TFSA | TORONTO FINANCIAL SERVICES ALLIANCE

Toronto as a Global Financial Centre

Strengthening Our Tax Advantage

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About the Toronto Financial Services Alliance (TFSA)

The Toronto Financial Services Alliance (TFSA) is a unique, public-private partnership dedicated to growing the financial services cluster and continuing to strengthen Toronto's profile as a top-ten global financial hub. Established in 2001 by the City of Toronto in partnership with the financial industry, TFSA works on behalf of the entire financial cluster, including its business and educational support sectors.

With both federal and provincial governments support, the TFSA has established:

- the Global Risk Institute in Financial Services, to leverage the sector's global reputation for stability; and
- the Center of Excellence in Financial Services Education, to capitalize on the Toronto region's talent capital advantages.

The TFSA is a catalyst for collaboration between the public and private sectors. Our mandate and reach provides us with a valuable perspective on the role the financial sector plays in promoting economic growth and prosperity and a deep understanding of the critical success factors for the industry.

Toronto as a Global Financial Services Centre

Toronto's financial services sector is one of the largest economic contributors to the country, province and city, contributing approximately 20% to the city's gross domestic product (GDP) and employing more than 350,000 people in direct and indirect jobs in the region. The city is the second-largest financial sector in North America by direct employment and the financial services sector is the second-largest employer in the Toronto region.[1] The TFSA recognizes the strong commitment that governments have made to work with the sector to strengthen Toronto's status as a global financial hub.

The chart below shows that the city has moved into the top ten in indices that measure global financial services centres:

Toronto's ranking as a global financial services centre

	Global Financial Centre Index (GFCI)			The Banker			
	Sept. 2010	March 2012	Sept. 2012	2010	2011	2012	
1	London	London	London	New York	New York	New York	1
2	New York	New York	New York	London	London	London	2
3	Hong Kong	Hong Kong	Hong Kong	Singapore	Singapore	Singapore	3
4	Singapore	Singapore	Singapore	Paris	Frankfurt	Frankfurt	4
5	Tokyo	Tokyo	Zurich	Luxembourg	Hong Kong	Hong Kong	5
6	Shanghai	Zurich	Seoul	Hong Kong	Paris	Dubai	6
7	Chicago	Chicago	Tokyo	**Toronto**	**Toronto**	**Toronto**	7
8	Zurich	Shanghai	Chicago	Sydney	Dubai	Sydney	8
9	Geneva	Seoul	Geneva	Zurich	Zurich	Amsterdam	9
10	Sydney	**Toronto**	**Toronto**	Amsterdam	Luxembourg	Paris	10
11	Frankfurt	Boston	Boston	Dubai	Sydney	Zurich	11
12	**Toronto**	San Francisco	San Francisco	Frankfurt	Tokyo	Luxembourg	12
13	Boston	Frankfurt	Frankfurt	Tokyo	Amsterdam	Dublin	13
14	Shenzhen	Geneva	Washington D.C.	San Francisco	Dublin	Tokyo	14
15	San Francisco	Washington D.C.	Sydney	Boston	Copenhagen	Chicago	15

1 *Talent Profile Chart Book*, June 2012, Centre for Excellence in Financial Services Education, www.explorefinancialservices.com/Files/Resources/Talent_Profile_June_2012_Print_Three.pdf

The financial services sector in Toronto boasts several strengths:

- Canada's banks have been ranked as the "soundest banking system in the world" by the *World Economic Forum* for the fifth year in a row;
- Toronto is home to two of the largest global life insurers;
- The Toronto Stock Exchange is ranked first in global metals and mining, energy and clean technology listings; and
- Toronto ranks as one of the top cities globally for assets under management.

Maintaining a Competitive Tax Advantage

A key element in marketing the Toronto region as a global financial hub, in addition to its sound regulatory environment and talented workforce, is a stable, competitive tax advantage.

In recent years, governments have taken important measures to improve the competitiveness of the Canadian tax system, including lowering corporate tax rates, harmonizing federal and provincial taxes, and adopting a single tax administrator. Harmonized sales and income tax systems promote compliance efficiencies and savings for Canadian businesses that otherwise would not be possible – an effective way to enhance efficiency and competitiveness.

