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TAX COMPETITIVENESS PROGRAM

Finding Silver Linings in the Storm:

An Evaluation of Recent Canada–US Crossborder Tax Developments

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In this issue...

Revisions to the Canada–US tax treaty are only a starting point to a raft of reforms required in the tax treatment of Canada–US crossborder investment.

The Study in Brief

Recently, a storm of activity has swirled around rules governing the tax treatment of Canada–US crossborder investment. The high degree of integration of the Canadian and US economies means that the effects of such tax changes can be significant.

One new development involves revisions to the Canada–US tax treaty – including the abolition of crossborder withholding tax rates for interest payments, the provision of treaty benefits for members of limited liability companies, and the development of mandatory arbitration processes for transfer pricing purposes – which could signal a readiness on Ottawa's part to make further efforts to ensure that tax does not unduly inhibit entrepreneurial efforts to tie together the North American economies.

Another important development: ongoing efforts by Ottawa to engage in corporate income tax competition with the United States and to inhibit certain aggressive crossborder tax-planning structures that enable Canadian taxpayers to obtain valuable tax benefits when they fund foreign operations.

In a number of areas, however, undue restrictions on, or distortions of, crossborder investment remain, which could harm Canada's economic interests. Further reform efforts should include: reviewing and targeting for elimination tax rules that unduly discriminate against the interests of US investors; eliminating withholding taxes on crossborder parent/subsidiary dividends; changing domestic group taxation laws, with the ultimate goal of crossborder tax loss relief; and enhancing administrative cooperation between the two countries' tax authorities to reduce compliance costs for firms with operations in both countries, including the development of a case-by-case approval process for tax relief for crossborder mergers and acquisitions.

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In the past year, a veritable storm of activity has swirled around the development of new rules to govern the tax treatment of Canada-US crossborder investment.

These developments include revisions to the Canada-US tax treaty, ongoing efforts to keep Canadian corporate income tax rates lower than their US counterparts, and federal government budget proposals to inhibit certain crossborder tax-planning strategies.

Because the Canadian and US economies are highly integrated – sharing, for instance, larger trade flows than any two other economies in history – tax developments that encourage or inhibit crossborder investment can have a significant effect (Cockfield 2005, 11-14). The United States is by far the most important source of inward foreign direct investment (FDI) in the Canadian economy.[1] Indeed, such is the importance of US investment in Canada that Canadian international tax policy often "aims for the moon, but lands in the United States" (Bird 1989, 433).

This *Commentary* evaluates recent Canada-US crossborder tax developments. It concludes that the storm of activity has a number of silver linings that reduce tax as a barrier to crossborder investment, and proposes tentative recommendations to further brighten the sky and facilitate investment between the two countries.

The next section discusses recent efforts to revise the Canada-US tax treaty, including the abolition of crossborder withholding tax rates for interest payments, the provision of treaty benefits for members of limited liability companies, which are business entities formed under laws of US states, and the development of mandatory arbitration processes for transfer pricing purposes. From an international tax law policy perspective, these efforts make sound policy sense and, in an environment of increasing regional economic integration, reduce tax barriers to US investment in Canada while striving to ensure that Canada's tax regime remains competitive vis-à-vis its US counterpart. In fact, these tax developments could signal a readiness on the part of the federal government to promote additional reform efforts to ensure that tax does not unduly inhibit entrepreneurial ties in North America.

The *Commentary* then discusses ongoing efforts by the federal government to engage in corporate income tax rate competition with the United States as well as to draft tax laws to inhibit certain aggressive crossborder tax-planning structures, including so-called double-dip financing schemes, which enable Canadian taxpayers to obtain valuable tax benefits when they fund foreign operations. The analysis supports the government's efforts to engage in tax competition but queries whether there are more effective reforms, other than restricting double dips, to deal with the problem of excessive interest deductions for foreign operations.

The final section of the paper sets out four tentative international tax proposals that have attracted academic and policy support over the years to further reduce tax as a barrier to Canada-US crossborder investment. While more research is required to explore potential costs and benefits, the federal government should consider taking steps to:

- reduce tax discrimination that favours domestic investment over US investment;
- abolish withholding taxes for crossborder parent/subsidiary dividends;
- amend group taxation laws and promote crossborder tax relief; and
- enhance tax cooperation through mechanisms such as a case-by-case tax approval process for crossborder mergers and acquisitions.

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1 At the end of 2007, US investors accounted for 58 percent of total FDI holdings in Canada, down from 61 percent in 2006; in dollar amounts, however, US direct investment holdings increased by $21.4 billion in 2006 to $288.6 billion in 2007 (Statistics Canada 2008). In contrast, Canadian investors provide a much smaller percentage of overall FDI flows to the United States: roughly $17 billion of $109 billion in FDI to the United States in 2007, approximately 16 percent of the inflows (United States 2007a).

These reforms could help to ensure that tax does not prevent the Canadian economy from reaping economic benefits through closer ties with the US economy.

Evaluating Recent Tax Treaty Changes

On September 21, 2007, Canada and the United States signed the Fifth Protocol to revise their bilateral tax treaty. Canada ratified the protocol on December 14, 2007, but the United States has not yet done so, and the protocol will not enter into force until this ratification takes place.[2] Before discussing the changes that will take place under the tax treaty, it may be helpful to describe briefly the role the treaty plays in setting the rules that govern the tax treatment of crossborder investment.

Currently, the tax treaty sets out two different methods of taxing crossborder investment, depending on whether the investment generates what is broadly construed as active business profits or "passive" income such as interest, dividends, or royalties. With respect to the former category, the treaty entitles each country to tax active business profits arising from FDI if the foreign investor maintains a "permanent establishment" in the other country to which the profits can be attributed. For example, if a US music retailer wished to expand into the Canadian market, opened a store in Toronto, and earned $1,000 in profits from sales to local consumers, the store would constitute a permanent establishment under the tax treaty, entitling the Canadian federal government to tax all business profits attributable to the store. If, however, the US retailer merely sold music to Canadian consumers, perhaps through a commercial website, without opening a store, Canada would generally not be permitted under the treaty to tax the profits generated by music sales to Canadian consumers.[3]

For the passive category, when a payment of crossborder interest is made to a nonresident individual or firm, the tax treaty currently mandates the imposition of a 10 percent gross withholding tax on the payment, and the payer is required to remit the withheld amount to the relevant tax authority, either the Canada Revenue Agency (CRA) or the US Internal Revenue Service (IRS). For example, if a Canadian parent company loans money to its US subsidiary, which then makes an interest payment of $100, the subsidiary is required to withhold $10 and remit that amount to the IRS, and the parent corporation receives the remaining amount.[4]

Canadian tax rules strive to tax Canadian residents on their worldwide income

As a broad generalization, Canadian tax rules strive to tax Canadian residents on their worldwide income – that is, their income from both domestic and foreign sources.[5] However, the tax laws of both Canada and the United States, as well as provisions of the tax treaty, are designed to provide relief from international double taxation. Since other countries might try to tax income generated within their borders by Canadian residents, Canada's tax rules attempt to inhibit such double taxation of the same income by providing a foreign tax credit to offset the Canadian tax otherwise payable on foreign-source income earned by Canadian taxpayers. In the withholding tax example, the Canadian resident taxpayer would generally be permitted to use a $10 foreign tax credit to offset Canadian taxes otherwise payable. In the permanent establishment example, the United States, which similarly grants foreign tax credits to relieve double taxation, would provide a foreign tax credit for Canadian taxes paid on the profits of the Toronto-based store.

