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Mr. Brian Pallister

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• (1110)

[English]

The Chair (Mr. Brian Pallister (Portage—Lisgar, CPC)): Good morning, committee members. Good morning to our witnesses today and also to those in Toronto.

Pursuant to Standing Order 108(2), our briefing on tax havens and tax avoidance will continue.

I'll go through the witnesses in the order I have them here. You've each been told you have a maximum of five minutes to present. We know this is an incredibly complex issue and defies a five-minute summary of any kind, but we have to allow time for exchange with committee members, as you're aware.

We thank you for participating in this process.

We begin with Nick Pantaleo of Price Waterhouse Coopers. Welcome. Over to you, sir, for five minutes.

Mr. Nick Pantaleo (Partner, Price Waterhouse Coopers): Good morning.

My name is Nick Pantaleo. I am a partner with Price Waterhouse Coopers and I have specialized in international taxation for most of my 20 years as a tax adviser.

I appreciate the opportunity to speak to this committee to discuss the proposal included in the March 19 federal budget to restrict the deductibility of interest.

The proposal has proven to be very controversial and has been roundly criticized in the Canadian business and tax community. The primary concern is that the proposal will make Canadian corporations less competitive, not only in international markets but in Canada as well.

For the reasons I will outline shortly, I strongly believe that more study and analysis is necessary before introducing restrictions on interest deductibility.

The budget also proposed the establishment of an advisory panel of experts to study, consult, and recommend measures to improve the fairness of Canada's international tax system.

Any proposal to restrict the deduction of interest should be made at the same time other changes are made to the system and should not be significantly out of step with actions taken by Canada's trading partners.

I do not believe that the budget proposal should proceed. Instead, the matter should be referred to the panel for further discussion and

public consultation to eliminate the current uncertainty that many Canadian companies are currently facing.

An important feature of the Canadian system is to permit Canadian taxpayers to deduct interest in respect of financing investments, including investments in foreign affiliates. This feature is not a tax loophole, nor did it develop by chance. It reflects a deliberate policy choice that for 35 years has been an integral part of the Canadian system for taxing foreign-sourced income.

The key objective of that system is to ensure the right balance between two basic needs: on the one hand, the need to protect the Canadian tax base, and on the other hand, the need to ensure Canadian corporations are competitive. The rules that permit a tax deduction for interest in respect of investments in foreign affiliates have always been considered to be consistent with that objective.

In short, Canada has been prepared to pay a cost in the form of granting a Canadian interest deduction to enhance the competitiveness of Canadian companies and thereby garner the resulting economic benefits, but Canada has not been prepared to write a blank cheque.

From my perspective, there are four principal features of the Canadian system for taxing foreign-sourced income that are relevant to this discussion. The first feature is that the system provides for the deferral from Canadian tax of foreign business income earned by foreign affiliates.

Under the second feature, Canada turns over primary taxing authority to the foreign jurisdiction in which foreign business income is generated. On the distribution of such income to Canadian corporate taxpayers, Canada effectively provides a foreign tax credit against Canadian income tax, or it provides a complete exemption from Canadian tax. This is done to ensure the income is not taxed twice.

As for the third feature, currently access to the exemption aspect of our rules is achieved through Canada's treaty network, but that access is not dependent upon the degree to which the foreign income has been taxed. Instead, Canada defers to the foreign country to decide whether and to what extent it will exercise its taxing jurisdiction. Another proposal in the budget will ensure that this feature will also apply to those jurisdictions that have a suitable exchange of tax information agreement in place with Canada.

The final feature of the system is that foreign passive income, as well as Canadian-sourced income shifted offshore through deductible charges, is subject to tax in Canada on a current basis, with credit given for any related foreign taxes paid.

The budget documents state that the restricted interest proposal is intended to prevent the mismatch between income and expenses. Put another way, the concern is that the current system provides too much of a foreign tax credit or exemption with respect to foreign income earned by a foreign affiliate.

This tax policy concern has received and is receiving attention from other countries in their design or re-evaluation of their system for taxing foreign-sourced income earned through their own foreign affiliates. But invariably, these countries seek to ensure that such restrictions on interest deductibility do not impair the ability of their companies to compete globally. In my view, the budget proposal provides no such assurance. In particular, the proposal effectively eliminates the deferral of taxation of foreign business income to the extent of the restricted interest deduction. Eliminating this deferral would be inconsistent with the approach taken by almost any other country in the world.

A number of countries have or are in the process of examining interest deductibility in the broader context of possible reforms to their system of taxing foreign-sourced income. Several of these countries seem to be dealing with interest deductibility in a comprehensive manner. Their focus is not only on domestic tax base erosion caused by interest on borrowings for outbound foreign investment but also on domestic tax base erosion arising from inbound investment by foreign corporations and in some cases the domestic tax base erosion resulting from domestic investments of their own corporations.

• (1115)

As the experience of other countries attests, the nature and scope of a tax deduction that is provided in a domestic tax system in respect of investments, including foreign investments, is a complex matter and must be carefully integrated with the other objectives of the system. Given its economic size, Canada cannot afford to deviate significantly from international norms, at least not without jeopardizing the competitiveness of Canadian companies.

Accordingly, the budget proposal deserves further analysis and study in a more comprehensive manner, to take into consideration not just the factors that were of critical importance and relevance in formulating the current interest deductibility policy 35 years ago, but also current economic developments and realities. I believe the budget documents, in fact, anticipate that such a study is necessary and it will take place.

Thank you.

The Chair: Thank you very much, sir.

We'll continue with Robert Raizenne from Osler, Hoskin and Harcourt. Welcome to you, sir.

Mr. Robert Raizenne (Osler, Hoskin & Harcourt): Thank you, sir.

I should start by saying that I've been practising as a corporate and international tax lawyer for more than 25 years, and I've been teaching corporate and international tax at the law school level for most of that time. So I've spent a fair bit of time learning and studying and practising in this particular area.

I thought I would start briefly by just touching on the two topics, in the sense of looking at the convocation notice I received. It seems that what we're dealing with here are tax havens and tax avoidance.

I wanted to start by first asking myself, "What is a tax haven?" I think it's a very useful point for us to spend a couple of minutes dealing with. We usually think of "tax haven" in the sense of a low-tax country, so we usually think of it in terms of geography. That's true, but it only goes so far. In the modern world, not only do we think of tax havens as particular low-tax jurisdictions; we also can think of high-taxing jurisdictions as being tax havens, in the sense that certain features of their tax systems can be used in such a way as to generate tax advantages.

So when we talk about tax havens, it's very difficult in the modern context to actually fix upon what jurisdictions we are talking about. By certain standards, Canada is a tax haven.

When we look at all the different tax features in the form of tax preferences that are part of our tax system, we have very important low-tax features, and these low-tax features have been put into our income tax legislation purposefully. They are not accidental or unintended features of our tax system. We have such things as international banking centre rules; we have very generous R and D rules; we have accelerated tax depreciation rules; we have all sorts of regional incentives that are built into our tax system. All of these tax preferences, in particular contexts, go to make Canada into something like a synthetic tax haven.

Just as that's the way our system operates, we have to look at the 200 other jurisdictions in the world that we're interacting with in the same context. That means, I think, that any effort to formulate the rules and function of tax havens is going to require a very important definitional exercise, which is the question of what we are talking about.

The second topic is the tax avoidance topic. I think it's important that we understand also that we have a very highly regulated system of taxation in Canada. We have numerous rules, many of which are layered one on top of the other, to deal with the issue of how to tax income earned in low-tax jurisdictions outside Canada. We have the so-called foreign affiliate rules, which are basically rules that govern multinational Canadian business. We have the foreign investment entity rules, which effectively deal with individual investors who are going offshore. We have transfer-pricing rules. We have foreign reporting rules with very significant penalties, which require taxpayers to report on an ongoing basis what it is they're doing offshore. It's important to remember that all Canadian taxpayers, including Canadian multinationals, are subject to this panoply of very complicated rules.

