

21 Canada, *Report of the Auditor General 2002*, *supra* note 10, chapter 11, at 17-29.

company structure by restricting the tax-effectiveness of loans made by foreign affiliates of Canadian subsidiaries to related non-affiliates. The department also introduced extensive foreign reporting requirements and stricter transfer-pricing, non-resident trust, and foreign investment entity rules.

With respect to the issue of foreign companies leveraging their Canadian subsidiaries, the department's reply to the auditor general expressed the view that the motivation for this planning would decrease in the future as Canadian tax rates become significantly lower than US tax rates.

The department concluded by stating that it would continue to consider improvements to the system, "recognizing that the system serves a number of policy goals, including supporting the international competitiveness of Canadian businesses."<sup>22</sup>

While it is arguable that additional tightening of the system should be considered (such as the proposed 2007 budget measure to restrict further access to the deeming rule, as described above and as recommended by the Mintz committee), it is not self-evident that reverting to the Mintz committee proposals 10 years later (but without the level of transitional relief and other safeguards recommended by the committee) was the best way to address any continuing deficiencies in our system for measuring and taxing foreign income. Despite the history of review and reform of the foreign affiliate rules, taxpayers did have reason to be surprised by the budget proposals.

Whether or not the Mintz committee's approach was the right solution in 1998, there have been significant developments since then, and the impact of those developments should be considered. Corporate tax rates in Canada have been reduced, as the committee recommended, but tax rates in many countries, already lower than Canadian rates, have declined even faster, and the total tax burden on Canadian companies remains relatively high.<sup>23</sup> There is naturally an incentive to locate debt in relatively high-tax jurisdictions like Canada. Canada's competitors have also been studying and reforming their own rules governing outbound taxation with a view to improving their competitive position and protecting their own domestic tax bases. Foreign takeovers of Canadian companies appear to be occurring at an alarming rate, and the potential acquirors are resident in countries that did not appear on the

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22 Department of Finance response, *ibid.*, at 32.

23 See Duanjie Chen, Jack Mintz, and Andrey Tarasov, *Federal and Provincial Tax Reforms: Let's Get Back on Track*, C.D. Howe Institute Backgrounder no. 102 (Toronto: C.D. Howe Institute, July 2007); Jack M. Mintz, *The 2006 Tax Competitiveness Report: Proposals for Pro-Growth Tax Reform*, C.D. Howe Institute Commentary no. 239 (Toronto: C.D. Howe Institute, September 2006); and KPMG's *Corporate and Indirect Tax Rate Survey 2007* (online: <http://www.kpmg.ca/en/services/tax/>). The KPMG survey states that the average tax rate at the beginning of 2007 was 24.2 percent in the European Union, 27.8 percent in the Organisation for Economic Co-operation and Development, and 36.1 percent in Canada. However, the United States and Japan continue to have higher rates, at 40 percent and 40.7 percent respectively. Canada's finance minister, Jim Flaherty, released an economic statement on October 30, 2007 (after this article was written) that proposed significant reductions in the federal corporate income tax rate over the next five years (steeper than the phased reductions already planned for 2008-2011).

Canadian radar screen 10 years ago (Brazil, Russia, and India, for example). The debate rages about whether the “hollowing out” of corporate Canada is real.<sup>24</sup> In light of all these developments, and an apparent lack of consensus on the economic data (at least to someone who is not an economist), this seems to be the ideal time for the government to undertake a comprehensive study of the issues surrounding foreign income taxation and competitiveness.

While it is not unreasonable to suggest that additional restrictions on the deductibility of interest expense should be considered, open consultation on such a complicated issue would have been preferred. A thorough study would consider how such restrictions would interact with other tax measures (including inbound investment rules such as thin capitalization and withholding taxes), how a stricter interest deductibility regime would compare with other tax systems, and the likely economic impact on the competitiveness of Canadian companies. Is it still true, as Finance officials thought in 1992, that international norms favour a less restrictive approach to interest deductibility? The 2007 budget approach of announcing an important departure from longstanding government policy without prior study or consultation is very different from the approach taken by previous governments in Ottawa and by other countries that have been considering the same issues (as discussed later in this article).

## THE REVISED PROPOSALS

The government refused to defer the proposals and undertake a study of interest deductibility as part of a comprehensive review. Instead, after being bombarded with criticism, Finance Minister Jim Flaherty responded by significantly scaling back the proposals and adding more transitional relief. On May 14, 2007, in a speech to members of the Toronto Board of Trade, Mr. Flaherty announced the introduction of a more narrowly focused set of proposals that would restrict the deductibility of interest to situations where a Canadian taxpayer obtains a so-called double-dip—an interest deduction in Canada and a second deduction in the foreign jurisdiction in respect of the same borrowed funds. According to Mr. Flaherty, the revised proposals are part of a crackdown on tax havens that will prevent the use of double-dips and other tax-avoidance schemes. He stated that the tax advantage provided by such structures would be eliminated after a five-year transition period.

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24 While Department of Finance officials are apparently skeptical that hollowing out is occurring, or is a problem that needs to be addressed (see “Investment Opportunities for Canada: Beyond the Hollowing Out Debate,” Deputy Minister Briefing, May 3, 2007, Department of Finance, released under the Access to Information Act), Finance Minister Jim Flaherty and then Industry Minister Maxime Bernier recently announced the creation and membership of a Competition Policy Review Panel (Industry Canada, “Canada’s New Government Creates Competition Policy Review,” *News Release*, July 12, 2007). The panel’s core mandate is to review the Competition Act and the Investment Canada Act. It will also examine the competition and investment regimes of other countries to assess reciprocity between their rules and Canada’s. The panel will report to the industry minister by June 30, 2008.

The minister's announcement provided very little detail about the revised proposals, but a redrafted notice of ways and means motion and related material were simultaneously released by the Department of Finance.<sup>25</sup> The department's Backgrounder states that interest expense and other borrowing costs of a Canadian taxpayer that are payable after 2011 and that relate to an investment in a foreign affiliate will be denied to the extent that they can be traced to a double-dip. It will be irrelevant whether the financing was entered into before or after the budget date, or whether the funds were borrowed from an arm's-length or non-arm's-length lender.

A single interest deduction will continue to be allowed in respect of funds borrowed by a Canadian taxpayer for the purpose of acquiring a foreign affiliate or making an equity investment in or a loan to a foreign affiliate.

The minister provided two examples of financing structures that are cause for concern. In the first example, a Canadian company borrows to invest in the shares of an affiliate in a tax haven and deducts the interest in respect of the loan (the first "dip"). The affiliate in turn makes a loan to another affiliate, which deducts the interest against its income from carrying on business in a third country (the second "dip"). A similar result can be obtained by using a "tower" structure—the minister's second example. In a tower structure, a US partnership with Canadian corporate partners borrows in order to finance an investment in the United States. Since the partnership can be treated as a US corporation for US tax purposes, the interest expense on the debt is deductible in both Canada and the United States. Both structures as depicted rely on the deeming rule to recharacterize interest income as active business income for Canadian tax purposes. Mr. Flaherty stated that such structures are "inherently unfair," and "hard-working Canadians" should not be asked to subsidize them.<sup>26</sup>

Note that the proposals do not affect double-dips into Canada (where the interest paid by the Canadian borrower is also deductible to the foreign parent or is not taxable—at least not immediately), but only outbound double-dips. Thus, the most significant impact is on Canadian multinationals and not Canadian subsidiaries, even if those subsidiaries have borrowed to make foreign investments. Though outbound double-dips under Canadian subsidiaries are possible, such financing structures are not frequently used owing to the existence of subsection 17(2) and other restrictions.

The Backgrounder issued on May 14 stated that a "Technical Roundtable of tax experts" would be created to provide input to the Department of Finance in the

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25 See Canada, Department of Finance, "Canada's New Government Improves Tax Fairness with Anti-Tax-Haven Initiative," *News Release* 2007-041, May 14, 2007, and accompanying Backgrounder; and "Notes for Remarks by the Honourable Jim Flaherty, Minister of Finance, to the Toronto Board of Trade."

26 "Notes for Remarks," supra note 25. The first of the two structures was discussed extensively during the PAC hearings in 1992 and defended by Finance officials at those hearings (supra notes 16 and 17 and the accompanying text). The tower structure was not in use by Canadian companies at that time.

drafting of legislation to implement the proposals. This group would operate independently of the expert panel announced in the budget proposals. It would not be asked for its views on the general policy or allowed to recommend alternatives to the proposals. The technical experts began meeting with Finance officials in June to review draft legislation.

