CANADIAN TAX JOURNAL

REVUE FISCALE CANADIENNE

PEER-REVIEWED ARTICLES

Corporate Income Shifting in an Era of Tax Multilateralism:
The Impact of Exchange-of-Information Agreements

Devan Mescall and Paul Nielsen

India's Goods and Services Tax: A Unique Experiment in Cooperative
Federalism and a Constitutional Crisis in Waiting

Ajitesh Kir

POLICY FORUM

Editors' Introduction—The Changing Nature of Work

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Sagaz at 20—Evaluating Employment and Independent
Contractor Relationships in a Changing World

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Promoting Tax Compliance by Regulating the Digital Economy—
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numérique — Initiative du Québec face à Uber

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Tax, Social Security, and Employment Status—Removing the
Distortions in the United Kingdom

Judith Freedman

Future Workforce Models—Enabling the Shift

Guy Jason and Shivani Joshi

(Continued on inside front cover)

(Continued from outside front cover)

FEATURES

Finances of the Nation: Net Income Tax Rates and the Changing Progressivity of the Cash Tax/Transfer System

Tahsin Mehdi and Brian Murphy

International Tax Planning: The Preacquisition Surplus Election: More Than Meets the Eye?

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Ana-Luiza Georgescu

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Michael J. Miller

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Robin Boadway and Kim Brooks

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RICHARD M. BIRD

1938-2021

We were very sad to learn of the passing, on June 9, of Richard M. Bird. Richard was not only a prolific author and a strong public voice, one of Canada's foremost economists, but also a long-time member of, and generous contributor to, the Canadian Tax Foundation. Over the course of his distinguished career—devoted to matters of tax policy and administration, local finance, and intergovernmental fiscal relations in developing countries—Professor Bird held numerous academic appointments around the world, served in a variety of institutes and global organizations, and received international recognition for his contributions to the theory and practice of public finance. His books and hundreds of articles, appearing over a period of almost 60 years, included numerous Foundation publications; in 1997, he received the Douglas J. Sherbaniuk Distinguished Writing Award. Richard was also a longstanding member of the *Canadian Tax Journal's* editorial board, a role in which he was active to the end, providing crucial advice, in the last few years, on how to advance the journal's prestige and vigour. He was awarded the Queen's Diamond Jubilee medal in 2012, in recognition of his many contributions to the Foundation, and he was honoured again, in 2017, with the Foundation's Lifetime Contribution Award, the most prestigious award that we confer. Richard will be greatly missed. We send our deepest condolences to his family.

RICHARD M. BIRD

1938-2021

La nouvelle du décès de Richard M. Bird, le 9 juin dernier, nous a grandement attristés. Richard n'était pas seulement un auteur prolifique et une voix publique forte, ainsi qu'un des plus éminents économistes du Canada, mais il était également un membre de longue date de la Fondation canadienne de fiscalité et un de ses généreux contributeurs. Au cours de sa brillante carrière, consacrée aux questions de politique et d'administration fiscales, de finances locales et de relations fiscales intergouvernementales dans les pays en développement, le professeur Bird a occupé de nombreux postes universitaires dans le monde entier, a œuvré dans divers instituts et organisations mondiales, et a obtenu une reconnaissance internationale pour ses contributions à la théorie et à la pratique des finances publiques. Ses livres et centaines d'articles, parus sur une période de près de 60 ans, comptaient de nombreuses publications de la Fondation; en 1997, il a reçu le Prix d'excellence en rédaction Douglas J. Sherbaniuk. Richard a également été membre de longue date du comité de rédaction de la *Revue fiscale canadienne*, un rôle dans lequel il a été actif jusqu'à la fin, fournissant de précieux conseils, au cours des dernières années, sur la façon de faire progresser la notoriété et la vitalité de la revue. Il a reçu la Médaille du jubilé de diamant de la Reine en 2012, en reconnaissance de ses nombreuses contributions à la Fondation, et il a de nouveau été honoré, en 2017, du Prix pour une contribution exceptionnelle de la Fondation, le prix le plus prestigieux que nous décernons. Richard nous manquera beaucoup. Nous offrons nos plus sincères condoléances à sa famille.

LAUREL AMALIA

1939-2021

It is with sadness that we share the passing of Laurel Amalia on June 4. Laurel served as the managing editor of the Canadian Tax Foundation from 1979 to 2006, overseeing the publication of the Foundation's books, conference proceedings, newsletters, and the *Canadian Tax Journal*. In establishing and carrying on an editorial program that produced tax and public finance publications of the highest quality, she made an important contribution to the development of tax writing in Canada. Renowned for her exacting standards, Laurel's direct manner, frank speech, and dry humour will live on in the memory of many Foundation authors and editors. Those with whom she worked remember her fondly. In recognition of her work at the Foundation, Laurel was awarded a Queen's Diamond Jubilee medal in 2012.

LAUREL AMALIA

1939-2021

C'est avec tristesse que nous vous faisons part du décès de Laurel Amalia le 4 juin dernier. Laurel a été rédactrice en chef de la Fondation canadienne de fiscalité de 1979 à 2006, elle a supervisé la publication des livres de la Fondation, des rapports de conférences, des bulletins et de la *Revue fiscale canadienne*. En établissant et en mettant en œuvre un programme éditorial pour produire des publications fiscales et financières publiques de la plus haute qualité, elle a apporté une contribution importante au développement de la rédaction fiscale au Canada. Réputée pour ses standards des plus rigoureux, le style direct de Laurel, son franc parlé et son humour pince-sans-rire resteront graver dans la mémoire de nombreux auteurs et éditeurs de la Fondation. Ceux et celles avec qui elle a travaillé se souviendront affectueusement d'elle. En reconnaissance de son travail à la Fondation, Laurel a reçu la Médaille du jubilé de diamant de la Reine en 2012.

CALL FOR BOOK PROPOSALS

The Canadian Tax Foundation, an independent, not-for-profit research and educational organization, is seeking proposals for books in the areas of taxation and public finance.

Since its inception in 1945, the Foundation has published many books and articles on a wide range of subjects within its areas of interest. The Foundation seeks proposals for research projects that will

- result in a book on a single topic of interest in the area of taxation or public finance;
- be undertaken by an experienced researcher who has expertise in an area of taxation or public finance; and
- be carried out within a time frame that is reasonable, given the nature of the project.

Projects selected by the Foundation may qualify for its full or partial financial support of the research and for its underwriting of the publication costs. The Foundation retains the absolute right at its sole discretion to choose whether to support a given proposal or to publish a project.

Interested parties should send a brief written outline of a proposal, for initial consideration by the Foundation, to:

Heather Evans
Executive Director and Chief Executive Officer
Canadian Tax Foundation / Fondation canadienne de fiscalité
145 Wellington Street West, Suite 1400
Toronto, Ontario M5J 1H8
hevans@ctf.ca

For further information, please contact the director, as indicated above, or the co-chairs of the Canadian Tax Foundation Research Committee:

Hugh Woolley
c/o Canadian Tax Foundation / Fondation canadienne de fiscalité

Kim Brooks
c/o Canadian Tax Foundation / Fondation canadienne de fiscalité

APPEL DE PROPOSITIONS DE LIVRES

La Fondation canadienne de fiscalité (FCF) / Canadian Tax Foundation, un organisme sans but lucratif indépendant de recherche et à caractère éducatif, souhaite recevoir des propositions de livres dans les domaines de la fiscalité et des finances publiques.

Depuis sa fondation en 1945, la FCF a publié de nombreux livres et articles sur divers sujets dans ses champs d'intérêt. La FCF souhaite obtenir des propositions de projets de recherche qui :

- mèneront à la rédaction d'un livre sur un sujet unique d'intérêt en fiscalité ou en finances publiques;
- seront dirigés par un chercheur chevronné ayant une expertise dans un domaine de la fiscalité ou des finances publiques;
- seront effectués dans un délai raisonnable, compte tenu de la nature du projet.

Les projets qui seront sélectionnés par la FCF pourront être partiellement ou totalement admissibles à une aide financière pour la recherche et les frais de publication. La FCF se réserve le droit absolu, et à sa seule discrétion, d'appuyer une proposition particulière ou de publier un projet.

Toute personne intéressée doit faire parvenir un bref sommaire de la proposition pour examen initial par la FCF à :

Heather Evans
Directrice exécutive et chef de la direction
Canadian Tax Foundation / Fondation canadienne de fiscalité
145 Wellington Street West, Suite 1400
Toronto, Ontario M5J 1H8
hevans@ctf.ca

Pour plus d'information, veuillez communiquer avec le directeur, tel qu'il est mentionné plus haut, ou avec les co-présidentes du comité de recherche de la Fondation canadienne de fiscalité :

Hugh Woolley
a/s Canadian Tax Foundation / Fondation canadienne de fiscalité

Kim Brooks
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■ ACTIVITÉS RÉCENTES ET À VENIR*

JOURNÉE D'ÉTUDES FISCALES

Webémission ■ le 7 juillet 2021

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Webcast ■ July 15, 2021

YOUNG PRACTITIONER FOCUS / FOCUS SUR LES JEUNES PRACTI CIENS (ENGLISH AND FRENCH)

Webcast ■ September 9, 2021

WESTERN CANADA TAX CONFERENCE

Webcast ■ September 28-29, 2021

ONTARIO TAX CONFERENCE

Webcast ■ October 26-27, 2021

ATLANTIC PROVINCES TAX CONFERENCE

Webcast ■ November 4-5, 2021

73RD ANNUAL TAX CONFERENCE

Webcast ■ November 24-25, 2021

* For further details on upcoming events, please visit the Canadian Tax Foundation website at www.ctf.ca. / Pour plus de renseignements, veuillez consulter le site Web de la Fondation à www.fcf-ctf.ca.

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Revue fiscale canadienne

PEER-REVIEWED ARTICLES

- 357 Corporate Income Shifting in an Era of Tax
Multilateralism: The Impact of
Exchange-of-Information Agreements

DEVAN MESCALL AND PAUL NIELSEN

- 391 India's Goods and Services Tax:
A Unique Experiment in Cooperative Federalism
and a Constitutional Crisis in Waiting

AJITESH KIR

POLICY FORUM

- 447 Editors' Introduction—The Changing
Nature of Work

DANIEL SANDLER, FRANCES WOOLLEY, AND
ALAN MACNAUGHTON

- 453 Sagaz at 20—Evaluating Employment and
Independent Contractor Relationships
in a Changing World

GRAHAM PURSE

- 475 Non-Standard Employment and Canada's
Initial Pandemic Response

WEI CUI

- 487 Write It Off (and Start Again)—Adapting
Home Office Deductions for the Digital Era

BHUVANA RAI

- 513 Promoting Tax Compliance by Regulating the
Digital Economy—Quebec's Uber Initiative

MICHAËL ROBERT-ANGERS AND LUC GODBOUT

- 529 Favoriser la conformité fiscale par
l'encadrement de l'économie numérique —
Initiative du Québec face à Uber

MICHAËL ROBERT-ANGERS ET LUC GODBOUT

- 545 Tax, Social Security, and Employment
Status—Removing the Distortions in
the United Kingdom

JUDITH FREEDMAN

- 559 Future Workforce Models—Enabling the Shift

GUY JASON AND SHIVANI JOSHI

FEATURES

- 575 Finances of the Nation:** Net Income Tax Rates and the Changing Progressivity of the Cash Tax/Transfer System
TAHSIN MEHDI AND BRIAN MURPHY
- 595 International Tax Planning:** The Preacquisition Surplus Election: More Than Meets the Eye?
TIM FRASER AND JIM SAMUEL
- 629 Personal Tax Planning:** Current Issues in Compensation
ANA-LUIZA GEORGESCU
- 641 Planification fiscale personnelle :** Les enjeux actuels de la rémunération
ANA-LUIZA GEORGESCU
- 655 Selected US Tax Developments:** Adams Challenge (UK) Limited: When Does a Treaty Provision Conflict with the Code?
MICHAEL J. MILLER
- 669 Current Tax Reading**
ROBIN BOADWAY AND KIM BROOKS

■ CANADIAN TAX JOURNAL

The *Canadian Tax Journal* publishes research in, and informed comment on, taxation and public finance, with particular relevance to Canada. To this end, the journal invites interested parties to submit manuscripts for possible publication as peer-reviewed articles, and it especially welcomes work that contributes to the analysis, design, and implementation of tax policies.

Articles may be written in English or French and should present an original analysis of the topic. Submitted work, or any substantial part or version thereof, must not have been previously published, either in print or online, and it must not be submitted or scheduled for publication elsewhere. The journal welcomes shorter submissions (from 4,000 to 8,000 words) focused on specific topics as well as longer submissions (to a maximum of 20,000 words) that analyze issues in depth.

Submitted articles are subject to a double-blind peer review; authors' identities are not known to reviewers, and reviewers' identities are not known to authors. (Non-peer-reviewed contributions may appear elsewhere in the journal.) Final decisions on publication of articles are made by the editors, Alan Macnaughton, Daniel Sandler, and Kevin Milligan, on the advice of reviewers. Many reviewers are drawn from the editorial board (listed on the inside front cover of this journal), although ad hoc reviewers are also consulted. Submissions may be (1) accepted outright; (2) accepted if recommended revisions are made; (3) revised by the authors, as requested by the editors on the advice of reviewers, and resubmitted for further review; or (4) rejected with reasons. The time from submission to the first editorial decision is usually two months or less.

Prospective contributors should submit a copy of the manuscript to the journal's editorial department. The preferred method of submission is by e-mail with an attached Word document. E-mail inquiries are welcome: write to CTFeditorial@ctf.ca. Contributors are responsible for providing complete and accurate citations to sources, a detailed abstract (200 to 400 words), and up to six keywords for indexing purposes.

The full text of many articles that have appeared in the *Canadian Tax Journal* since 1991 can be found on the Canadian Tax Foundation's website: www.ctf.ca. Additionally, the journal in its entirety appears in the Canadian Tax Foundation's *TaxFind*, which is updated regularly.

The *Canadian Tax Journal* is indexed in EconLit, ABI Inform, LegalTrac, Index to Canadian Legal Literature, CCH Canadian's Canadian Income Tax Research Index, Carswell's Income Tax References, Accounting and Law Index, Current Law Index, Canadian Index, Canadian Periodicals Index, Index to Canadian Legal Periodical Literature, Index to Legal Periodicals and Books, and PAIS International in Print.

■ REVUE FISCALE CANADIENNE

La *Revue fiscale canadienne* publie des recherches et des commentaires éclairés sur la fiscalité et les finances publiques, particulièrement pertinents pour le Canada. À cette fin, la revue invite les personnes intéressées à soumettre des articles en vue d'une éventuelle publication en tant qu'articles revus par des pairs, et elle accueille tout particulièrement les travaux qui contribuent à l'analyse, à la conception et à la mise en oeuvre des politiques fiscales.

Les articles peuvent être rédigés en anglais ou en français et doivent présenter une analyse originale du sujet. Les articles soumis, ou toute partie substantielle ou version des articles, ne doivent pas avoir été publiés antérieurement en format papier ou électronique, et ne doivent pas être soumis ou prévus pour publication ailleurs. Vous pouvez soumettre pour publication, dans la revue fiscale, des articles plus courts (4 000 à 8 000 mots) sur des sujets particuliers ainsi que des articles plus longs (maximum de 20 000 mots) analysant des sujets en profondeur.

Les articles soumis sont sujets à une double revue à l'aveugle par des pairs; l'identité des auteurs n'est pas connue des réviseurs et celle des réviseurs n'est pas connue des auteurs (certains articles non soumis à cette révision par des pairs peuvent paraître ailleurs dans la revue.) La décision finale de publier ou non un article est celle des rédacteurs en chef Alan Macnaughton, Daniel Sandler et Kevin Milligan, à la recommandation des réviseurs. Bien que certains réviseurs *ad hoc* soient aussi consultés, la majorité des réviseurs sont choisis parmi les membres du Comité de rédaction (énumérés à l'endos de la page couverture de la revue). Les articles soumis peuvent être 1) acceptés d'emblée; 2) acceptés après modifications; 3) modifiés par les auteurs tel que demandé par les rédacteurs en chef sur l'avis des réviseurs, et resoumis à une nouvelle révision; ou 4) rejetés avec raisons. Le temps écoulé entre la soumission d'un article et la première décision éditoriale est habituellement de deux mois ou moins.

Les aspirants contributeurs doivent soumettre un exemplaire de l'article proposé au service éditorial. Il est préférable que la soumission se fasse par courriel, avec une pièce jointe en Word. Les demandes de renseignements par courriel sont les bienvenues. Elles doivent être adressées à CTFeditorial@ctf.ca. Les contributeurs doivent soumettre l'ensemble de leurs sources, un précis détaillé de leurs articles (entre 200 et 400 mots), et jusqu'à six mots clés aux fins d'indexation.

On peut trouver le texte intégral de nombreux articles publiés dans la *Revue fiscale canadienne* depuis 1991 sur le site Internet de la Fondation : www.fcf-ctf.ca. De plus, la revue dans son entier se trouve dans *TaxFind*, qui est mis à jour régulièrement.

La *Revue fiscale canadienne* est indexée sous EconLit, ABI Inform, LegalTrac, Index to Canadian Legal Literature, Canadian Income Tax Research Index de CCH Canadian, Income Tax References de Carswell, Accounting and Law Index, Current Law Index, Canadian Index, Canadian Periodicals Index, Index to Canadian Legal Periodical Literature, Index to Legal Periodicals and Books, et PAIS International in Print.

■ CANADIAN TAX FOUNDATION

The Canadian Tax Foundation is Canada's leading source of insight on tax issues. The Foundation promotes understanding of the Canadian tax system through analysis, research, and debate, and provides perspective and impartial recommendations concerning its equity, efficiency, and application.

The Canadian Tax Foundation is an independent tax research organization and a registered charity with over 12,000 individual and corporate members in Canada and abroad. For more than 70 years, it has fostered a better understanding of the Canadian tax system and assisted in the development of that system through its research projects, conferences, publications, and representations to government.

Members find the Foundation to be a valuable resource both for the scope and depth of the tax information it provides and for its services, which support their everyday work in the taxation field.

Government policy makers and administrators have long respected the Foundation for its objectivity, its focus on current tax issues, its concern for improvement of the Canadian tax system, and its significant contribution to tax and fiscal policy.

MEMBERSHIP

Membership in the Foundation is open to all who are interested in its work. Membership fees are \$399.00 a year, except that special member rates apply as follows: (a) \$199.00 for members of the accounting and legal professions in the first three years following date of qualification to practise; (b) \$199.00 for persons on full-time teaching staff of colleges, universities, or other educational institutions; (c) \$40.00 for students in full-time attendance at a recognized educational institution; and (d) \$171.00 for persons who have reached the age of 65 and are no longer actively working in tax. Memberships are for a period of 12 months dating from the receipt of application with the appropriate payment.

Applications for membership are available from the membership administrator for the Canadian Tax Foundation: facsimile: 416-599-9283; Internet: www.ctf.ca; e-mail: ctfmembership@ctf.ca.

■ FONDATION CANADIENNE DE FISCALITÉ

La Fondation canadienne de fiscalité est un organisme indépendant de recherche sur la fiscalité inscrit sous le régime des œuvres de charité. Elle compte environ 12 000 membres au Canada et à l'étranger. Depuis plus de 70 ans, la FCF favorise une meilleure compréhension du système fiscal canadien et aide au développement de ce système par le biais de ses projets de recherche, conférences, publications et représentations auprès des gouvernements.

Les membres considèrent l'étendue et le détail de l'information offerte par la FCF comme une importante ressource. Ils apprécient également les autres services de la FCF qui facilitent leur travail quotidien dans le domaine de la fiscalité.

Les décideurs et administrateurs gouvernementaux respectent depuis longtemps l'objectivité de la FCF, son attention aux questions fiscales de l'heure, sa préoccupation envers l'amélioration du système fiscal canadien et son importante contribution au développement des politiques fiscales.

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Toute personne intéressée aux travaux de la FCF peut en devenir membre. Les droits d'adhésion sont de 399,00 \$ par année, à l'exception des tarifs spéciaux suivants : a) 199,00 \$ pour les personnes faisant carrière en comptabilité ou en droit pendant les trois premières années suivant leur admission à la profession; b) 199,00 \$ pour le personnel enseignant à temps plein dans un collège, une université ou une autre maison d'enseignement; c) 40,00 \$ pour les étudiants fréquentant à temps plein une maison d'enseignement reconnue; et d) 171,00 \$ pour les personnes qui ont 65 ans et plus et qui ne travaillent plus activement en fiscalité. La période d'adhésion est de 12 mois, à compter de la réception de la demande accompagnée du paiement approprié.

Il est possible de se procurer les demandes d'adhésion auprès de l'administratrice responsable de l'adhésion à la FCF : télécopieur : 514-939-7353; Internet : www.fcf-ctf.ca; courriel : adminmtl@ctf.ca.

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Corporate Income Shifting in an Era of Tax Multilateralism: The Impact of Exchange-of-Information Agreements

Devan Mescall and Paul Nielsen*

PRÉCIS

Se fondant sur des données tirées des rapports annuels, publiés entre 2003 et 2012, de plus de 100 000 filiales de multinationales de 55 pays, les auteurs de cet article étudient l'effet des accords d'échange d'information (« accords EI ») sur les transferts de revenu visant à réduire l'impôt. L'hypothèse est que la transparence créée par la signature d'accords EI diminue les transferts de revenu effectués par les multinationales pour réduire l'impôt. La question de savoir si ces accords ont une incidence sur le comportement des multinationales en matière de transfert de revenu reste sans réponse. Les auteurs constatent qu'en moyenne, les accords EI ont effectivement une incidence sur les transferts de revenu visant à réduire l'impôt. De plus, ils observent que les accords EI plus récents et perfectionnés sont associés à une plus grande diminution des transferts de revenu visant à réduire l'impôt que les accords EI antérieurs. Cette preuve remet en question l'hypothèse prédominante dans les études empiriques selon laquelle les accords EI sont homogènes. Des analyses complémentaires laissent entendre que les facteurs qui créent l'asymétrie d'information entre les multinationales et les administrations fiscales, par exemple les sociétés qui ont des niveaux élevés d'actifs incorporels et les administrations fiscales qui ont des règles strictes en matière de prix de transfert et d'exécution, peuvent diminuer ou accroître l'efficacité des accords EI pour modérer les transferts de revenu visant à réduire l'impôt. La preuve dégagée par cette étude montre qu'il est essentiel de tenir compte de l'environnement informationnel des administrations fiscales et de la substance d'un accord EI pour évaluer l'incidence d'un tel accord sur le comportement fiscal de contribuables aussi avertis que les multinationales.

* Devan Mescall is of the University of Saskatchewan (e-mail: mescall@edwards.usask.ca); Paul Nielsen is of TideWater Midstream and Infrastructure Ltd. (e-mail: pnielsen@tidewatermidstream.com). This study compiles data on exchange-of-information (EOI) agreements and corporations for the purposes of analysis. Data concerning EOI agreements have been collected from the website of the Organisation for Economic Co-operation and Development (www.oecd.org/ctp/exchange-of-tax-information/), and the authors' compiled EOI agreement data used for analysis are available at www.edwards.usask.ca/faculty/Devan%20Mescall/. Corporate data are from Bureau van Dijk's proprietary ORBIS database. The authors' code for generating the corporate variables and sample from the ORBIS data is available at the same web link.

ABSTRACT

Using data from the annual reports of over 100,000 subsidiaries of multinational enterprises (MNEs) from 55 countries between 2003 and 2012, the authors of this article investigate the impact of exchange-of-information agreements (“EOI agreements”) on tax-motivated income shifting. Transparency created by the signing of EOI agreements is expected to reduce the tax-motivated shifting of income by multinational corporations. Whether such agreements affect the income-shifting behaviour of multinational corporations is an unanswered question. The authors find evidence that, on average, EOI agreements do have an impact on tax-motivated income shifting. Additionally, they find that more advanced, modern EOI agreements are associated with a larger decrease in tax-motivated income shifting compared to the impact of early EOI agreements. This evidence challenges the prevalent assumption in empirical studies that EOI agreements are homogeneous. Supplemental analyses suggest that factors that affect the information asymmetry between MNEs and tax authorities, such as corporations with high levels of intangibles and tax authorities with strong transfer-pricing rules and enforcement, can diminish or enhance the effectiveness of EOI agreements in moderating tax-motivated income shifting. The evidence provided by this study shows that consideration of the tax authorities’ information environment and the substance of an EOI agreement is essential when assessing the impact of such an agreement on the tax behaviour of sophisticated taxpayers such as multinational corporations.

KEYWORDS: INFORMATION EXCHANGE ■ AGREEMENTS ■ MULTINATIONAL CORPORATIONS ■ AVOIDANCE ■ COMPLIANCE ■ ENFORCEMENT

CONTENTS

Introduction	359
MNEs, Domestic Tax Authorities, and the Challenges of Information Asymmetry	361
Tax-Motivated Income Shifting by MNEs	361
Reducing Information Asymmetry Between MNEs and Tax Authorities	363
Method	368
Sample	368
Data	369
Subsidiary-Level Data	369
EOI Agreement Data	370
Model	371
Results	377
Multivariate Regression Results Testing Hypotheses 1a and 1b	377
Multivariate Regression Results Testing Hypotheses 2a and 2b	378
Specification Checks	380
EOI Agreement Specification	380
Large Tax-Rate Differentials	380
Supplemental Testing	381
Characteristics of Modern EOI Agreements	381
Subsample Analyses	382
Conclusion	387

INTRODUCTION

In this article, we investigate the effects of international exchange-of-information agreements (“EOI agreements”) on tax-motivated income shifting by multinational enterprises (MNEs). Tax authorities in the Group of Twenty (G20) countries identify MNEs’ tax-motivated income shifting via transfer pricing as their second-highest source of compliance risk.¹ While a multinational corporation knows the entirety of its global tax arrangement, domestic tax authorities know in detail only a portion of that arrangement. This information asymmetry creates a playing field that greatly favours the MNE. Increased information flow between tax authorities is one means of mitigating this imbalance. Prior studies, detailed below, have documented mixed results concerning the impacts of EOI agreements on the tax-avoidance behaviour of individuals, but we are the first to provide direct evidence of the impact of EOI agreements on tax avoidance by multinational corporations.

Although EOI agreements have existed since 1963, over time, standard frameworks for such agreements developed by the United Nations and the Organisation for Economic Co-operation and Development (OECD) have continued to evolve. This evolution, from early to modern agreements, has created the potential for significant differences in the nature of EOI agreements to exist between any two tax authorities. Modern advancements in the exchange of tax information can be sourced to 2002 and the first model tax information exchange agreement (TIEA) that resulted from the OECD’s global transparency forum. The model TIEA was the first stand-alone agreement dealing only with the exchange of tax information. Previously, the exchange of tax information between countries was covered generally as part of a broader double tax convention (DTC). DTCs followed this advance with a new OECD model convention in 2005² that strengthened the tax information exchange provisions. Specifically, paragraphs 4 and 5 were added to article 26 of the model convention to address two significant deficiencies that had frequently stalled the exchange of requested information.³ Paragraph 4 ensures the provision of requested information even if it is not relevant to, or collected by, the tax administration of the information-providing state.⁴ Prior to this clarification, information exchange was ultimately limited to the unity of information needs of the contracting parties, since information that was specific to the needs of one party and not the other was rarely exchanged. Paragraph 5 states that the information-providing

1 Ernst & Young, *From the Source: The View from Tax Authorities, 2017-18 Tax Risk and Controversy Survey Series* (EY, 2018) (https://assets.ey.com/content/dam/ey-sites/ey-com/en_gl/topics/trust/ey-from-the-source-the-view-from-tax-authorities.pdf).

2 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, July 2005) (herein, together with subsequent versions, referred to as “the OECD model convention”).

3 Kevin A. Bell, “OECD Publishes New Model Tax Treaty” (2005) 108:12 *Tax Notes* 1231.

4 Vokhidjon Urinov, “Ensuring Tax Compliance in a Globalized World: The International Automatic Exchange of Tax Information” (PhD dissertation, McGill University, 2016).

state will not decline a request solely because the information is held by a bank or financial institution.⁵ Although exchange of information provisions and instruments continued to evolve after 2005, the inclusion of paragraphs 4 and 5 of article 26 was viewed as a notable improvement. According to McIntyre, these provisions should be included in an effective information exchange agreement.⁶ Prior research, detailed below, has focused exclusively on the existence of EOI agreements between tax authorities and their impact on taxpayer behaviour. However, in addition to investigating the impact of EOI agreements on corporate tax behaviour in general, we extend our research to investigate the impact of heterogeneity across EOI agreements. We therefore identify modern EOI agreements as such agreements that came into force, either as new agreements or as updated agreements, after the OECD's global forum on transparency produced the 2002 Model Agreement on Exchange of Information on Tax Matters (often referred to as "the OECD model TIEA").⁷

Our evidence suggests that, on average, the existence of an EOI agreement between the subsidiary and parent countries is correlated with a reduction in tax-motivated income shifting by MNEs. Additional evidence suggests that modern EOI agreements—those that came into force or were updated in 2002 or after—are more effective in moderating tax-motivated income shifting than are early EOI agreements.

These results contribute to the research in this area by providing empirical evidence of the impact of EOI agreements on the tax behaviour of multinational corporations and by showing that some EOI agreements are more effective than others. Supplemental analyses provide further evidence that situational factors affecting the information asymmetry between tax authorities and MNEs, such as MNEs with high levels of intangibles and tax authorities with strong investment in transfer-pricing regulation and enforcement, can diminish or enhance, respectively, the effectiveness of EOI agreements in moderating tax-motivated income shifting. Our results can be used to inform future decisions of policy makers and further research by legal scholars, specifically in recognizing the importance of the substantive content of EOI agreements and situational factors in influencing the behaviour of sophisticated taxpayers such as MNEs.

The evidence provided by our study has implications for future empirical studies investigating the impacts of EOI agreements and may allow incongruous results from prior studies to be reconciled. Prior studies investigating the impact of EOI agreements on individual tax avoidance and investment often produced mixed results.

5 Ibid.

6 Michael J. McIntyre, "How To End the Charade of Information Exchange" (2009) 125:6 *Tax Notes* 695-707.

7 "The 2002 Model Agreement on Exchange of Information on Tax Matters and Its Commentary," in Organisation for Economic Co-operation and Development, *Implementing the Tax Transparency Standards: A Handbook for Assessors and Jurisdictions*, 2d ed. (Paris: OECD, 2011), 103-48 (<https://doi.org/10.1787/9789264110496-en>).

The assumption that EOI agreements are homogeneous has been applied nearly universally in prior empirical studies, with the exception of some subsample analyses by agreement type (that is, DTC or TIEA). The results of our study highlight the importance of considering heterogeneity across EOI agreements in terms of early versus modern agreements, in addition to the information environment between the MNE and the tax authority.

The remaining sections of this article include a discussion of tax-motivated income shifting by MNEs and the impact of information asymmetry on tax authorities' enforcement efforts, followed by a description of the hypotheses, the research design, and the empirical results, and finally our concluding comments.

MNEs, DOMESTIC TAX AUTHORITIES, AND THE CHALLENGES OF INFORMATION ASYMMETRY

The structure and operation of corporations dramatically shifted with globalization of the world economy, creating challenges in both the theory and the practice of taxing corporations. Current practices in the taxation of corporations are born out of domestic tax systems and are implemented by domestic tax authorities. Tax enforcement requires timely, relevant, and reliable information. Jurisdictional restraints on the availability of information to domestic tax authorities limit the ability of those authorities to provide oversight of MNEs.

Tax-Motivated Income Shifting by MNEs

MNEs are responsible for meeting the tax requirements within the jurisdictions in which they have a legal obligation to comply. Tax filings require MNEs to source and self-report their income to the various jurisdictions. Transfer pricing is a key process for attributing income generated by an MNE to specific jurisdictions in which the MNE has compliance obligations. Transfer pricing requires a firm to value all internal exchanges of goods or services across tax jurisdictions. The OECD has endorsed the arm's-length principle (ALP) as the method by which international transfer prices should be evaluated. The ALP requires firms to elect transfer prices equivalent to what they would charge an unrelated party for the use of that good or service. The ALP is required for all OECD-recognized international tax agreements and has been incorporated into the domestic tax legislation of many countries. "Dozens of countries around the world have implemented transfer pricing laws, and virtually all of them are based on the arm's length principle."⁸

Despite wide acceptance of the ALP, its implementation is not without challenges. Transfer pricing involves a hypothetical transaction between the MNE and a presumed arm's-length party. Implementation of transfer pricing inherently lacks precision since it involves a number of economic assumptions, even without any

8 Organisation for Economic Co-operation and Development, *Transfer Pricing Legislation—A Suggested Approach* (Paris: OECD, June 2011), at 2.

tax-minimization incentive. In practice, the application of a range of reasonable economic assumptions results in a range of “reasonable prices” and allows MNEs some discretion in the reporting of revenues across jurisdictions.

A strength of the ALP, in theory, is that it is geographically neutral, since it is supposed to treat income in different locations in a similar manner. However, many feel that the view that ALP-based transfer pricing is therefore also neutral has become inaccurate.⁹ With jurisdictional differences in tax rates and policies, transfer pricing has real economic consequences for MNEs. Prior studies have documented the impact of potential tax savings on MNEs’ transfer-pricing decisions and the shifting of reported income from high-tax jurisdictions to low-tax jurisdictions.¹⁰ “Transfer pricing enables corporations to minimize tax payments by enabling capital to be exported to more favourable locations.”¹¹

Klassen and Laplante document the increasing impact and prevalence of tax-motivated income shifting by MNEs.¹² Their study estimates that the 380 firms examined were able to shift an additional \$10 billion in profit out of the United States in the 2005-2009 period relative to the 1998-2002 period.

The lack of precision inherent in the ALP method may create the potential for beneficial tax planning, but it also creates material risks for MNEs.¹³ Given conflicting incentives and asymmetry in the information available to the parties, it is not surprising that the determination of a range of “reasonable prices” leads to the positions of MNEs being challenged by tax authorities. As a result, transfer pricing has led to some of the most expensive tax disputes in the world, such as GlaxoSmith-Kline’s US\$3.4 billion transfer-pricing settlement with the Internal Revenue Service.¹⁴ Although these disputes often involve difficult-to-value intangibles such as patents and trademarks, disagreements over transfer pricing arise across all industries. The ALP method must also be applied to intra-company contract terms, such as volume and contract length, and this requirement has led to costly transfer-pricing disputes in industries where intangibles are the central issue. An example is the

9 See, for example, Prem Sikka and Hugh Willmott, “The Dark Side of Transfer Pricing: Its Role in Tax Avoidance and Wealth Retentiveness” (2010) 21:4 *Critical Perspectives on Accounting* 342-56 (<https://doi.org/10.1016/j.cpa.2010.02.004>).

10 John Jacobs, “Taxes and Transfer Pricing: Income Shifting and the Volume of Intrafirm Transfers” (1996) 34:2 *Journal of Accounting Research* 301-12.

11 Sikka and Willmott, *supra* note 9, at 343.

12 Kenneth J. Klassen and Stacie K. Laplante, “Are US Multinational Corporations Becoming More Aggressive Income Shifters?” (2012) 51:2 *Journal of Accounting Research* 1245-85.

13 See Devan Mescall and Kenneth J. Klassen, “How Does Transfer Pricing Risk Affect Premiums in Cross-Border Mergers and Acquisitions?” (2018) 35:2 *Contemporary Accounting Research* 830-65.

14 Internal Revenue Service, “IRS Accepts Settlement Offer in Largest Transfer Pricing Dispute,” *News Release IR-2006-142*, September 11, 2006.

Canada Revenue Agency's dispute with the Canadian uranium miner Cameco, in which the amount involved is estimated to be worth Cdn\$2.2 billion.¹⁵

Mescall and Klassen document evidence that the uncertainty around transfer pricing and the associated tax risks are costly to MNEs and market participants since the shares of MNEs with higher transfer-pricing risks are discounted when acquired in a cross-border merger and acquisition.¹⁶ Klassen, Lisowsky, and Mescall document and validate their findings that, as a result of these risks, more than half of the MNEs included in their study chose to trade off transfer-pricing tax savings for the benefits of tax certainty.¹⁷ An important avenue to achieve tax certainty is to reduce information asymmetry between the tax authority and the MNE by improving the information available to the domestic tax authority.

Reducing Information Asymmetry Between MNEs and Tax Authorities

Tax authorities have two strategies to improve the information available to them for multinational corporate tax enforcement. The first strategy is to improve the information reported by the MNE. Many countries now require MNEs to submit standardized documentation to support their transfer prices. Lohse and Riedel found that jurisdictions with specific transfer-pricing legislation and documentation requirements experienced approximately 50 percent less profit-shifting behaviour than jurisdictions lacking these measures.¹⁸

The second strategy is to improve the sharing of information between tax authorities to reduce the information asymmetry between the MNE and the domestic tax authority. In an effort to combat tax avoidance, the OECD and G20 initiated the development of an action plan to address base erosion and profit shifting (BEPS). The OECD has listed as one of the goals of the action plan “[e]nsuring transparency while promoting increased certainty and predictability,”¹⁹ with an emphasis on developing the international exchange of tax information. EOI agreements are intended to prevent organizations and individuals from avoiding tax by holding assets in or shifting income to other jurisdictions. Conceptually, EOI agreements reduce the information asymmetries between taxpayers and tax authorities, allowing domestic tax authorities to effectively assess the reasonableness of a taxpayer's position.

15 See *Cameco Corporation v. The Queen*, 2018 TCC 195; and “Cameco: Landmark Transfer Pricing Case Begins,” *CPA Canada Tax Update*, 2017 (<https://www.cpacanada.ca/en/members-area/profession-news/2017/may/tax-update-whats-new-spring-2017>).

16 Mescall and Klassen, *supra* note 13.

17 Kenneth J. Klassen, Petro Lisowsky, and Devan Mescall, “Transfer Pricing: Strategies, Practices, and Tax Minimization” (2017) 34:1 *Contemporary Accounting Research* 455-93.

18 Theresa Lohse and Nadine Riedel, *Do Transfer Pricing Laws Limit International Income Shifting? Evidence from European Multinationals*, CESifo Working Paper no. 4404 (Munich: Munich Society for the Promotion of Economic Research, 2013).

19 Organisation for Economic Co-operation and Development, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013), at 21 (emphasis in original).

EOI agreements come in several forms, including DTCs, TIEAs, and automatic exchange of information agreements (AEOIAs), for all of which the OECD has published acceptable frameworks. Unlike DTCs, TIEAs are expressly for the sharing of tax information; however, both types of agreement outline what kind of information the country is required to share or collect upon request. DTCs and TIEAs are known collectively as information-by-request agreements. These agreements may allow a tax authority to request information beyond what would be covered by an AEOIA. AEOIAs automatically share a defined list of tax information without the need for tax authorities to request such information or to respond to information requests. These agreements have been touted by the OECD as a major accomplishment in increasing tax transparency and cooperation. The ability of AEOIAs to provide timely information that is commonly required, together with the ability of TIEAs or DTCs to provide specific details beyond those included in the AEOIA information lists, provides tax authorities with complementary tools to address a variety of taxpayer scenarios.

Sodhani and Srivastava highlight the contemporary importance of EOI agreements when they state, “In order for countries to maintain sovereignty over the application and enforcement of their tax laws and to ensure the correct application of tax conventions, there is a need for effective EOI [agreements].”²⁰ The OECD model convention was first drafted in 1963. Article 26 of the model convention obliges the contracting parties to exchange appropriate information to allow for the application of the convention.

Despite the importance of EOI agreements, over time several limitations have diminished the utility of such agreements to domestic tax authorities. Early forms of the OECD model did not specifically address situations where the information requested was information not normally required by the providing tax authority—that is, where the information available was limited to the unity of practices between the two authorities. Other issues arose where the information requested was held by a party acting in a fiduciary capacity (such as a bank), creating uncertainty as to its obtainability. Additionally, Tonkovitch identifies risks that EOI agreements may leave tax authorities open to information exchange obligations beyond those required by the contracting parties.²¹

These shortcomings gave jurisdictions ample opportunity to deny information requests and created uncertainty over the effectiveness of EOI agreements. The efficacy of EOI agreements has frequently been questioned. For example, Shepard states:

20 Ashish Sodhani and Antika Srivastava, “Exchange of Information Agreements,” in *International Tax: A Compendium* (India: CCH, 2013), I-358 to I-392, at I-360.

21 Mark Tonkovitch, “The Treaty Network Theory: Accessing Foreign Tax Information Networks Under the OECD Model Convention” (2013) 61:4 *Canadian Tax Journal* 875-92.

The standard OECD information exchange agreement is nearly worthless. Information exchange under the standard agreement is sporadic, difficult, and unwieldy for tax administrators even under the best of circumstances. When a banking haven is the requested party, information exchange is nearly impossible. The information exchange article in the OECD model suffers from the same limitations. The OECD agreement is not drafted to provide serious, real-time help in tax administration.²²

EOI agreement provisions continue to evolve, with the goal of improving tax authorities' effective enforcement of tax rules with multinational taxpayers. In 2000, the OECD struck the Global Forum on Transparency and Exchange of Information in an attempt to overcome the challenges described above. The outcome was an important shift in multilateralism among tax authorities with the development of the OECD model TIEA,²³ which gave rise to the first bilateral TIEAs. These advances continued in 2005 when article 26 of the OECD model convention was substantially updated, to include provisions that addressed requests for information that were not normally required for tax administration within the providing regime.²⁴ These provisions were outlined in paragraph 4 of article 26. Paragraph 5 was also added to require the exchange of information even if the information was held by banks. These amendments were viewed as essential provisions in the progression toward an effective EOI agreement model.²⁵ This progress continued through regular revisions of the OECD model convention, most recently in 2017,²⁶ and the introduction of new arrangements including automatic exchanges of information. Discussing the advancements in EOI agreements, Baker states, "In the light of developments over the last few years, this shift of norm is not particularly surprising. However, the speed at which changes have been made in this field over the last couple of years has been astonishing."²⁷

Despite the progress, the effectiveness of EOI agreements to foster multilateralism and curb tax avoidance is an open question. Prior studies have looked for evidence as to whether the introduction or existence of EOI agreements affects the tax-avoidance behaviour of multinational taxpayers, in order to assess the effectiveness of such agreements, and have reported mixed results.

22 Lee A. Sheppard, "Don't Ask. Don't Tell, Part 4: Ineffectual Information Sharing" (2009) 53:13 *Tax Notes International* 1139-45, at 1139.

23 *Supra* note 7.

24 Bell, *supra* note 3.

25 McIntyre, *supra* note 6.

26 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, 2017).

27 Philip Baker, "Automatic Exchange of Information—The Arrival of a New International Norm of Taxation" [2013] no. 4 *British Tax Review* 371-73.

Focusing on the tax behaviours of individuals, Hanlon, Maydew, and Thornock provide evidence that the signing of TIEAs negatively affects tax evasion by US individuals through tax havens.²⁸ Extending the research of Hanlon et al., Kemme, Parikh, and Steigner consider a broader sample of countries, including countries in the European Union, and find no effect on tax-avoidance behaviours associated with the signing of TIEAs.²⁹ Kemme et al.'s evidence on the impact of EOI agreements on individuals' tax avoidance is consistent with the findings of Johannesen and Zucman.³⁰

In a corporate setting, several studies have investigated the impact of EOI agreements on investment decisions. Grottko and Kittl analyze the impact of EOI agreements on the location of subsidiaries of multinationals.³¹ They find evidence suggesting that the existence of an EOI agreement is positively associated with the location of US subsidiaries and that tax transparency is positively associated with US investment. However, their evidence on the effect of EOI agreements on the subsidiaries of German companies does not suggest the same positive impact. Gavrilova and Polakova document evidence of a positive investor reaction to the signing of TIEAs between countries included in an MNE's geographical network, suggesting that investors value the increased transparency.³² Saunders-Scott investigates the impact of EOI agreements on the overall consolidated profitability of an MNE.³³ She finds evidence that such agreements signed by the parent company's country may affect an MNE's consolidated profitability, providing indirect evidence that EOI agreements may influence MNEs' profit-shifting behaviours.

Despite the findings of prior studies, anecdotal evidence suggests that not all EOI agreements are created equal and that some EOI agreements may not provide a deterrent to income shifting, but may in fact legitimize previously questionable

28 Michelle Hanlon, Edward L. Maydew, and Jacob R. Thornock, "Taking the Long Way Home: US Tax Evasion and Offshore Investments in US Equity and Debt Markets" (2015) 70:1 *Journal of Finance* 257-87 (<https://doi.org/10.1111/jofi.12120>).

29 David M. Kemme, Bhavik Parikh, and Tanja Steigner, "Tax Havens, Tax Evasion and Tax Information Exchange Agreements in the OECD" (2017) 23:3 *European Financial Management* 519-42.

30 Niels Johannesen and Gabriel Zucman, "The End of Bank Secrecy? An Evaluation of the G20 Tax Haven Crackdown" (2014) 6:1 *American Economic Journal: Economic Policy* 65-91.

31 Markus Grottko and Maximilian Kittl, *First the Stick, Then the Carrot? A Cross-Country Evaluation of the OECD's Initiative Against Harmful Tax Competition*, University of Passau Working Paper no. B-21-16 (Passau, Germany: University of Passau, Faculty of Business and Economics, 2016).

32 Evelina Gavrilova and Aija Polakova, *Stairway to (Secrecy) Heaven: Market Attitudes Towards Secrecy Shopping*, Discussion Paper no. 2018/19 (Bergen: Norwegian School of Economics, Department of Business and Management Science, 2018).

33 Molly J. Saunders-Scott, "Does Information Exchange Affect Profit Shifting?" in *Three Essays on Profit Shifting* (PhD dissertation, University of Michigan, 2014), 61-85.

income-shifting arrangements. According to a 2016 news report on the impact of TIEAs between Canada and tax haven countries,

[i]n the last half-decade, deals the federal government enacted with offshore jurisdictions, ostensibly to allow the Canada Revenue Agency to crack down on tax evasion, have instead permitted tens of billions of dollars to flow into those locales, totally above board.³⁴

However, a 2013 survey of tax directors by the Corporate Executive Board suggests that multinational corporations have concerns about the impact of tax information exchanges on their transfer-pricing arrangements.³⁵ Discussing the study, Hoffelder notes:

Corporate tax heads in the survey say they are worried about transfer pricing currently since there is more of a collaborative information-sharing effort under way among the international tax authorities. “We’ve seen very large increases in information between the revenue authorities. There’s a lot of concern about that information exchange,” notes Villella [a senior director at the Corporate Executive Board].³⁶

Collectively, prior studies provide evidence that EOI agreements may affect the tax-avoidance behaviour of individuals and influence the profitability and investment decisions of multinational corporations. Notably, however, although tax-motivated income shifting is an important concern for tax authorities, no prior studies have directly investigated the impact of EOI agreements on income shifting by multinational corporations. In this study, using parent-subsidiary pairings, we provide a unique identification of the discretionary income related to tax savings reported in the subsidiary to investigate the effect of EOI agreements on tax-motivated income shifting by corporations. Consistent with the evidence discussed above suggesting that EOI agreements may influence MNEs’ decisions, we predict:

- *Hypothesis 1a*: When there is a tax motivation to shift income into the country of an MNE subsidiary, the existence of an EOI agreement between the MNE parent country and the MNE subsidiary country will reduce the amount of tax-motivated discretionary income reported in the subsidiary country.
- *Hypothesis 1b*: When there is a tax motivation to shift income out of the country of an MNE subsidiary, the existence of an EOI agreement between the MNE parent country and the MNE subsidiary country will increase the amount of tax-motivated discretionary income reported in the subsidiary country.

34 Zach Dubinsky, “Deals Canada Signed To Catch Tax Cheats Allow Billions in Taxes To Escape,” *CBC News*, June 17, 2016.

35 Kathy Hoffelder, “Big Companies Fear Offshore Tax Fallout,” *CFO*, February 21, 2013.

36 Ibid.

As described above, prior studies have found inconsistent results when considering the impact of EOI agreements on the tax-avoidance behaviour of individual taxpayers. However, apart from some analyses by agreement type (for example, a TIEA or a DTC), prior empirical studies have consistently treated EOI agreements as identical. In practice, there is significant heterogeneity across EOI agreements, since the content of such agreements may vary over time and between parties. It is possible that the heterogeneity in these agreements may have introduced noise into the analyses and be partly responsible for the mixed results of prior studies. Treatment of EOI agreements as a homogeneous group in empirical research is generally a simplifying assumption that contrasts with legal studies highlighting the more nuanced impacts of specific provisions. We investigate the impact of this assumption on how EOI agreements influence MNEs' income-shifting behaviours. It is possible that the existence of an EOI agreement, regardless of the specific details, creates an enforcement environment that affects an MNE's decision to engage in tax-motivated income shifting. However, it is also possible that MNEs, as sophisticated taxpayers, discern a difference between modern EOI agreements and early EOI agreements still in force. Within this study's sample, 17.5 percent of EOI agreements between the MNE subsidiary country and the MNE parent country are modern agreements that had the advantage of reflecting the advances made by the 2002 OECD model agreement and subsequently. We use EOI agreements that came into force in 2002 and later as a proxy for modern EOI agreements relative to early EOI agreements that did not have the advantages of mirroring the model provisions and the outcomes of the OECD global transparency forum. We predict:

- *Hypothesis 2a:* When there is a tax motivation to shift income into the country of an MNE subsidiary and an EOI agreement is in place between the MNE parent country and the MNE subsidiary country, the existence of a modern EOI agreement will have a greater impact in reducing the amount of tax-motivated discretionary income reported in the subsidiary country compared to situations where there is an early EOI agreement in place.
- *Hypothesis 2b:* When there is a tax motivation to shift income out of the country of an MNE subsidiary and an EOI agreement is in place between the MNE parent country and the MNE subsidiary country, the existence of a modern EOI agreement will have a greater impact in decreasing the amount of tax-motivated income shifted out of the subsidiary and increasing the amount of tax-motivated discretionary income reported in the subsidiary country, compared to situations where there is an early EOI agreement in place.

METHOD

Sample

Our study's sample includes 108,650 subsidiaries from 55 countries for which we could collect information on bilateral tax agreements and subsidiary-level financial information. Since we are interested in the specific details of TIEAs and DTCs, we limit the time frame to isolate the analysis from the impact of AEOIAs that were formally

endorsed by the G20 in April 2013.³⁷ We therefore use a sample period starting in 2003 and ending in 2012, consistent with Saunders-Scott.³⁸ This time frame also isolates the analyses from the impacts of the multilateral agreement on the OECD's BEPS action plan signed in 2013. In the sample, we have 502,796 subsidiary-year observations. The subsidiary-level data allow us to track any country-year changes in the reported income across subsidiaries and tax jurisdictions within the MNE.³⁹

Data

Subsidiary-Level Data

We utilize Bureau van Dijk's ORBIS database to create subsidiary data by collecting financial information from the annual industrials file and pairing the firms with their immediate foreign shareholder. ORBIS is a data set that collects its information from national and local accounts. It contains firm-level data on more than 93 million active corporations. A subset of 3 million corporations includes ownership information and is appropriate for the model. To examine intra-company income shifting, we limit the sample to those firms for which unconsolidated financial information is available. This allows us to observe the amount of income, assets, intangible assets, and labour costs inside a subsidiary independently from the entire corporate group. The dependent variable of interest is the discretionary income reported in the subsidiary. We estimate discretionary income reported in the subsidiary using the subsidiary's reported earnings before interest and taxes (EBIT), and controlling for economic determinants of income, including the subsidiary's assets, labour costs, and the gross domestic product (GDP) of the subsidiary country.

To isolate firms that have the ability to shift profits into another jurisdiction, we limited the sample to include only those firms that have an immediate foreign corporate shareholder with a minimum of 50 percent ownership in the subsidiary firm.⁴⁰ Although the 50 percent cutoff used is somewhat arbitrary, it can be difficult to determine ownership links in complex multinational corporate structures. Despite this, any foreign immediate shareholders with an ownership interest of at least 50 percent were included in the sample.

Table 1 summarizes the distribution of the sample across years. The sample is relatively evenly distributed across the period 2003-2012, with slightly more of the

37 Urinov, *supra* note 4.

38 Saunders-Scott, *supra* note 33.

39 Our code for generating the corporate variables and sample from the ORBIS data is available at www.edwards.usask.ca/faculty/Devan%20Mescall/.

40 Unfortunately, the ownership information available from ORBIS is static; as a result, we cannot determine when an ownership link was created, but only when it was recorded. The analysis will assume that ownership links recorded in ORBIS hold constant for all years in the sample. Because our analysis is dependent on identifying parent-subsidiary country pairings and the agreements between those countries, deviations of reality from this assumption will add noise to our analyses. However, since there is no reason to believe that any deviations will not be randomly distributed across country pairings, they are unlikely to bias our findings in one direction or another.

sample distributed in the 2007-2011 period. The 55 countries that formed the geographical distribution of subsidiaries in the sample are listed in table 2. Despite ORBIS's recent geographical expansions, there is still a focus on European firms. Countries accounting for more than 5 percent of the sample are Poland (5.13 percent), Germany (5.26 percent), the Czech Republic (6.84 percent), Spain (6.87 percent), the United Kingdom (7.79 percent), Italy (9.49 percent), France (10.35 percent), and Romania (15.67 percent). For comparison purposes, column 3 of table 2 summarizes data on the economy of each country, reported as a percentage of the overall GDP of the 27 EU countries at the end of the sample period in 2012.⁴¹ In general, the distribution of subsidiaries appears reasonable, given the size of the countries' economies. Two exceptions are a higher than expected volume of subsidiaries in Romania, and a lower than expected volume of subsidiaries in Germany.

As shown in table 3, the mean (median) *Tax Difference* (subsidiary tax rate less parent tax rate) is a tax-rate saving of -3.28 percent (-3.29 percent), suggesting that more than half of the subsidiaries in the sample are in countries with tax rates lower than the rate in the MNE parent country. The 25th and the 75th percentile of *Tax Difference* are -10.00 percent and 3.00 percent respectively, illustrating a skew toward locating subsidiaries in countries with a greater opportunity for tax savings.

Within the sample, 84.2 percent of firm-year observations appear in subsidiary countries that have EOI agreements with the MNE parent country, while only 17.5 percent of those agreements are *EOI Agreement: Modern Agreements* coming into force after the updated OECD model in 2002.

EOI Agreement Data

Data on the EOI agreements were obtained via the Exchange of Information Portal ("the EOI portal") of the OECD's Global Forum on Transparency and Exchange of Information, and were coded on the basis of whether the subsidiary country and the parent country had an agreement in force for that year.⁴² The data vary by country pairings and year. The EOI portal contains information on the type of agreement that was signed, the signatories, the date of signing, the date of entry into force, the OECD review status of the agreement, and the presence of paragraphs 4 and 5 of article 26 of the OECD model. Figure 1 summarizes the distribution of agreements across country pairings over the sample period.⁴³ Of all country pairings that exist in the sample, the proportion that had EOI agreements in place ranged

41 Eurostat, "GDP and Main Components (Output, Expenditure and Income)" (https://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=nama_10_gdp&lang=en).

42 Our compiled EOI agreement data used for analysis are available at www.edwards.usask.ca/faculty/Devan%20Mescall/.

43 The analysis in figure 1 is performed at the country-pairing level to provide insights into the prevalence of EOI agreements during the sample period and therefore includes only one observation per country pairing. In contrast, the regression analyses (discussed below), which are based on the subsidiary data available, result in multiple observations for country pairings.

TABLE 1 Sample Distribution Across the Study Period (2003-2012)

Year	Percentage of sample
2003	6.89
2004	8.02
2005	9.09
2006	10.16
2007	11.45
2008	11.96
2009	11.67
2010	12.73
2011	12.48
2012	5.55
Total	100.00

from 77.6 percent in 2003 to 89.2 percent in 2012. Of those agreements, the proportion of modern agreements (those coming into force after the endorsement of the 2002 OECD model TIEA) ranged from 9.9 percent in 2003 to 25.6 percent in 2012. Additionally, there is variance in the modern agreements, illustrated by the fact that those containing paragraphs 4 and 5 of article 26, or an equivalent, ranged from just 1.1 percent of all country pairings in 2003 to 12.4 percent in 2012. Last, the OECD reviews agreements and reports whether they meet the OECD's standards. In 2003, only 6.03 percent of all agreements had been reviewed and met the standards, compared to 18 percent in 2012. These data indicate a continued evolution of agreements over time.

Unfortunately, the information in the EOI portal is semi-static, in that it does not disclose expired agreements or their details. This omission is potentially problematic since we cannot determine the level of transparency that existed between the jurisdictions prior to the signing of the agreement. However, given the lack of available data on the previous agreements, we assume that the date listed in the EOI portal represents the first agreement signed between the jurisdictions.

MODEL

We expect that the income (EBIT) reported by the subsidiary is determined by both non-discretionary income (that explained by the subsidiary's economic activity) and discretionary income reported in the subsidiary by the MNE, some of which is attributable to tax motives. Because we are interested in the impact of an EOI agreement on the discretionary income attributable to tax motives, we control for the determinants of non-discretionary income within our model and include explanatory measures of the tax motives of the subsidiary. Since EOI agreements occur at a country-pairing level, our analyses recognize that the tax motive reflected in country pairings may be to shift income into the subsidiary country when that country's tax rate is less than the tax rate of the parent country or, alternatively, the tax motive may be to shift income out of the subsidiary country if that country's tax rate is greater than the tax rate in the parent country. We therefore separate our analysis

TABLE 2 Sample Distribution Across Subsidiary Countries

Country	Percentage of parent sample (1)	Percentage of subsidiary sample (2)	Percentage of EU 27 GDP ^a (3)
Austria	4.14	1.12	2.80
Belgium	3.29	3.87	3.39
Bulgaria	—	1.27	0.37
Canada	0.59	—	na
China	1.48	—	na
Croatia	0.01	1.26	0.39
Cyprus	2.24	—	0.17
Czech Republic	0.64	6.84	1.42
Denmark	2.53	1.13	2.23
Estonia	0.06	1.51	0.16
Finland	1.78	1.87	1.76
France	7.78	10.35	18.34
Germany	14.96	5.26	24.10
Hungary	1.22	1.15	0.88
Italy	5.90	9.49	14.26
Japan	1.69	0.10	na
Luxembourg	2.94	0.78	0.39
Netherlands	8.14	1.03	5.73
Norway	1.21	2.96	na
Poland	0.46	5.13	3.42
Portugal	0.51	2.06	1.48
Romania	0.26	15.67	1.17
Serbia	0.28	2.85	na
Slovakia	0.45	1.59	0.65
Spain	2.74	6.87	9.05
Sweden	4.33	2.57	3.78
Switzerland	6.00	—	na
Ukraine	0.14	2.07	na
United Kingdom	5.36	7.79	18.54
United States	8.21	—	na
Other countries with less than 1%	10.66	3.41	
Total	100.00	100.00	

EU = European Union; GDP = gross domestic product.

a At the end of the sample period in 2012.

Source: Eurostat (<https://ec.europa.eu/eurostat>).

into two separate models in which the first equation (1a) describes a model where the tax motivation is for the parent to shift income into the subsidiary (that is, the subsidiary's tax rate is lower than the parent's tax rate) and the second equation (1b) describes a model where the tax motivation is to shift income out of the subsidiary and into the parent (that is, the subsidiary's tax rate is higher than the parent's tax rate). We estimate the following models using ordinary least squares (OLS) regression with robust standard errors:

TABLE 3 Descriptive Statistics and Summary of Average Tax Rates

Variable	Panel A: Descriptive statistics					
	Observations	Mean	Standard deviation	25th percentile	Median	75th percentile
<i>Subsidiary Profit</i>	502,796	5.644	2.315	4.060	5.739	7.259
<i>EOI Agreement: All</i>	502,796	0.849	0.358	1.000	1.000	1.000
<i>EOI Agreement: Modern</i>	502,796	0.175	0.379	0.000	0.000	0.000
<i>EOI Agreement: Old</i>	502,796	0.674	0.469	0.000	1.000	1.000
<i>EOI Agreement: Para 4 & 5</i>	502,796	0.063	0.243	0.000	0.000	0.000
<i>EOI Agreement: OECD Reviewed</i>	502,796	0.124	0.329	0.000	0.000	0.000
<i>Tax Difference (Subsidiary Tax Rate – Parent Tax Rate)</i>	502,796	–3.280	9.349	–10.000	–3.290	3.000
<i>Tax Motivation: Shift-In</i>	502,796	0.613	0.487	0.000	1.000	1.000
<i>Tax Motivation: Shift-Out</i>	502,796	0.353	0.477	0.000	0.000	1.000
<i>Tax Haven Subsidiary</i>	502,796	0.016	0.125	0.000	0.000	0.000
<i>High Intangibles</i>	502,796	0.250	0.447	0.000	0.000	1.000
<i>Transfer-Pricing Enforcement: Parent High</i>	502,796	0.508	0.499	0.000	1.000	1.000
<i>Transfer-Pricing Enforcement: Both High</i>	502,796	0.328	0.469	0.000	0.000	1.000
<i>Subsidiary Labour Costs</i>	502,796	6.410	2.420	5.040	6.720	8.110
<i>Subsidiary Total Assets</i>	502,796	5.956	2.998	3.890	5.968	8.090
<i>Subsidiary Country's GDP</i>	502,796	10.093	0.507	9.690	10.261	10.440
<i>Subsidiary Intangible Assets</i>	502,796	2.020	2.700	0.000	0.000	3.710

(Table 3 is concluded on the next page.)

TABLE 3 Concluded

Panel B: Summary of average tax rates across sample and subsamples		
	Parent country Average tax rate	Subsidiary country Average tax rate
	<i>percent</i>	
Total sample	28.80	25.44
Subsamples		
<i>Shift-In</i> = 1	32.03	22.65
<i>Shift-In</i> = 0	23.70	29.89
<i>Shift-Out</i> = 1	23.86	30.72
<i>Shift-Out</i> = 0	31.46	22.62
<i>Tax Haven</i> = 1	30.59	21.81
<i>Tax Haven</i> = 0	28.76	25.54
<i>High Intangibles</i> = 1	29.07	26.29
<i>High Intangibles</i> = 0	28.52	24.56
<i>Parent Country High Enforcer</i> = 1	33.07	25.88
<i>Parent Country High Enforcer</i> = 0	27.42	26.06

$$\begin{aligned} \text{Subsidiary Income} = & \beta_1 \text{Tax Motivation: Shift-In} \times \text{EOI Agreement} \\ & + \beta_2 \text{Tax Motivation: Shift-In} + \beta_3 \text{EOI Agreement} \\ & + \beta X + \varepsilon \end{aligned} \quad (1a)$$

$$\begin{aligned} \text{Subsidiary Income} = & \beta_1 \text{Tax Motivation: Shift-Out} \times \text{EOI Agreement} \\ & + \beta_2 \text{Tax Motivation: Shift-Out} + \beta_3 \text{EOI Agreement} \\ & + \beta X + \varepsilon, \end{aligned} \quad (1b)$$

where

Subsidiary Income = the natural logarithm of EBIT reported in the unconsolidated financial statements of the subsidiary in the year (data obtained from the ORBIS data set).

Tax Motivation: Shift-In (*Shift-In*) = 1 when the tax rate in the subsidiary country is less than the tax rate in the parent country; 0 otherwise (data obtained from Ernst & Young's worldwide corporate tax guides and supplemented with KPMG's global tax database).

Tax Motivation: Shift-Out (*Shift-Out*) = 1 when the tax rate in the subsidiary country is less than the tax rate in the parent country; 0 otherwise (data obtained from Ernst & Young's worldwide corporate tax guides and supplemented with KPMG's global tax database).

EOI Agreement: All Agreements = 1 if an EOI agreement exists between the parent and the subsidiary countries in the year; 0 otherwise (data obtained from the OECD's EOI portal).

X is a vector of variables to control for the non-discretionary determinants of the subsidiary's income.

FIGURE 1 Percentage of Country Pairings with Exchange-of-Information Agreements

We assume that the subsidiary's economic income (non-discretionary income) is determined by the subsidiary's assets, labour costs, and investment in intangible assets, as well as the economic well-being attributable to its country of operations, measured by GDP. The specific variables controlled for are measured as follows:

Subsidiary Assets = the natural logarithm of total assets in the subsidiary as reported in the ORBIS database.

Subsidiary Labour Costs = the natural logarithm of the subsidiary's labour costs as reported in the ORBIS database.

Subsidiary Country GDP = the natural logarithm of the GDP of the subsidiary country in the year as reported in the World Bank database.

Subsidiary Intangible Assets = the natural logarithm of the value of the intangible assets reported by the subsidiary (data obtained from the ORBIS data set).

Descriptive statistics for each of the variables in the model are shown in table 3.

In addition to the controls for economic determinants of the subsidiary's income, we include fixed effects for the year, country of the subsidiary, and country of the parent. In supplemental testing, in columns 2 and 4 of table 4 we also include fixed effects for industry. Last, we estimate the model using OLS with robust standard errors.⁴⁴

We expect a positive coefficient on *Tax Motivation: Shift-In*, since the lower tax rate in the subsidiary provides a motivation to report higher income in the subsidiary. The interaction between *Shift-In* and *EOI Agreement* in equation 1a measures

44 In untabulated results, we estimate equations 1a and 1b using robust regression to control for outliers and find substantively similar results.

TABLE 4 Analyses of the Impact of EOI Agreements on Tax-Motivated Income Shifting by Multinational Enterprises: All EOI Agreements

	Prediction sign	Subsidiary income (1)	Subsidiary income (2)	Subsidiary income (3)	Subsidiary income (4)
<i>Shift-In × EOI Agreement</i>	-	-0.051 *** (-4.050)	-0.048 *** (-3.829)		
<i>Shift-Out × EOI Agreement</i>	+			0.076 *** (6.064)	0.069 *** (5.587)
<i>Tax Motivation: Shift-In</i>	+	0.057 *** (4.566)	0.044 *** (3.571)		
<i>Tax Motivation: Shift-Out</i>	-			-0.07 *** (-5.647)	-0.057 *** (-4.691)
<i>EOI Agreement: All</i>	?	0.017 * (1.733)	0.02 ** (2.081)	-0.043 *** (-5.225)	-0.035 *** (-4.315)
<i>Subsidiary Assets</i>	+	0.244 *** (205.580)	0.235 *** (180.685)	0.244 *** (205.594)	0.235 *** (180.699)
<i>Subsidiary Labour Costs</i>	+	0.491 *** (289.089)	0.515 *** (284.672)	0.491 *** (289.125)	0.515 *** (284.694)
<i>Subsidiary Country GDP</i>	+	-0.482 *** (-15.953)	-0.506 *** (-16.971)	-0.478 *** (-15.813)	-0.502 *** (-16.854)
<i>Subsidiary Intangible Assets</i>	?	0.024 *** (24.739)	0.023 *** (23.405)	0.024 *** (24.723)	0.023 *** (23.388)
Constant	?	4.401 *** (8.052)	3.342 *** (5.918)	4.445 *** (8.131)	3.38 *** (5.983)
Subsidiary country fixed effects		Yes	Yes	Yes	Yes
Parent country fixed effects		Yes	Yes	Yes	Yes
Year fixed effects		Yes	Yes	Yes	Yes
Industry fixed effects			Yes		Yes
Observations		502,796	500,818	502,796	500,818
R ²		0.644	0.657	0.644	0.657

EOI = exchange of information; GDP = gross domestic product.

Notes: Robust *t*-statistics in parentheses. *** *p* < 0.01, ** *p* < 0.05, * *p* < 0.1, all two-tailed.

the impact of the existence of an EOI agreement on tax-motivated income shifting. Hypotheses 1a and 1b predict a negative coefficient on this interaction between *Shift-In* and *EOI Agreement*, since we predict that the existence of the EOI agreement will moderate the tax incentive to shift income into the subsidiary.

Conversely, we expect a negative coefficient on *Tax Motivation: Shift-Out*, since the higher tax rate in the subsidiary provides a motivation to report less income in the subsidiary. The interaction between *Shift-Out* and *EOI Agreement* in equation 1b provides an alternative measure of the impact of the existence of an EOI agreement on tax-motivated income shifting. Note that *Shift-Out* is not simply the inverse of *Shift-In*, since 17,095 firm-year observations are in country pairings that share the same tax rate and therefore would not be considered to have a *Shift-In* or *Shift-Out* motivation. Hypotheses 1a and 1b predict a positive coefficient on the interaction between *Shift-Out* and *EOI Agreement* to moderate the negative impact of *Shift-Out* on the subsidiary's reported income.

We investigate hypotheses 2a and 2b by estimating equations 1a and 1b on a sample that is limited to only firm-year observations where EOI agreements are in place. We substitute the broad definition of EOI agreement to represent a subset of modern agreements:

EOI Agreement: Modern = 1 if an EOI agreement exists between the countries of the parent and the subsidiary in the year and that agreement came into force in 2002 or later; 0 otherwise (data obtained from the OECD's EOI portal).

Once again, the main variable of interest is the interaction between the tax motivation and the EOI agreement, which this time represents only modern agreements. Hypotheses 2a and 2b predict that the moderating impact on tax-motivated income shifting will be greater when a modern agreement is used. Therefore, hypotheses 2a and 2b predict a negative coefficient on the interaction between *EOI Agreement: Modern* and *Shift-In* and a positive coefficient on the interaction between *EOI Agreement: Modern* and *Shift-Out*.

RESULTS

Multivariate Regression Results Testing Hypotheses 1a and 1b

To test the hypotheses, we estimate equations 1a and 1b using OLS regression with robust standard errors to explore the impacts of tax-related motivations and the existence of EOI agreements on tax-motivated income shifting by the MNE. The results of estimating equation 1a, exploring *Tax Motivation: Shift-In*, are reported in columns 1 and 2 of table 4. The coefficient on *Shift-In* is positive and statistically significant at a 1 percent level, and provides evidence supporting the existence of tax-motivated income shifting into the subsidiary, since tax rates that are lower in the subsidiary country than in the parent country are correlated with greater levels of discretionary income reported in the subsidiary by the MNE. Hypothesis 1a predicts a negative coefficient on the interaction between *Shift-In* and *EOI Agreement*,

which suggests that the existence of *any* EOI agreement moderates the tax incentive to shift income into the lower-taxed subsidiary by the MNE. Consistent with hypothesis 1a, the coefficient on the interaction of *Shift-In* and *EOI Agreement* is -0.051 and significant at a 1 percent level. Column 2 provides a substantively similar result supporting hypothesis 1a while including industry fixed effects. The sum of the coefficient on *Shift-In* and the interaction between *Shift-In* and *EOI Agreement* is not statistically different from zero, suggesting that the impact of *Shift-In* is completely mitigated by the existence of an EOI agreement.

Columns 3 and 4 of table 4 present the results of estimating equation 1b and investigate *Tax Motivation: Shift-Out*. As predicted, the main effect on *Shift-Out* is negative and statistically significant at a 1 percent level, suggesting that less income is reported in the subsidiary when the tax rate in the subsidiary country is higher than the tax rate in the parent country. The coefficient on *EOI Agreement* $\times$ *Shift-Out* is positive and statistically significant at a 1 percent level and supports hypothesis 1b. Collectively, the evidence in table 4 provides evidence that the existence of an EOI agreement moderates the tax-motivated income shifting of MNEs.

Multivariate Regression Results Testing Hypotheses 2a and 2b

Table 5 provides the results of testing hypotheses 2a and 2b. Columns 1 and 2 provide insights into the effectiveness of early EOI agreements in moderating tax-motivated income shifting. Equations 1a and 1b are estimated using early EOI agreements measured as

EOI Agreement: Early = 1 if an EOI agreement exists between the countries of the parent and the subsidiary in the year and that agreement came into force before 2002; 0 otherwise (data obtained from the OECD's EOI portal).

Column 1 of table 5 provides the results of estimating equation 1a. The coefficient on the interaction between *Shift-In* and *EOI Agreement: Early* is not statistically significant, providing no evidence that early EOI agreements moderate tax-motivated income shifting into the subsidiary. Column 2 provides the *Shift-Out* results. The coefficient on the interaction of *EOI Agreement: Early* and *Shift-Out* is positive as predicted, at 0.02, and marginally significant at a 10 percent level. This provides some evidence that early EOI agreements do moderate some tax-motivated income shifting.

Columns 3 and 4 of table 5 present the results of again estimating equations 1a and 1b, respectively, this time using *EOI Agreement: Modern* as the measure of *EOI Agreement*. The coefficients on the interaction variables are as predicted and statistically significant at a 1 percent level. Specifically, the coefficient on *EOI Agreement: Modern* $\times$ *Shift-In* is -0.027 , and the coefficient on *EOI Agreement: Modern* $\times$ *Shift-Out* is 0.036, providing evidence that modern EOI agreements moderate tax-motivated income shifting.

Although columns 1 to 4 are useful to illustrate the differences between early and modern EOI agreements, to test for a statistical difference between the modern and

TABLE 5 Analyses of the Effectiveness of Early Versus Modern EOI Agreements

	EOI Agreement: Prediction sign	Sample				
		All firm-years Early agreements (1)	All firm-years Modern agreements (3)	All firm-years Modern agreements (4)	Only firm-years with EOI agreements Modern agreements (5) (6)	
<i>Shift-In</i> × <i>EOI Agreement</i>	−	−0.005 (−0.475)	−0.027 ** (−2.034)		−0.033 ** (−2.291)	
<i>Shift-Out</i> × <i>EOI Agreement</i>	+		0.02 * (1.854)	0.036 *** (2.584)		0.04 *** (2.657)
<i>Tax Motivation: Shift-In</i>	+	0.018 * (1.736)	0.017 *** (2.639)		0.012 (1.617)	
<i>Tax Motivation: Shift-Out</i>	−		−0.021 ** (−2.013)	−0.010 (−1.492)		0.005 (0.725)
<i>EOI Agreement</i>	?	0.026 *** (2.946)	−0.021 * (−1.792)	−0.05 *** (−7.156)	−0.012 (−0.983)	−0.046 *** (−6.043)
<i>Subsidiary Assets</i>	+	0.244 *** (205.601)	0.244 *** (205.562)	0.244 *** (205.557)	0.242 *** (188.992)	0.242 *** (188.995)
<i>Subsidiary Labour Costs</i>	+	0.491 *** (289.151)	0.491 *** (289.125)	0.491 *** (289.141)	0.489 *** (268.398)	0.489 *** (268.428)
<i>Subsidiary Country GDP</i>	+	−0.482 *** (−15.942)	−0.48 *** (−15.876)	−0.487 *** (−16.110)	−0.465 *** (−14.297)	−0.461 *** (−14.159)
<i>Subsidiary Intangible Assets</i>	+	0.024 *** (24.764)	0.024 *** (24.757)	0.024 *** (24.792)	0.026 *** (24.119)	0.026 *** (24.120)
Constant	?	4.389 *** (8.028)	4.393 *** (8.031)	4.419 *** (8.084)	4.848 *** (8.002)	4.826 *** (8.011)
Subsidiary country fixed effects		Yes	Yes	Yes	Yes	Yes
Parent country fixed effects		Yes	Yes	Yes	Yes	Yes
Year fixed effects		Yes	Yes	Yes	Yes	Yes
Observations		502,796	502,796	502,796	426,674	426,674
R ²		0.644	0.644	0.644	0.642	0.642

EOI = exchange of information; GDP = gross domestic product.

Notes: Robust *t*-statistics in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$, all two-tailed.

early agreements, we run analyses reported in columns 5 and 6. As described above, we estimate equations 1a and 1b limiting the sample to only firm-year observations where an agreement is present. We use *EOI Agreement: Modern* as the measure of *EOI Agreement*. If there were no difference between the types of agreements (early and modern), we would expect the coefficients on the interaction between tax motivations and *EOI Agreement: Modern* to be insignificant. However, hypothesis 2a predicts that the interaction coefficient (that is, the coefficient on the interaction between *EOI Agreement* and *Shift-In*) will again be negative to moderate *Shift-In*, and hypothesis 2b predicts the interaction coefficient (that is, the coefficient on the interaction between *EOI Agreement* and *Shift-Out*) to be positive to moderate *Shift-Out*. The coefficients are negative (positive) and statistically significant at a level of 5 percent or greater for the interaction with *Shift-In* (*Shift-Out*) as predicted, providing evidence that there is a statistically significant difference in the moderating effect of EOI agreements on tax-motivated income shifting between modern and early EOI agreements. Importantly, modern EOI agreements are correlated with greater moderation of tax-motivated income shifting compared to early EOI agreements.

Collectively, the evidence in table 5 is consistent with the evidence in table 4 and supports hypotheses 1a and 1b that EOI agreements moderate tax-motivated income shifting of MNEs, since both early and modern agreements show some evidence of effectiveness. Importantly, the results in columns 5 and 6 of table 5 provide consistent evidence that not all EOI agreements are equal in effectiveness. Specifically, the advances in developing effective EOI agreements that started with the 2002 OECD model TIEA result in EOI agreements that are associated with greater moderation of tax-motivated income shifting compared to earlier EOI agreements, supporting hypotheses 2a and 2b.

Specification Checks

EOI Agreement Specification

The measure of EOI agreements includes both DTCs and TIEAs. To control for the effects of the DTCs' additional scope, we ran equations 1a and 1b additionally including an indicator variable controlling for differences between TIEAs and DTCs. In untabulated results, we found that agreement type made no difference in the impact of agreements on tax-motivated income shifting, and results were substantively similar when this variable was included.

Large Tax-Rate Differentials

To ensure that the results were not driven by observations with exceptionally large tax-rate differentials, we estimated equations 1a and 1b after dropping the top 5 percent of tax differentials. The results remained substantively consistent with those in table 4, suggesting that the results are not being driven by observations with exceptionally large tax differentials.

Supplemental Testing

In the analyses discussed below, we further explore the effectiveness of modern EOI agreements to moderate tax-motivated income shifting. First, we explore specific elements of modern EOI agreements that may be responsible for the increased effectiveness. Specifically, we explore the impact of including paragraphs 4 and 5 of article 26 and the impact of OECD review for modern agreements.