As was pointed out by Mr. Adams, I think, in his testimony here on Tuesday, we now have 86 bilateral tax treaties. We have numerous multinational tax audit initiatives. We're doing lots in this area.

When we turn to the budget, I think it's important that we keep in focus that the last time we looked at these issues, we had a 14-year process, starting in 1962 and ending in 1976, before we changed what was then the old tax system. I would join Nick's point that we certainly shouldn't be contemplating the type of significant changes that are included in the 2007 budget without taking a serious and hard look at those ideas and considering what we should be doing.

• (1120)

The Chair: Thank you very much, sir.

We'll continue with James Hines, who is from the National Bureau of Economic Research. Mr. Hines, welcome to you; five minutes is yours.

Prof. James R. Hines, Jr. (Richard A. Musgrave Collegiate Professor of Economics and Professor of Law, University of Michigan): Thank you and good morning.

My name is James Hines, and I'm the Richard A. Musgrave collegiate professor at the University of Michigan.

There are roughly 45 major tax havens in the world today. Tax havens are widely used by international investors. In 1999, 59% of American multinational firms with significant foreign operations had affiliates in one or more tax havens.

American firms exhibit unusual activity levels and income production in foreign tax havens. Of the property, plant, and equipment held abroad by American firms in 1999, 8.4% was located in tax havens. Employment abroad by American firms was likewise concentrated in foreign tax havens, with 6.1% of total foreign employee compensation located in tax haven affiliates. American firms located 15.7% of their gross foreign assets in the major tax havens in 1999, and affiliates in these countries accounted for 30% of total foreign income in 1999. Much of reported tax haven income, of course, consists of financial flows from other foreign affiliates that parent companies own indirectly through their tax haven affiliates.

Tax havens are viewed with alarm in parts of the high-tax world, where there are concerns that their use may divert economic activity from countries with higher tax rates and erode their tax bases.

Alternatively, tax havens could encourage investment in other countries, if the ability to relocate taxable income into tax havens improves the desirability of investing in high-tax locations, or if low tax rates reduce the cost of goods and services that are inputs to production or sales in high-tax countries.

In fact, evidence compiled by Mihir Desai and Fritz Foley of Harvard University and by me indicates that the use of foreign tax havens appears to stimulate activity in nearby high-tax countries, a one percent greater likelihood of establishing a tax haven affiliate being associated with two-thirds of a percent greater investment and sales in nearby non-haven countries.

Should capital exporting countries such as Canada be concerned by rising home-country investment in tax havens? No, they should not: this growth simply reflects the growing scope and financial sophistication of multinational enterprises. Much of the use of foreign tax havens is designed to avoid foreign taxes or to avoid the need for costly financial transactions that would otherwise be

required to prevent triggering avoidable tax obligations. Neither of these should be causes of concern to capital exporting countries; on the contrary, the use of tax havens by Canadian firms likely stimulates business activity in Canada.

Does the availability of foreign tax havens offer unfair tax advantages for sophisticated international investors? It might at first appear so, but on further reflection, matters are not so simple, since multinational firms from one country compete with each other and compete with firms from around the world who also use tax havens.

This international competition ultimately drives pretax returns available from investments in tax havens down to break-even levels, much as the market for tax-exempt debt drives down returns and largely removes the benefits of acquiring such debt. As a result, those who invest in tax havens cannot earn supranormal returns from doing so. This competitive process implies that there is no unfair advantage to be had by investing in tax havens.

Would it be wise to limit the deductibility of domestic expenses, such as interest, for firms with significant foreign investments? Certainly it makes no sense to single out investments in tax havens for this purpose, since the use of tax havens is part of the ordinary international investment process. One might limit interest deductibility for all foreign investment, but doing so has the effect in practice of distorting the ownership of capital assets away from their most productive uses.

The problem is that foreign countries do not permit deductions for interest expenses that home countries deny. As a result, denying home country deductibility of interest expenses incurred for foreign investment would discourage foreign investment relative to domestic investment and thereby reduce the productivity of business enterprises in Canada.

The fact that a rising share of Canadian foreign investment is going through foreign tax havens is not actually relevant to the issue of interest deductibility. There are two reasons why not.

First, this is largely a holding company phenomenon; the vast bulk of what is called tax haven income is earned and taxed in countries other than tax havens.

Second, the competitive process implies that even income that is earned in tax havens is implicitly taxed by foreign competition that lowers pretax returns available there. As long as you tax purely passive foreign income on financial assets that are parked in tax havens, there is no need to limit domestic interest deductibility.

•(1125)

International business is a critical component of any wealthy economy in the world today. Limiting the interest deduction for foreign investment has the unfortunate effect of distorting investment patterns. Ultimately, the cost of imposing heavy tax penalties on foreign investment is borne by domestic workers in the form of lower wages as their economies become less productive.

The Chair: Thank you, Mr. Hines.

Roger Martin is with us by video conference. He is the dean of the Rotman School of Management.

Mr. Martin, we invite you to proceed. Thank you.

Dr. Roger Martin (Dean, Rotman School of Management, University of Toronto): Thank you, Mr. Chairman.

I'm going to take a little different tack from what I'd planned coming in here, because I don't think repeating what these very smart individuals have already said makes any sense. I agree with Mr. Pantaleo, Mr. Raizenne, and Dr. Hines on what they've said.

Maybe I'll just step back and ask, what is the context that I would encourage the committee to take as the setting in which all of this is happening? We've seen, in the last 25 years, a massive globalization of the business world, so lots of corporations are globalizing, operating in more countries, and facing situations where they are operating under very different tax jurisdictions. As was pointed out, there are many more tax treaties than there used to be and all sorts of complicated rules.

What's happening is that the opportunity for international tax arbitrage is increasing dramatically, and companies—wisely, as Dr. Hines has said—in the interest of being as efficient and effective as they can be, are being much more sophisticated than they would have been 25 years ago on this front. That's not going to change. If anything, they're going to get more sophisticated as more opportunities arise.

The big question for Canada is what's the incentive that we create for these companies to be more aggressive rather than less on international tax planning? I think the fact that we are an exceedingly highly taxed jurisdiction as it relates to corporations is the root issue we should be looking at. So I think this is why the corporations right now are very upset with this particular measure. It's not because it's crazy; it's an attempt to get more neutrality in the tax system. But any tax that increases for us, to make us an even higher corporate tax jurisdiction, will hurt our corporations and cause them to come and object to this.

I think we will have these kinds of challenges in trying to get neutral tax regimes on the corporate side as long as we have, along with Germany and the U.S., the highest marginal effective tax rates on corporate income in the world. I think that's what the committee should be paying attention to, the need to get that rate down considerably, because right now we have a tax system that, overall, discourages corporations from making investment. The result is that corporations invest less in Canada in machinery and equipment than they should to make themselves more productive. That is the bigger question, not the question of particular measures of interest deductibility.

Thank you very much.

•(1130)

The Chair: Thank you very much, Dean Martin.

We'll conclude with Finn Poschmann from the C.D. Howe Institute. Welcome, Finn.

Mr. Finn Poschmann (Director of Research, C.D. Howe Institute): Good morning, Mr. Chairman and members of the committee. Thank you for inviting me back. I'm only sorry I can't be there in person.

