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Navigating Disruption: The Politics of Business Tax Reform as Two-Level Game

Geoffrey Hale*

PRÉCIS

L'auteur aborde la politique de l'imposition des sociétés et de la concurrence fiscale internationale comme une série de jeux à deux (et parfois à multiples) niveaux qui s'enchâsse dans les débats plus vastes sur la concurrence internationale pour les investissements et la distribution des coûts et des avantages fiscaux au Canada. Se fondant sur plusieurs théories des relations internationales (néo-institutionnaliste, choix publics, et réaliste), l'auteur explore l'évolution du régime d'imposition des sociétés au Canada et la compare avec celle d'autres grands concurrents pour les investissements internationaux, en particulier les États-Unis — changements qui s'inscrivent dans un effort plus vaste pour équilibrer et intégrer les objectifs contradictoires et les objectifs qui se chevauchent des politiques économiques nationales et internationales. L'auteur résume le contexte historique et contemporain de la concurrence fiscale internationale, en particulier en ce qui concerne le fractionnement du revenu, les défis macroéconomiques et microéconomiques de l'arbitrage fiscal, et les compromis qu'implique la gestion de la politique fiscale nationale. L'auteur conclut en présentant les options possibles pour maintenir la souplesse fiscale et politique tout en réagissant efficacement à la concurrence fiscale croissante, comme l'incarne la réforme fiscale américaine de 2017 et d'autres changements politiques semblant indiquer une baisse de l'engagement politique à assurer un paradigme de l'économie ouverte chez les principaux partenaires commerciaux du Canada.

ABSTRACT

The author addresses the politics of business taxation and international tax competition as an interactive series of two- (and sometimes multi-) level games embedded in broader debates over international competition for investment and the distribution of fiscal costs and benefits within Canada. Drawing on several international relations theories (neo-institutionalist, public choice, and realist), the author explores the evolution of Canada's business tax system in relation to the evolving systems of other major competitors for international investment, especially the United States—changes that are occurring as part of a wider effort to balance and integrate competing and overlapping objectives of domestic and international economic policies. The author summarizes the historical and contemporary context for international tax competition, particularly with respect to

* Of the Department of Political Science, University of Lethbridge (e-mail: geoffrey.hale@uleth.ca).

income shifting, macro- and micro-challenges of tax arbitrage, and the tradeoffs involved in managing the domestic politics of taxation. The author concludes by identifying the options available for maintaining domestic fiscal and policy flexibility while responding effectively to growing tax competition, as embodied in the US tax reform of 2017 and other shifts in policy that point to declining political commitment to an open economy paradigm among Canada's major trading partners.

KEYWORDS: CANADA-US ■ CORPORATE INCOME TAXES ■ FOREIGN INVESTMENT ■ INTERNATIONAL TAXATION ■ TAX COMPETITIVENESS ■ TAX NEUTRALITY

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INTRODUCTION

A central challenge in the structuring of Canada's taxation system has been to attract and retain international corporate investment, including the promotion of regionally and globally competitive Canadian businesses, while reducing incentives and opportunities for tax arbitrage (including both adverse income and cost shifting) by both Canadian- and foreign-based corporations.[1] During his career, Tim Edgar addressed these issues in connection with both incoming and outgoing investment in the context of wider international and domestic policies.[2]

International fiscal competition occurs when governments deliberately structure or design tax systems, in detail or as a whole, in order to enhance or preserve their jurisdiction's relative attractiveness as a destination for capital investment and other mobile factors of production, including highly skilled individuals. They do so in response to similar actions by other governments or to the organizational and operational decisions of companies seeking to minimize their tax liabilities within

1 Arguably, federal tax policies in the 2006-2017 period were designed to promote income shifting *to* Canada, including the location of head offices and other operations in Canada, rather than promoting capital import neutrality.

2 For example, Tim Edgar, "Corporate Income Tax Coordination as a Response to International Tax Competition and International Tax Arbitrage" (2003) 51:3 *Canadian Tax Journal* 1079-1158; Tim Edgar, *Interest Deductibility Restrictions and Inbound Foreign Investment*, research report prepared for the Advisory Panel on Canada's System of International Taxation (Ottawa: Department of Finance, October 2008); and Tim Edgar, "Outbound Direct Investment and the Sourcing of Interest Expense for Deductibility Purposes," in Arthur J. Cockfield, ed., *Globalization and Its Tax Discontents: Tax Policy and International Investments* (Toronto: University of Toronto Press, 2010), 60-83.

the law. Accordingly, such competitive action may be proactive, defensive, or a combination of both.

Since the 1990s, successive federal governments in Canada have embraced an "open economy paradigm"[3] aimed at the navigation of cross-cutting political and economic interests, domestic and international, in order to enhance Canadians' economic opportunities. A major objective of this paradigm has been to promote the competitiveness of Canadian businesses in the context of North American and broader international market integration, notwithstanding the growing constraints on this element of globalization in recent years. The concept of competitiveness may reflect (1) aggregate measurements of taxation and its impact on after-tax returns on investment, or (2) key sector-specific metrics of disproportionate relevance to particular industries.

Of course, governments pursue this objective alongside other key political and economic goals, particularly the goal of domestic fiscal sustainability—that is, keeping overall levels of taxation and spending in approximate balance in order to finance the provision of essential public services at levels consistent with maintaining economic growth and improved living standards, and with constraining or reducing public debt relative to gross domestic product (GDP). More explicitly political goals of the open economy paradigm include facilitating Canadians' adaptation to changing social and economic realities, promoting national resilience in the face of periodic political and economic shocks, and (not the least of these goals) sustaining a broad enough distribution of the benefits of economic growth to secure a government's periodic re-election. As a result, although the prevailing (if not always observed) norms of tax policies differ in their forms of neutrality and other measures calculated to enhance economic efficiency, the tax system itself exists to serve broader clusters of public policy objectives that are often deeply embedded in public expectations and patterns of economic activity.[4]

In this paper, I address the challenges of business taxation as an interactive series of two- (and sometimes multi-) level games, embedded in broader debates over international competition for investment and the distribution of fiscal costs and benefits within Canada. I draw on a mixture of international relations theories (neo-institutionalist, public choice, and realist) of two-level games in international economic relations to explain the evolution of Canada's business tax system in relation to the systems of other major competitors for international investment—in particular, the United States. I summarize the historical and contemporary context of international tax competition, particularly as it relates to (1) income shifting,

3 David A. Lake, "Open Economy Politics: A Critical Review" (2009) 4:3 *Review of International Organizations* 219-44, at 224-31 (https://doi.org/10.1007/s11558-009-9060-y); and Richard M. Bird and J. Scott Wilkie, "Tax Policy Objectives," in Heather Kerr, Ken McKenzie, and Jack Mintz, eds., *Tax Policy in Canada* (Toronto: Canadian Tax Foundation, 2012), 2:1-39, at 2:24-25.

4 For a discussion of major structural elements of the tax system as tantamount to conventional elements of an economic constitution, see Geoffrey Hale, *The Politics of Taxation in Canada* (Peterborough, ON: Broadview Press, 2001), at 64-87.

(2) the evolution of Canadian business tax policies in response to macro- and micro-challenges of tax arbitrage, and (3) the challenges of managing the politics of taxation during a period of political and economic uncertainty possibly unrivalled since the 1970s. These three issues have become particularly pressing with the long-deferred reaction to international tax competition that the United States has taken in the Tax Cuts and Jobs Act (TCJA) of 2017, and with other policy shifts that point to a declining political commitment among Canada's major trading partners to an open economy paradigm.

TAX POLICIES AS TWO- (OR MULTI-) LEVEL GAMES

The extent of North American and wider international economic interdependence reinforces the intermestic dimension of Canada's tax system—that is, the blurring of traditional distinctions between primarily domestic and international policies[5] (including but not limited to business taxation policy) that reflects "interlinkages between all parts of the tax system."[6] Scholars of international political economy note certain parallels between the efforts of different governments—particularly the governments of democratic countries—to manage international economic and security relationships. Political leaders and their senior officials enjoy a degree of autonomy in international relations. However, they also face significant domestic institutional and political constraints[7]—not the least of which is the reality that major firms and other investors are independent actors whose interests may overlap with, but remain distinct from, those of their countries of formal residence. The relative success of a national government's international economic policies—whether these policies are (1) unilateral, (2) the product of tacit policy convergence through various forms of parallelism, or (3) the product of explicit negotiations—depends significantly on that government's capacity to achieve some degree of alignment between the interests of major economic actors, the national interests, and that government's ongoing relationships with other governments. However, the definition of "national interests" is heavily conditioned by the structure of national political

5 Bayless Manning, "The Congress, the Executive and Intermestic Affairs: Three Proposals" (1976) 55:2 *Foreign Affairs* 306-24 (https://doi.org/10.2307/20039647).