It is important that governments work toward a system that taxpayers can comply with better and revenue agencies can administer more effectively. Minimizing compliance costs and complexity increases investment and is a principle of sound tax policy.

A recent report ranked Toronto as the fifth most competitive tax jurisdiction among many international cities.[2] To maintain this advantage and ensure that investment and capital are allocated efficiently, governments and stakeholders must work together on several tax issues. The TFSA believes that more can be done to enhance compliance and administrative efficiencies in the Canadian tax system. This paper outlines some key tax issues that are impacting the competitiveness of the financial services sector in Toronto.

	Total Tax Index 2012
5	**Toronto**
15	London
30	Chicago
38	New York
46	Frankfurt

Goods and Services Tax/Harmonized Sales Tax and Financial Services

The TFSA supports the decision by the Canadian and Ontario governments to harmonize the Goods and Services Tax/Harmonized Sales Tax. However, the current GST/HST treatment of financial services creates issues ranging from administrative and definitional complexity to economic distortions. Tax policy in this area fails to be administratively or economically simple, efficient, neutral, or certain. The current system of exempting many financial services from GST/HST has the following shortcomings:

- Complexity is particularly apparent with respect to financial services providers in four respects:
  - determining exactly what is covered by the exemptions;[3]
  - allocating the costs of financial service providers between taxable and exempt activities for the recovery of GST/HST relating to the taxable activities;
  - accounting for GST/HST by suppliers of financial services on costs sourced from outside Canada that relate to making exempt supplies of financial services; and
  - complying with the rules.

2 KPMG's Competitive Alternatives 2012 – Special Edition: Focus on Tax. The study did not include some major financial centres, such as Singapore, Hong Kong and Dubai.

3 The definition of an exempt financial service is not clear, particularly in the area of "arranging for" a financial service. Legislative amendments over the years, particularly those passed in 2010, have expanded the tax base by defining many "arranging for" or intermediary services purchased by financial institutions as taxable, without establishing clear boundaries between exempt and taxable services.

This compliance burden is particularly onerous and has created, in effect, an entirely separate GST/HST regime for the financial sector. This has become inordinately complex and administratively burdensome both for financial institutions and the Canada Revenue Agency ("CRA").

- Inefficiency manifests itself in cascading tax for supplies made by financial services providers to other businesses that generally are entitled to recover GST/HST paid on their input costs. This particularly violates the fundamentals of a value added tax system, such as the GST/HST.

- Neutrality is lacking in the:
  - inherent bias against outsourcing by financial services providers;
  - differing levels of tax on substitutable or similar products; and
  - significant bias against related-party dealings in cross-border scenarios.[4]

Investment and job creation

Most GST/HST paid by financial institutions is not recoverable. This perpetually impairs the working capital of their business customers – permanently. Financial institutions either have to absorb this cost and/or pass it along to their customers in the form of higher prices for the financial services they provide.

This results in fewer available financial resources for job growth[5] and may deter the development of new products if companies believe that taxes will push the price point too high. In addition, the current Canadian practice of making retroactive amendments to GST legislation is not only contrary to good tax policy, but is damaging to Canada's global reputation and the City's ability to attract new investment in the financial sector.

Competitiveness

GST/HST on financial services creates inequities between business structures. For financial institutions, the GST/HST creates a self-supply bias, because services purchased from external domestic suppliers are (increasingly) subject to GST/HST, while the labour used to perform the same activities in-house is not. This stifles potential productivity gains from outsourcing some business activities to specialist firms. In addition, it inhibits the growth of economic clusters that often develop when a few large institutions outsource to new and innovative small specialist firms.

This self-supply bias is a particular problem for smaller firms, because they have less capacity to take activities in-house. Further, the requirement to self-assess GST/HST on outlays and expenses incurred outside Canada relating to Canadian business activities reduces the productivity and competitiveness of global financial institutions that have integrated cross-border operations. This is because financial services obtained from non-arm's length foreign suppliers are now taxed while those obtained from arm's length foreign suppliers are not.