One great thing about being down the batting order is that the key background information is all on the table and I can get straight to the meat of the matter. Of course the meat is the question of interest deductibility with respect to debt incurred for investments in foreign affiliates. Today it's framed as dealing with tax havens, but nonetheless that's the issue.

On this, I have a very few simple points. The first one is that the world has changed a lot in the past 35 years since the current framework for international taxation was put in place. The big change is in the size and the direction of investment flows. Canada has historically been very dependent on investment capital flowing in from abroad, but it's quite different now. Data released just yesterday from Statistics Canada will show you that for ten years now Canadians' foreign-directed investment abroad has exceeded foreigners' investment here. That's a big change.

At the same time, the complexity of the transactions has grown. Multinationals now more commonly steer investment through low tax jurisdictions and pursue other advanced international tax strategies. This has given rise around the world to concerns about threats to national tax revenues.

Now, Minister Flaherty perceives such a threat in Canada, and it's reasonable that he should. To see why, let's consider how Canada does things compared to our G-7 partners.

Canada generally permits dividends from foreign affiliates to be repatriated, to come back to Canada tax-free or exempt, on the assumption that it's already been taxed in the foreign jurisdiction, which is often a low tax jurisdiction. Keep in mind that there is a difference between a low tax jurisdiction and a tax haven.

Now, dividends that are not exempt would generally be taxable in Canada, with a credit for tax actually paid in the foreign jurisdiction. That's the general picture in all G-7 countries. Either foreign source income is taxable, with a credit, or it comes in exempt. But what about the flip side—the big question about interest deductibility with respect to those investments and affiliates? This is where Canada probably stands out a little, with fairly loose limits, and this has led many multinationals to book debt in Canada without bringing economic activity with it—reducing their Canadian tax liability—and that is what has attracted the minister's attention.

Professor Hines made a few superb points on whether or not this is something we need to worry about. But clearly the minister is worried about it and has proposed a course of action for dealing with it. The question is what to do about it, and when I said that Canada had very loose rules with respect to interest deductibility, that is not to say other countries necessarily have very tight ones. There are lots of rules, lots of very different rules, but they generally all do have rules on interest. The difference is that none of them, none of the G-7 countries, have a simple blanket denial on interest deductibility. Whether you're looking at France, Germany, Italy, or Japan, interest deductibility is key to the ratio of debt to assets or to equity, or limited as a percentage of earnings, but there's no simple denial.

This, of course, is what has Canadian businesses worried, worried because the minister's proposal is more restrictive than what their international competitors will face. For instance, a German firm could still route investments through the Netherlands when buying assets in the United States, enabling that firm to raise capital at a lower cost than the Canadian firm bidding for the same assets. This means Canadian firms absolutely will have a tougher time expanding in global markets, will face a higher cost of capital, and will have a harder time reaching scale efficiencies, delivering good value for money in the domestic market.

But there's more. When Canadian firms invest in foreign affiliates through offshore entities, they build trade flows with other foreign jurisdictions that their alternate investments flow to. So more trade means more business in Canada. In other words, the international financial system, and the tax system that goes with it, help build the Canadian economy, not just others.

So all this is to say that the minister is right when he says that the international tax system needs a look at. There is no question that many businesses' tax structures are finely tuned to take advantage of differences between countries' tax rates and tax systems. There is no question that part of the issue for Canada is the rules on interest deductibility. What there is a question about is whether the budget proposals are the right ones, or whether better options, such as lower tax rates or better-tuned rules on interest deductibility, would be the shrewder course. I think that's what we need to be looking at.

Thank you.

• (1135)

The Chair: Thank you very much, Mr. Poschmann. Nice to hear from you again.

We'll begin our questions now with Mr. McKay. Mr. McKay, seven minutes.

Hon. John McKay (Scarborough—Guildwood, Lib.): Thank you, Chair.

Thank you all for your very good presentations.

I was particularly struck by Mr. Raizenne's testimony, in which he said that we have 86 bilateral tax treaties. It was a 14-year process to work out the taxes that we currently have. It's a very complicated and layered set of rules. We have a general anti-avoidance rule, the rule of all rules, if you will.

So you have what is a very sophisticated, competitive system. Then you have the budget dropping a bomb into the system by

saying "cracking down on corporations that have avoided paying their fair share of taxes by using tax havens". Well, "cracking down" appears to be pejorative; use of "tax havens" appears to be pejorative; "have avoided paying their fair share of taxes", again, is pejorative. Then further on, to expand it, it says "by eliminating the deductibility of interest incurred to invest in business operations abroad".

This is a very peculiar way to go about addressing what I hear all the witnesses say may be something of a problem. I was therefore struck by Mr. Pantaleo's testimony that surely to goodness you would consult about this before you drop this bomb onto the tax system.

I would put it to all the panellists. If in fact we could wind this thing back, what would be your advice to the minister, in terms of how you would structure a panel and what the questions might be that the panel might look at, and would you include an economic analysis of the puts and takes, the benefits, and also the liabilities that flow from it, as Mr. Poschmann said, and increased trade flow and other economic opportunities that Dr. Hines referred to?

I'd be interested in asking you how you would see a proper analysis being done of this apparent issue.

• (1140)

Mr. Robert Raizenne: I'll take the first cut at that.

I would have thought we'd go back to the way things used to be done, which is that we used to have a white paper process on the finance side. I would have thought that what might have been good would have been to strike a panel to consider this over some period of time. I don't think that necessarily needs to be a very long time, but that what we would get from that panel is a white paper presentation as to what they think should be done.

Then there would then follow some sort of consultation process, whereby there would be public debate as to the pros and cons of the recommendations that had been made.

I just want to make one other point, which is this issue of how tax policy interacts with competitiveness. This is a very difficult issue. It's a very complicated issue. I really think that it's an issue that needs to be aired fully, and it is really dealt with in the budget documentation in a very cursory and offhand fashion.

The Chair: Just for the teleconference participants, I will generally leave it to the committee members to chair their own section of time. So this would be Mr. McKay's responsibility at this point, as to who he wishes to—

Hon. John McKay: It could be either Mr. Poschmann or Dean Martin. I'd be interested in hearing what they have to say.

Dr. Roger Martin: Sure. I'll lead off.

I just want to second Mr. Raizenne's comments. I really think that if you were going to set up a panel to think about this, the fundamental question before them should be how to create an internationally competitive corporate tax system for Canada. Ours now is uncompetitive, and dramatically so. It is one of the most unattractive corporate taxation systems in the world. That's not where we want to be. I think it's so critical for competitiveness that I would take that as a general question, not a specific narrower question about interest deductibility.

Hon. John McKay: I address this to all of the panel. What are, in your view, the unintended consequences of proceeding in the fashion the minister has chosen, namely to make this pretty bald statement in the budget? What is the reaction of business or economists to proceeding in that fashion?

Dr. Hines.

Prof. James R. Hines, Jr.: Moving in that direction, I agree with Dean Martin: you're already starting from a situation where Canada's tax system, by the standards of the world as a whole, is not terribly competitive. You would be moving in the opposite direction, in the wrong direction, making it less competitive.

What would that mean? It would mean that Canada would be a less attractive home for multinational firms, number one. Number two, even the firms that are here will wind up less productive in the long run, so you wind up with lower national incomes. I don't understand why a country would want to go in that direction.

Hon. John McKay: Are there any others who want to pick up on that?

Mr. Nick Pantaleo: If I could, there is also an immediate consequence to the proposal, which is just the general uncertainty that it creates in the current environment. There are a number of transactions that are dependent upon the ability to deduct interest. Indeed, a number of investments would have been made and economics determined on the basis of interest deductibility. This puts a significant monkey wrench into all of that. There's an immediate issue about dealing with the period of time we're in right now.