2 On July 10, 2008, the protocol was introduced to a US Senate committee to begin the ratification process. While the protocol will generally enter into force after congressional ratification, Article 27 sets forth a number of specific effective dates (some retroactive) for various provisions of the protocol.

3 Under certain narrow circumstances, if the US retailer sold digital music to Canadian consumers through a computer server in Canada, the server might constitute a permanent establishment, which would then entitle Canada to tax profits attributable to the server (Cockfield 2001).

4 Withholding taxes for certain crossborder payments date back to the original bilateral tax treaties that were modelled after League of Nations efforts in the post-World War I environment (see League of Nations 1925).

5 A major exception to this rule is that Canadian tax laws effectively exempt from Canadian taxation any active business profits generated within a foreign corporate affiliate that is based in a tax treaty partner or a country that has negotiated a tax information exchange agreement with Canada.

The Abolition of Withholding Taxes on Interest Payments

The most important change in the Canada-US tax treaty is the decision to abolish, over a stipulated time, withholding taxes on crossborder interest payments. For interest paid between non-arm's-length parties – for example, between a parent corporation and its wholly owned subsidiary – the new protocol proposes to reduce the interest withholding tax from 10 percent to 7 percent in the first year, to 4 percent in the second year, and to eliminate the withholding tax completely in the third year after the protocol enters into force.

The protocol also proposes to abolish immediately crossborder interest payments between arm's-length taxpayers – that is, taxpayers who cannot effectively exert control over one another. For example, a Canadian corporation that invested in US government bonds would no longer have to pay withholding tax on any interest the US government paid on the bonds. In addition to this treaty change, Canada amended the federal *Income Tax Act,* effective January 1, 2008, to repeal the withholding tax on crossborder interest payments between arm's-length parties.[6]

There are sound policy reasons to support these developments, in part because withholding taxes are sometimes portrayed as barriers to crossborder investment. For instance, if a taxpayer cannot receive a foreign tax credit for the withholding tax payment, then double taxation could result. Consider the example of a US firm that borrowed money from a related Canadian company to fund its crossborder investment. The Canadian firm would pay, say, $100 in interest and, prior to the treaty changes, would withhold and remit $10 to the CRA. The related US firm would be entitled to a foreign tax credit to offset the $10 it effectively paid in Canadian taxes; at the same time, this credit would reduce the tax owed by the US firm to the US government. But the related US company might not be eligible to use a foreign tax credit for the $10 it paid in Canadian tax if it declared a loss for the fiscal year (and hence did not owe any US tax) or if its net income tax owed to the US government on the payment was less than the gross amount that was withheld. Financial institutions often cannot obtain full foreign tax credits for these withholding taxes because the recipient of the interest might have a very narrow spread on the income, so that the domestic tax is less than the withholding tax. In such circumstances, double taxation can result that inhibits crossborder investment activities. Moreover, the withholding tax increases compliance costs for both companies – in particular, the US firm has to plan to avoid double taxation – which also discourages such ventures.

The abolition of the withholding tax does, however, raise the policy concern that Canada, as a net importer of capital from the United States, will lose revenues associated with the imposition of the withholding tax on crossborder interest payments to US companies – the Department of Finance estimates such revenues to have amounted to $381 million in 2005 (Canada 2008, 39).

Transfer-Pricing Issues

When multinational firms with related parties in the two countries transfer goods, services, or capital among the related parties, a transfer price is set for such transactions. The transfer price received or charged for goods, services, or financing is included in the supplier's income, and the corresponding cost or payment is deducted from the related party's profits. The transfer price is thus an important factor in allocating the profit from the transaction to the parties. In recent years, however, Canadian and US tax authorities increasingly have disagreed on how to divvy up taxable profits derived from businesses with operations in both countries. The two countries had negotiated a treaty provision on voluntary

6 *Income Tax Act*, R.S.C. 1985 (5th Supp.), c. 1, s. 212(1)(b).

arbitration of tax disputes in the Third Protocol, in 1995, but never implemented the provision, although binding arbitration provisions exist in both the Canada-Mexico tax treaty and the US-Mexico tax treaty. Under the new protocol, however, if the tax authorities cannot resolve a dispute, the taxpayer will, under certain conditions, be able to compel the authorities to refer the dispute to a panel for binding arbitration. This reform should help to resolve the issue of taxes owed and relieve taxpayers of having to worry about increasingly contentious tax disputes dragging on for years.

Tax laws in the two countries, as well as the tax treaty, require related companies to use the market price (or arm's-length price) when they charge for crossborder transfers of goods and services.[7] This requirement helps to prevent taxpayers from manipulating their profits so as to avoid paying their "fair" share of taxes to both countries. For example, because the two countries maintain different tax regimes, taxpayers engage in arbitrage strategies to gain tax benefits. A fairly straightforward strategy involves a company in one country increasing the price of intercompany transfers of goods shipped to a subsidiary in the country with the heavier tax burden, thereby shifting accounting profits to the lower-tax country – in effect, the company's profits are allocated for tax reasons. This kind of strategy, however, wastes businesses resources and diverts revenues away from the treasury of the country where the value-adding economic activity takes place.

Nevertheless, it is often difficult to determine the appropriate arm's-length price. For instance, when related companies transfer unique assets such as patents, there is no market transaction between them that can be used to determine the appropriate price. For this reason, taxpayers in Canada and the United States often get embroiled in disputes with their tax authorities, which assert that they have not charged the appropriate transfer prices for their crossborder transactions. Turner (1996) suggests that, because the IRS is perceived to have become more aggressive in auditing transfer prices, tax advisors might have compensated by recommending shifting more profits to the United States, resulting in fewer taxable profits in Canada. Partly in response to this perception, the CRA has audited the transfer pricing practices of multinational firms more aggressively in recent years, thus increasing compliance costs in this area and leading to more disputes between taxpayers and the Canadian tax authorities (Smith and Kelly 2005).

The danger of significant misallocation of revenues is exacerbated, moreover, because roughly two-thirds of the trade between Canada and the United States takes place between related firms (Rugman 1990, 36). In 2006, for example, the two countries had roughly $626 billion in trade (Statistics Canada 2007, chart 20:2). It is likely that related-party transactions between the two countries will increase as a result of global business trends, including a reduction in communications costs, which are encouraging higher levels of integration of crossborder supply chains and a more complex and sophisticated range of economic activities (Dymond and Hart 2008).

