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## **SWIMMING IN INTERNATIONAL TAX WATERS**

There is compelling evidence that more and more Canadians are part of the international investment pool. This can be shown by the fact that more and more Canadians are claiming foreign tax credits on their tax returns. Statistics Canada reports that there has been a greater increase in Canadian investment abroad relative to foreign investment here and Canadians continue to exhibit a strong appetite for foreign opportunities. In fact, there is a considerable body of evidence pointing to the fact that Canada is a stronger competitor in the vastly expanding global economy.

International competitiveness depends not on a particular isolated aspect of a country's business environment, but the economy as a whole. This is equally true of tax competitiveness, which depends on many factors including marginal tax rates and taxation of foreign source income.

For almost 40 years, Canada has maintained a system that encourages a corporation resident in Canada to earn income through a foreign affiliate, that is, through a non resident corporation in which the resident person has a significant if not 100% interest. This system can be confused with an anti-avoidance rule that perceives to block the movement of capital outside of Canada when in fact it is meant to encourage foreign activities of Canadians by providing substantial tax benefits on foreign active business income earned. This system, known as the "exempt surplus" system, provides a unique advantage for Canadian companies that you will not find in other tax developed jurisdictions including the United States, United Kingdom and Japan. Our system is more generous than the systems developed in these jurisdictions.

So, what does this mean? Through proper planning, Canadians are encouraged to take advantage of the existing rules and earn income outside of Canada at favorable tax rates, especially in jurisdictions whose tax rates may be lower than Canada's. In fact, Canada has entered into over 70 tax treaties for the very purpose of avoiding double tax and making sure that income is taxed at the most favorable rates. Tax treaties are designed to alleviate issues with respect to taxing methods that may differ from one country to the next. Tax treaties are not designed to cause more taxation.

The climate in which taxpayers and their advisers currently work is becoming increasingly hostile. Even the Pope has denounced tax havens. The days of simply drawing "boxes and circles" to complete a



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transaction may indeed be limited. One only needs to look to the fifth protocol to the Canada-US tax treaty to see examples of this phenomenon. Coupled with this is a perception of a global trend of questionable legislation and case law related to the cross-border flow of capital.

For example, there has been a lot of press recently about Switzerland. The US Department of Justice's case against Swiss bank UBS has ended in an out of court settlement in which UBS handed over the names of 4,450 of its American clients. The outcome has been described as a disaster for the Swiss financial centre on the basis that it would end the Swiss tradition of banking secrecy. Even though this is a US action, the perception in Canada is that this could also happen here. What is overlooked is that the names that were given to the Internal Revenue Service (IRS) were all names of individuals who were **NOT** reporting the existence of these accounts and were not paying tax on this income. This is not proper planning, it is evasion!

In France, 3,000 French citizens who hold Swiss bank accounts are being investigated by the French tax authorities. The names were provided by two Swiss banks who have operations in France. Why is France doing this? Because they believe that Swiss banks are holding over 3 billion Euros of UNDECLARED French deposits. Where is the planning here?

In the UK, the courts have ordered more than 300 banks to disclose to the tax authorities details of all offshore accounts held by UK taxpayers, while in Italy, undeclared overseas investments owned by Italian residents are now presumed to derive from tax evasion unless the taxpayer shows otherwise. Again the motivation for these actions is that the income is not being reported properly.

What do all of these actions have in common? Well, a few things for sure. First, these jurisdictions are all chasing tax cheaters, who fraudulently attempt to hide their money from home taxes. As well, they have offered tax amnesty to bring these taxpayers back into the system. Finally, you will note that these examples do not include Canada.

What can be determined from this information? There are several messages:

- 1) Canada is not nearly as aggressive on offshore tax evasion as some other jurisdictions;
- 2) Canada has a system of taxation in place that encourages proper offshore planning that can minimize, rather than evade taxes;



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- 3) If you want to hide your money, you do not need to consult with a tax planner. A tax planner's role is to structure a client's affairs in a way that complies with Canada's tax system while taking advantage of the incentives provided in our tax system for offshore activities.

There are many factors that influence how organizations are structuring their affairs and minimizing their global taxes. Fundamentally, the basic concepts of transfer pricing, the use of holding companies, and tax-effective financing have not changed. What has changed is the approach that certain tax authorities and influential international organizations are adopting and developing to change the rules of the game—or at least that seems to be their objective.

The current perceived hostile tax environment is the result of a number of simultaneous tax, regulatory, and financial-reporting developments such as those mentioned above. As economies worldwide continue to globalize at a record pace, traditional boundaries are being ignored. Regulators and tax authorities are struggling to keep up, and the demand for information is much greater than ever before. In their race to maintain their enforcement efforts, authorities and regulators inevitably focus on cross-border flows—not only unreported income and so-called tax arbitrage transactions, but also legitimate commercial transactions.

