CANADIAN TAX JOURNAL

REVUE FISCALE CANADIENNE

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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
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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

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c/o Canadian Tax Foundation / Fondation canadienne de fiscalité

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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 :

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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.

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Directrice exécutive et chef de la direction
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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
a/s Canadian Tax Foundation / Fondation canadienne de fiscalité

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■ ACTIVITÉS RÉCENTES ET À VENIR*

MIDI-CONFÉRENCE — JEUNES FISCALISTES : DÉPOUILLEMENT DES SURPLUS

le 13 décembre 2019, Montréal

MIDI-CONFÉRENCE — JEUNES FISCALISTES : ACQUISITION DE CONTRÔLE

le 24 janvier 2020, Montréal

MIDI-CONFÉRENCE — LITIGE FISCAL

le 12 février 2020, Montréal

TECHNICAL SEMINAR AND LIVE WEBCAST — TRANSFER PRICING

April 2, 2020, Montreal

TECHNICAL SEMINAR AND LIVE WEBCAST — ESTATE PLANNING AND TRUSTS

May 14, 2020, Montreal

PRAIRIE PROVINCES TAX CONFERENCE AND LIVE WEBCAST

June 1-2, 2020, Winnipeg

JOURNÉE D'ÉTUDES FISCALES — CONFÉRENCE ET WEBÉMISSION

le 9 juillet 2020, Montréal

BRITISH COLUMBIA TAX CONFERENCE AND LIVE WEBCAST

September 21-22, 2020, Vancouver

ST. JOHN'S TAX SEMINAR

September 25, 2020, St. John's

ONTARIO TAX CONFERENCE AND LIVE WEBCAST

October 26-27, 2020, Toronto

ATLANTIC PROVINCES TAX CONFERENCE

November 6-7, 2020, Halifax

SEVENTY-SECOND ANNUAL TAX CONFERENCE (2020)

November 29-December 1, 2020, Calgary

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Canadian Tax Journal

Published four times per year

Price: \$75 per copy (plus applicable taxes)

Subscription rate: \$343.75 per year (plus applicable taxes)

(HST registration no. R-106867260)

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2019, vol. 67, no. 4

(Issued January 2020)

ISSN 0008-5111

Printed in Canada

6,300 12-19

Revue fiscale canadienne

Publiée quatre fois l'an

Prix : 75 \$ l'exemplaire (taxes en sus)

Abonnement : 343,75 \$ par an (taxes en sus)

(Numéro d'enregistrement de TVH :

R-106867260)

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Internet : www.fcf-ctf.ca

2019, vol. 67, n^o 4

(publication : janvier 2020)

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■ 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.

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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.

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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.

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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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Contracting for Tax Room: The Law and Political Economy of Tax-Point Transfers

Rory Gillis*

PRÉCIS

Les transferts de points d'impôt peuvent être un outil fondamental pour modifier la répartition de la marge fiscale entre les gouvernements, mais le fédéralisme fiscal canadien a abandonné leur utilisation. Cet article fait valoir que l'utilisation peu fréquente des transferts de points d'impôt peut s'expliquer, en partie, par les obstacles à l'exécution des contrats intergouvernementaux. Le problème est double : 1) les transferts de points d'impôt consistent généralement en des opérations non séquentielles à long terme qui permettent aux gouvernements de s'acquitter de leurs obligations à des moments très différents; et 2) les mécanismes courants pour assurer le rendement dans les opérations non séquentielles à long terme ne sont pas accessibles ou ont peu de poids dans les accords de transfert de points d'impôt. Cette situation fait en sorte que ces obstacles contractuels peuvent décourager les gouvernements d'utiliser les transferts de points d'impôt pour obtenir une répartition optimale de la marge fiscale.

ABSTRACT

Tax-point transfers are potentially a foundational tool for changing the allocation of tax room between governments, but they have fallen into disuse in Canadian fiscal federalism. This article argues that the infrequent use of tax-point transfers can be explained, in part, by impediments to the enforcement of intergovernmental contracts. The problem is twofold: (1) tax-point transfers typically consist of long-term non-sequential transactions, in which governments perform their obligations at substantially different points in time; and (2) the common mechanisms for assuring performance in long-term non-sequential transactions are either unavailable or of only modest force in tax-point transfer agreements. The primary implication is that these contractual impediments may discourage governments from using tax-point transfers to achieve an optimal allocation of tax room.

KEYWORDS: FISCAL FEDERALISM ■ TRANSFERS ■ TAX POINTS ■ TAX ROOM ■ FEDERAL-PROVINCIAL

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INTRODUCTION

In recent years, heated political debates have occurred in Canada and the United States over the allocation of revenue between federal and subnational governments. In 2016, the Canadian federal government reduced the annual growth rate for the cash transfers that it provides to the provinces for health care. The provinces vociferously protested, and eventually walked out of the meetings that sought to negotiate a new accord. (The impasse was resolved in early 2017.)¹ In 2017, the

1 See Robert Benzie and Bruce Campion-Smith, "Ontario Welcomes New 10-Year Health Accord with Ottawa," *Toronto Star*, March 10, 2017 (www.thestar.com/news/canada/2017/03/10/ontario-quebec-reach-health-deals-with-ottawa-after-months-of-negotiations.html). See also Bruce Campion-Smith, "Health Talks Fail Despite Federal Pledges of More Cash for Home Care, Mental Health," *Toronto Star*, December 19, 2016 (www.thestar.com/news/canada/2016/12/19/provinces-reject-ottawas-pitch-on-healthcare.html).

US federal government imposed a cap on the federal tax deduction available for state and local taxes (SALT), which effectively reduced the tax room available to the states.² High-tax states announced plans to sue the federal government over the legislation.³

Amid the widespread controversy over the use of cash transfers and tax deductions in Canada and the United States, there has been little discussion of an alternative method for redistributing fiscal resources between governments—the use of tax-point transfers. A tax-point transfer occurs when one level of government lowers its tax rate on a tax base so that the other level of government can raise its tax rate by an equivalent amount. A tax-point transfer enables the transferee government to levy more tax points—the individual percentage points that make up tax room⁴—without increasing the combined federal-provincial tax rate.

Tax-point transfers were once common in Canadian fiscal federalism and were applied along various tax bases, including income tax. In 1942, the provinces transferred income tax points to the federal government in exchange for cash transfers. In 1972 and 1976, the federal government transferred income tax points to the provinces in lieu of pre-existing cash transfers and a series of credits and deductions for provincial taxes. But no income-tax-point transfers have occurred between the federal and provincial governments since 1976, and tax-point transfers have largely disappeared from federal-provincial negotiations.

This article has two objectives. First, it explains the primary function of tax-point transfers—they provide a coordinated means for changing, as circumstances warrant, the allocation of tax room between governments—and then it surveys the reasons why governments may wish to periodically change the allocation of tax room. Second, the article examines why tax-point transfers have fallen into disuse. Its central claim is that impediments to the enforcement of intergovernmental contracts provide a partial explanation. The problem is twofold: (1) tax-point transfers typically consist of long-term non-sequential transactions,⁵ in which governments

2 For a summary of the legislation, see Jared Walczak, “State Strategies To Preserve SALT Deductions for High-Income Taxpayers: Will They Work?” *Tax Foundation Fiscal Fact* no. 569, January 2018, at 3 (<https://files.taxfoundation.org/20180105094213/Tax-Foundation-FF569.pdf>).

3 Annie Nova and Darla Mercado, “Connecticut Say They Will Sue Federal Government Over Caps on Tax Deductions,” *CNBC*, January 26, 2018 (www.cnbc.com/2018/01/26/new-york-new-jersey-connecticut-plan-to-sue-federal-government-over-salt-caps.html).

4 The term “tax point” can also refer to individual percentage points of tax receipts. See, for instance, the discussion of the 1976 tax-point transfer at note 45 and following below. In this article, I use “tax point” to refer to individual percentage points of tax room except when referring to the 1976 transfer.

5 I borrow this term from Trebilcock and Leng, who use it to describe contracts where the two parties perform their obligations at substantially different points in time; see Michael Trebilcock and Jim Leng, “The Role of Formal Contract Law and Enforcement in Economic Development” (2006) 92:7 *Virginia Law Review* 1517–21.

perform their obligations at substantially different points in time; and (2) the common mechanisms for assuring performance in long-term non-sequential transactions are either unavailable or of only modest force in tax-point transfer agreements. These contractual impediments may discourage governments from using tax-point transfers to change the allocation of tax room, even when a change is in the public interest.

This article has four main sections:

1. In the first section, I define tax-point transfers, examine the prerequisites to their use, and briefly review two historical income-tax-point transfers.
2. In the second section, I examine tax-point transfers from the provinces to the federal government, which I refer to as “upward” tax-point transfers. First, I set out the primary reason why provinces may wish to increase the tax room allocated to the federal government: by transferring tax points to the federal government in exchange for subsequent cash transfers, provinces can reduce interprovincial tax-base shifting and increase the revenue of all governments. I then argue that upward tax-point transfers are rare, at least in part, because the most common tools for assuring contractual performance—judicial enforcement, the threat of termination or revocation, reputational sanctions, self-help, and the use of collateral—are of limited utility in tax-point transfer agreements. In the absence of effective enforcement mechanisms that ensure that the federal government will make good on the promised cash transfers, the provinces are unlikely to voluntarily surrender tax room.
3. In the third section, I examine tax-point transfers from the federal to provincial governments, which I refer to as “downward” tax-point transfers. First, I set out the primary reason why the federal government may wish to increase the tax room allocated to the provinces: downward tax-point transfers can resolve a number of incentive problems that arise in fiscal federalism. I then argue that the same contractual problems that afflict upward tax-point transfers render downward tax-point transfers unattractive from the federal perspective. In particular, in the absence of enforceable agreements, the federal government is likely to prefer alternative revenue-allocation mechanisms, such as cash transfers and deductions, which can be more effectively used to influence provincial spending decisions and advance federal interests.
4. Finally, in the fourth section, I consider the implications of the foregoing analysis for fiscal federalism and for law. For fiscal federalism, the contractual barriers to tax-point transfers mean that the allocation of tax room between governments may be suboptimal. For law, tax-point transfers shed new light on a legal doctrine—parliamentary sovereignty—that limits the capacity of governments to enter into enforceable intergovernmental agreements. While this doctrine seeks to maximize policy flexibility, it may actually limit the policy options available to governments.

WHAT IS A TAX-POINT TRANSFER?

Definition

A tax-point transfer has two elements. First, the transferor government lowers its tax rate on a tax base. Second, the transferee government raises its tax rate on the same base by an equivalent amount. These tax-rate changes are coordinated, so that the tax cut by the transferor government occurs in anticipation of the tax increase by the transferee government. A downward tax-point transfer (from the federal government to a province), for example, consists of a federal tax cut followed by a provincial tax increase. Conversely, an upward tax-point transfer (from a province to the federal government) consists of a provincial tax cut followed by a federal tax increase. Under either scenario, the transfer enables the transferee to increase its tax rate without increasing the combined federal-provincial tax rate.

A simple example illustrates the operation and effect of a tax-point transfer. Imagine a country with a national (“federal”) government and a single subnational (“provincial”) government, both of which occupy the same territory.⁶ Both governments impose a flat tax on income. The federal rate is 15 percent and the provincial rate is 5 percent, so that the combined federal-provincial rate is 20 percent. In this scenario, the federal government’s share of total income tax revenue is 75 percent and the provincial government’s share is 25 percent.

If the federal government transfers 5 tax points to the province, the federal tax rate falls to 10 percent and the provincial rate rises to 10 percent. The transfer has no effect on the combined federal-provincial tax rate, which remains at 20 percent, but changes the allocation of revenue between the two governments. The federal government’s share of income tax revenue decreases from 75 percent to 50 percent, while the province’s share increases from 25 percent to 50 percent. These results are shown in table 1.

For the provincial government, the value in the tax-point transfer comes from the tax room vacated by the federal government. In the absence of the transfer, the province could unilaterally increase its tax rate to 10 percent. The problem is that a unilateral tax increase would increase the combined tax rate to 25 percent. For two reasons, the province will almost certainly prefer that its tax increase be preceded by a 5-percentage-point federal tax cut. First, the size of the tax base—the total income available to be taxed—will typically be larger at a combined tax rate of 20 percent than at a combined rate of 25 percent, since taxpayers are more likely to engage in tax avoidance and evasion as tax rates rise.⁷ The result is that the province’s revenue will normally be higher if its 5-percentage-point tax hike is matched

6 This federal structure is admittedly unrealistic but simplifies the example.

7 For literature on the elasticity of tax bases, see Joel Slemrod, “Do Taxes Matter? Lessons from the 1980s” (1992) 82:2 *American Economic Review* 250–53; and Emmanuel Saez, Joel Slemrod, and Seth H. Giertz, “The Elasticity of Taxable Income with Respect to Marginal Tax Rates: A Critical Review” (2012) 50:1 *Journal of Economic Literature* 3–14.

TABLE 1 Example: Federal and Provincial Income Tax Rates and Revenue Allocation Before and After a Tax-Point Transfer^a

	Federal rate	Provincial rate	Combined rate	Federal tax share	Provincial tax share
			<i>percent</i>		
Pre-transfer	15	5	20	75	25
Post-transfer	10	10	20	50	50

a Based on a transfer of 5 income tax points from the federal government to the provincial government.

by a 5-percentage-point federal tax cut. This revenue effect is commonly known as a vertical tax externality.⁸ Second, a tax-point transfer provides the province with at least partial political cover for its tax increase. If the province acts unilaterally, its tax increase will lower voters’ after-tax income, potentially reducing the provincial government’s popularity. In contrast, a provincial tax increase that is part of a tax-point transfer has no effect on voters’ after-tax income, and therefore is less likely to provoke a negative reaction.

While the mechanics of tax-point transfers are relatively simple, there are four nuances that are worth observing.

First, the term “tax-point transfer,” though well established in Canada, is arguably a misnomer. The term suggests that the transferor government gives the transferee government tax points that would not otherwise be available to that government. In actuality, the transferee could raise its tax rates even without a transfer. The real object of exchange in a tax-point transfer is not tax points, but a promise of forbearance: in return for the transfer, the transferor promises to lower its tax rate, at least for a period of time. In this way, tax-point transfers are a mechanism for managing the vertical tax externalities that result when two levels of government occupy the same tax base. One implication is that precisely specifying the terms of the forbearance—the duration and scope of the tax cut by the transferor—is important to the implementation of the transfer. The most significant upward tax-point transfers in Canadian history—the tax rental agreements commencing in 1942 (discussed in a later section of this article)—had five-year terms, during which the provinces promised not to levy income taxes. Downward tax-point transfers (from the federal government to the provinces), however, have typically not had time limits, and thus have given rise to debates over whether the transfers remained in place in the decades following their implementation.⁹

8 When one level of government raises its tax rates, the size of the tax base decreases. Since the other level of government shares the same base, its revenues decrease. See Michael Keen, “Vertical Tax Externalities in the Theory of Fiscal Federalism” (1998) 45:3 *IMF Staff Papers* 454-85; and Michael J. Keen and Christos Kotsogiannis, “Does Federalism Lead to Excessively High Taxes?” (2002) 92:1 *American Economic Review* 363-70.

9 See *infra* notes 128-131 and the accompanying text.

Second, the design of tax-point transfers can be varied to achieve different effects on the allocation of tax room and revenue. There are three possibilities. In the standard form set out in the simple example above, the tax-point transfer is used to change both the allocation of tax room and the allocation of revenue: the transferee government ends up with a larger share of the levied tax points, so that its share of total government revenue from the tax increases. Alternatively, the terms of the transfer may require the transferee government to fully compensate the transferor for its revenue loss, in which case the tax-point transfer changes the allocation of tax room but not the allocation of revenue. Least commonly, tax-point transfers can be designed so that they change neither the allocation of tax room nor the allocation of revenue. For instance, in 1972 the federal government replaced deductions and credits for provincial income taxes with a downward tax-point transfer.¹⁰ The transfer changed the mechanism for coordinating federal and provincial tax rates, but had no effect on tax or revenue shares. In subsequent sections of this article, I set out a number of reasons why governments may choose one of these objectives over the others.

Third, tax-point transfers typically consist of exchanges that impose obligations—either implicit or explicit—on both the transferor and the transferee governments. At a minimum, a tax-point transfer requires that the transferee raise its tax rate to match the tax cut by the transferor government. If the transferee fails to raise its tax rates, the attempted transfer results in a cut to the combined federal-provincial tax rate rather than a reallocation of tax room. More significantly, a tax-point transfer frequently requires the transferee government to provide the transferor with consideration—something of value—in exchange for the transfer. Consideration is important because a tax-point transfer will typically decrease the transferor's revenue. Unless the transferor is perfectly benevolent, it will seek to receive something of value in exchange for its revenue loss. In Canadian experience, two types of consideration are most common: the transferor may receive monetary compensation or,

10 Between 1962 and 1972, the federal government offered credits for provincial personal income taxes and deductions for provincial corporate income taxes. The credit was capped at 28 percent of federal taxes owing, and the deduction at 10 percent of taxable income. All provinces levied personal and corporate income taxes, usually at rates near the cap. See J.C. Strick, *Canadian Public Finance*, 4th ed. (Toronto: Holt, Rinehart and Winston of Canada, 1991), at 159; Federal-Provincial Fiscal Arrangements Act, 1972, SC 1972, c. 8; and Kevin Milligan, "Canadian Tax and Credit Simulator: CTaCS," version 2016-2 (<http://faculty.arts.ubc.ca/kmilligan/ctacs/>). The 1972 downward transfer replaced the credit system for personal income taxes with a reduction in the marginal rate in several federal income tax brackets. The provinces then raised their personal income tax rates to occupy the vacated tax room. The use of the tax-point transfer, in lieu of a credit system, was designed to be approximately revenue-neutral for the federal government and provinces. Instead of claiming a credit or deduction for provincial taxes, taxpayers would simply pay a lower nominal rate of tax to the federal government and a higher nominal rate to the provincial government, so that total federal and total provincial revenues remained unchanged. As discussed below (under the heading "Downward Tax-Point Transfers"), the primary justification for replacing deductions and credits with a downward transfer relates to political economy.

in the absence of compensation, may be promised (or expect) some form of control over how the transferee spends its new revenue.

Fourth and finally, *uncoordinated* changes to federal and provincial tax rates may mimic the effect of a tax-point transfer. For example, between 2007 and 2008, the federal government cut the federal goods and services tax (GST) from 7 percent to 5 percent, describing the reduction as a “permanent tax cut” to promote “long-term growth.”¹¹ Within two years, the Quebec and Nova Scotia governments increased their provincial sales taxes by 2 percentage points, so that the combined federal-provincial rate in those provinces was the same as it was before the federal tax decrease.¹² In effect, this combination of tax-rate changes resembled an unintended (from the federal perspective) downward tax-point transfer. This article focuses on coordinated tax-point transfers, since they can be used as an intentional tool of tax policy, but uncoordinated changes may have similar effects.¹³

Prerequisites to Tax-Point Transfers

Constitutional Requirement

The only constitutional constraint on tax-point transfers in Canada is that both levels of government must have concurrent constitutional jurisdiction to impose the tax that is the subject of the transfer.¹⁴ For instance, the federal government cannot transfer tax points on imports and exports to the provinces, since the provinces lack constitutional jurisdiction to impose import and export taxes.¹⁵ As a practical matter,

11 “Harper Ends Year by Cutting GST to 5 Percent,” *City News*, December 31, 2007 (<http://toronto.citynews.ca/2007/12/31/harper-ends-year-by-cutting-gst-to-5-percent/>).

12 The federal tax cut and subsequent tax increase in Quebec resulted in a \$3 billion transfer of revenue from the federal government to Quebec. See Stephen Gordon, “Quebec Budget Shows Debt and Deficits Are Still Serious Business for One Government,” *National Post*, March 28, 2017 (<http://nationalpost.com/opinion/stephen-gordon-quebec-budget-shows-debt-and-deficits-are-still-serious-business-for-one-government>); Revenu Québec, “Hausse du taux de la taxe de vente du Québec à compter du 1^{er} janvier 2011 [Increase in the Rate of Quebec Sales Tax in 2011],” *Nouvelles fiscales*, March 23, 2009 (www.revenuquebec.ca/fr/salle-de-presse/nouvelles-fiscales/details/37879/2009-03-23/); and “NS Budget Makes HST Highest in Canada,” *CBC News*, April 6, 2010 (www.cbc.ca/news/canada/nova-scotia/n-s-budget-makes-hst-highest-in-canada-1.902107). (“HST” refers to the harmonized sales tax, which combines the GST and provincial sales tax in a single levy.)

13 One result is that it can occasionally be challenging to definitively identify tax-point transfers, since it may be unclear whether tax-rate changes were coordinated.

14 Under the Constitution Act, 1867 (UK), 30 & 31 Vict., c. 3, the federal government has jurisdiction over “The raising of Money by any Mode or System of Taxation” (section 91.3), and the provinces have concurrent jurisdiction over “Direct Taxation within the Province in order to the raising of a Revenue for Provincial Purposes” (section 92.2). For a review of the allocation of taxing powers, see Benjamin Alarie and Richard M. Bird, “Tax Aspects of Canadian Fiscal Federalism” (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1689311).

15 Constitution Act, 1867, *supra* note 14, sections 91.3 and 122. The Supreme Court of Canada has held that the federal and provincial governments may not transfer constitutional

this constraint is relatively insignificant. The constitution limits the provinces to “direct” taxes, but courts have adopted an expansive approach in interpreting the meaning of “direct.”¹⁶ The federal and provincial governments possess concurrent jurisdiction over the major tax bases, including income,¹⁷ consumption,¹⁸ and property taxes,¹⁹ and certain forms of estate taxes.²⁰ Tax-point transfers can occur along any of these tax bases.

Significantly, there is no constitutional prohibition in Canada that limits the capacity of the federal government to vary its tax rates from province to province. The absence of a constitutional requirement that federal tax rates be equal in all provinces enables what I will refer to as “asymmetric” tax-point transfers. The federal government is free to transfer tax points to some but not all provinces, if it so chooses, so that federal tax rates will be lower in some provinces than others.²¹ Similarly, the federal government is free to accept tax-point transfers from some but not all provinces, so that federal tax rates will be higher in some provinces than others. The absence of a prohibition in Canada contrasts with the uniformity clause in the US constitution, which requires that the rates of indirect federal taxes—excise, import, and export—be uniform in each state.²² While the US Supreme Court has created exceptions to the uniformity clause,²³ this constitutional requirement

jurisdiction to one another; therefore, the provinces cannot impose import and export taxes even if they have the federal government’s consent to do so: *Attorney General of Nova Scotia v. Attorney General of Canada*, [1951] SCR 31.

- 16 G.V. La Forest, *The Allocation of Taxing Power Under the Canadian Constitution*, 2d ed. (Toronto: Canadian Tax Foundation, 1981), at 202: “[T]he power of the provinces to levy direct taxation has been so broadly construed as in substance to permit them, in fact if not in form, to levy taxes from any source.” See also Alarie and Bird, *supra* note 14, at 13.
- 17 See, for example, *Bank of Toronto v. Lambe* (1887), 12 App. Cas. 572 (PC); and *Abbott v. Saint John (City)*, [1908] 40 SCR 597, at 604.
- 18 The provinces may impose sales taxes if the statutory obligation to pay the tax is placed on the consumer rather than the retailer. See, for example, *Atlantic Smoke Shops Limited v. Conlon*, [1943] 2 All ER 393 (JCPC), at paragraphs 12-13; and *Reference Re Quebec Sales Tax*, [1994] 2 SCR 715, at paragraphs 12 and 20.
- 19 Although the federal government has never levied property taxes, property taxes fall within its jurisdiction over “The raising of Money by any Mode or System of Taxation” (section 91.3 of the Constitution Act, 1867, *supra* note 14). See also La Forest, *supra* note 16, at 196.
- 20 *Eurig Estate (Re)*, [1998] 2 SCR 565; and *Burland v. The King*, [1922] 1 AC 215 (JCPC), at paragraph 25.
- 21 An example is the Quebec abatement. See *infra* note 27.
- 22 US Constitution, article I, section 8, clause 1: “The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States.”
- 23 In *United States v. Ptasynski*, 462 US 74 (1983), at 84-85, the US Supreme Court held that the uniformity clause does not prohibit the federal government from varying its tax rates from state to state to combat “geographically isolated problems,” but that it does prohibit rate variation

nevertheless imposes a constraint on tax-point transfers in the United States that does not exist in Canada.²⁴

Substantial Tax-Base Harmonization

Tax-point transfers are more feasible when the federal and provincial tax bases are substantially harmonized. For instance, if the federal GST includes all services, but a provincial sales tax excludes services, a downward transfer of sales tax points to that province would result in a reduction in the combined tax rate applicable to services. Contrary to the numerical example set out in table 1 above, the tax-point transfer would decrease combined tax rates and decrease combined government revenue, rather than merely reallocate tax room and revenue between governments.

In Canada, the major tax bases are relatively harmonized. In exchange for free federal tax collection and administration of most aspects of provincial income taxes,²⁵ nine provinces have substantially harmonized their personal income tax bases, seven have substantially harmonized their corporate income tax bases, and five have harmonized their sales tax bases. In the United States, where tax bases are less harmonized, tax-point transfers would be more complex.

Examples of Tax-Point Transfers

Historically, there have been a number of federal-provincial tax-point transfers,²⁶ including transfers along the personal and corporate income,²⁷ gasoline,²⁸ and estate

that is intended to provide an “undue preference” to some states over others. See also Nelson Lund, “The Uniformity Clause” (1984) 51:4 *University of Chicago Law Review* 1193-1229, at 1200-6. The implications of the uniformity clause for asymmetric tax-point transfers are further limited in that (1) the clause does not apply to income taxes, the most lucrative federal tax; (2) the federal government does not levy a general sales tax, which would be subject to the clause; and (3) the states cannot levy import and export taxes, so there is no possibility of asymmetric transfers of import and export tax points.

- 24 For instance, if the US government were to transfer alcohol excise tax points to Massachusetts but not to other states, the constitutionality of the transfer would turn on whether the federal government intended to provide Massachusetts with an advantage over other states. See *Ptasynski*, supra note 23. No such judicial scrutiny would apply to an equivalent tax-point transfer in Canada.
 - 25 For a description of the tax collection agreements in personal and corporate income taxation, see Munir A. Sheikh and Michel Carreau, “A Federal Perspective on the Role and Operation of the Tax Collection Agreements” (1999) 47:4 *Canadian Tax Journal* 845-60. Provinces are responsible for the cost of administering certain added-cost provincial tax credits.
 - 26 Confederation itself can arguably be viewed as effecting an upward tax-point transfer. The provinces relinquished their authority to levy the most lucrative tax of the time—customs duties—in exchange for annual subsidies (in addition to other consideration, such as the assumption of provincial debt). See Canada, *Report of the Royal Commission on Dominion-Provincial Relations*, vol. 1 (Ottawa: King’s Printer, 1940), at 40-45.
 - 27 In addition to the two transfers of personal income tax points reviewed below, the federal government also transferred personal income tax points to the provinces in 1972. For a
- (Notes 27 and 28 are continued on the next page.)

tax bases.²⁹ More recently, the federal and some provincial/territorial governments have entered into tax-point transfers with several First Nations.³⁰

This section briefly reviews the two most significant income-tax-point transfers between the federal and provincial governments: the 1942 upward tax-point transfer, effected by the tax rental agreements; and the 1976 downward tax-point transfer, which is the most recent income-tax-point transfer. The purpose of the review is twofold. First, these historical examples illustrate the mechanics of tax-point transfers and their effect on the allocation of tax revenue and tax room. Second, the examples provide context for the argument on contractual enforcement that is advanced in the remainder of this article. In particular, they show how tax-point transfers consist of exchanges in which non-simultaneous obligations are explicitly or implicitly agreed to by, or imposed on, both levels of government. The existence of these obligations raises the need for mechanisms that provide assurance that governments will fulfill their obligations.

1942 Upward Tax-Point Transfer (Tax Rental Agreements)

At the beginning of the Second World War, the federal government occupied the majority of personal and corporate income tax room but shared the personal income tax base with the provinces and some municipalities, and the corporate income tax base with the provinces.³¹ In 1941, the federal government proposed that the

discussion, see *supra* note 10. The federal government also engaged in a number of asymmetric downward tax-point transfers with Quebec in the 1950s and 1960s. Under these transfers, Quebec received tax points in lieu of cash transfers. The extant portion of these tax-point transfers is commonly known as the Quebec abatement. For a history, see David B. Perry, *Financing the Canadian Federation, 1867-1995: Setting the Stage for Change*, Canadian Tax Paper no. 102 (Toronto: Canadian Tax Foundation, 1997), at 207-24. The constitutional amendments permitting federal employment insurance and public pension plans also arguably enabled upward payroll tax transfers from the provinces to the federal government; see the Constitution Act, 1867, *supra* note 14, sections 91.2A and 94A.

- 28 In 1947, the federal government repealed its gasoline tax, so that the provinces could occupy the tax room. The federal government also withdrew its sales tax on residential electricity and gas consumption. See A. Milton Moore, J. Harvey Perry, and Donald I. Beach, *The Financing of Canadian Federation: The First Hundred Years*, Canadian Tax Paper no. 43 (Toronto: Canadian Tax Foundation, 1966), at 18-19.
- 29 David G. Duff, "The Abolition of Wealth Transfer Taxes: Lessons from Canada, Australia, and New Zealand" (2005) 3:1 *Pittsburgh Tax Review* 71-120, at 99.
- 30 Tracy MacKinnon and Michael Welters, "First Nations: Taxation and Business Structures," in *Report of Proceedings of the Sixty-Sixth Tax Conference*, 2014 Conference Report (Toronto: Canadian Tax Foundation, 2015), 39:1-29, at 39:21-23. See, for example, Tsawwassen First Nation Final Agreement, signed in the province of Ontario on December 8, 2006, c. 20, section 4(b)(i).
- 31 The federal share of corporate income tax receipts was 87 percent, with the provinces collecting the remaining 13 percent. The federal share of personal income tax receipts was 75 percent, the provincial share 20 percent, and the municipal share 5 percent. See Richard M. Bird, "Section H: Government Finance," Statistics Canada, at tables H52-74, H75-91, H92-112, and H113-123 (www150.statcan.gc.ca/n1/pub/11-516-x/sectionh/4057752-eng.htm).

provinces and municipalities abandon their personal and corporate income taxes for the duration of the war.³² The federal government's stated purpose was to increase federal revenues to finance the war effort.³³

Since the proposal would substantially decrease provincial revenues, the federal government used two means—a carrot and a stick—to induce provincial consent to the upward transfer of income tax points. First, as a carrot, it offered two compensation formulas to the provinces.³⁴ Each province could choose to receive annual cash transfers equal to the greater of

1. the revenues that the province and its municipalities had collected from personal and corporate income taxes in 1940, and
2. the net cost of servicing the province's debt in 1940 minus any succession duties (inheritance taxes) that the province had collected in 1940.

Second, as a stick, the federal government announced that it would substantially raise its personal and corporate income tax rates in each province, regardless of whether the province abandoned its own taxes, and that only those provinces that abandoned their taxes would receive compensation.³⁵

In combination, the carrot and stick presented the wealthier, low-debt provinces with a Hobson's choice. For instance, if Ontario chose to accept the first federal offer—compensation based on 1940 tax revenues—the province would miss out on the increase in income tax revenues that was likely to result from the growing wartime economy.³⁶ If it accepted the second offer—debt servicing—its revenues

32 Canada, House of Commons, *Debates*, April 29, 1941, at 2345 (J.L. Ilsley). The proposal also required the provinces to relinquish certain other provincial taxes on corporations.

33 Ibid. Finance Minister J.L. Ilsley also justified the proposal as a means of reducing the unfairness that resulted from variation in the combined federal-provincial tax rate from province to province. Given the wartime context, however, increasing federal revenues appears to have been the primary motive.

34 Moore et al., *supra* note 28, at 18-19.

35 Ilsley pledged to increase the minimum federal marginal personal income tax rate from 6 percent to 15 percent, the maximum marginal rate from 81 percent to 92 percent, and the minimum corporate tax rate from 30 percent to 40 percent. Canada, House of Commons, *Debates*, April 29, 1941, at 2345-55 (J.L. Ilsley). See also *ibid.*, at 2713: "After the most careful consideration of all the questions involved the government had reached the conclusion that the rates of personal and corporation income taxes should be raised by the dominion to the maximum levels which would be reasonable at this time, if the provinces were not in those fields." For a history of tax policy during this period, see Colin Campbell, "J.L. Ilsley and the Transformation of the Canadian Tax System" (2013) 61:3 *Canadian Tax Journal* 633-70, at 656-57.

36 Ilsley made a weak attempt to dispel provincial concerns that the federal proposal would cost them revenue: "It is true that if incomes continue to rise the provinces might receive even larger revenues from these two sources in the future than they did in the year 1940, but this would depend . . . in part upon the level and nature of dominion taxation and upon many other questions which cannot be foreseen or assessed at this time." Canada, House of Commons, *Debates*, April 29, 1941, at 2346.

would decrease below 1940 levels. If it rejected both offers, its tax revenues would certainly shrink below their 1940 levels, since the federal rate increases would cause avoidance responses that would decrease the size of the shared tax base.³⁷ Moreover, if other provinces accepted the federal government's proposal but Ontario did not, Ontario's combined federal-provincial tax rate would be substantially higher than the rate in other provinces, and this would encourage tax-base migration to the participating provinces.³⁸ Ontario and the other provinces had little choice but to accept the federal offer.³⁹ The five wealthier provinces chose reimbursement for their lost tax revenue. The remaining four provinces, which had smaller per capita income tax bases, chose to receive compensation to service their debt.⁴⁰

The result was a de facto contractual arrangement in which the provinces surrendered tax room in exchange for ongoing, annual cash transfers from the federal government.⁴¹ From a revenue perspective, the deal was a poor one for the provinces. With a booming wartime economy,⁴² Canada's total corporate and personal income tax revenues more than doubled between 1941 and 1943.⁴³ Since the wealthier provinces were compensated on the basis of their 1940 revenues, they did not share in this revenue growth. The provinces renegotiated the terms of the transfer in 1947, 1952, and 1957 to improve the compensation formula.⁴⁴ These agreements, collectively known as the tax rental agreements, remained in place until 1962.

1976 Downward Tax-Point Transfer

In 1976, the federal government transferred 13.5 points of personal income tax and 1 point of corporate income tax to the provinces, in lieu of a portion of the annual

37 For literature on vertical externalities, see *supra* note 7.

38 This revenue effect is known as a horizontal tax externality. See Pierre Salmon, "Horizontal Competition Among Governments," in Ehtisham Ahmad and Giorgio Brosio, eds., *Handbook of Fiscal Federalism* (Cheltenham, UK: Edward Elgar Publishing, 2006), 61-85.

39 The ongoing war effort, which was financed by the federal government, also made it difficult for provinces to refuse the federal offer. As Moore et al. observed, *supra* note 28, at 17, "[i]n the prevailing atmosphere of war tension it was almost incumbent on the provinces to accept the federal offer."

40 See *ibid.* The 10th province, Newfoundland (now Newfoundland and Labrador), did not join Canada until 1949.

41 The federal government enacted these agreements in the Dominion-Provincial Taxation Agreement Act, 1942, RSC 1942, c. 13.

42 Dominion Bureau of Statistics, *The Canada Year Book 1945* (Ottawa: King's Printer, 1945), at 905.

43 See Bird, *supra* note 31.

44 The provinces were not unanimous in accepting the new terms. Quebec and Ontario opted out of the 1947 agreements and began to impose their own corporate income taxes. In 1952, Ontario opted back into the tax rental agreements. By 1954, Quebec was imposing its own personal income tax in addition to its corporate income tax. See Moore et al., *supra* note 28, at 28-51.

cash transfers that the federal government had provided to the provinces for hospital insurance, medicare, and post-secondary education.⁴⁵ The tax-point transfer resulted in a reduction in federal marginal rates in each income bracket and an increase in provincial tax rates.⁴⁶ It also changed the allocation of income tax revenue between the two levels of government: the federal share of personal income tax receipts decreased from 65.8 percent to 58.8 percent, while the provincial share increased from 34.1 percent to 41.1 percent.⁴⁷

The 1976 tax-point transfer was expressly intended to finance provincial expenditures on hospital insurance, medicare, and post-secondary education. To offset the revenue loss that accompanied the transfer, the federal government reduced the cash transfers made to the provinces for these purposes. Since the tax points were worth less to provinces with smaller per capita tax bases, the federal government also equalized the revenue impacts of the transfer on each province.⁴⁸ In effect, provinces with lower per capita tax revenues had their cash transfers reduced by a lesser amount than provinces with higher per capita tax revenues.

Like the tax rental agreements, the 1976 tax-point transfer imposed implicit obligations on both levels of government. The federal government was required to (1) reduce federal tax rates and (2) reduce cash transfers. The provinces, in turn, were expected to subsequently (1) increase provincial tax rates by the amount of the federal tax cuts; (2) spend the resulting revenue on hospital insurance, medicare, and post-secondary education; and arguably, as discussed further below, (3) give public credit to the federal government for the value of the tax-point transfer, in much the same way as provinces are expected to credit the federal government for cash contributions.

The 1976 transfer also shared another similarity with the tax rental agreements: the transferee governments were generally more supportive of the transfer than was

45 Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977, SC 1976-77, c. 10. Since, at the time, provincial income taxes were levied as a percentage of federal income tax receipts, the term “tax points” referred to percentage points of federal income tax receipts rather than percentage points of taxpayer income. The tax-point transfer also replaced a pre-existing federal deduction of 4.357 points of provincial personal income tax and 1.0 points of provincial corporate income tax, which had been granted to the provinces in 1967 to help fund post-secondary education. Strick, *supra* note 10, at 162. For detailed descriptions of the transfers, see Perry, *supra* note 27, at 237-54; Robin W. Boadway, *Intergovernmental Transfers in Canada*, Financing Canadian Federation no. 2 (Toronto: Canadian Tax Foundation, 1980), at 23-24; and George E. Carter, “Financing Health and Post-Secondary Education: A New and Complex Fiscal Arrangement” (1977) 25:5 *Canadian Tax Journal* 534-50.

46 For instance, immediately prior to the transfer, a Nova Scotian taxpayer earning \$30,000 per year faced a marginal federal tax rate of 39 percent and a flat provincial tax rate equal to 38.5 percent of the federal tax owing. Following the transfer, the federal rate decreased to 36 percent and the provincial rate increased to 52.5 percent of federal tax owing. See Milligan, *supra* note 10.

47 Bird, *supra* note 31.

48 Strick, *supra* note 10, at 162. For an explanation of the mechanics of this process, see Canada, Department of Finance, “Associated Equalization” (www.fin.gc.ca/fedprov/aseq-eng.asp).

the transferor. The push for the downward tax-point transfer was led by Ontario, Quebec, and Alberta.⁴⁹ The federal government initially proposed that it retain the tax points and fund its contribution entirely through cash grants, but it eventually acquiesced to the tax-point transfer in the face of continued provincial demands for tax room in lieu of cash grants.⁵⁰

UPWARD TAX-POINT TRANSFERS

Why might governments engage in upward tax-point transfers? The primary benefit of increasing the federal government's share of tax room is that tax points will usually generate more revenue when levied by the federal government than by provincial governments. Provinces can exploit this federal tax advantage by transferring tax points to the federal government in exchange for cash transfers. A properly designed combination of tax-point and cash transfers enables both levels of government to split the surplus revenue generated by federal taxation, so that both have higher revenues than they would if the tax points were levied by the provincial governments.

The revenue case for upward tax-point transfers raises a puzzle: Why are these transfers rare? In Canada, there has been only one significant upward tax-point transfer, and it occurred in 1942. As discussed above, the transfer was proposed in an extraordinary wartime political climate, and the provinces agreed to it only after being pressured by the federal government. Contrary to the predictions of some theoretical economists (discussed below), provinces have not been inclined to exploit the federal tax advantage.

The central argument of this section is that impediments to contractual enforcement are a partial explanation for the lack of upward transfers. When a province transfers tax points to the federal government, the federal government must undertake to provide annual cash transfers to the province. Yet the province lacks an effective means of enforcing the terms of the bargain. The common methods of contract enforcement—judicial enforcement, the threat of termination or revocation, reputational sanctions, self-help, and the use of collateral—are either unavailable or of only modest force in the context of tax-point transfer agreements. A province that transfers tax points to the federal government must do so on faith that the federal government will keep its part of the bargain.

This section

- sets out the primary benefit of upward tax-point transfers;
- briefly reviews the historical record to demonstrate the provinces' hostility to upward transfers;

49 Perry, *supra* note 27, at 239. Smaller provinces were more ambivalent about a downward tax-point transfer, partly because tax points are worth less to provinces with smaller per capita tax bases.

50 Perry, *supra* note 27, at 238–39.

- argues that contractual impediments to upward tax-point transfers can at least partly explain that hostility;
- identifies the conditions under which upward transfers are likely to occur, even in the absence of contractual enforcement; and
- considers alternative explanations for the lack of upward tax-point transfers.

Primary Benefit

There are three reasons why tax points will typically generate more revenue when levied by the federal government rather than the provinces: one economic, one constitutional, and one administrative.

The Economic Advantage

The economic advantage of federal taxation is that federal tax bases are usually less mobile than provincial tax bases.⁵¹ With respect to the taxation of personal income, for example, taxpayers wishing to avoid paying a high rate of provincial income tax can move to a lower-tax province or channel their income through trusts that are resident in lower-tax provinces.⁵² In contrast, taxpayers wishing to avoid a federal income tax have to take the much more difficult step of relocating themselves or their income to another country, an option that will normally present a number of immigration, economic, and regulatory obstacles. The same problems of mobility for provincial tax bases arise in corporate taxation, where corporations can relocate their operations to lower-tax provinces; in sales taxation, where consumers can cross provincial boundaries to take advantage of lower taxes on their purchases; and, historically, in estate taxation, where taxpayers could relocate themselves or their wealth to provinces with low or no inheritance taxes.⁵³ The effect of tax-base mobility can be significant. Recent research finds that an increase of 1 percentage point in a province's top marginal personal income tax rate causes the top 1 percent of income earners to shift, on average, 0.97 percentage points of income to other provinces.⁵⁴ For corporate income tax, an increase of 1 percentage point in a province's rates is estimated to cause, on average, at least 2.6 percentage points of corporate income to shift to other provinces.⁵⁵ This interprovincial migration

51 See Robin Boadway and Anwar Shah, *Fiscal Federalism: Principles and Practice of Multiorder Governance* (Cambridge, UK: Cambridge University Press, 2009), at 161-62 and 166-67.

52 See Kevin Milligan and Michael Smart, "An Estimable Model of Income Redistribution in a Federation: Musgrave Meets Oates," *American Economic Journal: Economic Policy* (forthcoming) (<http://faculty.arts.ubc.ca/kmilligan/research/papers/Musgrave-Oates-Final.pdf>), at 12.

53 Interprovincial competition for wealthy taxpayers contributed to the repeal of provincial estate taxes in the 1970s. See Richard M. Bird, "Canada's Vanishing Death Taxes" (1978) 16:1 *Osgoode Hall Law Journal* 133-45, at 139-40; and Duff, *supra* note 29, at 102-7.

54 Milligan and Smart, *supra* note 52.

55 Jack Mintz and Michael Smart, "Income Shifting, Investment, and Tax Competition: Theory and Evidence from Provincial Taxation in Canada" (2004) 88:6 *Journal of Public Economics* 1149-68, at 1150.

of people, capital, and corporations can depress provincial tax revenues⁵⁶ and, in the extreme, encourage a race to the bottom in the setting of provincial tax rates.⁵⁷

Provinces can mitigate the problem of interprovincial tax competition by transferring tax points to the federal government. Through tax-point transfers, the provinces essentially bind their—and their competitors’—hands: a province that is tempted to lower its tax rates to attract tax base from other provinces has less scope to do so if most provincial tax points have been transferred to the federal government.⁵⁸

The greater efficiency of federal taxation has served as the basis for normative and positive theories that subnational governments should, and will, transfer taxing powers to the federal government. As a normative matter, a large body of foundational economic literature on fiscal federalism, often known as “first-generation fiscal federalism,” calls for federal governments to occupy most or all tax room along highly elastic tax bases, such as income tax, in order to maximize combined government revenues.⁵⁹ As a positive matter, there are two seminal predictions. First, Brennan and Buchanan, in their “Leviathan” theory of taxation, predict that subnational governments will delegate taxing powers to the federal government to prevent horizontal tax competition that reduces tax revenues.⁶⁰ Contrary to most of the normative literature, Brennan and Buchanan view this arrangement negatively: by delegating taxing powers to the federal government, the subnational governments effectively form “cartels” to shield themselves from competition.⁶¹ Second, Scott and Breton also predict that subnational governments will transfer taxing

56 Roger H. Gordon and Jeffrey K. MacKie-Mason, “The Importance of Income Shifting to the Design and Analysis of Tax Policy,” in Martin Feldstein, James R. Hines Jr., and R. Glenn Hubbard, eds., *Taxing Multinational Corporations* (Chicago: University of Chicago Press, 1995), 29–37.

57 See *supra* note 53.

58 The revenue case for upward tax-point transfers has limits. As Milligan and Smart show, *supra* note 52, the revenue-maximizing tax rate will vary between provinces on the basis of each province’s income distribution. If the federal government levies the same tax rate in each province, variation in the combined federal-provincial rate can occur only if the provinces retain some tax points. Therefore, from the perspective of maximizing total public revenue, it is undesirable for provinces to relinquish all tax points to the federal government.

59 Richard A. Musgrave, “Who Should Tax, Where, and What?” in Charles E. McLure Jr., ed., *Tax Assignment in Federal Countries* (Canberra: Australian National University, Centre for Research on Federal Financial Relations, 1983), 2–19, at 11; Roger H. Gordon, “An Optimal Taxation Approach to Fiscal Federalism” (1983) 98:4 *The Quarterly Journal of Economics* 567–86, at 583 (<https://doi.org/10.2307/1881778>); and Wallace E. Oates, *Fiscal Federalism* (New York: Harcourt Brace Jovanovich, 1972), at 7, 132, and 143. For more recent literature addressing this view, see Boadway and Shah, *supra* note 51, at 158 and 162; and Maria Flavia Ambrosiano and Massimo Bordignon, “Normative Versus Positive Theories of Revenue Assignments in Federations,” in *Handbook of Fiscal Federalism*, *supra* note 38, 306–38.

60 Geoffrey Brennan and James M. Buchanan, *The Power To Tax: Analytical Foundations of a Fiscal Constitution* (Cambridge, UK: Cambridge University Press, 1980), at 182.

61 *Ibid.*

powers to the federal government in exchange for cash transfers, but view the exchange positively.⁶² The exchange allows the provinces to take advantage of the gains from trade that result from the lower elasticity of federal tax bases.

These positive and normative theories do not expressly address tax-point transfers. They instead predict, or call for, a transfer of taxing powers from subnational to federal governments without specifying the mechanism to be used. In practice, however, an upward tax-point transfer is the only coordinated mechanism for effecting such a transfer, short of a constitutional amendment.

The Constitutional Advantage

The second advantage of federal taxation relates to the federal government's exclusive constitutional jurisdiction over indirect taxation. The Canadian provinces are limited to "direct" taxation, which Canadian courts, following John Stuart Mill, have defined as a tax "which is demanded from the very persons who, it is intended or desired, should pay it."⁶³ The drafters of the Constitution Act, 1867 limited the provinces to direct taxation in order to constrain provincial taxing power.⁶⁴ Since direct taxes are more visible than indirect taxes, it was expected that it would be difficult for provinces to obtain political support for high levels of direct taxes. Modern research in behavioural public finance confirms that taxpayers underestimate the magnitude of indirect taxes;⁶⁵ as a result, indirect taxation is more politically attractive than direct taxation.

Upward tax-point transfers allow provinces to replace politically salient direct taxes with less salient indirect federal taxes. Since there is less political opposition to indirect taxes, the federal government can potentially raise indirect tax rates to higher levels than the provinces can raise equivalent direct tax rates. Through cash transfers, the provinces can then share in the surplus revenue.

The Administrative Advantage

The third advantage of federal taxation is that federal tax administration and collection is often more efficient than provincial tax administration and collection owing

62 Albert Breton and Anthony Scott, *The Economic Constitution of Federal States* (Toronto: University of Toronto Press, 1978), at 143-48. Breton later extended these ideas; see Albert Breton, *Competitive Governments: An Economic Theory of Politics and Public Finance* (Cambridge, UK: Cambridge University Press, 1996), at 201-3.

63 *Bank of Toronto v. Lambe*, supra note 17, at 575.

64 See, for example, Province of Canada, *Parliamentary Debates on the Subject of the Confederation of the British North American Provinces*, 8th Parl., 3d sess., 1865, at 69 (Galt), 377 (Langevin), and 388 (Langevin); P.B. Waite, ed., *The Confederation Debates in the Province of Canada, 1865*, 2d ed. (Montreal: McGill-Queen's University Press, 2006), at 42 (Galt); and the Constitution Act, 1867, supra note 14, section 92.2.

65 Rupert Sausgruber and Jean-Robert Tyran, "Testing the Mill Hypothesis of Fiscal Illusion" (2005) 122:1-2 *Public Choice* 39-68 (<https://doi.org/10.1007/s11127-005-3992-4>).

to economies of scale.⁶⁶ Through tax-point transfers, the provinces can take advantage of these economies of scale to reduce costs. Significantly, however, tax-point transfers are not the only means of exploiting economies of scale. The Canadian government currently collects personal income taxes for nine provinces and corporate income taxes for seven provinces, even though the provinces independently set their own income tax rates.⁶⁷ In consideration for federal tax administration and collection, the participating provinces have harmonized their personal and corporate income tax bases with the federal government's, but have not engaged in upward transfers.

The Historical Puzzle

The historical record in Canada does not support the predictions made by the positive theorists discussed above (Brennan and Buchanan, and Scott and Breton). The only significant tax-point transfer from the provinces to the federal government occurred in 1942. Since that time, the provincial share of the three major taxes—personal income, corporate income, and general sales taxes—has steadily increased. The provincial share of corporate income, personal income, and general sales taxes is now at or near its highest point since the 1930s. Figures 1, 2, and 3 set out the respective shares of each of these tax bases for the relevant levels of government.⁶⁸

Rather than offering to transfer tax points, the provinces have generally demanded more tax room from the federal government. Boadway has observed that between 1945 and 1980,

[m]uch of the conflict in federal-provincial fiscal agreements after the Second World War . . . [arose] out of a desire by the provinces to be given more *tax room* by the federal government in . . . [the personal and corporate income tax] fields.⁶⁹

66 Bruno Heyndels and Jef Vuchelen, "Verdoorn's and Kaldor's Law in Tax Administration: An International Analysis" (1990) 22:4 *Applied Economics* 529-38 (<https://doi.org/10.1080/00036849000000009>).

67 Sheikh and Carreau, *supra* note 25, at 846-47.

68 These figures are based on graphs prepared by Milligan and published in Kevin Milligan, "Data on Government Revenue in Canada: Sources and Trends," *Finances of the Nation* feature (2017) 65:3 *Canadian Tax Journal* 693-709. Milligan's graphs cover the period 1935-2015. To extend the personal income tax data back to 1896, I have drawn on public finance statistics for selected years included in the *Report of the Royal Commission on Dominion-Provincial Relations*, *supra* note 26.

69 Boadway, *supra* note 45, at 43 (emphasis in original). See also George E. Carter, "Federal Restraints on the Growth of Transfer Payments to the Provinces Since 1986-87: An Assessment" (1994) 42:6 *Canadian Tax Journal* 1504-32, at 1531: "[A] climate of conflict and stress had developed in federal-provincial relations. . . . The three wealthiest provinces, along with Quebec, will increasingly press for an additional transfer of income tax room."

FIGURE 1 Personal Income Tax Shares—Federal, Provincial, and Municipal Governments, 1896-2015

FIGURE 2 Corporate Income Tax Shares—Federal and Provincial Governments, 1933-2016

FIGURE 3 General Sales Tax Shares—Federal, Provincial, and Municipal Governments, 1922–2016

The conflict has continued since 1980. In 2001, for example, the Quebec government established the Séguin commission⁷⁰ to study an alleged “fiscal imbalance” between the federal and provincial governments. The commission recommended that the federal government vacate the sales tax field and reduce income taxes to leave more tax room for the provinces.⁷¹ The federal government, however, rejected the recommendation.

The question is, given the apparent benefits of upward transfers, why have the provinces not engaged in revenue-increasing upward tax-point transfers?

Contractual Impediments to Upward Tax-Point Transfers

The central contractual problem with upward tax-point transfers is that provincial and federal obligations are not performed simultaneously.⁷² A tax-point transfer made in exchange for cash transfers has three steps:

70 Québec, Commission sur le déséquilibre fiscal, *Pour un nouveau partage des moyens financiers au Canada : Rapport* (Québec: Commission sur le déséquilibre fiscal, 2002) (herein referred to as “the Séguin commission”).

71 Ibid., at xii.

72 For literature on the enforcement problems that arise with long-term non-simultaneous contracts in other contexts, see Trebilcock and Leng, *supra* note 5, at 1521; Anthony Kronman, “Contract Law and the State of Nature” (1985) 1:1 *Journal of Law, Economics & Organization* 5–32, at 10; Oliver E. Williamson, *The Mechanisms of Governance* (Oxford: Oxford University Press, 1996), at 332; and Douglass C. North, *Institutions, Institutional Change and Economic Performance: The Political Economy of Institutions and Decisions* (Cambridge, UK: Cambridge University Press, 1990), at 54–60.

1. The provinces lower their tax rates.
2. The federal government raises its tax rate by an equivalent amount.
3. The federal government transfers cash to the provinces in year 1, year 2, and so on, unless and until the governments agree to vary the terms of the tax-point transfer.

While steps 1 and 2 can be performed simultaneously, step 3 imposes a perpetual obligation on the federal government. The risk for the provinces is that the federal government may at some future time cease or reduce cash transfers, or impose unacceptable conditions on those transfers, contrary to the terms of the agreement.

This section first identifies the two ways in which a federal government may breach a tax-point transfer agreement, and then argues that provinces lack an effective mechanism for ensuring that the federal government fulfills its promises. Since provinces have limited tools for ensuring federal compliance, they may resist voluntarily transferring tax points.

Potential Federal Breaches of Tax-Point Transfer Agreements

The federal government can breach a tax-point transfer by (1) ceasing or reducing cash transfers to the provinces, or (2) imposing conditions on the cash transfers that reduce their value to the provinces.

The federal incentive to cease or reduce cash transfers will exist whenever it is more advantageous to spend the cash on areas of federal jurisdiction. In a well-functioning federal system, this political incentive will arise whenever voters prefer a federal expenditure to an alternative provincial expenditure that is funded through cash transfers. More problematically, the federal incentive to cease or reduce cash transfers may exist even when social welfare is decreased by such cuts. Federal budgetary decisions are arguably subject to an externality problem. When the federal government reduces cash transfers to the provinces in order to increase expenditures on matters of federal jurisdiction, it obtains the full political benefit of the increased spending, but likely bears only a portion of the political cost of the cuts to provincial services.⁷³ The risk to provinces entering into tax-point transfer agreements is that this externality problem will lead the federal government to conclude that expenditures on federal jurisdiction are more politically advantageous than cash transfers to the provinces.⁷⁴

73 For example, if the federal government reduces its cash transfers to the provinces in order to increase spending on the postal service, a federal responsibility, voters will likely credit the federal government for the improvement in postal service performance and the increase in employment in the postal service. If the provinces subsequently cut health-care spending as a result of the cuts in federal cash transfers, the federal government will likely bear only a portion of voters' ire. Since the provincial governments have constitutional responsibility for health care, and must implement the cuts, it is likely that they too will feel the political repercussions of the reduction in federal cash transfers.

74 For example, in the 1990s, the Canadian government substantially reduced cash transfers to the provinces in order to eliminate a federal budget deficit. The cuts to cash transfers led to large

The federal government may also breach a tax-point transfer agreement by imposing conditions on cash transfers that restrict how provinces can spend the funds. Just as a \$100 gift card that can only be used in one store may be worth less to the recipient than \$100 in cash, a cash grant with restrictions will sometimes be worth less to a province than an unrestricted cash grant. Federal conditions on cash transfers may be normatively justifiable, as in the case, for example, of conditions that aim to internalize positive spillovers resulting from provincial expenditures; but they may also be imposed when the federal government has different spending priorities than the provinces, or when it wants the provinces to acknowledge or credit the federal government for its contribution.⁷⁵ Provinces that transfer tax points to the federal government make themselves vulnerable to federal attempts to influence provincial policy or to extract some of the political credit for provincial expenditures.⁷⁶

Enforcement Mechanisms

There are five mechanisms that are commonly used to assure performance in contracts: (1) judicial enforcement, (2) termination, (3) reputational sanctions, (4) self-help, and (5) collateral. These mechanisms are either unavailable or of reduced effectiveness in securing compliance with tax-point transfer agreements. The result is a *de facto* time inconsistency problem: provinces may resist upward transfers, even when upward transfers are their preferred policy, because of the federal government's inability to credibly commit to future cash transfers.⁷⁷

JUDICIAL ENFORCEMENT

The obstacle to judicial enforcement of tax-point transfer agreements is that, under the doctrine of parliamentary sovereignty, governments can unilaterally repudiate their contractual obligations without penalty. The leading Canadian case is the

provincial deficits and federal-provincial tensions. See "Understanding Canada's Health Care Costs: Final Report, Provincial and Territorial Ministers of Health," report presented to the 41st Annual Premiers' Conference, Winnipeg, Manitoba, August 9-11, 2000, at 8.

75 For example, the Canada Health Act, which governs cash transfers for health care, requires that the provinces "give recognition" to the federal contribution "in any public documents, or in any advertising or promotional material, relating to insured health services and extended health care services in the province." Canada Health Act, RSC 1985, c. C-6, section 13(b).

76 Unsurprisingly, the use of the federal spending power to influence expenditures in areas under provincial jurisdiction is contentious. See, for example, Andre Lajoie, "The Federal Spending Power and Fiscal Imbalance in Canada," in Sujit Choudhry, Jean-Francois Gaudreault-DesBiens, and Lorne Sossin, eds., *Dilemmas of Solidarity: Rethinking Distribution in the Canadian Federation* (Toronto: University of Toronto Press, 2006), 145-66; and Andrew Petter, "The Myth of the Federal Spending Power Revisited" (2008) 34:1 *Queen's Law Journal* 163-73.

77 For literature on the time inconsistency problem in other contexts, see Finn E. Kydland and Edward C. Prescott, "Rules Rather Than Discretion: The Inconsistency of Optimal Plans" (1977) 85:3 *Journal of Political Economy* 473-91; and Kyle Beardsley, "Agreement Without Peace? International Mediation and Time-Inconsistency Problems" (2008) 52:4 *American Journal of Political Science* 723-40.

1991 decision of the Supreme Court of Canada in *Reference Re Canada Assistance Plan (B.C.)*.⁷⁸ The issue before the court was whether the federal government could unilaterally amend federal legislation to reduce the annual cash transfers provided to British Columbia for social welfare programs. The BC government alleged that the federal cuts breached an earlier agreement between the two governments (the Canada Assistance Plan) under which the federal government had promised to fund 50 percent of the province's social welfare costs. The Supreme Court rejected the BC government's claim. At its narrowest, the decision held that the federal cuts did not breach the agreement between the two governments because the terms of the agreement left room for unilateral federal amendments to the funding formula.⁷⁹ More broadly, however, the Supreme Court held that intergovernmental contracts cannot limit parliamentary sovereignty over spending. Sopinka J, writing for the court, noted:

It is conceded that the [federal] government could not bind Parliament from exercising its powers to legislate amendments to the *Plan*. To assert the contrary would be to negate the sovereignty of Parliament. . . .

A restraint on the executive in the introduction of legislation is a fetter on the sovereignty of Parliament itself.⁸⁰

Sopinka J also quoted approvingly from the decision of the Supreme Court of South Australia in a similar case:

Ministers of State cannot . . . by means of contractual obligations entered into on behalf of the State fetter their own freedom, or the freedom of their successors or the freedom of other members of parliament, to propose, consider and, if they think fit, vote for laws, even laws which are inconsistent with the contractual obligations.⁸¹

The key implication of *Canada Assistance Plan* is that the federal government can unilaterally repudiate, through legislation and without penalty, any contractual obligation to provide cash transfers that are promised in exchange for an upward

78 [1991] 2 SCR 525.

79 Ibid., at 567.

80 Ibid., at 548 and 560.

81 Ibid., at 560 (quoting from *West Lakes Ltd. v. South Australia* (1980), 25 SARS 389, at 390). For related academic commentary, see Nigel Bankes, "Co-operative Federalism: Third Parties and Intergovernmental Agreements and Arrangements in Canada and Australia" (1991) 29:4 *Alberta Law Review* 792-838, at 804 (<https://doi.org/10.29173/alr1533>): "In the absence of constitutional effect being given to the agreement we must accept the conclusion, in the absence of Charter attack, that a . . . [government] may legislate in derogation of its contractual undertakings." See also Didier Culat, "Coveting Thy Neighbour's Beer: Intergovernmental Agreements Dispute Settlement and Interprovincial Trade Barriers" (1992) 33:2 *Cahiers de Droit* 617-38, at 620 (<https://doi.org/10.7202/043149ar>): "At best, it can be submitted that the legal nature of an intergovernmental agreement is akin to that of a 'gentleman's agreement.'"

tax-point transfer.⁸² Tax-point transfer agreements therefore differ from conventional non-governmental contracts in that judicial enforcement is generally not available as a remedy in the event of a breach (by either party).

TERMINATION

An aggrieved party can typically respond to a breach of contract by terminating or threatening to terminate the contract.⁸³ Through termination, the aggrieved party denies the breaching party the future benefits of the contract. For example, if a vendor of potatoes fails to pay the farmer who supplies him, the farmer can refuse to supply the vendor with the remaining potatoes that are due to be delivered under the contract. The vendor then loses out on future sales.

In the case of a tax-point transfer, however, an aggrieved province cannot deny the federal government the benefits of the transfer without incurring political and revenue costs. For example, consider a province that transfers 5 personal income tax points to the federal government, so that the transfer reduces the provincial income tax rate from 15 percent to 10 percent and increases the federal rate from 5 percent to 10 percent. If the province later terminates the agreement because the federal government has failed to provide the promised cash transfers, the province cannot restore taxes to their previous rates. The province can raise its own rate to its pre-transfer level of 15 percent, but it cannot force the federal government to lower the federal rate to 5 percent. In the absence of federal cooperation, the provincial rate increase raises the combined federal-provincial tax rate. This poses two problems for the province. First, the province will have to justify to voters why it has raised the combined tax rate, and will likely pay a political price for its decision. Second, provincial revenues will be lower than they were prior to the tax-point transfer. As discussed earlier (in relation to the example illustrated in table 1), a 15 percent provincial income tax will raise less revenue when the combined income tax rate is

82 It is an open question whether a court would enforce a tax-point transfer agreement if the federal government repudiated the required cash transfers through executive action (or inaction) rather than legislation. Parliamentary sovereignty protects the right of legislatures to legislate in derogation of contractual obligations, but in the absence of legislation, a contract is typically binding on a government. See, for example, *South Australia v. Commonwealth* (1962), 108 CLR 130, at 155, where Windeyer J held that an intergovernmental agreement may be enforceable if the two governments intended to “subject their agreement to the adjudication of the courts.” Similarly, in 2018, the BC Court of Appeal held that the Reciprocal Taxation Agreement and Comprehensive Integrated Tax Coordination Agreement between the BC and Canadian governments were enforceable on a third party because the agreements “bear the hallmarks of agreements that were intended to create legally binding obligations.” See *British Columbia Investment Management Corporation v. Canada (Attorney General)*, 2018 BCCA 47, at 142; leave to appeal to the Supreme Court of Canada granted October 11, 2018. Neither of these decisions, however, limits the capacity of governments to implement legislation repudiating their contractual obligations.

83 American Law Institute and the National Conference of Commissioners on Uniform State Laws, *The Uniform Commercial Code* (Philadelphia and Chicago: ALI and NCCUSL, 2012), sections 2-703(a) and (f) and 2-705.

25 percent than when the combined rate is 20 percent. Table 2 shows the effect of unilateral revocation of the agreement.

The Supreme Court of Canada's decision in *Canada Assistance Plan* impedes any contractual solution to this problem. For instance, a tax-point transfer agreement could include a termination clause that requires the federal government to lower its tax rates to pre-transfer levels in the event of a breach. Any such provision, however, would be legally unenforceable, since the provincial and federal governments cannot bind themselves to future increases or decreases in their tax rates without diminishing parliamentary sovereignty.

These challenges in revoking a tax-point transfer do not mean that provinces would passively accept a federal breach. The provinces might respond by raising their tax rates and attempting to persuade voters that the federal government was to blame. The problem for the provinces, however, is that this course of action has uncertain consequences. Some voters might accept the provincial story, but others may blame the provincial government or both governments. The central difficulty is that once an upward tax-point transfer has induced a federal tax increase, there is no politically cost-free way of undoing the transfer without federal cooperation.

REPUTATIONAL SANCTIONS

There are arguably reputational incentives for the federal government to comply with tax-point transfer agreements.⁸⁴ Federal and provincial governments are repeat players in intergovernmental fiscal negotiations.⁸⁵ When the federal government breaches a tax-point transfer agreement, it runs the risk that provinces will refuse to participate in such agreements in the future. Since the federal government benefits from tax-point transfers—by sharing in the resulting surplus revenue—it has a financial interest in keeping its promises.

Reputational sanctions can be an effective means of ensuring contractual performance.⁸⁶ There are two problems, however, that reduce their usefulness to provinces contemplating upward transfers.

First, the threat of withholding future upward transfers creates leverage only when there is a reasonable probability of future upward transfers. The federal government

84 For literature on the significance of reputation and social norms in the enforcement of contracts, see Lisa Bernstein, "Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry" (1992) 21:1 *Journal of Legal Studies* 115-57; Giangiacomo Bravo and Lucia Tamburino, "The Evolution of Trust in Non-Simultaneous Exchange Situations" (2008) 20:1 *Rationality and Society* 85-113; Ernst Fehr, Simon Gächter, and Georg Kirchsteiger, "Reciprocity as a Contract Enforcement Device: Experimental Evidence" (1997) 65:4 *Econometrica* 833-60; and Robert C. Ellickson, *Order Without Law: How Neighbors Settle Disputes* (Cambridge, MA: Harvard University Press, 1991).

85 Both levels of government have engaged in ongoing negotiations over fiscal arrangements since Confederation. See the *Report of the Royal Commission on Dominion-Provincial Relations*, supra note 26.

86 See generally the sources cited in note 84, supra, for a more detailed discussion.

TABLE 2 Tax-Point Transfer^a—Effect of Termination of Transfer Agreement

	Federal tax rate	Provincial tax rate	Combined rate	Federal tax share	Provincial tax share
			<i>percent</i>		
Pre-transfer	10	10	20	50	50
Post-transfer	15	5	20	75	25
Unilateral revocation	15	10	25	60	40

a Assumes a transfer of 5 income tax points from the federal government to the provincial government.

has a fiscal incentive to breach a tax-point transfer agreement whenever the benefits of doing so exceed the value of the remaining tax points that are likely to be transferred. If only a small number of tax points remain in provincial hands, or if future transfers are unlikely in the short to medium term, the federal government may conclude that renegeing on its agreement to provide cash transfers is in its best interest, notwithstanding any repercussions.

The second problem is that the identity of political decision makers in provincial and federal governments changes frequently. The federal political party in power at the time of fiscal negotiations may sincerely promise to provide perpetual cash transfers to the provinces, but that promise will be of uncertain value when a different party wins the next federal election. This problem is exacerbated by the perpetual nature of the cash transfers that must be promised in exchange for tax-point transfers. A province may conclude that all major federal political parties would make good on federal commitments for the foreseeable future. But the province cannot realistically predict the attitudes of political parties decades from now. By refraining from entering into tax-point transfers, the provinces retain control over their tax points.

SELF-HELP—POLITICAL PROTESTS

Provinces may respond to a federal breach by publicly criticizing the federal government and urging voters to support a different federal political party.⁸⁷ Provinces may also withhold cooperation in other matters that are important to the federal government. For example, provincial police forces could refuse to address federal priorities in criminal-law enforcement, or provincial governments could refuse to implement carbon taxes, despite federal urging. To the extent that the provinces can create electoral consequences for the federal government, their actions may discourage the government from renegeing on its promises.

87 For a discussion of measures taken by American states, see Jessica Bulman-Pozen and Heather K. Gerken, “Uncooperative Federalism” (2009) 118:7 *Yale Law Journal* 1256-1310.

These forms of political protest can be effective.⁸⁸ The problem for the provinces, however, is that it is difficult to predict whether a protest will succeed or not. Provinces that enter into tax-point transfers in the confidence that they can use political tools to force federal compliance essentially roll the dice: they make an uncertain bet that they will have the political power, in an unknown future political environment, to pressure the federal government into fulfilling its promises.

This article has already identified three instances in which provincial protests failed to cause changes in federal tax and transfer policy. First, in 2016, the provinces vociferously objected to the federal government's cuts to the annual increase in the Canada health transfer, but eventually all of them relented and agreed to the new terms.⁸⁹ Second, after the Séguin commission issued its report in 2002, the federal government rejected Quebec's request for additional tax room and engaged in a long-running public relations campaign to defend itself.⁹⁰ Third, in 1991, British Columbia was ultimately unable to persuade the federal government to reverse its decision to reduce cash transfers under the Canada Assistance Plan.

COLLATERAL

A final common device employed to assure the performance of a contract is the use of collateral.⁹¹ Theoretically, the federal government could post a large sum of money in trust or escrow to secure future cash transfers; then, in the event of the government's default, the provinces could access the collateral. Collateral would provide some assurance that the federal government will make good on its promise or, at a minimum, that the provinces will receive some compensation in the event of a breach.

There are two problems with the use of collateral in the context of tax-point transfer agreements. The first is that the sum of money that would need to be placed in trust or escrow is potentially massive. If, for instance, the provinces transferred a substantial number of personal income tax points to the federal government, the net present value of the future tax receipts would likely be in the hundreds of billions of dollars. The federal government is unlikely to have sufficient cash on hand to secure the transaction. The second problem is that the trust or escrow account would need to be administered by a third party that was beyond the legislative reach of the two governments; otherwise, one government could unilaterally change the terms of the

88 See *ibid.*, at 1265-74.

89 See *supra* note 1.

90 Stephen Laurent, "Canada's Fiscal (Im)balance: Both Sides of the Argument," *Library of Parliament, Parliamentary Research Branch In Brief*, PRB 02-36E (November 27, 2002), at 2 (<http://publications.gc.ca/collections/Collection-R/LoPBdP/EB-e/prb0236-e.pdf>); and Canada, Department of Finance, "The Fiscal Balance in Canada: The Facts," October 2002 (http://webarchive.bac-lac.gc.ca:8080/wayback/20061130044003/http://www.fin.gc.ca/facts/fbcbfacts4_e.html).

91 See generally *The Uniform Commercial Code*, *supra* note 83, section 9.

trust or escrow account through legislation. It is difficult to conceive of such a third party within Canada. The simplest solution would be to use a third party outside Canada as the administrator, but it is unlikely that Canadian governments would be willing to deposit huge sums of money with foreign administrators who were beyond the reach of Canadian law.