As an important step forward on transfer-pricing issues, Canada and the United States have agreed to use transfer-pricing guidelines established by the Organisation for Economic Co-operation and Development (OECD) to determine the appropriate market price to be charged between related parties. A common understanding of the rules and principles, along with mechanisms to force agreement according to the underlying facts and circumstances, should help to promote the effective resolution of transfer-pricing disputes between the two countries. In a related move, the CRA has expanded and streamlined its advanced pricing agreement (APA) program, under which taxpayers, the CRA, and foreign tax authorities agree on the methodology to calculate transfer

7 See s. 247 of Canada's *Income Tax Act,* reg. s. 1.482 of the US Internal Revenue Code, and Article IX of the Canada-US tax treaty.

prices.[8] One such method is to use the comparable uncontrolled price, whereby taxpayers establish an arm's-length price by referring to sales or purchases of similar products and transactions between unrelated parties. Despite this progress, however, there has been little improvement in the time it takes to finalize an APA, in part because of delays caused by dealings with the US tax authorities (Skretkowicz and Diebel 2006). Finally, in 2004, the Canadian and US tax authorities signed an agreement to adopt consistent transfer price documentation requirements through the Pacific Association of Tax Administrators (PATA), which could help to reduce compliance costs for firms with related-party operations in both countries (Canada 2004b). Extending PATA membership to the Mexican tax authorities would promote a more harmonious tax environment for the North American marketplace by allowing firms to follow one clear set of rules.

Notwithstanding this progress on transfer pricing, at least two areas of concern remain. First, Canada, unlike the United States, has decided to proceed with administrative pronouncements instead of enacting tax laws (see Canada 1999). Since these pronouncements are persuasive to courts, at best, a fair amount of uncertainty remains with respect to, for instance, the appropriate transfer-pricing methodology. Such tax uncertainty does not help to promote crossborder investment activity. The federal government could help to clear up this problem by legislating aspects of its information circular or at least by making reference to the OECD transfer-pricing guidelines in s. 247 of the *Income Tax Act.*[9]

Second, in an environment of heightened auditing, enhanced documentation requirements, and the need for more sophisticated tax advice (often by economists and other experts) to discern and protect an appropriate transfer-pricing methodology, compliance costs for Canadian firms inevitably are rising, which could inhibit crossborder investment. As discussed in more detail in the next section, the Canadian tax authorities should consider additional cooperative efforts with their US counterparts – for example, to reduce or eliminate some of the documentation requirements for highly integrated North American firms, while ensuring that enhanced audit cooperation lowers the risk that reduced reporting requirements will lead to abusive tax planning that erodes the Canadian tax base.

The Extension of Treaty Benefits to Owners of US LLCs

The Canada-US tax treaty has also been amended, under Article IV(6), to extend treaty benefits to owners of business entities called limited liability companies (LLCs), formed under the laws of US states and often used for crossborder investment purposes, and to deny treaty benefits for certain aggressive tax-planning structures. The first reform should facilitate US investment in Canada, but the second could inhibit some inward investment. At the end of the day, it remains unclear whether the net effect will be to increase or reduce tax as a barrier to crossborder investment between the two countries.

By way of background, under the current tax treaty, benefits are extended only to residents of

8 A recent study has found that 80 percent of APAs are negotiated among taxpayers and the Canadian and US tax authorities (Canada 2006/2007). The remaining 20 percent involve agreements with six other countries, principally Japan, the United Kingdom, and Australia.

9 In the past, Canadian courts have looked to OECD materials when interpreting provisions of Canadian tax treaties, and they may well refer to the OECD transfer-pricing guidelines, which the CRA has endorsed, to encourage consistency with the application of transfer-pricing rules used in other jurisdictions. For a discussion of the relationship between Canadian transfer-pricing rules and those of the OECD, see *SmithKline Beecham Animal Health Inc. v Canada,* [2002] 4 CTC 93 (FCA). An explicit reference within s. 247 of the *Income Tax Act* to adhere to the OECD guidelines would be the preferred route to promoting tax certainty.

each country, and the CRA has taken the position that LLCs and their owners do not qualify.[10] The reluctance to extend benefits to LLCs stems in part from the fact that Canadian federal and provincial business laws generally do not permit the formation of similar entities. Although LLCs have been around for several decades, their usage exploded in many states in the 1990s, and they are a familiar entity for US investors. An LLC resembles a Canadian corporation in that it generally provides immunity to its owners, who are referred to as "members," not shareholders, and corporate profits are taxed once at the corporate level and again at the shareholder level when the profits are distributed by way of dividends. Under the US tax regime, however, LLCs can be treated as fiscally transparent entities,[11] similar to Canadian partnerships, so that profits and losses "flow through" the entities – that is, the entities themselves are not taxed – and are taxed only once in the hands of the members. This tax treatment is particularly important for investors who foresee initial losses when a new venture is started, as they can often use these losses to offset gains from other sources of income. Since, under US tax laws, corporate taxpayers are generally permitted to engage in loss offsetting, US investors, all else being equal, would prefer to make domestic investments if they envision start-up losses.

In Canada, the two types of business entity that most closely resemble a US LLC are the Nova Scotia unlimited liability company – which has been around even longer than LLCs, though less frequently used for business purposes outside of tax planning – and the Alberta unlimited liability company, introduced in 2006. Like LLCs, these two entities are often used for tax-planning purposes by US investors to consolidate losses and to maximize their US foreign tax credits.[12]

The extension of treaty benefits to members of LLCs means that Canada will treat LLCs (and similar business entities) as corporations with Canadian source income, and any distribution of income to members will be subject to the reduced withholding tax rates set out in the new protocol. To illustrate, if a US resident were to receive income, profit, or gain, through a fiscally transparent US LLC, from Canadian sources that was then taxed as though it were earned directly by the US resident, that amount would be treated under the revised treaty as though it had been derived directly from US sources.

As the current treaty does not allow Canadian and US taxpayers to engage in crossborder loss offsetting, the new provision should facilitate inward investment by US investors by permitting them to reap tax benefits from losses that were previously trapped within their Canadian investments. On the other hand, in a more under-the-radar development, the Canadian Department of Finance has introduced complex new rules to restrict the use of certain hybrid business entities, which, like LLCs, are businesses that are treated as taxable entities in one country and as fiscally transparent entities in the other.[13] These entities, sometimes referred to as "reverse hybrids," are used in the Canada-US context to promote tax-efficient crossborder financings and holding structures.

In another important reform, Canada has agreed to try to inhibit "treaty shopping," which occurs when an investor outside Canada or the United States

10 The CRA's view has been that, unless it elects to be treated as a corporation for US federal income tax purposes, an LLC cannot be considered as resident under Article IV(1) of the treaty since it is not a person liable to tax in the United States at the entity level. See, for example, CRA doc. no. 2004-0064761R3 2004.

11 The US Internal Revenue Code prescribes the classification of various organizations for federal tax purposes, including which entities, domestic and foreign, are to be regarded as corporations *per se* (see I.R.C. Regs. § 301.7701-1). Generally, under the default classification rules, a domestically eligible entity is a partnership if it has two or more members and disregarded as an entity separate from its owner if it has a single owner (I.R.C. Regs. § 301.7701-3(b)(1)).

12 Under US "check-the-box" regulations, the default classification for LLCs and the similar Canadian business entities is to be treated as a flow-through entity.