Second, given that the purpose of EOI agreements is to reduce the information asymmetry between MNEs and tax authorities, we investigate whether the effectiveness of modern EOI agreements to moderate tax-motivated income shifting may be affected by situations where information asymmetry between the MNE and tax authorities may be higher or lower. For example, information asymmetry may be higher in situations where the MNE has a subsidiary in a tax haven country or the MNE has high levels of intangibles. Also, information asymmetry between the MNE and the tax authority may already be reduced in situations where the tax authority or authorities have invested in strong transfer-pricing disclosure regulations and enforcement.

Characteristics of Modern EOI Agreements

Two of the enhancements suggested as being responsible for the increased effectiveness of modern EOI agreements are the inclusion of paragraphs 4 and 5 of article 26 and OECD review. To consider whether these features further enhance the effectiveness of modern EOI agreements, we create two additional measures of EOI agreements and undertake analyses as follows:

EOI Agreement: Para 4 & 5 = 1 if an EOI agreement exists between the countries of the parent and the subsidiary in the year and that agreement contains paragraphs 4 and 5 of article 26; 0 otherwise (data obtained from the OECD's EOI portal).

EOI Agreement: OECD Reviewed = 1 if an EOI agreement exists between the countries of the parent and the subsidiary in the year and that agreement has been reviewed by the OECD and met the standards; 0 otherwise (data obtained from the OECD's EOI portal).

In untabulated results, we estimate equation 1a using a sample restricted to only firm-year observations that are in a country pairing with an *EOI Agreement: Modern*. We then use *EOI Agreement: Para 4 & 5* and *EOI Agreement: OECD Reviewed* as measures of EOI in two different estimations of equation 1a. The coefficients on the interaction of *EOI Agreement* $\times$ *Shift-In* in both the *EOI Agreement: Para 4 & 5* and the *EOI Agreement: OECD Reviewed* estimations are not statistically significant. This result suggests that although analyses in table 5 provide evidence that modern EOI agreements are more effective than early EOI agreements in moderating tax-motivated income shifting, within modern EOI agreements we find no evidence that modern EOI agreements that have paragraphs 4 and 5 of article 26 or have met the

OECD standards on review are more effective than other modern EOI agreements. One caveat to this analysis is that adoption of paragraphs 4 and 5 and the frequency of OECD review increased substantially in the latter portion of our sample. For example, considering new agreements coming into force, only 29 percent contained paragraphs 4 and 5 in 2006, the year after those provisions were included in the 2005 OECD model convention. However, 96 percent of new EOI agreements coming into force in 2012 contained such provisions. Similarly, when considering agreements that have been reviewed by the OECD and met the standard, the OECD database indicates that only 54 percent of new agreements coming into force in 2006 had been reviewed and met the standards of the OECD, compared to 85 percent of agreements that came into force in 2012. Therefore, although the sample period of 2003-2012 is well suited for testing our hypotheses, for reasons discussed previously, it may not be ideal for considering the impact of these specific characteristics of modern EOI agreements on income shifting. These specific characteristics may warrant future study, beyond the scope of this article.

Subsample Analyses

Since EOI agreements are intended to reduce tax-motivated income shifting via a reduction in the information asymmetry between the MNE and the tax authority, the analyses discussed below investigate the impact of various subsamples associated with higher or lower information asymmetry on the effectiveness of modern EOI agreements. For clarity of explanation, we report the results of the supplemental analyses using exclusively *Tax Motivation: Shift-In*. Untabulated results estimating equation 1b, using *Shift-Out*, provide substantively similar conclusions. To investigate the impact of subsamples where information asymmetry may be higher or lower, we use an analysis that involves introducing the subsample as an additional variable and interact it with our main variable of interest *EOI Agreement* $\times$ *Tax Motivation*. This results in a three-way interaction model to test each of the following subsamples. We include all interaction terms and main effects for the three variables (*Tax Motivation*, *EOI Agreement*, and *Subsample*). Since the results in table 6 consider only the *Shift-In* tax motivation, the evidence in tables 4 and 5 suggests that modern EOI agreements have a negative impact on the tax motivation to shift income into a subsidiary. Therefore, a three-way interaction in the following analyses can have one of the following three results:

1. A statistically significant negative coefficient on the three-way interaction suggests that the effectiveness of the modern EOI agreements to moderate the tax motivation to shift income into the subsidiary is improved when the subsample is present.
2. A statistically significant positive coefficient on the three-way interaction suggests that the effectiveness of the modern EOI agreements to moderate the tax motivation to shift income into the subsidiary is diminished when the subsample is present.

TABLE 6 Analyses of the Heterogeneous Impacts of Modern EOI Agreements on Tax-Motivated Income Shifting

	Prediction sign	Subsample			
		Tax haven subsidiary (1)	High level of intangibles (2)	Both high enforcers (3)	Parent country high enforcer (4)
<i>Impact of EOI on Shift-In × Subsample</i>	?	-0.256 (-0.797)	0.064 ** (2.438)	-0.120 *** (-3.496)	-0.077 ** (-2.446)
<i>Impact of EOI on Shift-In</i>	-	-0.027 ** (-2.000)	-0.043 *** (-2.652)	-0.043 *** (-1.214)	-0.032 (-1.637)
<i>Subsample × Shift-In</i>	?	-0.44 *** (-6.237)	0.058 *** (5.990)	0.003 *** (3.480)	-0.043 *** (-3.977)
<i>EOI × Subsample</i>	?	0.005 (0.015)	0.017 (0.740)	0.066 ** (2.131)	0.019 (0.679)
<i>Tax Motivation: Shift-In</i>	+	0.041 *** (3.108)	-0.001 (-0.140)	0.000 (0.016)	0.035 *** (4.016)
<i>EOI Agreement: Modern</i>	?	-0.018 (-1.489)	-0.019 (-1.355)	-0.003 (-0.186)	0.022 (1.344)
<i>Subsample</i>	?	-1.527 *** (-3.024)	-0.236 *** (-32.614)	0.066 ** (2.131)	0.006 (0.632)
<i>Subsidiary Assets</i>	+	0.244 *** (205.605)	0.245 *** (217.330)	0.238 *** (164.287)	0.242 *** (186.426)
<i>Subsidiary Labour Costs</i>	+	0.491 *** (289.188)	0.506 *** (296.208)	0.517 *** (239.617)	0.498 *** (267.710)
<i>Subsidiary Country GDP</i>	+	-0.486 *** (-16.076)	-0.488 *** (-15.798)	-0.319 *** (-7.101)	-0.318 *** (-9.140)
<i>Subsidiary Intangible Assets</i>	?	0.024 *** (24.824)	na	0.014 *** (13.094)	0.023 *** (22.350)
Constant		4.401 *** (8.047)	1.015 (0.046)	6.850 (0.118)	6.599 (0.013)
Subsidiary country fixed effects		Yes	Yes	Yes	Yes
Parent country fixed effects		Yes	Yes	Yes	Yes
Year fixed effects		Yes	Yes	Yes	Yes
Observations		502,796	502,796	354,126	430,533
R ²		0.644	0.634	0.609	0.635

EOI = exchange of information; GDP = gross domestic product.

Notes: Robust *t*-statistics in parentheses. *** *p* < 0.01, ** *p* < 0.05, * *p* < 0.1, all two-tailed.

3. An insignificant coefficient suggests that the effectiveness of the modern EOI agreements to moderate the tax motivation to shift income into the subsidiary is neither improved nor diminished when the subsample is present.

HIGHER INFORMATION ASYMMETRY SUBSAMPLES

Two situations associated with higher information asymmetry between MNEs and tax authorities are the use of tax havens and companies that have a higher level of intangible assets relative to tangible assets.

Tax Havens

Owing to the opaque nature of tax havens, EOI agreements involving a subsidiary in a tax haven are of interest for tax authorities dealing with MNEs. However, the interest of tax haven countries in providing information, even if an agreement is signed, remains unclear. We undertake a supplemental analysis to investigate whether the involvement of a tax haven in an EOI agreement affects the agreement's moderating impact on tax-motivated income shifting as documented above. Our primary variable of interest is the interaction of *Tax Haven* with *Impact of EOI on Shift-In*, documented previously. Specifically, we model

$$\text{Subsidiary Income} = \beta_1 \text{Tax Haven} \times \text{Impact of EOI on Shift-In} + \beta Y + \beta X + \varepsilon, \quad (2)$$

where

Impact of EOI on Shift-In = *EOI Agreement: Modern* $\times$ *Tax Motivation: Shift-In*. Both variables are measured as described above.

Tax Haven = 1 if the subsidiary's country is listed as a tax haven according to Hines; 0 otherwise.⁴⁵

Y is a vector of all main effects and two-way interaction variables between the variables in the principal three-way interaction (*EOI Agreement: Modern*, *Shift-In*, and *Tax Haven*).

X is a vector of control variables included in equations 1a and 1b.

Column 1 of table 6 presents the results of estimating equation 2, providing insights into the impact of tax haven involvement on the effectiveness of modern EOI agreements. The coefficient on the interaction of *Tax Haven* $\times$ *Impact of EOI on Shift-In* is not statistically significant. This evidence suggests that *Impact of EOI on Shift-In* is not statistically different for subsidiaries in tax haven countries and subsidiaries in non-tax haven countries. Put another way, modern EOI agreements appear to be equally effective whether the subsidiary is in a tax haven or a non-tax haven country. However, it is possible that the lack of statistical significance is due to a lack of statistical power since, within this study's sample, only 1.6 percent of our subsidiary sample contains tax haven observations. We leave deeper exploration of this issue using more tax haven-centric data to future research.

45 James R. Hines Jr., "Treasure Islands" (2010) 24:4 *Journal of Economic Perspectives* 103-26.

High Levels of Intangibles

Intangibles often create opportunities for MNEs to shift income, since intangible assets such as patents and trademarks are often more easily shifted across jurisdictions than tangible assets such as manufacturing equipment or plants. The determination of internal transfer prices for intangibles has a high level of asymmetry, because it relies on the MNE's proprietary data and judgments, owing to the lack of comparable external prices. The lack of an external comparable market heightens the information asymmetry between the MNE and the tax authority because an objective price is not easily identified by the external tax authority. We therefore investigate the impact of the heightened information asymmetry on the effectiveness of modern EOI agreements.

$$\text{Subsidiary Income} = \beta_1 \text{High Intangibles} \times \text{Impact of EOI on Shift-In} + \beta_2 \text{Impact of EOI on Shift-In} + \beta_Y Y + \beta_X X + \varepsilon, \quad (3)$$

where

Impact of EOI on Shift-In = *EOI Agreement: Modern* $\times$ *Shift-In Tax Motivation*. Both variables are measured as described above.

High Intangibles = 1 if the subsidiary country is in the top quartile of intangible assets/total assets in the sample; 0 otherwise.

Y is a vector of all main effects and two-way interaction variables between the variables in the principal three-way interaction (*EOI Agreement: Modern*, *Tax Motivation: Shift-In*, and *High Intangibles*).

X is a vector of control variables included in equations 1a and 1b.

We estimate equation 3 using OLS regression with robust standard errors, and the results are provided in column 2 of table 6. The coefficient on the interaction between *High Intangibles* and *Impact of EOI on Shift-In* is positive and statistically significant at a 5 percent level. This result suggests that the impact of modern EOI agreements on the tax motivation to shift in is decreased when the MNE has a high level of intangibles compared to the situation where the MNE has a low level of intangibles. This result suggests that the effectiveness of modern EOI agreements can vary depending on the characteristics of the MNE, particularly when factors such as higher levels of intangibles create greater information asymmetry between the tax authority and the MNE.

LOWER INFORMATION ASYMMETRY SUBSAMPLES: TAX AUTHORITY TRANSFER-PRICING ENFORCEMENT

Prior studies have documented the impact of transfer-pricing enforcement on the behaviour of MNEs.⁴⁶ We explore whether the level of transfer-pricing enforcement in the countries of the parent and the subsidiary has an impact on the effectiveness

46 Mescall and Klassen, *supra* note 13.

of EOI agreements in moderating tax-motivated income shifting. We begin by investigating whether countries that have already invested in robust transfer-pricing disclosure regulations and strong enforcement to reduce information asymmetry between the tax authority and MNEs benefit from an EOI agreement as much as countries that have not. It is possible that if both the parent country and the subsidiary country already have and enforce strong transfer-pricing regulations, EOI agreements may not be needed. Alternatively, tax authorities with strong transfer-pricing regulations and enforcement may be best prepared to use EOI agreements to reduce information asymmetry and maximize the benefits of such agreements. We therefore explore whether the impact of EOI agreements on tax-motivated income shifting is affected when transfer-pricing regulations and enforcement are strong. We undertake analysis by estimating the following model using OLS regression with robust standard errors:

$$\begin{aligned} \text{Subsidiary Income} = & \beta_1 \text{Transfer-Pricing Enforcement} \times \text{Impact of EOI on Shift-In} \\ & + \beta_Y + \beta_X + \varepsilon, \end{aligned} \quad (4)$$

where

Impact of EOI on Shift-In = *EOI Agreement* $\times$ *Shift-In Tax Motivation*. Both variables are measured as described above.

Transfer-Pricing Enforcement is measured in two different ways:

Both High Enforcers = 1 if both the subsidiary country and the parent country rank above the median in severity of transfer-pricing enforcement ranking in the year; 0 otherwise. Transfer-pricing enforcement ranking is measured as described in Mescall and Klassen.⁴⁷

Parent Country High Enforcer = 1 if the parent country ranks above the median in severity of transfer-pricing enforcement ranking in the year; 0 otherwise. Again, transfer-pricing enforcement ranking is measured as described in Mescall and Klassen.

Columns 3 and 4 of table 6 provide the results of estimating equation 4 using *Both High Enforcers* and *Parent Country High Enforcer* as the measures of *Transfer-Pricing Enforcement*. In column 3, the coefficient on the interaction of *Both High Enforcers* and *Impact of EOI on Shift-In* is negative and statistically significant at a 1 percent level. This suggests that the effectiveness of modern EOI agreements is enhanced when both countries already have strong transfer-pricing regulations and enforcement relative to other situations where at least one party to the EOI agreement does not have strong transfer-pricing enforcement. This in turn suggests that even when both countries already have strong transfer-pricing enforcement, an EOI agreement is associated with lower tax-motivated income shifting.

47 Mescall and Klassen, *ibid.*, develop a country-year specific measure of transfer-pricing risk that considers both the severity of transfer-pricing rules and enforcement.

Column 4 of table 6 displays the results of estimating equation 4 using *Transfer-Pricing Enforcement: Parent Country High Enforcer*. Since this analysis is focused on *Tax Motivation: Shift-In*, the parent country's tax authority is more likely to lose tax revenue owing to a higher tax rate compared to the tax authority in the subsidiary country. This analysis therefore focuses on the tax authority in the pairing that is most likely to apply and use the EOI agreement. In column 4 of table 6, the coefficient on the interaction of *Parent Country High Enforcer* and *Impact of EOI on Shift-In* is negative and statistically significant at a 1 percent level. This suggests that EOI agreements have a greater impact in reducing tax-motivated income shifting when the parent country already has strong transfer-pricing regulations and enforcement than when the parent country does not have such regulations and enforcement. This in turn suggests that an EOI agreement can be more effective in the hands of a tax authority that already has strong transfer-pricing regulations and enforcement in place. Thus, EOI agreements may be viewed as a complement to strong transfer-pricing measures, and not as a substitute therefor, in moderating tax-motivated income shifting.

Collectively, the results of our subsample analyses suggest that while EOI agreements are a useful tool to moderate tax-motivated income shifting by reducing information asymmetry between MNEs and tax authorities, in specific cases both situational factors and characteristics of the MNE and the tax authority can enhance or diminish the ability of the modern EOI agreement to moderate such behaviour by multinational corporations.

CONCLUSION

Our study investigates the impact of EOI agreements on tax-motivated income shifting by multinational corporations. We find evidence that EOI agreements between the MNE's parent country and the subsidiary country can have an impact on tax-motivated income shifting by the MNE, but some agreements are more effective than others. When we focus the analyses on modern versus early EOI agreements, we find that the existence of a modern EOI agreement is associated with a greater reduction in tax-motivated income shifting within the MNE. We define a modern EOI agreement as an agreement coming into force in 2002 or after, to coincide with the 2002 Agreement on Exchange of Information on Tax Matters that resulted from the OECD's global forum on transparency. In the sample of 55 countries over the period 2003–2012, 17.5 percent of EOI agreements were modern agreements.

The evidence of this study has several implications for policy makers and academics interested in continuing progress toward effective multilateralism in tax. First, we provide new insights into the impact of EOI agreements on the contemporary issue of corporate income shifting. Prior studies have investigated the impact of EOI agreements on individual taxpayer behaviours and have reported mixed results. This study is the first to document the direct impacts of EOI agreements on the tax-motivated income shifting of multinational corporations. MNEs benefit from the information asymmetry between themselves and domestic tax authorities with

respect to the MNE's global tax structure and operations. The results suggest that MNEs are sophisticated, and modern EOI agreements appear to be effective in improving the information environment of the tax authority.

Second, although prior empirical research has largely assumed that EOI agreements are homogeneous in nature, the evidence highlights the potential implications of maintaining this assumption. Although we focus only on one characteristic of the agreements—that is, early versus modern agreements—the results suggest that the impact on taxpayer behaviour may not be homogeneous. Applying the assumption that EOI agreements are homogeneous, Kemme et al., Hanlon et al., and Grottko and Kittl all found incongruous results on the impact of EOI agreements.⁴⁸ Given this study's evidence highlighting the differential impact on taxpayer behaviour across early versus modern EOI agreements, heterogeneity in EOI agreements may allow future research to reconcile the incongruous results from prior studies.

Third, supplemental analyses suggest that in addition to heterogeneity in the nature of agreements, heterogeneity in the information asymmetry between the MNE taxpayer and the tax authority also enhances or diminishes the effectiveness of EOI agreements in moderating tax-motivated income shifting. Specifically, the results suggest that EOI agreements are less effective when MNEs have high levels of intangibles, resulting in less transparency between the MNE and tax authorities. Additionally, EOI agreements may be more effective when tax authorities have invested in reducing information asymmetry through other means such as strong transfer-pricing disclosure rules and enforcement.

The study has several limitations. First, the study's reliance on tax rates does not account for the subtleties of some complex tax-avoidance strategies used by MNEs. Some of these strategies' advantages, such as double non-taxation, are not picked up by tax-rate differentials. Second, the study estimates tax constructs using Bureau van Dijk's ORBIS database, which reflects financial reporting numbers and not tax return data, and therefore may be subject to noise related to differences between financial and tax reporting rules and motivations. Additionally, readers should be aware, when considering our evidence, that consistent with other cross-jurisdictional studies, we were not able to control for all other economic and legislative impacts over the study period. Through our research design choices (for example, the sample period and our selection of control variables such as GDP and fixed effects for subsidiary country, parent country, and year), we have attempted to limit the influence of alternative economic circumstances and factors such as BEPS and AEOIAs that could affect our evidence. Additionally, we are unaware of other legislation or agreements that would vary over time and across country pairings in a similar fashion, but we cannot rule out that these may exist.

This new evidence on the impact of EOI agreements on tax-motivated income shifting creates several opportunities for future research investigating the role of

48 Kemme et al., *supra* note 29; Hanlon et al., *supra* note 28; and Grottko and Kittl, *supra* note 31.

multilateralism in tax matters in influencing corporate tax behaviour. Our examination is Europe-centric, reflecting the nature of the available ownership data. Additional research could consider other regional relationships or undertake a more comprehensive global examination. Our evidence suggests that the reduction of information asymmetry between MNEs and tax authorities contributes to the reduction of tax-motivated income shifting responsible for tax base erosion. Further studies focused on the factors responsible for information asymmetry between MNEs and tax authorities, and the interventions that could reduce it, could extend our understanding of this phenomenon.

India's Goods and Services Tax: A Unique Experiment in Cooperative Federalism and a Constitutional Crisis in Waiting

Ajitesh Kir*

PRÉCIS

On a longtemps soutenu qu'il peut être difficile pour des pays fédéraux, en particulier ceux qui disposent de pouvoirs fiscaux infranationaux importants, d'instaurer une taxe sur la valeur ajoutée (TVA) fédérale en raison des problèmes de coordination que cela implique, et qu'ils pourraient donc hésiter à adopter ce type de taxe. Cet article donne un aperçu de l'évolution des structures de TVA dans les systèmes fédéraux, où les différents niveaux de gouvernement ont des pouvoirs fiscaux distincts (qui parfois se chevauchent). L'auteur s'intéresse surtout à la taxe sur les produits et services (TPS) que l'Inde a adoptée récemment, mais il offre également une perspective comparative en examinant les systèmes de TPS/TVA du Canada, du Brésil et de l'Union européenne, et contribue ainsi au corpus jusqu'ici limité de travaux universitaires sur la coordination de la TVA dans les juridictions fédérales.

La TPS est sans doute la plus grande réforme fiscale de l'Inde depuis plusieurs décennies. Instaurée principalement pour créer un marché national unifié et mettre fin aux guerres fiscales et aux distorsions économiques, la réforme fiscale avait pour principal slogan « TPS — une nation, une taxe, un marché ». Cet article s'attarde à une caractéristique unique de la conception institutionnelle de la TPS indienne : un organisme central pour tous les États appelé le Conseil de la TPS. Ce qui rend cet organisme unique, c'est qu'il est prévu fonctionner suivant les principes du fédéralisme coopératif. Mais est-ce qu'un système fiscal concurrent, dont la survie même repose sur le fédéralisme coopératif, peut garantir un marché national unifié? Si oui, pour combien de temps? L'auteur met en lumière le rôle du Conseil de la TPS dans l'intégration du marché et il explique pourquoi ce conseil a réussi sur plusieurs fronts tout en échouant sur d'autres. Il aborde également une question constitutionnelle non résolue qui pourrait nuire à la capacité du Conseil de la TPS de servir de point d'appui au fédéralisme coopératif, à

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savoir si ses décisions sont exécutoires. L'incertitude entourant cette question pourrait entraîner une crise constitutionnelle si un ou plusieurs États décidaient de faire bande à part. L'auteur aborde quatre mesures qui pourraient être prises pour faire face à cette crise imminente.

ABSTRACT

It has long been argued that federal countries, especially those with strong subnational taxing powers, might face difficulty in implementing a federal value-added tax (VAT) because of coordination issues involved, and therefore might be reluctant to adopt one. This article provides insights on how VAT structures are evolving in federal systems, where different tiers of government have separate (and sometimes overlapping) taxation powers. While the author focuses mainly on India's recently enacted goods and services tax (GST), he also offers a comparative perspective, with reference to the GST/VAT systems in Canada, Brazil, and the European Union, thus adding to the hitherto limited body of scholarly work on VAT coordination in federal jurisdictions.

The GST is arguably India's biggest tax reform in several decades. Introduced primarily to create a unified national market and bring an end to tax wars and economic distortions, the tax reform's chief slogan was "GST—one-nation-one-tax-one-market." This article takes a closer look at a unique institutional design feature of the Indian GST—a centre-state body called the GST council. What makes this body unique is that it is envisaged as functioning on the principles of cooperative federalism. But can a concurrent tax system, whose very survival is based on cooperative federalism, guarantee a unified national market? If yes, for how long? The author highlights the role of the GST council in market integration and explains why the council has succeeded on several fronts while failing on others. He also addresses an unresolved constitutional issue that could affect the GST council's ability to function as the fulcrum for cooperative federalism—namely, the question of whether its decisions are binding. The uncertainty surrounding this issue could lead to a constitutional crisis if one or more states decide to opt out. The author discusses four possible ways to deal with this impending crisis.

KEYWORDS: FISCAL FEDERALISM ■ GOODS AND SERVICES TAX ■ VAT ■ COMPARATIVE ANALYSIS ■ CONSTITUTION ■ INDIA

CONTENTS

Introduction	393
Background	399
Fiscal Federalism in India: Pre-Independence	399
Fiscal Federalism in India: Post-Independence	402
Allocation of Taxing Powers	403
Distribution of Tax Receipts/Revenue Sharing	405
Impact of the GST on Fiscal Federalism	407
Why Was the GST Introduced?	407
Concurrent Taxation Under the GST	412
Revenue Sharing and the GST	418
Rationale for a Centre-State GST Institution	421
Market Integration Through Cooperative Federalism	421
Principles of Cooperative Federalism	421
The Supreme Court of India's Interpretation of Cooperative Federalism	423

The GST Council Experiment	424
Decision-Making Process	424
Has the GST Council Succeeded in Creating a Unified Market?	426
Unresolved Constitutional Issue Relating to the GST Council	428
Are the GST Council's Decisions Binding?	428
Possible Solutions To Avert the Impending Constitutional Crisis	430
Insights from Canada, Brazil, and the European Union	436
Canada	437
Brazil	438
The European Union	441
Conclusion	445

INTRODUCTION

In the interests of the prosperity of the country, a king should be diligent in foreseeing the possibility of calamities, try to avert them before they arise, overcome those which happen, remove all obstructions to economic activity and prevent loss of revenue to the state.

Kautilya, Arthashastra 8.4.50, 8.5.21 (R.P. Kangle, ed., 1963)¹

In India today, “the times they are a-changin’.”² During Prime Minister Narendra Modi’s first term in office (2014–2019), India’s economic growth rate touched a high of 8.3 percent.³ On August 8, 2018, the International Monetary Fund’s (IMF’s) mission chief for India likened the Indian economy to “an elephant starting to run”—in other words, “India’s economy is gaining momentum.”⁴ Only a few years later, it seems that the elephant is running backward. On January 20, 2020 (before the onslaught of the COVID-19 pandemic), the IMF projected India’s economic growth rate to dip to a low of 4.8 percent;⁵ COVID-19 and the resulting economic lockdown sent the projection spiralling further downward.⁶ The weakening of the economy has naturally

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- 1 Kautilya’s *Arthashastra* is an ancient Indian text and possibly the oldest surviving one (about 2,000 years old) on the science of wealth and the business of running a state (in those days, a kingdom). It contains vital information and advice on economic and tax policy, particularly various possible tools of taxation. See also L.N. Rangarajan (editor and translator), *Kautilya: The Arthashastra* (New Delhi: Penguin Books, 1992); and Thomas R. Trautmann, *Arthashastra: The Science of Wealth* (New Delhi: Penguin Books, 2012).
 - 2 Bob Dylan, *The Times They Are A-Changin’*, Columbia Records (1964).
 - 3 International Monetary Fund, “India’s Real GDP, 2016/17, Real GDP Growth Annual Percent Change,” *World Economic Outlook* (Washington, DC: October 2020), table A4.
 - 4 International Monetary Fund, “India’s Strong Economy Continues To Lead Global Growth” (Washington, DC: IMF, August 8, 2018) (<https://www.imf.org/en/News/Articles/2018/08/07/NA080818-India-Strong-Economy-Continues-to-Lead-Global-Growth>).
 - 5 Gita Gopinath, “Tentative Stabilization, Sluggish Recovery?” *IMF Blog*, January 20, 2020 (<https://blogs.imf.org/2020/01/20/tentative-stabilization-sluggish-recovery>).
 - 6 International Monetary Fund, *World Economic Outlook: The Great Lockdown* (Washington, DC: IMF, April 2020); and *World Economic Outlook Update: A Crisis Like No Other, an Uncertain Recovery* (Washington, DC: IMF, June 2020).

had an impact on government revenue, with both direct and indirect tax collections falling significantly short.⁷ Perhaps the economic legacy of the Modi government's first term requires closer attention. Of all the economic measures that were taken then, two stand out for particular scrutiny: demonetization⁸ and the introduction of the goods and services tax (GST). The economic impact of, and the market reaction to, demonetization reveal interesting insights.⁹ This article, however, focuses on the more dynamic and far-reaching measure of the two—the GST. In contrast to what happened in Canada's 1993 federal election, when the Progressive Conservative government under Prime Minister Kim Campbell lost miserably *because* of the GST, Prime Minister Modi's party won comfortably in India's 2019 election *despite* the GST.¹⁰

A form of value-added tax (VAT), the GST is arguably India's biggest tax reform in several decades.¹¹ Indeed, the fanfare surrounding it mirrored that of the announcement of India's independence in 1947. The GST was launched at a special televised midnight session held in the Central Hall of Parliament on June 30, 2017, which was attended by President Pranab Mukherjee, Prime Minister Modi, chief ministers of various states, members of Parliament, bureaucrats, and industrialists.¹²

7 Parliament of India, Lok Sabha, House of People, Written Answers to Unstarred Questions, September 19, 2020.

8 On November 8, 2016, Prime Minister Modi announced in an unscheduled national televised address that the two largest denomination notes, the INR500 and INR1,000 notes, would cease to be legal tender and be replaced by new notes. (INR500 and INR1,000 were equivalent, respectively, to US\$7.50 and US\$15.00, based on the exchange rate of US\$1 = INR66.6 that applied at the time of the announcement.) As a result of this announcement, 86 percent of the existing currency in circulation became illegal tender, effective at midnight of the same day.

9 Dhammika Dharmapala and Vikramaditya S. Khanna, *Stock Market Reactions to India's 2016 Demonetization: Implications for Tax Evasion, Corruption, and Financial Constraints*, Coase-Sandor Working Paper Series in Law and Economics no. 830 (Chicago: University of Chicago, Law School, 2018) (https://chicagounbound.uchicago.edu/law_and_economics/844). See also Gabriel Chodorow-Reich et al., "Cash and the Economy: Evidence from India's Demonetization" (2019) 135:1 *Quarterly Journal of Economics* 57-103.

10 On May 23, 2019, the Bharatiya Janata Party (BJP) won 303 seats, taking the total tally of the ruling National Democratic Alliance (NDA) to 353 seats in the 17th Lok Sabha (Lower House of Parliament). Elections were held for 543 seats. See Election Commission of India, "Election Commission of India Submits List of Newly Elected Members to the 17th Lok Sabha to the Hon'ble President of India," *Press Note* no. ECI/PN/60/2019, May 25, 2019.

11 The introduction of the GST qualifies as a tax reform (as economists typically use that term) since it seeks to broaden the tax base and to reduce rates in a roughly revenue-neutral manner. On what qualifies as a tax reform, see Joel Slemrod, "Is This Tax Reform, or Just Confusion?" (2018) 32:4 *Journal of Economic Perspectives* 73-96 (<https://doi.org/10.1257/jep.32.4.73>). On base broadening under the GST, see "A New, Exciting Bird's-Eye View of the Indian Economy Through the GST," in India, Ministry of Finance, *Economic Survey 2017-18*, vol. 1 (New Delhi: Ministry of Finance, January 2018), 32-42.

12 See India, Ministry of Information and Broadcasting, Press Information Bureau, "Special Webpage on Goods and Services Tax (GST) on PIB Website," June 30, 2017 (<https://pib.gov.in/>)

The reason for this uncommon treatment was not simply that the introduction of the GST represented a significant change in the tax system, but rather that it had very important implications for India's economic development in terms of creating a unified national market. The stress on creating a unified national market arose from the somewhat unusual situation where the centre (the national government), the 28 states, and the 8 union territories often used their separate taxing powers (granted under India's constitution)¹³ to make interstate trade more costly; different rates on the same goods in different states often led to economic distortions.¹⁴ Fittingly, then, the chief slogan for the tax reform was "GST—one-nation-one-tax-one-market."¹⁵

To be clear, this article is neither an analysis of the economic impact of the GST (on the ease of doing business, growth, inflation, etc.),¹⁶ nor an economic assessment under tax policy principles (fairness, neutrality, efficiency, complexity, transparency, etc.).¹⁷ This is, instead, a closer look at a unique institutional design feature of the Indian GST—a centre-state body called the Goods and Services Tax Council ("the GST council")—which could very well be its Achilles' heel.

The GST council is *sui generis*—an institution with no parallels in other federal countries. It is not a traditional regulatory authority, but a constitutional body.¹⁸ As a centre-state institution, it includes the finance minister of India as well as the finance ministers of states. It is tasked with making decisions on all matters concerning the GST, including which goods and services to tax, what rates to apply, and whom to exempt. For all practical purposes, the GST council is the backbone of the GST

PressReleaseDetail.aspx?PRID=1494240); and "Top Leaders, Industrialists, Filmstars Mark GST Launch," *New Indian Express*, July 1, 2017 (www.newindianexpress.com/business/2017/jul/01/top-leaders-industrialists-filmstars-mark-gst-launch-1622805--1.html).

13 See the discussion in the text below at note 66 and following.

14 Indian Tax Foundation, Research Wing, *Sales Tax in India, 1938-2001* (Delhi: Indian Tax Foundation, 2001).

15 India, Central Board of Indirect Taxes and Customs, "Benefits of GST: Goods and Service Tax" (www.cbic.gov.in/resources/htdocs-cbec/gst/Benefit.pdf).

16 On the economic impact of the GST, see the World Bank Group, *The Challenges of the Goods and Service Tax (GST) Implementation in India* (Washington, DC: World Bank, 2018) (<http://documents.worldbank.org/curated/en/846611542608567754/The-Challenges-of-the-Goods-and-Service-Tax-GST-Implementation-in-India>); World Bank Group, *India Development Update: India's Growth Story* (New Delhi: World Bank, March 2018) (<http://documents.worldbank.org/curated/en/814101517840592525/India-development-update-Indias-growth-story>); and Ajitesh Kir, "The Biggest Tax Reform Since Independence: Has the GST Improved the Ease of Doing Business in India?" (2018) 89:10 *Tax Notes International* 915-24.

17 For an assessment of the GST on complexity and fairness grounds, see Arun Kumar, "The Structurally Flawed GST: Finding an Alternative" (2019) 54:9 *Economic & Political Weekly* (www.epw.in/journal/2019/9/perspectives/structurally-flawed-gst.html).

18 Constitution of India, article 279A. References to India's constitution in this article are to the version in effect on December 9, 2020 unless the context indicates otherwise.

system. What makes the GST council unique is that it is envisaged as functioning on the principles of cooperative federalism.¹⁹ Both its decision-making process and its enforcement mechanism require the participation and cooperation of the centre and the states. In essence, the entire GST structure in India depends on the successful running of a centre-state body founded on collaboration and interdependence.

Cooperative federalism is a system by which state and national (central) governments supplement each other, and jointly and collaboratively perform a variety of functions.²⁰ It does not replace the legal framework of federalism; rather, it supplements and corrects that framework.²¹ Cooperative federalism embraces the realization that the promotion of general welfare is the common goal of all governmental units, and those units should work in concert, not in complete isolation, to reach that goal.²² It sees the two levels of government as partners, not rivals, and thus differs from competitive federalism.²³ But despite their collaboration and interdependence, both the centre and the states are acutely conscious that neither is subordinate to the other.²⁴ Voluntary participation is key.²⁵ And it is this inherent nature of the phenomenon of cooperative federalism that creates room for other forces: mutual leverage, bargaining, negotiation, pressure tactics, strategic behaviour, political alliances, and compromises.²⁶ Cooperative federalism operates in several spheres,²⁷ which include joint policy making through formal and informal forums (such as interstate conferences and statutory bodies), federal spending for the implementation of national programs (for example, through conditional grants-in-aid),²⁸ revenue collection/sharing (through mechanisms such as tax devolution and unconditional grants), and concurrent jurisdiction written into the constitution (for example, enabling both units to legislate on common subjects). This article

19 See *Economic Survey 2017-18*, supra note 11.

20 Daniel Judah Elazar, *Federalism: An Overview* (Pretoria: HSRC Publishers, 1995), at 41-45.

21 Anthony Harold Birch, *Federalism, Finance, and Social Legislation in Canada, Australia, and the United States* (Oxford, UK: Clarendon Press, 1955), at 305-6.

22 Edward S. Corwin, ed., *The Constitution of the United States of America Analysis and Interpretation: Annotations of Cases Decided by the Supreme Court of the United States to June 30, 1952* (Washington, DC: Government Printing Office, 1953), at 18.

23 Edward S. Corwin, "National-State Cooperation—Its Present Possibilities" (1937) 46:4 *Yale Law Journal* 599-623.

24 R.L. Watts, *New Federations: Experiment in the Commonwealth* (Oxford, UK: Oxford University Press, 1966), at 13.

25 Roderick M. Hills, "The Political Economy of Cooperative Federalism: Why State Autonomy Makes Sense and 'Dual Sovereignty' Doesn't" (1998) 96:4 *Michigan Law Review* 813-944.

26 M.J.C. Vile, *Federalism in the United States, Canada and Australia* (London: Her Majesty's Stationery Office, 1973), at 19-20.

27 Chandra Pal, *Centre-State Relations and Cooperative Federalism* (New Delhi: Deep & Deep, 1983).

28 Hills, supra note 25, at 858-65.

focuses on cooperative federalism in the sphere of concurrent jurisdiction, particularly in the field of concurrent taxation.²⁹

The GST regime, as I explain in greater detail in the next section, has considerably expanded the scope of concurrent taxation in India; before the GST, there was almost complete demarcation of taxing powers between the centre and the states. After the tax reform, because both units were granted power to simultaneously levy a separate tax on the same tax base, a centre-state institution was required to avoid conflict and foster cooperation and collaboration—a centre-state institution that could be used as an arena for negotiated cooperation³⁰ in the making of a national-level indirect tax policy. The formation of such an institution was previously unprecedented in India.

But can a concurrent tax system, whose very survival is based on cooperative federalism, guarantee a unified national market? If yes, for how long? The third section of this article attempts to answer these questions. It lays out the principles of cooperative federalism in fiscal matters that are prevalent in two of the oldest modern federations, the United States of America and Canada. It then segues into how decisions of the Supreme Court of India have interpreted cooperative federalism in the Indian context. With this background, I discuss the role of the GST council. In the last four years, the council has succeeded on several fronts and failed on some. The successes are largely due to political factors: the ruling party at the centre is also in power in several states. The failures are largely due to the continuous need for bargaining and compromise.

The fourth section discusses an unresolved constitutional issue relating to the GST council. The status of its decisions is still unclear. Article 279A(4) of the constitution of India states that the GST council shall “make recommendations” to the centre and the states on all matters relating to the GST; there is, however, no provision in the constitution that states that those recommendations are binding on either the centre or the states. One could argue that the council’s recommendations are not binding without clear constitutional language to that effect (given that the centre and states have concurrent power to levy the GST), or that perhaps the council’s “majority rules” decision-making process means that the centre and the states have ceded their respective rights to frame their own tax policy.³¹ The uncertainty surrounding whether the GST council’s decisions are binding could affect its ability to function as the fulcrum for cooperative federalism. It could also lead to a constitutional crisis, if one or more states decide to opt out and refuse to follow the majority’s decision.

29 See Pal, *supra* note 27, at 135. See also John Kincaid, “The Federalist and V. Ostrom on Concurrent Taxation and Federalism” (2014) 44:2 *Publius: The Journal of Federalism* 275-97.

30 See Elazar, *supra* note 20, at 41.

31 See Varun Kannan and Prashant Shukla, “Analysing the Working of the GST Council from the Perspective of Fiscal Autonomy of the States” (2017) *India Law Journal* (www.indialawjournal.org/analysing-the-working-of-gst-council.php).

I argue that there are four possible ways to deal with this impending crisis. The first and most obvious solution is to enact a constitutional amendment. This would settle the ambiguity once and for all, but would also be tough to achieve for lack of political will. The second solution is a court intervention to interpret the existing GST-related legislative provisions. Some of those provisions are framed in a manner that indicates that the GST council's decisions, despite being termed "recommendations," are indeed binding. The third solution is to build a dispute resolution mechanism for the GST council, along the lines of the existing interstate water disputes tribunals.³² These tribunals are the only quasi-judicial bodies in India that have original jurisdiction to decide interstate disputes, which would otherwise fall within the exclusive domain of the Supreme Court of India. The decisions of the water disputes tribunals are final and binding.³³ Article 279(A)(11) requires the GST council to establish a mechanism to adjudicate centre-state and interstate disputes arising out of its recommendations (or implementation thereof). Making the decisions of such a dispute resolution mechanism final and binding could be an indirect way of making the GST council's decisions binding.

The above three possible solutions seek to make the decisions of the GST council binding, and thus to ensure stability and continuity of the harmonized GST structure—that being one of the original goals of the GST. While the first and the second solutions may or may not pass the Indian Supreme Court's "basic structure test,"³⁴ the third might pass judicial scrutiny. Nonetheless, the third solution may not be ideal if disputes arising out of the GST council's decisions become routine.

The fourth possible solution focuses on improving the existing system by increasing states' incentives to abide by all decisions voluntarily. The constitutional provision relating to the GST council (article 279A) itself contains various means for doing so. The GST council can make recommendations regarding special rates to raise additional resources during a natural calamity or disaster,³⁵ floor rates with bands,³⁶ and special provisions for special-category states.³⁷ However, political partisanship may result in these powers not being equitably utilized.

Despite the use of tools for creating incentives, the possibility that states may deviate will continue to exist. Notions of fiscal autonomy run deep in all federations; federal units may simply walk away in the absence of a binding mechanism. In Canada, for instance, British Columbia pulled out of Canada's harmonized sales tax

32 See Constitution of India, article 262. See also The Inter-State River Water Disputes Act, Act No. 33 of 1956 (India), available on *India Code* (www.indiacode.nic.in/handle/123456789/1664?view_type=browse&sam_handle=123456789/1362).

33 Inter-State River Water Disputes Act, *supra* note 32, section 6.

34 *Kesavananda Bharati Sripadagalvaru and Ors v. State of Kerala and Anr*, [1973] INSC 258 (LII of India); AIR (1973) SC 1461 (India).

35 Constitution of India, article 279A(4)(f).

36 *Ibid.*, article 279A(4)(e).

37 *Ibid.*, article 279A(4)(g).

(HST) system barely three years after agreeing to participate. Nonetheless, a binding mechanism must not be so strict as to preclude modernization (as is happening with the European Union's VAT) or to trigger open defiance (as happened in Brazil).³⁸

The last section of the article presents concluding thoughts. It has long been argued that federal countries, especially those with strong subnational taxing powers, might face difficulty in implementing a federal VAT because of the coordination issues involved, and therefore might be less likely to adopt one.³⁹ This is a possible reason why the United States still hesitates to impose a federal VAT.⁴⁰ This article provides insights on how VAT structures are evolving in federal systems.

BACKGROUND

Fiscal federalism is the economic counterpart of political federalism; it is concerned with the assignment of appropriate fiscal instruments between different levels of government.⁴¹ Fiscal federalism is different from regulatory federalism.⁴² It covers matters of revenue and expenditure as well as fiscal links, both direct (such as inter-governmental transfers) and indirect (such as overlapping tax bases).⁴³ From a tax perspective, fiscal federalism refers to the existence of taxing powers in different constituent units of a federal system.⁴⁴

Fiscal Federalism in India: Pre-Independence

Understanding the true impact of the GST on fiscal federal relations requires a brief review of the historical background of the Indian federal structure as it existed in the early 20th century. Before India attained independence in 1947, its geographical territory and political organization were quite different from the form we see today. Pre-independence India was divided into British India and 562 princely states. The princely states together constituted two-fifths of the land and one-quarter of the

38 Insights from Canada, Brazil, and the European Union are discussed toward the end of this article.

39 Kathryn James, *The Rise of the Value-Added Tax* (New York: Cambridge University Press, 2015), at 181.

40 See Reuven S. Avi-Yonah, "Designing a Federal VAT: Summary and Recommendations" (2010) 63:2 *Tax Law Review* 285-300. See also Robert Carroll and Alan D. Viard, "Value Added Tax: Basic Concepts and Unresolved Issues" (2010) 126:9 *Tax Notes* 1117-26.

41 See C. Rangarajan, "Foreword I," in Naseer Ahmed Khan, ed., *Challenges and Issues in Indian Fiscal Federalism* (Singapore: Springer Nature, 2018), v-vii.

42 David A. Super, "Rethinking Fiscal Federalism" (2004) 118:8 *Harvard Law Review* 2544-2652.

43 Nirvikar Singh, "Fiscal Federalism," in Sujit Choudhry, Madhav Khosla, and Pratap Bhanu Mehta, eds., *The Oxford Handbook of the Indian Constitution* (Oxford, UK: Oxford University Press, 2016) (<https://doi.org/10.1093/law/9780198704898.003.0029>).

44 Claudio Sacchetto, "Analysis of Fiscal Federalism from a Comparative Tax Law Perspective," in Gianluigi Bizioli and Claudio Sacchetto, eds., *Tax Aspects of Fiscal Federalism: A Comparative Analysis* (Amsterdam: IBFD, 2011), 1-22.

population,⁴⁵ and had widely different characteristics. Some of them were comparable in size and importance to a British India province; others were much smaller and included estates of a few acres.⁴⁶ The princely state of Hyderabad, for instance, had an area of 82,700 square miles, a population of 12.5 million, and annual revenue of £5 million in 1930.⁴⁷ It was as large as Great Britain.

Although the princely states presented a striking diversity of characteristics—geographical, economic, and political—there was a feature that was common to all: they were not part of British territory and their subjects were not British subjects.⁴⁸ The British Crown's relationship with the princely states differed from that with British India. The Crown had executed treaties and agreements with the princely states that guaranteed internal sovereignty to the rulers and granted paramount power to the Crown. In return for the states' loyalty and annual tributes, the Crown was responsible for each state's external relations and territorial integrity.

Each princely state managed its own internal affairs; it made and administered its own laws; and it imposed, collected, and spent its own taxes.⁴⁹ In order to assist with the states' administration, a separate political department was set up, with resident officers posted in the states, to offer advice to the rulers and provide reports to the British authorities. On behalf of the Crown, the governor general kept watch over the activities of the states and of the political department.

British India was divided into nine major provinces and six minor ones.⁵⁰ After a constitutional reform in 1935, the provinces were reorganized and divided into governors' provinces and chief commissioner's provinces.⁵¹ Each province was administered by a governor (assisted by a council of ministers) and had a legislative assembly. The federal government comprised the governor general (as the representative of the Crown), a council of ministers, and a federal legislature. The 1935 reform attempted to separate the jurisdiction of the provincial governments from that of the federal government.⁵² While the powers of the various governments,

45 V.P. Menon, *Integration of Indian States* (New York: Macmillan, 1956).

46 Indian Statutory Commission, *Report of the Indian Statutory Commission, Volume 1—Survey*, presented by the secretary of state for the Home Department to Parliament by command of his majesty, May 1930 (London: His Majesty's Stationery Office, 1930).

47 Ibid.

48 For international purposes, however, the princely states were considered to be part of British territory and their subjects were considered to be British subjects. This is because they were not permitted to have diplomatic relations with any foreign power and their external relations were completely in the hands of the Crown. See Menon, *supra* note 45.

49 See *Report of the Indian Statutory Commission*, *supra* note 46.

50 Parliament of the United Kingdom, *Montagu-Chelmsford Report on Indian Constitutional Reforms* (April 1918).

51 V.P. Menon, *The Transfer of Power in India* (Princeton, NJ: Princeton University Press, 1957), at 51-54.

52 See the Government of India Act 1935.

legislatures, and courts in British India were derived from UK statutes, the bulk of the Indian legislation was left to the Indian legislatures. The secretary of state for India (a member of the UK executive) had overall responsibility for Indian affairs.

Since the two political units had completely different governing mechanisms, naturally their fiscal policies also differed to a great extent.⁵³ This resulted in a lack of coordination in the imposition of taxes, which obstructed the free flow of trade.⁵⁴ For instance, while British India imposed a single import and export duty at its boundary, most princely states imposed their own import and export duties at their frontiers; the right to impose such duties was seen as a sign of sovereignty.⁵⁵ Many states raised a substantial portion of their revenues from interstate customs duties. When the maritime states of Kathiawar levied customs duties of their own, the British Indian government responded by setting up a customs cordon between these states and the province of Bombay. Within the Indian subcontinent that existed then, there were a large number of tariff walls.⁵⁶

Fiscal autonomy was among the chief reasons why the rulers of princely states were reluctant to enter into a federal system with British India. Months before independence, even when it had become clear that they had no option but to choose between India and Pakistan, the rulers refused to budge from their position regarding the status quo on taxes.⁵⁷ Aside from customs duties, there were other revenue sources, such as corporation tax, sugar excise, and salt tax, that were dear to the princely states.⁵⁸ It was in view of the unwillingness of rulers to part with their financial independence that they were ultimately asked to accede only on three subjects—foreign affairs, defence, and communications—and were not asked to make any financial commitments.⁵⁹

Framers of the constitution of India realized that welding British India and the princely states into one federal structure required the removal of all internal customs barriers and the equal treatment of the princely states and the provinces. They also realized that they would have to find ways—through written constitutional provisions—to preserve fiscal autonomy, to a certain extent, for all constituent units of a federal system.

53 See B.R. Ambedkar, *The Evolution of Provincial Finance in British India: A Study in the Provincial Decentralization of Imperial Finance* (London, UK: P.S. King & Son, 1925).

54 See Menon, *supra* note 45, at 452-53.

55 See *Report of the Indian Statutory Commission*, *supra* note 46.

56 *Ibid.*

57 On May 17, 1946, the nawab of Bhopal wrote to Lord Wavell (then viceroy of India) stating that the finances of the forthcoming Union of India should be restricted to specific sources of revenue. On June 2, 1946, the nawab wrote another letter stating that a princely state should not be left as “no-man’s child,” without any effort by the Crown to protect it. See Menon, *supra* note 45, at 66-69.

58 *Ibid.*, at 38.

59 *Ibid.*, at 453. See also *A.N. Lakshman Shenoy v. ITO*, 1959 SCR 751 (India).

Fiscal Federalism in India: Post-Independence

India is a union of states,⁶⁰ and its territories comprise 28 states and 8 union territories. The constitution of India adopts the parliamentary system⁶¹ and provides for a federal structure⁶² based on a division of executive powers between the centre and the state executives, and a corresponding demarcation of legislative powers between the central legislature (that is, Parliament) and the legislatures of the states.

No other federal constitution in the world contains a scheme on federal financial relations as elaborate as that set out in the constitution of India.⁶³ Interestingly, the most significant feature of fiscal federalism in the United States is the near-absence of an explicit set of constitutional rules establishing the fiscal powers of the national and subnational governments and the relationship between them.⁶⁴

The Indian constitutional provisions with the deepest impact on fiscal federalism from the tax perspective⁶⁵ can be divided into two categories: (1) allocation of taxing powers and (2) distribution of tax receipts/revenue sharing. I briefly discuss those provisions below.

60 Constitution of India, article 1. See *State of Karnataka v. Union of India* (1977), 4 SCC 608, at paragraph 189 (India) (holding that regardless of whether India's constitution is described as federal or quasi-federal, the stark reality is that India is a union of states in which the balance of power between all constituent units ought never to be disturbed). It must be borne in mind, however, that contrary to other federations such as the United States, the Indian union was not formed by separate, independent, and sovereign states coming together.

61 The form of government envisaged under a parliamentary system is a representative democracy, in which the people exercise their sovereignty through an elected legislature, to which the executive is responsible. See *State of Bihar v. Bal Mukund Sab* (2000), 4 SCC 640 (India).

62 The Indian federal structure has often been called quasi-federal because it confers greater powers upon the centre relative to the states. There is a plethora of India Supreme Court judgments explaining Indian federalism, the latest one being delivered in 2018. In that case, *NCT of Delhi v. Union of India* (2018), 8 SCC 501 (India), the court held that, regardless whether the nature of Indian federalism is absolutely federal or quasi-federal, what matters is that federalism is part of the basic structure of India's constitution, since every state is a constituent unit with an exclusive legislature and executive, as in the case of the centre. See also *S.R. Bommai v. Union of India* (1994), 3 SCC 1, at paragraph 276 (India) (holding that the fact that, under the scheme of India's constitution, greater power is conferred upon the centre vis-à-vis the states does not mean that states are mere appendages of the centre).

63 See Pal, *supra* note 27, at 135.

64 Walter Hellerstein, "The United States," in *Tax Aspects of Fiscal Federalism*, *supra* note 44, 25-78. There are, however, certain constitutional provisions that deal with the power to tax. See, for instance, US Constitution, article I, section 2, clause 3; article I, section 8, clause 1; article I, section 9, clauses 4 and 5; article I, section 10, clauses 2 and 3; amendment XVI; and amendment X. Despite the absence of a significant constitutional assignment of taxing powers in the United States, there is a fairly clear functional allocation of such powers with respect to certain taxes.

65 Constitution of India, part XII, chapters I-II.

Allocation of Taxing Powers

Before the 2016 constitutional amendment relating to the GST, there was no overlap in the taxing powers of the centre and the states; both the centre and the states had independent sources of taxation. The constitution made their taxing powers mutually exclusive in order to avoid the difficulties that had arisen in some other federal constitutions with overlapping powers of taxation.⁶⁶ While that mutual exclusivity no longer holds good owing to the GST-related change (discussed later), the Indian constitution continues to retain an exhaustive enumeration and division of legislative powers of taxation.⁶⁷

The legislative powers of the centre and the states are clearly defined.⁶⁸ Parliament alone can legislate on subjects (including tax matters) enumerated in the union list; state legislatures alone can legislate on subjects (including tax matters) enumerated in the state list (except in a few special circumstances where Parliament can do so as well);⁶⁹ and both Parliament and the state legislatures can legislate on subjects contained in the concurrent list. The residuary power to make laws on subjects (including tax matters) not contained in either the state list or the concurrent list lies with Parliament.⁷⁰ Since tax-related subjects contained in the concurrent list are limited in number and scope (there are just three, one dealing with tax principles and the other two with duties and fees), various court decisions have held that the concurrent list does not enumerate any matters that deal with taxation.⁷¹ The significance of this, according to the Supreme Court of India, is that the distribution of legislative powers in relation to taxation ensures that a conflict of taxing powers cannot arise.⁷²

Under the general scheme of division of legislative powers, taxation is treated as a distinct matter and is separately set out in the legislative lists.⁷³ This means that there exists a clear distinction between general subjects of legislation and heads of

66 *Hoechst Pharmaceuticals Ltd. v. State of Bihar* (1983), 4 SCC 45, at paragraphs 75 and 76 (India).

67 *Godfrey Philips India Ltd. v. State of UP* (2005), 2 SCC 515, at paragraph 44 (India).

68 Constitution of India, articles 246 and 254. *Union of India v. HS Dhillon* (1971), 2 SCC 779, at paragraph 14 (India).

69 Constitution of India, articles 249-252.

70 Constitution of India, article 248. See *State of WB v. Kesoram Industries Ltd.* (2004), 10 SCC 201, at paragraph 240 (India) (holding that such residuary power of Parliament shall include the power to make any law imposing a tax not mentioned in either the concurrent list or the state list).

71 *State of AP v. New Delhi Municipal Committee*, AIR 1975 Del 223, at paragraph 8 (India); *Hoechst Pharmaceuticals Ltd.*, supra note 66, at paragraph 76; and *State of WB*, supra note 70, at paragraph 129 (holding that the concurrent list does not contain any head for taxation).

72 *Hoechst Pharmaceuticals Ltd.*, supra note 66, at paragraph 76. This, however, may change under the GST regime because the 2016 constitutional amendment permits a sort of overlapping of taxing powers in respect of intra-state supplies of goods and services.

73 *MPV Sundararamier & Co. v. State of AP*, AIR 1958 SC 468, at paragraph 51 (India); and *State of WB*, supra note 70, at paragraph 129.

taxation: while the general subjects of legislation figure in one group (entries 1 to 81 in the union list and entries 1 to 44 in the state list), taxes in relation thereto are separately mentioned under other heads (entries 82 to 92B in the union list and entries 45 to 63 in the state list). The concurrent list does not contain any taxation heads, barring entries 35, 44, and 47.⁷⁴ As noted above, the legislative fields for taxation under the concurrent list are limited, if not negligible.

Courts have been careful in dealing with cases involving taxing entries; the Supreme Court of India has held that taxing entries under the union and state lists must be construed with clarity and precision so as to maintain their exclusivity, and any construction of a taxation entry that may lead to overlapping must be avoided.⁷⁵ If the taxing power relates to a particular legislative field,⁷⁶ it means that other fields in the legislative lists must be construed to be excluded, so that there is no possibility of legislative trespass.⁷⁷

Since the fields of taxation are clearly enumerated in the union and state lists, and are given no worthwhile mention in the concurrent list, it is safe to say that the Indian constitution does not leave any room for overlapping of taxes,⁷⁸ apart from the tax-overlapping situation created by the GST-related constitutional amendment (discussed below).

74 The legislative field of entry 35 covers “principles” on which taxes on mechanically propelled vehicles are to be levied. The subject matter of entry 44 covers non-judicial stamp duties (excluding rates) and that of entry 47 covers fees in respect of any matter enumerated in the concurrent list, but does not include fees taken in any court. For discussion of entry 35 of the concurrent list, see *State of Assam v. Labanya Probha Devi* (1967), 3 SCR 611 (India) (holding that entry 35 does not deal with taxes on motor vehicles, but with the principles on which such taxes are to be levied). See also *B.A. Jayaram v. Union of India* (1984), 1 SCC 168 (India) (holding that Parliament or the state legislature may lay down the guidelines for the levy of taxes on mechanically propelled vehicles, by virtue of entry 35 of the concurrent list, but the right to levy such taxes vests solely with the state legislature under entry 57 of the state list). For discussion of entry 44 of the concurrent list, see *Bar Council of UP v. State of UP* (1973), 1 SCC 261 (India) (holding that entry 44 enables legislation by both Parliament and the states with regard to the imposition of stamp duty, which pertains to the domain of taxation). See also *VVS Rama Sharma v. State of UP* (2009), 7 SCC 234 (India) (holding that although entry 44 of the concurrent list permits both Parliament and the state legislatures to make laws regarding stamp duty on all documents, such laws must not prescribe the rates; that may be done through other entries in the union and state lists). For discussion of entry 47 of the concurrent list, see *Ratilal Panachand Gandhi v. State of Bombay*, 1954 SCR 1055 (India) (holding that entry 47 deals with laws imposing fees, not taxes).

75 *Godfrey Philips India Ltd.*, supra note 67, at paragraph 46.

76 The entries in the three legislative lists do not cover powers of legislation, but rather fields of legislation. The power to legislate is given under the constitution of India, article 246 and other articles. The function of the lists is not to confer powers, but merely to demarcate the legislative field. See *HS Dhillon*, supra note 68, at paragraph 22.

77 *Godfrey Philips India Ltd.*, supra note 67, at paragraph 46.

78 *State of WB*, supra note 70, at paragraph 129.

As a consequence of separate taxing powers, both the centre and the states have come to exercise exclusive domain over certain taxes. Direct taxes⁷⁹ are primarily in the domain of the centre; it has exclusive power to impose income tax⁸⁰ (on individuals, firms, and entities other than companies) and corporate tax, which together account for more than 50 percent of the total tax revenue collected by the centre.⁸¹ The states' power in the realm of direct taxes extends only to agricultural income.⁸²

The jurisdiction of both the centre and the states with respect to indirect taxes⁸³ has changed since the introduction of the GST. To be clear, in the pre-GST regime, the centre had the exclusive power to impose the following indirect taxes: excise duty (on the manufacture of all goods, except alcohol for human consumption); service tax (on the supply of services); customs duties (on the import and export of goods); and sales tax (on the interstate sale of goods). The states, in the pre-GST regime, had the exclusive power to impose the following indirect taxes: sales tax/VAT (on the intra-state sale of goods); luxury tax; entertainment tax; entry tax (octroi); tax on gambling, betting, and lottery; and purchase tax. The GST reform has subsumed almost all of the aforementioned indirect taxes⁸⁴ and replaced it with one tax—the GST. In the 2018 financial year, the GST accounted for 28.6 percent of the total tax revenue collected by the centre⁸⁵ and 24 percent of the total tax revenue of the states.⁸⁶

Distribution of Tax Receipts/Revenue Sharing

In most federations, intergovernmental fiscal transfers are predominantly in the form of “grants”; in India, however, central transfers to the states are mostly in the form of

79 Direct taxes are defined as those taxes whose burden is borne by the person who pays the tax. There is some debate as to whether this definition holds good any longer, considering that corporations do not always bear the incidence of the corporate tax. See Edward G. Fox, “Does Capital Bear the U.S. Corporate Tax After All? New Evidence from Corporate Tax Returns” (2020) 17:1 *Journal of Empirical Legal Studies* 71-115.

80 On income from all sources other than agricultural income. See Constitution of India, seventh schedule, union list, entry 82.

81 India, Ministry of Finance, 2019-20 Union Budget, Receipt Budget, February 2019 ([www.indiabudget.gov.in/budget2019-20\(I\)/rec.asp](http://www.indiabudget.gov.in/budget2019-20(I)/rec.asp)).

82 Constitution of India, seventh schedule, union list, entry 46.

83 Indirect taxes, as traditionally understood, are taxes whose burden can supposedly be passed on, in whole or in part, to other institutional units by increasing the price of the goods or services supplied. Indirect taxes are usually imposed on transactions, goods, or events.

84 I say “almost” because some indirect taxes are still outside the ambit of the GST—for example, customs duty, excise duty on tobacco, and sales tax on petrol and alcohol for human consumption.

85 The 2019-20 Union Budget, Receipt Budget, *supra* note 81.

86 Reserve Bank of India, Revenue Receipts of States and Union Territories with Legislature 2018-19, July 2018.

“tax transfers.”⁸⁷ The constitutional provisions on distribution of revenue mandate the centre to share a portion of its tax revenue with the states.⁸⁸ Some of these taxes are levied by the centre but collected and *appropriated* by the states;⁸⁹ some are levied and collected by the centre but *assigned* to the states;⁹⁰ and some are levied and collected by the centre but *distributed* between the centre and the states.⁹¹ The only central tax revenues that the centre is not required to share with the states are those from surcharges, which it regularly imposes on the income and corporate tax.⁹²

The manner of distribution of revenues from these central taxes (aside from surcharges and other taxes already assigned/appropriated) between the centre and the states, and among the states, is decided by the Finance Commission, a constitutional body.⁹³ The Finance Commission represents an original contribution of Indian federalism to this usually complicated aspect of the fiscal federal relationship.⁹⁴ Every five years, the Finance Commission decides the share of the states in the central tax-divisible pool (the vertical tax devolution) and the criteria for distribution of the states’ share among the states (the horizontal formula).⁹⁵ While any increase in the vertical tax devolution is hailed by the states (such as the recent increase from 32 percent to 42 percent),⁹⁶ determination of the horizontal formula creates acrimonious debate.⁹⁷

The Finance Commission also makes recommendations regarding grants-in-aid from the centre to the states.⁹⁸ Central grants-in-aid in India are general-purpose grants, made on the basis of financial need. Unlike in the United States, in India

87 Lekha Chakraborty, *Indian Fiscal Federalism at the Cross-roads: Some Reflections*, National Institute of Public Finance and Policy Working Paper no. 260 (New Delhi: NIPFP, April 2019), at 14.

88 Constitution of India, articles 268, 269, 269A, and 270. For a detailed explanation of the distribution of the centre’s tax revenue, see M.M. Sury, *Goods and Services Tax (GST) in India: Background, Present Structure and Future Challenges* (New Delhi: New Century, 2017), at 80-88.

89 Constitution of India, seventh schedule, union list, entry 91. These are stamp duties.

90 Central sales tax on interstate sale of goods; see Constitution of India, seventh schedule, union list, entry 92A. This has now been subsumed under the GST.

91 Income tax, corporate tax, customs duties, excise duties, and GST. Constitution of India, seventh schedule, union list, entries 82 (income tax), 85 (corporate tax), 83 (customs duties), and 84 (excise duties); and article 246A (GST).

92 Constitution of India, article 271.

93 *Ibid.*, article 280.

94 M.V. Pyee, *Constitutional Government in India* (New York: Asia Publishing House, 1965), at 544.

95 “The Fourteenth Finance Commission (FFC)—Implications for Fiscal Federalism in India?” in India, Ministry of Finance, *Economic Survey 2014-15*, vol. 1 (Ministry of Finance, Department of Economic Affairs Economic Division, February 2015), 129-37.

96 *Ibid.*

97 See Rangarajan, *supra* note 41, at vii.

98 Constitution of India, article 275.

the federal government is required to make annual grants-in-aid to states that need assistance. It is the Finance Commission that devises principles to determine such need as well as the quantum to be fixed for different states. The Finance Commission's role in the distribution of the centre's GST collections is limited; it has jurisdiction only over what the centre collects on the intra-state supply of goods and services.⁹⁹

Aside from the distribution of tax revenue and grants-in-aid, central government funds also flow to the states in the form of discretionary grants.¹⁰⁰ This is the Indian equivalent of the federal grants-in-aid in the United States.¹⁰¹ The central government is free to attach any conditions to these discretionary grants, such as the fulfillment of national programs. Over the years, the amount transferred to various states under these discretionary grants has far surpassed the amount transferred through grants-in-aid.¹⁰² The fact that these grants are discretionary, and not constitutionally mandated, makes them vital tools for the central government to cajole/coerce/entice the states.¹⁰³ The central revenue transfers to the states (tax plus grants) constitute almost half (49 percent) of the total aggregate revenue of the states.¹⁰⁴ Thus, if the central government's revenue performance declines, the states also are affected.¹⁰⁵

Impact of the GST on Fiscal Federalism

Why Was the GST Introduced?

One may ask, if the taxing powers in respect of indirect taxes were clearly demarcated in the constitution, why was it necessary to provide concurrent jurisdiction? The simple answer is that both the centre and the states used their separate taxing powers quite frequently, and without any coordination, creating separate economic spheres within India.¹⁰⁶ For instance, the sales tax and VAT rates on the same goods differed across India, and many states imposed entry taxes on goods entering through their boundaries.¹⁰⁷ The centre's excise tax coupled with its origin-based tax on the

99 Ibid., articles 269A and 270.

100 Ibid., article 282.

101 See Pal, *supra* note 27, at 149-50.

102 Ibid.

103 Hills, *supra* note 25, at 865-66; and Chakraborty, *supra* note 87, at 4.

104 See Reserve Bank of India, *supra* note 86. The amount of central transfers varies and does not constitute 49 percent of total revenues in all of the states. In some states, the ratio is much higher than that. The dependence on central transfers is much higher for special-category states, which have limited resources.

105 Y.V. Reddy, "Fiscal Federalism in India—Emerging Issues," in *Challenges and Issues in Indian Fiscal Federalism*, *supra* note 41, 1-6.

106 See India, Goods and Services Tax Council, "About GST," at paragraph 2.0, under the heading "Why GST?" (www.gstcouncil.gov.in/about-us).

107 See *Jindal Stainless Ltd. v. State of Haryana* (2017), 12 SCC 1 (India).

interstate sale of goods added to the existing distortionary effects, and constituted a serious impediment to the free flow of trade.¹⁰⁸ What made matters worse was that none of the taxes paid in the previous stages (input taxes) were available as credits.¹⁰⁹ This led to cascading of taxation.¹¹⁰

Viewed through a fiscal lens, India was not a single market, owing primarily to each state's disparate and uncoordinated use of its commodity tax powers.¹¹¹ This meant that it was often harder (or more expensive) to trade goods within states in India than it was in trade blocs such as the European Union.¹¹² Different rates of sales tax on the same commodity in different states often led to diversion of trade.¹¹³ It was not uncommon for buyers from one state to make purchases in another state simply in order to reduce sales tax liability. For instance, residents of the northern region of Jammu and Kashmir purchased truck chassis from the distant western region of Daman and Diu only because the latter levied a lower rate.¹¹⁴ Further, it was often cheaper to import goods from abroad than to obtain them locally by purchasing expensive inputs from other states.¹¹⁵ For example, before the GST, the production and sale of coal was subject to multiple taxes, imposed at different rates, with the cumulative tax being more than 13 percent. (The centre imposed excise duty, stowing excise duty, and central sales tax on interstate sales, and the states imposed VAT on intra-state sales at differing rates.)¹¹⁶ Because of this disparate and high-rate structure, domestic consumers often preferred to import coal from Indonesia and Australia instead of purchasing coal from producers in neighbouring states.¹¹⁷

108 Satya Poddar and Shalini Mathur, "India," in *Tax Aspects of Fiscal Federalism*, supra note 44, 187-222.

109 See "Benefits of GST: Goods and Service Tax," supra note 15.

110 Ibid.

111 See "Tax Reform in India: Trickle Through," *Economist*, December 17, 2009 (www.economist.com/node/15127568).

112 See "India's Economy: One Nation, One Tax," *Economist*, August 6, 2016 (www.economist.com/news/asia/21703370-tax-overhaul-will-have-welcome-if-unpredictable-consequences-one-nation-one-tax).

113 *Sales Tax in India, 1938-2001*, supra note 14, at 22.

114 Ibid. It must be noted, however, that purchasing from a lower-tax state makes economic sense only if the cost of transportation is lower than the tax differential.

115 Ibid.

116 See "Coal Consumers Being Taxed Much Less Under GST: Piyush Goyal," *Energy World*, *Economic Times*, August 4, 2017.

117 See National Institute of Public Finance and Policy, *Report on Reform of Inter-State Taxation in India* (New Delhi: NIPFP, June 2000) (www.nipfp.org.in/media/medialibrary/2014/11/Report_on_Reform_of_Inter-State_Taxation_in_India.pdf). See also Indian Chamber of Commerce, *The Indian Coal Sector: Challenges and Future Outlook* (PwC India, November 2012) (www.pwc.in/assets/pdfs/industries/power-mining/icc-coal-report.pdf); and Avinash Nair, "Domestic Coal More Expensive Than Imported Coal: Gujarat Govt Official," *Financial Express*, August 9, 2014 (www.financialexpress.com/archive/domestic-coal-more-expensive-than-imported-coal-gujarat-govt-official/1277710).

These are just two examples of how the pre-existing indirect tax regime operated in some respects like a tariff- or trade-barrier structure within India.

Rate differentials also caused other economic distortions, such as the unusual location of production centres, defying geographical advantages; this resulted in unnecessary transportation of raw material and finished goods, and thus cost escalations, not to mention the flight of capital and enterprise to low-tax states as a result of tax wars (more sophisticatedly known as tax competition).¹¹⁸ Stories of tax wars between states in India are legion;¹¹⁹ many states bent over backward to lure industries by offering competitive concessions in sales taxes.¹²⁰ This “beggar my neighbour” policy distorted the relative price of capital across commodities and regions.¹²¹ Such misallocation of resources, owing to disparate and uncoordinated tax systems, undermined economic efficiency¹²² and adversely affected India’s development efforts.

Rate wars were not the only problem. Since many states levied sales taxes on the basis of origin, the goods manufactured in the origin state could be subject to double taxation—once by the origin state and a second time by the centre.¹²³ Because no input tax credit was available in respect of the tax paid to the origin state, the origin-based sales tax system created a cascading effect, which increased the price of goods in the importing states.¹²⁴ The origin-based sales tax system also allowed these states to export their tax burden to consumers in other states, thereby enhancing tax disharmony in India.¹²⁵

This unusual situation necessitated the introduction of a single indirect tax, which would replace all the indirect taxes imposed by the centre and the states, and would also solve the cascading tax problem. This is the *raison d’être* of the GST—an all-encompassing destination-based tax on the consumption of goods and services. A form of VAT, the GST is a multi-stage consumption tax levied on value added.¹²⁶ In

118 *Sales Tax in India, 1938-2001*, supra note 14, at 21 and 26.

119 See *Sheen Golden Jewels (India) Pvt. Ltd. v. State Tax Officer*, 2019 SCC OnLine Ker 973 (India).

120 The option to offer sales tax concessions could be seen as a way of compensating states that lacked infrastructural facilities and would otherwise be unable to attract industries. See Sebastian Morris, Ajay Pandey, Sobhesh Agarwalla, and Astha Agarwalla, *Does GST in India Hurt Producing Regions? A New Estimate of the Tax Base Under GST of Select States*, Working Paper no. 2019-03-01 (Ahmedabad: Indian Institute of Management Ahmedabad, 2019).

121 For an evaluation of sales tax incentives given by Indian states, see M. Govinda Rao and V.B. Tulasidhar, “Cost and Efficacy of Fiscal Incentives: Case of Sales Tax Subsidy” (1986) 21:41 *Economic & Political Weekly* 1799-1806.

122 See Alan J. Auerbach and James R. Hines, “Taxation and Economic Efficiency,” in Alan J. Auerbach and Martin Feldstein, eds., *Handbook of Public Economics*, vol. 3 (Amsterdam: Elsevier Science, 2002), 1347-1421.

123 *Sales Tax in India, 1938-2001*, supra note 14.

124 M. Govinda Rao and François Vaillancourt, “Interstate Tax Disharmony in India: A Comparative Perspective” (1994) 24 *Publius: The Journal of Federalism* 99-114.

125 *Ibid.*

126 See India, Central Board of Indirect Taxes and Customs, *Goods and Service Tax (GST): Concept & Status, as on 1st August, 2019* (New Delhi: CBITC, 2019).

other words, the GST is levied at all stages from manufacture or import through final consumption, with credit for taxes paid in previous stages available by way of set-off.¹²⁷ The Indian GST follows the invoice method for calculating tax liability, which is the most widely used method of calculating VAT worldwide.¹²⁸ Approximately 165 countries have a VAT in one form or another¹²⁹ (a notable exception being the United States).¹³⁰ While in most countries, the VAT was introduced because it is a major source of revenue,¹³¹ in India the primary objective of introducing the GST was to create a unified national market by harmonizing the indirect tax structure throughout the country.¹³² With the constitutional amendment and legislation creating the GST,¹³³ almost all of the central and state indirect taxes were subsumed within a single unified structure.

To be clear, the GST is not India's first tryst with a VAT. Testing of the VAT system began in 1986, albeit with limited coverage.¹³⁴ The process started at the centre, with the introduction of a manufacturing-level VAT; then gradually, from 2005 onward, some states also adopted a VAT for the intra-state sale of goods.¹³⁵ These experiments improved economic efficiency, eased tax compliance, and yielded enhanced revenues.¹³⁶ But even then, there was little coordination of the tax base and

127 See India, Central Board of Excise & Customs, *Frequently Asked Questions (FAQs) on Goods and Services Tax (GST)* (Updated as on 1st January, 2018), 2d ed. (New Delhi: CBEC, March 31, 2017) (www.cbic.gov.in/resources/htdocs-cbec/gst/faq-gst-2018.pdf).

128 See Alan Schenk, Victor Thuronyi, and Wei Cui, *Value Added Tax: A Comparative Approach*, 2d ed. (Cambridge, UK: Cambridge University Press, 2015), at 28.

129 See Organisation for Economic Co-operation and Development, *International VAT/GST Guidelines* (Paris: OECD, 2017).

130 Reuven S. Avi-Yonah, "The Inexorable Rise of the VAT: Is the U.S. Next?" (2015) 150:1 *Tax Notes* 127-28.

131 Mihir A. Desai and James R. Hines Jr., "Value-Added Taxes and International Trade: The Evidence," March 2005 (unpublished comment) (www.hbs.edu/faculty/Pages/item.aspx?num=13855).

132 See "Benefits of GST: Goods and Service Tax," *supra* note 15.

133 See Constitution of India, articles 246A and 269A, added by the Constitution (One Hundred and First Amendment) Act, 2016, sections 2 and 9. After the 101st amendment came into effect, Parliament passed the Central Goods and Services Tax Act, 2017, No. 12 of 2017 (herein referred to as "the CGST Act 2017"); the Integrated Goods and Services Tax Act, 2017, No. 13 of 2017 ("the IGST Act 2017"); and The Union Territory Goods and Services Tax Act, 2017, No. 14 of 2017 ("the UTGST Act 2017"), followed by the state legislatures passing their respective state GST acts.

134 For a history of the VAT in India, see Sacchidananda Mukherjee, *Present State of Goods and Services Tax (GST) Reform in India*, National Institute of Public Finance and Policy Working Paper no. 2015-154 (New Delhi: NIPFP, September 2015) (www.nipfp.org.in/media/medialibrary/2015/09/WP_2015_154.pdf). See also Indian Tax Institute, *Value-Added Tax: With Reference to India* (New Delhi: Indian Tax Institute, 1997).

135 *Ibid.*

136 Poddar and Mathur, *supra* note 108, at 195.

rates, and no free flow of input tax credits across taxes and tax jurisdictions.¹³⁷ The existence of numerous exemptions, multiple rates, and disallowance of a tax credit continued to give rise to administrative complexities and economic distortions.¹³⁸ In such circumstances, complete rate and base harmonization of the central and state indirect taxes was considered the ideal policy outcome.¹³⁹

It is worth mentioning that complete harmonization does not necessarily fit well with the traditional normative discourse on fiscal federalism,¹⁴⁰ which sees interjurisdictional tax competition as a “good thing,” and not necessarily resulting in a race to the bottom.¹⁴¹ The traditional economic literature on fiscal competition is based on theoretical models that assume, among other things, that governments do not behave strategically relative to their neighbours, and that they have access to a full set of tax instruments to effectively engage in benefit taxation.¹⁴² In such theoretical models, interjurisdictional competition induces government officials to attract new business and jobs in ways that promote efficient allocation of resources.¹⁴³ Some even argue that interjurisdictional competition leads to fiscal discipline and prevents excessive taxation, since government officials fear chasing away key revenue-generating sources.¹⁴⁴ However, a different school of thought—using theoretical models in which governments do not have access to all tax instruments—argues that government officials care little about the impact that their decisions have on the tax base of their neighbours, resulting in suboptimal taxation and a low level of public services.¹⁴⁵ These modern theories on fiscal federalism tend to challenge the notion that fiscal competition is beneficial.¹⁴⁶ Since governments do not take into account the positive effect of an increase in their tax rate on the tax revenues in other jurisdictions, they tend to set inefficiently low tax rates; also, they tend to undertax in order to attract capital and increase their own tax base.¹⁴⁷

137 Ibid.

138 Ibid.

139 Constitution of India, article 279A(6).

140 See Wallace E. Oates, “An Essay on Fiscal Federalism” (1999) 37:3 *Journal of Economic Literature* 1120–49.

141 Wallace E. Oates, “Fiscal Competition or Harmonization? Some Reflections” (2001) 54:3 *National Tax Journal* 507–12 (<http://dx.doi.org/10.17310/ntj.2001.3.06>).

142 Ibid. See also Charles M. Tiebout, “A Pure Theory of Local Expenditures” (1956) 64:5 *Journal of Political Economy* 416–24.