Favourable Conditions for Upward Transfers

The contractual impediments described above do not mean that upward tax-point transfers will never occur again in Canadian fiscal federalism. There are two conditions that are favourable to upward transfers, even in the absence of effective contractual enforcement. First, when trust and goodwill between the two levels of government are high, provinces may be willing to transfer tax points without a contractual guarantee. High levels of trust and goodwill serve as a substitute for the traditional mechanisms of contract enforcement. Second, and paradoxically, upward transfers are also more likely in the presence of coercion. As indicated by the 1942 tax rental agreements, the provinces may be pressured or compelled to surrender tax room to the federal government. Coercion renders provincial concerns over contractual enforcement less significant, since the provinces may have little choice but to proceed with the transfer.

In the absence of these conditions, there are two design features that might also make upward tax-point transfers more palatable to the provinces. First, provinces can mitigate the consequences of a breach by transferring only a small number of tax points or by transferring tax points along less lucrative tax bases. When the amount of potential revenue at stake is smaller, the upward transfer carries less revenue risk to the provinces. Second, and more promisingly, an upward transfer could be structured so that provinces transfer tax points along one base in exchange for tax points along another base. For example, the provinces might agree to transfer corporate income tax points to the federal government in exchange for consumption tax (GST) points. This form of exchange—an upward tax-point transfer for a downward tax-point transfer—makes it more politically costly for the federal government to breach the terms of the transfer. If, for instance, the federal government were to breach the terms of the transfer by subsequently raising its consumption tax rate, it would have to justify to voters why it had raised the combined federal-provincial consumption tax rate. This arrangement is markedly different from a conventional upward transfer, where the federal government can repudiate an obligation to provide cash transfers without raising combined tax rates.

While these conditions and design features mean that upward transfers are possible, they do not obviate the need for enforcement mechanisms. The conditions identified above—high levels of trust or, alternatively, high levels of coercion—are difficult to achieve. The design features also have limits. Reducing the size of tax-point transfers constrains the capacity of the transfers to be used as tools for reallocating tax room. In addition, exchanging tax points for tax points raises a substantial coordination problem: an upward transfer must be paired with a downward transfer along another tax base. While such a transfer is possible, it may be

difficult to find an appropriate downward transfer, especially when the upward transfer is large.

Other Factors

Contractual constraints are not the only impediment to upward tax-point transfers. There are at least three other reasons why provinces may resist relinquishing tax points to the federal government, even when contractual enforcement is guaranteed. The contractual argument advanced in this article complements these explanations, and can help to fill a number of gaps.

First, provinces may resist upward transfers because they wish to retain provincial control over tax policy. When provinces relinquish all or most tax points to the federal government, they reduce their influence over tax-base definition. They also potentially limit their capacity to raise tax rates if future circumstances warrant. As a normative matter, there are two seminal justifications for retaining a substantial provincial role in taxation. Under Oates's decentralization theorem, subnational regions have different preferences for tax and spending policy that can best be met through decentralization.⁹² Under Tiebout's model of local government, individuals choose to reside in the jurisdiction that offers their preferred combination of tax and spending measures, thereby solving the preference revelation problem that plagues the financing of public goods.⁹³ Both Oates's and Tiebout's models require variation in subnational tax policy.

The attraction of tax-policy autonomy likely contributes to provincial resistance. There are two limitations, however, in the explanatory power of this theory. First, all provinces other than Quebec have been willing to cede substantial control over the definition of key tax bases through the tax collection agreements. Second, provinces could retain their flexibility to raise tax rates in the future by imposing time limits on any upward tax-point transfers, as was done in the 1942 tax rental agreements. These two factors suggest that the provincial desire for autonomy cannot fully explain the lack of time-limited upward transfers. The contractual impediment argument set out above offers an alternative explanation.

Second, some provinces, especially Quebec, have resisted upward transfers for more symbolic reasons. The nationalist movement in Quebec has linked control over tax policy to sovereignty.⁹⁴ Famously, at the 1955 Federal-Provincial Conference, Quebec Premier Maurice Duplessis cited the axiom "The right to tax is the

92 Oates, *supra* note 59, at 10-11 and 35.

93 Charles M. Tiebout, "A Pure Theory of Local Expenditures" (1956) 64:5 *Journal of Political Economy* 416-24.

94 Alarie and Bird, *supra* note 14; A. Milton Moore and J. Harvey Perry, *Financing Canadian Federation: The Federal-Provincial Tax Agreements*, Canadian Tax Paper no. 6 (Toronto: Canadian Tax Foundation, 1953), at 64-65; D.J. Dooley, "Quebec and the Future of Canada" (1965) 27:1 *Review of Politics* 17-31, at 25 and 27; and Gregory S. Mahler, "Canadian Federalism and the 1995 Referendum: A Perspective from Outside of Quebec" (1995) 25:4 *The American Review of Canadian Studies* 449-76.

right to govern,”⁹⁵ and warned that a province’s agreement to yield tax room to the federal government in exchange for cash transfers “would amount to replacing the reins enabling one to drive with shackles that paralyze and enslave.”⁹⁶ Unsurprisingly, Quebec withdrew from the tax rental agreements in 1947. Quebec nationalism has likely also made it easier for other provinces to oppose upward transfers by “provid[ing] an umbrella under which other [provinces] could subsequently shelter.”⁹⁷

The relationship between nationalism and tax sovereignty is complex and multifaceted, but it intersects in part with the contractual impediment argument advanced in this article. In the absence of enforceable contracts, an upward tax-point transfer places provinces in a position of dependency on the federal government, where they may find themselves “paralyzed” or “enslaved.” In the presence of enforceable contracts, however, an upward tax-point transfer establishes a *de facto* agency relationship between the two governments: the federal government acts as the province’s agent in maximizing tax revenue. Just as enforceable contracts can enhance the autonomy of individuals by providing them with options that would not otherwise exist,⁹⁸ they can also enhance the autonomy of governments.

Third, resistance to upward transfers may result from an interprovincial collective action problem. High-tax provinces may be willing to transfer tax points to the federal government, but low-tax provinces that gain from tax-base shifting, such as Alberta, may not. Absent the participation of the low-tax provinces, the upward transfer will be of less value to the high-tax provinces: tax base will still migrate to the provinces with the lower combined federal-provincial rate. The extent of this collective action problem will depend, in part, on the willingness and capacity of some provinces to offer substantially lower tax rates than others. If some provinces have significant natural resource wealth, or a disproportionate number of high-income taxpayers, they will be able to fund government services at lower average tax rates, which will in turn attract tax base from other provinces.⁹⁹

95 Quoted in Moore et al., *supra* note 28, appendix B, at 121.

96 *Ibid.*, at 123, where Duplessis also elaborated the concept of “*maîtres chez nous*,” stating that upward transfers “would amount to giving the key of one’s house to another.”

97 Alarie and Bird, *supra* note 14, at 28.

98 See Roy Kreitner, “Voicing the Market: Extending the Ambition of Contract Theory” (2019) 69:3 *University of Toronto Law Journal* 295–336, at 296 (<https://doi.org/10.3138/utlj.2018-0079>).

99 See, for example, Robin Boadway, “Natural Resource Shocks and the Federal System: Boon and Curse?” in selected proceedings from the 2006 Fiscal Federalism and the Future of Canada conference, Queen’s University, Institute of Intergovernmental Relations, September 28–29, 2006, at 8 (www.queensu.ca/iigr/sites/webpublish.queensu.ca/iigrwww/files/files/WorkingPapers/fiscallmb/boadway.pdf); Musgrave, *supra* note 59, at 18; Oates, *supra* note 59, at 132; and Boadway and Shah, *supra* note 51, at 158 and 162. The interprovincial collective action problem will also be influenced by the number of subnational governments. For instance, agreement among the 50 American states is less likely than agreement among the 10 Canadian provinces.

Collective action problems of this type undoubtedly contribute to the problem of coordinating federal and provincial tax rates. The advantage of the contractual impediment argument, however, is that it can fill two gaps in the collective action explanation:

1. The collective action theory suggests that there should be examples in Canadian history of upward tax-point transfers that were thwarted by a small number of holdout provinces. In fact, while wealthy provinces have generally been more supportive of downward transfers than poorer provinces,¹⁰⁰ there has been little demand from any of the provinces for upward transfers.¹⁰¹ The lack of interest in upward transfers is evidently not limited to the small number of provinces that gain from tax competition.¹⁰²
2. The prospect of one or more provinces refusing to participate in an upward tax-point transfer does not fully negate the revenue gains of upward transfers, so long as regional groups of provinces are willing to participate. The reason is that tax rates in neighbouring jurisdictions likely have a greater impact on the elasticity of a province's tax base than the tax rates of distant jurisdictions.¹⁰³ For instance, it is easier for taxpayers to avoid income or sales taxes by relocating their residence or purchases to a neighbouring province rather than a distant province. Additionally, taxpayers may be more likely to learn of tax-saving opportunities available in neighbouring provinces rather than distant provinces, owing to the role that geography plays in knowledge diffusion.¹⁰⁴ The significance of geography means that regional groups of provinces may have a fiscal incentive to engage in upward transfers, even if some Canadian provinces refuse to participate. The contractual impediment argument explains why these asymmetric upward transfers have not emerged: even if a regional group desires an upward transfer, it will refrain from doing so if it cannot be sure that the federal government will fulfill its part of the bargain.

100 See supra note 49.

101 See the discussion above under the heading "The Historical Puzzle."

102 To the extent that provincial attitudes toward upward transfers are fractured, the contractual impediment argument also provides an explanation. If some, but not all, provinces distrust the federal government, it will be harder to obtain the necessary coalition of provinces to implement the upward transfer.

103 See Milligan and Smart, supra note 52, at 16; Christian Frey, Christoph Gorgas, and Christoph A. Schaltegger, "The Long Run Effects of Taxes and Tax Competition on Top Income Shares: An Empirical Investigation" (2017) 63:4 *Review of Income and Wealth* 792-820, at 794, 798, and 817 (<https://doi.org/10.1111/roiw.12228>). For a discussion of the role of geography in international taxation, see Aleksandra Reidl and Silvia Rocha-Akis, *Testing the Tax Competition Theory: How Elastic Are National Tax Bases in Europe?* Department of Economics Working Paper series no. 112 (Vienna: Vienna University of Economics and Business, 2007), at 9.

104 André Torre, "On the Role Played by Temporary Geographical Proximity in Knowledge Transmission" (2008) 42:6 *Regional Studies* 869-89 (<https://doi.org/10.1080/00343400801922814>).

DOWNWARD TAX-POINT TRANSFERS

The case for downward tax-point transfers is more complex than the case for upward transfers. The primary benefit of downward transfers is that they create a more transparent relationship between tax rates and government revenues than do other mechanisms for transferring revenue, such as cash transfers, and deductions or credits for provincial taxes. By improving transparency, tax-point transfers make it easier for voters to assign political responsibility for taxing and spending decisions, and thus can remedy a number of incentive problems that afflict fiscal federalism.

This section proposes that the same contractual problems that arise with upward tax-point transfers make downward tax-point transfers unattractive to the federal government, even when downward transfers are welfare enhancing. In the absence of judicial enforcement, the federal government lacks an effective mechanism for controlling how provinces spend the revenue resulting from a tax-point transfer. In contrast, when the federal government transfers cash or offers credits or deductions to the provinces, it has more effective self-help mechanisms for ensuring that provinces comply with federal conditions.

Primary Benefit

Alternative Revenue-Allocation Mechanisms

Downward tax-point transfers can be placed within a family of mechanisms for transferring revenue from federal to provincial governments. Federal governments wishing to transfer revenue to provinces have a choice between transferring cash or tax room. Cash transfers provide revenue directly to provincial governments. Tax-room mechanisms enable provincial governments to increase their revenue by increasing their tax rates.

Tax-room mechanisms commonly include three alternatives: federal credits for provincial taxes paid; federal deductions for provincial taxes paid; and downward tax-point transfers. Under a credit, federal taxes owing are reduced by provincial taxes paid. Under a deduction, provincial taxes paid are deductible from the federal tax base. Under a downward tax-point transfer, federal nominal tax rates decrease and provincial nominal rates increase. Each of these options effectively opens up tax room for provincial governments.¹⁰⁵

Cash and tax-room mechanisms can be used to achieve the same allocation of revenue between governments. To illustrate the effects of each option, assume (as in the example at table 1 above) a country with a national (federal) government and a

105 The Canadian government has used all of these alternatives at various times. Between 1941 and 1962, under a variant of revenue sharing, federal transfers were partly tied to federal tax receipts in each province. Between 1962 and 1972, the federal government offered capped credits for provincial personal income taxes and capped deductions for provincial corporate income taxes. In 1972, most credits and deductions were replaced by tax-point transfers to the provinces, and in 1976, tax-point transfers replaced certain cash transfers. For a history of these changes, see Perry, *supra* note 27.

provincial government, both of which occupy the same territory. The total personal income tax base is \$100. The federal government has historically levied a 30 percent flat tax, which results in \$30 in annual federal revenue. The province does not levy a personal income tax and thus has no income tax revenue. Both governments wish to transfer \$15 in revenue from the federal government to the province without raising the combined personal income tax rate above 30 percent.

The governments have four options, which are set out in table 3. Each option transfers \$15 in revenue to the province, but uses a different combination of federal and provincial tax rates to effect the transfer. At one extreme—cash transfers—the federal rate is 30 percent and the provincial rate is 0 percent. At the other extreme—tax-point transfers—the federal rate and the provincial rate are equal at 15 percent.

As noted above, downward tax-point transfers create a more transparent relationship between nominal tax rates and government revenues than that achieved by the other allocation mechanisms. Following the above tax-point transfer, the ratio of federal tax rates (15 percent) to provincial tax rates (15 percent) is 1:1 (“the tax-rate ratio”), which accurately reflects the ratio of federal revenue (\$15) to provincial revenue (\$15) (“the revenue ratio”). In contrast, under a deduction, the ratio of federal to provincial tax rates is 1.17:1, which incorrectly suggests that net federal revenue is 17 percent greater than provincial revenue. The disparity is more pronounced under a credit, where the ratio of tax rates suggests that federal revenues are double provincial revenues, and most pronounced under a cash transfer, where the tax-rate ratio (infinity) suggests that provincial revenues are zero, even though revenues are equally divided between the federal and provincial governments. Table 4 sets out the effects of the four options.

This transparency advantage can be illustrated by placing the four revenue allocation mechanisms on a spectrum, as illustrated below. Transparency is greatest with tax-point transfers on the far right, since the tax rate and revenue ratios are 1:1. Moving to the left along the spectrum, the tax-rate ratio diverges from the revenue ratio. This divergence is greatest for cash transfers at the far left, where the tax-rate ratio is infinity.

The greater transparency of tax-point transfers has two related benefits. First, it reduces information costs for voters. A voter can determine the allocation of revenue between governments simply by looking at tax rates.¹⁰⁶ Of course, with

¹⁰⁶ This process is more complicated when progressive rate schedules are used. With progressive rates, a voter can use marginal rates to determine what share of his or her last dollar earned goes to each government, but not what share of his or her total tax payable goes to each government.

TABLE 3 Comparison of Options for Revenue Allocation to Provinces

	Federal tax rate	Provincial tax rate	Combined federal- provincial tax rate	Net federal revenue	Net provincial revenue
		<i>percent</i>			<i>dollars</i>
Cash transfer (\$15)	30.0	0	30	15	15
Credit	30.0	15	30	15	15
Deduction	17.6	15	30	15	15
Tax-point transfer	15.0	15	30	15	15

TABLE 4 Tax Rate and Revenue Ratios Under Revenue-Allocation Options

	Federal tax rate	Provincial tax rate	Net federal revenue	Net provincial revenue	Tax-rate ratio	Revenue ratio
		<i>percent</i>		<i>dollars</i>		
Cash transfer	30.0	0	15	15	∞	1:1
Credit	30.0	15	15	15	2:1	1:1
Deduction	17.6	15	15	15	1.17:1	1:1
Tax-point transfer	15.0	15	15	15	1:1	1:1

enough time, willpower, and skill, voters could untangle the relationship between tax rates and net revenues in even the most complicated systems of cash transfers, deductions, and credits. The advantage of tax-point transfers, however, is that the effort required to determine revenue allocation is greatly reduced.

Second, by reducing information costs, tax-point transfers better align the political costs of taxation with the political benefits of spending.¹⁰⁷ In a federal system where the federal government uses tax-point transfers in lieu of cash transfers, credits, and deductions, each level of government is responsible for levying the taxes needed to fund its expenditures. In contrast, under a system of cash transfers, the federal government arguably bears the political cost of levying taxes¹⁰⁸ while the

107 Proponents of the use of tax-point transfers in Canada have primarily emphasized political accountability. See, for example, Michael Smart, *Federal Transfers: Principles, Practice, and Prospects*, C.D. Howe Institute Working Paper (Toronto: C.D. Howe Institute, 2005), at 9-10 (proposing that the federal government transfer income tax points to the provinces); Michael Smart and Jack Mintz, "Why Quebec's Tax-Point Transfers Are a Good Idea," *National Post*, March 25, 2002; and Michael Smart and Richard Bird, "Transfer Real Taxing Power to the Provinces," *National Post*, June 27, 2006.

108 Unless voters hold the provincial government responsible for federal taxes because the resulting federal revenues are transferred to the provincial government. As argued above, however, voters face significant information costs in disentangling the relationship between federal tax rates and provincial expenditures.

provinces enjoy some or all of the political benefits of spending the resulting revenue. Credits and deductions similarly detach the political benefits of spending from the political costs of taxation, albeit by a lesser amount. Under a credit, the province levies the necessary taxes to fund its expenditures, but the federal government absorbs some of the political cost by retaining a high nominal tax rate that misleadingly suggests that the federal tax share is higher than it actually is. Under a deduction, the federal government also bears a portion of the political cost by retaining a misleadingly high nominal rate, although less dramatically than under a credit system.

Incentive Effects

By aligning the political costs of taxation with the political benefits of spending, downward transfers potentially resolve three incentive problems that commonly arise in fiscal federalism.¹⁰⁹

First, tax-point transfers can mitigate what is known as the “soft budget constraint” problem.¹¹⁰ Under a system of cash transfers, provinces have an incentive to run budget deficits rather than raise their own tax rates to fund expenditures.¹¹¹ As Smart has observed, “provinces have little incentive today to set their own fiscal houses in order, since spending restraint must weaken the case for future increases in federal [cash] transfers.”¹¹² Downward tax-point transfers also raise concerns that provinces may run deficits in the hope of justifying further tax-point transfers.¹¹³ The difference, however, is that tax-point transfers require the provinces to assume at least some political responsibility for levying the taxes necessary to fund their expenditures. The possibility of future tax-point transfers is therefore less likely to induce fiscal irresponsibility.

109 The body of literature that addresses incentives is often called “second-generation fiscal federalism.” See, for example, Yingyi Qian and Barry R. Weingast, “Federalism as a Commitment to Preserving Market Incentives” (1997) 11:4 *Journal of Economic Perspectives* 83-92, at 83-84; and Wallace Oates, “Toward a Second-Generation Theory of Fiscal Federalism” (2005) 12:4 *International Tax and Public Finance* 349-73.

110 See Smart, *supra* note 107, at 8-9; Yingyi Qian and Gérard Roland, “Federalism and the Soft Budget Constraint” (1998) 88:5 *American Economic Review* 1143-62; Jonathan A. Rodden, Gunnar S. Eskeland, and Jennie Litvack, eds., *Fiscal Decentralization and the Challenge of Hard Budget Constraints* (Cambridge, MA: MIT Press, 2003); and Timothy J. Goodspeed, “Bailouts in a Federation” (2002) 9:4 *International Tax and Public Finance* 409-21.

111 See Smart and Mintz, *supra* note 107; and Smart and Bird, *ibid*.

112 Smart, *supra* note 107, at 8.

113 The same problem applies to credits and deductions, albeit to a lesser extent. If the federal government offers credits or deductions to a province, the province has an incentive to run budget deficits so that the federal government will increase the size of the credit or deduction. Receiving credits or deductions is more attractive to a province than raising its own tax rates since the credit or deduction obscures the extent of provincial taxation.

Second, downward transfers resolve the vertical externality problem discussed earlier in this article. When the federal government bears the political cost of taxing, but the provinces enjoy the political benefits of spending the resulting revenue, the federal government has an incentive to reduce cash transfers in favour of expenditures on areas of federal jurisdiction, where it receives all of the political benefits resulting from the expenditures. The result is that areas of provincial jurisdiction may be underfunded. In contrast, under a system of tax-point transfers, the federal government passes on the political cost of taxation to the provinces. Tax-point transfers should therefore be more palatable to the federal government and reduce the risk that provincial areas of jurisdiction will be chronically underfunded.

Third, tax-point transfers can arguably lead to more productive provincial spending. Cash transfers can change marginal tax prices, which can in turn distort provincial spending decisions.¹¹⁴ When a province bears only a portion of the cost of an expenditure, it has an incentive to proceed if the benefits exceed its portion of the cost. The problem is that the benefits may exceed the province's share of the expenditure but not the combined cost to both governments. Cash transfers raise the concern that provinces will engage in expenditures that they never would have made if they had been required to fund the entire bill. Tax-point transfers remedy this problem.

Qualifications

There are two important qualifications to the case for downward tax-point transfers.

First, downward transfers can exacerbate interprovincial inequality. The per capita value of a tax point will vary with the size of provincial tax bases. For instance, Alberta's per capita fiscal capacity is approximately double Prince Edward Island's.¹¹⁵ If the federal government transferred equal tax points to all provinces, high-tax-base provinces (such as Alberta) would be made substantially better off than low-tax-base provinces (such as Prince Edward Island). The simplest remedy to this problem is to adjust federal cash transfers to equalize the revenue effects of the tax-point transfer, as the federal government did in 1976. By providing additional cash transfers to low-tax-base provinces (or reducing cash transfers to high-tax-base provinces), the federal government can undo the inequality created by the tax-point transfer.¹¹⁶

114 See Stanley L. Winer, "Some Evidence on the Effect of the Separation of Spending and Taxing Decisions" (1983) 91:1 *Journal of Political Economy* 126-40, at 127 (<https://doi.org/10.1086/261131>); and Richard M. Bird, "Fiscal Decentralization and Competitive Governments," in Gianluigi Galeotti, Pierre Salmon, and Ronald Wintrobe, eds., *Competition and Structure: The Political Economy of Collective Decisions: Essays in Honor of Albert Breton* (Cambridge, UK: Cambridge University Press, 2000), 129-49, at 136.

115 Jim Feehan, "Canada's Equalization Formula: Peering Inside the Black Box . . . And Beyond" (2014) 7:24 *SPP Research Papers* [University of Calgary School of Public Policy] 1-27, at 7.

116 Alternatively, the federal government could engage in asymmetric transfers. If the per capita value of a tax point transferred to a high-tax-base province is 50 percent greater than the

Second, the case for downward transfers is limited by the case for upward transfers. A discussion of the theory of the optimal division of tax room between governments is beyond the scope of this article.¹¹⁷ The distinct normative justifications for upward and downward tax-point transfers, however, can be combined to provide broad guidelines for the choice between these two forms of transfers. The choice presents a tradeoff. Upward transfers increase total government revenue but exacerbate incentive problems. Downward transfers likely decrease revenue but mitigate incentive problems. From a social welfare perspective, governments should engage in upward tax-point transfers when the welfare gains from increased revenue are greater than the welfare losses from increased incentive problems. Governments should engage in downward tax-point transfers when the welfare gains from reducing the incentive problems are greater than the welfare losses from decreased revenue.¹¹⁸

Contractual Impediments to Downward Tax-Point Transfers

Why have downward tax-point transfers fallen into disuse? At least part of the explanation is that the same contractual impediments that afflict upward tax-point transfers discourage the federal government from offering downward transfers. When the federal government transfers tax points to the provinces, it lacks an easy mechanism for enforcing the transfer's terms. Under the doctrine of parliamentary sovereignty, the federal government cannot use the courts to ensure that provinces spend the resulting revenue in accordance with federal preferences, notwithstanding any promises that the provinces may have made at the time the agreement was negotiated. The federal government also cannot easily revoke the transfer: it can raise its tax rates to pre-transfer levels if it is dissatisfied with provincial compliance, but it cannot compel the provinces to lower their tax rates to pre-transfer levels.¹¹⁹ In the absence of corresponding provincial tax cuts, the federal government will have to explain to voters why it has increased the combined federal-provincial tax rate.

per capita value of a tax point transferred to a low-tax-base province, the federal government could equalize the value of the transfers by transferring 50 percent more tax points to the low-tax-base province. The problem with this approach is that the downward transfer of all federal income tax points to a low-tax-base province may not equal the value of a much smaller tax-point transfer to a high-tax-base province. There may be no possible asymmetric transfer to the poorer province that can fully equalize the value of the transfers.

- 117 For a revenue-maximization theory of the optimal division of tax room, see Milligan and Smart, *supra* note 52, at 22-25. For a consideration of the optimal division of particular tax bases, see Robin W. Boadway and Harry M. Kitchen, "Personal Income Tax Reform in a Broader Context" (1999) 47:3 *Canadian Tax Journal* 566-602, at 581-83.
- 118 Subject to the disadvantages of downward tax-point transfers discussed below. To the extent that the disadvantages cannot be resolved by design features of the transfers, they should be taken into account in determining whether to proceed with a downward transfer.
- 119 This is the same problem that provinces confront with upward tax-point transfers. See the discussion above under the heading "Judicial Enforcement."

These contractual problems weaken the normative, or social welfare, case for downward tax-point transfers, and diminish the potential political benefits to a self-interested federal government. On both counts, cash transfers, and, to a lesser extent, credits and deductions, have a number of advantages. This section first considers the normative implications and then considers the implications for the federal government's political interests.

Normative Implications

The impediments to contractual enforcement raise two problems.

First, it is difficult to use tax-point transfers to internalize horizontal and vertical spillovers. Horizontal spillovers occur when a provincial good or service confers benefits on neighbouring provinces.¹²⁰ Provinces will generally underinvest in these goods and services, since they reap only a portion of the resulting benefits. Vertical spillovers occur when the expenditures made by one level of government generate tax revenue for another level of government.¹²¹ To the extent that provincial expenditures are motivated by the expected tax revenue generated by an expenditure, provincial governments will underinvest in goods and services. To correct this problem of underinvestment, the federal government should subsidize any spillover-creating provincial expenditures.

The problem with using tax-point transfers to internalize horizontal and vertical spillovers is that (as discussed above) it is difficult to enforce the conditions of a downward transfer. For instance, if the federal government transfers tax points to a province on the condition that the resulting revenues are used to fund health care, it has only limited enforcement options if the province chooses to spend the revenues on paying down the provincial debt.¹²² In contrast, with cash transfers, it is easier to encourage (if not enforce) compliance. If a province fails to use a cash transfer as promised, the federal government can refuse to make a cash transfer in the following year. The annual nature of cash transfers makes them easy to discontinue or reduce, and thus provides the federal government with more control over how the funds are spent.¹²³

120 Anwar Shah, "A Practitioner's Guide to Intergovernmental Fiscal Transfers," in Robin Boodway and Anwar Shah, eds., *Intergovernmental Fiscal Transfers: Principles and Practice* (Washington, DC: The World Bank, 2007), 1-53, at 7.

121 See Bev Dahlby, "Fiscal Externalities and the Design of Intergovernmental Grants" (1996) 3:3 *International Tax and Public Finance* 397-412. A productive expenditure will generate economic growth that increases the major tax bases, such as consumption and income. Since both levels of government share these tax bases, the government that funds the expenditure does not capture the entire revenue gain.

122 In the absence of enforcement of the transfer's terms, the transfer will have an income effect but not the desired substitution effect.

123 For example, when the federal government imposed penalties on British Columbia between 2002 and 2018 for breaching the Canada Health Act, it chose to reduce its cash transfers to the

Second, the impediments to contractual enforcement can result in horizontal tax competition that reduces total public revenues. The risk with any downward tax-point transfer is that some provinces might use the transfer to lower their combined federal-provincial tax rate. These provinces would immediately gain a competitive tax advantage, in that their combined tax rates would be lower than those in other provinces. The simplest solution to this problem is contractual: the federal government could require that provinces promise to occupy the vacated federal tax room for at least a minimum period of time. The challenge, however, is that the federal government lacks a legal mechanism for enforcing this obligation. If a province accepted a downward tax-point transfer but then substantially cut the provincial tax rate two years later, the federal government could not turn to the courts to compel the province to raise its tax rate.

In the absence of judicial enforcement, the federal government has two enforcement mechanisms to address horizontal tax competition, although both have limitations:

1. The government can guard against horizontal competition through the use of asymmetric tax-point transfers. If a province refuses to accept a tax-point transfer, the federal government can simply restore the federal tax rate in the holdout province to its original level, causing the holdout province to lose its tax advantage.¹²⁴ The challenge with this approach is political. For instance, if a province were to initially accept a tax-point transfer by raising its tax rate, but then later decrease that rate, the federal government would have to respond by raising the federal tax rate to its pre-transfer level. This move may be difficult to justify to voters, especially if the provincial tax cut occurs many years after the initial tax-point transfer. Voters may not accept, or care, that the combined tax increase is related to the previous tax-point transfer. Asymmetric transfers place the federal government in the unenviable position of having to cancel provincial tax cuts.

province rather than scale back a portion of the 1976 tax-point transfer: Michael Mui, "B.C. Fined for Medical Extra-Billing 16 Years in a Row," *The Star Vancouver*, April 12, 2018 (www.thestar.com/vancouver/2018/04/12/bc-fined-for-medical-extra-billing-16-years-in-a-row.html); and Pamela Fayerman, "Penalties Reduce Federal Transfer Payments to B.C. by \$500,000," *Vancouver Sun*, February 19, 2015 (www.vancouver.sun.com/health/penalties+reduce+federal+transfer+payments/10824574/story.html). More generally, the federal government could encourage compliance by withholding or reducing cash transfers to provinces that breach the terms of a tax-point transfer. The problem with this approach is that it is then the cash transfer, rather than the tax-point transfer, that operates as the conditional grant. As the federal government replaces cash transfers with tax-point transfers, its ability to use cash transfers to enforce adherence to the terms of a tax-point transfer decreases.

124 If the federal government credibly signals in advance that it will undo its tax cut in any holdout province, it may never have to engage in an asymmetric transfer. The threat may be enough to discourage provinces from holding out.

2. The federal government can exert pressure on the provinces to accept the tax-point transfer by reducing the amount of cash transfers by the value of the transferred tax points. The reduction in cash transfers presents provinces with a difficult choice: raise tax rates or cut public spending by the amount of the reduced cash transfer. The federal government used this mechanism in 1976. Reductions in cash transfers are a potentially effective mechanism, but they have two limitations:
 - a. Growth in other provincial revenue sources, such as natural resource revenues, may enable some provinces to reject the tax-point transfer without cutting public spending. The tax advantage gained by the non-participating provinces will attract tax base that at least partly offsets the decrease in federal cash transfers.
 - b. It may be politically difficult for the federal government to justify to the public that it reduced cash transfers to a province because the province had failed to *increase* its tax rates. Historically, the federal government has had difficulty justifying asymmetric cash transfers as part of tax-point transfers. For example, following the 1976 tax-point transfer, the federal government provided unequal per capita cash transfers to the provinces, but the inequality came under sustained attack from the wealthier provinces in the 2000s. The federal government agreed to restore equal per capita funding beginning in 2014.¹²⁵

In contrast to tax-point transfers, cash transfers, credits, and deductions do not create a risk of horizontal tax competition. With cash transfers, the tax room available to provincial governments remains unchanged. With credits and deductions, a provincial tax cut does not change the combined federal-provincial tax rate: the effective federal rate automatically increases to fill the vacated provincial tax room.

Political Implications

In addition to the normative implications, there are two reasons why the contractual impediments may discourage the federal government, as a self-interested political actor, from engaging in downward tax-point transfers.

First, tax-point transfers reduce the federal government's capacity to obtain a portion of the political credit for provincial expenditures. When the federal government provides cash transfers to the provinces, it regularly requires that the provinces take steps to recognize the federal contribution.¹²⁶ The renewal of cash

125 See James Gauthier, *The Canada Health Transfer: Changes to Provincial Allocations*, Background Paper no. 2011-02-E (Ottawa: Library of Parliament, Parliamentary Information and Research Service, February 2011), at 6 (http://publications.gc.ca/collections/collection_2011/bdp-lop/bp/2011-02-eng.pdf); and Josh Wingrove, "Ottawa's Per-Capita Health Transfers a Windfall for Alberta," *The Globe and Mail*, January 17, 2012 (www.theglobeandmail.com/news/politics/ottawas-per-capita-health-transfers-a-windfall-for-alberta/article1358853).

126 See *supra* note 75, referring to the requirement in the Canada Health Act.

transfers is also frequently accompanied by press conferences and advertisements that publicize the federal government's contribution.¹²⁷ Tax-point transfers are harder to use for political benefit. For example, in the 40 years following the 1976 tax-point transfer, the federal government claimed that the revenue resulting from the transfer was a federal contribution to the provinces.¹²⁸ The provinces, however, frequently disputed the claim; now that the tax points were levied by the provinces, the resulting revenue was, in their view, own-source provincial revenue.¹²⁹ A number of prominent experts agreed: the revenues generated from the transfers had gradually lost their federal character over time.¹³⁰ Since tax-point transfers are harder to revoke than cash transfers, credits, and deductions, the federal government had little leverage in the dispute. In 2007, it agreed to remove the 1976 tax-point transfers from the formula used to determine cash transfers under the Canada health transfer, beginning in 2014.¹³¹

Second, tax-point transfers make it difficult for the federal government to change its mind. When the federal government offers cash transfers to the provinces, it can reduce or cease the cash transfers if it later decides that it would rather spend the revenue on areas of federal jurisdiction. Similarly, the federal government can repeal or reduce a deduction or credit without raising nominal tax rates.¹³² In contrast,

127 See, for example, the 2017 renewal of the Canada health transfer, which allowed the federal government to announce new funding commitments to mental health care: Health Canada, "Federal, Provincial and Territorial Health Ministers Agree on Collaborative Approach To Improve Access to Mental Health and Addiction Services, Home and Community Care," *News Release*, August 21, 2017 (www.canada.ca/en/health-canada/news/2017/08/federal_provincialandterritorialhealthministersagreeoncollaborat.html). Since tax-point transfers do not require renewal, there is less opportunity for public funding announcements.

128 See Odette Madore, "The Transfer of Tax Points to the Provinces Under the Canada Health and Social Transfer," Government of Canada Publication no. BP-450E, October 1997 (<http://publications.gc.ca/Collection-R/LoPBdP/BP/bp450-e.htm>).

129 Prominently, a 2000 report prepared by the provincial ministers of health proclaimed that the "provinces/territories do not consider it legitimate to count the tax point value as part of [federal transfers] each year . . . since it is revenue collected from provincial/territorial tax effort." See Provincial and Territorial Ministers of Health, *supra* note 74, at 11-12. See also David B. Perry, "Health and Social Transfers" (2000) 8:5 *Canadian Tax Highlights* 34-35, at 35.

130 See Robin Boadway, "Policy Forum: The Annual Tax Expenditure Accounts—A Critique" (2007) 55:1 *Canadian Tax Journal* 106-29, at 119 ("[F]or all intents and purposes, the transfers are now part of provincial tax revenues"); Carter, *supra* note 45, at 547 (warning that the "association the tax transfer now has with a specific area of provincial expenditure" might "vanish"); George E. Carter, "Established Programs Financing: A Critical Review of the Record" (1988) 36:5 *Canadian Tax Journal* 1225-43, at 1230 ("[O]nly the cash transfer had retained a federal identity"); and Perry, *supra* note 27, at 275 ("In practical terms, the provinces had the better of the argument: the tax points were now in their hands, and they were not likely to give them back").

131 See Gauthier, *supra* note 125, at 6; and Wingrove, *ibid*.

132 This political advantage may explain why the US government capped the SALT deduction rather than raise nominal tax rates in high-tax states. See *supra* notes 2 and 3.

once tax points have been transferred, the federal government may be unable to reclaim them if its preferences (or circumstances) change. The problem is that the federal government cannot easily impose time limits on tax-point transfers. It may insist that the provinces return tax points after a limited period—say, five years—but there is a real risk that a downward transfer will result in the permanent, or at a minimum long-term, surrender of tax room.¹³³

CONCLUSION

Tax-point transfers are potentially a foundational tool of fiscal federalism. They provide a coordinated means for changing the allocation of tax room between governments. Upward transfers can be used to increase the revenue of both federal and provincial governments. Downward transfers can be used to mitigate the incentive problems that result from intergovernmental cash transfers.

This article's central claim is that problems with contractual enforcement render tax-point transfers less attractive to the transferor government than alternative funding mechanisms. The article provides a partial explanation for why provinces have failed to voluntarily engage in upward tax-point transfers despite the potential revenue gains: a province that transfers tax points surrenders control over the resulting revenue. The article also provides an explanation for the absence of downward tax-point transfers over the last 40 years. When the federal government transfers tax points rather than cash, it weakens its control over the resulting revenue, and also jeopardizes its efforts to claim a share of the political credit for provincial spending.

The problem of contract enforcement has implications for fiscal federalism and for law. For fiscal federalism, the contractual impediments to tax-point transfers mean that some welfare-enhancing changes in tax-room allocation may not occur. In the absence of contract enforcement, tax-point transfers require high degrees of intergovernmental trust; high degrees of coercion, as in the case of the 1942 tax rental agreements; or significant benevolence on the part of the transferor government. When trust, coercion, or benevolence are low, tax-point transfers in lucrative tax bases are difficult to achieve.

For law, the problems with contract enforcement cast new light on the doctrine of parliamentary sovereignty. An animating purpose of the doctrine is to preserve the flexibility of legislatures to change legislation as circumstances warrant.¹³⁴ This article observes that, at least in the context of tax-point transfers, the doctrine actually limits the policy options available to governments. Just as enforceable contracts expand the options open to individuals, they can expand the options open to governments.

133 Carter, *supra* note 45, at 547; and Carter, *supra* note 69, at 1529.

134 For a discussion of the rationale for prohibiting legislatures from binding their successors, see Eric A. Posner and Adrian Vermeule, "Legislative Entrenchment: A Reappraisal" (2002) 111:7 *Yale Law Journal* 1665-1705, at 1676.

Did the Adoption of IFRS Affect Corporate Tax Avoidance?

Oliver Nnamdi Okafor, Akinloye Akindayomi, and Hussein Warsame*

PRÉCIS

Cet article examine si l'adoption des normes internationales d'information financière (IFRS) a eu une incidence sur l'évitement fiscal des sociétés au Canada. Sur la base de 3 200 ensembles de données d'entreprise annuelles de 400 entreprises canadiennes cotées en bourse qui ont adopté les IFRS et de 400 entreprises américaines cotées en bourse, pour lesquelles on a effectué un appariement biunivoque à l'aide de l'appariement des coefficients de propension, les résultats de régression des auteurs montrent que l'adoption des IFRS a été suivie par une diminution du nombre de cas d'évitement fiscal des entreprises au Canada, du moins à court terme. L'étude révèle une augmentation importante de l'impôt payé comptant au cours de la période postérieure à l'adoption par les entreprises canadiennes qui ont adopté les IFRS par rapport aux entreprises américaines qui ont appliqué les principes comptables généralement reconnus aux États-Unis. D'autres résultats de régression fondés sur un petit échantillon de contrôle d'entreprises canadiennes qui n'ont pas adopté les IFRS présentent des données probantes de collaboration. Les auteurs examinent en outre certains attributs des contribuables et des questions comptables relevés dans les notes de service internes de l'Agence du revenu du Canada, en particulier les craintes que l'adoption des IFRS puisse accroître le risque d'évitement fiscal. Bien que les auteurs trouvent des preuves que les entreprises qui ont adopté les IFRS et se sont engagées dans la comptabilité d'exercice ont payé plus d'impôts au cours de la période postérieure à l'adoption des normes, leur analyse ne fournit aucune preuve de relations statistiquement significatives entre l'adoption des IFRS et l'évitement fiscal associé à la gestion des revenus, la propriété d'exploitations étrangères, l'appartenance à un secteur d'activité, la rentabilité, ou les pertes ou radiations de valeur. Globalement, les conclusions des auteurs présentent des preuves empiriques préliminaires mais solides

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que l'adoption des IFRS est associée à une diminution de l'évitement fiscal des sociétés, du moins à court terme.

ABSTRACT

This article investigates whether the adoption of international financial reporting standards (IFRS) affected corporate tax avoidance in Canada. Based on a 3,200 firm-year data set of 400 publicly listed Canadian firms that adopted IFRS and 400 listed US firms, matched one-to-one using propensity score matching, the authors' regression results show that IFRS adoption was followed by a decrease in corporate tax avoidance in Canada, at least in the short run. The study finds a significant increase in cash tax paid in the post-adoption period by Canadian firms that adopted IFRS compared to US firms that used US generally accepted accounting principles. Additional regression results based on a small control sample of Canadian firms that did not adopt IFRS present collaborative evidence. The authors further test specific taxpayer attributes and accounting issues identified in Canada Revenue Agency internal memorandums—in particular, concerns that the adoption of IFRS may increase the risk of tax avoidance. While the authors find evidence that the IFRS firms that engaged in accrual management paid more taxes in the post-adoption period, their analysis provides no evidence of statistically significant relationships between IFRS adoption and tax avoidance associated with revenue management, ownership of foreign operations, industry membership, profitability, or impairment losses or writeoffs. Taken together, the authors' findings present preliminary but strong empirical evidence that IFRS adoption is associated with a decrease in corporate tax avoidance, at least in the short run.

KEYWORDS: IFRS ■ INTERNATIONAL FINANCIAL REPORTING STANDARDS ■ TAX AVOIDANCE ■ CORPORATE TAXES ■ CANADA REVENUE AGENCY

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INTRODUCTION

A recent article by Okafor, Mains, Olabiyi, and Warsame¹ suggested that, on the basis of internal memorandums of the Canada Revenue Agency (CRA), the tax authority had concerns that the adoption of international financial accounting standards (IFRS) in Canada could affect the risk of inappropriate adjustments in corporate tax reporting. The authors of that article called for empirical studies on the effects of IFRS in relation to various tax issues. Prior studies had suggested that tax and financial reporting are linked, and the links may vary across jurisdictions and time.² Researchers have also found that the effects of IFRS on financial reporting are considerably heterogeneous across firms.³ Yet despite heightened interest in the effects of IFRS, very little is known about the impact on tax avoidance. In this study, we empirically investigate whether the adoption of IFRS affected corporate tax avoidance in Canada. We further test the effects of specific taxpayer attributes associated with the accounting issues identified in the CRA's internal bulletins on IFRS and corporate tax avoidance, including the attributes of revenue recognition, ownership of foreign operations, accrual management, profitability, and impairment losses or writeoffs. Since prior studies have suggested that the impact of the adoption of IFRS on financial reporting is not homogeneous across firms, we also test for the effects of taxpayer attributes such as firm size and industry membership.

Canada presents a unique setting for investigating the effects of IFRS because (1) its reporting environment mitigates self-selection bias,⁴ and (2) Canada permits

- 1 Oliver Nnamdi Okafor, Dawn Mains, Olayemi M. Olabiyi, and Hussein Warsame, "How Did the CRA Expect the Adoption of IFRS To Affect Corporate Tax Compliance and Avoidance?" (2018) 66:1 *Canadian Tax Journal* 1-22.
- 2 Martin N. Hoogendoorn, "Accounting and Taxation in Europe—A Comparative Overview" (1996) 5, supplement *European Accounting Review* 783-94 (<https://doi.org/10.1080/096381896000000050>); David A. Guenthera and Danqing Young, "The Association Between Financial Accounting Measures and Real Economic Activity: A Multinational Study" (2000) 29:1 *Journal of Accounting and Economics* 53-72 ([https://doi.org/10.1016/S0165-4101\(00\)00013-6](https://doi.org/10.1016/S0165-4101(00)00013-6)); Douglas A. Shackelford and Terry Shevlin, "Empirical Tax Research in Accounting" (2001) 31:1-3 *Journal of Accounting and Economics* 321-87 ([https://doi.org/10.1016/S0165-4101\(01\)00022-2](https://doi.org/10.1016/S0165-4101(01)00022-2)); In-Mu Haw, Bingbing Hu, Lee-Seok Hwang, and Woody Wu, "Ultimate Ownership, Income Management, and Legal and Extra-Legal Institutions" (2004) 42:2 *Journal of Accounting Research* 423-62; Maria Gee, Axel Haller, and Christopher Nobes, "The Influence of Tax on IFRS Consolidated Statements: The Convergence of Germany and the UK" (2010) 7:1 *Accounting in Europe* 97-122 (<https://doi.org/10.1080/17449480.2010.485382>); and Oliver Nnamdi Okafor, "Effects of IFRS on Accounting Quality and Tax Aggressiveness: Evidence from Canadian Mandatory Adoption" (PhD dissertation, Faculty of Graduate Studies, University of Calgary, 2015) (<http://dx.doi.org/10.11575/PRISM/25824>).
- 3 Holger Daske, Luzi Hail, Christian Leuz, and Rodrigo Verdi, "Adopting a Label: Heterogeneity in the Economic Consequences Around IAS/IFRS Adoptions" (2013) 51:3 *Journal of Accounting Research* 495-547; and Michel Blanchette, François-Éric Racicot, and Komlan Sedzro, *IFRS Adoption in Canada: An Empirical Analysis of the Impact on Financial Statements* (Toronto: Certified General Accountants Association of Canada, October 2013).
- 4 Hai Q. Ta, "Effects of IFRS Adoption on Earnings Quality: Evidence from Canada" (PhD dissertation, Drexel University, 2014).

firms listed on a US stock exchange to use US generally accepted accounting principles (GAAP) for financial reporting, thus presenting an opportunity for an additional control sample from the same institutional environment.⁵ We draw on bounded rationality theory⁶ and argue that organizations may adopt a satisficing alternative when the optimal option of maximizing after-tax income may not be viable owing to contexts and constraints. For example, the adoption of IFRS may create an uncertain reporting environment that prevents managers from pursuing aggressive tax avoidance in a country where tax enforcement is strong. Also, the additional disclosures required under IFRS may discourage aggressive tax avoidance by exposing firms that have greater tax-avoidance opportunities. To illustrate, *International Accounting Standard* IAS 12.81 mandates firms to disclose temporary differences associated with investments in subsidiaries, branches, and associates, and interests in joint arrangements for which deferred tax liabilities have not been recognized,⁷ unlike section 3465 of pre-IFRS Canadian GAAP, which merely recommends the disclosure.⁸

We use the non-GAAP cash effective tax rate⁹ as a proxy for corporate tax avoidance and present empirical evidence that the mandatory adoption of IFRS in Canada was followed by a decreased level of corporate tax avoidance. Our main analysis sample is a 3,200 firm-year data set of 400 publicly listed Canadian firms and 400 listed US firms, matched one-to-one using propensity score matching (PSM). Further, we find no evidence that the association between IFRS adoption and corporate tax avoidance was driven by revenue recognition, ownership of foreign operations, industry membership, profitability, and impairment losses or writeoffs. However, we find that IFRS firms that managed accruals paid more taxes in the post-IFRS adoption period.

Our findings are consistent with the predictions of bounded rationality theory that the uncertainty created by the change in GAAP, additional disclosures required under IFRS, and anticipation that the tax authority may heighten its monitoring

5 Oliver Nnamdi Okafor, Mark Anderson, and Hussein Warsame, "IFRS and Value Relevance: Evidence Based on Canadian Adoption" (2016) 12:2 *International Journal of Managerial Finance* 136-60.

6 Herbert A. Simon, "Theories of Bounded Rationality," in Charles Bartlett McQuire, ed., *Decision and Organization* (Amsterdam: North-Holland, 1972), 161-76 (http://innovbfa.viabloga.com/files/Herbert_Simon_theories_of_bounded_rationality_1972.pdf); Jens K. Roehrich, Johanne Grosvold, and Stefan U. Hoejmoose, "Reputational Risks and Sustainable Supply Chain Management" (2014) 34:5 *International Journal of Operations & Production Management* 695-719 (<https://doi.org/10.1108/IJOPM-10-2012-0449>); and Laura Jean Carfang, "Choices, Decisions, and the Call To Take Action: A Phenomenological Study Utilizing Bounded Rationality To Explore Complex Decision-Making Processes" (PhD dissertation, School of Education, Northeastern University, 2015) (<http://hdl.handle.net/2047/d20128379>).

7 See *CPA Canada Standards and Guidance Collection*, available on *Knotia* (Toronto: CPA) (online database).

8 *Ibid.*, part V.

9 Also called the non-conforming cash effective tax rate.

deterred firms from engaging in tax avoidance. This study extends the literature on the effects of IFRS to include corporate tax avoidance.

The discussion in the article proceeds as follows. First we present background for the study by reviewing the extant literature on tax effects of IFRS adoption and our rationale for relying on bounded rationality theory to understand whether the adoption of IFRS affects corporate tax avoidance. Next we present our research methodology, including our research design and data collection techniques. Then we present our empirical results, and conclude with a discussion of the findings and their implications for further studies.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

The current study was motivated by the need for a better understanding of the relationship between IFRS adoption and tax avoidance. Some previous studies have concentrated on the effect of IFRS adoption on financial reporting, including the impact on comparability and the relevance of financial reporting.¹⁰ Other studies have investigated the effect of IFRS adoption on the cost of capital,¹¹ accounting quality,¹² earnings quality,¹³ and market reaction.¹⁴ While findings are mixed, the

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- 10 Susana Callao, José I. Jarne, and José A. Laínez, "Adoption of IFRS in Spain: Effect on the Comparability and Relevance of Financial Reporting" (2007) 16:2 *Journal of International Accounting, Auditing and Taxation* 148-78 (<https://doi.org/10.1016/j.intaccaudtax.2007.06.002>); Øystein Gjerde, Kjell Knivsflå, and Frode Sættem, "The Value-Relevance of Adopting IFRS: Evidence from 145 NGAAP Restatements" (2008) 17:2 *Journal of International Accounting, Auditing and Taxation* 92-112 (<https://doi.org/10.1016/j.intaccaudtax.2008.07.001>); Denis Cormier, Samira Demaria, Pascale Lapointe-Antunes, and Robert Teller, "First-Time Adoption of IFRS, Managerial Incentives, and Value-Relevance: Some French Evidence" (2009) 8:2 *Journal of International Accounting Research* 1-22; Nikolaos I. Karampinis and Dimosthenis L. Hevas, "Effects of IFRS Adoption on Tax-Induced Incentives for Financial Earnings Management: Evidence from Greece" (2013) 48:2 *The International Journal of Accounting* 218-47 (<https://doi.org/10.1016/j.intacc.2013.04.003>); and Okafor et al., *supra* note 5.
 - 11 Mohammad Salam Al-Shiab, "The Effectiveness of International Financial Reporting Standards Adoption on Cost of Equity Capital: A Vector Error Correction Model" (2008) 13:3 *International Journal of Business* 271-98; and Holger Daske, Luzy Hail, Christian Leuz, and Rodrigo Verdi, "Mandatory IFRS Reporting Around the World: Early Evidence on the Economic Consequences" (2008) 46:5 *Journal of Accounting Research* 1085-1142 (<https://doi.org/10.1111/j.1475-679X.2008.00306.x>).
 - 12 Mary E. Barth, Wayne R. Landsman, and Mark H. Lang, "International Accounting Standards and Accounting Quality" (2008) 46:3 *Journal of Accounting Research* 467-98; and Ioannis Tsalavoutas and Lisa Evans, "Transition to IFRS in Greece: Financial Statement Effects and Auditor Size" (2010) 25:8 *Managerial Auditing Journal* 814-42 (<https://doi.org/10.1108/02686901011069560>).
 - 13 Muhammad Nurul Houqe, Tony van Zijl, Keitha Dunstan, and A.K.M. Waresul Karim, "The Effect of IFRS Adoption and Investor Protection on Earnings Quality Around the
- (Notes 13 and 14 are continued on the next page.)

preponderant view is that IFRS adoption has a net beneficial effect on financial reporting.

Only a few studies have examined how IFRS adoption relates to tax avoidance. These studies include some that

- modelled the connection between tax and financial reporting up to IFRS adoption in Norway;¹⁵
- examined the variability of effective tax rates before and after IFRS adoption in continental Europe;¹⁶
- investigated the impact on tax compliance of a departure from tax-based accounting to IFRS in the transition economy of China;¹⁷
- evaluated the tax and non-tax incentives for voluntary IFRS adoption in the United Kingdom;¹⁸ and
- studied the tax-induced incentives for earnings management in Greece.¹⁹

This article contributes to the above literature by examining the adoption of IFRS in Canada and its impact on corporate tax avoidance. It investigates the unanswered research question of whether the adoption of IFRS in Canada increased corporate tax avoidance, as anticipated by the CRA.

World" (2012) 47:3 *The International Journal of Accounting* 333-55 (<https://doi.org/10.1016/j.jintacc.2012.07.003>); and Thomas Jeanjean, "The Effect of IFRS Adoption, Investor Protection and Earnings Quality: Some Reflections" (2012) 47:3 *The International Journal of Accounting* 356-62.

- 14 Christopher S. Armstrong, Mary E. Barth, Alan D. Jagolinzer, and Edward J. Riedl, "Market Reaction to the Adoption of IFRS in Europe" (2010) 85:1 *Accounting Review* 31-61; Joanne Horton and George Serafeim, "Market Reaction to and Valuation of IFRS Reconciliation Adjustments: First Evidence from the UK" (2010) 15:4 *Review of Accounting Studies* 725-51; and Wayne R. Landsman, Edward L. Maydew, and Jacob R. Thornock, "The Information Content of Annual Earnings Announcements and Mandatory Adoption of IFRS" (2012) 53:1-2 *Journal of Accounting and Economics* 34-54.
- 15 Christopher Nobes and Hans R. Schwencke, "Modelling the Links Between Tax and Financial Reporting: A Longitudinal Examination of Norway over 30 Years up to IFRS Adoption" (2006) 15:1 *European Accounting Review* 63-87 (<https://doi.org/10.1080/09638180500510418>).
- 16 Namyoung Lee and Charles Swenson, "Shock and Law: Fin 48 Report Card, IFRS and Beyond" (2010) 2:3 *International Journal of Economics and Finance* 222-33 (<https://doi.org/10.5539/ijef.v2n3p222>).
- 17 K. Hung Chan, Kenny Z. Lin, and Phyllis L.L. Mo, "Will a Departure from Tax-Based Accounting Encourage Tax Noncompliance? Archival Evidence from a Transition Economy" (2010) 50:1 *Journal of Accounting and Economics* 58-73 (<https://doi.org/10.1016/j.jaccoco.2010.02.001>).
- 18 Jeff Ng, "Tax and Non-Tax Incentives for Voluntary IFRS Adoption: Evidence from the UK" (PhD dissertation, Booth School of Business, University of Chicago, 2010).
- 19 Karampinis and Hevas, *supra* note 10.

While the CRA had legitimate concerns that the adoption of IFRS in Canada would heighten the risk of inappropriate tax adjustments that could increase corporate tax avoidance, the logic of Simon's bounded rationality theory²⁰ indicates that corporate tax avoidance would not have increased. Bounded rationality refers to a pattern of behaviour toward a goal within the boundary imposed by certain conditions and constraints in the environment, and the limitations of the actor. This definition is consistent with Scott's view that individuals "act within specific, given constraints and on the basis of the information that they have about the conditions under which they are acting."²¹ These individuals anticipate the consequences of alternative actions and choose the option that maximizes their self-interest.

As Simon explains, bounded rationality theory integrates the conditions and constraints on the abilities of actors, whether individuals or firms, to process information that maximizes the expected utility of their decisions.²² Simon adds that, when assessing firms, the theories of bounded rationality must be modified to include risk, uncertainty, difficulties in finding and formulating alternatives, complexities in the firm's cost function, and other environmental constraints.²³ Thus, bounded rationality theory explains how organizations make decisions when the optimal solution may not be possible owing to contexts and constraints that compel the decision makers to select satisficing alternatives.²⁴

In this study, we apply the logic of bounded rationality theory to the corporate tax-avoidance literature. Firms, as economic entities, are motivated to minimize their taxes so that they can maximize after-tax income. However, firms' reporting choices are subject to the conditions and constraints imposed by regulators and the environment. The implementation of IFRS created uncertainty for Canadian firms, which were required to provide additional disclosures. For example, as noted above, IAS 12.81 mandates the disclosure of temporary differences arising from investments in subsidiaries, branches, and associates, and interests in joint arrangements, whereas the pre-IFRS Canadian GAAP recommended, but did not require, such disclosure.²⁵ Canadian firms operate in a tax environment where the risk of enforcement is high and the consequences of non-compliance are significant. These constraints limit a firm's ability to maximize after-tax income through tax avoidance, which is likely when the firm adopts an accounting standard that lends itself to aggressive reporting. Our view is consistent with the findings of Allingham and

20 Simon, *supra* note 6.

21 John Scott, "Rational Choice Theory," in Gary Browning, Abigail Halcli, and Frank Webster, eds., *Understanding Contemporary Society: Theories of the Present* (London, UK: SAGE, 2000), 126-38, at 127-28.

22 Simon, *supra* note 6, at 161-76.

23 *Ibid.*

24 See *ibid.* and the other sources cited in note 6, *supra*.

25 See *supra* notes 7 and 8.

Sandmo,²⁶ which, based on an economic analysis of crime,²⁷ suggest that taxpayers are rational and that a decision to avoid tax depends on a tradeoff between the expected payoff from underreporting and the severity of the punishment if they are caught cheating.

Recent studies further support the view that context and constraints affect tax compliance. Akhand and Hubbard²⁸ examine the relative effectiveness of coercive and persuasive approaches to promoting compliance and find that the use of these approaches in combination is more effective than the use of either separately. Farrar and Thorne include interactional fairness in the equation in their study and conclude that “compliance is highest in the presence of high information and an authoritative tone.”²⁹ Hanlon, Hoopes, and Shroff³⁰ argue that the government, through its tax authority, is the largest minority shareholder in any firm, since it shares both profits and deductible losses with the firm. Consistent with these findings and the bounded rationality argument, we postulate that the tax law, tax enforcement, additional disclosure requirements, and uncertainties associated with the new accounting standards may constrain firms from engaging in corporate tax avoidance. Prior studies have also found there is a tradeoff between financial-reporting and tax-reporting incentives.³¹ At the extreme end, if the adoption of IFRS causes managers of firms to become more aggressive in financial reporting to the extent that they may commit fraud, they may become less tax aggressive to avoid suspicion from tax authorities.³² Therefore, we examine the alternative prediction that corporate tax avoidance decreases in mandatory IFRS adoption in a high

26 Michael G. Allingham and Agnar Sandmo, “Income Tax Evasion: A Theoretical Analysis” (1972) 1:3-4 *Journal of Public Economics* 323-38 ([https://doi.org/10.1016/0047-2727\(72\)90010-2](https://doi.org/10.1016/0047-2727(72)90010-2)).

27 Gary S. Becker, “Crime and Punishment: An Economic Approach” (1968) 76:2 *Journal of Political Economy* 169-217.

28 Zakir Akhand and Michael Hubbard, “Coercion, Persuasion, and Tax Compliance: The Case of Large Corporate Taxpayers” (2016) 64:1 *Canadian Tax Journal* 31-63.

29 Jonathan Farrar and Linda Thorne, “Written Communications and Taxpayers’ Compliance: An Interactional Fairness Perspective” (2016) 64:2 *Canadian Tax Journal* 351-70, at 352.

30 Michelle Hanlon, Jeffrey L. Hoopes, and Nemit Shroff, “The Effect of Tax Authority Monitoring and Enforcement on Financial Reporting Quality” (2014) 36:2 *Journal of the American Taxation Association* 137-70 (<https://doi.org/10.2308/atax-50820>).

31 Steve Matsunaga, Terry Shevlin, and D. Shores, “Disqualifying Dispositions of Incentive Stock Options: Tax Benefits Versus Financial Reporting Costs” (1992) 30, supplement *Journal of Accounting Research* 37-68; Kenneth J. Klassen and Amin Mawani, “The Impact of Financial and Tax Reporting Incentives on Option Grants to Canadian CEOs” (2000) 17:2 *Contemporary Accounting Research* 227-62; and Amin Mawani, “Cancellation of Executive Stock Options: Tax and Accounting Income Considerations” (2003) 20:3 *Contemporary Accounting Research* 495-518 (<https://doi.org/10.1506/VNVL-GVQ9-GYYQ-Y3NK>).

32 Merle Erickson, Michelle Hanlon, and Edward L. Maydew, “How Much Will Firms Pay for Earnings That Do Not Exist? Evidence of Taxes Paid on Allegedly Fraudulent Earnings” (2004) 79:2 *The Accounting Review* 387-408.

tax-enforcement environment, at least in the short run. This is expressed in our first hypothesis:

Hypothesis 1: Corporate tax avoidance decreased in mandatory IFRS adoption in Canada.

Leuz and Wysocki³³ investigate the economics of disclosure and financial-reporting regulations and conclude that

- the costs and benefits of regulatory changes are difficult to estimate, and they largely remain an empirical issue;
- there is a lack of evidence on the externalities of reporting standards;
- the empirical literature has focused heavily on US regulatory changes, with a shortage of evidence on major regulatory changes in other countries; and
- it is difficult to isolate the effects of IFRS from other concurrent institutional changes, but important interactions between IFRS and institutional factors present major opportunities for research.

Prior studies also suggest that the effects of IFRS are not homogeneous across firms. Daske, Hail, Leuz, and Verdi³⁴ classify firms as either “serious adopters” or “label adopters.” They then examine firm-level heterogeneity using proxies that affect reporting incentives, reporting behaviours, and earnings quality, including firm size, ownership of foreign operation, and accruals, and they find that the effects of IFRS adoption are not homogeneous among the adopters. Blanchette, Racicot, and Sedzro³⁵ further present evidence, based on the adoption of IFRS in Canada, that the effects of adoption differ across firms. They find that differences between IFRS and Canadian GAAP have an industry effect on net income or loss, and on comprehensive income or loss, in the finance sector.

These findings are consistent with the concerns of the CRA discussed in recent studies.³⁶ The CRA internal bulletins allude to the risk that inappropriate revenue recognition, impairment losses, thin capitalization, and the deduction of borrowing costs may increase upon IFRS adoption. Thus, it is important to investigate these risks, and analyze how various firm characteristics and institutional factors interacted with IFRS adoption to affect corporate tax avoidance in Canada. This study further analyzes the interaction effects of revenue management, ownership of foreign operations, industry membership, firm size, profitability, accruals, and impairment

33 Christian Leuz and Peter D. Wysocki, “The Economics of Disclosure and Financial Reporting Regulation: Evidence and Suggestions for Future Research” (2016) 54:2 *Journal of Accounting Research* 525-622 (<https://doi.org/10.1111/1475-679X.12115>).

34 Daske et al., *supra* note 3.

35 Blanchette et al., *supra* note 3.

36 Okafor, *supra* note 2; and Okafor et al., *supra* note 1.

losses or writeoffs on the impact that the IFRS adoption had on cash taxes paid in Canada. Therefore, we formulate our second hypothesis as follows:

Hypothesis 2: The interaction of IFRS with firm characteristics and institutional factors likely affected corporate tax avoidance in Canada.

RESEARCH METHODOLOGY

Research Design

We use the non-GAAP cash effective tax rate (our dependent variable) as a proxy for corporate tax avoidance. The non-GAAP cash effective tax rate was computed by dividing cash paid or received in income taxes by cash flow from operations. We gave serious consideration to the selection of our proxy because we wanted to capture the unbiased effect of IFRS on corporate tax avoidance.

Blanchette, Racicot, and Girard examine the effects of IFRS on financial ratios in Canada and find that “ratios computed under IFRS are not directly comparable with those derived under pre-changeover Canadian GAAP.”³⁷ This suggests that proxies based on income statement items, such as the GAAP effective tax rate (the ratio of income tax expense to net income before taxes) and the accrual-based cash effective tax rate (the ratio of cash tax paid to net income before taxes), could produce spurious results. Since IFRS adoption may alter the calculation of the accrual-based numbers—for example, accounting income—researchers may not be able to isolate the effect of the accounting numbers on tax avoidance.

Hanlon and Heitzman³⁸ posit that changes in tax-accounting accruals do not affect cash effective tax rates. Hoopes, Mescall, and Pittman³⁹ further document that the use of cash flows from operations as a denominator in the computation of cash effective tax rates eliminates mechanical effects that may arise from the use of an accrual-based denominator such as accounting net income. Thus, a variable that uses cash taxes as the numerator and cash flows from operations as the denominator has more desirable properties in this case.

To address a concern that IFRS may have affected the computation of cash flows from operating activities used as the denominator, we reviewed section 1540 of the pre-changeover accounting standards⁴⁰ and IAS 7.⁴¹ Section 1540 and IAS 7

37 Michel Blanchette, François-Éric Racicot, and Jean-Yves Girard, *The Effects of IFRS on Financial Ratios: Early Evidence in Canada* (Burnaby, BC: Certified General Accountants Association of Canada, 2011), at 5 (<http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.662.1248&rep=rep1&type=pdf>).

38 Michelle Hanlon and Shane Heitzman, “A Review of Tax Research” (2010) 50:2-3 *Journal of Accounting and Economics* 127-78 (<https://doi.org/10.1016/j.jacceco.2010.09.002>).

39 Jeffrey L. Hoopes, Devan Mescall, and Jeffrey A. Pittman, “Do IRS Audits Deter Corporate Tax Avoidance?” (2012) 87:5 *The Accounting Review* 1603-39 (<https://doi.org/10.2308/accr-50187>).

40 *CPA Canada Standards and Guidelines Collection*, supra note 7, part V.

41 *Ibid.*, part I (as of January 1, 2012).

converged. We conclude that IFRS had no significant effect on the computation of cash flows from operating activities across the adoption period. Therefore, the non-GAAP cash effective tax rate is robust for examining the effects of IFRS on corporate tax avoidance.

Data Collection

This study collected and analyzed two years of pre-adoption and two years of post-adoption data, which are the years 2008 and 2009, and 2012 and 2013, respectively.⁴² Data from 2007 were collected to obtain opening balances for the 2008 fiscal year. We used two categories of sample firms in this study: Canadian firms (treatment) and propensity-matched US firms (control). Three criteria were used to select firms for inclusion in the treatment group:

1. listed on the Toronto Stock Exchange (TSX) in the period 2007–2013,
2. adopted IFRS in 2011, and
3. data on Bloomberg, Compustat, Yahoo Finance, and/or SEDAR.⁴³

To obtain data on our measure of goodwill impairment, we hand-collected the measure from Mergent Online, which covers most of the Canadian public companies. In cases where there is missing information for our variable, we manually search the 10-K filing of the firms through the SEDAR filing system. If the goodwill impairment writeoff variable is not reported in this system, we further search the company's website and other business websites, such as Yahoo Finance. We obtained Canadian data on enforcement from the CRA's website and the annual reports of the CRA to Parliament.

For the US firms used as the control sample, we obtained the financial data from Compustat. The US firms report under a different accounting regime, predominantly US GAAP. After identifying US firms with non-missing information for most of our regression variables, we used a PSM (propensity score matching) approach for one-to-one matching of the Canadian firms with the US firms using the pre-IFRS measures of industry, size, profitability, and growth.⁴⁴ Our final sample consists of 3,200 firm-year observations with 400 unique firms for each of the treatment and the propensity-matched control samples.

The nearest-neighbour match with no replacement of the PSM approach that we used, in addition to various robustness checks, helps to mitigate concern that the results in the post-adoption period are driven by the type of firms in our treatment sample that recovered after the global financial crisis. All observations of our dependent variable lie between zero and 1, and we coded cash tax received as zero. We note

42 We eliminated the year 2010 because IFRS adopters were required to restate their financial data for that year as if IFRS had been used for financial reporting.

43 The System for Electronic Document Analysis and Retrieval.

44 We are grateful to the anonymous reviewer who recommended that we use this approach to obtain the control sample.

that the research samples include the same firms in both the pre-adoption and post-adoption periods. Thus, each firm also acts as its own control.

Regression Model

We used ordinary least squares (OLS) regression to investigate corporate tax avoidance and adopted explanatory variables used in previous studies. Independent variables include the logarithms of average total assets, market value of equity, revenue, and leverage, as well as net operating loss, capital expenditure, inventory, and foreign operations. In addition to the variables of *IFRS* and *POST* (to control for time-fixed effects), we added an interaction variable *IFRSPOST* (β_3) as our main variable of interest, specifically to capture the tax effects attributable to IFRS adoption in the post-adoption period relative to the pre-adoption period between IFRS adopters and non-adopters. We also added an *INDUSTRY* dummy variable to moderate industry effects.

In equation 1 below, we present our baseline regression model for estimating the effects of mandatory adoption of IFRS on corporate tax avoidance.

$$CTA_{it} = \beta_1(IFRS_{it}) + \beta_2(POST_{it}) + \beta_3(IFRSPOST_{it}) + \beta_4 \log(SIZE_{it}) + \beta_5 \log(MVE_{it}) \\ + \beta_6 \log(REVENUE_{it}) + \beta_7 \log(LEVERAGE_{it}) + \beta_8(INDUSTRY_{it}) + \beta_9(NOL_{it}) \\ + \beta_{10}(CAPEX_{it}) + \beta_{11}(INVENTORY_{it}) + \beta_{12}(FOREIGN_{it}) + \beta_{13}(GDPGRWT_t) \\ + \beta_{14}(CHGTAX_t) + \beta_{15}(ENFORCE_t) + U_t, \quad (1)$$

where

CTA = a corporate tax-avoidance proxy, namely, *NON-GAAP CASH ETR*, computed as cash taxes paid or received scaled by cash flow from operations;⁴⁵

IFRS = a dummy variable that equals 1 for firms that adopted IFRS and zero for firms that did not adopt IFRS;

POST = an indicator variable that equals 1 for years after the adoption of IFRS and zero for the years before mandatory IFRS adoption;

IFRSPOST = an interaction variable that measures the effects of IFRS adoption;

$\log(SIZE)$ = the natural logarithm of average total assets;

$\log(MVE)$ = the natural logarithm of market value of equity;

$\log(REVENUE)$ = the natural logarithm of total sales;

$\log(LEVERAGE)$ = the logarithm of year-end total liability divided by year-end total equity;

INDUSTRY = a dummy variable that equals 1 for financial and rate-regulated entities and zero otherwise;

NOL = an indicator variable that equals 1 for a firm with a preceding-year net loss and zero otherwise;

CAPEX = capital expenditures scaled by average total assets;

45 We coded Tax refund as 0, and where either the numerator or denominator is 0, we coded *NON-GAAP CASH ETR* as 0.

INVENTORY = total inventory scaled by average total assets;
FOREIGN = an indicator variable that equals 1 for a firm with foreign operations and zero otherwise;⁴⁶
GDPGRWT = the annual percentage rate of growth in gross domestic product (GDP);⁴⁷
CHGTAX = the change in tax rate,⁴⁸ measured as the difference between the tax rate at time t and the tax rate at time $t - 1$;⁴⁹
ENFORCE = the percentage change in total audited files per year by the appropriate tax authorities;⁵⁰ and
U = the idiosyncratic error.

To further test the CRA's concerns that the change to IFRS in 2011 might result in an increased risk that adopters would not make appropriate adjustments for certain enumerated items,⁵¹ we identify seven vulnerable areas of accounting reporting that firms could target to engage in corporate tax avoidance. These contexts are

1. revenue management,
2. profitability,
3. foreign operations,
4. impairment writeoffs,
5. accrual management,
6. size, and
7. industry membership.⁵²

In other words, we anticipate that IFRS adopters within those seven contexts are likely to have an increased appetite for corporate tax avoidance in the post-adoption period. Therefore, for empirical operationalization, we have equation 2 below.

46 Firms with foreign exchange gains or losses are identified as having foreign operations.

47 This variable is defined as the annual percentage growth rate of GDP at market prices based on constant local currency. Aggregates are based on constant 2010 US dollars. Data obtained from the World Bank, "GDP Growth (Annual %)" (<https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG>).