Hon. John McKay: Is that an anecdotal view on your part, or is that direct evidence and within your personal knowledge?

Mr. Nick Pantaleo: It's within my personal knowledge. In fact, I have clients who had deals going the next day that had to be stopped because they were not sure just how the budget proposal was going to affect them. It was that significant to their transactions.

[Translation]

The Chair: Mr. St-Cyr, you have seven minutes.

Mr. Thierry St-Cyr (Jeanne-Le Ber, BQ): Thank you, Mr. Chairman.

I suppose everybody will agree that today's topic is very complex and difficult. I suppose that it is also the reason why we have lost all the students who were here at the beginning of the meeting.

I would like to deal with the issues separately. We have heard people talking about productivity and about tax evasion as if they were linked but they are two different things. Of course, it is obvious that corporations will always become more productive when we reduce their tax obligations but it is a totally different matter. The tax

rate of Canadian corporations affects their productivity. However, there has to be some balance.

When we talk about rules allowing corporations to escape from local tax rates, it obviously makes them more competitive but only because they do not have to submit to local rules or because they find ways to avoid paying tax. We have heard recently in this committee about the double dipping issue which allows some corporations to deduct twice or more the same interest from the taxes that they have to pay.

Do you think it is acceptable? As far as interest deductibility is concerned, I seem to understand that nearly everybody is in favor but do you think it is acceptable? Do you think it is a good thing that corporations can practice double dipping, triple dipping and so on? If it is not acceptable, is there a way for us to identify those cases and, ultimately, to prevent or control that?

• (1145)

[English]

Mr. Robert Raizenne: Again, I'll take the first stab at answering that question.

I think it's important to understand that the fundamental way in which the international tax system works is effectively comity, which is an international principle to the effect that we do what we want here and foreign countries do what they want to do in their own jurisdiction. When we mix up notions of avoidance and evasion and low tax rates, I think we're missing the fundamental point, which is that it's the right of the sovereign country where the income is earned to maintain its own tax system and to determine what its tax rate should be.

If in Canada we chose to cut corporate tax to let's say 25%, how would we feel if a foreign country intervened and said "That rate is too low, so we're going to jack it up"?

[Translation]

Mr. Thierry St-Cyr: Allow me to interrupt because you are answering my introduction which was only aimed at establishing some context. What I really want to know is if you think that we should tolerate double dipping.

Secondly, can it be identified? If we wanted to allow single deductibility but not double or triple deductibility, would we have the technical means to detect it and to forbid it?

[English]

Mr. Robert Raizenne: I would go back to my opening statement, which is to the effect that we have very extensive rules that go to determine whether the income in question is actually earned in the foreign country. So there's no issue of shifting around income in an improper way. We have very extensive rules dealing with that particular issue. Our basic tax policy is that if we're talking about active business, as opposed to investment-type income, if we're talking about actual business activity, we're inclined to leave the rate of taxation up to the jurisdiction in which the income is earned.

[Translation]

Mr. Thierry St-Cyr: Thank you.

[English]

Mr. Nick Pantaleo: If I could just add to that, I mentioned in my opening statement that there are basically two objectives of the system we have for taxing foreign income. One is to make sure that Canadian companies are competitive in the global marketplace but we're doing so in a way—at a reasonable cost—that we're not giving away the domestic tax base.

With respect to double-dipping, I see that more in the first objective. That is, allowing Canadian companies to be competitive means ensuring that they're playing on a level playing field with other global companies. If they have the ability to engage in such transactions as well, for the reasons Robert is articulating, then to deny that benefit to Canadian companies is to take away from one of the objectives the system is intended to generate and to do so in a way that it does not, in itself, reduce or take away from that first objective: reducing the domestic tax base.

Mr. Finn Poschmann: Can I get a word in here, Mr. Chairman?

The Chair: Certainly, sir.

Mr. Finn Poschmann: Thanks.

I just want to point out, on one practical aspect with respect to foreign multinationals, that we literally cannot prevent the double-dip. We can prevent a dip being taken against income earned in Canada through rules roughly like those proposed by the minister. The broader question, though, and it does, I understand, go back to your preamble, is whether we would want to and whether we would want to using rules such as those proposed by the minister. I get very uncomfortable about the idea of raising the cost of capital for Canadian firms.

When Canadian firms expand abroad—I'm not a champion of the national champion model—it makes no sense at all for the Canadian economy to hobble our firms in the international marketplace.

• (1150)

[Translation]

Mr. Thierry St-Cyr: In answer to the first part of my question which was whether you believe that it would be a good thing to prevent double dipping, I seem to have understood that most of you were opposed to that.

As to the second part of my question, which was whether we have the tools required to prevent it, you said, Mr. Poschmann, that you do not think there is a way to prevent that. We do not have enough information to be able to forbid double dipping.

Am I correct?

The Chair: Thank you very much, Mr. St-Cyr. Unfortunately...

[English]

Mr. Finn Poschmann: It is correct that we cannot abandon the double-dip. What we can do is prevent one of those dips being taken in Canada, should we so choose.

The Chair: Thanks, Finn.

Unfortunately, the time has elapsed for Monsieur St-Cyr.

We'll go to Mr. Del Mastro.

Mr. Dean Del Mastro (Peterborough, CPC): Thank you, Mr. Chair.

Thank you, panel, for appearing before us today.

I just wanted to establish a couple of things here. First of all, we, as the government, happen to agree with Mr. Martin and the panel. But we believe that corporate taxes are too high in Canada. We've signalled that the government is moving towards the lowest corporate tax rates in the G-7. That's in *Advantage Canada*. We've reduced corporate taxes to 18.5% by 2011. That's a commitment by the government. And there's a further commitment to reduce those to 17%.

I also wanted to make the comment that the government, the CRA specifically, made it very clear that it is working in partnership with countries like Australia, the United States, Germany, France, Great Britain, and others on the rules regarding low-tax jurisdictions or tax havens. So we are going to be going about this with a process that will level the playing field among G-7 nations and other OECD nations.

Mr. Poschmann, we've heard a couple of comments on double-dipping. We had a presentation by the CRA the other day on a case in which a Canadian company—this was an actual court case they took to court and lost—borrowed money from a tax haven. They borrowed \$200 million at 10%. They claimed a \$20-million interest expense against Canadian taxes. They then loaned that money to another tax haven and put it out into a subsidiary company in the United States. Both companies claimed the same interest deductibility of \$20 million in both countries. The CRA lost that case, indicating that as far as they're concerned, according to current tax laws, that was a legitimate claim, even though they did not experience a taxable interest expense against their Canadian income. Do you think that's appropriate?

Mr. Finn Poschmann: Do I think it's appropriate? I think the way to look at it is to ask what the costs are and what the benefits are. It's a policy analysis approach that applies to this case, as to any other. It's not clear what the costs to the Canadian revenue base are. And it's not clear what exactly the benefits of flowing investments through conduit entities or through low-tax jurisdictions are. This is an area that needs work.

What we do know, though, is that sudden tax changes certainly can affect the ability of business to compete in the world, and that's an issue.

Mr. Dean Del Mastro: Right.

I think what's being underlined here is that cracking down on what we would consider the illegitimate use of tax havens or low-tax jurisdictions is not going to be an easy task. It's going to take some precision to do that.

The minister has indicated that we're looking to crack down specifically on double-dipping, which I think is easy in this specific case. It's a very simple example to determine what the cost was to the Canadian economy. If you work on a 20% tax rate and they claimed a \$20 million expense that they did not have, the cost to the Canadian tax purse in this case would have been \$4 million in unpaid taxes. And then they also claimed that again in the United States.