143 Ibid.

144 Geoffrey Brennan and James M. Buchanan, *The Power To Tax: Analytical Foundations of a Fiscal Constitution* (Cambridge, UK: Cambridge University Press, 1980), at 184.

145 George R. Zodrow and Peter Mieszkowski, “Pigou, Tiebout, Property Taxation and the Underprovision of Local Public Goods” (1986) 19:3 *Journal of Urban Economics* 356–70.

146 See John Douglas Wilson, “Theories of Tax Competition” (1999) 52:2 *National Tax Journal* 269–304.

147 See Robin Boadway and Jean-François Tremblay, “Reassessment of the Tiebout Model” (2012) 96:11–12 *Journal of Public Economics* 1063–78 (<https://doi.org/10.1016/j.jpubeco.2011.01.002>).

According to these modern theories, tax competition reduces welfare in all jurisdictions, and tax coordination can be welfare improving.¹⁴⁸ The form and shape that such tax coordination must take depends largely on the context.¹⁴⁹

In the context of imposing a VAT in a federal system, both input tax credits and the taxation of cross-border purchases are very difficult to monitor and administer, especially where different states apply different tax rates and state VATs coexist with a federal one.¹⁵⁰ One of the ways in which this problem can be addressed is through a revenue-sharing mechanism between the federal and state governments that entails full uniformity of the tax base and rate structure.¹⁵¹ The key benefits of the GST regime are that it ensures availability of an input tax credit across all transactions—interstate and intra-state—as well as perfect harmonization of tax base and rates throughout India.¹⁵² It must also be said that different federations address inefficiencies in their internal economic unions in different ways.¹⁵³ Since India had already tried a system with uncoordinated tax rates and base, and failed, complete harmonization—in my view—seems to be the better choice to avoid the tax jungle that prevailed before the introduction of the GST.

Concurrent Taxation Under the GST

In order to ensure that the taxing powers in respect of indirect taxes were not materially affected—that is, that the fiscal autonomy of all units in the federation was more or less maintained—it became necessary to grant the centre and the states the same power to impose the new single indirect tax.¹⁵⁴ This is why there are four types of GST:

1. central GST (CGST)—a tax levied, collected, and retained by the centre on intra-state supplies of goods and services;
2. state GST (SGST)—a tax levied, collected, and retained by the states and those union territories that have legislatures on intra-state supplies of goods and services;¹⁵⁵

148 Ibid.

149 See Ravi Kanbur and Michael Keen, “Jeux Sans Frontières: Tax Competition and Tax Coordination When Countries Differ in Size” (1993) 83:4 *American Economic Review* 877-92.

150 Boadway and Tremblay, *supra* note 147.

151 Ibid.

152 See “Benefits of GST: Goods and Service Tax,” *supra* note 15.

153 Boadway and Tremblay, *supra* note 147.

154 Poddar and Mathur, *supra* note 108, at 199.

155 The Constitution (One Hundred and First Amendment) Act, 2016, section 14 added clause 26B to article 366 of the constitution, whereby the term “State” would include union territories with legislatures (Delhi, Puducherry, and Jammu and Kashmir) for the purposes of GST.

3. union territory GST (UTGST)—a tax levied, collected, and retained by those union territories that do not have legislatures on intra-state supplies of goods and services;¹⁵⁶ and
4. integrated GST (IGST)—a tax on interstate supplies of goods and services (which include imports of goods and services) that is levied and collected by the centre and then shared with the state in which those goods and services are consumed.

The taxes on intra-state supplies of goods and services are levied on a common tax base; that is, CGST and SGST/UTGST are levied simultaneously on the same intra-state supply of goods and services. The tax base for the IGST is different; nonetheless, the tax rates for interstate supplies are the same as the tax rates for intra-state supplies. This can best be explained by an example.¹⁵⁷ Assume that the combined GST rate on the supply of a particular good is 18 percent (comprising 9 percent as the CGST rate and 9 percent as the SGST rate).¹⁵⁸ If a supplier in state A supplies that good to a consumer within state A (an intra-state supply), CGST at the rate of 9 percent is imposed by the centre and SGST at the rate of 9 percent is imposed by state A on the same supply/transaction. If, instead, a supplier in state A supplies the particular good to a consumer in state B (an interstate supply), IGST at the rate of 18 percent is imposed by the centre. There is a detailed mechanism for the payment, collection, and distribution of these four types of GST; since that mechanism is not germane to our present discussion, I refrain from discussing it in the text.¹⁵⁹

156 Articles 239-241 of the constitution provide for the administration of union territories by the president of India (essentially, the central government) through administrators. The Parliament of India, by virtue of its legislative powers under articles 245-246 and 248 of the constitution, makes laws for union territories without legislatures (Andaman and Nicobar Islands, Lakshadweep, Ladakh, Chandigarh, Dadra and Nagar Haveli, and Daman and Diu). The Parliament of India passed the UTGST Act 2017 to provide for the levy and collection of GST (union territory tax) on all intra-state supplies of goods and services in union territories without legislatures.

157 See *Frequently Asked Questions (FAQs) on Goods and Services Tax (GST)*, supra note 127.

158 GST rates in respect of a good or service are notified separately by the centre and the states for CGST and SGST purposes. These rates are the same in both the centre and the states (at least until now) and have been notified on the recommendations of the GST council. The CGST rates for goods and services were initially set by the centre on June 28, 2017 and published in India, Ministry of Finance, Notification No. 1/2017, "Goods and Services Tax Compensation," June 28, 2017, and Notification No. 11/2017, "Central Tax (Rate)," June 28, 2017. The CGST rates have been revised several times by way of amendments to those notifications.

159 The input tax credit (ITC)—that is, the GST paid at the previous stage—can be used for the payment of output tax as follows: for CGST, an ITC is allowed for payment of CGST and IGST, in that order; for SGST, an ITC is allowed for payment of SGST and IGST, in that order; for UTGST, an ITC is allowed for payment of UTGST and IGST, in that order; and for IGST, an ITC is allowed for payment of IGST, CGST, and SGST/UTGST, in that order. Accounts between the centre and the states are settled after the taxpayers file their returns to

This new concurrent power of both the centre and the states to simultaneously impose a tax on the same tax base (the same intra-state supply of goods and services) must not be confused with the existing concurrent legislative power of the centre and the states pertaining to matters listed in the concurrent list of the Indian constitution.¹⁶⁰ As mentioned before, while Parliament has exclusive power to legislate on matters enumerated in the union list and state legislatures have exclusive power to legislate on matters enumerated in the state list, both Parliament and state legislatures have concurrent power to legislate on matters enumerated in the concurrent list. Legislation falling under the concurrent list may raise the question of repugnancy in certain situations.¹⁶¹ If there is repugnancy (conflict between a state law relating to a subject enumerated in the concurrent list and a central law relating to that subject), the parliamentary legislation will prevail; the state legislature's law will become void to the extent of the repugnancy.¹⁶² In other words, where there is a direct collision between a provision of a state law and that of a central law, both of which relate to one of the matters enumerated in the concurrent list, the state law will yield and be void to the extent of the repugnancy.¹⁶³ It does not matter whether the central law was enacted prior to or later than the state law.¹⁶⁴ In cases of repugnancy, the state law or provision thereof, as far as its applicability to that state is concerned, can be saved on one condition—if it receives presidential assent.¹⁶⁵

ensure that the SGST credit used to pay IGST is transferred by the originating state to the centre and the IGST credit used to pay SGST/UTGST is transferred by the centre to the destination state where the goods or services are eventually consumed. The ITC on account of CGST cannot be used toward payment of SGST/UTGST and vice versa. For further details, see *Frequently Asked Questions (FAQs) on Goods and Services Tax (GST)*, supra note 127.

160 Constitution of India, articles 246 and 254.

161 Repugnancy arises when two laws are fully inconsistent or absolutely irreconcilable with each other; that is, it is impossible to obey one without disobeying the other. Conflicting results are produced when both laws covering the same field are applied to a given set of facts. See *S. Satyapal Reddy v. Govt. of AP* (1994), 4 SCC 391, at paragraph 7 (India); and *Bar Council of UP*, supra note 74.

162 Whenever repugnancy between central and state law is alleged, it is first necessary to determine whether both laws relate to the same subject matter and whether each covers the entire legislative fields covered by the other. This can be established through dominant intention. See *Vijay Kumar v. State of Karnataka* (1990), 2 SCC 562 (India).

163 *M. Karunanidhi v. Union of India* (1979), 3 SCC 431 (India). The question of repugnancy arises only where both laws occupy the same field with respect to one of the matters enumerated in the concurrent list, and there is direct conflict between the two laws. It is only when both of these requirements are fulfilled that the state law shall, to the extent of repugnancy, become void.

164 *Hoechst Pharmaceuticals Ltd.*, supra note 66, at paragraph 67.

165 Constitution of India, article 254(2). The result of obtaining the assent of the president of India to a state act that is inconsistent with a previous central act relating to a concurrent list subject is that the state act will prevail in that state and will override the provisions of the central act with respect to their applicability to that state only. See *Hoechst Pharmaceuticals Ltd.*, supra note 66, at paragraph 67.

But even then, nothing prevents Parliament from making a law adding to, amending, varying, or repealing that state law.¹⁶⁶ Thus, Parliament's concurrent power to make laws with respect to matters enumerated in the concurrent list still trumps the state's concurrent power in that regard. The power to legislate in respect of matters in the concurrent list—although concurrent¹⁶⁷—is not equal. In sum, even though both Parliament and state legislatures have concurrent power to legislate on matters enumerated in the concurrent list, the parliamentary law has paramouncy over state law, which is superseded unless the state law receives presidential assent.

The new concurrent power granted by the GST-related constitutional amendment is different from the concurrent power that already existed pursuant to the concurrent list. The new concurrent power is an equal power; it is not subject to the question of repugnancy because it has nothing to do with the concurrent list. The new concurrent power has its source in a new article in the constitution (article 246A), which makes no reference to the concurrent list.

Article 246A was added to the constitution by a constitutional amendment¹⁶⁸ that provides for the distribution of legislative powers with respect to the GST.¹⁶⁹ This addition is to the existing main constitutional provision (article 246¹⁷⁰) that deals

166 Constitution of India, article 254(2), proviso. The proviso empowers Parliament to repeal or amend a repugnant state law that has received presidential assent.

167 *Hoechst Pharmaceuticals Ltd.*, supra note 66, at paragraph 38.

168 Constitution (One Hundred and First Amendment) Act, 2016, supra note 133, at section 2.

169 Article 246A of the Constitution of India reads as follows:

246A. Special provision with respect to goods and services tax.—

(1) Notwithstanding anything contained in articles 246 and 254, Parliament, and, subject to clause (2), the Legislature of every State, have power to make laws with respect to goods and services tax imposed by the Union or by such State.

(2) Parliament has exclusive power to make laws with respect to goods and services tax where the supply of goods, or of services, or both takes place in the course of inter-State trade or commerce.

Explanation.—The provisions of this article, shall, in respect of goods and services tax referred to in clause (5) of article 279A, take effect from the date recommended by the Goods and Services Tax Council.

170 Article 246 of the Constitution of India reads as follows:

246. Subject-matter of laws made by Parliament and by the Legislatures of States.—

(1) Notwithstanding anything in clauses (2) and (3), Parliament has exclusive power to make laws with respect to any of the matters enumerated in List I in the Seventh Schedule (in this Constitution referred to as the “Union List”).

(2) Notwithstanding anything in clause (3), Parliament, and, subject to clause (1), the Legislature of any State also, have power to make laws with respect to any of the matters enumerated in List III in the Seventh Schedule (in this Constitution referred to as the “Concurrent List”).

(3) Subject to clauses (1) and (2), the Legislature of any State has exclusive power to make laws for such State or any part thereof with respect to any of the matters

with distribution of legislative powers with respect to all subjects (general plus tax). What does this new constitutional provision do? It grants equal power to the state legislatures and Parliament as far as imposing the GST on the intra-state supply of goods and services is concerned; however, it clarifies that Parliament has the exclusive right to impose the GST on the interstate supply of goods and services. What is the implication? State legislatures, which hitherto had no right to impose any form of tax on the intra-state supply of services, now have that power; Parliament, which hitherto had no right to impose any form of tax on the intra-state supply of goods (except at the manufacturing stage, through an excise tax), now has that power.

What is interesting to note is that this new constitutional provision (article 246A) does not have any legislative list corresponding to the three lists referred to in the main constitutional provision (article 246)—that is, the union, state, and concurrent lists. Why is that so? Article 246A does not have a union or a state list because the new constitutional provision—insofar as it relates to the intra-state supply of goods and services—does not create any exclusive power for either Parliament or the state legislatures; it grants both institutions equal power in that regard. Further, article 246A does not have a concurrent list because, even though it grants concurrent power to both institutions, it does not want to create a situation where, owing to the principle of repugnancy,¹⁷¹ a state law has to lend itself to a central law. This is precisely why the GST-related constitutional amendment has not made any additions or modifications to the concurrent list; it has, however, made some substitutions and deletions to the union¹⁷² and state¹⁷³ lists, which were necessary to avoid any confusion or conflict with the new concurrent power bestowed under the new constitutional provision. The goal of the GST-related constitutional amendment is clear: to accord equal concurrent power to both Parliament and the state legislatures as regards the imposition of GST on the intra-state supply of goods and

enumerated in List II in the Seventh Schedule (in this Constitution referred to as the “State List”).

(4) Parliament has power to make laws with respect to any matter for any part of the territory of India not included [in a State] notwithstanding that such matter is a matter enumerated in the State List.

171 See *M. Karunanidhi*, *supra* note 163.

172 In the union list, entry 92 (dealing with tax on the sale of newspapers and advertisements) and entry 92C (dealing with tax on services) have been omitted. Entry 84 has been replaced with a new version that grants exclusive power to Parliament to impose excise duty on the manufacture of petroleum- and tobacco-related goods.

173 In the state list, entry 52 (dealing with entry taxes) and entry 55 (dealing with taxes on certain advertisements) have been omitted. Entry 54, which previously dealt with tax on the sale of goods (other than newspapers) has been replaced with a new version that grants exclusive power to the state legislatures to impose tax on the intra-state sale of petroleum-related goods and alcoholic liquor for human consumption. Entry 62, which previously granted states the exclusive right to impose taxes on luxuries, has been replaced with a new version that grants states the right to impose taxes on entertainment and amusements to the extent levied and collected by local governmental units.

services. To further that goal, the exercise of Parliament's residuary legislative power has been made subject to the new constitutional provision.¹⁷⁴

In a recent (January 2019) judgment,¹⁷⁵ the Kerala High Court has held that the GST-related constitutional amendment grants both the centre and the states "simultaneous—not concurrent—powers to legislate on certain items," noting further that "concurrency yields to repugnancy, but simultaneous legislative power does not."¹⁷⁶ This distinction between simultaneous and concurrent power, as offered by the Kerala High Court, is confusing and unnecessary. It appears that the Kerala High Court was trying to explain how, after the GST-related constitutional amendment, the state's power to legislate on the GST (in respect of intra-state supply) is exactly the same as that of the centre; that is, it is not subservient under any circumstances (as may be the case where, even though the state passes a law in respect of subject matter mentioned in the concurrent list, the state statute may be held void to the extent that it is repugnant to a central statute in respect of the same subject matter). For instance, the Kerala High Court observed that "to the legislative fields of exclusivity and concurrency, what has been added is the simultaneity—novel as it may sound."¹⁷⁷ But in explaining the nature of this new power, the Kerala High Court seems to have created an incorrect difference between the terms "simultaneous" and "concurrent";¹⁷⁸ concurrent power, as ordinarily understood, is a power that exists with another's power to do the same thing—it is a form of shared power, which may be exercised unilaterally by one of the holders of that power.¹⁷⁹

Nonetheless, the Kerala High Court acknowledges that this experiment of according equal legislative power to Parliament and the state legislatures in respect of the same subject matter (GST on the intra-state supply of goods and services) is unprecedented in India and represents a fundamental shift in legislative relations.¹⁸⁰ It marks a clear departure from the original distribution of legislative powers under the Indian constitution; more so, it creates a chink in the armour inasmuch as it opens the door to overlapping taxing powers.¹⁸¹ Remember the Indian Supreme

174 Constitution of India, article 248. The only situations in which Parliament can legislate for the states in respect of the intra-state supply of goods and services is when the Rajya Sabha passes an appropriate resolution for such purpose (see article 249), or while a proclamation of emergency is in operation (see article 250).

175 *Sheen Golden Jewels (India) Pvt. Ltd.*, supra note 119.

176 *Ibid.*, at paragraph 183.

177 *Ibid.*, at paragraph 180.

178 *Ibid.*, at paragraph 183.

179 See, for example, the definition of "concurrent power" in *Wolters Kluwer Bouvier Law Dictionary*, 2012 Desk ed.

180 *Sheen Golden Jewels (India) Pvt. Ltd.*, supra note 119.

181 Tax overlapping is the imposition of tax on essentially identical tax bases by more than one level of government. See United States, Advisory Commission on Intergovernmental Relations, *Tax Overlapping in the United States* (Washington, DC: US Government Printing Office, September 1961).

Court's observations that the distribution of legislative powers under the Indian constitution in respect of taxation ensures that a conflict of the taxing powers cannot arise.¹⁸² Well, those observations were made before the GST-related constitutional amendment. (One can only imagine what will happen to the enormous jurisprudence developed on this subject in prior judgments of the Indian Supreme Court.) In an October 2018 decision,¹⁸³ the Supreme Court of India acknowledged that the new constitutional provision (article 246A) confers concurrent taxing powers on Parliament and state legislatures to make laws with respect to the GST; interestingly, the court gave an expanded meaning to this new power.

Revenue Sharing and the GST

As mentioned earlier, all of the centre's tax revenue (except that collected from surcharges/cesses and that already assigned/appropriated to the states), including that raised through the CGST, is distributed between the centre and the states on the recommendations of the Finance Commission.¹⁸⁴ The change made to this arrangement, by way of the GST-related constitutional amendment, is that the revenue collected through the IGST (on the interstate supply of goods and services) falls outside the jurisdiction of the Finance Commission; the IGST revenue is distributed between the centre and the states on the recommendations of the GST council.¹⁸⁵

Another noteworthy change relating to revenue sharing is the introduction of a transitional compensation levy. The GST-related constitutional amendment enabled Parliament to pass a law for compensating the states, for a period of five years,¹⁸⁶ for their revenue loss on account of the GST.¹⁸⁷ Parliament passed a law¹⁸⁸ providing for the imposition of a GST compensation cess (GSTCC) on some commodities (such as tobacco and related products, aerated water, and motor vehicles) to generate funds for this purpose. Under that law, the annual revenue loss of a particular state is assessed on the basis of projected revenue and actual GST collection.¹⁸⁹ What that effectively means is that the revenue that the states expect to collect from their GST (SGST, to be specific) is protected up to June 2022; the centre will compensate for any revenue shortfall. Government statistics indicate that the average monthly

182 *Hoechst Pharmaceuticals Ltd.*, supra note 66, at paragraph 76.

183 *Union of India v. Mobit Mineral Pvt. Ltd.* (2019), 2 SCC 599 (India).

184 Constitution of India, article 270.

185 *Ibid.*, article 269A.

186 July 1, 2017 to June 30, 2022.

187 Constitution (One Hundred and First Amendment) Act, 2016, supra note 133, section 18.

188 The Goods and Services Tax (Compensation to States) Act, 2017, Act No. 15 of 2017.

189 The revenue projection is to be calculated on the basis of a projected growth rate of 14 percent and revenue collected by the states (from taxes now subsumed under the GST) in financial year 2015-16, the base year. See sections 3 to 6 of the Goods and Services Tax (Compensation to States) Act 2017, supra note 188.

requirement for compensation to the states has gone up since 2018.¹⁹⁰ But not all states have had a similar experience: some states (for example, Maharashtra and Tamil Nadu) have achieved reasonable growth in SGST revenue, and some (for example, Odisha and Goa) have faced a revenue loss.¹⁹¹

While delay in paying compensation to the states has been a recurrent problem for some time, a much more serious issue has surfaced of late—the centre's apparent inability to actually pay the compensation. As recently as September 2020, the centre proclaimed in Parliament that compensation requirements were unlikely to be met since collection of the GSTCC in the preceding few months had become a matter of concern, owing to COVID-19-related disruptions and a contraction of 22.6 percent in India's gross domestic product (GDP) for the April-June 2020 quarter.¹⁹² The central finance minister famously attributed these problems to "an act of God."¹⁹³ To wriggle out of its statutory obligation to pay, the centre provided the states with two borrowing options to meet their GST compensation shortfall for the entire 2020-21 fiscal year.¹⁹⁴

Borrowing options are stop-gap measures. The crucial question to ask is, what will happen after June 2022, once the compensation period ends? If some states continue to face GST revenue losses and the compensation period is not extended, it is highly probable that these states will want to set their own SGST rates to suit their revenue needs.¹⁹⁵ And if states deviate from the harmonized GST rate structure, GST rate wars may arise among the states.¹⁹⁶

Even though the states' own GST revenues are protected for the avowed compensation period, regardless of the amount of their SGST collection, their overall revenue may be affected if the centre's own GST revenue falls. As noted earlier,

190 Sacchidananda Mukherjee, *Inter-Governmental Fiscal Transfers in the Presence of Revenue Uncertainty: The Case of Goods and Services Tax (GST) in India*, National Institute of Public Finance and Policy Working Paper no. 255 (New Delhi: NIPFP, February 27, 2019) (www.nipfp.org.in/media/medialibrary/2019/02/WP_255_2019.pdf).

191 Ibid. See also India, Ministry of Finance, Press Information Bureau, "GST Revenue Collection for December, 2019 [INR] 1,03,184 of Gross GST Revenue Collected in the Month of December," January 1, 2020 (<https://pib.gov.in/PressReleaseIframePage.aspx?PRID=1598153>).

192 Parliament of India, Lok Sabha, Answer to Unstarred Question No. 212, September 14, 2020.

193 India, Goods and Services Tax Council, "Minutes of the 41st GST Council Meeting Held on 27th August, 2020" (www.gstcouncil.gov.in/41st-gst-council-meeting).

194 Ibid. Option 1 included a loan of INR97,000crore at a special rate of interest, repayable after eventual receipt of compensation from the centre. Option 2 included a loan of INR2,35,000crore (the additional amount being meant to cover the overall impact of COVID-19), with higher repayment costs.

195 See Sacchidananda Mukherjee, *Possible Impact of Withdrawal of GST Compensation Post GST Compensation Period on Indian State Finances*, National Institute of Public Finance and Policy Working Paper no. 291 (New Delhi: NIPFP, January 2, 2020) (www.nipfp.org.in/media/medialibrary/2020/01/WP_291_2020.pdf).

196 Mukherjee, *supra* note 190.

central transfers (through tax devolution and grants) constitute more than half of the total revenue in many states;¹⁹⁷ any shortfall in CGST or net IGST collections will naturally reduce the centre's ability to transfer funds to the states.¹⁹⁸

Following the implementation of the GST regime in the 2017-18 fiscal year, the centre's revenue from goods and services covered within the GST's scope declined by 10 percent, as compared with revenue generated in the 2016-17 fiscal year from central taxes subsumed within the GST.¹⁹⁹ According to the revised estimates in the centre's budget for 2018-19,²⁰⁰ the centre's CGST collection was expected to reach INR5,03,900crore (US\$71.99 billion); even though April 2019 recorded the highest monthly GST collection ever,²⁰¹ the overall collection for CGST reached only INR4,57,534crore (US\$65.36 billion)—a shortfall of INR46,366crore (US\$6.62 billion).²⁰² Any revenue shortfall in CGST collections may adversely affect central transfers unless the centre boosts its income and corporate tax collections.

The states' partial dependence on central transfers makes the states' GST (SGST) significant. Each state needs an assured source of revenue to meet its expenditure targets, in case the central transfers fall short for whatever reason. The SGST acts as this assured source. Since the centre is compensating for the SGST revenue loss for the time being, there is little reason to worry—unless, of course, the reduced CGST collections affect central transfers to the states. It is unclear what would happen then, because it is quite possible that some states (even after being compensated for the GST revenue loss) may still be in need of additional revenue to make good the deficit in the central transfer. Would the GST compensation, based on an annual revenue growth of only 14 percent, prevent these states from seeking a hike in the GST rates, or at least their own SGST rates? Or would states look to the only other worthwhile taxes still within their exclusive domain—stamp duty and registration fees?²⁰³ Only time will tell.

197 Ibid.

198 See generally India, Ministry of Finance, 2019-20 Union Budget, Transfer of Resources to States and Union Territories with Legislature, March 2019.

199 Comptroller and Auditor General of India, *Report of the Comptroller and Auditor General of India for the Year Ended March 2018*, Report no. 11 of 2019 (Union Government, Department of Revenue, Indirect Taxes—Goods and Services Tax, July 2019).

200 India, Ministry of Finance, 2019-20 Union Budget, Receipt Budget, March 2019. The 2019-20 budget contains revised estimates for 2018-19; see serial no. 8 in www.indiabudget.gov.in/budget_archive/ub2019-20/rec/tr.pdf.

201 India, Ministry of Finance, Press Information Bureau, "GST Revenue Collection for April, 2019 Recorded Highest Collection Since GST Implementation," May 1, 2019 (<http://pib.nic.in/PressReleaseDetail.aspx?PRID=1571397>).

202 India, Ministry of Finance, 2020-21 Union Budget, Receipt Budget, March 2020 (www.indiabudget.gov.in/budget2020-21/doc/rec/tr.pdf). The conversion from Indian rupees to US dollars is based on the then-existing exchange rate of US\$1 = INR70.

203 A. Sri Hari Nayudu, *Tax Revenue Efficiency of Indian States: The Case of Stamp Duty and Registration Fees*, National Institute of Public Finance and Policy Working Paper no. 278

Rationale for a Centre-State GST Institution

Four types of GST, and the new concurrent power to levy a separate tax on the same tax base, created a danger that the centre and the states may revert to the pre-GST regime of following their own tax policies. That would defeat the very purpose of introducing the GST. To deal with this danger, a mechanism was formulated to ensure that tax policies relating to the GST (that is, what rates to apply, what goods to exempt, what compliance rules to issue, and so on) are uniform throughout India. Because of the new concurrent jurisdiction, which accords actual equal legislative power to the states, unlike that under the concurrent list, such a mechanism necessarily required the participation of all stakeholders. This necessitated the creation of a centre-state institution for ensuring a coordinated and uniform national-level indirect tax policy.

Undoubtedly, such a centre-state institution can work only through cooperation and collaboration. Simply put, its success and survival depend on cooperative (or uncooperative)²⁰⁴ federalism.

MARKET INTEGRATION THROUGH COOPERATIVE FEDERALISM

Principles of Cooperative Federalism

Cooperative federalism, also known as “marble-cake federalism” in the United States,²⁰⁵ entails state and federal (central) governments supplementing each other and jointly performing certain functions.²⁰⁶ It does not supplant the existing legal structure of federalism—it simply corrects it.²⁰⁷ Cooperative federalism is based on

(New Delhi: NIPFP, August 7, 2019) (www.nipfp.org.in/media/medialibrary/2019/08/WP_278_2019.pdf).

- 204 Jessica Bulman-Pozen and Heather K. Gerken, “Uncooperative Federalism” (2009) 118:7 *Yale Law Journal* 1256-1310. Uncooperative federalism is a doctrine that denotes ways in which states can challenge, mould, and determine federal policy in a certain area, without necessarily wielding autonomous power therein. According to that doctrine, states can play the role of rivals and challengers to the federal government even where they lack autonomy and are federal servants; they may deviate from federal policy by adding variation, or simply refuse to comply with the national program, or otherwise obstruct it. Instances of uncooperative federalism (in the US context) have been seen in the case of the Clean Air Act of 1970 (in which some states managed to shape national environmental regulation) and the case of the USA Patriot Act of 2001 (in which some states passed resolutions calling for the repeal or amendment of certain provisions, and some even refused to enforce them).
- 205 Morton Grodzins, *The American System: A New View of Government in the United States* (Chicago: Rand McNally, 1966), at 7-8 and 60-152. Marble-cake federalism is distinguished from “layer-cake federalism,” in which the realms of power are clearly delineated.
- 206 Elazar, supra note 20. See also Daniel J. Elazar, “Cooperative Federalism,” in Daphne A. Kenyon and John Kincaid, eds., *Competition Among States and Local Governments: Efficiency and Equity in American Federalism* (Washington, DC: Urban Institute Press, 1991), 65-86.
- 207 Birch, supra note 21, at 305-6.

the idea that all federal units should work together toward achieving their common goal of promoting general welfare.²⁰⁸ Units in the federation are thus treated as partners, not rivals; this principle makes cooperative federalism different from competitive federalism.²⁰⁹ In modern federations such as the United States and Canada, the politics of federal revenue transfers, mixed financing, conditional grants, and intergovernmental bargaining serve to mitigate the negative effects of interjurisdictional competition.²¹⁰ Despite the collaboration, however, governmental units at both levels remain aware that neither is subordinate to the other.²¹¹ Since voluntary participation is fundamental,²¹² cooperative federalism inherently creates space for certain forces: mutual leverage, bargaining,²¹³ negotiation, pressure tactics, strategic behaviour, political alliances, and compromises.²¹⁴

Cooperative federalism usually operates in the following domains:²¹⁵ joint policy making through formal and informal forums; federal spending for the implementation of national programs;²¹⁶ and concurrent jurisdiction. The quintessential example of cooperative federalism in the domains of joint policy making and conditional federal spending is the working of the US Environmental Protection Agency.²¹⁷ We are concerned here with cooperative federalism in the domain of concurrent jurisdiction, especially concurrent taxation.²¹⁸

In the US tax architecture, for example, we see cooperative federalism in action when it comes to the coordination of federal and state corporate and personal income taxes. (Both federal and state governments in the United States enjoy broad power to tax income.)²¹⁹ Since concurrent federal and state taxation of income is a well-established norm,²²⁰ intergovernmental tax coordination attempts to make the system run smoothly, with the majority of states tying their tax bases to the federal

208 Corwin, *supra* note 22, at 18; and Philip J. Weiser, "Towards a Constitutional Architecture for Cooperative Federalism" (2001) 79:3 *North Carolina Law Review* 663-720.

209 Corwin, *supra* note 23.

210 Jonathan Rodden and Susan Rose-Ackerman, "Does Federalism Preserve Markets?" (1997) 83:7 *Virginia Law Review* 1521-72.

211 Watts, *supra* note 24, at 13.

212 Hills, *supra* note 25, at 815.

213 See Richard A. Primus, "The Limits of Enumeration" (2014) 124:3 *Yale Law Journal* 576-642, at 608.

214 Vile, *supra* note 26, at 19-20.

215 Pal, *supra* note 27, at 9-11.

216 Hills, *supra* note 25, at 858-71.

217 Robert L. Fischman, "Cooperative Federalism and Natural Resources Law" (2005) 14 *New York University Environmental Law Journal* 179-232.

218 See Pal, *supra* note 27; Kincaid, *supra* note 29; and Super, *supra* note 42.

219 Super, *supra* note 42, at 2593; Hellerstein, *supra* note 64.

220 *Mobil Oil Corp. v. Com.*, 445 US 425 (1980), at 448.

base. This intergovernmental coordination is advantageous on three main counts:²²¹ first, it reduces taxpayers' compliance burden; second, it improves tax administration; and third, it deters fraud and tax evasion. Certain facets of federal income taxation also help to maintain this coordination. Interest from state and local government bonds is exempt from federal income tax; and state and local tax (SALT) is partially deductible from the federal income tax base for taxpayers who itemize their deductions.²²² These facets of federal income taxation allow state governments to raise revenue for their basic needs without engaging in excessive competition with the federal government.²²³ Any change relating to these facets has the potential to create an adversarial relationship between the federal and state governments, owing to the profound revenue implications for states.²²⁴ For instance, following the recent SALT deduction cap (introduced in the Tax Cuts and Jobs Act of 2017),²²⁵ some states, such as New York, which benefited hugely from the SALT deduction, filed a law suit against the federal government²²⁶ and began using strategies to mitigate the impact of the cap.²²⁷ Circumventing the deduction cap would allow states to collect their full pre-2017 tax revenue, and also reduce the federal tax liability of their taxpayers.²²⁸ It remains to be seen, however, whether this strategic behaviour would pressure the federal government to remove the SALT deduction cap in the future, and what implications it has for cooperative federalism in the domain of concurrent taxation.

The Supreme Court of India's Interpretation of Cooperative Federalism

The Supreme Court of India has recognized the concept of cooperative federalism in a number of cases, most recently in *NCT of Delhi v. Union of India*.²²⁹ The court

221 Super, supra note 42, at 2594.

222 Hellerstein, supra note 64.

223 Super, supra note 42, at 2594.

224 Joyce Beebe, *Fiscal Federalism and the State and Local Tax Deduction Limit*, Rice University's Baker Institute for Public Policy Report no. 02.12.19 (Houston, TX: Rice University's Baker Institute for Public Policy, 2019) (www.bakerinstitute.org/media/files/files/401eb013/bi-report-021219-cpf-salt.pdf).

225 Pub. L. no. 115-97.

226 *State of New York v. Mnuchin*, 408 F Supp. 3d 399 (Dist. Ct. NY 2019). Four states (New York, Connecticut, Maryland, and New Jersey) sued the federal government on the ground that the SALT cap impaired their ability to pursue their own preferred tax policies. Following the dismissal of the suit, the states filed an appeal to the US Court of Appeals for the Second Circuit.

227 The "workarounds" include charitable contributions, payroll taxes, and passthrough business taxes.

228 Beebe, supra note 224, at 5-6.

229 Supra note 62. See also *State of Rajasthan and Others v. Union of India* (1978), 1 SCR 1 (India); *Swaraj Abhiyan (V) v. Union of India* (2018), 12 SCC 170 (India); and *K. Lakshminarayan v. Union of India*, 2018 SCC OnLine SC 2730 (India).

has held that the Constituent Assembly of India, when devising the federal provisions of the Indian constitution, could never have envisaged that the centre and the states would work at cross-purposes; rather, it envisaged coordination achieved through a cooperative/collaborative federal architecture. The idea behind cooperative federalism, according to the Indian Supreme Court, is negotiation and coordination, and the ironing out of differences that may arise between the centre and the states in their respective pursuits of development. Such an approach requires continuous and seamless interaction. The Indian Supreme Court has clarified, however, that the centre and the states must work within their respective spheres and not think of any encroachment.

The GST Council Experiment

The GST council is envisaged to function on the principles of cooperative federalism.²³⁰ Its successful functioning requires the participation and cooperation of the centre and the states. The GST council makes all decisions relating to the GST, most notably the scope of a taxable supply and the rate of tax to be levied. As of the time of writing, it has met more than 40 times and made numerous decisions.²³¹ Undoubtedly, the entire GST system in India hinges on the smooth functioning of a centre-state body structured on collaboration and interdependence.

Decision-Making Process

As a centre-state institution, the GST council includes representation from the centre as well as all of the states. Specifically, the council has 33 members: 2 from the centre (India's finance minister and the deputy finance minister), 1 from each of the 28 states (the state finance minister or any other nominated minister), and 1 from each of the 3 union territories with a legislature.²³²

The rules of the game, as far as the decision-making process of the council is concerned, are also designed to foster cooperation and collaboration. Although the quorum for a meeting is only one-half of the total number of members,²³³ neither the centre nor the states acting alone can ensure passage of a decision. The decision-making process requires a majority of not less than three-quarters of the weighted votes of the members present at a meeting and voting; the centre's vote carries one-third of the weight of the total votes cast, and the states' votes taken together carry

230 *Economic Survey 2017-18*, supra note 11.

231 See India, Goods and Services Tax Council, "GST Council Meetings" (<http://gstcouncil.gov.in/meetings>).

232 See India, Goods and Services Tax Council, "GST Council Members" (www.gstcouncil.gov.in/gst-council-members).

233 Constitution of India, article 279A(7). Since the number of members on the GST council is 33, the quorum is 17. Article 279A(7) does not explicitly state that this quorum must include at least one representative from the centre.

two-thirds of the weight of the total.²³⁴ Thus, both the centre and the states (assuming that all states vote as a bloc) hold a veto power in the decision-making process.²³⁵ This weighted voting procedure also creates a number of possibilities worth mentioning.²³⁶ First, if a state attends a meeting but abstains from voting, the voting power of the states that choose to vote will be affected. This is because the centre's weight of one-third of the total votes cast will remain the same, in effect granting the centre more voting power proportionately. Second, the quorum requirement exists only for a meeting and not for voting; therefore, even if all the states attend a meeting and only a few of them actually vote, the decision taken will still be valid. Third, given that the quorum for a meeting is one-half of the total number of members, a coalition of 17 states can block a decision from being taken by simply not attending the meeting.

The nature of the voting system leaves the centre with no option but to build consensus—through coercion or enticement²³⁷—to ensure that a decision passes. Building consensus and forging alliances inevitably require compromises to be made. That seems to be the case in keeping petroleum products, electricity, and alcohol for human consumption outside the purview of the GST until now. Further, although the majority-based weighted voting system aims to foster cooperative federalism, it also allows room for manipulation of the decision-making process by an alliance of the centre and a few states. For example, if the centre wants to exempt a particular good or service from the GST, it needs support only from as many states as will be required to attain a majority; it can simply ignore disagreements from other states regarding such an exemption. Gaining that support may not be too difficult a task given that the weighted voting system is based on a majority of the members “present and voting,” not a majority of all the members of the council or a majority of all the members present at a meeting.²³⁸

The political party (or coalition of political parties) that is in power at the centre and in a sizable number of states may successfully use the voting process to push its decision through, despite opposition from political parties that are in power in other states. At the time of writing, the ruling party at the centre (the Bharatiya Janata Party [BJP]) was also in power in 17 of the 28 states (on its own in some states and in coalition with regional political parties in others); in 2018, it was in power in

234 Constitution of India, article 279A(9).

235 See Sanjay Bhattacharjee and Palash Sarkar, *Voting in the Goods and Services Tax Council of India*, Munich Personal RePEc Archive Paper no. 86355 (April 16, 2018), at 9-10 (<https://mpra.ub.uni-muenchen.de/86355>).

236 Ibid.

237 Daniel Halberstam, “Of Power and Responsibility: The Political Morality of Federal Systems” (2004) 90:3 *Virginia Law Review* 731-834.

238 See Constitution of India, article 279A(9).

21 of the 28 states.²³⁹ Nevertheless, the GST council's voting process has not yet been utilized in a manner that would be averse to cooperative federalism. To date, all but one of the council's decisions have been unanimous. The 38th council meeting held on December 18, 2019 was the first occasion in more than three years when unanimity on decision making was not followed, and that was on a single issue.²⁴⁰ That issue was whether a single GST rate would be imposed on both state-run and state-authorized lotteries; the centre and 21 states (mostly ruled by or in coalition with the BJP) voted in favour, 7 states (all ruled by opposition parties) voted against, and 3 states abstained.²⁴¹

It is unclear whether this unanimity will continue, or whether voting along party lines will become more routine, given the changing political scenario. Opposition parties, which now govern 11 of the 28 states and 1 of the 3 union territories with legislatures, together account for 12 of the 33 council members. They may use all possible platforms to oppose central policy, and the GST council voting process may become a hotbed of political activity.

Has the GST Council Succeeded in Creating a Unified Market?

Article 279A(6) of the constitution of India mandates the GST council to develop a harmonized national market for goods and services. But can a tax system based on concurrent taxation and cooperative federalism guarantee a unified national market? To be fair, the GST has helped to unify the market to a certain extent, but the process of unification is not complete. Many crucial goods and services remain outside the ambit of the GST. For instance, states are still unwilling to forgo their exclusive right to tax the sale of their maximum revenue-generating goods and services—namely, petroleum products,²⁴² alcohol for human consumption, and electricity.²⁴³ This is why the GST-related constitutional amendment did not omit the legislative field in the state list relating to states' power to tax these goods and services.²⁴⁴

239 Qadri Inzamam, "With Jharkhand Loss, BJP's Footprint on Indian Map Reduces to Half," *Outlook*, December 24, 2019 (www.outlookindia.com/website/story/india-news-with-jharkhands-loss-bjps-footprint-on-indian-map-reduces-to-half/344619).

240 "In a First, GST Council Votes, States Say Centre Close to Sovereign Default," *Business Standard*, December 18, 2019 (www.business-standard.com/article/pti-stories/gst-compensation-states-say-centre-staring-at-sovereign-default-gst-council-sees-1st-ever-voting-119121801589_1.html).

241 India, Goods and Services Tax Council, "38th GST Council Meeting," December 18, 2019.

242 See "What's the Problem in Bringing Petrol Under GST? It's Complicated," *Business Today*, April 2, 2018 (www.businesstoday.in/current/economy-politics/problem-in-bringing--petrol-under-gst/story/268865.html).

243 See Navneeraj Sharma and Arvind Subramanian, "Putting Electricity in GST," *Indian Express*, December 7, 2017 (<http://indianexpress.com/article/opinion/columns/putting-electricity-in-gst-4971394>).

244 See Constitution of India, seventh schedule, state list, entries 51, 53, and 54.

According to a recent chief economic adviser to the Indian government, bringing electricity into the GST would result in four benefits:²⁴⁵ (1) reduce manufacturing costs; (2) improve the competitiveness of exporters; (3) reduce cross-subsidization of electricity tariffs; and (4) eliminate biases in electricity generation affecting the choice between renewable and thermal energy. But since electricity is an important source of revenue, states are reluctant to give up the exclusive right to levy sales tax on it.²⁴⁶ This attitude of states also undermines the “Make in India” initiative.²⁴⁷

Tax on petroleum products presents a particularly sticky situation, because those products continue to be taxed by both the centre and the states under a system in which an input tax credit is unavailable, resulting in cascading of taxes.²⁴⁸ Businesses that are dependent on petroleum products are adversely affected because keeping petroleum products outside the purview of the GST makes an input tax credit non-recoverable, leading to increased costs of doing business.²⁴⁹ The domestic airline industry is suffering not only because of the unavailability of an input tax credit but also because different tax rates on aviation turbine fuel in different states inhibit free competition.²⁵⁰ This fact alone shows how crucial the inclusion of petroleum products is to market integration. Under the GST-related constitutional amendment, it is for the GST council to recommend when petroleum products would be brought within the ambit of the GST;²⁵¹ that it has been unable to do so for the last three years is a clear failure on its part.

The GST's goal of “one-nation-one-tax-one-market” has not been fully achieved precisely because of the forces of cooperative federalism: bargaining and compromise. The centre recognizes the importance of including the aforementioned crucial goods and services left outside the scope of the GST; however, with a view to achieving political consensus on other important issues, it has conceded to the states' demands.²⁵² Cooperative federalism, as a general rule, often permits states to undermine federal policy.²⁵³

245 Ibid.

246 Ibid.

247 See Government of India, Make in India (www.makeinindia.com/about).

248 Sacchidananda Mukherjee and R. Kavita Rao, *Exploring Policy Options To Include Petroleum, Natural Gas and Electricity Under the Goods and Services Tax Regime in India*, National Institute of Public Finance and Policy Working Paper no. 2014-136 (New Delhi: NIPFP, 2014), at 8-9 (www.nipfp.org.in/media/medialibrary/2014/05/WP_2014_136.pdf).

249 See Poddar and Mathur, *supra* note 108, at 200-2.

250 “ATF Under GST Will Ensure Level Playing Field for Domestic Airlines: Prabhu,” *Business Standard*, April 7, 2019 (www.business-standard.com/article/pti-stories/atf-should-be-brought-under-gst-to-provide-level-playing-field-to-airlines-prabhu-119040700148_1.html).

251 Constitution of India, article 279A(5).

252 See Poddar and Mathur, *supra* note 108, at 201-2.

253 See Primus, *supra* note 213.

UNRESOLVED CONSTITUTIONAL ISSUE RELATING TO THE GST COUNCIL

Under the principles of cooperative federalism, each party to the arrangement has a reasonable degree of autonomy; it can bargain about the terms of cooperation and, if driven too hard, decline to cooperate.²⁵⁴ This feature of cooperative federalism—voluntary participation²⁵⁵—is at odds with the GST council’s “majority rules” decision-making process. As a result, there is a lack of certainty regarding the status of the GST council’s decisions.

Are the GST Council’s Decisions Binding?

Pursuant to article 279A(4) of the Indian constitution, the GST council is mandated to “make recommendations” on all matters concerning the GST. Interestingly, no constitutional provision clarifies that these recommendations are binding on either the centre or the states. It is quite possible that these recommendations are not binding without explicit constitutional language to that effect, considering that the centre and the states have concurrent power to levy the GST. It is also possible, on the contrary, that the GST council’s decision-making process implies that neither the centre nor the states have any remaining right to determine their own tax policy.²⁵⁶ The ambiguity regarding the status of the GST council’s decisions could adversely affect all efforts to foster cooperative federalism. Most importantly, this ambiguity could create a constitutional crisis in the event that one or more states opted out and decided not to abide by the majority’s decision.

For example, in March 2018, the state of Punjab unilaterally decided to exempt food items served in community kitchens at the Golden Temple, Amritsar (the most important temple in Sikhism) from payment of SGST—that is, the state’s share of the GST.²⁵⁷ That decision did not conform with the recommendations of the GST council. Under the state of Punjab’s GST legislation, the state may, on the recommendations of the GST council, exempt any good or service from tax, in the public interest.²⁵⁸ Instead of taking any action against the state of Punjab, the centre decided to refund its share of the tax (CGST) from the same transaction.²⁵⁹ This added to the ambiguity regarding the status of the GST council’s decisions.

254 Geoffrey Sawer, *Modern Federalism*, 2d ed. (Carlton, Victoria: Pitman Australia, 1976).

255 Hills, *supra* note 25.

256 Kannan and Shukla, *supra* note 31.

257 See Gurpreet Singh Nibber, “Punjab Govt Waives Its Half of GST on Langar Items at Golden Temple,” *Hindustan Times*, March 22, 2018 (www.hindustantimes.com/punjab/punjab-waives-its-share-in-gst-on-golden-temple-langar-asks-centre-to-follow-suit/story-JdC9FN8svFT25GsVTvZpIP.html).

258 Punjab Goods and Services Tax, 2017, Punjab Act No. 5 of 2017, section 11. All state GST statutes are more or less identical.

259 Yudhvir Rana, “Centre To Reimburse Its Share of GST on Langar,” *Times of India*, June 2, 2018 (<https://timesofindia.indiatimes.com/city/amritsar/centre-to-reimburse-its-share-of-gst-on-langar/articleshow/64421439.cms>).

There are three possible reasons why the GST council's decisions may not be binding. First, it may be believed that treating the council's decisions as binding would be unconstitutional, on the ground that doing so would violate the legislative supremacy of both Parliament and state legislatures, given the new concurrent taxation provision relating to goods and services (article 246A of the constitution). Before the GST, there was a clear separation of taxing powers between Parliament and the state legislatures in respect of goods and services.²⁶⁰ As discussed above, in order to implement a federal GST, the constitution was amended to grant concurrent taxing powers to Parliament and the state legislatures relating to the intra-state supply of goods and services.²⁶¹ This means that Parliament and state legislatures, and not some third institution, have an equal and independent right to impose taxes on the intra-state supply of goods and services. It may be believed that making the GST council's decisions mandatory would violate this constitutionally protected legislative supremacy.²⁶²

Second, it may be believed that making the GST council's decisions mandatory would be unconstitutional on the ground that doing so may have an adverse impact on federalism. The Supreme Court of India has long held that federalism is part of the basic structure of the constitution, and any amendment that violates the basic structure is invalid (the "basic structure test").²⁶³ Although the nature of Indian federalism envisages a stronger centre, it does not mean that the states are mere appendages of the centre.²⁶⁴ Any interference with the states' existing independent constitutional right to raise revenue under the GST may affect their fiscal autonomy.²⁶⁵ It may be believed that affecting the states' fiscal autonomy in such a manner would violate the basic structure test.

Third, it is possible, or even probable, that there is lack of political will to make the GST council's decisions mandatory since doing so may amount to surrendering fiscal autonomy.²⁶⁶ After all, why would the states completely surrender their only worthwhile constitutional right (however limited) to determine their own indirect tax policy?²⁶⁷ It is possible that the states have adopted a wait-and-watch approach. If the GST system is successful and their revenue targets are met, states may be willing to forgo that right.²⁶⁸ If instead they feel stifled by the decision-making process

260 *New Delhi Municipal Committee*, supra note 71, at paragraph 8; *Hoechst Pharmaceuticals Ltd.*, supra note 66, at paragraph 76; and *State of WB*, supra note 70, at paragraph 129.

261 The Constitution (One Hundred and First Amendment) Act, 2016, supra note 133, at section 2.

262 See *Jindal Stainless Ltd.*, supra note 107.

263 *Kesavananda Bharati*, supra note 34.

264 *S.R. Bommai*, supra note 62.

265 *Jindal Stainless Ltd.*, supra note 107; and *Abmedabad Municipal Corp. v. GTL Infrastructure Ltd.* (2017), 3 SCC 545 (India).

266 See *Poddar and Mathur*, supra note 108, at 199.

267 See *Kannan and Shukla*, supra note 31.

268 See *Rodden and Rose-Ackerman*, supra note 210.

of the GST council, they may opt out and revert to the old system. Worse still, with newly acquired powers of concurrent taxation, the states could take the further step of imposing different rates for taxes that were hitherto outside their jurisdiction (that is, service tax). The services sector is India's fastest-growing sector and represents 48.5 percent of India's GDP.²⁶⁹ States were previously denied the fruits of this expanding tax base.²⁷⁰ The expansion in the states' taxing power under the GST reform so as to include the intra-state supply of services is thus comparatively larger than that of the centre.²⁷¹ It is the uncertainty regarding the binding nature of the GST council's decisions that raises the risk that states may opt out. The joint decision-making process reduces the likelihood that such an eventuality will occur, but it does not necessarily prevent it altogether. As the Indian government has acknowledged, "the possibility of departure from the recommendations of [the GST council] cannot be completely ruled out."²⁷² It is this eventuality that may create a constitutional crisis.

Possible Solutions To Avert the Impending Constitutional Crisis

There are four possible ways to deal with this impending crisis. First, the most intuitive, is a constitutional amendment, clarifying that the "recommendations" of the GST council are binding on the centre and the states.²⁷³ This would settle the ambiguity once and for all, but would also be tough to achieve for lack of political will. The requirement for amending the constitution is onerous. The amendment bill has to be passed in each of the two houses of Parliament by a majority of the total membership of that house, and such majority should not be less than two-thirds of the members of that house present and voting.²⁷⁴ Since such an amendment would make changes to the existing constitutional provision relating to the GST council (article 279A), and have an impact on the legislative powers of the centre and the states, it would also have to be ratified by at least half of the states.²⁷⁵ Getting the states to agree on a constitutional amendment that would make it obligatory for them to accept the decision of a majority, even in situations where they register their dissent, appears improbable, at least for now. The states are yet to fully trust the GST system. This is exactly why they have resisted all forms of interference in their exclusive right to tax the sale of petroleum products.

269 The World Bank, "Services, Value Added (% of GDP)—India" (<https://data.worldbank.org/indicator/NV.SRV.TOTL.ZS?locations=IN>).

270 Poddar and Mathur, *supra* note 108, at 196.

271 India, Ministry of Finance, *Report of the Task Force on Goods and Services Tax, Thirteenth Finance Commission* (New Delhi: Ministry of Finance, December 15, 2009).

272 *Goods and Service Tax (GST): Concept & Status*, *supra* note 126, at paragraph 7.4.

273 Constitution of India, article 368.

274 *Ibid.* See also *Supreme Court Advocates-on-Record Association v. Union of India* (2016), 5 SCC 1 (India).

275 Constitution of India, article 368(2), proviso.

In the event that this constitutional amendment did secure agreement in Parliament, and the requisite number of states ratified it, it would still face the following judicial test: Does the constitutional amendment alter the basic structure of the Indian constitution? Dealing with the constitutionality of a 1971 constitutional amendment, whereby the rulers of the former princely states were deprived of their privy purses/annual payments and other privileges, the Indian Supreme Court clarified that if a constitutional amendment does not change the original identity, character, or personality of the constitution, it does not alter its basic structure.²⁷⁶ The basic structure, according to the Indian Supreme Court, consists mainly of the following features: supremacy of the constitution, a republican and democratic form of government, secularism, separation of powers, and the “federal character of the Constitution.”²⁷⁷

The second possible solution to the impending crisis is to seek a court intervention to interpret the existing GST-related legislative provisions. The wording of certain provisions suggests that the GST council’s decisions, despite being termed “recommendations,” are indeed binding. For instance, the language of section 9(1) of the CGST Act 2017²⁷⁸ (the centre’s GST legislation) suggests that the centre can impose tax only at rates that are recommended by the GST council. The language of the states’ GST statutes is almost identical to the central law; for example, section 9(1) of the Delhi SGST Act 2017 also indicates that there is no alternative to following the GST council’s recommendations as regards the tax rates.²⁷⁹ In such circumstances, a clarification from the Indian Supreme Court on the real meaning and effect of the GST council’s “recommendations” would be apt.²⁸⁰ It is settled law, under the principle of purposive interpretation, that a court is supposed to attach to a provision the meaning that serves the “purpose” behind it.²⁸¹

The purposive rule of interpretation is employed when the plain words of a statute are ambiguous or lead to no intelligible results, or if read literally, would

276 *Ragbunath Rao v. Union of India*, 1993 AIR SC 1267 (India).

277 *Ibid.*, at paragraphs 180 and 181.

278 CGST Act 2017, section 9(1) provides: “9. (1) Subject to the provisions of sub-section (2), there shall be levied a tax called the central goods and services tax on all intra-State supplies of goods or services or both, except on the supply of alcoholic liquor for human consumption, on the value determined under section 15 and at such rates, not exceeding twenty per cent., as may be notified by the Government on the recommendations of the Council and collected in such manner as may be prescribed and shall be paid by the taxable person.”

279 Delhi Goods and Services Tax Act, 2017, Delhi Act No. 3 of 2017, section 9(1) provides: “9. (1) Subject to the provisions of sub-section (2), there shall be levied a tax called the Delhi goods and services tax on all intra-State supplies of goods or services or both, except on the supply of alcoholic liquor for human consumption, on the value determined under section 15 and at such rates, not exceeding twenty per cent., as may be notified by the Government on the recommendations of the Council and collected in such manner as may be prescribed and shall be paid by the taxable person.”

280 *Gurudevdatra VKSSS Maryadit v. State of Maharashtra* (2001), 4 SCC 534 (India).

281 *Shailesh Dhairyawan v. Mohan Balkrishna Lulla* (2016), 3 SCC 619 (India).

nullify the very object of the statute.²⁸² It could very well be argued that although the decisions of the GST council are worded as “recommendations,” the purpose of the legal text is to treat them as binding decisions. In *Giridhar v. Commissioner of Wealth Tax*,²⁸³ the Supreme Court of India clarified that a purposive interpretation can be given even to a taxing statute, when a literal interpretation may lead to “absurd results.”²⁸⁴ Treating the GST council’s decisions as mere recommendations, in the literal sense, could possibly lead to unintended, if not absurd, results. A purposive interpretation, on the other hand, would also fit well with the court’s recent ruling on “pragmatic federalism.”²⁸⁵ There have been several occasions in the past when the court has interpreted constitutional language to resolve ambiguities in tax matters.²⁸⁶

A third possible way to prevent the impending constitutional crisis is to create a dispute resolution mechanism for the GST council that is similar to the existing interstate water disputes tribunals.²⁸⁷ While the Supreme Court of India has exclusive jurisdiction to decide interstate disputes, a special carve-out has been created for the interstate water disputes tribunals to adjudicate certain disputes relating to waters of interstate rivers or river valleys.²⁸⁸ Notably, these tribunals’ decisions are final and binding.²⁸⁹ Pursuant to article 279(A)(11) of the Indian constitution, the GST council is mandated to establish a mechanism to adjudicate any dispute (centre-state and interstate) arising out of its recommendations or implementation thereof. In the event that the decisions of such a dispute resolution mechanism were made final and binding, the effect could be that the GST council’s decisions would also indirectly become binding.²⁹⁰ This approach would also conform with the Indian government’s proposed solution for preventing any possible departure from the recommendations of the GST council. Writing about the GST council, the Indian government stated that “any departure would definitely affect other stakeholders and in such circumstances there must be a statutory body to which affected parties may approach for dispute resolution.”²⁹¹ The original GST-related constitutional amendment bill²⁹² had proposed the formation of a “Tax Dispute Settlement Authority,” which would

282 *Raghunath Rai Bareja v. Punjab National Bank* (2007), 2 SCC 230 (India).

283 (2015), 17 SCC 664 (India).

284 *Ibid.*, at paragraph 16.

285 *NCT of Delhi*, supra note 62. Pragmatic federalism implies permissive practicability. The object of this concept is to come up with innovative solutions to problems that emerge in a federation.

286 See Singh, supra note 43.

287 See Constitution of India, article 262; and Inter-State River Water Disputes Act, supra note 32.

288 See Constitution of India, article 131.

289 Inter-State River Water Disputes Act, supra note 32, section 6.

290 See generally Boudway and Tremblay, supra note 147.

291 *Goods and Service Tax (GST): Concept & Status*, supra note 126, at paragraph 7.4.

292 Constitution (115th Amendment) Bill 2014, section 279B.

adjudicate disputes arising out of a deviation from any of the recommendations of the GST council that resulted in a loss of revenue to a state or the centre, or affected the harmonized structure of the GST. The Tax Dispute Settlement Authority's decisions, as per the proposed bill, would be subject to the Indian Supreme Court's judicial review. This proposal, however, was shot down when a subsequent version of the amendment bill was sent to the Rajya Sabha (Upper House of Parliament) for consideration. The Select Committee of the Rajya Sabha considering the amendment bill noted that states were apprehensive that the proposed Tax Dispute Settlement Authority would affect their fiscal powers.²⁹³ There were concerns that the proposed body could override the legislative supremacy of state legislatures, thereby affecting their fiscal autonomy.²⁹⁴ As a result, the final amendment left it to the GST council to "establish a mechanism" to resolve such disputes; such a mechanism could include any method—negotiation, mediation, arbitration, or even a judicial authority.²⁹⁵

There are, however, some shortcomings with this approach of establishing a quasi-judicial authority. Interstate or centre-state tax disputes may be much more frequent than interstate water disputes. If tax disputes arising out of the GST council's decisions become routine, the dispute resolution process will become lengthy, costly, and inefficient. Further, reports suggest that despite being final and binding, the decisions of the water disputes tribunals face implementation problems.²⁹⁶ Often, parties have to approach the Supreme Court of India to direct enforcement of the tribunals' awards.²⁹⁷ The fact that the Supreme Court's intervention is often required for enforcement of awards shows that these tribunals—lacking contempt powers—have not proved to be the most efficacious forums for dispute resolution.²⁹⁸ Moreover, experience suggests that there can be considerable delay in resolving an interstate water dispute, from the stage of constituting a tribunal through to the eventual publication of the award. Interminable delay is often seen in cases in which resolution of the dispute itself would have serious political ramifications.²⁹⁹

While the first and the second possible solutions may or may not pass the Supreme Court of India's "basic structure test,"³⁰⁰ on the ground that federalism may

293 Parliament of India, Report of the Select Committee on the Constitution (One Hundred & Twenty-Second Amendment) Bill 2014, presented to Rajya Sabha on July 22, 2015, at 32.

294 Parliament of India, Constitution (One Hundred & Fifteenth Amendment) Bill 2011, Seventy-Third Report of the Standing Committee on Finance, presented to Lok Sabha on August 7, 2013.

295 Ibid., at 33.

296 Ramaswamy R. Iyer, "Inter-State Water Disputes Act 1956: Difficulties and Solutions" (2002) 37:28 *Economic and Political Weekly* 2907-10.

297 Ibid.

298 Harish Salve, "Inter-State River Water Disputes," in *The Oxford Handbook of the Indian Constitution*, supra note 43.

299 Ibid.

300 *Kesavananda Bharati*, supra note 34.

be affected by undermining the legislative authority of states, the third possible solution might pass judicial scrutiny, primarily because of the water disputes tribunals' precedent. Indeed, a former attorney general for India, in his written opinion issued to the Indian government more than six years ago, gave a thumbs-up to the formation of a similar quasi-judicial authority.³⁰¹ Nonetheless, the creation of a quasi-judicial authority may not have political support; the states may once again raise their initial apprehension about legislative supremacy and fiscal autonomy.³⁰²

The above three possible solutions are aimed at making the GST council's decisions binding, thus ensuring stability of the harmonized GST structure; after all, that was one of the original goals of the GST. The first discussion paper on the GST, published in 2009,³⁰³ stated that "an appropriate mechanism that will be binding on both the Centre and the States would be worked out whereby the harmonious rate structure along with the need for further modification could be upheld."³⁰⁴ Interestingly, it was a committee of state finance ministers that had prepared this first discussion paper on the GST; subsequently, in 2010, the centre had accepted the committee's suggestion relating to the "binding" mechanism.³⁰⁵ Making decisions of the GST council binding should not be seen as eroding the fiscal autonomy of the states; in this new system of concurrent taxation, where all stakeholders jointly participate in the decision-making process, harmonization of the tax base, tax rates, and tax administration should be seen as imperative.³⁰⁶

The fourth possible solution is to improve the existing system without making the GST council's decisions binding. This can be done by increasing the incentives for states to abide by all decisions voluntarily. The constitutional provision concerning the GST council provides the means to assuage some concerns of states. For instance, the GST council is empowered to recommend a special rate for a specified period to raise additional resources during any natural calamity or disaster.³⁰⁷ The GST council exercised this power in January 2019, when it approved the state of

301 Seventy-Third Report of the Standing Committee on Finance, *supra* note 294. The then attorney general for India observed that the decisions of such a dispute resolution body would not affect the supremacy of the legislatures over finance.

302 Report of the Select Committee on the Constitution, *supra* note 293; and Seventy-Third Report of the Standing Committee on Finance, *supra* note 294.

303 India, Empowered Committee of State Finance Ministers, *First Discussion Paper on the Goods and Services Tax in India* (New Delhi: Empowered Committee of State Finance Ministers, November 10, 2009).

304 *Ibid.*, at 14.

305 India, Department of Revenue, "Comments of DOR dated 1st January, 2010 on First Discussion Paper on GST" (<https://dor.gov.in/tax/comments-dor-dated-1st-january2010-first-discussion-paper-gst>).

306 *Report of the Task Force on Goods and Services Tax, Thirteenth Finance Commission*, *supra* note 271, at 104-8. See also Poddar and Mathur, *supra* note 108, at 205-6.

307 Constitution of India, article 279A(4)(f).

Kerala's proposal to levy a 1 percent cess on the intra-state supply of goods and services within the state of Kerala, following a devastating flood there in August 2018.³⁰⁸ The Kerala flood cess will be valid for a period of two years, and the revenue raised from it will be used for reconstruction and rehabilitation.³⁰⁹ Approving the state of Kerala's proposal is a good sign; had the GST council refused to do so, it is quite possible that the state would have had misgivings about the council and have attempted to explore other options, including defection. Another power of the GST council that allows for providing the states with an incentive to stay relates to the recommendation of floor rates with bands.³¹⁰ With rate bands flexibility for certain goods and services, states would have the option to levy a slightly higher tax within the stated band. This would enable states to cushion the impact of any revenue loss on account of the GST,³¹¹ once the GST compensation cess period ends in June 2022.³¹² The GST council can also recommend special provisions for special-category states.³¹³

The GST council has enough tools at its disposal to allow for flexibility in the event of economic exigencies while ensuring that the overarching GST structure does not collapse. However, the council also needs to ensure that these tools are indeed utilized, and that its decision-making process does not fall prey to political partisanship. Imagine the following scenario. The BJP, with a second term at the centre, also gains power in several more states in subsequent state elections, so that it has a comfortable majority for getting any decision passed in the GST council. Come June 2022 and the end of the GST compensation cess period, the centre will have no responsibility to compensate states that still face a revenue loss on account of the GST. If one of those states is ruled by an opposition party (say, the Indian National Congress), that state seeks the GST council's approval to levy a higher SGST rate on certain goods and services, and the council—purely for political reasons—refuses to recommend any rate bands or special provisions or concessions, it will probably be very difficult to keep that state within the GST system, unless it is

308 India, Goods and Services Tax Council, "Major Decisions Taken by the GST Council in Its 32nd Meeting Held Today Under the Chairmanship of the Union Minister of Finance & Corporate Affairs, Shri Arun Jaitley," January 10, 2019.

309 The Kerala Finance Bill 2019, Act 5 of 2019, section 14.

310 Constitution of India, article 279A(4)(e).

311 Report of the Select Committee on the Constitution, *supra* note 293; and Seventy-Third Report of the Standing Committee on Finance, *supra* note 294.

312 Mukherjee, *supra* note 190.

313 Eleven states have been granted special-category status on account of various factors, including hilly and difficult terrain, strategic location along borders, economic and infrastructural backwardness, and non-viable nature of finances. These states are Arunachal Pradesh, Meghalaya, Nagaland, Sikkim, Tripura, Himachal Pradesh, Uttarakhand, and Jammu and Kashmir (a union territory with a legislature but considered to be a "state" for the purposes of the GST).

economically very disadvantageous to defect. A possible disadvantage for a defecting state is that setting a GST rate higher than the rate under the harmonized GST system may lead to trade diversions to neighbouring jurisdictions with lower rates, thereby decreasing the state's tax revenue.³¹⁴ As a logical corollary, if a defecting state sets a GST rate lower than the rate under the harmonized GST system, the result may be opposite.

The fear that some states may deviate from the GST council's decisions in the future is real and not misplaced.³¹⁵ In the absence of binding decisions, there is no guarantee that the present system—despite the availability of tools for creating incentives—will remain intact.

Insights from Canada, Brazil, and the European Union

Since Canada and Brazil are, at present, the only federal countries other than India where subnational VATs operate in addition to the national/federal VAT,³¹⁶ it is expedient to restrict a comparative analysis to these federations alone. Other federal systems, including Austria, Germany, Australia, and Switzerland, have VATs operating at only one level of government.³¹⁷ For example, in Australia, the VAT is imposed at the federal level, and in Germany, it is collected at the state level.³¹⁸ The revenue generated from such VATs is either shared with the federal units or assigned to only one level of government. (In Austria and Germany, the revenue is shared between the centre and the states; in Australia, it is distributed entirely to the states; and in Switzerland, all of it goes to the centre.)³¹⁹ In addition, these federal systems grant little or no authority to the states with respect to the setting of rates and the tax base.³²⁰

No discussion on VAT is worthwhile without a customary salute to the VAT mothership, the European Union. Because the quintessential issues that arise with respect to subnational VATs, such as harmonization and fiscal autonomy, also resonate with respect to national VATs in a common market,³²¹ a brief digression on VAT-related decision making at the EU level is also warranted.

314 Mukherjee, *supra* note 190.

315 See *Goods and Service Tax (GST): Concept & Status*, *supra* note 126, at paragraph 7.4.

316 Richard M. Bird, "Central and Subnational VATs in Federal Countries," in Ehtisham Ahmad and Abdulrazak Al Faris, eds., *Fiscal Reform in the Middle East: VAT in the Gulf Cooperation Council* (Cheltenham, UK: Edward Elgar, 2010), 38-75.

317 *Ibid.*

318 Victoria J. Perry, "International Experience in Implementing VATs in Federal Jurisdictions: A Summary" (2009) 63:3 *Tax Law Review* 623-38.

319 See Bird, *supra* note 316.

320 See Perry, *supra* note 318.

321 Richard M. Bird, "Below the Salt: Decentralizing Value-Added Taxes," in Ehtisham Ahmad and Georgio Brosio, eds., *Handbook of Multilevel Finance* (Cheltenham, UK: Edward Elgar, 2015), 291-333.

Canada

Fiscal autonomy tends to be a prickly issue in all federations; federal units are quick to jump ship when they see no benefit in working with the federal government. In Canada, British Columbia, following a bitter political fight in 2011 on an issue relating to the HST, decided in 2013 to opt out and revert to its old provincial sales tax (PST), which the HST had replaced in 2010.³²²

The Canadian GST system, although quite different from that of India, provides useful insights for the way forward. Canada's federal government imposes a GST at the national level, which functions along with retail sales tax or VAT systems at the provincial level.³²³ The HST applies in participating provinces (5 out of the 10 Canadian provinces)³²⁴ at rates that differ from province to province; the federal government collects the HST and remits a portion to the provinces. Notably, Quebec has a provincial GST, the Quebec sales tax (QST), in addition to the federal GST; Quebec's tax administration collects both the QST and the GST, and remits the federal portion to the federal government.³²⁵ In participating provinces, the HST applies to the same tax base as the GST; in provinces that have not merged their PST into the HST, the tax base is quite different from that of the federal GST.³²⁶ The First Nations lands and reserves have a First Nations GST, where the federal GST does not apply.³²⁷ The federal government's relationship with the provinces participating in the HST system is governed by separate agreements executed with each participating province.³²⁸ These agreements (called comprehensive integrated tax coordination agreements) provide for the establishment of a tax policy review committee—the Canadian version of the GST council, if you will. This committee, comprising representatives from the federal government and each participating province, is tasked with providing advice to the federal and provincial ministers of finance on issues relating to the HST.³²⁹ If the committee cannot reach consensus on an issue, that issue is referred to the deputy federal and provincial ministers of finance. If they too fail to resolve the issue, the dispute resolution process kicks in,

322 Richard M. Bird, "The GST/HST: Creating an Integrated Sales Tax in a Federal Country" (2012) 5:12 *SPP Research Papers* [University of Calgary, School of Public Policy] 1-36.

323 See Schenk et al., *supra* note 128.

324 Participating provinces are those that have harmonized their provincial sales tax with the federal GST; they are Ontario, New Brunswick, Nova Scotia, Prince Edward Island, and Newfoundland and Labrador.

325 See Canada Revenue Agency and Revenu Québec, *General Information Concerning the QST and the GST/HST* (Quebec: Revenu Québec, 2019).

326 See Canada Revenue Agency, "General Information for GST/HST Registrants."

327 See Canada Revenue Agency, "First Nations Goods and Services Tax."

328 See, for example, Ontario, Ministry of Finance, "Comprehensive Integrated Tax Coordination Agreement Between the Government of Canada and the Government of Ontario" (www.fin.gov.on.ca/en/publications/2009/citca.html).

329 *Ibid.*, part III. The provincial tax rate is already mentioned in the agreement.

which is also based on reaching a consensus. If the issue still remains unresolved, despite being referred to the higher authorities at the federal and provincial level, the final solution offered is to refer it to a third party for consideration and advice.³³⁰ It is quite understandable why such a dispute resolution system, based on consensus, exists in the Canadian context—the above agreements can be terminated by each party through a written notice.³³¹ No wonder British Columbia was able to walk away from the HST system within a couple of years.³³² These intergovernmental agreements can be and have been renegotiated; there is no obstacle to either imposing different rates in HST participating provinces or exiting from the HST system.³³³ Neither Canada's dispute resolution system nor its GST/HST coordination methods seem to be workable in the Indian context.

Brazil

Brazil's indirect tax system of today is strikingly similar to India's indirect tax system of yesterday (the pre-GST regime). In short, it is extremely complex and contains a multitude of turnover taxes, which are levied at various levels of government, creating a massive cascading problem.³³⁴ The federal structure of Brazil includes a federal government, 26 states, a federal district, and numerous municipalities, all of which have separate taxing powers.³³⁵ As far as indirect tax is concerned, the federal government imposes a special VAT on industrialized goods (called "the IPI");³³⁶ the states and the federal district impose a VAT on goods and select services (called "the ICMS"); and the municipalities impose a cumulative tax on the remaining services not within the ICMS's scope (called "the ISS"). While the federal-level IPI and the state-level ICMS are non-cumulative taxes, with tax due in each transaction compensated by the amount charged in previous transactions, the municipal-level ISS is a cumulative tax; since none of these taxes are creditable against each other, a cascading effect is created.³³⁷ Although the federal-level IPI follows the tax-credit

330 Ibid., part XIV.

331 Ibid., part XV.

332 Bird, *supra* note 322, at 3. See also George Malcolm Abbott, "The Precarious Politics of Shifting Direction: The Introduction of a Harmonized Sales Tax in British Columbia and Ontario" (2015) 186 *British Columbian Quarterly* 125-48.

333 Bird, *supra* note 322, at 22.

334 World Bank, "Brazil: Options for Tax Reform, a Policy Note for Discussion" (Washington, DC: World Bank, 2018).

335 See Constitution of the Federative Republic of Brazil, 1988, articles 153, 155, and 156.

336 The federal government also imposes other indirect taxes, referred to as "COFINS" and "PIS" (social contribution taxes).

337 Thaynara Silva de Carvalho, "VAT in a Federal Structure: The Feasibility of Implementation of a Single, Broader-Based VAT in Brazil, Within the Parameters of the EU VAT Model" (MA thesis, Lund University, School of Economics and Management, Department of Business Law, 2016).

method of a VAT, it resembles an excise tax owing to its specific imposition on manufactured goods.³³⁸ It has thus been argued that no broad-based VAT truly exists at the national level in Brazil.³³⁹ Nonetheless, the state-level ICMS, being a broad-based tax on a variety of goods, does fit into the usual VAT model followed in other countries.³⁴⁰

In order to ensure harmonization of VATs across the states, Brazil's constitution places limits on the states' taxing power in respect of the ICMS.³⁴¹ For instance, although each state administers the ICMS on its own, the federal Senate has the power to establish the rates for interstate transactions and the minimum/maximum rates for intra-state transactions.³⁴² In practice, the ICMS rates for intra-state transactions—ranging from 17 percent to 19 percent—continue to be set by the states in the absence of any senate resolution.³⁴³ However, ICMS rates for interstate transactions are indeed set through a senate resolution; they vary between 7 percent and 12 percent, depending on the state of destination.³⁴⁴ As regards collection of ICMS, intra-state transactions follow the origin principle, and interstate transactions are subject to a hybrid origin-destination rule.³⁴⁵ Under the hybrid rule, the state of origin levies the applicable interstate rate, and the state of destination collects the difference between such interstate rate and its own internal rate.³⁴⁶ The part-origin, part-destination model is envisaged as reducing revenue disparity between states of production and states of consumption,³⁴⁷ but it does not solve the redistributive problem for which it was designed.³⁴⁸ Instead, it encourages fraudulent practices such as “invoice sightseeing,” wherein interstate sales are simulated through fake invoices.³⁴⁹

Despite constitutional safeguards to ensure a coordinated state-level VAT, the ICMS is burdened with administrative, efficiency, and equity issues.³⁵⁰ Varied rates and bases create a huge compliance burden for businesses operating in multiple

338 Ibid.

339 Ibid.

340 See Perry, *supra* note 318.

341 Ibid.

342 See Constitution of the Federative Republic of Brazil, 1988, articles 155(2)(IV) and (V).

343 See PricewaterhouseCoopers, *Worldwide Tax Summaries*, “Brazil: Corporate—Other Taxes.”

344 See *ibid.* A 4 percent rate applies on all interstate transactions of imported goods.

345 Ibid.

346 Ibid.

347 See Schenk et al., *supra* note 128.

348 See Perry, *supra* note 318.

349 Ibid., at 631.

350 Flávio Rubinstein, “Brazil,” in *Tax Aspects of Fiscal Federalism*, *supra* note 44, 649-721.

jurisdictions.³⁵¹ The chief concern with the ICMS, however, relates to harmful interstate tax competition, whereby most states grant exemptions and rate reductions to attract businesses, leading to significant economic distortions.³⁵² These tax wars have eroded the tax base and adversely affected the revenues of several states.³⁵³

Statutes aimed at harmonization of ICMS rates and bases across the states have been largely unsuccessful.³⁵⁴ One such statute (Complementary Law No. 24 of 1975), aimed at national coordination of ICMS, established an interstate body—the National Council of Fiscal Policy, known as CONFAZ (Conselho Nacional de Política Fazendária).³⁵⁵ CONFAZ, comprising finance secretaries from each state, the federal district, and the federal government (who chairs and coordinates), is mainly tasked with regulating the manner in which exemptions, incentives, and benefits are granted and revoked.³⁵⁶ Any exemption/incentive/benefit that a particular state seeks to provide necessarily requires the approval of CONFAZ, whose decisions (formalized through interstate covenants) are binding.³⁵⁷ Before 2017, CONFAZ's decisions relating to such matters required unanimous consent of all members; the unanimity rule allowed a single state to block tax incentives that any other state sought to implement.³⁵⁸ This led to several states granting illegal tax benefits without seeking the approval of CONFAZ, knowing full well that tax favours granted without respecting the procedure would be deemed null and void.³⁵⁹ As expected, Brazil's Supreme Court struck down a number of these unilateral incentives and directed the losing states to retroactively collect the forgone tax.³⁶⁰ Interestingly, some of the losing states found a way to avoid the court's direction; they coerced CONFAZ into permitting tax amnesty schemes for taxpayers who were liable to pay the forgone tax. Apparently, these states got their way by threatening to obstruct the approval of other important interstate covenants, which also required unanimity.³⁶¹

351 Perry, *supra* note 318.

352 *Ibid.*

353 Luiz de Mello, *The Brazilian "Tax War"—The Case of Value-Added Tax Competition Among the States*, OECD Economics Department Working Paper no. 544 (Paris: Organisation for Economic Co-operation and Development, February 14, 2007) (<https://doi.org/10.1787/286220576442>).

354 Rubinstein, *supra* note 350.

355 *Ibid.*

356 See Constitution of the Federative Republic of Brazil, 1988, article 155(2)(XII).

357 *Ibid.* The covenants must be ratified by the states' legislative branches.

358 *Ibid.*

359 Júlio M. de Oliveira and Rogério Gaspari Coelho, "Recent Changes in States' Tax Benefits Related to the ICMS in Brazil," *ITR (International Tax Review)*, September 14, 2017 (www.internationaltaxreview.com/article/b1f7n8xkbngj8/recent-changes-in-states-tax-benefits-related-to-the-icms-in-brazil).

