Will Fiscal Reform in Canada Affect United States Interests? *

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On February 24, 1967, the *Report of the Canadian Royal Commission on Taxation,* generally known as the *Carter Report,*[1] was tabled in the House of Commons; seldom has the report of any Royal Commission aroused so much interest in the Canadian public. The sweeping fiscal reforms recommended therein have been both widely acclaimed and severely criticized. The oil and mining industries and insurance companies are gravely concerned; the economists and tax practitioners, divided; the politicians, uncertain; and the general public is mystified and perhaps mildly amused at the level of fervour created by simply another Royal Commission report. Royal Commission findings are significant but they have a habit of not being implemented in their entirety. To what extent the recommendations of this Commission will find their way into Canadian fiscal legislation remains a matter of great conjecture.

The Commission was established by the federal government in September, 1962, and it was charged with a complete review of Canada's fiscal legislation at the federal level.

When finally tabled after more than four years of work, the *Report* bore testimony to the extensive and considered studies conducted by the Commissioners and their research staff. Their findings should be of considerable interest to students of fiscal and tax policy in any country of the Western World. In fact, the Commission drew heavily upon the experience and legislation of other countries and in particular upon the experience of the United States and the United Kingdom.

The mandate under which the Commission operated required it to consider in depth the role of foreign investment in Canada and the corresponding role that taxation is to play in creating either a hostile or a friendly attitude towards such investment.

In considering this question, the Commission proceeded on the assumption that the free movement of capital among nations would in the end lead to a more "efficient allocation of capital and greater

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[1] The Commission was headed by Kenneth Le M. Carter, a chartered accountant.

world production"[2] from which all nations would ultimately prosper, a worthy objective towards which Canada should work. At the same time the Commission did, nonetheless, recognize this objective as somewhat unrealistic because all nations would be obliged to abandon their fiscal sovereignty and create identical tax systems so that a person would not suffer a greater or a lesser tax burden by reason of his nationality or the location of his sources of income. This ideal situation, which the Commissioners classified as "international tax neutrality", cannot exist where there is a multitude of different national tax systems.

Concluding that international tax neutrality cannot be achieved in today's world, the Commission focused its attention on the treatment that should be accorded foreign investment in all its forms in Canada which would not be inconsistent with "the gradual realization of these world objectives."

The consideration of foreign investment in Canada was and is a delicate area of study because there is some unmeasured and unmeasurable feeling of hostility in Canada at this time towards foreign ownership and control of Canadian business and resources, meaning, of course, United States ownership and control. This feeling is, in the writer's view, like many contemporary Canadian issues; it may have political appeal but no economic or rational foundations. Nevertheless, it was a consideration which the Commission felt obliged to take into account.

Commission's View

The Commission concluded that foreign investment in all its forms confers a net economic benefit on the host country and that the reduction of the inflow of foreign capital into Canada would reduce the standard of living of Canadians. Foreign investment has made a marked contribution to the general progress of Canada in this century and in particular has been largely responsible for the development of Canada's natural resources.

The *Report* points out that Canada's approach to foreign investment from a tax point of view has left much to be desired. A number of piecemeal legislative measures have been introduced in recent years designed either to discourage certain forms of foreign investment or to improve the equity position of Canadians in foreign owned and controlled companies operating in Canada. What effect these measures have had is difficult to ascertain but the Commission

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[2] *Report of the Royal Commission on Taxation,* (Ottawa, 1966), (Hereinafter referred to as the *Report*), Vol. 2, p. 210.

warns that the relatively high level of confidence accorded to Canada as a place in which to invest can be destroyed through an erratic and irresponsible approach to the taxation of such investment. The *Report* states:

> Because it is impossible to estimate reliably how heavily the camel is loaded at any point in time, the policy maker can never be sure if the straw he is about to add will be the last one.[3]

The Commission found, *inter alia,* that foreign investment is highly desirable, that changing the form of foreign investment is unnecessary and that most of Canada's problems with respect to foreign control of its industry and resources are related not so much to deficiencies in the method of taxation of foreigners but rather to the discriminatory provisions which discourage Canadian equity investment.

Commission's Recommendations

The Commission also believed that some of its recommendations for the reform of domestic taxation would increase the ownership of Canadian equities by residents of Canada. The specific recommendations cited in support of this argument were:

(1) Full integration of personal and corporate income taxes for resident shareholders.

(2) Liberal treatment of business and property losses.

(3) Special incentives for new, small ventures.

In other words, the Commission chose not to *discourage* foreign investment but rather to *encourage* investment by Canadians. This is a positive approach of which the Commission did not find evidence in the actions of the federal government in recent years. For example, the 1963 federal budget instituted a differential withholding tax in respect of Canadian subsidiaries of foreign corporations whose equity shares were held to the extent of 25 per cent by Canadians. Withholding tax on dividends paid to a foreign parent in respect of such shares is 10 per cent. If more than a 25 per cent Canadian equity interest does not exist, the withholding tax is 15 per cent.[4] This particular legislation, and all legislation of its kind, was regarded as negative by the Commission and its repeal was recommended. The differential withholding tax was found to be repugnant because:

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[3] *Ibid.,* p. 217.

[4] *Income Tax Act,* Sec. 106(a), 139A(1) (all references to the *Income Tax Act* are to the *Income Tax Act,* R.S.C. 1952, c. 148 as amended).

(a) It could only be interpreted by non-residents as a desire by Canadians to reduce foreign direct investment;

(b) The reduction of withholding tax where the sufficient Canadian equity interest existed tended to increase the capital gain realized by foreign investors in such companies and tax exigible upon that increase would accrue to the advantage of foreign treasuries only;

(c) The 25 per cent figure was altogether arbitrary, and there was no basis upon which that particular figure could be justified.[5]

These conclusions seem valid and they lead one to suspect that very little considered thought underlay the introduction of the differential withholding tax.