As to the expert panel, at the time of writing it had not yet been constituted.<sup>27</sup> At a meeting of the International Fiscal Association (IFA) a few days after the May 14 announcement,<sup>28</sup> the finance minister affirmed that the expert panel will continue to have a restricted mandate. Specifically, it will be asked to consider such issues as debt loading by foreign parents of Canadian subsidiaries and the adequacy of Canadian thin capitalization rules.<sup>29</sup> It will not be allowed to consider the need for the anti-double-dip proposals.

### Observations on the Revised Proposals

The revised proposals contain many technical flaws. As currently formulated,<sup>30</sup> they would apply to many intercompany arrangements that do not constitute a double-dip and do not involve a tax haven. However, space does not permit a discussion of those issues, and the following comments relate only to the general policy behind the proposals. If the proposals do proceed, one hopes that these technical deficiencies will be addressed.

The lack of proper consultation and study of the policy underlying the proposals, and their relation to other aspects of the tax system, remains a serious concern. For example, commingling the FAPI rules with interest deductibility in this way may raise interpretive questions regarding the new purpose of these provisions. Although the revised proposals are ostensibly aimed at restricting interest deductibility, another interpretation is that they are intended to narrow the longstanding capital export

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27 Notably, the membership of the Competition Policy Review Panel had already been decided when the creation of that panel was announced on July 12 (supra note 24). The membership of the expert panel has not yet been made public, even though the panel was to produce an interim report by the end of 2007 and a final report by the end of 2008. Insofar as one of the mandates of the expert panel will be to identify additional measures to improve the fairness and competitiveness of Canada's international tax system, one might reasonably question how the minister intends to address and coordinate the recommendations from both the Competition Policy Review Panel and the expert panel on international tax, given the overlapping policy implications with respect to the competitiveness of Canadian businesses.

28 The annual meeting of the IFA's Canadian and US branches, held in Toronto on May 18, 2007.

29 Proposals to amend the thin capitalization rules were introduced in the 2000 federal budget, but in response to criticism, the government chose not to enact them. While it was stated that the proposals would be deferred for study, they have never resurfaced.

30 I am referring here to the implementation mechanism described in the Backgrounder issued on May 14, 2007. At the time I wrote this article, draft legislation had not yet been released. It was subsequently released on October 2, 2007; a notice of ways and means motion was introduced in the House of Commons on November 13, 2007.

incentive provision in the Act, and thus to operate as a backdoor FAPI rule. The risk with this commingled approach is that it becomes increasingly difficult to discern the object, spirit, and purpose of these and related provisions. Which is the predominant purpose of the proposals—the interest deductibility restriction or the narrowing of the capital export incentive? The answer may affect the type of tax planning that a taxpayer may undertake, as well as a court's view of it.

Notwithstanding any potential interpretive challenges arising from these proposals, it must be recognized that the treatment that the minister now characterizes as “inherently unfair” was deliberate Canadian tax policy for 35 years. At a minimum, the government ought to ensure that it considers the proposed changes in this area in the broader context.

Moreover, from a process perspective, it is unclear why the minister thinks it necessary to enact legislation on the interest deductibility proposals as soon as possible, given the announced transition period. It would make more sense for the minister and his officials to incorporate their views in any terms of reference that they intend to give the expert panel, and to ask the panel to specifically consider certain proposals.

The Backgrounder does not indicate whether the TIEA proposals as described in the budget documents will be affected by the scaling back of the interest deductibility proposals. The original budget documents stated that, with the interest deductibility proposal, it is “no longer necessary to link the exemption to the presence of a tax treaty.”<sup>31</sup> Perhaps the government is of the view that, by targeting the deeming rule, the revised proposals will be sufficient to stem abuse of the ability to earn exempt surplus on passive income earned in a tax haven country. However, if no Canadian borrowing can be traced to the income received by the affiliate in the tax haven country, the interest deductibility proposals will have no deterrent effect.

While the government should be applauded for narrowing the original proposals, the revised proposals are still significant. The two double-dip structures described in the Backgrounder<sup>32</sup> are commonly used by Canadian multinationals expanding abroad. When the new rules come into effect in 2012, they will have a significant impact on any company that has borrowed funds that can be traced to such a structure.

Whether there is anything wrong with international tax arbitrage and, if so, whether there is anything that governments can realistically do about it, are issues

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31 Supra note 2, at 243.

32 According to the minister, for now at least, the new interest deductibility rule will only address these two structures and not other forms of double-dips (such as, presumably, hybrid instruments or other hybrid entity structures that do not rely on the deeming rule): “It will be focused on those two. . . . There are other issues that we could focus on. . . . There are other ways, I’m sure. Lots of people get paid lots of money to develop tax avoidance schemes, and that’s to be expected. This will be a continuing effort by the Department of Finance.” (Finance Minister Jim Flaherty, quoted in an article by Heather Scoffield, “Flaherty Says Double-Dipping Not Doomed,” *Globe and Mail*, May 18, 2007.) It is difficult to understand the policy basis for distinguishing between forms of double-dips in restricting the deductibility of interest expense.

of great importance and debate among international tax academics and commentators.<sup>33</sup> It is certainly worth debating why, on a policy basis, Canada should deny a tax deduction to a Canadian taxpayer solely because a deduction is allowed in a foreign country in accordance with that country's own tax rules (and not deny the Canadian deduction if the investment is financed through equity and no foreign tax reduction is obtained). The foreign country deduction has no impact on Canadian tax revenues, and it is arguably of benefit to Canadian shareholders and the Canadian economy, since it increases the amount of after-tax income available to be returned to Canada.

David Dodge defended double-dips in his testimony before the PAC in 1992:

Provided that the basic structure of the transaction is indeed a structure that fits within our law, even though it minimizes the taxes paid abroad—not the taxes paid here but the taxes paid abroad—then it would not make sense to impose on our companies the necessity to pay more taxes abroad than their competitors.<sup>34</sup>

It is open to countries to address double non-taxation through bilateral agreements if they choose to do so.<sup>35</sup> Some commentators believe that bilateral negotia-

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33 See, for example, Ralph Cunningham, Claire Jones, and Tom Young, "Keeping Clear of the Rules" (2006) vol. 17, no. 10 *International Tax Review* 10-15; Tim Edgar, "Corporate Income Tax Coordination as a Response to International Tax Competition and International Tax Arbitrage" (2003) vol. 51, no. 3 *Canadian Tax Journal* 1079-1158; and Gregory May, "Getting Realistic About International Tax Arbitrage" (2007) vol. 85, no. 3 *Taxes: The Tax Magazine* 37-48, and the numerous articles and papers cited therein.

34 *Supra* note 17, at 38:18. Given that Canadian corporate tax rates remain relatively high by international standards (see *supra* note 23 and the accompanying text), it stands to reason that the benefit of the interest expense deduction will be greater in Canada than in the foreign country where the operations are carried on. Therefore, the view that Canadian double-dip structures reduce foreign taxes remains sound today. Moreover, many smaller Canadian-based companies may be unable to borrow abroad on the same terms and conditions available for a borrowing in Canada to finance their foreign operations. If Canadian corporate tax rates were to become low by international standards, the argument that using double-dip structures to finance foreign operations might reduce Canadian taxes would be stronger, although there would also be less incentive to use a double-dip structure for foreign operations. Irrespective of whether the benefit of the interest deduction is greater in Canada or abroad, it is still important to consider the relative competitiveness implications of any tax rules that would deny or limit interest deductibility.

35 For example, the fifth protocol to the Canada-US income tax convention, signed on September 21, 2007 (but not yet ratified), contains a new provision (paragraph 7 of article IV) that will affect certain double-dip structures between Canada and the United States. For a discussion of the treaty approach to double non-taxation, see International Fiscal Association, *Double Non-Taxation*, Cahiers de droit fiscal international, vol. 89a (Amerfoort, the Netherlands: Sdu Fiscale & Financiële Uitgevers, 2004). As discussed in the Canadian report, written by Dave Beaulne and Angelo Nikolakakis (*ibid.*, 235-53), Canadian courts interpreting Canada's tax treaties have not been very concerned about double non-taxation. This trend continues with the recent decision of the Federal Court of Appeal in *The Queen v. MIL (Investments) SA*, 2007 FCA 236. In that decision, the court determined that the continuation of MIL from the Cayman Islands to Luxembourg to gain the benefit of the Canada-Luxembourg tax treaty was

tions are a better alternative than unilateral action (such as the anti-double-dip proposals).<sup>36</sup>

The opportunities to claim multiple deductions for interest expense are linked to differences in how certain countries characterize particular legal entities and contractual arrangements for purposes of their domestic commercial and tax laws. While anti-double-dip or anti-arbitrage rules do exist in some other countries, as discussed below, such rules are not yet pervasive and tend not to be broadly applicable. As a result, many, if not most, foreign-based multinationals use double-dip structures to invest in Canada and other countries. For example, in my experience, it would be rare to find a large US multinational that has not financed a significant investment in its Canadian subsidiary through some form of double-dip structure.