Tax authorities have always been concerned with tax arbitrage and cross-border transactions. What is changing is the coordinated approach by which they are gathering knowledge, sharing information, and developing legislative and enforcement techniques.

Canada's first major effort in multilateral information exchange is through the Joint International Tax Shelter Information Centre (JITSIC), which was formed in April 2004 with the opening of an office in Washington, DC. JITSIC's original partners were Canada, Australia, the United States, and the United Kingdom. Recently Japan was added, and JITSIC has opened a second office in London. The stated objectives of JITSIC are as follows:

- increase public awareness of the risks associated with abusive tax schemes;
- recommend changes in tax administration practices for addressing abusive tax schemes;
- enhance enforcement efforts through coordinated "real time" exchanges of tax information;
- use the internet, public sources, and other techniques to track and identify promoters and users of tax schemes;



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- identify emerging trends in anticipation of the evolution of abusive tax schemes; and
- improve members' knowledge of techniques used to promote cross-border abusive tax schemes.

Another example of multilateral cooperation is the Seven Country Tax Haven Working Group ("the Working Group"), a subgroup of the Pacific Association of Tax Administrators (PATA). The working group, which is mainly focused on tax havens, includes the five JITSIC members as well as France and Germany. The members share information, conduct joint training sessions, and compile a database of various schemes used by promoters, including particular tax havens. One of the Working Group's major initiatives is the issuance of international alerts to its member tax administrations on tax-motivated transactions involving domestic taxpayers and tax havens. At least 10 alerts have been issued to date on matters including captive insurance, offshore trusts, and partnerships and withholding taxes.

Information is being gathered, disclosed, and shared as never before. This situation is generating new enforcement techniques and legislative responses, and in turn is putting tremendous pressure on corporate tax departments to respond to disclosure requirements in an accurate and timely manner. Perhaps the only certainty is that this trend will continue and leading-edge tax departments will have to adapt.

Globalization has dramatically increased the volume of cross-border trade. The use of tax treaties to minimize global taxes has been a fundamental part of tax planning for decades. In order to counter abusive treaty shopping, some countries (most notably the United States) have developed and implemented in their tax treaties limitation-on-benefits (LOB) provisions. The fifth protocol of the Canada-US tax treaty contains an LOB clause. Generally, an LOB clause provides that only "qualifying persons" can obtain treaty benefits. These qualifying persons typically include a natural person, various governmental organizations, and entities that either are significantly owned by "true" residents or carry on an active business in a residence state.

Some tax authorities of the OECD member states, including Canada, have challenged the fundamental concepts of tax treaties, such as residence, beneficial ownership, and, recently, inherent anti-abuse.

Canada is at the forefront with respect to the development of jurisprudence related to treaty shopping. In various Canadian cases, the Canadian Revenue Agency (CRA) challenged taxpayers on the basis of

Author: Gregory Sanders, Head of Tax Law Group  
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residence, beneficial ownership, and anti-abuse. Generally, Canada has lost as many of these cases as it has won. In 2007, Canada introduced the anti-tax haven effort. This ominously titled effort translated into only one tax amendment that prevents the double deduction of interest both in Canada and abroad (the double dip transaction).

In the Crown Forest case, the Supreme Court of Canada considered the residence provisions of the Canada-US tax treaty. The court held that in order to be a resident for treaty purposes, a person should be liable to the most comprehensive form of taxation imposed under the domestic law of a particular state. A more recent case has more broadly defined the definition of residence of an offshore trust to parallel that of corporate residence.

The global economy has clearly led to more aggressive tax planning and more aggressive tax authorities, but is this any different than what is taking place at home? With tightening economies and growing federal deficits, CRA's role will be to ensure that the maximum effort is put in place to collect tax revenue to offset this deficit. It does not matter if the planning is domestic or international, CRA's approach is the same. CRA is challenging domestic planning as much or more than it is challenging international planning, and the risks for a taxpayer should not be perceived as different simply because a plan involves an offshore element.

When looking to make offshore investments, you would be foolish not to look at the tax systems involved in your home jurisdiction as well as the jurisdiction where the investment takes place. At the very least, you want to avoid double tax.

In today's global marketplace, acquiring offshore assets seamlessly across international borders is a competitive necessity. Overcoming geographic boundaries entails facing complex new tax hurdles that can quickly undermine the potential benefits of international expansion. Proper planning is an essential element to any offshore activity.

The message is clear. Proper tax planning requires a tax advisor to review all options, whether domestic or international, and proper tax planning is a key element in ensuring you pay only the level of taxes required by the law.

*For more information or to speak with Gregory Sanders, contact Denisa Horak at [dhorak@perlaw.ca](mailto:dhorak@perlaw.ca).*

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HILL & McDOUGALL LLP/s.r.l.**

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