Commission's Philosophy Towards Foreign Investment

Indeed, the general statements contained in the *Report* should increase the confidence of foreign investors in Canada and should restore the confidence that may have been lost through the erratic and discriminatory legislation of the early 1960's. The Commission's philosophy towards foreign investment is well summarized in the following statement:

> Because we are convinced that Canada requires continued foreign investment, and because we are concerned with the cumulative impact of a sequence of relatively insignificant events on the confidence of foreign investors, we emphasize the necessity of weighing carefully the potential gains from changes in tax policies that affect the foreign investor against the potential losses that could result from a loss of confidence. Frequent minor changes in tax policy, even though each of them might bring about small increases in the net benefit Canada derives from foreign investment, probably should not be attempted. In this area it is important to seek the maximum long-term net benefit, and that will ofton mean foregoing short-run advantages. We do not wish to imply that tax changes cannot be made. Indeed, we recommend many sweeping reforms. What we advocate is that Canada should seek to establish a system of taxing foreign investment that is consistent with its best long-run interests and then hold to it. We believe that this requires a tax system that is fair to non-residents as a group and one that reflects Canada's desire to encourage the free flow of goods and capital in the world. No country has more to gain than Canada from a world where that goal is gradually realized.[6]

It is against the background of this philosophy that the specific recommendations of the Commission on the tax treatment of foreign investment and of foreigners in Canada is to be appraised. Are the specific recommendations of the *Report* calculated to carry out this philosophy?

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[5] *Report*, Vol. 2, p. 220.
[6] *Ibid.*, pp. 217-218.

It is upon residents of the United States that the recommendations regarding foreign investment will have the most impact. The United States is Canada's most important trading partner by a wide margin and it is from the United States that the bulk of foreign investment has come. In addition, the proliferation of United States subsidiary companies in Canada and activities of Americans at large in Canada have resulted in a substantial amount of personnel movement across the border.

In order to make this analysis meaningful, it is necessary to first consider the law as it presently exists and, specifically, to deal with the three kinds of Canadian income normally received by residents of the United States: that derived either through carrying on business in Canada, being employed in Canada or receiving income from property situated in Canada.

Taxation on World Income

The basis of liability for tax on world income in Canada is residence. A company or an individual who is considered to be resident in Canada is taxable on his world income during the period of residence.[7]

Non-residents, on the other hand, are taxable only in respect of Canadian income, either from being employed in Canada at any time in the year or in respect of income earned from carrying on business in Canada at any time in the year.[8] In addition, Canadian withholding tax is exigible in respect of certain kinds of income received by non-residents from sources in Canada.[9]

Unfortunately, the concepts of "residence", "business" and "carrying on business" are difficult to define, yet these concepts are fundamental to the present system of taxation in Canada.

Residence in Canada

The *Income Tax Act* provides that where a person sojourns in Canada for a period of, or periods, the aggregate of which is, 183 days or more in the year, he is deemed to be resident for the entire year.[10] In addition, a person who is "ordinarily resident" in Canada is deemed to be a resident.[11] The courts have interpreted the concept of "ordinarily resident" very broadly to the point where a person

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[7] *Income Tax Act,* Sec. 2(1).
[8] *Income Tax Act,* Sec. 2(2).
[9] *Income Tax Act,* Part III.
[10] Sec. 139(3)(a).
[11] Sec. 139(4).

with a long-established Canadian residence must virtually divest himself of any Canadian dwelling, restrict himself to very infrequent trips to Canada, preferably not for some period of time after residence has been abandoned and take a variety of other steps to ensure that a Canadian residence does not exist for income tax purposes.[12] It is possible to have two or more residences [13] so that the established residence outside Canada does not preclude the existence of a Canadian residence. There are no specific criteria to be applied in any given case. Residence is a question of fact.

In the case of a corporation, the problem is equally difficult because a corporation is considered resident where its central management and control are situated.[14] Until 1965 it was possible to have a company incorporated in Canada which was not a resident of Canada.[15] Historically, the central management and control rule dictated that residence be found to be where the directors resided and held meetings. As in the case of the individual, there can be more than one residence for a corporation, that is, more than one place in which the company "keeps house and does business." [16] However, more recent judicial decisions have taken a more flexible approach and it would now seem that where the directors merely carry out instructions of others, the true residence of the company may be in the jurisdiction of the person or persons from whom the instructions emanate.[17] Normally, this would be the residence of the controlling shareholder.

Canadian taxation authorities did not consider the inexact rules evolved by the jurisprudence adequate for the determination of residence, so in 1961 legislation was introduced to provide that a

[12] See, for example, *Thompson* v. *M.N.R.*, [1946] C.T.C. 51, [1946] S.C.R. 209, in which the taxpayer was held to be "ordinarily resident" for the purposes of the Act. Other cases in which taxpayers have not been held to be resident are *Beament* v. *M.N.R.*, [1952] C.T.C. 327, [1952] 2 S.C.R. 486, *Schujahn* v *M.N.R.*, [1962] C.T.C. 364, [1962] Ex. C.R. 328, *Meldrum* v. *M.N.R.*, (1950), 2 Tax A.B.C. 63, *No. 416* v. *M.N.R.*, (1957), 17 Tax A.B.C. 94.

[13] *Cooper* v. *Cadwalader*, (1904), 5 T.C. 101, *Thompson* v. *M.N.R.*, [1946] C.T.C. 51, [1946] S.C.R. 209.

[14] *De Beers Consolidated Mines Limited* v. *Howe*, (1906), 5 T.C. 198 at p. 213, [1906] A.C. 455 at p. 458, per Lord Loreburn, L.C., relying on the judgments delivered by Kelly, C.B., and Huddleston, B., in *Calcutta Jute Mills Company* v. *Nicholson*, (1876), 1 T.C. 83 and in *Cesena Sulphur Company* v. *Nicholson*, (1876), 1 T.C. 86 (both cases were disposed of at the same time).

[15] *Income Tax Act*, Sec. 139(4a).

[16] *Swedish Central Railway Company* v. *Thompson*, (1925), 9 T.C. 342, [1925] A.C. 495.