As the Department of Finance noted in its reply to the auditor general in 1992, it might be considered that outbound double-dips violate the principle of capital export neutrality from the perspective of the investor's home country, and that this non-neutrality encourages foreign investment over domestic investment. However, the principle of capital import neutrality is violated if investors from countries other than Canada can reduce the tax burden on income from a particular source country.

This illustrates neatly why it is impossible to achieve all the various neutralities in the real world. On a theoretical basis, multiple deductions of interest expense likely serve no redeeming purpose. They can result in a negative cost of capital and extremely low marginal effective tax rates, thereby distorting economic decision making (which should be based primarily on non-tax considerations) and resulting in economic inefficiency. However, while the theoretical purity of double-dip transactions may be questioned, the policy issue in Canada is whether Canadian companies should be allowed to compete on an equal footing in a world where such tax planning is pervasive, particularly at a time when there are concerns about a hollowing out of large Canadian-based multinationals. Why should a Canadian company be unable to use a double-dip structure to finance a foreign acquisition when a foreign-based multinational will most likely be able to do so in financing a Canadian (or other foreign) acquisition? Since many countries permit double-dips in one form or another, it is arguably imprudent for Canada to take the lead in denying access to the same advantage for Canadian-based companies.

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not abusive tax avoidance for purposes of the general anti-avoidance rule (GAAR). It was suggested to the court that it ought not to interpret the treaty to permit double non-taxation. However, the court stated that the GAAR is concerned with the incidence of Canadian tax, not the forgoing of tax revenues by Luxembourg. The Luxembourg tax treatment of the transaction was considered irrelevant. As noted in the Tax Court decision (2006 TCC 460), there was no indication in the treaty that the parties had sought to limit the benefits of the treaty in cases of double non-taxation, although it had been open to them to do so. Presumably, if the court had found evidence in the words of the treaty that the parties intended to prevent double non-taxation, the result might have been different.

36 See comments by Tony Attwood, formerly of the UK Inland Revenue and Joint International Tax Shelter Information Centre, suggesting that international tax arbitrage may best be addressed through treaty negotiations: Cunningham et al., *supra* note 33, at 12 and 13.

Of course, this point of view assumes that outbound investment by Canadian companies is good for Canada, complementing and contributing to domestic investment, income growth, and job creation, and thus justifying incentives to build Canadian-based global leaders.<sup>37</sup> David Dodge's comments from 1992 remain relevant today:

[A] lot of the jobs we have at Nortel arise because of offshore activities. It may be that the manufacture of a particular unit takes place offshore, but the design and a lot of the sophisticated, high value-added work is taking place here. . . .

So it is absolutely critical in this modern world . . . that Canadian-based companies, companies with their headquarters in Canada, companies with their R and D operations in Canada . . . stay here and are allowed to compete around the world on an equal footing with companies with headquarters elsewhere in the world.<sup>38</sup>

The finance minister has denied that restricting the Canadian deduction of interest expense for foreign investments will put Canadian companies at a competitive disadvantage. In his May 14, 2007 speech to the Toronto Board of Trade, he maintained that the Canadian system will continue to compare favourably with the systems of other countries considered as a whole, particularly in view of the planned reductions in Canada's corporate tax rate.

International taxation is complex and comparisons with other countries can be difficult. Even when one understands a tax system as a whole, it is difficult to make judgments about its international competitiveness. Unfortunately, the 2007 budget documents and the May 14 Backgrounder do not provide a thorough analysis of other tax systems in support of the view that the Canadian system will remain competitive. Instead, they refer to the tax systems of five major economies with substantial outbound foreign direct investment (the United States, Germany, Japan, France, and the United Kingdom), and highlight the features of each system that could be considered, on their face, to be particularly restrictive, such as the existence of a foreign tax credit rather than an exemption system, dual consolidated loss rules, or other anti-arbitrage rules.

It is necessary to examine how these and similar rules practically limit the planning opportunities available to multinationals located in foreign jurisdictions, and whether they significantly limit the ability of those companies to compete relative to Canadian multinationals. An additional open question is how similar the economies of competing jurisdictions are to Canada's and whether there are significant differences that would make their systems poor models for Canada. These are not easy questions.

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37 This was the view of the Mintz committee, *supra* note 11, at 6.2: "[I]nvestment outbound from Canada can contribute to economic growth and job creation at home. For example, Canadian-owned multinationals often rely on domestic sources of supply, and Canadian managerial talent and operational efficiency, to develop export markets for Canadian products and services."

38 *Supra* note 17, at 38:14-15.

## TAXATION OF OUTBOUND INVESTMENT IN OTHER JURISDICTIONS

### UNITED STATES

The United States has an extremely complex system for taxing outbound investment. A recent article by my colleagues Dennis Metzler and Shawn Porter describes that system in some detail and suggests that the Canadian proposals may tilt the competitive balance in favour of the United States.<sup>39</sup> Space restrictions do not permit a thorough analysis here. However, the key attributes of the US system will be discussed.

The United States has a deferral and credit system rather than a deferral and (primarily) exemption or territorial system like Canada's. As in Canada, the taxation of active business income earned by controlled foreign corporations (CFCs) is deferred until it is repatriated to the US parent company in the form of dividends (actual or deemed) or realized on the disposition of the CFC shares. At that time, the parent can claim a foreign tax credit in respect of taxes paid by the CFC.<sup>40</sup> A limiting provision requires the credit to be computed on the basis of the taxable income from foreign sources as a percentage of worldwide taxable income. The calculation can be extremely complex. Until recently, it involved the division of foreign-source income into as many as nine separate "baskets"; however, the American Jobs Creation Act of 2004<sup>41</sup> has reduced the number of baskets to two (passive and general category). This amendment should allow US companies to better average high- and low-taxed foreign income and reduce their overall effective tax rates.

Interest expense is generally deductible in the United States on a current basis even though the active business income earned by CFCs is not included in income until repatriated. The United States has no rules similar to the original budget proposals. However, a portion of the parent's interest expense must be allocated to foreign income for purposes of the foreign tax credit calculation, generally on the basis of the relative tax values of foreign and domestic assets. The allocation of interest expense of the US parent company against foreign-source income can make it difficult to repatriate funds to the United States without incurring an additional US tax cost. Repatriation should become easier in many cases when a one-time election, introduced by the 2004 Jobs Act, comes into effect in taxable years beginning after 2008. The election will require interest expense of a US corporation to be apportioned to foreign-source income only if the US corporation is overleveraged relative to the worldwide group.

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39 Dennis M. Metzler and Shawn D. Porter, "Interest Deductibility in Canada on Money Borrowed To Invest in Foreign Affiliates—Maintaining Competitiveness with the United States Regime" (2007) vol. 14, no. 1 *International Tax Planning* 964.

40 Section 902 of the Internal Revenue Code of 1986, as amended (herein referred to as "IRC").

41 American Jobs Creation Act of 2004, Pub. L. no. 108-357, enacted on October 22, 2004 (herein referred to as "the 2004 Jobs Act").

Despite the complexity of the US tax rules, particularly as they relate to the foreign tax credit calculation, the tax-planning opportunities available to US multinationals are extensive. As explained by Metzler and Porter, the “check-the-box” rules allow US multinationals significant latitude to reduce tax on foreign income and defer the repatriation of low-taxed foreign-source income to the United States. This planning has become even easier with the recent enactment of a three-year suspension of the rule that would otherwise include certain interaffiliate payments in subpart F income (similar to FAPI). In this respect, the US rules have been brought closer to Canada’s own deeming rule, which does not restrict interaffiliate payments to affiliates resident in the same country. Other planning opportunities allow US companies to create low-taxed foreign-source income that can facilitate the repatriation of high-taxed foreign-source income, and to accelerate or manage their foreign tax credits.

