CANADIAN TAX POLICY FOR GLOBAL SUCCESS

CANADIAN COUNCIL OF CHIEF EXECUTIVES
SUBMISSION TO THE
ADVISORY PANEL ON CANADA'S
SYSTEM OF INTERNATIONAL TAXATION

JULY 2008

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INTRODUCTION

The mandate of the *Advisory Panel on Canada's System of International Taxation* is to provide advice to the federal government on how to improve the competitiveness, efficiency and fairness of Canada's international tax rules, minimize compliance costs and facilitate administration and enforcement.

The members of the *Canadian Council of Chief Executives* (CCCE) head many of Canada's largest and most internationally engaged enterprises. The CCCE therefore has a strong and direct interest in strengthening the competitiveness of Canada's economy and in particular the ability of Canadian communities to attract the business investment and skilled people needed to drive global success.

International tax rules are highly complex, and even apparently small changes can have profound implications. In 2007, the decision to eliminate deductibility in Canada of interest on debt incurred for investment in foreign affiliates was estimated by the Department of Finance to have a maximum annual impact of $300 million to $400 million. Corporate analysis after the announcement suggested that individual companies could suffer losses of this magnitude and that the total impact would be in the billions of dollars a year.

How Canada chooses to tax business activities that cross borders affects both the ability of Canadian communities to attract investment and jobs and the ability of Canadian-based enterprises to compete globally. Canada's reputation as a destination for capital and as a base for international business growth also is affected by the process used to make changes in policy. The 2007 experience with the International Tax Fairness Initiative illustrates the critical need both for sound policy choices and for a thorough and transparent consultation process *before* making changes to international tax rules.

The government's decision to establish the Panel therefore represents an important opportunity to establish firm principles to guide Canada's strategy for international tax competitiveness.

THE COMPETITIVE ENVIRONMENT FOR INTERNATIONAL TAX POLICY

All taxes have an impact on competitiveness and growth, as do all decisions by governments on how to spend the taxes they raise. The impact of business taxation is especially strong because capital is so mobile. People with money to invest, whether they are Canadian or foreign, have many options around the world. Tax rules that affect business and investment have a direct impact on the returns that investors can earn in any given country.

Countries that impose high tax rates on business investment reduce the flows of investment they receive and lose out on the jobs that such investment creates. They also create incentives for companies doing business globally to recognize as much profit as possible in lower-tax jurisdictions. This in turn creates the need for complex rules and costly enforcement mechanisms to protect the tax base in high-tax countries. In a world in which capital flows freely across borders, high business tax rates simply do not pay. Economic models show clearly that cutting taxes on business investment provides by far the best bang for the buck in terms of accelerating economic growth.

As a general rule, countries that wish to foster economic growth should favour a tax mix that taxes consumption more heavily than investment and incomes. Countries that wish to maintain a relatively large public sector must be particularly careful to keep business taxes low. Sweden, with a total tax take that is much higher than in Canada, has a marginal effective rate on capital that is 42 percent lower.

Countries that have adopted a strategy of low tax rates on business investment and income have been highly successful in generating tax revenue and economic growth. Ireland, for example, with its corporate income tax rate of 12.5 percent, collects roughly the same amount of corporate tax revenue as Canada as a share of its economy. As Canada has found over the past decade, governments that reduce high rates of corporate taxation may well see their revenue from this source increase.

Low tax rates on business investment and income also can be powerful drivers of increased tax revenue from other sources as investment leads to growing operations, sales and employment. As demonstrated by the recently published *Total Tax Contribution* study by PricewaterhouseCoopers, federal and provincial corporate income tax are two of only 49 taxes that large Canadian enterprises either pay directly or generate through their activities. For every dollar paid directly in corporate income taxes, the participants in the PwC study paid an average of 82 cents in other taxes and 67 cents in additional levies such as resource royalties, and collected and remitted to governments a further $3.41 cents in other taxes from employees and customers.