6 Michael Keen, Li Liu, and Peter Harris, "Taxing Business in a Changing World," in *Canada: Selected Issues*, IMF Country Report 18/222 (Washington, DC: International Monetary Fund, June 28, 2018), 4-31, at 18.

7 Robert D. Putnam, "Diplomacy and Domestic Politics: The Logic of Two-Level Games" (1988) 42:3 *International Organization* 427-60; Helen V. Milner, *Interests, Institutions, and Information: Domestic Politics and International Relations* (Princeton, NJ: Princeton University Press, 1997); and Eugénia da Conceição-Heldt and Patrick A. Mello, "Two-Level Games in Foreign Policy Analysis," in *Oxford Research Encyclopedia of Politics* (Oxford: Oxford University Press, 2017) (https://doi.org/10.1093/acrefore/9780190228637.013.496).

institutions, including the capacity of a given structure to secure the consent or acquiescence of formal and informal veto holders or blocking coalitions.[8]

In this context, efforts to manage fiscal and trade relations and the interactions of national regulatory systems (among other systems) help to create a series of two- and multi-level games embedded within broader governance processes that combine relations among governments, transnational actors, and varied domestic interests inside and outside governments.[9] The restructuring of business tax systems, whether undertaken in conjunction with broader tax reforms, as during the 1980s, or in response to changing international and domestic business practices, as during the 2000s, typically requires a balancing of competing goals involving both external and domestic factors.[10]

At its simplest, the concept of international economic relations as two-level games is rooted in the interdependence of international and domestic political and policy processes in participating countries—interdependence with one another and with largely market-driven economic processes and relationships.[11] At one level, governments seek to manage their ongoing interactions with other national or central governments—and with other international economic actors—to mutual advantage within relatively stable legal and economic arrangements. These processes are punctuated by the periodic negotiation or revision of bilateral or multilateral agreements. At a second level, however, tax policy and other major national regulatory processes remain primarily national because of asymmetries of power, institutional arrangements, the relative interdependence or vulnerability between and among countries, the primacy of domestic legislative authority, and senior policy makers' desire to maintain control of their respective policy agendas.

The greater the political visibility or prospective economic impact of significant changes to tax policies (whether these changes arise from domestic or international considerations or from a mixture of both), the greater the relative importance of the second level of the game—that is, the level at which governments seek to create, with respect to proposed changes, a supportive consensus with public opinion and key domestic stakeholders (or, at least, seek to create the conditions necessary to

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8 Edward D. Mansfield and Helen V. Milner, *Votes, Vetoes, and the Political Economy of International Trade Agreements* (Princeton, NJ: Princeton University Press, 2012); and Geoffrey Hale, "Regulatory Cooperation in North America: Diplomacy Navigating Asymmetries" (2019) 49:1 *American Review of Canadian Studies* 123-49 (https://doi.org/10.1080/02722011.2019.1570956).

9 Putnam, supra note 7; Milner, supra note 7; and Geoffrey Hale, "Transnationalism, Transgovernmentalism and Canada-US Relations in the Twenty-First Century" (2013) 43:4 *American Review of Canadian Studies* 494-511 (https://doi.org/10.1080/02722011.2013.858757).

10 Hale, supra note 4, at 38 et seq.

11 The degree of politicization of these relationships depends on the extent to which they are intertwined with national security considerations (as with nuclear materials and export controls over defence-related technologies) or with the relative power (and related electoral calculations) of central and subnational governments over particular economic sectors as instruments of economic development, distributive politics, or both.

diffuse prospective or actual opposition). Writing almost 40 years ago, David Good observed that insiders responsible for federal tax policy "make tax policy by anticipating the outside world and, to the extent desirable and feasible, by accommodating tax policies to their anticipations."[12] The greater the technical complexity (or relative obscurity) of actual or proposed measures, the greater the relative autonomy of bureaucratic policy makers,[13] as long as these policy makers enjoy the confidence and support of their political "masters." Federal Department of Finance officials have substantially increased their engagement with major stakeholders and other attentive actors, institutionalizing their consultation processes since the political fiasco of the 1981 tax reform budget.[14] Since that time, these officials have also convened periodic advisory panels, which usually involve both private and (former) public sector experts on particularly technical or controversial issues, as with the Advisory Panel on Canada's International System of Taxation (2007-8).[15]

However, these debates are typically confined to a tax policy community composed of (1) economists and other policy professionals within the Department of Finance, (2) the select group of tax lawyers, accountants, and academic economists with whom the policy professionals interact, and (3) other "attentive actors" generally interested in particular segments of tax policy rather than in the system as a whole. Good's observation that "[a]ttentive actors . . . are separate and isolated components . . . distinguished from each other by a highly particularized interest in taxation"[16] appears to be as true as it ever was, particularly in highly technical, specialized fields such as international taxation. Broader public engagement generally occurs only when the debate becomes politicized as a result of divisions within the tax policy community or as a result of policy makers' failure to anticipate adequately the disruptive effects of proposed policy changes on entrenched interests or ordinary citizens.[17] Two-level games focused on particular policy initiatives may turn into multi-level games when they affect competing sets of institutional interests and objectives within governments that are interacting with competing sets of corresponding economic and/or societal interests.

Policy makers and disciplinary experts within the tax policy community seek to balance (1) the institutional objectives of maximizing overall revenues (as opposed to maximizing revenues from particular sources) in ways that are least disruptive to economic activity with (2) competing governmental and societal interests and objectives

12 David A. Good, *The Politics of Anticipation: Making Canadian Federal Tax Policy* (Ottawa: Carleton University, School of Public Administration, 1980), at xi.

13 Eric A. Nordlinger, *On the Autonomy of the Democratic State* (Cambridge, MA: Harvard University Press, 1981).

14 Hale, supra note 4, at 162-74.

15 Advisory Panel on Canada's International System of Taxation, *Final Report: Enhancing Canada's International Tax Advantage* (Ottawa: Department of Finance, December 2008).

16 Good, supra note 12, at xii-xiii.

17 Good, ibid.; and Hale, supra note 4.

(including the government's prospects of periodic re-election).[18] Good has described these balancing processes as "the politics of anticipation."[19] Savoie and others have characterized them as the institutionalized competition of "guardians and spenders."[20] Within this framework, the "guardian" role of the Department of Finance, particularly its tax policy branch, is largely defensive—whether in anticipating and limiting risks of tax arbitrage and other unintended consequences of prospective tax policy decisions, or in reacting to aggressive tax arbitrage and avoidance strategies used to exploit past policy decisions or to leverage modest policy anomalies into much broader fiscal crevasses.[21] Other governments face similar challenges, including the relative centralization or diffusion of responsibility for oversight of comparable policies across governments, differences in the legal or institutional processes to be navigated, and the presence of prospective veto players whose consent must be negotiated either by governments or through cross-national policy coalitions.[22]

However, international tax policies of particular governments are typically embedded within and largely dependent on the structures of national tax policies, as noted above. The major features of a government's international tax policy are relatively durable, and they are shaped by domestic institutions, slowly evolving balances of economic and social interests, and political and bureaucratic perceptions

18 Three elements of this internal debate—in which advocates of the "open economy" paradigm within the Canadian tax policy have come to conclusions that differ from prevailing outlooks in the United States—are the following: (1) the role of corporate income taxation ("withholding tax" and "backstop" as opposed to primary instrument of redistribution), (2) the ultimate incidence of capital taxation (its eventual distribution among workers, consumers, and shareholders), and (3) the efficiency effects or "deadweight loss" of different forms of taxation in different economic settings. Richard M. Bird and Thomas A. Wilson, "The Corporate Income Tax in Canada: Does Its Past Foretell Its Future?" (2016) 9:38 *SPP Research Papers* [University of Calgary, School of Public Policy] 1-32; Geoffrey Hale, "Cross-Border Fiscal Competition and Tax Reform," paper presented to the Association of Canadian Studies in the United States," Las Vegas, October 20, 2017; and Geoffrey Hale, "Institutions Matter: Fiscal Competition and Tax Reform in the United States and Canada," paper presented to the Western Social Sciences Association, Houston, April 7, 2018.

19 Good, supra note 12.

20 Donald J. Savoie, *The Politics of Public Spending in Canada* (Toronto: University of Toronto Press, 1990); and David A. Good, *The Politics of Public Money*, 2d ed. (Toronto: Institute of Public Administration of Canada and University of Toronto Press, 2014).

21 The two most notorious examples of such exploitation in recent memory are probably the scientific and research tax credit (SRTC) fiasco of the mid-1980s and the spectacular growth of income trusts between 1999 and October 31, 2006 (the date of Finance Minister Jim Flaherty's pre-emption of this technique outside the real estate sector). Current Finance officials point to the rapid growth of self-incorporation by members of professional firms, which prompted the federal government's controversial efforts to contain access to small business tax preferences in 2016 as a growing form of tax arbitrage. Alexandra Posadski, Eric Atkins, and David Parkinson, "Small Business, Big Trouble," *Globe and Mail*, September 16, 2017; and Keen et al., supra note 6, at 5-6.

