

Policy considerations at play in the taxation of foreign source income

Canada taxes its residents on their world-wide income. Driven, at least in theory, by the notions of equity and social equality with the concomitant need for redistribution of wealth, but in reality more likely driven by the need to satisfy government's demand for revenue, Canada taxes residents at rates which are among the highest in the world. The combined effect of these two features of Canadian income taxation could exert a baleful influence in two distinct aspects of Canadian economic life: the participation of Canadian business in the competition for global markets and the retention of Canadian wealth in Canada. How Canadian income tax policy has attempted to mitigate these two untoward effects is the topic of this paper. The requisite steps to mitigate these effects are almost diametrically opposed to each other. Not surprisingly, therefore, the implementation of the mitigating provision has occasioned acrimonious debate among members of the tax community and the resulting legislation ranks among the most complex in the *Income Tax Act*.¹

As Canadian economic life shifts from simple resource extraction to a mature economy, survival of Canada's high standard of living depends on the ability of Canadian enterprise to compete globally. An income tax regime which imposed a high rate of tax on the income earned by Canadian enterprise in foreign markets without regard to the exigencies of competition in a global economy would guarantee Canada a place in the scrap heap of

¹ The taxation of foreign source income raises issues of such complexity that in a 15-page paper it is possible only to isolate and discuss one small issue. The issue selected here is of interest because of the

history in short order.² Modifications of the simple rule of taxing all income, wherever earned, at Canada's normal high rates, are the first of the sorts of adjustments which Canadian income tax policy has had to implement in the interest of Canada's economic well being.

High rates of taxation of world-wide income without any modification of the basic principles of tax law would produce another effect, perhaps just as damaging to Canadian economic health as the hindering the ability of Canadian enterprise to competing effectively in the global economy. This second effect is the flight of Canadian capital off-shore to tax havens where it could earn investment income subject either to no tax or to substantially lower rates of tax than that imposed in Canada.

The conceptual problem which has to be addressed by Canadian tax policy is how a tax system which taxes world-wide income at high rates must be modified to enable tax-paying enterprises to compete effectively in foreign markets and at the same time prevent the flight of capital to tax havens. It is the solution of this problem which has engendered such uncharacteristically acrimonious debate among legislators, tax scholars, practitioners and government departments.

The attempts to solve this conceptual problem and the debates these attempts have engendered require a brief outline of the history of taxation of foreign income of Canadian residents. When income tax was introduced in Canada

interplay between the technical, policy, political and economic ramifications which it presents. It is, however, only a minute part of the overall scheme of the legislation.

² The 20th Century's central economic lesson was that an ideology whose obsession with equal distribution of wealth blinded its exponents to the need to foster the creation of the wealth that was to be re-distributed found itself on the scrap heap of ideas 10 years before the end of the century.

in 1917 the Canadian economy did not export capital and Canadian enterprise, primarily resource extraction, was confined almost exclusively to on-shore activities. In this state of affairs, taxation of foreign income of Canadian residents had no real significance. Accumulation of domestically produced wealth and the advent of corporate enterprise resident in Canada but with significant foreign activity became features of Canadian economic life only after the Second World War. Accordingly, in the first systematic study of the Canadian tax system begun in 1962 by a Royal Commission of Inquiry, these two issues were addressed for the first time.

Following the delivery of the Commission report in 1966³, the Department of Finance published its proposals for tax reform in 1969 and eventually in 1972 published draft legislation which included provisions relating to taxation of foreign affiliated corporations. Acrimony followed immediately. At the Twenty Sixth Annual Tax Conference of the Canadian Tax Foundation in the Autumn of 1974 one of the speakers, H Arnold Sherman⁴, spoke as follows about the new legislation:

Other more fortunate speakers are dealing with more clearly defined aspects of the Canadian taxation of foreign source income, leaving me with the most incomplete portion.

...

As part of the Canadian tax reform process, Bill C-259 introduced a whole new basis for the taxation of income from foreign affiliates, including:

- (a) a new concept, that of a foreign affiliate;
- (b) a newly created monster, foreign accrual property income (fapi); and
- (c) the taxation of dividends from (newly defined) foreign affiliates;

³ Canada, *Report of the Royal Commissions on Taxation* (Ottawa: Queen's Printer, 1966), commonly referred to as the Carter Commission report.