360 *Ibid.*

361 Rubinstein, *supra* note 350.

Thus, the decision-making system of CONFAZ was susceptible to political pressure and eventual compromise.³⁶²

In August 2017, the unanimity rule for decision making was replaced with a special quorum system.³⁶³ Under the new system, a state's proposal to grant ICMS benefits requires approval of a reduced quorum: at least two-thirds of all of the states, and at least one-third of the states in each of the five regions.³⁶⁴ The new system has been used by a number of states to seek approval of the tax incentives that they had previously granted without CONFAZ approval.³⁶⁵ It remains to be seen whether the new quorum system has reduced or accentuated the tax wars between Brazil's states.³⁶⁶ In any case, CONFAZ's ability to harmonize the ICMS is severely hampered by the inherent deficiencies of the ICMS system, mainly the hybrid origin-destination rule for interstate transactions.³⁶⁷

India's present GST architecture, with destination-based taxation and uniformity of rates/bases/exemptions, indicates that there is not much to incorporate from Brazil's ICMS system, which itself is set for a complete overhaul.³⁶⁸ Learning lessons from CONFAZ also appears to be difficult, partly because of the very different, much larger, role of the GST council. Nonetheless, CONFAZ's pre-2017 difficulty in curbing tax wars represents a warning signal for India; despite its decisions being binding, CONFAZ had been unable to ensure state-wide coordination, with many states avoiding the decision-making process altogether and granting unilateral incentives. This could have been because of CONFAZ's earlier unanimity requirement—a problem that the GST council does not face—or perhaps something else.

The European Union

The EU VAT, at first glance, appears to be a fully successful VAT harmonization experiment: 27 member states follow EU-wide standard rules with respect to numerous matters, including rates, exemptions, chargeable event, invoicing, filing of return, refund, and cross-border transactions.³⁶⁹ That by itself is a remarkable

362 Ibid.

363 Brazil, Complementary Law 160/2017, published on August 8, 2017.

364 EY, "Brazil: Changes on Approval of ICMS Benefits by CONFAZ and Validation of State Incentives Law Published," *Tax Insights*, August 25, 2017.

365 See de Oliveira and Coelho, *supra* note 359.

366 Renata Correia Cubas, "Tax Wars in Brazil and the Great Expectations for 2018," *ITR (International Tax Review)*, January 30, 2018 (www.internationaltaxreview.com/article/b1f7n37hrxbqws/tax-wars-in-brazil-and-the-great-expectations-for-2018).

367 Rubinstein, *supra* note 350.

368 Ana Carolina Carpinetti and Luiz Roberto Peroba Barbosa, "Brazil Aims To Reform Complex Tax System," *ITR (International Tax Review)*, August 22, 2019 (www.internationaltaxreview.com/article/b1gtv5h2rdfqc/brazil-aims-to-reform-complex-tax-system). See also "Brazil: Options for Tax Reform, a Policy Note for Discussion," *supra* note 334.

369 European Commission, "EU VAT Rules by Topic" (https://ec.europa.eu/taxation_customs/business/vat/eu-vat-rules-topic_en).

achievement. A closer look at the details, however, reveals a very different picture, and even some shortcomings.³⁷⁰ While EU-wide standards are indeed followed, there is significant variation in rules and procedures, exemptions, and rates across the member states, which tends to increase compliance costs, distort trade, and reduce productivity.³⁷¹ For VAT rates, the EU-wide standard rule is that every member state must apply a “standard rate” of not less than 15 percent (on the supply of all goods and services in general), and may apply one or two “reduced rates” of not less than 5 percent (on the supply of certain listed goods and services).³⁷² In addition, some member states may depart from this standard rule and impose special rates (a “parking rate”³⁷³ or a “super-reduced rate”³⁷⁴) for a temporary period (on the supply of certain other goods and services).³⁷⁵ In practice, there are disparate VAT rates across the European Union:³⁷⁶ 10 different standard rates (ranging from 27 percent in Hungary to 17 percent in Luxembourg), multiple reduced rates (Belgium has two reduced rates of 6 percent and 12 percent, while Germany has only one reduced rate of 7 percent), and some special rates (Ireland has a parking rate of 13.5 percent and a super-reduced rate of 4.8 percent). This has led to a complex situation, indicating that VAT rate harmonization in the European Union is very limited.³⁷⁷ In addition to the differentiated rate structure, there is little harmonization when it comes to exemptions, with most member states having obtained derogations from the mandatory list of exempt supplies to include additional exemptions.³⁷⁸ The prevalence of myriad rates and a multitude of exemptions means that the EU VAT fails the litmus test of a best-practice VAT.³⁷⁹

The question is, what is stopping the European Union from moving toward further VAT rate harmonization or base broadening? Apparently, the EU VAT reform

370 Institute for Fiscal Studies, *A Retrospective Evaluation of Elements of the EU VAT System*, Final Report TAXUD/2010/DE/328 (London, UK: IFS, December 2011).

371 Ibid.

372 See articles 97 and 99 of the VAT directive, *infra* note 381.

373 Parking rates must not be lower than 12 percent. They are imposed only in some member states and apply to certain goods and services that are not eligible for reduced rates now but were subject to reduced rates on January 1, 1991. For example, Austria imposes a 13 percent parking rate on wine from farm production carried out by the producing farmer.

374 Super-reduced rates can be lower than 5 percent and can include zero-rating. Super-reduced rates are imposed only in some member states and apply to few goods and services. For example, Ireland imposes a super-reduced rate of 4.8 percent on livestock.

375 See articles 102 through 130 of the VAT directive, *infra* note 381.

376 European Commission, *VAT Rates Applied in the Member States of the European Union*, document no. Taxud.c.1(2019)EN (Brussels: EC, January 1, 2019).

377 Christophe Waerzeggers, “The European VAT and the Common Market Framework: Lessons for the GCC,” in *Fiscal Reform in the Middle East*, *supra* note 316, 100-32.

378 Ibid.

379 Sijbren Cnossen, “Is the VAT’s Sixth Directive Becoming an Anachronism?” (2003) 43:12 *Bulletin for International Fiscal Documentation* 434-42.

is in limbo because of the European Union's peculiar legislative decision-making system in the field of taxation, which relies on unanimity.³⁸⁰ The EU VAT legal framework is largely incorporated in legally binding directives³⁸¹ and regulations.³⁸² A legislative proposal concerning a directive or regulation on VAT matters can be adopted only through a special legislative procedure that is subject to three caveats.³⁸³ First, the legislative proposal must seek to harmonize the member states' national VAT legislation to the extent that such harmonization is necessary for the establishment and functioning of the internal market and the avoidance of distortion of competition. Second, the European Council, the ultimate decision maker in this case, must consult the European Parliament and the Economic and Social Committee on such a legislative proposal. Third, the European Council (comprising government ministers or secretaries from each of the 27 member states) must act unanimously. While an abstention does not prevent a unanimous decision from being taken,³⁸⁴ even a single vote against can kill the legislative proposal. In other words, every member state has an effective power of veto over any legislative proposal concerning the EU VAT.³⁸⁵ Since every member state commands a veto in the decision-making process required to make changes to the EU VAT regime, one can imagine that mustering unanimous political support on contentious matters would be challenging. This is why the EU VAT is resistant to change. EU expansion in recent years has only made matters worse,³⁸⁶ thus stifling the modernization of the EU VAT.³⁸⁷

Recently, in January 2019, the European Commission published a reform proposal to change the voting method for the European Council's decision making on taxation matters from unanimity to a qualified majority,³⁸⁸ which is the standard voting method that the council uses for 80 percent of EU legislation. A qualified majority is reached in the European Council when 55 percent of member states,

380 Waerzeggers, *supra* note 377.

381 A directive is a direction to each member state to which it is addressed to achieve a particular result, with discretion as to form and methods. See article 288 of the Treaty on the Functioning of the European Union; entered into force on December 1, 2009. Member states are required to harmonize their VATs in accordance with VAT directives. The consolidated directive on VAT currently in place came into force on January 1, 2007. See European Union, Council Directive 2006/112/EC of 28 November 2006 on the Common System of Value Added Tax, OJ L 347, December 11, 2006 (herein referred to as "the VAT directive").

382 A regulation, unlike a directive, is directly applicable in all member states. See article 288 of the Treaty on the Functioning of the European Union, *supra* note 381.

383 Treaty on the Functioning of the European Union, *supra* note 381, article 113.

384 *Ibid.*, article 238(4).

385 See Waerzeggers, *supra* note 377.

386 *Ibid.*

387 See Schenk et al., *supra* note 128.

388 European Commission, *Communication from the Commission to the European Parliament, the European Council and the Council: Towards a More Efficient and Democratic Decision Making in EU Tax Policy*, COM (2019) 8 Final (Strasbourg: EC, January 15, 2019).

representing at least 65 percent of the total EU population, vote in favour of a legislative proposal.³⁸⁹ According to the European Commission, in today's larger and more integrated European Union, unanimity is neither practical nor effective; it prevents timely action, allows a single member state to block an important policy, is used as a bargaining chip against other demands, and undermines the overall goal of market integration.³⁹⁰ For VAT harmonization in particular, the unanimity rule has undermined efforts toward simplifying VAT forms, reducing cross-border fraud, and curbing tax evasion—all of which cost the European Union billions of euros in revenue every year.³⁹¹

Interestingly, the main reason why member states have held on to unanimity in taxation matters, despite yielding to a qualified majority in most other areas, is that they consider taxation to be closely linked to national sovereignty.³⁹² After all, taxation significantly affects national revenue, budgetary needs, and domestic politics. A possible veto guards against any undesired changes at the EU level that may impinge on a member state's perceived sovereignty.³⁹³ Since the autonomy to set VAT rates (within the permissible EU-wide standard rule discussed above) is considered a national fiscal prerogative,³⁹⁴ any attempt at further rate harmonization—to bring down substantial compliance costs, maintain economic efficiency, and smooth the functioning of the internal market³⁹⁵—continues to be at the mercy of each member state's veto power.³⁹⁶ That sums up the principal challenge for VAT harmonization in the European Union: How much tax autonomy should be permitted without interfering with the goal of a successful single market?³⁹⁷ That question also highlights the key takeaway for the Indian GST from the EU VAT experience. A comparison of the decision-making process under the Indian and EU systems indicates that the GST council's majority-cum-weighted voting mechanism is more practical than

389 European Union, Treaty on European Union, OJ C 191, July 29, 1992, article 16(4).

390 *Communication from the Commission to the European Parliament, the European Council and the Council*, supra note 388, at paragraphs 1 and 2.3.

391 *Ibid.*, at paragraph 2.2.

392 *Ibid.*, at paragraphs 1 and 2.2. See also Philipp Genschel and Markus Jachtenfuchs, "How the European Union Constrains the State: Multilevel Governance of Taxation" (2011) 50:3 *European Journal of Political Research* 293-314 (<https://doi.org/10.1111/j.1475-6765.2010.01939.x>).

393 *Ibid.*

394 Waerzeggers, supra note 377.

395 *Ibid.* An "internal market" is an area without internal frontiers in which the free movement of goods, persons, services, and capital is ensured. The principal goal of the European Union is to establish and ensure the functioning of an internal market among the member states. See article 26 of the Treaty on the Functioning of the European Union, supra note 381.

396 See Vladimir Tyc, "Harmonization of Indirect Taxes in the European Union" (2008) 50:3 *International Journal of Law and Management* 87-92.

397 Sijbren Cnossen, "How Much Tax Coordination in the European Union?" (2003) 10 *International Tax and Public Finance* 625-49 (<https://doi.org/10.1023/A:1026373703108>).

the European Council's unanimity rule. Nonetheless, the fact that the European Council's unanimous decision is binding ensures that whatever decision is taken in the exercise of pooled sovereignty at the EU level³⁹⁸ will at least be followed. That, unfortunately, cannot conclusively be said of the GST council's decisions.

CONCLUSION

The GST council represents a unique experiment in cooperative federalism. Its job is to reconcile seemingly irreconcilable goals. On the one hand, the strictness of concurrent taxation requires collaboration and coordination; on the other hand, the goal of market integration suffers from bargaining and compromise. To top it all, the possibly non-binding nature of the GST council's decisions indicates poor prospects for cooperative federalism to hold the entire GST structure together for long. It is nothing short of a miracle, as is the case with India itself,³⁹⁹ that this new tax system has worked until now without incident.

But will this last? Is it safe to assume that no state will ever opt out of the GST system? If a state defies the GST council's decisions, is it not possible that other states may follow suit, leading to the eventual breakdown of the entire structure? The uncertainty surrounding whether the GST council's decisions would be followed could affect its ability to function as the fulcrum for cooperative federalism. This uncertainty needs to be dealt with at the earliest opportunity to prevent a constitutional crisis.

Nevertheless, the fact that the GST council has been able to ensure smooth functioning of a VAT at the national and subnational level is truly remarkable. It has often been observed that a VAT would be difficult to operate in federations where different tiers of government have separate (and sometimes overlapping) commodity taxation powers.⁴⁰⁰ But this skepticism regarding federations with concurrent taxation powers imposing a federal VAT⁴⁰¹ no longer holds good. Earlier the Canadian,⁴⁰² and now the Indian, GST examples show that running a VAT in a federal system is indeed possible.⁴⁰³ The United States could draw from both examples in designing a coordinated federal VAT structure.⁴⁰⁴

398 *Communication from the Commission to the European Parliament, the European Council and the Council*, supra note 388, at paragraph 2.2.

399 Ramachandra Guha, *India After Gandhi: The History of the World's Largest Democracy* (Ecco Press, 2008).

400 Indian Tax Institute, *Value-Added Tax*, supra note 134, at 17.

401 James, supra note 39.

402 Schenk et al., supra note 128. See also Perry, supra note 318.

403 Sijbren Cnossen, "VAT Coordination in Common Markets and Federations: Lessons from the European Experience" (2010) 63:3 *Tax Law Review* 583-622.

404 Harley Duncan and Jon Sedon, "Coordinating a Federal VAT with State and Local Sales Taxes," in *The VAT Reader: What a Federal Consumption Tax Would Mean for America* (Falls Church, VA: Tax Analysts, 2011), 139-62.

Policy Forum: Editors' Introduction— The Changing Nature of Work

The pace of technological change in the last half-century is staggering. The earliest computers date back only to the mid-1940s, and the first personal computers were introduced in the mid-1960s. However, their advancement since their introduction—in terms of the computational power of both “supercomputers” and personal computers—has been exponential, while the price of such technology has greatly decreased.¹ This technological change has driven advancements in virtually every field of human endeavour. Indeed, the technological evolution has been so fast-paced that government policy has been unable to keep up. Issues such as the protection of free speech and personal privacy in the age of the Internet and medical ethical issues raised by genome research and DNA mapping are but two examples.

The changes in the ways that businesses operate and the nature of the income that they earn as a consequence of technological advancement have also significantly outpaced governments' considerations as to whether their tax policies need to change as well. The impact on a government's ability to impose and collect income taxes has garnered headlines in the international context, particularly for companies that do not require a permanent establishment in the traditional bricks-and-mortar sense to sell goods and services in a country²—most notably the so-called FAANG group.³ Such concerns have led the Organisation for Economic Co-operation and Development (OECD) to expand what constitutes a permanent establishment and to propose the introduction of a digital tax, which several countries have unilaterally introduced⁴ despite the OECD's call for international coordination.

1 On the exponential growth of technology, and the exponential decrease in the cost of computers, see Max Roser and Hannah Ritchie, “Technological Progress,” *Our World in Data* (www.ourworldindata.org/technological-progress).

2 See, for example, the collection of articles in the Policy Forum feature in (2000) 68:4 *Canadian Tax Journal* 1031-82.

3 FAANG is the acronym for Facebook, Apple, Amazon, Netflix, and Google (now Alphabet). Other acronyms include Microsoft in the group (sometimes replacing Netflix, as in FAAMG or GAFAM), and some include only Google (Alphabet), Amazon, Facebook, and Apple (GAFA).

4 Canada's minister of finance announced in the 2020 fall economic statement (Canada, Department of Finance, *Fall Economic Statement—Supporting Canadians and Fighting COVID-19*, November 30, 2020) that the government would introduce a tax on corporations providing digital services, with effect from January 1, 2022. Further details were provided in the 2021 budget; see Canada, Department of Finance, 2021 Budget, annex 7, “Consultations on Other Tax Measures: Supplementary Information,” 731-37, April 19, 2021.

Technological change has also had a profound effect on the workforce in many respects: the replacement of human labour with automation (and now, artificial intelligence); the creation of careers that were unheard of even 20 years ago, particularly in the knowledge economy; job mobility, including the movement of workers across provincial and international borders; and, more fundamentally, the contractual relationship between the worker and the person paying for the work. Largely gone are the days when employees looked for a “job for life” in which their retirement was financially secured through a defined benefit pension plan. Particularly since the major downsizing that occurred in the 1980s, displacing many mid-career middle-management employees, any sense of employer responsibility to offer such employment opportunities or employee fealty has all but disappeared. Individuals in today’s workforce expect to change careers many times. The nature of the working relationship has also changed, with people shifting between full-time employment, part-time employment, short-term or long-term contracts of employment, self-employment, and sometimes wanted or unwanted unemployment.

Many of the profound changes in the workforce have been highlighted and exacerbated by the COVID-19 pandemic. Those working in the knowledge economy fairly quickly shifted to working from home or “teleworking,” while for those in more traditional sectors and jobs, such as natural resource extraction, processing, manufacturing, and retail, teleworking has generally not been an option. Some workers in the latter (traditional) sectors—restaurants, hair salons, and the travel industry, to name a few—have been the hardest hit by job losses, while some of those in the knowledge sector have welcomed the opportunities for a different work-life balance created by teleworking. A recent Statistics Canada study, based on data from supplementary questions added to the February 2021 Labour Force Survey, found that at the start of 2021, 32 percent of Canadian employees aged 15 to 69 worked most of their hours from home, compared to just 4 percent in 2016.⁵ This study focused on new teleworkers⁶ and found, among other things, that more than 80 percent hoped to work at least half of their hours from home when the pandemic ends. These statistics, coupled with the finding that approximately 90 percent of these new teleworkers are (self-reportedly) at least as productive, if not more so, as they were when working outside the home, suggest that the location of work for many people has fundamentally changed and that this change may be permanent.

The six articles in this Policy Forum consider the changing nature of work and its impact on government policy concerning the taxation of work and the protection of income derived from work. Tax legislation relies on the ability of authorities to make sharp distinctions, between employment and self-employment, earnings and

5 Statistics Canada, “Study: Working from Home: Productivity and Preferences,” April 1, 2021. For an international comparison of teleworking by country and by industry, see Organisation for Economic Co-operation and Development, *Productivity Gains from Teleworking in the Post COVID-19 Era: How Can Public Policies Make It Happen?* (Paris: OECD, September 2020).

6 Described as those who usually worked outside the home before the COVID-19 pandemic and who worked most of their hours from home in the week of February 14-20, 2021.

investment income, and firms carrying on business in Canada and firms carrying on business elsewhere. Likewise, social protection programs such as employment insurance (EI) draw sharp lines between being laid off and being fired, or between being employed and being unemployed. Yet these distinctions are becoming blurred. The “platform economy” of businesses such as Uber and DoorDash has created an entire cohort of workers who do not fit neatly into old categories of “employed” or “self-employed.” These gig economy workers are only the most visible part of a profound change in the nature of work. The COVID-19 pandemic has accelerated another profound change: the increase of teleworking. As in other areas in which government policy appears to be lagging behind changes wrought by technological change, tax and social protection policies affecting labour have been slow to recognize the changing nature of work.

Several of the articles in this Policy Forum focus on distortions created by worker classification, which traditionally has involved a binary distinction between employee and independent contractor, and in which the determination applies across the legal spectrum, whether one is considering tort law, employment law, or tax law. In the first article, Graham Purse uses the jurisprudence since the Supreme Court of Canada’s 2001 decision in *Sagaz*⁷ to highlight the fact that this binary distinction—as opposed to the test for this determination (which, as the Supreme Court indicated in *Sagaz*, depends on weighing and balancing a consideration of a non-exhaustive list of relevant factors)—has profoundly different results depending on the particular issue in dispute. Purse suggests that, if the intent of government policy is to provide protection to workers, in terms of occupational health and safety as well as income protection (not just for job loss, but also for sick leave, parental leave, etc.), either the tests should be changed so that they are more likely to determine that a worker is an employee, or the distinction should be eliminated altogether, with more workers, and those paying for their work, being required to contribute to social programs for worker protection.

In the second article, Wei Cui examines the impact of non-standard work classifications⁸ in the context of the federal government’s response to the COVID-19 pandemic in comparison with more traditional responses to job loss, such as EI and work sharing. He points out that over the past 25 years, the percentage of non-standard workers in Canada’s workforce has remained steady, at around 30 percent, but that within this group, the percentage of employees (that is, temporary full-time employees and permanent part-time employees) has increased from around 65 percent to 74 percent. Cui considers the various traditional and COVID-related worker protection programs, taking into account two key observations: first, that non-standard workers are less adequately protected by EI than standard workers while also being more adversely affected by the pandemic; and second, that even for

7 671122 *Ontario Ltd. v. Sagaz Industries Canada Inc.*, 2001 SCC 59.

8 Cui defines non-standard workers as unincorporated self-employed individuals (that is, sole proprietors, with or without paid help), temporary (full-time) workers, and permanent part-time employees.

standard (full-time, long-term) employees, both the initial impact of the pandemic and the road to recovery may include their working for a time in non-standard “flexible” employment positions.

In the third article, Bhuvana Rai considers the deduction of expenses related to working from home, a situation that—as noted above—has increased for many since the start of the pandemic and could well continue even after returning to the employer’s office is possible. While both employees and independent contractors are subject to substantially the same threshold test before any home office expenses are deductible,⁹ once this threshold is met, there is a significant difference in the kind of expenses that are deductible by these two categories of workers. In particular, employees cannot deduct any amount on account of their mortgage or property taxes where the office is in an owner-occupied residence, whereas independent contractors can deduct a pro rata share of both. Furthermore, an employee has an added threshold in that the contract of employment must require the employee to incur the costs of a home office and the employer must certify that such is the case. Rai examines various possible reforms to make the treatment of home office expenses by employees and independent contractors more equitable.

In the fourth article, Michaël Robert-Angers and Luc Godbout consider Quebec’s novel approach to tax compliance of Uber drivers, which was struck through an agreement reached by the provincial government with Uber in 2016. While their article does not focus on worker classification per se, the concerns with tax compliance of Uber drivers—and particularly, the requirement to collect and remit goods and services tax (GST) and Quebec sales tax (QST) on their fares—stem in part from uncertainty as to whether such drivers are independent contractors (as they are typically characterized in their agreements with Uber) or employees. As independent contractors, many Uber drivers could perhaps have been classified as small suppliers, thus potentially alleviating the need for them to charge GST and QST on their fares and thereby creating an advantage over traditional licensed (and regulated) taxi service providers. Under the agreement between Quebec and Uber, all Uber drivers are required to be licensed for GST and QST purposes in order to use the Uber platform, and Uber collects GST and QST on their behalf. These requirements will also likely better ensure income tax compliance and reduce tax evasion by such workers, by giving the government more comprehensive and accurate sales information.

In the fifth article, Judith Freedman provides some thoughtful commentary on the previous four articles through a case study focusing on the United Kingdom,

9 Under subsections 8(13) (for employees) and 18(12) (for independent contractors) of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended, the home office either must be the principal place at which the work is performed, or must be used exclusively for such work and be used on a regular and continuous basis for meetings with customers or others (clients or patients, for independent contractors) in the course of such work. Where business offices have been closed during COVID-19, both employees and independent contractors have satisfied the former test.

where distortions in tax policy stemming from the classification of workers have been caused largely by the high rates of national insurance contributions in respect of workers classified as employees. Freedman advocates that the classification of the worker should not be a one-size-fits-all determination, so that the outcome need not necessarily be the same in tax law and employment law, for example. She concludes that “[t]hose concerned with tax and social security payments need to go back to first principles and focus on removal of differences that cause distortion and the creation of systems that support compliance.”¹⁰

In the sixth and last article, Guy Jason and Shivani Joshi examine some key income tax and payroll implications of teleworking by employees from the perspective of the employer and the tax authority.¹¹ The ability to telework opens virtually limitless possibilities with respect to the geographical location from which the employee works. Indeed, some tropical paradises are offering incentives to attract teleworkers as a means of replacing lost tourism dollars.¹² As Jason and Joshi discuss, when employees can work from anywhere in the world, several compliance concerns arise, such as whether the employee creates a permanent establishment for the employer (a question that is relevant not just internationally but also inter-provincially in Canada), whether the employer must withhold payroll taxes imposed by the jurisdiction in which the employee is located, and whether customers of the employer are required to withhold tax on payments made to the employer because the services are being performed by employees in the customer's country.

As all of these articles illustrate, there have been significant changes in the way in which workers provide their services as a result of technological advancement, including changes in the nature of the contractual relationship between the worker and the payer, and also in the location from which the worker's services are performed. The pace of change has accelerated greatly in the past 18 months owing to the COVID-19 pandemic. It is unlikely that the return to normality—whatever that may look like post-pandemic—will reverse these changes, and the government's tax policy and its tax administration will need to adapt to “the new normal.”

Daniel Sandler
Frances Woolley
Alan Macnaughton
Editors

10 Judith Freedman, “Policy Forum: Tax, Social Security, and Employment Status—Removing the Distortions in the United Kingdom,” in this feature, at 557.

11 Of course, teleworking is not limited to employees. Indeed, independent contractors who offer goods or services through digital platforms have more geographical freedom, since employees may be constrained in their location of work by their employers' policies.

12 See, for example, Monica Jackson, “Imagine Teleworking in Barbados Until COVID-19 Is Brought Under Control,” *Fresh Gigs Club*, March 5, 2021; and Lauren Stuttaford, “Will There Be More Digital Nomads from 2021?” *Air Doctor*, January 28, 2021.

Policy Forum: Sagaz at 20—Evaluating Employment and Independent Contractor Relationships in a Changing World

Graham Purse*

PRÉCIS

En 2001, la Cour suprême du Canada a tranché la décision *Sagaz*. Sa décision constitue une partie importante de la jurisprudence Canadienne qui détermine si un travailleur est un employé ou un entrepreneur indépendant. Au cours des vingt années suivantes, le travail a changé. Les tests traditionnels de classification des travailleurs peuvent ne plus être appropriés dans la nouvelle économie à la tâche ou à la demande. Les tests multifactoriels utilisés par les tribunaux pour classer les travailleurs dans deux catégories distinctes, chacune avec des avantages et des coûts très différents, ne sont possiblement plus appropriés. Les approches futures à cette question devraient envisager l'utilisation de tests juridiques qui sont soit plus susceptibles de produire une détermination que les travailleurs ont droit à diverses protections sociales, soit qui, à défaut, estiment que davantage de travailleurs paient et sont protégés par diverses protections sociales disponibles aux employés.

ABSTRACT

In 2001, the Supreme Court of Canada decided *Sagaz*. That decision became an important part of the Canadian jurisprudence that resolves whether a worker is an employee or an independent contractor. In the subsequent 20 years, the work world has changed. Traditional tests of worker classification may not be appropriate in the new on-demand or gig economy. The multifactor tests that courts use to slot workers into two discrete categories, each with vastly different benefits and costs, are arguably no longer appropriate. Future approaches to this issue should consider either the use of legal tests that are more likely to produce a determination that workers are entitled to various social

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protections or, alternatively, rules that deem more workers to pay into, and be protected by, various social protections available to employees.

KEYWORDS: EMPLOYMENT ■ INDEPENDENT CONTRACTORS ■ TAX POLICY ■ GIG WORKERS ■ SOCIAL SECURITY ■ TAX SYSTEMS

CONTENTS

Introduction	454
The Incentives of the Parties	455
The Unsatisfactory State of the Law in Canada	457
Multifactor Malaise	463
A Whole New World: I Can Show You a Sham	465
Reform Possibilities	467
Periodic Payment Approach	469
Alignment of Forms of Work	469
Bright-Line Test	470
Step-Back Test	471
ABC Test	471
Independent Worker Category	472
Caveat	473
Conclusion	473

INTRODUCTION

In 2001, the Supreme Court of Canada's decision in *Sagaz*¹ addressed yet again the question of whether a worker is an employee or an independent contractor. Like courts before and after, the Supreme Court applied a complex, multifactor analysis to answer a question with an arguably misplaced focus. The court conceded that the factors that it used were non-exhaustive and that it had followed no set formula as to their application; rather, the relative weight of the factors depended on the facts and circumstances of the particular case.

Sagaz is merely a symptom of a larger problem: a changing economy and an uncertain multifactor analysis that is used not only in tort law, but also in the application of various forms of employment legislation, contractual rights, and tax law. The multifactor analysis enunciated in *Sagaz* has little relevance to the policy issue of whether persons should, regardless of the nature of their work, pay into, and be entitled to, social protections that are designed to protect workers.²

1 671122 *Ontario Ltd. v. Sagaz Industries Canada Inc.*, 2001 SCC 59.

2 For an extensive discussion of the distinction between employees and independent contractors in certain areas of Canadian law and the different policy objectives that may apply in each area, see Lara Friedlander, "What Has Tort Law Got To Do with It? Distinguishing Between Employees and Independent Contractors in the Federal Income Tax, Employment Insurance, and Canada Pension Plan Contexts" (2003) 51:4 *Canadian Tax Journal* 1467-1519.

In this article, I first consider the distinction between employment and independent contractor status, along with incentive effects and compliance issues. Next, I review the development of Canadian jurisprudence that has wrestled with this problematic distinction. I then discuss how the on-demand, gig, and sharing economies may change the relevance of the distinction. Finally, I consider six possibilities for law reform in Canada. These reform possibilities assume that workers should have more access to social protections under federal and provincial law.

THE INCENTIVES OF THE PARTIES

There are a number of incentives that may cause workers to prefer an employment relationship. Workers are paid for human effort.³ This is true regardless of whether the effort of the worker is exerted under an employment or an independent contractor arrangement.⁴ A worker who is classified as an employee will be entitled to the benefits of social welfare legislation such as the Canada Pension Plan (CPP) and employment insurance (EI),⁵ along with occupational health and safety, workers' compensation,⁶ labour law,⁷ minimum wage laws, and laws governing hours of work.⁸

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- 3 Jinyan Li, Arjin Choi, and Cameron Smith, "Automation and Workers: Re-Imagining the Income Tax for the Digital Age" (2020) 68:1 *Canadian Tax Journal* 99-124, at 111: "Under the ITA, workers are treated differently depending on the characterization of their work despite the fact that all of the income they generate is derived from human effort."
 - 4 There are two notable alternatives to employment and sole proprietorship/independent contractor status. First, the personal services business rules, found in subsection 125(7) of the Income Tax Act, have long been intended to counteract disguised employment relationships that rely on the interposition of a company between the employee and the employer. See the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act. Second, where a worker incorporates, that worker may ultimately extract earnings as capital gains (taxed at a lower rate or even exempted) on the sale of the company stock, giving rise to horizontal equity concerns in respect of the treatment of a person earning the same stream of income as an employee.
 - 5 See Richard R. Carlson, "Why the Law Still Can't Tell an Employee When It Sees One and How It Ought To Stop Trying" (2001) 22:2 *Berkeley Journal of Employment & Labor Law* 295-368, at 368. Carlson was writing in a US context, but the same principle applies in Canada. Carlson further argues that employee status matters precisely because employment law makes it matter.
 - 6 See Karen Stilwell and Douglas Wright, "Employee vs. Independent Contractor: Is Everything That's New Old Again?" in 2014 *Atlantic Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2014), 7:1-27, at 7:1-2.
 - 7 See David Williams, "Social Security Taxation," in Victor Thuronyi, ed., *Tax Law Design and Drafting*, vol. 1 (Washington, DC: International Monetary Fund, 1996), 340-400.
 - 8 See Barry Leibowicz, "Independent Contractor or Employee?" (2011) 86:6 *CPA Journal* 46-55, at 47. Leibowicz notes that the social protections accorded to employees (many of which will be viewed as obligations on the employer) can be avoided if the work is instead performed by an independent contractor.

Many protections turn on this distinction, but it is a distinction that the tax system is arguably “ill equipped to handle.”⁹

Being an employee entitles workers to certain federal protections. The unemployment insurance program (EI since 1996)¹⁰ was established by the federal government in 1940 to assist workers who lost employment, because earlier provincial-municipal programs were unsuccessful.¹¹ The CPP commenced in 1967; it is intended as a general income-related pension program for workers.¹² These programs are intended to provide protections for workers in Canada by reducing the risks associated with loss of work and reducing poverty in retirement years. Independent contractors often participate in the CPP (or the Quebec equivalent, the Quebec Pension Plan [QPP]).

From the viewpoint of worker incentives, however, there may be major tax penalties associated with working as an employee.¹³ In Canada, employees tend to pay more tax, compared to independent contractors.¹⁴ Independent contractors benefit from more deductions than employees,¹⁵ the definition of income may be less clear-cut for contractors, and contractors are not subject to employer withholdings.¹⁶ By contrast, employer withholdings and reporting systems can assist with compliance, and deductions are limited.¹⁷

Employers (or payers) may have an incentive to characterize workers as independent contractors. Employers may intentionally misclassify workers in order to limit liability and labour costs. Pinsof has described a “culture of misclassification.”¹⁸

9 Walter H. Nunnallee, “Why Congress Needs To Fix the Employee/Independent Contractor Tax Rules: Principles, Perceptions, Problems, and Proposals” (1992) 20:2 *North Carolina Central Law Journal* 93-120, at 93.

10 Employment Insurance Act, SC 1996, c. 23.

11 See J. Harvey Perry, *A Fiscal History of Canada—The Postwar Years*, Canadian Tax Paper no. 85 (Toronto: Canadian Tax Foundation, 1989), at 681. As discussed subsequently in this article, applying EI to new forms of work relationships in the gig economy may be challenging.

12 Ibid., at 717.

13 Judith Freedman and Helen Miller, *Tax and Employment Status: Myths That Are Endangering Sensible Tax Reform* (London, UK: Institute for Fiscal Studies, July 2020), at 6. Freedman and Miller argue in a UK context that this problem has “grown over the years due to changes in working practices and the structure of the tax system.” Ibid.

14 Li et al., *supra* note 3, at 111.

15 Nunnallee, *supra* note 9, at 93.

16 See Stephen Smith, *Taxation: A Very Short Introduction* (Oxford: Oxford University Press, 2015), at 79. While business income is controlled by section 9 of the Act, employment income is strictly regulated by section 5, with very narrow scope for deductions or exclusions.

17 See section 153 of the Act, and Smith, *supra* note 16, at 77.

18 Jennifer Pinsof, “A New Take on an Old Problem: Employee Misclassification in the Modern Gig-Economy” (2015) 22:2 *Michigan Telecommunications & Technology Law Review* 341-73, at 349.

Furthermore, a worker can be unintentionally misclassified.¹⁹ Harned, Kryda, and Milito have observed that certain industries, such as delivery and construction, have experienced “persistent misclassification.”²⁰ Moreover, workers may contribute to the misclassification problem if they are motivated, because of the greater scope of deductions, to act as independent contractors.²¹

There may be some incentives related to value-added tax (VAT) as well. Independent contractors may claim input tax credits on purchases made for business purposes, even where there is an element of personal use. Additionally, platforms may have an incentive to have collection occur at the driver or service-provider level. For example, subsequent to the 2021 UK Supreme Court decision in *Uber BV*,²² it has been noted that Uber had taken the position that VAT should be borne by its drivers (who were unlikely to reach the £85,000 UK small supplier threshold),²³ and as a result, Uber may face a £2 billion VAT bill in the United Kingdom.²⁴

THE UNSATISFACTORY STATE OF THE LAW IN CANADA

Employment, tort, tax, and contractual issues can emerge from the determination of whether a person is an employee or an independent contractor.²⁵ This determination is multifaceted, and it is possible that, in a given fact situation, there could be a finding of employment under one aspect of Canadian law and of independent contractor status under another. *Sagaz*²⁶ is undoubtedly the leading case in Canada on the employee-or-independent-contractor distinction, having been cited more than 1,300 times by Canadian courts.

19 Jenna Amato Moran, “Independent Contractor or Employee? Misclassification of Workers and Its Effect on the State” (2009) 28 *Buffalo Public Interest Law Journal* 105-32, at 106. As Moran notes, *ibid.*, unintentional misclassification results from the difficulties inherent in ascertaining the status of the worker.

20 Karen R. Harned, Georgine M. Kryda, and Elizabeth A. Milito, “Creating a Workable Legal Standard for Defining an Independent Contractor” (2010) 4:1 *Journal of Business, Entrepreneurship & the Law* 93-117, at 112. This article addresses the situation in the United States, but the issue exists in Canada. The authors point to research by Harvard’s schools of law and public health estimating that the construction industry in Maine and Massachusetts had misclassification rates as high as one in seven.

21 Li et al., *supra* note 3, at 112.

22 *Uber BV v. Aslam*, [2021] UKSC 5.

23 See Guillermo Íñiguez, @guilleiniguez, *Twitter.com*, February 19, 2021: “For a long time, Uber argued that, even if it was found to be a transport provider, it was a mere intermediary, and its VAT burden should be borne by its allegedly self-employed drivers (who, incidentally, hardly ever reach the 80k GBP taxable threshold).”

24 Jamie Nimmo, “Uber ‘Could Face £2bn VAT Bill,’” *Sunday Times*, February 21, 2021.

25 For an extensive treatment of these four distinctions, see Friedlander, *supra* note 2, at 1469.

26 *Supra* note 1.

Table 1 shows some of the fundamental differences in the treatment of the two categories of workers in Canada.

Early Canadian cases often discuss independent contractor status in the context of vicarious liability actions.²⁷ Generally, employers are vicariously liable for torts of employees occurring in the course of their employment.²⁸ Carlson identified, at least in the United States, a shift by the 1880s from tort to worker status in court cases.²⁹ In the 1946 decision in *Montreal Locomotive*, Lord Wright described the task of earlier jurisprudence as often being to “determine whether the case was one of master and servant, mostly in order to decide issues of tortious liability on the part of the master or superior.”³⁰

Montreal Locomotive is an early, leading case that considered the test for worker classification. The Judicial Committee of the Privy Council observed that “[i]t has been suggested that a fourfold test would in some cases be more appropriate, a complex involving (1) control; (2) ownership of the tools; (3) chance of profit; (4) risk of loss. Control in itself is not always conclusive.”³¹ Lord Wright, writing for the judicial committee, concluded that “[i]n many cases the question can only be settled by examining the whole of the various elements which constitute the relationship between the parties.”³² He warned of the “difficulty which is inherent in deciding questions like this.”³³

When confronted with a similar problem in 1952, Lord Denning expressed concern that it is impossible to give a precise definition. He described the “troublesome question of the distinction between a contract of service and a contract for services,”³⁴ and argued that it was “difficult to say where the difference lies.”³⁵

In 1986, the Federal Court of Appeal issued its decision in *Wiebe Door*.³⁶ This case has been cited hundreds of times by Canadian courts attempting to resolve the

27 See, for example, *Johnston v. Hastie* (1870), 30 Up Can QB 232; *Cunningham v. Grand Trunk Railway* (1871), 31 Up Can QB 350; *Gillson v. North Grey Railway* (1874), 35 Up Can QB 475; *Grassick v. Toronto (City)* (1876), 39 Up Can QB 306; and *Walker v. McMillan*, [1882] 6 SCR 241.

28 Philip H. Osborne, *The Law of Torts*, 5th ed. (Toronto: Irwin Law, 2015), at 380-84. Osborne also explains, *ibid.*, at 386, the rationale for the strict liability rule—namely, by transferring risk to employers, the rule encourages employers to take steps to mitigate risks, such as training and supervision.

29 Carlson, *supra* note 5, at 315, footnote 96.

30 *Montreal (City) v. Montreal Locomotive Works Ltd.*, [1944] UKPC 44, at paragraph 19; [1946] 3 WWR 748; [1946] JCI No. 10; [1947] 1 DLR 161.

31 *Ibid.*, at paragraph 19.

32 *Ibid.*

33 *Ibid.*

34 *Stephenson, Jordan & Harrison Ltd. v. MacDonald & Evans*, [1952] WN 7; [1952] 1 TLR 101; 69 RPC 10 (Eng. CA).

35 *Ibid.*

36 *Wiebe Door Services Ltd. v. MNR*, 87 DTC 5025 (FCA).

TABLE 1 Comparison of Treatment of Employees and Independent Contractors in Canada

Legal issue	Employee	Independent contractor
Tort law	Vicarious liability for the employer	Generally no vicarious liability for the payer
Employment law	Occupational health and safety, workers' compensation, minimum wage laws, labour laws, and laws governing hours of work	Potentially permissive/mandatory enrolment in workers' compensation; ^a if a "dependent contractor," may be entitled to reasonable notice of termination
Income tax law	Payroll withholding taxes/limited deductions	Extensive deductions; more opportunity for avoidance and evasion
Employment insurance	Mandatory contributions	No contributions
Canada Pension Plan/ Quebec Pension Plan . . .	Mandatory contributions	Avoidable with incorporation ^b

a This is a complex issue with variations across Canadian provinces.

b The self-employed are covered by Canada Pension Plan/Quebec Pension Plan (and pay premiums), but by incorporating and paying dividends, this can be avoided. For unincorporated contract workers, this will generally not be an issue.

issue of whether a worker is an employee or an independent contractor. *Wiebe Door* originated in an appeal to the Federal Court of Appeal on the issues of CPP and unemployment insurance. The case distills the criteria into four tests: "(a) The degree or absence of control, exercised by the alleged employer, (b) Ownership of tools, (c) Chance of profit and risks of loss, (d) Integration of the alleged employees work into the alleged employer's business."³⁷

This brings us to *Sagaz*. In 2001, the Supreme Court of Canada held that "there is no universal test to determine whether a person is an employee or an independent contractor,"³⁸ but the court did agree substantively with the *Wiebe Door* approach:

The central question is whether the person who has been engaged to perform the services is performing them as a person in business on his own account. In making this determination, the level of control the employer has over the worker's activities will always be a factor. However, other factors to consider include whether the worker provides his or her own equipment, whether the worker hires his or her own helpers, the degree of financial risk taken by the worker, the degree of responsibility for investment

37 Ibid., at paragraph 3, per MacGuigan J (quoting from the decision of the Tax Court of Canada in *Wiebe Door*).

38 Supra note 1, at paragraph 47.

and management held by the worker, and the worker's opportunity for profit in the performance of his or her tasks.³⁹

Writing for the court, Major J expressed an important qualification to the above tests:

[T]he . . . factors constitute a non-exhaustive list, and there is no set formula as to their application. The relative weight of each will depend on the particular facts and circumstances of the case.⁴⁰

That statement exhibits an unusual degree of candour: (a) the test is non-exhaustive, (b) there is no set formula, and (c) weight is contextual. A cynical appraisal might suggest that the court is inviting judges to work backward from the conclusion that they desire in a particular case. But this is merely a symptom of the problem, namely, that courts are being asked to answer a question that is fact-dependent in the context of rules that do not always have clear policy objectives.

Two arguably unhelpful cases followed *Sagaz: Wolf*⁴¹ and *Royal Winnipeg Ballet*.⁴² Up to and including *Sagaz*, courts had generally weighed actual facts relating to the human supply of labour—that is, real events on the ground. Subsequent to *Sagaz*, “intention” was added to the determination.⁴³ The use of intention in resolving tax matters is contentious. Arnold, for example, has explained that a taxpayer's intention is both “purely subjective” and “invariably self-serving.”⁴⁴

In *Wolf*, the issue was whether a US contractor was an employee in Canada. The case related to facts occurring in Quebec and therefore involved an examination of the Civil Code of Québec.⁴⁵ In its 2002 decision, the Federal Court of Appeal

39 Ibid.

40 Ibid., at paragraph 48.

41 *Wolf v. Canada*, 2002 FCA 96.

42 *Royal Winnipeg Ballet v. Canada (Minister of National Revenue)*, 2006 FCA 87.

43 Tamara Larre, “The Role of Intention in Distinguishing Employees from Independent Contractors” (2014) 62:4 *Canadian Tax Journal* 927–70, at 928: “The following year, the Federal Court of Appeal's decision in *Wolf v. Canada* introduced a new element: the intention of parties.”

44 Brian Arnold, “Supreme Court Affirms Federal Court of Appeal Decision in Macdonald: Gains and Losses from Hedging of a Capital Asset Are on Capital Account,” *The Arnold Report*, posting No. 173, March 23, 2020 (www.ctf.ca): “A taxpayer's intention, which is purely subjective, should rarely, if ever, be relevant for tax purposes. I cannot think of a provision of the Act that refers to a taxpayer's intention. On the other hand, a taxpayer's purpose is often referred to in the Act and should be determined objectively on the basis of all the circumstances, including a taxpayer's testimony as to his or her subjective intention. However, courts must recognize that a taxpayer's testimony as to his or her subjective intention is invariably self-serving and should be given little or no weight, and certainly should not be used by the Tax Court to decide cases in favour of taxpayers that they find credible.”

45 Civil Code of Québec, CQLR c. CCQ-1991.

inserted an examination of the intention of the parties to the contract into the test,⁴⁶ but seemingly added the requirement that the performance and terms of the contract reflect the intentions of the parties.⁴⁷

Four years later, the Federal Court of Appeal again referred to intention, this time under common law, in *Royal Winnipeg Ballet*. Sharlow JA implicitly acknowledged the artificiality of the approach: “[I]f it is established that the terms of the contract, considered in the appropriate factual context, do not reflect the legal relationship that the parties profess to have intended, then their stated intention will be disregarded.”⁴⁸ This of course makes sense, since the intention of the parties has nothing to do with the actual reality of the conditions under which labour is supplied. If I intended to bake a cake, that expressed intention is not really relevant to a third party (for example, a customer), particularly if I actually ended up baking a meat pie.

It is in the dissent of Evans JA in *Royal Winnipeg Ballet* where a “thoughtful and persuasive” analysis can be found.⁴⁹ Evans JA found that the determination of the legal status of a worker “does not rest on the legal label attached to the agreement by the parties or on their purpose in entering into it.”⁵⁰ Although Evans JA was describing the interpretation of a contract, he went on to confirm that “[t]he common law of contract attaches little if any significance to parties’ understanding of, or stated intention about, the legal nature of their relationship.”⁵¹ This description is equally apt in a broader context: the legal system should attach relatively less significance to the terms of the relationship insofar as they may or may not entitle a supplier of human effort to the social protections afforded to employees.

More recently, the Federal Court of Appeal in *Connor Homes*⁵² proposed a two-step test that lessens the impact of prior decisions. Under the *Connor Homes* test, (1) the subjective intention of each party is ascertained, and (2) one ascertains whether “an objective reality sustains the subjective intent of the parties.”⁵³ With

46 The Civil Code of Québec, *ibid.*, at article 1425, specifically directs that common intention shall be used in interpreting contracts.

47 *Wolf*, *supra* note 41, at paragraph 120: “In our day and age, when a worker decides to keep his freedom to come in and out of a contract almost at will, when the hiring person wants to have no liability towards a worker other than the price of work and *when the terms of the contract and its performance reflect those intentions*, the contract should generally be characterised as a contract for services. If specific factors have to be identified, I would name lack of job security, disregard for employee-type benefits, freedom of choice and mobility concerns [emphasis added].”

48 *Royal Winnipeg Ballet*, *supra* note 42, at paragraph 61.

49 I find myself in agreement with Larre, *supra* note 43, at 942: “Unlike the decisions advocating the use of intention, which provide few and weak reasons for introducing such a significant change in the law, the decision of Evans JA provides thoughtful and persuasive ideas.”

50 *Royal Winnipeg Ballet*, *supra* note 42, at paragraph 92.

51 *Ibid.*, at paragraph 114.

52 *1392644 Ontario Inc. (Connor Homes) v. Canada (National Revenue)*, 2013 FCA 85.

53 *Ibid.*, at paragraphs 39-40.

respect, subjective intention adds nothing useful to the determination of whether the underlying facts present in working conditions support a particular legal result.

Subsequent to *Connor Homes*, it has been argued that jurisprudence of the Tax Court of Canada has evolved to such a state that “intention that is common to both parties can, to a certain degree, override objective indications of their relationship.”⁵⁴ Indeed, Graham J recently found a worker to be an independent contractor even though there was “no real risk of loss and no true ability to profit.”⁵⁵

The use of intention as a legal test introduces a significant degree of uncertainty into the characterization of relationships between parties for tax purposes. Equally troubling, payers and payees may be able, in the contract, to use “intention” to paper over their true relationship.⁵⁶ In 2021, in *Uber BV*, the UK Supreme Court—in contrast to the emerging Canadian approach—ruled that using the terms of the written contract to determine worker status, in the context of the UK worker legislation,

would reinstate the mischief which the legislation was enacted to prevent. It is the very fact that an employer is often in a position to dictate such contract terms and that the individual performing the work has little or no ability to influence those terms that gives rise to the need for statutory protection in the first place.⁵⁷

We cannot blame Canada’s courts for the state of the law. The courts are being asked to answer a question that is fact-dependent, often with a limited apparent policy rationale. Courts are not being called upon to answer the more important question: whether any given worker should be entitled to social protections (and a host of other benefits). The factual nature of the relationship between the payer and the payee in a work relationship—and the parties’ self-serving statements of intention—should not generally be primary in determining whether a person enjoys social protections and programs.

Added to this complexity is the emerging category of “dependent contractors,” which Canadian courts in some provinces have recognized.⁵⁸ This new category differs from the “binary employment classification system.”⁵⁹ A dependent contractor,

54 Jin Wen, “Employee Versus Contractor: Parties’ Intentions Outweigh Conduct” (2020) 10:4 *Canadian Tax Focus* 13, at 13.

55 *Insurance Institute of Ontario v. MNR*, 2020 TCC 69, at paragraph 68.

56 Tariq Jomaa, “Employee or Independent Contractor? Insurance Institute of Ontario” (2021) 21:1 *Tax for the Owner-Manager* 6-7, at 6: “Advisers can direct clients who are interested in creating independent contractor relationships to establish a common intention by explicitly stating the nature of the relationship in a written agreement.”

57 *Uber BV*, supra note 22, at paragraph 76.

58 See George A. Green, “Canada: Employment Law and the Emerging Notion of the Dependent Contractor,” *Mondaq*, November 14, 2018 (www.mondaq.com/canada/employee-rights-labour-relations/754750/employment-law-and-the-emerging-notion-of-the-dependent-contractor).

59 Pinsof, supra note 18, at 341.

unlike an independent contractor, may be entitled to reasonable notice of termination,⁶⁰ and the status of the worker is not necessarily determined by the terms of the contract between the parties.⁶¹

MULTIFACTOR MALAISE

Rather than conceding that worker classification often involves asking a question without reference to relevant policy objectives,⁶² courts and tax authorities around the world have developed multifactorial and nebulous approaches to try to bring additional certainty to worker classification. This has failed. If the question instead were whether persons should, regardless of the nature of their work, pay into, and be entitled to, social protections, the debate would be shaped by more important policy considerations.

Many common-law jurisdictions utilize a list of factors, which are then weighed, to ascertain whether an employment relationship exists. To show how unpredictable this process can be, I have attempted to aggregate, in the following list, the multiple factors relied on in various jurisdictions:⁶³

use of bids/quotes	marketing
availability of benefit plans	management responsibility
control of business decisions	more than one client
capital investment	no holiday/sick pay
terms of contract	opportunity for profit
worker's control of employees	remittance of own taxes

60 Green, *supra* note 58.

61 *Khan v. All-Can Express Ltd.*, 2014 BCSC 1429, at paragraph 27.

62 At least one judge has acknowledged the existence of a conceptual problem. In *Cotter v. Lyft, Inc.*, 60 F Supp 3d 1067, at 1081 (ND Cal. 2015), Vince Chhabria J wrote, “[T]he jury . . . will be handed a square peg and asked to choose between two round holes. The test the California courts have developed over the 20th Century for classifying workers isn’t very helpful in addressing this 21st Century problem.” See Miriam A. Cherry, “Beyond Misclassification: The Digital Transformation of Work” (2016) 37:3 *Comparative Labor Law & Policy Journal* 577–602, at 583.

63 The factors listed in the text above are derived from Canadian, US, UK, and Australian tax authority guidelines. See Canada Revenue Agency, “Employee or Self-Employed?” (www.canada.ca/en/revenue-agency/services/forms-publications/publications/rc4110/employee-self-employed.html#mpl_slf_mpld_wrkr); United States, Internal Revenue Service, “Independent Contractor (Self-Employed) or Employee?” (www.irs.gov/businesses/small-businesses-self-employed/independent-contractor-self-employed-or-employee); United Kingdom, “Employment Status” (www.gov.uk/employment-status/selfemployed-contractor); and Australian Taxation Office, “Difference Between Employees and Contractors” (www.ato.gov.au/Business/Employee-or-contractor/Difference-between-employees-and-contractors). Many of the factors set out in the guidelines cited above are used by the courts in the respective jurisdictions. It is expected that the UK guidance will be updated in 2021 in light of the *Uber BV* decision (*supra* note 22).

financial risk	right to refuse work
requirement to fix unsatisfactory work	risk
incurring of expenses	routine pay
independent work	work limited to a specific job/task
insurance	ability to subcontract
lack of continuity	submission of invoices
lack of integration	control over timing
lack of oversight	provision of tools
lack of protections	provision of training

and we cannot forget intention. We can also add relative bargaining power to the foregoing list.⁶⁴

In applying a multifactor analysis, one should be mindful of the following observations:

- “[T]here is no ‘magic’ or set number of factors that ‘makes’ the worker an employee.”⁶⁵
- Judges have “generally failed to articulate any consistent rule or test.”⁶⁶
- Judges have “perpetuated an ever-expanding catalogue of ‘factors.’”⁶⁷
- The process will involve the “weighing of multiple imprecise factors, many of which may point to different conclusions.”⁶⁸
- Multifactor lists also invite courts to emphasize some factors while ignoring others.⁶⁹
- Finally, as the Supreme Court of Canada has directed, “the . . . factors constitute a non-exhaustive list, and there is no set formula as to their application.”⁷⁰

All of this indicates, *ab initio*, that there will be significant uncertainty in worker classification. This uncertainty has been described as inviting an “unsound degree of subjectivity.”⁷¹ A realistic view is that the tests are uncertain and fail to address the question of whether a worker should be entitled to social protections.

64 *Autoclenz Limited v. Belcher*, [2011] All ER (D) 251, at paragraph 35.

65 Internal Revenue Service (IRS), “Independent Contractor (Self-Employed) or Employee?” *supra* note 63.

66 Carlson, *supra* note 5, at 299.

67 *Ibid.*

68 Leibowicz, *supra* note 8, at 46.

69 Kai Thordarson, “AB-5 and Drive: Worker Classification in the Gig Economy” (2021) 17:1 *Hastings Business Law Journal* 137-62, at 150.

70 *Sagaz*, *supra* note 1, at paragraph 48.

71 Thordarson, *supra* note 69, at 151.

A WHOLE NEW WORLD: I CAN SHOW YOU A SHAM

Twenty years after *Sagaz*, we are entering a world of “sham self-employment,” as described by Fredman et al.⁷² The on-demand, gig, and sharing economies all represent technological departures from customary forms of employment. We are witnessing the growth of these business models, generally facilitated by digital platforms.⁷³ Challenges in worker classification have increased in the sharing economy.⁷⁴ Applying traditional classification tests produces “awkward and puzzling results.”⁷⁵

Katz and Krueger reported substantial growth in alternative work arrangements in the United States between 2005 and 2015.⁷⁶ In Canada, there is evidence that many incorporated small businesses involve a single person with no employees, and the growth of these arrangements exceeds that of corporations with employees.⁷⁷ As the number of businesses using these “non-traditional” arrangements increases, so does the problem of worker misclassification.⁷⁸ Research by Jeon, Liu, and Ostrovsky shows that gig work is increasing in Canada, particularly with respect to online platforms; by 2016, gig workers constituted 8.2 percent of all workers in Canada.⁷⁹

Given that common-law tests for worker classification are uncertain, employers may have an incentive to “test the limits of the law.”⁸⁰ By creating relationships that are ambiguous, the putative employer can retain control over the worker while avoiding the obligations that arise from an employment relationship.⁸¹ In cases that

72 Sandra Fredman, Darcy du Toit, Mark Graham, Kelle Howson, Richard Heeks, Jean-Paul van Belle, Paul Mungai, and Abigail Osiki, “Thinking out of the Box: Fair Work for Platform Workers” (2020) 31:2 *King’s Law Journal* 236-49, at 236 (<https://doi.org/10.1080/09615768.2020.1794196>).

73 Blake E. Stafford, “Riding the Line Between Employee and Independent Contractor in the Modern Sharing Economy” (2016) 51:5 *Wake Forest Law Review* 1223-54, at 1224.

74 *Ibid.*

75 *Ibid.*, at 1239. Stafford explains that “courts have recognized that these ‘outmoded’ worker classification tests are ill-suited for the sharing economy and ultimately force ‘a square peg [into one of] two round holes.’” *Ibid.*

76 Lawrence F. Katz and Alan B. Krueger, *The Rise and Nature of Alternative Work Arrangements in the United States, 1995-2015*, NBER Working Paper no. 22667 (Cambridge, MA: National Bureau of Economic Research, 2016), at 2.

77 Stilwell and Wright, *supra* note 6, at 7:3. Stilwell and Wright observe that in the period 2001-2011 “the number of self-employed persons carrying on business through a corporation without paid help grew at an annualized rate of 4.6%, much faster than the rate of growth of incorporated businesses in which there is paid help.” *Ibid.*

78 Harned et al., *supra* note 20, at 94.

79 Sung-Hee Jeon, Huju Liu, and Yuri Ostrovsky, “Measuring the Gig Economy in Canada Using Administrative Data,” Statistics Canada, December 16, 2019 (www150.statcan.gc.ca/n1/pub/11f0019m/11f0019m2019025-eng.htm).

80 See generally Carlson, *supra* note 5, at 336.

81 *Ibid.*

are close to the line, employers can also “manipulate”⁸² or “contort”⁸³ aspects of the working relationship to avoid employment relationships. Penalties for misclassification can also arise,⁸⁴ as can compliance issues.⁸⁵

How does this new world of work differ from the old? There are some benefits to the new world. Hailing a taxi is often much less stressful than it was in the past; you can even choose the type of “taxi” and follow it on your cellphone as it comes to pick you up. It has been common for these types of digital companies (for example, Uber or Lyft) to classify workers as independent contractors.⁸⁶

These companies have asserted that they are merely facilitating transactions, but courts have been reluctant to accept arguments that such companies are not actually exerting a degree of control over workers.⁸⁷ The Organisation for Economic Co-operation and Development (OECD) has also explained that these types of digital markets tend to be traceable and may therefore assist with compliance.⁸⁸

The new world of work also raises some concerns about worker protections and the functioning of the tax system. To the extent that digital platforms control prices, work times, and aspects of service provision, they may actually undermine the freedom associated with independent contractor status.⁸⁹ These working conditions are a “far cry” from “genuine entrepreneurship.”⁹⁰

Compliance is another area of concern. For example, Prassl has observed that the “devolution of tax responsibility to individual contractors . . . makes collection

82 Jeffrey M. Hirsch, “Employee or Entrepreneur” (2011) 68 *Washington & Lee Law Review* 353-67, at 353.

83 Thordarson, *supra* note 69, at 143.

84 Harned et al., *supra* note 20, at 93: in the US context, “[a] business that misclassifies employees, whether in good faith or on purpose, will face expensive penalties.”

85 Compliance issues in respect of VAT in the United Kingdom are discussed in Jeremias Prassl, *Humans as a Service: The Promise and Perils of Work in the Gig Economy* (London, UK: Oxford University Press, 2018), at 125. Here, Prassl considers whether Uber drivers in the United Kingdom should charge tax on the supply of transportation services. He notes that Uber took the position in the United Kingdom that drivers should be responsible for VAT where the threshold is exceeded (as is the case under Canada’s goods and services tax [GST] rules for small suppliers).

86 Andre Andoyan, “Independent Contractor or Employee: I’m Uber Confused: Why California Should Create an Exception for Uber Drivers and the On-Demand Economy” (2017) 47:2 *Golden Gate University Law Review* 153-73, at 155-56.

87 See generally Thordarson, *supra* note 69, at 139.

88 Organisation for Economic Co-operation and Development, *The Future of Social Protection: What Works for Non-Standard Workers?* (Paris: OECD, 2018), at 33 (<https://doi.org/10.1787/9789264306943-en>). The OECD notes that “[t]his raises the potential for increasing social protection coverage and tax compliance by shifting activities from the informal to the formal economy.” *Ibid.*, at 31.

89 *Ibid.*, at 14.

90 Prassl, *supra* note 85, at 18.

cumbersome and patchy.”⁹¹ Deductions may be incorrectly claimed; supplemental income may not be reported.⁹² Businesses may argue that workers themselves (rather than the platform) are responsible for consumption tax remittances, despite the obvious administrative and compliance issues that this creates.⁹³ Firms may also use complex corporate structures to attempt to “evade the jurisdiction of courts in the region where workers in fact find themselves,”⁹⁴ as was the case in *Uber v. Heller*,⁹⁵ decided by the Supreme Court of Canada in June 2020.

REFORM POSSIBILITIES

The problems we face are that

- classification is difficult;
- the existing legal tests are time-consuming, costly to litigate, and not particularly helpful;
- the same tests generally apply to different areas of the law even though policy objectives may vary; and
- work is changing.

91 Ibid., at 127.

92 Brett Collins, Andrew Garin, Emilie Jackson, Dmitri Koustas, and Mark Paynek, “Is Gig Work Replacing Traditional Employment? Evidence from Two Decades of Tax Returns,” authorized through the IRS’s Statistics of Income (SOI) joint statistical research program, 2019, at 20 (www.semanticscholar.org/paper/Is-Gig-Work-Replacing-Traditional-Employment-from-Collins-Garin/df9805e28d866a78f4723b97e5f8527e526c6bb): “[M]any OPE [online platform economy—from a study of US data] participants may either not be correctly deducting their expenses or may not be correctly reporting their supplemental income at all. These findings raise concerns that as supplemental work in non-standard arrangements becomes more common, taxpayers may face increasing burdens in complying with the tax code.”

93 For example, Canada, Department of Finance, *Fall Economic Statement—Supporting Canadians and Fighting COVID-19*, November 30, 2020, addressed the issue of requiring suppliers of short-term rental arrangements (such as rentals through Airbnb) to collect and remit GST. See “Tax Insights: New GST/HST Regime for Non-Resident Vendors of Digital Products Will Be Effective July 1, 2021,” *PwC*, issue no. 2020-40, December 7, 2020: “GST/HST [harmonized sales tax] will apply to all supplies of short-term accommodation by private residential property owners that are facilitated through digital platforms.” Furthermore, as Cui has explained, “centralized tax collection by AirBnB is both less costly (for taxpayers and the government) and more likely to lead to compliance than asking individual landlords to remit GST”: Wei Cui, “Reforming GST Rules for Foreign Digital Suppliers,” *Finances of the Nation*, January 19, 2021 (<https://financesofthenation.ca/2021/01/19/reforming-gst-rules-for-foreign-digital-suppliers>).

94 Fredman et al., *supra* note 72, at 236.

95 *Uber Technologies Inc. v. Heller*, 2020 SCC 16. In this case, a company incorporated in Delaware and headquartered in San Francisco, required Netherlands-based arbitration for Canadian drivers with US\$14,500 in upfront fees plus legal fees and other costs. Although the case was decided on the equitable doctrine of unconscionability, Brown J’s concurring reasons arguably make the point better: namely, that Uber would seek to “undermine the rule of law by denying access to justice.” Ibid., at paragraph 101.

The multifactor tests that are used to try to slot workers into two discrete categories, each with vastly different benefits and costs, are arguably no longer appropriate.

Many of the benefits of being an independent contractor are related to tax mitigation and avoidance (or even evasion),⁹⁶ and the autonomy traditionally associated with such arrangements is being challenged by the changing nature of work. The better solution⁹⁷ is either to use tests that are more likely to produce a determination that the worker is an employee (and entitled to various protections),⁹⁸ or to eliminate the distinction altogether and deem all workers (including sole proprietors and incorporated single-person businesses) to pay into, and be protected by, various social protections available to employees.⁹⁹ Obviously, any determination of worker status should link contributions to social protections with entitlement to receive benefits therefrom.¹⁰⁰

As noted earlier, in the case of CPP, by incorporating and paying dividends, a worker can avoid the program.¹⁰¹ However, it is expected that many gig economy

96 The mandatory payroll withholdings under section 153 of the Act, along with the ability of the Canada Revenue Agency to issue net worth assessments under subsection 152(7), significantly reduce opportunities for evasion.

97 As with any proposal for increased social protections, the thorny issues of adverse selection and moral hazard must be addressed. While this article does not attempt to definitively resolve those debates, any expansion of coverage would necessarily require careful consideration of those issues and the associated design requirements. To the extent that a system provides all workers, regardless of effort, with entitlement to EI coverage, such a system may be more analogous to universal basic income, and therefore challenging. For a related discussion of the problems inherent to basic income, see David Green, Jonathan R. Kesselman, and Lindsay M. Tedds, *Covering All the Basics: Reforms for a More Just Society*, Munich Personal RePEc Archive Paper no. 105902 (January 2021), at 35 (<https://mpra.ub.uni-muenchen.de/id/eprint/105902>). However, some European countries offer a degree of unemployment protection to non-standard workers. On this point, see Slavina Spasova, Denis Bouget, Dalila Ghailani, and Bart Vanhercke, *Access to Social Protection for People Working on Non-Standard Contracts and as Self-Employed in Europe* (Brussels: European Commission, 2017), at 37-38.

98 See Stuart Adam, Helen Miller, and Thomas Pope, "Tax, Legal Form and the Gig Economy," in Carl Emmerson, Paul Johnson, and Robert Joyce, eds., *The IFS Green Budget* (London, UK: Institute for Fiscal Studies, 2017), 203-38, at 206: "Given the problems created, there should be a high bar for allowing differential tax rates across legal forms."

99 Carlson, *supra* note 5, at 356, argues that we should "rethink the necessity of using employee status as the basis for coverage." See also Brishen Rogers, "Employment Rights in the Platform Economy: Getting Back to Basics" (2016) 10 *Harvard Law & Policy Review* 479-520, at 519: "[T]here are powerful reasons to hold platform economy companies to employment duties." In a similar vein, Drahokoupil and Fabo state that, "given the precarious position of platform workers, policy makers should consider additional measures to address the risks related to platform-mediated work": Jan Drahokoupil and Brian Fabo, "The Platform Economy and the Disruption of the Employment Relationship" [2016] no. 5 *ETUI Policy Brief* 1-6, at 5.

100 Williams, *supra* note 7, at 356.

101 Unincorporated self-employed individuals do participate in the CPP/QPP programs. The worker can withdraw by incorporating and paying dividends rather than salary, but this will also mean that, on retirement, the worker will not receive benefits under those programs in

workers do not incorporate. Extending EI to, say, Uber drivers would be challenging because EI eligibility depends on hours worked. Likewise, it is difficult to determine whether an Uber driver has been laid off. These policy issues would need to be resolved.¹⁰²

There are at least six different potential solutions to the problems created by the changing nature of work:

1. a periodic payment test,
2. alignment of treatment of various legal forms used to supply labour,
3. a bright-line test in which two-thirds or more of payments are received from a single payer,
4. a step-back test,
5. a modification of the common law to apply the American ABC test, and
6. a newly created independent worker category.

Each of these options is discussed briefly below.

Periodic Payment Approach

Carlson suggests that a simpler rule in respect of periodic payments is possible. Under this solution, a worker who receives payments in a manner that is periodic and similar to payroll would automatically be entitled to coverage.¹⁰³ As Carlson explains, statutory coverage would be linked to the amount and regularity of the payment.¹⁰⁴

Alignment of Forms of Work

Freedman and Miller argue that the solution to the problem of worker classification lies in the alignment of treatment of legal forms of labour supply.¹⁰⁵ Legal form (for example, contractor versus employee), they suggest, should not be relevant to the determination.¹⁰⁶ Their approach is based on the premise that treatment for tax purposes need not be tied to employment status. There is much persuasive force in their argument.

respect of the years when contributions were suspended. Avoiding CPP and instead relying on dividends may be attractive insofar as it simplifies compliance for owner-managed companies—for example, the dividend recipient need not comply with monthly payroll obligations. For incorporated workers who receive dividends, quarterly income tax instalments may be owing pursuant to subsection 156(1) of the Act.

102 In commenting on this article, Frances Woolley indicated that these issues may be resolvable only by providing a modest universal credit; otherwise, the moral hazard problem may be insurmountable.

103 Carlson, *supra* note 5, at 357.

104 *Ibid.*

105 Freedman and Miller, *supra* note 13, at 6.

106 *Ibid.*, at 5.

The OECD's report on the future of social protections similarly makes the case for harmonization of social security, particularly for workers that "sit on the border" of work arrangements.¹⁰⁷ The report also makes an important adverse selection argument: If schemes of social insurance are voluntary, there is a strong incentive for high-risk workers to join, causing a "downward spiral of rising premia and falling coverage."¹⁰⁸ Perhaps most important is the incentive for firms to pivot toward workers with the least protections.¹⁰⁹

Spasova et al. observe that countries should "make insurance of social security schemes compulsory and reduce possibilities for exemptions."¹¹⁰ They also describe reforms in Lithuania that bring self-employed workers and non-standard workers into the social insurance scheme.¹¹¹ Finland, Belgium, and Spain, among others, have also seen recent "paradigmatic" reforms that are designed to increase social security for self-employed persons.¹¹² Denmark has a new unemployment insurance regime that covers persons in non-standard jobs.¹¹³ This Danish program includes persons in self-employment and persons combining multiple jobs.

Bright-Line Test

A bright-line test could be used. Canada's Income Tax Act is full of bright-line tests designed to ease administration.¹¹⁴ A rough-and-ready rule for automatic enrolment in social programs could be the derivation of more than two-thirds of income from a single payer, regardless of whether the payee is a sole proprietor or a one-person company. An anti-avoidance rule would be required for situations where workers split shifts in circumstances where employers attempt to avoid benefit entitlements.¹¹⁵ An anti-avoidance rule would also be necessary to counteract multiple persons incorporating a single company with tracking shares to avoid automatic enrolment. To reduce administrative and compliance costs, this test should be subject to a *de minimis* threshold, excluding payments below a certain amount.

107 OECD, *supra* note 88, at 14.

108 Ibid.

109 Ibid.

110 Spasova et al., *supra* note 97, at 18.

111 Ibid., at 63.

112 Ibid.

113 J. Kvist, *Denmark: A New Unemployment Insurance Scheme for the Future Labour Market*, ESPN Flash Report no. 2017/45 (Brussels: European Commission, European Social Policy Network, 2017), at 1.

114 For example, the "more than five full-time employees" test under the specified investment business rules; prescribed amounts of taxable capital employed and aggregate investment income realized triggering a grind in the small business deduction; and withholding brackets under regulation 103 for various retiring allowance payments.

115 See the comments below under "Independent Worker Category" with respect to requiring a primary employer to be responsible for remittances.

Step-Back Test

A step-back test could be used. As Harned et al. propose, a payer could not exercise any control over the worker between the formation of the arrangement and the completion of the task or project (on an interim step); otherwise, the worker would be deemed to be an employee.¹¹⁶ At the outset of the arrangement, the payer would be able to provide specifications and knowledge, but would not be allowed to influence how the work was performed.¹¹⁷ The disadvantages of this approach, as with any other that allows any discretion, are (1) that parties could engineer their affairs to avoid the application of the rule, and (2) that it would likely be difficult to discern whether a payer has influenced a worker during the course of work.

ABC Test

The ABC test (an American test), which is frequently considered in unemployment insurance cases,¹¹⁸ could be applied in Canada as a judicial modification of the common law. The ABC test starts with the presumption that a worker is an employee. In order to avoid classification as an employee, the worker would have to demonstrate all of the following conditions (essentially as described by Moran):¹¹⁹

- a. the individual is free from any control or direction;
- b. the services are performed outside the usual course of the hiring entity's business; and
- c. the worker ordinarily undertakes an independent trade or occupation.

To provide a disincentive to misclassification, an ABC scheme can be accompanied by significant penalties.¹²⁰

The ABC test was adopted by the California Supreme Court in *Dynamex*.¹²¹ The court addressed concerns about worker misclassification, observing that the

misclassification of workers as independent contractors rather than employees is a very serious problem, depriving federal and state governments of billions of dollars in tax revenue and millions of workers of the labor law protections to which they are entitled.¹²²

116 Harned et al., *supra* note 20, at 116-17: the employer “would have to step back from attempting to influence the individual’s decisions regarding how the task or project would be accomplished.”

117 *Ibid.*, at 116.

118 Pinsof, *supra* note 18, at 341.

119 Moran, *supra* note 19, at 109.

120 This can include back pay and retroactive benefits. See Thordarson, *supra* note 69, at 149.

121 *Dynamex Operations W. v. Superior Court and Charles Lee, Real Party in Interest*, 4 Cal. 5th 903 (CA 2018).

122 *Ibid.*, at 913, per Cantil-Sakauye CJ.

The Supreme Court of Canada likewise could change the law along these lines, restricting the test to three necessary elements and creating a presumption of employment. This change would also apparently satisfy the International Labour Organization's (ILO's) desire for a presumption of employee status.¹²³

Subsequent to the *Dynamex* decision, in 2019 California codified the court's ruling into law—a law that has helped to ensure that gig workers are entitled to benefits.¹²⁴ Some large payers (namely, Uber and Lyft) have lobbied successfully for exemptions via proposition 22, thereby denying such workers health and unemployment benefits.¹²⁵ A myriad of criticisms of California's approach have arisen in the wake of *Dynamex*,¹²⁶ and these issues would need to be addressed if Canada were to pursue this solution. Further, if an approach similar to the test in *Dynamex* were to be adopted in Canada, a de minimis threshold, excluding payments below a certain amount, would help to reduce administrative and compliance costs.

Independent Worker Category

There could be a new category of workers, as Harris and Krueger have suggested.¹²⁷ In the gig economy, the source of work may be an app. It is difficult to ascertain whether a worker is “working” when an app is running in the background on a phone; likewise, a worker may work “for” Lyft and Uber simultaneously.¹²⁸ Harris and Krueger propose that these types of workers should have a right to organize and that intermediaries (for example, Uber or Lyft) would be required to pay into social security on their behalf, but such workers would not be entitled to overtime.¹²⁹ Additionally, where an independent worker works for more than one payer, it may be that one of those payers acts as the primary employer for the purposes of enforcing protections and benefits.¹³⁰

123 See Harned et al., *supra* note 20, at 116: “[T]he ILO proposal for a presumption in favor of employee status (versus independent contractor) is one way to combat disguised employment relationships, but it still relies on relevant indicators that must be balanced and does nothing to alleviate the business owner's liability for a well-reasoned misclassification.”

124 See Suzin Win, “The Bill That Disrupted the Gig Economy: AB-5 and Uber's Troubling Response,” *GGU Law Review Blog*, March 2, 2020.

125 See Kate Conger, “Uber and Lyft Drivers in California Will Remain Contractors,” *New York Times*, November 4, 2020 (www.nytimes.com/2020/11/04/technology/california-uber-lyft-prop-22.html).

126 These criticisms have included concerns about the outsourcing of work, rules that may unduly burden small businesses, and limits on worker flexibility. See the discussion in Thordarson, *supra* note 69, at 161.

127 Seth D. Harris and Alan B. Krueger, *A Proposal for Modernizing Labor Laws for Twenty-First-Century Work: The Independent Worker*, Hamilton project, Discussion Paper no. 2015-10 (Washington, DC: Brookings, 2015), at 14.

128 *Ibid.*, at 13.

129 *Ibid.*, at 27.

130 Sarah A. Donovan, David H. Bradley, and Jon O. Shimabukuro, *What Does the Gig Economy Mean for Workers?* Congressional Research Service no. 7-5700 (Washington, DC: CRS, 2016), at 15.

Caveat

An issue with any of the six approaches discussed herein is that the employee-independent contractor distinction arises under different areas of law, some under federal jurisdiction and others not, with policy objectives that are not always consistent. The six approaches discussed above, if any were to be adopted, are intended only to resolve issues with respect to social and legal protections of workers. It is not intended that the above approaches would, for example, supplant laws on vicarious liability.

CONCLUSION

In 2001, the Supreme Court of Canada decided *Sagaz*. In that year, a 42-inch plasma TV would cost you around US\$10,000,¹³¹ Windows XP was released, and you would have to wait another six years to buy the first iPhone. In the intervening period, technological development has facilitated the online purchase and acquisition of groceries and restaurant services, the hailing of taxi equivalents, the instantaneous digital purchase of hard-to-find tax textbooks, and the rental of vacation properties—all literally from the palm of your hand, provided that your hand is holding a cellphone or tablet.

The economy, driven by technological development, is changing the meaning of what it is to work. Courts and policy makers should look at social protections in non-traditional work arrangements as something to be broadly available. Applying the 30 (or more) factors that courts and tax authorities consider in determining whether there is an employment relationship is not an inherently useful task. Add to this the ability of platforms to manipulate working conditions to avoid employee classification, as well as the perennial concern of incorporation as a potentially easy way—for the payer for the services—to avoid the entire characterization issue, and it is clear that more workers will lose protections.

Sagaz rightly acknowledged that there is no universal test to determine whether a person is an employee or an independent contractor. But so much hangs on that distinction. New sham self-employment relationships will rob marginalized workers of employment-law protections, along with access to occupational health and safety rules, sick pay, and parental leave. Why? The solution is to either use tests that are more likely to produce a determination that the worker is an employee, or eliminate the distinction altogether and deem that more workers must pay into social programs for their protection. Some European countries have already begun this process for the new economy.

131 Rick Marin, "Plasma TV: That New Object of Desire," *New York Times*, March 25, 2001 (www.nytimes.com/2001/03/25/style/plasma-tv-that-new-object-of-desire.html).