48 We used lagged differencing to mitigate multicollinearity and autocorrelation.

49 Canada, Library of Parliament, "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>).

50 Enforcement data were obtained from the websites of each tax authority. In particular, we obtained the CRA enforcement data from the CRA annual reports (see, for example, *infra* note 60).

51 Okafor et al., *supra* note 1; and Okafor, *supra* note 2.

52 We refer to items 1 through 5 as the primary enumerated items, and 6 and 7 as moderating items.

$$\begin{aligned}
CTA_{it} = & \beta_1(IFRS_{it}) + \beta_2(POST_{it}) + \beta_3(IFRSPOST_{it}) + \beta_4 \log(SIZE_{it}) + \beta_5 \log(MVE_{it}) \\
& + \beta_6 \log(REVENUE_{it}) + \beta_7 \log(LEVERAGE_{it}) + \beta_8(INDUSTRY_{it}) + \beta_9(NOL_{it}) \\
& + \beta_{10}(CAPEX_{it}) + \beta_{11}(INVENTORY_{it}) + \beta_{12}(FOREIGN_{it}) + \beta_{13}(GDPGRWT_t) \\
& + \beta_{14}(CHGTAX_t) + \beta_{15}(ENFORCE_t) + \beta_{16}TARGETS_{it} + U_t.
\end{aligned} \tag{2}$$

In equation 2 above, $\beta_{16}TARGETS_{it}$ is the vector of the seven individual contexts identified above. The variables for these target areas are as follows:

$IFRSPOSTREV = (IFRS \times POST \times \log(REVENUE))$, an interaction variable that measures the effects of IFRS adoption within the context of revenue management.

$IFRSPOSTROA = (IFRS \times POST \times ROA)$, an interaction variable that measures the effects of IFRS adoption within the context of the firm's profitability. *ROA* is the return on assets, measured by dividing net income by average total assets.

$IFRSPOSTFOREIGN = (IFRS \times POST \times FOREIGN)$, an interaction variable that measures the effects of IFRS adoption within the context of the firm's foreign operations.

$IFRSPOSTIMPAIR = (IFRS \times POST \times IMPAIR)$, an interaction variable that measures the effects of IFRS adoption within the context of goodwill impairment writeoffs. *IMPAIR* is the impairment of goodwill.

$IFRSPOSTTACC = (IFRS \times POST \times TACC)$, an interaction variable that measures effects of IFRS adoption within the context of accrual management. We follow Hribar and Collins⁵³ to measure *TACC* as net income minus cash flow from operations scaled by average total assets.

$IFRSPOSTSIZE = (IFRS \times POST \times \log(SIZE))$, an interaction variable that measures the effects of IFRS adoption controlling for the firm's size post-adoption.

$IFRSPOSTINDUSTRY = (IFRS \times POST \times INDUSTRY)$, an interaction variable that measures the effects of IFRS adoption controlling for the firm's industry membership.

All other variables in equation 2 are as defined in the list following equation 1.

We note that the seven contexts identified above empirically test the concerns highlighted in the CRA's internal bulletins referred to earlier, relating to the potential negative impact of IFRS adoption on corporate tax avoidance by IFRS adopters in the post-adoption period. We present and discuss our findings in the empirical results section below.

Our rationale for controlling for enforcement effects in our analysis (*ENFORCE*) was driven by assertions in the tax-enforcement literature where Hanlon et al. state that the government is the largest minority shareholder in any firm because, through its tax authority and enforcement mechanisms, it shares in the firm's profits

53 Paul Hribar and Daniel W. Collins, "Errors in Estimating Accruals: Implications for Empirical Research" (2002) 40:1 *Journal of Accounting Research* 105-34 (<https://doi.org/10.1111/1475-679X.00041>).

and deductible losses.⁵⁴ In addition to the rationale advanced above regarding the potential impact of heightened awareness of tax monitoring on firms' corporate tax-avoidance behaviour, we contextualize Hanlon et al.'s assertion within the bounded rationality framework by including the *ENFORCE* variable in our analysis.

Descriptive Statistics

We present the descriptive statistics and correlation coefficients of the main variables used in this study in panels A and B of table 1, respectively. The mean (median) of the dependent variable, *NON-GAAP CASH ETR*, is 0.127 (0.029) for the 800 unique firms with 3,200 firm-year observations. We will further analyze descriptive statistics later in this section. Recall that our design produced 400 unique Canadian firms that are IFRS adopters (the treatment group) and 400 unique US firms that used non-IFRS or US GAAP financial reporting (the control group). Each firm serves as its own control throughout the sample period for the main analysis and the "Canadian companies only" analysis.

Panel B of table 1 presents the Pearson correlation coefficients for the full sample. The correlation coefficients show the linear interdependence (or lack thereof) of the *NON-GAAP CASH ETR* on the predictor variables. For example, we find a negative (positive) and significant correlation between the variables *IFRSPOST* and *NON-GAAP CASH ETR*. This could signal that *NON-GAAP CASH ETR* increased for all companies after the adoption of IFRS, although one could argue that it also signals multicollinearity in the model. However, we note that a linear relationship between the two variables does not automatically mean that multicollinearity is a problem, because the variance of the OLS coefficient estimator does not depend only on strong linear relationships among the independent variables; it also depends on the size of error variance and the total sample variation.⁵⁵ Wooldridge elucidates that "for statistical inference, what ultimately matters is how big $\hat{\beta}_j$ is in relation to its standard deviation"⁵⁶ and Allison documents instances where multicollinearity can be safely ignored.⁵⁷ We define $\hat{\beta}_j$ as the OLS coefficient estimator and the index j as our main variable of interest, which is the interaction of *POST* and *IFRS*. Where a regression result signals the possibility of multicollinearity problems, we would rerun the regression without the potentially offending variable to confirm the consistency of our results.⁵⁸

54 See supra note 30.

55 Jeffrey M. Wooldridge, *Introductory Econometrics: A Modern Approach*, 5th ed. (Mason, OH: South-Western, Cengage Learning, 2013).

56 Ibid., at 96.

57 Paul Allison, "When Can You Safely Ignore Multicollinearity?" *Statistical Horizons*, September 10, 2012 (<http://statisticalhorizons.com/multicollinearity>).

58 In fact, in our regression models, we run the multicollinearity diagnostics, and the variance inflation factors (VIF) show acceptable numbers for our variables of interest; this finding further reinforces the notion that multicollinearity problems do not influence our results.

TABLE 1 Descriptive Statistics and Correlation Coefficients

Panel A: Mean, standard deviation, and median			
Variable	Mean	Standard deviation	Median
NON-GAAP CASH ETR	0.127	0.190	0.029
POST	0.500	0.500	0.500
IFRS	0.500	0.500	0.500
log(MVE)	3.929	2.001	3.405
log(REVENUE)	3.711	2.161	3.364
log(LEVERAGE)	-0.416	1.239	-0.342
NOL	0.290	0.454	0.000
CAPEX	0.076	0.095	0.044
INVENTORY	0.091	0.455	0.024
FOREIGN	0.346	0.476	0.000
log(SIZE)	4.045	1.832	3.633
INDUSTRY	0.165	0.371	0.000
IFRSPOSTROA	-0.235	2.652	0.006
IFRSPOSTIMPAIR	0.472	12.685	0.000
IFRSPOSTTACC	-0.087	0.233	-0.064
ENFORCE	0.202	0.340	0.198
GDPGRWT	0.412	2.055	1.373
CHGTAX	-0.60	0.899	-0.085
Observations	3,200		

(Table 1 is continued on the next page.)

TABLE 1 Continued

Panel B: Correlation matrix						
	NON-GAAP CASH ETR	IFRS	POST	log(SIZE)	log(MVE)	log(REVENUE)
NON-GAAP CASH ETR.....	1.000					
IFRS	-0.376	1.000				
POST	0.069	0.000	1.000			
log(SIZE)	0.370	-0.761	0.079	1.000		
log(MVE)	0.405	-0.728	0.106	0.925	1.000	
log(REVENUE)	0.433	-0.753	0.066	0.927	0.880	
log(LEVERAGE)	0.013	-0.077	0.029	0.249	0.104	1.000
NOL	-0.318	0.214	-0.101	-0.364	-0.383	-0.135
CAPEX	-0.141	0.187	-0.018	-0.146	-0.114	-0.107
INVENTORY	0.052	-0.042	-0.014	-0.013	-0.008	-0.005
FOREIGN	-0.006	0.107	0.049	-0.020	0.007	0.036
IFRSPOSTROA	0.084	-0.090	-0.034	0.185	0.154	-0.243
IFRSPOSTMPAIR	-0.024	0.037	0.011	-0.028	-0.029	-0.032
IFRSPOSTTACC	0.098	-0.001	0.057	0.074	0.074	-0.026
INDUSTRY	-0.079	0.014	0.000	0.157	0.068	0.278
ENFORCE	-0.150	0.190	-0.590	-0.195	-0.201	-0.042
GDPGRWT	0.051	0.076	0.811	0.002	0.003	-0.088
CHGTAX	0.250	-0.598	0.211	0.473	0.467	0.046

(Table 1 is concluded on the next page.)

TABLE 1 Concluded

	Panel B Concluded									
	CAPEX	INVENTORY	FOREIGN	IFRSPST ROA	IFRSPST IMPAIR	IFRSPST TACC	INDUSTRY	ENFORCE	GDPGRWT	CHGTAX
CAPEX.....	1.000									
INVENTORY.....	-0.055	1.000								
FOREIGN.....	0.037	-0.014	1.000							
IFRSPSTROA.....	-0.020	0.008	-0.052	1.000						
IFRSPSTIMPAIR.....	0.007	-0.005	0.015	-0.007	1.000					
IFRSPSTTACC.....	-0.073	0.001	-0.023	0.672	-0.005	1.000				
INDUSTRY.....	-0.089	-0.080	-0.187	0.067	-0.016	0.079	1.000			
ENFORCE.....	-0.010	-0.011	-0.016	-0.029	0.010	-0.042	0.003	1.000		
GDPGRWT.....	0.073	0.006	0.043	-0.013	0.023	0.007	0.001	0.066	1.000	
CHGTAX.....	-0.205	-0.003	-0.051	0.091	-0.012	0.044	-0.008	0.006	-0.113	1.000

Notes: Panel A presents the descriptive statistics and panel B presents the correlation coefficients for the primary variables in this study. See the accompanying text for the definitions of these variables. The sample contains Canadian firms listed on the Toronto Stock Exchange that adopted international financial reporting standards (IFRS adopters) and a controlled sample of US firms that use reporting standards different from IFRS (control firms). The sample period covers 2008, 2009, 2012, and 2013. Capital expenditure obtained from Bloomberg has a negative sign for all items. As a result, each capital expenditure was multiplied by a minus sign. The coefficients shown in bold in panel B represent significance at the conventional levels (1 percent, 5 percent, and 10 percent).

As part of the additional analysis we conducted, we present in panel A of table 4 the results of the descriptive statistics for IFRS and non-IFRS adopting firms with *NON-GAAP CASH ETR* greater than zero. (Table 4 appears below in the section headed “Additional Sensitivity Analysis.”) For this category of firms, the mean of the *NON-GAAP CASH ETR* for the IFRS (non-IFRS) firms is 0.188 (0.219). The mean *NON-GAAP CASH ETR* for Canadian firms (*IFRS* = 1) in the post-adoption period (*POST* = 1) equals 0.198, while their pre-adoption mean is equal to 0.170, translating to nearly 116.5 percent of the pre-adoption *NON-GAAP CASH ETR*. A similar analysis produced a reduced percentage of approximately 105 percent for the American firms with mean *NON-GAAP CASH ETR* (*IFRS* = 0) in the post-adoption period (*POST* = 1) of 0.224 and in the pre-adoption period (*POST* = 0) of 0.213.

For pictorial contexts, we provide graphic representations in figures 1 through 3 as complements to some of the descriptive and other analyses provided earlier. These graphs show the *NON-GAAP CASH ETR* movements across the sample period for firms in our overall sample (figure 1) and subsamples (figures 2 and 3). These graphs indicate consistent patterns with our descriptive and regression analysis findings.

EMPIRICAL RESULTS

Regression Results

In table 2, we offer some preliminary, but strong, evidence that relative to non-adopters, Canadian firms that adopted IFRS did not engage in corporate tax avoidance during the post-adoption period. Our primary variable of interest, *IFRSPPOST*, is consistently positive and significant across all of the eight models at the 5 percent or better significance level. Other variables generally have the relationship and sign that we anticipated. For example, we find

- a positive relationship between cash tax paid (the dependent variable) and revenue, market value of equity, GDP, and tax rate⁵⁹ (independent variables);
- a negative relationship between cash tax paid and leverage, capital expenditure, and operating loss; and
- less cash tax paid by larger firms and regulated entities.

Prior studies have documented mixed findings on the relationships between tax avoidance and firm characteristics.⁶⁰ We also find a negative relationship between our proxy for tax enforcement and cash tax paid by firms. Since it seems anomalous

59 We thank an anonymous reviewer for suggesting the addition of some control variables.

60 See Scott D. Dyreng, Michelle Hanlon, and Edward L. Maydew, “Long-Run Corporate Tax Avoidance” (2008) 83:1 *Accounting Review* 61-82; and T.J. Atwood, Michael S. Drake, James N. Myers, and Linda A. Myers, “Home Country Tax System Characteristics and Corporate Tax Avoidance: International Evidence” (2012) 87:6 *Accounting Review* 1831-60 (<https://doi.org/10.2308/accr-50222>).

FIGURE 1 Tax Avoidance, IFRS Adopters Versus Non-Adopters

IFRS = international financial reporting standards; GAAP = generally accepted accounting principles; ETR = effective tax rate.

FIGURE 2 Tax Avoidance in Quintiles, IFRS Adopters

IFRS = international financial reporting standards; GAAP = generally accepted accounting principles; ETR = effective tax rate.

Note: Quintiles calculated in the pre-IFRS adoption period.

FIGURE 3 Tax Avoidance in Quintiles by Industry (Financial and Non-Financial), IFRS Adopters

IFRS = international financial reporting standards; GAAP = generally accepted accounting principles; ETR = effective tax rate.

Note: Quintiles calculated in the pre-IFRS adoption period.

to suggest that a decrease in audit intensity is related to a higher payment of cash taxes, we were concerned. However, following a tenacious bottom-up investigation, we found that tax authorities are strategically targeting their audits to achieve higher impacts with lower number of audited files. According to the CRA, in the 2012-13 fiscal year,

[O]ur audit activities generated a higher fiscal impact per full-time equivalent (auditor). We did, however, complete a lower number of total audits than we did in 2011-2012. This is in part because of our strategic decision to focus more resources on auditing high-risk files.⁶¹

Our analysis indicates that while cash tax paid increased in the post-adoption period, the number of tax audits continually decreased over the study period. Thus, our findings support the CRA's statements pertaining to the effectiveness of its enforcement strategy in its 2012-13 annual report to Parliament. This suggests that, to the extent that a tax authority is effectively involved in high-impact audits, more cash taxes may be collected even with a smaller number of completed files. However, we caution that while this conjecture has held over our short study window, it may not persist in the long run, and tax authorities would need to increase

61 Canada Revenue Agency, *Annual Report to Parliament 2012-2013* (Ottawa: CRA, 2013), at 43 (www.canada.ca/content/dam/cra-arc/migration/cra-arc/gncy/nnnl/2012-2013/images/ar-2012-13-eng.pdf).

TABLE 2 Regression Results

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8
<i>IFRS</i>	-0.058*** (-4.39)	-0.056*** (-4.21)	-0.058*** (-4.44)	-0.057*** (-4.36)	-0.057*** (-4.35)	-0.054*** (-4.08)	-0.058*** (-4.43)	-0.058*** (-4.38)
<i>POST</i>	-0.056*** (-3.98)	-0.056*** (-3.98)	-0.056*** (-3.97)	-0.056*** (-3.98)	-0.056*** (-4.00)	-0.056*** (-4.00)	-0.056*** (-4.00)	-0.056*** (-3.98)
<i>IFRSPST</i>	0.034*** (2.71)	0.044** (2.41)	0.039*** (2.81)	0.038*** (2.92)	0.041*** (3.13)	0.063*** (2.62)	0.035*** (2.76)	0.034*** (2.71)
<i>IFRSPSTREVENUE</i>		-0.004 (-0.73)						
<i>IFRSPSTFOREIGN</i>			-0.012 (-0.84)					
<i>IFRSPSTINDUSTRY</i>				-0.022 (-1.25)				
<i>IFRSPSTTACC</i>					0.096** (2.07)			
<i>IFRSPSTSIZE</i>						-0.010 (-1.40)	0.000 (1.03)	
<i>IFRSPSTROA</i>								-0.000 (-0.19)
<i>IFRSPSTIMPAIR</i>								0.021*** (4.84)
<i>log(MVE)</i>	0.021*** (4.84)	0.021*** (4.84)	0.021*** (4.81)	0.021*** (4.87)	0.020*** (4.74)	0.021*** (4.84)	0.021*** (4.86)	0.021*** (4.84)
<i>log(REVENUE)</i>	0.038*** (8.45)	0.038*** (8.44)	0.038*** (8.43)	0.038*** (8.52)	0.038*** (8.50)	0.037*** (8.43)	0.037*** (8.32)	0.038*** (8.44)
<i>NOL</i>	-0.069*** (-9.39)	-0.070*** (-9.37)	-0.069*** (-9.39)	-0.069*** (-9.40)	-0.068*** (-9.22)	-0.070*** (-9.48)	-0.067*** (-9.01)	-0.069*** (-9.38)

(Table 2 is concluded on the next page.)

TABLE 2 Concluded

	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8
<i>CAPEX</i>	-0.130*** (-4.05)	-0.128*** (-3.99)	-0.129*** (-4.03)	-0.131*** (-4.08)	-0.123*** (-3.80)	-0.127*** (-3.96)	-0.131*** (-4.09)	-0.130*** (-4.05)
<i>INVENTORY</i>	0.007	0.007	0.007	0.007	0.007	0.007	0.007	0.007
<i>FOREIGN</i>	(1.08)	(1.10)	(1.08)	(1.09)	(1.04)	(1.11)	(1.07)	(1.08)
	0.006	0.006	0.009	0.006	0.007	0.006	0.007	0.006
	(0.98)	(0.97)	(1.27)	(0.90)	(1.03)	(0.93)	(1.02)	(0.99)
<i>log(LEVERAGE)</i>	-0.012*** (-4.20)	-0.012*** (-4.00)	-0.012*** (-4.19)	-0.012*** (-4.18)	-0.012*** (-4.19)	-0.012*** (-4.02)	-0.012*** (-4.21)	-0.012*** (-4.20)
<i>log(SIZE)</i>	-0.040*** (-6.64)	-0.040*** (-6.67)	-0.040*** (-6.64)	-0.041*** (-6.70)	-0.040*** (-6.62)	-0.039*** (-6.38)	-0.040*** (-6.61)	-0.040*** (-6.63)
<i>INDUSTRY</i>	-0.019** (-1.98)	-0.018* (-1.95)	-0.019** (-2.02)	-0.013 (-1.23)	-0.020** (-2.18)	-0.018* (-1.88)	-0.019** (-2.04)	-0.019** (-1.99)
<i>GDPGRWT</i>	0.009*** (2.94)	0.009*** (2.93)	0.009*** (2.93)	0.009*** (2.94)	0.009*** (3.03)	0.009*** (2.94)	0.009*** (2.99)	0.009*** (2.94)
<i>CHGTAX</i>	0.013** (2.51)	0.013** (2.52)	0.013** (2.50)	0.013** (2.51)	0.014*** (2.66)	0.013** (2.53)	0.013** (2.56)	0.013** (2.52)
<i>ENFORCE</i>	-0.039*** (3.05)	-0.039*** (3.04)	-0.039*** (3.05)	-0.039*** (3.05)	-0.038*** (2.99)	-0.039*** (3.04)	-0.039*** (3.03)	-0.039*** (3.05)
Observations	3,200	3,200	3,200	3,200	3,200	3,200	3,200	3,200
Adjusted <i>R</i> ²	0.256	0.256	0.256	0.256	0.257	0.256	0.256	0.256

Notes: This table presents the regression results of the baseline model and the other seven models explored in the study. The sample contains Canadian firms listed on the Toronto Stock Exchange that adopted international financial reporting standards (IFRS adopters) and a controlled sample of US firms that use reporting standards different from IFRS (control firms). The sample period covers 2008, 2009, 2012, and 2013. (Variable definitions are included in the accompanying text.) Capital expenditure obtained from Bloomberg has a negative sign for all items. As a result, each capital expenditure was multiplied by a minus sign.

*, **, *** Significant at the 10 percent, 5 percent, and 1 percent levels, respectively. The *t*-statistics are in parentheses.

their audit intensity to collect more taxes. Further, we rerun our regression without the enforcement variable, and our findings (not tabulated) remain consistent. Thus, our study has found overwhelming empirical evidence that does not support the CRA's anxieties regarding the likelihood that IFRS adopters would pay less tax in the post-adoption period. After we have controlled for factors that tend to increase the likelihood that more cash taxes would be collected, including revenue, profitability, change in tax rate, GDP growth, and enforcement, our variable of interest—*IFRSPPOST*—remains significantly positive. We further test empirically the CRA's concerns highlighted in the related bulletins that there is an increased risk that companies would not make appropriate adjustments for certain enumerated items.

As previously noted, we identify the following vulnerable areas of accounting reporting that firms could target to engage in corporate tax avoidance:

1. revenue management (*IFRSPPOSTREV*),
2. profitability (*IFRSPPOSTROA*),
3. foreign operations (*IFRSPPOSTFOREIGN*),
4. impairment writeoffs (*IFRSPPOSTIMPAIR*),
5. accrual management (*IFRSPPOSTTACC*),
6. size (*IFRSPPOSTSIZE*), and
7. industry membership (*IFRSPPOSTINDUSTRY*).

We report the results of this empirical exercise in model 2 through model 8 of table 2. From these seven model tests, IFRS post-adoption variables are not statistically significant for revenue management, foreign operations, industry membership, firm size, profitability, and impairment writeoffs or losses. On the other hand, we obtain positive and significant results for the IFRS post-adoption variable relating to accrual management. This indicates that there is no empirically justifiable support for the CRA's anxiety regarding the use of these targets or vulnerable areas, including accrual management, as sources of corporate tax avoidance following IFRS adoption. (*IFRSPPOSTTACC* in model 5 shows positive and significant results at the 5 percent or better significance level.) In other words, our results suggest that relative to non-adopters, Canadian firms that have adopted IFRS appear to engage in less corporate tax avoidance during the post-adoption period even as they engage in more accrual management. This finding arising from the interaction of IFRS with accrual management is consistent with the findings of prior studies that firms forgo tax benefits for financial reporting benefits.⁶²

To address the concern that the variables *MVE* and *SIZE* might be capturing the same measure of firms' overall size, we rerun our regression twice, each time omitting one of these variables. The results (which are not tabulated here for readability and parsimony) do not change our findings and remain qualitatively similar.

62 See the sources cited in note 31, *supra*.

Additional Sensitivity Analysis

Median Analysis of Enumerated Items

To ensure that the potential skewness of our data on either extreme of the data-points plane does not drive our results, we conduct a median analysis of equation 2 above and present the results in table 3. These analyses relate only to the continuous variables, since performing such analyses using a dichotomous variable may generate spurious and misleading inferences.⁶³ The inferences of our findings largely hold, especially relating to the primary enumerated items.⁶⁴

Non-Financial Firms, Positive Non-GAAP Cash Effective Tax Rate, and Alternative Control Sample

We present the regression results of other analyses that we conducted in panel B of table 4. First, we follow several IFRS studies that have documented the non-homogeneous impact on firms' financial reporting (financial versus non-financial firms), thereby testing whether the tax impacts are also heterogeneous.⁶⁵ To this end, we drop all financial firms in our main sample, and we continue to find that our main variable of interest (*IFRSPOST*) remains statistically significant at the 5 percent level (see model 1 in panel B of table 4). Although our sample size is thus reduced, we do not lose statistical analysis power since the adjusted R^2 remains unchanged.

Next, we repeat our main analysis for firms with *NON-GAAP CASH ETR* greater than zero, in two ways:

1. We select all firms that have at least one year of *NON-GAAP CASH ETR* greater than zero in our study period (model 2 in panel B of table 4).⁶⁶ The analysis involves a total of 2,320 firm-year observations of Canadian and US firms obtained from the full sample. Our main variable of interest (*IFRSPOST*) remains positive and significant at the conventional level.
2. We analyze 1,929 firm-year observations that have *NON-GAAP CASH ETR* (positive *CTA*) greater than zero. Again, *IFRSPOST* continues to retain a significant positive relationship with our proxy for corporate tax avoidance (see model 3 in panel B of table 4).

Finally, we examine an alternative control sample. Recall that our control sample is generated through the PSM technique applied to US firms that did not adopt IFRS.

63 Patrick Royston, Douglas G. Altman, and Willi Sauerbrei, "Dichotomizing Continuous Predictors in Multiple Regression: A Bad Idea" (2006) 25:1 *Statistics in Medicine* 127-41 (<https://doi.org/10.1002/sim.2331>).

64 It must be noted that we do not report other control variables for parsimony and readability, since the control variables largely reflect similar sign, significance properties, and magnitude when compared with table 2.

65 We are grateful to the anonymous reviewer who suggested that we conduct this analysis.

66 We term this group "profitable firms."

TABLE 3 Median Analysis of Variables of Interest

Variable	Model 1	Model 2	Model 3	Model 4	Model 5
<i>IFRSPPOSTREV</i>	−0.023 (−1.26)				
<i>IFRSPPOSTTACC</i>		0.047** (3.97)			
<i>IFRSPPOSTSIZE</i>			−0.035* (−2.03)		
<i>IFRSPPOSTROA</i>				0.015 (1.14)	
<i>IFRSPPOSTIMPAIR</i>					0.016 (0.87)
Observations	3,200	3,200	3,200	3,200	3,200
Adjusted R ²	0.256	0.259	0.257	0.256	0.256

Notes: This table presents the median analysis of the continuous variables selected to test the CRA's concerns that Canadian companies adopting international financial reporting standards (IFRS) in 2011 and beyond might avoid making appropriate adjustments for revenue management (*IFRSPPOSTREV*), profitability (*IFRSPPOSTROA*), accrual management (*IFRSPPOSTTACC*), and impairment writeoffs (*IFRSPPOSTIMPAIR*). The analysis also tests the effect of size (*IFRSPPOSTSIZE*). Other items, such as foreign operations and industry membership, are not tested because the measure of these two variables is dummy-coded and not continuous.

*, ** Significant at the 5 percent and 1 percent levels, respectively. The *t*-statistics are in parentheses.

To further check that our findings are not driven by the environmental differences between the United States and Canada, we rerun our regression using Canadian firms that did not adopt IFRS. We identify 40 Canadian firms that meet this primary reporting criterion and other data requirements, and 400 Canadian firms that are IFRS adopters. We present the results in models 4 and 5 in table 4, panel B. Our results consistently show that our primary variable of interest continues to maintain the sign and statistical significance at the conventional significance thresholds.⁶⁷ We continue to find stability and consistency in our model properties regarding variable signs and significance levels. In essence, our inferences hold even when we use Canadian companies as a control sample. We note, however, that we have a very limited number of Canadian firms (40) that meet the control sample criteria.

67 We run separate regressions with and without the variable *ENFORCE* (model 4 and model 5) to confirm that the results of our regressions are not endogenously driven. In model 4, the Stata analysis “omitted” *ENFORCE* from the regression. Therefore, in model 5, we dropped the *GDPGRWT* variable to capture the effect of the *ENFORCE* variable.

TABLE 4 Descriptive Statistics and Regression Results (Additional Analysis)

	Panel A: Descriptive statistics (mean, standard deviation, and median)					
	Mean		Standard deviation		Median	
	IFRS	Non-IFRS	IFRS	Non-IFRS	IFRS	Non-IFRS
<i>NON-GAAP CASH ETR</i>	0.188	0.219	0.227	0.198	0.108	0.173
<i>POST</i>	0.635	0.506	0.482	0.500	1.000	1.000
<i>IFRS</i>	1.000	0.000	0.000	0.000	1.000	0.000
<i>log(MVE)</i>	2.851	5.583	0.785	1.537	2.834	5.767
<i>log(REVENUE)</i>	2.738	5.607	0.738	1.323	2.615	5.827
<i>log(LEVERAGE)</i>	-0.060	-0.328	1.103	1.042	-0.130	-0.358
<i>NOL</i>	0.150	0.146	0.357	0.353	0.000	0.000
<i>CAPEX</i>	0.075	0.058	0.075	0.070	0.052	0.036
<i>INVENTORY</i>	0.067	0.111	0.108	0.128	0.016	0.076
<i>FOREIGN</i>	0.407	0.313	0.492	0.464	0.000	0.000
<i>log(SIZE)</i>	3.023	5.620	0.838	1.226	2.935	5.825
<i>INDUSTRY</i>	0.213	0.153	0.410	0.360	0.000	0.000
<i>IFRSPOSTROA</i>	3.359	0.048	17.640	0.112	4.331	0.054
<i>IFRSPOSTIMPAIR</i>	133.955	3.806	1578.41	23.927	0.000	0.000
<i>IFRSPOSTTACC</i>	-0.082	-0.082	0.195	0.099	-0.063	-0.065
<i>GDPGRWT</i>	1.008	0.269	1.936	2.004	1.745	1.842
<i>CHGTAX</i>	-0.990	-0.063	1.005	0.027	-0.500	-0.080
<i>ENFORCE</i>	-0.158	-0.267	0.182	0.438	-0.067	-0.304
Observations.....	474	1,455	474	1,455	474	1,455

(Table 4 is continued on the next page.)

TABLE 4 Continued

Panel B: Regression results					
	Model 1: Non-financial firms	Model 2: Profitable firms	Model 3: Positive non- GAAP cash effective tax rate	Model 4: Canadian companies only	Model 5: Canadian companies only
<i>IFRS</i>	-0.044*** (-2.91)	-0.045** (2.38)	0.009 (0.36)	-0.030* (-1.78)	-0.030* (-1.78)
<i>POST</i>	-0.055*** (-3.46)	-0.062*** (3.56)	-0.072*** (3.60)	-0.036 (-1.42)	0.018 (0.63)
<i>IFRSPOST</i>	0.036** (2.55)	0.065*** (3.68)	0.038* (1.66)	0.041* (1.76)	0.041* (1.76)
<i>log(MVE)</i>	0.162*** (3.31)	0.025*** (4.41)	0.033*** (5.01)	0.016* (1.81)	0.016* (1.81)
<i>log(REVENUE)</i>	0.044*** (8.07)	0.047*** (6.63)	0.025*** (2.76)	0.028*** (5.20)	0.028*** (5.20)
<i>NOL</i>	-0.069*** (-8.37)	-0.083*** (-7.88)	-0.088*** (-6.75)	-0.046*** (-5.52)	-0.046*** (-5.52)
<i>CAPEX</i>	-0.109*** (-3.07)	-0.193*** (-3.94)	-0.243*** (-3.83)	-0.049 (-1.44)	-0.049 (-1.44)
<i>INVENTORY</i>	0.007 (1.04)	0.005 (0.74)	0.267*** (6.39)	0.002 (0.40)	0.002 (0.40)
<i>FOREIGN</i>	0.003 (0.45)	0.010 (1.18)	0.004 (0.45)	-0.010 (-1.38)	-0.010 (-1.38)
<i>log(LEVERAGE)</i>	-0.015*** (-4.53)	-0.015*** (-3.47)	-0.013** (-2.53)	-0.001 (-1.18)	-0.001 (-1.18)
<i>log(SIZE)</i>	-0.039*** (-5.37)	-0.056*** (-6.53)	-0.049*** (-4.88)	-0.027** (-2.58)	-0.027** (-2.58)
<i>INDUSTRY</i>	Omitted	-0.010 (-0.79)	-0.007 (-0.46)	-0.031*** (-2.97)	-0.031*** (-2.97)

(Table 4 is concluded on the next page.)

TABLE 4 Concluded

	Panel B Concluded				
	Model 1: Non-financial firms	Model 2: Profitable firms	Model 3: Positive non- GAAP cash effective tax rate	Model 4: Canadian companies only	Model 5: Canadian companies only
<i>GDPGRWT</i>	0.008** (2.41)	0.010** (2.32)	0.011** (2.02)	0.006* (1.91)	
<i>CHGTAX</i>	0.016*** (2.74)	0.016** (2.00)	0.005 (0.45)	0.006 (1.32)	-0.012 (-1.57)
<i>ENFORCE</i>	-0.047*** (3.26)	-0.040** (2.50)	-0.044** (2.41)	Omitted	-0.095* (1.91)
Observations.....	2,672	2,320	1,929	1,760	1,760
Adjusted <i>R</i> ²	0.256	0.170	0.129	0.092	0.092

Notes: Panel A presents the descriptive statistics and panel B presents further analyses, including the regression results for the primary variables in the study for firms with a non-zero non-GAAP cash effective tax rate—that is, firms that paid taxes. See the accompanying text for the definitions of these variables. The sample contains Canadian firms listed on the Toronto Stock Exchange that adopted international financial reporting standards (IFRS adopters) and a controlled sample of US firms that use reporting standards different from IFRS (control firms). The high value for impairment for the IFRS firms was partly driven by a huge non-cash impairment charge in 2013. See “First Majestic Announces Financial Results for Q4 and Year End 2013,” *Firstmajestic.com*, February 26, 2014 (www.firstmajestic.com/news/2014/index.php?content_id=273); and “Epsilon Energy Ltd. Announces Full Year 2013 Results,” *Globenewswire.com*, March 20, 2014 (www.globenewswire.com/news-release/2014/03/20/1412281/0/en/Epsilon-Energy-Ltd-Announces-Full-Year-2013-Results.html). Capital expenditure obtained from Bloomberg has a negative sign for all items. As a result, each capital expenditure was multiplied by a minus sign.

The five models in panel B are described as follows. Model 1 shows the regression after dropping the firms in the financial or regulatory industry. Model 2 shows the regression for a subsample of firms that paid some taxes. Model 3 shows the regression using only firms with a positive non-GAAP cash effective tax rate; firms with zero corporate tax avoidance are dropped. Models 4 and 5 show the regression using only Canadian firms—that is, IFRS adopters and non-adopters. In model 4, the Stata analysis “omitted” *ENFORCE* from the regression. Therefore, in model 5, we dropped the *GDPGROWT* variable to capture the effect of the *ENFORCE* variable.

*, **, *** Significant at the 10 percent, 5 percent, and 1 percent levels, respectively. The *t*-statistics are in parentheses.

SUMMARY, DISCUSSION, AND CONCLUSION

We have examined whether the adoption of IFRS as the recommended GAAP for Canadian public companies in 2011 affected the tax-avoidance tendencies of these companies. The impact of IFRS adoption on corporate tax avoidance did not receive as much attention from academics as did its impact on financial reporting. Some of the main IFRS studies include its effect on comparability and the relevance of financial reporting, the cost of capital, accounting quality, earnings quality, and market reaction. The main findings are that the effect was generally positive. The few existing tax-related IFRS studies, which for the most part use European data, do not directly involve the likely impact of adoption on the tax-avoidance tendencies (tax aggressiveness) of public firms.

In designing our study, we recognized that the adoption of IFRS in Canada was unique, in that it was not part of the wave of European conversion that took place in the mid-2000s, and it was not followed by adoption in the United States. Accordingly, we used a pre-post research design in which Canadian companies acted as their own controls. More importantly, we also took advantage of the fact that the United States did not adopt IFRS and, using a PSM approach, put together a non-Canadian (US) control sample. Our main sample consists of 400 Canadian IFRS users matched one-to-one with 400 US firms that do not use IFRS. In the sensitivity tests, we made use of non-financial firms, profitable firms that paid taxes in at least one year of our study period, observations for which the non-GAAP cash effective tax rate was greater than zero, and a small sample of 40 Canadian public firms that did not convert to IFRS during our study period. We chose 2008 and 2009 as the pre-adoption period, and 2012 and 2013 as the post-adoption period. Since 2008 and 2009 were recession years in both Canada and the United States, we are interested in the relative increases in the non-GAAP cash effective tax rate among different samples, and we added GDP growth as a control variable. In all, our sample consists of

- 3,200 observations of US and Canadian firms for the main tests, and
- subsamples of 2,320 observations of US and Canadian firms that paid some taxes, 1,929 observations for a non-GAAP cash effective tax rate greater than zero, and 1,670 observations of Canadian companies only, for the sensitivity tests.

We hypothesized that, even though the CRA warned its tax auditors about, and trained them to look for, tax-aggressive transactions occasioned by the conversion to IFRS,⁶⁸ firms' tax-aggressiveness tendencies will decrease (at least in the short run) after IFRS adoption owing to uncertainties and complexities created by the conversion. We rely on the logic of bounded rationality theory to justify our hypothesis of a decrease in tax aggressiveness immediately after the adoption of IFRS. The

68 See Okafor et al., *supra* note 1.

theory suggests that when decision makers are confronted with constraints and uncertainties, they make satisficing decisions. One of the main features of IFRS is that while it gives some flexibility to managers, it also requires disclosures about transactions and estimates that may cause managers to release proprietary information. The tax authority, as a stakeholder in firms, could use such disclosures as the basis for additional tax audits. Therefore, managers are expected to moderate their tax-avoidance tendencies after IFRS adoption.

As our second hypothesis, we posited that, for the same bounded rationality reasons, we may not observe the tax-reducing adjustments that the CRA was concerned that managers may make to certain accounting items, such as revenue, profitability accounts, foreign operations, impairment writeoffs, and accruals. We also investigated whether firm size and industry membership affect the amount of tax that the government collects after the adoption of IFRS. One of our most important decisions in operationalizing the variables that went into our regression-based testing model was the choice of proxy for our corporate tax avoidance variable. Instead of using the usual GAAP-based effective tax rate as a proxy for corporate tax avoidance, we used the non-GAAP cash effective tax rate. Since the adoption of IFRS involved GAAP numbers, we argue that if either the numerator or the denominator of our proxy uses non-cash accounting numbers or GAAP-based tax rates, we may get spurious results. Therefore, our variable uses cash tax paid or received as the numerator and cash flows from operations as the denominator.

The results are consistent with our hypotheses and allay the CRA's concern about loss of taxes owing to users of Canadian GAAP switching to IFRS. In our main tests, where the control sample consists of US firms, the coefficient of the main variable of interest (*IFRSPOST*) in our regression model is positive and significant at conventional levels. Our interpretation of the positive coefficient of *IFRSPOST* in table 2, model 1, which captures the differential impact of IFRS after adoption, is that Canadian companies became less tax-aggressive, compared to US control firms, after the adoption of IFRS in 2011. The higher the *NON-GAAP CASH ETR*, the lower the tax aggressiveness. The results in table 2, model 1 also show that Canadian sample firms generally engage in more tax avoidance than their US counterparts, as indicated by the negative and significant coefficient of the IFRS variable. We also carried out a co-test of the variables *IFRS* and *IFRSPOST*, and the resultant coefficient is negative and significant. That is, while the Canadian IFRS-using firms became less tax-aggressive after the adoption year of 2011, they are still more tax-aggressive than the US control firms.

The sensitivity tests reported in panel B of table 4 (models 1 to 4) confirm the results from the main regression reported in table 2, model 1. The significant positive coefficient of the *IFRSPOST* variable indicates that Canadian firms that converted to IFRS became less tax-aggressive after 2011. In a nutshell, all the sensitivity tests show that IFRS converters became less tax-aggressive after the adoption of IFRS in 2011. The tests also show that, in general, Canadian firms seem to be more tax-aggressive than US firms, while Canadian IFRS users lost some tax aggressiveness relative to Canadian users of US GAAP after 2011.

The results of the test for our second hypothesis reported in table 2, models 2 to 8, show that the concerns of the CRA that managers may inappropriately adjust balances of accounts that relate to revenues, profitability, foreign operations, impairment writeoffs, and accruals may not materialize after the adoption of IFRS. With the exception of accruals, none of the proxies for these accounts are significant, while the coefficients of the variables of interest remain significant and the R^2 remains unchanged at 0.256. That is, while the training provided to CRA auditors to alert them to any inappropriately adjusted balances could be useful, it seems that IFRS conversion may not put the CRA at a disadvantage compared to old Canadian GAAP. The significant relationship between our corporate tax-avoidance proxy and accrual management is an interesting addition to the line of literature on the tradeoff that firms face in choosing between tax benefits and financial-reporting benefits. Our results are consistent with the findings in prior studies that firms would forgo tax benefits to appeal to their investors.

We ran some additional tests to rule out the possibility that our results are driven by measurement errors in these variables. More specifically, to rule out the possibility that skewness in the means of our variable *NON-GAAP CASH ETR* is driving our results, we reran the models using the median values of the variables. The coefficients and the significance levels of the variables are, by and large, similar to those in table 2. Furthermore, the additional sensitivity tests reported in table 3 do not change the conclusion that the CRA's concerns about improper adjustment of tax-related account balances by managers after the adoption of IFRS are allayed.

Lastly, we graphically illustrated the trajectory of *NON-GAAP CASH ETR* across the sample period for our sample of IFRS and non-IFRS firms that paid taxes in the study period (figure 1). We also grouped tax avoidance into quintiles and graph the top quintile of tax avoidance (lowest *NON-GAAP CASH ETR*) versus the lowest quintile of tax avoidance (highest *NON-GAAP CASH ETR*) for IFRS adopters (figure 2). We then identified the top quintile and lowest quintile by industry membership (financial or non-financial) (figure 3). While figure 1 shows a consistent pattern with our descriptive and regression analysis results for IFRS and non-IFRS adopters, figures 2 and 3 suggest that the top and lowest tax avoiders tend to converge after the adoption of IFRS across the industry categories, at least in the short run.

Overall, the results of our study give some comfort to the tax authorities, especially to the CRA, which was concerned about potential negative impacts occasioned by the conversion from Canadian GAAP to IFRS for public companies. The adoption of IFRS does not seem to increase the tax aggressiveness of Canadian public companies, at least in the short run. The long-run implications of our findings could be fertile ground for future research. The results also give comfort to Canadian accounting standard setters in providing empirical evidence that they did not inadvertently cause Canadian public firms to become more tax-aggressive. Our findings may also be beneficial to other countries still contemplating the adoption of IFRS. But a couple of caveats are in order. We assumed that US firms are good controls for Canadian firms that converted to IFRS. To the extent that the controls are incongruous owing to different economic and standard-setting environments in Canada and the

United States, our results may not be relied on. However, since our Canadian control sample, albeit small in number (160 observations), gives the same results, the concerns are partially ameliorated. An additional caveat relates to the proxies for some of the variables that we used to operationalize the concerns of the CRA about account balance adjustments. Again, several additional analyses produce consistent results, and future research may further refine our measures.

Policy Forum: Editor's Introduction— Provincial Finances

Long-range projections of fiscal sustainability in Canada by the parliamentary budget officer emphasize differences across the levels of government.¹ While federal debt is on a sustainable track over the long term, provincial debt is projected to rise drastically if current trends continue. Demographics largely explain these trends. Federal spending on the elderly is primarily for pensions, and spending on federal old age security as a percentage of gross domestic product is projected to peak quite soon, in 2032.² In contrast, provincial spending on the elderly is primarily for health care, and these expenditures will continue to rise until the 2040s. How provinces manage these expenditure needs in the future will be in large part determined by how well they plan for their fiscal situation now.

In this policy forum, we have gathered three contributions that examine provincial fiscal challenges, each focusing on an individual provincial case study. Two of the cases are provinces facing substantial short- and medium-term shortfalls, while the third province has made substantial progress on improving its fiscal outlook.

The forum begins with the situation of Newfoundland and Labrador. This province has seen a substantial drop in its fiscal balance, owing in part to the drop in global oil prices. But Wade Locke and Douglas May point out in their article that per capita spending and revenues are higher in Newfoundland and Labrador than in other provinces, so the overall size of the public sector may be hard to sustain even if oil revenues recover. Compounding these issues are demographic factors that are leading to further population declines. Locke and May do see possibilities of higher oil revenues in the future, if more development projects come on line in the 2030s and beyond. However, sustained oil revenues will mean that Newfoundland and Labrador will not receive equalization, so solutions to fiscal imbalances may need to be found inside the province rather than coming from Ottawa.

The next article examines New Brunswick. Richard Saillant and Herb Emery argue that in the last decade there has been persistent erosion of New Brunswick's fiscal sustainability, resulting from poor economic growth, a decrease in the labour force, and smaller growth in federal transfers. With provincial tax rates at or near the highest in the country and further demographic impacts on the way, the path

1 See Office of the Parliamentary Budget Officer, *Fiscal Sustainability Report 2018* (Ottawa: PBO, September 2018).

2 See Office of the Superintendent of Financial Institutions, Office of the Chief Actuary, *Actuarial Report on the Old Age Security Program as at 31 December 2015* (Ottawa: OSFI, 2017).

forward seems bleak, and the province may require substantial federal assistance to maintain national standards in its public services.

Finally, Luc Godbout writes about Quebec. Godbout argues that fiscal rules have played a large role in turning around Quebec's fiscal situation. Like some other provinces, Quebec adopted a balanced budget law starting in 1997-98—and deficits have been much smaller since. More uniquely, since 2006, dedicated revenue sources have been sequestered in the Generations Fund. So far, \$11 billion from the Generations Fund has been used to retire provincial debt, with more to come. Godbout argues that these fiscal institutions could be a model for other provinces seeking a way out from the burden of large accumulated debt.

The other provinces in Canada face varying challenges. For example, Alberta has a relatively young population, low debt, and substantial resource revenues, but expensive public services. In contrast, British Columbia's population is already older, but the budget is currently in balance. However, these differences across provinces in resource revenues, demographics, and fiscal management will be putting a sharply increasing amount of stress on our fiscal federation in the years to come. While the success of fiscal rules in Quebec provides some hope that home-grown solutions can be found within the provinces, these are unlikely to be enough in all cases. The best way forward would be to develop strategies encouraging broad-based and vigorous economic growth so as to reverse the effects of demographic decline and create new sources of revenue to fill provincial coffers. Failing that, it is hard to see a solution that does not involve increased federal assistance—which may further antagonize western provinces. Canada needs strong leadership to work on these challenges, starting now.

Kevin Milligan
Editor

Policy Forum: Newfoundland and Labrador's Debt Strategy—Waiting for a Saviour or Godot?

Wade Locke and Douglas May*

PRÉCIS

Lorsque le gouvernement de Terre-Neuve-et-Labrador est entré en fonctions à la fin de 2015, il a déclaré que le déficit prévu pour l'exercice en cours serait presque le double de celui prévu par le gouvernement précédent. Le nouveau gouvernement a ensuite adopté une position budgétaire très offensive dans son premier budget déposé en avril 2016. Cependant, à la suite de la démission de la ministre des Finances en juillet 2017, le gouvernement a semblé changer radicalement de stratégie en adoptant une réponse politique passive à l'aggravation du déficit. Alors qu'au cours des années suivantes le déficit annuel de Terre-Neuve-et-Labrador a diminué, sa dette nette et brute par habitant a grimpé en flèche et a atteint de nouveaux sommets par rapport à celle des autres provinces du Canada. Cet article présente une étude en profondeur de cette expansion et examine les probabilités de succès, à moyen et à long terme, de la stratégie budgétaire actuelle du gouvernement en réaction à l'aggravation de son problème d'endettement.

ABSTRACT

When the government of Newfoundland and Labrador assumed office in late 2015, it declared that the expected deficit for the current fiscal year would be almost double that which was budgeted for by the predecessor government. The new government then adopted a very aggressive fiscal-policy stance in its first budget, tabled in April 2016. However, following the finance minister's resignation in July 2017, the government seemed to dramatically change its strategy, adopting a passive policy response to the worsening deficit situation. While in subsequent years Newfoundland and Labrador's annual deficit has fallen, its net and gross debt per capita have ballooned and reached new heights relative to Canada's other provinces. This article presents an in-depth investigation of this expansion and examines the probabilities of success, in the medium and long term, of the government's current fiscal strategy as a response to its deepening debt problem.

KEYWORDS: DEBT ■ DEFICIT ■ FISCAL PLANNING ■ NEWFOUNDLAND AND LABRADOR ■ FISCAL SUSTAINABILITY ■ PROVINCIAL DEBT

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INTRODUCTION

Budgetary deficits are recorded when a government's explicit and implicit expenditures in any given year outstrip its revenues for that year.¹ Debt accumulation is simple to understand: deficits that are not counterbalanced through the acquisition of financial assets or by budgetary surpluses in other years accumulate as government debt obligations. However, it is more difficult to determine whether public-sector debt accumulation is the manifestation of good government policy, designed to fund needed infrastructure, or a tangible demonstration of a fiscal crisis, requiring immediate and drastic government action. Alternatively, debt finance may simply reflect a short-term fiscal problem that can be addressed by a deliberate plan executed within a reasonable time frame.

Compounding any assessment of a government's debt burden is the fact that there is not one universally accepted indicator of a fiscal crisis; rather, there are many indicators² that can be used for this purpose. Additionally, there is no general agreement as to the precise threshold for any of those indicators at which a particular debt profile transforms from good public policy to a full-blown fiscal crisis. In

1 Explicit expenditures—actual cash outlays incurred in the year under consideration—are illustrated by the hiring of public-sector employees and the purchase of software. Implicit expenditures, such as the interest costs associated with unfunded pension liabilities and other post-retirement employment benefits, are reported, under accrual-based budgeting, when the liability is incurred even though the associated payments may be made many years in the future. Implicit revenues are recorded when earned even if they are not received until later. For instance, on April 1, 2019, the government of Newfoundland and Labrador and the government of Canada, as part of their renegotiation of the Atlantic accord, reached an agreement that provided the province with a “new and guaranteed revenue stream that will deliver \$2.5 billion to the province”: Newfoundland and Labrador, Executive Council, “Landmark Atlantic Accord Agreement Achieved,” *News Release*, April 1, 2019 (www.releases.gov.nl.ca/releases/2019/exec/0401n07.aspx). While this agreement would provide “fixed cash installments from 2019 until 2056,” the provincial treasury would actually receive \$135 million in 2019; however, under accrual-based budgeting, the total of \$2.5 billion was recorded as revenue and the treasury recorded a surplus of \$1.9 billion: Newfoundland and Labrador, Department of Finance, 2019 Budget, Budget Speech, April 16, 2019, at 10 (www.gov.nl.ca/budget/2019/wp-content/uploads/sites/2/2019/04/Budget-Speech-2019.pdf).

2 These might include, for example, net debt per capita, net debt as a percentage of gross domestic product (GDP), and debt as a percentage of total revenue.

other words, it is important to appreciate that there is substantial subjectivity and interpretation associated with any analysis of the debt burden.

This article focuses on debt management in Newfoundland and Labrador. We begin with a description of the province's fiscal context. We then present a comparative interprovincial assessment of fiscal indicators, which is followed by an evaluation of the specific factors that contribute to Newfoundland and Labrador's fiscal circumstances. We discuss planning options for the way forward, and summarize our findings in a brief conclusion.

FISCAL CONTEXT

Newfoundland and Labrador is unique in ways that make it both amenable to and challenging for analysis of the evolution of its current net debt situation.³ Prior to offshore oil production in late 1997, the provincial government had reported only two small, cash-based budgetary surpluses since its Confederation with Canada in 1949. As shown in figure 1, another eight cash-based surpluses occurred between 1997-98 and 2018-19. In other words, in the nearly 70 years since Newfoundland (and Labrador) became a province of Canada, 85 percent of those years were characterized by deficits. These protracted deficits exacerbated Newfoundland and Labrador's current debt problem.

Newfoundland entered Confederation with a pre-union surplus,⁴ recording \$8.1 million as its first cash-based budgetary surplus in 1949-50, which at the time was equivalent to approximately \$25 per capita and 4 percent of gross domestic product (GDP). However, over the next 28 years, Newfoundland reported only one other cash surplus (of \$9.4 million in 1995-96). From 1949-50 to 1997-98, the provincial finances had accumulated cash deficits of \$5.1 billion. Even though another small cash surplus of \$3.8 million occurred in 1998-99, Newfoundland and Labrador's best fiscal performance occurred between 2005-06 and 2011-12, inclusive; we refer to this period as "the seven golden years."⁵ During those years, revenues from offshore oil contributed to seven consecutive cash surpluses totalling \$5.1 billion (with the largest, \$2.2 billion, occurring in 2008-09), or an average annual cash surplus of \$728 million. Unfortunately, the next seven years were a period

3 Net debt is equal to gross debt minus financial assets. Currently these assets include the historic costs associated with funding commitments relating to the Muskrat Falls project, an issue dealt with in more detail below.

4 According to Newfoundland's first provincial budget, the cash surplus on March 31, 1949 was \$41.4 million and the public debt was \$81.5 million. Newfoundland, Department of Finance, 1950 Budget, Budget Speech, April 26, 1950, at 17-18.

5 While the province's experience may not be of biblical proportions, Genesis 41:28 provides an apt analogy: "Seven years of great abundance are coming throughout the land of Egypt, but seven years of famine will follow them. Then all the abundance in Egypt will be forgotten, and the famine will ravage the land. The abundance in the land will not be remembered, because the famine that follows it will be so severe"(www.biblegateway.com/passage/?search=Genesis+41%3A15-38&version=NIV).

FIGURE 1 Cash- and Accrual-Based Budget Surplus/Deficit, Newfoundland and Labrador, 1949-50 to 2018-19

Sources: For fiscal years 1949-50 to 2004-05, cash-based data were taken from Newfoundland and Labrador, Department of Finance, *Public Accounts*, vol. III (St. John's: Department of Finance, various years); for 2005-06 to 2018-19, the cash-based data were taken from Newfoundland and Labrador, Department of Finance, *Report on the Program Expenditures and Revenues of the Consolidated Revenue Fund* (St. John's: Department of Finance, various years); and for 1994-95 onward, accrual-based data were taken from Newfoundland and Labrador, Department of Finance, *Public Accounts*, vol. I (St. John's: Department of Finance, various years).

of fiscal famine: the cumulative cash deficit in 2012-13 to 2018-19 was \$9.2 billion, the average annual cash deficit was \$1.3 billion, and the cash deficit peaked at \$2.6 billion in 2015-16, which was the highest in the province's history.

From 1994-95 onward, the government of Newfoundland and Labrador reported its public accounts on an accrual accounting basis. The first accrual-based surplus, \$133 million, occurred in 1997-98. From 2005-06 to 2011-12 (the seven golden years), the province reported \$5.7 billion in cumulative budget surpluses, resulting in an average annual surplus of \$810 million and peaking at \$2.4 billion.⁶ And from 2012-13 to 2018-19 (the years of fiscal famine), the provincial government faced accrual-based deficits, which totalled \$6.4 billion, peaked at \$2.2 billion in 2015-16, and averaged \$910 million per annum.

Newfoundland and Labrador's recent fiscal situation has been volatile, reflecting imprecise predictions of oil prices and uncertainty emanating from non-renewable

6 An accrual-based deficit of \$33 million was reported in 2009-10.

resource markets. We illustrate this volatility by focusing on fiscal sustainability indicators analyzed for three distinct periods, with representative years that are a decade apart. Specifically, we consider

1. the current fiscal problem, represented by fiscal year 2018-19;
2. the seven golden years associated with offshore oil production and illustrated by fiscal year 2008-09; and
3. the earlier fiscal challenges prior to the full revenue impacts of offshore oil and reflected by fiscal year 1998-99.

NEWFOUNDLAND AND LABRADOR RELATIVE TO OTHER CANADIAN PROVINCES

Figure 2 indicates that in 2018-19 Newfoundland and Labrador's net debt per capita, at \$29,340, was 64 percent higher than the average for all other provinces (\$17,867). As well (but not shown in figure 2), this level of debt per capita was 77 percent higher than the average for the other three Atlantic provinces (\$16,611) and exceeded the average for the next closest province, Ontario (at \$23,633), by 24 percent.⁷

In 1998-99, before the full revenue impacts of oil development in Newfoundland and Labrador were realized,⁸ the province's net debt per capita (\$14,543) was 161 percent of the average for all other Canadian provinces (\$9,022). The largest gap and the largest difference occurred in 2004-05, when the province's net debt per capita (\$22,976) was 248 percent of the average in the rest of Canada (\$9,278). Although Newfoundland and Labrador's net debt per capita increased by 7.1 percent between 1998-99 and 2008-09, the province's relative position improved, falling from 161 percent to 152 percent of the average for all the other provinces. Newfoundland and Labrador's net debt per capita debt in 1998-99 was the second-highest in Canada, surpassed by Quebec, at \$17,295. However, with a subsequent increase of 88 percent between 2008-09 and 2018-19 (from \$15,577 to \$29,340), Newfoundland and Labrador has recorded the highest level of net debt per capita of any province. Therefore, by this measure, Newfoundland and Labrador's fiscal position has deteriorated over the last 20 years.

As shown in figure 3, except for fiscal year 2008-09, when Newfoundland and Labrador posted the largest surplus per capita of any province (at \$4,595), the province has recorded a higher deficit per capita, relative to the other provinces, over the last 20 years. It ranked highest (at \$347) in 1998-99, and second-highest (at \$1,050)

7 Our calculations are based on Canada, Department of Finance, *Fiscal Reference Tables* (www.fin.gc.ca/pub/frt-trf/index-eng.asp) and Statistics Canada table 17-10-0005-01, "Population Estimates on July 1st, by Age and Sex."

8 Oil production commenced at the end of 1997, but the revenue flows to the provincial government were low in the first several years of production because of low profitability, and the threshold rates of return for the profit-sensitive royalties were not exceeded.

FIGURE 2 Net Debt per Capita, Newfoundland and Labrador Compared to the Average for All Other Canadian Provinces, 1994-95 to 2018-19

Sources: Authors' calculations based on Canada, Department of Finance, *Fiscal Reference Tables* (www.fin.gc.ca/pub/frt-trf/index-eng.asp); and Statistics Canada table 17-10-0005-01, "Population Estimates on July 1st, by Age and Sex."

in 2018-19, behind Alberta (at \$1,558). As well, from 1994-95 onward, Newfoundland and Labrador has experienced higher debt charges per capita than any other province. In both 1998-99 and 2018-19, the province's debt cost per capita was \$1,867, while the average for all the other provinces in those years was \$812 and \$803, respectively. The corresponding debt cost estimates for Newfoundland and Labrador and for all other provinces in 2008-09 were \$1,456 and \$694 per capita, respectively. Measured by the size of the per capita deficit, the situation in Newfoundland and Labrador has grown worse in recent years.

Surprisingly, despite having accumulated the highest net debt per capita of any province, in the last 20 years Newfoundland and Labrador simultaneously recorded the highest revenues per capita and its expenditures per capita surpassed those for all other Canadian provinces. By way of illustration,

- in 1998-99, Newfoundland and Labrador's revenues per capita were 122 percent of the average for all other provinces, while its expenditures per capita were 127 percent of the average;
- in 2008-09, the province's revenues per capita were 184 percent and its expenditures 132 percent of the average for the other provinces; and
- in 2018-19, the province's revenues per capita were 126 percent and its expenditures 132 percent of the average for all other provinces.

FIGURE 3 Deficit per Capita, Newfoundland and Labrador Compared to the Average for All Other Canadian Provinces, 1994-95 to 2018-19

Source: Canada, Department of Finance, *Fiscal Reference Tables* (www.fin.gc.ca/pub/frr-trf/index-eng.asp).

Furthermore, for these periods, Newfoundland and Labrador's per capita revenues and expenditures exceeded the levels in every other province, not just the average for all other provinces. In other words, in per capita terms, the province had more revenue to spend than other provinces, spent more than other provinces, and incurred more debt than other provinces.

As shown in table 1, the revenue impacts associated with oil royalties and associated corporate income taxes were the primary driver of Newfoundland and Labrador's elevated revenues per capita. The highest direct impact of oil revenues on the provincial treasury occurred in 2011-12, when 43.2 percent of provincial revenues were accounted for by the sum of royalties (\$5,323 per capita) and corporate income taxes from offshore oil activities (\$116 per capita). As well, the Atlantic accords of 1985 and 2005 provided more than \$5 billion to Newfoundland and Labrador. The peak impact for the 2005 agreement occurred in 2008-09. From that year onward, Newfoundland and Labrador no longer qualified for equalization; as a consequence, \$2,254 per capita (\$1.2 billion) in payments advanced under the 2005 accord could no longer be deferred and was recorded as revenue in the public accounts. As well, in 2008-09, the 1985 Atlantic accord transferred \$1,088 per capita to the provincial treasury.

In the seven golden years (2005-06 to 2011-12), when cash surpluses totalled \$5.1 billion and accrual-based surpluses totalled \$5.7 billion, the 1985 and 2005 accords transferred \$4.5 billion to the provincial treasury. Clearly, the negotiation

TABLE 1 Revenues per Capita Available to the Government of Newfoundland and Labrador, 1994-95 to 2017-18

Fiscal year	NL own revenues			Federal revenues		
	Oil royalties	Corporate income tax, oil	Other	1985 accord	2005 accord	Equalization entitlements
				<i>dollars</i>		
1994-95			3,413	0		1,668
1995-96			3,833	0		1,607
1996-97			3,977	0		1,767
1997-98	1	0	3,828	0		1,829
1998-99	7	0	3,917	0		2,184
1999-00	45	0	4,228	0		1,986
2000-01	75	0	4,233	0		2,268
2001-02	59	0	4,519	98		2,042
2002-03	156	0	4,676	341		1,750
2003-04	245	90	4,828	396		1,415
2004-05	512	105	5,124	250		1,528
2005-06	1,035	219	5,892	0	627	1,674
2006-07	829	329	6,243	215	429	1,345
2007-08	3,446	342	6,728	370	601	879
2008-09	4,376	241	7,258	1,088	2,254	0
2009-10	4,105	370	6,655	900	0	0
2010-11	4,597	447	7,166	1,230	0	0
2011-12	5,323	116	8,307	1,021	0	0
2012-13	3,473	152	8,747	0	0	0
2013-14	4,031	159	8,072	0	0	0
2014-15	2,957	183	8,055	0	0	0
2015-16	973	160	8,167	0	0	0
2016-17	1,853	33	9,528	0	0	0
2017-18	1,785	0	9,742	0	0	0

Sources: Authors' calculations based on Newfoundland and Labrador, Department of Finance, *Public Accounts* (St. John's: Department of Finance, various years); and Statistics Canada table 17-10-0005-01, "Population Estimates on July 1st, by Age and Sex."

of the Atlantic accord in 1985 and the revision of the accord in 2005 were significant factors affecting fiscal performance during that period.

Finally, it is interesting to note that in 2008-09, the accords and oil revenues combined accounted for 48.6 percent of provincial revenues. While revenue per capita has fallen in recent years, expenditures per capita have not. Consequently, the province's fiscal situation has not improved.

Newfoundland and Labrador's net debt was equivalent to 199 percent of its total revenue in 2018-19, the same value as in 1998-99. The province's relative position improved dramatically in 2008-09, when it was in the middle of all provinces with net debt equivalent to 92 percent of its total revenue. Newfoundland and Labrador, with net debt equivalent to 199 percent of its total revenue in both 1998-99 and 2018-19, was second only to Prince Edward Island (at 200 percent) in 1998-99 and to Ontario (at 220 percent) in 2018-19. When one considers the amount of additional revenue that would be required to offset net debt, it is clear that the province's situation has not improved.

The interest bite⁹ for Newfoundland and Labrador outpaced the average for all other provinces in 1998-99 and 2018-19. Debt charges as a percentage of total revenue declined from 25.5 percent (or about \$1 for every \$4) in 1998-99 to 12.8 percent (about \$0.50 for every \$4) in 2018-19. In 2008-09, the province's debt cost per dollar of revenue was in the middle of the pack, with the province allocating slightly more than \$1 of every \$12 to service its public debt. While the interest bite has been reduced, the province still has the highest cost of borrowing among the provinces, and the improvement is due primarily to the decrease in the overall cost of borrowing in Canada.¹⁰

While per capita indicators reveal some of the burden of Newfoundland and Labrador's net debt obligations, suggesting that the burden has become more severe both in absolute terms and relative to other provinces, converting these indicators into their GDP equivalents provides a slightly different perspective. Figure 4 illustrates how net debt as a percentage of GDP has evolved and how Newfoundland and Labrador performs relative to the other provinces.¹¹ For every year except 2011-12 to 2014-15, Newfoundland and Labrador's net debt as a percentage of GDP exceeded the average for all other provinces.

In 2017-18 and 1998-99, Newfoundland and Labrador's debt obligations relative to its GDP (44.4 percent and 69.6 percent, respectively) exceeded the average

9 The interest bite is the percentage of revenue needed to service the debt, or the amount of each dollar collected that goes to debt costs.

10 The average yield on long-term (10+ years) government bonds declined from 9.29 percent in June 1994 to 1.7 percent in June 2019. See CANSIM series V122487, "Government of Canada Marketable Bonds—Average Yield—Over 10 Years."

11 At the time of writing, nominal provincial GDP data were available from Statistics Canada up to and including 2017; therefore, the corresponding data for the 2017-18 fiscal year are the data for the last year discussed for the GDP indicators.

FIGURE 4 Net Debt as a Percentage of GDP, Newfoundland and Labrador Compared to the Average for All Other Canadian Provinces, 1994-95 to 2017-18

GDP = gross domestic product.

Sources: Authors' calculations based on Canada, Department of Finance, *Fiscal Reference Tables* (www.fin.gc.ca/pub/frt-trf/index-eng.asp); and Statistics Canada table 36-10-0222-01, "Gross Domestic Product, Expenditure-Based, Provincial and Territorial, Annual."

reported for all other provinces (30.2 percent and 29.4 percent, respectively). However, in 2008-09—one of the seven golden years—the province ranked in the middle of the other provinces. Even with the relative improvement brought about by enhanced oil revenues in 2008-09, Newfoundland and Labrador's debt obligations in that year (25.2 percent of GDP) still surpassed the average for the rest of Canada (20.8 percent). While the relative position of the province by this measure appears to be slightly better than its position based on per capita data, the situation has clearly deteriorated in recent years, even controlling for GDP.

Newfoundland and Labrador's deficit as a percentage of GDP (2.8 percent in 2017-18 and 1.7 percent in 1998-99) exceeded the average for all other provinces (0.3 percent) and was larger than the percentage reported for every other province in those years. Interestingly, for 2008-09, the province reported a surplus equivalent to 7.4 percent of GDP, which was the largest of any province reported between 1994-95 and 2017-18.¹²

12 Our calculations based on Canada, Department of Finance, *Fiscal Reference Tables*, *supra* note 7, and Statistics Canada table 36-10-0222-01, "Gross Domestic Product, Expenditure-Based, Provincial and Territorial, Annual."

Newfoundland and Labrador's debt cost as a percentage of GDP in 1998-99 (8.9 percent) and 2017-18 (3.0 percent) exceeded the average for all other provinces (2.6 percent and 1.4 percent, respectively). In 2008-09, Newfoundland and Labrador, with debt costs as a percentage of GDP at 2.4 percent, was the third-highest province, behind New Brunswick (3.4 percent) and Quebec (2.6 percent). The fiscal position of the province is seen as getting worse when this indicator is utilized as well.

SPECIFIC DRIVERS OF THE PROVINCE'S FISCAL CIRCUMSTANCES

Having provided some perspective on Newfoundland and Labrador's debt performance relative to that of other Canadian provinces, we will now analyze the components and drivers of the province's debt. The most recent public accounts provide data up to 2017-18 and report \$14.7 billion in net debt for the province, made up of \$22.5 billion in liabilities offset partially by \$7.9 billion in financial assets (see figures 5, 6, and 7).

The province's 2019 budget reported that net debt was estimated to rise to \$15.4 billion in 2018-19 and fall back to \$13.8 billion in 2019-20.¹³ The forecasted decline in net debt is the result of the renegotiation of the Atlantic accord between the government of Newfoundland and Labrador and the government of Canada in April 2019. Specifically, this agreement provided the province with a "new and guaranteed revenue stream that will deliver \$2.5 billion to the province."¹⁴ Using accrual-based accounting, the province applied the \$2.5 billion in future revenues to its current budget. This enabled the government to report an expected surplus of \$1.9 billion in 2019-20; however, according to the Dominion Bond Rating Service (DBRS), without this additional revenue source, the province would have recorded a deficit of \$577 million.¹⁵

Despite this good fortune bestowed on the province, Newfoundland and Labrador's fiscal position has not changed. In a recent interview, the minister of finance, Tom Osborne, noted that the government's deficit reduction plan aims to return the province to surplus by 2022-23, but he indicated that he "won't sacrifice services in order to get there."¹⁶ Of course, that position has direct implications for the province's willingness to cut expenditures in order to alleviate its fiscal problems; in another interview, the minister "acknowledged that government spending is still

13 Newfoundland and Labrador, 2019 Budget, *supra* note 1.

14 Newfoundland and Labrador, Executive Council, *News Release*, *supra* note 1.

15 Michael Connors, "No New Credit Rating Downgrade, but Tom Osborne 'Won't Sacrifice Services' To Get to Surplus," *NTV*, September 26, 2019 (<http://ntv.ca/no-new-credit-rating-downgrade-but-tom-osborne-wont-sacrifice-services-to-get-to-surplus/>).

16 *Ibid.*

FIGURE 5 Financial Assets, Liabilities, and Net Debt, Newfoundland and Labrador, 1994-95 to 2019-20

Sources: Newfoundland and Labrador, Department of Finance, *Public Accounts* (St. John's: Department of Finance, various years); and Newfoundland and Labrador, Department of Finance, 2019 Budget, April 16, 2019.

an issue.”¹⁷ The government's optimism appears to centre on the hope that the oil industry will expand and generate sufficient revenues to mitigate the province's fiscal difficulties, so that no adjustment to expenditures will be needed. This will allow the government to kick the can down the road one more time.

As shown in figure 5, from 1994-95 to 2017-18, the province's liabilities increased by 145 percent (from \$9.2 billion to \$22.5 billion), but its financial assets increased by 229 percent (from \$2.4 billion to \$7.9 billion). Consequently, net debt (liabilities minus financial assets) increased by 115 percent (from \$6.8 billion to \$14.7 billion). As well, despite the recent improvement resulting from the \$2.5 billion in additional Atlantic accord monies, net debt has been growing since 2011-12, driven by new bond issues in response to large deficits.

Except for the most recent period, post-retirement employment benefits have made up a large share of the province's outstanding liabilities (see figure 6). In 2006-07, these liabilities amounted to \$3.3 billion, or 25.1 percent of provincial liabilities; by 2015-16, they had more than doubled, increasing to \$7.4 billion and

17 “DBRS Maintains NL Credit Rating, but Outlook Remains Challenging for Province,” *VOCM*, September 26, 2019 (<https://vocm.com/2019/09/26/dbrs-credit-rating-nl/>).

FIGURE 6 Composition of Liabilities, Newfoundland and Labrador, 1994-95 to 2019-20

Sources: Newfoundland and Labrador, Department of Finance, *Public Accounts* (St. John's: Department of Finance, various years); and Newfoundland and Labrador, Department of Finance, 2019 Budget, April 16, 2019.

representing 45.5 percent of total provincial liabilities. In the 2019-20 budget, these liabilities are expected to increase to \$8.0 billion. The rate of growth has slowed, in part because of a change in the governance structure of provincially funded pension plans and the issuance of a promissory note, which effectively committed the province to converting its post-retirement employment benefit liabilities into explicit debenture debt outside the pension funds, or to pay a fixed amount each year from general revenue.¹⁸

It is also worth noting that a large portion of the province's financial assets results from equity in government business enterprises (GBE), which increased from \$0.6 billion, or 24.4 percent of financial assets, in 1994-95 to \$5.1 billion, or 65.4 percent, in 2017-18 (see figure 7). As well, a significant amount of GBE equity is made up of equity in Nalcor Energy, in general, and the Muskrat Falls project in particular. Since Muskrat Falls is not yet operational and has experienced significant

18 In 2014-15, the province and its unions changed the governance structure of its pensions and established joint and equal participation in the sponsorship and management of the Public Service Pension Plan; it also committed to a promissory note to pay off the unfunded pension liability at the time over a 30-year period. A similar arrangement was made with the Teachers' Pension Plan in the following year.