⁴ Significantly the Director of Taxation for Massey-Ferguson Limited, then perhaps the largest Canadian enterprise active in the world market.

all this in legislation of remarkable complexity, giving effect to the philosophy that 'if you can't fix it, complicate it'

Following the introduction of Bill C-259, it became obvious that major changes had to be made in the legislation to make it workable. This was particularly true with respect to fapi, but also to the taxation of dividends from foreign affiliates.

...

After Bill C-259 became law, the Minister of Finance announced that the whole field would be re-studied, but amendments of consequence were a long time coming, perhaps indicating the difficulty of reconciling with reality the concepts dreamed up by the theoreticians of the Carter Royal Commission and refined by the Department of Finance. On May 6, 1974, the Spring Budget included an extensive Resolution (No. 74), dealing with the taxation of the foreign income of Canadian taxpayers. This Resolution would have made two major changes in the taxation of dividends from foreign affiliates having a significant relieving effect ...

I need hardly remind you that all the Ways and Means Resolutions disappeared in a puff of smoke when the Government was defeated ...
That is where we stand today.

Why did foreign accrual property income deserve the epithet "monster"? To answer this question it may be as well to begin with the statement of the Minister of Finance on introducing the Budget amendments which included the foreign accrual property rules:

The proposed changes improve our protection against the improper use of tax havens to avoid Canadian tax on passive investment income and on income diverted from Canada. At the same time, the changes remove from the scope of these rules the income Canadians derive from their active business operations abroad.

Skipping over the fact that what the Finance Minister stigmatized as avoidance is at most deferral of Canadian tax, this statement indicates starkly why controversy has and likely will always plague the issue of taxation of foreign source income of Canadian residents. In the first place,

there is not now nor was there at the date of this statement any law, such as exchange control, preventing Canadian residents from investing their wealth outside of Canada should they choose. Nor, it would seem, is there any law which prevents Canadian residents from investing in a manner which yields no income in the fiscal period in which they invest, or in any specific fiscal period for that matter. It would seem at the least to be bad taste on the part of a Minister of the Crown to stigmatize such conduct as "improper". If the result of this is that there is no income on which the Canadian tax authorities can fasten a claim for tax, this hardly seems to merit the epithet "improper".

The Finance Minister's statement, perhaps unwittingly, reveals what is really problematic about the attempt to prevent the flight of capital. It is facile to speak of removing income earned from active business enterprise abroad from the scope of rules designed to impose a current tax on income earned from investing outside Canada. However, the legislative provisions intended to achieve this result are of such inordinate complexity⁵ that the Tax Director of a Canadian enterprise with operations abroad can be forgiven for castigating them as monstrous. At the least, such provisions impose substantial compliance costs, as well as the risk of large tax liabilities for being caught off-side, upon Canadian enterprise which carry on business in foreign countries.

Yet in his treatise on the taxation of controlled foreign corporations⁶ Professor Arnold describes the effect of the 1972 Tax Reform simply as follows:

⁵ See the description by Peter Cumyn of the foreign accrual property income rules proposed in the Budget of November 18, 1974, in a paper given at the same conference (Twenty-Sixth Tax Conference, 1974) at pp. 240 *et seq.*

⁶ Brian Arnold, *The Taxation of Controlled Foreign Corporations: and International Comparison*, Canadian Tax Paper No. 78, (Toronto: Canadian Tax Foundation, 1986).

The Canadian taxation of foreign source income became more sophisticated with the introduction of the 'foreign accrual property income' (FAPI) and foreign affiliate rules as part of the 1972 tax reform. ...

Under the FAPI rules, the deferral of Canadian tax on the foreign source income of Canadian-controlled foreign corporations was eliminated in respect of passive income; instead, such income was subjected to current Canadian tax with a credit for any foreign taxes paid. In addition, the exemption for dividends received by Canadian corporations from foreign corporations became dependent on the type and source of income earned by the foreign corporation, in accordance with a complex set of 'foreign affiliate' regulations.