In addition to impairing job growth, as discussed above, the non-recoverability of the GST/HST and the resulting tax cascading, increase the costs of doing business for financial institutions and their customers – including the cost of capital investments – making them less competitive.

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4 The 2010 legislative amendments in respect of imported supplies were developed largely in response to the 2003 decision of the ***Tax Court of Canada*** (see ***State Farm Mutual Auto Insurance Co et al v The Queen***, [2003] ETC 2829). However, they went much further, imposing partial taxation on otherwise exempt financial services purchased from foreign non-arm's length related parties, retroactive to 2005. The amendments were based on a presumption that the consideration for a financial service could be broken down into its component parts (e.g., purchased inputs, in-house services, risk premiums and profit margin), some of which would be taxable on a self-assessment basis. The taxable components were defined as "loading," a theoretical concept for which no data is generally available in real-world commercial transactions. As a result, multi-national financial institutions in Canada are now engaged in lengthy audit negotiations with the CRA to agree on an arbitrary tax liability. The lack of clarity in taxation of these services will continue to create uncertainty until the concept of "loading" in the legislation is revisited.

5 For example, Dr. Jack M. Mintz, Palmer Chair of Public Policy at the School of Public Policy, in his report ***Ontario's Bold Move to Create Jobs and Growth: Impact of the 2009 Ontario Budget and Other Recent Tax Measures on Investment, Jobs and Incomes***, predicts Ontario will benefit from the removal of non-recoverable provincial sales tax on business inputs as part of Ontario harmonizing its provincial sales tax with the GST. This and other tax measures are estimated to create 591,000 jobs over 10 years.

In particular, Canadian financial institutions compete with American financial institutions in providing financial services to large Canadian businesses. There is no value added tax like the GST/HST in the United States. Unlike their U.S. counterparts, Canadian financial institutions must embed GST/HST in the pricing of services to these corporations.

Recommendations on GST/HST

Short-term: The Department of Finance should address some of the inherent deficiencies of the GST/HST legislation. These initiatives should include possible improvements to the rules as they apply to:

- the requirement to self-assess GST/HST on the "loading" element of certain financial services supplied by non-arm's length parties to Canadian financial institutions; and
- compliance by pension plans and their employers to account for GST/HST on pension related expenses.

The TFSA encourages the Department of Finance to expedite the review of these areas and develop suitable solutions quickly. The TFSA also recommends that the Department of Finance and CRA commit to revisiting its guidelines as it applies to making adverse retroactive amendments to GST legislation and to apply resources to the multi-year backlog of financial sector audits.

Long-term: The Department of Finance should continue to undertake a comprehensive examination of the application of GST/HST to financial services, as part of ongoing efforts to improve the current system. The TFSA encourages the Department of Finance to work closely with stakeholders to implement long-term solutions to the problems with the current system to ensure greater tax neutrality, simpler administration, reduced definitional complexity, and increased productivity and competitiveness.

Finally, as noted, the TFSA supports harmonizing the provincial sales taxes with the GST. Overall, doing so is better for the economy and helps create jobs and stimulate investment. However, a harmonized scenario exacerbates the deficiencies of the current system as it applies to financial services. Therefore, from the perspective of the financial sector, improvements to the current GST system are necessary. With this in mind, the TFSA recommends that the federal government work with those provinces that continue to impose sales taxes to encourage them to harmonize with the GST.

Taxation of Corporate Groups

The TFSA was pleased when the federal government accepted the recommendations of a number of organizations, including the Canadian Bankers Association (CBA) and the Canadian Life and Health Insurance Association (CLHIA), by announcing in its 2010 budget that it intended to consult with the provinces, taxpayers and other stakeholders to explore whether new rules for the taxation of corporate groups could improve the functioning of the Canadian tax system.

In November 2010, the government released a consultation document seeking to gather information and views from stakeholders about possible approaches to, among other things:

- introducing a new system; and
- increasing its understanding of possible implications of a new system of group taxation.

In April 2011, several taxpayers and organizations, including the CBA and the CLHIA, prepared detailed submissions in response to that consultation document.