FIGURE 7 Composition of Financial Assets, Newfoundland and Labrador, 1994-95 to 2018-19

Source: Newfoundland and Labrador, Department of Finance, *Public Accounts* (St. John's: Department of Finance, various years).

cost overruns, the price of electricity within the province, in the absence of a mitigation plan, is expected to double; however, the provincial government has committed to developing a mitigation plan that will avoid this result.

At the time of writing, the details of the mitigation plan are not known, but it could have significant consequences for the net debt situation of the province. If the price received by Nalcor Energy is not consistent with the equity value, that value will have to decrease and provincial net debt will increase correspondingly. This issue is dealt with in more detail below.

THE WAY FORWARD

As noted above, the provincial government has forecasted a return to surplus in 2022-23; however, it is unlikely that this goal will be achieved within that time frame. Our skepticism emanates from a couple of observations. First, the provincial economy is returning to more normal levels of economic activity, rather than being bolstered by activities associated with large construction projects such as Muskrat Falls or development of the Hebron offshore oil field. Second, the province's population is aging rapidly and shrinking in absolute size. The demographic effects are expected to be manifested through two routes: (1) many baby boomers are now retiring or

will be retiring over the next decade; and (2) a continued increase in net outmigration is anticipated as people leave the province in search of employment and improvement of their personal circumstances.

There are negative forces affecting the province's fiscal balance, even with the recent assistance from the federal government associated with adjustments to the Atlantic accord. As shown in the public accounts,¹⁹ on the expenditure side of the budget, health-care expenditures are the largest component of provincial expenditures, and these will be strongly influenced by demographics. Public-sector salaries are also a large component of expenditures, and these costs are obviously determined by the number of people on the provincial payroll and their compensation rates, including fringe benefits. The number of public-sector workers per 1,000 in Newfoundland and Labrador's population is well above the Canadian average. The rates of compensation on a weekly level have been consistent with the all-province average, but well above regional levels.²⁰ Compensation commitments for public-sector workers occur not only during their working lives, but also after retirement until death or the death of the worker's spouse. Our investigation reveals that these future costs can be effectively transferred to the next generation. The question is whether the shrinking population will have the income or the borrowing capacity to fund these financial obligations when they become due. At the time of the 2008 financial crisis associated with housing debt in the United States, we saw that a solution for individual homeowners was to default on their mortgages and move. A more equitable or moral solution perhaps is to prepare now for the future.

The paradox is that Newfoundland and Labrador, with the highest revenue per capita of any province, is also the province with the highest gross (and potentially net) debt per capita. It is helpful to consider the issues and associated evidence in more detail.

First, we consider the elephant in the room—demographics. Figure 8 provides a picture of the province's demographic profile in 2016. The predominance of baby boomers stands out. The so-called echo, which is often seen in other population profiles, is entirely absent, perhaps because of outmigration. Newfoundland and Labrador has a very low fertility rate; in 2017, at 1.33, it was the lowest rate of any province and well below the replacement rate of 2.11 children (for a representative woman aged 15–49). The rate can be expected to fall further as the province's economy deteriorates. Our forecast is that the number of deaths in 2019 will exceed 5,000 while the number of births will be less than 4,000; therefore, the province's population will experience a further natural decline. As well, a loss of construction jobs and perhaps future attrition in the public sector could result in an increase in interprovincial outmigration, which would probably not be offset by an increase

19 Newfoundland and Labrador, Public Accounts 2017–18 (St. John's: Department of Finance, 2018).

20 Newfoundland, Department of Finance (www.gov.nl.ca/fin/economics/pop-projections/).

FIGURE 8 Age Cohorts by Gender, Newfoundland and Labrador, 2016

Source: Compiled by Newfoundland and Labrador, Department of Finance, Community Accounts Unit, based on information provided from Statistics Canada, 2016 Census of Population.

in international immigration. In summary, the province's population is declining, and we believe that this trend can be expected to accelerate.

Figure 9 shows that Newfoundland and Labrador suffered a rapid population decline from around 1992, the beginning of the fishing moratoria, until around 2007. During the seven golden years, there was a period of population growth, stimulated by increases in oil prices and royalties and in corporate profits, along with increased employment in the public and construction sectors. After 2012-13, as the construction of some larger projects began to wind down, so naturally did employment, and the population began to fall.

As shown in figure 9, the population estimate for 2019 is 521,542, a drop of almost 4,062 from 2018. A recent (August 2019) population projection made by the province's Department of Finance²¹ also has the population declining over the next decade, using the low-growth scenario predicted in the budget, but the decline is far slower than that in our prediction and in Statistics Canada's. The trend line shown in figure 9 suggests that population growth in the medium term can be difficult to predict. However, given the province's very low fertility rate and the large presence of older baby boomers, there is some consensus that the population will fall below 500,000 in the next decade or two.

Figure 10 shows the sources of revenue for the government of Newfoundland and Labrador from 1994-95 to 2017-18, as reported in the public accounts. Historically, personal income tax has represented the single most important source of

21 Special tabulations provided by the Labour Statistics Division of Statistics Canada.

FIGURE 9 Population Estimates and Projections, Newfoundland and Labrador, 1986-2038

Notes: The fast-aging scenario contains the following assumptions at the Canada level: the total fertility rate reaches 1.40 children per woman in 2042-43 and remains constant thereafter; life expectancy at birth reaches 88.0 years for males and 91.3 years for females in 2067-68; interprovincial migration is based on the trends observed between 1991-92 and 2016-17; the immigration rate reaches 0.65 percent in 2042-43 and remains constant thereafter; the annual number of non-permanent residents reaches 1,080,910 in 2043 and remains constant thereafter; the net emigration rate reaches 0.18 percent in 2042-43 and remains constant thereafter.

The slow-aging scenario contains the following assumptions at the Canada level: the total fertility rate reaches 1.79 children per woman in 2042-43 and remains constant thereafter; life expectancy at birth reaches 85.6 years for males and 88.8 years for females in 2067-68; interprovincial migration is based on the trends observed between 1991-92 and 2016-17; the immigration rate reaches 1.08 percent in 2042-43 and remains constant thereafter; the annual number of non-permanent residents reaches 1,944,400 in 2043 and remains constant thereafter; the net emigration rate reaches 0.13 percent in 2042-43 and remains constant thereafter.

Sources: Newfoundland and Labrador, Department of Finance, Economic and Project Analysis Division; and Statistics Canada: for 1986-2019, table 17-10-0005-01, “Population Estimates on July 1st, by Age and Sex”; for 2020-2038, table 17-10-0057-01, “Projected Population, by Projection Scenario, Age and Sex, as of July 1 ($\times 1,000$).”

FIGURE 10 Sources of Provincial Revenues, Newfoundland and Labrador, 1994-95 to 2017-18

Source: Newfoundland and Labrador, Department of Finance, *Public Accounts* (1994-2018) (St. John's: Department of Finance, various years).

tax revenues; in 2017-18, it contributed just over 20 percent of total revenues. Two factors give cause for concern with respect to the prediction of provincial revenues over the medium term. First, as illustrated in figure 11, the number of jobs in the construction industry is falling and perhaps returning to historical levels. In the peak year, 2015, employment in this industry represented just over 14 percent of total employment in the province.²² The jobs in electric power engineering construction are associated with the Muskrat Falls hydroelectric dam and the Labrador to Newfoundland transmission line. These jobs pay well, but both projects are nearing completion. As they come to an end over the next two years, some workers will likely move out of the province while others may remain and take lower-paying jobs (if these are available).

The second factor of concern is the aging population. Figures 12 and 13 help to illustrate the potential problem. Figure 12 shows the average levels of provincial

22 Statistics Canada table 36-10-0480-01, "Labour Productivity and Related Measures by Business Sector Industry and by Non-Commercial Activity Consistent with the Industry Accounts."

FIGURE 11 Construction Industry Jobs by Sector, Newfoundland and Labrador, 2000-2018

Source: Statistics Canada table 36-10-0480-01, "Labour Productivity and Related Measures by Business Sector Industry and by Non-Commercial Activity Consistent with the Industry Accounts."

income tax payable by age group for selected years between 2000 and 2018. The pattern is expected and may be reassuring, given the large increase between 2016 and 2018 for individuals in their prime earning years (ages 40-59). However, we note the sharp drop in average taxes payable for the 65-69 cohort compared to the 60-64 cohort; our estimate shows a decrease from \$4,850 to \$2,320 (not quite 50 percent). Figure 13 illustrates the demographic wave. Currently, the largest age cohort is the group of individuals aged 60-64. Many of these individuals are expected to retire in the next five years, and the vast majority will have retired by the end of the next decade. Increased efficiencies and technological change, along with increased competition for a dwindling core-age labour force, suggest that Newfoundland and Labrador will have a relatively smaller population of wage earners in the near term.

The other side of the treasury coin is that individuals receive transfers from government. However (as shown in figure 14), the bulk of the transfer burden, primarily for older adults (aged 65+), falls on the federal government, with payments through the Canada Pension Plan, old age security (OAS), and the guaranteed income supplement (GIS). Income support transfers by the provincial government basically disappear for those aged 65+ in the presence of the federal transfers of OAS and GIS, as do workers' compensation payments for retirees.

FIGURE 12 Average Provincial Income Tax Payable by Age Cohort, Newfoundland and Labrador, Selected Years, 2000-2018

Source: Simulations using Statistics Canada, Social Policy Simulation Database and Model (SPSD/M), v. 27.1, September 2019.

FIGURE 13 Distribution of Population by Age Cohort, Newfoundland and Labrador, Selected Years, 2000-2018

Source: Simulations using Statistics Canada, Social Policy Simulation Database and Model (SPSD/M), v. 27.1, September 2019.

FIGURE 14 Average Federal and Provincial Transfers per Capita, by Age of Recipient, Newfoundland and Labrador, 2019

Source: Simulations using Statistics Canada, Social Policy Simulation Database and Model (SPSD/M), v. 27.1, September 2019.

Given the employment and demographic trends outlined above, the question is whether the provincial government can alter the cards it is dealt in terms of personal income taxes. The brief answer is, “Probably not.” The province’s current personal income tax rates are generally in line with those in other provinces. Moreover, the provincial government has promised not to raise taxes. The challenge for the government may be to keep wealthier taxpayers in the province, since this group is often the most mobile.

It should also be noted that many workers in the provincial public sector effectively have their base wages frozen, except for step increases, until 2020 as part of “no-layoff” agreements with public sector unions. In conclusion, the most likely medium-term scenario is that personal income tax revenues will fall.

Sales taxes are the second most important source of tax revenue for the provincial government. Figure 15 shows the general upward movement of both personal income tax and sales tax revenues in the 2010–2017 period. This trend began with the recovery after the 2008 financial crisis, followed by some tax increases. Sales taxes in Newfoundland and Labrador, like income taxes, are now in line with those in the other Atlantic provinces. Further increases seem unlikely in the short run, given regional harmonization of tax rates and political promises. It is interesting to note that Newfoundland and Labrador’s Department of Finance has estimated that future revenues from these two tax sources are not expected to be quite as high as the recent historical levels. Our instinct is that these two sources of revenue will decline in nominal and real (inflation-adjusted) terms. At the same time, we acknowledge that it is extremely difficult, if not impossible, to predict revenues beyond a

FIGURE 15 Personal Income and Sales Tax Revenues, Newfoundland and Labrador—Actual, 1994-95 to 2017-18, and Forecasted, 2018-19 to 2019-20

Sources: For actual revenues, Newfoundland and Labrador, Department of Finance, *Public Accounts* (St. John's: Department of Finance, various years); for forecasted revenues, Newfoundland and Labrador, Department of Finance, *Estimates* (St. John's: Department of Finance, 2019).

few years with any accuracy. Planning for debt sustainability therefore requires prudent, longer-term, risk management.

With respect to personal taxes, another observation is interesting and relevant. While most of us acknowledge and complain about the wide variety of personal taxes that we pay, we tend to be less aware of the transfers we receive. Our simulations using Statistics Canada's SPSPD/M 27.1 program²³ estimate that for 2019 just over one-half (50.5 percent) of all households in Newfoundland and Labrador are net contributors to the federal and provincial governments. Our calculations include all direct taxes, such as personal income taxes, and all indirect commodity taxes, such as general sales taxes and gasoline taxes. The percentage of net contributors varies by family type; for example, about 8.7 percent of single elderly individuals are net contributors, compared to 80.5 percent of married non-elderly individuals with no children living at home. The top 5 percent of households in the province, by total income, will contribute about 27.4 percent of all direct taxes in 2019. Whether or not the tax burden could be increased is a value judgment. However, there is likely to be resistance to any proposal to raise taxes, as evidenced by the current concern

23 Social Policy Simulation Database and Model.

over an increase in household electricity rates to assist in covering the costs associated with the Muskrat Falls project.

The great hope on the revenue side lies with potential oil royalties. The rationale for such hope can be seen in figures 16 and 17. From 2005-06 to 2012-13, oil prices and production levels were high, and the jewel in the Exxon-Mobil crown, Hibernia, had unexpectedly reached payout (that is, the consortium had recovered its asset costs associated with the offshore platform). With relatively low operating costs per barrel and high prices in US dollars for Brent oil, profits and royalties were high. Forecasting oil royalties can be a risky business. While the general discussion revolves around demand and supply, evoking images of competitive market forces, non-competitive and geopolitical forces also play a formative role, as does rapidly changing technology. One only has to consider the change in market prices in September 2019.

The prospect of substantial oil field development in the years ahead appears promising. Oil fields in the region are often in deeper water, implying higher production costs and risk. The question is, if new viable discoveries are made, when will these fields come into production, and how much will the oil be worth on the market over their lifetime? The Canadian picture has become more complicated with the changes to the regulatory environment enacted by Bill C-69.²⁴ In our view, it is unlikely that new development and production (excluding the White-Rose extension, the development of which is under way), will occur before 2030. This perspective seems to be consistent with that of the federal and provincial governments, as reflected in federal gap funding to be made available under a revised Atlantic accord.

Could royalty rates be increased for existing projects? We think not, given that these rates are set before development occurs and, when the government is not the primary developer, are subject to international competitive forces. Because of changing technology with respect to production and development, as well as the potential for falling prices, supply-side stakeholders have become and will continue to be more cost-conscious. The implication is that there will be a reduction in the economic benefits to the province during the development stage—for example, through new construction jobs or more business for local suppliers—compared to projects undertaken in the recent past.

In conclusion, on the revenue side of the government's future financial statements, there is not much room for manoeuvring with respect to the province's own revenue sources in the medium term. Given our earlier observations on the aging population, the winding down of large resource-development projects, and out-migration, we are in accord with projections that traditional revenue sources might decline. However, we acknowledge the adjusted revenue inflow from the federal government through the Atlantic accord. The issue is the rate and duration of

24 Bill C-69, An Act To Enact the Impact Assessment Act and the Canadian Energy Regulator Act, To Amend the Navigation Protection Act and To Make Consequential Amendments to Other Acts, SC 2019, c. 28, royal assent June 21, 2019.

FIGURE 16 Royalty Payments to the Government of Newfoundland and Labrador—Actual, 1994-95 to 2017-18, and Forecasted, 2018-19 to 2019-20

Sources: For actual payments, Newfoundland and Labrador, Department of Finance, *Public Accounts* (St. John's: Department of Finance, various years); for forecasted payments, Newfoundland and Labrador, Department of Finance, *Estimates* (St. John's: Department of Finance, 2019).

revenue loss. By our estimation, a number of factors could accelerate the decline around 2022—though we reiterate our caution about the reliability of predictions extending beyond the next three or four years. The variability is evident from figure 18.

On the expenditure side, figure 18 shows that provincial government expenditures have remained remarkably constant in current-dollar terms since about 2014. A conjecture is that expenditures rose when revenues rose (primarily owing to increased oil production).

Perhaps, then, it is easy to understand why some might believe that oil revenues could be the solution to the province's fiscal problems. However, as we have explained earlier in this article, the underlying causes of the present debt situation are complex and thus not amenable to an easy remedy. Moreover, there is public resistance to a reduction in expenditures, in nominal dollars.

As well, the major public-sector unions have negotiated an agreement with the provincial government in which general wages do not increase in return for no layoffs. The agreement is in place until 2020. The result is that real wages adjusted for inflation are falling. Economic theory would predict that, at some point, it will be difficult to attract new entrants into the labour force if wages in other jurisdictions are increasing. The number of provincial civil servants per 1,000 residents is

FIGURE 17 Oil Royalties as a Percentage of Total Provincial Revenues, Newfoundland and Labrador—Actual, 1994-95 to 2017-18, and Forecasted, 2018-19 to 2019-20

Sources: For actual data, Newfoundland and Labrador, Department of Finance, *Public Accounts* (St. John's: Department of Finance, various years); for forecasted data, Newfoundland and Labrador, Department of Finance, *Estimates* (St. John's: Department of Finance, 2019).

higher than is generally the case in other provinces and, in particular, in the neighbouring provinces of New Brunswick and Nova Scotia. The average weekly wages for Newfoundland and Labrador's civil servants are also higher.

A common justification for Newfoundland and Labrador's higher provincial expenditures is that the province has a large rural population that is very spread out. This observation is true, but then so is it true for many other provinces in Canada. To our knowledge, interprovincial cost comparisons have not been carried out specifically for rural areas. The general public may find Newfoundland and Labrador's current expenditure pattern acceptable, since government jobs pay well and there is an urgent need for secure employment in rural areas, where traditional jobs in fishing, fish processing, and logging are in decline. To the extent that the government provides employment opportunities, the argument goes, it may help to slow population decline through outmigration and aging.

The number of individuals in electoral constituencies tends to be lower in rural areas than in urban areas, and correspondingly, the number of voters per rural member of the provincial legislature is relatively low. That fact, coupled with few newcomers in these communities, leads to fewer degrees of separation between the local politician and her or his constituents. Bluntly put, it is hard to close beds in a local hospital when those who need beds may be relatives, friends, or neighbours.

FIGURE 18 Provincial Government Revenues and Expenditures, Newfoundland and Labrador, 1994-95 and 2019-20

Sources: For actual revenues and expenditures, Newfoundland and Labrador, Department of Finance, *Public Accounts* (St. John's: Department of Finance, various years); for adjusted revenues, Newfoundland and Labrador, Department of Finance, *Estimates* (St. John's: Department of Finance, 2019).

The politician is therefore faced with conflicting priorities. Fiscal realities and economic efficiency may play second fiddle to sociopolitical considerations.²⁵ Often, rural communities are defined by the presence of a school or a community health centre.

The above observations do not solve the fiscal sustainability problem, but they may help to explain the province's procrastination in dealing with it. While kicking the can down the road may not be the best solution from an economic perspective, it may be the only solution from a political perspective.

The new entrant into the fiscal room is the Muskrat Falls hydroelectric project. The problems associated with this project are not unique to the province, but they are representative of its history. While the final construction costs associated with Muskrat Falls can be estimated, the future revenues cannot. Even in the short run, the revenues from users are unlikely to cover the legally required cash outlays. Is the

25 In our opinion, it was probably these considerations that caused the current government to abandon its previous proactive, deficit-reducing strategy when the former finance minister, Cathy Bennett, resigned in July 2017; the government adopted a new, passive approach under the current finance minister, Tom Osborne.

project sustainable? It may be, with an infusion of cash from investors or from a saviour.

Normally, any analysis of fiscal sustainability involves invoking GDP, such as the debt-to-GDP ratio. While such an approach may have loose validity when the factors of production and associated incomes are internally held, and perhaps the debt is also, the Newfoundland and Labrador economy does not fit this traditional mould. The economy is very open, with natural resource exports playing a large role in final goods output. Specifically, over the past couple of decades, oil production has been of increasing importance, but has fallen off since 2008. Moreover, oil royalty regimes are determined before development projects are approved. The implication is that the provincial government has little ability to alter the capture of incomes generated by oil sales. In a similar manner, justifying public goods expenditures by reference to percentages of GDP, rather than population, makes little sense in a situation where much of the economic output is generated by capital-intensive natural resource industries predominantly owned by non-residents.

CONCLUSION

In summary, while Newfoundland and Labrador's future looks bright if the province's natural resources and the associated rents are properly managed, the coming decade will be a challenge. There is a fiscal deficit gap to be dealt with. The government's current strategy seems to be "steady as she goes," combined with warnings about future expenditure reductions and the promise of future balanced budgets. For the reasons outlined in this article, we believe that the government's objectives will be very difficult to achieve over the next decade. Another part of the current strategy is the implicit understanding that the federal government will produce an innovative intervention. Such interventions are not new to the province, nor to the former dominion. The prospect of default on the debt of the Dominion of Newfoundland during the Great Depression in November 1932 resulted in the establishment of a commission of government in 1934, in which seven members were representatives of the British government and three were from Newfoundland. The commission's mandate was to govern in such a way as to produce a sustainable and efficient public sector. A second intervention occurred after the declaration of a northern cod moratorium by the federal government in July 1992. The northern cod adjustment and replacement program was instituted to provide income support to processors and fish harvesters who lost income because of the moratorium. The federal government's guarantee on bonds issued to finance the Muskrat Falls project, as well as its recent infusion of front-end funding to the province under the Atlantic accord, contributes, we believe, to a general understanding of a federal backstop, or a saviour, should fiscal unsustainability become a reality. In such event, the question is whether the federal government would impose conditions on the provincial government in exchange for its financial support. Our casual belief is that there would be no explicit conditions. One confounding observation is that currently the revenue per capita of the government of Newfoundland and Labrador is

the highest of any province; thus, Newfoundland and Labrador is a “have” province and consequently denied access to equalization funds under current arrangements.

Our final thought is that the province’s fiscal situation may not be sustainable in the medium term. The government’s current strategy is to maintain expenditures, in nominal terms, as well as the existing tax structure, while looking to Ottawa for medium-term assistance (as evidenced by recent adjustments to the Atlantic accord). As we have noted, history has demonstrated the success of this strategy. What history has not previously shown is Newfoundland and Labrador as the richest “have” province in Canada. In the longer term, the belief is that the province’s saviour is to be found in its recent past experience and the hope of its future repetition with major oil discoveries and high oil prices. Without a saviour, the path is clear: Another year older and deeper in debt. Rather than waiting for Godot, who never arrives, the province hopes that its fiscal saviour will come soon.

Policy Forum: Is New Brunswick Heading over the Fiscal Cliff?

Richard Saillant and Herb Emery*

PRÉCIS

Cet article examine le bilan financier récent du Nouveau-Brunswick et les grandes tendances susceptibles de façonner sa trajectoire dans les années à venir. La situation financière du Nouveau-Brunswick s'est considérablement érodée au cours de sa « décennie perdue », de 2007-08 à 2016-17. Pendant cette période, les gouvernements qui se sont succédé à la tête de la province ont obtenu de piètres résultats, tant en termes absolus que par rapport aux autres provinces maritimes, dans leur adaptation aux chocs majeurs qui ont beaucoup nui à la croissance des recettes de la province. La capacité du gouvernement de générer des recettes restera probablement limitée dans l'avenir, tandis que les pressions en matière de dépenses en soins de santé s'accroîtront avec le vieillissement rapide de la population. Les auteurs concluent que, d'une manière critique, l'avenir financier du Nouveau-Brunswick n'est peut-être plus entre ses mains, mais entre les mains de provinces plus riches ayant une population plus jeune et celles du gouvernement fédéral.

ABSTRACT

This article examines New Brunswick's recent fiscal track record and major trends likely to shape its trajectory in the years ahead. New Brunswick's fiscal position eroded considerably over its "lost decade," from 2007-08 to 2016-17. During this period, the province's successive governments performed poorly—both in absolute terms and relative to the other maritime provinces—in adjusting to major shocks that seriously impaired revenue growth. Looking forward, the government's revenue-generating capacity is likely to remain constrained, while health-care spending pressures will mount with a fast-aging population. The authors conclude that, in a critical way, New Brunswick's fiscal future may no longer be in its own hands, but in the hands of richer provinces with a younger population, and the federal government.

KEYWORDS: FISCAL PLANNING ■ REVENUE ■ SPENDING ■ EQUALIZATION ■ ECONOMIC DEVELOPMENT
■ NEW BRUNSWICK

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INTRODUCTION

In November 2007, New Brunswick premier Shawn Graham announced his vision to make the province “self-sufficient” within two decades.¹ To outside observers accustomed to equating success in the global economy with interdependence and collaboration, Graham’s call for self-sufficiency must have sounded puzzling, if not downright retrograde. Yet, in New Brunswick, there was little ambiguity about what the premier had in mind when he used this term. To most New Brunswickers, self-sufficiency meant reversing the province’s status as a perennial “have-less,” a laggard that depends on handouts from Ottawa. It also meant restoring pride by making the province a place where people would come to visit not just their grandparents, but also their grandchildren.² Finally, self-sufficiency meant no longer relying on Bay Street and Wall Street to make ends meet each year. On this last count, New Brunswick had been doing quite well in the years prior to Graham’s announcement. Since the turn of the millennium, the government had posted a surplus in all but two fiscal years. Net debt, which had doubled in the 1990s, had stopped growing. And with the economy going strong, the ratio of debt to gross domestic product (GDP) was on a firm downward trajectory, dropping from 33 percent in 2000-01 to 25 percent in 2006-07.³

New Brunswick’s motto is “*Spem reduxit*,” which can be loosely translated as “Hope restored.” Given how well the province had fared since the turn of the millennium, Graham no doubt felt that New Brunswick might at last achieve its longstanding dream of self-sufficiency. As it turned out, fate had different plans: ironically, the province’s economy and finances began to nosedive almost immediately after the premier made his announcement, entering what can aptly be called a “lost decade,” which stretched over fiscal years 2007-08 to 2016-17. During this

1 New Brunswick, Office of the Premier, “Release of Our Action Plan To Be Self-Sufficient in New Brunswick,” *News Release NB 1522*, November 23, 2007.

2 Donald J. Savoie, *Visiting Grandchildren: Economic Development in the Maritimes* (Toronto: University of Toronto Press, 2006).

3 Data on fiscal position from Canada, Department of Finance, *Fiscal Reference Tables 2018* (Ottawa: Department of Finance, October 2018) and data on GDP from Statistics Canada table 36-10-0222-01, “Gross Domestic Product, Expenditure-Based, Provincial and Territorial, Annual.”

period, the government recorded nine consecutive deficits, nearly doubling its net debt along the way. And with the economy in the doldrums, the debt-to-GDP ratio shot up dramatically, from 25 percent in 2007-08 to a peak of 40 percent in 2016-17.

Comparing New Brunswick with its sister maritime provinces, Prince Edward Island and Nova Scotia, reveals the sheer magnitude of New Brunswick's fiscal nosedive. As table 1 shows, New Brunswick stands out as the clear leader for debt growth among the three provinces from 2007-08 to 2016-17. On a per capita basis, net debt grew by 91 percent, compared to 51 percent in Prince Edward Island and 22 percent in Nova Scotia. The debt-to-GDP ratio tells a similar story, with New Brunswick registering the sharpest gain and moving from the lowest ratio among the three provinces in 2007-08 to the highest in 2016-17.

In Atlantic Canada, it is perhaps only comparison with Newfoundland and Labrador that can give New Brunswick some fiscal solace. However, comparing these two provinces is a challenging task. A first difficulty is that Newfoundland and Labrador's fortunes are now inextricably tied to the price of a single commodity (oil), and this injects a high degree of volatility into the province's fiscal outcomes. For instance, if the time frame in table 1 were pushed ahead one year (that is, to the period 2008-09 to 2017-18), the numbers would show that Newfoundland and Labrador grew its debt about as fast, rather than a third as fast, as New Brunswick.

A second difficulty relates to the debt carried by NB Power and Nalcor Energy, the electric utilities owned, respectively, by the governments of New Brunswick and of Newfoundland and Labrador. Between 2007 and 2019, Nalcor grew its liabilities by a factor of 10, from \$1.3 billion to \$13.0 billion,⁴ as it struggled with the escalating cost of the Muskrat Falls hydroelectric generation and transmission project. NB Power, for its part, although also heavily indebted (with total liabilities of \$5.3 billion as of March 2019), did not grow its debt nearly as much.⁵ As a result, if one focuses on the growth in provincial debt backed by taxpayers rather than net debt alone, it becomes clear that Newfoundland and Labrador saw its fiscal situation deteriorate much faster than New Brunswick's.

Of note, NB Power and Nalcor are considered "self-supporting" for accounting purposes; consequently, their liabilities are not rolled into consolidated provincial accounts. In practice, however, both are albatrosses around their owners' fiscal necks. The government of Newfoundland and Labrador has recently recognized that Nalcor is not self-supporting. On April 15, 2019, just before triggering an election, the Ball government announced a plan to shift a major part of the burden of the extra costs of power generation at Muskrat Falls (estimated at \$726 million for the first full year of operation) from ratepayers to taxpayers.⁶ In New Brunswick,

4 Nalcor Energy, *2019 Q1 Financial Report* (for period ending March 31, 2019) (St. John's: Nalcor Energy, 2019) and *2008 Business and Financial Report* (St. John's: Nalcor Energy, 2008).

5 NB Power, *2018/19 Annual Report* (Fredericton: NB Power, 2019) and *2010/11 Annual Report* (Fredericton: NB Power, 2011).

6 Newfoundland and Labrador, Executive Council, "Premier Ball Releases Plan To Protect Residents from the Cost Impacts of Muskrat Falls," *News Release*, April 15, 2019.

**TABLE 1 Growth in Net Debt in the Four Atlantic Provinces,
Fiscal Years 2007-08 to 2016-17**

	Total		Percent of GDP		Per capita	
	2007-08	2016-17	2007-08	2016-17	2007-08	2016-17
	<i>millions of dollars</i>		<i>percent</i>		<i>dollars</i>	
Newfoundland and Labrador	10,188	13,598	35.1	42.9	20,014	25,684
Prince Edward Island	1,347	2,172	29.1	34.2	9,781	14,779
Nova Scotia	12,116	14,949	35.7	36.0	12,957	15,856
New Brunswick	7,069	13,820	25.0	40.0	9,483	18,104

GDP = gross domestic product.

Source: Canada, Department of Finance, *Fiscal Reference Tables 2018* (Ottawa: Department of Finance, October 2018); Statistics Canada table 17-10-0005-01, "Population Estimates on July 1st, by Age and Sex"; Statistics Canada table 36-10-0222-01, "Gross Domestic Product, Expenditure-Based, Provincial and Territorial, Annual"; and authors' calculations.

the prospect of taxpayers coming to the rescue of NB Power and its ratepayers is less immediate, although concerns about the utility's debt load remain high. In 2016, Standard & Poors, a credit-rating agency, found that NB Power was no longer self-supporting,⁷ a conclusion it reached before NB Power and the government of New Brunswick committed to the refurbishment of the Mactaquac hydroelectric generating station. This project, which is estimated to cost up to \$3.6 billion, will serve only to maintain rather than increase the utility's electricity-generation capacity.⁸ Readers may recall that New Brunswickers could have been relieved of most of NB Power's liabilities had the Graham government not backtracked on a deal to sell the corporation to Hydro-Québec in 2010, amid popular opposition and harsh criticism from none other than Danny Williams, then premier of Newfoundland and Labrador and father of what critics now refer to as "the Muskrat Falls boondoggle."

THE REASONS BEHIND NEW BRUNSWICK'S LOST DECADE

The government of New Brunswick was struck by three major shocks that deeply altered its fiscal landscape toward the end of the 2000s: the 2008 financial crisis and its aftermath, the progressive exit of baby boomers from the labour force, and a sharp decline in federal transfers. However, to understand New Brunswick's lost decade, one has to consider not only these shocks, but also how successive governments responded to them. As we will see, it is the government's responses to these

7 Standards & Poors Global Ratings, "Province of New Brunswick 'A+' Ratings Affirmed on Modest Improvement in Budgetary Performance and Exceptional Liquidity," June 23, 2016.

8 NB Power, "NB Power Recommends Life Achievement Option for Mactaquac Generating Station," *News Release*, December 20, 2016.

shocks, rather than the shocks themselves, that explain why New Brunswick fared so much more poorly than the other maritime provinces, and Nova Scotia in particular.

The 2008 Financial Crisis and Its Aftermath

New Brunswick was hit hard by the 2008 financial crisis and its aftermath because of the province's high trade exposure, particularly to the US market. The Graham government, like the federal government and other provincial governments, resorted to Keynesian means to stimulate the economy and limit the negative effects of the US recession. Those included record spending on infrastructure and tax reductions for both individuals and corporations.⁹

The Progressive Exit of Baby Boomers from the Labour Force

New Brunswick, like the rest of Atlantic Canada, has a much larger share of baby boomers in its population than the country as a whole. For about 10 years now, baby boomers have been retiring in droves. Largely as a result of this phenomenon, Canada's labour force growth has slowed down materially, from a long-term average (1981-2010) of 1.4 percent to 0.9 percent from 2010 to 2018.¹⁰ Yet Canada's slowdown is quite mild compared to that in New Brunswick, where the labour force dropped from a long-term average growth rate of 1.0 percent to an actual *decline* of 0.3 percent.¹¹ This recent divergence in labour force growth is clearly reflected in economic data. Between 1981 and 2010, in terms of GDP, Canada and New Brunswick grew at roughly the same annualized pace (2.4 percent and 2.2 percent, respectively); by contrast, from 2010 to 2017, Canada grew more than five times faster than New Brunswick (2.1 percent versus 0.4 percent).¹²

Slower Growth in Federal Transfers

New Brunswick relies on federal transfers for 35 percent of its revenues, the second-highest ratio (after Prince Edward Island) among the 10 provinces.¹³ During New Brunswick's lost decade, federal transfers grew on average by 1.6 percent, below the rate of inflation; by contrast, from 2000-01 to 2007-08, they grew on average by 6.1 percent.¹⁴ Overall, had transfer growth remained unchanged, New Brunswick would have received a cumulative total of over \$4 billion more in payments than it actually did.

9 New Brunswick, Department of Finance, 2009 Budget, Budget Speech, March 17, 2009.

10 Statistics Canada table 14-10-0018-01 (Archived), "Labour Force Characteristics by Sex and Detailed Age Group, Annual."

11 Ibid.

12 Statistics Canada table 36-10-0222-01, *supra* note 3.

13 *Fiscal Reference Tables 2018*, *supra* note 3.

14 Ibid.

There are many reasons for this sharp drop in federal transfers. One reason is that transfers to all provinces had been growing at an unsustainable pace in the years leading up to the financial crisis. From 2000-01 to 2007-08, total major federal transfers doubled, from \$23 billion to \$46 billion. In annualized terms, this amounts to a growth rate of 9.3 percent, nearly three times the rate of growth in Ottawa's revenues (3.4 percent).¹⁵

A second reason is the changes to the allocation formula for the Canada social transfer (CST) and the Canada health transfer (CHT). Until 2007, funding allocated under these two transfers and their predecessors took into account the value of tax points transferred to provinces by the federal government in earlier decades. Since tax points are worth less to poorer than richer provinces, Ottawa provided less cash funding to the latter so that overall funding (cash plus value of tax points) to all provinces would be equal on a per capita basis. Starting in 2007-08, the value of tax points was no longer taken into account in calculating CST payments; consequently, all provinces started to receive the same per capita cash amount. Furthermore, the government fixed the growth in total CST payments at 3 percent annually. This did not mean that all provinces would see their payments under the transfer grow by 3 percent each year; rather, slow-growing provinces would receive less, while faster-growing ones would get more. For example, from 2010-11 onward, payments to New Brunswick grew by 2.2 percent annually compared to 3.7 percent for Alberta. As for the CHT, the shift to a per capita cash allocation took place in 2014-15; and, starting in 2017-18, total payment growth was changed from a fixed rate of 6 percent to the rate of growth in nominal GDP, with a floor of 3 percent.

A third and final reason for the decline in federal transfers to New Brunswick is the radical changes to the equalization program carried out by Ottawa in 2009, to shield itself from the consequences of Ontario's qualification for payments. Given its size, Ontario's inclusion as a recipient province threatened to produce a dramatic escalation in program costs. To avoid this, the federal government capped the growth in total equalization payments at the rate of growth in Canadian nominal GDP. This was a fundamental change to the architecture of the program. Previously, the total amount spent on equalization had not been determined in advance; rather, it was a variable sum whose level depended on disparities in fiscal capacities among provinces. With the 2009 reform, equalization became like a pie that, at best, grows in size in tandem with the national economy, and is then shared among recipient provinces. Making room for Ontario (which, at one point, received up to 20 percent of total equalization funding) meant that there was less money available to traditional recipients such as New Brunswick. As a result, between 2009-10 and 2015-16, equalization payments to New Brunswick *declined* on average by 0.2 percent annually—the most important multi-year drop since the establishment of the program in 1957. By contrast, from 2000-01 to 2008-09, payments to New Brunswick grew by 5.6 percent annually.

15 Ibid.

New Brunswick's Response to a New Era of Slow Revenue Growth

The financial crisis and its aftermath, the progressive exit of baby boomers, and the sharp slowdown in federal transfer growth dealt a serious blow to the New Brunswick government, crippling the revenue side of its ledger. Yet New Brunswick is not the only province to have faced such major setbacks. Nova Scotia, for example, found itself in similar circumstances but managed to produce much better fiscal outcomes. Why?

To answer this question, one must identify the differences in policy choices made by the two governments. At the outset, however, it is important to stress that New Brunswick did not systematically underperform on all counts by comparison with Nova Scotia. In at least one key area—program spending—New Brunswick displayed significantly greater discipline. Indeed, when revenue growth plummeted at the turn of the 2010s, both Nova Scotia and New Brunswick managed to reduce their spending considerably, but New Brunswick did a better job. Between 2010-11 and 2015-16, New Brunswick limited its growth in program spending to 1.2 percent, well below the rate of inflation. Nova Scotia, for its part, increased its spending by 2.8 percent, a rate roughly in line with the average for provincial and territorial governments in Canada.¹⁶

That said, there are three main reasons for Nova Scotia's superior fiscal outcomes. First, the province increased taxes much sooner than New Brunswick. In 2010, the New Democratic Party government, led by Darell Dexter, announced a 2 percentage point increase in its portion of the harmonized sales tax (HST), thus becoming the first provincial government to fully scoop up the fiscal room vacated by the federal government when it lowered the goods and services tax (GST) by 1 percentage point in each of 2006 and 2008. New Brunswick followed suit six years later. We estimate that by waiting that long to return the HST to its pre-2006 level, the New Brunswick government forewent a cumulative total of approximately \$1.6 billion in revenues.¹⁷

Second, in no small part because it increased taxes sooner, Nova Scotia ran fewer and smaller deficits. Between 2007-08 and 2016-17, Nova Scotia's accumulated deficit (the sum of annual deficits and surpluses) stood at \$473 million, a small amount compared to New Brunswick's \$3.3 billion. And since Nova Scotia did not borrow as much extra money as New Brunswick, when interest rates decreased, its

16 Ibid.

17 Authors' calculations based on the average of HST revenues from 2009-10 to 2011-12 and nominal GDP growth over the 2010-2016 period. Of note, net forgone revenues would likely have been lower by about 25 percent given that, when New Brunswick ultimately raised its HST rate, it provided a tax credit to offset the impact of the increase for low income earners. Data on HST revenues are taken from New Brunswick, Office of the Comptroller, *Public Accounts for the Fiscal Year Ended 31 March 2011*, vol. 2 (Fredericton: Office of the Comptroller, 2011); data on GDP are from Statistics Canada table 36-10-0222-01, *supra* note 3.

annual debt-servicing charges declined (from \$925 million in 2007-08 to \$824 million in 2016-17), while New Brunswick's grew (from \$576 million to \$667 million). Over time, such differences add up: from 2007-08 to 2016-17, New Brunswick recorded a cumulative increase in debt-servicing charges¹⁸ of \$715 million, while Nova Scotia saw a decline of \$825 million.

Third, Nova Scotia took on fewer of the kind of liabilities that appear immediately on the government's balance sheet but not on the income statement. An example is money borrowed to fund capital projects such as schools, hospitals, or highways. While the capital borrowed for such projects is immediately added to the debt, it is recognized only gradually on the income statement as an annual amortization expense. In New Brunswick, such liabilities reached a cumulative total of \$3.4 billion over the 2007-08 to 2016-17 period, accounting for just over half of the growth in net debt (figure 1). In Nova Scotia, the total was around \$1 billion lower.

THE ROAD AHEAD: IS NEW BRUNSWICK HEADING OVER THE CLIFF?

The economist Ron Kneebone has examined New Brunswick's fiscal management over the period from 1981-82 to 2016-17.¹⁹ His analysis suggests that New Brunswick's lost decade (2007-08 to 2016-17) stands in sharp contrast to its longer-term track record. Indeed, Kneebone found that from 1981-82 to 2007-08, New Brunswick's governments were the most successful among the maritime provinces in keeping the operating account more or less in fiscal balance. From 2007-08 to 2016-17, however, the province lost its discipline as successive governments incurred a decade-long string of sizable deficits. Kneebone's findings also suggest that New Brunswick's sharp fiscal deterioration was primarily induced by policy decisions rather than cyclical conditions, with the ratio of policy-induced to cyclically induced deterioration estimated at 2:1. The exact meaning of this ratio is debatable, since Kneebone's definition of policy-induced fiscal deterioration encompasses everything that is not related to the business cycle, including circumstances beyond New Brunswick's control, such as much slower growth in federal transfers. What is not debatable, however, is that New Brunswick managed its finances much more poorly than the other maritime provinces over its lost decade because it made different policy choices.

New Brunswick's finances have stopped deteriorating in recent years. Since 2017-18, the province's books have shown small surpluses, and in the 2019 budget, the government projected a small decline in net debt, a first since 2006-07.²⁰ Three

18 This refers to the cumulative increase (or decrease) in debt-servicing charges relative to the total amount that would have been paid had charges remained at their 2007-08 levels. Authors' calculations based on data from the *Fiscal Reference Tables 2018*, supra note 3.

19 Ron Kneebone, "Government Finances in New Brunswick" (2019) 1:1 *Atlantic Canada Economic Review* 1-18.

20 New Brunswick, Department of Finance, 2019 Budget, Budget Speech, March 19, 2019, at 6.

FIGURE 1 Growth in Net Debt and Accumulated Deficit, New Brunswick, 2007-08 to 2017-18

Note: The accumulated deficit is a subcomponent of net debt.

Sources: Canada, Department of Finance, *Fiscal Reference Tables* (Ottawa: Department of Finance, various years); and New Brunswick, Finance and Treasury Board, *Public Accounts* (Fredericton: Finance and Treasury Board, various years).

main factors drove New Brunswick's return to fiscal balance. First, on July 1, 2016, the provincial portion of the HST was raised to from 8 percent to 10 percent, thus fully occupying the fiscal room vacated by the federal government when it lowered the GST in 2006 and 2008. Second, between 2015 and 2017, the provincial economy benefited from a "sugar high" after oil prices collapsed, the loonie depreciated sharply, and the Bank of Canada lowered interest rates. Finally, federal transfer growth rebounded strongly after years of stagnation during the first half of the decade.

Looking forward, however, the prospects for revenue growth are much bleaker. The economy stalled in 2018 (with growth of only -0.1 percent),²¹ and forecasters are pointing to a growth rate in the range of 0.5 percent to 1.0 percent for 2019 and 2020.²² As for the longer term, the ongoing exit of baby boomers from the labour

21 Statistics Canada table 36-10-0402-01, "Gross Domestic Product (GDP) at Basic Prices, by Industry, Provinces and Territories."

22 See, for instance, TD Economics, "Provincial Economic Forecast: Economic Growth and Job Markets Diverge in 2019," June 17, 2019 (<https://economics.td.com/provincial-economic-forecast>); RBC Economics, "Momentum Shifting Down in Most Provinces," June 7, 2019 (www.rbc.com/economics/economic-reports/pdf/provincial-forecasts/provfest-jun2019.pdf); and BMO Economics, "Provincial Economic Outlook for August 23, 2019," August 23, 2019.

force should continue to severely constrain New Brunswick's economic growth potential—and thus its own-source revenue growth prospects—for at least another decade. It is not clear that the government has much room to make up for slower own-source revenue growth by raising taxes further or borrowing more. New Brunswick's fiscal burden is already high, particularly in relation to provinces west of the Ottawa River. In 2017, the ratio of provincial taxes to GDP stood at 14.1 percent in New Brunswick, one-third more than Ontario's ratio and twice Alberta's.²³ New Brunswick has high personal tax, provincial sales tax, and property tax rates, and a myriad of other fees and charges. Corporate income tax rates are not out of line with those of other provinces, but only if one ignores the provincial property tax on business, which results in the highest marginal effective tax rates on capital in Canada.²⁴ As for the debt burden, New Brunswick's net debt as a percentage of GDP stood at 39 percent at the end of 2017-18, more than double the (non-weighted) average of the six provinces to the west (19 percent).²⁵

Given the above, barring a dramatic reversal in New Brunswick's economic fortunes or successful efforts to reduce the province's high fiscal burden, the government should not expect own-source revenues to grow much beyond 3 percent annually on average over the next decade. Coincidentally, 3 percent is also a good estimate for what New Brunswick should expect in terms of growth in federal transfer payments under current allocation formulas. Since 2017-18—the year when the new allocation formula for the CHT came into effect—New Brunswick's combined CHT and CST payments have grown by 3.2 percent annually. As for equalization, payments escalated sharply in recent years (up by 6.4 percent 2018-19 and 8.0 percent in 2019-20) as a result of Ontario's gradual exit from the ranks of equalization-receiving provinces.²⁶ However, now that the room vacated by Ontario has been allocated to the remaining five traditional recipient provinces, from this point forward New Brunswick should expect payment growth that is more in line with nominal Canadian GDP growth.²⁷

At issue is whether total revenue growth in the neighbourhood of 3 percent annually will be enough for New Brunswick to address the formidable health-care

23 Authors' calculations based on data from the *Fiscal Reference Tables 2018*, supra note 3, and Statistics Canada table 36-10-0222-01, supra note 3.

24 Adam Found and Peter Tomlinson, *Business Tax Burdens in Canada's Major Cities: The 2018 Report Card*, C.D. Howe Institute E-Brief (Toronto: C.D. Howe Institute, December 11, 2018).

25 Authors' calculations based on data from the *Fiscal Reference Tables 2018*, supra note 3, and Statistics Canada table 36-10-0222-01, supra note 3.

26 *Fiscal Reference Tables 2018*, supra note 3.

27 Recall that overall growth in equalization payments is capped at nominal GDP growth. New Brunswick's future payment growth will depend on a host of factors, including its population growth and the evolution of fiscal capacity gaps among provinces, particularly among individual recipient provinces, in relation to the national standard.

spending pressures resulting from a fast-aging population. If one looks at the historical record, there is some ground for optimism, but even more for skepticism. The case for optimism is based on New Brunswick's recent success in containing spending. Notwithstanding Kneebone's assessment that New Brunswick's record over much of the past decade was one of "fiscal recklessness,"²⁸ the province has proved quite adept at tightly managing health-care spending in recent years. In 2018, real per capita spending on health care was essentially the same as in 2010, despite an aging population that fuelled the demand for services.²⁹

Paradoxically, New Brunswick's recent success in halting spending growth will likely make future success harder to achieve. That is because many of the low-hanging fruits in terms of efficiency savings have likely been harvested. New Brunswick is now in the bottom rungs of Canadian provinces in terms of health-care spending per capita.³⁰ There is also evidence that cost containment measures have had a negative impact on services, with New Brunswick showing some of the highest rates of deterioration in wait times for many procedures, such as hip and knee replacement and cataract surgeries.³¹ With a voting public that is aging fast—the median voting-age New Brunswicker turned 52 in 2018, up five years over the last decade³²—it is unclear to what extent further deterioration in health-care services can be allowed without major consequences at the polls.

There are two other major reasons for skepticism. The first is that New Brunswick has barely seen the tip of the iceberg in terms of spending pressures induced by aging. As figure 2 illustrates, health-care spending increases exponentially as seniors grow older, from around \$6,000 per capita for those aged 65–69 to around \$11,000 and \$23,000, respectively, for those aged 75–79 and 85–89.³³ In 2019, the first baby boomers turned 73. The number of seniors aged 75 and over in New Brunswick is projected to more than double over the next two decades, from 65,000 in 2018 to around 145,000 in 2038.³⁴

28 Kneebone, *supra* note 19, at 13.

29 Real spending calculated using Canadian Institute for Health Information, *National Health Expenditure Trends, 1975 to 2018* (Ottawa: CIHI, 2019), and Statistics Canada table 18-10-0005-01, "Consumer Price Index, Annual Average, Not Seasonally Adjusted."

30 Canadian Institute for Health Information, "Age-Adjusted Public Spending Per Person" (<https://yourhealthsystem.cihi.ca/hsp/inbrief?lang=en#/indicators/014/age-adjusted-public-spending-per-person;/mapC1;mapLevel2;/>).

31 Canadian Institute for Health Information, "Benchmarks for Treatment and Wait Time Trending Across Canada" (<http://waittimes.cihi.ca/>).

32 Authors' calculations based on data from Statistics Canada table 17-10-0005-01, "Population Estimates on July 1st, by Age and Sex."

33 CIHI, *supra* note 29.

34 Statistics Canada table 17-10-0005-01, *supra* note 32, and Statistics Canada table 17-10-0057-01, "Projected Population, by Projection Scenario, Age and Sex, as of July 1," scenario M1.

FIGURE 2 Provincial Health-Care Spending per Capita, New Brunswick, 2016

Source: Canadian Institute for Health Information, *National Health Expenditure Trends, 1975 to 2018* (Ottawa: CIHI, 2019).

The second reason for skepticism relates to the dynamics of provincial health-care spending in Canada. As figure 3 illustrates, historically, New Brunswick's health-care spending has closely tracked the average of Canadian provinces. This reflects, to a large extent, the fact that New Brunswick, like other provinces, must compete with its peers to secure and retain health professionals.³⁵ Figure 3 also shows that spending grew very fast, but did not follow a straight line: moderation in the 1990s was followed by exuberance in the 2000s and a return to moderation in the 2010s. The big question is whether this recent period of moderation will continue indefinitely or, as in the past, will give way to an escalation in spending. To be sure, it is easier to contain spending growth when all provinces are faced with fiscal difficulties of one form or another, as was the case in the 1990s and much of the 2010s. Conversely, it is not a coincidence that health-care spending exploded in the 2000s just as provincial finances recovered amid strong economic growth and the federal government's fiscal largesse. In our view, there are strong grounds to suspect that Canada may be on the cusp of a renewed escalation in health-care spending. Already there are budding signs that spending discipline is weakening, with the Canadian Institute for Health Information (CIHI) reporting an average increase of 4 percent in provincial health-care spending per capita in 2017 and 2018.³⁶ A major driver of this increase was Quebec, where spending increased by

35 See Richard Saillant, *A Tale of Two Countries: How the Great Demographic Imbalance Is Pulling Canada Apart* (Halifax: Nimbus, 2016).

36 CIHI, *supra* note 29 (preliminary data).

FIGURE 3 Real per Capita Provincial Health-Care Spending, New Brunswick and the Canadian Average (All Provinces), 1975-2017

Notes: Per capita spending is in 2002 constant dollars. Spending in 2017 is the forecasted amount.

Sources: Canadian Institute for Health Information, *National Health Expenditure Trends, 1975 to 2018* (Ottawa: CIHI, 2019); and Statistics Canada table 18-10-0005-01, "Consumer Price Index, Annual Average, Not Seasonally Adjusted."

around 5 percent as the government moved to narrow the gap between physician compensation in the province and the national average. Looking forward, competition among provinces for health professionals is likely to intensify as baby boomers continue to age.

Using data from the CIHI on spending by age for 2016³⁷ and assuming general inflation of 2 percent, we estimate that New Brunswick would need to grow its health-care spending by 3.5 percent to 4.0 percent annually over the next 15 years just to meet the spending pressures induced by general inflation and an aging population. New Brunswick might be able to sustain such a pace of growth, albeit with difficulty and considerable restraint in other spending areas; however, it is likely in no position to grow its health-care spending much beyond that level.

That said, not all provinces share New Brunswick's bleak fiscal prospects. West of the Ottawa River, provincial governments have more room to increase taxes, benefit from much stronger economies, and receive faster-growing transfers from Ottawa to provide care for their rapidly expanding ranks of seniors. Thus, those provinces are in a much better position than New Brunswick to compete for health professionals and, if history is any guide, fuel escalating compensation growth.

37 CIHI, *supra* note 30.

In a critical way, New Brunswick's fiscal future and the future of its health-care system are no longer in the province's hands, but in the hands of richer provinces with a younger population. This time around, if other provinces trigger a renewed escalation in health-care compensation, New Brunswick will be in no position to follow suit. Under such a scenario, barring further help from Ottawa, New Brunswick could be faced with the unattractive choice of either heading over the fiscal cliff or providing public services that are inconsistent with the idea of a single, common social citizenship in Canada. In other words, New Brunswick may be about to find out that it is not a self-sufficient island and that its hope for a restored fiscal future will depend on the policy choices of other provinces and Ottawa.

Policy Forum : Dette du Québec — Dompter la bête

Luc Godbout*

PRÉCIS

Le poids de la dette du Québec a fortement évolué depuis 1960. Alors que la dette était pratiquement inexistante avant la Révolution tranquille, elle a été en augmentation quasi constante jusqu'au milieu des 1990, dans la foulée où le gouvernement enregistrait 40 années déficitaires consécutives. Ayant atteint l'un des plus lourds poids d'endettement mesuré en proportion du produit intérieur brut au sein des provinces canadiennes, ayant subi deux décotes rapides de sa cote de crédit par Moody's au milieu des années 1990 et craignant une autre décote, le gouvernement du Québec a posé des gestes pour assainir ses finances publiques.

Après avoir tracé l'évolution de l'endettement du Québec depuis les années 1960, cet article expose succinctement les rouages de deux lois dont le Québec s'est doté afin d'offrir une plus grande transparence des finances publiques dans la gestion de son budget et sa dette. Il s'agit de la Loi sur l'équilibre budgétaire promulguée en 1996 et de la Loi sur le remboursement de la dette et instituant le Fonds des générations, votée en 2006. Par la suite, en dépit des effets de la Grande Récession sur l'atteinte de l'équilibre budgétaire et de ses répercussions sur l'endettement, l'article présentera de quelle manière a évolué la situation budgétaire et financière du Québec en matière d'équilibre budgétaire, d'endettement, d'intérêts sur la dette ou encore de la cote de crédit. Il est maintenant possible d'affirmer que les deux lois votées ont manifestement contribué à améliorer la situation du Québec.

MOT-CLÉS : DETTE ■ DÉFICIT ■ ÉQUILIBRE BUDGÉTAIRE ■ INTÉRÊT SUR LA DETTE ■ COTE DE CRÉDIT ■ FONDS DES GÉNÉRATIONS

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DETTE DU QUÉBEC, DE LA RÉVOLUTION TRANQUILLE À NOS JOURS

Au début des années 1960, la dette du Québec était des plus modestes. Dans le budget du Québec de février 1959, soit à la fin du régime du gouvernement de Duplessis, le ministre des Finances a mentionné que le gouvernement n'a pas « voulu profiter du mouvement général pour emprunter et engager inutilement l'avenir¹ ». Ce qu'il ne savait pas était qu'il allait devenir le dernier ministre des Finances au Québec à présenter un budget équilibré pendant les prochaines quatre décennies.

Les choix politiques faits depuis 1959 ont significativement modifié la situation de l'endettement au Québec. Le premier budget présenté par le gouvernement de Jean Lesage en 1961 marque le coup d'envoi de la Révolution tranquille. Le *Discours du Budget* expose clairement et délibérément comment le gouvernement entend recourir à l'endettement pour moderniser le Québec et combler des retards vis-à-vis d'autres juridictions. On peut y lire que « pour rattraper autant de retards, le gouvernement sera obligé d'emprunter. Il n'est en effet pas juste de faire porter sur la seule génération présente le coût des améliorations durables qui serviront tout autant aux générations futures². »

Au fil des décennies, les déficits budgétaires ont eu pour conséquence un alourdissement de l'endettement. Figure 1 indique diverses phases d'évolution de la dette nette du Québec en proportion du produit intérieur brut (PIB) de 1970 à 2020. Ces changements peuvent être compris dans cinq phases :

1. *Les années 1960 et 1970* : une progression lente, mais constante;
2. *Les années 1980* : une progression rapide dans la première moitié de la décennie suivie d'une stabilisation et d'une modeste tendance à la baisse dans la deuxième moitié;
3. *Les années 1990* : une progression rapide dans la première moitié des années 1990, suivie d'une tendance à la baisse, avec le retour à l'équilibre budgétaire à la fin de la décennie;
4. *Les années 2000* : une poursuite de la tendance à la baisse dans la première moitié de la décennie suivie d'une tendance haussière exacerbée par la crise financière de 2008 et par la Grande Récession qui s'en est suivie;

1 Québec, ministère des Finances, Budget 1959-1960, Discours sur le budget, le 20 février 1959, à la p. 4.

2 Québec, ministère des Finances, Budget 1961-1962, Discours sur le budget, le 14 avril 1961, à la p. 84.

FIGURE 1 Dette nette en pourcentage du PIB, Québec, 1961 à 2017

PIB = produit intérieur brut.

Sources et notes : Dette financière nette de 1970 à 1981 : Statistique Canada tableaux 36-10-0221-01, « Produit intérieur brut, en termes de revenus, provinciaux et territoriaux, annuel », 10-10-0052-01 (Archivé), « Bilan des administrations publiques générales fédérale, provinciales et territoriales et des administrations publiques locales », et 36-10-0325-01 (Archivé), « Produit intérieur brut provincial (PIB), en termes de dépenses, comptes économiques provinciaux, annuel, 1961-1980 ». Dette nette 1981 et après = années financières donc 1981-1982 à 2023-2024 : Comptes publics, Budgets du Québec, diverses années.

5. *Les années 2010* : une légère hausse dans la foulée de la Grande Récession en début de décennie suivie d'une amorce à la baisse à partir du sommet de 2012 allant en s'accéléralant.

Le présent article s'intéresse à la fois au solde budgétaire et à la dette du Québec et explique le contexte des changements qui se sont produits au cours des dernières décennies. Au milieu des années 1990, le gouvernement du Québec a posé des gestes pour assainir ses finances publiques. Il est maintenant possible d'affirmer que deux lois votées, l'une forçant l'équilibre budgétaire et l'autre le remboursement de la dette, ont manifestement contribué à améliorer la situation du Québec.

LA LOI SUR L'ÉQUILIBRE BUDGÉTAIRE ET LA RÉSERVE DE STABILISATION

Le Québec a connu 40 années déficitaires consécutives, de 1958 à 1998, et sa dette accumulée est passée d'une valeur totale de 2,5 milliards de dollars au début

des années 1970 à plus de 100 milliards de dollars en 1998³. Ayant atteint l'un des plus lourds niveaux d'endettement parmi les provinces canadiennes, ayant été décoté par Moody's en 1993 et en 1995 et devant la crainte d'une autre décote, le gouvernement du Québec a réussi, dans la foulée d'un sommet socio-économique, à placer les finances publiques au cœur des discussions et à faire émerger un consensus québécois sur la nécessité de rétablir l'équilibre budgétaire.

Le discours inaugural prononcé par le premier ministre du Québec Lucien Bouchard, à son arrivée à l'Assemblée nationale en 1996, témoigne de la volonté de placer comme priorité « *nationale* » le retour à l'équilibre budgétaire. Il souligne que l'élimination du déficit n'a qu'un seul but : préserver la qualité de vie des femmes et des hommes du Québec, protéger les institutions que le Québec s'est données depuis les années Lesage et prémunir les générations futures contre la dette et la désespérance⁴.

La Loi sur l'équilibre budgétaire⁵ (ci-après « LEB »), adoptée par l'Assemblée nationale à l'unanimité, a pour but de juguler les déficits à répétition, protégeant ainsi la capacité d'agir du gouvernement. En vertu de la LEB, le gouvernement se voit interdire d'encourir un déficit budgétaire⁶ et donc, la LEB impose une contrainte dans la gestion des finances publiques québécoises. Elle régit les opérations financières du gouvernement en l'obligeant à équilibrer les revenus et les dépenses et à afficher un solde budgétaire nul, sauf dans des circonstances particulières. Dans le cas où un déficit apparaît, la LEB prévoit un mécanisme relativement contraignant afin de retourner à l'équilibre budgétaire.

La LEB précise d'une part, que lorsqu'un déficit apparaît, si le montant est inférieur à 1 milliard de dollars, le gouvernement doit, dans l'exercice suivant, produire un excédent équivalant à ce déficit⁷. D'autre part, la LEB mentionne que si le déficit est supérieur à 1 milliard de dollars, il doit être justifié par l'une des conditions spécifiées et être remboursé sur un maximum de cinq ans selon les modalités énoncées⁸ notamment un remboursement d'au moins 1 milliard de dollars la première année et de 75 pour cent du montant total dans les quatre premières années. Les conditions prévues justifiant un tel déficit sont les suivantes⁹ :

- une catastrophe ayant un impact majeur sur les revenus ou les dépenses;
- une détérioration importante des conditions économiques;

3 Québec, ministère des Finances, Budget 2007-2008, Plan budgétaire, le 24 mai 2007, à la p. J-15.

4 Discours inaugural prononcé par le premier ministre du Québec, Lucien Bouchard, à l'Assemblée nationale du Québec, le 25 mars 1996.

5 RLRQ c. E-12.00001.

6 Article 6 LEB.

7 Article 8 LEB.

8 Article 11 LEB.

9 Article 10 LEB.

- une modification dans les programmes de transferts fédéraux aux provinces qui réduirait de façon substantielle les paiements de transferts versés au gouvernement du Québec.

La LEB prévoit également la création d'une réserve de stabilisation¹⁰ à laquelle sont affectées les sommes correspondant à l'excédent budgétaire de chaque année financière. Cette réserve est essentiellement théorique, mais elle sert au maintien de l'équilibre budgétaire; le solde de la réserve est réduit du montant nécessaire à l'atteinte d'un équilibre budgétaire lorsqu'un déficit budgétaire apparaît pour une année donnée. Évidemment, le solde de la réserve de stabilisation ne peut en aucun cas être négatif¹¹.

Annuellement, le ministre des Finances du Québec doit faire rapport à l'Assemblée nationale sur les écarts constatés et sur l'état de la réserve de stabilisation¹². Cet exercice est réalisé dans le cadre du discours budgétaire.

En choisissant de mettre en place la LEB, le Québec s'est inspiré de ce qui se faisait ailleurs, dont dans certaines provinces canadiennes. En 1996, cinq provinces canadiennes avaient déjà mis en place de telles lois soit la Colombie-Britannique, l'Alberta, la Saskatchewan, le Manitoba et le Nouveau-Brunswick¹³. Évidemment, les contraintes de ces lois varient d'une province à l'autre. Par exemple, dans le cas de la Colombie-Britannique¹⁴, la loi spécifie une obligation annuelle d'équilibrer son budget; sinon, des réductions salariales du Conseil exécutif sont prévues sous certaines conditions. Le Québec a plutôt opté pour le remboursement prospectif des déficits budgétaires, le cas échéant.

Comme c'est le cas pour les autres provinces canadiennes, le respect de la LEB s'est avéré impossible lors de la Grande Récession. Le gouvernement du Québec a suspendu temporairement l'obligation d'atteindre l'équilibre budgétaire pour les exercices financiers 2009-10 et 2010-11, et par la suite, un retour graduel à l'équilibre budgétaire en 2014-15 a été prévu.

Est-ce que la LEB a amélioré la situation budgétaire du Québec? Le suivi des changements du solde budgétaire montré au figure 2 suggère que depuis que la LEB existe (la zone grisée), le gouvernement du Québec s'est véritablement soucié d'équilibrer son budget.

10 Article 5.1 LEB.

11 Article 5.1 LEB.

12 Article 15 LEB.

13 Étienne Faravaque, Martial Foucault et Marcelin Joanis, « Les règles budgétaires dans les provinces canadiennes : Nomenclatures et éléments d'analyse » (2012) 88:3 *L'Actualité économique* 281-315 (<https://doi.org/10.7202/1021501ar>); et Stephen Tapp, « The Use and Effectiveness of Fiscal Rules in Canadian Provinces » (2013) 39:1 *Canadian Public Policy — Analyse de politiques* 45-70. (<https://doi.org/10.3138/CPP.39.1.45>).

14 Balanced Budget and Ministerial Accountability Act, SBC 2001, c. 28.

FIGURE 2 Évolution du solde budgétaire, aux fins de la LEB, en pourcentage du PIB, gouvernement du Québec, de 1981 à 2023

PIB = produit intérieur brut.

Source : Québec, ministère des Finances, *Comptes publics*, diverses années.

Dans l'ensemble, et depuis 1996, les soldes budgétaires annuels aux comptes publics du Québec¹⁵ sont demeurés à l'intérieur d'une fourchette variant de plus ou moins 1 pour cent de la valeur du PIB, dispersés autour du point d'équilibre. Depuis 2015-16, le Québec enregistre toutefois des surplus¹⁶. Les soldes budgétaires au sens de la LEB présentent les soldes aux comptes publics, nets des versements au Fonds des générations (discutés dans la prochaine section). En tenant compte des sommes versées au Fonds des générations, le Québec prévoit que le budget sera équilibré pour les années fiscales 2019-20 à 2023-24.

LE FONDS DES GÉNÉRATIONS

La Loi sur la réduction de la dette et instituant le Fonds des générations (ci-après « LDFG »)¹⁷ a été adoptée en 2006 pour une entrée en vigueur en 2007. Lors de sa mise en place, le poids de la dette prenait des proportions inquiétantes

15 Excédent (déficit) aux comptes publics, qui prend en compte la provision pour éventualités.

16 « Le rapport mensuel des opérations financières au 31 mars 2019 », publié en juin par le ministère des Finances (www.finances.gouv.qc.ca/documents/mensuel/fr/MENFR_rmof_13_11.pdf), indique une révision à la hausse du solde de 1,9 milliards de dollars pour 2018-2019, faisant passer l'estimation préliminaire du surplus, après versements au Fonds des générations, mais avant affectation à la réserve de stabilisation, de 2,5 à 4,4 milliards de dollars.

17 RLRQ c. R-2.2.0.1.

aux yeux du gouvernement, surtout par rapport à l'évolution de l'économie. Il signalait que le Québec était au 31 mars 2006, la province canadienne la plus endettée. Le ratio dette totale/PIB s'élevait à 42,7 pour cent, alors que la moyenne canadienne était de 25 pour cent¹⁸. Les intérêts sur la dette étaient le troisième poste en importance dans les dépenses du Québec, après la santé et l'éducation. Ils représentaient 12,7 cents pour chaque dollar de revenus budgétaires en 2005-06¹⁹.

L'objectif central de la LDFG est de réduire la dette en termes relatifs afin de diminuer le transfert intergénérationnel du fardeau de la dette. Pour y parvenir, le gouvernement a créé le Fonds des générations (Fonds). Ultimement ce Fonds doit servir exclusivement au remboursement de la dette et à titre d'instrument de transparence de finances publiques en révélant les sommes que le gouvernement affecte à ce remboursement.

Pour montrer le sérieux de sa démarche, le gouvernement a fait voter une loi afin de s'assurer d'une réduction régulière de la dette selon un plan connu et prévisible, et non au gré des disponibilités budgétaires. C'est pour cette raison que la LDFG indique une cible précise d'endettement à atteindre pour 2025-26; à savoir, le montant de la dette représentant les déficits cumulés ne pourra excéder 17 pour cent du PIB du Québec et la dette brute ne pourra excéder 45 pour cent du PIB²⁰.

Lors de la rédaction de la Loi, il apparaissait difficilement concevable pour le gouvernement d'augmenter les impôts et les taxes pour alimenter le Fonds.

Conséquemment, la LDFG prévoit des sources alternatives de revenus qui sont dédiées à ce fonds, provenant pour l'essentiel d'Hydro-Québec²¹. Outre trois sources de versements provenant d'Hydro-Québec, il y a aussi les revenus miniers; un montant fixe de la taxe spécifique sur les boissons alcooliques; les biens non réclamés; les dons, legs et autres contributions reçus par le ministre des Finances ainsi que bien évidemment, les revenus de placement générés par le Fonds lui-même. Les dispositions de la LDFG précisent également trois autres sources de revenus, même si celles-ci ne génèrent aucun versement pour le moment comme un décret est nécessaire pour préciser la valeur des sommes qui doit être affectée au Fonds²². Ces autres sources sont 1) une partie des bénéfices d'Hydro-Québec découlant de la vente d'électricité à l'extérieur du Québec provenant de nouvelles capacités de production; 2) des redevances sur l'eau captée et 3) des sommes provenant de la vente d'actifs, de droits ou de titres du gouvernement²³.

18 Québec, ministère des Finances, *Le Fonds des générations — Pour favoriser l'équité entre les générations, la pérennité des programmes sociaux et la prospérité* (Québec : ministère des Finances, Mars 2006), à la p. 2. Le concept de dette utilisé était celui de la dette totale. Il a ensuite été remplacé par celui de la dette brute et la dette représentants les déficits cumulés.

19 *Le Fonds des générations*, supra, note 18, à la p. 21.

20 Article 1 LDFG.

21 Article 3 LDFG.

22 Québec, ministère des Finances, Budget 2014-2015, Plan budgétaire, le 4 juin 2014, à la p. H.10.

23 Article 3 LDFG.

Comme pour la LEB, en vertu de la LDFG, le ministre des Finances du Québec doit faire rapport annuellement à l'Assemblée nationale, à l'occasion du discours sur le budget, sur l'évolution de la dette représentant les déficits cumulés et de la dette brute, des sommes portées au crédit du fonds et, le cas échéant, de celles utilisées pour rembourser la dette brute²⁴.

Pourquoi le gouvernement a-t-il créé le Fonds dans lequel des sommes sont versées et qui serviront éventuellement à rembourser une partie de la dette plutôt que de rembourser directement chaque année une partie de la dette à l'aide de revenus dédiés? Une des raisons est la volonté de profiter d'un effet de levier, soit d'un rendement supérieur dans le Fonds que le montant des intérêts payés sur les emprunts du gouvernement. À cet égard, depuis sa création, le rendement annuel du Fonds des générations a dépassé les coûts d'emprunt du gouvernement du Québec 11 années sur 12.

Le tableau 1 trace l'ensemble des revenus dédiés et les revenus de placements, qui ont été payés annuellement au Fonds depuis 2006-07 ainsi que les remboursements de la dette et les projections réalisées par le ministère des Finances jusqu'à l'exercice 2023-24. En outre, il indique des revenus forfaitaires dédiés reçus au fil des années, par exemple, un montant de 300 millions de dollars provenant du Fonds d'information sur le territoire au cours de l'exercice 2013-14.

En ce qui concerne les remboursements de la dette, le Fonds a rendu possible un premier remboursement d'emprunt de 1 milliard de dollars au cours de l'exercice 2013-14²⁵. Un deuxième remboursement d'emprunt de 8 milliards de dollars a eu lieu en 2018-2019 alors qu'en 2019-20 un troisième remboursement de 2 milliards de dollars est prévu²⁶. En dépit des remboursements d'emprunt, la valeur comptable du Fonds est prévue atteindre près de 21 milliards de dollars en 2023-24.

SITUATION ACTUELLE

La situation actuelle des finances publiques du Québec est présentée en matière d'équilibre budgétaire, d'endettement, d'intérêts sur la dette ou encore de la cote de crédit.