[17] *Bullock* v. *Unit Construction Co.* (1959), 38 T.C. 712, [1960] A.C. 351, [1959] 3 All E.R. 831.

company be deemed to be resident in Canada throughout a taxation year if it was incorporated in Canada and if it carried on business in Canada at any time during the year. The location of the seat of central control and management became academic where the foregoing conditions existed.[18] Subsequently, in 1965, the provision was further amended to provide that any company incorporated after April 26, 1965 in Canada is a resident of Canada and a company incorporated before that date which carries on business in Canada in any taxation year ending after that date loses its non-resident status forever.

Carrying on Business in Canada and Employed in Canada

What constitutes "carrying on business" in Canada is another area of difficulty and ambiguity. The *Income Tax Act* defines business as including:

> a profession, calling, trade, manufacture or undertaking of any kind whatsoever and includes an adventure or concern in the nature of trade, but does not include an office or employment.[19]

The jurisprudence of the United Kingdom determined that carrying on business *in* a country was not the same thing as carrying on business *with* a country.[20] It would have been possible within the framework of the tests laid down by the jurisprudence[21] to conduct a substantial trade "with Canada" as opposed to "within Canada" and to avoid falling within the net of Canadian taxation but for the following provision of the *Income Tax Act*[22] which gave an extended meaning to "carrying on business":

> Where, in a taxation year, a non-resident person (a) produced, grew, mined, created, manufactured, fabricated, improved, packed, preserved or constructed, in whole or in part, anything in Canada whether or not he exported that thing without selling it prior to exportation, or (b) solicited orders or offered anything for sale in Canada through an agent or servant whether the contract or transaction was to be completed inside or outside Canada or partly in and partly outside Canada, he shall be deemed, for the purposes of this Act, to have been carrying on business in Canada in the year.

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18 *Income Tax Act,* Sec. 139(4a).

19 Sec. 139(1)(e).

20 *Grainger* v. *Gough,* (1896), 3 T.C. 462 at p. 467, [1896] A.C. 325 at p. 335, per Lord Herschell. His precise words were: "I think there is a broad distinction between trading *with* a country, and carrying on a trade *within* a country."

21 See *Sulley* v. *A.-G.,* (1860), 2 T.C. 149, 5 H. & N. 711, 157 E.R. 1364, *Erichsen* v. *Last,* (1880), 1 T.C. 351, 8 Q.B.D. 414, *Smidth (F.L.) & Co.* v. *Greenwood,* (1922), 8 T.C. 193, [1922] 1 A.C. 417, and *Firestone Tyre & Rubber Co.* v. *Lewellin,* (1956), 37 T.C. 111, [1956] 1 All E.R. 693, aff'd [1957] 1 All E.R. 561 (H.L.).

22 Sec. 139(7).

Where a non-resident carries on business in Canada, he is taxable on his Canadian income in the same manner as a Canadian is taxable thereon and at the same rates.[23] In computing that income, he is permitted the deductions that would be permitted to a resident to the extent that they may reasonably be considered applicable in the earning of such income.[24]

The same rules apply to non-resident persons employed in Canada [25] and, of course, it is easier to determine whether a person is employed in Canada than it is to determine whether he is carrying on business in Canada.

If the person carrying on business in Canada is a non-resident corporation, then, in addition to the normal corporate rates applicable, the *Income Tax Act* imposes a 15 per cent tax on the "after tax earnings", meaning the corporation's taxable income earned in Canada less the corporate income tax payable, less any provincial taxes that were not deducted and credited in computing the taxable income and less an allowance for net increases in the corporation's capital investment in Canada.[26] The ostensible purpose of this provision, added in 1961, was to remove any advantage derived from conducting a branch operation as opposed to incorporating a Canadian subsidiary.

Income from Property

Income from property in Canada received by non-residents is subject to a withholding tax, generally at a rate of 15 per cent. The kinds of income against which the withholding tax is exigible are spelled out in Section 106 of the *Income Tax Act*, the most frequently encountered being dividends, interest payments, income from estates or trusts, rents and royalties. As mentioned in the introductory comments set forth above, where a sufficient degree of Canadian ownership exists in the equity stock of a foreign-owned and controlled Canadian subsidiary, the withholding tax on dividends is reduced from 15 per cent to 10 per cent.[27] There are other reduced rates applicable in respect of certain kinds of interests and royalties but in no instance is a withholding tax imposed in excess of 15 per cent.[28]

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[23] Sec. 2(b).
[24] Sec. 31.
[25] Sec. 2(a).
[26] Sec. 110B.
[27] See *supra* at p. 61.
[28] *Income Tax Act*, Part III.

Canada-U. S. Tax Convention

Insofar as residents of the United States are concerned, the general rules set forth above are modified by the provisions of the *Canada-U. S. Tax Convention* and accompanying Protocol which came into effect as of and from January 1, 1941. It has been amended by several supplementary conventions.[29] With respect to United States corporations or individual residents of the United States carrying on business in Canada, Article I of the Convention exempts industrial and commercial profits from Canadian income tax except to the extent that such profits are allocable to a permanent establishment in Canada. The term "permanent establishment" is defined in Section 3(f) of the Protocol to the Convention. The amount attributable to the permanent establishment will be

> the net industrial and commercial profit which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions. Such net profit will, in principle, be determined on the basis of the separate accounts pertaining to such establishment.[30]

In addition, there must be added the 15 per cent tax referred to above which is exigible under Section 110B of the Canadian *Income Tax Act*. By Section 808(3) of the Regulations to the *Income Tax Act*, the profits not attributable to the permanent establishment are exempted from this 15 per cent tax. As a result, the tax is commonly referred to as a "branch tax."