22 Hale, supra note 8; and Mansfield and Milner, supra note 8.

of national, institutional, and political (self-)interest.[23] Pantaleo and Smart observe that "Canada uses all three patterns [of international taxation]: worldwide, territorial, and remittance basis (or deferral) . . . depend(ing) on the nature of both the taxpayer and the income."[24] Notwithstanding significant structural reforms in the 1980s, the central elements of Canada's existing tax system were designed during a period of relatively limited international interdependence, although the formally worldwide character of its business tax system has evolved into a "*de facto* territorial form of international taxation for active (business) income."[25]

The growth of Canada's interdependence with the North American and global economies since the 1980s has reinforced cross-cutting forms of fiscal and tax competition at several levels in allocating the costs and benefits of government activities—competition between citizens (or "residents") and governments, between individuals and corporations (as well as large and small firms), between national and foreign governments, and among their citizens, who benefit to varying degrees from different kinds of international investment. In some cases, as discussed in the next section of this paper, major tax policy changes have accompanied or followed fundamental changes in Canada's international relationships—most notably, the negotiation of the Canada-US Free Trade Agreement in 1986-87 and the subsequent rapid growth in both inbound and outbound stocks of foreign direct investment relative to GDP. In other cases, these tax policy changes have been responses to incremental changes in the international policy environment—for example, changes in marginal tax rates, thin capitalization rules, and the debates over whether (and how) to restrict the deductibility of arm's-length interest payments on the international transactions that were the object of much of Tim Edgar's research.[26]

Changes to domestic tax policies in Canada and in its major trading partners, especially the United States, create policy externalities, both for other governments and (particularly) for businesses that often incorporate tax considerations into their allocation of investments, organization of supply chains, and choice of transactional forms across jurisdictional boundaries[27]—a "bottom-up" form of tax competition. Cockfield has observed that growing international economic integration, combined with differences in national tax rules, has increased competition between national

23 Hale, supra note 4, at 63-87. See Douglas G. Hartle, *The Revenue Budget Process of the Government of Canada: Description, Appraisal, and Proposals*, Canadian Tax Paper no. 67 (Toronto: Canadian Tax Foundation, 1982); Savoie, supra note 20; and Good, supra note 20.

24 Nick Pantaleo and Michael Smart, "International Considerations," in *Tax Policy in Canada*, supra note 3, 12:1-48, at 12:4.

25 Keen et al., supra note 6, at 7; compare Simon Richards and Dylan Gowans, "Corporate Income Taxes in Canada: Revenue, Rates and Rationale," *HillNotes*, March 21, 2017 (https://hillnotes.ca/2017/03/21/corporate-income-taxes-in-canada-revenue-rates-and-rationale/).

26 Edgar, *Interest Deductibility Restrictions*, supra note 2; and Edgar, "Outbound Direct Investment," supra note 2.

27 Edgar, "Corporate Income Tax Coordination," supra note 2, at 1081.

governments and multinational firms by encouraging the latter to "shift the location of their investments and operations to countries that impose relatively lower . . . tax burdens,"[28] and to engage in tax arbitrage between and among countries through sophisticated tax-planning, financial, and transfer-pricing strategies.[29]

As a result, governments have become increasingly sensitive to the use of income shifting and other forms of tax arbitrage to reduce their tax bases—a major concern raised by the 1997 report of the Technical Committee on Business Taxation ("the Technical Committee"). Federal tax policies since 2000 have been aimed at reducing Canada's vulnerability to such activities, creating a relatively favourable environment for internationally competitive Canadian companies, and welcoming inward foreign investment (outside a handful of protected sectors).[30]

The multi-level game of tax competition functions within a dynamic environment characterized by a mixture of intergovernmental competition, cooperation in navigating differences between national tax systems, and evolving strategies of adaptation to changing fiscal and other competitive conditions by Canadian- and foreign-based multinational corporations (MNCs), with implications for investment flows, employment, and government revenues. National governments may cooperate selectively to limit both double taxation and the arbitrage that results in tax base erosion, both of which result from tax competition and differences among national tax systems. Such cooperative arrangements may take the form of "hard law," as in bilateral tax treaties, or of "soft law" that is dependent on integration with national legal systems, such as the recent Organisation for Economic Co-operation and Development (OECD) multilateral convention[31] and its International VAT/GST [value-added tax/goods and services tax] Guidelines of 2017.[32] Even so, Arnold notes that such measures are "essentially products of domestic law . . . that affect cross-border transactions,"[33] as with many other forms of international regulatory cooperation.[34]

28 Arthur J. Cockfield, "Introduction: The Last Battleground of Globalization," in *Globalization and Its Tax Discontents*, supra note 2, 3-17, at 5.

29 Ibid., at 6; and Edgar, "Corporate Income Tax Coordination," supra note 2.

30 Geoffrey Hale, *Uneasy Partnership: The Politics of Business and Government in Canada*, 2d ed. (Toronto: University of Toronto Press, 2018), at 291-315.

31 Organisation for Economic Co-operation and Development, Multilateral Convention To Implement the Tax Treaty Measures To Prevent Base Erosion and Profit Shifting, released November 24, 2016.

32 Organisation for Economic Co-operation and Development, *International VAT/GST Guidelines* (Paris: OECD, April 12, 2017).

33 Brian J. Arnold, "Canada's International Tax System: Historical Review, Problems and Outlook for the Future," in *Canada's International Law at 150 and Beyond*, Paper no. 8 (Waterloo, ON: Centre for International Governance Innovation, February 2018), 1-12, at 1-2.

34 Anne-Marie Slaughter, *A New World Order* (Princeton, NJ: Princeton University Press, 2004).

As a result, Canadians governments have tended toward the incremental adaptation of domestic tax policies to changing international conditions. High-profile measures, such as the elimination of capital taxes on non-financial corporations (2002-2008) and phased reductions in corporate tax rates (2006-2012), have been combined with broader reductions in personal income or consumption tax rates that are intended to maintain a rough balance between levels of personal and business taxation, and with other measures intended to meet broader fiscal targets, such as balanced budgets or the gradual reduction in federal-net-debt-to-GDP ratios.

FOREIGN INVESTMENT AND INTERNATIONAL TAX COMPETITION

[T]he main policy challenge [in tax reform] is to develop effective international tax rules and processes within what is essentially a non-cooperative government setting.[35]

International tax competition takes place in different dimensions because of differences in the structures of national tax systems (and related domestic political expectations) and differences in the national rates of taxation for different types of economic activity. Governments may engage in tax competition in numerous ways: by setting marginal tax rates below those of major competitors, by privileging various forms of economic activity, or by altering tax structures—for example, by creating territorial tax structures that tax domestic but not active offshore business income.

Policy makers must decide how to integrate or prioritize different forms of tax neutrality—that is, the application of equal or similar tax rates to businesses (and other taxpayers) that are in similar circumstances. In principle, governments may seek to pursue capital import neutrality (CIN), in which foreign-based and domestically based firms are taxed at similar rates on business operations in the same jurisdiction; or capital export neutrality (CEN), in which the foreign-source income of domestically based MNCs is taxed at rates comparable with the rates applied to income from their domestic business activities.[36] CIN is typically associated with source-based or territorial tax systems, as well as with a "level-playing field" between domestic businesses and affiliates of foreign-based firms.[37] CEN is associated with residence-based or worldwide tax systems and, in principle, with the pursuit of global production efficiency in the international allocation of capital.[38]

35 Cockfield, supra note 28, at 8.

36 Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998), at 6:3-4; Advisory Panel on Canada's System of International Taxation, supra note 15, at 12-13; and Jane G. Gravelle, *Reform of U.S. International Taxation: Alternatives*, CRS Report RL34115 (Washington, DC: Congressional Research Service, August 1, 2017), at 3-7.

37 Michael P. Devereux, *Taxation of Outbound Direct Investment: Economic Principles and Tax Policy Considerations*, research report prepared for Advisory Panel on Canada's International System of Taxation (Ottawa: Department of Finance, July 2008), at 4-5 and 9-10.

38 Ibid., at 6.

In practice, many countries, including Canada, have hybrid systems that recognize the difficulty, if not the impossibility, of achieving capital import and export neutrality simultaneously.[39] The growth in international economic integration and the expansion of MNCs based in multiple countries, including Canada, have led to the spread of a third concept of neutrality that supports source-based (territorial) taxation of active business income. The objective of this form of neutrality—namely, capital ownership neutrality (CON), sometimes called "market neutrality"—is that "[t]axes should not distort competition . . . between any companies operating in the same market."[40] Canadian governments seeking to promote internationally competitive, Canadian-based MNCs in the absence of effective coordination of international taxation regimes have embraced CON for active business income, if not without controversy among champions of other normative tax principles within the tax policy community.[41] At the same time, these governments have used evolving foreign accrual property income (FAPI) rules to preserve their capacity to tax passive international income by limiting the conversion of active to passive income of Canadian-based firms' foreign affiliates.

