Canada-European Investment and Tax Issues

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This report is prepared for the Canada-European Roundtable to assist governments to develop better tax policies to help spur investment. While trade negotiators have focussed on regulatory matters that affect Canada-European trade and multilateral investment, one should always bear in mind that there are significant tax issues that impact on Canada-European investment as well.

In the preparation of this report, several companies were consulted to obtain their views on Canada-EU tax policies issues that affect cross-border investments.[1] This report provides a summary of the most important issues that should be considered by Canada and EU member states in improving the investment climate for businesses engaged in Canada-EU trade.

The report first reviews the primary governance differences that impact on Canada and EU tax policy reforms with respect to Canada-EU cross-border investments. It then reviews some principles that should be considered for guiding policy changes. Several issues are then considered for possible reforms in the future: withholding and personal incomes taxes that impact on non-resident investments, permanent establishment rules, treaty dispute mechanisms, capital gains taxes on cross-border corporate reorganizations and non-income tax harmonization.

While a question has arisen as to which EU member state treaty provides the best practices, only one company made an explicit statement in this regard. It viewed that Netherlands provided the best set of rules, including the absence of withholding taxes and good regulatory practices that facilitate Canadian trade.

Differences in governance – implications for change

In preparation of this report, it is well recognized that Canada and the European Union have quite different governance structures for tax matters. This is quite important in terms of recognizing which level of government plays an important role in setting tax policies that impact on Canada-EU investment. In Canada, the federal government has the dominant taxing power affecting business. In Europe, it is the member states of the EU that are responsible for taxation.

In Canada, both federal and provincial governments in levy corporate income taxes although seven of the provinces currently harmonize their provincial tax with the federal base. Three of the provinces, accounting for about three-quarters of provincial corporate income – Ontario, Quebec and Alberta – collect their own corporate tax although Ontario is currently negotiating a tax collection agreement with the federal government for the corporate income tax. Canada's federal government is largely responsible for bilateral income tax treaty negotiations. The federal government usually takes the lead on issues related to the taxation of international income. The provinces do set their own corporate

[1] Those who have provided specific comments include Alcan, Bombardier, CHC Helicopters, Chrysler Daimler, KPMG, Northam Realty, Thomsons and ThyssenKrupp. I am especially grateful to Fil Cormano of CHC Helicopters whose detailed tables are used in this report.

income tax rates on income that is allocated by formula to the province and have used to tax credits and, in the case of non-harmonizing provinces, other tax preferences that impact on business investment. Also, the provinces levy other taxes, such as capital taxes, on businesses. However, in general, provincial policies are far less relevant to Canada-EU cross-border investments.

In the EU, the member states are responsible for taxation powers. Each member state establishes corporate income and other business taxes levied in their jurisdictions. Each negotiates its bilateral income tax treaties with other states. The EU itself has no taxing power although the EU treaty among member states requires certain principles to be followed such as non-discriminatory practices against residents of other states and the prohibition of barriers to the free mobility of capital across EU states. These two principles have recently been used in a number of cases in the European Court of Justice that have significantly impacted on corporate tax policies in the European Union. However, by and large, member corporate income taxes are not harmonized although some discussions have taken place to promote a formula allocation method for determining corporate income taxes in the EU, along the lines used in Canada and other federations, a policy that would be welcomed by Canadian companies that operate in many European countries today.

Objectives for taxing Canada-EU cross-border investments

Government have several objectives for tax policy with respect to cross-border investments. Ultimately, the aim of tax policy is to raise revenues for governments with the least impact in distorting economic decisions made by market participants. Efficient tax policy removes obstacles to cross-border investment as well as reduces any tax preferences that might favour some taxpayers. Fair taxation implies that business taxes should be neutral amongst different activities – differential taxation to reduce taxes on vulnerable parts of the population is best left to personal taxes on residents in the jurisdiction. Less complicated taxes reduces both compliance costs for taxpayers and administrative costs for governments.