Article II of the Convention specifically excludes from the term "industrial and commercial profits" income in the form of rentals and royalties, interest, dividends, management charges and gains derived from the sale or exchange of capital assets. Income of this kind other than capital gains is subject to withholding tax which cannot exceed 15 per cent by virtue of Article XI of the Convention. In Canada's case, this is the same rate as the normal statutory withholding tax rate but it is 15 per cent less than the standard withholding tax rate in force in the United States. Until 1961 it was further provided in that Article that, subject to certain qualifications, dividends paid by a subsidiary in Canada to a parent company in the United States were to be subject to only a 5 per cent withholding tax. Although that benefit has been eliminated, the 15 per cent rate can still be reduced to 10 per cent in the event that

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[29] See Supplementary Conventions of June 12, 1950, August 8, 1956 and October 25, 1966.

[30] Article III.

there is a sufficient degree of Canadian ownership of the capital stock of the subsidiary company as mentioned above.[31]

Amounts received from Canadian trusts and estates by residents of the United States are exempt from Canadian tax to the extent that the distribution is from income derived from sources outside of Canada.[32] This provision was added in 1956.

Residents of the United States who receive compensation for personal services performed in Canada enjoy the benefits provided by Article VII of the Convention which differ substantially from the rules normally applicable to non-residents. In brief, there is no income tax exigible if an individual is present in Canada for a period or periods not exceeding 183 days during a taxation year and if his compensation is received as an officer or employee of a United States resident, corporation or other entity, or of a permanent establishment in the United States of a Canadian enterprise *or* his compensation for such services does not exceed $5,000. However, if his stay in Canada exceeds 183 days, he will be taxed as a resident of Canada and the provisions of the Convention will cease to have application. The sojourning rule mentioned above can raise particular problems for United States citizens who find themselves in Canada for more than 183 days in a year because there would be a deemed residence for the whole year and world income becomes subject to Canadian income tax. Apparently, the foreign tax credit granted under the United States *Internal Revenue Code*[32a] would apply only to Canadian taxes on income from sources in Canada and it would not be available in respect of Canadian income tax on income from United States sources during the year.[32b]

Pension or annuity income received from Canada by a resident of the United States is not subject to Canadian tax by virtue of the Convention.[33] This provision is beneficial to many who retire in the United States after spending their working lives in Canada.

Carter Commission Recommendations

There are numerous recommendations of the Commission which might have a significant effect on the treatment of Canadian income received by residents of the United States if the Convention existing between the two countries is either abolished or amended so as to

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[31] See *supra* at p. 61.
[32] Article XIII E.
[32a] Aug. 16, 1954, c. 736, 68 A Stat. 895, 26 U.S.C. §§33, 901.
[32b] 26 U.S.C. §931(g).
[33] Article VI A.

reflect the Commission's proposals. Some effect will be felt even if the present Convention is allowed to stand. Curiously enough, the Commission's views on this subject are somewhat obscure. The possibility of such a step being taken is considered later on. Accordingly, the following comments on certain specific recommendations are made on the basis that the Convention will not be applicable, at least not in its present form.

The brief review of Canada's existing tax structure as it affects non-residents indicates that Canada taxes different kinds of income received by non-residents in different ways. The Commission entertained the possibility of imposing a uniform rate of tax on all kinds of Canadian source income received by non-residents. The merits of such a system would be the difficulty of practicing tax avoidance and the simplicity of administration; however, the Commission rejected the concept of a uniform rate principally because of the foreign tax credit provisions which may apply in the jurisdiction of the recipient of the income. In order to collect the maximum amount of tax from foreigners and yet not deter them from either investing, being employed or carrying on business in Canada, it is important that the tax exigible by Canada not exceed the credit against taxes to which the taxpayer is entitled in his own jurisdiction.

On the other hand, if the Canadian tax is less than the amount of credit available, the Canadian treasury suffers, the foreign taxpayer's position is not improved and the only beneficiary is the treasury of the foreign government concerned. The Commission therefore concluded that if foreign governments vary the credits for foreign taxes given to their residents, Canada should not impose a tax at a uniform rate on all types of income. But before deciding how to tax the different kinds of Canadian income received by foreigners, the Commission was obliged to consider the fundamental criteria to be used in determining who is a foreign taxpayer. In other words, what distinguishes a foreigner from a Canadian for income tax purposes?

Essentially the Commission recommended that residence continue to be the basis for determining tax liability on world income. Although the Commission considered the concept to be illusive and vague, it was at the same time recognized as the basis of the existing Canadian practice and the test that has always been applied. Therefore, a "foreign investor" will continue to be defined as a non-resident of Canada even if the Commission's proposals are implemented.

The Commission reached a similar conclusion with respect to the concept of "carrying on business" in Canada with the added sug-

gestion that the concept of "permanent establishment" which is found in most treaties to which Canada is a party be incorporated into the domestic legislation so that the existence of such an establishment would be "conclusive evidence that business was carried on in Canada."[34]

Therefore, the Commission has not abandoned the principle of taxing different kinds of income on different bases; nor has it abandoned the fundamental concepts upon which tax liability of foreigners is distinguished from that of Canadians, that is, non-residence and carrying on business. The following is a brief description of how the Commission believes the different types of Canadian income most commonly received by non-residents should be taxed.

Carrying on Business in Canada

Business income should be subject to Canadian income tax to be determined in the same way for residents and non-residents alike. To examine all the implications of this proposal, it would be necessary to discuss the Commission's proposals with respect to the determination of business income for Canadian residents in general. Such a discussion is beyond the scope of this article but some of the more important suggestions representing departures from the existing system are singled out for comment.

Generally, the Commission recommended that business income be computed more in accordance with accounting and business practice and that most of the statutory rules for the computation of income which differ from such practice be repealed. The tax base should be broadened to include all property gains, gifts, windfalls and the foregiveness or cancellation of debts. This, of course, for Canadians, is one of the most contentious recommendations of the Commission because Canadians have never been subjected to a tax of any kind on capital gains. Another recommendation of particular significance is that the existing dual corporation tax rate be abolished and be replaced by a flat rate of 50 per cent. At the present time, corporations in Canada pay a federal income tax of 21 per cent on the first $35,000 of taxable income and a tax of 50 per cent on any taxable income in excess of $35,000.[35]

Many other significant changes were recommended with respect to deductibility of expenses, the treatment of business losses, special concessions for new businesses and so forth. Of the recommendations

[34] *Report*, Vol. 4, p. 545.
[35] *Income Tax Act*, Sec. 39.

just mentioned, the most important for non-residents in general carrying on business in Canada is probably the suggested flat corporate rate of tax of 50 per cent on all income. The reason for this importance is discussed further on. All the Commission's recommendations will of course be equally applicable to Canadian subsidiaries of non-resident corporations. For example, companies, whether American or Canadian controlled, engaged in the so-called extractive industries, such as mining and oil, received a rude shock when the Commission recommended the abolishment of the favoured tax treatment which they have received in the past.