In practice, a US multinational can take advantage of these opportunities to manage its effective tax rate. As noted by Metzler and Porter, the ability to manage the effective tax rate is dependent on the corporation’s facts and circumstances and the level of planning undertaken. The President’s Advisory Panel on Federal Tax Reform noted the importance of the circumstances of each taxpayer to the tax results that can be achieved under the current system, and concluded that tax planning “may effectively allow corporations to obtain territorial tax treatment for active business income through ‘self-help,’ and some corporations may be able to receive tax treatment that is even more favorable.”<sup>42</sup> A task force of the American Bar Association similarly concluded, “[f]or U.S. multinational taxpayers, despite their complexity, the current U.S. rules can be the best of all worlds.”<sup>43</sup>

The President’s Advisory Panel recommended that the United States adopt a territorial (exemption) system of taxation for foreign earnings in order to eliminate certain distortions caused by the current deferral and credit system, particularly the disincentive to repatriate funds to the United States. The territorial system would include restrictions on the deductibility of interest expense; however, these restrictions would apply only to the extent that the US operations of a US multinational were more heavily leveraged than the multinational’s foreign operations. Interest expense would be disallowed to the extent that the ratio of foreign debt to foreign assets was lower than the ratio of worldwide debts to assets. Some portion of general and administrative expenses would also be allocated to foreign income and disallowed. The debate continues to rage in the United States on whether US multinationals

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42 President’s Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals To Fix America’s Tax System* (Washington, DC: President’s Advisory Panel on Federal Tax Reform, November 2005), 104 (online: <http://www.taxreformpanel.gov/final-report>).

43 American Bar Association Section of Taxation Task Force on International Tax Reform, “Report of the Task Force on International Tax Reform” (2006) vol. 59, no. 3 *The Tax Lawyer* 649-812, at 663. The task force report contains a detailed analysis of the President’s Advisory Panel proposals and other US proposals to introduce a territorial system.

would be better off with the current system, a territorial system with interest allocation rules of some nature, or even a full accrual system for all income.<sup>44</sup>

As noted in the Department of Finance Backgrounder, the US system also contains dual consolidated loss (DCL) rules, which, broadly speaking, can apply to prevent the deduction of a loss amount by a dual resident corporation in more than one jurisdiction.<sup>45</sup> In this respect, the DCL rules bear some similarity to the Canadian anti-double-dip proposals.

On March 19, 2007, the Internal Revenue Service (IRS) and the Treasury issued final revised regulations replacing regulations published in 1992.<sup>46</sup> While these regulations will affect some types of double-dip transactions, there are many other double-dip arrangements that fall outside the DCL rules. For example, the tower structure described above, which is commonly used for inbound investment into the United States and is well known to the US Treasury (and considered “inherently unfair” by Canada’s minister of finance), is not caught by the DCL rules. This is because the partnership in the tower structure, though treated as a US corporation under the check-the-box rules, is not technically a dual resident corporation or a “separate unit” of a domestic corporation. The preamble to the final regulations states that the IRS and the Treasury “continue to study these and similar structures.”<sup>47</sup>

More relevant from the perspective of investment into Canada, hybrid entity and hybrid instrument structures that are used for financing Canadian subsidiaries of US companies also remain viable. For example, while certain structures involving third-party debt will now be offside the DCL rules, other structures will be unaffected provided that the Canadian entity (typically a Nova Scotia or Alberta unlimited liability company, which is a disregarded entity for US tax purposes) borrows from its US parent. These structures are common and will become even more attractive when the new protocol to the Canada-US income tax convention comes into effect, ultimately reducing the rate of withholding tax on non-arm’s-length interest payments from 10 percent to zero.<sup>48</sup>

For tax practitioners and policy makers outside the United States, it is difficult to understand the purpose of the DCL rules and why they appear to be so ineffective at preventing double-dips and other international tax arbitrage.

Kevin Dolan, senior vice-president of Merrill Lynch, has recently argued that the United States has a longstanding laissez-faire attitude to international tax arbitrage and the DCL rules are an anomaly. The following extract is taken from a letter

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44 See Edward D. Kleinbard, “Throw Territorial Taxation from the Train” (2007) vol. 114, no. 5 *Tax Notes* 547-64, for a criticism of territorial taxation and advocacy of a full accrual system for all foreign income.

45 IRC section 1503(d), first introduced in 1986.

46 TD 9315, 2007-15 IRB 891.

47 Ibid.

48 A number of these structures will be affected by the new protocol; see *supra* note 35.

he sent to Treasury and IRS officials, dated May 31, 2007, concerning proposed foreign tax credit regulations to be issued under IRC section 901.<sup>49</sup>

International tax arbitrage is both pervasive in the U.S. tax system and well accepted. International arbitrage in leasing has existed for decades and is explicitly sanctioned.<sup>[50]</sup> It is perfectly acceptable for a lessor to be treated as the tax owner of leased equipment for U.S. tax purposes even though the lessee is treated as the owner for foreign tax purposes, thereby entitling both parties to claim depreciation and/or investment tax credits in their home countries. It is also pervasive in the subchapter C area<sup>[51]</sup> and in the financial products area.<sup>[52]</sup> International tax arbitrage was even sanctioned in the foreign tax credit area as recently as 1998 in Notice 98-5, which clearly accepted arbitrage in foreign tax credit transactions provided that they satisfied economic substance principles. Former International Tax Counsel Hal Hicks was quoted as saying that, from a tax policy perspective, Treasury does not believe that international tax arbitrage is an “inherent tax evil”:

There’s nothing inherently wrong with cross-border tax arbitrage. It is a natural byproduct of the global economy interacting with disparate tax systems. The question is not whether there is a foreign tax benefit, but how the U.S. rules apply.<sup>[53]</sup>

Similarly, Former Chief Counsel B. John Williams stated:

We all know that cross-border activities are vital to our economy. They necessarily involve two tax authorities and we can expect from time to time inconsistent treatment of tax items or structures by the Internal Revenue Code as compared to the tax law of a foreign country. We are confident in the principles and integrity of our tax law and, unless the law requires otherwise, we will determine the appropriate tax treatment of an item based solely on the application of U.S. law.

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49 Kevin D. Dolan, “Tax Professional Seeks Withdrawal of Proposed Foreign Tax Credit Regs (Public Comments on Regulations),” Tax Analysts document no. 2007-13277, May 31, 2007; 2007 TNT 107-52. Dolan was writing in his individual professional capacity and not on behalf of Merrill Lynch. His letter became the basis of an article that raises similar points: Kevin Dolan, “Foreign Tax Credit Generator Regs: The Purple People Eater Returns” (2007) vol. 115, no. 12 *Tax Notes* 1155-60. Footnotes in the quotation that follows are reproduced from the original.

50 Technical Advice Memorandum 9748005, August 19, 1997.

51 See, for example, Rev. rul. 80-154, 1980-1 CB 68; Rev. rul. 83-142, 1983-2 CB 68; and Private Letter Ruling (PLR) 9835011, May 26, 1998, as to cash distributions that were disregarded for US tax purposes but not for foreign tax purposes, and PLRs 9111033, December 17, 1990 and 9344009, August 4, 1993, as to reorganization transactions that were treated as taxable sales for foreign purposes but as tax-free reorganizations for US purposes.

52 See, for example, Rev. rul. 74-27, 1974-1 CB 24, PLR 9322039, March 11, 1993, and PLR 9125038, March 27, 1991, as to repos, and Rev. rul. 81-251, 1981-2 CB 156; Rev. rul. 78-118, 1978-1 CB 219; and General Counsel Memorandum 35405, July 19, 1973, as to loan participations.

53 Sheryl Stratton, “Tax Arbitrage Not Inherently ‘Evil,’ Treasury Official Says,” Tax Analysts document no. 2006-787, January 13, 2006; 2006 TNT 9-3.

In certain cases, Congress has provided that the U.S. tax treatment of a transaction be determined through an analysis that, to some degree, takes into account the foreign tax treatment of the transaction. Examples include Section 894(c), which addresses certain treaty abuses, and Section 1503(d) [the DCL rules], which limits the availability of a double deduction in the U.S. and a host country for the same item of tax accounting loss. Where there is no statutory mandate, however, we will determine the U.S. treatment of the transaction by applying the appropriate U.S. tax principles.”<sup>54]</sup>

As stated more eloquently above, there is no principle in the foreign tax credit rules or elsewhere that suggests that U.S. tax consequences should turn on foreign tax treatment. Even the exceptions cited by Mr. Williams are anomalies. Section 894(c) relates to bi-lateral income tax treaties, which are a negotiated bargain between two countries whereby one gives up the right to tax in order to cede that right to the other country in order to mitigate double taxation. Quite naturally, the U.S. Government did not want to cede the right to tax if in fact the treaty partner is not imposing tax, and it made sense in that context to give up U.S. tax only if the foreign treaty partner is in fact imposing tax. *Section 1503(d) precludes “double dipping” of interest deductions, which generally involves some form of arbitrage. But most of us are still trying to figure out what U.S. tax policy exists for denying a U.S. multinational an interest deduction that also reduces foreign tax. That provision was more of a protectionist trade measure aimed at foreign multinationals that were buying U.S. companies, and U.S. multinationals got caught in the middle because it would have been difficult to defend a non-reciprocal provision aimed only at foreign buyers.* [Emphasis added.]