Policy Forum: Non-Standard Employment and Canada's Initial Pandemic Response

Wei Cui*

PRÉCIS

Les travailleurs à la demande et leur classification potentiellement erronée en tant qu'entrepreneurs indépendants attirent beaucoup l'attention publique, mais il faut reconnaître que la flexibilité fait déjà largement partie du monde du travail traditionnel. L'effet de la pandémie de COVID-19 sur le marché du travail porte à croire que les employés atypiques pourraient être encore plus vulnérables que les travailleurs indépendants. Cet article soutient que l'assurance-emploi traditionnelle et les programmes connexes couvrent inadéquatement les employés flexibles, et que des politiques ciblant les marges intensives de l'emploi sont nécessaires pour aider les travailleurs précaires.

ABSTRACT

Despite public attention to gig workers and their potential mis-classification as independent contractors, much flexible work already takes place in the sphere of formal employment. The impact of the COVID-19 pandemic on the labour market suggests that non-standard employees may be even more vulnerable than the self-employed. This article suggests that traditional employment insurance and related programs inadequately serve flexible employees, and policies targeted at the intensive margins of employment are needed to help precarious workers.

KEYWORDS: EMPLOYMENT ■ WORK ■ FLEXIBLE ■ ASSISTANCE ■ POLICY

CONTENTS

Introduction	476
EI, CERB, and CRB	479
Work Sharing	482
CEWS	484
Conclusion	486

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INTRODUCTION

The phrase “flexible work” is apt to conjure up thoughts of Uber drivers, Task-Rabbit freelancers, Amazon Mechanical Turks, and other gig workers offering their services as independent contractors on digital platforms. For legal and tax professionals, discussions of the ascendance of flexible work in the digital economy thus promise to breathe new life into the well-worn legal distinction between employees and independent contractors. And for many members of the public, media reports in the last few years may seem to convey the message that if gig workers can be reclassified as employees—if, that is, a legal controversy can be resolved in a certain way—an important social objective, namely, better protecting precarious workers, will be advanced.

However, these assumptions are belied by evidence that much flexible work already takes place in the sphere of formal employment. Data from the Labour Force Survey¹ (LFS) show a long-term decline in the percentage of unincorporated (“own-account”) self-employed workers among all workers in Canada (that is, the sum of formal employees and the self-employed) (see figure 1). The share for unincorporated self-employed workers was 9 percent in 1990, peaked at 11.3 percent in 1998, but has stayed below 9 percent since 2011. Even in 2020, when the COVID-19 economic shock pushed many workers into this category, the unincorporated self-employed represented only 8.5 percent of all Canadian workers, just slightly above the average (8.4 percent) since 2011. In fact, the fastest-growing category of non-standard workers has been temporary employees (full-time or part-time): the proportion of such workers relative to all Canadian workers started at 9.4 percent in 1997 and reached a peak of 11.7 percent in 2017 (although it has since dropped back, to 10.9 percent in 2019 and to 9.8 percent during the 2020 economic contraction).

If we define “non-standard workers” as comprising the categories of the unincorporated self-employed (with or without paid help), temporary employees, and permanent part-time employees,² LFS data show that the proportion of non-standard workers relative to total workers in Canada has remained largely stable since 1997, peaking at 32.2 percent in 1998 and dropping to 29.8 percent in 2019. The most notable change has been the increasing share of employees (and the declining share of independent contractors) among non-standard workers: the former rose from 64.8 percent in 1998 to 73.4 percent in 2017 (see figure 2).

Analogous patterns have been found in the United States: the American population of contract workers who are formally employed has grown faster than the population of independent contractors.³ More troublingly, temporary employees in

1 Statistics Canada, table 14-10-0287-01, “Labour Force Characteristics, Monthly, Seasonally Adjusted and Trend-Cycle” (<https://doi.org/10.25318/1410028701-eng>).

2 An equivalent definition would sum up the unincorporated self-employed, full-time temporary employees, and part-time employees.

3 Lawrence F. Katz and Alan B. Krueger, “The Rise and Nature of Alternative Work Arrangements in the United States, 1995-2015” (2019) 72:2 *Industrial and Labor Relations Review* 382-416.

FIGURE 1 Proportion of Non-Standard Workers in the Workforce by Category, 1997-2019

Source: Statistics Canada, table 14-10-0287-01, “Labour Force Characteristics, Monthly, Seasonally Adjusted and Trend-Cycle” (<https://doi.org/10.25318/1410028701-eng>).

FIGURE 2 Proportion of Employees Among Non-Standard Workers, 1997-2019

Source: Statistics Canada, table 14-10-0287-01, “Labour Force Characteristics, Monthly, Seasonally Adjusted and Trend-Cycle” (<https://doi.org/10.25318/1410028701-eng>).

the United States generally earn lower wages and are more likely to be taking non-standard jobs involuntarily than are independent contractors.⁴ This pattern may hold in Canada as well: the proportion of part-time employees who were involuntary part-timers in Canada was 21.8 percent in 2018,⁵ whereas only 5 percent of self-employed individuals surveyed reported “could not find suitable paid employment” as their reason for being self-employed.⁶ Therefore, part-time and other non-standard employees may well be more vulnerable, on average, than independent contractors.

The already large (and possibly growing) size of the non-standard employment sector, and the fact that “flexible employees” may be just as vulnerable as (if not more vulnerable than) the self-employed, raise many policy challenges, including two important types of challenges in particular for employment insurance (EI). First, flexible employees may be inadequately protected by traditional social insurance such as EI, even though they are more adversely affected by economic shocks such as the one that the pandemic has delivered. For example, Canadian women in part-time jobs made up 13 percent of total employment in February 2020 but accounted for 33 percent of all job losses between February and May 2020. Part-time male workers represented 7 percent of the pre-COVID-19 workforce but 17 percent of job losses during the same period.⁷ These data imply that as the pandemic is brought under control, half of the jobs to be recovered will be part-time. Yet by August 2020, Canadian-born workers had recovered 86 percent of the full-time jobs lost but only 44 percent of the part-time jobs.⁸ Part-time workers thus seem to have been both worse-hit by the COVID-19 fallout and slower to recover than full-time employees and the self-employed.⁹ Gaps in EI coverage for part-time workers would therefore leave the most vulnerable unprotected.

4 Lawrence F. Katz and Alan B. Krueger, *Understanding Trends in Alternative Work Arrangements in the United States*, NBER Working Paper no. 25425 (Cambridge, MA: National Bureau of Economic Research, 2019).

5 Organisation for Economic Co-operation and Development, “Incidence of Involuntary Part Time Workers,” *OECD.Stat* (https://stats.oecd.org/Index.aspx?DataSetCode=INVPT_I).

6 Lahouaria Yssaad and Vincent Ferrao, *Self-Employed Canadians: Who and Why?* Statistics Canada catalogue no. 71-222-X (Ottawa: Statistics Canada, 2019), at 8, table 3.

7 See Behnouth Amery and Brittany Feor, “Impacts of COVID-19 on Women Working Part-Time,” *LMiC*, June 18, 2020 (<https://lmic-cimt.ca/impacts-of-covid-19-on-women-working-part-time>).

8 See Behnouth Amery and Bolanle Alake-Apata, “Part-Time and Full-Time Employment Among Immigrants: A Tale of Two Recoveries,” *LMiC*, October 8, 2020 (<https://lmic-cimt.ca/part-time-and-full-time-employment-among-immigrants-a-tale-of-two-recoveries>). Immigrants are significantly less able than Canadian-born workers to recover full-time jobs lost, while being significantly better able to recover part-time jobs.

9 Tammy Schirle and Mikal Skuterud report that by April 2020, the unincorporated self-employed had suffered a 55 percent decline in aggregate hours worked relative to February, but by August, roughly 80 percent of such reductions had been recovered. See Tammy Schirle

The second challenge for EI is that when “standard” employees (those who hold permanent full-time positions) are subject to an adverse economic shock, both the initial deterioration of their circumstances and their paths of recovery may lead them into non-standard employment. That is, standard employees no longer face just two states of the world—permanent full-time employment and unemployment—but a third, in-between state of “flexible employment.” Any insurance scheme must address this third state as well.¹⁰

The next section considers these two issues in greater detail by analyzing how flexible workers in Canada’s formal employment sector are treated by four main components of the federal government’s fiscal response to the COVID-19 pandemic:

1. enhanced EI,
2. the Canada emergency response benefit (CERB) and the Canada recovery benefit (CRB),
3. work sharing (which is part of the EI program), and
4. the Canada emergency wage subsidy (CEWS).

EI, CERB, AND CRB

Part-time and temporary employees have long faced challenges in accessing EI benefits, as well as benefits typically offered by employers, such as drug, vision, dental, and mental health care.¹¹ But there appear to have been improvements in EI coverage for non-standard employees in recent years. According to the Canada Employment Insurance Commission, EI coverage of permanent part-time employees rose to 86 percent in 2018 (from 66 percent in 2014 as reported by Busby and Muthukumar),¹² and coverage of temporary non-seasonal workers increased from

and Mikal Skuterud, “The Challenge of Designing Income Support Programs for the Self-Employed,” *Finances of the Nation*, September 22, 2020 (<https://financesofthenation.ca/2020/09/22/income-support-programs-for-the-self-employed>).

- 10 See the Institute for Research on Public Policy panel in November 2020: Stéphanie Lluis, Tammy Schirle, and Mikal Skuterud, “The Future of EI Within Canada’s Social Safety Net: Access, Adequacy, and Work Incentives,” Institute for Research on Public Policy (IRPP), November 18, 2020 (<https://irpp.org/irpp-event/webinar-the-future-of-ei-within-canadas-social-safety-net-access-adequacy-and-work-incentives>).
- 11 According to Busby and Muthukumar, while between 91 percent and 95 percent of full-time permanent workers qualified for EI after being laid off, access to EI for part-time workers ranged from 48 percent to around 70 percent, depending on year and region. Among temporary non-seasonal workers, only 60 percent to 70 percent were EI-eligible upon layoff or expiry of the contract. New entrants to the labour force have even greater difficulty in accessing EI: for youth and immigrants, only around 40 percent to 60 percent have sufficient hours to qualify for benefits. Colin Busby and Ramya Muthukumar, *Precarious Positions: Policy Options To Mitigate Risks in Non-Standard Employment*, C.D. Howe Institute Commentary no. 462 (Toronto: C.D. Howe Institute, 2016), at 15. In computing these ratios, the authors considered only workers who had contributed to EI.

- 12 Ibid.

73 percent in 2014 to 78.5 percent in 2018.¹³ In 2020, the federal government made temporary enhancements to EI (for one year) to make the program “more simple, flexible and generous.”¹⁴ Key changes include reduced insurable employment hour requirements (120 hours of insurable work or more can now qualify for regular and special benefits, wherever one lives in Canada); a floor to the benefit rate set at \$500 per week; at least 26 weeks of benefits;¹⁵ and waiver of the usual 1-week waiting period and medical certificate requirement for EI sickness benefit claimants. The reduced insurable hour requirement could certainly help part-time and temporary workers who lose their employment—as does the \$500 per week floor for benefits.

The basic condition for claiming EI benefits, though, is that the worker must have lost employment (unless the worker participates in a work-sharing agreement, as discussed below). If a worker continues working without a layoff, the enhanced EI benefit will not be available. Compare this to the CERB/CRB. A CERB/CRB claimant must have earned at least \$5,000 in 2019 or 2020, and must have not returned to work owing to COVID-19 *or* have seen an income drop of at least 50 percent. On a first look, CRB claimants are entitled to the same level of benefits as EI claimants: a minimum of \$500 per week for up to 26 weeks.¹⁶ However, this apparent parity is deceptive: a part-time or temporary employee who has retained his or her job but has suffered an income drop of 50 percent (for example, through reduced hours) will not be eligible for EI benefits, but can only claim benefits under the CERB/CRB.

Further, if an EI claimant receives benefits but works part-time while on claim, benefits are clawed back by 50 cents for each dollar earned. In contrast, the CRB's clawback rules (also 50 cents for every dollar) apply only for earnings over \$38,000, and the clawback occurs only when the claimant files an income tax return in the following year. The CRB is thus much more generous than EI benefits available to those engaged in part-time work.¹⁷ A part-time employee is therefore better off under the CRB than under EI. Can a part-time employee opt for the CRB instead of claiming EI? The answer is no: anyone who is eligible for EI (including by virtue

13 Canada Employment Insurance Commission, *2018-2019 Employment Insurance Monitoring and Assessment Report* (Ottawa: CEIC, 2020), at 70, table 14.

14 Canada, Department of Finance Canada, *Fall Economic Statement 2020—Supporting Canadians and Fighting COVID-19*, November 30, 2020, at paragraph 2.1.2 (www.budget.gc.ca/fes-eea/2020/report-rapport/toc-tdm-en.html). The government, *ibid.*, claims that the EI program is “supporting an additional 400,000 people” as a result of these changes. The package announced in November 2020 modified earlier policies delivered through the CERB program.

15 Proposed changes announced on February 19, 2021 would extend regular EI benefits to a maximum of 50 weeks.

16 Proposed changes announced on February 19, 2021 would extend benefits under the CRB to a maximum of 38 weeks.

17 Patrick Brethour, “Canada Recovery Benefit vs. EI: Which Program Will Get People Working Again?” *Globe and Mail*, October 2, 2020.

of the reduction of the insurable hour requirement to 120 hours) will not be eligible for the CRB.¹⁸

It has been widely commented that the CRB is a generous program in that claimants have not previously paid any insurance premium for the benefits they receive, whereas EI claimants will have made such contributions. But the CRB's generosity is also manifest on the benefits side. First, to claim EI benefits, an employee (part-time or full-time) must have suffered a loss on the extensive margin (being laid off) and not just on the intensive margin (through reduced hours or pay), whereas the CRB (and also the CERB) does not require such layoff.¹⁹ Second, EI benefits are clawed back at a 50 percent rate for any hour worked, whereas clawback of benefits received from the CRB is triggered only at a higher income level. Even for workers who have contributed to EI, the CRB is likely to present (and the CERB is likely to have presented) more attractive benefits. In estimating the number of workers who might have benefited from the expanded EI, an important question to consider is how many of those workers would have chosen the CERB/CRB instead.

These observations illustrate how flexible work within the employment space might fall through the cracks of a policy framework that focuses only on full-time employment and self-employment. Arguably, EI's work-while-on-claims rules reflect the fact that EI is primarily designed as insurance for full-time workers (aside from special regional variations catering to seasonal industries): full-time workers who are laid off are encouraged to search for full-time jobs, while part-time work during claim periods is meant to be only transitional, not the normal state.²⁰ The CERB/CRB, fortunately, did not assume that formal employees are amply taken care of by EI. While the CERB/CRB's benefits for the self-employed have been widely

18 See Canada Recovery Benefits Act, SC 2020, c. 12, s. 2, section 3(1)(g): a benefit under the CRB can be claimed only if "no benefit period, as defined in subsection 2(1) of the Employment Insurance Act, was established or could have been established in respect of any week that falls within the two-week period." Under the Canada Emergency Response Benefit Act (CERBA), SC 2020, c. 5, s. 8, a worker is ineligible if he or she actually made a claim under the Employment Insurance Act. Therefore, EI-eligible workers could still qualify under the CERBA if they made no EI claims. In fact, the government actively encouraged workers to make CERB claims instead of EI claims because the "EI system was not designed to process the unprecedented high volume of applications received in the past week. Given this situation, all Canadians who have ceased working due to COVID-19, whether they are EI-eligible or not, would be able to receive the CERB to ensure they have timely access to the income support they need." See Canada, Department of Finance, "Government Introduces Canada Emergency Response Benefit To Help Workers and Businesses," *News Release*, March 25, 2020.

19 As discussed below, work sharing mitigates this problem to some extent for permanent full-time workers but is less likely to do so for part-time workers.

20 Stéphanie Lluís and Brian McCall, "Employment and Job Search Implications of the Extended Weeks and Working While on Claim Pilot Initiatives" (2019) 45:2 *Canadian Public Policy* 129-72 (<https://doi.org/10.3138/cpp.2018-031>).

discussed,²¹ in reality these programs may have provided even more substantial assistance to employees.

WORK SHARING

A similar neglect of flexible employment can be observed in Canada's work-sharing program. Work sharing is intended to be a short-term work (STW) scheme that supports job retention during business downturns by subsidizing hours not worked. Its features are more easily rationalized if the program is understood as being targeted at firms considering layoffs of permanent employees. A traditional rationale for work sharing is that EI standing alone creates a perverse incentive: since employees laid off would be entitled to claim EI benefits but employees facing reduced hours and reduced pay would not, employers may be more tempted to lay off employees. The work-sharing program, by making EI benefits available for reduced hours, mitigates this effect of EI.²² It follows that if the EI program is primarily intended to provide insurance for permanent full-time workers, work sharing also serves this limited purpose. Indeed, an explicit restriction of the program is that only permanent, year-round, EI-eligible "core staff" are eligible to participate.

Other features of work sharing reflect this orientation. For example, equal, proportional reductions must be made for all employees within a work unit described in a work-sharing agreement. This egalitarianism may mean that workers who would not otherwise have been laid off (for example, employees with sufficient seniority) bear the greatest portion of the work-sharing cost. However, it also means that employers are less likely to include employees with different wage rates and work status in the same work-sharing agreement. In particular, part-time workers are less likely to be included.

Another related feature is that work sharing limits the hours reduced to no more than 60 percent and no less than 10 percent of the worker's normal hours. Some have suggested that by limiting hour reductions per worker, STW programs can indirectly encourage employers to spread reductions more broadly among employees. Given that part-time workers have reduced hours to begin with, proportional reduction requirements may also make it less likely for part-timers to participate in work sharing.²³

21 The CRB has been hailed as EI for the self-employed. Robin Boadway, "The Canada Recovery Benefit: Employment Insurance or Basic Income Guarantee?" *Finances of the Nation*, October 9, 2020 (<https://financesofthenation.ca/2020/10/09/crb-ei-or-basic-income-guarantee>).

22 This perspective on work sharing implies that the latter is not even a job retention program per se, but a program aimed at alleviating the negative effect on job retention of the existence of an EI program.

23 A US Department of Labor report suggests that maximum hour reduction requirements are imposed in some states specifically to limit "the ability of employers to subsidize the wages of new part-time employees." See Stephen Walsh, Karen Needels, Rebecca London, Walter Nicholson, Deana McCanne, and Stuart Kerachsky, *Evaluation of Short-Time Compensation Programs, Final Report*, submitted to United States Department of Labor, Employment and

Finally, many of the procedural costs of work sharing—including the need for participating employers and employees to enter into an agreement with the government—imply that it is only when the cost of layoff is high that work sharing is sufficiently attractive to employers. A report published in 2011 by the Organisation for Economic Co-operation and Development (OECD) commented that this may explain why STW schemes are relatively rare in countries (such as the United States and Canada) where legal protections for full-time workers are relatively weak.²⁴ Again, this suggests that STW programs in general, and Canada's work-sharing program in particular, may never have been intended to help flexible workers.

Work sharing's bias toward permanent full-time workers appears to be reflected in the program's takeup. Two-thirds of work-sharing agreements entered into between 2014 and 2018 involved employers in the goods-producing sectors,²⁵ whereas the number of part-time workers in these sectors was less than 1/10 of the number of part-time workers in services sectors.

In contrast, STW schemes in other countries have become more accommodating with respect to flexible employees during the COVID-19 pandemic.²⁶ The French *activité partielle*, for example, treats all employees with a contract (permanent or not) as eligible.²⁷ The German *Kurzarbeit* is normally available to workers on temporary contracts and apprentices, and it was extended to agency workers at the start of the COVID-19 crisis.²⁸ The Italian STW scheme (*cassa integrazione guadagni*) seems to allow much greater hour reduction—all the way to zero.²⁹ Japan's employment adjustment subsidy has also been extended to cover non-regular workers who

Training Administration (Oakland, CA and Princeton, NJ: Berkeley Planning Associates and Mathematica Policy Research, Inc., March 1997), at 4-23.

- 24 Alexander Hijzen and Danielle Venn, *The Role of Short-Time Work Schemes During the 2008-09 Recession*, OECD Social, Employment and Migration Working Papers no. 115 (Paris: OECD, January 2011). Hijzen and Venn posit that "[e]ven if workers in non-regular jobs are eligible for STW in principle, the incentive for firms to place such workers on STW is likely to be considerably weaker than for their core workforce. Participation in these schemes tends to be costly for employers, while hiring and firing costs tend to be low for workers in non-regular jobs": *ibid.*, at paragraph 42.
- 25 Canada Employment Insurance Commission, *2017-2018 Employment Insurance Monitoring and Assessment Report* (Ottawa: CEIC, 2019), at 125, table 41. The fact that goods-producing sectors have a great share of private-sector unions is consistent with the observation that short-term work arrangements tend to be utilized more when the costs of layoffs are high.
- 26 See Stefano Scarpetta et al., *OECD Policy Responses to Coronavirus (COVID-19), Job Retention Schemes During the COVID-19 Lockdown and Beyond* (Paris: OECD, October 2020) (www.oecd.org/coronavirus/policy-responses/job-retention-schemes-during-the-covid-19-lockdown-and-beyond-0853ba1d).
- 27 *Ibid.*, at 3.
- 28 *Ibid.*, at 4. Moreover, restrictions on taking other jobs while on STW were lifted. Workers are allowed to cumulate additional earnings and STW benefits as long as total income does not exceed previous earnings. See *ibid.*
- 29 *Ibid.*

are not covered by EI.³⁰ Indeed, the OECD notes that extending coverage to non-permanent workers is one of the key modifications to existing STW schemes that countries made in response to the COVID-19 crisis.³¹

Of course, it would be wrong to fault the Canadian government for not making work sharing more accessible to flexible workers during the COVID-19 crisis: after all, the much larger CEWS program, discussed below, was open to both employers and employees. Work sharing can hardly be viewed as defective when employers may also choose to claim benefits under CEWS. Nonetheless, the foregoing discussion underscores the fact that standard STW schemes tend to neglect the needs of employees engaged in flexible work.

CEWS

In contrast to work sharing, the wage subsidies available through CEWS cover payroll expenses associated with almost all employees, regardless of time actually worked, EI eligibility, etc. Moreover, they apply to all types of remuneration, regardless of how reduced hours or reduced pay are distributed among employees. This means that it is likely that many employed workers received benefits as individuals under the CERB/CRB because of reduced earnings, while at the same time their remaining payroll was subsidized through CEWS. Thus, flexible workers can be better off under CEWS than under work sharing for at least two reasons: first, because CEWS is more accessible for such workers; and second, because the benefits that workers receive under the CRB may be more generous than any EI benefits that those workers can claim under a work-sharing agreement (as discussed above).

The positive impact of wage subsidy programs on flexible workers has been noted as a major reason to supplement or even replace STW schemes with wage subsidies. The OECD has remarked on the ability of CEWS (and a similar temporary wage subsidy scheme in Estonia) to provide “a more flexible form of support for firms which can manage their hours freely without any reporting requirements.”³² It notes that

firms may have weak incentives to hold on to non-standard workers during periods of STW, especially if the scheme imposes a direct cost on employers. This seems to be a place where the work subsidy program can be very helpful.³³

30 Japan also allows workers to apply for the subsidy directly when their small to medium-sized enterprise employers have not applied for the subsidy despite reducing hours, instead of relying on a tripartite agreement. See *ibid.*

31 *Ibid.*, at 5: “Nine [OECD] countries extended eligibility . . . to include temporary, temporary-agency and even certain categories of self-employed workers . . . [so as to] reduce the risk that STW schemes reinforce labour market duality.”

32 *Ibid.*, at 6.

33 *Ibid.*, at 5.

Indeed, the Netherlands has even replaced its existing STW scheme with a temporary work subsidy program that bears a significant resemblance to CEWS.

A recent study of regional wage subsidies in US empowerment zones showed that when wage subsidies are capped per employee (as was the case with CEWS), employers may be more inclined to hire part-time or low-wage workers.³⁴ This may seem unsatisfactory when wage subsidies are meant to induce full-time employment at high wages. But if the employment of part-time and low-wage workers is the government's goal, then the evidence speaks in favour of wage subsidies. When we consider the pandemic's disproportionate impact on both low-wage and part-time workers, helping this portion of the Canadian workforce seems especially important.³⁵

Work subsidy programs like CEWS intend to support employment relationships not only on the extensive margin (that is, preventing layoffs) but also on the intensive margin, by helping to maintain wage levels across a wide range of employment arrangements. Interestingly, this very rationale for CEWS has also been the cause of a great deal of criticism directed at the program: many have blamed CEWS for "supporting many jobs that may be at no risk."³⁶ It is indisputable that CEWS can be designed to be more narrowly targeted; this criticism applies almost universally to all fiscal responses to economic crises anywhere,³⁷ and to the majority of social assistance and active labour market programs even during non-emergency times. But evaluating CEWS purely on the basis of the number of jobs saved (and the associated cost) can also be problematic if that approach unreflectively privileges the extensive margin of employment (that is, if only potential layoffs mark jobs at risk), or if it ignores the fact that much non-standard employment is intrinsically precarious, and thus there may be neither need nor easy means for specifying reduced hour or earning loss requirements for such work.

34 Joel A. Elvery, c. Lockwood Reynolds, and Shawn M. Rohlin, *Employer Wage Subsidy Caps and Part-Time Work*, Federal Reserve Bank of Cleveland Working Paper no. 21-01 (Cleveland, OH: Federal Reserve Bank of Cleveland, January 2021).

35 More generally, wage subsidy programs in other countries have been shown to have substantial intensive margin effects. See Emmanuel Saez, Benjamin Schoefer, and David Seim, "Payroll Taxes, Firm Behavior, and Rent Sharing: Evidence from a Young Workers' Tax Cut in Sweden" (2019) 109:5 *American Economic Review* 1717-63.

36 See Michael Smart and Ben Eisen, "There Are Better Ways of Helping the Economy Than CEWS," *Policy Options*, January 26, 2021 (<https://policyoptions.irpp.org/magazines/january-2021/there-are-better-ways-of-helping-the-economy-than-cews>). Another difference between wage subsidy and STW schemes is that the former subsidize not just job retention, but also new hiring. CEWS critics have also downplayed this aspect of CEWS.

37 Among the common criteria for effective fiscal stimulus—the "three T's" of temporary, timely, and targeted—the first criterion appears to be the main way to resolve tensions between the latter two.

CONCLUSION

It might seem natural to group the federal government's fiscal support of Canadian workers during the pandemic into two categories: the CERB/CRB and (enhanced) EI represent *employment/income insurance for individuals*, while work sharing and CEWS are *job retention* programs targeted at employers. The former pair of policies has been widely recognized as Canada's attempt to broaden the social safety net during an unprecedented crisis—a recognition that is reflected in both calls for further enhanced benefits³⁸ and critiques alleging the policies' excessive generosity.³⁹ In contrast, work sharing remains less well known, and CEWS has received mostly negative attention among academic commentators.

I began this commentary by noting that the future of work may be most actively manifest in the varieties of flexible work within the formal employment sector: transitions both out of and back into employment are increasingly likely to begin or end with part-time or temporary employment. Consequently, the design of a social safety net for precarious workers may need to focus more on flexible employees than on either independent contractors or unemployed workers seeking full-time employment. From this perspective, an alternative pairing of the components of Canada's pandemic fiscal support emerges.

On the one hand, the design of both EI and work sharing, even during a period of extraordinary government spending, seems inadequately suited for flexible employees. This may have resulted from an unwarranted fixation on the extensive margin of employment, which characterizes the EI regime and therefore its derivative program, work sharing. This same fixation may also have influenced critiques made of CEWS.

On the other hand, both the CERB/CRB and CEWS have helped workers at the intensive margin of employment. It is critical to recognize that the CERB/CRB may have provided significant assistance to employed individuals—the number of claimants has far outstripped the number of self-employed individuals in Canada. And it is critical to remember that CEWS is not just a job retention, but also literally a wage support, program. Any redesign of social insurance to serve the need of flexible employees will have to incorporate some form of intensive margin intervention.

38 See Miles Corak, "An Employment Insurance System for the 21st Century: Lesson 2, The Future of Work Calls for Better Income Insurance," *Finances of the Nation*, February 1, 2021 (<https://financesofthenation.ca/2021/02/01/an-employment-insurance-system-for-the-21st-century-lesson-2-the-future-of-work-calls-for-better-income-insurance>), advocating for higher replacement rates and maximum insurance earnings under EI.

39 See John Lester, "Overcompensation of Income Losses: A Major Flaw in Canada's Pandemic Response," *Finances of the Nation*, December 8, 2020 (<https://financesofthenation.ca/2020/12/08/overcompensation-of-income-losses-a-major-flaw-in-canadas-pandemic-response>), providing evidence of overcompensation of income loss under the CERB; and Boadway, *supra* note 21, expressing concern about the CRB's ability to deal with the moral hazards of self-employed claimants.

Policy Forum: Write It Off (and Start Again)—Adapting Home Office Deductions for the Digital Era

Bhuvana Rai*

PRÉCIS

Cet article examine les dispositifs juridiques actuels et historiques de déduction des dépenses d'emploi — en particulier ceux associés à un bureau à domicile — en vertu de la Loi de l'impôt sur le revenu du Canada, et conclut que le critère juridique actuel pour ces déductions est inéquitable, inefficace et imprécis. L'auteur examine les déductions pour emploi offertes aux contribuables dans d'autres juridictions et propose des options pour modifier la déduction pour emploi au Canada. Les changements proposés tiendraient compte des modes de travail de plus en plus axés sur le numérique, favoriseraient l'équité et procureraient une plus grande certitude aux contribuables.

ABSTRACT

This article examines the current and historical legal schemes for deducting employment expenses—particularly those associated with a home office—under Canada's Income Tax Act, and concludes that the current legal test for such deductions is inequitable, ineffective, and imprecise. The author reviews the employment expense deductions available to taxpayers in other jurisdictions and proposes options for modifying Canada's employment expense deduction. The proposed changes would account for increasingly digital modes of working, advance equity, and add to taxpayer certainty.

KEYWORDS: DEDUCTIONS ■ EXPENSES ■ EMPLOYEES ■ TAX POLICY

CONTENTS

Introduction	488
Evolution of Employment Expense Deductions	490
Current Law	490
Taxation of Net Income from 1917 to 1966	491
Evolution of Employment Expense Deductions Under the 1970-71-72 Act	493

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Repeal of the Flat-Rate Deduction and Additional Requirements: 1988 Onward	494
Introduction of the CEC	495
Principles Governing the Deduction of Home Office and Office Supply Expenses	495
Limitations on the Deduction of Office Supply Expenses	496
Limitations on the Deduction of Home Office Expenses	497
Conditions of Employment	498
International Comparisons	499
Proposed Changes	503
Desired Outcome	503
Option 1: Implement the Carter Commission's Recommendation	504
Option 2: Incremental Change	506
Deduction of Office Supplies Under Subparagraph 8(1)(i)(iii)	506
Deduction of Home Office Expenses Under Subparagraph 8(1)(i)(ii) and Subsection 8(13)	507
Employer Certification Under Subsection 8(10)	508
Limitations of the CEC	510
Conclusion	511

INTRODUCTION

An introductory scene from the film “The Accountant” (2016) features the eponymous anti-hero consulting with an insolvent couple seeking to reduce their tax bill. The accountant grills the wife about her hobby production of homemade jewellery, coaching the couple so that they qualify for home office and vehicle deductions. These deductions, it seems, constitute a silver bullet in the financial arsenal. The couple walk away happy, their immediate monetary problems solved.

Real life often disappoints in comparison with the rosy picture painted by Hollywood, and it appears that tax deductions are no exception. Canadian fiscal law limits access to home office expense deductions, particularly for workers who are employees (rather than those who are self-employed). Few employees are eligible to deduct home office expenses, and the types of expenses that qualify are restricted. Administrative burdens mean that taxpayers who should qualify for employment expense deductions may not actually be able to avail themselves of them.

The onset of the COVID-19 pandemic in 2020, and the persisting spread of the virus in 2021, has forced hundreds of thousands of workers to unexpectedly work from home on an indefinite basis. As a result, the question of whether some portion of the expenses incurred in establishing and maintaining home offices should be deductible has taken on new urgency.¹ While temporary administrative and legislative concessions have been made for the 2020 taxation year, in this article I argue

1 See, for example, Chartered Professional Accountants of Canada and Canadian Tax Foundation, “Summary of Outstanding COVID-19 Tax Issues (Excluding the Canada Emergency Wage Subsidy),” June 1, 2020 (www.cpacanada.ca/-/media/site/operational/ex-executive/docs/02409-ex-summaryoutstandingcovid-19taxissues-en_june-1-final.pdf);

that the fundamental issues with the existing home office expense deduction call for more permanent legislative amendment.

Given the rise of alternative models of employment, policy makers have been encouraged to revise tax and benefit systems to ensure that workers are not given an unintended incentive to characterize themselves as self-employed.² One area to consider is the unequal tax treatment of employees, compared to individuals who are self-employed, with respect to the deduction of expenses, particularly in light of the realities of work in the digital era.³ The existing Canada employment credit (CEC) currently available to Canadian employees is an expensive and inadequate solution to these issues.

In this article, I review the evolution of Canadian tax law governing the deductibility of employment-related home office and office supply expenses, and examine the corresponding deductions available to employees in other countries. I then propose changes to modernize and simplify the existing Canadian rules.

The general issue of deductions from employment income is broad. I focus specifically on the following expenses and costs, which are most likely to be applicable to salaried employees working from home because of COVID-19:

- expenses relating to the use of a workspace in a domestic residence (including rent, utilities, and mortgage interest); and
- expenditures on office supplies (paper, telephone and cellphone subscriptions, Internet access, etc.).

Only deductions available to employees under paragraph 8(1)(i) of the Income Tax Act (ITA)⁴ are considered in this article. Although supplies and rent could also be deducted under paragraph 8(1)(f) for an employee who sells property or negotiates contracts, this alternative source of a deduction raises additional issues that go beyond the scope of this article.

Jamie Golombek, "Can You Deduct Home-Office Expenses If You're Forced To Work from Home During the Pandemic?" *Financial Post*, April 24, 2020; Joshua Freeman, "Can You Deduct Office Expenses If You're Working at Home During COVID-19?" *CTV News*, May 8, 2020 (<https://toronto.ctvnews.ca/can-you-deduct-office-expenses-if-you-re-working-at-home-during-covid-19-1.4931364>); and Elizabeth Thompson, "Hundreds of Thousands of Canadians Could Get a Tax Break for Working from Home During Pandemic," *CBC News*, July 23, 2020 (www.cbc.ca/news/politics/covid-pandemic-tax-deduction-1.5658739).

2 See, for example, Organisation for Economic Co-operation and Development, *Taxing Wages 2020* (Paris: OECD, 2020).

3 See the article by Graham Purse in this Policy Forum for further comments on the misclassification of workers.

4 RSC 1985, c. 1 (5th Supp.), as amended. Unless otherwise stated, statutory references in this article are to the ITA.

EVOLUTION OF EMPLOYMENT EXPENSE DEDUCTIONS

Current Law

In its current iteration, paragraph 8(1)(i) permits most employees⁵ to deduct specified expenses from their employment income, including amounts incurred as

(ii) office rent, or salary to an assistant or substitute, the payment of which by the officer or employee was required by the contract of employment,

(iii) the cost of supplies that were consumed directly in the performance of the duties of the office or employment and that the officer or employee was required by the contract of employment to supply and pay for, . . .

to the extent that the taxpayer has not been reimbursed, and is not entitled to be reimbursed in respect thereof.

Taxpayers seeking to rely on this provision are generally required to have a T2200 form signed by an employer attesting to the conditions of employment.⁶ Any amount deducted in respect of a workspace in the home—described as “a self-contained domestic establishment in which the individual resides”⁷—is further limited by paragraph 8(13)(a): the workspace must be either

- the principal place at which an individual performs the duties of employment, or
- used by the employee exclusively for the purpose of earning income from employment, *and* used on a regular and continuous basis for meeting customers or other persons in the ordinary course of performing the duties of employment.

Although the language in the current version of paragraph 8(1)(i) dates back to the tax reform of the 1970s,⁸ the law—and academic thought—governing the deduction of employment expenses has fluctuated between permissiveness and restrictiveness during the history of income taxation in Canada.

5 Excluding salespeople captured by paragraph 8(1)(f).

6 Subsection 8(10); CRA form T2200, “Declaration of Conditions of Employment.”

7 Subsection 8(13). Subsection 248(1) defines “self-contained domestic establishment” to mean “a dwelling-house, apartment or other similar place of residence in which place a person as a general rule sleeps and eats.”

8 Income Tax Act, SC 1970-71-72, c. 63 (herein referred to as “the 1970-71-72 Act”), enacting Bill C-259, An Act To Amend the Income Tax Act and To Make Certain Provisions and Alterations in the Statute Law Related to or Consequential upon the Amendments to That Act; royal assent December 23, 1971.

Taxation of Net Income from 1917 to 1966

The Income War Tax Act of 1917⁹ taxed “income,” defined as

the annual *net* profit or gain or gratuity, whether ascertained and capable of computation as being wages, salary, or other fixed amount, or having unascertained as being fees or emoluments, or being profits from a trade or commercial or financial or other business or calling, directly or indirectly received by a person from any office or employment, or from any profession or calling [emphasis added].¹⁰

While the Income War Tax Act divided taxable income into categories of “ascertained” (generally speaking, employment) income and “unascertained” profits or fees, the legislation did not expressly limit the deduction of employment expenses. In fact, early legislators appear to have intended that liabilities such as alimony payments would be deducted from taxable income, simply because the Income War Tax Act used the word “net.”¹¹

In the early 1920s, case law drew a sharp distinction between employment income and income from a business or property. In 1924, Audette J of the Exchequer Court of Canada commented, in obiter, that “[a]n annual salary from any office or employment—an amount which is duly ascertained and capable of computation . . . constitutes of itself a *net income*.”¹²

On the basis of this comment, the Department of National Revenue disallowed any deductions from employment income until 1943, when the issue was relitigated in *Samson v. MNR*.¹³ The Exchequer Court revised its position, holding that deductions could be made from employment income provided that they were not disallowed by legislation as “disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income.”¹⁴ This reasoning was followed in the case of a Manitoba lawyer attempting to deduct annual fees paid to the Law Society of Manitoba. The Department of National Revenue’s policy at the time permitted lawyers who were fee earners to deduct law society fees, but not lawyers who earned salaries. The Exchequer Court now held that there was

9 SC 1917, c. 28.

10 Income War Tax Act, RSC 1927, c. 97, section 3.

11 See Canada, House of Commons, *Debates*, September 20, 1917, comments of Sir Thomas White, as reported in Bryan Pontifex, *Canadian Income Tax: The Income War Tax Act, 1917, with Explanations by the Minister of Finance and Instructions of Finance Department* (Toronto: Carswell).

12 *In Re the Salary of Lieutenant-Governors (In the Matter of the Income War Tax Act, 1917, and Amendments)*, [1931] Ex. CR 232, at 235 (emphasis added). (Although the case was decided in 1924, the decision was not published until 1931.)

13 [1943] CTC 47 (Ex. Ct.).

14 Income War Tax Act, *supra* note 10, at paragraph 6(a), as amended by 13-14 Geo. V, c. 52.

“no justification in principle for any such discrimination of treatment.”¹⁵ Employees were thus, briefly, entitled to deduct membership dues against their income.¹⁶

Relief from taxation of gross employment income was short-lived. The Income War Tax Act was promptly amended as follows to wholly prevent any deductions from employment income:¹⁷

(6) In computing the income from an office or employment, no amount is deductible for a disbursement or expense laid out for the purpose of earning the income.

The new statute published in 1948¹⁸ clarified that certain deductions permitted by particular sections of the statute (dealing with travelling expenses) would be permissible, but that no others “whatsoever” were to be accounted for in computing employment income.¹⁹

In 1951, the 1948 Act was amended to incorporate, for the first time, the predecessor of the present-day paragraph 8(1)(i). Subsection 11(10), as it then was, read:

11(10) Notwithstanding paragraphs (a) and (h) of subsection (1) of section 12, the following amounts may, if paid by a taxpayer in a taxation year, be deducted in computing his income from an office or employment for the year

(a) annual professional membership dues the payment of which was necessary to maintain a professional status recognized by statute that he was required by his contract of employment to maintain,

(b) office rent, or salary to an assistant or substitute, the payment of which by the officer or employee was required by the contract of employment,

(c) the cost of supplies that were consumed directly in the performance of the duties of his office or employment and that the officer or employee was required by the contract of employment to supply and pay for, and

(d) annual dues to maintain membership in a trade union as defined

(i) by paragraph (r) of subsection (1) of section 2 of the Industrial Relations and Disputes Investigation Act, or

(ii) in any provincial statute providing for the investigation, conciliation or settlement of industrial disputes,

15 *Bond v. MNR*, [1946] CTC 281 (Ex. Ct.).

16 See also *Rutherford v. MNR*, [1946] CTC 293; and *Cooper v. MNR*, [1949] CTC 146.

17 Income Tax Act, SC 1948, c. 52 (herein referred to as “the 1948 Act”), subsection 6(6), as reproduced in Lara Friedlander, “What Has Tort Law Got To Do With It? Distinguishing Between Employees and Independent Contractors in the Federal Income Tax, Employment Insurance, and Canada Pension Plan Contexts” (2003) 51:4 *Canadian Tax Journal* 1467-1519, at 1487, footnote 88. See also *The Queen v. Swingle*, [1977] CTC 448.

18 Supra note 17.

19 Ibid., section 5; *Swingle*, supra note 17, at paragraph 22. See also Gwyneth McGregor, “Taxes and Expense Accounts” (1960) 8:2 *Canadian Tax Journal* 118-22.

or to maintain membership in an association of public servants the primary object of which is to promote the improvement of the members' conditions of employment or work,
to the extent that he has not been reimbursed, and is not entitled to be reimbursed in respect thereof.²⁰

Evolution of Employment Expense Deductions Under the 1970-71-72 Act

In 1962, the Royal Commission on Taxation ("the Carter commission") was engaged to examine the federal income tax laws and make recommendations for improvement. The resulting report commented as follows on the inequitable treatment of business expenses and employment expenses:

The unfair discrimination between employees and the self-employed arises primarily because the self-employed can, in computing their business or professional income, deduct all reasonable expenses incurred for the purpose of producing such income. Employees, in computing their income from employment, can only claim a few specified deductions as set forth in sections 5 and 11 of the Income Tax Act and no other deductions whatsoever. Skilled manual workers and employed professionals are particularly affected by these stringent limitations on deductions.²¹

The commission recommended that all expenses incurred in the expectation of generating gains (whether in the form of employment income or business income) should be deductible, provided that such expenses are not personal living expenses. To deal with the practical administrative difficulties of itemized employment expenses for employees, the commission suggested that an optional deduction of 3 percent of employment income (to a maximum of \$500)²² could be taken in lieu of an itemized employment expense deduction:

In our view the deduction of expenses by employees and self-employed persons should be treated in exactly the same way. The present unfair discrimination against employees should be removed. However, because a large number of employees would be involved, the task of assessment would be enormous if each employee submitted an itemized claim for his or her actual expenses. To reduce the administrative problem to manageable proportions we think it would be necessary to provide an optional deduction of a percentage of gross employment income, with a dollar limit, that could be taken by an employee in lieu of the deduction of actual expenses. Those employees with deductible expenses greater than the percentage deduction should be able to deduct their

20 1948 Act, *supra* note 17, as amended by SC 1951, c. 51.

21 Canada, *Report of the Royal Commission on Taxation*, vol. 3 (Ottawa: Queen's Printer, 1967) (herein referred to as "the Carter report"), at 285 (chapter 14—Employment Income).

22 Worth approximately \$4,040 today, per the Bank of Canada's inflation calculator, which is based on the consumer price index (CPI) prepared by Statistics Canada. Bank of Canada, "Inflation Calculator" (www.bankofcanada.ca/rates/related/inflation-calculator).

actual expenses. Because self-employed individuals would be expected to have expenses in excess of the optional deduction proposed, we do not feel that this proposal discriminates in favour of employees.²³

The Carter commission's proposal in this regard was partially implemented. The 1970-71-72 Act²⁴ contained the following deduction:

8(1) In computing a taxpayer's income for a taxation year from an office or employment, there may be deducted such of the following amounts as are wholly applicable to that source or such part of the following amounts as may reasonably be regarded as applicable thereto:

(a) a single amount in respect of all offices and employments of the taxpayer, equal to the lesser of \$150 and 3% of the aggregate of

(i) his incomes for the year from all offices and employments (other than the office of a corporate director) before making any deduction under this section, and

(ii) all amounts included in computing his income for the year by virtue of paragraphs 56(1)(m) and (o).

The 1970-71-72 Act also contained the deductions currently available in subparagraphs 8(1)(i)(ii) and (iii) in substantively the same form as they exist today.

Repeal of the Flat-Rate Deduction and Additional Requirements: 1988 Onward

By 1988, the flat-rate deduction had been amended to the lesser of 20 percent of employment income and \$500.²⁵ At that time, Parliament was in the midst of substantial tax reform that culminated in Bill C-139.²⁶ One of the aims of this legislation was to turn certain employment deductions into credits, with the aim of creating more progressive taxation. Despite members of the Opposition noting that no specific credit would replace this deduction, which was primarily of use to middle income earners,²⁷ paragraph 8(1)(a) of the ITA—the flat-rate deduction for employment expenses—was repealed.

Bill C-139 also added the requirement for employer certification in subsection 8(10). That provision currently reads as follows:

23 Carter report, *supra* note 21, at 290.

24 *Supra* note 8.

25 Approximately \$990 today, based on the Bank of Canada's inflation calculator, *supra* note 22.

26 Act To Amend the Income Tax Act, the Canada Pension Plan, the Unemployment Insurance Act, 1971, the Federal-Provincial Fiscal Arrangements and Federal Post-Secondary Education and Health Contributions Act, 1977 and Certain Related Acts; and Canada, Department of Finance, *Explanatory Notes to Legislation Relating to Income Tax (Bill C-139)* (Ottawa: Department of Finance, June 1988).

27 House of Commons, *Debates*, July 19, 1988, at 17774, Simon De Jong.

An amount otherwise deductible for a taxation year under paragraph (1)(c), (f), (h) or (h.1) or subparagraph (1)(i)(ii) or (iii) by a taxpayer shall not be deducted unless a prescribed form, signed by the taxpayer's employer certifying that the conditions set out in the applicable provision were met in the year in respect of the taxpayer, is filed with the taxpayer's return of income for the year.

In 1991, amendments to section 8 further restricted taxpayers' employment expenses.²⁸ Notably, subsection 8(13) was passed to limit office expenses in respect of a workspace in a personal residence. This restriction was motivated by an amendment similarly restricting the deduction of home office expenses of self-employed persons under paragraph 18(12)(a). Employee deductions were to remain, at best, equal, and on the whole, less generous than deductions for the self-employed.

Introduction of the CEC

In 2007, Parliament introduced subsection 118(10) providing a new tax credit, the CEC (retroactive to 2006), to help to offset the work-related expenses incurred by employees.²⁹ The CEC is a non-refundable credit equal to the product of

- the lowest federal tax rate and
- the lesser of the taxpayer's employment income for the year and \$1,000 (in 2007, indexed to inflation).

In the 2020 taxation year, the credit reduced taxes owing by 15 percent of \$1,245, or \$186.75.³⁰

PRINCIPLES GOVERNING THE DEDUCTION OF HOME OFFICE AND OFFICE SUPPLY EXPENSES

The vacillating law on the issue of deducting home office and office supply expenses during the short history of Canadian income tax legislation reflects the disparity between the tax treatment of employees and the treatment of self-employed persons. The ITA continues to tax income from a business or property on a net basis, subject to specific statutory limitations. By contrast, employment income is taxed, *prima facie*, on a gross basis. The only expenses that may be deducted are those specifically enumerated in section 8.³¹

28 Bill C-15, An Act To Amend the Income Tax Act, the Canada Pension Plan, the Cultural Property Export and Import Act, the Income Tax Conventions Interpretation Act, the Tax Court of Canada Act, the Unemployment Insurance Act, the Canada-Nova Scotia Offshore Petroleum Resources Accord Implementation Act and Certain Related Acts, enacted by the Income Tax Amendments Revision Act, 1991, c. 49; royal assent December 17, 1991.

29 Budget Implementation Act, 2006, No. 2, SC 2007, c. 2; royal assent February 21, 2007.

30 Canada Revenue Agency, "Line 31260—Canada Employment Amount."

31 Subsection 8(2).

The general limitations imposed by the current legislation distinguish sharply between employees and the self-employed. The policy basis of this distinction remains unclear despite many challenges to its reasonableness over the years (including, notably, the criticisms expressed by the Carter commission). It appears that the chief defence advanced by the government is that the policy serves the objective of administrative efficiency.³²

Although it is almost 55 years since the Carter report noted the unfairness of the distinction between employees and the self-employed, the commission's comments are equally applicable today. However, general unfairness aside, there are also concerns about the specific deductions permitted by the ITA and, in some cases, the ways in which they are interpreted. A summary of the applicable limitations follows.

Limitations on the Deduction of Office Supply Expenses

The types of deductible office supplies that are permitted are limited partly because of the restrictive interpretation of the phrase "supplies that were consumed directly" in current subparagraph 8(1)(i)(iii). Since the introduction of that language, courts have interpreted the term "consumed" as implying "used up," and have accordingly restricted the deduction of the cost of tools.³³

This practice continued throughout the late 1990s. Members of the Royal Canadian Mounted Police who had deducted the costs of pagers, telephone services, and other items relevant to their employment (gloves, flashlights, handcuff keys, etc.) were not permitted to do so on the ground that these supplies could not be "consumed."³⁴ Computer expenses were also disallowed on the same ground, even when employees were required to purchase and provide computers for the purposes of their employment.³⁵ The Canada Revenue Agency (CRA) does not permit deductions for the monthly cost of Internet access and monthly telephone charges:

Generally, supplies are for items directly used for work and include such items as pens, pencils, paper clips, stationery, stamps, street maps, directories and long-distance telephone calls, provided they were paid to earn employment income. However, the monthly basic rate for the telephone, the cost to purchase a computer, fax or other such equipment are not deductible.³⁶

32 F.E. LaBrie, *The Principles of Canadian Income Taxation* (Don Mills, ON: CCH Canadian, 1965), at 109, cited in Friedlander, *supra* note 17.

33 See, for example, *Herman Luks [No. 2] v. MNR*, [1958] CTC 345 (Ex. Ct.).

34 *Ouzilleau et al. v. MNR*, [1999] 1 CTC 2701 (TCC); see also CRA document no. 9701805, March 14, 1997.

35 *Ibid.*

36 CRA document no. 9816945, September 28, 1998; see also *Interpretation Bulletin* IT-352R2, "Employee's Expenses, Including Work Space in Home Expenses," August 26, 1994.

The CRA applies the same reasoning to disallow the costs of cellphones, tools, and uniforms.³⁷

At the Tax Court of Canada, Bowman ACJ (as he then was) questioned this general line of reasoning in *Fardeau v. The Queen*:

What of the monthly cost of the pager and cell phone? Certainly those services are “supplies.” Just as obviously they are consumed.

Interpretation Bulletin IT-352R2 draws a distinction between the cost of

(d) telegrams, long-distance telephone calls and cellular telephone airtime that reasonably relate to the earning of employment income.

which it says is deductible under subparagraph 8(1)(i)(iii) and the cost of

- (a) the monthly basic service charge for a telephone line;
- (b) amounts paid to connect or licence a cellular telephone;

which it says is not.

I suppose that in dealing with income tax matters we should be used to drawing subtle distinctions but this distinction is a little too subtle for me. Indeed, it makes no sense whatever. If, as here, the officer has to supply his own cellular phone and use it in the course of his duties the monthly service charge is as much a cost of a service that is supplied as is the cellular telephone airtime.³⁸

It appears that the permissive reasoning in *Fardeau* was not widely followed. In *Barry v. The Queen*,³⁹ the appellant argued that he was functionally required to have a cellphone because of his on-call status (and he did not own a cellphone until he commenced the subject employment). The Tax Court denied the deduction of the cellphone expenses, and that decision was upheld by the Federal Court of Appeal.

Limitations on the Deduction of Home Office Expenses

Subparagraph 8(1)(ii) permits employees to deduct office rent where the payment of such rent is required by the contract of employment. However, as noted previously, the deduction is subject to the precondition in paragraph 8(13)(a) that the workspace must be either

- the principal place at which an individual performs the duties of employment, or
- used by the employee exclusively for the purpose of earning income from employment, *and* used on a regular and continuous basis for meeting customers or other persons in the ordinary course of performing the duties of employment.

A similar precondition is found in paragraph 18(12)(a) for the home office of a self-employed individual, although it is more likely that a greater proportion of

37 IT-352R2, *supra* note 36, at paragraphs 9-10.

38 2002 DTC 3867, at paragraphs 16-18 (TCC).

39 2013 TCC 221; *aff'd* 2014 FCA 280.

self-employed individuals can meet the “principal place of business” condition in subparagraph 18(12)(a)(i) compared to employees meeting the equivalent condition in subparagraph 8(13)(a)(i).

Few cases have evaluated these requirements. The CRA has indicated as recently as 2013 that only face-to-face encounters will qualify as “meetings”; that is, e-mails, telephone calls, and video conferencing will not qualify.⁴⁰ The term “principally” is taken, administratively, to mean 50 percent or more of the time.⁴¹

It is worth noting the longstanding rule that even if an employee meets all of the other home office requirements in subsection 8(13), he or she cannot deduct capital cost allowance, property taxes, home insurance, or mortgage expenses, because subparagraph 8(1)(i)(ii) applies to only “rent.”⁴² For example, in *Felton v. MNR*,⁴³ the taxpayer was required by a contract of employment to maintain an office in his home, which he owned. He did so, using the space exclusively for the duties of his employment. The taxpayer attempted to deduct a proportion of his mortgage interest, property taxes, insurance, utilities, and maintenance costs for his home. The Tax Court held that such payments did not qualify as “office rent” for the purposes of subparagraph 8(1)(i)(ii). The decision in *Felton* was followed in *Lester v. The Queen*,⁴⁴ even though the appellant’s use of a home office in the latter case was made specifically to save a related corporation from having to incur additional costs for office rent and related overhead expenses. The CRA’s administrative practice is to permit the deduction of electricity, heat, water, and utilities on a proportionate basis.⁴⁵

Conditions of Employment

Generally, the CRA has accepted that the term “contract of employment” can be given a broad meaning.⁴⁶ This position is supported by case law, which indicates that implied terms of employment may be considered where express terms are unavailable.⁴⁷ In practice, however, implicit terms are not given much weight where express terms are available.⁴⁸

The CRA has generally taken the position—supported by case law—that the T2200 form is an absolute requirement for any deduction to be claimed in respect of

40 CRA document no. 2013-0481171E5, December 10, 2013; see also CRA document no. 2009-0337751I7, November 30, 2009.

41 CRA document nos. 9205995, March 25, 1992, and 2007-0228231I7, May 24, 2007.

42 IT-352R2, *supra* note 36, at paragraph 6.

43 [1989] 1 CTC 2329 (TCC).

44 2011 TCC 543.

45 *Haltrecht v. MNR*, [2000] 2 CTC 2749 (TCC).

46 CRA document no. 2018-0758641E5, March 19, 2019.

47 *Rozen v. The Queen*, 85 DTC 5611; cited (and distinguished) in *Barry*, *supra* note 39 (FCA), at paragraph 13.

48 *Kreuz v. The Queen*, 2012 TCC 238.

home office expenses,⁴⁹ even where an employee makes good faith efforts to obtain the form from the employer and is rebuffed.⁵⁰

An employer is not required by the ITA to complete a T2200. Employers have been concerned about potential liability for filling out the form since the requirement for certification was added to the ITA.⁵¹ The CRA has stated that an employer must be “reasonably certain” that an employee qualifies for the deduction before signing form T2200.⁵²

An employee cannot force an employer to issue a T2200 if the employee disagrees with the employer’s interpretation of the ITA—a matter that has caused some litigation. Courts have indicated that it may be possible in “exceptional circumstances” for an employment expense claim to succeed if an employer “unreasonably refused, or was unable” to complete and sign a T2200 form.⁵³ Taxpayers have generally not been successful in making the “exceptional circumstances” argument. For example, in *Kreuz*,⁵⁴ an employer that had previously issued T2200s for substitute teachers changed its policy and decided that it would no longer do so. The appellant argued unsuccessfully that the implied terms of his employment meaningfully required him to have an automobile.⁵⁵ The Tax Court held that the employer would need to be unreasonable or to act in bad faith for the T2200 requirement to be waived.⁵⁶

International Comparisons

The Organisation for Economic Co-operation and Development (OECD) publishes an annual study detailing the personal income taxes and social contributions paid by employees among member countries.⁵⁷ Select information from some comparable OECD countries (supplemented on occasion with information from primary sources) can be found in table 1.⁵⁸ Without further inquiry as to how the rules are administered in each region, it appears that Canada is among the least permissive countries with respect to employee deductions of work-related expenses.

49 See, for example, CRA document no. 2009-0325851M4, July 20, 2009.

50 *Chao v. The Queen*, 2018 TCC 72; see also *Kreuz*, supra note 48.

51 CRA document no. 9707055, May 14, 1997.

52 CRA document no. 2007-0228231I7, May 24, 2007.

53 *Brochu v. The Queen*, 2010 TCC 274, at paragraph 11.

54 *Kreuz*, supra note 48.

55 *Ibid.*, at paragraph 35.

56 *Ibid.*, at paragraph 76; followed in *Chao*, supra note 50.

57 OECD, supra note 2.

58 Not all OECD countries are included in table 1. The choice of countries is based on their similarity to the Canadian income tax scheme and the availability of information concerning employment-related tax deductions. I have not included the United States owing to recent changes in the deductibility of employment expenses, which may be reviewed by the Biden administration. Except as indicated in the notes to the table, I have not independently verified the information drawn from the OECD’s 2020 annual study.

**TABLE 1 Deduction of Work-Related Expenses by Employment—
Comparison of Rules in Selected OECD Countries**

Country	Scope of deductions for work-related expenses
Australia	Any work-related expenses may be deducted, including the cost of replacing tools of trade, providing and cleaning protective clothing and footwear, travelling between jobs, and travelling in the course of employment. ^a
Austria	Amounts in excess of €132 may be claimed in respect of expenditures on work clothes, tools and equipment, home office, training, council works contributions, travel to and from work, computers, Internet access, motor vehicles, language courses, and telephone charges. Home office expenses may be deducted if the items purchased are used almost exclusively for occupational activities and if the home office constitutes the centre of the taxpayer's entire business and occupational activities. ^b Notably, proportionate financing costs of the home office and depreciation expenses of the furniture may be claimed. ^c
Belgium	Salaried employees are entitled to a standard 30 percent deduction for work-related expenses, up to €4,810 per person. ^d
Denmark	Actual costs incurred in order to acquire income are deductible from taxable income. These costs are deductible to the extent that they exceed the basic amount of DK6,100. ^e
Estonia	No specific employment-related deductions are permitted. ^f
Finland	A standard deduction of €750 is available to employees. Finnish employees may itemize and claim expenses exceeding this standard deduction. Permissible expenses include home office expenses, which are deductible if the employer has not arranged an office for the employee or if the job involves a substantial amount of work that is done at home. The deduction available is a flat-rate formulaic deduction based on primary, part-time, and occasional use of the home office. ^g
France	A deduction is available for work-related expenses based on either the actual amount of expenditure or a standard allowance of 10 percent of net pay (ranging from €441 to €12,267 per earner). ^h
Germany	A standard lump-sum deduction of €1,000 is available per employee. If expenses exceed this amount, they can be deducted if they are substantiated. ⁱ If the home office is the focus of all operational and professional activities, the full amount of the expenses may be deducted. If the home office is not the focus of all operational and professional activities but no other workplace is available, up to €1,250 may be deducted per year. ^j
Ireland	Work-related expenses may be deducted to the extent that they are wholly, exclusively, and necessarily incurred in the performance of duties of employment. ^k

(Table 1 is continued on the next page.)

TABLE 1 Continued

Country	Scope of deductions for work-related expenses
Netherlands	An employer may reimburse work-related expenses tax-free, up to a fixed percentage of the total wages of employees (1.7 percent in 2020). ¹
New Zealand	Taxpayers may not deduct expenses or losses to the extent that they are incurred in the context of deriving income from employment. ^m
Norway	Every individual receives a minimum allowance of 45 percent (in 2020) of personal income, with a minimum of NOK4,000 and a maximum of NOK100,800. ⁿ Wage earners are entitled to a special employment deduction at that rate, but the minimum deduction is NOK31,800 and the maximum is NOK104,450. ^o To the extent that a taxpayer's actual expenses exceed the minimum standard deduction, the expenses may be itemized and deducted. Such expenses include car allowance deficits, board for business travel not involving overnight stays, home office, specialist literature, further education, tools, work clothing, and voluntary accident and illness insurance. ^p Home office expenses are deductible if the taxpayer uses part of the home exclusively as a home office. If the property is owned by the taxpayer, he or she will generally benefit from a flat-rate deduction. ^q
Spain	No specific deductions relating to employment expenses appear to be available. Instead, taxpayers benefit from an employment-related allowance. For taxpayers with net employment income (gross income less employee social security contributions) below €13,115, the deduction is €5,565. For taxpayers exceeding this threshold, the deduction is scaled down. ^r
Sweden	In principle, Sweden taxes on a net income basis, and all expenses incurred to fulfill the duties of employment are deductible to the extent that they exceed the standard deduction. ^s However, home office expenses are limited: the employer must not provide an office, and simply working from home on an occasional basis is not sufficient to qualify for the deduction of home office expenses. ^t
Switzerland	Employees may deduct 3 percent of net income for expenses, with a minimum deduction of CHF2,000 and a maximum deduction of CHF4,000. ^u
United Kingdom . . .	Flat-rate expenses for tools and special clothing are allowed for employees in certain occupational categories. ^v For items that are widely incurred, in broadly similar amounts, and for which receipts are difficult to receive (such as subsistence or costs of cleaning uniforms), employers are permitted to pay or reimburse, at benchmark rates, expenses incurred by employees in performing their duties. If the advisory benchmark rates are used, the expenses may be reimbursed tax-free without needing prior approval of an officer of HM Revenue & Customs. ^w

(Table 1 is continued on the next page.)

TABLE 1 Continued

Country	Scope of deductions for work-related expenses
United Kingdom (cont.)	<p>Employers are permitted to reimburse employees for the cost of additional household expenses where the employee works from home. (This rule applies wherever an employee frequently works from home or follows a pattern.) The weekly limit for such reimbursement prior to 2020 was £4. This amount was raised during the COVID-19 pandemic to £6 weekly. These amounts do not have to be reported by the employer or the employee.^x</p> <p>If an employer does not reimburse the employee, the employee may claim deductions for expenses if (1) the employee is obliged to incur and pay the expense as the holder of the employment and (2) the amount is incurred wholly, exclusively, and necessarily for the employee's work.^y</p> <p>Home office expenses that may be deducted include additional heating and lighting, and metered water, but not mortgage interest or rent, council tax, water rates, or insurance. Employers are permitted to reimburse (tax-free) certain additional costs including additional insurance costs.^z</p>

a OECD, *Taxing Wages* 2020.

b Austria, Federal Ministry, Finance, *The Tax Book 2021: Tips for Employee Tax Assessment 2020 for Wage Taxpayers* (Vienna: Bundesministerium für Finanzen, 2020).

c Ibid.

d OECD, *Taxing Wages* 2020.

e OECD, *Taxing Wages* 2020. This basic amount applies to 2018 and is adjusted annually: Danish Customs and Tax Administration, "Tax Rates" (<https://skat.dk/skat.aspx?oid=2035568&prev=2018&lang=US&tab=4>).

f OECD, *Taxing Wages* 2020. See also the Income Tax Act (Estonia); passed December 15, 1999, translation published January 31, 2018 by Riigi Teataja (www.riigiteataja.ee/en/eli/531012018001/consolide).

g OECD, *Taxing Wages* 2020. See also Finnish Tax Administration (Verohallinto), "Home Office Deduction" (www.vero.fi/en/individuals/tax-cards-and-tax-returns/income-and-deductions/expenses-for-the-production-of-income/home-office-deduction).

h OECD, *Taxing Wages* 2020.

i OECD, *Taxing Wages* 2020.

j Bundesfinanzministerium, current letter Az. IV C 6-S 2145/07/10002.

k OECD, *Taxing Wages* 2020.

l Government of the Netherlands, "Work-Related Costs Scheme: Staff Allowances" (<https://business.gov.nl/regulation/work-related-costs-scheme>).

m Income Tax Act 2007 (New Zealand), 2007 No. 97, section DA 2, subsection (4).

n OECD, *Taxing Wages* 2020.

o Norwegian Tax Administration, "Rate for: Minimum Standard Deduction" (www.skatteetaten.no/en/rates/minimum-standard-deduction/?year=2020).

p Ibid.

q Norwegian Tax Administration, "Home Offices" (www.skatteetaten.no/en/business-and-organisation/tax-for-businesses/tax-return/deductions/deduction-tool-for-sole-proprietorships/deductions-related-to-office-space/home-offices).

r OECD, *Taxing Wages* 2020.

(Table 1 is concluded on the next page.)

TABLE 1 Concluded

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- s Swedish Tax Agency, “Belopp Och Procent—Inkomstår 2021 [Amount and Percentage—Income Year 2021]” (www.skatteverket.se/privat/skatter/beloppochprocent/2021#h-Beskattningsbarinkomst); see also OECD, *Taxing Wages 2020*.
- t Swedish Tax Agency, “Common Deductions in the Tax Return” (www.skatteverket.se/servicelankar/otherlanguages/inenglish/individualsandemployees/declaringtaxesforindividuals/commondeductionsinthetaxreturn.4.7be5268414bea064694c75e.html).
- u OECD, *Taxing Wages 2020*.
- v Ibid.
- w United Kingdom, HM Revenue & Customs, “EIM30240—Exemption for Amounts Which Would Otherwise Be Deductible: Payments at a Benchmark Rate.”
- x UK Government, “Expenses and Benefits: Homeworking” (www.gov.uk/expenses-and-benefits-homeworking/whats-exempt).
- y Income Tax (Earnings and Pensions) Act 2003 (UK), 2003, c. 1, section 336(1).
- z United Kingdom, Association of Taxation Technicians, “Home Sweet Home—Tax Relief and Home Working” (www.att.org.uk/home-sweet-home-%E2%80%93-tax-relief-home-working).

Sources: Organisation for Economic Co-operation and Development, *Taxing Wages 2020* (Paris: OECD, 2020), and documents cited in the accompanying notes.

PROPOSED CHANGES

Desired Outcome

What principles should we aspire to in revising the deductibility of home office expenses? I propose that any changes should be aimed toward achieving the following ends:

- *Horizontal equity.* Individuals earning similar amounts in similar circumstances should be taxed similarly. The gap between employees and the self-employed should be narrowed, with fewer distortionary tax incentives favouring the self-employed.⁵⁹
- *Vertical equity.* Any proposed changes should ensure that the tax system is at least as progressive as the current system (and the CEC).
- *Administrative burden.* Existing and additional administrative burdens—both for the government and for the taxpayer—should be minimized.
- *Cost.* Deductions and credits alike reduce revenues collected by the government. If a deduction or credit is granted for the purpose of affecting behaviour, it should efficiently do so. Otherwise, the deduction or credit should advance the principles of horizontal and vertical equity.

59 The following comment by Judith Freedman in this Policy Forum applies equally to Canada’s existing employee expense deduction scheme: “The UK system at present results in a strong tax and social security contribution incentive not to be an employee.” Judith Freedman, “Policy Forum: Tax, Social Security, and Employment Status—Removing the Distortions in the United Kingdom,” at 550.

I review two options for changing the deductibility of work-related expenses incurred by employees. Option 1 proposes a dramatic change: permitting employees to deduct expenses as initially recommended by the Carter commission. This option would require a substantial shift in how Canada assesses employment income. Given that the Carter commission's proposal was not fully implemented, this option is unlikely to be adopted today. Accordingly, option 2 proposes a more moderate reform: the implementation of incremental changes that would make the tax system fairer and more efficient. After discussing the relative merits of both options, I comment on the limitations of the CEC, arguing that it is an expensive and inefficient way to recognize the expenses incurred by employees.

Option 1: Implement the Carter Commission's Recommendation

From the perspective of horizontal fairness, the most equitable way to deal with the issue of employment expenses would be to permit employees to deduct expenses as initially proposed by the Carter commission. Further, as the commission suggested, employees should have the option of deducting the lesser of 3 percent of employment income and \$4,000 (adjusted for inflation) in order to relieve them of the administrative burden of having to compile and review itemized expenses.⁶⁰ The option to deduct a percentage of income (with the ability to itemize where appropriate) takes into account the chief criticism of the Australian report on tax reform, which identified compliance as a substantial issue.⁶¹ This reform should be combined with repeal of the existing CEC.

Moving from a credit to a deduction raises concerns about preserving vertical tax equity. Some apprehension has been expressed that relatively unsophisticated taxpayers with lower incomes may be less likely than higher-income taxpayers to use or take full advantage of deductions. Empirical evidence from Australia (which permits taxpayers to take itemized deductions for employment expenses) suggests that this is not the case in the context of deducting employment expenses. In 2003-4, for example, the benefit from the deduction of employment expenses as a percentage of income was highest for low and middle income earners earning less than \$60,000 per year (7.2 percent of taxable income compared to 2.9 percent for higher income earners).⁶²

While the potential impact of indiscriminate income tax deductions for employees should not be ignored, the proposed system is likely not to cause further vertical

60 This number is in line with the recommendation of the Carter commission. The maximum amount of the deduction is lower than that in most OECD countries that impose a maximum amount for employment expense claims.

61 Australia, Department of the Treasury, *Australia's Future Tax System, Report to the Treasurer, December 2009, Part Two, Detailed Analysis*, vol. 1 of 2 (Canberra: Commonwealth of Australia, 2010), at 57.

62 Cynthia Coleman, "Tax Refund Versus Tax Return?" (2007) 22:2 *Australian Tax Forum* 49-64, at 50.

inequity for two reasons. First, higher income earners are more likely to have expenses paid by their employers—a consideration that may explain the Australian data.⁶³ This means that higher income earners are already benefiting from vertical inequity, and that lower income earners may in fact benefit more from an employment expense deduction. Second, the proposed system differs from the Australian model by proposing a flat maximum amount for the deduction for most taxpayers. This means that the maximum percentage of income that can be deducted by an employee decreases as the employee earns more income.

The administrative burden of this system would likely be no greater than that for the existing system, depending on whether or not other changes (such as changes to the T2200) are effected.

In terms of cost, there is no denying that implementing these proposals would substantially increase the scope of the existing scheme for claiming employment expenses.⁶⁴ However, the existing scheme is also expensive, without attaining the same level of equity. In the 2017 taxation year, the CEC cost approximately \$2.385 billion dollars and was received by about 18.1 million people.⁶⁵ (For reference, the federal government's annual tax revenues for 2017 were \$209.269 billion.)⁶⁶ By comparison, in 2017, permitting taxpayers to deduct 3 percent of their employment income to a maximum of \$4,000 would have cost a maximum of 3 percent of federal revenues collected from personal income taxes in that year, or \$4.609 billion⁶⁷—nearly double the cost of the CEC. The actual cost would likely be lower because of the general proposed maximum cap of \$4,000 (even if a small proportion of taxpayers opted to itemize their deductions). Furthermore, taxation statistics from the Australian government suggest that, even when employees were given unfettered access to deductions, 69 percent of claimants claimed no more than AU\$2,500 and 88 percent claimed no more than AU\$5,000 in employment expenses.⁶⁸

63 Jonathan Baldry, "Abolishing Income Tax Deductions for Work-Related Expenses" (1998) 5:1 *Agenda: A Journal of Policy Analysis and Reform* 49-60. See also Coleman, *supra* note 62.

64 All costs approximated in this article are calculated at the federal level. Provincial costs may differ.

65 Canada, Department of Finance, *Report on Federal Tax Expenditures: Concepts, Estimates and Evaluations 2020* (Ottawa: Department of Finance, 2020), part 4.

66 Canada, Department of Finance, "Annual Financial Report of the Government of Canada Fiscal Year 2018-2019" (www.canada.ca/en/departement-finance/services/publications/annual-financial-report/2019/report.html).

67 Calculated by taking 3 percent of personal income tax revenues as reported *ibid*.

68 Based on analysis of data in table 18 from the Australian Taxation Office, "Taxation Statistics 2017-18" (www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Taxation-statistics/Taxation-statistics---previous-editions/Taxation-statistics-2017-18/). At the time of writing, AU\$1 is approximately equivalent to Cdn\$0.97.

Option 2: Incremental Change

Even if employees are not permitted to deduct employment expenses writ large, the existing employment expense deduction should be modified to remove the administrative burden on the employer and to permit the deduction of expenses that are integral to modern work.

Deduction of Office Supplies Under Subparagraph 8(1)(i)(iii)

The following changes should be made to subparagraph 8(1)(i)(iii):

- The stipulation that an expense is required by a contract of employment should be replaced with the usual practice of the employer or industry. The norms of an office or employment set the expectation of an employer and the behaviour of a taxpayer just as much as a written contract of employment. Employees who have legitimate employment-related reasons for incurring certain expenses should be permitted to deduct them against employment income. This change would require a legislative amendment removing the term “contract of employment” from subparagraph 8(1)(i)(iii).
- Where employees are required to pay periodic fees relating to electronic communication, they should be permitted to deduct a fixed amount representing the average reasonable annualized cost of that service. For example, a fixed amount representing the average amount of annual Internet charges should be deductible by every employee who is required to be accessible outside regular business hours or to work using his or her home Internet service. Similarly, a deduction should be allowed for the cost of any cellphone plan or monthly Internet subscription that must be maintained by an employee if he or she is not reimbursed for that expense. This change does not require a legislative amendment; the phrase “cost of supplies consumed directly” is broad enough to cover this administrative practice.

Home Internet and telephone usage will inevitably have both personal and business-related elements. This is why a flat-rate system representing the average cost (or average marginal cost) of Internet or telephone charges may be more appropriate—and less hassle—than asking taxpayers to estimate or apportion their usage.

Making these changes would increase horizontal equity. Self-employed taxpayers are generally permitted to deduct those expenses that are made or incurred for the purpose of gaining or producing income from the business or property.⁶⁹ Expanding the scope of permissible deductions from that required by a contract of employment to that which is typical of an industry puts employees on a more equal footing with self-employed taxpayers while still reducing the potential for overclaiming. Vertical equity would likely be unaffected by this change.

69 Paragraph 18(1)(a).

The administrative burden on the CRA will likely increase if it is required to determine whether the general practice of an industry supports a deduction; however, the CRA is already required to make this determination, to some extent, when reviewing industry-specific claims. Moreover, the existing administrative burden in respect of claims for home Internet and telephone usage is likely to be reduced by the adoption of a flat-rate deduction.

Deduction of Home Office Expenses Under Subparagraph 8(1)(i)(ii) and Subsection 8(13)

Changes should also be made to subparagraph 8(1)(i)(ii) and subsection 8(13), as outlined and explained below:

- Subparagraph 8(1)(i)(ii) permits the deduction of rent, but not rent-like payments, in respect of home offices. The requirement that taxpayers pay rent has no principled justification, and the legislation should be amended to remove the explicit reference to “rent.” Taxpayers who own their residence (thereby choosing not to rent a separate office space) should be permitted to deduct a reasonable imputed rent attributable to the proportion of their home used as office space. If that poses administrative difficulties with respect to valuation, taxpayers could instead be permitted to deduct the current expenses associated with the office space (that is, pro rata portions of mortgage interest, insurance, utilities, etc.).
- More than ever before, the modern work environment requires office workers to have home offices. Estimates from 2019 indicated that telework capacity in Canada (the share of jobs that could plausibly be performed from home) was approximately 39 percent.⁷⁰ Employee hotelling situations (where employees do not have assigned offices and may work from transient spaces) were already on the rise prior to the pandemic. With video conferencing abruptly becoming the norm, it is realistic to expect that, in the future, many employees will be meeting virtually with customers or other persons in the ordinary course of performing the duties of employment. The cost of doing so should fulfill the conditions of subparagraph 8(13)(a)(ii). Accordingly, the CRA’s administrative policy, which indicates that meetings require people to meet in person, should be changed.
- Subparagraph 8(13)(a)(i) is too vague and should be clarified. The requirement that a workspace be the “principal place” at which an individual performs the duties of employment is subject to wide interpretation. Even with the CRA’s policy of defining “principal” as 50 percent or more, the application is not clear. For example, would the requirement of this provision be met in the situation where a taxpayer was required to work exclusively from home

70 Canada, Department of Finance, *Fall Economic Statement 2020—Supporting Canadians and Fighting COVID-19*, November 30, 2020, at paragraph 4.8.3.

from January 1 to May 31 of 2021 and then returned to the office for the remainder of the year? For five months of the year, the principal place at which the taxpayer performed the duties of employment would be the home office, but it would be elsewhere for the remaining seven months. Subparagraph 8(13)(a)(i) should be clarified to indicate legislative intent. The fairest outcome would be to permit taxpayers to deduct a proportion of their home office expenses based on the proportion of time during which they work from that office on an annual basis. Subsection 18(12), dealing with home office expenses for the self-employed, should be similarly amended.

Implementing these changes would increase horizontal equity between employees in different industries (that is, those who are expected to work from home and those who are not). However, the changes relating to home office expenses may result in an additional administrative burden for both taxpayers and the CRA with respect to the substantiation and auditing of home office claims. Accordingly, the current scheme in subparagraph 8(1)(i)(ii) and subsection 8(13) could be replaced with a reasonable per diem deduction for taxpayers who have home offices. This rate should be intended to cover costs such as Internet service, rent, software, utilities, and similar costs. This approach has already been adopted, on a temporary basis, for 2020,⁷¹ and is similar to the approach that already exists in the United Kingdom.

The incremental changes proposed above would be less onerous to the public purse than permitting employees to generally deduct employment expenses. The federal government estimated that the simplification of the home office expense deduction in 2020 cost between \$210 million and \$260 million for that taxation year.⁷² Given the government's estimate of 39 percent of telework capacity in Canada, it is likely that this cost will decrease following the pandemic.