Équilibre budgétaire

Près de 25 ans après la mise en place de la LEB, il y a lieu de reconnaître sa contribution au retour de l'équilibre budgétaire du Québec. La LEB semble imposer encore aujourd'hui une contrainte réelle au gouvernement présumant d'un jugement collectif négatif pour un gouvernement ne démontrant pas les efforts nécessaires à vouloir la respecter.

24 Article 11 LDFG.

25 Québec, ministère des Finances, Budget 2013-2014, Plan budgétaire, le 20 novembre 2013.

26 Québec, ministère des Finances, Le point sur la situation économique et financière du Québec, le 3 décembre 2018.

TABLEAU 1 Évolution financière du Fonds des générations

Exercice financier	Revenus dédiés										Autres versements	Versé au Fonds	Versé à la dette	Valeur comptable à la fin
	Valeur comptable au début	Redevances hydrauliques		Indexation du prix de l'électricité	Autres contributions	Revenus miniers	Tax spécifique sur les boissons alcooliques	Biens non réclamés	Revenus de placement	Total				
		Hydro-Québec	Producteurs privés											
millions de dollars														
2006-07	0	65	11		500 ^a	—		5	3	584		584		584
2007-08	584	367	46			161	100	—	36	449	200 ^b	649		1 233
2008-09	1 233	548	88			80	100		—50	587	132 ^c	719		1 952
2009-10	1 952	569	89					7	60	725		725		2 677
2010-11	2 677	560	90					16	94	760		760		3 437
2011-12	3 437	591	91					9	149	840		840		4 277
2012-13	4 277	625	92					12	232	961		961		5 238
2013-14	5 238	670	93					19	339	1 121	300 ^d	1 421	1 000	5 659
2014-15	5 659	660	101	71			100	32	315	1 279		1 279		6 938
2015-16	6 938	641	100	98			100	55	298	1 453	131 ^e	1 584		8 522
2016-17	8 522	678	104	164			80	53	422	2 001		2 001		10 523
2017-18	10 523	695	102	218	215		145	6	412	2 293		2 293		12 816
2018-19	12 816	699	103	258	215		231	500	15	1 085		3 106	8 000	7 922
2019-20	7 922	706	102	305	215		245	500	15	416		2 504	2 000	8 426
2020-21	8 426	736	104	385	215		292	500	15	437		2 684		11 110
2021-22	11 110	751	106	475	215		319	500	15	566		2 947		14 057
2022-23	14 057	786	108	575	215		352	500	15	709		3 260		17 317
2023-24	17 317	809	110	680	215		387	500	15	866		3 582		20 899

Note : Comme il s'agit de nombres arrondis, leurs sommes peuvent ne pas correspondre aux totaux indiqués.

- a Les revenus de 500 millions de dollars en 2006-07 proviennent de la vente de la participation d'Hydro-Québec dans Transelec Chile.
- b Le versement de 200 millions de dollars en 2007-08 a été effectué à même les sommes affectées à la réserve budgétaire en 2006-07.
- c Le versement de 132 millions de dollars en 2008-09 a été effectué à même la réserve de stabilisation et découle de la vente d'actifs de la Société immobilière du Québec.
- d Le versement de 300 millions de dollars en 2013-14 provient du Fonds d'information sur le territoire.
- e Le versement de 131 millions de dollars en 2015-16 provient du surplus cumulé de la Commission des normes du travail.

Source : Québec, ministère des Finances, Budget 2019-2020.

Le gouvernement du Québec estime son surplus budgétaire pour l'année se terminant au 31 mars 2019 à 4,4 milliards de dollars après le versement au Fonds des générations²⁷. Représentant 1 pour cent du PIB au Québec, le figure 3 illustre qu'il s'agit d'une performance enviable à l'égard des autres provinces canadiennes.

De son côté, la réserve de stabilisation ouvrant droit à faire des déficits budgétaires dans les années futures s'élève à 11,6 milliards de dollars au 31 mars 2019.

Endettement

Alors que le ratio dette en proportion du PIB du Québec indiquait une relative tendance haussière depuis trois décennies, on voyait une amélioration dans la foulée de la LEB puis de la LDFG.

Sur une base comparative et illustrative avec l'Ontario, le figure 4 indique qu'après le retour à l'équilibre budgétaire généralisé à la fin des années 1990, la dette nette du Québec en proportion du PIB a suivi une tendance baissière semblable à celle de l'Ontario sans pour autant parvenir à réduire l'écart entre l'Ontario (45,9 pour cent contre 30,6 pour cent en 1997-98, soit 15,3 points comparativement à 16,2 points en 2006-07). L'écart était encore favorable à l'Ontario par 13,7 points en 2012-13, mais a été réduit à quasi-nul en 2018-19. En 2023-24, les prévisions budgétaires indiquent que l'écart de ratio d'endettement sera à l'avantage du Québec par près de 4 points.

Par rapport à l'ensemble des provinces canadiennes, le poids de la dette nette du Québec en proportion du PIB observait un écart à la moyenne de 21,3 points de pourcentage en 2006-07 alors que cet écart n'est plus que de 9,7 points en 2018-19²⁸.

Enfin, sous l'angle de l'atteinte des cibles de la LDFG, l'évolution du poids de la dette brute en proportion du PIB depuis la Grande Récession était de 54,3 pour cent en 2013-14 contre 46,1 pour cent au 31 mars 2019. Au 31 mars 2020, le ratio atteindra 45,3 pour cent, soit grosso modo l'objectif de la LDFG, mais six ans plus tôt que l'exige la loi. L'autre cible, celle du poids de la dette représentant les déficits cumulés en proportion du PIB (17 pour cent) sera atteinte en 2025-26, comme prévue dans la LDFG²⁹.

Intérêt sur la dette

Conséquence d'un endettement plus élevé, le Québec consacrait également un effort plus important au paiement des intérêts sur la dette mesurée en proportion des revenus consolidés.

Même si une part de la baisse du poids du service de la dette s'explique évidemment par la baisse des taux d'intérêt, au moment de l'entrée en vigueur de la LEB en 1996-97, les intérêts sur la dette représentaient 15,7 pour cent des

27 Voir supra, note 16.

28 Québec, ministère des Finances, *Comptes publics*.

29 Québec, ministère des Finances, Budget 2019-2020, Plan budgétaire, le 21 mars 2019, section I.

FIGURE 3 Solde budgétaire en pourcentage du PIB prévu des provinces canadiennes à la fin de 2018-19

PIB = produit intérieur brut.

Note : Il s'agit du solde budgétaire tel que présenté dans les budgets provinciaux sauf pour le Québec. Dans le cas du Québec, le solde est déterminé avant et après le versement au Fonds des générations.

Sources : Budgets des gouvernements provinciaux et « Le rapport mensuel des opérations financières au 31 mars 2019 », publié en juin par le ministère des Finances (www.finances.gouv.qc.ca/documents/mensuel/fr/MENFR_rmof_13_11.pdf).

revenus consolidés au Québec contre 14,8 pour cent en Ontario. En 2017-18, le ratio a chuté dans les deux provinces pour atteindre 8,5 pour cent au Québec et 7,9 pour cent en Ontario³⁰.

Les prévisions budgétaires de mars 2019 indiquent que les intérêts sur la dette mesurée en proportion des revenus consolidés seront en 2023-24 de 7,4 pour cent au Québec et 8,9 pour cent en Ontario.

Cote de crédit

Au tournant des années 1990, pendant que la cote de crédit de l'agence de notation Moody's passait en Ontario de Aa2 à Aa3 en 1995, la cote de crédit du Québec a été deux fois révisée à la baisse de Aa3 à A1 en 1993 et à A2 en 1995. Comme noté précédemment dans cet article, en 1996, avant la mise en place de la LEB, la crainte d'une nouvelle décote était présente.

30 Québec, ministère des Finances, *Comptes publics*.

FIGURE 4 Dette nette en pourcentage du PIB, Québec et Ontario, 1981 à 2023

PIB = produit intérieur brut.

Source : Québec, ministère des Finances, *Comptes publics*, diverses années.

Depuis la mise en place de la LEB et subséquemment de la LDFG, la cote de crédit du Québec s'est améliorée. En 2012, en abaissant la cote de crédit de l'Ontario de Aa1 à Aa2, Moody's se trouvait à placer sur un pied d'égalité la dette du Québec et celle de l'Ontario. Actuellement, la cote du Québec (Aa2) est supérieure au Aa3 obtenu par l'Ontario. Seules trois provinces ont aujourd'hui une meilleure cote que le Québec (Colombie-Britannique, Saskatchewan et Alberta).

Un constat similaire est obtenu en utilisant la notation de Standard & Poor's où depuis 2017, le Québec (AA-) obtient une meilleure note que l'Ontario (A+), une situation jamais observée auparavant en 50 ans.

PERSPECTIVES

À court terme, les perspectives continuent d'être favorables pour les finances publiques du Québec : le plan budgétaire quinquennal projette l'équilibre budgétaire chaque année jusqu'en 2023-24 inclusivement; la dette nette du Québec en proportion du PIB est en décroissance et l'écart de ratio d'endettement en regard de l'ensemble des provinces est également en diminution.

Même si l'économie québécoise roule à plein régime et que les finances publiques apparaissent saines, le gouvernement doit tout de même faire face à l'important défi de la transition démographique. En effet, les plus récentes perspectives démographiques de l'Institut de la statistique du Québec montrent

que la population âgée de 20 à 64 ans — qui a crû de 1,1 million de personnes entre 1981 et 2018 — serait en décroissance de 155 269 personnes entre 2018 et 2030, soit une diminution de ce groupe de 3,1 pour cent. Pendant la même période, en Ontario ce groupe sera en croissance de 0,7 pour cent selon le scénario de projection démographique³¹.

Évidemment, cet élément démographique n'est pas sans conséquence sur la croissance économique. Tirant la plus grande partie de sa force de travail de la population âgée de 20 à 64 ans, le Québec risque d'avoir davantage de difficultés à augmenter sa production, sa richesse et son niveau de vie dans les prochaines décennies. Cette plus faible croissance attendue de l'économie québécoise aura lieu dans le même temps où s'observera une pression accrue sur les coûts de santé associés au vieillissement de la population, entraînant un effet important sur la croissance des dépenses publiques. Par conséquent, l'appariement des revenus et des dépenses des gouvernements risque d'être de plus en plus difficile à réaliser.

Une analyse produite en 2018 par la Chaire en fiscalité et en finances publiques³² de l'Université de Sherbrooke a projeté, basée sur une série d'hypothèses³³, la capacité du gouvernement à maintenir à la fois l'équilibre budgétaire et le niveau d'endettement. L'analyse révèle que, considérant la présence notamment du Fonds, la prochaine décennie tend relativement vers l'équilibre budgétaire et un niveau d'endettement sous contrôle. Cependant, à partir de la fin de la prochaine décennie, les déficits budgétaires tendront à progresser. Ainsi, malgré des hypothèses misant sur l'augmentation des taux d'emploi, sur la croissance de la productivité et sur l'évolution de la technologie dans le domaine de la santé, on s'attend à ce que les finances publiques du Québec soient sous tension à long terme.

À la lumière de cette analyse, alors que l'assainissement des finances publiques depuis le milieu des années 1990 rend le Québec en meilleure posture pour affronter le défi de la transition démographique, les finances publiques et les outils développés au cours des dernières décennies devront encore une fois s'ajuster pour une gestion efficace de l'endettement.

31 Source Québec : Institut de la statistique du Québec, *Perspectives démographiques du Québec et des régions, 2016-2066* (Québec : Institut de la statistique du Québec, 2019), et Statistique Canada tableau 17-10-0005-01, « Estimations de la population au 1^{er} juillet, par âge et sexe »; source Ontario : Statistique Canada, tableau 17-10-0057-01, « Population projetée, selon le scénario de projection, l'âge et le sexe, au 1^{er} juillet », scénario M1.

32 Yves St-Maurice, Luc Godbout, Matthieu Arseneau et Suzie St-Cerny, *La soutenabilité budgétaire à long terme du Québec, édition 2018. Des défis subsistent*, Cahier de recherche n° 2018-14 (Sherbrooke : Université de Sherbrooke, Chaire de recherche en fiscalité et en finances publiques, novembre 2018).

33 Par exemple, les taux d'emploi par groupe d'âge, la productivité des travailleurs et plusieurs dépenses influencées par la démographie comme les dépenses en santé.

Policy Forum: Quebec’s Debt— Taming the Beast

Luc Godbout*

ABSTRACT

The burden of Quebec’s debt has changed significantly since 1960. While the province incurred very little debt in the years before the Quiet Revolution, its borrowing increased steadily from 1961 until the mid-1990s. By the time the trend was reversed, the Quebec government had recorded a deficit for 40 consecutive years. Having achieved one of the heaviest debt burdens, measured as a share of gross domestic product, among the Canadian provinces, and having seen two rapid downgrades of its credit rating by Moody’s in the mid-1990s, fearing a further downgrade the Quebec government took steps to clean up its public finances.

After outlining the evolution of Quebec’s debt since the early 1960s, this article briefly describes two statutes enacted by the government to provide greater transparency with respect to the province’s finances, enabling better management of its budget and debt. These statutes are the Balanced Budget Act, passed in 1996, and the Act To Reduce the Debt and Establish the Generations Fund, passed in 2006. The article discusses the impact of the Great Recession on the province’s budgetary balance and indebtedness, and shows how Quebec’s financial situation has changed in terms of its fiscal balance, debt, debt interest, and credit rating. It is now possible to affirm that the two statutes adopted by the government have clearly helped to improve Quebec’s fiscal position.

KEYWORDS: DEBT ■ DEFICIT ■ FISCAL PLANNING ■ INTEREST ■ CREDIT ■ QUEBEC

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QUEBEC'S CHANGING DEBT BURDEN, FROM THE QUIET REVOLUTION TO THE PRESENT

In the early 1960s, Quebec had a very low debt level. In the February 1959 provincial budget, at the end of the Duplessis era, the minister of finance stated that the government did not “wish to take advantage of the general movement to borrow and needlessly impact the future [unofficial translation].”¹ Little did he know that he would be the last finance minister in Quebec to table a balanced budget for the next four decades.

Political choices made since 1959 have significantly changed the debt burden in Quebec. The first budget tabled by Jean Lesage's government in 1961 marked the start of the Quiet Revolution. The budget speech clearly and deliberately set out how the government intended to use debt to modernize Quebec and catch up with other jurisdictions. It stated that “to bridge so many gaps, the government will have to borrow. It is not fair to make the present generation alone bear the cost of sustainable improvements that will serve future generations equally well [unofficial translation].”²

Over the decades, fiscal deficits have resulted in mounting debt. Figure 1 shows actual and projected changes in Quebec's net debt as a percentage of gross domestic product (GDP) from 1970 to 2022. These changes can be described as falling into five phases:

1. *the 1960s and 1970s*: a slow but steady increase;
2. *the 1980s*: a rapid increase in the first half of the decade, followed by a leveling off and a modest downward trend in the second half;
3. *the 1990s*: a rapid increase in the first half of the decade, followed by a downward trend, with a return to balanced budgets by the end of the decade;
4. *the 2000s*: a continuation of the downward trend in the first half of the decade, followed by an upward trend aggravated by the 2008 financial crisis and the resulting Great Recession; and
5. *the 2010s*: a slight increase in the wake of the Great Recession at the beginning of the decade, with a downward trend starting from the peak in 2012 and gathering momentum thereafter.

This article examines the burden of Quebec's debt and explains the background to the changes that have occurred over the past decades. In the mid-1990s, the Quebec government took steps to put its financial house in order. It is now clear that two statutes that were enacted, one forcing balanced budgets and the other imposing debt repayment, have clearly helped to improve Quebec's situation.

1 Québec, Ministère des Finances, 1959-1960 Budget, Discours sur le budget (French only), February 20, 1959, at 4.

2 Québec, Ministère des Finances, 1961-1962 Budget, Discours sur le budget (French only), April 14, 1961, at 84.

FIGURE 1 Net Debt-to-GDP Ratio, Actual and Forecasted, Quebec, 1970-2023

GDP = gross domestic product.

Sources: Net financial debt, 1970-1981: Statistics Canada tables 36-10-0221-01, "Gross Domestic Product, Income-Based, Provincial and Territorial, Annual," 10-10-0052-01 (Archived), "Balance Sheet of Federal, Provincial and Territorial General and Local Governments," and 36-10-0325-01 (Archived), "Provincial Gross Domestic Product (GDP), Expenditure-Based, Provincial Economic Accounts, Annual, 1961-1980." Net debt 1981-2022 (fiscal years 1981-82 to 2023-24): Québec, Ministère des Finances, *Public Accounts* and budgets (various years).

THE BALANCED BUDGET ACT AND THE STABILIZATION RESERVE

Quebec ran deficits for 40 consecutive years, from 1958 to 1998, and its accumulated debt rose from a total value of \$2.5 billion in the early 1970s to more than \$100 billion in 1998.³ Grappling with one of the highest debt levels among Canadian provinces, two credit-rating downgrades by Moody's in 1993 and 1995, and fears of a further drop, the Quebec government held a socioeconomic summit during which it managed to place public finances at the top of the agenda and bring about a Quebec consensus on the need to restore fiscal balance.

The inaugural speech of Quebec Premier Lucien Bouchard, upon his arrival in the National Assembly in 1996, reflected the commitment to make returning to balanced budgets a "national" priority.⁴ He stated that eliminating the deficit had only one goal: to preserve the quality of life of Quebec men and women, protect the

3 Québec, Ministère des Finances, 2007-2008 Budget, Budget Plan, May 24, 2007, at J-15.

4 Inaugural speech by the premier of Quebec, Lucien Bouchard, to the National Assembly of Quebec, March 25, 1996.

institutions that Quebec had built since the Lesage years, and save future generations from debt and despair.

The Balanced Budget Act⁵ (“the BBA”), enacted in 1996 and adopted unanimously by the National Assembly, aims to curb recurring deficits, thereby protecting the government’s ability to act. Under the BBA, the government is prohibited from incurring a budget deficit;⁶ as a result, the BBA constrains the management of Quebec’s public finances. It governs the government’s financial operations by requiring it to balance revenues and expenditures and have a zero budget balance, except in special circumstances. In the event of a deficit, the BBA provides for a relatively restrictive mechanism to return to fiscal balance.

First, the BBA states that when a deficit appears, if the amount is less than \$1 billion, the government must achieve an equivalent offsetting surplus in the next fiscal year.⁷ Second, the BBA states that if the deficit is greater than \$1 billion, it must be warranted by one of several specified conditions and be repaid over a maximum of five years in accordance with a set schedule—namely, repayment of at least \$1 billion in the first year and 75 percent of the total amount in the first four years.⁸ The conditions warranting a deficit of more than \$1 billion are as follows:⁹

- a disaster having a major impact on revenues or expenditures;
- a significant deterioration in economic conditions; or
- a change in federal programs of transfer payments to the provinces that would substantially reduce transfer payments to the Quebec government.

The BBA also provides for the creation of a stabilization reserve¹⁰ to which amounts equal to the budget surplus for each fiscal year are allocated. This reserve is basically theoretical, but it serves to maintain a balanced budget: the balance in the reserve is reduced by the amount necessary to achieve a budgetary balance when a budget deficit appears for a given year. Naturally, the balance of the stabilization reserve cannot be negative under any circumstances.¹¹

The Quebec minister of finance must report to the National Assembly annually on any variance recorded and on the operations of the stabilization reserve.¹² This reporting occurs in the budget speech.

5 CQLR c. E-12.00001.

6 BBA section 6.

7 BBA section 8.

8 BBA section 11.

9 BBA section 10.

10 BBA section 5.1.

11 BBA section 5.1.

12 BBA section 15.

In choosing to implement balanced budget legislation, Quebec drew inspiration from what was being done elsewhere, including in some Canadian provinces. By 1996, five provinces—British Columbia, Alberta, Saskatchewan, Manitoba, and New Brunswick—had already enacted such legislation.¹³ It goes without saying that the constraints of these statutes vary from province to province. For example, in the case of British Columbia,¹⁴ the statute stipulates an annual requirement to balance the budget, barring which Cabinet salary reductions apply under certain conditions. Quebec opted instead for the prospective repayment of any budget deficits.

As in the case of other Canadian provinces, compliance with the BBA proved impossible during the Great Recession. The Quebec government temporarily suspended the requirement to achieve balanced budgets for fiscal years 2009-10 and 2010-11, and subsequently provided for a gradual return to balanced budgets in 2014-15.

Has the BBA improved Quebec's fiscal situation? The tracking of changes in the budgetary balance shown in figure 2 suggests that since the introduction of the BBA (the grey area), the Quebec government has been genuinely concerned about balancing its budget. Overall, from 1996 onward, the annual budgetary balances in Quebec's public accounts¹⁵ have remained within a range of ± 1 percent of GDP, scattered around the point of equilibrium. Since 2015-16, however, Quebec has registered surpluses.¹⁶ Budgetary balances within the meaning of the BBA represent balances in the public accounts net of payments to the Generations Fund (discussed in the next section). Taking into account the amounts paid to the Generations Fund, Quebec expects a balanced budget in fiscal years 2019-20 to 2023-24.

GENERATIONS FUND

The Act To Reduce the Debt and Establish the Generations Fund¹⁷ ("the ADGF") was passed in 2006 and came into force in 2007. When it was enacted, the debt burden was becoming worrisome to the government, particularly in relation to economic conditions. As at March 31, 2006, Quebec was the most indebted province

13 Étienne Faravaque, Martial Foucault, and Marcelin Joanis, "Les règles budgétaires dans les provinces canadiennes : Nomenclatures et éléments d'analyse" (2012) 88:3 *L'Actualité économique* 281-315 (<https://doi.org/10.7202/1021501ar>); and Stephen Tapp, "The Use and Effectiveness of Fiscal Rules in Canadian Provinces" (2013) 39:1 *Canadian Public Policy* 45-70 (<https://doi.org/10.3138/CP39.1.45>).

14 Balanced Budget and Ministerial Accountability Act, SBC 2001, c. 28, as amended.

15 Surplus (deficit) in the public accounts, including the provision for contingencies.

16 The "Monthly Report on Financial Transactions: Preliminary at March 31, 2019," released June 19, 2019 by the Ministère des Finances (www.finances.gouv.qc.ca/documents/mensuel/en/MENEN_rmop_13_11.pdf), indicated an upward revision of the \$1.9 billion balance for 2018-19, increasing the preliminary estimated surplus, after payments to the Generations Fund but before allocation to the stabilization reserve, from \$2.5 billion to \$4.4 billion.

17 CQLR c. R-2.2.0.1.

FIGURE 2 Changes in Budgetary Balances as a Percentage of GDP, Actual and Projected, Quebec, 1981-82 to 2023-24

GDP = gross domestic product.

Source: Québec, Ministère des Finances, *Public Accounts*.

in Canada. The total debt-to-GDP ratio stood at 42.7 percent, compared with the Canadian average of 25 percent.¹⁸ Interest on the debt was Quebec's third-largest spending item after health and education. It represented 12.7 cents for each dollar of budgetary revenue in 2005-06.¹⁹

The key objective of the ADGF is to reduce debt in relative terms, in order to curb the intergenerational transfer of the debt burden. To achieve this goal, the government created the Generations Fund ("the Fund"). Ultimately, the Fund is to be used exclusively for debt repayment and to serve as an instrument of transparency in public finances by disclosing the amounts that the government is setting aside for debt repayment.

To demonstrate the seriousness of the government's approach, the legislation was designed to ensure that the debt would be repaid, not on the basis of budgetary availability, but in accordance with a known and predictable plan. It is for this reason that the ADGF sets out a precise debt target—namely, by 2025-26, the amount

18 Québec, Ministère des Finances, *The Generations Fund: To Foster Inter-Generational Equity, Sustainable Social Programs and Prosperity* (Québec: Ministère des Finances, March 2006), at 2. The debt concept used was total debt. This debt concept was subsequently replaced by other concepts—gross debt and debt representing accumulated deficits.

19 *The Generations Fund*, supra note 18, at 21.

of debt representing the province's accumulated deficits is not to exceed 17 percent of Quebec's GDP and gross debt is not to exceed 45 percent of GDP.²⁰

At the time the legislation was drafted, it was difficult for the government to increase taxes to support the Fund. Accordingly, the ADGF provided for alternative sources of revenue that would be dedicated to the Fund, mainly from Hydro-Québec.²¹ In addition to three sources of payments from Hydro-Québec, there are also mining revenues; a fixed amount of the specific tax on alcoholic beverages; unclaimed property; gifts, bequests, and other contributions received by the minister of finance; and, of course, the investment income generated by the Fund itself. The provisions of the ADGF also specify three other revenue sources, although they do not generate any payments at this time since an order in council is required to specify the value of the amounts to be allocated to the Fund.²² These other sources are (1) a part of Hydro-Québec's earnings on the sale of electricity outside Quebec as a result of increased generating capacity; (2) charges on water withdrawal; and (3) sums derived from the sale of government assets, rights, or securities.²³

As with the BBA, under the ADGF, the Quebec minister of finance must report to the National Assembly annually, in the budget speech, on the evolution of both the debt representing the accumulated deficits and the gross debt, on the sums credited to the Fund, and on any sums used to repay the gross debt.²⁴

Why did the government create the Fund, into which monies are paid and which will eventually be used to pay off part of the debt, rather than paying off a portion of the debt directly each year with dedicated revenues? One reason is the desire to benefit from a leverage effect—that is, a higher return in the Fund than the amount of interest paid on government borrowings. In this regard, the annual yield of the Fund since its inception has exceeded the Quebec government's borrowing costs in 11 out of 12 years.

Table 1 shows the amount of dedicated revenues and investment income paid into the Fund annually since 2006-07, as well as debt repayments and projections made by the Ministère des Finances up to 2023-24. In addition, it shows dedicated lump-sum revenues received over the years, such as \$300 million from the Territorial Information Fund in the 2013-14 fiscal year.

With respect to debt repayments, the Fund made possible an initial loan repayment of \$1 billion in fiscal 2013-14.²⁵ A second repayment of \$8 billion took place in 2018-19, and a third repayment of \$2 billion is expected in 2019-20.²⁶ In spite of

20 ADGF section 1.

21 ADGF section 3.

22 Québec, Ministère des Finances, 2014-2015 Budget, Budget Plan, June 4, 2014, at H.10.

23 ADGF section 3.

24 ADGF section 11.

25 Québec, Ministère des Finances, 2013-2014 Budget, Budget Plan, November 20, 2012.

26 Québec, Ministère des Finances, Update on Québec's Economic and Financial Situation: Fall 2018, December 3, 2018.

loan repayments, the book value of the Fund is expected to reach nearly \$21 billion in 2023-24.

CURRENT STATE OF QUEBEC'S FINANCES

The current state of Quebec's public finances is presented in terms of fiscal balance, debt levels, interest on debt, and credit ratings.

Fiscal Balance

Almost 25 years after the enactment of the BBA, its contribution to Quebec's return to balanced budgets should be acknowledged. The statute still seems to impose a genuine constraint on the government, presuming a negative collective judgment for a government that does not exert the necessary effort to comply with it.

The Quebec government estimates its budgetary surplus for the year ending March 31, 2019 at \$4.4 billion after the payment to the Fund,²⁷ representing 1 percent of the province's GDP. Figure 3 shows that this compares enviably with the performance of the other Canadian provinces.

The stabilization reserve, which can be used to allow budget deficits in future years, amounted to \$11.6 billion as at March 31, 2019.

Debt Levels

While Quebec's debt-to-GDP ratio showed a relative upward trend over the past three decades, an improvement appeared following the enactment of, first, the BBA and then the ADGF. Figure 4 compares Quebec's debt levels with Ontario's between 1981-82 and 2023-24 (projected). It shows that, after the return to general fiscal balance in the late 1990s, Quebec's net debt-to-GDP ratio followed a downward trend similar to Ontario's, but it did not narrow the gap between the two provinces (45.9 percent compared to 30.6 percent or 15.3 points in 1997-98, compared to 16.2 points in 2006-07). The gap was still favourable to Ontario by 13.7 points in 2012-13 but was reduced to nil (-0.2 points) in 2018-19. The budget forecasts indicate that in 2023-24 the debt-ratio gap will favour Quebec by 3.8 points.

The net debt-to-GDP ratio gap between Quebec and all other Canadian provinces was an average of 21.3 points in 2006-07 and declined to 9.7 points in 2018-19.²⁸

Finally, in terms of meeting the ADGF targets, the gross debt-to-GDP ratio after the Great Recession stood at 54.3 percent in 2013-14, compared to 46.1 percent as at March 31, 2019. As at March 31, 2020, the ratio will reach 45.3 percent, roughly meeting the ADGF target, but six years earlier than the statutory requirement. The other target, the debt burden representing accumulated deficits as a percentage of GDP (17 percent), will be met by 2025-26, as set out in the ADGF.²⁹

27 See *supra* note 16.

28 Québec, Ministère des Finances, *Public Accounts*.

29 Québec, Ministère des Finances, 2019-2020 Budget, Budget Plan, March 21, 2019, at section I.

FIGURE 3 Budgetary Balance as a Percentage of Projected GDP, Canadian Provinces, at Fiscal Year-End 2018-19

GDP = gross domestic product.

Note: This figure shows the budgetary balance as presented in provincial budgets except for Quebec. For Quebec, the balance is determined before and after payment to the Generations Fund.

Sources: Provincial government budgets and Québec, Ministère des Finances, “Monthly Report on Financial Transactions, Preliminary at March 31, 2019,” June 19, 2019 (www.finances.gouv.qc.ca/documents/mensuel/en/MENEN_rmop_13_11.pdf).

Interest on Debt

As a result of higher debt levels, greater effort was required from Quebec to pay the interest on debt measured as a percentage of consolidated revenues.

Although part of the decline in the debt-service burden obviously resulted from lower interest rates, at the time the BBA came into force in 1996-97, interest on debt accounted for 15.7 percent of consolidated revenues in Quebec compared with 14.8 percent in Ontario. In 2017-18, the ratio fell in both provinces, to 8.5 percent in Quebec and 7.9 percent in Ontario.³⁰

The March 2019 budget forecast indicates that interest on debt measured as a percentage of consolidated revenues will be 7.4 percent in Quebec in 2023-24 and 8.9 percent in Ontario.

30 Québec, Ministère des Finances, *Public Accounts*.

FIGURE 4 Net Debt-to-GDP Ratio, Quebec and Ontario, Actual and Projected, 1981-82 to 2023-24

GDP = gross domestic product.

Source: Québec, Ministère des Finances, *Public Accounts*.

Credit Ratings

In the first half of the 1990s, while Moody's changed Ontario's credit rating from Aa2 to Aa3 in 1995, it downgraded Quebec's rating twice, from Aa3 to A1 in 1993 and to A2 in 1995. As noted earlier in this article, in 1996, before the enactment of the BBA, there were fears of a new downgrade.

Since the introduction of the BBA and subsequently the ADGF, Quebec's credit rating has improved. In 2012, by lowering Ontario's credit rating from Aa1 to Aa2, Moody's placed Quebec's debt on an equal footing with Ontario's debt. Currently, Quebec's rating (Aa2) is higher than Ontario's (Aa3). Only three provinces now have a better rating than Quebec—British Columbia, Saskatchewan, and Alberta.

The same conclusion can be drawn using Standard & Poor's credit rating; as of 2017, and for the first time in 50 years, Quebec (at AA–) has a better credit rating than Ontario (at A+).

OUTLOOK

In the short term, the outlook for Quebec's public finances continues to be favourable: the five-year budget plan projects a balanced budget for every year up to and including 2023-24; Quebec's net debt-to-GDP ratio is declining; and the debt-ratio gap relative to all provinces is also narrowing.

Although the Quebec economy is running at full speed and public finances appear sound, the government still faces the major challenge of the transition in the province's demographic makeup. According to the most recent demographic outlook of the Institut de la statistique du Québec, the population aged 20-64, which grew by 1.1 million from 1981 to 2018, is expected to decline by 155,269, or 3.1 percent, from 2018 to 2030. In Ontario, over the same period, this age group is poised to grow by 0.7 percent under the demographic projection scenario.³¹

Clearly, demographics will have an impact on economic growth. Because Quebec draws most of its workforce from the population aged 20-64, it may be more difficult for the province to increase production, wealth, and the standard of living in the coming decades. The slower economic growth anticipated for Quebec will occur at the same time as increased pressure on health-care costs associated with the aging population, sparking significant growth in public spending. As a result, matching of government revenues and expenditures may be increasingly difficult to achieve.

An analysis produced in 2018 by the Université de Sherbrooke Chair in Taxation and Public Finance³² projected, on the basis of a series of assumptions,³³ the government's ability to maintain both fiscal balance and debt levels. The analysis shows that, particularly in view of the Fund's presence, the trend over the next decade is toward balanced budgets and debt levels under control. However, from the end of the next decade, fiscal deficits are projected to increase. Thus, despite assumptions based on higher employment rates, productivity growth, and technological developments in health care, it is expected that Quebec's public finances will be under strain over the long term.

In light of that analysis, while the improvement in public finances since the mid-1990s places Quebec on a more solid footing to face the challenge of the demographic shift, public finances and tools developed over the past decades will have to be readjusted for effective debt management.

31 Quebec data from Institut de la statistique du Québec, *Perspectives démographiques du Québec et des régions, 2016-2066* (Québec: Institut de la statistique du Québec, 2019), and Statistics Canada table 17-10-0005-01, "Population Estimates on July 1st, by Age and Sex"; Ontario data from Statistics Canada table 17-10-0057-01, "Projected Population, by Projection scenario, Age and Sex, as of July 1," scenario M1.

32 Yves St-Maurice, Luc Godbout, Matthieu Arseneau, and Suzie St-Cerny, *La soutenabilité budgétaire à long terme du Québec, édition 2018. Des défis subsistent*, Cahier de recherche 2018/14 (Sherbrooke: Université de Sherbrooke, Chaire de recherche en fiscalité et en finances publiques, November 2018).

33 For example, employment rates by age group, worker productivity, and several demographically influenced expenditures such as health-care spending.

The Relationship Between Restrictions on the Deduction of Interest Under Canadian Law and Canadian Tax Treaties

Brian J. Arnold*

PRÉCIS

L'auteur analyse les dispositions des conventions fiscales conclues par le Canada et celles des conventions fiscales types de l'Organisation de coopération et de développement économiques (OCDE) et des Nations Unies (ONU) pour déterminer si elles empêcheraient l'application des restrictions à la déduction des intérêts en vertu de la Loi de l'impôt sur le revenu du Canada — notamment, les règles sur la capitalisation restreinte et les règles qui considèrent les intérêts comme des dividendes. Bien que les dispositions des conventions types empêchent l'application des règles canadiennes sur la capitalisation restreinte, les dispositions des conventions fiscales canadiennes ont été négociées soigneusement pour permettre l'application de ces règles. L'auteur se demande également si les dispositions des conventions types de l'OCDE et de l'ONU devraient être interprétées comme empêchant l'application des règles sur la capitalisation restreinte, et il conclut que les restrictions à la déduction des intérêts en vertu du droit national ne devraient être empêchées par les dispositions des conventions types que si ces restrictions sont discriminatoires.

ABSTRACT

The author analyzes the provisions of Canadian tax treaties and those of the Organisation for Economic Co-operation and Development (OECD) and United Nations (UN) model conventions to determine whether they would prevent the application of the restrictions on the deduction of interest under the Canadian Income Tax Act—namely, the thin capitalization rules and rules that deem interest to be dividends. Although the provisions of the model conventions would prevent the application of the Canadian thin capitalization rules, the provisions of Canadian tax treaties have been carefully negotiated to allow the application of those rules. The author also questions whether the provisions of the OECD and UN model conventions should be interpreted to prevent the application of thin capitalization rules, and he concludes that restrictions on the deduction of interest under domestic law should be prevented by the provisions of the model conventions only if those restrictions are discriminatory.

KEYWORDS: INCOME TAX TREATIES ■ INTEREST DEDUCTIBILITY ■ NON-DISCRIMINATION RULES ■ DEBT-TO-EQUITY RATIO ■ TRANSFER PRICING ■ OECD AND UN MODEL CONVENTIONS

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INTRODUCTION

During his academic career, Tim Edgar wrote extensively about interest deductibility;¹ during the early part of his career, he and I co-authored several articles on interest deductibility in Canada.² As a result, I thought that a paper on the topic of interest deductibility would be suitable for a symposium in Tim's honour. I have

1 See, for example, 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; Tim Edgar, Jonathon Farrar, and Amin Mawani, "Foreign Direct Investment, Thin Capitalization, and the Interest Expense Deduction: A Policy Analysis" (2008) 56:4 *Canadian Tax Journal* 803-69; Tim Edgar, "The Thin Capitalization Rules: Role and Reform" (1992) 40:1 *Canadian Tax Journal* 1-54; Tim Edgar, "The Classification of Corporate Securities for Income Tax Purposes" (1990) 38:5 *Canadian Tax Journal* 1141-88.

2 See, for example, Brian J. Arnold and Tim Edgar, "Reflections on the Submission of the CBA-CICA Joint Committee on Taxation Concerning the Deductibility of Interest" (1990) 38:4 *Canadian Tax Journal* 847-85; Brian J. Arnold and Tim Edgar, "Interest Deductibility," in Roy D. Hogg and Jack M. Mintz, eds., *Tax Effects on the Financing of Medium and Small Public Corporations* (Kingston, ON: Queen's University, John Deutsch Institute for the Study of Economic Policy, 1992), 59-78; Brian J. Arnold and Tim Edgar, "The Draft Legislation on Interest Deductibility: A Technical and Policy Analysis" (1992) 40:2 *Canadian Tax Journal* 267-303; Brian J. Arnold and Tim Edgar, "Deductibility of Interest Expense" (1995) 43:5 *Canadian Tax Journal* 1216-44.

chosen to explore the relationship between (1) restrictions on the deduction of interest under Canadian domestic law and (2) the provisions of Canadian tax treaties.

Following this introduction, I describe restrictions on the deduction of interest under the Canadian Income Tax Act.³ Because most of these restrictions apply to interest paid to both residents and non-residents, they do not raise any concerns with respect to the provisions of tax treaties. However, treaty issues do arise with respect to Canada's thin capitalization rules, since those rules apply only to interest paid to substantial non-resident shareholders of Canadian-resident corporations and non-resident beneficiaries of Canadian-resident trusts, and with respect to certain Canadian tax rules dealing with the deduction of interest by non-residents in computing their Canadian-source income. Treaty issues also potentially arise with respect to Canadian rules that deem interest to be paid to non-residents.

The central focus of this paper is the relationship between the provisions of Canada's tax treaties and the restrictions on the deduction of interest under the Act. To provide a comparative perspective, I also examine the relationship between the provisions of the Organisation for Economic Co-operation and Development (OECD) and United Nations (UN) model conventions and domestic-law restrictions on the deduction of interest. I endeavour to answer the following question: To what extent do the provisions of Canada's tax treaties—and, by way of comparison, the provisions of the OECD and UN model conventions—limit the application of restrictions on the deduction of interest, and, in particular, the application of the thin capitalization rules? I conclude that Canada's tax treaties have been negotiated and designed to ensure that they do not prevent the application of either the thin capitalization rules or rules that deem interest to be dividends.

RESTRICTIONS ON THE DEDUCTION OF INTEREST UNDER CANADIAN DOMESTIC LAW

As a result of some questionable court decisions, the deduction of interest under the Canadian income tax system has been based on the assumption that interest is a non-deductible capital expense.⁴ As a result, in general, interest is deductible only in accordance with the provisions of paragraph 20(1)(c), which allows the deduction of interest only on borrowed money or on the unpaid purchase price of property that is used for the purpose of earning income from a business or property. Under paragraph 20(1)(d), compound interest is deductible if it meets the conditions of paragraph 20(1)(c) and is paid in the year. Thus, like many countries, Canada

3 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this paper are to the Act.

4 The proposition that interest is a non-deductible capital expense has been reiterated many times by the Supreme Court of Canada. See, for example, *Bronfman Trust v. The Queen*, [1987] 1 SCR 32; and *Tennant v. MNR*, [1996] 1 SCR 305. Interest is deductible under subsection 9(1) as an ordinary business expense for financial institutions and in certain special circumstances under the Canada Revenue Agency's (CRA's) administrative practices (see *Income Tax Folio* S3-F6-C1, "Interest Deductibility," at paragraph 1.7).

does not allow the deduction of interest on funds that are used to earn exempt income⁵ or to finance personal consumption. The definition of “exempt income” does not include dividends from Canadian or foreign corporations even though such dividends are not subject to any Canadian tax.⁶ Tracing is the basic method used to determine whether borrowed funds are used for a qualifying income-earning purpose; however, other methods, such as positive ordering and apportionment, are used when tracing is impossible.⁷ The extensive case law under paragraph 20(1)(c) is overly generous to taxpayers, allowing them to deduct interest even where their purpose is to earn gross revenue rather than net income and even where they have only an ancillary purpose of earning gross revenue.⁸

The deduction of interest under paragraph 20(1)(c) is limited to the amount of interest paid in the year or payable in respect of the year,⁹ or a reasonable amount, whichever is the lesser. The purpose of the limitation of the amount of deductible interest to a reasonable amount is unclear, since section 67 prohibits the deduction of all expenses except to the extent that they are reasonable in the circumstances.¹⁰

In addition to these general rules with respect to the deduction of interest, the Act contains many specific rules that deny or limit the deduction of interest. These rules may take the form of (1) limitations or prohibitions on the deduction of interest or (2) alternative or additional conditions to those in paragraph 20(1)(c) for the deduction of interest. For example, interest expenses that would otherwise be deductible under paragraph 20(1)(c) are restricted in the following circumstances:

- No deduction is allowed for interest expenses incurred to acquire vacant land.¹¹
- No deduction is allowed for interest expenses during the construction or renovation of a building.¹²

5 Paragraph 18(1)(c) of the Act.

6 Subsection 248(1), the definition of “exempt income,” provides that exempt income is any property received or acquired that is not included in a person’s income under part I of the Act “but does not include a dividend on a share.” Dividends from Canadian-resident corporations and foreign corporations are included income under subsections 82(1) and 90(1), respectively, but such dividends received by a Canadian-resident corporation are deductible in computing taxable income under subsections 112(1) and 113(1), respectively.

7 See *Income Tax Folio S4-F2-C1*, “Deductibility of Fines and Penalties,” at paragraphs 1.28-1.58.

8 See, for example, *Ludco Enterprises Ltd. v. Canada*, 2001 SCC 62; and, most recently, *TDL Group Co. v. Canada*, 2016 FCA 67.

9 However, the CRA allows interest to be deducted on an accrual basis by taxpayers that use the accrual method of accounting for income tax purposes. See *supra* note 7, at paragraph 1.13.

10 Also, section 247 could apply to prevent the deduction of interest paid by a Canadian resident to a non-arm’s-length non-resident to the extent that the interest exceeds an arm’s-length amount.

11 Subsection 18(2).

12 Subsection 18(3.1).

- No deduction is allowed for interest paid by a resident corporation or trust to specified non-residents (thin capitalization rules).¹³
- The deduction of prepaid interest is limited to the amount that reasonably relates to the particular year.¹⁴
- The deduction of interest payable on certain long-term debt obligations is limited to the reasonable amount attributable to the particular year.¹⁵
- No deduction of interest is allowed with respect to borrowed funds used to make contributions to deferred savings plans, such as registered retirement savings plans and tax-deferred savings plans.¹⁶
- The deduction of interest with respect to certain weak-currency borrowings is limited to the amount of interest that would have been incurred if the taxpayer had borrowed an equivalent amount on the same terms in the currency that was ultimately used to earn income.¹⁷
- The deduction of interest paid by a Canadian resident to a non-arm's-length non-resident may be disallowed to the extent that the interest exceeds the amount that would be paid if the parties were dealing at arm's length.¹⁸

The only restrictions on the deduction of interest in the list above that apply solely to payments of interest to non-residents are Canada's transfer-pricing and thin capitalization rules. The transfer-pricing rules apply to transactions or series of transactions between "a taxpayer or partnership and a non-resident person with whom the taxpayer or the partnership, or a member of the partnership, does not deal at arm's length" where the terms or conditions differ from the terms or conditions that persons dealing at arm's length would have agreed to.¹⁹ The rules also apply where persons dealing at arm's length would not have entered into the transaction or series of transactions and the transaction or series was entered into primarily to obtain a tax benefit.²⁰ The transfer-pricing rules do not apply to transactions between residents of Canada.

The thin capitalization rules apply for the purposes of the computation of the income of a corporation or trust from a business or property (other than the Canadian banking business of an authorized foreign bank). Therefore, the rules apply to both resident and non-resident corporations and trusts. However, the rules apply only to deductible interest paid or payable on outstanding debts owed to "specified

13 Subsection 18(4).

14 Subsection 18(9).

15 Subsections 18(9.2)-(9.8).

16 Subsection 18(11).

17 Section 20.3.

18 Subsection 247(2).

19 Paragraph 247(2)(a).

20 Paragraph 247(2)(b).

non-residents” to the extent that those debts exceed 1.5 times the equity of the corporation or trust. “Specified non-residents” are defined to be

- non-resident beneficiaries of a trust that own, alone or together with non-arm’s-length persons, an interest in the trust with a fair market value of 25 percent or more of the value of all the interests in the trust; and
- non-resident shareholders of a corporation that own, alone or together with non-arm’s-length persons, shares with 25 percent or more of the votes or the fair market value of all the shares of the corporation.

The thin capitalization rules do not apply to interest paid or payable to Canadian-resident beneficiaries of a trust or Canadian-resident shareholders of a corporation. Broad anti-back-to-back rules apply for the purposes of the thin capitalization rules.²¹ Under these rules, which were revised extensively in 2016, certain amounts owing by an intermediary to a specified non-resident are deemed to be owed to the specified non-resident by the Canadian corporation or trust if there is a link between the amount owed by the Canadian corporation or trust to the intermediary and the amount owed by the intermediary to the specified non-resident. Even broader back-to-back rules apply for the purposes of part XIII withholding tax on interest paid to non-residents.²²

Canada’s thin capitalization rules differ from those of other countries in that the Canadian rules focus on interest paid to substantial non-resident shareholders of Canadian corporations and substantial non-resident beneficiaries of Canadian trusts, whereas most countries’ thin capitalization rules apply only to interest paid to related or associated non-residents. In effect, most countries’ rules function as specific transfer-pricing rules dealing with interest. In contrast, Canada’s thin capitalization rules are more accurately characterized as debt-equity characterization rules.

Non-residents carrying on business in Canada (or earning rental income from real property in Canada and electing to be taxed on a net basis) are entitled to deduct interest in accordance with the same rules as are described above with respect to residents of Canada.²³ A non-resident’s income from business carried on in Canada is determined as if the non-resident had no other income and was entitled to any deductions reasonably applicable in whole or in part to that business.²⁴ Other than this general “reasonableness” principle, there are no specific rules for allocating a non-resident’s interest or other expenses to its income from business carried on in Canada.²⁵ The basic approach used to determine whether a non-resident has used

21 Subsections 18(6) and (6.1).

22 Subsections 212(3.1)-(3.81).

23 Non-resident actors are also allowed to elect under section 216.1 to pay tax on a net basis.

24 Paragraph 4(1)(a).

25 Except for certain special cases, such as pilots and actors; see subsections 115(3) and 212(5.1).

borrowed funds for the purpose of earning business income in Canada is factual tracing, supplemented by apportionment where tracing is impossible; this approach also applies to the deduction of interest by residents. However, special rules apply to authorized foreign banks carrying on a branch banking business in Canada. Such banks are allowed to deduct (1) interest expenses directly attributable to liabilities of the business in Canada, (2) notional interest expenses with respect to amounts advanced to or used on behalf of the Canadian branch by its foreign parent, and (3) other funds used to operate the Canadian business; however, the deduction is denied to the extent of the amount of interest at the Bank of Canada rate on the amount by which 95 percent of the value of the assets of the Canadian branch exceeds its liabilities and advances to the branch.²⁶

Non-residents are subject to the same restrictions on the deduction of interest that apply to residents, as described above. In particular, non-resident corporations and trusts carrying on business in Canada or earning income from property are subject to Canadian transfer-pricing rules and thin capitalization rules. For the purposes of applying the 1.5:1 debt-to-equity ratio to a Canadian branch of a non-resident corporation or trust, the equity of the branch is deemed to be equal to 40 percent of the cost of the property used in the branch business in excess of the debts allocated to the branch.²⁷

Finally, interest deductions may be disallowed under the general anti-avoidance rule (GAAR), which applies to tax benefits from avoidance transactions that are contrary to the underlying rationale of the relevant provisions of the Act.²⁸ An avoidance transaction is defined to mean a transaction, whether alone or as part of a series of transactions, whose primary purpose is to obtain a tax benefit. Since the primary purpose of most financing arrangements is to raise funds for business or investment purposes, it is often difficult for the government to show that financing transactions are avoidance transactions. In any event, the courts have refused to approve the application of GAAR to financing transactions in the cases heard to date.²⁹

The Act also contains rules that, although they do not limit the deduction of interest, have the effect of offsetting the deduction of interest. The foreign affiliate dumping rules are intended to deal with transactions whereby a Canadian corporation controlled by a non-resident corporation incurs third-party or related-party debt or issues shares to acquire the shares of a foreign affiliate.³⁰ Although the interest deduction is not restricted, the corporation is deemed to have paid a dividend on which part XIII withholding tax is imposed or, where the Canadian corporation issues shares, its paid-up capital is reduced so that the corporation cannot return as

26 Section 20.2. Under paragraph 18(1)(v), the interest deduction of an authorized foreign bank is limited to the amount calculated under section 20.2.

27 Subsection 18(5), the definition of "equity amount" paragraph (c).

28 Section 245.

29 See *The Queen v. Canadian Pacific Ltd.*, 2001 FCA 398; and *Hill v. The Queen*, 2004 TCC 386.

30 Section 212.3.

much capital on a tax-free basis and cannot increase its debt owed to specified non-residents by 1.5 times the amount by which the paid-up capital was originally increased. The provisions of Canada's tax treaties are unlikely to have any effect on these rules, although this issue is beyond the scope of this paper.

In general, the Canadian income tax system adheres assiduously to the legal form of transactions and financial instruments. In accordance with this basic principle, the term "interest" in the Act has a narrow private-law meaning, which does not include amounts that are economically equivalent to interest. The deductibility of such amounts is governed by specific provisions of the Act.³¹ For example, borrowing expenses other than interest are deductible on a straightline basis over five years;³² the full amount of a discount is deductible, when paid, where the amount of the discount does not exceed 3 percent of the principal amount of the debt obligation; however, only one-half of any larger discount is deductible.³³

Adherence to legal form also applies to the characterization of debt and equity securities.³⁴ Thus, shares of a corporation are invariably treated as shares even where they have terms typical of debt obligations, such as a fixed term and fixed payments. Similarly, debt obligations are invariably treated as debt even where they have characteristics of equity, such as a right to participate in profits. The Act does not contain any comprehensive rules that characterize debt or equity in accordance with their terms, although it does contain complex specific rules to prevent the use of certain preferred shares for tax-avoidance purposes.³⁵ In general, although the Act sometimes deems payments on debt obligations to be dividends and deems dividends to be interest,³⁶ it does not deem the underlying property on which payments are made to be something other than its legal character under private law. For example, shareholder benefits and loans and excessive interest under the thin capitalization rules are deemed to be dividends for the purposes of part XIII withholding tax.³⁷ Under the back-to-back rules for the purposes of the thin capitalization rules, the amount owing under the first leg of a back-to-back arrangement is deemed to be owed to the non-resident that funds the first leg through the second leg of the

31 See paragraphs 20(1)(e), (e.1), (e.2), (f), and (l.1).

32 Paragraph 20(1)(e).

33 Paragraph 20(1)(f).

34 See, for example, *Barejo Holdings ULC v. The Queen*, 2015 TCC 274; aff'd 2016 FCA 304; and *Barejo Holdings ULC v. The Queen*, 2018 TCC 200.

35 Parts IV.1 and VI.1 of the Act; and the definitions in subsection 248(1) of "term preferred share," "taxable preferred share," "short term preferred share," "guaranteed share," and "collateralized preferred share."

36 For example, payments on an "income bond" or "income debenture," which is defined in subsection 248(1) to be a bond or debenture under which interest is payable only if the issuer has profits, are not deductible (paragraph 18(1)(g)) and are deemed to be dividends (subsections 15(3) and (4)).

37 Paragraph 214(3)(a) and subsection 214(16).

arrangement, and interest on that deemed debt is deemed to be owed to that non-resident.³⁸ Similarly, under the back-to-back rules for the purposes of the withholding tax on interest, interest is deemed to be paid to the ultimate non-resident that funds the second (or higher) leg of the arrangement.

THE RELEVANT PROVISIONS OF THE OECD AND UN MODEL CONVENTIONS

In this section, I provide a brief overview of the effect that the provisions of the OECD and UN model conventions³⁹ would have on the application of restrictions on the deduction of interest under Canadian law. The key provisions are articles 9(1) (transfer pricing) and 24(4) and (5) (non-discrimination) with respect to the deduction of interest paid by Canadian residents to non-residents, and articles 7 (attribution of profits to permanent establishments [PEs]) and 24(3) (non-discrimination) with respect to the deduction of interest by non-residents.

Deduction of Interest Paid by Canadian Residents to Non-Residents

Article 1(3): Saving Clause

Article 1(3), the saving clause, provides that, subject to specific exceptions, tax treaties are not intended to prevent countries from taxing their residents without any limitations imposed by the treaty.⁴⁰ For bilateral treaties that do not contain the saving clause—which include most treaties, given that article 1(3) was added to the OECD and UN model conventions only in late 2017—the result should be the same as for treaties that include the saving clause. The 2017 commentary on article 1 confirms this interpretation explicitly: “Paragraph 3 [of article 1] confirms the general principle that the Convention does not restrict a Contracting State’s right to tax its own residents.”⁴¹

38 Subsection 18(6.1). As discussed above, any excess non-deductible interest is deemed to be a dividend.

39 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Full Version 2017* (herein referred to as “the OECD model convention”) (Paris: OECD, 2019) (<https://doi.org/10.1787/g2g972ee-en>); and United Nations, *United Nations Model Double Taxation Convention Between Developed and Developing Countries 2017 Update* (New York: United Nations, 2018) (herein referred to as “the UN model convention”).

40 The exceptions include article 23, which requires residence countries to provide relief for double taxation through an exemption or foreign tax credit. For an excellent recent discussion of the saving clause, see Patricia A. Brown, “Come on in, the Water’s . . . Choppy: The Expansion of the Saving Clause Beyond the United States,” in Brian J. Arnold, ed., *Tax Treaties After the BEPS Project: A Tribute to Jacques Sasseville* (Toronto: Canadian Tax Foundation 2018), 55-73.

41 Paragraph 18 of the commentary on article 1 of the OECD model convention and paragraph 9 of the commentary on article 1 of the UN model convention, quoting paragraph 18 of the OECD commentary.

Whether a tax treaty with a saving clause allows a contracting state to deny or limit the deduction of interest by residents depends on the exceptions to the saving clause. The key exception is article 24, the non-discrimination article, although it is notable that article 9(1) and article 7, dealing with transfer pricing and the attribution of profits to PEs, respectively, are not listed as exceptions.

Currently, the treaty with the United States is the only Canadian tax treaty with a saving clause.⁴² It is an open question whether Canadian courts would interpret Canadian tax treaties without a saving clause—especially those treaties entered into before the 2017 addition to the commentary stating that there is a general principle that tax treaties do not restrict a country's right to tax its own residents—to be subject to an implicit principle that tax treaties do not limit the taxation by a country of its own residents unless these treaties do so explicitly. Although Canada did not agree to modify its treaties to include the saving clause pursuant to the multilateral convention to implement base erosion and profit shifting (BEPS) changes,⁴³ it seems likely that Canada will agree to include the saving clause on a bilateral basis.

Article 9: Transfer Pricing

Article 9(1) of the OECD and UN model conventions states the arm's-length principle that is applicable to commercial and financial relations between associated enterprises. According to the arm's-length principle, where the prices charged in transactions between associated enterprises differ from the prices (arm's-length prices) that would be charged in similar or comparable transactions between unrelated or independent enterprises, the tax authorities can adjust the profits of the enterprises to reflect the true profits that would have been earned if the transactions had taken place at arm's length. If one contracting state applies its transfer-pricing rules, in accordance with the arm's-length principle in article 9(1), to increase the profits of a resident enterprise from transactions with a related enterprise resident in the other contracting state, article 9(2) requires the other state to provide a corresponding adjustment to the profits of the related enterprise in order to eliminate double taxation.

Article 9 of the OECD and UN model conventions is potentially applicable to deductible payments of interest between associated enterprises in excess of an arm's-length interest rate and to payments of interest on debt outstanding between

42 The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC 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.

43 Organisation for Economic Co-operation and Development, Multilateral Convention To Implement Tax Treaty Related Measures To Prevent Base Erosion and Profit Shifting, adopted on November 24, 2016, and signed by Canada at Paris, France, on June 7, 2017 (www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.pdf).

associated enterprises in excess of an arm's-length amount of debt.⁴⁴ Moreover, according to the commentary, article 9(1) prevents the application of domestic thin capitalization rules to the extent that they result in profits to the borrower that are in excess of the amount of profits that would have occurred in an arm's-length situation.⁴⁵

Most Canadian tax treaties contain a provision similar to article 9 of the OECD and UN model conventions.

Article 11(6): Excessive Interest

Article 11(6) provides that the other paragraphs of article 11 do not apply to excessive interest (interest in excess of the amount that would have been paid in the absence of a special relationship between the parties) paid by a resident of one contracting state to a related person resident in the other contracting state. The excess interest is taxable under the laws of the two countries with due regard to the other provisions of the treaty.⁴⁶ Unlike article 9, which applies where either the rate of interest or the amount of debt exceeds the arm's-length amount, article 11(6) applies only to situations where the rate of interest is excessive.⁴⁷

Canadian tax treaties contain provisions similar to article 11(6) of the OECD and UN model conventions.

Article 24: Non-Discrimination

Article 24(4) of both the OECD and UN model conventions provides that interest, royalties, and other amounts paid by a resident of one contracting state to a resident of the other contracting state must be deductible in computing the profits of the payer under the same conditions as if they were paid to a resident of the country in which the payer is resident.⁴⁸ However, article 24(4) does not apply if article 9(1) or 11(6) applies to the payment. In effect, article 24(4) precludes a state from discriminating against residents of the other state by denying the deduction of interest, royalties, or other amounts paid to them where a deduction is allowed for such payments to its own residents.

44 Paragraph 3 of the commentary on article 9 of the OECD model convention; and paragraph 1 of the commentary on article 9 of the UN model convention, quoting paragraph 3 of the commentary on article 9 of the OECD model convention.

45 Ibid.; and paragraph 74 of the commentary on article 24 of the OECD model convention.

46 The excess interest is not deemed to be a payment other than interest for the purposes of the treaty, although it might be treated as a dividend under domestic law; however, article 10 of the treaty would not apply because the excess interest is not "income from other corporate rights." This issue is discussed below.

47 Paragraph 35 of the OECD commentary on article 11; and paragraph 22 of the UN commentary on article 11.

48 See, generally, Luc Hinnekens and Philippe Hinnekens, "General Report," in International Fiscal Association, *Non-Discrimination at the Crossroads of International Taxation*, Cahiers de droit fiscal international, vol. 93a (The Hague: Sdu Fiscale & Financiële Uitgevers, 2008) 15-54, at 31-34.

Article 24(5) provides that a corporation resident in one contracting state that is owned or controlled by residents of the other state should not be taxed less favourably than resident corporations owned or controlled by residents of the first state.⁴⁹ Unlike article 24(4), article 24(5) does not contain any exception for article 9(1) or 11(6). However, the commentary on article 24 clarifies that the same exceptions to article 24(4) should be read into article 24(5):

Since the provisions of paragraph 1 of Article 9 or paragraph 6 of Article 11 form part of the context in which paragraph 5 must be read (as required by Article 31 of the *Vienna Convention on the Law of Treaties*), adjustments which are compatible with these provisions could not be considered to violate the provisions of paragraph 5.⁵⁰

Articles 24(4) and (5) do not prevent a country from imposing on non-residents additional information-reporting or other requirements for the deduction of expenses that are not imposed on residents, since those provisions apply only to the taxation imposed by a country and not to any connected requirements.⁵¹ More generally, article 24 does not apply to domestic-law measures expressly authorized by the provisions of the treaty.⁵² The commentary also provides that “[i]t is . . . open to Contracting States to modify this provision [article 24(4)] in bilateral conventions to avoid its use for tax avoidance purposes.”⁵³

As discussed in more detail below, Canadian tax treaties do not contain provisions comparable to articles 24(4) and (5) of the OECD and UN model conventions unless these provisions are subject to an exception for Canada’s thin capitalization rules.

49 For a discussion of the potential application of article 24(5) to thin capitalization rules, see Craig Elliffe, “Unfinished Business: Domestic Thin Capitalization Rules and the Non-Discrimination Article in the OECD Model” (2013) 67:1 *Bulletin for International Taxation* 26-38. See also John F. Avery Jones et al., “Art. 24(5) of the OECD Model in Relation to Intra-Group Transfers of Assets and Profits and Losses” (2011) 3:2 *World Tax Journal* 179-225.

50 Paragraph 79 of the commentary on article 24 of the OECD model convention; and paragraph 4 of the commentary on article 24 of the UN model convention, quoting paragraph 79 of the OECD commentary.

51 Paragraph 75 of the commentary on article 24 of the OECD model convention; and paragraph 4 of the commentary on article 24 of the UN model convention, quoting paragraph 75 of the OECD commentary.

52 Paragraph 4 of the commentary on article 24 of the OECD model convention; and paragraph 1 of the commentary on article 24 of the UN model convention, quoting paragraph 4 of the OECD commentary on article 24. For example, withholding taxes on dividends, interest, and other amounts authorized by the treaty would not violate article 24.

53 Paragraph 73 of the commentary on article 24 of the OECD model convention; and paragraph 2 of the commentary on article 24 of the UN model convention, quoting paragraph 73 of the OECD commentary on article 24.

Deduction of Interest by Non-Residents

Article 7 deals with the taxation by one state of profits from a business carried on in that state by a resident of the other state to the extent that those profits are attributable to a PE in the first state. Under article 7(2) of the OECD and UN model conventions, the PE is deemed to be a separate entity that deals independently with the rest of the enterprise. This separate-entity assumption is intended to make the arm's-length principle of article 9(1) and the transfer-pricing guidelines applicable, by analogy, for the purpose of computing the profits attributable to a PE.⁵⁴

Article 7 of the OECD model convention was substantially revised in 2010 to fully implement the separate-entity principle.⁵⁵ Thus, for example, a PE is considered to have the same amount of debt and equity that a separate entity carrying on the same activities would have, irrespective of the amount of actual debt and equity of the entity of which the PE is a part. Although article 7 is not discussed in detail here, aspects of the commentary on article 7 are relevant to domestic-law restrictions on the deduction of interest.

The commentary on article 7 of the OECD model convention, as revised in 2010, indicates that article 7(1) allocates taxing rights over profits attributable to a PE and that article 7(2) determines the profits that are so allocated. The commentary goes on to provide expressly that the computation of the profits of a PE, including the deductibility of expenses, is determined in accordance with domestic law.⁵⁶

Because article 7(2) incorporates the arm's-length standard of article 9, presumably the same result should apply under article 9. Thus, the fundamental purpose of both article 7 and article 9 is to allocate profits between parts of an enterprise in the contracting states or related enterprises in the contracting states, but neither article deals with the computation of profits or the deductibility of expenses, which are matters for domestic law.

Article 7(3) of the UN model convention provides two specific rules with respect to the deduction of expenses in computing the profits of a PE.⁵⁷ First, expenses incurred for the purposes of the business of the PE "shall be allowed as deductions"

54 Paragraph 16 of the OECD commentary on article 7; and paragraph 14 of the UN commentary on article 7.

55 See, generally, Jacques Malherbe and Philip Daenen, "Permanent Establishments Claim Their Share of Profits: Does the Taxman Agree?" (2010) 64:7 *Bulletin for International Taxation* 359-66; Luis Nouel, "The New Article 7 of the OECD Model Tax Convention: The End of the Road?" (2011) 65:1 *Bulletin for International Taxation* 5-12; and Hans Pijl, "Interpretation of Article 7 of the OECD Model, Permanent Establishment Financing and Other Dealings" (2011) 65:6 *Bulletin for International Taxation* 294-306.

56 Paragraph 30 of the commentary on article 7 of the OECD model convention states: "Paragraph 2 does not deal with the issue of whether expenses are deductible when computing the taxable income of the enterprise in either Contracting State. The conditions for the deductibility of expenses are a matter to be determined by domestic law."

57 Article 7(3) of the OECD model convention was similar before the 2010 update.

whether they are incurred in the PE state or elsewhere. Second, no deductions are allowed for notional royalties, fees for services, or interest paid by a PE to its head office or another part of the enterprise, except in the case of financial institutions.⁵⁸ These rules may seem to contradict the basic principle, identified above, that the deductibility of expenses is determined under domestic law;⁵⁹ however, the UN commentary clarifies that, like article 7 of the OECD model convention, article 7(3) deals with the attribution or allocation of expenses to a PE, and the deductibility of those expenses is determined under domestic law.⁶⁰

Under article 24(3) of both the OECD and UN model conventions, a country cannot impose tax on a PE of a resident of the other contracting state “less favourably” than it imposes tax on its own residents carrying on similar activities. Thus, if a country allows residents carrying on business to deduct interest, it must allow the residents of its treaty partners carrying on business in the country to deduct interest on the same or more favourable terms.⁶¹ However, article 24(3) does not prevent a country from applying its transfer-pricing rules to disallow the deduction of excessive interest paid to an associated non-resident enterprise.⁶²

Most Canadian tax treaties contain provisions similar to article 7 of the OECD model convention as it read before 2010; a few contain a provision similar to article 7

58 Paragraph 18 of the UN commentary on article 7, quoting paragraph 41 of the 2008 commentary (Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, July 2008)) on article 7 of the OECD model convention. The exception for notional interest of PEs of financial institutions reflects the fact that the ordinary business of such institutions involves making and receiving advances, so that notional interest expenses are likely to approximate the actual interest expenses of the enterprise attributable to the PE.

59 Paragraph 17 of the UN commentary on article 7 indicates that the basic objective of article 7(3) is “to ensure that the expenditure claimed as a deduction in determining the taxable profits is relevant, referable and necessary for carrying out the business operations. There has to exist a nexus between the expenditure and the business activity so that the expenditure incurred is justified by business expediency, necessity or efficiency.”

60 Paragraph 18 of the UN commentary on article 7, quoting paragraph 30 of the 2008 commentary on article 7 of the OECD model convention: “[P]aragraph 3 only determines which expenses should be attributed to the permanent establishment for the purpose of determining the profits attributable to that permanent establishment. It does not deal with the issue of whether those expenses, once attributed, are deductible when computing the taxable income of the permanent establishment since the conditions for the deductibility of expenses are a matter to be determined by domestic law, subject to the rules of Article 24 on Non-discrimination (in particular, paragraphs 3 and 4 of that Article).”

61 Paragraph 40(a) of the commentary on article 24 of the OECD model convention; and paragraph 2 of the commentary on article 24 of the UN model convention, quoting paragraph 40(a) of the OECD commentary on article 24.

62 Paragraph 42 of the commentary on article 24 of the OECD model convention; and paragraph 2 of the commentary on article 24 of the UN model convention, quoting paragraph 42 of the OECD commentary on article 24.

of the 2010 OECD model convention.⁶³ Many Canadian tax treaties also contain provisions similar to article 24(3) of the OECD and UN model conventions.

Article 29(9): The General Anti-Abuse Rule

Article 29(9) of the OECD and UN model conventions allows a country to deny the benefit of a treaty where one of the main purposes of a transaction is to obtain such a benefit, unless the taxpayer can establish that granting the benefit in the circumstances would be in accordance with the object and purpose of the treaty. Article 29(9) applies “notwithstanding any other provision of . . . [this] Convention,” so that it would prevail in the event of a conflict with another provision of the treaty. It is theoretically impossible for article 29(9) to be applied to restrict the deduction of interest because, as noted above, the deductibility of expenses, including interest, is a matter for domestic law. However, it is conceivable that article 29(9) could result in the restriction of the deduction of interest indirectly by denying the benefit of article 7, 9, or 24 of a treaty.

Many of Canada’s tax treaties will contain a general anti-abuse rule identical to article 29(9) of the OECD and UN model conventions once the multilateral convention becomes effective for those treaties. However, since Canada’s GAAR applies in the event of any conflict with the provisions of a treaty,⁶⁴ it is unclear what, if any, impact the addition of the treaty general anti-abuse rule to any Canadian tax treaties will have.

The commentary on both the OECD and UN model conventions deals extensively with the relationship between the provisions of tax treaties and domestic anti-avoidance rules, and it concludes generally that there is no conflict between them.⁶⁵ The commentary does not deal explicitly with the situation where the application of a domestic anti-avoidance rule, such as the Canadian thin capitalization rules, results in the denial or limitation of the deduction of interest in a manner that arguably violates article 24. In this situation, there is a potential conflict between two fundamental principles of tax treaties: (1) tax treaties should not prevent countries from protecting their tax base from abuse and (2) countries should not discriminate against residents of the other contracting state. According to the commentary, as noted above, thin capitalization rules based on a fixed debt-to-equity ratio that apply only to non-residents are contrary to article 24 and article 9(1) unless they

63 For example, the treaties with the United Kingdom and the United States.

64 Income Tax Conventions Interpretation Act, RSC 1985, c. I-4, as amended, section 4.1.

65 Commentary on article 1 of the OECD and UN model conventions. See Brian J. Arnold, “Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model” (2004) 58:6 *Bulletin for International Fiscal Documentation* 244-60; and Stef van Weeghel, “General Report,” in International Fiscal Association, *Tax Treaties and Tax Avoidance: Application of Anti-Avoidance Provisions*, Cahiers de droit fiscal international vol. 95a (The Hague: Sdu Fiscale & Financiële Uitgevers, 2010), 17-55.

conform to the arm's-length standard.⁶⁶ On the other hand, the application of other anti-avoidance rules, such as the business purpose test, substance-over-form rules, economic substance and step transaction doctrines, the abuse-of-law doctrine, and legislative general anti-abuse rules, are not generally considered to be contrary to or prevented by the provisions of tax treaties.⁶⁷

Summary

The effect of the provisions of the OECD and UN model conventions on domestic-law restrictions on the deduction of interest can be summarized as follows:

- Articles 24(4) and (5) prevent a contracting state from limiting the deduction of interest (and other disbursements) paid to residents of the other contracting state where the deduction of interest paid to residents of the first state is not similarly limited, unless the limitations are covered by article 9(1) or 11(6).
- Article 9(1) prevents the application of domestic restrictions on the deduction of interest, including thin capitalization rules, to the extent that they apply only to interest paid to non-residents and result in the taxation of profits in excess of the arm's-length profits.
- Article 24(3) prevents a contracting state from discriminating against residents of the other state that are carrying on business in the first state through a PE; arguably, article 24(3) would prevent a state from limiting the deduction of interest by a non-resident in computing the profits attributable to a PE under article 7 (for example, through the application of thin capitalization rules) where residents of the state are not subject to a similar limitation.
- With the exception of articles 9(1) and 24, the provisions of the OECD and UN model conventions do not deal with or have any effect on the deductibility of interest and other expenses.
- According to the commentary, the provisions of tax treaties based on the OECD and UN model conventions do not prevent the application of domestic anti-avoidance rules.