I think that Canadians in general would have a problem. This type of example is not creating any economic spin in Canada. All it's doing is reducing the overall responsibility to pay Canadian taxes.

Ultimately, what we're looking for is broad-based tax fairness so we can bring that corporate tax rate down as soon as possible, because I'm sure that everyone on the panel here today will agree that the lower corporate tax rates are in Canada, the less incentive there is to use a low-tax jurisdiction. In fact, as Canadian tax rates drop, there is virtually no incentive to use low-tax jurisdictions. And I'm sure you'd agree with that.

• (1155)

Dr. Roger Martin: Yes, and I would encourage you to ask the fundamental question—and I'm sure if Dr. Hines put his great analytical capability to bear on it, he'd come up with the right answer—and that is, why do we think that corporate income taxation at all is a good idea?

Corporations are not animate objects; they're legal constructions. People own corporations. People get dividends from corporations. I don't think there's actually any logic supporting the notion that the taxation of corporate income is really good for any economy. And I think that slowly but surely, through international tax arbitrage, it's going away. I think the only question facing Canada is whether we want to be the last country in the world to get on board with that, or be somewhere closer to the front of the line.

Mr. Dean Del Mastro: Mr. Martin, we're probably getting into a discussion that's a little broader than what the focus of the committee is, which is to specifically look on tax havens and tax avoidance use in Canada.

I just wanted to ask you a really quick question on hollowing out. We saw Statistics Canada release some reports today that said that far from hollowing out, what we're actually seeing is a thickening in Canada. Hollowing out is not real. It's not something that we see.

I just wondered if you had any specific comments on that. In addition, in yesterday's *National Post* there were some comments by Andrew Coyne, who spoke about the 90¢ Canadian dollar and how that is also working to Canada's benefit to prevent hollowing out from occurring.

Dr. Roger Martin: The work I've done on it would suggest that we are thickening up more than we are hollowing out, so we're growing globally competitive, Canadian-owned, Canadian-headquartered companies at a much faster rate than we're losing them.

That doesn't mean I'm not concerned about our Canadian companies being taken over. And I think this is why we have to have policies that make sure that they've got every chance that any other companies have to invest in upgrading and becoming competitive.

I think the data does not suggest we are being hollowed out. So I would concur with Statistics Canada on that front.

Mr. Dean Del Mastro: Thanks, gentlemen, very much.

The Chair: We'll continue now with John McCallum. You have five minutes, sir.

Hon. John McCallum (Markham—Unionville, Lib.): Thank you, Mr. Chair.

Thank you to all the witnesses for being here, or for being with us by video.

I may be wrong, but I seem to detect an unusually high degree of consensus, even unanimity, in this group of witnesses. I would like to test that. I have only five minutes, but I want to test three propositions and see if you all agree with them.

First, if you take the budget at its word, which says, in a blanket statement, “eliminate the deductibility of interest”, then given the impact of that action on competitiveness, it would not be a good idea to proceed with this at this time. Is there any disagreement on that?

Silence means you're okay.

Second, I think you've been saying that it would be a good idea to develop some kind of task force composed of tax experts and economists, perhaps business people, to look at the international Canadian tax system and to make recommendations that take into account both competitiveness and a possible need to tighten it up in certain areas where it might need tightening.

Is that a reasonable proposition?

A voice: Yes.

Hon. John McCallum: Okay.

On the third one there might be more disagreement.

I'm not a tax expert, but I'm a little more expert than I was a few months ago, because I've been speaking to a number of experts. If there were such a task force, I get the feeling, particularly in the case of Finn Poschmann—this also coincides with what I've heard elsewhere—that a more fertile field for going after abuse to protect the tax base would be debt-dumping rather than double-dipping. By that I mean, as I think Finn expressed it, foreign affiliates coming into Canada, borrowing lots of money to reduce their taxes, and investing in third countries is a more important challenge to our tax base and something to be gone after, more important than double-dipping, which at least one or two of you said was as much a competitiveness issue.

Is that proposition agreed to?

• (1200)

Mr. Robert Raizenne: Sir, just to put that in its context, that is tax-rate-driven. The reason foreign multinationals dump debt into Canada is that Canada has a high corporate tax rate. They can save more money if the interest expense is parked, if you wish, in Canada rather than being in some other jurisdiction that has a lower tax rate.

Hon. John McCallum: So I think we'd all agree that over the medium term, we would like to get the tax rate down. But if for the moment we take that tax rate as a given, then what you just said implies there's a significant incentive for foreign affiliates to do that. It could be a significant drain on the tax base, so therefore it would be something that such a task force should look into, perhaps more than double-dipping.

Is that correct?

Mr. Nick Pantaleo: That would certainly be my position, sir. And it certainly would be consistent with the approaches that other countries have taken in looking at this particular issue.

Hon. John McCallum: Finn, would that be your position? I think you said that.

Mr. Finn Poschmann: Yes, that's certainly consistent, John, with what I said.

Hon. John McCallum: Does anybody not have that position?

I get three out of three on all my points.

I rest my case, Mr. Chairman. Thank you.

The Chair: Thank you.

I'd like to chip in a little bit here.

At this point, I think we have consensus that lower tax rates would reduce the incentive somewhat for money to go offshore. We have the consensus that paying taxes makes us less competitive. Ultimately, if there were no corporate taxes, we'd be really competitive.

Now, that being established, what I'm concerned about is more the fairness aspect of this. My understanding, like that of Mr. McCallum's, is evolving as we have these discussions. I understand that we have tax treaties with a number of other countries. Mr. Hines alluded to that. The intention of these tax treaties was to avoid double taxation, essentially. The principal intention was to make sure that once we enter into a tax treaty with another country.... As you've said, their sovereign authority over the taxation of the income rests with them, and we allow the money to be repatriated tax free.

What we've created then is a circumstance where companies, whether offshore or locating here, are Canadian, can lever, tax-deduct, reduce tax obligation in Canada, shift the money offshore, earn the money there, and then repatriate earnings back to Canada, with certain definitions being complied with, tax free.

Is that a fair overview?

Hearing no objection, I will proceed.

So we sign a tax treaty with Barbados when they have a comparable tax rate, and then they subsequently change it so that you can set up a Barbadian corporation and pay 1% tax. We keep the treaty intact and we see a 4,000% increase in the establishment of Canadian dollars going to Barbados, where they pay 1% tax, or perhaps in some extreme cases 2%. These same companies can then bring the money back to Canada, having deducted and reduced their Canadian tax initially, so paying essentially no tax at all. And none of you are saying that's a problem.

I'd be interested in hearing a little more intensive discussion on specifically the issue of havens. We're talking about OECD-defined tax havens with Barbados and Cyprus, who have been the principal attractions of increased Canadian outflow. I'm interested in knowing how you perceive that as fair in any way, shape, or form.

Does somebody want to comment?

Mr. Raizenne.

Mr. Robert Raizenne: I guess I would reply by taking what is a very good question and sort of pushing it forward, which is to say that it's not true that Barbados is a tax haven in the common-sense use of that term. They are a high-taxing jurisdiction. They have

certain features of their tax system that in certain circumstances allow for low tax, just like Canada, which is a high-taxing jurisdiction, has numerous features of its tax system that allow for low tax or no tax, in certain circumstances.

The Chair: Sir, I'm not disputing that there are different provisions for reduced tax in different jurisdictions, but I think the Stats Canada data on this are indisputable. There's been an amazingly large increase in the outflow of cash to Barbados. Despite its being an attractive sun spot, a place with half the population of Ottawa isn't drawing that much money for any reason other than it doesn't tax very much. Okay?

• (1205)

Mr. Robert Raizenne: Yes.