In principle, each state would levy efficient, fair and simple taxes eliminating double taxation of investments made by residents in foreign jurisdictions since both the capital exporting and capital importing government might claim the power to tax investments. The treaties also restrict discriminatory actions against non-resident investors. Canada and EU governments have generally accepted the principles of removing tax obstacles to cross-border trades in capital as well as discrimination against foreign investors in their jurisdiction.

The development of bilateral income tax treaties between Canada and EU countries have generally been successful in eliminating the possible double taxation of income earned on cross-border investments. Nonetheless, several issues have been raised that suggest that Canada and EU member states could improve taxation policies in order to encourage a better climate for capital flows across the Atlantic.

Withholding taxes

Withholding taxes are a barrier to cross-border investment to the extent that they add to taxes paid. If such taxes are credited against liabilities paid by non-residents to their home government, the withholding tax has no impact on the cost of doing business but does result in a transfer of revenue from the home to host country involved.

Often, withholding taxes are not credited against home tax liabilities either because the home country exempt foreign income earned by multinationals from paying tax or the withholding tax may be in excess of any tax on profits. The latter arises since withholding taxes are applied to gross receipts without recognition of the costs incurred outside the host country to fund the activity. The lack of crediting is important with respect to withholding taxes on interest and royalties since the net income earned by a multinational is well below the gross receipts subject to withholding tax.

Canada and many EU member states exempt foreign-source dividends received by their multinationals from corporate income tax. Therefore, any withholding tax levied by the host country effectively increases the tax cost for foreign investors. Canada generally negotiates a withholding tax of 5 percent for companies with significant interest in the subsidiary and 15 for portfolio dividends (see Table attached). Canada by treaty tends to tax interest at a 10 or 15 percent rate although arm's length interest related to longer-term indebtedness (typically five years) is exempt from withholding tax by domestic legislation. Royalty payments may be exempt under some treaties for certain qualified sources such as software and culture (except film and television rights) but otherwise subject to a 10 percent withholding tax rate. Lease payments are subject to a 10 percent withholding tax.

In the case of Germany, withholding taxes in excess of the Canada-Germany treaty paid on dividends paid to Canadian residents are refunded. However, this is an administrative burden on Canadian shareholders and an inappropriate barrier.

Such withholding taxes put Canadian investments made by European multinationals at a disadvantage relative to some other jurisdictions with no withholding taxes. This is particularly important with respect to European investments in the United States since the US has negotiated the elimination of withholding taxes with EU states on interest and in some cases, dividends. Canadian investments in Europe are at a disadvantage compared to other foreign investors in the EU since the non-Canadian foreign investors in Europe are exempted from withholding taxes by treaty.

To facilitate investment between Canada and the EU, Canadian and EU member states should make an effort to eliminate withholding taxes on a broad range of income sources, especially to improve competitiveness in relation to the United States. The elimination of withholding taxes in the Canada-EU context would encourage greater capital flows

across the Atlantic as well as assist Canadian and EU companies to be more competitive internationally.

Withholding tax and personal income tax on non-resident-owned limited partnerships

Canada currently disregards partnerships as an entity for income tax purposes. Thus, limited partnerships are denied the same treaty rights as corporations. The effect is for a 25 percent withholding tax to be levied on sources of income, which can be reduced to a treaty rate if an application for refunds according to the treaty where the non-resident resides. This is quite onerous for limited partnerships since the numerous investors have small amounts of investment.

Alternatively, investors in limited partnerships owning real estate in Canada may be subject to Canadian personal tax at rates that apply to first dollars of income, since no exemption is provided as in the case of Canadian residents when remitting personal income taxes. Some countries do provide at least a partial exemption – the United States for example provides an exemption equal to one-half of the regular personal income tax exemption – that reduces substantially the amount of tax paid by non-resident owners of limited partnership funds. The effect of the high personal tax in Canada on non-resident owners of limited partnerships, especially from Germany, is to discourage investment in Canada relative to the United States.