However, as noted above, Canadian governments face cross-cutting pressures in managing international tax competition, pressures that impose limits on their effective autonomy. At the level of domestic politics, these governments are constrained by public expectations (expectations rooted in normative principles of vertical equity) that corporate income taxation should contribute to public services, income transfers, and other redistributive functions. Three major policy considerations have disciplined policy makers' responses to these pressures. First, there is strong economic evidence that in relatively small, open economies, higher taxes on capital have relatively high adverse effects on economic growth.[42] Second, there is widespread recognition among Canadian tax economists (unlike US economists) that a sizeable share of capital taxation is ultimately borne not primarily by shareholders but by workers (in the form of lower wages) and by consumers (in the

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39 Pantaleo and Smart, supra note 24, at 12:4; and David A. Weisbach, *The Use of Neutralities in International Tax Policy*, Coase-Sandor Institute for Law & Economics Working Paper no. 697 (Chicago: University of Chicago Law School, Coase-Sandor Institute for Law and Economics, August 2014).

40 Devereux, supra note 37, at 11.

41 For example, Arnold, supra note 33, at 11, criticizes the deductibility of interest on funds loaned to foreign affiliates of Canadian-based firms to generate active business income that is effectively tax-exempt in Canada as a "dubious policy of subsidizing offshore investment by Canadian multinationals."

42 Maximilian Baylor and Louis Beauséjour, *Taxation and Economic Efficiency: Results from a Canadian CGE Model*, Working Paper 2004-10 (Ottawa: Department of Finance, November 2004); and Kevin Milligan, *Tax Policy for a New Era: Promoting Growth and Fairness*, Benefactor's Lecture 2014 (Toronto: C.D. Howe Institute, November 2014).

form of higher prices).[43] Third, although the statistics vary across types of businesses, available data indicate that more than half of business tax costs are incurred through profit-insensitive taxes.[44] The Technical Committee suggested that these tensions should be managed by more closely aligning profit-insensitive taxes with the benefits received by the businesses that pay them.[45] However, the enthusiasm with which federal officials resorted to user fees during Ottawa's fiscal restructuring of the 1990s led Finance Minister John Manley in 2002, following strong pressure from business groups, to impose strong parliamentary checks on the introduction of new user fees. These restrictions were relaxed only with the 2017 federal budget.[46]

Second, Canada's relatively open, trade-dependent economy has long constrained governments' taxing of mobile factors of production by enforcing effective corporate income tax (CIT) rates that are relatively competitive, particularly in comparison with the US rates.[47] These constraints were decisive in Canada's shift to value-added

43 *Report of the Technical Committee on Business Taxation*, supra note 36, at 1:3; Jonathan R. Kesselman and Ron Cheung, "Tax Incidence, Progressivity and Inequality in Canada" (2004) 52:3 *Canadian Tax Journal* 709-89; Bird and Wilkie, supra note 3; Robin W. Boadway and Jean-François Tremblay, *Modernizing Business Taxation*, C.D. Howe Institute Commentary no. 452 (Toronto: C.D. Howe Institute, May 2016); and Kenneth J. McKenzie and Ergete Ferede, "Who Pays the Corporate Tax? Insights from the Literature and Evidence for Canadian Provinces" (2017) 10:6 *SPP Research Papers* [University of Calgary, School of Public Policy] 1-26.

44 The CIT's share of total business taxation varies widely with cyclical levels of corporate profitability and shifts in the overall federal-provincial tax mix. The CIT's share of total business taxation increased from 22 percent in 1995 to about 37 percent in 2015, and to 43 percent in 2016. *Report of the Technical Committee on Business Taxation*, supra note 36, at 2:19; and Peter Van Dyck and Andrew Packman, *Total Tax Contribution and the Wider Economic Impact: Surveying Canada's Leading Enterprises* (Toronto: PricewaterhouseCoopers and the Business Council of Canada, 2018) (https://thebusinesscouncil.ca/publications/2018ttc/).

45 *Report of the Technical Committee on Business Taxation*, supra note 36, at 1:7 and 1:10-11.

46 For discussion of the User Fees Act, SC 2004, c. 6, and the effective constraints that it imposed on the expansion of user fees by the federal public service before its replacement by the Service Fees Act, SC 2017, c. 20, section 451, see Connie Hache, "Financing Public Goods and Services through Taxation or User Fees: A Matter of Public Choice?" (PhD dissertation, University of Ottawa, School of Political Studies, 2015) (http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.1032.3659&rep=rep1&type=pdf). A 2017 Senate report criticized the Service Fees Act for "removing all meaningful transparency and consultations" from proposed increases in user fees. Andrew Griffith, "Bill C-44 Division 21: Risks and Implications of the Service Fees Act," brief to Senate Committee on National Finance, at 2 (https://sencanada.ca/content/sen/committee/421/NFFN/Briefs/C-44__Brief_e.pdf).

47 Canada. Department of Finance, *The Tax Systems of Canada and the United States: A Study Comparing the Levels of Taxation on Individuals and Businesses in the Two Countries* (Ottawa: Department of Finance, November 1978) (released with the November 16, 1978 federal budget); and Canada, "Role of Marginal Effective Tax Rates in Canadian Tax Policy," presentation to MENA-OECD Investment Program, Paris, January 2009 (www.oecd.org/mena/competitiveness/42031384.pdf); and Hale, supra note 30, at 302-11.

taxation since the early 1990s, gradually followed by the shift to sales tax harmonization in the six provinces east of Manitoba, which contributed to sharply lower marginal effective tax rates (METRs) in participating provinces.[48] However, a trans-ideological taxpayers' revolt,[49] which resulted in the reversal of a harmonization agreement in British Columbia in 2010, along with the continuing public resistance to higher consumption taxes reflected by widespread political opposition to rising carbon taxes, demonstrate the practical political limits of such a strategy, especially if it is introduced without equivalent fiscal compensation to taxpayers.[50]

Third, efforts to reduce corporate taxes in response to wide international trends (and in response to the efficiency arguments noted above) are constrained domestically by public expectations that such tax reductions will be matched or exceeded by comparable tax reductions for individuals and households, with due attentiveness to distributive considerations. Since the political fiasco of Allan MacEachen's tax reform budget of 1981, Canadian political leaders have typically been unwilling to pursue substantive tax reform initiatives unless they can be packaged as broadly based tax reduction for most Canadian taxpayers.[51] Moreover, in Canada, unlike the United States, substantial changes to federal tax policies involving tax reduction have typically been conditional on fiscal sustainability, whether such sustainability is based on continued economic growth or strict spending discipline. These constraints help to explain the relatively targeted character of initial federal responses to US business tax reforms of 2017 in Canada's economic statement of November 2018.[52]

The Evolving Context for International Tax Competition

Whether in setting marginal tax rates or making adjustments to major business tax incentives, Canadian governments have always been sensitive to international tax

48 Hale, supra note 30, at 302-5.

49 George Malcolm Abbott, "The Precarious Politics of Shifting Direction: The Introduction of a Harmonized Sales Tax in British Columbia and Ontario" [2015] no. 186 *BC Studies: The British Columbia Quarterly* 125-48 (https://doi.org/10.14288/bcs.v0i186.185567).

50 The Trudeau government has tacitly recognized this reality, responding to growing political resistance to the introduction of carbon taxes in several parts of Canada, by crafting its carbon tax "backstop" for provinces that withdraw from or refuse to participate in the federal scheme to recycle most revenues to residents of provinces to which the scheme will apply. See "For the Liberals, a Spoonful of Sugar Helps the Carbon Tax Go Down," *Globe and Mail*, October 24, 2018. Federal support for "emissions-intensive trade-exposed" (EITE) industries reflects similar efforts to mitigate the competitive effects of introducing carbon taxes in the absence of comparable actions by Canada's major trading partners. Sarah Dobson and Jennifer Winter, "Assessing Policy Support for Emissions-Intensive and Trade-Exposed Industries" (2018) 11:28 *SPP Research Papers* [University of Calgary, School of Public Policy] 1-44.

51 The introduction of the federal GST in 1990 was the exception that has proved the rule. Finance Minister Michael Wilson made the tax visible at point of sale in order to discourage his successors from raising it in future (conversation with author, 1994), whatever its effects on the Mulroney government's prospects for re-election.

52 Canada, Department of Finance, *Investing in Middle Class Jobs: Fall Economic Statement 2018* (Ottawa: Department of Finance, November 2018).

competition, particularly as it affects investment and employment in major Canadian industries.[53] At the same time, these governments have acted repeatedly, albeit often with limited success, to limit the erosion of Canada's income and consumption tax bases by various forms of tax arbitrage. These factors reflect major elements of the "macro," sectoral, and "micro" dimensions of tax competition.