Canada is the only G7 country, and one of the few members of the OECD, that has no formal system of taxation of corporate groups. The TFSA would like to see Canada adopt a loss system. We believe it:

- would be relatively easy to implement and administer;
- has broad support among Canadian companies; and
- offers significant benefits for the federal and provincial governments and for Canadian companies in all industries, including:
    - enhancing the efficiency, competitiveness, fairness and neutrality of the tax system;

- ensuring greater tax certainty;
- reducing administration and compliance burdens; and
- improving transparency and monitoring of the system, especially the impact on provincial income tax bases.

Financial institutions carry on business through a variety of organizational structures. These often involve the use of separate legal entities, which are economically integrated into the corporate group. In fact, the governing legislation for many types of financial institutions requires them to set up separate legal entities for certain lines of business. Because the current system requires companies in a commonly controlled group to report and pay tax on an unconsolidated or legal entity basis, losses incurred by some affiliates within a group cannot be offset against profits earned by other affiliates in a timely manner, as they could in the case of a corporation that operates through multiple operating divisions.

While the CRA has developed administrative practices to permit losses to be used within a group, for financial institutions of all sizes many of these practices are costly and time-consuming to implement and monitor.[6] They can also give rise to various degrees of uncertainty for taxpayers and the federal and provincial revenue agencies, such as whether some transactions undertaken to transfer losses between group members:

- are "commercial;"
- result in an inappropriate shifting of profits and losses between provinces; and
- are consistent with the underlying intent and spirit of the federal and provincial tax acts.

A formal system for the taxation of corporate groups would address these shortcomings.

One reason often cited for Canada's failure to adopt a formal system of that nature is its uncertain effect on provincial income tax bases and revenue. We understand that most (perhaps all) provinces are not satisfied with the lack of certainty under the current system. However, the recent consultation process has revealed some potential solutions, including the explicit disclosure of the details of losses transferred within a group. This disclosure could be the basis for a provincial loss recapture system to ensure no province is a "net loser," either short-term or long-term.

The TFSA would encourage and participate in a stakeholders' meeting or conference with federal and provincial officials to focus specifically on provincial issues and concerns.

Recommendation on taxation of corporate groups:

We urge the Federal and Ontario governments to give increased priority to seeking consensus with all provinces and to engage other stakeholders in the next steps in moving towards a more formal system for the taxation of corporate groups.

Advisory Panel on Canada's System of International Taxation

As trade increases in goods, services and capital, Canada's economy continues toward greater integration with the global economy. Accordingly, the country's income tax system will increasingly have to deal with more cross-border situations in three main contexts:

- non-resident taxpayers investing, carrying on business or being employed in or with Canada;
- Canadian taxpayers investing, carrying on business or being employed in or with jurisdictions outside Canada; and
- non-resident taxpayers investing or carrying on business in or with jurisdictions outside Canada but through a Canadian corporation or other legal vehicle.

6 Even a simple loss transfer strategy can involve a number of people within a corporate group. It would not be unusual for a loss strategy to require the equivalent of two to four people working full-time on the development, implementation, maintaining and eventually unwinding of the strategy. Complicated strategies involving, say, the transfer of a significant amount of losses within a public group with minority shareholders normally require the assistance of external consultants to address financial, legal, accounting, tax and valuation issues. This will add to the cost of implementing and maintaining these strategies.

This must occur in a manner that is not only fair and competitive but also as efficient as reasonably possible.

Many features of Canada's income tax system that are relevant in cross-border situations have come under relatively close scrutiny in the last two decades:

- The 1990s brought about significant revisions to our "foreign affiliate" rules, focussed primarily on refining the meaning of the term "active business" and related concepts, and introducing a number of specific "base erosion" provisions and similar measures. This was aimed at preventing erosion of the Canadian tax base as a result of transactions and arrangements that were considered to shift to foreign affiliates and other non-resident entities income and gains that should be taxable in Canada.

- Also in the 1990s, Canada's transfer pricing rules were modernized, with the introduction of section 247 of the *Income Tax Act*.