THE PROVISIONS OF CANADIAN TAX TREATIES RELEVANT TO RESTRICTIONS ON THE DEDUCTION OF INTEREST

Introduction

As noted in the previous section, although, in general, Canadian tax treaties follow the provisions of the OECD model convention (including articles 7 and 9, which deal with the attribution of profits to PEs and the determination of profits of associated

⁶⁶ See paragraph 88 of the UN commentary on article 1; and paragraph 74 of the OECD commentary on article 1.

⁶⁷ Paragraphs 76-81 of the commentary on article 1 of the OECD model convention; and paragraphs 40-47 of the commentary on article 1 of the UN model convention.

enterprises), they do not follow the OECD version of article 24. Canadian tax treaties can be expected to include the general anti-abuse rule in article 29(9) and the saving clause in article 1(3) of the OECD and UN model conventions. However, those provisions are unlikely to have any effect on restrictions on the deduction of interest under Canadian domestic law. As discussed above, article 29(9) allows countries to deny treaty benefits in certain circumstances. Since tax treaties do not deal with the deductibility of interest except as a matter of non-discrimination under article 24, article 29(9) would appear to have a very limited role with respect to restrictions on the deduction of interest under domestic law. Article 1(3) allows states to tax their residents without regard to the treaty, subject to several exceptions, including the non-discrimination article; therefore, the key issue is the effect of articles 9(1) and 24 on restrictions on the deduction of interest under Canadian law.

Canadian Tax Treaty Policy with Respect to the Non-Discrimination Article

Clearly, one aim of Canadian tax treaty policy is to ensure that the provisions of its tax treaties do not prevent Canada from applying its thin capitalization rules. This aim is accomplished in a variety of ways, all of which appear to be effective. As noted above, the only provisions of the OECD and UN model conventions that could prevent the application of Canada's thin capitalization rules are provisions similar to articles 24(4) and (5) and article 9(1), which is an exception to articles 24(4) and (5). Article 24(4) prevents a contracting state from allowing the deduction of interest and other disbursements paid by its residents to residents of the other state on terms that are less favourable than those applied to the deduction of interest paid to its own residents. Article 24(5) prevents a contracting state from treating resident corporations owned or controlled by residents of the other contracting state less favourably than it treats resident corporations owned or controlled by its own residents. Both provisions are subject to an exception for less favourable treatment that is in accordance with article 9(1) or 11(6), which allows countries to adjust the amount of non-arm's-length or excessive payments of interest.

The four major methods used to preserve the application of Canada's thin capitalization rules in its tax treaties are the following:

1. *Tax treaties without any non-discrimination article.* Six treaties—the treaties with Australia, Ivory Coast, Kuwait, New Zealand, Oman, and Papua New Guinea—do not have any non-discrimination article.
2. *Tax treaties without articles 24(4) and (5).* Eleven treaties—those with Austria, Finland, France, Jordan, Malaysia, Moldova, Russia, Singapore, Ukraine, United Kingdom, and Venezuela—have non-discrimination articles, but those articles do not contain provisions similar to articles 24(4) and (5) of the OECD and UN model conventions.
3. *Tax treaties without article 24(4) and with article 24(5) limited to most-favoured-nation treatment.* Over 50 treaties have non-discrimination articles without

any provision similar to article 24(4), but with a provision that is similar to article 24(5) and is limited to most-favoured-nation treatment (unlike article 24(5) of the OECD and UN model conventions, which provides national treatment). Article 24(5) of the OECD and UN model conventions ensures that Canadian-resident corporations controlled by residents of the other contracting state are treated no worse than Canadian-resident corporations controlled by residents of Canada. In contrast, the most-favoured-nation treatment provided by article 24(5) of these treaties ensures only that Canadian-resident corporations controlled by residents of the other contracting state will be treated no worse than Canadian-resident corporations controlled by the residents of any third country. Thus, Canada is not required to allow Canadian-resident corporations to deduct interest paid to the residents of these countries as long as interest paid to the residents of any other country with which Canada has a tax treaty is not deductible.

4. *Tax treaties with article 24(4) subject to an exception for restrictions on the deduction of interest and with article 24(5) limited to most-favoured-nation treatment.* Thirteen treaties⁶⁸ contain non-discrimination articles with provisions similar to articles 24(4) and (5) of the OECD and UN model conventions; however, the provision equivalent to article 24(5) is limited to most-favoured-nation treatment, as described above. All of these treaties also contain a specific exception that allows Canada to apply its thin capitalization rules. A typical exception reads as follows:

The provisions of [paragraph 4] shall not affect the operation of any provision of the taxation laws of a Contracting State:

- (a) relating to the deductibility of interest and which is in force on the date of signature of this Convention (including any subsequent modification of such provisions that does not change the general nature thereof); or
- (b) adopted after such date by a Contracting State and which is designed to ensure that a person who is not a resident of that State does not enjoy, under the laws of that State, a tax treatment that is more favourable than that enjoyed by residents of that State.

This exception, although reciprocal, is clearly intended to allow Canada to continue to apply its thin capitalization rules despite the treaty.⁶⁹ It applies only to restrictions on interest deductibility that were in effect at the time that the treaty was signed, and to any subsequent modification of those restrictions that does not alter their general nature. Although the thin capitalization rules have been amended

68 Armenia, Denmark, Lebanon, Mexico, Mongolia, Norway, Portugal, Romania, Slovak Republic, Slovenia, Sweden, and the United States.

69 See the United States, Department of the Treasury, Technical Explanation to the Canada-United States Treaty, April 1984. The Canadian Department of Finance issued a news release indicating that the US technical explanation accurately reflects the understanding of the Government of Canada of the interpretation of the treaty.

several times since they were first enacted in 1972, none of those amendments have altered the general nature of the rules.⁷⁰ Any new restrictions on the deduction of interest adopted by one state after such a treaty is signed can discriminate against residents of the other contracting state, but only if those restrictions are designed to ensure that those residents are not treated more favourably than the first state's own residents.

It is not obvious which of these four methods Canada prefers for preserving the thin capitalization rules in its tax treaties. It seems reasonable to assume that the method adopted in any particular treaty is the one preferred by the other country.

In addition to the four methods described above, which are used by Canada to ensure that its tax treaties do not prevent the application of the thin capitalization rules, the treaties with Belgium, Brazil, Bulgaria, and Uzbekistan achieve the same result in a manner that is peculiar to each of these treaties. Article 24(4) of the treaty with Belgium applies only to royalties; article 24(4) of the treaty with Brazil provides only most-favoured-nation treatment; and article 24(4) of the treaty with Bulgaria provides national treatment for amounts other than interest, in accordance with article 24(4) of the OECD and UN model conventions, but it provides only most-favoured-nation treatment with respect to interest. Article 24(4) of the treaty with Uzbekistan is identical to article 24(4) of the OECD and UN model conventions, but article 24(7) contains an exception for domestic provisions designed to counter tax avoidance.⁷¹

Therefore, since no Canadian tax treaties have non-discrimination provisions that are similar to article 24(4) or (5) of the OECD and UN model conventions and would prevent the application of the thin capitalization rules, the only provision in Canadian tax treaties that could possibly do so is article 9(1).

70 In *Ramada Ontario Limited v. The Queen*, 94 DTC 1071 (TCC), the Tax Court held that in article XXV(7) of the Canada-United States treaty, the "general nature" of the thin capitalization rules meant their purpose and that purpose was not affected by subsequent amendments that altered the definition of "equity." Similar provisions are typically found in the elimination-of-double-taxation articles in Canadian tax treaties. For a discussion of the meaning of these provisions, see Brian J. Arnold, "Unlinking Tax Treaties and the Foreign Affiliate Rules: A Modest Proposal" (2002) 50:2 *Canadian Tax Journal* 607-29, at 619-23.

71 Article 24(7) provides: "The provisions of paragraph 4 shall not affect the provisions of the taxation laws of a Contracting State that are designed to counter transactions or arrangements having as their objective the avoidance of taxation." See Convention Between the Government of Canada and the Government of the Republic of Uzbekistan for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed at Ottawa on June 17, 1999, article 24(7). Presumably, the Canadian tax authorities would take the position that the thin capitalization rules are included in this exception for tax-avoidance provisions. According to paragraph 2 of the protocol of the treaty with Uzbekistan, both article 24(4) and the exception will become effective only on an exchange of letters by the competent authorities. It is unclear whether such an exchange of letters has taken place. If an exchange of letters has not occurred, neither article 24(4) nor the exception would apply, and the treaty with Uzbekistan would not preclude the application of the Canadian thin capitalization rules.

Canadian Tax Treaty Policy with Respect to the Characterization of Interest and Dividends and Debt and Equity

The distinction between interest and dividends is implicitly assumed by the OECD and UN model conventions;⁷² for example, article 24(4) refers to the deduction of interest and other disbursements but does not mention dividends, presumably because dividends are not deductible. It is unclear whether article 24(4) or (5) of the OECD and UN model conventions prevents the application of domestic rules that deem interest to be dividends or dividends to be interest.

The term “dividends” is defined in article 10(3) to mean income from shares “not being debt claims,” and includes “income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.” “Interest” is defined in article 11(3) to mean “income from debt claims of every kind.” Canadian tax treaty practice is different in this regard. Under most Canadian tax treaties, the term “dividends” is defined to include “income that is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.” Moreover, the definition of “interest” is defined to include “income assimilated to income from money lent by the taxation laws of the Contracting State in which the income arises” and excludes any amount included in the definition of a dividend. Thus, interest that is recharacterized as a dividend under the Act is treated as a dividend for the purposes of Canadian tax treaties because it is taxed as income from shares under Canadian law, and because the definition of “dividend” in Canadian treaties is not limited to income from corporate rights. However, interest deemed to be a dividend would be outside the definition of “dividends” in article 10(3) of the OECD and UN model conventions because it is not income from corporate rights. Instead, such interest would appear to be within the definition of “interest” in article 11(3) as income from a debt claim despite the fact that it is deemed to be a dividend under domestic law. Similarly, a dividend that is deemed to be interest under Canadian law would be treated as interest for the purposes of the interest article because the definition of “interest” is not limited to income from debt claims; however, the deemed interest would be treated as a dividend under the OECD and UN model conventions because it is income from corporate rights and not from debt claims.

The term “interest” in article 24(4) of the OECD and UN model conventions and in its counterpart in Canadian tax treaties is not defined; the definition of “interest” in article 11(3) literally applies “as used in this Article.” Thus, the issue is whether the definition of “interest” in article 11(3) applies for the purposes of article 24(4). In the context of the treaty as a whole, including the reference to article 11(6) in article 24(4), the preferable interpretation is probably that interest for the purposes of article 24 should have the same meaning as it has for article 11.

72 Paragraph 3 of the UN commentary on article 11 states that “[a]t the domestic level, interest is usually deductible in calculating profits.”

However, this interpretation is not supported by any authority that I am aware of; and there is an argument that, as an undefined term, “interest” in article 24(4) should have its domestic-law meaning in accordance with article 3(2).

Under Canadian tax treaties, any interest that is deemed to be a dividend would not be subject to article 24(4) irrespective of whether “interest” has the meaning that it has for the purposes of article 11 or its meaning under the Act, since both meanings are the same. However, under the OECD and UN model conventions, interest that is deemed to be a dividend under domestic law is still interest for the purposes of article 11. On the one hand, if this meaning applies for the purposes of article 24(4), article 24(4) will apply to prevent the domestic-law restrictions on the deduction of the interest; on the other hand, if the domestic-law meaning of interest applies for the purposes of article 24(4), article 24(4) will not apply because the interest is deemed to be a dividend.

Where, instead of deeming interest to be a non-deductible dividend, domestic law deems the underlying property in respect of which interest payments are made to be equity rather than debt, the result would likely be different. Article 11(3) of the OECD and UN model conventions defines “interest” as income from “debt claims.” As an undefined term, “debt claims” should have its domestic-law meaning under article 3(2) of the treaty unless the context of the treaty requires a different meaning. Therefore, if domestic law deems certain debt to be equity and, accordingly, any payments on the deemed equity are deemed to be dividends, article 24(4) or (5) would not apply to such deemed dividends. This result seems to be at least curious, and probably unsatisfactory—not because the application of the treaty depends on domestic law, which is often the case, but because the application of the treaty depends on the way in which domestic law achieves a particular result and not on the result itself.

Canadian Tax Treaty Policy with Respect to Article 9(1)

Although Canada has effectively ensured that the non-discrimination article does not prevent the application of Canada’s thin capitalization rules, the issue remains whether article 9(1) of Canadian tax treaties does so.⁷³ A detailed analysis of the relationship between article 9(1) and restrictions on the deduction of interest, including thin capitalization rules, is beyond the scope of this paper;⁷⁴ however, I present a brief summary of the arguments below.

73 The issue has been raised in one Canadian case, *Specialty Manufacturing Ltd. v. The Queen*, 99 DTC 5222 (FCA). The taxpayer argued that article 9(1) of the treaty with the United States restricted Canada’s ability to apply its thin capitalization rules. The complete answer to this argument was the saving clause in the treaty; however, the court held that the amount of the debt was clearly in excess of an arm’s-length amount, so that article 9(1) allowed Canada to disallow the excessive interest.

74 For my views on this issue, see Brian J. Arnold, “The Relationship Between Thin Capitalization Rules and Tax Treaties,” in Bettina Banoun, Ole Gjems-Onstad, and Arvid Aage

In general, the issue is whether article 9(1) is “restrictive” or “illustrative.” These two interpretations reflect the divergent views of OECD member countries as discussed in the 1986 report on thin capitalization.⁷⁵ Under the “restrictive” approach, article 9(1) prohibits adjustments to the profits of an enterprise in excess of an arm’s-length amount (for example, by denying or limiting the deduction of interest paid by a resident to an associated non-resident). As discussed subsequently, most commentators conclude that unless article 9(1) restricts countries in this way, it is meaningless. In contrast, under the “illustrative” approach, article 9(1) provides a non-binding statement of the arm’s-length principle and a framework for the adjustment of profits, but it does not prohibit a country from taxing profits of resident enterprises in excess of an arm’s-length amount. Assuming that article 9(1) prevents a country from taxing profits in excess of an arm’s-length amount, does it also prevent the application of domestic anti-avoidance rules, such as thin capitalization rules, that may have this effect? A subsidiary issue is whether article 11(6), which deals with excessive payments of interest, is consistent with the proper interpretation of article 9(1).

As noted above, although the OECD commentary is not completely clear, it seems to favour the restrictive view of article 9(1); and it clearly states that thin capitalization rules based on a fixed debt-to-equity ratio that apply only to payments of interest to non-residents are contrary to article 9(1) to the extent that they result in the taxation of more than the arm’s-length profits of an enterprise.⁷⁶ Surprisingly, no country, and in particular not Canada, has entered a reservation on article 9(1), perhaps because a reservation is unnecessary in light of the two views recognized in the OECD thin capitalization report. However, the commentary on article 9(2) recognizes that countries might tax more than the arm’s-length profits of an enterprise and indicates that in such situations, the other country is not required to make a corresponding adjustment.⁷⁷

Skaar, eds., *Hoyt Skattet, Festschrift til Frederik Zimmer på 70-årsdagen* (Oslo: Universitetsforlaget, 2014), 5-28. For the more conventional view that article 9(1) prevents a country from taxing more than the arm’s-length profits of taxpayers, see Ekkehart Reimer and Alexander Rust, eds., *Klaus Vogel on Double Taxation Conventions*, 4th ed. (Alphen aan den Rijn, the Netherlands: Kluwer Law International, 2015), 600-04.

75 Organisation for Economic Co-operation and Development, *Thin Capitalisation*, adopted by the OECD Council on 26 November 1986, reproduced in 2017 OECD model convention, at R(4)-1.

76 Paragraph 3 of the commentary on article 9 of the OECD model convention; and paragraph 1 of the commentary on article 9 of the UN model convention, quoting paragraph 3 of the commentary on article 9 of the OECD model convention.

77 Paragraph 6 of the commentary on article 9 of the OECD model convention; and paragraph 6 of the commentary on article 9 of the UN model convention, quoting paragraph 6 of the commentary on article 9 of the OECD model convention.

A textual analysis of article 9(1) indicates that it uses the permissive word “may” rather than the mandatory “shall.”⁷⁸ Therefore, the plain meaning of article 9(1) permits, but does not require, a country to increase the profits of an enterprise as a result of non-arm’s-length transactions. Further, by implication, article 9(1) does not preclude a country from taxing the profits of an enterprise in excess of its arm’s-length profits by limiting interest deductions. Literally, article 9(1) allows a country to increase the profits of an enterprise where it engages in transactions with an associated enterprise in the other contracting state and the profits of the first enterprise are understated because of the non-arm’s-length conditions of these transactions. Article 9(1) does not say anything about whether a country can tax a resident enterprise on profits in excess of its arm’s-length profits.

Taking into account the context of the treaty as a whole, the restrictive interpretation of article 9(1) is not persuasive, in my view. It should be noted that article 9 is different from the other distributive rules of the treaty in that it deals with the allocation of taxing rights between two residence countries, whereas the other rules deal with the allocation of taxing rights between the source and residence countries. Nevertheless, the restrictive view of article 9(1) is contrary to the fundamental principle that a tax treaty does not restrict a country’s rights to tax its own residents unless it does so explicitly.⁷⁹ This principle, which is reflected in the saving clause (article 1(3), added to the OECD and UN model conventions in 2017), is subject to several exceptions, but article 9(1) is not among them.⁸⁰ Therefore, the restrictive view of article 9(1) is contrary to article 1(3) and to the fundamental principle that treaties do not restrict the rights of countries to tax their own residents, which, according to the commentary, is implicit in all tax treaties.

The relationship between articles 7 and 9 is also a relevant consideration. Under article 7, a country *may* tax the business profits of a resident of the other country carrying on business through a PE in the country but only “the profits attributable to that permanent establishment.” It would be strange for article 7 to restrict the authority of a country in which a PE is located to tax an amount in excess of the arm’s-length profits attributable to the PE, but not for article 9 to do so with respect to associated enterprises.⁸¹ Therefore, it is argued that article 9(1) should be interpreted to restrict a country’s right to tax a resident enterprise on more than its

78 Wherever the word “may” is used in other distributive articles of the OECD and UN model conventions, the provisions are not intended to be restrictive of the taxing rights of the relevant country. Moreover, wherever the word “may” is used in a provision that imposes a limitation on a country’s taxing rights, the limitation is explicit: see, for example, article 7. Where the provisions of the model conventions are intended to operate in a restrictive fashion, they use the term “shall be taxable only,” or the expression “may be taxed,” with the restriction spelled out explicitly, as in articles 7, 10, and 11 (and 12 and 12A of the UN model convention).

79 Paragraph 18 of the OECD commentary on article 1.

80 Article 9(2) is an exception to article 1(3); therefore, the exclusion of article 9(1) cannot be considered an oversight.

81 See Reimer and Rust, *supra* note 74, at 603.

arm's-length profits. Although this is a reasonable argument in terms of tax treaty policy, the wording of article 9(1) does not justify a restrictive interpretation as clearly as the wording of article 7 does.

Three other points support the illustrative view of article 9(1). First, although the Group of Twenty (G20)/OECD BEPS action 4 final report⁸² did not deal with the relationship between restrictions on the deduction of interest under domestic law and articles 9(1) and 24, the report's recommendation to limit interest deductions to a percentage of an enterprise's earnings before interest, taxes, depreciation, and amortization applies to interest paid to both arm's-length and non-arm's-length persons. Second, it is widely accepted that tax treaties do not affect limitations on the deduction of meals and entertainment expenses even where those expenses are incurred with respect to arm's-length persons; it is difficult to differentiate between such expenses and other expenses, including interest. Third, in the particular case of Canada, it would be perverse to interpret article 9(1) to prevent Canada from applying its thin capitalization rules when Canada has taken such clear action in all its tax treaties to ensure that the non-discrimination article does not prevent the application of these rules.

Therefore, my view is that, despite the overwhelming weight of case law and scholarly authority to the contrary, article 9(1) does not and should not preclude the application of thin capitalization rules even if they result in the taxation of a resident enterprise on more than its arm's-length profits. Tax treaties should prevent the application of thin capitalization rules and other restrictions on the deduction of expenses only if those restrictions are contrary to article 24.

Canadian Tax Treaty Policy with Respect to Non-Residents Carrying On Business in Canada Through a PE

The issue with respect to non-residents is whether the provisions of Canadian tax treaties that are equivalent to articles 7 and 24(3) of the OECD and UN model conventions prevent restrictions on the deduction of interest by non-residents in computing profits attributable to a PE. As discussed above, article 7 limits Canada to taxing the profits attributable to a PE in Canada; the arm's-length transfer-pricing guidelines under article 9 apply for this purpose. Thus, an argument can be made that Canada cannot deny interest deductions that result in the taxation of a non-resident on more than the arm's-length profits attributable to the PE. However, article 7 deals with the computation of profits (revenue and expenses) attributable to a PE; it does not deal with the deductibility of expenses for this purpose. Since it is generally accepted that countries can limit the deduction of arm's-length meals and entertainment expenses incurred by non-residents, it would seem that they can also limit the deduction of arm's-length interest expenses in determining taxable

82 Organisation for Economic Co-operation and Development, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4—2015 Final Report* (Paris: OECD, 2015).

profits. Therefore, in my view, article 7 of Canada's tax treaties does not prevent the application of Canada's thin capitalization rules to non-residents carrying on business in Canada. This interpretation of article 7 is consistent with the illustrative view of article 9(1) advanced above.

Article 24(3) of Canada's tax treaties prohibits Canada from discriminating against non-residents carrying on business in Canada through a PE. Under Canada's thin capitalization rules, the deduction of interest paid by a non-resident to other non-residents is restricted, but interest paid to Canadian residents is not similarly restricted. Therefore, the issue is whether a non-resident carrying on business in Canada that is not allowed to deduct interest under Canada's thin capitalization rules is treated less favourably than a resident of Canada carrying on similar activities. The key point in the analysis of this issue is the selection of the appropriate comparator. In my view, the appropriate comparator is a Canadian enterprise carrying on business activities similar to those carried on by the non-resident through the PE and paying interest to non-residents. Such a Canadian enterprise would be subject to Canada's thin capitalization rules and would not be entitled to the protection against discrimination provided by articles 24(4) and (5) of the OECD and UN model conventions.⁸³ This result makes sense, because under articles 7 and 24(3), non-residents carrying on business through a PE in Canada are treated the same, with respect to restrictions on the deduction of interest, as Canadian corporations or trusts paying interest to non-residents are treated under articles 9(1) and 24(4) and (5).

In contrast, applying the same comparator in the context of the OECD and UN model conventions would prevent the application of Canada's thin capitalization rules to a non-resident carrying on business in Canada through a PE in Canada to the extent that those rules result in the disallowance of arm's-length interest. Since a Canadian enterprise paying interest to non-residents would be entitled to the protection of articles 24(4) and (5), a non-resident carrying on business through a PE in Canada would be entitled to the same protection under article 24(3). However, the exceptions for articles 9(1) and 11(6) in article 24(4) would also apply for the purposes of article 24(3), with the result that domestic restrictions on the deduction of interest in excess of an arm's-length amount would not be prevented by article 24(3).⁸⁴ This result makes sense in the context of the model conventions

83 It could be argued that deeming a non-resident's equity to be 40 percent of the net assets used in carrying on business through a PE in Canada is less favourable treatment than the determination of the equity of a Canadian-resident corporation carrying on similar business activities. However, a PE is fundamentally different from an independent enterprise and has no equity of its own. Therefore, it is necessary to determine the equity of a PE indirectly, and using the net asset value of the PE seems to be a reasonable proxy for a Canadian corporation's equity.

84 Paragraph 42 of the commentary on article 24 of the OECD model convention; and paragraph 2 of the commentary on article 24 of the UN model convention, quoting paragraph 42 of the OECD commentary on article 24.

because, under articles 7 and 24(3), non-residents carrying on business through a PE are treated the same, with respect to restrictions on the deduction of interest, as resident enterprises paying interest to non-residents are treated under articles 9(1) and 24(4) and (5).⁸⁵

CONCLUSION

In this paper, I have analyzed whether the provisions of Canadian tax treaties affect the restrictions on the deduction of interest under Canadian law. I have reviewed the relevant provisions of Canadian tax treaties and of the OECD and UN model conventions to determine whether they would prevent the application of the Canadian restrictions on the deduction of interest. On the basis of this review, I conclude that all of Canada's tax treaties have been carefully negotiated and drafted to ensure that they do not prevent the application of Canada's thin capitalization rules or rules that deem interest to be dividends. In contrast, the OECD and UN model conventions would prevent the application of any thin capitalization rules, including Canada's, based on a fixed debt-to-equity ratio to the extent that those rules apply only to interest paid to non-residents and disallow the deduction of interest that complies with the arm's-length standard.

Moreover, I question whether the position of the OECD and UN model conventions with respect to thin capitalization rules represents good tax treaty policy. In particular, I suggest that, in light of the addition of the saving clause to the model conventions in 2017, article 9(1) should not be interpreted to prevent the application of domestic restrictions on the deduction of interest that result in the taxation of more than the arm's-length profits of an enterprise. Instead, domestic restrictions on the deduction of interest should be prevented only if they are discriminatory under articles 24(3), (4), or (5).

85 The parallel results for the tax treatment of non-residents carrying on business through a PE under articles 7 and 24(3) and the tax treatment of residents under articles 9(1) and 24(4) and (5) would be clearer if article 7(2) were an explicit exception to article 24(3) and the issue had been explained in the commentary.

The Transfer-Pricing Profit-Split Method After BEPS: Back to the Future

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PRÉCIS

En 2018, le Cadre inclusif sur l'érosion de la base d'imposition et le transfert des bénéfices (BEPS) de l'Organisation de coopération et de développement économiques et du Groupe des Vingt (OCDE/G20) : action 10 a publié des directives révisées sur la méthode transactionnelle de partage des bénéfices. Malheureusement, les directives révisées n'ont pas permis de faire en sorte que la méthode de partage des bénéfices soit plus souvent la méthode d'établissement des prix de transfert la plus appropriée. Les directives révisées indiquent expressément que l'absence d'opérations non contrôlées comparables ne justifie pas, en soi, l'utilisation de la méthode de partage des bénéfices. Dans les anciennes directives, la méthode de partage des bénéfices était peu souvent utilisée. Dans les directives révisées, le seuil d'admissibilité pour l'utilisation de la méthode de partage des bénéfices est encore restrictif. Il est donc probable que la méthode de partage des bénéfices sera rarement la méthode d'établissement des prix de transfert la plus appropriée. Néanmoins, la méthode de partage des bénéfices résiduels est envisagée par l'Action 1 du projet BEPS pour l'imposition de l'économie numérique. Deux des propositions dans le premier pilier de la courte Note politique de 2019 du Cadre inclusif portent sur l'utilisation de la méthode de partage des bénéfices résiduels pour répartir les bénéfices. Ces propositions impliquent de nouvelles règles de répartition des bénéfices qui vont au-delà du principe du lien de dépendance.

ABSTRACT

In 2018, the Organisation for Economic Co-operation and Development/Group of Twenty (OECD/G20) Inclusive Framework on base erosion and profit shifting (BEPS): action 10 issued revised guidance on the transactional profit-split method. Regrettably, the revised guidance failed to provide the opportunity for the profit-split method to be more often the most appropriate transfer-pricing method. The revised guidance expressly states that the lack of comparable uncontrolled transactions, by itself, is not a basis for the use of the profit-split method. Under the former guidance, the profit-split method was used infrequently. In the revised guidance, the threshold requirements for the use of

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the profit-split method are still restrictive. Consequently, it is likely that the profit-split method will rarely be the most appropriate transfer-pricing method. Nevertheless, the residual profit-split method is being considered for BEPS action 1, on the taxation of the digital economy. Two of the proposals under pillar 1 of the Inclusive Framework's 2019 short policy note involve the use of the residual profit-split method to allocate profits. These proposals involve new profit allocation rules that go beyond the arm's-length principle.

KEYWORDS: ARM'S LENGTH ■ BEPS ■ OECD ■ PROFIT-SPLIT ■ TRANSFER PRICING

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INTRODUCTION

The Organisation for Economic Co-operation and Development's (OECD's) base erosion and profit shifting (BEPS) report¹ identified the extensive tax-avoidance practices that are used by multinational enterprise (MNE) groups and that result in substantial revenue losses to national governments. Some of these groups, according

1 Organisation for Economic Co-operation and Development, *Addressing Base Erosion and Profit Shifting* (Paris: OECD, 2013) (herein referred to as "the BEPS report").

to the report, have engaged in aggressive tax avoidance.² One of the chief tax-avoidance strategies identified in the report is the manipulation of transfer pricing and, in particular, the use of intangibles to shift profits to low-tax jurisdictions.³ The 2015 OECD final reports on actions 8-10 seek to allocate profits to jurisdictions on the basis of value creation.⁴

The 2017 OECD transfer-pricing guidelines,⁵ which are based on the arm's-length principle, are premised on a comparison of controlled transactions with comparable uncontrolled transactions. One of the situations in which the arm's-length principle may be applied is one where an associated enterprise has internal comparable uncontrolled transactions. The Achilles heel of transfer pricing is the lack, at times, of comparable uncontrolled transactions. High-speed, high-quality business information systems and communications systems have, inter alia, enabled MNE groups to achieve high levels of integration, which makes comparability a challenge. MNE groups are organized along business lines rather than national borders. MNE groups have the goal of profit maximization, which involves minimizing income tax. Moreover, these groups often enter into transactions that are not reflected in transactions between independent parties.

The OECD's transactional profit-split method ("the profit-split method") represents an opportunity to move away from the uncertainty of the arm's-length principle. But the 2018 OECD revised guidance on the profit-split method⁶ failed to pave the way for formulary (that is formula-based) methods, maintaining the rhetoric of the arm's-length principle. (This revision was undertaken as part of the Inclusive Framework on BEPS: Action 10.)⁷ The 2018 revised guidance claims that the profit-split method cannot be treated as the most appropriate method solely because comparable uncontrolled transactions are unavailable.⁸ Nevertheless, comparable

2 Ibid., at 6.

3 Ibid.

4 Organisation for Economic Co-operation and Development, *Aligning Transfer Pricing Outcomes with Value Creation, Action 8-10—2015 Final Reports* (Paris: OECD, 2015).

5 Organisation for Economic Co-operation and Development, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, July 2017) (herein referred to as "the 2017 OECD transfer-pricing guidelines"). First published in 1995.

6 Organisation for Economic Co-operation and Development, *Revised Guidance on the Application of the Transactional Profit-Split Method: Inclusive Framework on BEPS: Action 10* (Paris: OECD, 2018) (herein referred to as "the 2018 OECD revised guidance").

7 The OECD established the Inclusive Framework on BEPS in June 2016 so that all interested countries and jurisdictions could work together. Over 115 countries and jurisdictions have already joined on an equal footing in developing standards on BEPS-related issues and in reviewing and monitoring its consistent implementation. See Organisation for Economic Co-operation and Development, "What Is BEPS?" (www.oecd.org/tax/beps/beps-about.htm); and Organisation for Economic Co-operation and Development, "OECD/G20 Inclusive Framework on BEPS" (www.oecd.org/tax/flyer-inclusive-framework-on-beps.pdf).

8 2018 OECD revised guidance, at paragraph 2.128.

uncontrolled transactions are usually unavailable in the three situations where the OECD profit-split method is considered to be the most appropriate method—that is, (1) situations involving high degrees of integration, (2) situations involving the contribution of unique and valuable intangibles by the associated enterprises, and (3) situations where the associated enterprises share the same economically significant or closely related risks. The 2018 OECD revised guidance states in detail that the profit-split method may be the most appropriate method if, according to the accurately delineated transaction, the associated enterprises share the same economically significant or closely related risks.⁹

For the allocation of profits to members of an MNE group, the alternative to the arm's-length principle is formulary apportionment, or formulary methods. There is controversy over the relative merits of these alternatives. The 2017 OECD transfer-pricing guidelines rejected formulary apportionment as being an arbitrary and inappropriate method for the allocation of profits between associated enterprises. However, the OECD appeared to be shifting its view of formulary methods when it claimed, in 2018, that it was agnostic on the subject of the arm's-length principle.¹⁰

In this paper, I argue that the 2018 OECD revised guidance on the profit-split method has failed to take the opportunity to move away from the use of the arm's-length principle in allocating profits within MNE groups, and toward the use of formulary factors. The frequent lack of comparable uncontrolled transactions has made transfer pricing arbitrary, and it has created substantial uncertainty for taxpayers and tax administrations. The apparent change in the OECD's rhetoric on the significance of the arm's-length principle was not reflected in the 2018 OECD revised guidance, which placed significant limits on the situations in which the profit-split method may be used. The OECD's revision of the profit-split method was contentious; the revised guidance was finalized in June 2018, following three discussion drafts. A US official asserted that the 2018 OECD revised guidance ensures that the use of the profit-split method will remain infrequent.¹¹ Within months of the release of this guidance, the OECD, the Group of Twenty (G20), and the Inclusive Framework announced that two of the options being considered for BEPS action 1 (on measures for taxing the digital economy) involve the residual profit-split method that uses formulary methods.

9 Ibid., at paragraphs 2.139-2.142.

10 Pascal Saint-Amans, director of the OECD Centre for Tax Policy and Administration, stated at the International Fiscal Association (IFA) congress in 2018 that the OECD was agnostic with respect to the arm's-length principle: See 72d Congress of the International Fiscal Association (IFA), Seoul, September 2-6, 2018, seminar E: IFA/OECD, September 5, 2018, available on *Taxsutra.com* (www.taxsutra.com/sites/taxsutra.com/files/webform/IFA%202018%20-%20Day%203_0.pdf).

11 Christopher Bello, branch 6 chief, IRS Office of Associate Chief Counsel (International), referred to in Ryan Finley, "Narrower OECD Profit Split Guidance Is a Result of U.S. Efforts" (2018) 91:4 *Tax Notes International* 404.

In the next section of this paper, I provide background on the BEPS project and outline some of the proposed revisions to the profit-split method. I discuss the expectations that the profit-split method would become more widely used and that there would be a movement away from the arm's-length principle. Following that discussion, I consider the stringent threshold requirements on the use of the profit-split method that are set out in the 2018 OECD revised guidance. I show that this guidance does not reflect earlier OECD proposals that the profit-split method be made a more frequently used transfer-pricing method, and this guidance does not contain the proposed deviations from the arm's-length principle. In the final section of this paper, I consider the potential use of the residual profit-split method under BEPS action 1, which addresses the taxation of the digital economy.

BACKGROUND

In this section of the paper, I set out the proposals for the reform of the profit-split method—a reform that was eventually finalized in the 2018 OECD revised guidance. The OECD and the G20 had expected that the updated profit-split method would be able to be more widely used. One expectation was that this method could be applied when reliable comparable uncontrolled transactions were unavailable. Moreover, the aggressive tax-avoidance practices of certain multinationals were based on exploiting the flaws in the OECD guidelines that preceded the BEPS transfer-pricing revisions.

The BEPS Project

The BEPS action plan¹² found that globalization has resulted in the integration of national economies and markets. The features of the globalized international economy are capital mobility, fewer trade barriers, substantial advances in telecommunications and business information systems, and the rapidly growing importance and value of intangibles in MNEs. These developments have allowed MNE groups to operate as unitary global enterprises rather than as separate entities in a global group. Moreover, globalization has resulted in increased intragroup trade, and MNEs now command a substantial amount of global gross domestic product (GDP).¹³ Because the services sector and digital products are increasingly available on the Internet, many MNEs maintain operations in several countries in order to exploit (1) economies of scale and (2) savings related to location, such as lower labour costs. From these countries, MNEs are able to provide services, digital products, and tangible products to their customers while maintaining a limited presence in the countries where their customers are located.¹⁴

12 Organisation for Economic Co-operation and Development, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013) (herein referred to as “the BEPS action plan”), at 7 (<https://doi.org/10.1787/9789264202719-en>).

13 Ibid.

14 Ibid.

Concurrent with these developments has been the growth in aggressive tax planning by MNEs.¹⁵ Tax planners identified opportunities for tax arbitrage, and MNEs claimed that they were complying with existing tax laws despite the aggressive planning. In short, MNEs and their tax advisers were operating at a global level, and their aggressive tax planning was substantially eroding the tax bases of nation states. In response to these developments, the BEPS project was commenced, with the BEPS action plan setting out 15 actions to counter the tax-avoidance opportunities available to MNEs.¹⁶

The International Monetary Fund (IMF) has asserted that, although it is too early to determine the impact of the BEPS measures, the scope for international profit shifting remains significant.¹⁷ The areas of concern identified by the IMF are (1) the allocation of risk within MNEs, (2) the valuation of intangibles, and (3) the avoidance or limitation of a physical presence.¹⁸ In support of its assertion that profit shifting has not been countered, the IMF cites the reliance on the “arbitrary qualitative limits” of the BEPS measures, such as the BEPS action 4 measures with respect to interest.¹⁹

In 2019, the OECD, the G20, and the Inclusive Framework noted that MNEs’ unprecedented reliance on intangibles and intragroup services has exposed weaknesses in the existing international tax rules.²⁰ MNE groups operating in the digital economy are able to make substantial profits from user or market jurisdictions (that is, the jurisdictions in which they have significant user participation or customers) without having a significant physical presence in these jurisdictions. The failure of the existing rules to allocate appropriate profits to user or market jurisdictions has caused dissatisfaction in several jurisdictions, some of which have enacted measures. This dissatisfaction has resulted in the consideration of the two basic measures for the allocation of profits to user or market jurisdictions.²¹ These measures are considered below, in the final section of this paper.

The BEPS action plan notes that a formula-based approach has the potential to deal with some of the types of tax avoidance engaged in by MNEs:

15 Ibid., at 8.

16 Ibid.

17 International Monetary Fund, *Corporate Taxation in the Global Economy*, Policy Paper no. 19/007 (Washington, DC: IMF, 2019), at paragraph 12 (www.imf.org/en/Publications/Policy-Papers/Issues/2019/03/08/Corporate-Taxation-in-the-Global-Economy-46650).

18 Ibid.

19 Ibid.

20 Organisation for Economic Co-operation and Development, *Programme of Work To Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy: Inclusive Framework on BEPS* (Paris: OECD, 2019), at paragraph 11 (www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf).

21 Ibid., at paragraph 7.

Alternative income allocation systems, including formula based systems, are sometimes suggested. However, the importance of concerted action and the practical difficulties associated with agreeing to and implementing the details of a new system consistently across all countries mean that, rather than seeking to replace the current transfer pricing system, the best course is to directly address the flaws in the current system, in particular with respect to returns related to intangible assets, risk and over-capitalisation. Nevertheless, special measures, either within or beyond the arm's-length principle, may be required with respect to intangible assets, risk and over-capitalisation to address these flaws.²²

This statement is significant: it marks the OECD's change of adherence with respect to the arm's-length principle, a change made in response to the tax-avoidance opportunities that existed under the OECD guidelines prior to the May 2016 BEPS updates to the OECD guidelines.²³

BEPS action 10 sets out the following objectives:

Develop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties. This will involve adopting transfer pricing rules or special measures to: . . . (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains.²⁴

Discussion Draft on BEPS Action 1

The following statement in the OECD's discussion draft on BEPS action 1²⁵ reflects an intention to move away from the arm's-length principle:

When the arm's-length principle was initially devised, it was common that each country in which an MNE group did business had its own fully integrated subsidiary to carry on the group's business in that country. This structure was dictated by a number of factors, including slow communications, currency exchange rules, customs duties, and relatively high transportation costs that made integrated global supply chains difficult to operate. With the advent of the development in information and communication

22 BEPS action plan, *supra* note 12, at 20.

23 On May 23, 2016, the OECD Council approved the updates to the OECD guidelines as contained in the 2015 OECD final reports on actions 8-10 (*supra* note 4). See Organisation for Economic Co-operation and Development, *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13—2015 Final Report* (Paris: OECD, October 5, 2015). For further information, see Organisation for Economic Co-operation and Development, "OECD Council approves incorporation of BEPS amendments into the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" (www.oecd.org/tax/oecd-council-approves-incorporation-of-beps-amendments-into-the-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations.htm).

24 BEPS action plan, *supra* note 12, at 20-21.

25 Organisation for Economic Co-operation and Development, *OECD's Discussion Draft on BEPS Action 1: Addressing the Tax Challenges of the Digital Economy* (Paris: OECD, 2014).

technology (ICT), reductions in many currency and custom barriers, and the move to digital products and a service based economy, these barriers to integration broke down and MNE groups began to operate much more as single global firms. Corporate legal structures and individual legal entities became less important and MNE groups moved closer to the economist's conception of a single firm operating in a co-ordinated fashion to maximise opportunities in a global economy. Attention should therefore be devoted to the implications of this increased integration in MNEs and evaluate the need for greater reliance on value chain analyses and profit-split methods. This work should also address situations where comparables are not available because of the structures designed by taxpayers and could also include simpler and clearer guidance on the use of profit splits along the lines that have been successfully applied in connection with global trading and other integrated financial services businesses.²⁶

Commentators noted that there were concerns about the OECD's proposed change of policy, which involved moving from the arm's-length principle to formulary apportionment.²⁷

Addressing the Tax Challenges of the Digital Economy (2014)

An OECD/G20 2014 report on the tax challenges of the digital economy²⁸ identified topics related to the digital economy and transfer pricing that need to be examined. The 2014 report noted the importance of intangibles to MNEs, the monetization of data, the development of global value chains, and the consequences for transfer pricing.²⁹ Moreover, the 2014 report pointed out that it would be appropriate to provide "simpler and clearer guidance on the application of the transfer pricing methods, including profit splits in the context of global value chains."³⁰

The 2014 report acknowledged that the transfer-pricing rules need to be revised to reflect the current integration of MNE groups made possible by high-speed, high-quality information and communications systems. It noted that when the arm's-length principle was established, an MNE group had a subsidiary incorporated in the country in which the group operated.³¹ These subsidiaries, prior to globalization,

26 Ibid., at paragraph 163.

27 United States Council for International Business, "Re: USCIB Comment Letter on the OECD Discussion Draft on BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains," submitted to Organisation for Economic Co-operation and Development, Centre for Tax Policy and Administration, Transfer Pricing Unit, February 5, 2015, at 4-8 (www.uscib.org/docs/Action_Item_10_Profit_splits_final_February_5_2015.pdf).

28 Organisation for Economic Co-operation and Development, *Addressing the Tax Challenges of the Digital Economy, Action 1: 2014 Deliverable* (Paris: OECD, 2014) (herein referred to as "the 2014 report").

29 Ibid., at 15-16.

30 Ibid., at 16.

31 Ibid., at 119.

would have had to be autonomous because they would have had difficulty communicating with the parent company on a daily basis. Other factors that would have required a subsidiary to be autonomous were (1) currency exchange rules, (2) customs duties, and (3) transportation costs that would make a global supply chain uneconomic.³² Autonomous subsidiaries would be evaluated on the basis of their individual performance, and they would have the incentive to maximize their profits. In this separate accounting context, the arm's-length principle would have been a realistic measure. Murphy and Baker have observed that in the 1920s and 1930s, consolidated accounting for an MNE group was rare, and that, in consequence, separate accounting provided support for the arm's-length principle.³³ For the past 70 years, however, company law and the accounting profession have recognized that MNE groups operate as unitary businesses; as a consequence, consolidated accounting has been the norm.³⁴

The creation of high-speed and high-quality information and communications systems, the reductions in the currency and customs restrictions, and the movement toward the provision of services and digital products provided a framework in which MNE groups could operate as integrated global entities.³⁵ As global entities, MNE groups reflected the economic concept of a single firm operating to maximize its global profits.³⁶ The 2014 report stated that the consequences of this integration by MNEs, which represents a paradigm shift, need to be examined, with a movement toward "greater reliance on value chain analyses and profit-split methods."³⁷ The 2014 report also noted that the proposed measures should deal with the situations in which—because of the structures implemented by some MNE groups—comparables are unavailable. In particular, the proposed measures "could also include simpler and clearer guidance on the use of profit methods, including profit splits along the lines that have been successfully applied in connection with global trading and other integrated financial services businesses."³⁸ In sum, the 2014 report contains a clear indication that the arm's-length principle has shortcomings in the context of global supply chains and that the use of profit splits should be more widespread.

32 Ibid.

33 Richard Murphy and Andrew Baker, *A Response to the Consultation of an IMF 2019 Analysis of International Corporate Taxation* (London, UK and Sheffield, UK: City, University of London and Sheffield Political Economy Research Institute, December 2018), at 5 (www.taxresearch.org.uk/Documents/IMFSubmission.pdf).

34 Ibid., at 5.

35 2014 report, *supra* note 28, at 119.

36 Ibid.

37 Ibid.

38 Ibid.

2014 Discussion Draft

In accordance with the mandate of the BEPS action plan and the 2014 report, the OECD issued the 2014 discussion draft.³⁹ The 2014 discussion draft considers situations in which the profit-split method might be the most appropriate transfer-pricing method. One of the most significant challenges in transfer pricing is the lack of comparable uncontrolled transactions that are either identical or similar to the controlled transactions; the 2014 discussion draft mentions that one of the shortcomings of one-sided transfer-pricing methods is the lack of reliable comparables.⁴⁰ The discussion draft claims that, if the lack of comparables is a major obstacle, the profit-split method may be useful if it can be used to “determine an arm’s length outcome in accordance with the functions of the parties.”⁴¹ It is incorrect, however, to assert that the profit-split method may be used to determine an arm’s-length outcome in a situation where there are no comparables. In this situation, the capacity to determine compliance with the arm’s-length principle is limited. Moreover, the compliance is based on a hypothesis that cannot usually be tested.

The 2014 discussion draft claims that in situations where comparable uncontrolled transactions do not reflect the functions or risks of the tested party, the profit-split method may “offer the means to vary or flex the results under a one-sided method.”⁴² The example provided in the draft states that a one-sided method results in the finding of an operating market range of 4-10 percent for one of the parties to the controlled transactions. In this situation, a baseline margin of 7 percent is used, which could be adjusted in a pre-determined computation up to 10 percent and down to as low as 4 percent depending on the levels of consolidated profits earned by the associated enterprises. The 2014 discussion draft includes a question about the example, seeking comments on the circumstances in which a profit-split approach would be useful in supporting the application of other methods.⁴³

The 2014 discussion draft considers the fragmentation of functions in an integrated value chain of MNEs.⁴⁴ An MNE group creates a value chain in which group members are allocated functions such as logistics, warehousing, marketing, and sales.⁴⁵ In this situation, it may be difficult to find comparable uncontrolled transactions that carry on identical or similar activities.⁴⁶ Furthermore, this situation may

39 Organisation for Economic Co-operation and Development, *Public Discussion Draft BEPS Action 10: Discussion Draft on the Use of Profit Splits in the Context of Global Value Chains 16 December 2014- 6 February 2015* (Paris: OECD, 2014) (herein referred to as “the 2014 discussion draft”) (www.oecd.org/ctp/transfer-pricing/discussion-draft-action-10-profit-splits-global-value-chains.pdf).

40 Ibid., at paragraph 29.

41 Ibid.

42 Ibid., at paragraph 32.

43 Ibid., at 10, question 21.

44 Ibid., at paragraphs 26-28.

45 Ibid., at paragraph 26.

46 Ibid.

be complicated by a high degree of integration between the associated enterprises—a level of integration that would not be reflected in independent enterprises. The fragmentation in an MNE group makes it challenging to find comparable uncontrolled transactions, which will not contain the same function, asset, and risk profile as the controlled transactions.⁴⁷ The 2014 discussion draft states that if fragmentation prevents reliable comparable transactions from being obtained, “it may be feasible to support the outcomes of pricing based on potential comparables with a transactional profit split approach.”⁴⁸ The approach suggested in the discussion draft is one that may be used to identify comparables for some or all of the fragmented activities on a combined basis, and whose contribution analysis could be applied to allocate the combined profits.⁴⁹ This proposal on fragmentation was not reflected in the 2018 OECD revised guidance on the profit-split method.

The Final Two Discussion Drafts

Before the finalization of the 2018 OECD revised guidance, the OECD issued two further discussion drafts. One appeared in July 2016,⁵⁰ the other in June 2017.⁵¹ In total, the OECD published three discussion drafts concerning the revision of the guidance on the profit-split method. This extensive process indicates that the OECD and the Inclusive Framework faced challenges in establishing consensus on the matter.

THE 2018 OECD REVISED GUIDANCE

The 2018 OECD revised guidance, published in June 2018, states that the guidance on the profit-split method in the 2017 OECD transfer-pricing guidelines is deleted and replaced with sections C.1-C.5 and annex II to chapter II.⁵² The 2018 revised guidance is a response to the mandate under BEPS action 10. The profit-split method had been part of the OECD guidelines since 1995 and was initially a method of last resort. The 2010 OECD guidelines provided that all of the transfer-pricing methods have equal weight and that the most appropriate method should be used. This policy remained unaltered by the 2018 OECD revised guidance.⁵³ As I discuss below, the profit-split method is rarely used and has remained, in effect, a transfer-pricing method of last resort.

47 Ibid., at paragraph 27.

48 Ibid.

49 Ibid.

50 Organisation for Economic Co-operation and Development, *Public Discussion Draft: BEPS Actions 8-10, Revised Guidance on the Profit Splits 4 July-5 September 2016* (Paris: OECD, 2016) (www.oecd.org/tax/transfer-pricing/BEPS-discussion-draft-on-the-revised-guidance-on-profit-splits.pdf).

51 Organisation for Economic Co-operation and Development, *Public Discussion Draft BEPS Action 10 Revised Guidance on Profit Splits 22 June-15 September 2017* (Paris: OECD, 2017) (www.oecd.org/ctp/transfer-pricing/Revised-guidance-on-profit-splits-2017.pdf).

52 2018 OECD revised guidance, *supra* note 6, at 11-44.

53 Ibid., at paragraph 2.114.

The 2018 OECD revised guidance claims that it “clarifies and significantly expands the guidance on when a profit-split method may be the most appropriate method.”⁵⁴ I would suggest, however, that this revised guidance has failed to expand the scope for using the profit-split method. In particular, it has left the profit-split method tied to the arm’s-length principle, given that comparable uncontrolled transactions are (paradoxically) unavailable for MNE groups that are highly integrated. The underlying policy, reflected in the threshold requirements, is that the profit-split method should continue to be sparingly used. Moreover, the profit-split method cannot be used because reliable comparables, *per se*, are unavailable.⁵⁵

The profit-split method set out in the 2018 revised guidance is based on the arm’s-length principle, notwithstanding initial suggestions of a move away from this principle. The revised guidance provides that the profit-split method seeks to “establish arm’s length outcomes or test reported outcomes for controlled transactions in order to approximate the results that would have been achieved between independent enterprises engaging in a comparable transaction or transactions.”⁵⁶ The profit-split method involves two steps. First, one identifies the profits to be split from controlled transactions.⁵⁷ Second, those profits are divided between the parties on an economically valid basis that approximates the division of profits that would be established between arm’s-length parties.⁵⁸ The 2018 revised guidance claims that the profit-split method is best suited to situations where the profits to be allocated to the parties can be reliably valued on the basis of the parties’ relative contributions to the profits arising from the controlled transactions.⁵⁹

The 2018 OECD revised guidance notes that the references to “profits” should be treated as also applying to losses from controlled transactions.⁶⁰ If the profit-split method is the most appropriate method, it should apply in the same manner to both profits and losses.⁶¹

The Transactional Profit-Split Method as the Most Appropriate Method

The 2018 OECD revised guidance requires the selection of the transfer-pricing method that is the most appropriate for the tested party.⁶² The most appropriate method will be determined on the basis of

54 See *ibid.*, executive summary.

55 *Ibid.*, at paragraph 2.114.

56 *Ibid.*

57 *Ibid.*

58 *Ibid.*

59 *Ibid.*

60 *Ibid.*, at paragraph 2.115.

61 *Ibid.*

62 *Ibid.*, at paragraph 2.116, referring to paragraph 2.2.

- the respective strengths and weaknesses of the methods;
- the degree of appropriateness in view of the accurately delineated controlled transactions;
- the availability of reliable information; and
- the degree of comparability between the controlled and uncontrolled transactions.⁶³

The basis for using the profit-split method is the following: the result that it provides reflects the result that independent parties would have reached in the same or similar circumstances. In the absence of comparables, the arm's-length principle is merely a hypothesis; it is difficult to determine objectively what independent parties would have done. It can be argued on this basis that formulary approaches, such as the profit-split method, result in the same profit allocations to jurisdictions that independent parties would have made.⁶⁴ Moreover, it has been asserted that the arm's-length principle and formulary methods should be viewed as being part of a continuum of methods.⁶⁵ Nevertheless, the 2017 OECD transfer-pricing guidelines treat formulary apportionment as an inappropriate method of allocating profits within an MNE group.⁶⁶

Strengths and Weaknesses of the Transactional Profit-Split Method

The key advantage of the profit-split method is that it provides solutions for cases in which both parties to a controlled transaction make unique and valuable contributions, such as unique and valuable intangibles.⁶⁷ In these circumstances, it is highly unlikely that comparable transactions are available for the application of a one-sided method. This point is noted in the 2018 OECD revised guidance: "[T]here will be no reliable comparables information which could be used to price the entirety of the transaction in a more reliable way, through the application of another method."⁶⁸ The revised guidance provides that in such a case, profits may be allocated, under the profit-split method, on the basis of the parties' contributions, which are determined by reference to the relative values of their respective functions, assets, and risks.⁶⁹

The 2018 OECD revised guidance treats the profit-split method as potentially the most appropriate method for highly integrated operations when a one-sided method

⁶³ Ibid.

⁶⁴ See Reuven S. Avi-Yonah, "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation" (1995) 15:1 *Virginia Tax Review* 89-159, at 94.

⁶⁵ Ibid., at 158-59.

⁶⁶ See the 2017 OECD transfer-pricing guidelines, *supra* note 5, at paragraphs 1.15-1.32.

⁶⁷ 2018 OECD revised guidance, *supra* note 6, at paragraph 2.119.

⁶⁸ Ibid.

⁶⁹ Ibid.

would not be appropriate.⁷⁰ The guidance recognizes that the advantage of the profit-split method is that it provides flexibility through its ability to take into account the specific and usually unique facts and circumstances of the parties to a controlled transaction.⁷¹ These facts and circumstances are unlikely to be replicated in uncontrolled transactions. If a high degree of uncertainty for the parties to a controlled transaction arises from their shared assumption of economically significant risks (or from their separate assumption of closely related economically significant risks), the profit-split method provides flexibility to allow for a profit split that provides each party with a so-called arm's-length profit that is based on the results of the risks in the controlled transaction.⁷²

The 2018 OECD revised guidance notes that another strength of the profit-split method is that the contributions of the parties to the transaction are directly tested.⁷³ The method provides for the identification of the contributions of the parties to the controlled transactions and for the calculation of the respective values of these contributions, such that the appropriate arm's-length compensation for the parties can be determined.⁷⁴

A weakness of the profit-split method, according to the guidance, is the difficulty of applying it.⁷⁵ The method may appear accessible to taxpayers and tax authorities because its application relies less than other methods on comparable uncontrolled transactions between independent entities.⁷⁶ However, as the guidance argues, both taxpayers and tax authorities may have difficulty in obtaining the necessary information to apply the method.⁷⁷

The 2018 OECD revised guidance points out several further challenges that the profit-split method may pose.⁷⁸ First, there may be difficulties in measuring the income and costs for the parties to the controlled transaction. Such measuring requires that the accounting information for the controlled transactions be produced on a common basis, with adjustments for differences in accounting standards and currencies. Second, in applying the profit-split method to the parties' net profit from the controlled transaction, it may be difficult to determine the appropriate expenses involved in the transaction and then to allocate these costs to the controlled transactions and the other transactions of the parties. Third, it may be difficult to determine which profit-splitting criteria should be applied. Moreover, the process involves various other demands: (1) the exercise of judgment and the documenting

70 Ibid., at paragraph 2.120.

71 Ibid., at paragraph 2.121.

72 Ibid.

73 Ibid., at paragraph 2.122.

74 Ibid.

75 Ibid., at paragraph 2.123.

76 Ibid.

77 Ibid.

78 Ibid.

of the reasoning involved in the application of the profit-split method; (2) a determination of how the profits from the controlled transactions were calculated; and (3) an identification of the basis on which the profit-splitting factors were selected.⁷⁹

The 2018 OECD revised guidance acknowledges the claim that, because independent parties rarely use the profit-split method, the use of this method by associated enterprises should be similarly rare.⁸⁰ The guidance notes, however, that if the profit-split method is determined to be the most appropriate method, the infrequency of its use by independent parties is not an obstacle to its application by others;⁸¹ its use is not restricted to situations that replicate the arrangements of independent parties. The profit-split method is based on “verifying arm’s length outcomes for controlled transactions.”⁸²

The Accurately Delineated Transaction

An accurate delineation of the controlled transaction is an important part of the process for determining whether the profit-split method is the method most appropriate for that transaction.⁸³ This accurate delineation will involve a determination of the commercial and financial relations between the parties to the controlled transaction, an analysis of the contributions of the parties, and an identification of the context of the controlled transaction.⁸⁴ The 2018 OECD revised guidance states that the existence of unique and valuable contributions by each party may be the most important factor in determining whether the profit-split method is the most appropriate method for a controlled transaction.⁸⁵ When it comes to evaluating whether the parties’ contributions are unique and valuable, a relevant factor is the context of the controlled transaction, including the industry involved.⁸⁶ The existence of a high level of integration between the parties or the parties’ shared assumption of economically significant risks would also be a factor supporting the use of the profit-split method.⁸⁷ The more of these factors that are present in a particular case, the more compelling the support for using the profit-split method.

The profit-split method is not appropriate, according to the 2018 OECD revised guidance, if the accurate delineation of the controlled transaction reveals that one of the parties (1) performs only simple functions; (2) does not assume economically

79 Ibid.

80 Ibid., at paragraph 2.124.

81 Ibid.

82 Ibid.

83 Ibid., at paragraph 2.125.

84 Ibid.

85 Ibid., at paragraph 2.126.

86 Ibid.

87 Ibid.

significant risks; and (3) does not make a contribution that is unique and valuable.⁸⁸ The basis for this conclusion is that, given the relative contributions and assumption of risk by the parties, it is unlikely that the share of profits from such a controlled transaction would reflect the outcome of an arm's-length transaction.

The 2018 OECD revised guidance notes that a lack of closely comparable uncontrolled transactions should not be the basis, *per se*, for determining that the profit-split method is the most appropriate method.⁸⁹ The guidance claims that, subject to the circumstances, if there exist uncontrolled transactions that are "sufficiently comparable" but not identical to the controlled transactions, a one-sided method is more reliable than the use of the profit-split method.⁹⁰ The unequivocal point made in the guidance is that a lack of close comparables cannot be the only basis for the use of the profit-split method. Nevertheless, the three-part restriction that I cite in the previous paragraph is substantial, given that comparability is the main challenge when it comes to transfer pricing.

Surprisingly, the 2018 OECD revised guidance asserts that if information is available that independent parties in certain industries "commonly use profit splitting approaches" in situations similar to that of the controlled transaction, then the profit-split method may be the most appropriate for the controlled transaction.⁹¹ The profit-split method is rarely used for controlled transactions, and it is likely that its use in uncontrolled transactions would be even more infrequent. Curiously, the 2018 OECD revised guidance claims that industry practices may indicate that each party makes unique and valuable contributions to the controlled transactions and that the parties are highly interdependent.⁹² Transfer pricing requires a case-by-case analysis, and determinations as to contributions and interdependence are based on the accurate delineation of the controlled transaction. This raises the question of how industry practices will affect the accurate delineation of the controlled transactions.

When the Transactional Profit-Split Method May Be the Most Appropriate Method

In this section of the paper, I set out the conditions in which the profit-split method may be the most appropriate method for the allocation of profits among members of an MNE group. According to the 2018 OECD revised guidance, the profit-split method may be the most appropriate when

- each party to the controlled transactions makes unique and valuable contributions;
- the business operations are highly integrated; or,
- the parties share economically significant risk.

88 Ibid., at paragraph 2.127.

89 Ibid., at paragraph 2.128.

90 Ibid.

91 Ibid., at paragraph 2.129.

92 Ibid.

Although the profit-split method provides a viable alternative for allocating profits, its future use in transfer pricing is not likely to become widespread.

Unique and Valuable Contributions by Each Party to a Controlled Transaction

Contributions that parties may make to a controlled transaction include the functions performed and the assets used or contributed.⁹³ Such contributions will be treated as unique and valuable if they are (1) not comparable to contributions made by parties to uncontrolled transactions in comparable circumstances, and (2) an important source of actual or potential benefits that arise from the controlled transactions.⁹⁴ The 2018 OECD revised guidance claims that these factors are often connected; comparables for these contributions are rarely available *because* they are an important source of economic advantage.⁹⁵ The guidance notes that risks arising from the respective unique and valuable contributions cannot be controlled by “the other party” and that the existence of such control may affect the accurate delineation of the controlled transaction.⁹⁶ The guidance provides the following example. One party to a controlled transaction is the developer and manufacturer of a significant component of a product.⁹⁷ The other party to the transaction is the developer and manufacturer of another important component of the same product. Both parties make valuable and unique contributions that are reflected in valuable intangibles that provide substantial economic benefits to the parties. Although neither party is able to control the development risk for the product, the parties are jointly able—through working together in the controlled transactions—to control risks and share the profits arising from their collaboration.⁹⁸

The 2018 OECD revised guidance claims that if it is not possible to obtain reliable comparable uncontrolled transactions, the profit-split method may be the most appropriate method for controlled transactions involving the transfer of fully developed intangibles.⁹⁹ The profit-split method may also be the most appropriate method for controlled transactions involving partially developed intangibles.¹⁰⁰

Highly Integrated Business Operations

The 2018 OECD revised guidance claims that if an MNE group is highly integrated, the profit-split method may be appropriate.¹⁰¹ A substantial degree of integration is

93 Ibid., at paragraph 2.130.

94 Ibid.

95 Ibid.

96 Ibid.

97 Ibid.

98 Ibid.

99 Ibid., at paragraph 2.132.

100 Ibid.

101 Ibid., at paragraph 2.133.

required for this to be the case. The threshold set out in the guidance is as follows: one party's contributions (determined on the basis of functions performed, assets used, and risks assumed) to the controlled transactions are so closely connected to the other party's contributions that the individual contributions of each party cannot be reliably determined.¹⁰² The guidance acknowledges that most MNEs operate in an integrated manner but that there are "many instances" of integrated operations in which the contributions of one of the parties to a controlled transaction can be evaluated on the basis of comparable uncontrolled transactions.¹⁰³

For example, according to the guidance, if the parties to a controlled transaction provide complementary activities that are discrete, comparable transactions may be available. The basis for this claim is that if each contribution to the controlled transaction in each stage can be measured on the basis of functions performed, assets used, and risks assumed, these contributions may be comparable with those for comparable uncontrolled transactions.¹⁰⁴ However, this restriction on the use of the profit-split method appears to be misguided. First, transfer pricing is based on an analysis of the party that makes the simplest contributions to the controlled transaction. As a result, the tax authority for the party that makes the more complex contributions has to rely exclusively on a transfer-pricing analysis that has taken place in the other jurisdiction and that is based on information located in that jurisdiction. This is an important limitation of the arm's-length principle: it cannot usually be applied to the party that makes the more complex contributions to controlled transactions. The critical challenge is being able to find comparable uncontrolled transactions for the purposes of a comparability analysis. It will often be difficult to find reliable comparables.

The 2018 OECD revised guidance notes that for some controlled transactions, the contributions of the respective parties may be so highly integrated that it is impossible to evaluate the individual contributions.¹⁰⁵ In such cases, the profit-split method may be the most appropriate method of allocating income among members of the MNE group. The example provided is that of the global trading of financial instruments by associated enterprises.¹⁰⁶ Another example provided is one in which the integration of the contributions takes the form of a high degree of interdependency between the associated enterprises—for example, when the associated enterprises have long-term arrangements whereby each party has made significant contributions, and the business advantage of the arrangements depends on the continued participation of each associated enterprise,¹⁰⁷ the profit-split method may be the most appropriate method. In this example, the parties have made significant

102 Ibid.

103 Ibid.

104 Ibid.

105 Ibid., at paragraph 2.134.

106 Ibid.

107 Ibid., at paragraph 2.135.

contributions and are dependent on each other. The 2018 OECD revised guidance states that in such a case, a profit-split method provides flexibility for dealing with the outcomes of the risks of the controlled transactions arising from the interdependence of the parties.

In highly integrated business operations, the associated enterprises may share economically significant risks or may independently assume closely related and economically significant risks.¹⁰⁸ The revised guidance provides that in such cases, the profit-split method may be the most appropriate method.¹⁰⁹ An important question is whether the method should be applied to anticipated or actual profits.¹¹⁰

Another controlled-transaction situation in which the profit-split method may be the most appropriate method, according to the guidance, is a situation where one party to the transaction contributes to the control of economically significant risk that is assumed by the other party to the controlled transaction.¹¹¹ In this situation, the party contributing to the control of the risk would be able to share in any returns arising from the risk or would be required to bear any losses that result from the risk being realized. But the mere contribution of the party to the control of risk does not by itself justify the use of the profit-split method.¹¹²

Shared Assumption of Economically Significant Risks and Separate Assumption of Closely Related Risks

The profit-split method may be the most appropriate method when the accurate delineation of the transaction establishes that the parties to the controlled transaction share the assumption of associated, economically significant risks.¹¹³ Even if the accurate delineation discloses that both parties assume separate risks associated with the transaction, the profit-split method may be found most appropriate if the results of the risks cannot be isolated.¹¹⁴

The use of the profit-split method in the case of the shared or interrelated risks of associated enterprises depends on whether these risks are sufficiently significant, from an economic perspective, to warrant the parties' sharing of the profits associated with the risks.¹¹⁵ The economic significance of these risks should be determined by reference to their status in the actual or anticipated profits and the status of the risk for one of the parties where that party's business extends "beyond those covered by the relevant profits."¹¹⁶

108 Ibid., at paragraph 2.136.

109 Ibid.

110 Ibid.

111 Ibid., at paragraph 2.137.

112 Ibid.

113 Ibid., at paragraph 2.139.

114 Ibid., at paragraph 2.140.

115 Ibid., at paragraph 2.141.

116 Ibid.

If the profit-split method is the most appropriate method when the parties share economically significant risks or when each party separately assumes inter-related, economically significant risks, the profit being split, according to the 2018 OECD revised guidance, should probably be actual profits and not anticipated profits.¹¹⁷ The basis for this claim is that a split of actual profits will reflect the actual outcomes of the risks for each party to the controlled transaction, whereas a split of anticipated profits will focus on the outcome of the risks for only one party.¹¹⁸

Lack of Comparables

The 2018 OECD revised guidance notes that the situations where the profit-split method is the most appropriate method are usually situations where the elements needed for other transfer-pricing methods are absent.¹¹⁹ Other transfer-pricing methods rely on comparable uncontrolled transactions. The revised guidance claims that if reliable uncontrolled comparable transactions are available, it is less likely that the profit-split method will be the most appropriate method.¹²⁰ Nevertheless, the guidance also states that if the profit-split method is used when reliable comparables are unavailable, information from independent parties “may still be relevant to the application of the method.”¹²¹

At the same time, the revised guidance claims that a lack of reliable uncontrolled comparables cannot be the only basis for resorting to the profit-split method.¹²² This qualification is significant, given that the most significant challenge in transfer-pricing analysis is finding reliable comparables. The 2014 discussion draft suggested that the use of the profit-split method should be increased in situations where reliable comparables are unavailable.¹²³ I would suggest that the 2018 OECD revised guidance should expressly state that the profit-split method may be used if reliable comparables are unavailable. The profit-split method has the capacity to be used on an objective basis to allocate the profits from controlled transactions to the members of the MNE group.

THE SHORTCOMINGS OF THE ARM’S-LENGTH PRINCIPLE

Transfer pricing is premised on separate accounting and on the arm’s-length principle. According to the 2017 OECD transfer-pricing guidelines, the arm’s-length principle is used by MNE groups and by tax administrations in OECD countries.¹²⁴

117 Ibid., at paragraph 2.142.

118 Ibid.

119 Ibid., at paragraph 2.143.

120 Ibid.

121 Ibid., at paragraph 2.144.

122 Ibid., at paragraph 2.143.

123 2014 discussion draft, *supra* note 39, at paragraph 29.

124 Ibid., at paragraph 1.1.

The principle is based on uncontrolled transactions between independent parties. When independent parties enter into contracts, the conditions of their financial and commercial relations involve the operation of market forces. The arm's-length principle is effective if a market exists for goods, assets (such as intangibles), or services that are being transferred within an MNE group. In the case of unique intangibles, however, it is a significant challenge to find comparable items being sold in uncontrolled transactions.¹²⁵ In addition, the substantial size and centralized control of MNE groups may give these groups efficiency advantages over independent entities. Accordingly, the transfer prices for such controlled transactions will be different from the arm's-length prices used by parties to an uncontrolled transaction.¹²⁶ The US General Accounting Office (GAO) has noted that tax authorities and MNE groups will face significant problems in applying the arm's-length principle to intangibles involved in controlled transactions by associated enterprises.¹²⁷

When transfer prices for parties to a controlled transaction do not reflect the arm's-length principle, the tax liabilities of the parties and the tax revenues of their respective jurisdictions may be distorted.¹²⁸ OECD countries have agreed that the taxable income of associated enterprises may be adjusted to correct any distortions arising from controlled transactions. The resulting adjustment should be based on the conditions of the commercial and financial relations that would be found between independent parties in comparable transactions and comparable circumstances.¹²⁹ Accordingly, as the 2017 OECD transfer-pricing guidelines state, the arm's-length principle is founded on comparability: “‘comparability analysis’ . . . is at the heart of the application of the arm's-length principle.”¹³⁰ Strikingly, these 2017 guidelines assert that “[t]he arm's-length principle has also been found to work effectively in the vast majority of cases.”¹³¹ The veracity of this statement is now questionable, in light of the BEPS project.

The OECD has historically adhered to the arm's-length principle. However, as discussed above, it has recently indicated that it is willing to consider formulary methods when the arm's-length principle is ineffective in allocating profits to the

125 United States, Government Accountability Office, *International Taxation Information on the Potential Impact on IRS and U.S. Multinationals of Revised International Guidance on Transfer Pricing*, report to the United States Senate, Committee on Finance, document no. GAO-17-103 (Washington, DC: GAO, January 2017), at 23; and see François Vincent, “Transfer Pricing and the Attribution of Income to Permanent Establishments: The Case for Systematic Global Profit Splits (Just Don’t Say Formulary Apportionment)” (2005) 53:2 *Canadian Tax Journal* 409-16, at 410.

126 See United States, Government Accountability Office, *supra* note 125, at 23.

127 *Ibid.*

128 2017 OECD transfer-pricing guidelines, *supra* note 5, at paragraph 1.3.

129 *Ibid.*

130 *Ibid.*, at paragraph 1.6.

131 *Ibid.*, at paragraph 1.9.

jurisdictions in which MNE groups operate.¹³² As stated above, the OECD and the Inclusive Framework are no longer limited by the arm's-length principle. The arm's-length principle, as set out in the OECD guidelines, is both flexible and ambiguous.¹³³ Transfer pricing often involves uncertainty: it relies on the identification of comparable uncontrolled transactions in identical or comparable circumstances, but the controlled transactions in which MNEs engage with associated enterprises are often not replicated in uncontrolled transactions. Moreover, for many MNE groups, intangibles—for example, trademarks, patents, marketing intangibles, and knowhow—are becoming increasingly important. The existence of high-value or unique intangibles makes comparability a challenge in transfer pricing.

The first step in transfer pricing is the accurate delineation of a controlled transaction, which involves identifying the relative contributions of the parties to the transaction. The relative contributions are determined on the basis of the functions performed, the assets used, and the risks assumed by the respective parties. The second step in transfer pricing is to identify comparable uncontrolled transactions and the most appropriate transfer-pricing method that may be used to determine whether the controlled transaction satisfies the arm's-length principle.