Thus were the battle lines between the theoreticians and those involved in the fray of international competition drawn right from the outset. The battle simmered for some years but burst into the public gaze on 24th November 1992 when the Auditor General in his annual report to Parliament⁷ issued a stinging criticism of the state of the legislation relating to the taxation of foreign source income. In his report the Auditor General stated "hundreds of millions of dollars in tax revenue have already been lost and will continue to be at risk". The primary concern raised by the Auditor General's report was the erosion of the Canadian tax base resulting from the deduction of interest costs of borrowed money used for the purpose of earning foreign source income.⁸ However, the Auditor also pointed out deficiencies in the in the FAPI rules, in particular, the lack of appropriate definition of *active business income* and the deductibility of active business losses in computing FAPI. The report complains that as a result of deficiencies in the foreign affiliate and FAPI rules, these rules were being used to transfer foreign subsidiaries'

⁷ Canada, *Report of the Auditor General of Canada to the House of Commons 1992* (Ottawa: Supply and Services, 1992)

⁸ This aspect of the Auditor General's Report, the policy considerations at issue and the legislative response have discussed elsewhere: see, Brian J Arnold, *The Deductibility of Interest to earn Foreign Source Income* (1996), C R vol II 45:1; and see Patrick Schindler, *The Legacy of Mark Resources*, an unpublished paper

losses to their Canadian parents, to move income of Canadian corporations offshore and to convert the income of Canadian corporations into tax-free income.

Professor Arnold, who had previously expressed these very criticisms in his treatise⁹ on the taxation of controlled foreign affiliates, described the Auditor General's criticisms as follows:

Although the auditor general's report might be criticized for sensationalism ... the deficiencies in the FAPI and foreign affiliate rules described in the report were accurate and were widely known and exploited by tax practitioners.

The Department of Finance did not share Professor Arnold's view that the recommendations of the Auditor General were "mild and reasonable". The departmental response to the Auditor General's report included the following passage:

The existing foreign affiliate regime accurately reflects the policy intention of Parliament and provides for the taxation of all income that is intended to be subject to Canadian income tax. Moreover, any theoretical revenue gains that might be realized by amending the Income Tax Act would be largely offset as a result of behavioral changes on the part of taxpayers. Specifically, any significant change in the existing rules would likely result in large number of businesses moving completely offshore.

The Department also noted that the existing system promotes the international competitiveness of Canadian business and that the economic cost of implementing a system which departed from international norms would far outweigh the revenue gains.

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⁹ See note 6 above

The Auditor General's report was referred to the Standing Committee on Public Accounts of the House of Commons. There the questioning by members of the committee of senior members of the Department of Finance took on a strident and aggressive tone. The committee heard from several outside specialists, including Professor Arnold, who had assisted the Auditor General in drafting his report. The report issued by the Committee included the following extraordinary remarks:

The almost arrogant self-assurance with which the Department of Finance rejected the Auditor General's comments encouraged the Committee to fully explore the question of the taxing of foreign subsidiaries.

...

The Committee does not accept the words of the Department of Finance when it questions the good faith of a number of foreign subsidiaries of Canadian corporations working in these developing countries that are considered tax havens.

The Committee recommended, among other things, that the Department of Finance should assess the merits of according exempt surplus status to foreign affiliates which operate in tax havens, should draft a definition of *active business income* for the purposes of the FAPI provisions and should draft appropriate amendments to the *Income Tax Act* to prevent offsetting active business losses of a foreign affiliate against passive income.

Scott Wilkie and others, in a thoughtful article published shortly after the Public Accounts Committee tabled its report to the House of Commons deplored the effect his public debate could exert on the conduct of an effective, considered, impartial and dispassionate evaluation of the foreign

affiliate system.¹⁰ These authors point out that an evaluation or criticism of the foreign affiliate system requires

an understanding of what, in principle, the rules are designed to achieve and what policy choices and limitations they reflect ...

The authors refer to the inherent difficulty of designing a tax system

"to accommodate international commercial and economic pressures while preserving a measure of sovereignty over the determination and sustainability of the domestic tax base".

Three desiderata determine the shape of international tax legislation: first, the need to allocate tax revenues between jurisdictions in a manner each considers fair; secondly, neither to encourage nor discourage international capital flows; and, thirdly, to enable countries, within these constraints, to impose a domestic tax system of their choice.