Employer Certification Under Subsection 8(10)

The employer certification requirement in subsection 8(10) should be removed.⁷³ This requirement is an administrative burden that creates anxiety about liability for employers and offers them no real benefit. As a result, employers tend to be overly

71 Canada Revenue Agency, "Introducing a Simplified Process for Claiming the Home Office Expenses for Canadians Working from Home due to the COVID-19 Pandemic," *News Release*, December 15, 2020 (www.canada.ca/en/revenue-agency/news/2020/12/introducing-a-simplified-process-for-claiming-the-home-office-expenses-for-canadians-working-from-home-due-to-the-covid-19-pandemic.html).

72 *Fall Economic Statement 2020*, supra note 70, at 117; see also Canada, Office of the Parliamentary Budget Officer, "Legislative Costing Note: Simplifying the Home Office Expense Deduction," February 4, 2021 (<https://pbo-dpb.s3.ca-central-1.amazonaws.com/artefacts/5a071094fe9ba2e62f75f43cd0d4828c16de764081bd20454f5c3dc163dcec78>).

73 The impact of this change would be broader than the impact of amending the home office expense provisions, as described in this article, but the same principles generally apply.

conservative in certifying that their employees qualify for the expense deduction. Unusually, there is no legal requirement that an employer correctly fill out the T2200 form. Employees with the least bargaining power are most likely to be affected by this requirement, and least able to advocate for themselves with an unwilling employer. Removing the provision is therefore likely to increase vertical equity.

Employees should be trusted to attest on their own behalf if attestation is required (or the requirement of attestation should be removed completely to save the administrative hassle of reviewing these forms). This removes the unnecessary middleman and the unnecessary burden on the employer. Taxpayers are already trusted to self-report several items on their returns without immediate supporting documentation (such as charitable donation receipts). The CRA can flag individual cases for audit where the expenses claimed do not appear to be reasonable according to industry practice (as it already does in the context of claims by self-employed individuals). Employees can provide supporting documentation as and when required.

The fact that employees are substantially more numerous than self-employed individuals raises concerns about potential tax leakage and evasion if the certification requirement is removed. Individual expense claims are likely to be low; as a result, the cost of auditing every claim would be high in the absence of a document such as the T2200. However, the T2200 cannot be of much use in alleviating these concerns. The T2200 does not dispose of the issue of whether or not an employee actually incurred certain expenses; it merely stands for the proposition that the employer required the employee to pay the expenses. The expenses must still be audited on their own (if so required). In most cases, an audited employee will be able to provide a written employment agreement (or a communication by which such agreement was modified) in lieu of a T2200 to prove that the legal requirements to claim employment expenses have been met.

Information reporting is highly effective in promoting tax compliance⁷⁴ and should not be dispensed with lightly. However, it is also not a panacea,⁷⁵ particularly where there are no economic incentives for the failure to comply with government mandates.⁷⁶ Currently, there is no legal requirement that employers issue T2200 forms or that they accurately report information therein; as a result, this form of information reporting has relatively low value.

A related concern is potential tax evasion. Self-employed individuals are reported to have lower rates of compliance than employees.⁷⁷ By making it easier to claim the employment expense deduction, the government may inadvertently increase non-compliance and evasion. There are several responses to this suggestion. First,

74 Leandra Lederman, "Reducing Information Gaps To Reduce the Tax Gap: When Is Information Reporting Warranted?" (2010) 78:4 *Fordham Law Review* 1733-59, at 1738.

75 *Ibid.*, at 1736.

76 Edward K. Cheng, "Structural Laws and the Puzzle of Regulating Behavior" (2006) 100:2 *Northwestern University Law Review* 655-718, at 666.

77 *Ibid.*, at 677-78.

the T2200 requirement, subject as it is to the employer's whim, is primarily likely to impose costs on employees who are least able to negotiate with their employers. This vertical inequity should not be tolerated, even if there is a risk of increased evasion. Second, the longstanding assumption that self-employed individuals disproportionately evade taxes is being challenged with new evidence of situations where employees and employers collude to understate employee wages.⁷⁸ This raises the question of whether the employer is really a reliable third party for the purposes of information reporting. Finally, the CRA has generally found that adjustments to the income of self-employed individuals result from unintentional errors.⁷⁹ Such unintentional errors should be limited in the case of employment expense deductions that have already been implemented and studied in several other countries.

Employer certification is neither necessary nor sufficient to prove that employment expenses were incurred as required by a taxpayer's contract of employment. The requirement for a T2200 should be removed.

Limitations of the CEC

The CEC is not an adequate solution to the existing horizontal inequity in the tax treatment of employees and the self-employed, and it does not promote vertical equity. However, given that the cost of the CEC is relatively high, it should be held to correspondingly high standards of taxpayer equity.

Statistics Canada has estimated that, as of December 2017, approximately 18.5 million individuals over the age of 15 years were employed or had a job but were not at work⁸⁰—that is, more or less every Canadian resident who was employed and earning income appears to have received the CEC in 2017.

The CEC fails to achieve horizontal equity because of its severely limited scope but broad application. It cannot begin to defray the costs of employment for those who incur such expenses because the actual amount of the credit to any individual is very small. For example, the average monthly cellphone bill in Canada in 2019 was \$101, or more than \$1,200 per year.⁸¹ Any taxpayer who was required to use a personal cellphone for employment-related purposes would use the CEC on this item alone. However, employees who take the filing position that they do not incur employment-related expenses are still fully entitled to the credit. Full-time and part-time employees receive the same credit regardless of their status. Since a matching credit is not available in most provinces or territories, the individual

78 Joel Slemrod, "Tax Compliance and Enforcement" (2019) 57:4 *Journal of Economic Literature* 904-54, at 918.

79 Canada Revenue Agency, *Tax Assured and Tax Gap for the Federal Personal Income Tax System* (Ottawa: CRA, 2017).

80 Statistics Canada table 14-10-0287-03, "Labour Force Characteristics by Province, Monthly, Seasonally Adjusted."

81 Canadian Radio-television and Telecommunications Commission, *Communications Monitoring Report 2019* (Ottawa: CRTC, 2020).

impact of the CEC is relatively low despite its high overall cost. By contrast, adjustments to employment expense deductions would automatically affect the calculation of taxable income for taxpayers in provinces that have tax collection agreements with the federal government. (However, the result would be to increase the overall cost of a deduction.)

With respect to the problem of vertical equity, while the form of the CEC—a non-refundable tax credit—is likely, in theory, to benefit lower-income taxpayers, a deduction with a maximum cap is more likely to be equitable in fact.⁸² This is particularly true given that higher-income taxpayers are more likely to be reimbursed by their employers for employment-related expenses.

Does the CEC have some goal other than equity? If the aim of the CEC is to encourage employment, it is also unlikely to succeed in that goal. The form of a tax incentive must be considered when evaluating its likely efficacy.⁸³ American analysis suggests that tax credits tend to be less transparent—and thus, less salient—than immediate cash-based transfers.⁸⁴ Even if individuals act with full knowledge of the CEC, it is unlikely that a credit limited to 15 percent of \$1,245 will move the needle in terms of whether they look for employment. The CEC does not achieve the goal of tax fairness, and it likely does not promote employment in any meaningful way.

CONCLUSION

The COVID-19 pandemic has underscored shifts in the nature of modern work. Permanent legislative amendment and changes in administrative policy should be considered to facilitate the deductibility of employment expenses in this digital era. The proposals outlined above are commonsense measures that would reduce the burden on employers, protect employees from employers unwilling to provide T2200s, and reduce the current inequity between employees and self-employed persons. If implemented correctly, they will also reduce the overall administrative burden for the CRA by reducing the need to review and process T2200 forms, and ideally, by replacing the need for individual review with flat-rate deductions. While tax collection may decrease as a result of these measures, the overall cost is estimated to be a small fraction of total tax revenues.

82 See the discussion of Australian tax data in the text accompanying note 62 above.

83 See, for example, Raj Chetty, Adam Looney, and Kory Kroft, “Salience and Taxation: Theory and Evidence” (2009) 99:4 *American Economic Review* 1145–77.

84 Raj Chetty, “Salience and Taxation: Evidence and Policy Implications, Testimony for the Committee of Finance, United States Senate, Hearing on ‘How Do Complexity, Uncertainty and Other Factors Impact Responses to Tax Incentives?’” March 30, 2011 (www.finance.senate.gov/imo/media/doc/033011rc.pdf).

Policy Forum: Promoting Tax Compliance by Regulating the Digital Economy—Quebec’s Uber Initiative

Michaël Robert-Angers and Luc Godbout*

PRÉCIS

La numérisation de l'économie change la façon dont les entreprises interagissent avec leurs clients et fournisseurs. Elle facilite les transactions entre particuliers et simplifie la conduite des affaires à l'étranger, sans nécessiter de présence physique. Cette tendance lourde entraîne aussi de nombreux défis pour les administrations fiscales qui se voient confrontées à de nouvelles pratiques d'affaires qui remettent en question les façons traditionnelles de prélever les recettes fiscales, les forçant à innover. Au Québec, le contexte entourant la légalisation des activités de la multinationale Uber a mené celle-ci à accomplir, pour le compte des chauffeurs utilisant sa plateforme, des activités de conformité fiscale échouant normalement aux employeurs. L'implication de la multinationale Uber qui verse directement à Revenu Québec la taxe de vente applicable sur les transactions des chauffeurs favorise la protection des recettes fiscales, notamment celles des taxes à la consommation dans un secteur économique à prévalence d'évasion fiscale.

ABSTRACT

The development and expansion of the digital economy is changing how companies interact with their customers and suppliers. Digital business models facilitate transactions between individuals and make it easier to conduct business abroad without the need for a physical presence. However, the growing use of such models creates many challenges for tax administrations. In particular, these new business practices call into question the traditional ways of collecting tax revenues, and thus force tax administrations to innovate. In Quebec, the context surrounding the legalization of the operations of the multinational Uber has led to an agreement between the company

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and the provincial government providing that Uber will carry out, on behalf of the drivers using its platform, tax compliance activities that employers would normally perform. Specifically, Uber now pays the sales tax applicable to drivers' transactions directly to Revenu Québec. This arrangement helps to protect commodity tax revenues in an economic sector where tax evasion is prevalent.

KEYWORDS: GST ■ GIG WORKERS ■ QST ■ QUEBEC ■ TAX-COLLECTION AGREEMENTS ■ TAX EVASION

CONTENTS

Introduction	514
The Platform Economy, the Taxi Industry, and Taxation	516
Conflict Between Uber and Revenu Québec	517
Pilot Project	518
Change from the Previous Circumstances	518
Innovations and Simplifications for Uber Drivers	520
Protection of Tax Revenues	522
Prevalence of Tax Evasion in the Taxi Industry	523
Tax Revenues Before and After the MFQ-Uber Agreement	525
Inspiration for Other Sectors and the Rest of Canada	526

INTRODUCTION

Faced with business practices in the digital economy that use alternative means to sell goods and services, the institutions that are responsible for maintaining the integrity of our tax systems have two choices: they can opt for keeping the status quo, with the risk that the legislative framework may no longer be fully in line with business realities, owing to the occasional requirement to deal with inconsistencies; or they can be proactive, adapting to changing realities (at the risk of upsetting part of the population) in an attempt to resolve new tax issues and maintain a tax framework that is consistent in its application to taxpayers.

To this end, since January 1, 2019, in accordance with the recommendations of the Organisation for Economic Co-operation and Development (OECD), Quebec requires foreign companies that do not have a place of business in the province, and make supplies of incorporeal property and services, to collect the Quebec sales tax (QST).¹ The same requirement has applied since September 1, 2019, to Canadian suppliers of property (corporeal and incorporeal) and services located outside Quebec. As of January 4, 2021, 806 suppliers outside Quebec were registered for

1 Act Respecting the Québec Sales Tax, CQLR c. T-0.1, c. VIII.1 (herein referred to as "the AQST"). Under an agreement between the federal and Quebec governments, Revenu Québec (RQ) administers the goods and services tax (GST) and the harmonized sales tax (HST) in accordance with the rules set by the federal government. In this specific case, the Canadian government asked the city of Quebec not to collect the GST.

QST purposes,² with taxes collected amounting to nearly \$120 million for the 2019–2020 fiscal year.³

The government of Canada initially refused to follow suit (in the first mandate of the Liberal government, from 2015 to 2019), claiming that a new tax on intangible personal property and services would increase the tax burden on Canadians. However, it recently announced that it will apply the goods and services tax (GST) and harmonized sales tax (HST) on electronic supplies to consumers starting in July 2021.⁴

In addition to the question of the place of business, special tax issues are associated with new technologies that allow individuals to exchange goods and services by selling or renting via a digital platform.

Digital platforms drive growth in the number of vendors and service providers that can qualify as small suppliers,⁵ which do not have to register for GST/HST and QST purposes, or to collect these taxes, as most traditional suppliers do. Eventually, this could result in a loss of tax revenue.

In addition, a lack of knowledge of tax legislation by individuals participating in the sharing economy, the anonymity surrounding these transactions, and the involvement of foreign companies as online intermediaries create opportunities for underreporting income and promote tax evasion.⁶

In high tax burden environments, such as that in Quebec, taxpayers who evade their tax obligations enjoy a significant advantage over competitors who are obliged to follow the rules. Consequently, to preserve the province's tax base and maintain fairness, Quebec's minister of finance proactively entered into agreements with two sharing economy platforms based outside Canada. As a result of one of these agreements, Uber has been collecting sales taxes (GST and QST) related to the activities of its Quebec partner drivers (Uber drivers) since September 2016.⁷ This

2 Revenu Québec, "Suppliers Outside Québec That Are Registered for the QST" (www.revenuquebec.ca/en/businesses/consumption-taxes/gsthst-and-qst/special-cases-gsthst-and-qst/suppliers-outside-quebec/suppliers-outside-quebec-that-are-registered-for-the-qst).

3 Quebec, Finances Québec, 2020–2021 Budget, Additional information, March 2020, at B.4.

4 Canada, Department of Finance, *Fall Economic Statement 2020—Supporting Canadians and Fighting COVID-19*, November 30, 2020, at 223.

5 See the definition of "small supplier" in subsection 148(1) of the Excise Tax Act, RSC 1985, c. E-15 (herein referred to as "the ETA").

6 Revenu Québec, "La lutte contre l'évasion fiscale [Fighting tax evasion]," PowerPoint presentation to Université de Sherbrooke master of taxation students, Quebec, February 2020, at 65.

7 An agreement was also entered into with Airbnb in July 2017 for the collection of tax on short-term lodging. See Revenu Québec, "Entente de conformité fiscale relative à la taxes sur l'hébergement à l'égard des hôtes utilisant la plateforme 'AIRBNB' [Tax on Lodging Compliance Agreement for Hosts Using the Airbnb Platform]" (www.revenuquebec.ca/documents/entente-airbnb.PDF). Canada will apply GST/HST on rentals of short-term accommodation provided through a platform beginning in July 2021. See *Fall Economic Statement 2020*, supra note 4, at 231.

agreement,⁸ which won the prestigious *Financial Times* award in the “innovation in collaboration” category,⁹ came almost a year before Canada amended the definition of “taxi business” under the Excise Tax Act to include passenger transportation organized or coordinated using a platform.¹⁰

The first part of this article details certain tax innovations provided for in the tax compliance agreement entered into between Quebec and Uber, and clarifies the environment in which the agreement was implemented. The second part assesses the extent to which the initiative has effectively contributed to preserving the tax base and maintaining tax fairness in Quebec. In this respect, Quebec’s initiative could inspire the rest of Canada, and a few thoughts on this subject are presented in a brief concluding section.

THE PLATFORM ECONOMY, THE TAXI INDUSTRY, AND TAXATION

The arrival of Uber in Quebec’s major urban centres¹¹ in late 2013 has profoundly changed taxi services, shaking up a provincially regulated supply management

8 Entente relative aux exigences de conformité fiscale au Québec à l’égard des chauffeurs utilisant les plateformes « uberX », « uberXL » ou « uberSELECT » [Agreement Regarding Tax Compliance Requirements in Quebec for Drivers Using the “uberX,” “uberXL” or “uberSELECT” Platforms], signed in 2016 (<http://cffp.recherche.usherbrooke.ca/wp-content/uploads/2021/01/entente-uber-MFQ-projetpilote.pdf>), retrieved from the RQ website in the fall of 2020. A similar agreement was also entered into in 2019 with Coopérative de solidarité Eva, another sharing economy business in the remunerated passenger transportation services sector. It should be noted that Uber plans to transfer part of its activities to Canada as of July 1, 2021. In such a case, Uber would then have the additional obligation to collect sales taxes on taxable supplies made with drivers. See Tara Deschamps, “Uber Canada’s Ride-Hailing, Food-Delivery Businesses To Shift from Being Based in Netherlands,” *The Globe and Mail*, June 24, 2021.

9 Joshua Oliver, “Thinking Outside the Box Gives Taxman Easy Ride from Cab Drivers,” in *FT North America Innovative Lawyers 2018* (London, UK: Financial Times, December 2018), 36-37.

10 Subsection 240(1.1) of the ETA provides that a person carrying on a taxi business is required to register for the GST regardless of the person’s sales. However, prior to July 1, 2017, the definition of “taxi business” did not explicitly include passenger transportation through fares organized or coordinated using an electronic platform or system, leaving it open to interpretation as to whether Uber drivers may qualify as small suppliers. See Ian Caines and Zvi Halpern-Shavim, “Income and Commodity Tax Considerations for the Sharing Economy,” in *Report of Proceedings of the Sixty-Eighth Tax Conference*, 2016 Conference Report (Toronto: Canadian Tax Foundation, 2017), 35:1-26. The definition of “taxi business” in section 1 of the AQST has been harmonized with the revised federal definition. However, neither the federal nor the Quebec legislation provides for the collection and remittance of sales taxes by Uber on behalf of drivers, or for information on the drivers’ activities to be transmitted to the relevant tax authority. In Quebec, these matters are addressed instead by the tax compliance agreement discussed in this article.

11 Uber is not present throughout Quebec but instead focuses on the greater Montreal, Quebec City, and Gatineau areas.

model.¹² In the past, a permit system for the provision of remunerated passenger transportation services provided access to work, while a rate system governed the amounts charged to clients. It stands to reason that the entry of a new player that operated by a radically different service model would be met with fierce opposition from the traditional taxi industry.

Conflict Between Uber and Revenu Québec

Uber does not operate in the same manner as the traditional taxi industry. The multinational connects customers with unlicensed drivers or taxi owners, and electronic payment is required for transactions, whereas cash payment was, until recently, the industry's preferred method of payment. Uber, which acts in particular as a dispatcher, determines the fare of a trip based on supply and demand, and charges its drivers a service fee (calculated as a percentage of the rate charged to the customer) for the use of its platform.¹³

Initially, Uber drivers operated illegally. In addition to the unlicensed taxi service, non-collection of sales taxes quickly became an issue. In May 2015, Revenu Québec (RQ) searched the offices of Uber Canada Inc. in Montreal, alleging that it “assists drivers using the Uber app to evade compliance with tax legislation, including the required payment, remittance or instalments of GST and QST.”¹⁴ It must be understood that, theoretically, the non-collection of sales taxes gave Uber drivers a competitive edge over the traditional taxi industry, enabling them to offer customers savings of nearly 15 percent on their trips.¹⁵

Uber filed a court challenge of the search warrant obtained by RQ and attempted to argue that the transportation services provided through its platform were not taxi services, since the price of the service offered by Uber drivers was not regulated, and that consequently, Uber drivers could avail themselves of the small supplier provision.¹⁶

12 In contrast to Quebec's approach, in a number of Canadian provinces the regulation of taxi services has been devolved to the municipal level. See Urwana Coiquaud and Lucie Morissette, “La déréglementation du secteur des taxis au Québec : Une négociation entre l'État et Uber [Deregulation of the Québec Taxi Industry: A Negotiation Between the Government and Uber],” in *Chronique internationale de l'IRES*, no. 168 (Noisy-le-Grand, France: Institut de Recherches Économiques et Sociales, 2019), 101-9.

13 Québec, Ministère des Transports, de la Mobilité durable et de l'Électrification des transports, *Document d'information sur le transport rémunéré de personnes par automobiles* [Information Document Regarding Passenger Transportation by Automobile] (Québec: Ministère des Transports, de la Mobilité durable et de l'Électrification des transports, 2016), at 3 (www.transports.gouv.qc.ca/fr/ministere/acces-information-renseignements-personnels/documents-reglement-diffusion/demande-acces/Documents/2016/05/lai-2016-2017-018-document-information-transport.pdf).

14 *Uber Canada inc. c. Agence du revenu du Québec*, 2016 QCCS 2158, at paragraph 51 (our translation).

15 *Ibid.*, at paragraph 221.

16 Ian Caines and Zvi Halpern-Shavim, “Taxis, Taxes, and the Complexity of Compliance in the Sharing Economy” (2017) 7:1 *Canadian Tax Focus* 2-3.

In May 2016, the trial court ruled that the search warrant was not to be quashed. The judge determined that sales taxes were to be collected, finding that

UberX drivers cannot be considered small suppliers who are not required to register for the purposes of collecting and remitting taxes by considering that they are not carrying on a taxi business, as they are in violation of the Act by not holding a taxi licence.¹⁷

The judge also found that Uber did indeed help the drivers to evade their tax obligations. This decision was confirmed by the Quebec Superior Court in August 2016.¹⁸

Pilot Project

In September 2016, a pilot project was entered into between the minister of transport of Quebec (MTQ) and Uber Canada Inc. to allow Uber and its drivers to operate legally in Quebec.¹⁹ However, the agreement was conditional on “compliance with government tax requirements.”²⁰

To this effect, a complementary agreement was reached between the minister of finance of Quebec (MFQ) and Uber Canada Inc./Rasier Operations BV (“the MFQ-Uber agreement”).²¹ This agreement remedied the non-compliance attributed to Uber drivers by RQ in the collection and remittance of sales taxes that were documented in the trial concluded just a few weeks earlier. The court decisions in favour of the Quebec government, combined with the social pressure that Uber would have been under if it had continued to operate illegally in the absence of an agreement, is thought to have given Quebec an enviable negotiating position.

Change from the Previous Circumstances

The MFQ-Uber agreement clarifies the tax requirements to be met by the digital platform and confirms that the activities of Uber drivers constitute taxi businesses.²² It stipulates that drivers are required to

17 *Uber Canada*, supra note 14, at paragraph 206 (our translation).

18 *Uber Canada inc. c. Agence du revenu du Québec*, 2016 QCCA 1303, at paragraph 64; leave to appeal to the Supreme Court of Canada dismissed February 23, 2017.

19 Entente ministre des Transports, de la Mobilité durable et de l'Électrification des transports and Uber Canada Inc. [Agreement Between the Minister of Transport, Sustainable Mobility and Transport Electrification and Uber Canada Inc.], signed September 9, 2016 (www.transports.gouv.qc.ca/fr/salle-de-presse/nouvelles/Documents/2016-09-09/entente-uber.pdf).

20 *Ibid.*, section 2.8 (our translation).

21 *Supra* note 8.

22 Section 2 of Bill 100, Act To Amend Various Legislative Provisions Respecting Mainly Transportation Services by Taxi (enacted by SQ 2016, c. 22; royal assent June 10, 2016)

- register for GST and QST purposes in order to use the platform and
- authorize the subsidiary Rasier Operations BV²³ (with which the drivers transact to access the Uber platform) to remit to RQ, for and on behalf of the drivers, as an instalment payment, the amounts determined on the basis of the net tax calculated using the quick method of accounting in respect of their taxi transportation services.

In addition, Rasier Operations BV is required to

- make available to RQ the names and addresses of drivers, their social insurance numbers, their GST and QST registration numbers, the number of paid kilometres travelled, the number of taxi services provided, the amounts of supplies, and the taxes collected;
- make available to drivers the information necessary to allow them to file their annual GST and QST and income tax returns—specifically, amounts collected (including taxes), applicable GST and QST amounts, total amounts to be remitted under the quick method of accounting, amounts paid by Rasier Operations BV to RQ for each driver as instalment payments, and net amounts paid to drivers; and
- indicate on the receipt given to the client the amounts of GST and QST and the driver's registration numbers.

In some respects, Uber is required to perform activities normally performed by employers (withholding and transmitting tax information). The customized requirements in the agreement facilitate the collection of sales tax revenues and validation of tax compliance for RQ²⁴ and reduce the administrative burden for Uber drivers.²⁵

defines “taxi transportation services” to include, unless an exception is made, any paid passenger transportation service by automobile.

- 23 Rasier Operations BV is a non-resident corporation that holds a licence to use Uber technology services granted by Uber BV. It is not subject to Canadian tax. See Marwah Rizqy, “Impact de l'économie numérique de partage sur la fiscalité de la province de Québec et de ses municipalités [Impact of the Digital Sharing Economy on the Taxation of the Province of Quebec and Its Municipalities],” in *Revue française de finance publique*, no. 135 (Paris: Librairie Générale de Droit et de Jurisprudence, 2016), 193–204, at 193. However, by transferring the Canadian activities of Rasier Operations BV to Canada (see *supra* note 8), the profit generated thereon would be subject to Canadian corporate income tax.
- 24 Although no withholding tax is required from the platform with respect to personal income tax, the MFQ-Uber agreement provides RQ with information on Uber drivers' tax businesses. This information enhances compliance by facilitating audit activities.
- 25 Nicholas X. Cloutier, “Taxation of the Sharing Economy and the Digital Economy,” presented at the Canadian Tax Foundation's 2019 Corporate Management Tax Conference and live webcast, Toronto, February 27–28, 2019, PowerPoint presentation, at 19.

On October 19, 2019, the Act Respecting Remunerated Passenger Transportation by Automobile²⁶ was adopted, perpetuating the obligation for a platform to enter into an agreement to comply with government tax requirements and ending the pilot project.

Innovations and Simplifications for Uber Drivers

To encourage voluntary compliance by taxpayers with their tax obligations, RQ has adopted the goal of simplifying the tax-filing process.²⁷ The MFQ-Uber agreement is in line with this objective in acknowledging, on the one hand, that the taxi activities of some Uber drivers are limited, allowing them to generate only supplementary income,²⁸ and, on the other hand, that some Uber drivers may not realize that the platform considers them to be self-employed workers and not employees, thereby affecting their tax obligations.

The tax compliance required of traditional taxi businesses may include remitting quarterly GST and QST instalment payments and maintaining records (of the number of commercial and total vehicle kilometres travelled). Meeting these requirements can be particularly burdensome for those Uber drivers who carry on a low level of taxi activities. Under the MFQ-Uber agreement, tax compliance for Uber drivers is simplified. However, as described below, the obligation of Rasier Operations BV to collect and remit sales taxes involves “directing” certain elections normally left to the discretion of the taxpayer.

26 Bill 17, Act Respecting Remunerated Passenger Transportation by Automobile, SQ 2019, c. 18; royal assent October 10, 2019. Section 37 of the legislation states, “When the fare of a trip made as part of the transportation system is collected electronically, on behalf of the drivers registered with the system operator, by the operator or a supplier whose services the operator retains, the operator or, if applicable, the supplier must enter into an agreement with the Minister of Finance to ensure compliance with government requirements regarding taxation. The Minister of Revenue may, on such conditions the Minister determines, exempt an operator or supplier or a class of operators or suppliers from the requirement set out in the first paragraph. The Minister may, however, cancel the exemption or modify the conditions.” More specifically, the MFQ-Uber agreement was extended to December 31, 2020 following the end of the pilot project, and at the time of writing, discussions were taking place between the MFQ and Uber. See Quebec, Ministère des Transports, “Transport rémunéré de personnes par automobile — Dispositions transitoires [Remunerated Passenger Transportation by Automobile—Transitional Provisions]” (www.transports.gouv.qc.ca/fr/entreprises-partenaires/trpa/Documents/trpa/TRPA-dispositions-transitoires.pdf).

27 Quebec, Finances Québec, 2013-2014 Budget, November 20, 2012, at F.8.

28 Quebec, Ministère des Transports, *Analyse d'impact réglementaire — Projet de règlement sur le transport rémunéré de personnes par automobile* [Regulatory Impact Analysis—Draft Regulation Respecting Remunerated Passenger Transportation] (Quebec: Ministère des Transports, 2020), at 8. RQ considers that the weekly activity of Uber drivers ranges from a few hours a month to more than 60 hours a week. Nearly 1,000 of the 15,000 taxi drivers operating in Quebec simultaneously use the Uber platform.

- *Use of the quick method of accounting.*²⁹ This method is used to calculate the amounts to be remitted to RQ by Rasier Operations BV. In practice, taxes are normally collected from customers, but the amount to be remitted to RQ is reduced (as shown in table 1) to take into account a deemed amount of input tax credits (ITCs) and input tax refunds (ITRs).³⁰
- *Use of a GST and QST fiscal year ending December 31 and annual filing frequency, with GST and QST returns to be filed online.*³¹ The alignment of the annual filing frequency for the information made available to Uber drivers with the annual filing frequency for income tax and GST and QST returns simplifies the reporting mechanism, allowing Uber drivers who carry on no other commercial activities, or who use no other platforms, to directly report the information received, and reducing the need for tax specialists. In addition, with information being submitted electronically by drivers, RQ can more readily compare such information against that submitted by Rasier Operations BV.

Given that a portion of non-compliance results from taxpayers' unawareness of the rules and/or their inability to meet tax obligations, rather than deliberate evasion tactics, the simplification and reduced cost of compliance are fairly significant.³²

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- 29 In practice, Uber drivers may elect not to use the quick method, particularly if they carry on other commercial activities. However, the calculation of the amounts paid by Uber to RQ is in all cases made at the rates set out in the MFQ-Uber agreement. As a result, drivers who do not elect to use the quick method of accounting are required to make the necessary adjustments when filing their returns.
- 30 In addition to the deemed ITCs and ITRs, drivers can claim ITCs and ITRs for property used primarily in the course of commercial activities.
- 31 The MFQ-Uber agreement provides that drivers who carry on other commercial activities may retain their fiscal year and reporting frequency, and carry out their compliance activities in their usual manner. See Revenu Québec, "Drivers Related to a Transportation System Operator Under Agreement Who Do Not Carry on Other Commercial Activities" (www.revenuquebec.ca/en/businesses/consumption-taxes/gsthst-and-qst/special-cases-gsthst-and-qst/drivers-related-to-a-transportation-system-operator-under-agreement/drivers-who-do-not-carry-on-other-commercial-activities).
- 32 Wilson Prichard et al., *Innovations in Tax Compliance: Conceptual Framework*, World Bank Group Policy Research Working Paper no. 9032 (Washington, DC: World Bank Group, October 2019), at 20 (<https://openknowledge.worldbank.org/bitstream/handle/10986/32492/WPS9032.pdf>).

TABLE 1 Rates of Net Sales Taxes To Be Remitted to Revenu Québec

	GST	QST
	<i>percent</i>	
Rate of collectible tax	5.00	9.975
Quick method of accounting remittance rate	3.78	7.26
1% credit for taxable supplies (first \$30,000 of supplies for GST and first \$31,421 of supplies for QST)	(1.05)	(1.10)
Rate of taxes collectible by Rasier Operations BV to be remitted to Revenu Québec on behalf of Uber drivers	2.73	6.16

GST = goods and services tax; QST = Quebec sales tax.

Source: Revenu Québec, “Drivers Related to a Transportation System Operator Under Agreement Who Do Not Carry on Other Commercial Activities” (www.revenuquebec.ca/en/businesses/consumption-taxes/gsthst-and-qst/special-cases-gsthst-and-qst/drivers-related-to-a-transportation-system-operator-under-agreement/drivers-who-do-not-carry-on-other-commercial-activities).

PROTECTION OF TAX REVENUES

In Quebec’s traditional remunerated passenger transportation sector, tax evasion consists of the following:

- Non-compliance with the mandatory registration of operators as agents for GST/HST and QST purposes, and failure to collect these taxes;
- Non-filing of income tax, withholding tax and tax returns;
- Transactions made in cash, without the sales being recorded;
- Non-issuance or non-retention of invoices, supporting documents and records.³³

Prior to the pilot project rolled out in 2016, Quebec’s tax losses associated with the taxi industry were estimated at \$71.8 million, plus \$19.2 million in contributions to paragonovernmental organizations, such as the Régie des rentes du Québec (see table 2).³⁴

33 Revenu Québec, *Analyse d’impact réglementaire : Facturation obligatoire dans le secteur du transport rémunéré de personnes* [Regulatory Impact Analysis: Mandatory Billing in the Remunerated Passenger Transportation Sector] (Quebec: Revenu Québec, 2017), at 4 (our translation).

34 Montreal taxis are required to offer their customers the option of paying their fare by credit or debit card as of October 2015. However, this did not have a major impact on the level of reported revenues of the traditional taxi industry estimated by RQ, which rose from \$384 million in 2014 to \$399 million in 2016. In fact, an assessment of the average gross revenues reported by taxi lease drivers and taxi driver-owners indicates that the level has remained stable between 2013 (when Uber still had a small presence in Quebec) and 2016. See Ministère des Finances du Québec, documents transmitted during an access-to-information request, June 10, 2019 (in French only) (www.finances.gouv.qc.ca/documents/AccesInfo/fr/AINFR_2019-11202.pdf).

TABLE 2 Estimated Annual Tax Losses Associated with the Taxi Industry in Quebec, 2011

	Tax losses
	\$ millions
Income taxes	35.4
Québec sales tax	23.8
Health services fund, drug insurance, etc.	2.5
Credits and support programs	10.1
Subtotal—consolidated revenue fund	71.8
Contributions—paragovernmental organizations	19.2
Total	91.0

Source: Revenu Québec, *Analyse d'impact réglementaire : Facturation obligatoire dans le secteur du transport rémunéré de personnes* [Regulatory Impact Analysis: Mandatory Billing in the Remunerated Passenger Transportation Sector] (Quebec: Revenu Québec, 2017), at 13.

PREVALENCE OF TAX EVASION IN THE TAXI INDUSTRY

While an amount of \$72 million in tax losses may seem immaterial in terms of Quebec's overall tax revenues, it is important to understand that the taxi industry generates estimated annual revenues ranging from \$500 million³⁵ to \$700 million.³⁶ As a result, although not all players in the taxi industry are necessarily involved in tax evasion schemes, the concentration of tax losses is high, indicating that some are working under the table.

In this environment, how has the MFQ-Uber agreement changed the taxi market and the associated tax revenues in Quebec?

RQ estimates that reported taxable supplies from the conventional taxi industry (excluding Uber driver supplies) totalled \$389 million in 2017 (see figure 1).³⁷ However, these revenues constitute only a portion of the industry's total revenues.³⁸

35 Comité provincial de concertation et de développement de l'industrie du taxi, *Un nouveau modèle pour le taxi au Québec — Mémoire présenté aux auditions publiques de la Commission des transports et de l'environnement portant sur le projet de loi no. 100* [A New Model for Taxis in Quebec—Brief Presented at the Public Hearings of the Commission des transports et de l'environnement on Bill no. 100] (Longueuil, QC: CPCDIT, May 2016), at 6.

36 *Analyse d'impact réglementaire*, supra note 33, at 7.

37 Document released further to an access-to-information request (in French only). See Revenu Québec, "Compilation des revenus bruts et des fournitures taxables de l'industrie du taxi 2013-2017 [Compilation of Gross Revenues and Taxable Supplies of the Taxi Industry, 2013-2017]," April 23, 2019 (www.revenuquebec.ca/documents/fr/docs_adm/20-051980-001_DOC.pdf).

38 The revenue evasion estimate in the taxi industry is based on the 2011 QST loss to which the growth rate of consumer spending in the taxi and limousine sector was applied. In a response

FIGURE 1 Estimated Taxi Sector Revenues, Quebec, 2013-2017

Source: Revenu Québec, “Compilation des revenus bruts et des fournitures taxables de l’industrie du taxi 2013-2017 [Compilation of gross revenues and taxable supplies of the taxi industry, 2013-2017],” April 23, 2019, and authors’ estimates.

From the time that Uber arrived in Quebec until the pilot project was rolled out in September 2016, Uber’s market share likely reduced the reported and unreported revenues of the conventional taxi industry. However, Uber and its drivers contributed to tax evasion in the taxi transportation sector as a result of their failure to collect sales taxes during this period.

While exact figures cannot be confirmed, the revenues reported by Quebec Uber drivers in 2017, the first full year in which Uber’s activities were covered by the pilot project, amounted to approximately \$100 million.³⁹ It is fair to assume

dated June 6, 2019, RQ confirmed that its estimated tax loss for 2011 was still valid in 2018. See Revenu Québec, documents released further to an access-to-information request (in French only) (www.revenuquebec.ca/documents/fr/docs_adm/19-046757_LD.pdf).

39 The estimate of Uber drivers’ income as of September 2016 is based on the royalties collected under the MTQ-Uber agreement (Quebec, Ministère des Transports [www.transports.gouv.qc.ca/fr/ministere/acces-information-renseignements-personnels/documents-reglement-diffusion/demande-acces/Documents/2019/04/DA-2018-2019-00505-tableau-redevances.pdf]) and trips valued at \$11.40 (including taxes), which was the average fare per trip in Montreal in 2016. See Jérôme Lavolette, “Planification stratégique d’un système de transport par taxi [Strategic Planning of a Taxi Transportation System]” (master’s thesis, Université de Montréal, École polytechnique de Montréal, 2017), at 143.

that reported revenues in the traditional taxi industry would have been higher had it not been for Uber's market share, but it can also be argued that the collection of sales taxes by Uber drivers has led to a reduction in the avoidance of tax on taxable supplies in the taxi industry.

The availability of more accurate data would allow us to conduct additional research and refine our findings on the effect of the MFQ-Uber agreement in reducing tax evasion. Nevertheless, the fact that income in the conventional taxi industry remained relatively stable from 2014 to 2017, both before and after the pilot project, suggests that the majority of Uber driver revenues curbed tax evasion in the industry.

TAX REVENUES BEFORE AND AFTER THE MFQ-UBER AGREEMENT

Uber drivers' trips are covered by electronic payments, involving a computerized exchange of information regarding both the parties to the transaction and disclosure to RQ. The MFQ-Uber agreement can be considered to have helped to reduce tax evasion by improving industry compliance even before the sales registration system was rolled out in the industry.⁴⁰

Accordingly, has the tax impact of Uber's arrival and its supervision by RQ been entirely positive? Not quite.

The impact of the tax loss related to the service fees that Uber charges its drivers should not be underestimated. The fees charged by Uber, which now amount to 25 percent of trip fares, generated gross revenue leakage of some \$20 million in Quebec in 2017 alone.⁴¹

Until recently, the profits generated by Uber on its intermediation activities between drivers and customers in Quebec were not subject to corporate income tax in Quebec.⁴² Transferring these activities to Canada could be a game changer. Similarly, the work of the OECD aimed at creating a common solution that would mandate taxation of the profits of non-resident corporations where those profits are actually earned would make it possible to tax Uber's profits in Quebec. In the event that the work of the OECD on this initiative is not concluded by January 1, 2022, Canada intends to impose a temporary tax on the gross revenues from Canadian

40 *Analyse d'impact réglementaire*, supra note 33, at 5. Initially planned for late 2019, a technology solution using the capabilities of the sales recording module is to be implemented in all vehicles used for paid passenger transportation (including vehicles used by Uber partner drivers) by November 2021. Every operator must provide the customer with an invoice (in electronic or paper format). The technology solution developed by RQ leverages the possibilities of the sales recording module used in restaurants and bars, and will send all invoices produced to RQ in real time.

41 Our estimate.

42 The multinational Uber, which generated revenues of \$14.2 billion in 2019, actually reported an operating loss of \$8.6 billion. See Uber, *2019 Annual Report* (San Francisco: Uber, 2020), at 55.

sources of certain multinationals (such as Uber) operating in the digital economy.⁴³ The details of this tax are still forthcoming, including a proposed allocation formula that would be used to transfer all or part of the resulting revenues to the provinces.

INSPIRATION FOR OTHER SECTORS AND THE REST OF CANADA

Setting up a tax compliance agreement with a non-resident requires significant effort. Nonetheless, it is a tool to consider when there is a high incidence of tax evasion in a given sector and when the foreign intermediary would benefit from working with the tax authorities, if only to improve its corporate image. Furthermore, Quebec has already indicated that it may use targeted tax compliance agreements again.

Although the amounts of tax revenue involved are relatively limited, the actions taken by RQ in the Uber case seem to show a concern for fairness among taxpayers from a tax liability standpoint. RQ made sure that Uber's integration into the Quebec taxi industry, which many did not support, was carried out in compliance with tax obligations, even if it meant having to innovate to reach this goal.

Uber drivers in Quebec have the applicable sales taxes on their trips collected and remitted to RQ on their behalf as instalment payments (and have information disclosed on their activities). In other Canadian provinces also, Uber collects sales taxes on behalf of drivers; however, the amounts are paid weekly to the drivers, who must set them aside and remit them to the Canada Revenue Agency (CRA).⁴⁴

Overall, the response to Uber in the rest of Canada is comparable to that in the majority of OECD countries, which do not use sales tax instalment payments and do not have the same level of detail on Uber drivers' transactions as exists in Quebec, enabling the verification of sales tax and income tax compliance.⁴⁵ Insofar as the mechanics of the MFQ-Uber agreement could simplify and improve tax compliance for drivers in the rest of Canada, it may be appropriate for the CRA to consider the Quebec model. In such a case, a high degree of consistency between the provinces and the federal government would provide a better negotiating position in relation to Uber, somewhat like the coordination of the Ministère des Transports and the MFQ in Quebec.

The CRA considers that the new business models supported by digital technologies, while creating new compliance risks, have the potential to facilitate the

43 *Fall Economic Statement 2020*, supra note 4, at 131.

44 Uber, "How To File Taxes as an Uber Partner," 2019, at 9 (<https://d1nyezh1ys8wfo.cloudfront.net/static/PDFs/AB%20CON%20CSK+handbook.pdf>).

45 See Organisation for Economic Co-operation and Development, *The Sharing and Gig Economy: Effective Taxation of Platform Sellers: Forum on Tax Administration* (Paris: OECD, March 2019) (<https://doi.org/10.1787/574b61f8-en>), chapter 2.

reporting and payment of taxes.⁴⁶ In the specific case of the sharing economy, platforms centralize transactions, the processing of which is facilitated by information technology. However, this centralization raises questions about the application of the small supplier rule.⁴⁷

First, the platforms have information about the providers of goods or services that, owing solely to the transactions that they intermediate, does not allow those providers to qualify as small suppliers. Organizing the sharing of this information with the CRA appears to be a priority for compliance purposes.

Second, the small supplier rule is intended to minimize the administrative burden on very small businesses and enhance administrative efficiency in collecting, remitting, receiving, and recovering small amounts after deducting taxes paid on inputs. However, in the decades since the drafting of this rule, the business environment has evolved.

In Quebec and elsewhere in Canada, the expansion of the sharing economy could have a more acute adverse effect on tax bases in the future, particularly with respect to commodity taxes. The proliferation of small suppliers is a real issue that challenges traditional methods of collecting tax revenues.

Widespread use of tax agreements in the sharing economy to subject all transactions to sales taxes is probably not appropriate.⁴⁸ However, a revision of the tax framework appears to be unavoidable so that sharing economy platforms can be involved in the collection of sales taxes when necessary. While this reform will require a highly proactive approach by tax administrations, Quebec's experience with the MFQ-Uber agreement shows that it is feasible.

46 See Canada Revenue Agency, "Underground Economy Strategy 2018-2021" (www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/corporate-reports-information/underground-economy-strategy-2018-2021.html).

47 Section 148 of the ETA.

48 In 2018, 210 local and foreign sharing economy initiatives across 16 sectors were identified in Quebec. See Quebec, Groupe de travail sur l'économie collaborative, *Moderniser et renforcer les politiques publiques et réussir face aux transformations associées à l'économie collaborative* [Modernizing and Strengthening Public Policy and Succeeding Amid Transformations Related to the Sharing Economy] (Quebec: Groupe de travail sur l'économie collaborative, June 2018), at 10.

Policy Forum : Favoriser la conformité fiscale par l'encadrement de l'économie numérique — Initiative du Québec face à Uber

Michaël Robert-Angers et Luc Godbout*

ABSTRACT

The development and expansion of the digital economy is changing how companies interact with their customers and suppliers. Digital business models facilitate transactions between individuals and make it easier to conduct business abroad without the need for a physical presence. However, the growing use of such models creates many challenges for tax administrations. In particular, these new business practices call into question the traditional ways of collecting tax revenues, and thus force tax administrations to innovate. In Quebec, the context surrounding the legalization of the operations of the multinational Uber has led to an agreement between the company and the provincial government providing that Uber will carry out, on behalf of the drivers using its platform, tax compliance activities that employers would normally perform. Specifically, Uber now pays the sales tax applicable to drivers' transactions directly to Revenu Québec. This arrangement helps to protect commodity tax revenues in an economic sector where tax evasion is prevalent.

PRÉCIS

La numérisation de l'économie change la façon dont les entreprises interagissent avec leurs clients et fournisseurs. Elle facilite les transactions entre particuliers et simplifie la conduite des affaires à l'étranger, sans nécessiter de présence physique. Cette tendance lourde entraîne aussi de nombreux défis pour les administrations fiscales qui se voient confrontées à de nouvelles pratiques d'affaires qui remettent en question les façons traditionnelles de prélever les recettes fiscales, les forçant à innover. Au Québec, le contexte entourant la légalisation des activités de la multinationale Uber a mené celle-ci

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à accomplir, pour le compte des chauffeurs utilisant sa plateforme, des activités de conformité fiscale échouant normalement aux employeurs. L'implication de la multinationale Uber qui verse directement à Revenu Québec la taxe de vente applicable sur les transactions des chauffeurs favorise la protection des recettes fiscales, notamment celles des taxes à la consommation dans un secteur économique à prévalence d'évasion fiscale.

MOTS CLÉS : TPS ■ TRAVAILLEURS À LA DEMANDE ■ TVQ ■ QUÉBEC ■ ACCORDS DE PERCEPTION FISCALE ■ ÉVASION FISCALE

CONTENTS

Introduction	530
Économie de plateforme, industrie du taxi et fiscalité	533
Conflit entre Uber et Revenu Québec	533
Projet pilote	534
Changement par rapport à la situation antérieure	535
Innovations et simplifications pour les chauffeurs Uber	536
Protection des recettes fiscales	538
Prévalence de l'évasion fiscale dans l'industrie du taxi	539
Recettes fiscales avant et après l'entente MFQ-Uber	541
Pistes d'inspiration pour d'autres secteurs et le reste du Canada	542

INTRODUCTION

Confrontées aux pratiques d'affaires de l'économie numérique utilisant des moyens alternatifs pour vendre des biens et services, les institutions responsables de maintenir l'intégrité de nos régimes fiscaux ont deux choix : soit elles peuvent choisir de privilégier le statu quo, au risque que le cadre législatif ne soit plus tout à fait en phase avec les réalités commerciales, devant parfois s'accommoder de certaines incohérences; soit elles peuvent être proactives, et s'adapter à la réalité changeante (au risque de mécontenter une partie de la population) afin de tenter de résoudre les nouveaux enjeux fiscaux et maintenir un cadre fiscal avec une application cohérente aux contribuables.

Dans cet esprit, en conformité avec les recommandations de l'Organisation de coopération et de développement économiques (OCDE), le Québec exige depuis le 1^{er} janvier 2019 que les entreprises étrangères sans place d'affaire au Québec et qui effectuent des fournitures de biens incorporels et de services prélèvent la taxe de vente du Québec (TVQ)¹. La même obligation s'applique depuis le 1^{er} septembre 2019 aux fournisseurs canadiens de biens (corporels et incorporels) et de services

1 Loi sur la taxe de vente du Québec, LRQ c. T-0.1, c. VIII.1 (ci-après « la LTVQ »). À la suite d'une entente conclue entre les gouvernements du Canada et du Québec, l'Agence du revenu du Québec (RQ) administre la taxe sur les produits et services (TPS) et la taxe de vente harmonisée (TVH) sur son territoire, et ce, selon les règles définies par le gouvernement du Canada. Dans ce cas précis, le gouvernement canadien a expressément demandé à Québec de ne pas percevoir la TPS.

situés à l'extérieur du Québec. En date du 4 janvier 2021, 806 fournisseurs hors-Québec étaient inscrits au fichier de la TVQ², les taxes collectées s'élèvent à près de 120 millions de dollars pour l'exercice 2019-2020³.

De son côté, le gouvernement du Canada a d'abord refusé d'en faire autant (pendant le premier mandat du gouvernement libéral de 2015 à 2019), prétextant qu'une nouvelle taxe visant les biens intangibles et les services viendrait alourdir le fardeau fiscal des canadiens. Celui-ci annonce maintenant qu'il appliquera la taxe sur les produits et services (TPS) et la taxe de vente harmonisée (TVH) relativement aux fournitures par voie électronique auprès de consommateurs à compter de juillet 2021⁴.

En plus de la question liée à la place d'affaires, des enjeux fiscaux particuliers sont associés aux nouvelles technologies permettant à des particuliers d'échanger entre eux des biens et des services par vente ou location via une plateforme numérique.

Les plateformes numériques favorisent la multiplication de vendeurs et de prestataires de service pouvant se qualifier de petits fournisseurs⁵, ceux-ci n'ayant pas à s'inscrire aux fichiers de la TPS/TVH et de la TVQ, ni à percevoir ces taxes comme le font la plupart des fournisseurs traditionnels. Éventuellement, ceci pourrait résulter en perte de recettes fiscales.

De plus, la méconnaissance des lois fiscales par les particuliers participant à l'économie collaborative, l'anonymat entourant ces transactions et le recours à des entreprises étrangères agissant comme intermédiaires en ligne créent des occasions de sous-déclaration de revenus et favorise l'évasion fiscale⁶.

En contexte de poids de la fiscalité élevé, comme c'est le cas au Québec, les contribuables qui se soustraient à leurs obligations fiscales bénéficient d'un avantage significatif face à leur compétiteurs forcés d'observer les règles. Conséquemment, en vue de préserver sa base fiscale et de maintenir l'équité, le ministre des Finances du Québec a été proactif en concluant des ententes avec deux plateformes de l'économie collaborative basées à l'extérieur du Canada. Par l'effet de l'une de ces ententes, Uber perçoit les taxes de vente (TPS et TVQ) liées aux activités de ses chauffeurs-partenaires québécois (chauffeurs Uber) depuis

2 Revenu Québec, « Liste des fournisseurs hors Québec inscrits au fichier de la TVQ » (www.revenuquebec.ca/fr/entreprises/taxes/tpstv-et-tvq/situations-particulières-liées-a-la-tpstv-et-a-la-tvq/fournisseurs-hors-quebec/liste-des-fournisseurs-hors-quebec-inscrits-au-fichier-de-la-tvq/).

3 Québec, Finances Québec, Budget 2020-2021, renseignements additionnels, mars 2020, à la p. B.4.

4 Canada, ministre des Finances, *Soutenir les canadiens et lutter contre la Covid-19 — Énoncé économique de l'automne de 2020*, 30 novembre 2020, à la p. 223.

5 Définition de « petit fournisseur » au paragraphe 148(1) de la Loi sur la taxe d'accise, LRC 1985, c. E-15 (ci-après, la LTA).

6 Revenu Québec, « La lutte contre l'évasion fiscale », Présentation PowerPoint aux étudiants à la maîtrise en fiscalité de l'Université de Sherbrooke, Québec, février 2020, à la p. 65.

septembre 2016⁷. Cette entente⁸, qui a été récompensé par le prestigieux prix du *Financial Times* dans la catégorie « *innovation in collaboration* »⁹, est intervenue près d'un an avant que le Canada ne modifie la définition d'« entreprise de taxis » prévue à la Loi sur la taxe d'accise pour y inclure le transport de passagers organisé ou coordonné à l'aide d'une plateforme¹⁰.

La première partie de cet article détaille certaines innovations fiscales prévues à l'entente de conformité fiscale conclue entre le Québec et Uber et précise le contexte dans lequel celle-ci a été mise en place. La seconde partie évalue dans quelle mesure l'initiative a effectivement contribué à la préservation de la base d'imposition et au maintien de l'équité fiscale au Québec. À cet égard, l'initiative du Québec pourrait inspirer le reste du Canada, et quelques réflexions à ce sujet sont présentées dans la conclusion de l'article.

- 7 Une entente est également intervenue avec Airbnb en juillet 2017 pour la perception de la taxe d'hébergement à court terme. Voir Revenu Québec, « Entente de conformité fiscale relative à la taxe sur l'hébergement à l'égard des hôtes utilisant la plateforme Airbnb » (<https://www.revenuquebec.ca/documents/entente-airbnb.PDF>). Le Canada appliquera la TPS/TVH sur la location de logements provisoires effectuée par l'intermédiaire d'une plateforme à compter de juillet 2021. Voir *Énoncé économique de l'automne de 2020*, supra, note 4, à la p. 231.
- 8 Entente relative aux exigences de conformité fiscale au Québec à l'égard des chauffeurs utilisant les plateformes « uberX », « uberXL » ou « uberSELECT » (<https://cffp.recherche.usherbrooke.ca/wp-content/uploads/2021/01/entente-uber-MFQ-projetpilote.pdf>), signée en 2016 et récupérée sur le site de Revenu Québec à l'automne 2020. Une entente semblable a également été conclue en 2019 entre avec la Coopérative de solidarité Eva, une autre entreprise de l'économie collaborative du secteur des services de transport rémunéré de personnes. Il est à noter que Uber envisage transférer une partie de ses activités au Canada à compter du 1^{er} juillet 2021. Dans un tel cas, Uber aurait alors l'obligation supplémentaire de percevoir les taxes de ventes sur les fournitures taxables effectuées auprès des chauffeurs. Voir Tara Deschamps, « Uber Canada's Ride-Hailing, Food-Delivery Businesses To Shift from Being Based in Netherlands », *Globe and Mail*, 24 juin 2021.
- 9 Joshua Oliver, « Thinking Outside the Box Gives Taxman Easy Ride from Cab Drivers », *FT North America Innovative Lawyers 2018* (London, UK : Financial Times, December 2018).
- 10 Le paragraphe 240 (1.1) de la LTA prévoit qu'une personne qui exploite une entreprise de taxis est tenue de s'inscrire au fichier de la TPS, et ce, peu importe son chiffre d'affaires. Cependant, avant le 1^{er} juillet 2017, la définition d'« entreprise de taxis » n'incluait pas explicitement le transport de passagers moyennant tarifs organisé ou coordonné à l'aide d'une plateforme ou d'un système électronique, laissant à interprétation quant à la possibilité, pour les chauffeurs Uber, de se qualifier à titre de petit fournisseur. Voir Ian Caines and Zvi Halpern-Shavim, « Income and Commodity Tax Considerations for the Sharing Economy », dans *Report of Proceedings of the Sixty-Eighth Tax Conference*, 2016 Conference Report (Toronto : Foundation canadienne de fiscalité, 2017), 35:1-26. Il est à noter que la définition d'« entreprise de taxis » contenue à l'article 1 de la LTVQ a été harmonisée à la définition fédérale révisée. Toutefois, ni la loi fédérale ni celle du Québec ne prévoient pas la perception et la remise des taxes de vente par Uber pour le compte des chauffeurs et la transmission d'information à RQ sur les activités des chauffeurs. Ces mécanismes sont plutôt encadrés par l'entente de conformité fiscale discutée dans ce texte.

ÉCONOMIE DE PLATEFORME, INDUSTRIE DU TAXI ET FISCALITÉ

L'arrivée d'Uber dans les grands centres urbains du Québec¹¹ à la fin de 2013 est venue modifier profondément les services de taxi, bousculant un modèle de régulation basé sur la gestion de l'offre sujet à une réglementation provinciale¹². Jusque-là, un système de permis pour offrir des services de transport de personnes rémunérés assurait l'accès au travail, tandis qu'un système de tarif régissait les montants exigés aux clients. Il va sans dire que l'entrée en scène de ce nouveau joueur avec un modèle de service radicalement différent a suscité une opposition acharnée de l'industrie traditionnelle du taxi.

Conflit entre Uber et Revenu Québec

Uber n'utilise pas les façons de faire de l'industrie traditionnelle du taxi. La multinationale met en relation des clients et des transporteurs ne détenant pas de permis de chauffeurs ou de propriétaires de taxi, et le paiement électronique est exigé dans le cadre des transactions alors que le paiement comptant était, jusqu'à tout récemment encore, privilégié par l'industrie du taxi. Uber, qui accomplit notamment les fonctions de répartiteur, détermine le prix d'une course en fonction de l'offre et de la demande et perçoit des chauffeurs des frais de services (calculés en pourcentage du tarif facturé au client) pour l'utilisation de sa plateforme¹³.

Au départ, les activités des chauffeurs Uber se déroulaient dans l'illégalité. Outre le service de taxi offert sans permis, la non-perception des taxes de vente a rapidement soulevé des problèmes. En mai 2015, Revenu Québec (RQ) a mené une perquisition dans les bureaux d'Uber Canada Inc. à Montréal, alléguant que celle-ci « aide les chauffeurs utilisant l'application Uber à éluder l'observation d'une loi fiscale, notamment le paiement, la remise ou un versement requis relatif à la TPS et la TVQ »¹⁴.

11 Uber n'est pas présent dans l'ensemble du Québec, il est actif dans les régions du Grand Montréal, de la Capitale nationale et de l'Outaouais.

12 À la différence de plusieurs provinces canadiennes où le pouvoir réglementaire associé à l'activité de taxi est dévolu aux villes. Voir Urwana Coiquaud et Lucie Morissette, « La déréglementation du secteur des taxis au Québec : une négociation entre l'État et Uber », dans *Chronique internationale de l'IRES*, n° 168 (Noisy-le-Grand, France : Institut de Recherches Économiques et Sociales, 2019), 101-109.

13 Québec, Ministère des Transports, de la Mobilité durable et de l'Électrification des transports *Document d'information sur le transport rémunéré de personnes par automobiles* (Québec : Ministère des transports, de la Mobilité durable et de l'Électrification des transports, 2016), à la p. 3 (<https://www.transports.gouv.qc.ca/fr/ministere/acces-information-renseignements-personnels/documents-reglement-diffusion/demande-acces/Documents/2016/05/lai-2016-2017-018-document-information-transport.pdf>).

14 *Uber Canada inc. c. Agence du revenu du Québec*, [2016] QCCS 2158, au paragraphe 51.

Il faut bien comprendre qu'en théorie, la non-perception des taxes de vente procurait un avantage compétitif aux chauffeurs Uber au détriment de l'industrie du taxi traditionnelle, leur permettant d'offrir à leurs clients une économie de près de 15 pour cent sur leurs courses¹⁵.

Uber a contesté en cour le mandat de perquisition obtenu par RQ et a tenté de faire valoir que les services de transport offerts par l'entremise de sa plateforme n'étaient pas des services de taxi, le prix du service offert par les chauffeurs Uber n'étant pas réglementé, et que conséquemment les chauffeurs Uber pouvaient se prévaloir de la disposition visant les petits fournisseurs¹⁶.

En mai 2016 le tribunal de première instance a estimé que le mandat de perquisition ne devait pas être annulé. Dans son analyse, le juge a déterminé que les taxes de vente devaient être perçues, évaluant que

Les chauffeurs UberX ne peuvent être considérés comme des petits fournisseurs qui n'ont pas l'obligation de s'inscrire pour les fins de la perception et de la remise des taxes en considérant qu'ils n'exploitent pas une entreprise de taxi, car ils contreviennent à la Loi en ne détenant pas de permis de taxi¹⁷.

Le juge a également évalué que Uber a effectivement aidé les chauffeurs à se soustraire à leurs obligations fiscales. Cette décision fut confirmée par la cour supérieure du Québec en août 2016¹⁸.

Projet pilote

En septembre 2016, un projet pilote est intervenu entre le ministre des Transports du Québec (MTQ) et Uber Canada Inc. en vue de permettre à Uber et ses chauffeurs d'opérer légalement au Québec (« entente MTQ-Uber »)¹⁹. L'entente est toutefois conditionnelle au « respect des exigences gouvernementales en matière de fiscalité »²⁰.

À cet effet, une entente complémentaire est intervenue entre le ministre des Finances du Québec (MFQ) et Uber Canada Inc./Rasier Operations B.V. (« entente MFQ-Uber »)²¹. Celle-ci corrige les manquements attribués aux

15 Ibid., au paragraphe 221.

16 Ian Caines et Zvi Halpern-Shavim, « Taxis, Taxes, and the Complexity of Compliance in the Sharing Economy » (2017) 7:1 *Canadian Tax Focus* 2-3.

17 *Uber Canada*, supra, note 14, au paragraphe 206.

18 *Uber Canada Inc. c. Agence du revenu du Québec*, [2016] QCCA 1303, au paragraphe 64; demande d'autorisation d'appel à la Cour suprême du Canada rejetée le 23 février 2017.

19 Entente Ministère des transports de la Mobilité durable et de l'Électrification des transports et Uber Canada Inc. (www.transports.gouv.qc.ca/fr/salle-de-presse/nouvelles/Documents/2016-09-09/entente-uber.pdf).

20 Ibid., article 2.8.

21 Supra, note 8.

chauffeurs Uber par RQ en matière de perception et de remise de taxes à la consommation qui ont été documentés dans le cadre du procès conclu à peine quelques semaines plus tôt. La décision des tribunaux en faveur du gouvernement du Québec, conjuguée à la pression sociale subie par Uber liée au fait de continuer à opérer dans l'illégalité si aucune entente n'est conclue, auront procuré au Québec une position de négociation enviable.

Changement par rapport à la situation antérieure

L'entente MFQ-Uber clarifie les exigences de nature fiscale à respecter par la plateforme numérique et confirme que les activités des chauffeurs Uber constituent des entreprises de taxis.²² On y prévoit que les chauffeurs utilisant la plateforme doivent

- s'inscrire au registre de la TPS et de la TVQ pour utiliser la plateforme et
- autoriser la filiale Rasier Operations B.V.²³ (avec laquelle les chauffeurs transigent pour accéder à la plateforme Uber) à verser à RQ, pour et à leur acquit, à titre d'acompte provisionnel, les montants déterminés sur la base de la taxe nette calculé selon la méthode rapide de comptabilité à l'égard de leurs services de transport par taxi.

De plus, Rasier Operations B.V. doit

- rendre disponible à RQ le nom et l'adresse des chauffeurs, leur numéro d'assurance sociale, leur numéro d'inscription aux fichiers de la TPS et de la TVQ, le nombre de kilomètres payants parcourus, le nombre de services de taxi fournis, les montants de fournitures et les taxes perçues;
- rendre disponible aux chauffeurs les informations nécessaires pour leur permettre de produire leur déclaration annuelles de TPS et de TVQ et leur déclaration de revenu — à savoir les sommes perçues (taxes incluses), les montants de TPS et TVQ applicables, le montant total des sommes à verser selon la méthode rapide de comptabilité, les montants versés par Rasier Operations B.V. à RQ pour chaque chauffeur à titre d'acomptes provisionnels et les montants nets versés aux chauffeurs;

22 Article 2 de la Loi modifiant diverses dispositions législatives concernant principalement les services de transport de taxi (adoptée par LQ 2016, c. 22, sanctionnée le 10 juin 2016), définit l'expression « service de transport par taxi » pour y inclure, à moins d'exception, tout service de transport rémunéré de personnes par automobile.

23 Rasier Operations B.V. est une société non résidente qui détient une licence d'utilisation des services technologiques Uber accordée par Uber B.V. Celle-ci n'est pas assujettie à l'impôt canadien. Voir Marwah Rizqy, « Impact de l'économie numérique de partage sur la fiscalité de la province de Québec et de ses municipalités », dans *Revue française de finance publique*, n° 135 (Paris : Librairie Générale de Droit et de Jurisprudence, 2016), à la p. 193. Cependant, en transférant les activités canadiennes de Rasier Operations B.V. au Canada (voir supra, note 8), le bénéfice dégagé sur ces activités serait assujetti à l'impôt canadien sur le revenu des sociétés.

- indiquer sur le reçu remis au client les montants de TPS et TVQ et les numéros d'inscription du chauffeur.

À certains égards, on exige qu'Uber accomplisse des activités relevant normalement des employeurs (retenue et transmission d'information fiscale). Les exigences personnalisées prévues à l'entente, d'une part, facilitent la perception de recettes de taxes de vente et la validation de la conformité fiscale pour RQ²⁴ et, d'autre part, ont pour effet de limiter le fardeau administratif des chauffeurs Uber²⁵.

Le 19 octobre 2019, la Loi concernant le transport rémunéré de personnes par automobile²⁶ a été adoptée, venant pérenniser l'obligation pour une plateforme de conclure une entente visant le respect des exigences gouvernementales en matière de fiscalité et mettant fin au projet pilote.

Innovations et simplifications pour les chauffeurs Uber

Afin de favoriser le respect volontaire des obligations fiscales des contribuables, RQ s'est donné pour objectif de simplifier les processus de déclarations fiscales²⁷. L'entente MFQ-Uber s'inscrit dans cet objectif en prenant acte, d'une part, que les activités de taxi d'une partie des chauffeurs Uber sont limitées, ne permettant de dégager qu'un revenu d'appoint²⁸, et d'autre part, que certains chauffeurs Uber

24 Bien qu'aucune retenue fiscale ne soit exigée de la plateforme en matière d'impôt sur le revenu des particuliers, l'entente MFQ-Uber dote Revenu Québec d'informations sur les entreprises de taxi des chauffeurs Uber. Ces informations permettent de renforcer la conformité en facilitant les activités de vérification.

25 Nicolas X. Cloutier, « Taxation of the Sharing Economy and the Digital Economy », présenté au 2019 Corporate Management Tax Conference and live webcast de la Fondation canadienne de fiscalité, Toronto, 27-28 février 2019, présentation PowerPoint, à la p. 19.

26 Projet de loi 17, Loi concernant le transport rémunéré de personnes par automobile, LQ 2019, c. 18. L'article 37 prévoit que, « Lorsque le prix des courses effectuées dans le cadre du système de transport est perçu, par voie électronique, pour le compte des chauffeurs inscrits auprès du répondant du système, par celui-ci ou un fournisseur dont il retient les services, le répondant ou, selon le cas, le fournisseur doit conclure avec le ministre des Finances une entente visant le respect des exigences gouvernementales en matière de fiscalité. Le ministre du Revenu peut, selon les modalités qu'il détermine, dispenser un répondant ou un fournisseur ou une catégorie de répondants ou de fournisseurs de l'exigence prévue au premier alinéa. Il peut toutefois révoquer sa dispense ou en modifier les modalités ». Concernant plus spécifiquement l'entente MFQ-Uber, celle-ci a été prolongée jusqu'au 31 décembre 2020 suite à la fin du projet pilote et des discussions ont lieu entre le MFQ et Uber au moment d'écrire ces lignes. Voir Québec, Ministère des transports, « Transport rémunéré de personnes par automobile — Dispositions transitoires » (www.transports.gouv.qc.ca/fr/entreprises-partenaires/trpa/Documents/trpa/TRPA-dispositions-transitoires.pdf).

27 Québec, Finances Québec, Budget 2013-2014, 20 novembre, 2012, à la p. F.8.

28 Québec, Ministère des transports, *Analyse d'impact réglementaire — Projet de règlement sur le transport rémunéré de personnes par automobile* (Québec : Ministère des transports, 2020), à la p. 8. RQ estime que l'activité hebdomadaire des chauffeurs Uber varie de quelques heures par mois à plus de 60 heures par semaine. Près de 1 000 chauffeurs de taxi utilisent simultanément la plateforme Uber, ceux-ci sont estimés à 15 000 au total au Québec.

pourraient ne pas réaliser que la plateforme les considère comme des travailleurs indépendants et non des employés, modifiant leurs obligations fiscales.

La conformité fiscale exigée des entreprises de taxi traditionnelles peut comprendre le paiement d'acomptes provisionnels trimestriels de TPS-TVQ et le maintien de registres (le nombre de kilomètres parcourus à des fins commerciale et le total des kilomètres parcourus par le véhicule). Ces tâches peuvent s'avérer lourdes lorsque mises en proportion à la faible ampleur des activités de taxi réalisées par une partie des chauffeurs Uber.

En vertu de l'entente MFQ-Uber, la conformité fiscale des chauffeurs Uber est simplifiée. En revanche, tel que discuté ci-après, l'obligation de la perception et de la remise des taxes de vente par Rasier Operations B.V. implique de « diriger » certains choix normalement laissés à la discrétion du contribuable.

- *Utilisation de la méthode rapide de comptabilité*²⁹. Cette méthode est utilisée pour calculer les sommes à remettre à RQ par Rasier Operation B.V. En pratique, les taxes sont prélevées normalement auprès des clients, mais le montant à remettre à RQ fait l'objet d'une réduction (voir le tableau 1) pour tenir compte d'un montant présumé de crédits de taxe sur intrants (CTI) et de remboursement de taxe sur intrants (RTI)³⁰.
- *Utilisation d'un exercice financier et d'une fréquence de déclaration de TPS et de TVQ annuelle se terminant le 31 décembre, les déclarations de TPS et de TVQ devant être produites de façon électronique*³¹. L'arrimage de la période de production annuelle des informations rendues disponibles aux chauffeurs Uber et les périodes de déclaration de revenu et de déclaration annuelle de TPS et de TVQ simplifie la mécanique de déclaration, permettant au chauffeur Uber sans autres activités commerciales ou n'utilisant pas d'autres plateformes de reporter directement les informations reçues, diminuant le recours aux spécialistes de l'impôt. De plus, la transmission électronique des

29 En pratique, un chauffeur Uber peut choisir de ne pas utiliser la méthode rapide, notamment dans le cas où celui-ci exerce d'autres activités commerciales. Cependant, le calcul des sommes versées par Uber à RQ se fait dans tous les cas aux taux établis dans l'entente fiscale. Le chauffeur qui n'effectue pas fait le choix de la méthode rapide de comptabilité doit par conséquent apporter les ajustements nécessaires au moment de produire sa déclaration.

30 En surplus des CTI et RTI présumés, les chauffeurs ont la possibilité de demander des CTI et des RTI pour leurs immobilisations utilisées principalement dans le cadre de leurs activités commerciales.

31 L'entente MFQ-Uber prévoit que les chauffeurs exerçant d'autres activités commerciales peuvent conserver leur exercice financier ainsi que leur période de déclaration, effectuant leurs activités de conformité selon leur façon de faire habituelle. Voir Revenu Québec, « Chauffeur qui est lié à un répondant sous entente et qui n'exerce pas d'autres activités commerciales » (www.revenuquebec.ca/fr/entreprises/taxes/tpstvh-et-tvq/situations-particulieres-liees-a-la-tpstvh-et-a-la-tvq/chauffeur-lie-a-un-repondant-sous-entente/chauffeur-qui-nexerce-pas-dautres-activites-commerciales/).

TABEAU 1 Taux de taxes de vente nettes à remettre à Revenu Québec

	TPS	TVQ
	<i>pour cent</i>	
Perception	5,00	9,975
Taux de la remise pour méthode rapide de comptabilité	3,78	7,26
Crédit de 1 % des fournitures taxables (première tranche de 30 000 \$ de fournitures pour TPS, 31 421 \$ de fournitures pour TVQ)	(1,05)	(1,10)
Taux des taxes percevables par Rasier Operations B.V. à verser à Revenu Québec au nom des chauffeurs Uber	2,73	6,16

TPS = taxe sur les produits et services; TVQ = taxe de vente du Québec.

Source : Revenu Québec, « Chauffeur qui est lié à un répondant sous entente et qui n'exerce pas d'autres activités commerciales » (<https://www.revenuquebec.ca/fr/entreprises/taxes/tpstvh-et-tvq/situations-particulieres-liees-a-la-tpstvh-et-a-la-tvq/chauffeur-lie-a-un-repondant-sous-entente/chauffeur-qui-nexerce-pas-dautres-activites-commerciales/>).

informations par les chauffeurs facilite leur comparaison avec l'information obtenue de Rasier Operations B.V. par RQ.

Dans la mesure où une partie de la non-conformité résulte de l'inconscience du contribuable et/ou de son incapacité à assumer ses obligations fiscales, et n'est pas le résultat de tactiques délibérées, la simplification et la minimisation des coûts de conformité revêtent une certaine importance³².

Protection des recettes fiscales

Au Québec, dans le secteur traditionnel du transport rémunéré de personnes, la problématique d'évasion fiscale prend la forme suivante :

- non-respect de l'inscription obligatoire des exploitants à titre de mandataires aux fichiers de la TPS/TVH et de la TVQ, et non-perception de ces taxes;
- non-production de déclarations de revenus, de retenues à la source et de taxes;
- transactions effectuées en argent comptant, sans que les ventes soient enregistrées;
- non-délivrance ou non-conservation de factures, de pièces justificatives et de registres³³.

32 Wilson Prichard et al., *Innovations in Tax Compliance*, World Bank Group Policy Research Working Paper n° 9032 (Washington, DC : World Bank Group, octobre 2019), à la p. 20 (<https://openknowledge.worldbank.org/bitstream/handle/10986/32492/WPS9032.pdf>).

33 Revenu Québec, *Analyse d'impact réglementaire — Facturation obligatoire dans le secteur du transport rémunéré de personnes* (Québec : Revenu Québec, septembre 2017), à la p. 4.

Avant le projet pilote, déployé en 2016, les pertes fiscales du Québec associées à l'industrie du taxi étaient estimées à 71,8 millions de dollars auxquelles s'ajoutent 19,2 millions de dollars en cotisations à des organismes paragouvernementaux, comme la Régie des rentes du Québec (voir le tableau 2)³⁴.

PRÉVALENCE DE L'ÉVASION FISCALE DANS L'INDUSTRIE DU TAXI

Si un montant de 72 millions de dollars de perte fiscale peut sembler non matériel dans l'ensemble des recettes fiscales du Québec, il faut cependant comprendre que cette industrie ne génère que des revenus annuels estimés entre 500 millions de dollars³⁵ et 700 millions de dollars³⁶. Ainsi, malgré que l'ensemble des acteurs de l'industrie du taxi ne soit pas nécessairement impliqué dans des manœuvres d'évasion fiscale, la concentration de perte fiscale y est élevée, indiquant la présence de travail au noir.

Dans ce contexte, comment l'entente MFQ-Uber est-elle venue modifier le marché du taxi et les recettes fiscales québécoises qui lui sont associées?

RQ estime que les fournitures taxables déclarées de l'industrie du taxi traditionnel (excluant les fournitures des chauffeurs Uber) ont atteint 389 millions de dollars en 2017 (voir la figure 1)³⁷. Or, ces revenus ne constituent qu'une partie des revenus totaux de l'industrie³⁸.

34 Les taxis de Montréal doivent offrir à leur client la possibilité de payer leur course par carte de crédit ou de débit depuis octobre 2015. Cependant, ceci n'a pas eu une incidence majeure sur le niveau de revenus déclarés de l'industrie traditionnelle du taxi estimé par RQ, celui-ci étant passé de 384 millions de dollars en 2014 à 399 millions de dollars en 2016. En fait, une évaluation du revenu brut moyen déclaré par les chauffeurs locataires et les propriétaires chauffeurs de véhicules de taxi indique que ceux-ci sont demeurés stables entre 2013 (alors qu'Uber était encore peu présent au Québec) et 2016. Voir Ministère des finances du Québec, documents transmis lors d'une demande d'accès à l'information (www.finances.gouv.qc.ca/documents/AccesInfo/fr/AINFR_2019-11202.pdf).

35 Comité provincial de concertation et de développement de l'industrie du taxi, *Un nouveau modèle pour le taxi au Québec — Mémoire présenté aux auditions publiques de la Commission des transports et de l'environnement portant sur le projet de loi n° 100* (Longueuil, QC : CPCDIT, mai 2016), à la p. 6.

36 *Analyse d'impact réglementaire*, supra, note 33, à la p. 7.

37 Document transmis dans le cadre d'une demande d'accès à l'information. Voir Revenu Québec, « Compilation des revenus bruts et des fournitures taxables de l'industrie du taxi 2013-2017 », 23 avril 2019 (www.revenuquebec.ca/documents/fr/docs_adm/20-051980-001_DOC.pdf).

38 L'estimation des revenus éludés dans l'industrie du taxi repose sur la perte fiscale en matière de taxes de vente du Québec de 2011 à laquelle le taux de croissance des dépenses de consommation du secteur du taxi et des limousines a été appliqué. RQ a confirmé que son évaluation de la perte fiscale pour 2011 était toujours valable en 2018 dans une réponse datée du 6 juin 2019. Voir Revenu Québec, documents transmis dans le cadre d'une demande d'accès à l'information (www.revenuquebec.ca/documents/fr/docs_adm/19-046757_LD.pdf).

TABLEAU 2 Estimation des pertes fiscales annuelles associées à l'industrie du taxi au Québec (2011)

	Pertes fiscales
	<i>millions de dollars</i>
Impôt sur le revenu	35,4
Taxe de vente du Québec	23,8
Fonds des services de santé, assurance médicaments, etc.	2,5
Crédits et programmes de soutien	10,1
Sous-total — Fonds consolidé du revenu	71,8
Cotisations — organisations paragouvernementaux	19,2
Total	<u>91,0</u>

Source : Revenu Québec, *Analyse d'impact réglementaire — Facturation obligatoire dans le secteur du transport rémunéré de personnes* (Québec : Revenu Québec, 2017), à la p. 13.

Entre le moment de l'arrivée d'Uber au Québec et le déploiement du projet pilote en septembre 2016, les parts de marchés accaparés par Uber venaient vraisemblablement réduire les revenus déclarés et non-déclarés de l'industrie du taxi traditionnel. Par contre, Uber et les chauffeurs contribuaient à l'évasion fiscale dans l'industrie, en ne prélevant pas les taxes de vente au cours de cette période.

Bien qu'il ne soit pas possible de les confirmer avec exactitude, les revenus déclarés par les chauffeurs Uber du Québec en 2017, première année complète où ses activités furent encadrées par le projet pilote, sont de l'ordre de 100 millions de dollars³⁹. On peut estimer que les revenus déclarés de l'industrie traditionnelle du taxi auraient été plus élevés n'eût été des parts de marché accaparées par Uber, mais on peut également avancer que la perception des taxes de vente par les chauffeurs Uber a provoqué une réduction des fournitures taxables où les taxes ont été éludées dans le secteur du taxi.