Although the scale of Canada's relative international interdependence has fluctuated, the maintaining of competitive effective tax rates for traded sectors has been a major objective of Canadian policies for many years. Ottawa's approach to CIT rate-setting strategies and to restrictions on income-shifting practices has generally been defensive—a response to incremental trends (or periodic tax reforms) in other countries. Since 1989, Ottawa has been more innovative in addressing competitive issues related to consumption taxes—in large measure because of competitive pressures and opportunities created by the absence of a national sales tax in the United States.

Federal and provincial governments have also sought to address competitiveness issues in managing the evolution of environmental taxation, whether in paralleling US federal and/or state policy initiatives before 2010[54] or the former's subsequent federal inaction on carbon-pricing measures. The Trudeau government's decision to implement (without corresponding US action) a national carbon-pricing strategy in response to Canada's 2017 Paris Accord commitments illustrates the numerous challenges of balancing environmental objectives, competitiveness issues, and trade-offs imposed by Canada's decentralized federal system and regionally diversified energy endowments.

Canada has tracked effective US tax rates, particularly for manufacturing, to varying degrees since the 1970s, although this was done more as an informal than a formal policy goal until the Harper government committed itself in 2006 to achieving "the lowest tax rate on new business investment in the [Group of Seven] G7."[55] Successive efforts to reform the antiquated federal sales tax, culminating in its replacement by the federal GST in 1990, sought to limit progressive base erosion while achieving neutrality in the tax treatment of domestic and imported goods and services in an economy characterized by the growing disaggregation of business activity.[56] Major tax reforms in the United States and Great Britain, which significantly reduced marginal income tax rates for individuals and businesses in the

53 *The Tax Systems of Canada and the United States*, supra note 47; *Report of the Technical Committee on Business Taxation*, supra note 36; and "Role of Marginal Effective Tax Rates in Canadian Tax Policy," supra note 47.

54 Geoffrey E. Hale, "Canada-US Relations in the Obama Era: Warming or Greening?" in G. Bruce Doern and Christopher Stoney, eds., *How Ottawa Spends, 2010-2011: Recession, Realignment, and the New Deficit Era* (Montreal and Kingston, ON: McGill-Queen's University Press, 2010), 48-67.

55 Canada, Department of Finance, *Advantage Canada: Building a Strong Economy for Canadians* (Ottawa: Department of Finance, October 2006), at 14 and 73-78.

56 Hale, supra note 4, at 207-23.

mid-1980s, created both demonstration effects and political imperatives for other industrial countries, including Canada.[57] More recently, the rapid growth of digital commerce has created challenges in the enforcement of VATs on cross-border commerce, and it has intensified debates over registration requirements for large-scale offshore vendors.[58]

Canada continues to have one of the world's most open economies, as illustrated by the relative importance of international trade and investment as a share of the country's GDP, and this increases the relative importance of Canada's tax competitiveness and fiscal sustainability. Two-way trade accounted for 64 percent of Canada's GDP in 2017, the fourth-highest percentage in the Group of Twenty (G20) after Germany, Korea, and Mexico.[59] At 90.1 percent of GDP, Canada's total stock of outward foreign direct investment (FDI) is the largest among G20 nations, as is the total value of Canada's inward FDI, based on the OECD definition of "equity" plus net loans to enterprises in foreign economies that result in at least 10 percent ownership of foreign affiliates. Keen et al. estimate that US-based multinationals have generated about 15 percent of CIT revenues in recent years[60]—a figure that is subject to significant erosion depending on the effectiveness of Canadian federal responses to recent US tax reforms.

Table 1 outlines outward and inward stocks as shares of GDP for Canada and the world's largest economies between 2005 and 2017. Table 2 points to longer-term trends in inward and outward FDI, using Statistics Canada's equity-based measurement. Differences between the two benchmarks illustrate the relative importance of related-party debt in the structuring of foreign affiliates.

Canada's average outward and inward flows of FDI in the 2008-2017 period have also been among the largest of G7 and G20 countries, averaging 3.7 and 2.6 percent of GDP, respectively, between 2008 and 2017 (substantially above the G7 averages of 1.9 and 1.2 percent, respectively).[61] However, non-tax considerations—not least the global takeover boom of 2005-2007 and the ebb and flow of international energy investments (or disinvestments in 2016-17)—have typically played larger roles in

57 Ibid., at 192-98; and United States, Congressional Budget Office, *Corporate Tax Rates: International Comparisons* (Washington, DC: Congressional Budget Office, November 2005).

58 Bruno Basalisco, Jimmy Gårdebrink, Martina Facino, and Henrik Okholm, *E-commerce Imports into Canada: Sales Tax and Customs Treatment* (Copenhagen: Copenhagen Economics, March 2017); PricewaterhouseCoopers, *Rise in Canada's De Minimis Threshold: Economic Impact Assessment* (Toronto: Retail Council of Canada, December 2017); Rosalie Wyonch, "Competitive Digital Taxation for Federal Budget 2019," C.D. Howe Institute *Intelligence Memo*, December 12, 2018; and Jack Mintz, "Who Dares To Tax the Flix?" *Financial Post*, January 22, 2019.

59 World Bank, "Trade (% of GDP)," 2018 (https://data.worldbank.org/indicator/NE.TRD.GNFS.ZS).

60 Keen et al., supra note 6, at 28, note 7.

61 Organisation for Economic Co-operation and Development, "FDI Flows," 2019 (https://doi.org/10.1787/99f6e393-en).

TABLE 1 Outward and Inward Direct Investment: Canada in International Context

	Outward			Inward		
	2005	2011	2017	2005	2011	2017
	percentage of GDP					
Canada	**59.2**	49.9	**90.1**	**54.6**	**48.2**	**65.2**
United Kingdom	49.1	**65.6**	61.7	31.2	43.9	61.2
European Union	34.6	48.0	66.5	29.9	38.4	57.4
Germany	29.1	38.1	43.5	22.6	26.3	25.8
United States	27.8	29.1	40.4	21.5	22.6	40.5
Japan	8.3	15.2	30.7	2.1	3.7	4.1
China	2.8	5.6	12.3	20.6	25.2	24.3

Note: Boldface indicates the highest percentage in a year.

Source: Organisation for Economic Co-operation and Development, "FDI Flows," 2019 (https://doi.org/10.1787/99f6e393-en).

TABLE 2 Canada's Outward and Inward Foreign Direct Investment

	1990	2000	2005	2011	2013	2017
	percentage of GDP					
Canadian direct investment abroad	14.2	32.3	31.9	38.3	41.0	52.4
Foreign direct investment	18.9	28.9	28.1	35.6	36.3	38.6

Sources: Statistics Canada, table 36-10-0008-01 (formerly CANSIM table 376-0051), "International Investment Position, Canadian Direct Investment Abroad and Foreign Direct Investment in Canada, by Country, Annual," and table 36-10-0222-01 (formerly CANSIM table 384-0038), "Gross Domestic Product, Expenditure-Based, Provincial and Territorial, Annual"; and author's calculations.

these developments than tax considerations, with two major exceptions discussed later in this section.

Although both the United States and Canada raised taxes during the 1990s as part of broad budget-balancing strategies, the 1997 Technical Committee report noted that Canada's METRs were substantially above international norms, creating both opportunities and incentives for income shifting through the accumulation of debt financing in Canadian operations of multinational firms. A key structural challenge in limiting income shifting is that Canada's income tax system (like that of the United States before 2018) makes financing expansion through debt "inherently tax-preferred to equity."[62]

62 Keen et al., supra note 6, at 10. At the same time, the capacity to shelter retained earnings in (small) Canadian-controlled private corporations creates an inherent bias toward retained earnings financing. This bias is reinforced by the typically more generous spread between general corporate and small business tax rates in most provinces (except Quebec)

The committee identified several areas in which Ottawa could engage in base broadening and limit opportunities for tax arbitrage (for example, by the tightening of thin capitalization ratios) while functioning within "international norms." However, the committee also recommended continuing the effective exemption of active business income from foreign affiliate taxation, but with tighter restrictions on the deductibility of interest in Canada used to finance international interaffiliate transactions.[63]

The Technical Committee's most significant long-term impact was to draw attention to the importance of *aggregate* business taxation, in the form of METRs, on international capital flows. Although the Chrétien and Martin governments began to reduce Canadian METR levels to the levels of other major industrial countries, with phased CIT and capital tax reductions after 2000, the Harper government formalized this process between 2007 and 2012 by introducing major reductions to marginal CIT rates and providing provinces with incentives to harmonize their sales taxes with the GST. As a result, Canada's average corporate METR fell from 43 percent in 2000 to 26.5 percent in 2013.[64]

Canadian governments have gradually, if perhaps belatedly, tightened thin capitalization rules since the 1980s: they reduced permitted debt-to-equity ratios from 3:1 (in 1987) to 2:1 (in 2000), following the Technical Committee report; and to 1.5:1 in 2012, following the Advisory Panel report.[65] In addition, disallowed interest paid by non-resident investors is taxable as dividends under the terms of relevant tax treaties.[66] However, successive governments have preferred incremental changes and the expansion of anti-avoidance measures to major structural changes such as those suggested by Tim Edgar—for example, suggestions that Canada follow the example of Australia, New Zealand, and the United Kingdom in applying thin capitalization rules to arms-length borrowing, or that Canada significantly limit restrictions on deductibility of interest borrowed by Canadian-based multinationals to lend to foreign affiliates.[67]

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and in the federal tax system. Average provincial small business rates outside Quebec were 10.3 percentage points below comparable general corporate rates in 2018, compared with 4 percentage points in Quebec in 2018 (4.9 percent in 2019), and, for the federal spread, 5 percentage points in 2018 (6 percent in 2019).