In an article published in 2002, Michael Danilack and Irwin Halpern discuss the history and policy surrounding the DCL rules. They agree that section 1503(d) was originally designed to address double-dips into the United States in order to deny foreign buyers of US companies an advantage over US buyers; however, before the legislation was enacted, the rules were extended to outbound transactions, primarily in a misguided attempt to mitigate the potential for a successful discrimination challenge.<sup>55</sup> Danilack and Halpern argue that the regulatory drafters subsequently extended the application of the rules in the outbound context beyond the original goals of Congress, resulting in unduly burdensome and discriminatory rules applicable to US multinationals. Moreover, in their view, the DCL rules are out of line with the US thinking on international tax arbitrage (at least in 2001, when they wrote the article):

[I]t is clear that unilateral harmonization or anti-arbitrage efforts [like the DCL rules] are out of synch with current thinking. Over the past several years, such efforts have

54 B. John Williams Jr., “Chief Counsel Statement on Transfer Pricing, International Tax Issues,” Tax Analysts document no. 2003-7169, March 18, 2003; 2003 TNT 54-47.

55 See Michael Danilack and Irwin Halpern, “It’s Time To Rethink the Dual Consolidated Loss Rules” (2002) vol. 2, no. 1 *Journal of Taxation of Global Transactions* 53-62. In their view, the extension was misguided because a discrimination challenge would not have been successful.

been viewed uniformly as weighing heavily on the export neutrality side of the balance, to the detriment of the global competitiveness of U.S. enterprises. To wit, the U.S. government has pruned away a number of recent anti-arbitrage undertakings before they could come to fruition. The Notice 98-11 saga is well known and will not be retold here. It must be noted, however, that underlying that proposal was the basic hypothesis that a reduction of foreign taxes should lead to a subpart F inclusion. Thus, the drafters of Notice 98-11 viewed achieving both foreign tax reduction and deferral of U.S. tax as counter to sound U.S. tax policy. This hypothesis has been criticized strongly by both taxpayers and Congress and, at least for the time being, has been effectively quashed.<sup>56</sup>

In summary, while the effectiveness of the DCL rules is open to debate (certainly they do not restrict many double-dips for either inbound or outbound transactions), there is a view that they are burdensome to US taxpayers and out of step with the general US approach to international tax arbitrage. Canada should consider seriously whether adopting similar unilateral measures, such as the proposed anti-double-dip rules, is the appropriate approach, particularly if those measures place the burden primarily on Canadian multinationals.

## UNITED KINGDOM

The United Kingdom has embarked on a consultation process that may result in a radical transformation of its entire system for taxing outbound investments. Unlike the Canadian approach, the process has included informal discussions with business during 2006, followed by the release of a discussion document in June 2007.<sup>57</sup> While consultations are continuing, the new system could take effect in 2009.

Currently, the United Kingdom has a credit system for taxing dividends from foreign subsidiaries. It also has CFC rules under which a UK company can be taxed on the undistributed profits of certain foreign subsidiaries located in low-tax countries. A number of exclusions apply, depending on the activities and location of the subsidiary. The focus of the UK CFC rules, unlike Canada's FAPI rules, is the character of the entity rather than the character of particular sources of income.

The discussion document proposes to replace the foreign tax credit system with an exemption system for most foreign dividends received by large and medium-sized UK companies in respect of holdings of 10 percent or more, and to replace the CFC rules with a modernized controlled corporation (CC) regime.

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56 Ibid., at 60. For criticism of Notice 98-11, see, for example, HR 672, 106th Cong., 1st sess. (1999); S 572, 106th Cong., 1st sess. (1999). The authors provide several other examples of the perceived disparity between the DCL rules and prevailing views on international tax arbitrage. They make the case that tax treaties or multilateral consultations present the only effective means to address double non-taxation and similar issues.

57 United Kingdom, HM Treasury and HM Revenue & Customs, *Taxation of the Foreign Profits of Companies: A Discussion Document* (London: HM Treasury, June 2007).

The discussion document notes that, historically, the United Kingdom favoured a credit system over an exemption system with a view to achieving capital export neutrality,<sup>58</sup> and explains the problem with that approach as follows:

[T]here is a difference between principle and practical outcome. Income from overseas investment is not generally taxed in the UK until it is repatriated as dividends. The amount of additional tax collected on lowly [sic] taxed foreign profits is small since multinational groups take advantage of mixing, leave profits offshore or remit profits in non-taxable form. This leads to the conclusion that seeking CEN [capital export neutrality] via a credit system is not successful in the context of a multinational business, and since the Government is not proposing to move to a consolidated system (so it taxes worldwide profits in the UK) CEN cannot be achieved.<sup>59</sup>

The drivers of the proposals included

- globalization, particularly the increase in foreign ownership of UK companies;<sup>60</sup>
- the increased use of exemption systems by other countries;<sup>61</sup>
- a desire to improve the competitiveness and attractiveness of the United Kingdom as a location for multinational business;<sup>62</sup>
- concern about complexity and compliance costs;<sup>63</sup> and
- concern about the current system's bias against the repatriation of profits, which distorts commercial decision making.<sup>64</sup>

Where a large or medium-sized UK corporation owns 10 percent or more of a foreign corporation and where the investment is subject to the proposed CC rules, a dividend from the corporation will be exempt from UK tax, regardless of the country of residence of the corporation or the level of foreign tax applicable to its earnings. Limited exceptions will apply, for example, in situations where the dividend was not previously eligible for a foreign tax credit (such as a dividend that was tax-deductible to the payer).

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58 United Kingdom, Inland Revenue, *Double Taxation Relief for Companies* (London: Inland Revenue, March 1999) (cited in the discussion document).

59 *Supra* note 57, at paragraph 2.16. At an Oxford University conference, "Corporation Tax: Battling with Boundaries," June 28-29, 2007, Edward Troup, director of business and indirect tax at HM Treasury, defended the pragmatic nature of the proposals, declaring that "to be accused of being pragmatic is praise, not a charge." See Joann M. Weiner, "Exempting Foreign Profits from Taxation in the U.K." (2007) vol. 47, no. 3 *Tax Notes International* 214-20, at 220.

60 *Supra* note 57, at paragraphs 2.7 and 2.8.

61 *Ibid.*, at paragraphs 2.16, 3.2, and 3.7.

62 *Ibid.*, at paragraph 2.19.

63 *Ibid.*, at paragraphs 2.20 and 3.1.

64 *Ibid.*, at paragraph 3.5.

The discussion document notes that a credit system affords a degree of protection to the tax base since profits must ultimately be repatriated. The document suggests that the tax base can be protected under an exemption system by a modern income-based CC regime and targeted interest relief changes.<sup>65</sup>

While the details of the proposed CC regime are beyond the scope of this article, the new rules would be designed to shift the focus “from an entity based ‘all-or-nothing’ regime to a targeted, income-based regime, which will tax the UK parent on specifically defined mobile income that is within [its] control.”<sup>66</sup> The proposed rules are quite similar to the Canadian FAPI rules, applying to passive income and to certain mobile types of active business income. Exemptions would be provided for certain intragroup payments (among other income items), as in the case of the Canadian deeming rule, although the scope of these exemptions is not entirely clear.<sup>67</sup> While it appears that a treasury company should be able to make loans to affiliates in other countries, the exemption may not be available if the financing entity has “more equity than would be expected for a typical intra-group lender.”<sup>68</sup>

The discussion document states that there is no need for “complex interest restriction rules, such as those based on apportionment.”<sup>69</sup> A number of options were considered, including the following:

- the disallowance of interest allocated to foreign profits (presumably using either the tracing method, as under the 2007 Canadian budget proposals, or a legislated formula);
- “thinner capitalization” rules, which would disregard the value of subsidiaries when determining allowable interest deductions; and
- “fat capitalization” rules, which would deem a parent to have received interest from a subsidiary that was funded with little or no debt.<sup>70</sup>

However, given the complexity and compliance difficulties inherent in each of these options, and the fact that the Exchequer receives little tax in respect of foreign profits in any event, all three options were rejected.<sup>71</sup>

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65 Ibid., at paragraph 3.8.

66 Ibid., at paragraph 4.8. The CC rules will also be extended to investments in UK companies (hence the substitution of “controlled corporation” for “controlled foreign corporation”). As Weiner explains, *supra* note 59, this change relates to EU law considerations.

67 *Supra* note 57, at paragraphs 4.25 and 4.26.

68 Ibid., at paragraph 4.25. Paragraph 4.36 notes that the group treasury exemption should ensure that the new CC regime does not “overreach its objectives,” a goal that is referred to several times in the discussion document.