La disponibilité de données plus précises permettrait de mener des recherches supplémentaires et d'affiner nos constats sur l'effet de l'entente MFQ-Uber en matière de réduction de l'évasion fiscale. Néanmoins, le fait que les revenus de l'industrie du taxi traditionnelle ont demeurés relativement stables entre 2014

39 L'estimation des revenus des chauffeurs Uber à compter de septembre 2016 s'appuie sur les redevances perçues dans le cadre de l'entente MTQ-Uber (Québec, Ministère des Transports [www.transports.gouv.qc.ca/fr/ministere/acces-information-renseignements-personnels/documents-reglement-diffusion/demande-acces/Documents/2019/04/DA-2018-2019-00505-tableau-redevances.pdf]) et de courses d'une valeur de 11,40 \$ (taxes incluses), soit le coût moyen par course à Montréal en 2016. Voir Jérôme Laviolette, « Planification stratégique d'un système de transport par taxi » (mémoire de maîtrise, Université de Montréal, École polytechnique de Montréal, 2017), à la p. 143.

FIGURE 1 Estimation des revenus du secteur du taxi, Québec 2013 à 2017

Sources : Revenu Québec, « Compilation des revenus bruts et des fournitures taxables de l'industrie du taxi 2013-2017 », 23 avril 2019, et estimations des auteurs.

et 2017, soit avant et après le projet pilote, semble indiquer que la majorité des revenus des chauffeurs Uber est venue compresser l'évasion fiscale dans l'industrie.

RECETTES FISCALES AVANT ET APRÈS L'ENTENTE MFQ-UBER

Les courses des chauffeurs Uber font l'objet de paiements électroniques, impliquant un échange informatisé d'informations sur les deux parties à la transaction et une divulgation à RQ. On peut estimer que l'entente MFQ-Uber a contribué à réduire l'évasion fiscale en améliorant la conformité dans l'industrie et ce, avant même qu'on y déploie le système d'enregistrement des ventes⁴⁰.

40 *Analyse d'impact réglementaire*, supra, note 33, à la p. 5. D'abord prévue pour la fin de 2019, une solution technologique exploitant les possibilités du module d'enregistrement des ventes sera implantée dans tous les véhicules utilisés pour le transport rémunéré de personnes (incluant les véhicules utilisés par les chauffeurs-partenaires Uber) d'ici novembre 2021. Tout exploitant devra remettre au client une facture (sous format électronique ou encore sous format papier). La solution technologique développée par RQ exploite les possibilités du module d'enregistrement des ventes présent dans les restaurants et les bars et enverra l'ensemble des factures produites à RQ en temps réel.

Donc, que du positif au plan fiscal associé à l'arrivée d'Uber et à son encadrement par RQ? Pas tout à fait.

Il ne faut pas sous-estimer l'impact de la perte fiscale liée aux frais de services facturés par Uber à ses chauffeurs. Les frais exigés par Uber, qui s'élèvent maintenant à 25 pour cent du prix des courses, ont généré une fuite de revenus bruts d'une vingtaine de millions de dollars au Québec, rien qu'en 2017.⁴¹

Jusqu'à tout récemment, les bénéfices générés par Uber sur ses activités d'intermédiation menées entre chauffeurs et clients québécois n'étaient pas assujettis à l'impôt des sociétés au Québec⁴². Le transfert de ces activités vers le Canada pourrait changer la donne. De même, les travaux de l'OCDE visant la mise en place d'une solution commune qui exigerait l'imposition des bénéfices des sociétés non-résidentes là où ils sont effectivement pourrait permettre d'imposer les bénéfices réalisés par Uber au Québec. Dans le cas où les travaux de l'OCDE ne connaîtraient pas de dénouement avant le 1^{er} janvier 2022, le Canada a l'intention d'imposer temporairement une taxe sur les revenus bruts de source canadienne de certaines multinationales de l'économie numérique dont Uber fait partie⁴³. Les précisions entourant cette taxe demeurent à venir, incluant la partie des revenus qui serait reversée aux provinces.

PISTES D'INSPIRATION POUR D'AUTRES SECTEURS ET LE RESTE DU CANADA

Les efforts à déployer pour mettre en place une entente de conformité fiscale avec un non-résident sont importants. Il n'en demeure pas moins qu'il s'agit d'un outil à considérer lorsque l'occurrence d'évasion fiscale est élevée dans un secteur donné et où l'intermédiaire étranger a avantage à collaborer avec l'administration fiscale, ne serait-ce que pour améliorer son image corporative. D'ailleurs, le Québec a déjà indiqué qu'il pourrait recourir à nouveau à des ententes de conformité fiscale ciblées.

Bien que les montants de recettes fiscales en jeu soient relativement limités, les actions déployées par RQ dans le dossier Uber semblent montrer un souci d'équité entre contribuables en matière d'assujettissement aux taxes et impôts. RQ s'est assuré que l'intégration d'Uber dans l'industrie du taxi au Québec, qui est loin de faire l'unanimité, s'effectue dans le respect des obligations fiscales, quitte à devoir innover pour s'assurer de l'atteinte de cet objectif.

Les chauffeurs Uber du Québec voient les taxes de vente applicables sur leurs courses perçues et remises à RQ en leur nom à titre d'acomptes provisionnels

41 Estimation des auteurs.

42 Il est à noter que la multinationale Uber, qui a généré des revenus de 14,2 milliards de dollars en 2019, montre toutefois une perte d'opération de 8,6 milliards de dollars. Voir Uber, *2019 Annual Report* (San Francisco : Uber, 2020), à la p. 55.

43 *Énoncé économique de l'automne de 2020*, supra, note 4, à la p. 131.

(et font l'objet de divulgation d'information sur leurs activités). Dans les autres provinces canadiennes, Uber collecte également les taxes de vente pour le compte des chauffeurs; cependant, les montants sont reversés hebdomadairement aux chauffeurs qui doivent eux-mêmes les mettre de côté pour ensuite les verser à l'Agence du revenu du Canada (l'ARC)⁴⁴.

Globalement, la réponse du reste du Canada à Uber se compare à celle de la majorité des pays de l'OCDE, qui n'utilisent pas l'acompte provisionnel pour fins de taxe de vente et ne disposent pas du même niveau de détail sur les transactions des chauffeurs Uber que le Québec, afin de vérifier leur conformité en matière de taxes de vente et d'impôts sur le revenu⁴⁵. Dans la mesure où la mécanique prévue à l'entente MFQ-Uber pourrait simplifier et améliorer la conformité fiscale des chauffeurs dans le reste du Canada, il pourrait toutefois être pertinent que l'ARC considère le modèle du Québec. Dans un tel cas, une grande cohésion entre les provinces et le fédéral permettrait de disposer d'une meilleure position de négociation face à Uber, un peu à l'image de la coordination du MTQ et du MFQ au Québec.

L'ARC considère que les nouveaux modèles d'affaires supportés par les technologies numériques, bien qu'ils créent de nouveaux risques de non-conformité, peuvent potentiellement faciliter la déclaration et le paiement des taxes et impôts⁴⁶. Dans le cas précis de l'économie collaborative, les plateformes centralisent les transactions et les technologies de l'information en facilitent le traitement. Cette centralisation amène toutefois à s'interroger sur l'application de la règle de petit fournisseur⁴⁷.

D'abord, les plateformes disposent d'information sur des fournisseurs de biens et de services qui, en raison des seules transactions où elles agissent comme intermédiaire, ne leur permet pas de se qualifier de petit fournisseur. Organiser le partage de cette information avec l'ARC apparaît à prioriser à des fins de conformité.

Ensuite, la règle de petit fournisseur vise à minimiser le fardeau administratif des très petites entreprises et à améliorer l'efficacité de l'administration pour la perception, la remise, l'encaissement et le recouvrement de faibles montants une fois déduite les taxes payées sur les intrants. Cependant, pendant les décennies depuis la rédaction de cette règle, l'environnement d'affaire a évolué.

44 Uber, « How To File Taxes as an Uber Partner », 2019, à la p. 9 (<https://d1nye3h1ys8wfo.cloudfront.net/static/PDFs/AB%2CON%2CSK+handbook.pdf>).

45 Voir Organisation de coopération et de développement économiques, *The Sharing and Gig Economy: Effective Taxation of Platform Sellers: Forum on Tax Administration* (Paris : OCDE, mars 2019), chapitre 2.

46 Voir Agence du revenu du Canada, « Stratégie relative à l'économie clandestine 2018-2021 » (www.canada.ca/fr/agence-revenu/programmes/a-propos-agence-revenu-canada-arc/rapports-information-entreprise/strategie-relative-economie-clandestine-2018-2021.html).

47 Article 148 de la LTA.

Au Québec et partout au Canada, l'expansion de l'économie collaborative pourrait affecter négativement les assiettes fiscales avec plus d'acuité à l'avenir, celle des taxes à la consommation en particulier. La multiplication des petits fournisseurs constitue un enjeu réel et remet en question les modes traditionnels de perception des recettes fiscales.

L'utilisation à grande échelle des ententes fiscales dans le secteur de l'économie collaborative pour assujettir l'ensemble des transactions aux taxes de vente n'est probablement pas appropriée⁴⁸. Toutefois, une révision du cadre fiscal apparaît incontournable afin d'impliquer les plateformes de l'économie collaborative dans la perception des taxes de vente lorsque cela est nécessaire. Ceci appellera à une grande proactivité des administrations fiscales, mais l'expérience de l'entente MFQ-Uber montre que c'est envisageable.

48 En 2018, 210 initiatives locales et étrangères de l'économie collaborative présentes dans 16 secteurs d'activité ont été recensées au Québec. Voir Québec, Groupe de travail sur l'économie collaborative, *Moderniser et renforcer les politiques publiques et réussir face aux transformations associées à l'économie collaborative* (Québec : Groupe de travail sur l'économie collaborative, juin 2018), à la p. 10.

Policy Forum: Tax, Social Security, and Employment Status—Removing the Distortions in the United Kingdom

Judith Freedman*

PRÉCIS

La pandémie de COVID-19 a mis les systèmes fiscal et de sécurité sociale à rude épreuve. Des fissures qui existaient depuis un certain temps déjà se sont creusées davantage et il est peu probable qu'elles se referment sans travaux à la structure. De nouvelles connaissances sur la nature changeante du travail, combinées au développement de technologies capables de fournir des solutions modernes et pratiques à de vieux problèmes, offrent la possibilité de repenser la manière dont nous imposons les travailleurs à la demande et autres fournisseurs de travail atypiques. Cet article soutient qu'au moment d'examiner la conception des dispositions fiscales et de sécurité sociale, nous devons nous affranchir des classifications de statuts d'emploi élaborées dans d'autres domaines du droit, à d'autres fins. Afin d'accroître l'équité et de supprimer les distorsions, nous devrions chercher, dans la mesure où c'est possible concrètement, à harmoniser le traitement fiscal et de sécurité sociale de tous ceux qui fournissent un travail. Quand ce n'est pas possible, malgré les avantages que procurent les nouvelles technologies, ce sont les objectifs de la politique fiscale et des avantages sociaux qui devraient dicter les lignes de démarcation plutôt que les liens avec la jurisprudence qui a évolué dans d'autres domaines.

ABSTRACT

The COVID-19 pandemic has strained tax and social security systems. Cracks that have existed for some time have been opened up further and are unlikely to close without structural repair. New insights into the shifting nature of work, combined with the development of technologies that can provide modern, practical solutions to old problems, offer the opportunity to rethink the way we tax gig workers and other non-standard providers of labour. This article argues that we need to free ourselves from the employment status classifications developed in other areas of law, for other purposes, when we consider the design of tax and social security provisions. We should aim to harmonize the tax and social security treatment of all those who provide labour as far as is practically possible in order to increase equity and remove distortions. Where that cannot be achieved, despite the benefits of new technologies, dividing lines should be

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dictated by tax and benefits policy objectives rather than linkages to case law that has evolved in other areas.

KEYWORDS: EMPLOYMENT ■ TAXATION ■ SOCIAL SECURITY ■ UNITED KINGDOM ■ CLASSIFICATIONS
■ POLICY

CONTENTS

Introduction	546
The Different Purposes of Classification	548
A Case Study: The UK System	550
Conclusions and the Way Forward	557

INTRODUCTION

The rise of platform working has placed new strains on an already imperfect system of classification of service providers. These strains were clearly evident before the COVID-19 pandemic. Indeed, flexible working, casual jobs, and part-time working presented challenges long before digital platforms appeared.¹ The problems have been exacerbated by the technology that has made platform working so successful. The pandemic has made a difference in ways that may be more permanent than the crisis itself.

Now is the time to harness the technology that has intensified the problems and make it work for the purposes of tax and social security administration. In order to do this, we need to be prepared to move away from previous thinking about worker classification and recognize that policy areas with different objectives may require varying treatment. Simply re-examining old classifications from the case law (master and servant, employed and self-employed, dependent contractors and those doing business on their own account) and trying to tweak these boundaries to cover new situations is unlikely to provide sustainable solutions.

In many ways, these issues are not new but have been developing for years. However, the articles contributed to this Policy Forum are different from those that would have been written two years ago on the same topic. The COVID-19 pandemic has put further pressure on the rules used in most legal systems to classify types of work. The link between, on the one hand, labour and service provider classification and, on the other hand, the structures available through which to provide state support has been highlighted by the disaster that struck our societies in 2020 and that continues still. Administrative records and machinery have taken on a completely new significance in the light of the need to deliver financial assistance quickly. The cracks in our systems revealed in this way will not close up once the pandemic has retreated. Now that a torch has been shone onto them, they need to be tackled.

1 See, for example, Organisation for Economic Co-operation and Development, *The Future of Social Protection: What Works for Non-Standard Workers?* Policy Brief on the Future of Work (Paris: OECD 2018) (<https://doi.org/10.1787/9789264306943-en>).

Research by the Organisation for Economic Co-operation and Development (OECD) has shown that the majority of OECD member states have utilized a pre-existing short-term work scheme in order to deliver assistance, although most of them have increased access and coverage. However, less than half of those member states have increased access for workers in non-standard jobs. The administrative issues have been a significant reason for this limited access.²

The legal distinction between the employed and the self-employed or independent contractors has been significant not only for tort law, employment law, immigration law, and other areas, but also for tax and social insurance payments in many jurisdictions. Pandemic support schemes have had to rely heavily on existing classifications and mechanisms in order to deliver aid quickly and efficiently without providing opportunities for limitless fraud. As Wei Cui³ and Graham Purse⁴ describe in their articles in this Policy Forum, the problems with using those classifications have exposed the fault lines in current arrangements.

This certainly has been the case in the United Kingdom. Despite an extensive furlough scheme for employees (the coronavirus job retention scheme [CJRS]) and substantial support schemes for the self-employed (the self-employment income support scheme [SEISS]), it is claimed that there are 3 million UK taxpayers who lack any assistance from the state, partly—though not exclusively—owing to definitional problems.⁵ Those who are unsupported include new starters in employment not reflected in filings before the cutoff date and also precarious employees, such as those on “zero hours” contracts,⁶ who were not offered furlough. The exclusion of these groups mirrors some of the problems noted by Cui in this Policy Forum. Some low-paid self-employed gig workers were covered by SEISS and so were possibly better off than others engaged in precarious employment. Similarly, in the United States, some Uber and Lyft drivers have been able to tap into the economic injury disaster loans program as independent contractors for grants and loans with little scrutiny, because they are not employees.⁷

2 Stefano Scarpetta et al., *OECD Policy Responses to Coronavirus (COVID-19), Job Retention Schemes During the COVID-19 Lockdown and Beyond* (Paris: OECD, October 2020), at 7, table 1 (www.oecd.org/coronavirus/policy-responses/job-retention-schemes-during-the-covid-19-lockdown-and-beyond-0853ba1d).

3 Wei Cui, “Policy Forum: Non-Standard Employment and Canada’s Initial Pandemic Response.”

4 Graham Purse, “Policy Forum: Sagaz at 20—Evaluating Employment and Independent Contractor Relationships in a Changing World.”

5 Parliament of the United Kingdom, “COVID-19: Support for Jobs,” December 20, 2020 (<https://publications.parliament.uk/pa/cm5801/cmselect/cmpubacc/920/92007.htm>); Excluded, “Who Is Excluded?” (www.excludeduk.org/excluded-taxpayers). Some of the exclusions are policy-based.

6 Known in Canada, more accurately, as contracts with no guaranteed minimum hours.

7 Faiz Siddiqui and Andrew Van Dam, “As Uber Avoided Paying into Unemployment, the Federal Government Helped Thousands of Its Drivers Weather the Pandemic,” *Washington Post*, March 16, 2021.

A vociferous excluded group in the United Kingdom has been company directors of owner-managed (usually personal service provider) companies,⁸ who have paid themselves mainly by way of dividend rather than by salary through their wholly owned companies. For this group, incorporation has been a convenient way of saving tax and national insurance (social security) contributions (NICs) since (as explained further below) it allows owner-managers to convert labour income into income from capital, by paying themselves dividends or capital income instead of receiving self-employed remuneration or employment salary. Other reasons for this arrangement are claimed as well, but tax and NICs appear to be major drivers, especially if the alternative is that the owner-manager might be classified as an employee rather than as being self-employed. Now, for some who chose to incorporate, the result is low eligibility for CJRS, since they have kept their own wages deliberately low, and no eligibility for SEISS, since they are not classified as self-employed. Despite great pressure for a support scheme to include this group of directors, the UK chancellor and treasury have so far resisted on the basis that it is not possible to find a method of differentiating dividends that are in effect remuneration from dividends that are not.⁹ Legal classifications have had a major impact here.

The number of excluded people has been reduced a little by actions taken in March 2021,¹⁰ but it has not been eliminated, and the owner-manager director problem has not been tackled.

THE DIFFERENT PURPOSES OF CLASSIFICATION

The legal classifications of suppliers of labour are required to serve disparate purposes. Employment law aims to counter inequalities in the labour market by supplementing contractual arrangements with statutory rights and duties, and even by overriding contracts in some cases. Tax law, on the other hand, aims to raise and sometimes to redistribute revenue; but generally, good tax policy would require that tax should be neutral as to the contractual or commercial arrangements between the parties.

8 Known in Canada as personal services businesses. The United Kingdom does not have the equivalent of the anti-avoidance provisions regarding these companies found in Canadian legislation (such as paragraph 18(1)(p) of the Income Tax Act, RSC 1985, c. 1 [5th Supp.], as amended [herein referred to as “the ITA”]), although it does have provisions known as “IR 35” described below. For a comparative discussion, see David G. Duff, “Income Taxation of Small Business: Toward Simplicity, Neutrality and Coherence,” in Glen Loutzenhiser and Rita de la Fera, eds., *The Dynamics of Taxation: Essays in Honour of Judith Freedman* (Oxford, UK: Hart, 2020), chapter 4.

9 “No More Coronavirus Support To Come for Limited Company Directors, Chancellor Rishi Sunak Tells Martin Lewis,” *Money Saving Expert*, March 5, 2021.

10 The history of this scheme is summarized very well in Antony Seely and David Hirst, *Coronavirus: Self-Employment Income Support Scheme*, House of Commons Library Briefings Paper no. 8879 (London: UK Parliament, House of Commons Library, March 18, 2021).

It is generally assumed that certain aspects of social insurance, such as statutory sick pay, should piggyback on the employment-law classification since they have a similar function—the protection of certain groups—although the extent to which that is so will be discussed further below. However, this argument is much less obvious when it comes to other aspects of social protection, such as retirement pensions.

Different jurisdictions have different approaches to the provision of social insurance, but in most countries, it is very firmly linked to employment. In some systems, provision is made by the state on the basis of contributions. In others, there is more of a market-based approach using private schemes for at least some aspects of coverage, such as health and pensions. It is also possible to make more universal provision through the general system of taxation, as in the case of the UK national health system, where health care is not related to contributions at all. In the United States, health-care insurance is linked to employment.¹¹ Which system is adopted can make a large difference to the significance of employment status, making the issue one of enormous complexity. Whichever system is adopted, perhaps the best route to simplicity and equity, as Purse points out in his article in this Policy Forum, and as has been suggested by the OECD,¹² is to harmonize social security contributions across all types of providers of labour as far as possible. The contributions could continue to be earnings-related and give rise to earnings-related benefits if that was the design of the system, but they would not differ depending on the legal classification of the service provider. This solution would reduce the incentives to use independent contractors rather than employees, although engagers might still wish to escape the burdens of employment regulation. However, at least the drivers would not all be pushing in that direction.

When we move on to consider taxation, there appears to be no good argument in principle for applying a different tax rate on the basis of different worker classifications. There will be practical differences relating to the way in which the tax base is calculated and to assessment methods, depending on how payment is made. The nature of the relationship may also have an impact on the availability of a mechanism for tax collection: withholding at source is an effective method of enforcement and will result in higher compliance rates where it can be applied. But there seems to be no necessity for the rules surrounding employment protection and social insurance to dictate the practical rules about when withholding or a reporting mechanism for payments should apply. As we see in the article by Robert-Angers and Godbout in this Policy Forum,¹³ there may be ways to use digital platforms and other third parties for reporting and tax compliance purposes in the absence of an

11 Mical Raz, “Time To Unlink Work and Health Insurance in the US?” *Futurity*, April 1, 2020 (www.futurity.org/health-care-insurance-employment-covid-19-2322532).

12 See OECD, *supra* note 1, at chapter 1, especially paragraph 1.8.1.

13 Michaël Robert-Angers and Luc Godbout, “Policy Forum: Promoting Tax Compliance by Regulating the Digital Economy—Quebec’s Uber Initiative.”

employment relationship. Doing so should not have an impact one way or the other on the employment relationship. The employment legislation governing this should be drafted to achieve the objectives of employment protection.

This article argues that we need to free ourselves from the view that employment status must dictate tax and social security treatment. As far as possible, we should be aiming to harmonize the tax and social security treatment of all those who provide labour, so that the classifications do not matter in any event; but if practicalities do require different treatment for different groups, the dividing lines should be dictated by the objectives of each area and the associated practicalities. One size does not fit all when it comes to worker classifications.

A CASE STUDY: THE UK SYSTEM

The United Kingdom is currently dealing with an extreme version of a problem experienced in many jurisdictions.¹⁴ The UK system at present results in a strong tax and social security contribution incentive not to be an employee. This is largely due to higher rates of NICs paid by the employed than by the self-employed (the main employee rate being 12 percent and the main self-employed rate being 9 percent). In addition, employers make a NICs payment of 13.8 percent above a low threshold for employees but not for others. The total difference in contributions is very significant.¹⁵ There is no equivalent levy on the self-employed, unlike the position in some jurisdictions, including Canada. As explained below, the differences in benefits entitlement are not sufficient to account for these contribution differences.¹⁶

14 More detailed accounts of this problem can be found in Claire Crawford and Judith Freedman, "Small Business Taxation," in James Mirrlees, Stuart Adam, Timothy Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles, and James Poterba, eds., *Dimensions of Tax Design: The Mirrlees Review* (Oxford: Oxford University Press, 2010), 1028-99; Stuart Adam, Helen Miller, and Thomas Pope, "Tax, Legal Form and the Gig Economy," in Carl Emmerson, Paul Johnson, and Robert Joyce, eds., *The IFS Green Budget* (London, UK: Institute for Fiscal Studies, 2017), 203-38; Dan Tomlinson and Adam Corlett, *A Tough Gig?—The Nature of Self-Employment in 21st Century Britain and Policy Implications* (Resolution Foundation, February 2017) (www.resolutionfoundation.org/app/uploads/2017/02/Self-employment-presentation.pdf); Abi Adams, Judith Freedman, and Jeremiah Prassl, "Rethinking Legal Taxonomies for the Gig Economy: Tax Law, Employment Law, and Economic Incentives" (2018) 34:3 *Oxford Review of Economic Policy* 475-94 (<https://doi.org/10.1093/oxrep/gry006>); and Stuart Adam and Helen Miller, "Principles and Practice of Taxing Small Business," in *The Dynamics of Taxation*, supra note 8, 97-116.

15 There are thresholds and other issues to be taken into account. A simplified summary of the rates can be found in Shorthouse & Martin Ltd., "National Insurance Contribution" (www.shorthousemartin.co.uk/national-insurance-contributions). See also Judith Freedman and Helen Miller, *Tax and Employment Status: Myths That Are Endangering Sensible Tax Reform* (London, UK: Institute for Fiscal Studies, July 2020), at 9 (www.ifs.org.uk/publications/14957).

16 See infra note 39. Stuart Adam and Helen Miller, *Taxing Work and Investment Across Legal Forms: Pathways to Well-Designed Taxes*, IFS Report no. R184 (London, UK: IFS, 2021), at 38

As in Canada, there are some computational differences when calculating taxation as between the employed and the self-employed. These are generally less significant than the impact of NICs, but in some circumstances can be very important. Broadly speaking, employees can deduct only expenses that are wholly, exclusively, and necessarily incurred in the performance of their duties, whereas self-employment expenses need only to be incurred wholly and exclusively for business purposes. The objectivity of the employment test is very strictly applied in the case law, making the expenses rule for employees in the United Kingdom very narrow.¹⁷

The largest savings can be achieved by incorporating a one-person business and converting remuneration through the company into dividend income, which is not subject to NICs. The owner will take some payment by way of remuneration to satisfy (lightly policed) minimum wage requirements and to obtain a NICs contribution record, but much of the income can escape NICs. Dividend tax rates have been increased, in part to reduce this gap, but there is still often a tax and NICs advantage to incorporation.¹⁸ In addition, tax planning by way of income splitting among family members is facilitated by incorporation.¹⁹

(<https://ifs.org.uk/uploads/R184-Taxing-work-and-investment-across-legal-forms.pdf>). Adam and Miller put the overall NICs advantage of self-employment at around £5.9 billion.

- 17 Judith Freedman and Emma Chamberlain, "Horizontal Equity and the Taxation of Employed and Self-Employed Workers" (1997) 18:1 *Fiscal Studies* 87-118. Since that article was written, rules for travel expenses for employees have been relaxed a little by statute, so that employees can sometimes even be better off than the self-employed in this respect, but some significant advantages for the self-employed remain. As in Canada, there are differences as a result of these rules between the employed and the self-employed when it comes to the deduction of home-working expenses, a matter of particular importance since the pandemic began. However, in the United Kingdom, there was already a streamlined administrative process for employees claiming home-working deductions, and therefore the administrative issues raised by Bhuvana Rai in this Policy Forum do not appear to be as pressing in the United Kingdom as in Canada: see Bhuvana Rai, "Policy Forum: Write It Off (and Start Again)—Adapting Home Office Deductions for the Digital Era," under the heading "Limitations on the Deduction of Home Office Expenses." Since 2003, it has been possible for an employer to make tax-free payments to help employees to cover reasonable expenses incurred while working from home (for limited costs). Alternatively, employees can make the deduction, provided that it is wholly, exclusively, and necessarily incurred. To assist in administration, the employee may choose a standard amount in each case (£6 per week or £26 per month) as an alternative to actual costs incurred. During the pandemic, there has been a relaxation of the usual tests provided that the employee is working at home because of the coronavirus. If home working continues to be widely used, one can imagine pressure for relaxation of the tests to be continued also; otherwise, the requirement for the expenditure to be necessary and for the employee to have no choice about where he or she will work will remain very narrow. More detail can be found in Association of Tax Technicians, "Home Sweet Home—Tax Relief and Home Working" (www.att.org.uk/home-sweet-home-%E2%80%93-tax-relief-home-working).

- 18 Adam and Miller, using stated assumptions, and including NICs in their definition of tax, show that "[f]or a job generating £40,000, tax in 2020-21 is £3,300 (respectively, £4,300)

(Notes 18 and 19 are continued on the next page.)

To counter the NICs advantages of incorporation, the United Kingdom has legislation to deal with these personal service companies, colloquially known as IR 35 (after the press release that first announced it). This legislation works by deeming the income from certain contracts operated through an intermediary to be employment income for tax and NICs purposes.²⁰ Problematically, the tests used to ascertain whether IR 35 applies are linked to the case-law employment classification tests that apply across the board to employment law, tax, tort, immigration law, and other areas. The case law is purportedly the same in each area, although, given that the decisions are so fact-based, one can see variations in application. The use of the employment classification tests when an intermediary is involved is particularly complex and unsatisfactory, and has given rise to much litigation.²¹ HM Revenue & Customs has attempted to assist with a computer-based employment status indicator, with mixed success.²²

Initially this system was designed to impose on the engager the burden of deciding whether the IR 35 rules applied, but heavy lobbying resulted in a switch to placing the liability onto the engaged. This change resulted in much uncertainty and compliance cost, but raised little revenue, because the rules were not widely applied. The policy was partially changed in 2017 when it was decided to shift the burden of deciding whether IR 35 applied to engagers, if they were in the public sector. In April 2021, this shift was extended to the private sector,²³ giving rise to much concern and many dire predictions. In some cases, businesses have moved to direct employment without an intermediary. Some contractors have announced that they are retiring or going offshore, and many will move to using what are called

higher if the job is completed through an employment contract rather than by someone who is self-employed (running their own company)." See Adam and Miller, *supra* note 16, at 7-8 including figure ES.1.

- 19 There have been some attempts to prevent the use of this strategy through anti-avoidance legislation, but these have not been successful. See *Jones v. Garnett*, [2007] UKHL 35; and Glen Loutzenhiser, "Income Splitting and Settlements: Further Observations on Jones v Garnett" [2007] no. 6 *British Tax Review* 693-716. The UK general anti-abuse rule would not apply. The United Kingdom does not have legislation like the Canadian legislation dealing with tax on split income (Budget Implementation Act, 2018, No. 1, SC 2018, c. 12, sections 13(5) through (7), amending ITA section 120.4); see Duff, *supra* note 8, at 80.
- 20 The amended legislation is found in the Income Tax (Earnings and Pensions) Act (ITEPA) 2003, 2003, c. 1, part 2, chapter 8. The word "workers" is defined in ITEPA section 49, in terms similar but not identical to those used in the Employment Rights Act 1996, 1996, c. 18.
- 21 For a useful list of all recent IR 35 cases, see Contractor Calculator, "IR 35 Court Cases: History of All Cases and References to Judgments" (www.contractorcalculator.co.uk/ir35_court_cases_judgments.aspx).
- 22 United Kingdom, HM Revenue & Customs, "Check Employment Status for Tax," March 2, 2017 (www.gov.uk/guidance/check-employment-status-for-tax).
- 23 For a fuller account, see H. Collins and Judith Freedman, "Section 7 and Schedule 1: Workers' Services Provided Through Intermediaries" [2020] no. 4 *British Tax Review* 394-407.

umbrella companies to try to get around the problem.²⁴ We can expect increased complexity, artificiality, and litigation. All this is bringing the issue to a head, and there is considerable pressure on the government to introduce reforms.

A further complication is that in the United Kingdom, for tax and NICs purposes, there are two classifications of worker: employed and self-employed. For employment-law purposes, legislation has added a third classification of “worker” (eligible for some, but not all, protections available to employees)²⁵ and self-employed. A determination that a person is a worker for employment-law purposes can be made even if the person is self-employed for tax and NICs purposes.²⁶ Thus, the recent decision by the UK Supreme Court that Uber drivers are workers²⁷ does not prevent them from being self-employed for tax purposes. If that is the outcome, they may pay lower tax and NICs but may be entitled to the national minimum wage (NMW), although not, for example, unemployment benefit. This treatment is not as illogical as some have suggested, since the NMW comes from the engager whereas unemployment benefit comes from the state, but it does raise concerns about the complexity of the position for workers and the ways in which engagers in particular large platforms can work with the system to get to a result that keeps their payments to the minimum. Uber lost its case in the Supreme Court, but its drivers still do not have full benefits as employees, and in the pandemic it has been the state that has supported them through the SEISS.²⁸

24 “IPSE Research: Half of Freelancers Planning To Stop Contracting in the UK After IR35 Reforms,” *IPSE (Association of Independent Professionals and the Self Employed)*, March 15, 2021 (www.ipse.co.uk/ipse-news/news-listing/ipse-research-freelancers-stop-contracting-uk-ir35.html).

25 Workers are entitled to the national minimum wage and to holiday pay, but not to sick pay and parental leave pay. They do not have redundancy and unfair dismissal rights as employees do and will not be entitled to state unemployment benefits as of right.

26 *Pimlico Plumbers Ltd v. Smith*, [2018] UKSC 29.

27 *Uber BV v. Aslam*, [2021] UKSC 5.

28 This also happened in the United States; see *supra* note 7. The Uber decision in the United Kingdom was also not decisive on the value-added tax (VAT) position because it was based on a purposive interpretation of employment-law legislation and explicitly excluded consideration of VAT. (VAT is the UK version of Canada’s goods and services tax.) At present, Uber drivers are responsible for their own VAT, and most are below the United Kingdom’s relatively high VAT registration threshold of £85,000. As in Canada, with the small supplier exemption discussed by Robert-Angers and Godbout, *supra* note 13, this results in loss of revenue and undermines the level playing field with other taxi services. There is pressure for these concerns to be addressed in the United Kingdom, and the Supreme Court’s analysis, while not directly relevant, can only add to that: Jamie Nimmo, “Uber ‘Could Face £2bn VAT Bill,’” *Sunday Times*, February 21, 2021. The UK government issued a call for evidence in 2020 but as yet has not made any announcements on how it plans to proceed: United Kingdom, HM Revenue & Customs, *VAT and the Sharing Economy: Call for Evidence* (London, UK: HM Revenue & Customs, December 9, 2020) (www.gov.uk/government/publications/vat-and-the-sharing-economy-call-for-evidence).

Given the different levels of payment of NICs paid by the employed, the self-employed, and those operating through personal service companies, it is no surprise that the UK chancellor stated when setting up the COVID-19 support scheme:

But I must be honest and point out that in devising this scheme—in response to many calls for support—it is now much harder to justify the inconsistent contributions between people of different employment statuses. If we all want to benefit equally from state support, we must all pay in equally in future.²⁹

In 2017, a review of employment status issues was commissioned by the UK government. This report (the Taylor review) recommended that “we need to make the taxation of labour more consistent across employment forms while at the same time improving the rights and entitlements of self-employed people.”³⁰

With this I can agree.³¹ However, the report then went on to recommend replacing the “worker” classification with a “dependent contractor” category and stated that

[i]n developing the new “dependent contractor” test, renewed effort should be made to align the employment status framework with the tax status framework to ensure that differences between the two systems are reduced to an absolute minimum.³²

Renaming the worker category is widely considered to complicate rather than simplify the position,³³ and it is not clear how the employment status framework and the tax status framework could be usefully aligned using this third category. Making taxation more consistent across all classifications seems to be a preferable idea. However, as at the time of writing, the government has taken no action to implement these recommendations, despite indications that doing so is on its agenda.³⁴ Once the issues are examined, implementation is more complex than it seems.

29 United Kingdom, HM Treasury, “Chancellor’s Statement on Coronavirus (COVID-19): 26 March 2020” (www.gov.uk/government/speeches/chancellor-outlines-new-coronavirus-support-measures-for-the-self-employed).

30 Matthew Taylor, Greg Marsh, Diane Nicol, and Paul Broadbent, *Good Work: Taylor Review of Modern Working Practices* (London, UK: Department for Business, Energy & Industrial Strategy, July 2017) (herein referred to as “the Taylor review”), at 9.

31 The Taylor review did not examine tax-motivated incorporation and so did not include this in its prescription. Tackling this problem would be more complex and would require some way of treating income of the company as employment income regardless of whether it was paid out by way of wages or in the form of dividends. This treatment is partly achieved by IR 35, but in a cumbersome and incomplete way. For other proposals, see Crawford and Freedman, *supra* note 14; and Adam and Miller, *supra* note 16.

32 Taylor review, *supra* note 30, at 38.

33 Adams, Freedman, and Prassl, *supra* note 14, at 488.

34 United Kingdom, Department for Business, Energy & Industrial Strategy, *Good Work: A Response to the Taylor Review of Modern Working Practices* (London, UK: Department for Business,

It is important to note the final piece of the UK jigsaw, which is that, although the UK national insurance scheme is known as a contributory one, and this has been significant in persuading the population to accept ever-increasing NICs more readily than higher income taxes, the contributory element and the earnings-related aspects have been much depleted in recent years.³⁵ In part, this has been the result of a push from the Left for greater inclusion, so that non-contributory benefits have been expanded. In tension with that, but having a similar overall effect in this context, has been the push by the Right for more means testing.³⁶ NICs payments are the basis for eligibility in some cases, and so remain contributory in that sense, but while the contributions are earnings-related, the benefits entitlements are not. That being the case, benefits payments are low. This has been a problem during the pandemic, hence the requirement to top up benefits through special schemes. This situation has led to calls for a move toward a more contributory, earnings-related element,³⁷ now that so many more people have experienced the difficulties of living on the amounts paid.

State retirement pensions, in particular, are not earnings-related and are available to the employed and the self-employed alike provided that they have paid NICs or been credited over a sufficient period. Health insurance is universal and not related to employment. Hence, individuals incorporating a company can build up entitlement to the full state retirement pension by paying themselves a low wage and converting the rest of their income into dividends. Only job-seekers allowance (automatic entitlement for employees for the first six months, at a low flat rate)³⁸ and some forms of parental pay are different as between the employed and the self-employed.

Given this, the difference between the total payments of NICs in relation to an employed person and those relating to a self-employed person or persons paying themselves via dividends is not justifiable on the basis of the differences in benefits. The value of the differences in the job-seeker's allowance and statutory maternity/paternity/adoption/shared parental pay is small. Adam and Miller estimate that those differences would only justify setting the self-employed NIC rate at less than

Energy & Industrial Strategy, February 2018) (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/679767/180206_BEIS_Good_Work_Report_Accessible_A4_.pdf).

35 See Nicholas Timmins, Gemma Tetlow, Carl Emmerson, and Stephen Brien, *Jobs and Benefits: The Covid-19 Challenge: A Joint Report by the Institute for Government and Social Security Advisory Committee* (London, UK: Institute for Government and Social Security Advisory Committee, 2021) (www.instituteforgovernment.org.uk/sites/default/files/publications/jobs-benefits-covid-challenge.pdf).

36 John Hills, *Inclusion or Insurance? National Insurance and the Future of the Contributory Principle*, CASE Paper no. 68 (London, UK: London School of Economics, Centre for Analysis of Social Exclusion, May 2003).

37 See, for example, Timmins et al., *supra* note 35.

38 The amount of the allowance is £74.35 per week for most people. This can be topped up by a benefit known as “Universal Credit,” based on means-testing.

1 percentage point below the combined employer and employee rates.³⁹ In order to remove differences based on classification, those differences could be ironed out by improvements to entitlements for the self-employed, as Taylor suggests, without costing a great deal, while softening the blow of the higher rate a little.

Nevertheless, the vociferous self-employed lobby argues that there should be large differences in the rates of NICs charged owing to the risks that the self-employed take, though this is an argument that has no basis in logic. As explained in a recent Tax Law Review Committee paper, even if it is desired to encourage or support certain working arrangements, blanket tax relief for all “self-employed” (which is bound to be a heterogeneous group, however defined) is not a well-targeted or effective way to achieve this objective.⁴⁰

Unfortunately, aligning the NICs payments for the employed and the self-employed has become a political hot potato. An attempt to make a very small adjustment in this direction resulted in failure in 2017 and was politically disastrous for the chancellor concerned.⁴¹ It seems likely that such alignment could happen only as part of a major structural reform, for which many in the United Kingdom hope, but which does not seem to be on the table for now.

The United Kingdom intends to enact legislation implementing the OECD model rules for reporting by platform operators with respect to sellers in the sharing and gig economy. This will lead to interesting developments in the collection of information from platforms such as Uber, which appears to be one way forward, but currently will still result in tax being collected on the basis that the drivers are self-employed for tax purposes, regardless of their worker status under employment law. A reporting requirement is a compliance solution along the lines of Quebec’s Uber initiative,⁴² but it does not tackle the more fundamental underlying problems. Nevertheless, it is certainly worth examining if larger reforms are not possible. The United Kingdom’s cumulative deduction at source (PAYE) system was introduced as a result of administrative need, and a similar move to deduction at source from certain types of workers should be possible even if they are not employees for any other purpose, especially using digital tax collection, which would make record keeping and tracking easier.⁴³

39 Adam and Miller, *supra* note 16, at 37: “That is, the combined rate on employees is 22.7%; differences in benefits would only justify reducing this to around 22% for the self-employed—still more than double the current 9% rate.”

40 Freedman and Miller, *supra* note 15.

41 Mehreen Khan, “Hammond Scraps National Insurance Rise at Cost of £500m a Year,” *Financial Times*, March 15, 2017 (www.ft.com/content/bec1bd84-d485-3af2-822b-090cf7ddb72c).

42 See the article by Robert-Angers and Godbout in this Policy Forum, *supra* note 13.

43 Judith Freedman, “Tax Administration Shaping Tax Reform: Does Employment Status Matter for Tax?” *Tax Journal*, February 18, 2021.

There may be changes to the UK value-added tax (VAT), given that the government's 2020 call for evidence on VAT and the sharing economy⁴⁴ includes the possibility of legislative change, but no announcement has been made on this as yet. Again, technological solutions may assist where platforms are concerned, and potential problems can be turned to advantage.

CONCLUSIONS AND THE WAY FORWARD

Tax policy responses to the changing nature of work are not straightforward. The question of worker classification intersects many areas of law. Classification of different types of work into a set of categories intended to apply for many different purposes may look like a simplification but in fact is likely to make it harder to achieve our objectives in each area. Employment law needs to protect those who have unequal bargaining power in their work relationship. Characteristics that are relevant for that purpose may not be pertinent to the question of how much tax should be paid or to compliance needs. There is no necessary relationship between the employment relationship and the social security arrangements made by the state to protect those who need support at a particular point in their lives. Contributory insurance-style social security systems that may involve a mix of state and private provision also do not need to depend on the employment relationship.

This brief discussion of the problems currently being experienced in the United Kingdom echoes with many of the issues discussed in other articles in this Policy Forum, although the combination of UK social security changes, the sharp differences between the amounts of NICs paid in relation to the employed and the self-employed, and the complex measures taken to try to deal with this have resulted in a set of problems in the United Kingdom that may be harder to unravel than in most jurisdictions.

This was a major problem before COVID-19 struck. The pandemic highlighted further faults in our systems. Finding solutions is not easy, but recognition that we are not bound to classifications developed for other situations is important for making progress. Those concerned with tax and social security payments need to go back to first principles and focus on removal of differences that cause distortion and the creation of systems that support compliance. Employment lawyers will then be able to tackle the issues that they need to deal with without tax distortions further complicating their important task.

44 See HM Revenue & Customs, *supra* note 28.

Policy Forum: Future Workforce Models— Enabling the Shift

Guy Jason and Shivani Joshi*

PRÉCIS

Adopter le travail à distance, en tout ou en partie, permet aux employeurs d'offrir la flexibilité que de nombreux employés recherchent et de réaliser diverses économies de coûts. Au moment de s'engager dans cette voie, il est toutefois important que les entreprises examinent dès le départ beaucoup d'aspects touchant la fiscalité et la paie pour atténuer les risques liés à la non-conformité. Quels sont ces aspects liés à l'impôt sur les sociétés et à la paie? Une politique officielle peut-elle aider à atténuer les risques de non-conformité? Quels autres aspects faut-il prendre en compte outre l'impôt et la paie? La politique gouvernementale doit-elle soutenir ce changement? Cet article résume les divers aspects de l'élaboration d'une politique organisationnelle en matière de travail à distance et conclut que, comme c'est le cas pour toute autre stratégie d'entreprise, le travail à distance comporte des avantages, à condition de gérer efficacement la complexité et les coûts qui y sont associés.

ABSTRACT

Embracing remote work, either fully or partially, allows employers to offer the flexibility that many employees are seeking and also to benefit from various cost savings. As organizations embark on this journey, there are many tax and payroll considerations that should be reviewed up front so that risks relating to non-compliance can be mitigated. What are these corporate tax and payroll considerations? Can a formal policy help to mitigate compliance risks? What are other considerations besides tax and payroll? Should government policy support this workforce shift? This article summarizes the various considerations in developing an organizational remote work policy and concludes that, as is the case for any other business strategy, remote work arrangements have their benefits provided that the associated complexity and costs can be effectively managed.

KEYWORDS: PAYROLL ■ GLOBAL ■ RISK ■ TAXATION ■ POLICY ■ FLEXIBLE

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CONTENTS

Introduction	560
Organization Perspective	560
International Corporate Income Tax Considerations	561
Canadian Corporate Tax Concerns	565
International Payroll Tax Issues	567
Domestic Payroll Tax Issues	569
Non-Tax Considerations	569
Tax Authority Perspective	570
Conclusion	573

INTRODUCTION

The COVID-19 pandemic has provoked a shift in employers' mindsets, making remote working possible and even widely accepted. While the impact of remote working on employees' mental well-being and their interactions within the organization will continue to be debated, remote working is expected to remain an important workforce strategy alternative for the indefinite future. Embracing remote working now allows employers to offer the flexibility that many employees are seeking, and therefore both attract and retain talent, as well as potentially tap into a more diverse, global talent pool.

However, as an organization's leaders assess the merits of remote working and how it can contribute to organizational growth, besides the sociological and human considerations, there are critical tax, immigration, and other legal implications¹ that need to be understood and planned for. In this article, we consider some of the key income tax and payroll implications from an organization and tax authority perspective. Since a remote work policy could involve employees working beyond domestic borders, it is imperative that organizations develop a clear organizational policy, after carefully analyzing what roles and functions can be performed remotely and from what jurisdictions, to keep a manageable tax-risk profile. We provide general comments concerning the international tax implications, which may be subject to situational exceptions that lie beyond the scope of this Policy Forum.

ORGANIZATION PERSPECTIVE

While remote working may result in an employee no longer working in the physical workspace of the employer, by extension, an employee could be working remotely almost anywhere in the world. From a tax perspective, this raises the concern that

1 A detailed analysis of some of these implications would move away from the pertinent considerations, and hence we provide references to other publications for more in-depth analysis.

the benefactor of the employee's services could be in a jurisdiction other than the one where the employment services are being performed.

With remote working, unless an employer has an organizational policy that specifies the jurisdictions from which an employee can (or cannot) work and a process to obtain appropriate approvals, an employee has the discretion to make the choice of employment location. This can lead to an employer being exposed to the laws and regulations of other jurisdictions. When the pandemic hit and many organizations issued work-from-home directives, many employees realized that they could effectively perform their employment duties from any location, and they let personal preferences drive their decision on where to work. It was only after a few months had passed that employers realized that their employees could in fact be working from a jurisdiction disparate from their employment location.

From a tax perspective, an employer may establish a taxable presence in another jurisdiction as a result of the employment duties carried out by employees. Furthermore, the employer may be subject to payroll laws in the other jurisdiction, requiring the employer to comply with various payroll and social security regulations. It is important to note that even though having even one employee in a particular jurisdiction can trigger tax and payroll issues, where multiple employees choose a particular jurisdiction for remote working, there is an increased risk exposure. Moreover, such an arrangement may draw more attention from tax authorities, who could view it as an opportunity to collect additional revenues.

International Corporate Income Tax Considerations

In most countries, the taxation of non-residents follows a territorial pattern of taxation. For example, Canada's Income Tax Act² imposes tax obligations on non-resident corporations that carry on business in Canada.³ Whether a business is being carried on in Canada is generally a question of fact based on common-law factors connecting a business to a particular place. Typically, the threshold to be considered for "carrying on business in Canada" is quite low, and it may be met

2 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

3 Income earned by a non-resident from carrying on a business in Canada is taxable under paragraph 2(3)(b), and where such activities include services rendered in Canada for a fee, commission, or similar consideration, any payment made to the non-resident is subject to withholding of 15 percent pursuant to paragraph 153(1)(g) and regulation 105. Furthermore, IC75-6R2 states that "[a]lthough most tax treaties between Canada and other countries provide for some relief from Canadian tax, Canada normally does not relinquish its right to withhold pursuant to Regulation 105": *Information Circular* IC75-6R2, "Required Withholding from Amounts Paid to Non-Residents Providing Services in Canada," February 23, 2005, at paragraph 4.

where certain deeming provisions apply to the activities of a non-resident, such as activities performed by agents or employees.⁴ However, the tax treaty between Canada and the country of residence of the non-resident (if such a treaty exists) may override the domestic rules on the basis of a set of conditions whereby Canada gives up the right to tax non-residents who carry on business in Canada unless they do so through a permanent establishment (PE) in Canada.⁵ The long-established view of the Canada Revenue Agency (CRA) is that the determination of the existence of a PE is a question of fact.⁶ The CRA has further stated that article 5 of the model tax convention of the Organisation for Economic Co-operation and Development (OECD)⁷ provides the appropriate framework for the determination of whether a PE exists;⁸ specifically,

- there must be a place of business;
- the place of business must be fixed, such that a degree of permanence exists; and
- the non-resident must be carrying on its business wholly or partly through this fixed place of business.

4 Paragraph 253(b) of the Act provides in part:

For the purposes of this Act, where in a taxation year a person who is a non-resident person or a trust to which Part XII.2 applies . . .

(b) solicits orders or offers anything for sale in Canada through an agent or servant, whether the contract or transaction is to be completed inside or outside Canada or partly in and partly outside Canada, . . .

the person shall be deemed, in respect of the activity . . . , to have been carrying on business in Canada in the year.

5 In general, the rules contained in a tax treaty override those contained in federal tax legislation, but not necessarily tax legislation at the provincial level (in Canada) or the state level (in the United States).

6 *Income Tax Technical News* no. 33, September 16, 2005.

7 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, November 2017) (herein referred to as “the OECD model”).

8 CRA document no. 2019-0798751C6, May 15, 2019. In this document, the CRA provides the following examples of a PE:

Example 1: Generally, a service business is carried on where the services are provided because that is the profit-producing activity of the business. In this case, if the U.S. resident consultant has a service business and carries on this business in Canada from the shared workspace on a regular basis, the consultant will likely be considered to have a PE in Canada.

Example 2: Although the shared workspace is owned by another entity, the premises are a fixed location of the business of the U.S. resident corporation through which the business is carried on, and would be considered a PE.

For example, the Canada-US tax treaty⁹ determines “doing business in Canada” on the basis of whether the non-resident has a PE in Canada. The treaty defines the term “permanent establishment” in article V to include certain situations where an employee is working remotely in the other country. For example, under article V(5), a PE could be created by virtue of having an employee who habitually enters into contracts for, or on behalf of, the employer while remotely working in the other country.¹⁰ Furthermore, article V(9) states that a services PE may arise where an enterprise in one contracting state provides services in the other contracting state and

(a) those services are performed in [the other contracting state] by an individual who is present in that other State for a period or periods aggregating 183 days or more in any twelve-month period, and, during that period or periods, more than 50 percent of the gross active business revenues of the enterprise consists of income derived from the services performed in that other State by that individual; or

(b) the services are provided in that other State for an aggregate of 183 days or more in any twelve-month period with respect to the same or connected project for customers who are either residents of that other State or who maintain a permanent establishment in that other State and the services are provided in respect of that permanent establishment.

Where one or more employees of a Canadian company are working remotely from the United States for a period of at least 183 days in any 12-month period, a services PE of the Canadian company may be created in the United States if other conditions laid out in article V(9) of the treaty are met.¹¹ Where a services PE exists, the business profits attributable to the PE will be subject to tax in the United States and the Canadian company will be required to register and file tax returns in the United States (and potentially in certain states if nexus has been established). This could be true with respect to other countries with similar services PE clauses in their

9 The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007 (herein referred to as “the Canada-US treaty”).

10 Article V(5) of the Canada-US treaty provides:

(5) A person acting in a Contracting State on behalf of a resident of the other Contracting State—other than an agent of an independent status to whom paragraph 7 applies—shall be deemed to be a permanent establishment in the first-mentioned State if such person has, and habitually exercises in that State, an authority to conclude contracts in the name of the resident.

11 See Lorna Sinclair, “The Services PE Provision of the Canada-US Income Tax Treaty,” in *Report of Proceedings of the Sixty-First Tax Conference*, 2009 Conference Report (Toronto: Canadian Tax Foundation, 2010), 22:1-29.

tax treaties.¹² It should also be noted that the provincial/state tax rules for allocation of income can vary significantly by country.¹³

While reviewing remote work implications, it is important for an organization to determine whether any countries should be excluded as permissible locations for remote work. By identifying any country that may have strict corporate taxation rules, higher tax rates, or particularly aggressive tax authorities, the employer can perform a cost-benefit assessment before approving that jurisdiction as permissible for remote

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- 12 See, for example, article 5 of the Convention Between the Government of Canada and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, signed at London on September 8, 1978, as amended by the protocols signed on April 15, 1980, October 16, 1985, May 7, 2003, and July 21, 2014; and article 5 of the Convention Between Canada and France for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed at Paris on May 2, 1975, as amended by the protocols signed on January 16, 1987, November 30, 1995, and February 2, 2010. With respect to “similar clauses,” Sinclair, *supra* note 11, at 22:24-25, note 9, cites paragraph 42.23 of the commentary on article 5 of the 2008 version of the OECD model, which sets out the following alternative provision:

Notwithstanding the provisions of paragraphs 1, 2 and 3, where an enterprise of a Contracting State performs services in the other Contracting State

a) through an individual who is present in that other State for a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual, or

b) for a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for connected projects through one or more individuals who are present and performing such services in that other State

the activities carried on in that other State in performing these services shall be deemed to be carried on through a permanent establishment of the enterprise situated in that other State, unless these services are limited to those mentioned in paragraph 4 which, if performed through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph. For the purposes of this paragraph, services performed by an individual on behalf of one enterprise shall not be considered to be performed by another enterprise through that individual unless that other enterprise supervises, directs or controls the manner in which these services are performed by the individual.

Sinclair also cites paragraphs 42.11 through 42.48 of the commentary on article 5.

- 13 See Justin Heisler and Darlene Shaw, “Cross-Border Tax Issues with a Business Focus,” in *2017 Atlantic Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2017), 3:1-25, at 3:6: “An additional state tax complexity that often arises, and that is a stark contrast to the Canadian system, is the allocation of income between states. For Canadian tax purposes, income is allocated between provinces based on standardized factors, primarily average revenues and wages, although there are other industry-specific methodologies that can apply. In the U.S., each state has its own rules on how to determine the percentage of taxable income allocated to that state. This concept is referred to as ‘state allocation.’ Most states will typically allocate income based on sales or on an average of property, payroll and sales.”

work. This can help to mitigate unintentional non-compliance with corporate or payroll tax obligations and avoid unintended tax inefficiencies for the company.

Furthermore, an employer needs to consider the roles of employees who should be permitted to work remotely. Under Canadian tax rules, the residence of a corporation is determined on the basis of a case-law test (considering the location of the corporation's central management and control) and a statutory test that deems companies incorporated in Canada after April 26, 1965 to be resident in Canada.¹⁴ Under the central management and control test, a corporation is generally considered to be resident in the jurisdiction where its board of directors meets and exercises control over its affairs.

A reality of the digital age is that senior executives could be in any location while connecting via video or teleconference, making it extremely difficult, if not impossible, for tax authorities to ascertain the true location of the mind and management of a company. In a remote work scenario, where senior executives or directors of an organization work remotely from another country, this could lead to the “mind and management” shifting to another jurisdiction. Hence, it is important that while drafting any remote work policy, organizations pay special attention to permissible remote work locations for senior executives/directors.

Canadian Corporate Tax Concerns

Where employees remain in Canada and simply choose to work outside their regular province or territory of employment, the employer should consider the potential impact on provincial corporate taxes. Regulation 400(2) provides a definition of “permanent establishment” for the purposes of determining taxable income earned in the year in a province.

Under this definition, “permanent establishment” in respect of a corporation means “a fixed place of business of the corporation,” which includes, among other things, an office. In addition,

(a) where the corporation does not have any fixed place of business [“permanent establishment”] means the principal place in which the corporation's business is conducted;

(b) where a corporation carries on business through an employee or agent, established in a particular place, who has general authority to contract for his employer or principal or who has a stock of merchandise owned by his employer or principal from which he regularly fills orders which he receives, the corporation shall be deemed to have a permanent establishment in that place; . . .

(f) the fact that a corporation has business dealings through a commission agent, broker or other independent agent or maintains an office solely for the purchase of merchandise shall not of itself be held to mean that the corporation has a permanent establishment.¹⁵

14 Subsection 250(4).

15 Regulation 400(2).

The CRA has stated that where an employee works remotely in another province, an employee or agent can be deemed to operate a PE of a corporation only if the employee has a general authority to bind the employer and enter into contracts on behalf of the employer.¹⁶ Furthermore, the CRA has clarified that where a corporation rents an office and has an employee who conducts the “day-to-day business of the corporation” through that office, that office will be considered to be a “fixed place of business of the corporation.”¹⁷ Similarly, where an employee, perhaps a senior executive, has the authority to bind the employer, and is working remotely in a province other than his or her prior province of employment, the home office of the employee could be considered to be a PE of the employer.

The determination of whether a home office becomes a PE of the employer is important because the corporation’s taxable income for the year is generally allocated to the province on the basis of gross revenues for the year attributable to the PE in the province, as well as salaries and wages paid in the year to employees of the PE.¹⁸ However, corporate tax rates and exemption limits vary in each province, and employees who are working remotely may have an impact on this provincial allocation.¹⁹ This issue is equally relevant in an international context for countries such as the United States²⁰ and Switzerland from a state/canton perspective.

16 CRA document no. 2010-0378421I7, October 13, 2010. The CRA states that while no formal legal right to use a place is required for a permanent establishment to exist, in the case of a home office of an employee, a corporation would essentially have no ability to exercise control over the premises. Generally, a home office would be under the complete control of an employee and would probably not be objectively identified with the business of the corporation. In such circumstances, it is questionable whether the home office could be viewed as a “fixed place of business of the corporation.”

17 Ibid.

18 See regulation 402(3); and Taxation Act, CQLR c. I-3, r. 1, section 771R1.

19 For example, the small business corporate income tax rate is 2 percent in British Columbia and 3.2 percent in Ontario. The corporate income tax rate for companies other than small businesses is 16 percent in Nova Scotia and 10 percent in Ontario. See 2020 tax rates in Deloitte, “Corporate Income Tax Rates (%),” updated to January 31, 2020 (www2.deloitte.com/content/dam/Deloitte/ca/Documents/tax/ca-en-2016-2020-corporate-income-tax-rates-aoda.pdf).

20 Most US states have rules regarding the potential income tax nexus impact of remote worker activities. For example, in the context of the exceptional circumstances resulting from COVID-19, Pennsylvania’s Department of Revenue has issued guidance providing that employees working from home during the pandemic should not, by themselves, create a taxable nexus for the purposes of the corporate net income taxes imposed. See United States, Pennsylvania Department of Revenue, “Will an Employee Working from Home Temporarily Due to the COVID-19 Pandemic Create Nexus for PA Corporate Net Income Tax (CNIT) Purposes for a Business That Otherwise Does Not Have Nexus with PA?” April 3, 2020 (https://revenue-pa.custhelp.com/app/answers/detail/a_id/3738/~will-an-employee-working-from-home-temporarily-due-to-the-covid-19-pandemic).

Establishing a PE in multiple provinces may not be a bad thing, particularly if a PE is established in a province with a lower corporate income tax rate.²¹ Moreover, beyond the provincial corporate income taxes, consideration should be given to the impact on the employer's level of provincial payroll taxes²² and eligibility for provincial tax credits and incentives.²³ Under the right circumstances, establishing a PE in a particular province (even if there is no corporate office) may have a positive overall tax impact on the organization.

Hence, even where employees are permitted to work remotely within the country, there should be an established process to assess the overall impact from a corporate tax perspective. Even where the tax impact is not significant, consideration should be given to potential additional provincial registration and compliance obligations, whether they be related to corporate tax, sales tax, or payroll.

International Payroll Tax Issues

Most countries have PAYE (pay as you earn)²⁴ or withholding regimes whereby an employer paying salaries or other remuneration to an employee is required to withhold and remit income and payroll taxes (such as social security, health insurance, workplace safety premiums, and employment insurance) where applicable. These requirements could be applicable regardless of the residence of the employee or the employer. In Canada, for example, a foreign employer with employees working in Canada has the same payroll reporting and withholding obligations as a Canadian-resident employer.²⁵

Where an employee works remotely from a jurisdiction other than his or her home country, the employer needs to ensure that it understands and complies with the payroll obligations in that jurisdiction; otherwise, it risks being exposed

21 See *supra* note 19.

22 For example, in Quebec, the employer contribution rate to the health services fund is 4.26 percent in 2021; see Revenu Québec, *Formulas To Calculate Source Deductions and Contributions* (Quebec: Revenu Québec, 2021) (www.revenuquebec.ca/documents/en/formulaires/tp/TP-1015.F-V%282021-01%29.pdf). In Ontario, employers are subject to an employer health tax contribution of 1.95 percent in 2021, subject to exemption limits; see Ontario, Ministry of Finance, “Employer Health Tax” (www.fin.gov.on.ca/en/tax/eh/index.html).

23 For example, most Canadian provinces offer various research and development (R & D) tax credit programs that supplement federal incentives. Rates range from 3.5 percent in Ontario to 30 percent in Quebec. See Martin Vezina, “Survey of Global Investment and Innovation Incentives, Canada” (Deloitte, 2020) (www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-survey-of-global-investment-and-innovation-incentives-canada-2020.pdf).

24 See Celeste M. Black, “The Future of Work: The Gig Economy and Pressures on the Tax System” (2020) 68:1 *Canadian Tax Journal* 69-97, at 81: “Many jurisdictions employ a collection mechanism like the one used in Australia and Canada, whereby employers are obliged to withhold income tax from the pay of their employees and forward this tax to the revenue authority in advance of assessment.”

25 Paragraph 153(1)(a) and regulation 102.

to liability and potential penalties in that other location. For example, a UK citizen who is employed by a Dutch branch office in the United Arab Emirates and working remotely in Croatia may not expose the employer to any additional employer income tax or social security obligations, whereas an employee of a Canadian company working remotely from California will subject the Canadian employer to additional US payroll withholding and reporting obligations.²⁶

Furthermore, where the employer accommodates an employee's request to work remotely, unintended cash flow issues for the employee may result if the employee is subject to tax withholdings in the traditional country of employment but is ultimately subject to tax in the country in which the services are performed and/or where the employee is tax-resident.

It is also important to consider the impact on reporting and compliance with respect to any deferred compensation and retirement plans. Most tax-preferred plans have strict requirements regarding employee eligibility, and there could be adverse tax consequences as a result of non-compliance—for example, where an employee fails to inform the employer of a change in tax residence while on a remote working arrangement. This could affect the plan since the plan administrator may not be aware of the change in the circumstances of contributing employees, and this could lead to incorrect disclosures or filings with tax authorities.

Hence, as part of any remote work policy, the employer should ensure that it has a clear understanding of its payroll obligations in the remote work location, including how those obligations may interact with payroll requirements in the employee's primary location of employment.²⁷ An employer should therefore

- review any employer payroll registration, withholding, remitting, and reporting obligations in the remote work country;
- assess the impact on home-country payroll requirements (and consider whether a waiver or letter of authority may be obtained to reduce any ongoing home-country withholding requirements);²⁸

26 In addition to US federal, state, and local income taxes, US social security contributions under US Federal Insurance Contributions Act ("FICA") should be considered. This legislation has territorial application: in the absence of a certificate of coverage or any other exemption, an employee may be subject to US FICA contributions in addition to income taxes.

27 See D. Brett Anderson and Matthew R. Kraemer, "Mobility and Executive Compensation," in *Report of Proceedings of the Seventieth Tax Conference*, 2018 Conference Report (Toronto: Canadian Tax Foundation, 2019), 12:1-41, at 12:35: "The taxation of mobile-employment income is not an area where 'aggressive' tax planning (or even 'non-aggressive' tax planning) is widely used to lower the aggregate tax burden. Instead it is an area fraught with traps for the unwary. Avoiding those traps can involve addressing difficult interpretive issues, complying with often duplicate reporting and withholding obligations in multiple countries (and jurisdictions within each country), and in many cases the potential for double taxation."

28 For example, where a Canadian company has employees who are residents of Canada but work remotely from Florida in the winter months, and the company is subject to US payroll obligations, the employees could seek a reduction in source deductions for Canadian income tax, by filing CRA form T1213, "Request To Reduce Tax Deductions at Source."

- ensure that the payroll system is set up to manage any tax remittances in both countries;
- assess the impact on employer-level payroll taxes, such as employment insurance, workplace safety insurance, and contributions to a health-care services fund; and
- maintain an effective system to track employee presence and workdays to avoid an inadvertent failure to comply with employer obligations.

Domestic Payroll Tax Issues

If an employee reports to work at an establishment of the employer in a particular province or territory, the rate of withholding on employee remuneration is based on the applicable rate for that province or territory. However, if the employee relocates while working remotely and is not required to report for work at the employer's establishment, the employer obligation shifts to income tax withholding based on the province in which the employer's establishment is located and from which the employee's salary is paid.²⁹

For example, if an employee is hired in Toronto but relocates to work remotely from Vancouver, the employer will need to assess whether the relocation affects the rate of withholding to be applied on remuneration paid to the employee (from Ontario to British Columbia) as well as other payroll tax implications to the employer (such as the applicability of Ontario employer health tax versus BC employer health tax). As noted previously, this may be advantageous to the employer, especially where employees are working remotely from provinces with lower (or potentially no) employer-level payroll tax regimes.³⁰

Non-Tax Considerations

Besides tax and payroll, there are multiple other issues that should be considered with respect to remote work, including immigration, employment law, and data privacy. The potential impact on employee benefits and compensation should also be considered since geographical location often has a significant bearing on how compensation ranges are determined for specific job types. The impact on compensation could also be different where remote work is adopted to accommodate an employee's personal request rather than being initiated by the employer for business reasons.

For example, where an employer *requires* an employee to work remotely (perhaps owing to workspace constraints at the primary office location), the employee may expect an increase in compensation to offset additional expenses that he or she will incur in order to be able to work effectively from the remote location. In contrast, where remote work is offered to an employee as a perquisite, to meet his or her desire for increased flexibility, additional compensation may not be warranted.

29 CRA T4001, "Employers' Guide: Payroll Deductions and Remittances."

30 See *supra* note 22.

Thus, an organization's remote work policy should be aligned with its overall human resources policy, considering the potential impacts on compensation by changes in location, merit increases, overtime pay, etc. There are many stakeholders in an organization who need to work together for an organization to come up with an efficient remote work policy.

During the pandemic, many employees started working remotely, either by choice or out of necessity owing to travel restrictions. In consideration of the OECD's guidance on the topic,³¹ many countries announced measures designed to provide temporary relief with respect to certain international tax issues that arose as a result of the exceptional and temporary circumstances brought about by the pandemic.³² Each country's measures varied in terms of their scope and the coverage period of the relief.³³ Since such relief was provided on a temporary basis only, the specific programs and policies introduced are not discussed in this article.

TAX AUTHORITY PERSPECTIVE

From a policy perspective, there are a variety of economic considerations related to remote work—for example, increasing workforce productivity, reducing geographical inequality, and contributing to lower carbon emissions.³⁴ From a tax perspective, the goal of any taxation system is to raise revenue fairly and efficiently without imposing undue compliance costs and administrative burdens on taxpayers and tax authorities. Compliance costs include the costs relating to various information and tax filings, but also include the time and effort spent to acquire the knowledge and information necessary to complete those filings, which may also involve the need for professional tax advice.

In recent times, various efforts have been made to address the international taxation issues arising as a result of the digitalization of the world economy. Resolving these issues is currently the top priority for the OECD and Group of Twenty

31 Organisation for Economic Co-operation and Development, "OECD Policy Responses to Coronavirus (COVID-19): Guidance on Tax Treaties and the Impact of the COVID-19 Pandemic," January 21, 2021.

32 In Canada, for example, the CRA released guidance in May 2020: Canada Revenue Agency, "CRA and COVID-19: International Income Tax Issues" (www.canada.ca/en/revenue-agency/campaigns/covid-19-update/guidance-international-income-tax-issues.html). In the United States, the Internal Revenue Service announced relief through Rev. procs. 2020-20, 2020-20 IRB 801 and 2020-27, 2020-20 IRB 803 dated April 21, 2020.

33 For tax relief announced by the CRA relating to foreign workers in Canada, see Chantal Baril, "Covid-19 and Travel Restrictions: Impacts on Foreign Workers and Their Employers from a Canadian Tax Perspective" (2020) 28:2 *Taxation of Executive Compensation and Retirement Journal* 1-8.

34 See Matthew Clancy, *The Case for Remote Work*, Economics Working Paper no. 20007 (Ames, IA: Iowa State University, Department of Economics, April 2020) (https://lib.dr.iastate.edu/econ_workingpapers/102).

inclusive framework and has been a key area of focus of the base erosion and profit shifting (BEPS) project since its inception.³⁵ As the OECD has noted,

[a]t the centre of the debate is whether international income tax rules, developed in a “brick-and-mortar” economic environment more than a century ago, remain fit for purpose in the modern global economy. The fundamental elements of the global tax system which determined where taxes should be paid (“nexus” rules based on physical presence) and what portion of profits should be taxed (“profit allocation” rules based on the arm’s length principle), have served their purpose well. Namely, they have enshrined tax certainty and helped to eliminate double taxation stimulating global trade.

Today, however, three important phenomena facilitated by digitalisation—scale without mass, reliance on intangible assets, and the centrality of data—pose serious challenges to elements of the foundations of the global tax system.³⁶

While international tax treaties generally grant the taxing rights to the country in which the employee is physically present while discharging his or her duties, subject to certain *de minimis* thresholds,³⁷ with the advent of remote work, the value from those services could easily be enjoyed in another jurisdiction. For example, where a Canadian-headquartered company hires a senior executive who is allowed to work remotely from the United States (and is a non-resident of Canada), even though the benefactor of the services is the Canadian company, the personal employment income of the senior executive may not be subject to tax in Canada if there are no Canadian workdays. Furthermore, US tax authorities are likely to contend that the Canadian company has a taxable presence in the United States and therefore should be subject to US corporate tax. With ongoing technological advancements, while remote work may become easier, it will likely become more challenging for organizations and tax authorities to agree on the application of tax rules in an international setting. This problem is further exacerbated where tax authorities adopt or increasingly adhere to the strict enforcement of jurisdictional tax laws³⁸ to maximize their revenue.

It is with respect to this complexity that Canada has an opportunity to make important policy choices. As one writer has observed,

35 See Organisation for Economic Co-operation and Development, “Action 1, Tax Challenges Arising from Digitalisation” (www.oecd.org/tax/beps/beps-actions/action1).

36 Ibid., under the heading “What Is the Issue?”

37 For example, article XV(2)(a) of the Canada-US treaty considers income from dependent personal services not to be taxable in the other state where such remuneration does not exceed \$10,000 in the currency of that other state.

38 For example, if a US citizen employed in New York by a US company works remotely from Canada for a few months to take care of ailing parent, the New York “convenience of employer” rules require the employee to be subject to New York state taxation on employment income attributable to services rendered in Canada.

[t]ax policy makers must also consider the new employment patterns set during the pandemic. Trends already under way were accelerated by the crisis. For example, many businesses were able to mitigate the pandemic's economic impact by expanding their reliance on existing technologies that enable employees to work remotely. As the digitalization of the economy expands, flexible work arrangements and reduced commuting times are likely to continue, now that the model has been thoroughly tested. At the same time, any effort to achieve consensus on the tax policy front must take into account the dramatically different experiences of front-line workers, who do not have the option of remote work.³⁹

Other writers warn that in this digital age, if close to 50 percent of the workforce will soon be leaving traditional employment jobs, the sustainability of the income tax as an instrument of generating revenue in a fair and equitable manner will be threatened.⁴⁰ For example, the stringent regulation 102 compliance requirements placed on non-resident employers, in terms of both registration and payroll remittance/filing obligations in Canada, may make Canada unattractive as a location for remote workers.⁴¹ From a Canadian context, this could mean that Canadian revenue authorities will face issues such as the following:

- Loss of income tax revenue where a remote worker's employment income goes unreported. A non-resident employer may not register, withhold, and remit in Canada; or, alternatively, the employer may choose to disguise the employee's status by claiming that he or she is an independent contractor. Organizations that contract labour from self-employed workers will generally face lower payroll tax burdens on a per-worker basis.⁴²

39 Heather Evans, "Tax Policy Post-Pandemic: A Unique Opportunity" (2020) 1:3 *Perspectives on Tax Law & Policy* 1-3, at 3.

40 Jinyan Li, Arjin Choi, and Cameron Smith, "Automation and Workers: Re-Imagining the Income Tax for the Digital Age" (2020) 68:1 *Canadian Tax Journal* 99-124.

41 See Fatima Laher, "Moving Employees Cross-Border: The Business Challenges of Having a Mobile Workforce," in *Report of Proceedings of the Sixty-Ninth Tax Conference*, 2017 Conference Report (Toronto: Canadian Tax Foundation, 2018), 24:1-24, at 24:15: "There is an exception to the withholding obligation and to some reporting obligations for certain non-resident employers that are paying employment income to non-resident employees for performing the duties of an office or employment in Canada after 2015. Employer certification allows 'qualifying non-resident employers' to be relieved of Canadian tax withholding and certain reporting requirements for payments to 'qualifying non-resident employees.' The legislation allows the minister of national revenue to certify an employer if the employer has applied in prescribed form and the minister is satisfied that the employer is resident in a treaty country and meets the established conditions." Laher also notes, *ibid.*, at 24:17, "Regulation 102-R waiver is another option for employers seeking relief from withholding on Canadian remuneration paid to a non-resident employee who is tax-treaty-exempt."

42 In countries where this tax treatment differential is large (for example, in the Netherlands and the United Kingdom), the tax rules may drive increased use of self-employed workers.

- Loss of income tax revenue from workers who work for a Canadian employer but decide to work remotely and cease residence ties with Canada in order to avoid the (generally) higher tax rates applied at the upper tax brackets.⁴³
- Failure to attract the right talent necessary for innovation-infused economic growth in Canada.⁴⁴

These factors point to the need for Canadian tax authorities to develop a tax policy based on an international context,⁴⁵ so that as organizations review their workforce strategies, including remote work, Canada becomes an attractive option for hiring and maintaining an employee workforce. Therefore, any policy decisions relating to remote work should consider simplifying the employer compliance burden with respect to remote workers in Canada, thereby increasing the effectiveness of the tax administration system in collecting appropriate revenues.

CONCLUSION

While remote work is bound to gain more acceptability as businesses seek to capitalize on the benefits offered from this workforce strategy, it is imperative that the relevant tax and payroll risks are identified and appropriate steps taken to mitigate exposures. Organizations should develop a comprehensive remote work policy framework that clearly lays out the employment activities that are permissible to be performed remotely and from which locations. For example, an employee with contractual authority to bind the employer will likely increase the corporate risk exposure, compared to an employee providing bookkeeping services. Similarly, any jurisdiction that may have a high risk owing to stringent corporate tax rules or the absence of a tax treaty should be identified as a location from which remote work is

43 It is pertinent to note that Canada's net personal average tax rate is actually below the OECD average computed across OECD countries at lower income brackets. See Organisation for Economic Co-operation and Development, *Taxing Wages 2021* (Paris: OECD: 2021) (<https://doi.org/10.1787/83a87978-en>).

44 Aspects of Canada's current tax system impede the stated growth objectives. The particular impediments to Canadian innovation are (1) Canada's uncompetitive personal income tax rates; (2) its international tax regime, which favours offshore rather than domestic innovation; and (3) a lack of adequate incentives for capital investment in world-class R & D activities in Canada. Siobhan Goguen, "Canada's Post-Pandemic Tax Policy: Encouraging Growth Through Innovation in Canada" (2020) 1:3 *Perspectives on Tax Law & Policy* 10-12.

45 See the Organisation for Economic Co-operation and Development, *Productivity Gains from Teleworking in the Post COVID-19 Era: How Can Public Policies Make It Happen?* (Paris: OECD, September 2020), suggesting that to maximize the gains for productivity and welfare inherent in the use of more widespread telework, governments should promote investments in the physical and managerial capacity of firms and workers to telework, and address potential concerns for worker well-being and longer-term innovation related in particular to the excessive downscaling of workspaces. Also see table 1 in this document for the role of policies and institutions in making telework more productive.

not permissible, unless appropriate measures are first taken. It would be an uphill challenge to do this for every location from which an organization's employees may wish to work remotely, but an employer could reasonably identify and assess certain locations of interest. The policy should specifically prohibit working remotely from countries that have not been cleared by the employer. While this may create an additional administrative burden and increase compliance costs, other benefits such as access to a larger talent pool, savings in real estate costs, and meeting employees' needs for flexibility could outweigh the costs. Just like any other business strategy, remote work has its benefits provided that the associated complexity and costs can be effectively managed.

FINANCES OF THE NATION

NET INCOME TAX RATES AND THE CHANGING PROGRESSIVITY OF THE CASH TAX/TRANSFER SYSTEM

Tahsin Mehdi and Brian Murphy*

For almost 60 years, the Canadian Tax Foundation published an annual monograph, Finances of the Nation, and its predecessor, The National Finances. In a change of format, the 2014 Canadian Tax Journal introduced a new “Finances of the Nation” feature, which presents annual surveys of provincial and territorial budgets and topical articles on taxation and public expenditures in Canada.

The underlying data for the Finances of the Nation monographs and for the articles in this journal will be published online in the near future.

In this article, using new data released in 2019, Tahsin Mehdi and Brian Murphy examine changes in the progressivity of the federal and provincial income tax system, in conjunction with changes in the progressivity of federal and provincial cash transfers since 1992, by examining effective tax rates. Many of the major components of the system of income taxes and cash transfers have become somewhat more progressive collectively over time. This has resulted in an improved net tax position for lower-income taxfilers as well as the top third of taxfilers. On the other hand, taxfilers in the middle quintile have experienced a drop in their net tax position since 1992.