13 Article IV(7) of the revised tax treaty contains two highly technical rules. Under the first rule (paragraph (a)), treaty benefits may be limited where, for example, income from Canadian sources is derived by a US resident through a Canadian partnership that is treated as a fiscally transparent entity for Canadian tax purposes and as a nonresident corporation for US tax purposes. Under the second rule (paragraph (b)), treaty benefits may be limited where, for example, income from Canadian sources is derived by a US resident through a Canadian unlimited liability company that is treated as a corporation for Canadian tax purposes and as a fiscally transparent entity for US tax purposes. The new article will take effect on the first day of the third calendar year that ends after the Fifth Protocol enters into force.

engages in tax planning to gain access to the benefits of the Canada-US treaty. This represents a policy change from earlier negotiations with the United States, since the federal government traditionally had taken the view that, in order to attract more investment to Canada, treaty benefits should be provided to investors based outside the United States and had agreed in 1984 only to prevent foreign investors from using the treaty to gain access to the US market.

The elimination of certain hybrid business entities for planning purposes and the new reciprocal limitations-on-benefits article will have a countervailing effect, however, on the move to extend treaty benefits to members of LLCs. Thus, North American tax advisors will need to review carefully existing and planned crossborder tax planning structures to ensure they comply with the treaty changes. At the end of the day, it is not clear that US or Canadian investors will be in a better or worse tax position to take advantage of potential start-up losses from their crossborder investments.

In summary, most of the tax treaty initiatives appear to support Canadian economic interests and represent real progress in eliminating tax as a barrier to Canada-US crossborder investment. Moreover, this progress could signal readiness on the part of the federal government to tackle other tax policy challenges.

Assessing Ongoing Reform Efforts

Two ongoing reform efforts by the Canadian federal government have particular significance for crossborder investment: steps to maintain Canada's tax competitiveness vis-à-vis the United States, and draft legislation to eliminate double-dip financing of crossborder investments with related firms in the United States and elsewhere.

Protecting Canada's Tax Competitiveness through Corporate Tax Rate Competition

An interesting feature of Canada's international tax policy in recent years has been Ottawa's effort to engage in explicit corporate income tax rate competition with the United States (as well as with other trade partners). For instance, under the previous Liberal government, the Department of Finance began to publish pronouncements that touted the "Canadian tax advantage" by drawing comparisons between Canadian corporate income tax rates and their US counterparts (while generally ignoring the rates in other countries). A 2002 document set out a number of such comparisons, and forecast that the average federal corporate tax rate in Canada would be more than six percentage points lower than its US counterpart by 2008 (Canada 2002). The current government appears to be engaging in a similar strategy by, for example, drawing attention to its announcement to reduce federal corporate income tax rates from 19.5 percent in 2008 to 15 percent by 2012, and showing how these rates compare favourably to US rates. After announcing the cut in the House of Commons on October 30, 2007, Finance Minister Jim Flaherty noted, "This will give businesses in Canada a substantial tax advantage over competitors in the United States – to be precise, a statutory tax rate advantage of 12.3 percentage points and an overall tax advantage on new business investment of 9.1 percentage points in 2012" (Flaherty 2007).

EXAMINING THE MERITS OF TAX COMPETITION: Is tax rate competition a good idea from a policy perspective? There is a significant body of literature that examines the merits of tax competition, although the bulk of these writings focuses on theoretical considerations and subnational tax issues (see, for example, Wilson and Wildasin 2003; McKenzie 2006). A lack of empirical work in the international tax arena and uncertainty about the ways taxpayers react to tax changes with respect to crossborder investment thus creates problems for legal analysis (see, for example, Cockfield 2007).

Recognizing these limits, concerns nevertheless remain that tax competition can lead to a so-called race to the bottom as countries compete by continually lowering rates to the point where they are unable to fund needed government services. In a related point, countries that engage in tax competition might feel the need to focus taxation on less mobile factors of production, such as workers, while providing relief to more mobile factors, such

as capital; the end result, according to some circles, could be an increasingly regressive tax system with a heavier tax burden on labour and a relatively lighter burden on investments (and, hence, on taxpayers who own these investments). Moreover, in an environment of increased economic integration, it is more difficult to restore progressivity to the income tax system by raising taxes on high-income workers who may move to a country with a relatively lighter tax burden.[14]

Will tax competition in the Canada-US context lead to a race to the bottom? When one takes into consideration the economic and political needs of each country, it seems unlikely that this will take place (Cockfield 2005, 164-74). Both countries wish to enhance their ability to attract inward investment, but both also prefer to preserve as much political control as possible over their tax systems because they use these systems to promote different economic and social policy goals. Canada, as the smaller economic unit, closely follows US tax policy developments in certain cases to ensure that they do not harm its ability to attract and maintain US investment. Accordingly, for the federal government, economic concerns trump political concerns, and in matching US moves, it often foregoes its sovereign right to pursue distinct tax policy. Because the United States draws a much smaller amount of inward investment from Canada, it does not need to engage in tax competition with Canada. It is either indifferent or unwilling to sacrifice tax sovereignty to follow the lead of a foreign country. It also bears mentioning that, according to one view, relatively smaller economies can benefit to a greater extent from tax competition as investors in these countries are more sensitive to tax differences than are investors in larger economies (Wilson and Wildasin 2003). For these reasons, Ottawa's strategy to engage in limited corporate income tax rate competition is both rational and likely to promote economic benefits to the Canadian economy.

The US does not need to engage in tax competition with Canada ...

A potential drawback of this strategy – at least, to the extent that it promotes actual differential tax burdens – is that it might encourage tax distortion as US investors seek out Canadian investments for tax reasons, rather than for real economic reasons, which could inhibit capital productivity in both countries. In other words, giving a break to US investors would raise the after-tax returns on their crossborder investments, which might induce inward investment into Canada even if, in the absence of taxes, it would have been more efficient for these US investors to invest at home. This might distort crossborder investment decisions to allocate these investments in a manner that is not economically efficient (see Committee of Independent Experts on Company Taxation 1992, chap. 10). Reduced efficiencies, in turn, might lead to a reduction of the overall economic welfare or living standards that the citizens of the two countries might otherwise enjoy.

Another worry is that lowering tax rates could diminish corporate tax revenues. In fact, despite ongoing rate reductions, these revenues have been on the rise in recent years, in part because of the taxation of robust corporate profits from the resources sector (Canada 2007). This outcome might be a short-term result, however, which could change depending on a weakening of demand for natural resources or other factors.

RELATIVE TAX BURDENS ON CAPITAL: In any event, it is also important to note that, government hype notwithstanding, Canada continues to impose a higher tax burden on investment than does the United States under many circumstances. Corporate tax rates, in any case, determine only a portion of this burden, as other aspects of the tax system – such the ability of taxpayers to write off equipment depreciation – as well as nontax factors – such as interest and inflation rates – also contribute to the ultimate tax burden on crossborder investment. Moreover, taxes on individual

14 Analysis of income tax data on taxpayers who left Canada for foreign countries during the 1990s shows that individuals who earned more than $150,000 a year were seven times as likely to leave than the average taxpayer (Statistics Canada 2000).

investors, in addition to corporate taxes, ultimately must be taken into consideration when scrutinizing overall tax burdens on crossborder capital.