63 *Report of the Technical Committee on Business Taxation*, supra note 36, at 1:4, 3:26, and 6:11-30.

64 Chen and Mintz define METRs as "the portion of capital-related taxes paid as a share of the pre-tax rate of return on capital for marginal investments": Duanjie Chen and Jack M. Mintz, "The 2014 Global Tax Competitiveness Report: A Proposed Business Tax Reform Agenda" (2015) 8:4 *SPP Research Papers* [University of Calgary, School of Public Policy] 1-19.

65 Supra note 15.

66 Evelyn Moskowitz, *Financing Issues: The Thin Capitalization Rules* (Ottawa: Canadian Bar Association, May 29, 2010), at 3-4, note 7 (www.cba.org/cba/cle/PDF/Tax10_Moskowitz_FinanciingIssues_ThinCapitalizationRules_paper.pdf); and John M. Campbell, "Thin Capitalization Regime," *International Tax Newsletter*, November 2012 (www.millerthomson.com/en/publications/communiques-and-updates/international-tax-newsletter/november-2012/thin-capitalization-regime/).

67 Edgar, "Outbound Direct Investment," supra note 2.

The issues of interaffiliate financing and the deductibility, in Canada, of funds borrowed for investment abroad has been reinforced by the scale of outbound FDI in international financial centres and other low-tax jurisdictions, particularly because dividends from such affiliates are often tax-exempt in Canada.[68] For example, Bermuda and four other Caribbean tax havens have accounted for an average of 16.5 percent of outward Canadian FDI and for 2.3 percent of inward FDI since 2013, reflecting the frequent use of these countries as venues for international financial transactions.[69] The 2007 federal budget announced plans (hereinafter referred to as "section 18.2")[70] to restrict, by 2011, so-called double-dip transactions involving the use of funds borrowed in Canada to "obtain at least two interest deductions on the amount of money borrowed" through foreign affiliates located in low-tax jurisdictions.[71] Strong corporate resistance to this measure—given the persistence of measures favourable to "tax-efficient" interaffiliate financing by foreign affiliates of US, British, and Dutch-based MNCs (among others),[72] the onset of the global financial crisis, and (possibly) the record number of foreign takeovers of major Canadian firms in 2007-8—convinced the Advisory Panel on Canada's International System of Taxation to recommend the withdrawal of the measure in its final report.[73] In response, Finance Minister Jim Flaherty rescinded section 18.2 in his February 2009 budget. This incident suggests that the nature of international tax competition effectively limits the capacity of relatively small countries such as Canada to introduce major structural changes to their international taxation systems without some degree of coordination with (or clear demonstration effects of policy changes made by) major economic powers without the risk of increasing relative financing costs for these countries' resident MNCs.

A second cross-cutting challenge to the achievement of international tax equity is a by-product of domestic tax changes within Canada. The Chrétien and Martin

68 François Lavoie, *Canadian Direct Investment in "Offshore Financial Centers"* Statistics Canada catalogue no. 11-621-MIE (Ottawa: Statistics Canada, March 2005); and Brian Mustard, "Canada's System of International Taxation: A Look Back, a Look Forward" (2013) 61, special supp. *Canadian Tax Journal* 257-70.

69 Statistics Canada, table 36-10-0008-01 (formerly CANSIM table 376-0051), "International Investment Position, Canadian Direct Investment Abroad and Foreign Direct Investment in Canada, by Country, Annual."

70 Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended.

71 Office of the Auditor General of Canada, *Report of the Auditor General of Canada to the House of Commons* (Ottawa: Office of the Auditor General of Canada, December 2002), chapter 11, at exhibit 11.3. See also Canada. Department of Finance, *Explanatory Notes relating to the Income Tax Act, the Excise Act, 2001, and the Excise Tax Act* (Ottawa: Department of Finance, February 2009), at clause 7 (www.fin.gc.ca/drleg-apl/biafeb09n-eng.asp); and Edgar, "Outbound Direct Investment," supra note 2.

72 The Netherlands accounted for 11.2 percent of outward Canadian FDI stocks in 2017, and Luxembourg for another 6 percent—percentages that are disproportionately high in relation to the status of these countries as European trading partners. Statistics Canada, supra note 69.

73 Supra note 15, at 50-53; and Mustard, supra note 68, at 259.

governments' gradual phaseout of Income Tax Act restrictions on international investments by pension funds and other retirement savings vehicles in the early 2000s (combined with prudential pressures for diversification of their investments) contributed to the rapid growth of offshore investments by major public sector (and other) pension funds. Foreign holdings of Canada's 10 largest pension investment managers were estimated at 55.4 percent of their $1.2 trillion of assets under management in 2014.[74] The economic interactions of pension fund investments with tax policies (particularly for offshore investments), and the variety in ownership structures, are sufficiently complex to deter broad generalizations about their economic effects.[75] The sizable role played by tax-exempt investors in both domestic and international capital markets[76] significantly constrains the expanded taxation of active business income by foreign affiliates of Canadian MNCs without risking significant issues of horizontal equity. At the same time, the Canada-US tax convention allows for reciprocal exemptions from withholding taxes on cross-border investment income paid to non-resident pension funds.[77]

However, concerns over the sheltering of investment income in foreign tax havens in recent years have given governments in many major industrial countries a shared interest in limiting the erosion of their personal and CIT bases and increasing their effectiveness in combatting outright tax evasion. The OECD base erosion and profit shifting (BEPS) project, inaugurated in 2013, has benefited from three major factors critical to overcoming previous political and bureaucratic obstacles to intergovernmental cooperation. First, the unilateral action of the US Congress in passing the Foreign Account Tax Compliance Act (FATCA) of 2010 required foreign

74 Boston Consulting Group, *Measuring Impact of Canadian Pension Funds* (Toronto: BCG, October 2015), at 11 (http://image-src.bcg.com/Images/Measuring-Impact-of-Canadian-Pension-Funds-Oct-2015_tcm79-39773.pdf). By 2018, the proportion of offshore investments was substantially larger (85 percent) for the Canada Pension Plan Investment Board (CPPIB) and for Quebec's Caisse de Dépôt (64 percent). See Esteban Duarte, "Overseas Shopping Protects AAA Rating," *Financial Post*, April 23, 2019.

75 Vijay Jog and Jack Mintz, "The 30 Percent Limitation for Pension Ownership in Companies: Policy Options" (2012) 60:3 *Canadian Tax Journal* 567-608, at 581-86.

76 Jog and Mintz, ibid., at 584, note that in 2004 "[t]ax-exempt investors [held] 40 percent of total [Canadian] corporate assets, Canadian taxable investors [held] 20 percent, and the remainder [were] held by non-residents." Conversely, the "top 10" Canadian pension investment funds accounted for almost 60 percent of the stock of Canadian direct investment abroad in 2014: Boston Consulting Group, supra note 74. Rosenthal and Austin estimate that retirement accounts and plans held 37 percent of taxable holdings in US "C" corporations in 2015, foreign residents about 26 percent, US household investors (including partnerships) 24.2 percent, and non-profit organizations about 4.9 percent. However, passthrough vehicles now account for more than half of taxable US business income. Steven M. Rosenthal and Lydia M. Austin, "The Dwindling Taxable Share of U.S. Corporate Stock" (2016) 151:7 *Tax Notes* 923-34.