Permanent establishment rules

While Canada and EU member states agree to the use of permanent establishment rules to determine the tax to be paid in a source country, variation in the application of rules results in an efficient allocation of investments to those jurisdictions with more favourable treatment. Some of the key differences, as provided in the appendix, are with the respect to the treatment of exploration for natural resources, construction and installation of projects, consultancy and management services, multiple activities of a preparatory nature, dependent agent-ancillary activities, independent-agent exclusivity and insurance. Different thresholds may also be used with respect to the time taken for activity in a country to establish permanent residency. For example, maintenance of an aircraft for a few weeks in a country might result in the profits being subject to tax as a permanent establishment in that country. A more common approach among EU countries would be helpful in clarifying rules for permanent establishments.

Dispute mechanisms

Disputes with respect to determining whether income is earned in a particular state – when several are involved – can be difficult for investors, especially Canadians with EU concerns. The effort and time to deal with tax disputes serves as another obstacle to

border investments to the extent that it makes transactions more difficult to achieve. Some specific cases include the following:

- The procedures under competent authority between Europe and Canada should be improved and sped up.
- EU transfer pricing documentation requirements should be harmonized.
- EU and Canadian tax administrators should look towards providing a common analysis of treaties and set up common comments to avoid unnecessary situations of over or under taxation.
- Some thought could be given to a procedure for cross-border advance pricing agreements under treaties.

Cross-border corporate re-organizations

A barrier to cross-border corporate re-organizations arises from capital gains taxation on shares exchanged between EU and Canadian entities. Typically, if only resident companies are involved, a rollover is provided that allows shareholders to defer capital gains taxes on shares when corporations are merged, amalgamated or acquired. However, if a non-resident company is involved, no capital gains tax rollover is provided.

The Canadian government has indicated an interest in looking at measures to provide capital gains tax relief for cross-border investments. The EU and Canada should consider measures that would remove this barrier to capital market mobility.

Non-income tax issues

Existing bilateral tax treaties between Canada and EU member states are focussed on income tax issues. By and large, these treaties have done much to encourage cross-border investments between Canada and the EU. However, there are several other tax issues of importance that are not related to income taxation that could be covered in a separate treaty. For example, the application of social security taxes on expatriate employees should avoid double taxation. The treatment of VAT-related transactions could involve tax barriers to investments when businesses are unable to recover taxes on their business inputs when non-registered in a particular EU country.

Conclusion

Canadians tend to focus on their relations with the United States, including the bilateral tax treaty which is currently under negotiation. If the EU and Canadian trade and cross-border investments are to receive greater attention in the future, it would be important to begin greater dialogue between EU member states and Canada on various tax issues. Some of the proposed changes above would be consistent with discussions currently taking place with the United States.

European Union Member States
Withholding Rates in Treaties with Canada
as at April 30, 2006

	Interest		Dividends		Royalties		Year
	Treaty	Domestic*	Treaty	Domestic*	Treaty	Domestic*	Signed
Member States							
Austria	15	25	5/15	25	0/10	20	1976
Belgium	10	15	5/15	25	0/10	15	2002
Cyprus	15	0	15	0	0/10	10	1984
Czech Republic	10	15	5/15	15	10	25	2001
Denmark	10	0/30	5/15	0/28	0/10	30	1997
Estonia	10	0/24	5/15	0/24	10	15	1995
Finland	10	0	10/15	28	0/10	28	1990
France	10	16	5/15	25	0/10	33.3	1975
Germany	10	0	5/15	20	0/10	20	2001
Greece			No Treaty				
Hungary	10	0	5/15	0	0/10	0	1992
Ireland	10	0/20	5/15	0/20	0/10	20	2003
Italy	10	0/12.5/27	5/15	27	0/5/10	22.5	1977
Latvia	10	10	5/15	10	10	5/15	1995
Lithuania	10	10	5/15	0/15	10	10	1997
Luxembourg	10	0	5/15	20	0/10	0	1999
Malta	15	0	15	0	0/10	0	1986
The Netherlands	10	0	5/15	25	0/10	0	1986
Poland	15	20	15	0/19	0/10	0/20	1987
Portugal	10	20	10/15	25	10	15	1999
Slovakia	10	19	5/15	0	0/10	19	2001
Slovenia	10	25	5/15	25	10	25	2000
Spain	15	15	15	15	0/10	25	1976
Sweden	10	0	5/15	0/30	0/10	0	1996
United Kingdom	10	20	5/15	0	0/10	22	1978