The reform of the profit-split method became a debate about the viability of the arm's-length principle and about whether deviations from this principle that are based on formulary methods are justified. As discussed above, there was expectation that, because of the shortcomings of the arm's-length principle, the profit-split method might become more widely used. The current and former guidance on the profit-split method, however, set out high threshold requirements for its use, ensuring that it is rarely applied.¹³⁴ Others have argued that the arm's-length principle is not under threat¹³⁵ and that the revisions to it should therefore be modest. The 2017 OECD transfer-pricing guidelines acknowledge that the separate-entity approach does not take into account economies of scale and the integration of MNE groups.¹³⁶ These guidelines acknowledge that there exist no generally accepted objective criteria by which to allocate between associated enterprises the benefits that MNEs, by being part of a group, reap from economies of scale or integration.¹³⁷ The GAO

132 See Yariv Brauner, "Tax Treaties in the Aftermath of BEPS" (2016) 41:3 *Brooklyn Journal of International Law* 973-1041. The article notes that country-by-country (CbC) reporting, according to the OECD, may be used only for the purposes of risk assessment in transfer-pricing enforcement. But there is a concern that some countries, particularly small developing countries, may use CbC reporting to apply formulary methods to allocate profits to a resident MNE.

133 Helen Rogers and Lynne Oats, "Emerging Perspectives on the Arm's-Length Principle and Formulary Apportionment" [2019] no. 2 *British Tax Review* 150-65, at 152.

134 See Brauner, *supra* note 132, at 1037-38.

135 See Christian Kaeser, Jeffrey Owens, and Sam Sim, "Going the Way of the Polaroid: Digital Taxation and the End of the Arm's-Length Principle" (2019) 95:3 *Tax Notes International* 211-19.

136 2017 OECD transfer-pricing guidelines, *supra* note 5, at paragraph 1.10.

137 *Ibid.*

analysis (considered in more detail below) claims that risk is another area in which the arm's-length principle faces problems, "because risk cannot be allocated between associated entities."¹³⁸

Some commentators have called for the retention of the arm's-length principle,¹³⁹ claiming that in the context of the proposals for BEPS action 1 (considered below), this principle should survive as a "broad church" that countries can continue to adopt.¹⁴⁰ These commentators claim that a movement toward formulary apportionment, as anticipated in the 2014 discussion draft's proposed revision to the guidance on the profit-split method, would result in the misuse of the profit-split method by tax authorities and (as a consequence of this misuse) in double taxation.¹⁴¹ Brauner has contended that the OECD has resisted suggestions that it should re-evaluate the arm's-length principle, despite a gradual move away from the arm's-length principle.¹⁴² He claims that both the OECD and the United States, prior to the BEPS project, deviated from the arm's-length principle while remaining strident supporters of it.¹⁴³ The OECD's continued support of the arm's-length principle is reflected in the 2018 OECD revised guidance.

A US Internal Revenue Service (IRS) official has stated that the proposals in the 2018 OECD revised guidance were significantly more limited than the proposals in the 2014 discussion draft.¹⁴⁴ This official claimed that the 2014 discussion draft reflected the view, shared by several countries, that the profit-split method should be applied more broadly than it is, in order to prevent aggressive tax avoidance by MNE groups.¹⁴⁵ The official noted that the use of the profit-split method could not be based on a lack of comparables per se, because there will often be "challenges in identifying good comparables."¹⁴⁶ The official also noted that threshold requirements for the use of the profit-split method are high in order to ensure that its use is limited.¹⁴⁷ A senior US Treasury official has claimed that the profit-splitting measures developed for BEPS action 1 on the digital economy will continue to be based on

138 See United States, Government Accountability Office, *supra* note 125, at 14.

139 See Kaeser et al., *supra* note 135; Jefferson VanderWolk, "The Arm's-Length Standard Enters Its Second Century" (2019) 93:9 *Tax Notes International* 961-68; Robert Robillard, "BEPS: Is the OECD Now at the Gates of Formulary Apportionment?" (2015) 43 6/7 *Intertax* 447-53; Robert Robillard, "Profits' in Profit-Split Methods: Hazardous Crossovers on the Way to Global Formulary Apportionment" (2017) *Tax Notes International* 167-73; and Finley, *supra* note 11.

140 Kaeser et al., *supra* note 135, at 212.

141 Robillard, *supra* note 139, at 167.

142 Yariv Brauner, "Formula Based Transfer Pricing" (2014) 42:10 *Intertax* 615-31, at 625.

143 *Ibid.*, at 626.

144 Finley, *supra* note 11, at 404.

145 *Ibid.*

146 *Ibid.*

147 *Ibid.*

the arm's-length principle.¹⁴⁸ But a former US Treasury official (the former co-chair of the OECD Work Party 6 [on transfer pricing]), noted that the OECD's proposals for taxing the digital economy "would radically depart from the arm's-length principle."¹⁴⁹ The former Treasury official claimed that what had been a debate over the interpretation and application of the arm's-length principle between countries has become a debate over the viability of the arm's-length principle.¹⁵⁰

Risks Assumed by Associated Enterprises

A transfer-pricing analysis is required to determine which associated enterprise to a controlled transaction bears economically significant risks and whether that party has the financial capacity to assume the risk. As discussed above, one of the situations in which the profit-split method may be used is a situation where the parties share economically significant risks or where each party's risks are interdependent with the other party's risks.

The GAO has argued that the guidance in the 2017 OECD transfer-pricing guidelines creates problems for tax authorities and MNEs because it is inaccurate in its account of the way risks are assumed by associated enterprises.¹⁵¹ The GAO's premise is that the transfer of risk within MNE groups cannot replicate the way in which risks are transferred between independent parties.¹⁵² Because of the differences between an MNE group and unrelated parties, the GAO's premise holds even if the associated enterprise has the ability to control risk and the capacity to assume risk. The GAO claims that if a parent company and its subsidiary enter into a transaction in which the economically significant risks are transferred to the subsidiary, the parent company cannot transfer all the risk because any losses incurred by the subsidiary from those risks will be reflected in the market value of the parent company.¹⁵³ The example provided shows that if a parent transfers to a subsidiary an intangible and its associated, economically significant risks, the parent, through its equity interest in the subsidiary, will have either a gain or a loss from any anticipated or unanticipated profits and losses arising in the subsidiary.¹⁵⁴ Consequently, according to the GAO's analysis, the arm's-length principle is limited in its ability to deal with the allocation of risks in controlled transactions.¹⁵⁵

148 Ryan Finley, "Harter Says Tax System Will Not Abandon Arm's-Length Principle" (2019) 95:4 *Tax Notes International* 354, at 354. The official is Lafayette G. Harter III, US Treasury deputy assistant secretary for International Tax Affairs.

149 Ryan Finley, "OECD Digital Tax Proposals Are Latest Threat to Arm's Length Concept" (2019) 93:8 *Tax Notes International* 873, at 873. The former Treasury official is Michael McDonald.

150 Ibid.

151 See United States, Government Accountability Office, *supra* note 125, at 9.

152 Ibid.

153 Ibid.

154 Ibid.

155 Ibid., at 11.

The GAO considers that these shortcomings have consequences for economic efficiency and equity in relation to transfer pricing.¹⁵⁶ If profit allocations are based on an incorrect analysis of risk within MNE groups, the allocations may be inequitable if the parties assuming the risk are not actually bearing those risks. It is widely accepted that one feature of a good tax system is equity between taxpayers. Moreover, the GAO asserts that the reforms proposed in the 2017 OECD transfer-pricing guidelines may not be effective: if risk is not effectively considered in transfer pricing, the resulting uncertainty may create the potential for profit shifting through transfer-pricing manipulation.¹⁵⁷

The European Union's Proposals To Simplify the Profit-Split Method

The European Union (EU) has noted that the “clarification and standardisation” of the profit-split method would result in benefits for both tax authorities and taxpayers through reduced compliance costs, simplified audits, and increased predictability and certainty.¹⁵⁸ The EU reached consensus in 2018 on a two-stage process: the first stage would concentrate on clarifying certain concepts related to the use of the profit-split method; the second stage would explore ways of simplifying the profit-split method.¹⁵⁹ This work reflects the residual profit-split proposals in BEPS action 1 (discussed in the next section of this paper). I would argue that these measures should have been considered before the 2018 OECD revised guidance was finalized. The EU survey, completed in 2018, found that the profit-split method was rarely used and that its use was usually limited to advance pricing agreements.¹⁶⁰ The survey did not find an industry in which the profit-split method was widely used.¹⁶¹ Although it had been applied in some sectors (the finance sector, the industrial equipment sector, the automotive industry, the information technology sector, the consumer goods sector, the pharmaceutical industry, the chemical industry, and the food sector), it was used sparingly.¹⁶²

BEPS ACTION 1: PILLAR 1—RESIDUAL PROFIT-SPLIT PROPOSAL

It is my contention that the 2018 OECD revised guidance fell short of providing allocation methods that can be applied when comparables are unavailable or unreliable.

156 Ibid.

157 Ibid., at 11 and 19.

158 European Commission, *Joint Transfer Pricing Forum: The Application of the Profit Split Method Within the EU*, document no. JTPF/002/2018/EN (Brussels: EC, March 2019), at 3.

159 Ibid., at 10.

160 Ibid., at 15.

161 Ibid., at 3-4.

162 Ibid.

Under this guidance, the situations in which the profit-split method may be used are limited. The OECD and the G20, under the Inclusive Framework, took considerable time to finalize the revisions concerning the profit-split method, and this lengthy process, involving multiple discussion drafts, indicates that the use of this method is a controversial topic. Within months of the finalization of the 2018 OECD revised guidance, the residual profit-split method was being considered as a potential policy measure for BEPS action 1.

There are two approaches to splitting profits under the profit-split method.¹⁶³ The first approach is based on a contribution analysis, which involves determining the relative contributions of each party. The other approach is the residual profit-split method. The residual profit-split method uses a two-step process. First, the less significant contributions are determined through a one-sided transfer-pricing method that uses comparable uncontrolled transactions.¹⁶⁴ Second, the residual profit is allocated on the basis of whether the party's contributions are unique and valuable or are attributable to a high level of integration, or whether there is a shared assumption of economically significant risks.¹⁶⁵

On January 23, 2019, the OECD and the G20, under the Inclusive Framework, published a policy note on the tax challenges of the digitalization of the economy.¹⁶⁶ The policy note provides a brief background to the BEPS action 1 report, which concluded that the digitalization of the global economy would make it impossible to develop measures restricted to the digital economy.¹⁶⁷ Under the mandate given by the G20 ministers in March 2017, the Inclusive Framework's Task Force on the Digital Economy delivered, in March 2018, an interim report on the tax challenges arising from digitalization.¹⁶⁸

The policy note states that under the approaches of both BEPS action 1 and the interim report, an agreement was reached to consider, and reach consensus on, proposals under two "pillars."¹⁶⁹ Pillar 1 deals with the "broader challenges of the digitalised economy"¹⁷⁰ and focuses on the allocation of taxing rights. The second pillar addresses other BEPS issues.

163 2018 OECD revised guidance, *supra* note 6, at paragraphs 2.149-2.152.

164 *Ibid.*, at paragraph 2.152.

165 *Ibid.*

166 Organisation for Economic Co-operation and Development, *Addressing the Tax Challenges of the Digitalisation of the Economy—Policy Note: As Approved by the Inclusive Framework on BEPS on 23 January 2019* (Paris: OECD, 2019) (herein referred to as "the policy note").

167 *Ibid.*, at 1.

168 Organisation for Economic Co-operation and Development, *Tax Challenges Arising from Digitalisation—Interim Report 2018: Inclusive Framework on BEPS* (Paris: OECD, 2018) (herein referred to as "the interim report").

169 Policy note, *supra* note 166, at 1.

170 *Ibid.*

With respect to the first pillar, the OECD and G20 again indicate that the proposals, which are being considered on a “without prejudice” basis, require a deviation from the arm’s-length principle:

The Inclusive Framework recognises that the implications of these proposals may reach into fundamental aspects of the current international tax architecture. Some of the proposals would require reconsidering the current transfer pricing rules as they relate to non-routine returns, and other proposals would entail modifications potentially going beyond non-routine returns. In all cases, these proposals would lead to solutions that go beyond the arm’s-length principle.¹⁷¹

In February 2019, the OECD and G20 issued a consultation document on the tax challenges of digitalization.¹⁷² This document’s proposals regarding, respectively, user participation and marketing intangibles involve the use of the residual profit-split method in circumstances that call for deviations from the arm’s-length principle.

The User Participation Proposal

The 2019 consultation document includes a “user participation” proposal with respect to the value that certain businesses create through the participation of an active user base that enables data and content to be exploited.¹⁷³ Under this proposal, the current rules would be modified to allocate profits to jurisdictions in which the businesses have “active and participatory user bases.”¹⁷⁴ The jurisdictions in which the users are located would be allocated profits under a residual profit-split analysis.

The routine profit of an MNE group would be determined on the basis of the transfer-pricing rules.¹⁷⁵ The proposal in the 2019 consultation document acknowledges that the value created through user participation is not allocated to user jurisdictions under the existing transfer-pricing methods, which are premised on the physical presence of an MNE.¹⁷⁶ This proposal would allocate some of the non-routine profit to the jurisdictions in which the users are located. The proposal provides the opportunity to use formulas to “approximate the value of users, and the users of each country, to a business.”¹⁷⁷

171 Ibid., at 2.

172 Organisation for Economic Co-operation and Development, *Public Consultation Document Addressing the Tax Challenges of the Digitalisation of the Economy 13 February-6 March 2019* (Paris: OECD, 2019) (herein referred to “2019 consultation document”).

173 Ibid., at paragraph 17.

174 Ibid., at paragraph 22.

175 Ibid., at paragraph 25.

176 Ibid., at paragraphs 20 and 23.

177 Ibid., at paragraph 27.

The Marketing Intangibles Proposal

The “marketing intangibles” proposal in the 2019 consultation document deals with the ability of certain MNE groups to operate in a jurisdiction, either remotely or through a limited local presence, to develop a customer base and other marketing intangibles.¹⁷⁸ Under this approach, a functional link is considered to exist between the market jurisdiction and marketing intangibles.¹⁷⁹ This proposal would alter the existing transfer-pricing rules to provide for the allocation to the market jurisdiction of profits from marketing intangibles and the associated risks.¹⁸⁰

One way of allocating profits from marketing intangibles to market jurisdictions would be under a revised residual profit-split approach that uses approximations.¹⁸¹ This approach would require various steps: the determination of the relevant profits, the determination of routine functions, and the subtraction of the routine profits from the total profits. The final step would be the division of the non-residual profits.¹⁸² The routine profits could be determined through transfer-pricing analysis or through what the 2019 consultation document describes as a “more mechanical approach,” such as a markup on costs or on tangible assets.¹⁸³ The “more mechanical approach” is designed to simplify the routine-profit calculation approach, and it is a move away from the comparability analysis required under the 2017 OECD transfer-pricing guidelines. To determine non-routine profits, several approaches may be used, including (1) the cost-base method; (2) an approach based on the costs incurred in developing the marketing intangibles; and (3) formulaic approaches.¹⁸⁴ A formulaic approach could use fixed contribution percentages based on the business model employed by the MNE group. After the profit attributable to marketing intangibles is determined, the profits would be allocated to market jurisdictions on the basis of an agreed-upon factor such as sales or revenue.¹⁸⁵

A movement away from the arm’s-length principle offers the advantage of increased certainty and simplicity, and it recognizes the limitations of the arm’s-length principle. The 2019 consultation document outlines as follows the proposed simplifications to the profit-split method:

178 Ibid., at paragraph 30.

179 Ibid.

180 Ibid., at paragraph 32.

181 Ibid., at paragraph 47.

182 Ibid.

183 Ibid.

184 Ibid.

185 Ibid., at paragraph 48.

This proposal would involve the following steps:

1. the determination of the total or combined profits to be split;
2. the identification of the residual (i.e. non-routine) portion of this total or combined profits by subtracting the returns allocable to routine functions; and
3. the determination of the portion of the residual profit to be re-allocated.

While this proposal would retain many similarities to the existing profit-split method, it may apply to a broader aggregate—combined profit of multiple entities—and introduce simplifying conventions that are intended to make the calculations easier. This is because the more the above steps are based on detailed and factual determinations (e.g. conventional transfer pricing analysis), the greater is the risk of disputes and uncertainty in the outcome produced by the proposal. Reducing complexity in the implementation of the various above steps, while at the same time making sure that any approximation is principle-based, will thus be a key policy consideration.¹⁸⁶

CONCLUSION

In this paper, I have argued that the 2018 OECD revised guidance on the profit-split method failed to meet the expectations that the method could be more widely used and could provide flexibility through the use of formulary methods. The proposals in the revised guidance were premised on the fact that the arm's-length principle is subject to limitations in certain situations. The guidance, although it marginally increased the situations in which the profit-split method might be considered the most appropriate method, intended that this method would be infrequently used. The guidance set out high threshold requirements for the use of the profit-split method, such that it is usually not viewed as the most appropriate method. One shortcoming of the guidance is its suggestion that the method cannot be used solely because reliable uncontrolled transactions are unavailable. Given the extent of intragroup trade and the integration of MNE groups, such comparables are often unavailable. Nevertheless, unless the integration of such groups reaches the substantial threshold requirements, the profit-split method will continue to be, in practice, the method of last resort.

The policy note and the 2019 consultation document included the use of the residual profit-split method as one of the potential measures for allocating profits to countries under BEPS action 1 (on the taxation of the digital economy). The proposal that the residual profit-split method be used in this situation brings to mind the proposals for the reform of the profit-split method. Again, the proposed use of the residual profit-split method is premised on deviating from the arm's-length principle and using simplified formulary measures. It is a pity that these reforms were not included in the 2018 OECD revised guidance on the profit-split method.

186 Ibid., at paragraphs 74 and 75.

Value Creation: A Constant Principle in a Changing World of International Taxation

Jinyan Li, Nathan Jin Bao, and Huaning (Christina) Li*

PRÉCIS

Les auteurs considèrent la nouvelle nomenclature de la création de valeur en termes de signification, de base théorique et d'importance dans le contexte de l'imposition internationale des bénéfices des entreprises. L'argument principal des auteurs est que le principe de la création de valeur est une élaboration profonde de la doctrine de l'allégeance économique, qui constitue la base théorique du système fiscal international actuel; et que les normes fiscales internationales, telles que le principe de lien de dépendance, visent à donner effet à la doctrine de l'allégeance économique (et maintenant au principe de création de valeur). Comme l'a démontré le projet de l'Organisation de coopération et de développement économiques/Groupe des Vingt sur l'érosion de la base d'imposition et de transfert de bénéfices, il semble qu'il y ait un consensus mondial selon lequel le principe de création de valeur devrait guider l'élaboration de nouvelles règles — non seulement les règles visant à protéger les assiettes fiscales existantes des pays (par exemple, les règles anti-évitement), mais aussi les règles d'attribution de nouveaux droits fiscaux en ce qui concerne les revenus tirés d'une économie numérique et immatérielle. Les auteurs évaluent les propositions de réforme fiscale les plus récentes à la lumière du principe de création de valeur, et ils recommandent l'adoption d'une règle mondiale de partage des bénéfices comme moyen de refléter avec précision la création de valeur.

ABSTRACT

The authors consider the new nomenclature of value creation in terms of its meaning, theoretical basis, and importance in the context of the international taxation of business profits. The authors' central claim is that the principle of value creation is a profound elaboration of the doctrine of economic allegiance, which is the theoretical basis for the current international tax system; and that international tax norms, such as the arm's-length principle, are meant to give effect to the doctrine of economic allegiance (and now to the principle of value creation). As demonstrated by the Organisation for Economic Co-operation and Development/Group of Twenty base erosion and profit shifting project, there is apparently global consensus that the value-creation principle should guide the development of new rules — not only the rules to protect countries' existing tax bases

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(for example, anti-avoidance rules) but also the rules to allocate new taxation rights in respect of income derived in a digital and intangible economy. The authors evaluate the most recent tax-reform proposals in the light of the value-creation principle, and they recommend a global profit-split rule as a way of accurately reflecting value creation.

KEYWORDS: BEPS ■ DIGITAL ECONOMY ■ TRANSFER PRICING ■ ARM'S-LENGTH PRINCIPLE ■ PROFIT-SPLIT ■ GLOBAL VALUE CHAINS

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INTRODUCTION

The notion of value creation was cited by the Group of Twenty (G20) leaders when they launched the base erosion and profit shifting (BEPS) project in 2013: "Profits should be taxed where economic activities deriving the profits are performed and where value is created."¹ The BEPS action plan² refers to value creation specifically

1 Group of Twenty, "G20 Leaders' Declaration," St. Petersburg, September 6, 2013, at paragraph 50 (www.g20.utoronto.ca/2013/Saint_Petersburg_Declaration_ENG.pdf).

2 Organisation for Economic Co-operation and Development, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013) (herein referred to as "the BEPS action plan"), at paragraph 50 (<https://doi.org/10.1787/9789264202719-en>).

in action 1 (the digital economy) and actions 8-10 (transfer pricing).³ Merely by titling the project “base erosion and profit shifting,” the G20 and the Organisation for Economic Co-operation and Development (OECD) implied that there exists a fundamental tax base that is eroded or shifted by taxpayers, notably multinational enterprises (MNEs); and that this tax base is measured in terms of the value created in a country.⁴ More specifically, the BEPS project seemed to intend the value-creation principle to have both negative and positive functions in the process of determining a country’s tax base. The negative function is the more prominent one, manifested in the anti-avoidance or base-protection measures of actions 2-4⁵ and actions 6-10:⁶ profit cannot be allocated for tax purposes to a country where no economic activities take place.⁷ The positive function is manifested mainly in action 1, in respect of developing rules for the allocation of new taxing rights in the digital age.

The BEPS project and (since 2016) the Inclusive Framework on BEPS⁸ have recognized value creation as a guiding principle, and technical rules (either anti-avoidance rules or new allocation rules) have been re-worked to give effect to this principle.⁹ Implicit in the BEPS project is the belief that (1) a country’s taxing right is based on the economic activities or value created in that country, and (2) the artificial manipulation of the location of profit should be prevented through better rules. The project has been viewed¹⁰ as “the most significant re-write of the international tax

3 Organisation for Economic Co-operation and Development, *Addressing the Tax Challenges of the Digital Economy, Action 1—2015 Final Report* (Paris: OECD, 2015); and *infra* note 92.

4 “BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity,” see Organisation for Economic Co-operation and Development, “What Is BEPS?” (www.oecd.org/tax/beps/beps-about.htm), under the heading “What Is the Issue?”

5 Actions 2-4 address the issues of hybrid mismatch arrangements, use of controlled foreign companies, and interest deduction. See BEPS action plan, *supra* note 2.

6 Actions 6-10 address the issues of treaty shopping, the artificial avoidance of permanent establishment (PE) status, and transfer pricing. See BEPS action plan, *supra* note 2.

7 Stanley I. Langbein and Max R. Fuss, “The OECD/G20-BEPS-Project and the Value Creation Paradigm: Economic Reality Disemboguing into the Interpretation of the ‘Arm’s Length’ Standard” (2018) 51:2 *International Lawyer* 259-409, at 285.

8 OECD/G20 Inclusive Framework on BEPS (herein “the Inclusive Framework”) has 134 countries and jurisdictions (as of August 2019) that collaborate “on the implementation of . . . [BEPS] measures.” See “What Is BEPS?” *supra* note 4.

9 BEPS action plan, *supra* note 2. Implicit in the BEPS project is the belief that a country’s taxing right is based on the economic activities or value created in that country and that “artificial” manipulation of the location of profit should be prevented through better rules.

10 See for example, Hugh J. Ault, Wolfgang Schön, and Stephen E. Shay, “Base Erosion and Profit Shifting: A Roadmap for Reform” (2014) 68:6/7 *Bulletin for International Taxation* (published online, available on IBFD tax research platform); Reuven S. Avi-Yonah and Haiyan Xu, “Evaluating BEPS: A Reconsideration of the Benefits Principle and Proposal for UN Oversight” (2016) 6:2 *Harvard Business Law Review* 185-238; Yariv Brauner, “What The BEPS” (2014) 16:2 *Florida Tax Review* 55-115; Allison Christians, “BEPS and the New International Tax Order” [2016] no. 6 *Brigham Young University Law Review* 1603-48; Allison Christians and

rules in a century,”¹¹ with the potential to significantly transform the international tax regime,¹² and it has been viewed as signalling the “emergence of a new international tax regime.”¹³

Through the Inclusive Framework, G20 countries and OECD countries, along with other countries, have committed to implementing the measures recommended by the BEPS project. By mid-2019, the international community had agreed on “a road map for resolving the tax challenges arising from the digitalisation of the economy, and committed to continue working toward a consensus-based long-term solution by the end of 2020.”¹⁴ The road map focuses on technical issues to be resolved through the two pillars identified in the programme of work¹⁵ of May

Stephen Shay, “General Report,” in International Fiscal Association, *Assessing BEPS: Origins, Standards, and Responses*, *Cabiers de droit fiscal international* vol. 102a (The Hague: Sdu, 2017), 17-63; Michael Devereux and John Vella, “Value Creation as the Fundamental Principle of the International Corporate Tax System,” European Tax Policy Forum Policy Paper 2018, at 1 (<https://ssrn.com/abstract=3275759>); Itai Grinberg and Joost Pauwelyn, “The Emergence of a New International Tax Regime: The OECD’s Package on Base Erosion and Profit Shifting (BEPS)” (2015) 19:24 *American Society of International Law Insights*, October 28, 2015 (online); Itai Grinberg, “International Taxation in an Era of Digital Disruption: Analyzing the Current Debate” (2019) 97:3 *Taxes: The Tax Magazine* 73-104; Mindy Herzfeld, “The Case Against BEPS: Lessons for Tax Coordination” (2017) 21:1 *Florida Tax Review* 1-59; Yariv Brauner and Pasquale Pistone, eds., *BRICS and the Emergence of International Tax Coordination* (Amsterdam: IBFD, 2015).

- 11 Organisation for Economic Co-operation and Development, *OECD/G20 Base Erosion and Profit Shifting Project 2015 Final Reports, Information Brief* (Paris: OECD, 2015), at 3 (www.oecd.org/ctp/beps-reports-2015-information-brief.pdf). See also Tizhong Liao, “Shendu canyu quanqiu shuishou hezuo, chixu dazao guoji shuishou shengjiban” [Participating In-Depth in International Cooperation of Tax Administration and Continuing To Build Up an Upgraded Version of International Taxation] (2016) 71:5 *International Taxation in China* (in Chinese).
- 12 Reuven S. Avi-Yonah and Haiyan Xu, *China and the Future of the International Tax Regime*, University of Michigan Law and Economics Research Series Paper no. 17-017 (Michigan: University of Michigan, October, 2017) (<http://dx.doi.org/10.2139/ssrn.3056796>); Reuven S. Avi-Yonah, “A Perspective of Supra-Nationality in Tax Law,” in *BRICS and the Emergence of International Tax Coordination*, supra note 10, 33-40; and Richard Vann, “Current Trends in Balancing Residence and Source Taxation,” in *BRICS and the Emergence of International Tax Coordination*, supra note 10, 367-92.
- 13 See Grinberg and Pauwelyn, supra note 10.
- 14 Organisation for Economic Co-operation and Development, “International Community Agrees on a Road Map for Resolving the Tax Challenges Arising from Digitalisation of the Economy,” *OECD.org*, May 31, 2019 (www.oecd.org/ctp/international-community-agrees-on-a-road-map-for-resolving-the-tax-challenges-arising-from-digitalisation-of-the-economy.htm). In June 2019, the G20 leaders approved the Organisation for Economic Co-operation and Development, *Programme of Work To Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy: Inclusive Framework on BEPS* (Paris: OECD, 2019) (www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf).
- 15 The Inclusive Framework published an interim report in March 2018: Organisation for Economic Co-operation and Development, *Tax Challenges Arising from Digitalisation—Interim*

2019. Pillar 1 concerns the allocation of new taxing rights to the jurisdictions where clients or users are located. Pillar 2 concerns the designing of anti-abuse rules to ensure that MNEs pay a minimum level of tax in jurisdictions where value is created. In this paper, we focus on pillar 1.

In this paper, we make two main contributions to the debates on international tax reform. First, we demonstrate that the value-creation principle has existed throughout the history of international taxation. We challenge the view that value creation is a “new mantra”¹⁶ or is “fundamentally at odds with the arm’s length principle that serves as the backbone of transfer pricing rules.”¹⁷ We argue that the criticism of value creation as being vague or subjective¹⁸ is misplaced, because the value-creation principle is not a technical rule but “a useful, if not profound, elaboration of”¹⁹ the doctrine of economic allegiance. The latter doctrine provided the theoretical basis for the existing international tax structure and norms (such as the arm’s-length principle). The value-creation principle helps sharpen the focus on rules to prevent “stateless income.”²⁰

Second, we evaluate the pillar 1 proposals in light of the value-creation principle, and we explain why they are encouraging but inadequate. We recommend, in their stead, a global profit-split (GPS) rule that takes into account multiple factors (for example, assets, workforce, and sales) in allocating MNEs’ group profit to all relevant contributors to value creation or links in global value chains (GVCs).

The remainder of this paper is organized as follows. Below, in the second section, we provide an overview of the theory of economic allegiance. In the process, we

Report 2018: Inclusive Framework on BEPS (Paris: OECD, March 2018); Organisation for Economic Co-operation and Development, *Addressing the Tax Challenges of the Digitalisation of the Economy—Policy Note: As Approved by the Inclusive Framework on BEPS on 23 January 2019* (Paris: OECD, 2019); Organisation for Economic Co-operation and Development, *Public Consultation Document Addressing the Tax Challenges of the Digitalisation of the Economy 13 February–6 March 2019* (Paris: OECD 2019); and *Programme of Work*, supra note 14, in May 2019. On October 9, 2019, the OECD released a public consultation document, *Secretariat Proposal for a “Unified Approach” Under Pillar One* (Paris: OECD, October 2019). This unified approach received support from the G20 finance ministers during their meeting on October 17–18, 2019 (www.brettonwoodsproject.org/2019/10/g20-press-briefing-analysis-annual-meetings-2019/).

16 Wolfgang Schön, “Ten Questions About Why and How To Tax the Digital Economy” (2018) 72:4/5 *Bulletin for International Taxation* 278–92, at 280, describing value creation as a new mantra.

17 Herzfeld, supra note 10, at 1.

18 Grinberg, supra note 10, at 29, mentioning “any exercise to define specific sources of value creation is entirely subjective”; and Johanna Hey, “‘Taxation Where Value Is Created’ and the OECD/G20 Base Erosion and Profit Shifting Initiative” (2018) 72:4/5 *Bulletin for International Taxation* 203–8, at 203, referring to “[t]he unclear concept of value creation as an allocation factor.”

19 Langbein and Fuss, supra note 7, at 262.

20 This term was coined by Edward D. Kleinbard in two papers: “Stateless Income” (2011) 11:9 *Florida Tax Review* 699–773; and “Lessons of Stateless Income” (2011) 65:1 *Tax Law Review* 99–171.

show that the value-creation principle is a modern articulation of that theory—that is, the theory that a country's taxing rights are based on the economic allegiance that a given taxpayer owes to that country by being a resident in it or by having income sourced in it. We also show that the arm's-length principle was meant to implement the doctrine of economic allegiance in respect of allocating the income of an enterprise between countries. We provide an overview of Canadian tax laws (domestic statutes and tax treaties) that adhere to the principles of economic allegiance (and value creation), and then we consider the legal constraints on the application of the value-creation principle.

In the third section of this paper, we describe departures from the value-creation principle, and we suggest that such departures are mainly the result of inadequate rules and problematic interpretations of the arm's-length principle. In the fourth section, we examine the recent trend in favour of the value-creation principle, and we discuss the emerging consensus on a road map for redesigning the technical rules. In the fifth section, we discuss the ways in which pillar 1's proposals—especially the unified approach, proposed in October 2019, to reallocate taxing rights to the market jurisdictions—are a step in the right direction but fall short of fully reflecting the value-creation principle. We also discuss why a global profit-split (GPS) rule, based on multiple factors, is a superior option. In the final section, we offer some key findings and conclusions.

VALUE CREATION AS AN ELABORATION OF ECONOMIC ALLEGIANCE

The Nomenclature of Value Creation

The BEPS project introduced the nomenclature of value creation and seemed to presume that a country's tax base is defined by the value created in that country. As a nomenclature, value creation is not only modern, in that it can be applied to new business models and GVCs; it is also functional, in that it supports both new anti-avoidance rules and new rules on the allocation of taxing rights. The older concept of economic allegiance, by comparison, has been used to support the assignment of taxing rights.

Economic Allegiance

It has been observed that

[i]nternational taxation as it was conceived in the 1920s and 1930s had two objectives that are difficult to reconcile: trade among nations undistorted by unwarranted and unjustifiable tax-induced barriers, and the preservation of national fiscal sovereignty as expressed through tax policy and tax legislation.²¹

21 Scott Wilkie, "New Rules of Engagement? Corporate Personality and the Allocation of 'International Income' and Taxing Rights," in Brian J. Arnold, ed. *Tax Treaties After the BEPS Project: A Tribute to Jacques Sasseville* (Toronto: Canadian Tax Foundation, 2018), 349-71, at 353.

The foundation of international taxation is the doctrine of economic allegiance, which was proposed by four economists (Bruins, Einaudi, Seligman, and Stamp) in their 1923 report on double taxation.²²

The doctrine of economic allegiance,²³ as set out in the 1923 report, provided a theoretical basis “for an international convention to remove the evil consequences of double taxation”²⁴ while respecting the fiscal sovereignty of nations. This doctrine posits that a taxpayer’s income should be divided among countries according to the taxpayer’s relative economic interests in each country²⁵ or among “all those governments to whom the . . . [taxpayer] owes economic allegiance.”²⁶ The 1923 report posited four elements of economic allegiance: (1) the acquisition (or production) of wealth, (2) the location of wealth, (3) the enforceability of the rights to wealth, and (4) the consumption of wealth.²⁷ The first three elements correspond to source of income, and the last one corresponds to residence.

The production or acquisition of wealth, which corresponds to origin of income, is the most important in terms of business profits. The economists’ 1923 report stated:

By production of wealth we mean all the stages which are involved up to the point [of] wealth coming to fruition, that is, all the stages up to the point when the physical production has reached a complete economic destination and can be acquired as wealth. The oranges upon the trees in California are not acquired wealth until they are picked, and not even at that stage until they are packed, and not even at that stage until they are transported to the place where demand exists and until they are put where the

22 Gijsbert W.J. Bruins, Luigi Einaudi, Edwin R.A. Seligman, and Sir Josiah Stamp, *Report on Double Taxation Submitted to the Financial Committee Economic and Financial Commission*, League of Nations document no. E.F.S.73.F.19 (Geneva: League of Nations, April 5, 1923) (herein referred to as “the 1923 report”).

23 The 1923 report, *ibid.*, at 21, made it clear that this doctrine was not new in 1923 but had “come to be widely accepted in connection with the ordinary taxes on property and income.” The faculty or ability-to-pay theory influenced the income tax system in the United States, the United Kingdom, and other countries in the early 1920s. As is explained below, the Canadian Income War Tax Act also reflected this theory.

24 Recommending a basis for removing double taxation through a convention is one of the terms of reference for the four economists in the 1923 report, *ibid.*, at 2.

25 The 1923 report, *ibid.*, at 20, states: “A part of the total sum paid according to the ability of a person ought to reach the competing authorities according to his economic interest under each authority. The ideal solution is that the individual’s whole faculty should be taxed, but that it should be taxed only once, and that the liability should be divided among the tax districts according to his relative interests in each. The individual has certain economic interests in the place of his permanent residence or domicile, as well as in the place or places where his property is situated or from which his income is derived. If he makes money in one place he generally spends it in another.”

26 *Ibid.*

27 *Ibid.*, at 23.

consumer can use them. These stages, up to the point where wealth reaches fruition, may be shared in by different territorial authorities.²⁸

More specifically, the economists said that

[w]hen we are speaking of the origin of the wealth, we refer naturally to the place where the wealth is produced, that is, to the community the economic life of which makes possible the yield or the acquisition of the wealth. This yield or acquisition is due, however, not only to the particular thing but to the human relations which may help in creating the yield.

The origin of the wealth therefore may have to be considered in the light of the original physical appearance of the wealth, its subsequent physical adaptations, its transport, its direction and its sale.²⁹

In the case of “intangible personality or incorporeal movables” (for example, corporate securities), the economists emphasized the economic situs or the owner’s residence.³⁰

From the perspective of the countries that seek to tax international income, the competence to tax is based on the government’s rendering of services to taxpayers,³¹ such as providing the necessary legal framework within which legal rights can be enforced. To prevent double taxation, the economists offered four possible alternatives, including “exemption for income going abroad” and “classification and assignment of sources,”³² that found their way into the original draft model tax conventions.

Economic Allegiance and International Tax Norms

The Assignment of Taxing Rights Under Earlier Model Tax Conventions

The theoretical framework of economic allegiance influenced the work of seven technical experts³³ who were tasked by the League of Nations with developing practical solutions to the problems of double taxation and tax evasion. Their 1925 report³⁴ laid the foundation for the first draft model conventions in 1928. Drawing

28 Ibid (emphasis in original).

29 Ibid., at 24.

30 Ibid., at 34-35.

31 Ibid., at 20.

32 Ibid., at 42.

33 They represented Belgium, Czechoslovakia, France, the United Kingdom, Italy, the Netherlands, and Switzerland. See Sunita Jogarajan, *Double Taxation and the League of Nations* (Cambridge: Cambridge University Press, 2018), at 26.

34 League of Nations, *Double Taxation and Tax Evasion, League of Nations: Technical Experts to the Economic and Financial Committee Double Taxation and Tax Evasion Report and Resolutions Submitted by the Technical Experts to the Financial Committee*, League of Nations document no. F.212 (Geneva: League of Nations, February 1925) (herein referred to as “the 1925 report”).

on national tax practices of the time,³⁵ these experts recommended the classification and assignment approach, and they endorsed the idea of the source taxation of business profits. The 1925 report sets out the following permanent establishment (PE) rule:

If the enterprise has its head office in one of the States and in another has a branch, an agency, an establishment, a stable commercial or industrial organisation, or a permanent representative, each one of the contracting States shall tax that portion of the net income produced in its own territory.³⁶

Further technical experts were subsequently added, including representatives from the United States, to develop model tax conventions on the basis of the 1925 report. The 1927 report³⁷ by these experts treated a subsidiary enterprise as a PE.³⁸ Their 1928 report³⁹ contains alternative draft models, one of which (Draft Convention Ic) became the basis for the subsequent OECD model.⁴⁰ These models distributed taxing rights to the two contracting states, and they did not address the question of how to allocate business profits in a situation where both the residence and source country have taxing rights. This question was later addressed by article 9 of the OECD model, which was developed under the influence of the Carroll report.⁴¹

The Carroll Report and the Arm's-Length Principle

During the 1920s and 1930s, member countries of the League of Nations adopted different methods of attributing profit to a branch or a PE: some used separate

35 The 1923 report and the 1925 report took note of the fact that some countries imposed personal tax (similar to present progressive income taxes) and others impersonal taxes (separate taxes imposed at a proportional rate on different categories of income based on source).

36 1925 report, *supra* note 34, at 31.

37 League of Nations, *Double Taxation and Tax Evasion: Report*, League of Nations document no. C.216.M.85 (London: League of Nations, April 12, 1927) (herein referred to as “the 1927 report”).

38 Draft model in the 1927 report, *ibid.*, article 5.

39 League of Nations, *Double Taxation and Tax Evasion: Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion*, League of Nations document no. C.562.M.178.1928.II. (Geneva: League of Nations, October 31, 1928) (herein referred to as “the 1928 report”).

40 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Full Version 2017* (Paris: OECD, 2019) (<https://doi.org/10.1787/g2g972ee-en>) (herein referred to as “the OECD model”). See Jogarajan, *supra* note 33, at 177; and Jinyan Li, *International Taxation in the Age of Electronic Commerce: A Comparative Study* (Toronto: Canadian Tax Foundation, 2003), at 37–44.

41 Mitchell B. Carroll, *Taxation of Foreign and National Enterprises, vol. IV, Method of Allocating Taxable Income*, League of Nations document no. C.425(b).M.217(b).II.A (Geneva: League of Nations, 1933) (herein referred to as “the Carroll report”). For more discussion of this report, see chapter 1 in Richard S. Collier and Joseph L. Andrus, *Transfer Pricing and the Arm's Length Principle after BEPS* (Oxford: Oxford University Press, 2017).

accounting, and others used fractional apportionment. As a result, even when countries had agreed to the PE rule, double taxation could still arise owing to the different allocation methods. Mitchell B. Carroll, an American tax lawyer, was commissioned to formulate “a scientific regime of allocation.”⁴² The acceptance of the doctrine of economic allegiance was not open to debate. The allocation regime set out in the Carroll report (1933) was, in essence, “technically an extension of the basic structure”; as such, it was “principally based upon and revolve[d] round arguments pertinent to determining the ‘origin of income’ viz. the value creation.”⁴³

The Carroll report states that a general regime of allocation

entails abandoning all precepts of liability other than those of fiscal domicile and source, and requires that the concept of fiscal domicile be uniformly defined and that the concept of source be defined and strictly limited to sources obviously within the jurisdiction of the State.⁴⁴

Such a narrow concept of source would “preclude the telescopic extension of the concept of source in order to trace profits through corporations created under the laws of another country.”⁴⁵ The Carroll report regards the “organic unity” or “fractional apportionment” method as “too wide an approach” and therefore as “violating the basic idea of source taxation.”⁴⁶

The Carroll report adopts a legalistic view of income allocation.⁴⁷ It notes the “fundamental legal difference” between a subsidiary and a branch (that is, subsidiaries can enter into legally binding contracts with their parent or affiliated companies, and branches cannot).⁴⁸ It says that profit in law and in economic fact can be different:

In law, a taxable profit might accrue to the producing corporation if title to the goods were transferred to the selling corporation. In economic fact, no profit accrues to the enterprise consisting of the producing corporation and the selling corporation, until the goods have been sold by the selling corporation to outsiders.⁴⁹

The report concludes with the following positions:

As the conduct of business between a corporation and its subsidiaries on the basis of dealings with an independent enterprise obviates all problems of allocation, it is recommended that, in principle, subsidiaries be not regarded as permanent establishments

42 Carroll report, *supra* note 41, at 198.

43 Langbein and Fuss, *supra* note 7, at 295.

44 Carroll report, *supra* note 41, at 169.

45 *Ibid.*, at 169.

46 Langbein and Fuss, *supra* note 7, at 298.

47 Carroll report, *supra* note 41, at 176-78, inferred legal principles for the allocation of business profits from a survey of existing practices.

48 *Ibid.*, at 176.

49 *Ibid.*

of an enterprise but treated as independent legal entities; and if it is shown that inter-company transactions have been carried on in such a manner as to divert profits from a subsidiary, the diverted income should be allocated to the subsidiary on the basis of what it would have earned had it been dealing with an independent enterprise.⁵⁰

The Carroll report concludes, further, that branches “should be treated in so far as possible as independent entities, in order that the income allocated to a branch may be equivalent to that which would have been derived by an independent enterprise.”⁵¹ These are the forerunners of the arm’s-length principle.⁵²

The Carroll report has been criticized for “derogating the principles which underlay the overall effort made by the League during the 1920s”⁵³ and for being biased in favour of capital-exporting countries.⁵⁴ The report’s legalistic approach to income allocation influenced the transfer-pricing rules for decades to come. While purporting to create a method of profit allocation within the framework of economic allegiance, the Carroll report narrows the scope of value created in the source state by permitting taxpayers to allocate profit through contractual arrangements.

Embedded Principle in Canadian Tax Laws

Canadian Domestic Law

In the 1923 report, the four economists noted that the doctrine of economic allegiance was embedded in the tax systems of some countries. In Canada’s system, for example, the doctrine was enshrined in the Income War Tax Act, 1917.⁵⁵ The IWTA imposed taxes on “every person residing or ordinarily resident in Canada or carrying on any business in Canada.”⁵⁶ It identified economic allegiance with Canada through two tests: (1) the test of residence and (2) the test of carrying on business in Canada. With respect to value creation, a taxpayer’s income was created in Canada if one or both of the tests were met. From Canada’s perspective, under the doctrine

50 Ibid., at 177.

51 Ibid.

52 The recommendations of the Carroll report were converted into model treaty provisions in 1933, and they subsequently became part of the 1943 Mexico and 1946 London Model Conventions. The forerunner of the current article 9 of the OECD model is regarded as derived from section 45 of the US Revenue Act of 1928. See Collier and Andrus, *supra* note 41, at 42-43.

53 Langbein and Fuss, *supra* note 7, at 295; Richard J. Vann, “Taxing International Business Income: Hard-Boiled Wonderland and the End of the World” (2010) 2:3 *World Tax Journal* 291-346, at 321.

54 Langbein and Fuss, *supra* note 7, at 295.

55 Income War Tax Act, 1917, SC 1917, c. 28 (herein referred to as “the IWTA”).

56 IWTA subsection 4(1).

of economic allegiance, Canada provided services⁵⁷ to the taxpayer or acted as a co-venturer with the taxpayer in earning the income.⁵⁸

The intellectual backdrop to the IWTa was Edwin R.A. Seligman's theory of income tax in general and the international aspect of income tax in particular.⁵⁹ (Seligman was one of the four economists who wrote the 1923 report.) Moreover, Seligman's thinking influenced the design of the American income tax system, which influenced the IWTa.⁶⁰

Since 1917, the technical rules supporting Canada's tax base have become more extensive and nuanced. Descriptive charging rules, such as withholding tax provisions, have been added, as have statutory deeming rules, such as section 253 of the Income Tax Act.⁶¹ More significantly, the tax base is protected by an increasing number of anti-avoidance rules,⁶² such as section 219, which imposes a "branch profits tax" on the after-tax profits of a Canadian branch; subsection 212(13), which deems certain base-erosion payments to be subject to withholding tax; and sections 91 and 95, which (1) characterize certain Canadian-source business income deflected to a controlled foreign affiliate as foreign accrual property income (FAPI) and (2) tax the income on an imputation basis.⁶³ At the heart of these rules is the concept of a business carried on in Canada, which is the concept of value creation.

In allocating income to a business carried on in Canada through a branch or PE, section 26 of the 1927 IWTa⁶⁴ recognized the principle of dividing the income between the country of production and the country of sale. Section 26 reads as follows:

57 "Economic allegiance" is the expression used in the 1923 report, *supra* note 22, at 23: "A country of stable government and laws which will render him those services without which he could not enter into the third stage of consumption with confidence is a country to which he owes some economic allegiance."

58 For further discussion of the notion of source, see Jinyan Li and J. Scott Wilkie, "Source of Income and Canadian International Taxation," in Jinyan Li, J. Scott Wilkie, and Larry F. Chapman, eds., *Income Tax at 100 Years: Essays and Reflections on the Income War Tax Act* (Toronto: Canadian Tax Foundation, 2017), 10:1-42.

59 Colin Campbell and Robert Raizenne, "The 1917 Income War Tax Act: Origins and Enactment," in *Income Tax at 100 Years*, *supra* note 58, 2:1-96, at 2:16-17.

60 *Ibid.*, at 2:17, stating: "The architectural harmony in this regard between the 1917 Act and the recently enacted [1913] US revenue laws is striking."

61 Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act").

62 A corporation is a Canadian resident if it was created under Canadian laws under subsection 250(4) of the Act or has, under case law, its central management and control in Canada (see *Fundy Settlement v. Canada*, 2012 SCC 14). These two tests are close to the notion of "fiscal domicile" of corporations in the 1923 report, *supra* note 22; and the Carroll report, *supra* note 41.

63 For further discussion, see Jinyan Li, Arthur Cockfield, and J. Scott Wilkie, *International Taxation in Canada*, 4th ed. (Toronto: LexisNexis, 2018); see back-to-back rules, *ibid.*, at 229-34; foreign affiliate dumping rules, *ibid.*, at 354-55; and surplus stripping rules, *ibid.*, at 390-92.

64 Income War Tax Act, RSC 1927, c. 97 (herein referred to as "the 1927 IWTa"). Section 27 of this act deems any non-resident person "who lets or leases anything used in Canada, or who

Where a non-resident person produces . . . anything within Canada and exports the same without sale prior to the export thereof, he shall be deemed to be carrying on business in Canada and to earn within Canada *a proportionate part of any profit ultimately derived from the sale thereof outside of Canada* [emphasis added].

This principle is now embedded in section 253 and section 4 of the Act.⁶⁵ Under section 4, the amount of income in Canada is computed on the assumption that the Canadian part of the business is an independent enterprise and that a reasonable allocation of revenue and expenses must be made.⁶⁶

Canadian subsidiaries of foreign companies are taxed as residents. To prevent the shifting of Canadian-source income to a foreign parent, a fair-pricing rule was provided in subsection 3(2) of the 1917 IWTa, which reads as follows:

Where an incorporated company conducts its business, whether under agreement or otherwise, in such manner as either directly or indirectly to benefit its shareholders . . . , by selling its product or the goods and commodities in which it deals at less than the fair price which might be obtained therefor, the Minister may . . . determine the amount of which shall be deemed to be the income of such company for the year, and in determining such amount the Minister shall have regard to the fair price which, but for any agreement, arrangement or understanding, might be or could have been obtained for such product, goods and commodities.⁶⁷

The fair-pricing rule was influenced by the arm's-length standard in the United States.⁶⁸ Subsection 3(2) implicitly recognizes separate accounting, and it authorizes

receives a royalty or other similar payment for anything used . . . in Canada" to be carrying on business in Canada. This deeming rule was replaced by a subsequent rule that subjected rent and royalties to withholding tax.

65 The origin of the current section 4 is paragraph 139(1)(a) of the Income Tax Act, RSC 1952, c. 148. The Carroll report classified the Canadian approach as "fractional apportionment"; see Carroll report, *supra* note 41, at 73.

66 Similarly, when a non-resident person offers anything for sale in Canada (such that Canada is a market country), regardless of where the contract may be completed, a proportionate portion of the taxpayer's income is allocated to Canada by virtue of paragraph 253(b) and section 4.

67 Even though the wording of the provision does not specifically address cross-border transactions, historical records of Parliamentary debate on the draft legislation show that the minister of finance, Mr. White, clearly "understood the need to defend Canada's fiscal border and acted accordingly" and understood that "[f]ailure to police cross-border dealings between persons not having separate economic interests would inevitably lead to reduced tax revenue." See Campbell and Raizenne, *supra* note 59, at 2:50.

68 Section 45 of the US Revenue Act of 1928, Pub. L. no. 70-562 (predecessor of current section 482 of the Internal Revenue Code of 1986) read as follows: "In any case of two or more trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Commissioner is authorized to distribute, apportion, or allocate gross income or deductions between or among such trades or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such trades or businesses."

the minister to adjust the taxpayer's income only if the intercompany pricing deviates from fair market prices. It influenced Carroll in his recommendation of the arm's-length principle.⁶⁹

Subsection 3(2)⁷⁰ is the origin of the modern transfer-pricing rules in section 247. In 1948, the fair-pricing rule was broadened to apply to non-residents carrying on business in Canada.⁷¹ In 1972, the phrase "reasonable amount" replaced the phrase "fair price."⁷² In 1997, section 247 was enacted, with a view to modernizing the transfer-pricing regime so that Canada's fiscal border would be better defended.⁷³

To summarize, the Canadian tax jurisdictional rules and allocation rules implicitly recognize the value-creation principle. Canada does not seek to tax income that is derived without Canada's involvement or contribution. Further, Canada adheres to the value-creation principle in its tax treaties by following the OECD model.⁷⁴

Tax Treaties

The OECD model can be traced to the 1928 draft conventions that were developed within the theoretical framework of the economists' 1923 report.⁷⁵ The model assigns taxing rights between two contracting states by reference to residence or source and by reference to the type of income. Under the residence-source paradigm, business income is taxable primarily in the source country (as per article 7 of the model), and other types of income, especially income from capital, is taxable primarily or exclusively in the residence country (as per articles 11 and 12). To the extent that income is taxable at source, the residence country bears the burden of relieving double taxation through a system of foreign tax credits or exemptions (as per article 23).

In the case of business income, manifestations of value creation are found in article 5, and the measurement of such value is governed by articles 7 and 9.⁷⁶ Article 5 defines a "permanent establishment" to be a fixed place of business through which

69 Collier and Andrus, *supra* note 41, at 34.

70 See IWTA, *supra* note 55.

71 Subsection 17(3) of the Income Tax Act, SC 1948, c. 52.

72 See subsection 69(2) of the Income Tax Act, SC 1970-71-72, c. 63, which succeeded subsection 17(3), using the phrase "reasonable amount."

73 Campbell and Raizenne, *supra* note 59, at 2:50.

74 For further discussion of the history of Canadian treaty policy, see Brian J. Arnold and Jacques Sasseville, "A Historical Perspective on Canada's Tax Treaties," in *Income Tax at 100 Years*, *supra* note 58, at 11:1-53.

75 For further discussion of the role of the 1923 report, see Hugh J. Ault, "Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practice" (1992) 47:3 *Tax Law Review* 565-608, at 567; Reuven Avi-Yonah, "The Structure of International Taxation: A Proposal for Simplification" (1996) 74:6 *Texas Law Review* 1301-59, at 1305-10; and Jogarajan, *supra* note 33, at 32.

76 Other articles, such as 11(4) and 12(3) of the OECD model, *supra* note 40, also protect the source taxation of business profit by giving article 7 priority.

the business of an enterprise is wholly or partly carried on; a PE includes a place of management and a branch, and it excludes a fixed place of business maintained to conduct activities of a preparatory or auxiliary character. Article 5 deems a building site or construction or installation project to constitute a PE if it lasts more than 12 months. Article 5 also includes activities of dependent agents, but it excludes a subsidiary per se as a PE. Article 5 thus indicates that the factors in value creation include physical assets and premises (capital), human activities and human agency, and market (but only if the sales proper, as opposed to auxiliary activities, are done through a fixed place of business or agent). Article 5 ignores less significant value-creation factors in order to simplify tax compliance and administration.

Article 7 limits the amount of profit taxable in the source country to the amount that is attributable to a PE in that country. For the purposes of attribution, article 7 treats the PE as if it were

a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.⁷⁷

Accordingly, the key factors are “functions,” “assets,” and “risks.” The same factors are relevant to the application of the arm’s-length principle, which is enshrined in article 9.

Article 9(1) reflects the approach recommended by the Carroll report, which is based on the arm’s-length principle. According to this approach, the profits of a subsidiary are expected to reflect an amount that would have accrued if the subsidiary were an independent enterprise. The profits of a subsidiary that would have accrued if it were an independent enterprise but have not accrued by reason of non-market-based conditions made or imposed between the subsidiary and its associated enterprises would be included for tax purposes. The 2017 transfer-pricing guidelines⁷⁸ are regarded as the most influential interpretation of the arm’s-length principle. Even though article 9(1) does not mention “price” or “transactions,” the OECD interpreted it as requiring tax authorities “to adjust the actual price to an arm’s length price, in order to arrive at a proper level of taxable income.”⁷⁹ Prices of non-arm’s-length transactions are compared with comparable arm’s-length transactions on the basis of an analysis that recognizes the actual transactions as the starting point and intragroup contracts as decisive evidence.⁸⁰

77 OECD model, *supra* note 40, article 7(2).

78 Organisation for Economic Co-operation and Development, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, July 2017) (herein referred to as “the 2017 guidelines”). Earlier versions were published in 1979, 1995, and 2010.

79 Organisation for Economic Co-operation and Development, *Transfer Pricing and Multinational Enterprises* (Paris: OECD, 1979), at 9 (herein referred to as “the 1979 guidelines”).

80 See below, under the heading “Legalistic Interpretation of the Arm’s-Length Principle.”

Legal Constraints on Implementing Value Creation

The value-creation principle needs to be “rulified”⁸¹—that is, translated into operating legal rules. As the earlier experiences of the League of Nations show, it is challenging to craft legal rules that give effect to the doctrine of economic allegiance. The technical experts of the league, along with Carroll, introduced legal constraints to the doctrine in order to accommodate country-specific tax practices and administrative difficulties. The proliferation of anti-avoidance rules in Canada demonstrates the need for constant legislative elaboration with respect to whether income (value) belongs to the Canadian tax base.

The value-creation principle must work in combination with other important legal principles, such as (1) the principle of fiscal sovereignty, which produces divergent national tax laws; (2) the principle of accessory, under which tax laws defer to or are accessory to general laws; and (3) the *Duke of Westminster*⁸² principle, under which taxpayers are entitled to engage in tax planning in order to minimize their tax. The influence of these other principles has led to some serious deviations from the value-creation principle in practice, some of which are considered below.

DEVIATIONS FROM VALUE CREATION

“Stateless Income” and Fictional Allegiance

Stateless income⁸³ refers to the income of MNEs that, as a result of tax planning, is not taxable in either the “real” residence country or the source country. Instead of having an economic allegiance, the taxpayer has merely legal or fictional allegiance to a country. The “home state” of the income has no competence to tax in an economic sense. Such stateless income defies the theory of economic allegiance and deviates from the value-creation principle.⁸⁴

Stateless income is not illegal, however. Taxpayers are entitled to take advantage of deficiencies in tax laws. These deficiencies may include outdated or inadequate rules and problematic interpretations, some of which are reviewed below.

Residence Bias and Meaningless Corporate Residence

The current residence-source paradigm under the OECD model is biased in favour of residence by limiting the scope of source-based taxation. For example, article 7 permits the source state to tax business profits only if the profits are attributed to a PE in that state. Article 12 assigns exclusive taxing right to the residence state in

81 The term “rulified” was used in Susan C. Morse, “Value Creation: A Standard in Search of a Process” (2018) 72:4/5 *Bulletin for International Taxation* 196–202, at 196.

82 *Inland Revenue Commissioner v. Westminster (Duke)*, [1936] AC 1 (HL).

83 See the two papers in *supra* note 20.

84 The 1923 report, *supra* note 22, makes no reference to the phenomenon of “stateless” income. The Carroll report, *supra* note 41, contemplates that business profits will be allocated to the enterprise’s country of fiscal domicile on the basis of real centre of management; or will be allocated to the country of source on the basis of a PE.

respect of royalties. Article 22 assigns any “other income” (that is, income that is not covered by a specific article) to the residence state. Such a bias will not lead to stateless income if the residence state is where the income is earned. In the case of corporate residence, however, that is often not the case.

The definition of “corporate residence” is formalistic, permitting corporations to self-select their country of residence for tax purposes. Corporate residence is primarily a legal matter: it is determined on the basis of which country’s laws govern the constitution of the corporation or where the corporation’s central management and control reside under the governing law.⁸⁵ The legal concept of corporate residence has been criticized as “unsatisfactory,”⁸⁶ “incoherent,”⁸⁷ and “unworkable.”⁸⁸ It can be totally divorced from the economic origin of corporate income, and it represents a merely “legal” allegiance.⁸⁹

Inadequate Source Rules

The existing source rules and allocation rules are inadequate, contributing to the stateless income problem for two main reasons. First, they do not cover intangibles, which are key factors in value creation for MNEs.⁹⁰ For example, article 5 of the OECD model and section 253 of the Act do not define “source of business profit”;

85 For more discussion of corporate residence, see Robert Couzin, *Corporate Residence and International Taxation* (Amsterdam: IBFD, 2002); David Elkins, “The Myth of Corporate Tax Residence” (2017) 9:1 *Columbia Journal of Tax Law* 5-43; Omri Marian, “Jurisdiction to Tax Corporations” (2013) 54:4 *Boston College Law Review* 1613-65; and Omri Marian, “The Function of Corporate Tax-Residence in Territorial Systems” (2014) 18:1 *Chapman Law Review* 157-83; Guglielmo Maisto et al., “Dual Residence of Companies Under Tax Treaties” (2018) 1:1 *International Tax Studies* 2-75.

86 Couzin, *supra* note 85, at 272.

87 Michael J. McIntyre, “Determining the Residence of Members of a Corporate Group” (2003) 51:4 *Canadian Tax Journal* 1567-73. According to McIntyre, at 1569, corporations simply cannot have a residence. For example, McIntyre noted that “[a]sking where a corporation ‘keeps house’ is like asking whether a corporation would be a carnivore if it happened to be an animal.” Similarly, “[a] corporation engages in business in much the same way that the owner of a baseball team plays baseball.” See *ibid.*, at 1569.

88 Elkins, *supra* note 85, at 31.

89 The 1923 report, *supra* note 22, discusses the taxing right over business enterprises by reference to the origin of income, and it emphasizes (at 31) the location of the head office as “the real brains of the management.” (See also the discussion, at 23, of “control and direction by directors”). It also discusses, at 31, the enforceability of economic rights. The league’s technical experts found it particularly difficult to reach a conclusion regarding the “fiscal domicile” of companies in the 1925 report, and they recommended that the fiscal domicile be the place where the head office or real centre of management is located. See Jogarajan, *supra* note 33, at 79 and 81.

90 As a source of value creation, intangibles were presumably not significant enough in 1923 to cause double taxation or to be considered in the 1923 report, but are a major creator of value in today’s knowledge economy. Intangible income can be directed by MNEs to countries with mere legal allegiance.

they merely describe manifestations of value creation in an agricultural and industrial economy (such as production or human sale activities). These rules recognize rival factors of production (such as capital, land, and labour) and observable business activities, including human activities conducted in person. They do not encompass intangible and non-rival factors (for example, know-how, corporate synergy, and trademark) or remote human activities.

Second, the existing allocation rules focus on internal or supply-side factors in value creation. They do not consider the activities of a corporation's customers or users in adding value for the corporation. This shortcoming is clear in the debates about taxing digital businesses.

Legalistic Interpretation of the Arm's-Length Principle

The legalistic approach to interpreting the arm's-length principle provides opportunities for tax planning, which is a major cause of stateless income.⁹¹ The BEPS transfer-pricing report states:

The arm's length principle has proven useful as a practical and balanced standard for tax administrations and taxpayers to evaluate transfer prices between associated enterprises, and to prevent double taxation. However, with its perceived emphasis on contractual allocations of functions, assets and risks, the existing guidance on the application of the principle has also proven vulnerable to manipulation. This manipulation can lead to outcomes which do not correspond to the value created through the underlying economic activity carried out by the members of an MNE group.⁹²

The legalistic approach grants significant fiscal respect to corporate personality, and it emphasizes contractual allocation as a basis for constructing the controlled transactions to be tested and for conducting functional analysis. In effect, such an approach treats each member of an MNE family as an "orphan," an approach that defies the business reality and causes "family" profits to be allocated to the "orphan" in a tax-friendly jurisdiction. As Wilkie has said,

[T]he corporate form provides the means for unlimited fragmentation and rearrangement of integrated business activities and their ostensible economic outcomes, without entailing corresponding changes in how business is actually conducted; and it supplies the "place"—a sealed repository located in an accommodating political jurisdiction—in which the formal separation of the owner of income from the place where it is earned is perfected and validated.⁹³

91 See, for example, Langbein and Fuss, *supra* note 7; Kleinbard, "Stateless Income," *supra* note 20; "G20 Leaders' Declaration," *supra* note 1, at paragraph 50.

92 Organisation for Economic Co-operation and Development, *Aligning Transfer Pricing Outcomes with Value Creation, Action 8-10—2015 Final Reports* (Paris: OECD, 2015), at 9 (<http://dx.doi.org/10.1787/9789264241244-en>) (herein referred to as "the BEPS transfer-pricing report.")

93 See Wilkie, *supra* note 21, at 356.

Contracts between legal personalities in an MNE group are also respected, and contractual prices may be challenged only if they deviate from arm's-length prices. Proving arm's-length price is difficult, especially in cases where it does not exist. By default, income is contractually allocated to serve tax-minimization purposes. For example, through the pricing of base-erosion payments or sales, profits derived in production or market countries can be directed "at will to tax-friendly repositories."⁹⁴

The 2017 transfer-pricing guidelines⁹⁵ are the most authoritative source of the interpretation of article 9 of the OECD model and the underlying arm's-length principle. The OECD has gradually downplayed the role of intragroup contracts and increased the relevance of underlying reality and economic substance, but the fundamental legalistic approach has remained, as the following chronology shows:⁹⁶

- The 1979 guidelines viewed intragroup contracts as decisive and held that "underlying reality" should be considered only if contractual agreements were altered arbitrarily or otherwise suspicious.⁹⁷
- The 1995 guidelines recognized the existence of residual profit; added two profit-based methods (that is, the transactional net margin method and the profit-split method) to the three traditional methods (comparative uncontrolled price, resale price, and cost plus); and took value creation into consideration when the functional analysis was being performed or when the transfer-pricing method was being selected and applied. The 1995 guidelines also articulated the process of analyzing "functions, assets used, and risks assumed" in comparative analysis and downplayed the significance of the legal ownership of intangibles.⁹⁸
- The 2010 guidelines added a section (chapter 9) on restructuring, in order to address the concern that MNEs were (1) restructuring operations to centralize the functions, assets, and risks in a single entity based in a tax-friendly country; and (2) converting what had been full-fledged distributorships into "limited function" distributorships, primarily for transfer-pricing purposes. With respect to the contractual assignment of risks and the consequential profit attribution, the 2010 guidelines state that any "contractual allocation of risk between associated enterprises" will be respected only to the extent

94 Ibid.

95 The 2017 guidelines, *supra* note 78.

96 For a more detailed examination of the OECD transfer-pricing guidelines and the influence of the American arm's-length standard on such guidelines, see Collier and Andrus, *supra* note 41; and Langbein and Fuss, *supra* note 7.

97 The 1979 guidelines, *supra* note 79, at 20.

98 Organisation for Economic Co-operation and Development, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995), at paragraph 2.26 (herein referred to as "the 1995 guidelines").

that it has economic substance.⁹⁹ Contractual allocations have economic substance when evidence exists that similar allocation is used in comparable arm's-length contracts (that is, in open-market comparables). In the absence of such comparables, economic substance will be based on a hypothetical market analogy—that is, based on “whether that allocation of risk is one that might be expected to have been agreed between independent parties in similar circumstances.”¹⁰⁰ However, the 2010 guidelines emphasize that non-recognition of the contractual allocation of risk or restructuring is appropriate only if the allocation or restructuring lacks economic rationality, and only in a narrow class of cases.¹⁰¹

- The 2017 guidelines increase the emphasis on economic substance and the allocation of residual profit. With respect to intangibles,¹⁰² the guidelines recognize the value created by parties who, although they are not legal owners, perform DEMPE (development, enhancement, maintenance, protection, and exploitation of the intangibles) functions. Legal ownership alone does not necessarily generate a right to all (or indeed any) of the return that is generated by the exploitation of the intangible. Through ex-post returns, income from hard-to-value intangibles after the transfer can still be allocated to the transferor that developed the intangibles. Centralized entities created to hold intangibles or to supply funding are entitled to a risk-free return.
- In June 2018, the OECD released revised guidance on an expanded use of the transactional profit-split method.¹⁰³ The guidance reiterates the position that only profits arising from the controlled transaction¹⁰⁴ are split according to either a contribution-based split or residual split method (the latter is more common). The guidance also says the following: “Additionally, it should be remembered that the starting point in the accurate delineation of any transaction will generally be the written contracts which may reflect the intention of the parties at the time the contract was concluded.”¹⁰⁵

99 Organisation for Economic Co-operation and Development, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 2010), at paragraph 9.12 (herein referred to as “the 2010 guidelines”).

100 Ibid., at paragraph 9.19.

101 Ibid., at paragraph 9.171.

102 The 2017 guidelines, *supra* note 79, chapter VI.

103 Organisation for Economic Co-operation and Development, *Revised Guidance on the Application of the Transactional Profit Split Method: Inclusive Framework on BEPS: Action 10* (Paris: OECD, 2018) (herein referred to as “the 2018 revised guidance”). The transactional profit-split method is considered the most suitable where “Each party makes unique and valuable contributions; [t]he business operations are highly integrated such that the contributions of the parties cannot be reliably evaluated in isolation from each other; [t]he parties share the assumption of economically significant risks, or separately assume closely related risks.” See *ibid.*, executive summary.

104 Such profits can be actual profits or anticipated profits.

105 2018 revised guidance, *supra* note 103, at 2.161.

To summarize, the OECD's approach to interpreting the arm's-length principle (despite recent revisions to its guidance in this regard) remains focused on transactional pricing, leaving residual profit to be allocated to an intermediary through intragroup contracts. The OECD continually rejects the "global formulary apportionment"¹⁰⁶ of profits as not "acceptable in theory, implementation, or practice."¹⁰⁷ The complexities created by the 2018 revised guidance increase the difficulties for countries, especially developing countries, that lack the necessary resources to engage in highly technical analysis.¹⁰⁸ Accordingly, profits derived from productive activities or from the sale of goods and services end up being stateless.

Unilateralism in International Taxation

The goal of taxing profits according to value creation or economic allegiance would be easier to achieve if there were only two countries in the world: a residence country and a source country. These two countries could follow the OECD model so that income was taxed in either the source country or the residence country, but not in both or neither. They could also follow the transfer-pricing guidelines and use the two-sided profit-split method to allocate residual profit.¹⁰⁹ Such a bilateralist framework, however, does not fit well within the real world of multiple countries and MNEs that operate through GVCs. In the absence of a multilateral tax convention, the right to tax international income is expressed through domestic tax laws. Even though the domestic tax laws of many countries adopt the basic residence-source paradigm and the arm's-length principle, the respective tax regimes of these countries differ significantly from one another in terms of policy emphasis and technical implementation.¹¹⁰

Unilateralism in international taxation leads to gaps and overlaps between national tax laws in the taxation of international income. Even when two countries have a tax treaty, the treaty provisions may be interpreted differently in each country or be used by taxpayers in third countries, and the result is stateless income.

106 The glossary in the 2017 transfer-pricing guidelines defines this term to mean "an approach to allocate the global profits of an MNE group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined formula." See *supra* note 78, at 26.

107 *Ibid.*, at 1.15.

108 *Ibid.*, at 6.39. See United Nations, "Practical Manual on Transfer Pricing for Developing Countries (2017)," September 11, 2017 (www.un.org/development/desa/capacity-development/tools/tool/united-nations-practical-manual-on-transfer-pricing-for-developing-countries-2017).

109 See Michael Kobestky, "The Transfer-Pricing Profit-Split Method After BEPS: Back to the Future" (2019) 67:4 *Canadian Tax Journal* 1077-1105.

110 See part 4 in B.J. Arnold, Hugh Ault, and Graeme Cooper, eds. *Comparative Income Tax*, 4th ed. (forthcoming).

RECENT U-TURN TOWARD VALUE CREATION

Political Endorsement

Departures from the value-creation principle prompted the G20 to launch the BEPS project, which provided political endorsement of the principle. In the name of improving tax fairness and justice, G20 and OECD countries—and, subsequently, countries participating in the Inclusive Framework—seem to have reached some consensus on the implementation of the value-creation principle and on a road map for future reforms. Some participating countries, such as China,¹¹¹ have emphasized the importance of value creation as a guiding principle. As some commentators have observed, “It is now widely taken as axiomatic that the existing international corporate tax system is based on the [value-creation] principle,” and there also appears to be “widespread agreement, at least amongst policy makers, that the system should be based on this principle.”¹¹²

Rising Multilateralism

There are signs of increasing multilateral cooperation in tax matters in respect of substantive tax laws and tax administration. For example, the BEPS project¹¹³ introduced minimum standards¹¹⁴ and a multilateral convention¹¹⁵ in order to address

111 Jinyan Li, “China and BEPS: From Norm-Taker to Norm-Shaker” (2015) 69:6/7 *Bulletin for International Taxation* 55; Liao, *supra* note 11; Conrad Turley, David Chamberlain, and Mario Petriccione, *A New Dawn for the International Tax System: Evolution from Past to Future and What Role Will China Play?* (Amsterdam: IBFD, 2017).