77 Jack M. Mintz and Stephen R. Richardson, "Not Just for Americans: The Case for Expanding Reciprocal Tax Exemptions for Foreign Investments by Pension Funds" (2014) 7:34 *SPP Research Papers* [University of Calgary, School of Public Policy] 1-25.

financial institutions to provide the Internal Revenue Service with information on accounts held by US clients. These provisions—effectively a policy reversal intended to preserve US policy discretion (also known as "sovereignty") outside constraints imposed by previous multilateral processes—provided a model for the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes in its framing of model tax information exchange agreements (TIEAs) and, ultimately, a model for the 2017 multilateral convention, in order to enable participating countries to combat aggressive tax planning without triggering domestic US concerns over the erosion of domestic sovereignty.[78]

The BEPS project and TIEAs rely on amendments to existing tax treaties and the implementation of varied national laws, a reliance that is consistent with traditional conventions of horizontal ("soft law") international cooperation.[79] Accordingly, the BEPS project and TIEAs limit the political challenges of harmonizing diverse national legal institutions—a traditional barrier to international tax policy cooperation—while enabling expanded cooperation through transgovernmental networks to enhance the enforcement of domestic tax laws. The BEPS process has also enabled the Canada Revenue Agency to facilitate its international enforcement by requiring country-by-country disclosure of Canadians' international corporate income and transactions, including the disclosure of investment funds and data on transfer pricing, along with the exchange of information among national tax collection authorities since 2016.[80]

US Tax Reforms of 2017: Consequences for Cross-Border Tax Competition

Major structural changes to the US tax system, which were approved by Congress in 2017, have resulted in both significant CIT rate reductions and many technical tax policy innovations that have changed the competitive environments for investment and tax planning in Canada and other countries. Passage of the 2017 TCJA on a party-line vote followed several years of debates over whether US CIT rates had become uncompetitive relative to those of major trading partners and investment destinations.[81] Many observers expressed concerns that the US residence-based (worldwide) CIT system had provided US-based MNCs with significant incentives for income shifting—particularly through the use of corporate inversions to shift

78 Arnold, supra note 33, at 9.

79 Slaughter, supra note 34.

80 Organisation for Economic Co-operation and Development, *Action 13: Country-by-Country Reporting Implementation Package* (Paris: OECD, 2015); and Canada Revenue Agency, "Guidance on Country-by-Country Reporting in Canada," November 23, 2018 (www.canada.ca/en/revenue-agency/services/forms-publications/publications/rc4651/guidance-on-country-country-reporting-canada.html).

81 Hale, "Cross-Border Fiscal Competition and Tax Reform," supra note 18.

their head offices to other countries (see figure 1), including Canada—notwithstanding periodic efforts to tighten anti-avoidance rules.[82] Table 3 contrasts the composition of financial sources of US outbound FDI with the composition of financial sources of US inbound FDI in 2016, showing the much higher proportion of intracompany debt in the latter.

The TCJA reduced top US federal marginal CIT rates from 35.3 percent (39 percent, when average state tax rates are included) to 21 percent, and it reduced average combined METRs from an average 35.3 percent to 18.9 percent, with significant sectoral variations, eliminating a previous average Canadian advantage estimated at 14.2 percentage points across sectors and provinces.[83] It converted the US tax system from its previously worldwide (residence-based) structure, with credits for foreign taxes paid and deferral of taxes on non-repatriated profits, to a broadly territorial system, with one-time transitional taxes that are based on deemed repatriation of liquid and illiquid assets earnings and are payable over eight years.[84]

More significantly for ongoing tax competition, the US tax reform creates substantial incentives for the repatriation and attraction of capital to the United States and for moving the costs of income shifting and other tax-planning measures to other countries, thus suggesting the tactics used in strategic trade policies rather than the mere pursuit of CIN.[85] Indeed, the TCJA may be the most aggressive exercise in many years in tax competition and engineering designed to increase domestic investment and international income shifting, although some of its sharp edges may be blunted by phaseout periods on particular measures, growing fiscal exigencies, and partisan shifts in coming years. Macroeconomic incentives for the reallocation of international investment are reinforced by Congress's decision to fund "permanent" business tax rate reductions by increasing deficits (and, implicitly, by increasing

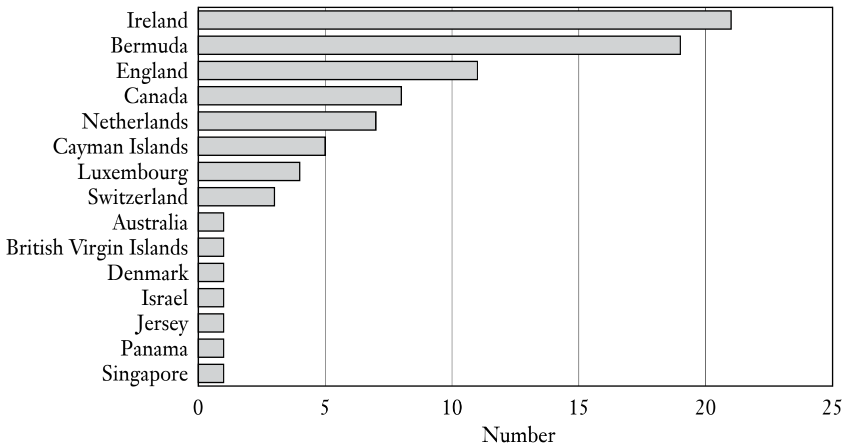
82 Michelle Clark Neely and Larry D. Sherrer, "A Look at Corporate Inversions, Inside and Out" (2017) 25:1 *Regional Economist* [Federal Reserve Bank of St. Louis] and Donald J. Marples and Jane G. Gravelle, *Corporate Expatriation, Inversions, and Mergers: Tax Issues*, CRS Report no. R43568 (Washington, DC: Congressional Research Service, September 25, 2014). The 2016 anti-avoidance regulations designated any "foreign acquiring company" as a domestic entity if 80 percent or more of its equity is held by former US owners of the business (or of multiple firms acquired in "serial" transactions), with other penalties applying to firms with 60 percent or more US ownership. Paul Seraganian, Jennifer Lee, William Corcoran, and Ramin Wright, "Major U.S. Anti-Inversion Regulations Impact Canadian Companies Both in and out of the Inversion Sandbox," April 11, 2016 (www.osler.com/en/resources/cross-border/2016/major-u-s-anti-inversion-regulations-impact-canad).

83 Jack Mintz and Duanjie Chen, *The U.S. Corporate Effective Tax Rate: Myth and the Fact*, Tax Foundation Special Report no. 214 (Washington, DC: Tax Foundation, February 2014); and P. Bazel and J. Mintz, "Canadian Policy Makers Consider Response to U.S. Tax Overhaul," *Tax Policy Trends*, October 2018 [University of Calgary, School of Public Policy], 1-2.

84 Erica York, *Evaluating the Changed Incentives for Repatriating Foreign Earnings*, Tax Foundation Fiscal Fact no. 615 (Washington, DC: Tax Foundation, September 27, 2018).

85 Jack Mintz, *Global Implications of U.S. Tax Reform*, EconPol Working Paper 08/2018 (Munich: Ifo Institute, March 2018); and Keen et al., supra note 6.

FIGURE 1 Completed US Corporation Tax Inversions, 1982-2017



Source: Zachary Mider, "Tracking Tax Runaways," *Bloomberg.com*, March 1, 2017 (www.bloomberg.com/graphics/tax-inversion-tracker).

TABLE 3 Composition of Financial Sources of US Direct Investment Abroad and Foreign Direct Investment in the United States, 2016

	US direct investment abroad	Foreign direct investment in US
	percent	
Equity capital	10.0	53.0
Reinvested earnings	95.8	20.4
Intracompany debt	−5.8	26.6

Source: James K. Jackson, *U.S. Foreign Direct Investment Abroad: Trends and Current Issues*, CRS Report no. R21118 (Washington, DC: Congressional Research Service, June 29, 2017), at 4.

international borrowing given relatively low US savings rates), rather than by offsetting rate cuts with more extensive base broadening or by substantially increasing US federal spending in separate budgetary actions. Mintz and others have noted several elements in the TCJA that are of critical importance to Canadian businesses in both Canada and the United States:

1. the expensing, through 2022, of investment in assets with expected lifespans of less than 20 years, with plans for phasing out these measures by 2027;
2. the accelerated (five-year) amortization of research and development expenditure;
3. an exemption for dividends received from foreign affiliates with at least 10 percent ownership by the US parent (a measure that parallels existing Canadian policies);

4. a new base erosion anti-avoidance tax (BEAT) on the adjusted taxable income of foreign affiliates operating in the United States, with significant restrictions on related-party transfers; and
5. new global intangible low-taxed income (GILTI) tax rules on both foreign and domestic income of US-based multinationals.[86]

These measures are partly offset by limits on the deductibility of interest expenses to a maximum of 30 percent, excluding real estate investments—with the additional effect of discouraging income shifting through increased debt financing of the US affiliates of foreign-based multinationals. Taken together at a macro level, these measures have eliminated the Canadian METR advantage over most sectors. They have created significant incentives to shift investments, particularly in intellectual property, to the United States, and to reallocate debt financing to other countries, including Canada.