*Source: Ernst & Young Worldwide Corporate Tax Guide, 2005 Edition

Application of Article V of the OECD Model Treaty on Permanent Establishments in Treaties between Canada and Member States of the European Union

Ref	Text of Paragraph	Treaties with Different Wording
1.	For purposes of this convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.	
2.	The term permanent establishment includes especially: (a) a place of management; (b) a branch; (c) an office; (d) a factory; (e) a workshop, and (f) a mine; an oil or gas well, a quarry or any other place of extraction of natural resources.	**Austria** – reference to oil & gas well excluded; **Cyprus** – a store or other sales outlet; a farm or plantation; and a place of extraction of timber or forest produce – each constitutes a PE; **Estonia, Latvia, Luxembourg, Portugal, Slovakia, Slovenia & Sweden –** includes any place relating to the "exploration for or the exploitation of" natural resources in PE definition; **France** – exploration of natural resources constitutes a PE if it represents a fixed base; **Slovenia, Spain & U.K.** – 2(e) exception from PE definition re fixed place maintained for advertising, supply of information, scientific research or similar activities.
3.	A building site or construction or installation project constitutes a permanent establishment only if it lasts for more than 12 months.	**Belgium** – Installation or drilling rig is a PE if it is used for > 3 months in a 12 month period; **Czech Republic** – furnishing of services including consultancy & management services for a period of more than 6 months in any 12 month period is a PE; **Cyprus, Estonia, Latvia, Lithuania & Portugal** – PE created if project last more than 6 months; **Germany** – drilling rig or ship to explore for national resources is a PE if it lasts for > 3 months in any 12 month period; **Italy** – exception from PE definition re fixed place maintained for advertising, supply of information, scientific research or similar activities; **Malta** – also includes drilling site or ship for exploration or development of natural resources or related supervisory activities if it continues for, in aggregate, more than 183 days in any 12

Ref	Text of Paragraph	Treaties with Different Wording
3.	*[continued]* A building site or construction or installation project constitutes a permanent establishment only if it lasts for more than 12 months.	months period. **Slovakia & Slovenia** – furnishing of services including consultancy & management services for a period of more than 9 months in any 12 month period is a PE.
4.	Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include: (a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise; (b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery; (c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; (d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise; (e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character. (f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraph a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary nature.	**Austria, Spain & UK** – In paragraph 3(e), the maintenance of a fixed place of business for purposes of advertising, supply of information, scientific research or similar activities which have a preparatory or auxiliary character does not constitute a PE, but there is no equivalent to paragraph 4(f) dealing with a combination of factors.
5.	Notwithstanding the provisions of paragraphs 1 and 2, where a person – other than an agent of an independent status to whom paragraph 6 applies – is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4	**Austria, Spain & UK** – only the purchasing of goods is allowed as an exemption from PE status.

Ref	Text of Paragraph	Treaties with Different Wording
	which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.	
6.	An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on a business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.	**Estonia, Latvia & Lithuania** – an independent agent will not be considered independent if the agent is devoted "wholly or almost wholly on behalf of the enterprise".
7.	The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute a permanent establishment of the other.	
	Other	**Belgium** – paragraph 8 – insurance enterprise is deemed to have a PE if it collects premiums or insures risk in the other State, other than with regard to reinsurance; Portugal – carrying on business (other than activities described in paragraph 4) for > 120 days in any 12 month period beginning or ending in a taxation year is deemed to be a PE.

Source: Fil Cormano, CHC Helicopters