69 Ibid., at paragraph 5.1.

70 Ibid., at paragraph 5.4.

71 Ibid., at paragraph 5.5.

The discussion document does recommend two targeted anti-avoidance measures:

1. interest claimed by UK members of a multinational group would be restricted by reference to the group's total consolidated external finance costs; and
2. the existing "unallowable purpose" rules (discussed below) would be strengthened.<sup>72</sup>

The scope of the first proposal is not clear and is the subject of much discussion. Very little information is provided in the discussion document. Many interested parties are asking HM Revenue & Customs (HMRC) for examples of how this rule will apply in various situations (inbound and outbound investment, upstream loans from subsidiaries, cash-rich parent companies, etc.). It appears that this rule would apply to UK multinationals as well as to UK subsidiaries of foreign multinationals, although the wording is not clear.

In addition, the discussion document notes that "if the UK sub-group has higher actual finance costs than the entire group's overall external finance costs, this strongly indicates that the UK sub-group's finance costs are not commercial."<sup>73</sup> It has been suggested that the limitation would thus apply only if the actual amount of debt of the UK group exceeded the entire arm's-length debt of the worldwide group. If this is what is intended, rather than a proportionate limitation based on relative asset values or a similar test, the provision would likely not be very restrictive.

Under the existing regime, interest expense incurred by UK companies in respect of foreign investments is deductible currently, subject to a number of potential limitations, including

- thin capitalization rules,<sup>74</sup>
- the unallowable purpose rules,<sup>75</sup> and
- anti-arbitrage rules.<sup>76</sup>

The UK thin capitalization rules apply to related-party debt and to certain arm's-length debts guaranteed by related parties.<sup>77</sup> There is no safe harbour rule, such as a legislated debt-to-equity ratio: interest on borrowings may be disallowed to the extent that the borrower could not have borrowed the same amount on the same terms from a third-party lender.

72 Ibid., at paragraph 5.8. See *infra* notes 75 and 78 and the accompanying text.

73 Ibid., at paragraph 5.7.

74 Income and Corporation Taxes Act 1988 (UK), 1988, c. 1, schedule 28AA.

75 Finance Act 1996 (UK), 1996, c. 8, schedule 9, paragraph 13.

76 Finance (No. 2) Act 2005 (UK), 2005, c. 19, sections 24-31.

77 As of April 1, 2004, the thin capitalization rules also apply to loans between connected UK companies.

The unallowable purpose rules may apply to limit the deduction of interest expense where the main purpose, or a main purpose, of a borrowing is to generate a UK tax advantage. Since 1996, when this anti-avoidance legislation was introduced, its application has been relatively narrow, and it has not been the subject of any decided tax case. The discussion document seeks to bolster the effectiveness of these rules by broadening their scope beyond the purpose of the borrowing, to encompass the purpose of related schemes or arrangements and the purpose(s) of other companies in the group.<sup>78</sup>

While the anti-arbitrage rules are not addressed in the discussion document, they are one of the key methods currently available to restrict interest expense relating to cross-border transactions. The Department of Finance Backgrounder cites these rules as evidence that Canada's proposed anti-double-dip rules are not out of step with international norms. Unlike the proposed Canadian rules, the UK rules apply to both inbound and outbound double-dip structures.

The anti-arbitrage rules may apply to deductions arising after March 16, 2005 where a scheme involving a hybrid entity or hybrid instrument increases a UK tax deduction to more than it would have been in the absence of the scheme. The rules may apply<sup>79</sup> if

- the transaction giving rise to the deduction is part of a "qualifying scheme"<sup>80</sup> involving the use of a hybrid entity or hybrid instrument;
- the scheme has certain specified characteristics that allow the hybrid entity or hybrid instrument to create either a double deduction or a deduction not matched by a taxable receipt;
- the main purpose or one of the main purposes of the scheme is to obtain a UK tax advantage;<sup>81</sup> and
- the UK tax advantage obtained is more than a minimal amount.<sup>82</sup>

The rules contain a further provision that applies to receipts that would not otherwise be taxable where the following conditions are met:

- the UK company enters into a scheme and receives an amount on which it is not liable to UK tax;

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78 An interesting parallel can be found in paragraph 95(6)(b) of the Act, which is also narrowly drafted (not containing a series of transactions rule, for example) and is not as broadly applicable as some CRA officials might wish.

79 The rules do not automatically apply; they only apply upon issuance of a notice to the taxpayer by HMRC.

80 A qualifying scheme can be a single transaction, a series of related transactions, or any other arrangement or understanding of any kind, including the establishment of a particular capital structure.

81 In this respect, the anti-arbitrage rules have a broader application than the current unallowable purpose rules, which refer to the purpose of the borrowing, not the scheme as a whole.

82 Currently the threshold is £50,000.

- the amount may be deducted from the taxable income of the payer;
- the tax mismatch is a reasonable expectation of the parties to the scheme; and
- the payment constitutes a contribution to the capital of the company.

When these proposals were introduced in 2005, they created a sensation in the United Kingdom similar to the reaction to the Canadian budget proposals. Initially, there was concern that all tax-efficient cross-border planning involving debt would be caught by the rules. However, it appears that guidance notes issued by HMRC have allayed some of the initial concerns.<sup>83</sup> For example, the guidance notes cite the case of a UK subsidiary that borrows from its foreign parent via a hybrid entity in order to finance the building of a new factory.<sup>84</sup> As a result of the scheme, both the UK subsidiary and the foreign parent obtain an interest deduction. The notes state that since the loan was made for a non-tax purpose, it is reasonable to suppose that the investment would have been made in the absence of the scheme. Therefore, the appropriate comparative transaction is a “plain vanilla” loan to the UK subsidiary (rather than an equity investment) and, subject to the terms and conditions of the debt, the arbitrage legislation may not apply.

On the other hand, the guidance notes state that if a UK subsidiary simply converts a portion of its equity into debt in a scheme that uses a hybrid entity and there is no purpose other than to exploit the arbitrage opportunity, the scheme will be considered to have UK tax avoidance as its main purpose.<sup>85</sup>

The rules are very tough and, I understand, have been effective in achieving their aims. A former HMRC official who was responsible for drafting the guidance notes has been quoted as stating that the legislation was “not anti-arbitrage, but rather anti-avoidance through arbitrage. . . . Those moving companies about for no business purpose or economic reality, are getting caught by the arbitrage rules.”<sup>86</sup> However, there still seems to be some uncertainty, two years on, about what structures are permissible and how the guidance notes will be applied. The situation continues to evolve.

## AUSTRALIA

Australia’s system for taxing outbound investment is somewhat similar to the Canadian system in that the active business income of foreign subsidiaries is not taxed in Australia on an accrual basis, and dividends received directly by corporate taxpayers from the subsidiaries are generally exempt when received. Similar to the Canadian FAPI and foreign investment entity rules, certain foreign income earned by an Australian resident may be subject to accrual taxation under CFC, foreign investment fund, and transferor trust rules.

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83 United Kingdom, HM Revenue & Customs, “Avoidance Involving Tax Arbitrage: Guidance Notes,” August 3, 2005; and Cunningham et al., *supra* note 33.

84 Guidance notes, *supra* note 83, at paragraph 25.

85 *Ibid.*, at paragraph 28.

86 Cunningham et al., *supra* note 33, at 14.

Among other sources, exempt foreign income includes non-portfolio dividends derived from a foreign corporation in which an Australian corporation holds more than 10 percent of the voting shares and certain (generally active) foreign branch income. All other income derived from foreign sources is included in assessable income, and a credit is provided for foreign taxes paid on that income. The amount of the credit is limited to the amount of Australian tax that would be payable on that income.

The exemption system was introduced in 1991. However, it has undergone changes over the past few years. Originally, the exemption applied to non-portfolio dividends paid out of comparably taxed profits (that is, paid by a company resident in a listed country or by a company resident in an unlisted country out of profits taxed in a listed country).<sup>87</sup> Similar to Canada's taxable surplus system, non-portfolio dividends from unlisted countries were generally taxable with a credit for underlying foreign tax and withholding tax.<sup>88</sup> In 2004, following a recommendation of the Australian Board of Taxation<sup>89</sup> and after extensive public consultation, the exemption system was broadened to include non-portfolio dividends from unlisted countries.<sup>90</sup> The purpose of this measure was to improve the competitiveness of Australian companies investing in foreign countries and to encourage the repatriation of profits from unlisted countries.<sup>91</sup>

The Australian interest deductibility rules, however, are very different from the Canadian rules. Of particular interest is the development of these rules as they apply to outbound investments.