Very large companies, which inevitably do business internationally, are especially important generators of tax revenues for Canadian governments. The PricewaterhouseCoopers study covered 39 companies including ones accounting for 61 percent of the market capitalization of the S&P/TSX 60 Index. In 2006, these companies paid or collected more than $30 billion in revenue for Canadian governments, while also paying an average salary to employees of $60,428, about 60 percent higher than the national average. Within this sample, the ten largest tax contributors (25 percent of the participating companies) accounted for 64 percent of taxes borne and 68 percent of taxes collected in 2006. Clearly, governments need to be sensitive to the impact of tax policy on the investment decisions of large, globally engaged businesses, and should encourage the establishment and growth of more such enterprises in Canadian communities.

Canada has made important progress over the past decade in reducing its corporate tax rates. Successive federal governments will bring the statutory federal rate of corporate income tax from 28 percent in 2000 to 15 percent by 2012. Most provincial governments are moving in the same direction, and federal and provincial governments have been reducing or eliminating capital taxes as well. The federal Department of Finance estimates that by 2012, Canada's average combined federal-provincial corporate income tax rate will be 11 percentage points below that in the United States, and its marginal effective tax rate on business investment will be 9 percentage points lower.

While this also is intended to give Canada the lowest statutory corporate tax rate among the G7 countries, the reality is governments around the world are moving in the same direction on corporate taxation. The benchmark for competitive tax rates is not static.

Canada has a particular need to maintain a significant tax advantage over the United States. The sheer size and dynamism of its market makes Canada's neighbour and major trading partner an instinctive first choice for international investors looking at North America. Despite considerable economic integration over the past two decades, remaining trade and security barriers offer further reasons for investors to prefer locations south of the Canada-United States border. Canada has no choice but to offer incentives on other fronts such as tax policy if it wants to see growing business investment in Canadian operations that are integrated with North American supply chains and serve customers across the continent.

THE GOAL OF CANADA'S INTERNATIONAL TAX STRATEGY

The essential goal of all tax policy is to help sustain and enhance the standard of living and quality of life of Canadians. To succeed in this goal, tax policy must in particular make Canadian communities attractive places *in which* and *from which* to do business globally.

The CCCE believes that the central goal of Canada's system of international taxation should be to encourage high-value activities in Canadian communities. It should encourage Canadian and foreign investors alike to see our country as a great place to start and build global businesses. What matters is not whether a business is controlled by Canadian or foreign shareholders, but what corporate functions and operations it chooses to locate in Canada.

High-value activity can be generated both by the head offices of Canadian-controlled enterprises and through continental or global responsibilities exercised by the Canadian operations of foreign-owned multinational enterprises. Both Canadian-owned and foreign-owned enterprises, whether publicly traded or privately held, face the same competitive challenges globally and consider the same criteria when deciding where to invest. ***Regardless of ownership, all large Canadian-based enterprises engage in activities that extend beyond Canada's borders and hence are affected directly by Canada's tax policies as they affect international investment decisions.***

Canada is a relatively small player in a highly competitive global market. Sooner rather than later, Canadian companies that wish to grow must look beyond Canada's borders. They must look abroad for customers and for suppliers. They must look abroad for investors and for investment opportunities.

Microeconomic research also has established that international engagement, by Canadian and foreign-owned enterprises alike, makes them more productive and more innovative than companies that operate solely within Canada. Companies that do business beyond Canada's borders tend to invest more in research, in employee training and in development of new products. Continual innovation and growing productivity in turn are critical to higher incomes for Canadian families and a stronger tax base for Canadian governments.

Canada's system of international taxation therefore should encourage both inbound and outbound flows of capital. Inbound flows give

Canadian-based enterprises access to a broader and deeper pool of capital. More liquid capital markets in turn provide a lower cost of capital that encourages business investment in Canada and helps Canadian-based enterprises to grow profitably. At the same time, outbound portfolio investment by Canadians gives them access to more diversified opportunities that enhance returns and reduce risk, while outbound direct investment by Canadian-based enterprises leads to more efficient supply chains, expanded production and increased sales, and ultimately creates more high-value jobs in Canadian communities.

PRINCIPLES FOR CANADA'S INTERNATIONAL TAX STRATEGY

1. **Make Canada's tax rates attractive internationally.** The discussion paper focuses on a number of technical tax issues that affect both inbound and outbound flows of business investment. The higher the rates Canada charges, the more need there is for complex and costly rules and enforcement mechanisms to prevent tax leakage through strategies such as transfer pricing and debt dumping. Making Canada a jurisdiction with relatively low corporate tax rates both would help Canadian enterprises to grow and would encourage companies operating internationally to recognize in Canada as much of their global profits as possible.