KEYWORDS: TAX RATES ■ GOVERNMENT TRANSFERS ■ REDISTRIBUTION ■ INEQUALITY

CONTENTS

Introduction	576
Tax Rates	577
Transfer Rates	580
Net Tax Rates	583
Conclusion	589
Appendix	591

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INTRODUCTION

Recent changes to the federal tax system combined with a growing interest in the taxation of the top 1 percent once again bring into question the progressivity of the tax system.¹ Studies have noted that new top brackets introduced federally and provincially have had only minor impacts on tax revenue and redistribution.²

One way to study tax progressivity is to focus on the evolution of nominal and marginal tax rates in federal and provincial/territorial tax systems. However, nominal tax rates and top-end marginal tax rates do not provide a full picture of the impacts on households, owing to the wide number of tax rules and the differing financial situations of Canadian taxpayers. An alternative measure is the average effective tax rates experienced by Canadian taxpayers.

Progressivity from a household point of view has two sides: contributing taxes and receiving transfers. However, taxpayers can both pay taxes and receive government cash transfers or refundable tax credits. Kenworthy argues that while the progressivity of the tax system matters to some extent, what matters most for transfer progressivity is the quantity of tax revenues rather than the progressivity of the tax mix.³

The literature tends to look at the tax and transfer system through two lenses, taxes and transfers, but in this article, we consider the interaction of the two systems. There are individuals who receive a large share of their income from government and pay less tax than others. Seldom do we measure tax burden in a way that accounts for income transferred to individuals by the government. In this article, we first look at effective tax rates and effective transfer rates individually. But we then examine the combination of these two rates using net tax rates for the large cash transfers and income/payroll taxes, which are the most progressive elements of the tax/transfer system. Most taxpayers pay taxes and also receive cash transfers. Their net tax rate is calculated as their tax paid less their cash transfers received divided by their total income. If their net tax rate is negative, their transfers exceeded their taxes; if their net tax rate is positive, their taxes exceeded their transfers. Consequently, an improved net tax position means that, after taking both taxes and transfers into account, individual filers either received a greater share of their income from the government or paid a smaller share of their income to the government.

1 While there is a progressive income tax in Canada, progressivity, or vertical equity, is but one of the goals of the tax system, which include horizontal equity, neutrality, revenue generation, and efficiency. See, for example, Brian Murphy, Mike Veall, and Michael Wolfson, "Top-End Progressivity and Federal Tax Preferences in Canada: Estimates from Personal Income Tax Data" (2015) 63:3 *Canadian Tax Journal* 661-88.

2 See, for example, Michael Smart, "Taxation of Top Incomes in Canada—Recent Developments in Rates and Redistribution," *Finances of the Nation* feature (2019) 67:2 *Canadian Tax Journal* 349-61.

3 Lane Kenworthy, *Progress for the Poor* (New York: Oxford University Press, 2011), at chapter 8.

Data used in this article are derived from Statistics Canada's Longitudinal Administrative Databank, which is a 20 percent sample of taxfilers from the T1 Family File. Since 2018, Statistics Canada has been releasing table 11-10-0054-01 and table 11-10-0058-01 containing statistics on effective tax rates of individuals and families.⁴ The tables provide annual data dating back to 1992. Effective tax rates are distributional measures of tax burden calculated as the average of each household's ratio of taxes to income within a given population.

TAX RATES

The tax and transfer system plays an important role in reducing income inequality.⁵ Throughout the 1980s and 1990s, studies documented rising market income inequality in Canada.⁶ A slight decline in after-tax income inequality was observed in the 1980s, suggesting that the tax and transfer system played an offsetting role. But a substantial rise in after-tax income inequality during the 1990s indicated that while taxes and transfers reduced overall inequality levels, they did not quite reverse the underlying trends.⁷ The 1990s was a decade marked by major changes in the tax and transfer system. Specifically, the employment insurance (EI) program was overhauled, reforms to social assistance programs were made, and the Canada child benefit (CCB) system was expanded.

In this section, we look at Canada's income tax/payroll system, which is predominantly characterized by three major types of taxes: federal income taxes, provincial income taxes, and federal payroll taxes. The federal payroll taxes comprise employees' payroll contributions to the EI and Canada Pension Plan/Quebec Pension Plan (CPP/QPP) programs as well as self-employed contributions to the CPP/QPP.⁸

4 Statistics Canada table 11-10-0054-01, "Federal and Provincial Individual Effective Tax Rates," and table 11-10-0058-01, "Federal and Provincial Effective Tax Rates of Census Families."

5 See, for example, Andrew Heisz and Brian Murphy, "The Role of Taxes and Transfers in Reducing Income Inequality," in David A. Green, W. Craig Riddell, and France St-Hilaire, eds., *Income Inequality: The Canadian Story*, vol. 5 (Montreal: Institute for Research on Public Policy, 2015), 435-77 (<https://on-irpp.org/2neR7rL>).

6 See, for example, Marc Frenette, David A. Green, and Kevin Milligan, "The Tale of the Tails: Canadian Income Inequality in the 1980s and 1990s" (2007) 40:3 *Canadian Journal of Economics* 734-64 (<https://doi.org/10.1111/j.1365-2966.2007.00429.x>).

7 See, for example, Marc Frenette, David A. Green, and Kevin Milligan, "Taxes, Transfers, and Canadian Income Inequality" (2009) 35:4 *Canadian Public Policy* 389-411 (<https://doi.org/10.3138/cpp.35.4.389>).

8 Payroll taxes have been included in this analysis for a few reasons. First, CPP/QPP and EI contributions are close to 20 percent of aggregate taxes paid by households and, importantly, are the main source of taxes and increases in taxes for lower-income workers (given that the analysis excludes commodity taxes and property taxes). While some may consider CPP/QPP contributions to be more like insurance premiums, in this context the contributions are not voluntary and must be paid by persons with earnings. In addition, the CPP/QPP benefits paid do not all come from the CPP/QPP fund but rather are financed from general government revenues.

In 2017, Canadians paid more than \$265 billion in federal and provincial income taxes and federal payroll taxes (see appendix table 1). In aggregate, these taxes represented just under a fifth of total household income. However, owing to the progressivity of the tax system, on average, Canadian taxfilers spent 11.7 percent of their income on such taxes.⁹ About 5.4 percent was spent on federal income taxes, which represents the largest component of the tax system; 3.6 percent was spent on provincial income taxes; and 2.7 percent was spent on federal payroll taxes. Figure 1 shows the evolution of effective tax rates for the three major types of taxes since 1992.

Overall, effective tax rates are down from 1992 levels. The overall rate rose through the mid-1990s largely owing to increased federal surtaxes, peaking in 1997 at 13.8 percent and then declining for 12 years to a low of 11.3 percent in 2009. It subsequently increased to 11.7 percent in 2017.

While the federal tax system had three nominal tax brackets throughout the 1990s, a fourth bracket was introduced in 2001, and more recently a fifth bracket was added in 2016. While these changes increased tax rates on high-income taxfilers, the overall effective tax rate dropped in the years following the addition of the new brackets, owing to reductions in the nominal rates for some of the lower brackets in 2001 and 2016.

The provincial effective tax rate trend is mostly characterized by surtax reductions in the latter part of the 1990s. Some provinces raised their higher income brackets while others lowered them. The federal payroll effective tax rate captures the EI program and the CPP/QPP. The federal payroll rate was rising until around 2003. The rise was largely driven by increasing CPP/QPP rates at the time. Generally, the overall effective tax rate has decreased since the 1990s. It hit its lowest point (11.3 percent) in the last 25 years during 2009, when incomes declined as a result of the worldwide recession. Since then, effective tax rates have been gradually rising.

Effective tax rates vary considerably across the income distribution. While, on average, the overall effective tax rate was 11.7 percent, the top 1 percent paid an effective rate of 31.0 percent. Not only do effective tax rates vary across the income distribution, but there is also significant variation within income groups, as illustrated in figure 2. Figure 2 shows the interquartile effective tax rate ranges in 2017; specifically, it shows the broad ranges of rates across the distribution and highlights the fact that taxfilers with similar incomes pay different effective tax rates depending on their individual mix of income sources (since tax rates are not uniform across

9 In this article, income refers to before-tax income (employment income, investment and pension income, government transfers, and other income such as scholarships, retiring allowances, and alimony) plus capital gains and registered retirement savings plan withdrawals made by taxfilers under 65 years of age, less social benefits repayments. Further adjustments to allocate elected split-pension amounts to the spouse claiming the amount are also made. For details, see Nell Hamalainen and Tahsin Mehdi, *Effective Income Tax and Transfer Rates: Technical Reference Note*, Income Research Paper series catalogue no. 75F0002M (Ottawa: Statistics Canada, April 16, 2019).

Source: Statistics Canada table 11-10-0054-01, “Federal and Provincial Individual Effective Tax Rates.”

income sources) and the applicable provisions of the federal Income Tax Act.¹⁰ For instance, dividends and capital gains are taxed at lower rates, while not all filers are entitled to all deductions and tax credits. Although, on average, the top 1 percent of taxfilers paid an effective rate of 31.0 percent in 2017, 5 percent of them paid an effective rate below 6.0 percent while 5 percent paid a rate above 45.7 percent.

Figure 3 shows the percentage of taxfilers across the income distribution who paid federal and provincial income taxes and federal payroll taxes in 1992 and 2017. As would be expected, the proportion of taxpayers varies across the income distribution. On average, 79.5 percent of Canadian taxfilers paid some type of income/payroll tax in 2017. Among the one-fifth of those who did not pay income/payroll taxes, the majority were in the bottom 50 percent of the income distribution. In fact, while the share of income for the top 10 percent increased from 31.7 percent in 1992 to 35.3 percent in 2017, the share of income/payroll taxes paid by the top 10 percent increased from 43.3 percent in 1992 to nearly 50 percent (49.6 percent) in 2017. The top 1 percent increased their share of income from 8.8 percent in 1992 to 11.3 percent in 2017, while their share of income/payroll taxes increased from 13.1 percent in 1992 to 18.6 percent in 2017. Note that figure 3 includes federal and provincial income taxes as well as federal payroll taxes. If we consider the two largest components of the income tax system—namely, federal and provincial

10 Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended.

FIGURE 2 Interquartile Ranges of Effective Federal and Provincial Income Tax and Federal Payroll Tax Rates by Income Vingtile, 2017

Source: Statistics Canada table 11-10-0054-01, “Federal and Provincial Individual Effective Tax Rates.”

income taxes—the fraction of taxpayers is lower, particularly in the bottom half of the income distribution. Around 60.2 percent of taxfilers in the bottom half of the income distribution did not pay any federal or provincial income taxes, up from 56.7 percent in 1992. From 1992 to 2017, on average, around 30 percent of all filers did not pay any federal or provincial income taxes. When federal payroll taxes are included, the number drops to around 20 percent.

TRANSFER RATES

The transfer system plays a major role in income redistribution and is one of the mechanisms for mitigating income inequality. Canada’s transfer system consists of programs offered by the federal government, which account for the bulk of transfers, and those offered by the provincial/territorial governments. Figure 4 shows the evolution of effective transfer rates from 1992 to 2017.¹¹ On average, the effective transfer rate has remained, for the most part, between 25 percent and 30 percent during this period, with a maximum level of 29.5 percent observed in 1993, and a minimum of 24.9 percent occurring in 2007.

11 Effective transfer rates are calculated as the average of the ratios of transfers to incomes within a given population.

FIGURE 3 Percentage of Taxfilers Paying Federal and Provincial Income and Federal Payroll Taxes by Income Vintile, 1992 and 2017

Source: Statistics Canada table 11-10-0054-01, "Federal and Provincial Individual Effective Tax Rates."

What about the size of the individual transfer programs? In 2017, Canadians received more than \$178 billion in federal and provincial government transfer payments. Figure 5 shows the size of the major transfer programs in terms of aggregate trends (in 2017 constant Canadian dollars, using all-items consumer price index data from Statistics Canada, table 18-10-0005-01).¹² Aggregate CPP/QPP and old age security (OAS) transfers have more than doubled since 1992, partly owing to an aging population. CPP/QPP rose steadily from around \$23 billion in 1992 to more than \$52 billion in 2017. OAS increased from around \$18 billion in 1992 to nearly \$37 billion in 2017. An expanded CCB, which replaced the universal child-care benefit and the Canada child tax benefit in 2016, increased from around \$7 billion in 1992 to more than \$23 billion in 2017. Appendix table 1 enumerates the aggregate amount of income, taxes, and transfers.

On average, 70 percent of taxfilers received some sort of government cash transfer in 2017, whether from the federal or the provincial governments, or both. In

12 Statistics Canada table 18-10-0005-01 (formerly CANSIM table 326-0021), "Consumer Price Index, Annual Average, Not Seasonally Adjusted."

FIGURE 4 Effective Transfer Rates by Source of Transfer, 1992-2017

Source: Statistics Canada table 11-10-0054-01, “Federal and Provincial Individual Effective Tax Rates.”

1992, over three-quarters (75.7 percent) of taxfilers received government transfers. The percentage of taxfilers who received federal government transfers decreased from 73.7 percent in 1992 to 66.1 percent in 2017. There are comparatively fewer provincial transfer recipients, but the proportion of filers who received provincial transfers increased from 25.5 percent in 1992 to 45.8 percent in 2017. Figure 6 charts the trends among government transfer recipients across the income distribution in 2017. The vast majority of taxfilers in the bottom half of the distribution received some form of government transfer. The proportion of transfer recipients tends to peak at the sixth vingtile before tapering off.

Because most cash transfer programs incorporate some kind of means testing, the amount of transfers depends on the socioeconomic position of recipients in the income distribution. Figure 7 shows the composition of aggregate transfer income by source and income vingtile, to measure the relative size of the various transfer programs. It can be seen that the share of CPP/QPP income has expanded across the income spectrum since 1992. As would be expected, social assistance is more prevalent along the lower tail of the income distribution. EI’s share of transfers decreased from 25.1 percent in 1992 to 10.6 percent in 2017. CPP/QPP accounted for 29.6 percent of transfers in 2017, up from 21.4 percent in 1992.

Canadians received an average of \$6,457 in transfer payments in 2017, a slight increase from \$5,646 in 1992. They paid, on average, \$9,834 in income/payroll taxes in 2017, slightly up from \$8,592 in 1992. Of course, average taxes paid or transfers received vary significantly across the income distribution, as illustrated by figure 8. The vast majority of taxfilers (making less than \$56,200 annually) paid less than \$10,000 in income/payroll taxes in 1992 and 2017. The top 1 percent of Canadians

FIGURE 5 Aggregate Transfer Income by Benefit Program, 1992-2017

CCB = Canada child benefit; CPP/QPP = Canada Pension Plan/Quebec Pension Plan; EI = employment insurance; OAS = old age security.

Source: Statistics Canada, Longitudinal Administrative Databank, 1992-2017.

paid, on average, \$183,019 in income/payroll taxes in 2017, a 53 percent increase since 1992.

Up to this point, we have discussed taxes and transfers, but we have focused on the two systems separately. There are individuals who receive a large share of their income from government and pay less tax than others. In the next section, we calculate tax burden in a way that accounts for income transferred to individuals by the government.

NET TAX RATES

Net tax rates in this article are income/payroll taxes less government cash transfers as a percentage of total income. They provide a measure of tax burden by netting out the effect of transfer incomes that people receive from the government.

In 2017, the net effective tax rate among all taxfilers was -15.8 percent, a slight increase from -14.5 percent in 1992. Between 1992 and 2017, the net effective tax rate consistently remained negative, indicating that, on average, taxfilers received more income from the government than they paid in income/payroll taxes. However, as shown in figure 9, whether the net effective tax rate is negative or positive depends on the taxfiler's relative position in the income distribution. Notice that the rates up to the 13th vingtile are all negative, indicating that, on average, taxfilers with incomes below \$50,200 received more in transfers than they paid in income/payroll taxes. In other words, the bottom two-thirds of the distribution received more in government transfers than they paid in income/payroll taxes.

FIGURE 6 Percentage of Transfer Recipients by Income Vingtile, 2017

Source: Statistics Canada table 11-10-0054-01, “Federal and Provincial Individual Effective Tax Rates.”

Looking at figure 9, three distinct sets of taxfiler profiles emerge. The first group of taxfilers, in vingtile 2 to vingtile 6 of the income distribution, received a larger share of their income from the government in 2017 compared to 1992. The second group of taxfilers, in vingtile 7 to vingtile 12 (roughly the middle quintile), received a smaller share of their income from the government in 2017 compared to 1992. These two groups of taxfilers still benefited in the sense that, on average, they received more in transfers than they paid in income/payroll taxes. The third group of taxfilers, above the 12th vingtile, generally paid more in income/payroll taxes than they received in cash transfers. Compared to 1992, they received a somewhat larger share of their income from transfers in 2017.

But these trends did not come about overnight. Underlying the evolution of net effective tax rates from 1992 to 2017 are decades of policies and economic cycles that helped to shape those changes. Taxfilers in the bottom two-thirds of the income distribution generally remained the net beneficiaries of the tax/transfer system throughout this period; on average, they received more in government transfers than they paid in income/payroll taxes. That is, the net effective tax rate for the bottom two-thirds has consistently remained negative, while the rate for the top third has stayed above zero.

FIGURE 7 Distribution of Transfer Income by Source and Income Vingtile

CCB = Canada child benefit; CPP/QPP = Canada Pension Plan/Quebec Pension Plan; EI = employment insurance; OAS = old age security; RDSP = registered disability savings plan; WITB = working income tax benefit.

Source: Source: Statistics Canada, Longitudinal Administrative Databank, 1992 and 2017.

FIGURE 8 Average Federal and Provincial Income Taxes, Federal Payroll Taxes, and Transfers by Income Group, 1992 and 2017

Source: Statistics Canada table 11-10-0054-01, “Federal and Provincial Individual Effective Tax Rates.”

The 1990s marked a decade of gradually increasing effective tax rates, and the trend was no different when it came to net rates. Generally, taxfilers with incomes over \$45,500 saw an increase in their effective income tax rates, which was largely aimed at federal deficit reduction. The rates for these filers peaked at around 24 percent in the mid-1990s before gradually decreasing after the late 1990s. Their rates hit their lowest levels at about 20 percent during the financial crisis of 2009, but have been gradually rising ever since. The effective federal and provincial cash transfer rates for this group of taxfilers hovered around the 5 percent to 7 percent level in the midst of their changing effective income tax rates. So, compared to 1992, the improvement in the net tax position of taxfilers with incomes over \$45,500 can mostly be attributed to decreasing effective income tax rates since the late 1990s.

The effective transfer rates have always been higher than the effective income tax rates for taxfilers with incomes below \$45,500. For the middle part of the distribution—say, those with incomes between \$22,000 and \$45,500—the effective income tax rate held steady at approximately 11 percent throughout much of the 1990s, but the effective transfer rate dropped from a high of 37 percent in the early 1990s to around 30 percent in the latter part of that decade. The effective transfer rate, along with the effective income tax rate for these taxfilers, trended downward until the 2009 financial crisis, which caused the two rates to diverge. Transfer rates went up

FIGURE 9 Effective Federal and Provincial Income Tax and Federal Payroll Tax Rates Net of Federal and Provincial Transfers by Income Vingtile, 1992 and 2017

Source: Statistics Canada table 11-10-0054-01, “Federal and Provincial Individual Effective Tax Rates.”

while tax rates went down. But the early 2010s propagated a downward trend in transfer rates and a gradual increase of income tax rates. Both tax and transfer changes have contributed to the change in the net tax position of taxfilers with incomes below \$45,500.

For taxfilers with incomes below \$22,000, generally effective income tax rates have stayed at about 2 percent, so the transfer system plays a more significant role in explaining the changes seen in figure 9. The effective transfer rates suggest that this group of lower-income filers received around half of their incomes from government transfers. Generally, they experienced a drop in effective transfer rates during the 1990s, a stabilization during the 2000s, and a steady increase since 2009.

Relative to 1992, income shares stayed roughly the same or decreased in 2017 across the distribution with the exception of the top 5 percent, which increased its share of income from 20.8 percent in 1992 to 24.5 percent in 2017. So the differences in the three profiles observed in figure 9 can be mostly attributed to the tax or transfer system rather than to shifts in income.

We know from our previous analysis that the share of government transfers going to lower-income taxfilers, such as those with incomes between \$3,500 and \$19,500, has increased since 1992, while it has decreased for filers with incomes over \$22,000 but below \$45,500. This trend is illustrated in figure 10, which shows how aggregate transfers and the various individual transfer programs are distributed

FIGURE 10 Share of Transfer Income by Source and Income Vingtile, 1992 and 2017

CCB = Canada child benefit; CPP/QPP = Canada Pension Plan/Quebec Pension Plan; EI = employment insurance; OAS = old age security.

Note: Dollar figures in parentheses in the legend indicate the lower bound of 2017 income threshold.

Source: Statistics Canada, Longitudinal Administrative Databank, 1992 and 2017.

across the income distribution. For taxfilers with incomes above \$41,100, some groups saw a slight decrease while others saw a slight increase in transfer shares. But the biggest increases and decreases in transfer shares were generally observed for taxfilers with incomes below \$45,500.

CPP/QPP is the largest transfer program in Canada. As shown in figure 10, in 2017 nearly 20 percent of these benefits went to the bottom 30 percent of the income

distribution, up from 14 percent in 1992. The share of OAS transfers going to the bottom 30 percent also increased from about 25 percent in 1992 to almost 30 percent in 2017. Social assistance is a provincial/territorial transfer program targeting the lower portion of the income distribution. In 2017, over 65 percent of social assistance payments went to the bottom 30 percent of the income distribution, up from around 45 percent in 1992. These share increases in some of the major transfer programs for the bottom of the income distribution were generally offset by corresponding decreases along the middle of the distribution. The share of EI going to the top half of the distribution, in particular those with incomes over \$41,100, increased from about a third in 1992 to nearly two-fifths in 2017.

CONCLUSION

Many of the major components of the system of income taxes and cash transfers have become somewhat more progressive since 1992. Taxfilers in the bottom two-thirds of the income distribution generally benefited from the tax/transfer system in the sense that, on average, they tended to receive more in government transfers than they paid in income/payroll taxes, as measured by net effective tax rates (income/payroll taxes net of government cash transfers). Decades of policies and economic cycles have contributed to the evolution of net effective tax rates. Changes have resulted in an improved net tax position (with filers receiving more benefits net of taxes or paying lower taxes net of transfers in 2017) for both lower-income taxfilers and the top third of taxfilers. Relative to 1992, the middle quintile received less income from the government in 2017 but were still net beneficiaries of the tax/transfer system.

This article has examined changes in the progressivity of the federal and provincial income tax system in conjunction with changes in the progressivity of federal and provincial cash transfers since 1992, by analyzing effective tax rates as well as net effective tax rates.

More than \$265 billion in federal and provincial income taxes and federal payroll taxes was spent by Canadians in 2017. In aggregate, these taxes represented just under a fifth of total household income. However, owing to the progressivity of the tax system, on average, Canadian taxfilers spent 11.7 percent of their income on such taxes. Almost 80 percent of Canadians paid some form of income/payroll tax. Effective income tax rates paid by taxfilers vary depending on the filer's position in the income distribution. The top 1 percent of taxfilers paid an effective rate of 31.0 percent in 2017. In fact, the top decile paid nearly half (49.6 percent) of all income/payroll taxes in 2017, up from 1992, when they paid 43.3 percent of all income/payroll taxes. The share of income going to the top decile was 35.3 percent in 2017, up from 31.7 percent in 1992.

The effective transfer rate in Canada generally remained in the 25 percent to 30 percent range between 1992 and 2017. Taxfilers received more than \$178 billion in federal and provincial government transfers in 2017. (On average, 70 percent of taxfilers received transfer payments from the government, and a significant portion

of transfer recipients were in the bottom 50 percent of the income distribution.) Some of the largest elements of the transfer system have seen significant increases owing to demographic factors such as aging. CPP/QPP and OAS transfers, which are federal programs and the two largest transfer programs, more than doubled between 1992 and 2017. CPP/QPP transfers increased from around \$23 billion in 1992 to more than \$52 billion in 2017, while OAS transfers increased from around \$18 billion in 1992 to nearly \$37 billion in 2017. The relative sizes of transfer programs were also measured, and it was determined that CPP/QPP accounted for nearly 30 percent of transfers in 2017, up from 21.4 percent in 1992.

To measure tax burden in a way that includes the effect of transfers, we examined net effective tax rates, which are based on taxes paid less cash transfers received. On average, the net effective tax rate among all taxfilers was -15.8 percent in 2017 and was always negative from 1992 onward. But when we examined the rates across the income distribution, they tended to be negative only for those taxfilers with incomes below \$50,200. Negative net effective tax rates indicate that these filers received more income from the government than they paid in income/payroll taxes. Moreover, changes in progressivity varied along the income distribution. We identified three groups of taxfilers when comparing net effective tax rates for 1992 and 2017. The first group of taxfilers were lower-income filers from vingtile 2 through vingtile 6, who, despite a small tax increase, received a relatively larger share of their income from the government in 2017 compared to 1992. The second group of taxfilers were from vingtile 7 through vingtile 12, and they received a relatively smaller share of their income from the government in 2017 compared to 1992. The third group comprised taxfilers above the 12th vingtile, and they generally paid more in income/payroll taxes than they received in government transfer payments (though they still received a somewhat larger share of their income from the government in 2017 compared to 1992). The net effective tax rate for the top 1 percent remained virtually unchanged since their relatively small share of transfer income remained about the same.

The group differences can be mostly attributed to changes in the transfer system. In 2017, nearly 20 percent of CPP/QPP transfer payments went toward the bottom 30 percent of the income distribution, up from 14 percent in 1992. The share of OAS transfers for the bottom 30 percent increased from around 25 percent in 1992 to nearly 30 percent in 2017. Over 65 percent of social assistance, which is a provincial transfer program and not as large as CPP/QPP or OAS, went to the bottom 30 percent, up from 45 percent in 1992. Some of these share increases were generally offset by corresponding decreases along the middle of the income distribution. The share of EI going to the top 50 percent, particularly taxfilers above the 12th vingtile, increased from around a third in 1992 to nearly two-fifths in 2017.

APPENDIX

TABLE 1 Aggregate Income, Taxes, and Transfers in Millions of 2017 Dollars, 1992-2017

Panel A: 1992-2000									
	1992	1993	1994	1995	1996	1997	1998	1999	2000
Modified total income.....	774,589	785,851	864,025	801,606	816,443	845,089	876,555	912,225	967,826
Taxes									
Federal.....	88,115	86,447	88,664	92,053	95,541	102,053	107,203	110,918	117,388
Provincial.....	55,250	57,621	59,360	61,607	63,229	65,893	66,125	67,432	70,219
Federal payroll.....	19,612	20,148	21,414	21,800	21,445	22,851	23,561	24,826	26,385
Transfers									
Canada Pension Plan/Quebec Pension Plan	23,165	24,576	26,330	27,074	28,262	29,084	30,237	30,866	31,189
Old age security.....	18,134	18,748	19,559	20,036	20,684	21,252	22,176	22,534	22,950
Canada child benefit.....	3,732	7,698	7,979	7,726	7,627	7,616	7,700	7,906	8,928
Employment insurance.....	27,150	25,449	21,711	18,358	17,261	14,719	14,473	13,507	12,449
Social assistance.....	13,707	17,323	17,958	17,656	15,833	14,893	13,609	12,379	11,446
Net federal supplements.....	5,786	5,935	6,298	6,338	6,374	6,445	6,783	6,805	6,810
Provincial tax credits.....	1,615	1,700	1,670	1,692	1,688	1,878	2,390	2,236	2,124
Workers' compensation.....	6,268	5,457	5,393	5,553	5,379	5,361	5,235	5,299	5,420
Goods and services tax credit.....	4,219	4,288	4,236	4,329	4,273	3,822	3,705	3,568	3,588
Family benefits.....	4,385		908	825	1,450	1,449	2,299	2,218	1,482
Working income tax benefit.....									
Registered disability savings plan.....									
Children's fitness tax credit.....									

(Table 1 is continued on the next page.)

TABLE 1 Continued

Panel B: 2001–2009									
	2001	2002	2003	2004	2005	2006	2007	2008	2009
Modified total income.....	983,638	978,735	990,917	1,034,339	1,079,195	1,137,636	1,184,038	1,183,195	1,172,870
Taxes									
Federal.....	109,335	108,245	109,679	113,132	114,773	121,699	121,485	122,912	112,456
Provincial.....	65,459	62,514	63,291	67,592	72,472	76,422	79,205	77,344	74,724
Federal payroll.....	28,286	29,716	30,426	30,539	31,195	31,199	31,989	32,290	32,505
Transfers									
Canada Pension Plan/Quebec Pension Plan ...	32,026	32,983	33,554	34,994	35,946	37,045	38,061	39,143	41,306
Old age security.....	23,593	23,936	24,504	25,037	25,486	26,224	26,795	27,485	28,755
Canada child benefit.....	9,760	10,051	10,121	10,580	11,115	11,298	11,075	10,789	11,021
Employment insurance.....	14,237	16,053	15,924	15,538	14,916	15,309	15,821	16,064	22,211
Social assistance.....	10,772	10,248	9,881	9,900	9,806	9,764	9,837	10,046	10,905
Net federal supplements.....	6,918	7,223	7,372	7,589	7,777	8,210	8,669	8,613	8,880
Provincial tax credits.....	2,411	2,077	2,099	2,060	2,009	3,702	2,094	2,977	3,115
Workers' compensation.....	5,672	5,761	5,500	5,490	5,532	5,515	5,673	5,880	5,929
Goods and services tax credit.....	3,578	3,680	3,639	3,664	3,699	4,281	3,597	3,614	3,830
Family benefits.....	1,331	1,204	1,085	996	2,526	2,560	2,617	2,854	3,152
Working income tax benefit.....							547	567	1,185
Registered disability savings plan.....									2
Children's fitness tax credit.....									

(Table 1 is concluded on the next page.)

TABLE 1 Concluded

Panel C: 2010–2017									
	2010	2011	2012	2013	2014	2015	2016	2017	
Modified total income.....	1,194,685	1,217,516	1,242,522	1,285,228	1,320,830	1,363,859	1,340,772	1,405,708	
Taxes									
Federal.....	116,535	120,481	123,189	127,691	131,120	139,031	131,519	140,252	
Provincial.....	74,836	77,312	79,601	82,535	86,264	90,552	86,788	87,294	
Federal payroll.....	32,687	33,543	35,199	36,441	37,292	38,009	38,551	37,932	
Transfers									
Canada Pension Plan/Quebec Pension Plan ...	41,854	42,755	44,888	46,863	47,926	49,877	51,341	52,698	
Old age security.....	29,096	29,878	31,268	32,511	33,415	34,607	35,675	36,837	
Canada child benefit.....	11,234	11,082	11,146	11,192	10,941	10,913	17,021	23,363	
Employment insurance.....	20,853	18,451	17,749	17,387	17,472	18,449	19,397	18,823	
Social assistance.....	11,398	11,235	11,407	11,687	11,723	11,912	12,078	12,603	
Net federal supplements.....	8,870	9,261	9,795	10,024	10,056	10,626	10,954	11,609	
Provincial tax credits.....	6,262	5,873	5,766	5,694	6,209	7,129	7,186	7,776	
Workers' compensation.....	5,753	5,607	5,479	5,331	5,190	5,142	5,228	5,308	
Goods and services tax credit.....	3,830	3,728	3,746	3,845	3,853	4,072	3,983	4,020	
Family benefits.....	3,264	3,131	3,364	3,438	3,289	3,470	3,663	3,878	
Working income tax benefit.....	1,203	1,201	1,144	1,212	1,168	1,160	1,161	1,128	
Registered disability savings plan.....				1	2	2	2	3	
Children's fitness tax credit.....						215	142		

Note: Dollar figures were adjusted using all-items consumer price index data from Statistics Canada table 18-10-0005-01 (formerly CANSIM table 326-0021), "Consumer Price Index, Annual Average, Not Seasonally Adjusted."

Source: Statistics Canada, Longitudinal Administrative Databank, 1992 to 2017.

INTERNATIONAL TAX PLANNING

Co-Editors: Ken Bottenham and Ian Bradley*

THE PREACQUISITION SURPLUS ELECTION: MORE THAN MEETS THE EYE?

*Tim Fraser and Jim Samuel***

Regulation 5901(2)(b) permits a corporation resident in Canada (CRIC) to make an election in respect of a dividend paid by a foreign affiliate of the CRIC such that the dividend will be treated as a reduction to the adjusted cost base of the foreign affiliate shares on which it is paid, rather than as a distribution from the foreign affiliate's surplus pools. Making this "preacquisition surplus election" is often perceived as a straightforward, and administratively simple, way for the CRIC to ensure that the dividend does not result in the unwanted, and potentially adverse, distribution of the foreign affiliate's surplus pools. However, as this article points out, it is important that a CRIC undertake a detailed analysis before deciding to make the election, in order to avoid potential exposure to unintended consequences.

This article provides an overview of the legislative history of the election and its underlying policy rationale, and describes the limitations of and restrictions on its use. The authors present some conceptual guidelines (along with examples of their application) for identifying certain circumstances in which the making of the election may be particularly favourable or unfavourable. They also compare and contrast this election with the "qualifying return of capital" (QROC) election under subsection 90(3), which may be available in some circumstances as an alternative mechanism for achieving a similar result.

KEYWORDS: FOREIGN AFFILIATES ■ SURPLUS ■ DIVIDENDS ■ PAID-UP CAPITAL ■ ELECTION ■ ADJUSTED COST BASE

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PERSONAL TAX PLANNING

Co-Editors: Sonia Gandhi* and Dino Infanti**

CURRENT ISSUES IN COMPENSATION

*Ana-Luiza Georgescu****

This article discusses the main categories of compensation programs as distinguished for tax purposes and describes some of the potential tax implications that may be associated with certain changes made to these compensation programs, as well as some approaches to mitigate such tax impacts. It also reviews proposed legislative changes in the area of stock options and suggests what companies should be considering in preparation for these changes. Further, in the context of the COVID-19 pandemic, this article discusses key aspects of “working from anywhere” in relation to certain compensation programs, and the potential and expected impact of environmental, social, and governance corporate imperatives in designing and determining executive compensation.

KEYWORDS: COMPENSATION ■ SALARY DEFERRAL ARRANGEMENTS ■ STOCK OPTIONS ■ EMPLOYMENT PRACTICES ■ CORPORATE GOVERNANCE ■ WORK ENVIRONMENT

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PLANIFICATION FISCALE PERSONNELLE

Co-rédacteurs de chronique : Sonia Gandhi* et Dino Infanti**

LES ENJEUX ACTUELS DE LA RÉMUNÉRATION

*Ana-Luiza Georgescu****

Cet article traite des principales catégories de programmes de rémunération aux fins de l'impôt et décrit quelques-unes des conséquences fiscales que peuvent avoir certains changements apportés à ces programmes de rémunération, ainsi que des moyens d'atténuer ces effets fiscaux. Il examine également les modifications législatives proposées être apportées dans le domaine des options d'achat d'actions, et propose des mesures que les entreprises devraient prendre en prévision de ces modifications. En outre, dans le contexte de la pandémie de COVID-19, cet article aborde les aspects clés du « travail de n'importe où » relativement à certains programmes de rémunération, ainsi que l'effet éventuel et attendu des impératifs environnementaux, sociaux et de gouvernance des sociétés dans la conception et la détermination de la rémunération des dirigeants.

MOTS CLÉS : RÉMUNÉRATION ■ ENTENTES D'ÉCHELONNEMENT DU TRAITEMENT ■ OPTIONS D'ACHAT D' ACTIONS ■ PRATIQUES D'EMPLOI ■ GOUVERNANCE DES SOCIÉTÉS ■ ENVIRONNEMENT DE TRAVAIL

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SELECTED US TAX DEVELOPMENTS

Co-Editors: Peter A. Glicklich* and Michael J. Miller**

ADAMS CHALLENGE (UK) LIMITED: WHEN DOES A TREATY PROVISION CONFLICT WITH THE CODE?

*Michael J. Miller***

In the United States, statutes and treaties are on an equal footing. Thus, in the event of a conflict between a statute and a treaty, the treaty does not automatically take precedence over the statute. Moreover, the US courts go to great lengths to avoid finding the existence of any conflict. This article discusses a recent case in which the Tax Court held, among other things, that a punitive deduction-disallowance rule applicable solely to non-US persons did not conflict with the non-discrimination article of the income tax treaty in effect between the United States and Canada.

KEYWORDS: TREATIES ■ INTERNAL REVENUE CODE ■ CONFLICT ■ DEDUCTIONS ■ NON-DISCRIMINATION ■ JURISPRUDENCE

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CURRENT TAX READING

Co-Editors: Robin Boadway, Kim Brooks, Jinyan Li, and Alan Macnaughton*

John Lester, “Benefit-Cost Analysis of Federal and Provincial SR&ED Investment Tax Credits” (2021) 14:1 *SPP Research Papers* [University of Calgary, School of Public Policy] 1-46 (<http://dx.doi.org/10.11575/sppp.v14i.70039>)

Canadian federal and provincial governments provide generous support for research and development (R & D) undertaken by firms in Canada. The support differs markedly by size of firm. Large firms can claim a 15 percent non-refundable tax credit from the federal government, while small and medium-sized Canadian controlled private corporations are eligible for a 35 percent refundable tax credit. The credits are based on non-capital R & D expenditures, and eligible expenditures fall with income earned and with outsourced R & D. Provincial supplements differ among provinces, and they increase the large firm credit to about 20 percent and the small firm credit to over 40 percent. Many small firms also obtain financial support from the Industrial Research Assistance Program, increasing the subsidy rate to nearly 60 percent. Subsidy rates for large business are comparable with those in other Organisation for Economic Co-operation and Development (OECD) countries, but support for small businesses is more generous.

In this paper, John Lester studies whether this level of subsidization, and the preferential treatment of small firms, is justified. He applies a cost-benefit analysis (CBA) to evaluate the net benefits of existing federal and provincial R & D support programs, and to inform proposals for policy change. The main rationale for government support is that R & D expenditures lead to knowledge and innovations whose benefits spill over to other firms in the economy. Firms undertaking R & D will neglect these spillover benefits and spend too little on R & D in the absence of government support. Subsidization will increase R & D spending and generate more spillover benefits. The CBA aims to compare the increase in spillover benefits with the cost of the subsidy for different sizes of firms.

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The key ingredients of Lester's CBA are as follows. On the benefit side, he judges that the elasticity of responsiveness of R & D expenditures to subsidy-induced costs is -1.4 for small firms and -1 for large firms. Next, he estimates that small firms eligible for the 35 percent credit generate spillover benefits of about 20 percent of expenditures, while larger firms claiming the 15 percent credit generate significantly larger spillovers of just over 50 percent. Costs, which include the cost of the subsidy itself, are augmented by various factors. Administrative costs to the government are judged to be 2.1 percent of subsidy costs in the case of small firms and 1.7 percent for large ones, while compliance costs are assumed to be 14.2 percent of the subsidy for small firms and 5.7 percent for large ones. A portion of the benefits will be transferred abroad: 2.1 percent of the benefit to small firms and 18 percent of the benefit to large firms will be transferred through lower export prices, and 3 percent of the benefits of large firms will be transferred through profits to foreign owners. There is an average lag of three years between the undertaking of R & D and the generation of increased profits. All existing inefficiencies facing small firms, such as capital market imperfections, are ignored.

Lester argues that evidence supports the assumption that spillover benefits are a constant proportion of R & D expenditures, while costs increase with the subsidy rate. This implies that net benefits as a function of the subsidy rate take an inverted U-shape. This implies that for large and small firms, there will be optimal subsidy rates with which existing subsidy rates can be compared.

CBA results are reported separately for large and small firms. Lester estimates that the federal large-firm R & D tax credit yields a net benefit of about 26 percent of tax revenue forgone. Knowledge spillovers constitute the most important benefit of R & D, and the transfer of benefits to foreigners via lower export prices is the biggest cost. Sensitivity analysis indicates that the qualitative results are fairly robust in response to changes in parameters. Estimates of how net benefits change with the subsidy rate confirm an inverted U-shape. The peak of the curve gives an optimal federal subsidy rate of 25 percent to 28 percent, which is considerably higher than the existing rate. Provincial R & D subsidy rates to large firms are 5.5 percent on average, resulting in a combined federal-provincial rate of about 18.5 percent. This serves to increase the net benefit, but the rate remains below the estimated optimum.

The CBA of the generous federal small-firm R & D tax credit shows a net loss of 18 percent of the cost of subsidy, contrary to the large-firm case. The spillover rate of small-firm R & D is low relative to the subsidy rate, while administration and compliance costs are very high. The optimal small-business subsidy rate is estimated to be about 10 percent, which is substantially lower than the combined federal-provincial subsidy rate of over 40 percent. The net loss from small-business subsidization is largest in Quebec, where the subsidy rate is highest, and much smaller in Ontario.

Lester observes that the net benefit of subsidizing R & D nationwide would be maximized if the provinces eliminated their subsidy programs and the federal government set the large and small firm credit rates at their optimal values of about

28 percent and 11 percent, respectively. A piecemeal approach would be for the federal government to unilaterally increase its large-firm tax credit rate to 20 percent and reduce the small-firm rate to 10 percent, though this might be challenging politically. Gains would be enhanced if the provinces were to adopt a 10 percent tax credit rate for both large and small firms. With this piecemeal approach, the combined federal-provincial statutory rate would be 28 percent for large firms and 19 percent for small firms.

Other aspects of the program could be revisited, such as the definition of eligible expenditures, expenditure limits and refundability. This would require a more demanding CBA.

R.B.

Wei Cui, “The Digital Services Tax: A Conceptual Defense”

(2019) 73:1 *Tax Law Review* 69-111

Digital services have grown rapidly in recent years, driven largely by multinational giants originating in the United States. These firms have been hugely profitable, but they have proven to be elusive taxpayers owing in part to their reliance on intangible capital and intellectual property, which is highly mobile among countries. Existing international business tax regimes seem ill-suited to taxing their profits, which can be readily shifted to low-tax jurisdictions. Two sorts of tax policy initiatives have been proposed. One is to reform the corporate tax system to discourage profit shifting. Some experts advocate moving to a destination-based cash flow tax (DBCFT). Others argue for retaining income-based corporate taxes but distinguishing between normal returns to capital, which would be taxed at origin, and above-normal returns to capital, which would be taxed at destination. The second policy initiative proposed is to implement digital services taxes (DSTs) on the services supplied by the largest multinational providers. This innovative and thoughtful article by Wei Cui explores the latter approach.

Cui’s perspective is that a DST can achieve two normative objectives of international taxation while corporate tax proposals cannot. First, a DST can be an efficient tax by applying to the rents generated by large digital platforms. Second, it can be fair to the extent that the rents are taxed in the jurisdiction in which they arise. He argues persuasively that while a DBCFT can be relatively efficient and discourages profit shifting, it is not fair. It assigns all tax revenue to destination countries, despite the fact that some of the rents might have arisen in origin countries. To Cui, fairness entails allocating rent tax revenues to the country responsible for generating the rents. Much of his article explains how a DST could be designed to do just that. He argues, using a series of examples, that digital platform rents do not necessarily arise where the final users reside. For each type of digital service, location-specific rents (LSRs) must be identified, and the DST applied to them.

Cui begins with a brief discussion of existing DST proposals by the European Commission and the United Kingdom. These proposals base taxing rights on the location of users regardless of whether they actually make payments for digital

services. This approach recognizes that platform rents accruing to a country need not be based on the physical location either of the platform or of the payment to it. However, these proposals assume that value is created at the location of the user, which—as Cui argues—need not be the case.

The core section of the paper considers LSRs arising on digital platforms. Since marginal costs are minimal, a DST is like a tax on rents. Cui emphasizes that digital platforms can generate hidden forms of LSRs. He begins with the case of multi-sided platforms such as Facebook or Google. These platforms generate network externalities: the benefits to advertisers increase with the number of users, so losses on one side of the market, intended to attract more users, can be compensated with gains on the other. Moreover, users and advertisers can be in different countries. Cui argues that in the case of both advertising and online marketplaces, platforms generate LSRs in the country of the product users or purchasers, so DST revenues should be assigned on the basis of destination. In other cases, the LSRs occur on the producer side. Platforms such as Airbnb, Uber, Microsoft, and Android subsidize the seller side and charge the consumers. Though revenues are obtained from the latter, rents arise on the seller side. A DST in this case would apply in the country of the supplier—that is, at origin.

Platform rents can also arise in one-sided markets where network effects occur among users. These platforms often obtain payments from users, who also generate the LSRs. The same applies to the personalization of remote services, which generates demand without affecting supply. In these cases, the DST should apply at the users' location. On the other hand, where platforms obtain data from users, the data are mostly of value to the platform itself, not a source of sales revenue. The data raise platform rents mainly through advertising, intermediation, and the online provision of goods and services. The DST should apply to the latter.

These examples illustrate that digital platforms generate rents whose location may differ from the source of payment and is determined by market structure. The DST should be designed to tax LSRs, and could be based on destination, source, or residence depending on the case.

The alternative to a DST on the rents derived from digital platforms is the corporate tax. While several tax experts and tax commissions have recommended reforming the corporate tax to make it a tax on rents, it remains, in most countries, mainly a tax on the equity income of corporations. This not only implies that the tax distorts corporate investment and financing decisions but also encourages international tax competition and profit shifting. Cui reminds us that the current system for the international allocation of taxing rights accepts countries' right to tax their resident corporations, to tax non-resident business income obtained from a permanent establishment, and to use the arm's-length principle (ALP) to allocate profits among related businesses. Cui argues that this approach, which relies on physical presence as well as transfer pricing using the ALP, is not suitable for allocating platform rents. The maximization of platform profit involves pricing decisions on both sides of the platform, and ALP rules cannot be relied on to determine the location of rents.

Cui also argues that recent proposals for the international allocation of profits are based solely on efficiency and ignore fairness considerations. As mentioned above, most methods involve assigning rents on the basis of the destination of final sales, on the grounds that this mitigates profit shifting. Cui claims persuasively that taxes on rents should be assigned to the country where the rents are generated, and that country need not be the destination country. This implies that the inventors of platform technologies should not keep the entire profit from the invention—a position that is unlikely to find favour in the United States, where much of the digital innovation has occurred.

Cui presents his arguments carefully and intuitively, but further research remains to be done. The analysis is done on a case-by-case basis, drawing on a number of specific examples. The reader yearns for some general principles that could inform the design of actual taxes. As it stands, a DST system would be platform-specific. For some platforms, DST revenues should be assigned to countries where users reside, while for some countries assignment would be based on the supply side. Presumably it is possible that for some platforms, rents are generated on more than one side of the market. This is hardly the recipe for a feasible DST system. The alternative would be to imagine using the corporate tax system for the taxation of platform rents. Cui's analysis suggests that neither a destination nor a source system of corporate tax would be universally desirable. It all depends on where platform rents are generated. Clearly, Cui's prescription—to assign platform rents where they are generated—is not yet ready for policy application. It does, however, provide a very promising beginning for subsequent tax policy analysis.

R.B.

Neal Winokur, *The Grumpy Accountant: One Fed-Up Tax Pro's Practical Plan To Fix Canada's Senselessly Complicated Tax System*

(Green Onion Publishing, 2020)

The Grumpy Accountant is not the kind of book that I would typically review for the *Canadian Tax Journal*, but I read it over the December holidays, and it was fun. The self-published book is exactly what the title suggests: a push for a less complicated tax system.

The book contains a number of suggestions (for example, getting rid of all credits and deductions for individuals or replacing capital cost allowance with cash-basis accounting for businesses) that reveal the author as either unaware of the meaning of income in the income tax or more interested in moving away from the income tax than in simplifying it. But if Winokur's argument is a challenge to the income tax, it is an unconscious, unarticulated one.

Thus, the value of the book is not in its contribution to the simplification of the income tax literature. Nevertheless, Winokur makes two worthwhile contributions. First, he identifies some common misperceptions about the income tax system in a way that is lots of fun. The characters in his book (Elaine, Jerry, and George) explore all manner of tax issues as Jerry's life moves through the ordinary cycle—

from early career, through marriage and children, to owning and incorporating a business. Jerry's interactions with his accountant, George, allow Winokur to remind readers that (for example) a refund means that you've loaned the government money; that when you withhold and remit taxes you are carrying out a government function for no (or limited) compensation; and that when you earn additional income—even if it pushes you into the next tax bracket—it is (usually) still worth earning the income. Those are lessons that students in introductory tax classes need to be taught, too.

The book's second contribution is to offer relatively straightforward tax advice to novice taxpayers. For many middle-income individuals, a tax lawyer or an accountant is beyond their means. This book talks about some of the basic tax tips that might help taxpayers navigate the tax system: it addresses challenges in audit processes and issues in back filing, and it offers reminders about keeping receipts.

The book concludes with a summary list of Winokur's suggestions for tax simplification. None of these recommendations take into account the fairness or incentive consequences of the proposed suggestions. And they ignore all of the literature about the political challenges that arise from the concessions that inevitably get made (and that add complexity to the system) any time an effort is made to simplify the tax system. But who cares? If you've got time on holiday and you want a fun and easy read, or if you're looking for a way to remind students about some standard tax myths and tips, this book is a worthwhile compendium. And it is nice to be reminded of the many people in the tax profession who care about the system and would love to see some of its failings addressed.

K.B.

Hope Ashiabor, *Tax Expenditures and Environmental Policy*

(Cheltenham, UK: Edward Elgar, 2020)

Ashiabor has undertaken extensive work on tax and the environment over roughly 20 years: this book benefits from his extended study. The core contribution of the book is Ashiabor's analysis of the potential to use tax expenditures as a tool for advancing environmental policy. The analysis is drawn from the experiences of several countries, including Australia, Canada, the European Union, the United Kingdom, and the United States. Instead of offering a country-by-country review of approaches, Ashiabor's work is thoroughly comparative: he identifies a number of distinct topics and then discusses alternative policy approaches, drawing from the different countries' experiences.

The book is divided into seven chapters. Chapter 2 offers an orientation to the tax expenditure concept. Chapter 3 justifies the use of tax expenditures to advance environmental policy. Chapter 4 compares tax expenditures to direct expenditures, focusing on the evidence of how those expenditures result in behavioural change. Chapter 5 explores how to reduce the likelihood that environmental policy will be stymied by efforts to reduce spending by cutting tax expenditures; it argues in favour of earmarking. Chapter 6 turns to design features (and reducing perverse incentives), using employee car subsidies as a case study. Chapter 7 returns to the

central discussion of whether tax expenditures can serve as useful tools for promoting environmental goals.

My favourite part of the book was the analysis, in chapter 6, of restructuring transport subsidies. The idea of using a big case study was inspired. Passenger vehicles are the largest contributor to transport sector emissions, but because of tensions over supporting industry development and employment, our policy response remains limited. As Ashiabor quips, “[S]ubsidies tend to go where the votes are, and these votes are invariably in the driver’s seat.”¹

Ashiabor uses Australia’s approach to taxing fringe benefits as a test case. His choice of Australia is understandable, given that he lives in that country, but the choice makes less sense when we consider Australia’s anomalous design (tax on the employer) for the taxation of fringe benefits (that is, a tax on the employer). Ashiabor takes the reader through the extended history of the taxation of the fringe-benefit value of car use, an area of taxation that saw reform from the 1980s through to the 2000s. Front and centre in the early political debates were concerns related to equity and neutrality in tax system design. It was not until the late 1990s and early 2000s that the debates started to look also to the environmental consequences of the fringe-benefits tax policy. Yet in spite of substantial evidence regarding environmental harm, including noise, and the costs of congestion and accidents, change to tax policy remained elusive. Chapter 6 also offers a brief discussion of the approach to fringe-benefits taxation of passenger vehicles in the United Kingdom, the European Union, and Canada.

Climate change is the issue of the coming generation, and the need to ensure a viable planet has to be the central policy issue of governments in the coming years. Ashiabor’s book offers reasoned analysis on the potential for tax expenditures to make a modest difference to that all-important project. His work is not unflaggingly optimistic: he identifies many challenges when it comes to using tax expenditures as a tool. It is clear, however, that tax expenditures may play an important role in encouraging the development of new technologies and in suppressing problematic behaviours and technologies.

K.B.

Jan Vleggeert, “On Independence, the Erosion of the Tax Debate, and What We Can Do About It,” *Universiteit Leiden*, November 3, 2020 (www.universiteitleiden.nl/en/news/2020/11/on-independence-the-erosion-of-the-tax-debate-and-what-we-can-do-about-it)

This short lecture, translated from the Dutch, is a plea for the independence of tax academics. Vleggeert bemoans the “double-hats”—that is, tax academics who combine their roles as law professors with jobs at tax advisory firms.² With this lecture, Vleggeert steps boldly into hotly contested territory. It is hotly contested in Europe,

1 At 199.

2 At 3.

anyway, where the last five years or so have seen heated debate about whether tax academics compromise their ability to speak freely (because of the pressure of private client interests or conflicts of interest) when they also seek engagements with tax advisory firms. According to a 2016 news story, as Vleggeert reports, about three-quarters of professors of tax law and fiscal economics have an appointment with a law or accountancy firm.

Vleggeert's concerns extend to tax professors who assist the Ministry of Finance. In this regard, however, he notes that many serve without remuneration and that they carry out their duties in the public interest, thus maintaining, as he sees it, their independence.

Vleggeert's short lecture is ultimately a brave bid for an independent tax academy. In support of his position, he cites the difficulty that both private- and public-sector tax professionals have in publishing work that might be seen to be contrary to their clients' (or the government's) position on vital issues of importance, such as tax avoidance.

If the translation of Vleggeert's lecture is accurate, the disclosure requirements for academics in the Netherlands (Vleggeert is head of his department at Leiden University) are more stringent than those in Canada. The Dutch Code of Conduct for Academic Research requires some measure of independence, and it requires that ancillary functions be disclosed on the website of the professor's university. Vleggeert raises useful questions that have not been explored in Canada—about the independence of the tax academy, and about the influence of clients on work authored by both tax academics and practitioners.

K.B.

Daniel Halliday and Miranda Stewart, *On 'Dynastic' Inequality*, Melbourne Legal Studies Research Paper no. 903 (Melbourne: University of Melbourne, Law School, 2020) (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3672887)

In an earlier issue of the *Canadian Tax Journal*, I drew readers' attention to Halliday's excellent book, *The Inheritance of Wealth: Justice, Equality, and the Right To Bequeath*.³ Here, Halliday joins forces with Miranda Stewart in a paper that starts with the broad question of whether the replication of inequality (dynastic inequality) is morally objectionable and what tax policy reforms might target inequalities that replicate old distributive trends, while leaving newer trends intact.

Halliday and Stewart define dynastic inequality as "any inequality that endures such that the persons between whom an inequality exists are situated in ways that replicate, or closely resemble, a prior inequality between their respective parents."⁴

3 Daniel Halliday, *The Inheritance of Wealth: Justice, Equality, and the Right To Bequeath* (Oxford: Oxford University Press, 2018), reviewed in this feature, (2019) 67:2 *Canadian Tax Journal* 481-98, at 494-95.

4 At 4.

This definition is then refined to focus on *wealth* inequality. Part 2 of the paper reviews the rationales for moral objections to dynastic inequality. Part 3 looks at how inequality might replicate itself.

For a tax audience, the juicy part comes next, in part 4: What does all of this mean in terms of tax policy reform? The proposals are not so much novel, as targeted. The authors focus expressly on how tax systems can be used to reduce dynastic wealth inequality. They identify two ways. The first is tax wealth stocks. This requires that wealth accretion be taxed not only on its realization but also periodically; individuals could be taxed annually (for example) on their share of the overall wealth stock. The second way to reduce dynastic wealth inequality is to use state-provided services (financed through taxes) to improve the opportunity and mobility of new generations. This approach requires robust efforts to remove discriminatory barriers based on, for example, race, class, geography, or gender.

The paper is devoted more to the justificatory argument than to tax policy prescriptions. I hope that the authors continue their collaborative work and eventually provide more texture to their tax policy recommendations. But even if they do not carry their research further, their justificatory rationale and their broad policy directions may help some of us (in particular, those of us who are interested in the recent plethora of wealth tax proposals) to evaluate and sort out preferred approaches in the light of their consequences for dynastic inequality.

K.B.

Jane G. Gravelle, “Sharing the Wealth: How To Tax the Rich”

(2020) 73:4 *National Tax Journal* 951-68

Calls for increasing taxes on the wealthy have become more frequent both in Canada and elsewhere. These calls come in response to (1) the growing inequality in income and wealth distributions, (2) the unequal burden of the COVID-19 pandemic, (3) the apparent ease with which higher-income taxpayers are able to avoid taxes, and (4) the need to deal with the debt fallout from the pandemic. Gravelle takes as given the objective of extracting more tax revenue from the rich, and she considers alternative policies for doing so. She presents her views in a highly readable manner that will be accessible to non-specialists. Her arguments are supported by a substantial technical literature that she documents for interested readers. Although the article is written for a US audience, many of her suggestions will resonate in Canada.

Gravelle sets the stage by reviewing how sources of income differ among income groups. As incomes rise, the share of income obtained from returns to capital relative to income from labour increases. Capital gains and private business income, too, become increasingly important at higher income levels. Since these forms of income—especially capital gains, which are taxed at preferential rates, and only on realization—are treated favourably by the income tax system, the income tax structure favours the rich. The rich are also able to benefit disproportionately from charitable contributions of assets that have accrued in value but whose accrued gains have not been taxed. Moreover, accrued capital gains escape taxation altogether if assets are bequeathed to heirs since the base value of inherited assets is stepped up

at the time of death. These built-in biases in the income tax system make it difficult to target the rich by changes in the income tax system; this is the case, at least, so long as capital gains are taxed only on realization.

Gravelle explores three alternative ways of increasing the tax paid by the wealthy. The first, which is specific to the United States, involves reforms to the estate and gift tax, including the treatment of capital gains at death. With respect to the latter, she proposes taxing capital gains at death by using the basis value of assets to the decedent—a system that is familiar to Canadians and entails some administration and compliance costs as well as, possibly, some liquidity issues. With respect to the estate and gift tax, she considers various options for increasing progressivity: reducing the exemption, increasing the tax rate, phasing out the exemption as the estate size increases, or adopting a progressive rate structure. A further possibility is to limit the share of an estate that can be deducted as a charitable bequest.

The second policy Gravelle considers is to tax capital gains as they accrue rather than when they are realized. This poses obvious valuation problems that can be addressed in a couple of ways. One way is to apply mark-to-market valuation procedures. Although this approach is feasible for publicly traded assets, it would be challenging for assets not traded publicly. She proposes using a so-called lookback method for the latter while still collecting the tax when the asset is sold. The lookback method involves using various data—on the basis value, the sale price, and the length of time for which the asset has been held—to estimate how much tax would have been paid had the asset been taxed on accrual each year, assuming its change in value has been constant over the holding period. The administrative complexity thus introduced into the system would have to be set against the equity gains. Some of these administration costs could be reduced by having an exemption level, so that the accrual approach would not apply to small capital gains. Sheltered savings would also be exempt from the system, possibly including owner-occupied housing. Gravelle discusses other complications with adopting an accrual basis, including the desirability of indexing capital gains, the treatment of losses, and dealing with avoidance.

Finally, Gravelle considers an annual wealth tax, which is a more direct way of addressing inequality and has, she argues, the potential to raise significant revenues. She discusses alternative approaches to coverage, exemption levels, and wealth tax rates, and what they imply for revenue-raising possibilities. She briefly reviews some of the key issues in designing and implementing a wealth tax, such as avoidance and evasion, annual wealth valuation, and liquidity problems. She also notes that while wealth taxation can be effective at targeting wealthy taxpayers, it increases taxes on assets already subject to taxation.

Gravelle's preferred alternative is to tax unrealized capital gains. Despite the administrative challenges of this approach, it would target a form of income that is preferentially taxed. In the Canadian context, another alternative that would avoid the administrative complexity of accrual taxation would be to reduce the preferential capital gains exemption rate.

R.B.

Clemens Fuest, Felix Hugger, and Susanne Wildgruber, *Why Is Corporate Tax Revenue Stable While Tax Rates Fall? Evidence from Firm-Level Data*, CESifo Working Paper no. 8605 (Munich: Munich Society for the Promotion of Economic Research, 2020)

Corporate income tax rates in OECD countries have fallen by a third over the past three decades—a reflection, arguably, of tax competition induced by globalization and the increased mobility of corporate profits. This has led to concerns that corporate tax revenues will erode, and that labour income and consumption will be called on to foot an increasing share of tax revenues. Surprisingly, the decline in corporate tax rates has not been accompanied by a decline in corporate tax revenues. They have kept steady at about 3 percent of gross domestic product (GDP). This is puzzling and poses a conundrum for corporate tax policy. If corporate tax revenues do not decline with corporate tax rates, will they fail to rise if corporate tax rates are increased? The answer depends on what has caused corporate revenues to remain steady in the face of falling tax rates.

To study this issue, the authors of this paper use a comprehensive, unconsolidated, firm-level dataset of corporations in 33 OECD countries from 1995 to 2016. They estimate that the reduction in corporate tax rates was fully offset by an increase in overall corporate profits before tax, albeit with differences among sectors. The analysis proceeds in two steps. In the first, the dataset is used to compile a time series of corporate taxes paid and pre-tax profits for all 33 countries. The number of firms changes over time, and they vary widely in size, so all variables are measured as a proportion of value-added. In the second step, changes in pre-tax profits are decomposed into (1) earnings before interest, taxes, depreciation, and amortization (EBITDA); (2) depreciation; and (3) financial profits or losses.

On average, the value-added of the firms in the dataset constitutes about one-quarter of national value-added, although the share differs among countries. The average share of pre-tax profits in added value is about 20 percent, of which EBITDA contributes 35 percent, financial profits –2 percent, and the value of depreciation –13 percent. Corporate taxes paid are 5.7 percent of value-added, and taxes as a proportion of pre-tax profits, or average effective tax rates, are 27.6 percent.

In step 1, the average statutory tax rate fell from 43 percent to 26.5 percent over the period, which was almost the same as the decline in effective tax rates. Pre-tax profits as a share of GDP rose from 13.5 percent to 22.1 percent. As a result, corporate taxes as a share of GDP stayed between 5 percent and 6 percent. In effect, the rise in pre-tax profits completely offset the decline in tax rates.

In step 2, the increase in pre-tax profits was decomposed into the three elements mentioned. A rise in the EBITDA contributed 26.4 percent of the increase in pre-tax profits; higher financial income contributed 36.6 percent; and a decline in depreciation contributed 37 percent, although these proportions varied over time. Results for various sub-samples of the data were studied. Although the specific results varied by firm size, country, and industry, the qualitative results were confirmed.

The authors offer various possible explanations for the results. They attribute the increase in reported EBITDA to increased market power, a decline in labour's

share of output, and a rising share of firms in information technology, communications, and finance. The increase in financial profits is mainly a result of declining interest rates. The decline in depreciation results from a reduction in investment and an increase in the share of intangible investment. Other factors include an increase in the corporate share of aggregate GDP because of greater incorporation of personal businesses, and an increase in corporate profits because of investment stimulated by power tax rates.

The reader comes away with the impression that there was little causal relation between the fall in corporate tax rates and the increase in pre-tax profits. To the contrary, the fact that the two trends offset each other seems to be more a fortuitous result due to other factors. If corporate tax rates had not been reduced for competitive reasons, tax revenues as a proportion of GDP would have risen substantially. In that sense, the results do not warrant complacency by tax policy makers.

R.B.

Clemens Fuest, Florian Neumeier, and Daniel Stöhlker, *Tax Cuts Starve the Beast! Evidence from Germany*, CESifo Working Paper no. 8009 (Munich: Munich Society for the Promotion of Economic Research, 2019)

The idea that government spending can be constrained by reducing the revenues available to it is a pervasive one. Proponents of smaller government argue that broad-based tax systems, such as the goods and services tax (GST), make it easier for governments to raise revenues, so should be avoided. What are simple tax systems to some people are cash cows to other people. Similarly, fiscally conservative governments, when they are in office, sometimes combine sizeable cuts in expenditure and tax in order to make it more difficult for their successors to expand the size of government. The well-known flypaper effect relies on the same intuition. It posits that increases in grants from higher to lower levels of government induce greater increases in government spending than if the grants had been made to taxpayers. This paper studies a related idea, referred to as “starving the beast”—that is, the idea that exogenous reductions in tax revenue will cause government expenditures to fall rather than causing debt or tax rates to rise.

The authors test the starving-the-beast hypothesis by estimating how German states respond to exogenous changes in their tax revenues. This is a suitable experimental setting, given that German states have broad discretion over expenditures and debt but limited influence over tax revenues, which are controlled by the federal government and shared with the states. Previous studies have yielded mixed results because of the difficulty of identifying exogenous changes in tax revenues. The authors use a so-called narrative approach to construct a data series of exogenous state tax changes for the period 1988-2011. This involves reading official documents with a view to assigning tax changes to seven different categories—for example, counter-cyclical, deficit-driven, spending-driven, and structural. Tax changes are classified as endogenous or discretionary, and the discretionary changes are used as the main explanatory variable.

The base-case empirical analysis uses panel data for German states for 1992–2011 to regress the change in per capita state public spending on (1) exogenous tax changes, which had lagged for four years; (2) various state-specific variables; (3) dummies for election years, coalition governments, and left-wing governments; and (4) linear and quadratic time trends. The results show legislated tax changes having a strong and statistically significant impact on aggregate state spending, with the main effect coming after a two- to three-year delay. The sum of the lagged tax coefficients is close to one, indicating strong support for the authors’ starving-the-beast hypothesis.

Fuest et al. then report on factors that affect the strength of the spending response. States react faster and with greater magnitude to tax cuts than to tax increases. Responses to tax changes are comparable for both highly and modestly indebted states, for states that are governed by single-party and coalition governments, and for states governed by left-leaning and right-leaning governments. The starving-the-beast hypothesis is apparently very robust. The authors redo the empirical estimation, using eight major sub-categories of state spending. The largest responses are found for administration and social security, though with different lags. The response of infrastructure spending is smaller, and the lags are longer. Responses to tax changes in the remaining five categories, including (notably) health and education, are not statistically significant.

The authors caution that the results may not carry over to federations whose institutional features are different from Germany’s. In Canada, provinces have much more discretion over tax revenues and are less likely to experience federal bailouts, so reactions to revenue shocks may differ. The same applies to some extent to the United States, although evidence on the flypaper effects there lends some support to the starving-the-beast hypothesis. The validity of that hypothesis is arguably very germane to Canada, given the tendency of successive federal governments to change fiscal stances. To what extent, for example, will a reduction in the GST rate induce not just the incumbent government but also future ones to restrain their expenditures?

R.B.

Steven Hamilton, “A Tale of Two Wage Subsidies: The American and Australian Fiscal Responses to COVID-19”

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Australia and the United States deployed very different public health responses to the COVID-19 pandemic. Australia imposed restrictive lockdown measures early, and severely restricted the movement of people between interprovincial and interstate borders. The United States used much milder restrictions and, with some exceptions, allowed people to move freely both at home and abroad. The result was starkly different patterns of case counts, with Australia peaking at about 17 per million residents at the end of March, 2020, while the United States temporarily peaked at close to 100 cases per million in early April and then resurged rapidly to more than 120 per million at the end of June. Death rates differed by similar orders of magnitude.

Despite these different outcomes in public health, both countries faced similar economic consequences. Beginning in early March, unemployment rates soared and participation rates plunged in both countries, albeit by more in the United States than in Australia. Governments in both countries realized that broad stimulus measures were not suitable policy responses, and instead enacted targeted measures that were intended to protect firms from going bankrupt and workers from losing their jobs. Failure to do so would have permanently scarred the economies and made recovery more difficult to recover.

Among the measures enacted in both countries were forms of wage subsidies intended to encourage firms to retain workers during the pandemic. The form and administration of the programs differed considerably between Australia and the United States. The author of this article presents a case study comparing the two approaches.

Australia's JobKeeper program paid qualifying businesses a fixed subsidy per worker of Aus\$750 per week regardless of their wages or the number of hours they worked, conditional on the firm paying all workers at least Aus\$750 per week. To qualify, firms (including the self-employed) had to have experienced a drop in revenues of at least 30 percent since one year earlier. Foreign workers and hourly workers employed for less than 12 months were not eligible. The Australian Tax Office (ATO) administered the program, using an electronic payroll reporting system that records payrolls immediately as workers are paid. About half of Australian businesses of all sizes received the JobKeeper subsidy, which covered about one-quarter of all jobs.

In the United States, worker support took the form of the Paycheck Protection Program (PPP), administered by the Small Business Administration (SBA). This was a subsidized loan program that supported small businesses that retained workers and maintained payrolls. Firms with fewer than 500 employees were eligible, along with the self-employed. The SBA guaranteed loans made by financial institutions to firms that certified that the loan was necessary to support their ongoing operations. The loan was for five years, with a 1 percent interest rate, and was limited to 2.5 months of the firms' prior-year payroll costs. A portion of the loan equal to the proportion of full-time equivalent employees retained would be forgiven if the firm spent at least 60 percent of the loan on wage costs and the rest on certain current costs over a 24-week period. Thus, the PPP was an implicit wage subsidy program. Three-quarters of small businesses employing half of the US workforce received PPP support.

The United States also enacted an alternative to the PPP called the employee retention credit, which allowed firms to draw on their income taxes and payroll tax contributions withholdings. This more modest program applied to firms of all sizes.

Hamilton compares the JobKeeper and PPP programs. They supported similar proportions of firms and jobs, but in very different ways. The PPP relied on banks to provide funding and therefore was able to make funds available quickly. The JobKeeper program was delivered by the ATO, and took four to five weeks to get up and running because the necessary infrastructure had first to be put in place. The use of banks for the PPP meant that funds were first extended to firms with close relationships with banks, including larger firms. As well, the PPP was designed for a

short reduction in economic activity and was inadequate for the protracted lockdown that ensued. The JobKeeper program, on the other hand, was overly generous: the shutdown was shorter than expected.

As mentioned above, the JobKeeper program applied to businesses of all sizes, with eligibility based on a fall in revenues, while the PPP applied to firms of all sizes, with much looser (self-declared) eligibility requirements. Both programs disbursed about 2.5–3.5 percent of GDP in funding, but the per-worker subsidy in Australia was much higher—a reflection of the program’s tighter eligibility conditions. Finally, the subsidy bases differed. The PPP covered all wage payments, subject to reasonable per-worker limits, and even covered some non-payroll costs. The JobKeeper program provided a fixed amount per worker, so it inevitably paid some firms too much and others too little. A greater proportion of firms in Australia reported having laid workers off and reduced their hours of work.

Hamilton summarizes some lessons learned from the Australia-US comparison. The PPP was faster but insufficiently targeted, and inadequate. The JobKeeper program was better targeted to the firms most in need, but it offered too much support to some businesses, and it offered the support for too long a period. Neither program was able to respond to changes in circumstances. Hamilton argues that the Internal Revenue Service (IRS), with the right administrative infrastructure, has the potential to implement a large-scale wage subsidy program and provide needed liquidity more efficiently than the banks. The IRS is far better able to overcome informational asymmetries in determining loan requirements and forgiveness. To build the necessary capacity, however, would require a large investment in infrastructure in an institution that has been starved for funds in recent years. Building capacity would include having a system that transmits payroll information to the tax authority in real time, as in Australia. Perhaps there are lessons to be learned by Canada as well.

R.B.

Cheryl Misak, *Frank Ramsey: A Sheer Excess of Power*

(New York: Oxford University Press, 2020)

Readers who studied public finance at university will likely have heard of the Ramsey rule for taxation. In its simplest version, the Ramsey rule advocates setting commodity tax rates inversely proportional to elasticities of demand for the commodities. The Ramsey rule has been extended to public utility pricing and was the analytical precursor to the optimal tax approach to income tax design—an approach pioneered by Atkinson, Diamond, Mirrlees, and Stiglitz. There is some debate about how relevant optimal tax analysis is to tax policy, exactly, though this approach did form the methodological foundation for the influential 2011 Mirrlees Review⁵ commissioned by the Institute of Fiscal Studies in the United Kingdom.

5 James A. Mirrlees, Stuart Adam, Tim Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles, and James Poterba, *Tax by Design: The Mirrlees Review* (Oxford, UK: Oxford University Press, 2011).

It turns out that providing the seeds of optimal tax analysis was only a small part of Frank Ramsey's contribution to knowledge. This recent biography, by the University of Toronto philosopher Cheryl Misak, gives a fascinating account of Ramsey's work and personal life, and of the fascinating society in which he circulated. Ramsey died in 1930, at the age of 27. During his short life, he made fundamental contributions to economics, mathematics, and philosophy. In addition to his seminal paper on optimal taxation—which appeared four decades before modern optimal taxation literature began to accumulate—he made foundational contributions in two other unrelated areas. His paper on optimal savings formed the basis of the Ramsey optimal savings rule, which has influenced the optimal growth literature and, more recently, optimal environmental policy. Less well known is the work he did on subjective probability, which influenced the evolution of intertemporal decision theory.

Misak does a remarkable job of explaining Ramsey's contribution to economics. His contributions to mathematics and philosophy are no less remarkable, and both are explained in accessible detail. Equally fascinating is the Cambridge milieu in which Ramsey thrived. Despite his young age, Ramsey was treated as an equal by the giants of his three disciplines: Keynes and Harrod in economics, Keynes and Russell in the foundations of mathematics, and Moore and Wittgenstein in philosophy. His personal life was every bit as interesting, especially the time he spent moving in the Bloomsbury circle and engaging with psychoanalysts in Europe. Even his family background is unusual for its diverse accomplishments: his father was a Cambridge mathematics don, while his brother followed a very different intellectual and spiritual path from Frank, eventually becoming the Archbishop of Canterbury.

This is not exactly bedtime reading on tax policy. Nonetheless, for those with the time and inclination, the story of Frank Ramsey's life is a very rewarding (and humbling) read.

R.B.

Yariv Brauner, "Tax Treaty Negotiations: Myth and Reality" (2020)

(https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3722607)

This is an exciting paper about the notoriously opaque tax-treaty-negotiation process. I may have brought more enthusiasm to the reading of it than others would: about 15 years ago, I interviewed several tax treaty negotiators, only to discover how impossible it would be to use any of that qualitative data, given research ethics constraints with respect to confidentiality. Brauner has overcome those limits by administering an extensive survey—extensive enough to have enabled him to maintain the confidentiality of the responders.

Over four years, 207 active and former treaty negotiators responded to Brauner's survey. To ensure confidentiality, the administrator's country (and continent) of origin was not collected. Roughly half of the respondents were from OECD member states; the other half were not. The survey collected data on training, preparation,

tax treaty policy, substance, and negotiation processes. Brauner followed the survey with 21 interviews; the interviewees may or may not have completed the survey. The interviews were designed to assess the reasonableness of the survey results.

Brauner's paper is long enough to be a monograph. If you love tax treaties, you should read it. The best I can do here is highlight a few findings that I found striking:

- Roughly a third of treaty negotiators received no specific training.
- Most treaty negotiators knew very little about the laws, policies, and economic position of the treaty partner.
- Treaty negotiators from OECD countries generally had access to general written policy; treaty negotiators from other countries generally had to rely on ad hoc policies or no policies.
- Generally, the decision to negotiate a treaty is driven by political and diplomatic needs, and the decision to renegotiate a treaty stems from treaty- and situation-specific issues.
- Personal relationships were seen as important for productive tax treaty negotiations; negotiators from OECD countries had more such relationships than negotiators from other countries.

Brauner uses the results of his survey to consider the various positions regarding how tax treaties should be interpreted. He concludes that the Vienna Convention on the Law of Treaties may still provide sensible guidance, but that the imbalances between the parties to a treaty should be taken into account.

K.B.

Carlo Garbarino, "The Taxation of Highly-Mobile Individuals: The Case of Entertainers and Sportspersons" (2020) (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3736042)

If you teach international tax, you will know that article 17 inevitably produces a very engaged discussion. Who doesn't want to figure out how the allocation of taxing rights intersects with National Hockey League salary caps?

Garbarino is among the elite tax treaty scholars who have written about most, if not all, tax treaty articles in their careers. (Put another way, he's the Gretzky of tax treaty authors.) In this primarily doctrinal paper, Garbarino digs into article 17. He reviews each of the provisions within article 17, highlighting difficult interpretive issues and recent cases. The paper explores the relevant characterization issues, distinguishing article 17 income from business profits (article 7) and royalties (article 12) as well as from payments to employees (articles 15, 18, and 19). The paper also addresses the rationale for the anti-avoidance provision and its effectiveness in dealing with "star companies."

K.B.

Aitor Navarro, *Tax Sparing Clauses as a Policy Instrument of Developing Countries and Their Descent: Evidence from the Latin-American Tax Treaty Network*, Copenhagen Business School Law Research Paper no. 20-17

(Copenhagen: CBS Law, 2020) (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3669121)

Tax-sparing clauses, given their relative scarcity in the over 3,000 bilateral tax treaties around the world, have been given a fair amount of attention. In this paper, Navarro contributes to that literature by focusing on the tax-sparing clauses in the Latin-American tax treaty network.

The Latin-American tax treaty network is made up of 250 tax treaties and 16 countries. That network of treaties is home to 74 tax-sparing clauses, 22 of which were subject to sunset periods that have expired. Navarro's work focuses on the 52 remaining clauses.

Navarro's review offers some interesting data points. Perhaps not surprisingly, Brazil's network includes the most tax-sparing provisions (21 of 30 treaties). Contingent tax-sparing clauses—clauses where the source state may use any design feature, such as exemption or rate reduction, to reduce its level of taxation, and the residence state will grant an equivalent credit—are used in 19 of the clauses. The remaining tax-sparing provisions (33) are matching credit clauses (where a specific percentage is assumed on a passive income stream). Seventeen of the clauses were enacted following the 1998 OECD report on tax sparing,⁶ which advised against the use of tax-sparing provisions. None of those clauses, however, were in treaties negotiated by the three OECD members among the Latin American countries.

K.B.

6 Organisation for Economic Co-operation and Development, *Tax Sparing: A Reconsideration* (Paris: OECD, 1998).