Australia formerly disallowed interest expense on debt incurred to earn exempt foreign income. If such interest expense exceeded assessable foreign income in any given year, the excess was not currently deductible, but could only be deducted against future taxable foreign income. The rules were very much like the original Canadian budget proposals.

Under the current rules, interest is deductible even if it is attributable to debt incurred to earn exempt foreign-source dividend income;<sup>92</sup> however, the deductibility of interest expense is subject to broad thin capitalization restrictions. The

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87 The definitions of listed and unlisted countries have changed several times over the years.

88 A foreign tax credit in respect of underlying foreign corporate tax paid on dividends is no longer available, in line with the move to exempt all non-portfolio dividends.

89 The Board of Taxation is an advisory body to the Treasurer and the government. It was established in response to the Ralph report (infra note 94 and the accompanying text) in recognition of the need for an independent advisory body that would "contribute a business and broader community perspective to improving the design of taxation laws and their operation": excerpt from the board's mission statement (online: <http://www.taxboard.gov.au/content/charter.asp>).

90 This amendment and a number of other favourable changes were introduced by the New International Taxation Arrangements (Participation Exemption and Other Measures) Bill 2004.

91 Australia, Bills Digest no. 133 2003-04, "New International Tax Arrangements (Participation Exemption and Other Measures) Bill 2004."

92 A deduction is not available for interest income incurred to earn exempt foreign branch income.

specific provision that allows such interest to be deductible<sup>93</sup> was introduced simultaneously with new thin capitalization rules.

In 1998, the Australian government announced plans for comprehensive reform of the business tax system. Following public consultation, in July 1999 the Review of Business Taxation released its final report (widely known as the Ralph report),<sup>94</sup> providing the foundation for many subsequent tax reforms. Among these were significantly revised and expanded thin capitalization rules, enacted by the New Business Tax System (Thin Capitalisation) Act 2001. The revised rules apply to foreign entities investing in Australia as well as Australian entities investing overseas and include all debt of the Australian operations (both related-party and third-party debt). The old thin capitalization rules applied only to foreign related-party debt (like Canada's current rules) and foreign guaranteed debt.

Along with the expansion of the thin capitalization tax base, the debt-to-equity ratio (a safe harbour test) was increased to 3:1<sup>95</sup> from 2:1, and two additional thin capitalization tests were introduced as an alternative to the safe harbour test: a worldwide gearing test and a broader arm's-length test.<sup>96</sup>

Currently, under the safe harbour test, the maximum allowable debt amount is calculated as 75 percent of the average value of the entity's Australian assets, with some adjustments. This formula is based on a 3:1 debt-to-equity ratio. In certain circumstances, the two optional tests may produce better results. The maximum allowable debt is the greatest amount produced by any of the three tests.

The worldwide gearing test looks at the Australian entity's worldwide leverage and in certain circumstances can allow the Australian operations to be leveraged at up to 120 percent of the leverage of the worldwide group.<sup>97</sup>

The arm's-length test determines the debt amount that could have been borrowed from an independent party if the entity's Australian operations were independent from the foreign operations. The arm's-length test is not commonly used owing to the extensive documentation requirements and the complexity of economic analysis. However, it may be advantageous for companies operating in industries with generally higher levels of debt.

Why did Australia choose to abandon the old approach in favour of a broader thin capitalization regime? On the basis of the findings of the Ralph report, the

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93 Income Tax Assessment Act 1997, section 25-50.

94 Australia, Review of Business Taxation, *A Tax System Redesigned: More Certain, Equitable and Durable* (Canberra: Australian Government Publishing Services, July 1999).

95 Financial entities can utilize a 20:1 ratio for certain portions of their lending business.

96 Under the old rules, there was a limited arm's-length test dealing with guaranteed foreign debt in certain circumstances.

97 The worldwide gearing test is not applicable to foreign entities and Australian entities controlled by foreign entities. Specific thin capitalization rules apply to financial entities and to authorized deposit-taking institutions (ADIs). The worldwide gearing test is comparable to the changes to the US interest allocation rules made under the 2004 Jobs Act, discussed above, that are applicable after 2008.

government concluded that the old interest deductibility and thin capitalization rules were ineffective in achieving their objective—to ensure that multinational entities did not allocate excessive amounts of debt to their Australian operations. The Treasury identified the following problems with the rules:<sup>98</sup>

- The old interest deductibility rules for outbound investments could easily be circumvented; because they relied on *tracing* the use of borrowed funds, it was relatively easy to establish a use of funds that ensured deductibility.
- Because the rules applied on a single-entity basis, it was possible to circumvent them by interposing entities to separate the foreign income from the expenditure.
- The old rules were not adequate to prevent multinational entities from taking advantage of the differential tax treatment of debt and equity to reduce their Australian tax.

## NEW ZEALAND

New Zealand is in the midst of comprehensive reform of its system for taxing foreign investment. An independent committee that was created to study the tax system reported to the government in October 2001.<sup>99</sup> The government issued a discussion document suggesting possibilities for reform in December 2006,<sup>100</sup> followed by an update in May 2007.<sup>101</sup>

New Zealand, alone among OECD countries, currently has an accrual system for taxing the income of foreign subsidiaries of domestic companies: all foreign income, whether active or passive, is taxed immediately in New Zealand with a credit for foreign taxes paid. However, all income earned in eight “grey-list” countries, including Canada, is exempt.<sup>102</sup> The exemption was designed to reduce compliance costs for New Zealand companies with subsidiaries in countries with tax systems and income tax rates comparable to New Zealand’s system and rates.

I understand that New Zealand expected other countries to be persuaded of the merits of an accrual system and to follow its lead in moving away from tax systems that provide for deferral with an exemption or credit for dividends. This never occurred. Now the New Zealand government is concerned that its current system,

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98 Australia, Treasury Department, *New Business Tax System (Thin Capitalisation) Bill 2001: Explanatory Memorandum* (Canberra: Treasury Department, 2001), 69 and 209.

99 See New Zealand, *Independent Tax Review 2001: Final Report* (Wellington: New Zealand Treasury, October 2001).

100 New Zealand, *New Zealand’s International Tax Review: A Direction for Change* (Wellington: New Zealand Inland Revenue, Policy Advice Division, December 2006).

101 New Zealand, *New Zealand’s International Tax Review: An Update: Developing an Active Income Exemption* (Wellington: New Zealand Inland Revenue, Policy Advice Division, May 2007).

102 The other grey-list countries are Australia, Germany, Japan, Norway, Spain, the United Kingdom, and the United States.

while conceptually attractive, discourages the retention and establishment of New Zealand-based multinational businesses.<sup>103</sup> The December 2006 discussion document stressed the importance of such businesses to the New Zealand economy.<sup>104</sup>

The December document also stated that, while the accrual system could be advocated on the basis of capital export neutrality, which would promote the global efficiency of capital allocation,

[i]n practice, it makes very little sense for a small, open economy like New Zealand's to "go it alone" in promoting capital export neutrality. New Zealand is much too small to do anything significant to promote global efficiency in the way that worldwide capital is allocated.<sup>105</sup>

The government is now advocating an exemption system<sup>106</sup> coupled with accrual taxation of passive income<sup>107</sup> and the extension of its existing interest allocation rules to outbound investment (similar to Australia's approach). A series of technical papers is expected to be released soon, and further input solicited from the public on technical design issues.

According to the May 2007 discussion document, the reforms have been guided by three principles:<sup>108</sup>

1. They should not discourage legitimate business activity.
2. They should minimize compliance costs.
3. They should maintain a degree of protection of the domestic tax base.

It is the third objective that is the impetus for the proposed interest allocation rules:

The policy case for interest allocation rules is clear. If an exemption is to be given for offshore active income it is necessary to measure it properly. Among other things, this requires a reasonable allocation of interest costs throughout the group to match those costs to the income being earned. Otherwise a disproportionate share of the global interest costs could be allocated against the New Zealand tax base.<sup>109</sup>

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103 *Supra* note 100, at paragraph 2.28.

104 *Ibid.*, at paragraphs 2.17, 2.18, and 2.24.

105 *Ibid.*, at paragraph 2.8.

106 An anti-arbitrage rule would provide that the exemption for dividends received from a foreign subsidiary is not available if the dividend is deductible to the payer (for example, a dividend on an Australian mandatorily redeemable preferred share).

107 Passive income such as interest would be taxed on an accrual basis, but there would be a same-country exception where the payer is earning active business income and is resident in the same country as the recipient. See the May 2007 discussion document, *supra* note 101, at paragraph 3.14.

108 *Ibid.*, at paragraph 2.4.