The Chair: Mr. Hines.

Prof. James R. Hines, Jr.: Oh, I agree, that's certainly why the money is going to Barbados. And the same process happens with American companies, I should add. You see basically the same phenomenon—not surprisingly, because the economies are very similar.

The thing to remember is that the income earned when an investor puts money in Barbados or Cyprus is not actually earned in Barbados and Cyprus. There are hardly any factories or employees there—a small number. Basically, those are conduit destinations that then take that money and invest it in Europe or South America or wherever the thing may go. And in those destinations, it is taxed. It all depends on where, of course. But I think it's only looking at the first piece of the puzzle to see where the money goes initially.

The Statistics Canada data you're correctly representing really looks at the first place the money is going, but then it's turned around. It's sort of like saying if I put money in the bank, it goes into my local corner bank, but of course that's not really where it goes, because then the bank turns around and loans it to a company somewhere else.

The Chair: Mr. Hines, I appreciate that. So the money goes to Barbados, and then it goes to this other jurisdiction you speak of, which taxes it at a certain rate. However, the money is redirected to that jurisdiction, and the expense or carrying charges are deducted in that jurisdiction as well—the double-dipping model, correct? So the money goes to another jurisdiction. It is borrowed by that corporation. It reduces its tax obligations there to nil, or virtually nil, and then recycles the money.

I'm not disputing that the recycling of the money creates jobs and wealth. What I'm asking you is whether we should continue to be complacent, as has been the case for a number of years under various political leaderships, and be accepting of tax treaties with jurisdictions that charge virtually no tax, when in fact the intention of tax treaties was originally to avoid double taxation. We create no taxation when we honour tax treaties with countries that do not tax money at any significant rate. Isn't that correct?

Prof. James R. Hines, Jr.: But it's not bad for Canada or the United States to have Canadian or American companies face low foreign tax obligations. It's better for us, because that saves you money, compared to the alternative.

The Chair: Sure it saves people money because they don't have to pay when they deduct money, the interest charges here, and they don't have to pay on the earnings elsewhere. I understand that. I understand that there are many tradespeople and farmers and teachers in this country who would be more competitive if they didn't pay tax too.

What I'm getting at is this. Do you think it's fair to continue to honour a tax treaty after the provisions have changed? In other words, when we signed the tax treaty with Barbados, as Mr. Raizenne accurately pointed out, they had a tax jurisdiction that was generally acceptable by Canadian standards. Now, implicated in your earlier statement, you're saying we should leave it to them to tax the way they want, but in fact we haven't changed the tax treaty subsequent to their making available reduced tax rates of 1% and 2% to corporations, which are now massively relocating there.

Isn't that laissez-faire approach a kind of benign neglect, and isn't it really, in a way, a kind of race to the bottom in terms of the reduced revenue generation capabilities that occur as a consequence?

Prof. James R. Hines, Jr.: We have no evidence that there is reduced revenue generation in North America or around the world as a consequence of this.

The second thing I would say is that to fight against that is going to make you poorer.

The Chair: Yes, well, that contradicts what the Auditor General's office has certainly reported in numerous reports to us. It also contradicts what Mr. Mintz's report for the previous government referred to back in about 1996.

In any case, I see my committee members also want to ask questions.

Monsieur Carrier, *cinq minutes*.

[Translation]

Mr. Robert Carrier (Alfred-Pellan, BQ): Thank you, Mr. Chairman. I will share my time with my colleague.

Since I am not a regular member of the committee, I want to underline that I appreciate the only document we have received in both official languages. This helps me understand your answers better. I am referring to the document of the C.D. Howe Institute. Thank you, Mr. Poschmann.

I have a general question for all of you, gentlemen. I would like to know what you think of the Canadian tax system as far as competitiveness is concerned, which is an issue that has been raised today. What countries have a more attractive tax system for investors? I am asking this question to see how Canada compares with the others. What would be our rank? Should Canada improve the competitiveness of its tax system or are we average on that score?

Who would like to answer?

• (1210)

[English]

Mr. Nick Pantaleo: I'll start this time.

I would rank Canada's system as being relatively favourable, more favourable than a lot of the other systems that other countries have throughout the world. In many respects the system that Canada has, in particular its exemption for foreign business income and the safeguards it has to protect the tax base, are those that a number of other countries today are looking to emulate to a large degree. You have countries such as New Zealand, the U.K. most recently, saying that they are looking at studying and moving toward more of an exemption type of system, in many respects much like what Canada has.

In various types of studies of transactions that could take place in an international arena, comparing where would a favourable jurisdiction be to have as the top company, Canada has come out very well on those types of studies, with respect to the U.S., with respect to some of the other European countries. It's tough to kind of categorize it specifically, but I would say overall it's very favourable.

[Translation]

Mr. Robert Carrier: Is your opinion shared by your colleagues?

[English]

Dr. Roger Martin: Considering there was some complaint of a lack of disagreement earlier, why don't I weigh in and disagree? I think, in terms of its overall tax structure, Canada has one of the least attractive and least intelligently constructed tax structures in the industrialized world.

What we've decided to do, overall, is to tax at below the OECD average, so we're not actually a high-tax jurisdiction, but we've decided to tax the things we want more of very heavily and the things we want less of lightly, and I don't think that's a good idea.

So for business investment, which we would like more of, to create better and more jobs that are more productive, we've decided to tax that very highly. Countries like Sweden and Denmark, interestingly the more socialist countries, have figured out that what they want to do is try to make their companies as productive as possible and collect the taxes from the people who have high-paying jobs in those companies and the investors in those companies.

I think we have it completely wrong, and the only thing that saves us is that the United States has an unattractive structure as well. They do it all at a lower level, but the day the United States wakes up and takes their taxation of corporate investment down is the day that Canada is in big trouble. So I think we have a vulnerable position because we've decided to tax corporate investment so high, and I think that's not an attractive system.

[Translation]

The Chair: You have a little bit of time left, Mr. St-Cyr.

Mr. Thierry St-Cyr: You are asking a lot. If the choice is between lowering corporate taxes or maintaining access to tax havens or to those jurisdictions that have lower rates of taxation, what would be your preference?

[English]

Mr. Nick Pantaleo: I'm not sure that those are necessarily mutually exclusive. Nobody here is advocating the use of the tax base—

[Translation]

Mr. Thierry St-Cyr: I would like to know what you would do if you had the choice. We all have to make choices as parliamentarians and that is also the case for the government. If there is no choice...

[English]

The Chair: Merci.

C'est clair that the choice is not going to be made today.

We will move to Mr. Dykstra now.

Mr. Rick Dykstra (St. Catharines, CPC): Merci.

I have a question for Mr. Martin. I want to take your comments a little further and clarify the need to take direct aim at corporate tax rates. These are things we heard in our pre-budget consultations. Is what we need to do with respect to lowering them specifically what you're speaking to?

Dr. Roger Martin: Yes. And in particular I mean the impact of taxation on the propensity for Canadian corporations to invest in machinery, equipment, hardware, software, innovation, building the companies. Our corporate tax rate is unhelpfully high.

• (1215)

Mr. Rick Dykstra: Just to take that further—and maybe Mr. Poschmann can respond to this as well—I would like to talk about the whole aspect of fairness. I understand that all of you are here today to argue that the lower we go with respect to corporate tax rates the better, especially those that have a positive impact on the economy, or at least on investment in Canada. I don't think any of us are going to argue with that.