In addition to the fact that non-resident corporations carrying on business in Canada will be taxed at a flat rate of 50 per cent, the Commission recommended the retention of the special tax imposed under Section 110B of the *Income Tax Act* which is referred to above. As before, the purpose of this provision is to ensure that a non-resident corporation derives no advantage from carrying on business in Canada through a branch operation as opposed to carrying on business through a Canadian subsidiary.

Would the position of a United States corporation carrying on business in Canada or of an individual resident of the United States carrying on business in Canada be adversely affected by these proposals?

A United States corporation carrying on business in Canada would be able only to repatriate 42.5 per cent of its profits before taxes because of the flat rate of 50 per cent plus the special 15 per cent tax on after-tax income, which would result in an effective combined tax rate of 57.5 per cent. The amount repatriated might be somewhat increased depending upon the figure against which the 15 per cent special tax is applied. As mentioned above, the amount against which the tax is now applied under Section 110B is subject to a reduction for non-deductible Provincial taxes and an allowance for net increases in the corporation's capital investment in Canada. However, it is likely that the total tax load would exceed the United States tax otherwise payable on the Canadian source income, and thus the credit for foreign taxes provided for in Section 901 of the *Internal Revenue Code* might be lost in part.

This situation, however, would be very little different from that presently existing where a United States corporation earns substantial income in Canada through a permanent establishment. The point is that where a full credit under Section 901 may now be available because of the low rate of Canadian income tax, that is, 21 per cent applying to the first $35,000 of taxable income, smaller operations

which are conducted by United States corporations in Canada would become less interesting. Probably many branch operations currently benefit through the low rate on the initial $35,000 of taxable income.

The same would be true where a United States corporation elects to carry on business in Canada through a wholly owned Canadian subsidiary. In such event the indirect credit for Canadian corporate income tax would be taken by virtue of Section 902 of the *Internal Revenue Code.*

It is difficult to estimate reliably the precise impact of the elimination of the dual rate of corporate income tax in Canada because of the foreign tax credit system provided for in the *Internal Revenue Code.* For example, even where the credit in respect of Canadian taxes is greater than the United States taxes otherwise payable on the Canadian source income, the United States taxpayer might elect to take the "overall limitation" provided for in Section 904 of the *Internal Revenue Code* and by this means still absorb the credit differential through the offsetting effect of lower taxes in other jurisdictions. Nevertheless, on balance, the position of the United States corporation carrying on business in Canada and the position of the United States parent of a Canadian subsidiary would be worsened by the elimination of the dual rate of Canadian corporate income tax. Whether the position would be worsened to the point of discouraging United States companies from carrying on business as before is doubtful except perhaps, in the case of a small branch or small subsidiary, where the initial low rate constitutes a real incentive. In that instance, the Commission may be adding the "last straw."

Where an individual resident of the United States carries on business in Canada, the effect of the recommandations is equally difficult to evaluate. Because the Canadian and United States tax rates on individuals would approximate each other if the recommendations are implemented, no prejudice of any consequence would exist because a substantial, if not full, foreign tax credit would be available to him to offset the Canadian taxes. For example, a married man in the United States without children and with taxable income of $25,000 paid a tax of $5,523 in 1966 and his Canadian counterpart paid a tax of $7,725. Under the proposals, the Canadian tax would become $5,511.[36] Therefore, a full foreign tax credit should be available to the United States resident.

The special 15 per cent "branch" tax which the Commission wishes to retain would not apply to individuals.

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[36] *Report,* Vol. 3, p. 179.

Income from Property in Canada

Income derived by non-residents from property in Canada is taxed at a flat rate of 15 per cent. In no case is it greater than 15 per cent. It is irrelevant whether or not there is a treaty with Canada because Canada's statutory rate is 15 per cent. The Commission found that:

> Statutory withholding rates reflect nothing more than a judgment as to the best level from which to start the bargaining process with other countries for mutual reductions. By this process rates of 30% or higher which are imposed by the laws of some countries have in most treaties become a bargained rate of 15%.[37]

With the exception of dividend payments, the Commission concluded that all other types of property income such as royalties, rentals, interest and similar payments should be subject to withholding tax of 30 per cent which would be reduced "when specific circumstances warrant a lower rate for certain countries and certain kinds of payments.[38] The rationale underlining the withholding rate differential between dividend income and other kinds of income seems to be that the source of the dividend income has already been subject to Canadian taxation. Therefore, the Commission recommended that the statuory rate of 15 per cent not be disturbed and that a reduction from that amount to perhaps 10 per cent be offered in future treaty negotiations if reciprocal concessions are obtained.

The Commission also recommended that the exemption from withholding tax on interest paid to tax-exempt foreign investors be continued. These foreign investors represent an important source of capital in Canada and their tax-exempt status prohibits them from taking any credit for the Canadian withholding taxes. In the Commission's opinion, such a tax would only have the effect of increasing the interest rate payable by the Canadian borrower.