Studies of the marginal effective tax rate (METR) strive to take these factors into account; the results reflect a rough estimate of the tax burden investors face for each additional dollar of crossborder investment (see, for example, Boadway 1985). Once these METRs are generated, they can be compared with the METRs investors face in other countries to see whether a particular national tax system imposes a relatively higher or lower tax burden. One such study (United States 2007b), which takes into account both corporate and individual income tax regimes, suggests that, in many Canadian sectors, investments face a higher overall tax burden than they do in the United States – indeed, in 2006, Canada had the second-highest METR (after Germany) of the G7 countries (ibid., 40). Importantly, taxes imposed on corporations and individuals by the provinces are significant contributors to Canada's higher METR. Another recent study shows, however, that when one takes into account only taxes paid by corporations, the tax burden on capital is, on average, lower in Canada (Mintz 2007, 9). While METRs try to measure the effect of tax on marginal investment decisions, average corporate tax rates can also be helpful in assessing the overall portion of economic activity taken up by corporate taxes; by this criterion, average corporate tax as a percentage of gross domestic product over the 2000-05 period was 3.8 percent for Canada and 2.2 percent for the United States (United States 2007b, 42-43).[15]

THE END OF CORPORATE INCOME TAX RATE REDUCTIONS? Not all studies just referred to take into account the recent round of rate reductions and other efforts by the federal government to reduce the tax burden on individuals and businesses. Nonetheless, to the extent that tax competition brings overall benefits to the Canadian economy, it might be necessary to amend other aspects of Canada's tax regime besides rates, to reduce the tax burden on marginal investment below its US counterpart. Such a move, however, would run up against theoretical objections by tax policy analysts who generally support the view that low tax rates and a broad tax base are necessary to promote tax efficiencies and corresponding long-term economic growth (see, for example, Canada 1966; Committee of Independent Experts on Company Taxation 1992).

Importantly, Canada and the United States have agreed to curtail certain harmful forms of tax base (but not tax rate) competition for crossborder financial and other services through the OECD's harmful tax competition project. Canada, for example, has dismantled "preferential tax regime" provisions – that is, tax provisions surrounding nonresident-owned investment companies, international banking centres, and international shipping – that were identified in earlier OECD reports (OECD 1998, 2000). And, in its 2008 budget, Ottawa supported tax breaks to encourage more research and development and manufacturing activities. These reforms suggest that the Canadian federal government is pursuing heightened tax base competition by giving special breaks to certain sectors to enable them to compete more effectively in the international arena.

Protecting the Income Tax Base by Eliminating Double-Dip Financing

Another recent policy initiative by the federal government is its effort to inhibit aggressive crossborder financing structures that were perceived to reduce Canadian tax revenues unduly. While this reform was motivated by compelling policy reasons, there might be more effective tax initiatives with which to attack the apparent

15 The study, conducted by the US Treasury Department, explains the United States' relatively high METR and relatively low average tax rate by noting that the United States has a relatively narrow tax base that permits more depreciation, more corporate tax preferences, and a relatively high corporate income tax rate that incentivizes tax planning, which further reduces overall revenues.

problem of excessive interest deductions to fund foreign operations.

COMPELLING POLICY REASONS TO INHIBIT AGGRESSIVE CROSSBORDER FINANCING: In its 2007 budget, Ottawa initially proposed to deny interest deductions for any interest expenses that could be traced to earnings-exempt foreign-source income. In its original proposal, the Department of Finance (Canada 2007, 241-42) noted that this reform had been discussed earlier by the Technical Committee on Business Taxation (Canada 1997) and by the auditor general of Canada. The main opposition to this reform came from those who felt this step would make Canadian companies less competitive than their foreign counterparts, since eliminating tax-favoured foreign financing would raise the cost of capital for crossborder ventures (Brown and Poschmann 2007). In May 2007, Ottawa amended the earlier proposal to target only interest expenses attributable to more aggressive or "double-dip" and other "tax-efficient" financing structures. This proposal, which provides for a transition period to 2012, was set out in draft legislation by the Department of Finance on October 2, 2007, and enacted as new section 18.2 of the *Income Tax Act* on December 14, 2007.

Double-dip financing structures arise from the peculiarities of Canadian tax laws and the ways these laws interact with the tax laws of foreign countries. By way of background, in the normal course of events, a business deducts its interest expenses as a cost of doing business, and the interest is included and taxed in the hands of the creditor – for example, if a Canadian bank receives $100 in interest income, it will be taxed on this income. Because of Canadian tax laws, however, interest on loans through the financing of affiliates located in low or nil tax jurisdictions often are not subject to tax. A related party in Barbados, for instance, can loan money to a related Canadian company, but the interest income is subject to the lower tax of Barbados, which is also a tax treaty partner of Canada's. Moreover, the Canadian company can generally repatriate the interest income from its financing affiliate in Barbados on a tax-exempt basis.[16] This is sometimes referred to as a "single dip," as the Canadian debtor corporation deducts the interest and lowers its tax bill while the corresponding income inclusion in the foreign affiliate is free of tax (assuming the affiliate is located in country without a corporate income tax).

A double dip occurs when the foreign financing affiliate lends money to a related operating company typically based in a relatively high-tax country, such as the United States.[17] The operating company pays interest to the financing affiliate and is entitled to deduct the interest payment to reduce its taxable income in the high-tax country. If properly structured, the interest payment will remain untaxed by the financing affiliate's country and, again, the money can be repatriated to Canada free of Canadian tax. Double-dip financing structures hence permit two interest deductions in two countries for, effectively, one loan transaction.

For a number of reasons, the double dip can be portrayed as offending international tax law and accounting policy principles. As a starting point, there is a general accounting and tax law principle called the matching principle, which maintains that businesses should be entitled to a business expense deduction if this expense can be matched with the production of income for the business.[18] The single and double dip, however, sidestep the matching principle, since an item of income escapes taxation while providing a tax benefit to the Canadian corporation, which also erodes the Canadian tax base. By dodging the matching

16 This result is achieved through the "exempt surplus" rules in s. 95 of the *Income Tax Act,* which permit the tax-exempt repatriation of profits from active business income generated within a tax treaty partner country. Section 95(2) permits the interest income to be recharacterized as active business income, so that it can generally be distributed on a tax-exempt basis to the Canadian affiliate. Recent tax law changes extend the exemption system to foreign affiliates based in countries that have negotiated a tax information exchange agreement with Canada.

17 A second dip can also take place in Canada, for example, as part of a structure to guard against foreign-exchange risk.

18 Accounting principles, including the matching principle, must be used as a guide for the calculation of business profits for tax law purposes unless there is an express provision in the *Income Tax Act* that indicates otherwise. See Canderel Ltd. v. R. [1998] 1 S.C.R. 147 (S.C.C.).

principle, the double dip also violates the tax policy goal of horizontal equity, which calls for the same tax treatment of similarly situated taxpayers. A domestic business is entitled to deduct interest expenses to fund its income-producing activities. Yet a Canadian firm that is expanding its business internationally can take advantage of double-dip financing, which effectively lowers the cost of debt capital for foreign operations – that is, the tax benefits make it less expensive to borrow money to finance foreign projects. As a result, tax laws that permit double dips generally impose different tax treatment on domestic firms and firms with international operations.

A policy concern exists that this differential treatment could demoralize taxpayers who are not eligible for the double dip (or the single dip, for that matter). A reasonable Canadian taxpayer – let us call her "the woman on the Ajax GO train," a term that can stand in for the reasonable English taxpayer referred to by English and Canadian tax court judges as "the man on the Clapham omnibus"[19] – might be puzzled indeed by the creative tax planning that appears to favour firms with resources that enable double interest deductions on the same item of income. If the woman on the Ajax GO train owns a business, she might additionally be upset that her own local business cannot access debt capital on a similarly tax-favoured basis. The notion that the financing activities of domestic and international firms should be taxed in a similar manner induces tax compliance among residents because they perceive the tax system to treat similarly situated taxpayers in a similar manner (Shay, Fleming, and Peroni 2002).