Where the difficulty comes in is with respect to tax fairness. I'd like to get your comments on that. You specifically spoke about corporations and allowing them to have a low tax rate to be able to rejuvenate and reinvest. The difficulty I have is with the fairness. How much should individuals have to pay to be able to provide the services that all of us expect in this country? Further, where does that line get drawn with respect to corporations and business? While you argue, Mr. Martin, that they are not physical life specimens, they are entities. In fact those folks who own the companies, or those of us who are shareholders, do have a direct responsibility to share in the fairness of who pays taxes in this country.

Dr. Roger Martin: I agree with the last part. I just think it's a very fractured logical structure to ask the question of whether it's fair, as between people and inanimate objects. I mean, we have this notion that it's...I don't know, sort of a post-Marxist overhang thing that likes to characterize corporations as fat cats, which suggests they're animate.

Mr. Rick Dykstra: No, no. That's not—

Dr. Roger Martin: I'm interested in the people who own corporations paying their fair share of the tax burden, definitely—the people who get dividends from them and who own corporations. You can create absolute fairness that way in taxing this intermediary.

Mr. Rick Dykstra: Mr. Martin, I respect what you're saying. We can get into the argument.... It makes for a good laugh around the table when we talk about corporations being inanimate objects and individuals being people, but at the end of the day, someone owns

those corporations and someone signs a cheque to transfer money with respect to tax paid.

Maybe, Mr. Poschmann, you can comment on this, as well. The fact is that there has to be a balance and there has to be fairness so that individuals aren't overburdened with respect to tax. I think you were alluding to that in your opening comments.

Mr. Finn Poschmann: Thank you.

I don't have to disagree with you. What I'd like to get across, though, is a sense of caution. We're talking about a specific tax measure, which on some axes of fairness and equity makes perfect sense. On other axes of fairness and equity, it doesn't necessarily make a lot of sense. You can't hit them all at once. It's simply impossible in the international tax system. You can't hit everything all at once.

But the other point, and this is where there is special caution, is do you really think that with this proposed measure there will be a net long-run increase in government revenue? Will you build economic activity in Canada? Will it really generate revenue from government over the long haul? I'm not sure about that, and that's why I recommend a careful look at it.

Mr. Rick Dykstra: Thank you.

The Chair: Thank you, Mr. Poschmann.

We continue with Massimo Pacetti now.

Mr. Massimo Pacetti (Saint-Léonard—Saint-Michel, Lib.): Thank you, Mr. Chairman.

Thank you to the witnesses for appearing. Only the crew of witnesses that we have before us could make a complex issue like this even more complex, so I'm going to try to make it a little bit easier.

If we could just stick to the motion, where we're looking at tax havens and tax avoidance and how we can even work on this interest deductibility, there's an easy solution. We have one in Quebec, where people cannot deduct interest expense if they don't have offsetting interest income. So wouldn't that be the solution for the interest deductibility where—I think, Mr. Poschmann, you alluded to it—it has to be against Canadian income? Would that not be an easy solution to fix all of this?

Mr. Robert Raizenne: It might be easy, but it would be pretty ill-advised in the sense that the idea of so-called restricted interest expense was first put forward, I think, in the 1981 federal budget. I don't believe anybody has suggested that it is an appropriate rule in a corporate context. We don't have that principle whether Canadian corporations are investing in Canada, we don't have it whether they're investing offshore, the theory being that interest expense is a real and immediate cost.

• (1220)

Mr. Massimo Pacetti: It's real, and you can actually track it. You can actually see where the money is being invested, so why can't we track the money coming in? It's logical.

Mr. Robert Raizenne: We have never tried to do that on the basis that it's just too uncertain, and we want to use the interest expense as an incentive.

Mr. Massimo Pacetti: Let me ask a question to Mr. Pantaleo, because our time is limited.

Mr. Pantaleo, you're an accountant. Can we easily track that interest income and interest expense?

Mr. Nick Pantaleo: In a large corporate structure it's not at all easy to do. Funds get commingled together, they get used for different purposes, they come in from different directions. It might be easy for you and me to trace where our one source of income goes, but for corporations with multiple entry points for cash and exit points, in fact it is very difficult to track that in a very accurate fashion, assuming that is something you want to do in the first place.

Mr. Massimo Pacetti: Revenue Canada does it for people who have investments in investment properties. They can't re-mortgage their investment property and use the money for personal purposes, so the logic doesn't.... Why do corporations have to be exempt where individuals have to be accountable to the CRA? It's probably more complex for individuals, who don't have a proper set of books, who don't have a CFO or even any basic accountants on their staff. The logic doesn't hold, I'm sorry. I think that's one of the solutions.

I don't want to spend too much time, but I'd like to ask maybe you and Mr. Raizenne, what are the tax structures, what is the tax planning, what are some of the structures that are being put in place now in your firms from an accounting point of view and that of law firms? For corporations that come to you for tax planning advice, are you suggesting that they go and invest in tax havens, or are you more leaning toward places like Barbados that are lower income, or perhaps Ireland? What is the tendency there?

Mr. Nick Pantaleo: Sir, the first thing to remember is that the corporations are looking for the ultimate area where their funds are going to be invested and where they are going to be most productive and create the most value for the corporation and for its shareholders. Nobody thinks about Barbados or some of these other jurisdictions in the first instance. It's a way to achieve your ultimate goal, and as tax advisers, we obviously are required and asked by our clients to help them to devise the most tax-effective structure that could—

Mr. Massimo Pacetti: Again, our time is limited. It might not be the first thing on their mind, but obviously the proof is in the pudding; we've seen the statistics go up. It might be the second or third thing. When they are devising places to invest, will they choose a place like Barbados, where they have a treaty with Canada, or will they choose another tax haven? I'll use an example: Bahamas, where there is no tax treaty with Canada.

Mr. Nick Pantaleo: They will typically look for jurisdictions that have tax treaties with Canada.

Mr. Massimo Pacetti: Does that benefit Canada, the way that the tax system is in place here?

Mr. Nick Pantaleo: Currently, and to get back to a point the chairman was alluding to earlier, another thing the tax treaties allow Canada to do is in effect to track taxpayers as to where they are going. The treaties do serve other purposes, exchanges of information and the like, which in today's environment is equally important—

Mr. Massimo Pacetti: Are they doing it because they don't want to be subject to having information verified with those tax treaty countries, or are they working with tax treaty countries?

Can I go to Mr. Raizenne, please?

Mr. Robert Raizenne: No, I would say absolutely not. We have very extensive rules. We have all of these tax treaties. We're trying to enter into exchange of information agreements with most of the countries we don't have tax treaties with. That era of CRA not knowing what's going on is ending.

Mr. Massimo Pacetti: We had CRA here the other day, and they said there are some corporate structures they can't access, they can't see through. They said they were getting pretty decent cooperation, but not on every single corporate audit do they get the whole organizational structure.

Mr. Robert Raizenne: There may be individual instances, but they're making huge efforts to try to ensure they know what's going on and that taxpayers in Canada are complying with all these different rules.

The Chair: Thank you, gentlemen.

We will continue with Madam Ablonczy now.

Ms. Diane Ablonczy (Calgary—Nose Hill, CPC): Thank you, Mr. Chair.

I think what everyone in this committee wants to do, no matter what our political stripe, is to have tax fairness in a way that ensures that Canadians' quality of life and standard of living remains high.

I was struck by you, Mr. Martin, and your passionate argument for no taxes for corporations. Let's suppose we all agree with that, which I doubt, but let's suppose we all do. I think we would all know we couldn't do that overnight.

As you know, our government wants to give Canada both a tax advantage through lower personal and corporate taxes and also a regulatory advantage by cutting the compliance burden in a whole number of ways, including tax reporting.

The tax loophole and tax haven argument is designed to get to lower regulation, lower taxes, in both the personal and corporate sense. So things like closing the double-dipping, the double claiming of a particular exemption for one expense, is one of the things we're doing.