   To this end, federal and provincial governments should continue to reduce corporate income tax rates, with the near-term goal of achieving a combined federal-provincial rate of 25 percent as recommended by the federal Minister of Finance. The federal government also has eliminated the withholding tax on interest paid to unrelated foreign lenders and will eliminate withholding tax on interest paid to related lenders in the United States over the next three years through the bilateral tax treaty.

The next step on this front should be to eliminate withholding taxes on dividend payments within multinational groups, on a reciprocal basis with other countries, and most urgently with the United States. In recent years, the United States has negotiated a nil withholding rate with many of its other major trading partners, including the United Kingdom, Mexico, the Netherlands, Sweden, Germany, Denmark, Finland and Belgium, for direct dividends from companies that are more than 80-percent owned. The ownership threshold in the United States-Japan treaty is 50 percent. Withholding taxes on dividends are a significant barrier to the efficient movement of capital across borders, and given Canada's position as the United States' largest trading partner, it is vital for our country to move quickly to correct this competitive disadvantage.

Because corporate tax rates are such powerful levers for driving economic growth, the competitive environment is highly dynamic. Governments therefore must continue to benchmark Canadian rates against a range of major competitors for investment globally and not just the United States. This likely will require a combined federal-provincial corporate income tax rate significantly below 25 percent over the longer term. The C.D. Howe Institute, for instance, has suggested a rate of 20 percent for large and small businesses alike.

In addition, governments should complete the elimination of capital taxes as quickly as possible. They also should continue to reduce personal taxes on savings and investment and the top marginal income tax rate that is most visible to internationally mobile talent. Jurisdictions that still have sales taxes on business inputs should convert them to value-added taxes similar to or harmonized with the Goods and Services Tax. To the extent that taxation may be used as a policy lever for addressing other issues such as climate change, any changes should seek to shift the overall tax mix toward a consumption base.

2. **Maintain a level playing field for Canadian and foreign investors in Canada.** Inbound foreign investment provides important benefits to Canadians. Direct investment in Canadian operations by foreign enterprises creates jobs in Canadian communities that are connected with global knowledge networks and supply chains. Access to foreign capital in turn is essential for the growth of Canadian-based enterprises.

   Tax policy should encourage investment by both Canadian and foreign investors and as much as possible should not be biased in favour of one or the other. The June 2008 report of the *Competition Policy Review Panel* suggested that Canadian companies are disadvantaged relative to non-Canadian companies in this respect. As the report recommended, the International Tax Panel should take a close look at the relevant tax rules and ensure that Canadian-based enterprises are able to compete on an equal footing for acquisitions in Canada.

In the past, Canada's status as a high-tax jurisdiction for business required a heavy reliance on policy mechanisms to counter improper transfer pricing, debt loading or treaty shopping by companies operating internationally, as they sought to shift taxable profit to lower-tax jurisdictions. As Canada's corporate tax rates fall relative to other jurisdictions, the risk of erosion of Canada's tax base decreases, as does the need for preventive mechanisms such as thin capitalization or earnings stripping rules. To the extent such mechanisms are still required to protect the Canadian tax base, Canada should choose those that are simplest to administer and most predictable.

Canada does need to consider carefully the growing impact on capital markets in Canada and abroad of tax-exempt entities. Sovereign wealth funds and other tax-exempt foreign entities are a large and growing source of low-cost capital for Canadian-based enterprises, but there remains a need to ensure that in principle, foreign entities doing business in Canada do pay Canadian tax on what is properly considered Canadian-source income.

Canada of course has its own tax-exempt vehicles, notably pension funds that are active investors at home and abroad. To the extent Canadian tax policy continues to enable domestic investment through tax-exempt vehicles, it should not disadvantage investment in Canada by foreign equivalents or impose any measure on foreign tax-exempt funds that it is not prepared to see other countries impose on Canadian funds.

