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Editor's Introduction: Examining the Canadian Budget Proposals for Taxation of International Income

We have noted in other issues of the journal our hope that the timely publication of commentary on important Canadian tax issues will both provoke and facilitate informed discussion, to enlighten how these issues are understood and possibly, as well, to contribute to how they mature as tax policy and ultimately tax legislation. In this issue, we include several contributions sparked by the March 19, 2007 federal budget's review of how international income earned indirectly by Canadian taxpayers should be taxed. The budget and the discussion that immediately ensued, culminating in additional announcements by the minister of finance in May 2007, and in now impending legislation, notably section 18.2 and certain changes to the foreign affiliate rules to expand the reach of the exempt surplus regime, foreshadow a fundamental re-examination of important structural elements of the Canadian tax system bearing on the measurement and taxation of international income. This development, interestingly, does not raise new considerations (as the history of Canadian income taxation shows). As well, Canada is not the only country that is trying to come to grips with how the globalization of international business impinges on the adequacy and effectiveness of a tax system, in the context of larger business, commercial, and trading arrangements with broader economic effects.

The budget contemplated important reforms in respect of the taxation of business income earned by foreign affiliates of Canadian taxpayers in two main ways. First, the budget proposed to restrict the deductibility of interest on financing undertaken by Canadian taxpayers with respect to investments in foreign affiliates that earn income exempt from Canadian tax. Owing to the immediate and passionate reaction of the business and tax communities, this proposal evolved, in the short period between the presentation of the budget on March 19, 2007 and mid-May, into a more broadly based initiative represented as countering certain kinds of perceived offshore tax avoidance. The revised proposal described a regime for tracing funds borrowed by a Canadian taxpayer to the ultimate use of those funds to earn exempt business income—principally income in the form of interest on underlying indebtedness that is deemed to have the character of active business income when earned by a foreign affiliate that provides financing to other foreign affiliates. This initiative is now embodied in a package of pending legislation, in section 18.2, introduced by the minister of finance to the House of Commons on November 13, 2007 as a notice of ways and means motion and carrying forward as Bill C-28, tabled in the House of Commons by the minister on November 21, 2007. Second, the budget proposed other major structural reforms to the foreign affiliate system. These would further ingrain a territorial approach to the taxation of foreign business income without regard to the jurisdictions in which it is earned, as long as reliable information about the circumstances in which the income is earned is readily available to the Canadian finance and tax authorities. As well, the proposed reforms would further entrench limitations already present in the rules allowing "deemed active business income" to be earned by foreign affiliates, so as to more closely approximate an approach—sometimes referred to as a Canadian "cone"—that is currently reflected in section 17 of the Income Tax Act ("the Act"). Changes to the Act to implement this initiative are found in the same pending legislation.

The contributions that follow approach these developments from several perspectives.

Allan Lanthier and Jack Mintz consider the proposed limitations on interest deductibility from a theoretical perspective, with reference to whether a more thorough-going limitation on "gearing" or leverage within a corporate group should be introduced into the Act. Sandra Slaats, through a comparative examination, offers her perception of the experience of certain countries with respect to issues now confronting the Canadian tax system.

One of the concerns seemingly meant to be addressed by the budget initiative in this regard is excessive borrowing by Canadian members of multinational groups to finance business operations conducted indirectly outside Canada. The concern is that the ability to deduct interest to reduce Canadian-source income distorts both the correspondence between Canadian-source revenue and expenses incurred to earn it, and the measurement of foreign income that underlies relief from Canadian tax with reference to an actual, or possibly expected, measure of foreign taxation that in some manner "sets off" or limits Canadian tax referable to the same foreign income.

The interest deductibility initiative is interesting for a number of reasons. First, this is, of course, not the first time that limitations of this nature have been addressed. In the early 1970s, the Act was amended specifically to permit interest to be deductible for financing the acquisition of shares producing non-taxable dividends. At the time, this relief was offered to encourage the competitiveness of Canadian enterprise. In the early 1980s, a more broadly based proposal to limit the deduction of interest in certain circumstances was introduced; however, after considerable adverse reaction, it did not proceed. In 1998, the *Report of the Technical Committee on Business Taxation* (co-chaired by Jack Mintz and Allan Lanthier) explored the taxation of international income, and anticipated the need to more accurately measure the relationship between interest deducted in computing Canadian income with reference to investments in foreign operations and the revenue and resulting income generated by those operations. Finally, the milestone March 19, 2007 federal budget and its metamorphosis into section 18.2 address this issue face on.

This issue, and the related structural proposals to change how income earned by foreign affiliates is treated, is not occurring in a vacuum. A number of countries are actively engaged in examining how their tax systems should apply to foreign income. Issues being addressed include whether and to what extent foreign business income earned in branch or incorporated form should be treated in a similar, if not the same, fashion; whether a more thorough territorial approach to the taxation of foreign income is appropriate; and, interestingly, whether limitations on the deductibility of interest are necessary in order to preserve proper relative measures of domestic and foreign income and resulting tax bases.

Some of the most recent—and, from Canada's vantage point, possibly the most interesting—examples of alternative approaches to these issues are found in discussion documents published by the New Zealand Inland Revenue in December 2006, May 2007, and October 2007 and by the United Kingdom Treasury and HM Revenue & Customs in June 2007. Although the approaches advanced in these studies are somewhat different from those presented in or foreshadowed by the Canadian budget proposals and ensuing legislation, there are common elements. In particular, there is a fundamental conceptual recognition of the need to limit, in some manner, the deduction of interest in a taxpayer's home jurisdiction with respect to a financing undertaken to support foreign business operations where the income derived is not immediately, or possibly ever, taxable, even upon repatriation.

In the third contribution to the debate, Melanie Huynh, Eric Lockwood, and Michael Maikawa examine the government's proposals for refining the taxation of international income from a more technical perspective. As noted above, the pending changes and more general attention to international taxation reflect a movement to a more comprehensive territorial approach to taxing foreign business income. Again, a number of countries continue to review their tax systems to determine the desirability of similarly directed changes. These countries include the United States, Australia, Denmark, France, New Zealand, and the United Kingdom. Although each of these countries approaches this subject somewhat differently and more or less comprehensively, it is interesting that they are all paying attention to the same kinds of considerations at the same time. Underlying their interest as national tax systems in addressing these very difficult issues is a recognition that their relative economic positions, and the interests of their taxpayers as exponents of their economies or as acquirors of capital, require that contemporary imperatives of globalization with respect to how business income is earned internationally be taken into account in judging and indeed re-evaluating the adequacy of prevailing tax rules and, in some cases, the consistency of how those rules apply to business income earned in branch rather than incorporated form.

This issue of the journal thus addresses yet another important Canadian tax development. It is meant to provide a platform for evaluating important issues made prominent by the budget from tax policy, comparative tax law, and technical perspectives. Our hope, as always with our themes, is to encourage discussion in an open and thoughtful way.

Scott Wilkie
Editor