In a related point, the favouring of crossborder financing also violates the international tax policy principle of capital export neutrality, which maintains that the tax system should not provide tax incentives to invest abroad. As discussed previously, when tax artificially reduces the costs of certain crossborder transactions, this might induce taxpayers to engage in unproductive activities for tax reasons, not for real economic rationales. In this case, double-dip financing structures could act as an incentive for Canadians to invest abroad, distorting investment decisionmaking in an unproductive manner.

PROBLEMS WITH THE DOUBLE-DIP PROPOSAL: Nevertheless, complicating factors urge caution in the implementation of the legislation to restrict double-dip financing. Once single dips become acceptable on the basis of promoting Canadian tax competitiveness (as Ottawa apparently now accepts), it is not clear that eliminating the double dip would promote Canadian economic interests. One problem is that the second dip normally takes place in a third country where business operations are based, not in Canada, hence the deduction reduces taxable profits and revenues for foreign governments, but not necessarily for the federal government. As discussed in the example above, the second interest deduction generally takes place when a related business based in a high-tax country such as the United States makes an interest payment to a related financing affiliate based in a tax haven. Because the double dip does not unduly erode the Canadian income tax base, it is not clear how the attack on double-dip financing fits with Ottawa's larger strategy to combat the abusive use of tax treaties.

Because Canadian firms apparently have used the double dip for at least several decades, they assert that this financing structure has helped them to compete with foreign competitors by reducing the cost of raising debt capital (Brean 1984, 120). If this claim is true, the elimination of this method for financing arguably could harm the interests of Canadian firms while saving revenues only for foreign governments. As mentioned, METR studies generally estimate that the tax burden on investment in many sectors is higher in Canada than in the United States, but these studies do not account for sophisticated crossborder tax planning that ultimately determines the tax bill that firms with operations in both countries pay. According to one view, many US international tax rules – including the check-the-box regime that allows US

19 See, for example, Justice Bowman, in *Klotz v The Queen,* [2004] 2 CT.C. 2892 (T.C.C.), affirmed [2005] D.T.C. (F.C.A.).

taxpayers to elect how their business entities will be treated for crossborder tax-planning purposes – appear to encourage international tax arbitrage that reduces tax revenues in relatively high-tax countries such as Canada (Rosenbloom 1998). It is thus difficult to say whether tax-planning activities make Canadian firms more or less tax competitive with respect to their US counterparts, which deploy their own aggressive tax-planning structures.[20]

It is also important to note that technical problems associated with Ottawa's legislation might inhibit broader crossborder financing schemes than double dips or the other targeted tax-efficient structures; if this is the case, the proposed changes would further restrict the ability of Canadian firms to plan for tax efficiencies in the Canada-US context and place these firms at a greater tax disadvantage (Slaats 2007, 688). This uncertainty also suggests that Ottawa should proceed with caution, as we simply do not know whether this reform will have a material effect on crossborder investment decisions by US investors.

Moreover, if the US or any other foreign government deems the revenue loss to be unacceptable, it can take unilateral steps to restrict double dip and other financing strategies involving Canadian resident corporations, as the US government has done in the past to restrict perceived overly aggressive tax-planning strategies by US investors with investments in Canada (Kane 2004).[21] As previously discussed, the Fifth Protocol would amend the Canada-US tax treaty to inhibit the use of certain tax-efficient structures for planning purposes – for example, structures that deploy reverse hybrid entities. In fact, new Article IV(7)(b) of the treaty appears to be designed to restrict the use of double-dip financing structures, which raises the question of whether the Canadian government's additional unilateral measures to restrict double-dip financing and similar strategies are even necessary, at least in the Canada-US context. If US tax laws facilitate tax planning that takes advantage of different Canadian and US laws to reduce global tax liabilities, including a reduction in Canadian tax revenues, it is unclear why the Canadian tax authorities would cooperate with their US counterparts to restrict certain forms of tax planning that unduly reduce US tax revenues.

Finally, the draft legislation requires the tracing of Canadian interest payments to the financing of foreign-source income. The tracing concept requires segregating funds borrowed for financing foreign operations from other funds. This approach is notoriously difficult to enforce, however, in part because the Supreme Court of Canada has accepted certain tax-planning structures that appear to circumvent the requirement.[22] In addition, to avoid the legislation, Canadian firms might engage in tax planning to move their financing activities out of Canada or substitute the debt for other tax-preferred financing, even if it is less economically efficient to do so.[23] Accordingly, the new tax laws might not achieve their goal of restricting excessive interest deductions to fund foreign operations.

ALTERNATIVE SOLUTIONS: Another perspective maintains that there are more efficient routes to attack the apparent problem of excess interest deductions for foreign operations. Several commentators who have scrutinized this issue carefully maintain that an Australian-type "thin capitalization" rule may be more effective at combating this problem than the approach currently

20 In 2000, the US Treasury and IRS issued final regulations to clarify the rules that permit treaty benefits for crossborder income paid to certain hybrid entities. See I.R.C. Regs. § 1.894-1(d), which describes the eligibility rules for reduced treaty rates for income derived by an entity that is fiscally transparent. Articles IV(6) and IV(7)(a) of the revised Canada-US tax treaty, which attack the use of certain reverse hybrid entities for planning purposes, appear to follow the approach set out in these US final regulations.

21 For example, the United States has passed tax laws denying treaty benefits and recharacterizing deductible interest payments as nondeductible dividend payments for certain transactions involving, inter alia, Canadian resident corporations.

22 See, for example, *Ludco Enterprises Ltd. v Canada,* [2001] 2 S.C.R. 1082 (S.C.C.), which held that interest deductions were permissible within an international tax planning structure that provided significant tax benefits.

23 Studies (for example, Altshuler and Newlon 1993) show that multinational firms can substitute different financing and repatriation strategies to reduce global tax liabilities, and that these substitutions are largely unconstrained by nontax factors.

advocated by the federal government (see, for example, Mintz and Lanthier 2007; Edgar 2008). Thin capitalization rules are tax laws that strive to prevent excessive interest deductions in related companies based in different countries. Under the Australian approach, the thin capitalization regime applies, with modifications, to both outbound and inbound FDI. In contrast, Canada's thin capitalization rules apply only in the context of inbound financing, so that, if a loan is made from a related party based outside Canada to its Canadian corporate affiliate, the affiliate is permitted to deduct only those interest payments associated with interest on debt that exceeds the specified 2:1 debt-to-equity ratio (see Li, Cockfield, and Wilkie 2006, 121-26). In other words, if the Canadian corporate affiliate is too "thinly capitalized" with equity – that is, if its debt-to-equity ratio exceeds 2:1 – the rules will deny the deduction of a portion of its interest payment to the foreign related company.