109 *Ibid.*, at paragraph 5.12.

To protect the New Zealand tax base, the government proposes to extend the existing interest allocation rules to companies with CFCs and to remove investments in the CFCs from their New Zealand assets for purposes of calculating their New Zealand debt-to-assets ratio.<sup>110</sup>

However, the government does not intend the rules to be too restrictive:

[T]he government recognises that the . . . rules will apply to a range of different businesses and industry sectors. Appropriate levels of debt will vary across these sectors. It will therefore be necessary to keep the interest allocation rules relatively loose. Tighter rules, which may be appropriate in some circumstances, would risk unfairly denying interest in others.<sup>111</sup>

With a 75 percent [safe harbour] threshold, a significant percentage of the New Zealand income of a company with either an offshore parent or CFCs is open to be sheltered by interest expenses relating to offshore activity.<sup>112</sup>

The discussion document concludes that the existence of the safe harbour would strike a balance between benefiting firms newly entering offshore activities and providing protection against aggressive tax planning.<sup>113</sup>

## THE NETHERLANDS

The Netherlands generally has an exemption system for foreign income. In addition to a traditional thin capitalization restriction on interest deductibility, the Netherlands has restrictions on deductibility of interest on related-party loans used to fund

- a dividend or capital reduction payment to a related party;
- a capital contribution to a related party; and
- the acquisition of an entity (related or unrelated) such that the entity is a related party after the purchase.

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110 Ibid., at paragraph 5.13.

111 Supra note 101, at paragraph 5.16.

112 Ibid., at paragraph 5.18. Under current rules, interest deductions are not challenged if the debt of the New Zealand group does not exceed 75 percent (a debt-to-asset ratio of 3:1). If the safe harbour is exceeded, interest deductions are limited to either a debt level consistent with this threshold or 110 percent of the worldwide group's debt percentage, whichever is higher. The discussion document proposes retaining similar limits when the rules are extended to outbound investments.

113 Ibid., at paragraphs 5.19 and 5.20.

The interest is not deductible unless

- there is a business reason for both the transaction and the loan; or
- the interest is taxed in the hands of the creditor at an effective rate of at least 10 percent (based on Dutch rules).<sup>114</sup>

Note that there is no restriction on the deductibility of third-party interest, whatever the use of the funds.

The Netherlands formerly had a form of anti-arbitrage rule with respect to hybrid instruments. The participation exemption was denied to a Dutch recipient of a dividend if the payment was deductible to the payer. That provision was repealed at the beginning of 2007.

## GERMANY

Germany also generally has an exemption system for foreign income. German business tax reform changes were enacted as of August 17, 2007. The tax reform included a reduction in German income tax rates as well as a new general limitation on the deductibility of interest to supplement Germany's traditional thin capitalization rules.

For taxation years beginning after May 25, 2007, the general corporate rate will be reduced from 25 percent to 15 percent, resulting in an effective rate (with trade tax) of approximately 29.8 percent. The current effective rate is approximately 38.65 percent.

Interest will be limited to 30 percent of annual taxable income before interest, tax depreciation, and loss carryforwards. The limitation will apply to interest on all indebtedness, whether owed to related or unrelated persons. It will be possible to carry forward excess interest expense to future years. The limitation will not apply where the net interest expense is less than €1 million, where the taxpayer is not part of a group of companies, or where the German borrower's equity ratio is at least as high (with 1 percent tolerance) as the worldwide group's ratio. In practice, this equity ratio exception will not be available in many situations, since it is necessary to deduct the book value of shares in group subsidiaries that are not part of a German tax group from the borrower's equity for the purpose of the calculation.

Currently, Germany also has a rule that denies the deduction of interest on borrowings relating to intercompany share acquisitions. This rule will be repealed as a consequence of the introduction of the new general limitation on interest deductibility.

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114 After this article was written, the Netherlands introduced a proposal to tighten this second requirement.

## IMPLICATIONS FOR CANADA OF DEVELOPMENTS IN OTHER COUNTRIES

It is apparent that many countries are reconsidering their rules relating to the taxation of foreign income and the deduction of interest expense. All countries have an interest in protecting their domestic tax base while ensuring that their tax system attracts and supports business investment. Canada is not unique in this respect. The Canadian government should consider carefully whether it would be advisable to adopt any of the approaches taken in other countries.

At the same time, Canadian policy makers must consider how Canada's economy compares with the economies of other countries that have enacted restrictive measures, and whether any distinctions justify a different approach. For example, because of the small domestic market in Canada, growing Canadian companies typically need to expand outside their home country much sooner than competitors based in other countries. These companies become exposed to higher costs and risks of conducting business internationally when they are more constrained in their ability to finance and manage those costs and risks than their larger foreign competitors. The New Zealand government concluded that it makes little sense for a small open economy to be a leader in the promotion of worldwide capital export neutrality. Whatever one's view of the impact of tax policy on Canada's current ability to produce global leaders, the May 14, 2007 proposals would undoubtedly constitute a competitive setback for Canadian businesses.

With those proposals, Canada has started down the road of enacting anti-avoidance rules that will deny interest expense in particular circumstances. This approach is comparable in some respects with the US DCL rules and the UK anti-arbitrage rules. However, there are many reasons why the anti-double-dip proposals in particular, and similar rules in general, represent a misguided approach.

As noted above, the Canadian proposals can be criticized for the questionable relevance of a foreign tax deduction, statutory ambiguity created as a result of commingling the FAPI rules and interest deductibility, the restriction of the proposals to specific double-dip structures, and their focus on Canadian rather than foreign multinationals. The proposals also rely on tracing, which leads to differential treatment between taxpayers who are able to structure their affairs to avoid the rules and taxpayers who cannot.

Anti-avoidance rules are always very difficult to craft and to administer. Detailed rules risk providing a road map for clever taxpayers and their advisers; broad general rules create uncertainty for taxpayers and drive the revenue authorities to issue lengthy administrative guidelines in order to avoid catching "acceptable" transactions. As noted above, the US DCL rules, which appear to fall into the former category, have not been very effective at limiting the use of double-dip structures for investment into and out of the United States. While the UK rules appear to have been more effective, the broad scope of the rules has created the need to provide relief through administrative positions, with the resulting uncertainty that always arises when taxpayers must rely on administrative relief, rather than legislation, to

plan their affairs. It is my understanding that the Dutch rule that requires a business purpose for certain intercompany loans and transactions is similarly uncertain in its scope, as anti-avoidance rules based on business purpose tend to be.

Australia, New Zealand, and Germany have taken a more formulaic approach to the protection of their tax base. A restriction on interest expense based on a formula involving assets or income is simpler to administer and more difficult for taxpayers to avoid through tax planning. There are many options for devising such a rule, and these have been studied by other countries. If there is serious concern about the erosion of the Canadian tax base through interest expense, a thoughtful examination of these options may represent a better route for Canada.

Whatever approaches are considered and taken, it is imperative that the impact on Canadian competitiveness be determined. As noted, anti-arbitrage measures in other countries remain the exception rather than the rule, and are of questionable effectiveness. The formulaic restriction of interest expense (beyond traditional thin capitalization rules) is gaining favour but is still limited to a few countries. While the world has changed to some degree, it has arguably not changed radically since Canadian Department of Finance officials declared that our system was consistent with international norms and necessary to ensure the competitiveness of Canadian companies.

Instead of pushing ahead precipitously with the anti-double-dip proposals, Canada would be better served by following the lead of other countries and considering interest deductibility relating to foreign investments as part of a broad-based consultative process.

Other countries have embraced the need for consultation. For example, the UK discussion document notes:

It is crucial to the ongoing competitiveness of the UK that reform of foreign profits meets the needs of both business and Government; this objective can only be met through a continuation of open and constructive dialogue with business on these issues, and a shared understanding of the behavioural impacts of the proposed reforms.<sup>115</sup>

The Australian Board of Taxation has emphasized the

need for an ongoing process of review and reform of the tax system, rather than an uncoordinated, intermittent and piecemeal approach to reform as and when significant problems present themselves.<sup>116</sup>

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115 *Supra* note 57, at paragraph 1.12.

116 Australia, Board of Taxation, *International Taxation: A Report to the Treasurer* (Canberra: Department of Communications, Information Technology and the Arts, February 28, 2003), 31.

The New Zealand discussion document of May 2007 states that

consultation and feedback [have] been invaluable in enabling the government to assemble a balanced package of reforms that is appropriate for the New Zealand context.”<sup>117</sup>

It is hoped that the Canadian government will reconsider its approach, defer the anti-double-dip legislation, and refer it to the expert panel for consideration along with other policy options.

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117 *Supra* note 101, at paragraph 1.2.