Wilkie and his co-authors draw from these premises the conclusion that any legislation in this field necessarily involves difficult "trade-off" and that the evaluation of legislation therefore involves an understanding of the legislated rules and an evaluation of how effectively these rules achieve their objectives. These objectives ought to be flexible and respond to changing economic and commercial conditions, including the enhanced mobility of capital.¹¹

¹⁰ J Scott Wilkie, Robert Raizenne, Heather I Kerr and Angelo Nikolkakis, *The Foreign Affiliate System in View and Review* in *Tax Planning for Canada-US and International Transactions*, 1993 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1994), 2:1-72.

¹¹ *Ibid* pg. 2:9

By implication, the entire absence of such considerations in the Auditor General's Report and the tone of the Public Accounts Committee hearings and its report to the House Commons suggest that the driving force was a narrow preoccupation with maximizing the tax collection without regard to any larger or different policy concerns.¹²

Although the Report of the Public Accounts Committee was not binding on officers of the Crown, nonetheless, impelled perhaps by a sense of accountability to the House of Commons, the Department of Finance carried out the steps commended by the Committee. Amendments relating to the foreign affiliate provisions were contained in the budget of 22nd February 1994; a second draft of these amendments was released on 23rd June 1994 and on 23rd January 1995 the third draft of the proposed amendments was released by the then Minister of Finance Paul Martin.

Professor Arnold, in a long article in the 1994 Canadian Tax Journal¹³ presented a comprehensive analysis of technical and policy considerations arising out of the 1994 draft amendments. The first amendment discussed by Prof Arnold is the new definition of *active business income*. Previously, the Department of Finance and commentators¹⁴ had favoured leaving the

¹² Note that Revenue Canada's position in this debate was that legislative amendments were needed to limit the ability of Canadian corporations to "import" foreign losses through the deductible loss provision, to define active business income for purposes of the definition of FAPI and to reduce the interest deduction claimed by Canadian taxpayers by the net investment income of any controlled foreign affiliates of the taxpayer: see Robert M Beith, *Auditing Foreign Affiliates: Practice and Policy*, in International Fiscal Association (Canadian Branch), *Special Seminar on International Tax issues* (Toronto: Carswell Thomson Professional Publishing, 1994) 235 at p. 237.

¹³ Brian J Arnold, *An Analysis of the 1994 Amendments to the FAPI and Foreign Affiliate Rules*, (1994), C T J vol 42 No. 4 p. 993

¹⁴ See for example Wilkie et al, *op cit* and see also Allan R Lanthier, *Policy or Abuse? The Auditor General's Report* (1993), C T J vol 41 No. 4, 613. At pp. 633-4 Lanthier argues that a facts and circumstances definition is better than a bright line test as the latter creates opportunities for structuring transactions that will fall within the letter but outside spirit of the law.

definition of *active business* largely to a facts and circumstances determination by the courts. It seems however that the Auditor General's report, the position of Revenue Canada and the Public Accounts Committee report to the House of Commons were cumulatively sufficient to overcome this point of view.

The January 1995 amendments to the FAPI and foreign affiliate rules represent, for the time being, the final shape of the legislation. However, the tension between the taxing authorities and the taxpayers¹⁵ has not ceased and the current state of the legislation cannot be viewed as permanent. In April 1998 the Minister of Finance released the *Report of the Technical Committee on Business Taxation*¹⁶ popularly referred to as the Mintz Committee Report. This report made several controversial proposals, including several in the field of international taxation. These proposals are summarized in a 1999 article by Nick Pantaleo¹⁷ as follows: that the affected Departments should

- Strengthen the definition of "foreign affiliate" so that only foreign companies in which Canadian corporations have a significant interest can be considered foreign affiliates and have access to the benefits of the foreign affiliate system.
- Subject to a de minimis rule for smaller businesses, disallow interest expense on borrowings made by Canadian taxpayers that are used to invest in foreign affiliates.
- Maintain the FAPI exemption provision found in subparagraph 85(2)(a)(ii),¹⁸ except for payments from related non-resident corporations

¹⁵ And perhaps it should be added, between the legislating policy arm and the collecting arm of the taxing authorities

¹⁶ Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998). This report is commonly referred to as the Mintz Committee Report.