Of interest, Australia previously attempted to inhibit abusive interest deductions for foreign operations through tax laws that tried to trace local interest deductions to the earning of tax-exempt income in foreign countries, in a way similar to Ottawa's new legislation's attempt to attack double dips. Australia abandoned this approach, however, in favour of reforming its thin capitalization laws, which was thought to be a more effective way to attack the problem (Australia 2001).

It also bears mentioning that many European countries are also redesigning their thin capitalization rules so as to offer roughly equal treatment to inbound and outbound financing as a result of a decision by the European Court of Justice.[24] If the new tax laws prove to be difficult or impossible to enforce, the Canadian government should consider similar reform efforts to amend Canadian thin capitalization rules, which ultimately could prove more effective at attacking the policy problem of excessive interest deductions to fund foreign operations.

Finding Our Way through the Storm: Reducing Tax as a Barrier to Crossborder Investment

As we have seen, a number of recent tax developments should generally reduce tax as a barrier to Canada-US crossborder investment. This section briefly considers further tentative proposals in this direction, although a fuller exploration of the costs and benefits associated with each proposal would be required before one could make more concrete recommendations. Nevertheless, the federal government should consider further reducing discriminatory tax treatment that favours Canadian investors over US investors, eliminating withholding taxes on crossborder parent/subsidiary dividends, promoting crossborder tax relief, and enhancing cooperation between tax authorities to reduce compliance costs for multinational firms with operations in the two countries.

Reduce Canadian Tax Discrimination

In certain cases, Canada continues to pursue discriminatory tax policies that favour Canadian tax interests over those of US and foreign investors. Such discrimination inhibits inward investment from the United States and encourages unacceptable tax distortions that, in the long run, are contrary to Canada's economic interests.

Earlier comparative analysis has shown that discrimination against nonresidents is significantly greater in the Canadian tax system than in those of the United States, the United Kingdom, Australia, or New Zealand (Arnold 1991). A concern in the Canada-US context is the fact that Canada has agreed to extend national – that is, nondiscriminatory – treatment under the US-Canada tax treaty only to permanent establishments of US residents in some circumstances, whereas the United States extends national treatment to US corporations owned or controlled by Canadians

24 For example, in its 2000 *Lankhorst-Hohorst decision,* the Court ruled that, as a result of the EC Treaty, thin capitalization rules cannot impose unequal treatment between resident and nonresident EU companies, leading many EU countries to redesign those rules. In contrast, the one Canadian decision in this area held that such discrimination may be permissible under the Canada-US tax treaty – see *Specialty Manufacturing Ltd. v Canada,* [1998] 1 C.T.C. 2095 (T.C.C.), aff'd [1999] 3 Ct.C. 82 (F.C.A.).

(Wilkie 1994).[25] This is needed, for instance, to permit discriminatory tax treatment under Canada's thin capitalization rules, which might be another reason to consider reforming such rules to target inbound and outbound financing as a way to inhibit double-dip financing. The OECD is currently reviewing possible changes to the nondiscrimination provision in Article XXIV of the OECD model tax treaty under the rationale that expanding national treatment could promote more efficient capital flows among its member countries (see OECD 2007), a reform effort that serves to highlight the problematic nature of the Canadian treaty approach.

Canada's tax laws also include other provisions that discriminate in favour of "Canadian corporations" – generally, corporations that have been incorporated in Canada. For example, such corporations are eligible for tax-deferred rollovers or amalgamations, while foreign corporations often cannot take advantage of this preferential treatment (see Avery Jones et al. 1991, 372-73). Moreover, certain payments, such as those for crossborder services, are subject to a 15 percent withholding tax when paid to nonresident corporations (and other nonresident persons), while the same payments to a Canadian corporation do not attract the withholding tax, which might create a tax disincentive for nonresident service providers to operate in Canada to the extent that they cannot obtain a waiver or foreign tax credit for the withholding tax.[26]

While the North American Free Trade Agreement (NAFTA) does not generally govern crossborder income tax issues, deferring instead under Article 2103(2) to the rights and obligations granted through bilateral tax treaties, tax protectionism is particularly ill-suited to a closely integrated free trade area. As the economies of the two countries become more entwined, the cost of maintaining this discriminatory treatment appears to be escalating. At a minimum, the federal government should scrutinize this treatment and take steps to reform areas where it is causing undue distortions in crossborder investment.

Eliminate the Withholding Tax on Parent/Subsidiary Dividends

In recent years, a number of governments have become convinced that there are compelling policy reasons to eliminate withholding taxes on dividends paid by subsidiary corporations to their parent corporations – so-called parent/subsidiary dividends or direct dividends. In 1990, the EU member states passed a directive to eliminate withholding taxes on parent/subsidiary dividends. In 2001, the United States and the UK agreed to eliminate withholding taxes on parent/subsidiary dividends set out in their tax treaty, as did the United States and Mexico in 2004. Other countries, including Australia, have similarly been trying to eliminate withholding taxes on direct dividends in their tax treaty networks.

As noted earlier, a withholding tax can act as a significant barrier to crossborder investment by increasing compliance costs and contributing, in certain cases, to international double taxation. According to one view, parent/subsidiary dividend withholding leads to unacceptable distortions of investment decisionmaking and, for this reason alone, should be abolished (Easson 1991, 17). The combination of the withholding tax on direct dividends and the interaction of the imputation system in Canada and the classical system in the United States, in fact, might be the leading tax factor in discouraging and distorting crossborder investment decisionmaking (Steines 1994). A

25 See Article 25 of the tax treaty. The treaty provision also prohibits discrimination against individuals on the basis of nationality or citizenship, but Canada, unlike the United States, does not use nationality or citizenship as the basis for taxation, focusing instead on residency. Article 25(8) of the tax treaty provides, however, that Canada can continue to offer discriminatory treatment only for tax laws relating to the deduction of interest that were in force on the date the treaty's signing as well as subsequent modifications; this exception effectively permits discriminatory treatment by Canada's thin capitalization rules that were in place prior to the treaty's signing.

26 See Regulation 105 of the *Income Tax Act*. The withholding tax on services traditionally has been justified on the basis that it can be difficult to collect taxes on services income from nonresidents. Under the Fifth Protocol to the Canada-US tax treaty, a US service provider who is deemed to operate through a permanent establishment in Canada would not be subject to the withholding tax.

withholding tax on direct dividends with other nations might have been appropriate when Canada was a "small, capital-importing country" (Brean 1984, 158), but it is no longer appropriate given Canada's current status as a larger, net-capital-exporting country. The end result is that Canadian companies might increasingly be at a tax disadvantage relative to companies in countries that have eliminated the tax. Moreover, the maintenance of such a tax is, like other areas of discriminatory tax treatment, incompatible with attempts to tie together the economic interests of Canada and the United States in a highly integrated free trade area.

Despite compelling policy reasons to abolish the tax, however, the federal government, during the negotiations leading up to the Fifth Protocol, refused to offer this concession to the United States, in large part because of the revenues at stake: as a net capital importer from the United States, Canada stands to lose almost $1 billion (see Canada 2008, 39) if it abolished the tax, which is currently set at a rate of 5 percent for direct dividends. Because Canada, as a net capital importer from the United States, insists on keeping the tax, the federal government naturally would find it difficult to request that such a tax be reduced or eliminated by countries that are net capital importers from Canada. Thus, abolishing the tax in the Canada-US treaty would place Canada in a better position to negotiate similar reforms in other tax treaties, which should encourage further inward investment into Canada and potentially result in additional tax revenue from the taxation of this increased investment.