The Commission has proposed that payments made to non-resident beneficiaries of Canadian estates and trusts be subject to a withholding tax of 15 per cent. This is the same as at present, *but* the trust or estate itself will be subject to initial tax at the rate of 50 per cent on the income distributable or accumulated for the benefit of non-resident beneficiaries. This combination of initial and withholding taxes could result in total taxes of 57.5 per cent for the account of the non-resident beneficiary which the Commission acknowledged could be onerous. Accordingly, a non-resident beneficiary would be entitled to elect to pay tax as "if his allocable share of the income of the trust had been paid to him directly." [39] If the income is

[37] *Report,* Vol. 4, p. 546.
[38] *Ibid.,* p. 547.
[39] *Ibid.,* pp. 200, 554.

derived from dividends of Canadian corporations, there would be no advantage in this election; however, if derived from rents, royalties or similar payments, there would be a considerable advantage because only a 30 per cent withholding tax would apply and the excess paid by the trust would be refunded to him. The Commission recommends that income of the trust from foreign direct investment[40] be taxable in the same way as similar income received by a corporation; however, it would seem that the election to be taxed as if he had received the income directly should also be available to the beneficiary where income is received by the trust from foreign direct investments. Had such income been received directly by the non-resident, there would have been no Canadian tax, so presumably where an election is made, the non-resident becomes entitled to a refund of all tax paid by the trust on such income.[41]

How these recommendations would affect the United States corporations and individuals deriving income from property in Canada depends upon a variety of factors including the nature of the recipient and the foreign tax credit to which the recipient is entitled under the relevant provisions of the *Internal Revenue Code.* For example, if a 30 per cent Canadian withholding tax on interest payments exceeds the foreign tax credit to which the recipient is entitled under the per country limitation provision, the "overall limitation" alternative might be invoked to offset lower foreign taxes paid in other jurisdictions against the higher Canadian tax. In the case of individuals, the overall limitation alternative is less likely to be available and the 30 per cent Canadian tax could be onerous. A married United States investor without dependent children would require substantial income before the full credit for Canadian withholding tax of 30 per cent could be obtained. For example, a married person in the United States without any children paid $11,538 in tax on $40,000 of income at 1966 rates[41a] — less than 30 per cent. Similarly, corporations in the United States which enjoy a special status, such as life insurance companies, might have an effective rate of United States tax lower than the 30 per cent tax withheld and part of the credit could be lost.

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[40] A foreign direct investment should be defined as an investment by a Canadian resident or associated group of Canadian residents (a) in a non-resident corporation in which he or the group holds a 10 per cent or greater interest in the voting power, in the profits or in the assets distributed on liquidation of the non-resident corporation, or (b) in a foreign property or business in which he or the group holds a 10 per cent or greater interest.

[41] *Report,* Vol. 4, p. 200.

[41a] *Report,* Vol. 3, p. 179.

It is difficult to evaluate accurately the effect of these proposals on United States investors. It is clear that their situation has not been improved but it is hard to evaluate the extent to which it has been worsened, if at all.

The Commission has also made a specific proposal to remedy a problem which exists at the present time and which would continue to exist even if the other proposals respecting property income are implemented. Specifically, the Commission recommended that "interest payments by a Canadian corporation to non-resident investors with whom it was not dealing at arm's length should be deemed to be dividends." [42]

Dividends are not deductible in computing taxable income at the present time nor would they be under the proposed recommendations. Generally, interest payments are deductible. Consequently, there is an incentive for non-resident investors to extract interest payments from Canadian corporations which they control, thereby avoiding the application of Canadian corporate income tax. The payments would simply be subject to the withholding tax which the Commission has recommended be increased from 15 per cent to 30 per cent. There may therefore be an incentive to a non-resident investor to change the form of investment in Canadian corporations from equity to debt. As pointed out above, the repatriation of Canadian corporate source income by United States investors through dividends can be subject to an overall tax burden of 57.5 per cent and would continue to be so under the Commission's proposals. Moreover, the Commission does not recommend that the integration of corporate and individual income tax which would be available to resident shareholders be extended to non-residents. The reaction of United States investors to this form of discrimination might very well be to reduce the Canadian corporate tax exigible if possible by extracting payment in forms other than dividends.

Personal Service Income

Sweeping reforms have been recommended with respect to personal service income derived by non-residents of Canada. In lieu of being taxed as a resident with respect to such Canadian income, the Commission has recommended the application of a withholding tax at a flat rate of 30 per cent on income earned in Canada by non-residents. The Commission drew upon United States experience in making this proposal. However, an election would be made available to such non-residents which would permit them to be taxed as

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[42] *Report,* Vol. 4, p. 92.

residents of Canada should they so choose. Presumably, a non-resident would then file a return showing his world income and would be entitled to a refund to the extent that the withholding tax of 30 per cent exceeds the tax that would otherwise be exigible should he be taxed as a resident of Canada in respect of the Canadian income.

Because the 30 per cent withholding tax might very well exceed the United States tax applicable to such income, a substantial portion of the United States foreign tax credits might be lost. It is therefore probable that if the recommendation is implemented, many United States citizens falling into this category may elect to be taxed as Canadian residents in order to reduce the Canadian tax exigible.[43]

The Commission has also given consideration to income derived by non-residents from personal services rendered outside Canada. These usually take the form of fees for professional services of one kind or another. Of course, most of this income flows to the United States and at the present time is rarely subject to Canadian income tax of any kind. The Commission has recommended that withholding tax at the rate of 10 per cent be applied to such income.[44] The reduced rate is in consideration of the fact that such income would probably not be regarded as foreign source income by the United States authorities and hence would not be eligible for any foreign tax credit. The validity of this recommendation is questionable since it is evident that the fees against which it will be applied will be increased to take account of the tax. Since such fees would normally be deductible in computing Canadian taxable income, the Canadian treasury will suffer because the Canadian income tax of the payor will be reduced by perhaps as much as 50 per cent, the top marginal rate proposed for individuals and the flat rate proposed for corporations.

Tax on Capital Gains

Capital gains are not subject to tax in Canada. This is true whether they are realized by residents or non-residents. In this connection Article VIII of the *Canada-United States Tax Convention* provides:

> Gains derived in one of the contracting States from the sale or exchange of capital assets by a resident or a corporation or other entity of the other contracting State shall be exempt from taxation in the former State, provided

[43] The option of filing a Canadian tax return is also recommended for non-residents receiving gifts, bequests, income portion of pension and annuity payments. No credit would be given for foreign taxes on Canadian source income. See *Report*, Vol. 4, p. 556.