Canada also must ensure that its treatment of tax-exempt funds does not lead to unfair or unintended distortions. In particular, tax policy should ensure that tax-exempt funds, whether foreign or domestic, do not gain a tax advantage over taxpaying corporations in competing for growth opportunities through acquisitions.

Similarly, as tax rules now stand, large tax-exempt funds have the ability to mimic the former tax benefits of the income trust structure by taking a company private and loading it with debt. Individual Canadians saving through Registered Retirement Savings Plans do not have the scale to take companies private and so continue to face double taxation on the dividends paid to them by taxable Canadian corporations. This is primarily an issue of horizontal equity between beneficiaries of different retirement savings vehicles within Canada, but addressing it may have implications for Canada's treatment of foreign tax-exempt entities as well.

3. **Avoid discouraging Canadian-based enterprises from investing abroad.** In the perennially job-short economy of the late 20th century, the policy instinct of Canadian governments was to do everything possible to encourage short-term job creation in Canada. As our country moves through a structural shift to a perennially labour-short economy, public policy must concentrate on the quality rather than quantity of job creation.

   Decisions about investing in Canada and investing abroad are not zero-sum. Investment abroad drives both trade and the growth of Canadian businesses. The Organisation for Economic Co-operation and Development (OECD) has estimated that each dollar of outward direct investment generates two dollars of additional exports for the originating country. This greater engagement in the global economy in turn leads to higher profits for Canadian shareholders, more and better jobs in Canada in high-value activities such as head-office operations and higher national income.

An international tax policy that supports foreign investment by Canadian-based enterprises is particularly important for a relatively small economy like Canada's. For Canadian-based companies to achieve global scale, they must grow beyond Canada's borders. This in turn requires them to have a degree of access to business opportunities, financial capital and intellectual capital that provides at least a level playing field when competing with foreign-based global enterprises.

Canada's most recent significant change to its international tax rules moved in precisely the wrong direction. As noted by the *Competition Policy Review Panel*, the tax measures introduced in 2007 to limit the deductibility of interest on money borrowed in Canada for investment in foreign affiliates will not enhance the Canadian revenue base and will disadvantage Canadian-based enterprises seeking to become global players by increasing their cost of capital. This measure also will reduce the competitiveness of Canadian-based enterprises investing abroad in relation to foreign enterprises that are not subject to similar restrictions in their home jurisdictions. In order to encourage and support

Canadian enterprises to invest abroad, restrictions on interest deductions and other expenses related to foreign investments should be eliminated.

More investment abroad today by Canadian-based enterprises means more higher-quality jobs in Canadian communities in the years ahead. An international tax strategy that works in concert with other policy instruments to encourage international investment by Canadian-based enterprises will pay large and growing dividends to all Canadians.

4. **Simplify Canada's international tax system.** Over the years, Canada's international tax system has become mind-numbingly complex. This complexity does nothing to add to government revenue, but is both immensely frustrating and extremely costly for businesses that are simply trying to comply with the rules while planning their future growth.

   Despite the best of intentions, the vast body of Canada's tax rules and treaties continues to create unfair outcomes. Anomalies in the way Canada's foreign tax credits are computed, for instance, still lead to some Canadian companies with branches in foreign countries paying both Canadian and foreign tax on the same income. Similarly, current bilateral tax treaties do not always ensure that different types of revenue are treated consistently with respect to withholding taxes.

   A central objective of tax policy should be to simplify rules wherever possible. For instance, foreign affiliates of Canadian businesses generally do not get taxed by Canada on their income from operations in other countries with which Canada has a tax treaty. These earnings flow as tax-free dividends to Canadian corporate owners, and taxed in Canada only when distributed to individual shareholders in this country. The 2007 federal budget indicated that in future, this exemption would expand to include countries that enter into an agreement to share taxpayer information. This expansion of coverage is positive for Canadian companies interested in expanding into a broader range of markets, but it does not go far enough.

As Canadian companies increasingly look for business opportunities beyond Canada's borders, the Canadian system of international taxation must evolve to support such endeavours. Accordingly, the Canadian system should move to a “full exemption” system of taxation including capital gains on foreign investments, in order to facilitate international expansion and competitiveness of Canadian companies and foreign multinational companies investing from Canada. This would also enable the tax system to be simplified greatly and ease a compliance burden, and should not have a major fiscal impact since companies generally do not bring taxable surpluses back to Canada under the current rules. It would also allow the existence of an Income Tax Treaty or Tax Information Exchange Agreement between Canada and a foreign country to be eliminated as a primary factor in determining whether a foreign business activity is subject to Canadian tax or not.