¹⁷ Nick Pantaleo, *Foreign Affiliates under Siege: an Update* (1999), CTJ vol 47 No. 2, p 291.

¹⁸ Briefly, income received by a foreign affiliate of a taxpayer that would otherwise be income from property will be deemed to be active business income if the income is paid, directly or indirectly, by another foreign affiliate, or a related non-resident corporation, and the expenditure is deductible, or would be deductible, in computing the active business income of the payer.

that are not foreign affiliates of the Canadian taxpayer, if the related-party status arises solely as a result of share ownership by a foreign parent company that is resident outside Canada.

- Include in taxable surplus payments in respect of interaffiliate transactions if the income is received by an entity that, although located in a tax treaty jurisdiction, is expressly denied benefits under that treaty.
- Renegotiate existing tax treaties to ensure that all tax-privileged entities in treaty countries are denied access to the exemption system with respect to income from interaffiliate transactions.
- Encourage Revenue Canada to apply the offshore investment fund provisions more aggressively and, if necessary, make appropriate amendments to strengthen those provisions.

The most recent impetus for change, and the last to the date of this article, derives from the report issued by the Organization for Economic Co-operation and Development on harmful tax competition¹⁹. This report, in addition to recommending the enactment of controlled foreign corporation rules also recommends that the exemption methodology should not apply to foreign income which has benefited from harmful tax practices. With the exception of the recommendation that the FAPI exemption in subparagraph 95(2)(a)(ii) not extend to "second tier" financing²⁰, the Mintz Committee recommendations have not been implemented.

It is time to survey the present state of the rules relating to controlled foreign affiliates and to see how they conduce to competitiveness for Canadian enterprise doing business abroad and at the same discourage (or at least not encourage) the flight of capital from Canada in search of a tax haven.

¹⁹ Organization for Economic Co-operation and Development, *Harmful Tax Competition: An Emerging Global Issue* (Paris: m OECD, 1998)

²⁰ Anomolously, this recommendation is given effect by an amendment to section 17 instead of to section 95(2)(a), with the result that second tier financing generally are caught.

Two background considerations, which provide the back-drop against which the efficacy of the legislation should be viewed from a policy perspective, are the need for capital export neutrality and capital import neutrality. Capital export neutrality conduces to economic efficiency, capital import neutrality to competitiveness. Specifically, to preserve the international competitiveness of Canadian businesses, active business income of a foreign affiliate should be subject only to tax in the foreign jurisdiction and should be able to be repatriated to Canada tax free. The Department of Finance statement in its response to the 1992 Auditor General's Report²¹ indicates the reason for this:

The ability to receive dividends from a foreign affiliate on a tax-free basis is intended, at least in part, as a proxy for the foreign tax credit that would have been available to the Canadian company if it had carried on its business through a foreign branch rather than a subsidiary. It also helps to ensure that there is no tax impediment to corporations re-investing their foreign earnings in their Canadian operations.²²

At the same time, capital export neutrality, necessary for the efficient use of capital, dictates that taxation does not hinder the free flow of capital. It has even been argued that legislation which imposes tax obstacles to investment in low tax countries may have the unwanted effect of depriving developing nations of access to capital. These two considerations, capital export and capital import neutrality are divergent and cannot be reconciled with respect to the same sources of income. The present Canadian system preserves capital export neutrality by ensuring that capital does not leave Canada for

²¹ Report of the Auditor General to the House of Commons for 1992, Minister of Supply and Services Canada 1992, pp. 46 to 55.

²² Ibid page 52

purely tax reasons by a tax regime that assimilates the tax consequences as much as possible to the tax treatment which would have been accorded to that capital had it stayed in Canada. This is the purpose of the FAPI rules: passive income earned by Canadian capital abroad is taxed in Canada at Canadian domestic rates and, most importantly, without deferral.