[44] *Ibid.*, p. 553.

such resident or corporation or other entity has no permanent establishment in the former State.

To date, even having a permanent establishment in Canada did not create any liability for tax on capital gains realized by non-residents because no such tax is provided for in the Canadian domestic legislation. The Commission has now recommended a tax at the full rates applicable to ordinary income on capital gains. In other words, with few exceptions, capital profits will be treated in the same manner as business profits.

In this area the Commission has given the non-resident a substantial benefit by recommending that the proposed capital gains tax not apply to property gains of non-residents unless the non-resident carries on business in Canada through a "permanent establishment" and the gain is realized on property employed in that business. The recommendation also seeks to broaden the definition of "permanent establishment" to include real property and mining and petroleum rights as well as the shares of closely held companies which in turn hold real property.

Vis-à-vis residents and corporations of the United States, this recommendation creates somewhat of an enigma in view of the provisions of the existing Convention. Under the Convention, Canada has the right to tax capital gains of residents or corporations of the United States when there is a permanent establishment in Canada. The proposal of the Commission does not go that far because the tax is to be imposed only where the asset upon which the gain is realized is used in a business carried on through a permanent establishment. On the other hand, the proposed definition of "permanent establishment" is broader than the definition found in Section 3(f) of the Protocol to the Convention. Whether or not the Convention will be terminated or amended is discussed below.

The proposed exemption of foreigners from the capital gains tax is based upon practical considerations only. The *Report* makes it clear that the recommendation would be otherwise if enforceable procedures were available to effectively impose the tax on non-residents.

Canada-U. S. Tax Convention

The Commission's intentions with respect to the future of the existing Convention are not clear. Article XXII of the Convention permits either party to terminate the Convention and Protocol and subsequent Amendments upon giving at least six months' prior notice to that effect. The termination then becomes effective on the January 1st following the expiration of the six-month period.

The Commission did not suggest that this step be taken by Canada and in fact specifically approved the "present extent of Canada's treaty arrangements" and recommended that more be negotiated.[45]

Also, when considering the effect of the increased withholding tax, the *Report* states:

> Initially this change would adversely affect very few non-resident investors because most are residents of countries with which Canada has tax treaties that provide for a 15 per cent rate.[46]

This is a clear indication that there should be no immediate attempt to terminate the various treaties.

Elsewhere the *Report* suggests that the higher level of withholding tax would be useful in future treaty negotiations. Presumably the withholding tax would be reduced against reciprocal concessions.

It would therefore appear from the *Report* that, at least for the present, all the provisions for the Convention between Canada and the United States will continue to apply even if the Commission's recommendations are implemented. However, if the existing conventions, and in particular the one with the United States, are allowed to stand without at least substantial amendments, the proposed reforms will have no value other than curiosity pieces because Canada has tax treaties with almost every country having substantial commercial dealings with Canada. At the same time, Section 2 of the Protocol to the Convention requires the governments of the United States and Canada to "consult together" in the event of "appreciable changes in the fiscal laws" of either country.

Canada would no doubt at least seek amendments to the Convention and Protocol to implement the increased withholding tax proposal and the proposed capital gains tax (which, as pointed out above, would require only a new definition of "permanent establishment") and perhaps to change the basis of taxation of personal service income received by residents of the United States.

In addition, the loophole whereby United States parent companies of Canadian subsidiaries might extract payments of interest in lieu of dividends would probably be closed.

However, the foregoing is pure speculation. Perhaps the government will prefer to leave the Convention intact in order to forestall any retaliation by the United States. Yet the implementation of a capital gains tax in Canada without applying the same rules to

[45] *Ibid.*, p. 569.
[46] *Ibid.*, p. 540.

Americans holding Canadian property other than securities would likely create great resentment among Canadian taxpayers. Immediate amendments to the Convention as a minimum step would therefore seem inevitable.

Non-resident-Owned Investment Corporations and Foreign Business Corporations

These companies are creatures of Canadian statute law which enjoy special status and many of which are of particular interest to United States corporations and citizens.

The non-resident-owned investment corporation status requires that 95 per cent of the corporation's issued shares, bonds, debentures and other funded indebtedness be beneficially owned by non-residents. Its income must be derived from certain kinds of investments as defined in Section 70 of the *Income Tax Act.* Where the necessary qualifications exist, the company may elect to pay a tax of 15 per cent on its income. Subsequent distributions to the non-resident owners are tax free.

Basically, the Commission did not see this kind of company as encouraging investment in Canada because most of the qualified investments would be subject only to a 15 per cent rate of tax if held directly by the non-residents; however, the Commission regarded it as a vehicle for the practice of tax avoidance by the non-resident investor in his own jurisdiction because it permits him to accumulate funds in a foreign jurisdiction, that is, Canada, in a corporation which is subject only to the modest withholding rate of tax of 15 per cent.

The Commission recommended the repeal of these provisions over a period of time because they are offensive to the philosophy adopted by the Commission "not to facilitate international tax avoidance." The suggestion is that after the effective date of the repealing legislation, these companies be required to reduce their net assets by 10 per cent per year so that in ten years the provisions can be completely withdrawn.

As far as United States interests are concerned, this recommendation is somewhat anticlimatic in view of the far-reaching provisions of the *Revenue Act of 1962* [47] as it affected accumulations in foreign companies controlled from the United States; however, the last vestiges of tax avoidance through the use of these vehicles would be eliminated through the implementation of this recommendation.

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[47] Oct. 16, 1962, 76 Stat. 960.