5. **Make Canada a magnet for talent and creativity.** Canadian-based multinational enterprises have developed superior expertise in many areas that enable them to aggressively compete for business on a global basis. Such a capacity represents high value jobs in many Canadian communities. The federal government should ensure that Canada's international tax strategy supports and encourages the development of such "centres of excellence", where Canadian expertise, knowledge and skills can be profitably provided to customers outside Canada. The tax system certainly should try to tax foreign-based enterprises simply due to the provision of services from Canadian-based enterprises.

   Corporate tax policy is not the only lever that can affect a country's ability to attract investment in high-value activities such as corporate head offices. Highly skilled individuals generally have a great deal of freedom to choose where they wish to work and to live with their families. Relatively low rates of personal income tax on high levels of income also have been proven as a strategy for attracting high-end jobs that require internationally mobile talent. The United Kingdom and the Netherlands are two countries that have deliberately used personal tax policy as a tool for attracting multinational head-office activity. Other countries such as Ireland have put more of an emphasis on encouraging innovation by giving personal tax relief to royalties on intellectual property. If Canada wants to compete effectively for highly-skilled people who can drive innovation and the growth of globally competitive businesses, its system of international taxation must be attractive both to corporate investors and to high-income individuals.

6. **Ensure transparency and consistency in making tax changes.** Because international tax rules are so complex, it is all too easy for apparently innocuous changes to have devastating and unanticipated consequences. Introducing changes to international tax rules without thorough prior consultation can be dangerous both to Canada's economy and its reputation, as the federal government discovered when it introduced the 2007 changes affecting interest deductibility. In addition to reassessing this particular policy change, it is essential to prevent such mistakes from being repeated.

   Moving forward, governments must ensure that any planned change to Canada's system of international taxation is subjected to comprehensive and current analysis of its impact, and that the conclusions of this analysis are tested through open consultation with affected firms.

   Governments do need to adjust taxation policies over time to reflect changes in the business environment and the competitive dynamics of a global economy. However, governments must recognize that many international investments are large and complex, involving long-term financing arrangements. Canada's success in attracting such investments depends on investor confidence in the stability of its rules.

While nothing should prevent governments from changing policies over time, it is vital to ensure that any changes that would have the effect of increasing a company's tax burden do not apply retroactively. At the very least, investment decisions made on the basis of existing rules should be grandfathered and protected against any adverse impact for a period of at least ten years. Consistency and transparency are essential to maintaining confidence in Canada as a reliable as well as attractive location for investment.

CONCLUSION

Tax policy is a critical lever for encouraging Canada's future prosperity. Low corporate tax rates reduce the need for complex rules and mechanisms to protect Canada's tax base while encouraging the business investment that is essential to economic growth and stronger tax revenues. A competitive tax environment drives both foreign investment in Canada and the international growth of Canadian-based enterprises. The best way to encourage both inbound and outbound investment is therefore to keep cutting Canada's corporate tax rates.

Canada needs to take a hard look at how other economies have been successful in using international tax policy to drive investment and growth, and ensure that our policies are better than those offered by our major competitors. In conducting this review, it should consider the impact of both corporate and personal tax policies on Canada's ability to compete for business investment, to attract skilled labour and to foster the development and commercialization of new technologies. And it should repeat such reviews on a regular basis to ensure that our country remains competitive within a dynamic tax environment globally.

Canada's increasingly labour-short economy means that the overall emphasis of public policy should shift from the quantity to the quality of job creation. While international investment by Canadian-based enterprises may result in short-term job gains outside Canada, this investment is critical in enabling companies to become more productive and more innovative, to achieve global scale and ultimately to build robust head offices in Canadian communities. While maintaining a neutral stance with respect to the ownership of capital being invested in Canada, our country's international tax system needs to facilitate investment abroad by Canadian-based companies through competitive tax rates and a sound, stable and predictable legislative framework.