- Comprehensive reporting rules were introduced, requiring taxpayers to be more fully transparent regarding the ownership of foreign assets and sources of foreign income.

- In the most recent decade, the focus has moved on to other elements of our system, including the determination and use of foreign affiliate "surplus" accounts.

- Canada's "thin capitalization" rules have also been refined in various respects, including the gradual reduction of the permitted ratio of debt-to-equity. The more traditional ratio of 3:1 dropped to 2:1, and most recently to 1.5:1 (as part of the 2012 federal budget, and following the report of the government's Advisory Panel on Canada's System of International Taxation).

- The 2012 budget (and the Advisory Panel's report) also tackled concerns that arise in the context of non-resident multinational corporations with Canadian subsidiaries that hold interests in foreign affiliates, under the "foreign affiliate dumping" provisions.

The cumulative effects of these various measures, as well as the public policy dialogue they have prompted, have strengthened the technical integrity and fairness of our system. This has promoted a better understanding of the importance and difficulty of balancing openness to cross-border trade and investment against the protection and due administration of the Canadian tax base.

The time has come to refocus attention on matters such as the competitiveness and efficiency of our system. The Advisory Panel made several recommendations in this regard. In particular:

- Canada should move to a more robust exemption system in respect of income and gains from a foreign active business.

  Under current rules, a foreign affiliate can derive exempt surplus only to the extent that it is resident in and/or earns income or certain gains from a "designated treaty country," (a country with which Canada has concluded either a comprehensive income tax convention or a tax information exchange agreement). This requirement penalizes Canadian multinationals that have business operations in other countries. It may also have the effect of imposing a relatively high-rate of Canadian taxation on legitimate multinational investment involving foreign source income being derived ultimately by non-resident direct or indirect public shareholders of Canadian corporations.

  The current rules also treat differently:

  - foreign active business income earned indirectly through a foreign affiliate versus directly through a Canadian corporation; and
  - foreign active business income versus capital gains from the direct or indirect disposition of foreign active business assets.

  These distinctions perpetuate the complexity and inefficiency associated with maintaining and policing foreign affiliate surplus accounts, and may also have consequences that undermine the fairness and competitiveness of our system.

- Canada should revisit the base erosion rules, with a view to introducing refinements that strike a better balance between protecting the integrity of our tax base and enhancing the competitiveness of Canadian multinationals.

  The 2012 federal budget signalled the government's openness in this regard in relation to multinationals operating in the financial services sector. However, this concern is broader, because the competitiveness of Canadian multinationals in other sectors is also vital to the strength and growth of the Canadian economy.

- Compliance burdens associated with cross-border services should be reconsidered.

  Under regulations 102 and 105, withholding from payments to non-resident service providers and employees may be required in a wide variety of circumstances, even though no Canadian income taxes would ultimately be payable. Ultimately, the inordinate compliance and administration costs imposed on the system are borne by ordinary Canadian taxpayers.

Recommendation on Advisory Panel Findings:

The TFSA recommends that the government accelerate progress toward implementing these key recommendations of the Advisory Panel. Doing so would enhance the fairness, competitiveness and efficiency of our tax system, and ultimately contribute significantly to a strong and growing Canadian economy – the most important requisite for the strength and growth of Canada's financial institutions.

Foreign Affiliate Dumping

As noted above, the 2012 federal budget introduced measures designed to address concerns that arise in the context of "foreign affiliate dumping." These measures would apply to non-resident multinational corporations with Canadian subsidiaries that hold interests in foreign affiliates. Broadly speaking, these measures aim "to ensure that cross-border investment is not used as a tool to erode the corporate tax base" through certain types of transactions that "reduce the Canadian tax base without providing any significant economic benefit to Canadians." However, the measures are not intended to affect "*bona fide* business transactions."

The foreign affiliate dumping measures would apply equally to a Canadian corporation that is a wholly owned subsidiary of a non-resident multinational corporation and to a Canadian public corporation that has a majority shareholder that is a non-resident corporation. Their application to Canadian public corporations introduces a new risk factor for them. When material, these risks would have to be disclosed to shareholders, and would make Canada a less attractive location in which to establish or maintain a Canadian multinational corporation.