I guess we picked that one partly because it has such widespread support. We've had the Auditor General say this should be eliminated, we had the Mintz committee saying it should be eliminated, we had this committee of the House saying it should be eliminated, and the public accounts committee as well. So that's where we're starting. But in the paper Mr. Poschmann co-authored, he talked about beyond this we have to concentrate on tax distortions that encourage debt dumping into Canada.

In the context of wanting to make the whole system fair for everybody, Mr. Poschmann, I wonder if you could just expand on that a little bit. How would this tie into our study on tax loopholes and tax havens?

• (1225)

Mr. Finn Poschmann: Thank you, Mr. Chairman and Ms. Ablonczy—terrific.

There is just one point about the Mintz committee. The 1998 report did recommend a change roughly along the lines of that proposed by the March 19 budget, absolutely. However, the report went on to say you would only do this in the context of fairly generous grandfathering rules and a carefully considered and fairly lengthy transition mechanism, because it would be a substantive change.

I have another comment on your preamble, if I may. I think lower personal tax rates make a lot of sense for Canada. We are not seeing any shortage of revenue on the part of the provincial government, so I am fully supportive of measures that would lower corporate and personal tax rates over time as well as loosen up on regulation. My concern is that we are going to have to look to the next budget for that, I think, because there wasn't a lot of evidence of that in the past budget. So I think that is something worth getting on the table.

As to debt dumping, I referred specifically to debt-to-asset ratios. The general approach is called thin cap. This is a set of rules that several countries use. Canada uses them in some instances in a limited application. It limits the amount of debt relative to equity or relative to earnings that a corporation books in Canada. Above that threshold, interest is no longer deductible.

That certainly would get at the debt dumping we've talked about. I certainly see such a measure as consistent with the minister's aims. I would encourage the committee and the finance minister to look at these mechanisms as something that would make sense for Canada.

Ms. Diane Ablonczy: Okay. Thank you. That's helpful.

The Chair: Thank you.

Mr. Poschmann, perhaps you could elaborate a bit on your knowledge of what other countries are doing. My understanding in respect of the repatriation side of things here, where we allow the deductibility in full for offshore investment, is that in some cases it is not taxed to any degree and then is allowed to be repatriated, or earnings are allowed to be repatriated. Are other jurisdictions addressing this? If so, who, and how?

Mr. Finn Poschmann: The exemption model would apply to France, Germany, Japan—pretty much—and Italy. The U.K. uses a model whereby you have a taxation and a credit for taxes paid abroad. These models all do exist out there; there is a range of them in place. I believe one of the witnesses at the table mentioned that the U.K. is considering shifting towards the exemption system, in which case they would be confronted with this very question of whether interest would be deductible.

• (1230)

The Chair: Then it's fair to say we are not entirely alone in terms of allowing repatriation fully and tax-free, but a number of our competitors do have more restrictive or less preferential policies in place right now.

Mr. Finn Poschmann: That's right, Mr. Chairman. In France, Germany, Italy, Japan, and the U.K., there are different variations on thin-cap rules of one sort or another with respect to foreign investment. The U.S. has a quite different system, but trust me, you do not want to know about it.

The Chair: Thank you for not telling us.

Go ahead, Mr. Thibault.

Hon. Robert Thibault (West Nova, Lib.): *Merci, monsieur le président.* I thank all panels for their presentations today.

It seems to me that we're in an age in which our corporations are having increased competitiveness globally. It is more difficult to compete, and we have a tax measure here, or an announcement of a potential tax measure, that ties us to the porch. It reduces our competitiveness. It doesn't define how, but it sends the message out to the corporate world that their competitiveness will be reduced, without giving the outline on how. It will be sometime in the future. I believe it was a measure that he never thought he'd implement. He thought it was a good 20-second sound bite that he could go into an election with, on competitive taxes and on tax fairness.

He followed that with income trusts and followed that with original equipment manufacturer contracts with the ISS, or in-service supply mode. You see a lot of hollowing out. There were companies being sold abroad, economic assets being sold abroad, so it makes me quite nervous on that competitiveness thing.

You said, Mr. Pantaleo, that there were deals already that had fallen apart because of this thing. Do you see this contributing to Canadian corporations leaving, or to corporations not establishing themselves in Canada?

Mr. Nick Pantaleo: I certainly see that it will end up being a consideration that these companies will be looking at. Deals were in process, as the companies are always engaged in new activities, so certainly it had a very immediate effect on those companies and created some uncertainty as to how the new rules would apply to them, because of course there was no draft legislation introduced along with the budget.

Hon. Robert Thibault: Someone made the argument that I've heard used by the Conservative members on occasion. It is that the system we have now.... And I recognize its weaknesses; I realize that there are people taking undue advantage of it. Some will typify it as a race to the bottom because of things like double deductions and things like that, but the measure I see here, without its being completely fleshed out and without its being competitive, might cause us to drown near some ideological top.

What does this mean for us? If we go in this direction, if we stop Canadian corporations that need affiliates abroad, that need raw material abroad, and the only way they can do it is by buying into a foreign company, opening a mine, or opening a process abroad, and they can't deduct their interest in Canada, what does it mean for their competition with the Spanish companies and French companies and American companies that are competing in the same market we are?

Mr. Nick Pantaleo: One of the things we can look to is that this measure—the ability to deduct interest—was introduced in the early 1970s, and it was specifically to avoid the disadvantages Canadian companies were undergoing in the pre-1972 period. What clearly was seen afterwards with this measure was that the cost of capital for these companies, which would make the acquisitions cheaper for them and prove the overall economics of their acquisitions, was becoming much more favourable. It seems to me that one of the consequences of this particular measure, if implemented as it's drafted, is going to be to reverse that trend. It will just make those types of costs that much more and lead to some of the other considerations you alluded to earlier.

Hon. Robert Thibault: Thank you.

The Chair: Mr. Murphy, do you have a quick question?

Hon. Shawn Murphy (Charlottetown, Lib.): I want to ask Mr. Raizenne and Mr. Pantaleo about the whole issue of uncertainty here. The announcement in the budget was clear and unequivocal that the companies could not deduct interest for foreign acquisitions. There has been some opposition throughout the financial community. There seem to be statements being made now that it's going to be interpreted narrowly and deferred.

I don't want to use the word "confusion", but I think there is uncertainty in the financial markets. It's almost to the point where the fear of being hanged is worse than being hanged. How do you think that is affecting the financial markets and transactions that are being contemplated?

• (1235)

Mr. Robert Raizenne: I would answer that by simply pointing out that tax is a very important cost of carrying on business. Business people like to know what the tax rules are. For almost two months we've had this controversy about what this actually means. The minister now seems to be saying it doesn't really mean what the March 19 statement said because somehow the elimination of the interest deduction in Canada is going to be tied to double-dipping.

Presumably that means that if there's no double-dipping you're going to get the interest deduction in Canada.

This is a very unhelpful circumstance, where people are effectively reading the *National Post* daily to see what the latest version of this idea is.

Hon. Shawn Murphy: Mr. Pantaleo.

Mr. Nick Pantaleo: I would add that if the proposal is implemented, CFOs or CEOs will be wrestling with what this actually means. Shareholders and analysts need to know these things. In today's environment companies want to come clean about the impact of major developments, and this would be a major development. They are wrestling with exactly what the final consequences of such a measure will be on their companies. This is a concern for them, I know.

The Chair: Thank you very much to the gentlemen in Toronto and here for your participation today. We really appreciate it.

The clerk gives her best wishes to you, Mr. Martin. Thank you for participating.

[Proceedings continue in camera]

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