Amend Group Taxation Laws and Encourage Crossborder Tax Relief

As outlined previously, a major barrier to crossborder investment is that multinational firms operating in both Canada and the United States generally are unable to enjoy crossborder loss consolidation even though they are trying to benefit from synergies. The denial of loss deductions thus discourages crossborder entrepreneurial activity and risk taking, as governments fully tax any profits when a business succeeds, but deny loss deductions when a business fails. The European Commission has identified group taxation and crossborder tax relief as a major area for policy reform to promote efficient capital flows within the EU, and such reform has been encouraged by European Court of Justice decisions that maintain that the different treatment of losses between European countries violates the freedom of establishment guaranteed by the EC Treaty (European Commission 2001).

Before Canada can negotiate similar steps, however, the federal government likely would have to amend its group taxation laws. Currently, Canadian tax laws do not permit the filing of consolidated tax returns for groups of related companies. As a general rule, losses incurred by one corporation within a corporate group cannot be offset against the profits of corporations within the same group (with an exception in the case of certain corporate reorganizations, such as the liquidation of a subsidiary into a parent corporation). As a result, for certain corporations, these losses may be forever "trapped" within the corporation.

The United States, in contrast, permits the filing of consolidated tax returns (when ownership equals or exceed 80 percent of common shares), allowing the offsetting of full losses. About two-thirds of OECD countries similarly permit loss offsetting within corporate groups (Donnelly and Young 2002). In addition, US tax law permits tax-planning structures that facilitate loss-offsetting strategies among different parts of a business: under the now well-established entity classification rules, a US "C" corporation can operate as a parent company, with dozens of single member LLCs underneath it, and retain all of the corporate law protection benefits while remaining a single taxpayer to the IRS, and without engaging the complexities of the consolidated rules.

While it is true that Canadians can also engage in tax planning to promote loss offsetting, these activities take up resources. For example, corporations in a loss position sometimes lend money to a related party that is profitable. The related party can then invest in preferred shares of the company in the loss position, reducing its own taxable

profits by deducting interest expenses on the loan. The CRA has taken the administrative position that such strategies between non-arm's-length parties are permissible (Canada 2004a). In addition to taking up unnecessary tax planning resources, loss offsetting via these strategies is available only in limited cases.

Problems with Canada's group taxation rules have prompted proposals to revamp the system since at least the 1960s and the report of the Royal Commission on Taxation (Canada 1966). More recently, the Technical Committee on Business Taxation recommended a formal system for transferring losses between members of the same corporate group (Canada 1997, 4.18). A barrier to reform, however, is that, since most provincial corporate income tax systems follow the federal system, the reduction of profits in some provinces might lead corporations to engage in loss-offsetting strategies to reduce their income subject to tax and, hence, to a fall in tax revenues in those provinces.

Nevertheless, reform in this area is important if Canada is to maintain its international tax competitiveness. Donnelly and Young (2002) argue that allowing intragroup transfers of corporate losses would do far more to enhance Canada's tax competitiveness than could be accomplished by further corporate income tax rate reductions. The federal government should, in consultation with the provinces, consider formalizing laws to enable loss offsetting by Canadian business entities with an eye to expanding crossborder group loss offsetting down the road.

Enhance Administrative Cooperation to Reduce Compliance Costs

Canada should also implement measures to reduce administrative and compliance costs for crossborder investment, including exempting taxpayers in both Canada and the United States from having to comply with some of the more onerous international tax rules – such as the controlled foreign corporation rules in place in both countries – that are designed to counter tax avoidance and tax evasion. Another important step would be to streamline the documentation requirements for transfer-pricing purposes for North American firms; one set of documents, encouraged by the PATA reforms noted earlier, should suffice to offer evidence to the tax authorities that reasonable efforts have been made to determine the appropriate transfer prices.

Commentators have also identified a number of problem areas surrounding mergers and reorganizations arising from the two countries' different tax rules (see, for example, Brown and Manolakas 1997). At times, these different rules impose income taxes on accrued gains on different types of crossborder corporate formations, reorganizations, and liquidations even while, within each country, the same activities are normally conducted on a tax-free or tax-deferred basis. The existing tax treaty provides only limited relief in this area, as capital gains taxes on crossborder restructuring operations remain prohibitively high, forcing Canadian and US firms to maintain their existing inefficient structures.[27] Since further North American economic integration likely would be accompanied by additional consolidation of corporate activity, the NAFTA countries should take steps to address this issue.

Another idea would be to form a trilateral government institution, perhaps constituted by the Canadian, US, and Mexican tax authorities, to grant case-by-case approval of tax-free or tax-deferred North American mergers and acquisitions (McIntyre 1994). Such an organization could scrutinize deals and grant tax relief if it felt that the merger would not result in tax avoidance. This proposal is consistent with a change under the Fifth Protocol to the Canada-US tax treaty that proposes to enhance crossborder audit cooperation by, among other things, permitting tax authorities from Canada or the United States to conduct joint audits and investigate and depose witnesses in each other's country. Such enhanced cooperation would

27 Article XIII(8) of the Canada-US tax treaty provides that tax authorities "may agree" to try to provide relief for double taxation or overtaxation of crossborder combinations, but the provision does not mandate such relief nor does it set out a process to expedite the grant of relief, if any.

facilitate crossborder tax planning while protecting against activities that violate Canadian and/or US tax laws or that would result in an unacceptable reduction in tax revenues in one or both countries.

These recommendations are also consistent with global international tax trends, which emphasize administrative cooperation between tax authorities to smooth over problems exacerbated by the interaction of different national income tax regimes (Cockfield 2006). By focusing on administrative cooperation, governments will feel less of a need to harmonize their tax laws and policies with those of other countries, which follows their desire to preserve sovereign control over their tax systems to the greatest extent possible.

Conclusion

Amid the recent storm of activity surrounding Canadian-US tax developments, a number of changes to the Canada-US tax treaty strive to reduce tax as a barrier to crossborder investment, and could represent an encouraging signal of readiness to tackle other problems. The willingness to tackle double-dip and other tax-efficient financing structures follows sound policy goals, but at this point it remains an open question whether other reform efforts, such as reforming the thin capitalization rules, might be better suited to restricting abusive interest expense deductions for international financings.

There remain a number of other problem areas that unduly restrict or distort crossborder investment, ultimately with the potential to harm Canada's economic interests. A reform package could include: reviewing and targeting for elimination tax rules that unduly discriminate against the interests of US investors; eliminating withholding taxes on crossborder parent/subsidiary dividends; changing domestic group taxation laws, with the ultimate goal of crossborder tax loss relief; and enhancing administrative cooperation between the two countries' tax authorities to reduce compliance costs for firms with operations in both countries, including the development of a case-by-case approval process for tax relief for crossborder mergers and acquisitions.

Tax barriers to crossborder capital flows are increasingly unsuitable in a highly integrated free trade area that strives to promote the economic interests of individuals in Canada and the United States through heightened trade and investment ties. The federal government should promote the creation of more silver linings in the storm by taking action to reduce still further tax barriers that all too frequently dampen crossborder investment activity.

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