Canada has developed a unique and world-class junior resource sector that has raised public equity to finance projects around the world. These Canadian companies have head offices in Canada, create jobs and support economic growth. Canada is the top jurisdiction globally for raising mining capital and one of the world's largest equity markets for exploration and mineral development. The TSX and TSX Venture exchanges were responsible for 39% ($12.5 billion) of equity capital raised globally for mining in 2011. The TSX is also the top destination for financing international mining projects, where over the last decade more than 80% of global mining equity financings were transacted, together accounting for over $105 billion of global equity – over one-third of the global total. Listing 58% of the world's public mining companies in 2011, 1,646 of the exchange's 3,380 issuers – almost half – are mining companies.

The application of these measures could put this global reputation at risk and may not be justified by a risk-based assessment.

Normally, Canadian public corporations would not engage in transactions that are not "*bona fide* business transactions," because doing so would be inconsistent with their obligations under Canada's corporate governance and securities laws and regulations.

Recommendation on foreign affiliate dumping:

The TFSA recommends that the foreign affiliate dumping measures be revised to exclude all Canadian public corporations from the application of the proposed measures or at a minimum to exclude Canadian public corporations that meet conditions that are designed to protect the Canadian tax base.

Attracting Multinational Corporate Treasury Operations

Multinational corporations have significant treasury operations that must be managed carefully. In recent years they have also accumulated significant cash balances because of liquidity concerns arising from the global financial crisis. Recent estimates put the figure above USD 7 trillion. At the same time, and despite some recent cautionary indicators, Canadian financial institutions have maintained strong balance sheets and earned a global reputation for strength, stability and good management.

Treasury operations involve two main traditional substantive elements: cash pooling and risk management. Risk management includes the management of both investment risk and risk in relation to foreign exchange and interest rate fluctuations. Recent cash accumulation has introduced a heightened focus on investment risk.

Treasury operations also involve certain process elements, including cash sweeping and deployment, single account facilities, risk monitoring and risk management instruments.

The TFSA believes current circumstances create an opportunity to capitalize on the global comparative advantage of Canadian financial institutions in this regard, and to promote and enhance the selection of Canadian financial institutions by both Canadian and foreign multinationals to operate and manage treasury functions. This would include promoting and enhancing the use of Canadian financial institutions:

- as deposit counterparties (giving them greater access to low-cost funds); and
- to manage funds and treasury operations to the extent Canadian financial institutions do not have the capacity to be (or their clients do not want them to be) the deposit counterparties.

Canadian tax rules could be adjusted to encourage the location of these operations in Canada. The following options could be considered:

- for non-residents, whether members of Canadian or foreign multinational groups:
  - eliminate Canadian withholding tax on funds paid to them; and
  - do not allow using services of, or having treasury accounts with Canadian financial institutions, to trigger "carrying on business in Canada" status;
- impose no Canadian income tax on any spread within a Canadian treasury account or investment vehicle;
- for foreign affiliates of Canadian multinationals, do not allow using services of Canadian financial institutions or having treasury accounts with Canadian financial institutions to create “foreign accrual property income”; and
- create appropriate exceptions from the application of the proposed “upstream loan” and “foreign affiliate dumping” rules.

In brief, governments could consider reductions in Canadian income tax on any of these activities in light of the potential for job creation. While current Canadian income tax rules do include certain elements that would be consistent with this objective, the TFSA believes that additional refinements could be warranted.

Recommendation on multinational corporate treasury operations:

The TFSA recommends that the federal government review and revise Canadian income tax rules to make Canadian financial institutions more attractive to Canadian and global multinationals as operators and managers of global treasury operations.

Conclusion

The TFSA congratulates the Federal and Ontario governments on their efforts to strengthen the national and provincial tax system. Both governments have provided a strong framework for growing the financial services sector, attracting new investment, and creating jobs for Canadians.

The TFSA and the financial services sector continue to look forward to working closely with all levels of government to support a strong and global financial services sector in Canada.