The foreign business corporation is another vehicle which the Commission viewed as an instrument for the practice of international tax avoidance. The companies are normally incorporated in Canada and resident, that is, managed and controlled, in Canada. All the business of such companies must be carried on outside of Canada. They pay no Canadian income tax. Their numbers have in fact diminished considerably because the status could not be obtained after 1959 but those corporations existing at that time continue to exist unless they have since been disqualified. According to the Commission, these companies have facilitated "international tax avoidance on a grand scale... principally through purchases of goods in the United States and their sale in other countries under the protection of Canada's treaties."[48] Apparently they were used in this manner by residents of the United States. Remembering that under Canada's treaties there would be no income tax in either the country of purchase or sale in the absence of permanent establishments in both jurisdictions, the profits realized could be repatriated to the United States after payment of only the nominal Canadian withholding tax of 15 per cent. This is an example of Canada's being used as a tax haven.

The Commission recommends the gradual repeal of these provisions over a period of five years in the case of foreign business corporations whose shares are listed on a recognized Canadian stock exchange and immediate repeal in all other cases.

Domestic Tax Reform

Other recommendations of the Commission on domestic taxation would dramatically affect many special interest groups in the United States and in particular the extractive industries. Most of the generous concessions made to the petroleum and mining industries in various provisions of the *Income Tax Act* would be eliminated. For example, the present depletion allowances accorded to the mining and petroleum industries would be eliminated together with the three-year tax holiday for new mines. Inasmuch as both these industries are in large measure controlled from the United States, these specific proposals have already attracted much attention and criticism south of the border.

Life insurance companies have also been unpleasantly surprised by the *Report.* Under existing legislation, life insurance companies are taxed only on the amounts credited to shareholders' accounts or

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[48] *Report,* Vol. 4, p. 558.

otherwise appropriated to shareholders less certain defined amounts. Consequently Canadian life insurance companies have paid very little income tax because the amounts credited rarely exceed the amount required to pay dividends on the outstanding shares. Because foreign insurance companies with branch operations in Canada have no shareholders' accounts in Canada, they do not pay any tax under the *Income Tax Act* on their Canadian business income.

Subject to special provisions designed to accommodate the particular status of life insurance companies, the Commission recommends that their business income be determined and taxed in the same way as the business income of companies in general. This recommendation includes the branch operations of non-resident companies which would, under the recommendation, become subject to the special branch tax of 15 per cent as well.

The proposed treatment of the extractive industries and life insurance companies briefly touched upon represent only two of many areas where special interest groups in the United States may be affected by the Commission's recommendations for domestic taxation reform. A discussion of the many areas in depth would be like opening the proverbial "Pandora's Box" and is well beyond the scope of these comments which are specifically directed to the international aspects of the *Report.*

However, the examples cited illustrate the extent to which United States interests with branch or subsidiary operations in Canada are or should be interested in the domestic reforms recommended. We have already considered how the elimination of the dual rate of corporate income tax may affect the yield to be realized through subsidiary or branch operations in Canada. That proposal would of course affect all operations of United States companies in Canada. There is, however, another recommendation which has aroused great interest among Canadians but which will not be extended to nonresidents, namely, the full integration of personal and corporation taxes. This represents one of the most novel and least expected recommendations of the *Report.* Under the proposal all corporations would be taxed at a flat rate of 50 per cent. The income of individuals and families would be taxed at progressive rates as before but the top marginal rate would be 50 per cent. The shareholder would gross up all dividends received to include the 50 per cent tax paid by the corporation and include the grossed up amount in his income. He would then receive a credit against his own tax for the full amount of the corporate tax paid. A refund would be given for the excess which would exist unless the taxpayer is in the top marginal rate of 50 per cent.

The obvious benefits of this proposal are not to be extended to non-residents because, in the Commission's opinion, the benefit would not accrue as much to the non-resident shareholder as it would to foreign treasuries. The Commission doubted that this proposal would adversely affect the attitude of foreign investors because their overall position is not much different from that existing at the present time. The position of Canadian shareholders would of course be improved and United States residents might be induced to sell some of their present shareholdings to Canadians. Some critics have referred to this as an attempt "to buy back Canada". Actually, Canadian shareholders already enjoy a substantial benefit over their United States counterparts by virtue of the dividends received from taxable Canadian corporations. This credit was introduced in 1949 at a rate of 10 per cent[49] and was increased in 1953 to 20 per cent.[50] The recipient of the dividend may deduct 20 per cent thereof from his tax. This represents a very substantial benefit to Canadians but there is no recorded evidence of a rush by United States shareholders to dispose of their Canadian shareholdings when this measure was introduced. Although the credit would be greater under the proposal it is unlikely that the attitude of United States shareholders would be any different than before. Their attitude will be determined largely if not solely by the extent to which foreign tax credits can be obtained in the United States against the Canadian tax exigible. The philosophy of the investor is pragmatic.

Conclusion

The Commission's recommendations with respect to foreign income derived from Canadian sources are many and varied, but their immediate impact either on the attitude of the foreigners concerned or the benefits to accrue to the Canadian treasury are very difficult to evaluate. Undoubtedly the purpose of the proposed reforms is to maximize the tax obtainable from foreign interests at the expense of foreign treasuries where possible and at the same time make Canada sufficiently interesting to attract foreign capital. From the standpoint of Canadians these are worthy objectives but the fair balance to be struck between them will be difficult to attain.

From the point of view of United States interests, the implementation of the suggestions discussed herein should not create any serious problems or necessitate major readjustments to existing

[49] 13 Geo. VI, S.C. 1949 (2nd Sess.), c. 25, s. 17.

[50] 1-2 Eliz. II, S.C. 1952-53, c. 40, s. 12(1).

arrangements. In fact, unless and until a new treaty is negotiated, most of the recommendations concerning the treatment of international income will have no effect at all.

Will the recommendations of the *Carter Report* be implemented? At first the outlook for implementation was pessimistic because of the publicized statements of the Commission to the effect that it was a "package deal"; all or nothing at all. That position has since been modified and government spokesmen have stated that legislation will be introduced to implement substantial portions of the *Report* in 1968.[51] Despite these statements, it is evident that the *Report* has not yet received general acceptance in many important areas and the resistance to its early implementation may well be stronger than the forces in support of it.

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[51] Honourable M. Sharp, Minister of Finance addressing Canada Tax Foundation in Toronto on April 26, 1967.