The GILTI rules have been described as a "foreign minimum tax" on "supernormal" (over 10 percent) investment returns—sometimes labelled "excess profits."[87] They are designed to limit the sheltering in low-tax jurisdictions of profits generated by US technology industries, in particular, which account for a disproportionate share of US exports and services trade. These rules also complement US strategic trade policies, including tighter intellectual property rules negotiated under the US-Mexico-Canada Agreement (USMCA) of October 2018.[88] Some observers suggest that these measures are also intended to pre-empt or "guide" prospective outcomes of OECD discussions of digital taxation, including but not limited to the outcomes related to international apportionment of taxes on major global technology firms, many of which originate in the United States.[89]

Ideological and partisan polarization in Washington makes the durability of these measures after 2020 an open question. However, the cumulative effect of what certain observers have described as the "weaponization of uncertainty"[90] in international trade and economic relations creates an ongoing threat to Canada's investment climate and competitiveness. Fiscal countermeasures announced by Finance Minister Bill Morneau in November 2018 matched the TCJA's provision for the expensing of capital investment in assets with expected lifespans of less than 20 years, and the subsequent phasing out of these measures by 2027. Morneau also

86 Mintz, supra note 85, at 3-4.

87 Bazel and Mintz, supra note 83.

88 Junyi Chen, "USMCA (NAFTA 2.0): What's New for Intellectual Property in Canada," October 12, 2018 (www.blaney.com/articles/usmca-nafta-20-whats-new-for-intellectual-property-in-canada).

89 G. Charles Beller, "GILTI: 'Made in America' for European Tax—Unilateral Measures and Cooperative Surplus in the International Tax Competition Game" (2019) 38 *Virginia Law Review* 271-313.

90 For example, see Meredith Crowley and Dan Ciuriak, *Weaponizing Uncertainty* (Toronto: C.D. Howe Institute, June 19, 2018), at 7.

announced the tripling of initial depreciation rates for a range of other assets in order to address assorted issues of supply chain competitiveness within Canada. Taken together, these measures are expected to reduce average federal METRs from 17.0 to 13.8 percent (see figure 2).

Ottawa's November 2017 measures are a stopgap, comparable with, if more extensive than, provisions for accelerated depreciation introduced by the Harper government following similar US measures approved by Congress as part of the Obama administration's 2009 stimulus bill. However, because the likelihood of partisan gridlock in Congress following the 2018 midterm elections limits the prospects for much US policy innovation before the 2020 presidential elections, Canada has time to consider options for a broader range of policy measures to sustain its competitiveness in an evolving global environment.

CONCLUSION: EVOLVING CANADIAN TAX POLICIES FOR AN UNCERTAIN WORLD

The broader federal strategy for international tax competitiveness, a strategy that crystallized over the decade following the Technical Committee report of 1997 and was subsequently implemented under the Harper government, was contingent on a broader domestic strategy—aimed at fiscal sustainability, debt reduction, and widespread improvements in domestic living standards—that paid careful attention to distributive considerations. Various scholars have suggested broader blueprints for comprehensive or structural corporate tax reforms.[91] However, historical experience suggests that any such undertaking is likely to be too economically and politically disruptive to reward any government that has the temerity to initiate it within the extended time frame required for effective policy design and implementation, unless fiscal conditions permit broadly based tax reductions for most individuals and businesses. Proposals for major changes in overall levels and distribution of taxes must begin with the tax system as it is, not as we might wish it to be in the best of all possible worlds.[92]

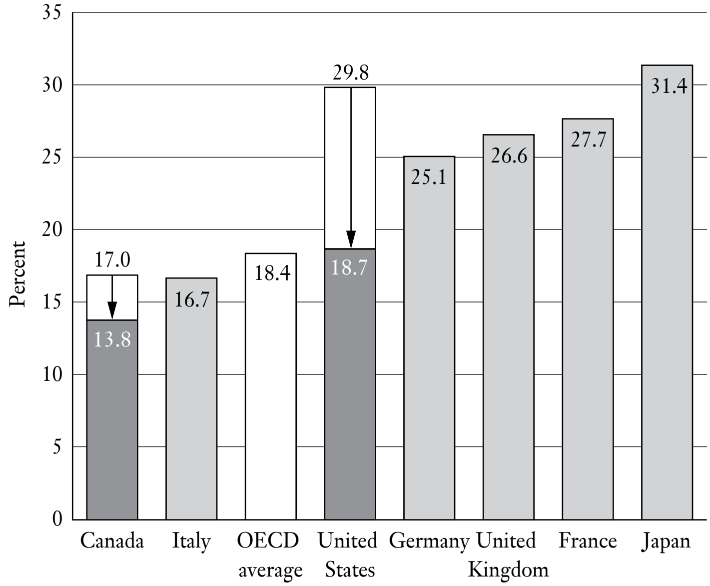
The existing tax system is embedded within the economic lives and expectations of Canadians—often in contradictory ways, as demonstrated by the recent political fiasco over the Trudeau government's proposed restrictions of 2016-17 on access to the small business deduction.[93] Levels of public trust in political, economic, and academic elites are sufficiently tenuous that politically sustainable tax reform depends, as it always has, not merely on revenue neutrality but on achieving a consensus of affected societal interests whose consent is contingent on there being

91 For example, see Milligan, supra note 42; Chen and Mintz, supra note 64; Boadway and Tremblay, supra note 43; and Kenneth McKenzie and Michael Smart, *Tax Policy Next to the Elephant: Business Tax Reform in the Wake of the US Tax Cuts and Jobs Act*, C.D. Howe Institute Commentary no. 537 (Toronto: C.D. Howe Institute, March 2019).

92 Hale, supra note 4, at 27.

93 Posadski et al., supra note 21.

FIGURE 2 Corporate METRs Across G7 Countries: Impact of US Tax Reforms (2017) and Canadian Responses (2018)



Source: Canada, Department of Finance, *Investing in Middle Class Jobs: Fall Economic Statement 2018* (Ottawa: Department of Finance, November 2018), at 59.

broadly distributed reductions in overall levels of taxation without the disruption of valued public services.[94] However, tax and spending measures must be kept in a rough balance to ensure fiscal sustainability in the face of ongoing demographic trends in aging.

To achieve public consent to significant tax policy changes while maintaining the overall competitiveness of Canada's tax system (the two-level game that has been the focus of this article), the government that emerges from the upcoming federal election should set broad policy goals that recognize the interaction of various elements of the tax system, including, but not limited to, corporate and international tax levels.

There are two keys to maintaining the balance between competitiveness and public consent. First, governments should use the personal tax system as their principal tool for addressing issues of distributive equity, while making incremental changes to the corporate tax system that contribute to greater efficiency, growth, and business competitiveness. Second, in the Canadian context, the government

94 Edelman Canada, "2018 Edelman Trust Barometer: Canada," February 2018 (www.edelman.ca/sites/default/files/2018-02/2018-Edelman-Trust-Barometer-Canada_ENGLISH.PDF); Proof Inc., "CanTrust Index 2019: Canada Is Seeing Cracks in the Foundation of Trust," April 2019 (www.getproof.com/thinking/the-proof-cantrust-index/); and Hale, supra note 4, at 26-27.

should continue the recent years' trend of maintaining competitive METRs for Canadian businesses relative to major global competitors while (1) redressing major sectoral anomalies that undermine competitiveness and (2) incrementally extending measures to limit base erosion in a way that is consistent with broader international norms.

To achieve these objectives, the Department of Finance should

- maintain levels of accelerated depreciation that are broadly competitive with US levels, while attempting to limit distortions in their application across industry sectors;
- align profit-insensitive taxes on businesses more closely with the costs of providing related public services, subject to transparent justification of direct costs and services;
- review patent box models that could encourage innovation in Canada, reviewing them on the bases of expert analyses of evolving models in other industrial countries;[95]
- consider expansion of the thin capitalization rules to include arm's-length debt transactions in the financing of foreign affiliates of Canadian-based firms, subject to careful examination of the effects of such measures in other countries;
- limit competitive pressures from "carbon leakage" by monitoring the impacts of carbon taxation in order to balance ongoing progress toward overall reductions in carbon emissions with the mitigation of impacts on particularly "trade-exposed" industries;
- limit base erosion and address the growing challenge of offshore internet commerce by tightening GST/HST (harmonized sales tax) requirements for offshore vendors, with a reasonable de minimis threshold, following Quebec, Saskatchewan, and the recent *Wayfair*[96] decision in the United States.

Purposeful incrementalism of this sort, which addresses aggregate levels of taxation while identifying sectoral opportunities for and vulnerabilities to international tax competition, is likely to be more practically achievable and sustainable than theoretically ambitious approaches that have the potential to disrupt existing economic relationships and trigger substantial political conflict.

95 For example, see John Lester and Jacek Warda, "An International Comparison of Tax Assistance for R&D: 2017 Update and Extension to Patent Boxes" (2018) 11:13 *SPP Research Papers* [University of Calgary, School of Public Policy] 1-33.

96 *South Dakota v. Wayfair, Inc.*, 585 US (2018).