This incidentally serves to protect the Canadian tax base from erosion. But this treatment of exported capital has to be clearly and definitively separated from the export of capital needed to finance Canadian enterprise doing business overseas and, in addition, the earnings need to be capable of being repatriated tax free. The nub of the problem is how to distinguish these two sets of circumstances. Here the notion of *active business* and *active business income* comes into play. As has been previously mentioned, a debate broke out between proponents of a judicially controlled "facts and circumstances" test and a statutory "bright line test" for *active business income*, a debate which eventually reached the House of Commons upon tabling of the report of the Public Accounts Committee after hearings on the 1992 Auditor General's report.

Despite its initial preference for a judicially controlled definition, the Department of Finance apparently bowing to political pressure, enacted a statutory definition. *Active business* of a foreign affiliate of a taxpayer is defined in section 95(1) to mean any business carried on by the taxpayer other than an investment business carried on by the affiliate or a business that is deemed by subsection 95(2) to be a business other than an active business of the affiliate. For the purposes of section 95(1), business excludes an adventure in the nature of trade.

Income from an active business includes any income of the affiliate for the year that pertains to or is incidental to the active business carried on by the affiliate but excluding other income which is the affiliate's income from property and excluding income from a business deemed by subsection 95(2) not to be an active business.

So the nub of the definition of *active business* is the meaning of *investment business*. Carrying on an investment business under the 1995 definition involves deriving income from property (including interest, dividends, royalties, etc); from insurance or re-insurance; from factoring accounts receivable; profit from disposition of investment property (which includes shares, unless they constitute excluded property, partnership or trust interests, debts or annuities, commodities or commodity futures, currency, real estate, resource properties and interests in any of the these.

The definition of *investment business* is subject to the qualification that if throughout the taxation year the business employs more than five employees and deals principally with arms length persons, then it is not an *investment business*. In this negative manner, the definition places a business which meets these provisos back into the category of an *active business*.

However, there are two exclusions from the operation of this qualification: businesses referred to in several paragraphs²³ are deemed not in any event to be active businesses. A second exclusion relates to certain qualified businesses, for example insurance companies, which may still be caught by the definition of *investment business* despite having more than five full time

employees unless they meet particular requirements, including being subject to regulation in the country in which they are doing business.

This manner of definition is so obtuse that a question and answer algorithm is required to understand it. Such an algorithm is provided by Sandra Jack in Appendix I of her 1995 article²⁴. The algorithm is as follows:

- (a) Is there a business? If yes, then proceed
- (b) Is it an adventure in the nature of trade? If no, then proceed
- (c) Is the business deemed to be other than an active business pursuant to section 95(2)? If no, then proceed
- (d) Is it an *investment business*? If no, then proceed
- (e) Is the income deemed to be property income pursuant to section 95(2)(l)? If no, then it is income from an active business.

The algorithm is complicated by several qualifications. If the answer to (a) is no, or if the answer to (b) is yes, or if the answer to (d) is yes, or if the answer to (e) is yes, then there is still the further question:

- (f) Does paragraph 95(2)(a) treat the income as income from an active business? If yes, then it is income from an active business.

Otherwise, the income is FAPI and has to be accrued and included in the taxpayer's income for the year without regard to whether the income has been distributed to the taxpayer.

Further consideration of the foreign affiliate rules is beyond the scope of this paper. The technical and policy considerations relating to taxation of

²³ 95(2)(a.1), (a.2), 9a3.), (a.4), and (b)

²⁴ Sandra E Jack, *The Foreign Affiliate Rules: The 1995 Amendments* (1995), C T J vol 43. No. 2, p 347 at page 396.

foreign income have been considered in a large number of learned articles and treatises. The significant sources are referred to in the bibliography.

The conclusion reached at the end of a paper of such limited scope as this is that what begins as a conceptually simple task of preventing erosion of the Canadian tax base, or of achieving equity among taxpayers, without at the same time hampering the competitiveness of Canadian industry abroad quickly dissolves into issues of such complexity that the epithet "monstrous" applied by the tax director of a Canadian corporation²⁵ which in its time contributed significantly to Canada's wealth seems appropriate. Perhaps taxing authorities, taking a long view, should be less assiduous in seeking to protect the tax base. Larger concerns than the integrity of the tax base seem to be in play.

²⁵ See the comment of H Arnold Sherman, Director of Taxation for Massey-Ferguson Limited, quoted above at p. ??s

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