112 Devereux and Vella, *supra* note 10, at 1; and Richard Vann, “Policy Forum: The Policy Underpinnings of the BEPS Project—Preserving the International Corporate Income Tax?” (2014) 62:2 *Canadian Tax Journal* 433-41, at 441.

113 For the first time in recent history, the political influence of the G20 and the technical power of the OECD were married, with a view to recommending changes to treaty rules and domestic rules. This approach contrasted with previous OECD reform efforts, which followed a bottom-up approach and were driven by technocrats who specialized in fiscal policy and taxation. The BEPS project may also signal the end of American constructive unilateralism in setting international tax standards. See Grinberg and Pauwelyn, *supra* note 10.

114 These are the action 5 minimum standard, concerning the nexus or substantial activities requirement; the action 6 minimum standard, which requires countries’ treaties to include (1) an express statement on non-taxation (generally in the preamble) and (2) one of three methods of addressing treaty shopping; the action 13 minimum standard, concerning country-by-country (CbC) reporting by MNEs; and the action 14 minimum standard, concerning the enhancement of the effectiveness of dispute resolution mechanisms.

115 Organisation for Economic Co-operation and Development, Multilateral Convention To Implement Tax Treaty Related Measures To Prevent Base Erosion and Profit Shifting, adopted on November 24, 2016, and signed by Canada at Paris, France, on June 7, 2017 (www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.pdf). For discussions, see David G. Duff, “Tax Treaty Abuse and the Principal Purpose Test: Part 1,” *International Tax Planning* feature (2018) 66:3 *Canadian Tax Journal* 619-77; and “. . . Part 2,” *International Tax Planning* feature (2018) 66:4 *Canadian Tax Journal* 947-1011.

vulnerabilities in existing tax treaties. The minimum standards are touted as “global” because they are expected to be adopted by the (now 134) countries and jurisdictions that are joining the Inclusive Framework.¹¹⁶ The minimum standards hold out the promise of minimizing stateless income. For example, the action 13 minimum standard on country-by-country (CbC) reporting requires an MNE to prepare a CbC report with aggregate data on the global allocation of income, profit, taxes paid, and economic activity among countries in which the MNE operates.¹¹⁷ These CbC reports thus prepared are shared with tax administrations in various countries for use in high-level transfer-pricing assessments.¹¹⁸

With respect to cooperation in tax administration and information sharing, the Multilateral Convention¹¹⁹ facilitates international cooperation for a “better operation of national tax laws, while respecting the fundamental rights of taxpayers.”¹²⁰ The Global Forum on Transparency and Exchange of Information for Tax Purposes, which now has 154 members, is the international body for ensuring the implementation of the standards of tax transparency and the exchange of tax information.¹²¹ Another example of international cooperation is the Platform for Collaboration on Tax, launched in April 2016 by the International Monetary Fund, the OECD, the UN, and the World Bank Group to provide technical assistance to interested developing countries.

116 See “What Is BEPS?” *supra* note 4.

117 The CbC reporting required by action 13 contains a master (global) file and a local (country) file. The master file must describe, among other things, the important drivers of business profit; the supply chain for the group’s five largest products or service offerings by turnover and main geographic markets for the group’s products and services; the principal contributions to value creation by individual entities within the group (that is, the key functions performed, the important risks assumed, and the important assets used); the MNE’s overall strategy for the development, ownership, and exploitation of intangibles, including the location of principal research and development (R & D) facilities and the location of R & D management; and the identification of any members of the MNE group that provide a central financing function for the group, including the country under whose laws the entity is organized and the place of effective management of such entities. The local (country) file must include, among other things, a detailed description of the business and business strategy pursued by the local entity.

118 Organisation for Economic Co-operation and Development, “Action 13 Country-by-Country Report” (<https://www.oecd.org/tax/beps/beps-actions/action13>).

119 Organisation for Economic Co-operation and Development, *The Multilateral Convention on Mutual Administrative Assistance in Tax Matters: Amended by the 2010 Protocol* (Paris: OECD, 2011) (<https://dx.doi.org/10.1787/9789264115606-en>).

120 See *ibid.*, at 33.

121 Organisation for Economic Co-operation and Development, *Global Forum on Transparency and Exchange of Information for Tax Purposes* (Paris: OECD, 2019) (www.oecd.org/tax/transparency). For further discussion, see Arthur J. Cockfield, “Sharing Information in the 21st Century: Big Data Flows and Taxpayers as Data Subjects” (2019) 67:4 *Canadian Tax Journal* 1179-99.

Increasing Recognition of the Business Reality of MNEs

Economic substance or business reality has gained progressively more recognition in the various OECD transfer-pricing guidelines.¹²² The Supreme Court of Canada viewed business reality as relevant to the application of the domestic transfer-pricing rule.¹²³ The BEPS action plan “foresaw the possibility of introducing special measures . . . beyond the arm’s length principle,”¹²⁴ and this set the stage for innovative ways of allocating the global profits of MNEs. The BEPS project has authorized an expanded use of the profit-split method, especially in regard to allocating income that arises from the “synergistic benefits of operating as a group” and from “integrated global value chains.”¹²⁵ The BEPS project took a more global view of MNEs. For example, the earnings before interest, taxes, depreciation, and amortization (EBITDA) or earnings before interest and taxes (EBIT) rule in action 4 (limitation on interest deductions) takes into account the worldwide MNE group’s interest-to-EBITDA ratio.

Some G20 countries, such as China, take a more holistic, global, and substance-over-form approach to applying the arm’s-length principle.¹²⁶ The proposed common consolidated corporate tax base (CCCTB) in the European Union (EU)¹²⁷ is a proposal to allocate group profit by a method that is more aligned with business reality than is the transactional pricing approach. There is a growing body of literature on the allocation of MNEs’ global profits according to formulary apportionment methods.¹²⁸ The direction of the pillar 1 allocation methods proposed by the Inclusive Framework is consistent with this growing trend.

122 See above, under the heading “Legalistic Interpretation of the Arm’s-Length Principle.”

123 *GlaxoSmithKline Inc. v. Canada*, 2012 3 SCC 52, at paragraph 53.

124 This is reiterated in the Tax Annex to the “G20 Leaders’ Declaration,” supra note 1; and BEPS transfer pricing report, supra note 92, at 9.

125 BEPS transfer-pricing report, supra note 92, at 11, 55, and 60.

126 Jinyan Li, *International Taxation in China: A Contextualized Analysis* (Amsterdam: IBFD, 2016).

127 See European Commission, “Common Consolidated Corporate Tax Base (CCCTB)” (https://ec.europa.eu/taxation_customs/business/company-tax/common-consolidated-corporate-tax-base-ccctb_en). Under the CCCTB, the profit of all entities of a corporate group above a specified threshold (€750 million) turnover would be computed under harmonized rules, and the consolidated profits (and losses) would be apportioned to each country involved according to a formula composed of fixed assets, payroll/workforce, and sales. The EU also proposed that the CCCTB would apply to the taxation of digital companies that have a “digital presence” in an EU member country. See European Commission, “Fair Taxation of the Digital Economy” (https://ec.europa.eu/taxation_customs/business/company-tax/fair-taxation-digital-economy_en).

128 For a review of the main proposals, see the International Monetary Fund, *Corporate Taxation in the Global Economy*, Policy Paper no. 19-007 (Washington, DC: IMF, March 2019).

ROAD MAP FOR THE FUTURE

Value Creation as the Basis for Developing Global Consensus

The Inclusive Framework emphasizes the importance of developing a consensus-based solution to the allocation of profits that is “underpinned by sound economic principles and conceptual basis.”¹²⁹ In the absence of any explicit reference to other principles or theories, value creation or economic allegiance presumably continues to be the guiding principle for building consensus.

Value creation has been viewed by some as “a deceptively misleading claim” that “camouflages as neutral and apolitical the highly political and distributive nature of the international tax system,”¹³⁰ and it has been criticized for being vague or subjective.¹³¹ In our view, these criticisms may actually point toward the strengths of the value-creation principle as the basis for developing global consensus, the achievement of which is, by its nature, politically difficult and technically complex. The Inclusive Framework members’ unprecedented achievement of consensus on the road map speaks to this point. As a conceptual basis for reform, the value-creation principle cannot be expected to provide “the practical guidance needed to answer all questions.”¹³² New technical rules are needed. That is why the pillar 1 proposals are welcome first steps.

Pillar 1 Proposals To Allocate New Taxing Rights to Market Jurisdictions

The pillar 1 proposals allocate “new taxing rights”—taxing rights on income generated from cross-border activities in the digital age.¹³³ Given the existence of a nexus based on user participation, marketing intangibles, or significant economic presence, new taxing rights would be allocated to the market jurisdictions according to three rules:

1. The modified residual profit-split (MRPS) method would allocate residual or non-routine profit to the market jurisdiction, using an allocation key, such as revenues. Routine profits would be allocated according to existing transfer-pricing rules.
2. The fractional apportionment method (FAM) would allocate a fraction of an MNE’s overall profit (or business line) to the market jurisdictions by using a formula based on factors such as employees, assets, sales, and users.

129 *Programme of Work*, supra note 15, at paragraph 13.

130 Allison Christians, “Taxing According to Value Creation” (2018) 90:13 *Tax Notes International* 1379-83, abstract (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3230370).

131 Grinberg, supra note 10, at 95, mentioning that “any exercise to define specific sources of value creation is entirely subjective.” Hey, supra note 18, at 203, refers to “[t]he unclear concept of value creation as an allocation factor.”

132 See supra note 128, at 18.

133 *Programme of Work*, supra note 15, at paragraph 30.

3. Distribution-based approaches (DBA) would specify a baseline profit (routine as well as non-routine profit) in the market jurisdiction for marketing, distribution, and user-related activities, and such baseline profit could function as a minimum or maximum return.

All three proposals recognize that physical presence in the market jurisdiction is not the only factor in value creation. Value creation can be manifested by indicators of an MNE's remote but sustained and significant involvement in the economy of a market jurisdiction, including indicators such as making their goods and services available to customers and users in a particular market and commercially exploiting the data created by such customers and users. The Unified Approach proposed by the OECD in October 2019 adopts a new nexus based on sales to customers and users in a jurisdiction. In terms of the allocation of profit, all three proposals are less legalistic than the alternatives, and all focus on total profitability (or business line or regional business) as opposed to price or profit from controlled transactions. The MRPS approach separates routine and non-routine profit in order to recognize value created by intangibles. It was presumed that the existing transfer-pricing rules would continue to apply to profit that does not generate "new taxing rights." The FAM ostensibly departs from the longstanding OECD position on global formulary apportionment. The DBA was intended to satisfy the "strong demand for simplicity and administrability."¹³⁴ The Unified Approach proposed by the OECD in October 2019 adopts a formulary apportionment method for allocating to market jurisdictions a multinational corporation's group profit derived from consumer-facing businesses. This new method is meant to "complement" the existing transfer-pricing rules and applies only to residual profit attributable to marketing intangibles. The sole allocation key is sales.

The OECD proposal to assign new taxing rights to market jurisdictions is aligned with the value-creation principle. The sales-based formulary apportionment method represents a major shift in the OECD's thinking about transfer pricing. However, because of the ring fencing of the new approach to consumer-facing businesses and the adoption of a single factor in the formula, this method falls short when it comes to recognizing value created by other factors. In the section below, we propose a general GPS rule that would be consistent with value creation.

Proposal: A General Global Profit-Split Rule

The GPS rule that we propose would build on the pillar 1 proposals.¹³⁵ It would extend the MRPS method to all, allocating group residual profit to all members of

¹³⁴ Ibid., at paragraph 32.

¹³⁵ It is beyond the scope of this paper to elaborate on the details of the GPS rule that we propose. For discussion of the details involved in designing formulary apportionment, see Reuven S. Avi-Yonah, Kimberly A. Clausing, and Michael C. Durst, "Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Split" (2009) 9:5 *Florida Tax Review* 497-553; Devereux and Vella, *supra* note 10; and Grinberg, *supra* note 10.

the group according to a multi-factor formula (factors such as employees, assets, and sales) that is similar to the formula contemplated by the FAM. To determine the amount of routine profit for allocation, a baseline profit rate could be used to achieve simplicity.

The main strength of the GPS rule is that it allocates profit to all links of the GVCs and all factors that create or contribute to value and profit. A multi-factor apportionment rule is better aligned with value creation and more faithful to the doctrine of economic allegiance. The economists' 1923 report suggested that the production of income involves multiple stages.¹³⁶ The modern businesses of MNEs are globally integrated, and each link of the GVCs contributes to the overall profit.¹³⁷ Human capital development fuels the growth of GVCs.¹³⁸ Therefore, the value-creation principle requires that global profit be allocated to countries where production, marketing, and DEMPE take place.¹³⁹ Allocation of residual profit on the basis of a single factor or on the basis of the market jurisdiction alone does not reflect either business realities or the value-creation principle.¹⁴⁰

CONCLUSION

In this paper, we have demonstrated that the concept of taxing profits according to value creation is a new expression of an old idea—namely, the idea of economic allegiance. Economic allegiance provided the theoretical framework for the existing international tax system, including the arm's-length principle, and the value-creation principle has been a constant for the past century. Recent reforms, through the BEPS project and the Inclusive Framework, have brought the value-creation principle to the forefront of the debate over deviations from the principle that are caused by inadequate rules, legalistic interpretation of the arm's-length principle, and the artful manipulation of existing rules by MNEs. We view the pillar 1 proposals as a movement in the right direction, but we consider that they fall short when it comes to allocating profit according to the value-creation principle. We propose a

136 The 1923 report, *supra* note 22, at 23.

137 See Wolfram F. Richter, *Aligning Profit Taxation with Value Creation*, CESifo Working Paper no. 7589 (Munich: Munich Society for the Promotion of Economic Research, April 2019) (www.ifo.de/DocDL/cesifo1_wp7589.pdf).

138 Romero J.S. Tavares and Jeffrey Owens, "Human Capital in Value Creation and Post-BEPS Tax Policy: An Outlook" (2015) 69:10 *Bulletin for International Taxation* 590-601.

139 World Intellectual Property Organization, *World Intellectual Property Report 2017: Intangible Capital in Global Value Chains* (Geneva: WIPO, 2017) (www.wipo.int/edocs/pubdocs/en/wipo_pub_944_2017.pdf), reporting that intangibles accounted for over 30 percent of the value of manufactured goods sold throughout the 2000-2014 period.

140 Allocating residual profit to market jurisdictions is difficult to justify under the logic of the current system of source taxation, and doing so would not be supported by production countries or DEMPE countries. See Johannes Becker, Joachim Englisch, and Deborah Schanz, "Re-Allocation of Taxing Rights for Big Data Business Models," August 7, 2019 (<https://ssrn.com/abstract=3433715>).

method that extends these proposals and allocates both new and existing taxing rights to countries in which value is created.

To develop new allocation rules that affect countries' economic interests and MNEs' interest in maximizing their after-tax profits is a complex undertaking. Given the importance of a consensus-based approach, more research is needed to support the technical design of such rules.

The Digital Services Tax on the Verge of Implementation

Wei Cui*

PRÉCIS

La France a adopté la taxe sur les services numériques (TSN) en 2019, et le Royaume-Uni, l'Espagne, l'Italie et d'autres pays sont en voie de promulguer des législations pour l'adoption de taxes semblables. La TSN peut être vue comme une taxe sur les loyers basée sur le lieu (LBL), et résout sans doute des problèmes vraiment nouveaux en matière de fiscalité internationale. L'auteur passe brièvement en revue cette justification de la TSN et examine plus en détail la TSN à la lumière de trois critiques. La première critique est que certaines caractéristiques de la TSN la rendent semblable aux droits douaniers sur les importations créant une distorsion. La deuxième est que la TSN ne serait pas payée par les plateformes numériques, mais serait simplement transférée aux utilisateurs des plateformes. La troisième est que les gouvernements qui font la promotion de la TSN ne semblent pas la caractériser comme une taxe sur les LBL; ils ont plutôt préconisé une réforme de l'impôt sur le revenu. L'auteur propose des moyens de rationaliser les caractéristiques de la TSN qui l'apparentent à un droit douanier, réfute les arguments superficiels sur l'effet de la TSN, et offre un cadre pour comprendre pourquoi les petites économies pourraient plaider simultanément en faveur de la TSN et d'une réforme de l'imposition du revenu à l'échelle internationale.

ABSTRACT

France enacted the digital services tax (DST) in 2019, and similar legislation is pending in the United Kingdom, Spain, Italy, and other countries. The DST can be viewed as a tax on location-specific rent (LSR), and it arguably solves genuinely new problems in international taxation. The author briefly reviews this justification of the DST and further examines the DST design in light of three criticisms. The first criticism is that certain features of the DST render it similar to distortionary import tariffs. The second is that the DST would not be borne by digital platforms but would only be shifted to platform users. The third is that governments promoting the DST seem not to characterize it as a tax on LSR but, instead, have advocated reforming the income tax. The author suggests ways of rationalizing the DST's tariff-like features, refutes casual arguments about the DST's incidence, and offers a framework for understanding why small economies might advocate simultaneously for the DST and for the reformation of international income taxation.

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KEYWORDS: DIGITAL ■ INTERNATIONAL TAXATION ■ TECHNOLOGICAL CHANGE ■ TARIFFS ■ TAX INCIDENCE ■ OECD

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INTRODUCTION

In March 2018, the European Council and the UK government each proposed to introduce a digital services tax (DST), to be levied on the revenue that large digital platform companies earn from advertising, online intermediation, or the transmission of data.¹ To justify their respective proposals, these governments argued that the international income tax regime currently applicable to multinational companies results in the undertaxation of such companies, and that the regime must be reformed soon in order to allocate greater taxing rights to jurisdictions where digital platform users create value. They proceeded to present the DST as a short-term remedy for the undertaxation of digital platforms, pending a new consensus on multilateral tax reform within the Organisation for Economic Co-operation and Development (OECD).

DST proposals may represent the most intriguing global development in tax policy in recent years. Most academic and policy commentators have been surprised by how quickly these proposals have followed—and now threaten to overtake—the OECD's base erosion and profit shifting (BEPS) project, which national governments only recently began to implement. Even the basic idea of a DST, let alone a detailed idea of its design, was unheard of before late 2017, and yet the governments of numerous countries have already seized upon the idea and demonstrated substantial resolve regarding its implementation. In July 2019, France formally enacted DST legislation, with DST liabilities applicable retroactively to the beginning of 2019.² In the same month, the UK government, contemplating a UK DST, released detailed

1 United Kingdom, HM Treasury, *Corporate Tax and the Digital Economy: Position Paper Update* (London, UK: HM Treasury, March 2018) (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/689240/corporate_tax_and_the_digital_economy_update_web.pdf); European Commission, Taxation and Customs Union, Proposal for a Council Directive on the Common System of a Digital Services Tax on Revenues Resulting from the Provision of Certain Digital Services, COM/2018/0148 final, March 21, 2018.

2 France, République française, "Loi no 2019-759 du 24 juillet 2019 portant création d'une taxe sur les services numériques et modification de la trajectoire de baisse de l'impôt sur les sociétés," *Legifrance.gouv.fr*, 24 juillet 2019 (www.legifrance.gouv.fr/affichLoiPreparation.do?idDocument=JORFDOLE000038203221&type=general&typeLoi=proj&legislature=15).

proposed legislative language, draft administrative guidance, and further policy explanations.³ Although the near-term future of UK policymaking is highly uncertain under Boris Johnson's government, the DST legislation is scheduled to be included in the fall 2019 budget, which would result in the tax's taking effect in April 2020. Spain, Austria, and the Czech Republic have also introduced DST legislation. It is widely anticipated that more countries may do the same.

Among the many fascinating features of the DST is that, prior to its delineation by various governments, it had no intellectual proponent. The DST had not been anticipated in the academic literature, and the idea of it seems to have been plucked out of thin air by bureaucrats and politicians. Partly for this reason, much of the initial commentary on the DST treated it as a policy proposal with no intellectual substance, and as motivated purely by protectionism, populism, or political opportunism. Only since 2018 have scholars begun to seriously analyze this novel policy instrument.⁴ Elsewhere, I have offered a rationalization of the DST as a tax on location-specific rent (LSR).⁵ That is, many countries already levy royalties, rent taxes, and the corporate income tax on natural resource extraction; one can think of the DST as a tax on economic rents earned by digital platform companies from particular locations. Taxes on LSR possess two highly desirable features. First, they generate tax revenue with minimal distortions to business decisions. Second, rent that can be attributed to specific locations permits a natural allocation of taxing rights: the jurisdictions in which the rent is located can reasonably claim primary taxing rights, and this in turn implies natural solutions to coordination problems in mitigating the risk of excessive taxation. Once platform rent is seen as location-specific, familiar tax policy frameworks become available for analyzing the DST. For example, the choice between a revenue-based tax and a tax defined over a rent base is familiar in the context of taxing natural resources. Revenue-based royalties on

3 United Kingdom, HM Revenue and Customs, "Introduction of the New Digital Services Tax, Draft Legislation," July 11, 2019 (www.gov.uk/government/publications/introduction-of-the-new-digital-services-tax); United Kingdom, HM Revenue and Customs, *Digital Services Tax Draft Guidance* (London, UK: HM Revenue and Customs, July 11, 2019) (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/817666/20190711_-_Draft_Guidance_vfinal.pdf); and United Kingdom, HM Treasury, *Digital Service Tax: Response to the Consultation* (London, UK: HM Treasury, July 2019) (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/816389/DST_response_document_web.pdf).

4 For recent scholarship sympathetic to the DST, see Wolfram Richter, "The Economics of the Digital Services Tax," July 2019 (www.wiwi.tu-dortmund.de/wiwi/de/forschung/gebiete/fp-richter/workingprogress/FPR-WORI-WIP-TheEconomicsoftheDigitalServicesTax.pdf); Daniel Shaviro, "Digital Service Taxes and the Broader Shift from Determining the Source of Income to Taxing Location-Specific Rents," September 2019 (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3448070).

5 Wei Cui, "The Digital Services Tax: A Conceptual Defense," *Tax Law Review* (forthcoming); and Wei Cui, "The Superiority of the Digital Services Tax over 'Significant Digital Presence' Proposals," *National Tax Journal* (forthcoming).

resource extraction are frequently adopted alongside rent taxes and income tax, and the DST can straightforwardly be analogized to resource royalties.⁶

As the implementation of real-world DSTs begins, however, it is important to comment on certain discrepancies between the rationalization of the DST as a tax on LSR on the one hand, and actual DST design on the other. Such discrepancies fall into at least three categories. First, critics of the DST, while they have emphasized features of the tax that resemble import tariffs or that amount to a distortionary tax on business-to-business (“B2B”) transactions, have downplayed significant applications of the DST from which these features are absent. The presentation of the DST as a tax on LSR, by contrast, has stressed these other applications. Just as it is wrong for DST critics to continue to ignore the rent-tax features of DSTs, it is arguably wrong for DST proponents to omit discussion of the tariff-like features of the DST or its potential distortions of B2B transactions. Alternative or additional justifications for the DST must be considered.

Second, the characterization of the DST as a tax on LSR provides a framework for analyzing the DST’s economic incidence. Others have predicted different incidence effects, even claiming that such predictions have been confirmed by real-world observations. It is illuminating to compare the predicted incidence effects of a tax on LSR with these actual observed price changes that seem to have followed the DST’s adoption. For example, Amazon recently announced that it would charge merchants in France a higher commission that corresponded to the DST rate.⁷

Third, and finally, it must be acknowledged that the national governments that are enacting the DST have refrained from promoting it as a tax on LSR. Instead, they continue to justify the DST as an interim measure, pending the satisfactory reform of international income taxation. It is rather unlikely, however, that the corporate income tax can be converted into a tax on LSR. Indeed, the traditional expectation has been that taxes on economic rent will be imposed independently of the income tax: the two are far from being interchangeable. It is thus important to reflect on whether the conception of the DST as a tax on LSR may ultimately gain some political, as distinct from merely intellectual, purchase.

In this paper, I tackle these issues in order. In the first section, I briefly review the analysis of the DST as a tax on LSR, emphasizing central examples of the DST’s application in which it neither is tariff-like nor bears on B2B transactions. In the second section, I discuss applications of the DST in which it has a tariff-like effect or distorts B2B transactions, and I describe justifications for the DST that may be offered in spite of these effects. In the third section, I consider the perceived conflict

6 This is elaborated in Wei Cui and Nigar Hashimzade, *The Digital Services Tax as a Tax on Location-Specific Rent*, CESifo Working Paper no. 7737 (Munich: Munich Society for the Promotion of Economic Research, 2019) (www.cesifo.org/DocDL/cesifo1_wp7737.pdf).

7 “Amazon Says French Clients To Bear Cost of France’s New Digital Tax,” *Courthouse News Service.com*, August 1, 2019 (www.courthousenews.com/amazon-says-french-clients-to-bear-cost-of-frances-new-digital-tax).

between the characterization of the DST as a tax on rent and the observation that the DST apparently leads to price changes. In the fourth and final section, I discuss the reasons for expecting the focus in the discourse on international tax reform to gradually move from income taxation to the taxation of LSR.

THE DST AS A TAX ON LOCATION-SPECIFIC PLATFORM RENT

Governments proposing the DST in 2018 appealed to a notion of “user value creation” that many critics have objected to as merely metaphorical and indeterminate in meaning. However, it is possible to give the phrase “user value creation” a precise interpretation: it is a matter of identifying specific locational origins of producer or consumer surplus.

Consider a hypothetical company, “Googl,” that has developed a technology (“Search Algorithm”) and thereby incurred large fixed costs and ongoing research and development (R & D) expenses. Googl designs a Web interface in country X’s language, mainly for individual users in country X; Googl has developed interfaces in many other languages for other countries. The interface requires an upfront investment and maintenance spending. Googl operates servers in a low-tax jurisdiction (country Z) in order to support Search Algorithm and multiple interfaces, consuming much of country Z’s electricity supply. Despite these very large non-marginal costs, Googl’s marginal cost from its main revenue-generating business—that is, the targeted placement of advertisements based on user searches—is almost zero. The prices that Googl is able to charge purchasers of advertising are well above marginal cost because of the market power that Googl possesses.

Consider, specifically, one line of Googl’s business: ad placement on the country X interface, targeted at users in country X. Among the purchasers of advertising space on Googl are not only country X businesses but also producers and sellers of goods and services from other countries, including country Y. Because of (nearly) zero marginal cost, the revenue that Googl earns during a given period from ads targeted at country X consumers and paid by country Y producers (this revenue is R_{XY}) is roughly its gross profit from this business. Suppose that after the allocation and deduction of the non-marginal costs (for example, electricity and server depreciation) incurred by Googl in country Z against this profit during the same period, net profit π_{XY} remains. (The computation of π_{XY} does not yet take into account Googl’s other fixed expenditures—for example, R & D.)

It seems plausible to attribute π_{XY} to country X, if the following two conditions are met:

1. The production functions and supply curves of producers in country Y (that is, the purchasers of ad space) do not change because of Search Algorithm or Googl’s country X interface.
2. Googl’s earning of the profit π_{XY} does not interfere with its deployment of Search Algorithm in other countries.

The logic of such profit attribution runs as follows. First, the satisfaction of condition 1 allows the following argument: R_{XY} is extracted from additional producer surplus that producers in country Y expect to earn by making sales to consumers in country X. But if such expected surplus arises even if production functions have not changed, it must come from an expected shift in the demand curve of the consumers in country X, caused by the ads placed on Googl. Nothing, however, has happened in country Y to generate the possibility of the interaction between Googl and country Y sellers. Second, the satisfaction of condition 2 leads to the argument that since the deployment of Search Algorithm in country X has no opportunity costs, one can view the entire profit (π_{XY}) as earned from country X. This is the case even if the infrastructural support for the platform is located in country Z. The reason is that while this infrastructure is entirely mobile, π_{XY} is immobile because it can be earned only in connection with country X.

Therefore, if conditions 1 and 2 both obtain, Googl's profit, earned from country Y producers, can be said to have an origin in country X—the origin being country X consumers' engagement with the Googl platform. It is important to note that, although advertisers and individuals doing online searches are all "users" of Googl, condition 1 articulates a situation where one can say that "user value creation" arises in one of the two user jurisdictions, but not the other. In particular, the significant value creation in this case occurs in the consumer jurisdiction. Moreover, the amount of value created can be measured (rather than being indeterminate). Before costs are taken into account, this amount is at least R_{XY} , since this is the least amount that producer surplus in country Y is expected to increase as a result of country X's users' interactions with Googl (it is at least π_{XY} after taking into account Googl's fixed costs).

How can country X capture a portion of Googl's profit that reflects "value creation" in the sense just identified? One possibility is for country X to impose a low-rate tax on R_{XY} , which would be equivalent to a higher-rate tax on π_{XY} . Since R_{XY} is earned by Googl in the form of payments from country Y, country X cannot impose such a tax by levying an import tariff or a traditional withholding tax: there is no payment from country X corresponding to R_{XY} for such a levy to bear on. Figure 1 illustrates this misalignment between value creation and source of payment. Instead, country X must ask Googl to voluntarily report and remit the tax on R_{XY} . This is how a DST would apply to Googl. One of the basic innovations of the DST is that it tackles the misalignment between payment and value creation, which is made administratively possible when Googl, as a large multinational company, can be expected to comply with the DST obligation even in the absence of country X's ability to track payments from country Y.

Even though the tax on advertising revenue earned by Googl is not a tariff in this particular case, it is a tax on B2B transactions. Does such a tax necessarily reduce production efficiency by distorting the relative costs of country Y firms' choice of inputs? The answer is no. First, it is quite conceivable that Googl would not change the price of advertising, if (1) it had already set the price of advertising at profit-maximizing levels (and its profit already allows the recovery of fixed costs),

FIGURE 1

and (2) the marginal cost of advertising is zero. In such a case, Google's profit-maximizing price before the application of the DST remains the profit-maximizing price after the DST. Second, if Google changes its price of advertising in response to the DST, country Y producers may change their advertising strategies, but this is arguably still distinct from changing inputs to production. Country Y producers' profits may decline, but it is not at all clear that the overall welfare effect of the DST is negative.

The ideas motivating the foregoing arguments can be re-enforced by a second hypothetical example. Another tech company—call it AirBB—has developed a technology, “Sharing Economy,” that intermediates between consumers in need of short-term accommodation and property owners. AirBB has a cost structure similar to Google's—that is, a large fixed cost of investment in technology, additional fixed costs associated with country interfaces, and zero marginal costs in facilitating transactions. The infrastructural support for AirBB's country interfaces, which can be located in any country, is, again, located in country Z. AirBB earns revenue from charging consumers who (1) book accommodation located in country X, and (2) may reside in another country, Y. After deducting fixed costs allocable against this revenue (R_{XY}), AirBB's profit from this line of business is π_{XY} .

An important difference between Google and AirBB is that the latter's revenue is extracted from consumers, as a result of additional consumer surplus that the digital platform creates. This surplus arises thanks to the ability of AirBB to reduce transaction costs for property owners and bring them to market. Therefore, it is plausible to postulate that instead of condition 1, an analogue condition holds: condition 1*. The demand curve of country Y consumers does not change because of Sharing Economy or the country X interface. (Condition 2 continues to hold for AirBB.)

Both landlords and tourists are users of AirBB. However, condition 1* posits that “user value creation” arises mainly in the producer's jurisdiction: changes in the supply curve are causally responsible for the increase in consumer surplus, which in turn generates revenue for AirBB. For this reason, it is plausible to attribute the latter's profit to country X and not to country Y.

As in the Google example, there is a misalignment between the country of value creation (country X) and the source of payment (country Y). Figure 2 illustrates this misalignment for AirBB. It is not possible for country X's government to extract a share of AirBB's profit earned from consumers in country Y by levying a tariff or withholding tax. Instead, a DST imposed by country X on R_{XY} must be voluntarily reported and remitted by AirBB. In AirBB's business model, fees collected from landlords in country X may constitute an additional revenue stream subject to the DST. But at least the DST imposed on R_{XY} , collected from guests in country Y, would not be a tax on B2B transactions. There arises no issue of distortionary impact on production choices.

Might AirBB pass the cost of the DST on to its guest users? Again, two points need to be made. First, if AirBB's marginal cost is zero, and if it has already set its price at profit-maximizing levels before the introduction of the DST, then the theoretical prediction is that AirBB cannot increase its after-tax profits by increasing its prices. Second, suppose that AirBB, in response to the DST, does for some reason increase the prices that it charges to guest users; this would result in a wealth transfer from country Y guests to country X's government. It is not always clear why this reduces welfare, whereas the sense in which country X has claimed a greater share of the "value created" in it is rather evident.

The examples of Google and AirBB illustrate some central applications of the DST. A prominent feature of current DST proposals is their relatively narrow scope. Platform revenue from online advertising (especially advertising on social media and search platforms) and from fees and commissions from online intermediation constitutes the main tax base. The online provision of digital content and services is generally carved out of the DST scope, as are systems of online payment and online messaging and communication. One natural interpretation of the scope of the DST's application and exemptions is that the DST is focused on platforms that serve distinct groups of users, where (1) one group of users is subsidized while profit is made from another group of users, and (2) it is a relatively pervasive phenomenon for these groups of users to be situated in different countries. Thus, in cases of online content provision (gaming, for example, and video and music streaming), the most prominent platform users (that is, gamers, and consumers of video and music) are not the groups subsidized. These users pay for the value generated by users on the other side (that is, creators of content), so they do not represent sources of value creation that are unmatched by payment.⁸ In the case of online payment and communication systems, the task of identifying which side is subsidized may be sufficiently difficult that mismatches between value creation and sources of payment raise less of a policy concern.

By contrast, online advertising and online intermediation are precisely the platforms that offer the clearest possibility of aiming different pricing strategies at

8 And, unlike the countries of AirBB landlords, countries where creators of online content reside may feel that they already extract sufficient value from platform transactions. There is no great misalignment between value creation and payment.

FIGURE 2

different groups of users located in different countries. These examples show that the DST responds to two novel problems in international taxation. First, two-sided business models operating at a global scale create misalignments between sources of value creation and origins of payment. Second, non-rival use and remote deployment of digital technology generate a significant new class of location-specific rent. With respect to the problem of misalignment, the DST offers a solution that arguably is not feasible under the income tax or any pre-existing tax instrument. And with respect to the problem of new types of LSR, although the DST is not the only possible solution (as I discuss in the next section of this paper), it certainly comes closer to a solution than does any other existing proposal.

ARE DSTS TARIFF-LIKE, AND IF THEY CAN BE, SO WHAT?

Although I believe that the examples discussed above offer the most compelling illustrations of DST design, other applications of real-world DSTs (enacted or proposed) cannot be rationalized in the same way. For example, readers may have noted that in the Googl and AirBB examples, the producers purchasing advertisements from Googl and the guests booking accommodation on AirBB may come from country X—that is, the same country where users of Googl’s search engine and AirBB landlords are located. In such cases, the place of LSR is the same as the source of payment; the DST would apply even in the absence of any misalignment between the two. Indeed, it may be that real-world DSTs cover more transactions among domestic parties than transactions among users from different countries: for example, Amazon France may mainly mediate transactions among French sellers and French buyers; and Uber’s UK app may mainly facilitate rides given by UK drivers to UK passengers. Any DST imposed on the platform companies would still be conceptually and legally distinct from tariffs (and withholding taxes): conceptually, a DST imposed on revenue from advertising that is targeted at French users is distinct from a tax on revenue from French advertisers; and, legally, the obligation of DST remittance lies with the payee and not the payer. In many cases, however, the DST

would be imposed on the same transactions as hypothetical tariffs or withholding taxes on foreign providers of digital services would apply to.

Moreover, although the argument can be made, in the case of advertising, that advertising expenditures represent fixed rather than marginal costs of production and that, therefore, a tax on the purchase of advertising (a B2B transaction) would not affect marginal production decisions, there are clearly other instances in which DST does alter marginal costs. The most obvious example is fees charged on the basis of the value of online transactions. When Amazon Marketplace charges online sellers a higher commission (purportedly as a result of the introduction of the DST), the online sellers' marginal costs clearly increase. Whether the DST is distortionary thus crucially depends on the understanding of DST incidence—of whether, and why, Amazon would pass on the DST cost.

These examples raise the following question: If the DST would have effects similar to those of tariffs on the import of services, and if it might distort production decisions, would it still be justifiable as a solution to new problems in international taxation? Certainly, opponents of the DST have rushed to compare DSTs to “protectionist” tariffs, and they have asserted that DSTs are in violation of World Trade Organization (WTO) rules (although no details have yet been offered to substantiate such comparisons).⁹ Such comparisons and assertions seem not to apply at all to the examples that I discussed in the previous section of this paper: it is not at all clear what WTO rules, if any, would apply to a tax imposed by country X on the revenue that Google or Airbnb receives from country Y. However, where the DST applies to platforms that link users from the same country, or where the DST distorts decisions about business input purchases, such critiques of the DST may be relevant.

There has, in fact, been a recent surge of unilateral tax policy instruments that appear to have tariff-like effects. Many of them are independent of, and in some cases precede, the introduction of the DST. The US base erosion and anti-abuse tax (BEAT),¹⁰ which formed an important part of the Tax Cuts and Jobs Act of 2017, denies deductions for a wide range of services imported into the United States, purportedly to ensure a minimal tax base for US companies.¹¹ The denial of a deduction has the same effect as a tariff on the input purchase generating the expense. The Indian equalization levy on foreign providers of advertising services to Indian firms is another example. One rationalization for such policies draws on the “strategic trade” literature.¹² When countries have sufficient market power in global goods or

9 See for example, “Trade Law Analysis of EU’s Digital Tax Proposal,” *Lexology.com*, September 6, 2018 (www.lexology.com/library/detail.aspx?g=3a817cf7-28c7-42fd-ad68-a5ae4b300c9c).

10 The US Tax Cuts and Jobs Act, Pub. L. no. 115-97, has introduced base erosion and anti-abuse tax (BEAT) regime.

11 For a recent critical analysis, see Chris William Sanchirico, “Earnings Stripping Under the BEAT,” *Tax Law Review* (forthcoming) (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3395416).

12 Joseph Bankman, Mitchell Kane, and Alan Sykes, “Collecting the Rent: The Global Battle To Capture MNE Profits,” *Tax Law Review* (forthcoming).

services markets, either as monopoly suppliers or as monopsony purchasers, they may impose import or export tariffs and raise revenue at the expense of foreign firms. Such tariffs may be optimal from the perspective of the enacting country, even if they distort trade and reduce global welfare.¹³ WTO rules may in principle apply to prevent the imposition of some such tariffs, although they are not always successful in doing so.

Notably, this type of rationalization of tariffs applies regardless of the types of goods or services traded. So-called optimal tariffs may be imposed on non-digital goods and services whose production requires substantial fixed and marginal costs. The only relevant factor is whether the enacting countries have market power. Given that at least some of the countries proposing to enact the DST—for example, Spain, Austria, and the Czech Republic—are unlikely to wield any kind of special market power with respect to digital services, this explanation of countries' motivation for imposing DSTs seems inapplicable.

Recently, the German economist Wolfram Richter advanced an interesting new explanation for why small countries might impose tariffs on the import of digital services.¹⁴ According to Richter, many types of digital services can be supplied remotely across the globe at zero marginal cost.¹⁵ To charge positive prices for such services, multinational companies must establish some kind of market power—for example, through intellectual property (IP) right regimes. Richter argues that, under certain conditions, it is possible for the service-importing country to enhance national welfare by imposing taxes on digital services: the tax revenue collected may outweigh the efficiency losses that result from domestic firms choosing to use less of the taxed service input. The paradigmatic case for Richter's analysis is cloud computing. An import tariff on domestic firms' purchase of cloud computing services may make domestic firms less efficient; from a national perspective, however, this loss of efficiency may be compensated by the surplus expropriated from foreign firms.

Interestingly, Richter makes two further arguments. First, the imposition of such "optimal tariffs" by small countries may still be globally non-optimal, because, over time, it may diminish the quality, if not the quantity (given zero marginal cost), of the digital services that multinational firms offer. If each tariff-importing country is so small that, by itself, it cannot influence the quality of technology developed elsewhere in the world, a "prisoner's dilemma" may emerge: countries are collectively better off by not enacting import tariffs, but it makes sense for each country individually to levy such tariffs. Second, WTO mechanisms may have little impact on

13 Thus the imposition of such tariffs cannot be justified from a global welfare perspective.

14 Richter, *supra* note 4.

15 This assumption, of course, importantly underlies the justification of the DST as a tax on rent, even though it takes the form of a tax on revenue. As discussed below, even opponents of the DST have often conceded this assumption. See, for example, Julien Pellefigue, *The French Digital Service Tax: An Economic Impact Assessment* (n.p.: Deloitte Taj, société d'avocats, March 21, 2019).

this type of behaviour, which is individually rational but collectively suboptimal: the most that a WTO ruling against the tariff-imposing country can bring about is retaliatory sanctions against the country. However, the trade in global technological services is already highly asymmetrical, and may become even more so in the future. The technology-exporting countries will thus lack proper instruments for retaliation.

Richter thus offers a novel explanation, though not a justification, for hypothetical DSTs imposed on B2B digital services. The explanation does not quite fit currently enacted or proposed DSTs, for at least two reasons. First, no DST currently applies to the range of B2B services (for example, cloud computing) that Richter is interested in, though it is not out of the question that the scope of the DST may in the future expand in this direction. Second, given the current design of the DST, even if one ignores the quality of technological services, the DST's tariff-like effects may still have distortionary effects, even if it is assumed that the marginal cost of advertising is strictly zero. For example, a tariff on advertising purchases may drive up the price of advertising for producers in the tariff-imposing country (country X), if producers in country X compete with producers from other countries for advertising slots. That is, the sale of advertisements to country X producers may have opportunity costs, even if it has zero marginal cost of production. Recall that in the justification of the DST that I offered above, a basic assumption is that the simultaneous deployments of Search Algorithm and Sharing Economy by Google and AirBB in different countries are truly non-rival. This assumption is justified when the taxing right over advertising revenue is conditional on where the target of the advertising is located—which is generally the case for current real-world DSTs. But this assumption may not be justified for the type of DST considered by Richter.

This leads to one last justification for the DST's tariff-like features. Earlier, I presented the DST as solving two novel problems of international taxation: (1) the misalignment between value creation and sources of payment, and (2) the emergence of a new class of LSR. It may be that ultimately, and in the long term, the latter problem is of much greater significance. The non-rival deployment of technology can be found not just in two-sided business models but also, to a significant extent, even in non-digital industries such as pharmaceuticals. The countries of LSR may want to capture such rent through tariff-like instruments, and Richter's argument shows that when marginal costs of production are zero, even small countries might usefully deploy such instruments. What the argument based on the concept of LSR adds to Richter's argument is the following: even when import tariffs are globally non-optimal from the perspective of pure efficiency, their justification may consist in something more than the self-interested calculation of a particular country. Import tariffs may possess an additional legitimacy: the rent is located in that country, after all.

CAN WE PREDICT THE INCIDENCE OF THE DST?

Economic theory suggests that when a tax is imposed on the revenue of a digital platform, the incidence of the tax depends first on the platform's marginal cost in

producing this revenue. If the marginal cost is zero, then the tax on revenue is a tax on pure profit, and the platform itself bears the tax fully.¹⁶ When the platform's marginal cost in producing revenue is not zero, then a variety of outcomes are possible: the tax may be passed on partially or fully to users, or, in unusual market structures, it may still be fully borne by the platform.¹⁷ It is also possible for users to face a price increase higher in amount than the amount of the tax (an instance of "over-passthrough").

Such theoretical statements naturally seem unsatisfying, because they do not offer any intuitive or empirically grounded predictions. However, they can provide backing for conclusions derived from common sense. For example, when it is reported that Amazon Marketplace has increased the commission charged to online sellers on Amazon.fr to reflect the 3 percent French DST, and that Amazon claims that it has no choice but to do so because it is not able to absorb the tax, common sense tells us that we should take Amazon's word with a grain of salt. Platforms change their commission fees quite often, and often the reasons that they give for doing so are mere excuses.¹⁸ Economic theory backs up this common sense by telling us that no law of economic incidence is at play here. If Amazon's commission were determined entirely by the marginal cost of its offering of services, as would be the case in a perfectly competitive market, then the additional cost certainly would be passed on. But a claim by Amazon that it operates in a perfectly competitive market would simply be implausible.¹⁹

Is there any *a priori* reason to expect a platform to increase the commission it charges to merchants as a result of the introduction of the DST? An economic

16 Hans Jarle Kind and Marko Koethenbuerger, "Taxation in Digital Media Markets" (2018) 20:1 *Journal of Public Economic Theory* 22-39 (<https://doi.org/10.1111/jpet.12257>).

17 Marc Bourreau, Bernard Caillaud, and Romain De Nijs, "Taxation of A Digital Monopoly Platform" (2018) 20:1 *Journal of Public Economic Theory* 40-51 (<https://doi.org/10.1111/jpet.12255>).

18 See Mike Isaac, "How Uber Got Lost: The Once-Swaggering Company Is Losing More Money and Growing More Slowly Than Ever, What Happened?" *New York Times*, revised August 23, 2019 (www.nytimes.com/2019/08/23/business/how-uber-got-lost.html), reporting that Uber announced a new \$1 "safe rides fee" in April 2014 that was described as necessary to fund "an industry-leading background check process, regular motor vehicle checks, driver safety education, development of safety features in the app, and insurance." For discussion of how "the fee was devised primarily to add \$1 of pure margin to each trip," see Connie Loizos, "Uber Tries To Reassure Customers That It Takes Safety Seriously, Following NY Times Book Excerpt," *Techcrunch.com*, August 24, 2019 (<https://techcrunch.com/2019/08/24/uber-tries-to-reassure-customers-that-it-takes-safety-seriously-following-nytimes-book-excerpt>).

19 Compare the report of Amazon's announcement, *supra* note 7, to the statement in Thomson Reuters, "EXPE—Expedia Group Inc at Citi Global Technology Conference," edited transcript from Citi 2019 Global Technology Conference, New York, September 4, 2019, at 5-6 (<https://ir.expediagroup.com/static-files/e6ff3f65-a8fa-4ccb-a6e8-d1d5c56faad1>), where the Treasurer of the Expedia Group announced that the French DST retroactively applicable to the beginning of 2019 would be booked by Expedia in Q3 of 2019 and reduce the group's EBITDA.

analysis of the French DST, carried out by Deloitte-Taj in April 2019,²⁰ which reached a highly unfavourable assessment of the DST, attempts to articulate such an a priori reason. This analysis assumes that the platform's marginal cost of providing intermediation services is zero²¹ and that therefore any passthrough is not caused by a change in the relationship between price and marginal costs. Deloitte-Taj offers instead a variety of explanations, to the general effect that merchants' demand for a given online marketplace's intermediation services is inelastic. Some merchants may be able to stay in business by having only an online presence. Others maintain multiple presences on different online platforms, so they may be indifferent to the commission increase of any particular platform. Merchants' inelastic demand is also supposedly evidenced by users' continuing to use the platform (that is, the lack of "user exodus") when Esty and Uber previously increased their commission fees. No matter how much weight one might want to give to such claims and explanations, they clearly would not prove much: if merchants' demand for platform services were inelastic, why has the platform not previously increased its commission in order to earn greater profit? And if we do not assume that firms maximize their profit where they can, why do they have to pass on the cost of taxes?

Another popular (and casual) assertion among DST opponents is that the DST will ultimately be passed on to final consumers—especially in the jurisdiction that imposes the tax. But it is often not clear what this means. Consider the case of the DST as it is applied to advertising revenue (as in the Google example): since advertising expenditure represents a fixed and not a marginal cost, even if the DST results in higher costs for advertising, the claim that merchants would pass on such higher costs is generally implausible. Now consider the case of the DST as applied to AirBB revenue from guests' booking accommodation: if AirBB passes on the DST cost, it would almost certainly be to final consumers,²² but if the consumers are foreign, the DST would be far from pointless.²³

Perhaps the most interesting type of DST passthrough to consumers occurs when a platform raises prices for one group of users (for example, merchants) in response to the tax, and this group of users passes the cost increase on to the other group of users (for example consumers). If Amazon Marketplace increases commissions charged to online sellers as a result of the DST (note that it is not clear why this

20 Pellefigue, *supra* note 15.

21 One might have expected the clients for whom Deloitte Taj produced the study to correct the authors of the study if this assumption was demonstrably false.

22 Andrew J. Bibler, Keith F. Telster, and Mark J. Tremblay, *Inferring Tax Compliance from Pass-Through: Evidence from Airbnb Tax Enforcement Agreements*, McMaster University, Department of Economics Working Paper no. 2018-06 (Hamilton, ON: McMaster University, July 2018) (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3117021).

23 An analogy might be to the corporate income tax. One major benefit of the corporate income tax is that it allows a country to tax domestic rent earned by foreign investors. This benefit is not negated by the fact that the corporate income tax also might be borne by domestic investors.

would be the case), would the online sellers simply increase the prices of online goods by the same amount? The Deloitte-Taj study predicts that this would indeed happen, and it not unreasonably cites empirical studies from the United States that demonstrate that the collection of state sales taxes on online sales increased online prices and reduced online sales volume.²⁴ For an online merchant, a higher commission charged by Amazon seems no different from a higher sales tax on online transactions. Yet there are reasons to question even this analogy. Suppose that all online and offline sales are already subject to the sales tax (or value-added tax). If online and offline sales are perfect substitutes for each other, then online sellers cannot pass higher commission fees on to consumers, since the latter have the option of making purchases offline. And if online and offline sales are not perfect substitutes (for example, if online sellers can achieve better product differentiation through online reviews), then online sellers may already be earning some type of rent, which may then absorb at least a part of the commission increase.

Overall, although economic theory currently does not generate many useful predictions about the incidence of a tax on platforms' revenue, it does suggest that many of the confidential predictions about such incidence are groundless and likely only rhetorical. Finally, it is worth noting that such rhetoric, coming from DST opponents, may be self-contradictory. This is because another popular line of attack on the DST is that it creates the risks of double or excessive taxation on platform companies. But if the platform doesn't even bear the burden of the DST, how does the fear of double taxation arise?

“SEE YOU AT THE OECD!”

I believe that the characterization of the DST as a tax on LSR (akin to resource royalties) is largely consistent with the rationales that governments adopting the DST have publicly offered for it. However, it must be acknowledged that no government has presented the DST as a standalone tax on LSR. Instead, France and the United Kingdom have emphasized that the DST is an interim measure that will be replaced once multilateral agreement is reached on a reform of the international rules for corporate taxation. The claim seems to be the following: Whatever can be achieved under the DST could be better achieved through a re-design of the income tax. According to this perspective, the merit of the DST mainly lies in its utility as an instigator of a multilateral negotiation process, in particular at the OECD. This is a striking stance. Note, for instance, that when the United Kingdom unilaterally enacted the diverted profits tax (DPT) in 2015, it did not claim that the DPT was temporary and ought to be replaced by multilateral agreements. Presumably, this is because the governments promoting the DST anticipate that countries will have more interest in revising the international tax regime for digital platforms than they had in the policy objectives of the DPT.

24 See, for example, Brian Baugh, Itzhak Ben-David, and Hoonsuk Park, “Can Taxes Shape an Industry? Evidence from the Implementation of the ‘Amazon Tax’” (2018) 73:4 *Journal of Finance* 1819-55 (<https://doi.org/10.1111/jofi.12687>).

Ironically, the position of DST opponents can similarly be summarized as “See you at the OECD!” Their argument is that only multilateral solutions to any purported problem in taxing digital platforms are legitimate, and that DSTs ought to be non-starters. Using DSTs to force countries to come to the OECD negotiation table smacks of bad faith and, indeed, makes it much less likely that such negotiation will succeed.²⁵ It may come as a surprise to many long-time observers of international taxation that, in 2019, multinationals and US politicians unfailingly conjure up an image of the OECD as an institution that routinely resolves tough disagreements in international taxation. To some, multinationals’ new-found faith in the OECD’s tax policy prowess is difficult to accept at face value.

Whose enthusiasm for the OECD is more genuine, the DST’s proponents or its opponents? In my view, we face a genuine puzzle here—and the solution to the puzzle shows how the conception of the DST as a tax on LSR is useful, even though it has not been embraced by any government. The puzzle is the following: typically, countries (such as the United States) that wield substantial economic power are the ones that can afford to act unilaterally and strategically, while smaller countries with less economic power are more interested in cooperation (because they are more vulnerable to the impact of strategic action). In the debate over the DST, however, smaller countries such as the United Kingdom and France appear to act unilaterally first, while the United States appears to advocate for cooperation. What explains this counterintuitive configuration?

Consider two alternative characterizations of the core problems facing the international tax regime today. According to the first characterization,²⁶ the powers of the largest multinational companies have expanded dramatically in the last decade, as has their ability to dodge taxes on corporate profits. Individual governments face growing challenges when it comes to battling by themselves corporate titans on the taxation front; these governments must work with one another to rein in these corporate titans. The impetus for international cooperation thus issues from the

25 See Amazon, Google, and Facebook’s testimony for an investigation of the French DST: “Pursuant to the Request for Comments Published by the Office of the United States Trade Representative, Google Submits the Following Notice of Intent To Testify and Proposed Hearing Statement in Relation to Docket Number USTR-2019-0009,” available on *Regulations.gov* (<https://beta.regulations.gov/document/USTR-2019-0009-0015>); Amazon, International Tax Policy and Planning, “RE: Docket Number USTR-2019-0009—Request To Appear at Public Hearing,” submitted to Office of the United States Trade Representative, August 12, 2019, available on *Regulations.gov* (<https://beta.regulations.gov/document/USTR-2019-0009-0014>); Afep, Association of Large French Companies, “Written Comments on Section 301 Investigation Regarding the Potential Trade Distortive Impact on the French Digital Services Tax (USTR-2019-0009),” July 31, 2019, available on *Regulations.gov* (<https://beta.regulations.gov/document/USTR-2019-0009-0004>).

26 A compelling expression of this view can be found in Lawrence H. Summers, “Corporations Are Cheating the Global Tax System. World Leaders Can’t Afford To Ignore It,” *Washington Post*, April 10, 2019 (www.washingtonpost.com/opinions/2019/04/10/corporations-are-cheating-global-tax-system-world-leaders-cant-afford-ignore-it/).

asymmetry in power between national governments and private companies. Countries such as France and the United Kingdom may have experienced such asymmetry earlier and more acutely than the United States, and therefore may be more eager for international cooperation. And since what is at stake is the ability of all governments to tax corporate profits under the income tax, the OECD is a natural forum where national governments can collectively broker a deal with businesses. From this perspective, France, the United Kingdom, and the United States should all have a genuine desire for cooperation; their respective desires for cooperation differ only in degree.

This first characterization of the fundamental problem of international taxation today cannot, of course, explain why France and the United Kingdom would resort to unilateral measures in order to instigate multilateral negotiation. A second characterization is more illuminating.²⁷ According to this view, we are entering an age in which the increasing asymmetries among countries in respect of technology ownership create a long-term bias against the majority of countries (call them the technology have-nots) because their ability to raise revenue is less than that of technology-rich countries. For example, if corporate returns increasingly accrue to intellectual property (IP), and if the ownership of such property becomes, inevitably, increasingly concentrated in companies from a few countries, then most countries that lack substantial IP ownership face the dire predicament, under the traditional income tax, of not being able to tax corporate returns at all. The countries that enjoy IP ownership, by contrast, do not face a similar predicament. When countries face asymmetrical incentives, cooperation among them may not naturally develop. In such situations, it may be individually rational for technology-poor countries to adopt, in some circumstances, unilateral measures such as tariffs, withholding taxes, or DSTs. Such unilateral actions would remain consistent with the acceptance of the superiority of a cooperative solution, whereby the technology-rich countries somehow allocate more of the corporate tax base to the technology-poor countries. In other words, two options are equally acceptable to the technology-poor countries: either unilateral measures that directly expropriate some corporate surplus from multinationals, or multilateral measures whereby the technology-rich countries help to redistribute some corporate surplus in a cooperative fashion.

The last-mentioned cooperative measures would largely be unprecedented. The technology-poor countries may offer to carry out the negotiation at the OECD—as good an institution as any other for negotiating an unprecedented form of cooperation.²⁸ But the risk of resorting to the OECD is that governments and companies from the technology-rich countries may change the topic—for example, back to a discussion that ignores the asymmetries between countries. Indeed, it has long been

27 This view can be found in Richter, *supra* note 4. See also, Kai-Fu Lee, *AI Superpowers: China, Silicon Valley, and the New World Order* (Boston: Houghton Mifflin Harcourt, 2018).

28 And systematic redistribution among countries can perhaps be achieved through some kind of formulaic apportionment under the corporate income tax. See Richter, *supra* note 4.

recognized that the income tax treaty framework itself first arose among developed countries, in whose advanced economies the balance of trade can be expected to even out the give and take between residence and source countries. Many scholars have argued that the income tax treaty framework is highly resistant to recognizing the asymmetries between developed and developing countries.²⁹ It may thus be quite unclear whether the OECD is a good forum for all kinds of international cooperation or whether it is capable of sustaining only an old type of cooperation, which fails to acknowledge the new problem that is arising in international taxation from national asymmetries in technology ownership, and that may be the only type of cooperation in which technology-rich countries (and large multinationals) are interested.

In this kind of context, I believe that considerations of unilateral taxes on LSR, such as the DST, uniquely advance the discussion. The LSR characterization of the DST fundamentally acknowledges technological asymmetry among countries.³⁰ And it proposes normative arguments that allow us to see beyond such asymmetry: even if platform technologies are invented mainly in the United States, the rent earned by the deployment of such technologies elsewhere in the world can coherently and reasonably be seen as arising in these other places. To the extent that such arguments are persuasive, they can move us closer to a language that fosters unprecedented international cooperation and redistribution, the objective of which is to undo some of the asymmetries brought about by technology.

29 For a recent critical discussion of this scholarship, see Eric Zolt, "Tax Treaties and Developing Countries," *Tax Law Review* (forthcoming).

30 In Shaviro's words, *supra* note 4, at 46, it is mere unreflective "market triumphalism" to dismiss the DST as a desperate policy measure pursued by countries that lag behind the United States in nurturing successful digital platforms.

A New Global Tax Deal for the Digital Age

Allison Christians and Tarcisio Diniz Magalhaes*

PRÉCIS

L'Organisation de coopération et de développement économiques (OCDE) est engagée dans un projet visant à relever les défis fiscaux liés à la numérisation de l'économie. Tel qu'énoncé initialement dans son programme de travail publié en mai 2019, l'objectif est de parvenir à un consensus sur un nouveau droit d'imposition qui permettrait aux pays d'imposer les multinationales même en l'absence d'une présence physique traditionnelle. Dans cet article, les auteurs soutiennent qu'après examen, le plan semble surtout axé sur le rééquilibrage des droits d'imposition, principalement dans un certain nombre d'États membres de l'OCDE et quelques autres États clés non membres, et que, de ce point de vue, l'effort urgent mené pour conclure une nouvelle entente fiscale mondiale à l'ère numérique risque de reporter à un moment non précisé un débat fort nécessaire sur les implications plus vastes de distribution de l'entente fiscale mondiale actuelle. La première partie de l'article présente un aperçu de certains des principaux facteurs qui ont incité l'OCDE à se pencher sur ce sujet. La deuxième partie examine les origines et l'évolution du lien dans le régime fiscal international, montrant pourquoi ce concept se prête à une large expansion. La troisième partie porte sur l'éventail des réformes actuellement à l'étude, soutenant que l'accent mis sur la numérisation fait oublier le lien que l'on devrait faire avec d'autres programmes de politiques urgents à l'échelle internationale également en cours d'élaboration, notamment un engagement mondial à créer des institutions qui soutiennent le développement économique durable. L'article se termine par une prédiction selon laquelle, suivant sa trajectoire actuelle, le programme de travail sur la numérisation produira probablement une nouvelle entente fiscale mondiale ressemblant beaucoup à l'ancienne, avec une redistribution relativement modeste des droits d'imposition entre quelques États clés, manquant ainsi l'occasion d'entreprendre une véritable réforme.

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ABSTRACT

The Organisation for Economic Co-operation and Development (OECD) is in the midst of a project intended to tackle the tax challenges arising from the digitalization of the economy. As initially laid out in its program of work released in May 2019, the goal is to develop consensus on a new taxing right that would allow countries to tax multinationals even in the absence of traditional physical presence. In this paper, the authors argue that upon inspection, the plan seems primarily focused on rebalancing taxing rights mostly among a number of OECD member states plus a few other key non-OECD states, and that, viewed from this perspective, the urgent effort to forge a new global tax deal for the digital age risks deferring a much-needed discussion on the broader distributive implications of the current global tax deal to some unspecified future time. The first part of the paper offers a brief survey of some of the main factors that prompted the OECD to turn its attention to this topic. The second part considers the origins and development of nexus in the international tax regime, showing why this concept is amenable to broad expansion. The third part examines the range of reforms currently under consideration, arguing that the framing on digitalization misses a necessary connection to other pressing international policy programs that are also under development, most notably a global commitment to building institutions that support sustainable economic development. The paper concludes with a prediction that on its current trajectory, the program of work on digitalization is likely to produce a new global tax deal that looks much like the old global tax deal, with a relatively modest redistribution of taxing rights among a few key states, thus missing an opportunity for meaningful reform.

KEYWORDS: TAXATION ■ DIGITALIZATION ■ OECD ■ USERS ■ ECONOMIC PRESENCE ■ INTANGIBLES

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INTRODUCTION

The international tax community is currently focused on an urgent tax policy priority, namely, tackling the tax challenges arising from the digitalization of the economy. The urgency arises, according to a series of international policy documents,¹ because multinational firms are increasingly able to access local consumers using digital platforms that avoid the customary thresholds to taxation, thus preventing some states from collecting their desired share of the global tax base. The response of the Organisation for Economic Co-operation and Development (OECD) is to initiate a coordinated global movement to adjust the organizing norms of the international tax regime to this new economic reality. As set out in pillar 1 of the 2019 OECD work program, the goal is to develop consensus on a new taxing right, which would take shape in one of three proposals based on the concepts of user participation, marketing intangibles, substantive economic presence, or a combination of them.²

Using the language of new taxing rights signals a rare opening of the discourse around well-established traditions. The OECD expressly seeks not only rule changes that are expected to alter the distribution of current taxing rights among states, but also justified rationales that would explain why these expected distributive impacts

1 See Organisation for Economic Co-operation and Development, *Public Discussion Draft BEPS Action 1: Address the Tax Challenges of the Digital Economy 24 March 2014–14 April 2014* (Paris: OECD, 2014) (herein referred to as “the 2014 OECD public discussion draft”); Organisation for Economic Co-operation and Development, *Addressing the Tax Challenges of the Digital Economy, Action 1—2015 Final Report* (Paris: OECD, 2015) (herein referred to as “the 2015 BEPS final report”); Organisation for Economic Co-operation and Development, *Tax Challenges Arising from Digitalisation—Interim Report 2018: Inclusive Framework on BEPS* (Paris: OECD, 2018) (herein referred to as “the 2018 OECD interim report”); Organisation for Economic Co-operation and Development, *Addressing the Tax Challenges of the Digitalisation of the Economy—Policy Note: As Approved by the Inclusive Framework on BEPS on 23 January 2019* (Paris: OECD, 2019) (herein referred to as “the 2019 OECD policy note”); Organisation for Economic Co-operation and Development, “Brief on the Tax Challenges Arising from Digitalisation: Interim Report 2018” (www.oecd.org/tax/beps/brief-on-the-tax-challenges-arising-from-digitalisation-interim-report-2018.pdf) (herein referred to as “the 2018 OECD brief”); Organisation for Economic Co-operation and Development, “Tax and Digitalisation,” *OECD Going Digital Policy Note*, March 2019 (www.oecd.org/going-digital/tax-and-digitalisation.pdf) (herein referred to as “the 2019 OECD going-digital policy note”); Organisation for Economic Co-operation and Development, *Public Consultation Document Addressing the Tax Challenges of the Digitalisation of the Economy 13 February–6 March 2019* (Paris: OECD 2019) (herein referred to “the 2019 OECD public consultation document”); and Organisation for Economic Co-operation and Development, *Programme of Work To Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy: Inclusive Framework on BEPS* (Paris: OECD, 2019) (herein referred to as “the 2019 OECD work program”) (www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf). Organisation for Economic Co-operation and Development, *Public Consultation Document Secretariat Proposal for a “Unified Approach” Under Pillar One 9 October–12 November 2019* (Paris: OECD, 2019) (herein referred to as “the 2019 OECD secretariat unified approach”).

2 As defined and discussed more fully below.

should be broadly accepted. Since this discussion takes place against the backdrop of conventional residence- and source-state designations, the 2019 OECD work program appears to take seriously some longstanding complaints about the division of taxing rights between states that take the role of both residence and source (most of which are OECD members) and those that mostly take the role of the source state (most of which are non-members). A closer inspection, however, reveals that the work program takes a narrower focus, separating source states into subcategories in order to focus on what the OECD calls “market jurisdictions”—namely, states in which significant numbers of digital service users, customers, or consumers are located.³

While virtually every population in the world has some digital service users, the major market jurisdictions are mostly OECD member states, with the United States and Europe taking their usual roles at the centre of policy-making attention, in addition to some very prominent states outside the OECD membership—notably China and India, and to a lesser extent Brazil. In proposing to alter nexus and profit allocation to benefit market jurisdictions, the 2019 OECD work program does not seek to examine the balance between residence and source taxation after all. Instead it seems to be about rebalancing taxing rights—mostly among the relatively affluent OECD member states plus a few other key non-OECD states—while otherwise freezing for the foreseeable future the current consensus on the general division of taxing rights between residence and source states.

Viewed from this perspective, the international tax community’s urgent effort to forge a new global tax deal for the digital age is bound to forestall a much-needed discussion on the broader distributive implications of the current global tax deal. As this new deal takes shape, it looks set to recalibrate the international tax regime to ensure that most of the benefits of cross-border cooperation continue to accrue to the relatively affluent member states of the OECD.⁴ To be sure, room must be made

3 The 2019 OECD work program, *supra* note 1, at 23, note 4: “In the context of the programme of work, the term ‘market jurisdiction’ refers to the jurisdiction where the customers of the business are located or, in the case of businesses that supply services to other businesses, the jurisdiction where those services are used. In the context of many digitalised business models, this definition would cover the jurisdiction where the user is located either because the user acquires goods or services directly from the on-line provider or because the on-line provider provides services to another business (such as advertising) targeting such users.” In a recent policy paper, the International Monetary Fund (IMF) defines a “market country” as being the same as a “destination country”—that is, a country where the purchaser is located. See “Acronyms and Glossary” in International Monetary Fund, *Corporate Taxation in the Global Economy*, Policy Paper no. 19/007 (Washington, DC: IMF, 2019) (www.imf.org/en/Publications/Policy-Papers/Issues/2019/03/08/Corporate-Taxation-in-the-Global-Economy-46650).

4 See, for example, Stephen E. Shay, “Comment on Selected Aspects of Proposals in Public Consultation Document on Addressing the Challenges of the Digitalization of the Economy,” submission to the Organisation for Economic Co-operation and Development, Centre for Tax Policy and Administration, Tax Policy and Statistics Division, March 6, 2019, at 3 (<https://doi.org/10.2139/ssrn.3349186>): “The proposed time line for this project is too

for a few other key states, but the plan, despite its apparently universal scope, still stands to leave many others, including most lower-income states, largely out of the core discussion. If so, the process would continue a long tradition of exclusion in international tax policy making, even while it demonstrates the clear need for a holistic discussion of what states owe each other in designing the distribution of taxing rights.

The aim of this paper is therefore to critically examine the emerging new global tax deal for the digital age, and in particular the decision to draw up new taxing rights that will mainly benefit a relatively small number of states while leaving the policy priorities of other states to be addressed another day, or not at all. The first part of the paper provides a brief survey of some of the main factors that prompted the OECD to turn its attention to this topic. The second part considers the origins and development of nexus and profit allocation in the international tax regime, showing why these concepts are amenable to broad expansion and examining the range of reforms currently under consideration. The third part examines the likely winners and losers of the proposal to define a new taxing right within the currently demarcated framework, and shows that the framing on digitalization misses a necessary connection to other pressing international policy programs that are simultaneously under development, most notably a global commitment to building institutions that support sustainable economic development.

The paper concludes with a prediction that the 2019 OECD work program on digitalization, if it continues on its current trajectory, is likely to produce a new global tax deal that looks much like the old global tax deal, with a relatively modest redistribution of taxing rights among a few key states. Since such an outcome would not resolve pressing issues involving the rest of the world, it would represent a missed opportunity for the international community. A more holistic approach would undoubtedly take more time and prompt states to act unilaterally in the interim, but uncoordinated unilateral action will be the long-term result in any case if a consensus based on a more narrow scope provides no satisfactory answers to the pressing concerns of many states.⁵

truncated to allow the amount of analysis that is required to achieve broader change. It plays into the hands of those interests with the resources to operate on short deadlines and that prefer the status quo and minimal change.”

- 5 See, for example, Tim Edgar and David Holland, “Source Taxation and the OECD Project on Attribution of Profits to Permanent Establishments” (2005) 37:6 *Tax Notes International* 525-39, at 532, stating that “an allocation method should be seen to be fair, in the sense that it is accepted by a wide range of jurisdictions as implementing an acceptable division of revenue . . . [and] the detailed rules of any allocation method should be robust against taxpayer manipulation. Otherwise, the realization of the accepted allocation of the income tax base is undermined”; 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, advocating for the international adoption of rules aimed at achieving consistency in tax treatment to counter the perfect substitutability of lower-taxed with higher-taxed transactions, which is a condition created by mobile investment capital.

VALUE AND THE DIGITAL ECONOMY

The 2019 OECD work program was announced in May 2019, following a proliferation of uncoordinated moves by various states to tax digital giants, notably Google, Amazon, Facebook, and Apple.⁶ In early 2018, the European Commission (EC) had proposed the introduction of the concept of “digital permanent establishment,” together with a temporary digital services tax.⁷ Spain, Italy, the Czech Republic, Austria, and New Zealand soon announced their intention to follow suit.⁸ France acted in mid-2019,⁹ adopting a digital services tax that generated a great deal of public debate—including opposition from the United States in the form of a presidential tweet threatening retaliatory action.¹⁰ Following the fall Group of Seven (G7) meeting, however, President Macron announced that an agreement had been

- 6 The 2019 OECD going-digital policy note, *supra* note 1, at 1: “While the introduction of unilateral measures in a number of countries has underscored the urgency of the issue and the need to re-assess some of the key international tax principles, these divergent positions have made a consensus-based solution difficult to achieve.” The concern is the re-emergence of tax unilateralism, and the rise of multiple forms of taxation that would discourage cross-border investment. See Reuven S. Avi-Yonah, “Three Steps Forward, One Step Back? Reflections on ‘Google Taxes’ and the Destination-Based Corporate Tax” [2016] no. 2 *Nordic Tax Journal* 69-76 (<https://doi.org/10.1515/ntaxj-2016-0007>), discussing the United Kingdom’s diverted profits tax (DPT), Australia’s multinational anti-avoidance law (MAAL), and India’s equalization levy; Ricardo García Antón, “The 21st Century Multilateralism in International Taxation: The Emperor’s New Clothes?” (2016) 8:2 *World Tax Journal* 147-92, at 167, questioning the alleged shift to multilateralism in international tax and stressing the persistence of “unilateralism as always”; Arthur J. Cockfield, “Shaping International Tax Law and Policy in Challenging Times” (2018) 54:2 *Stanford Journal International Law* 223-40, claiming that recent global trends such as nationalism, populism, and anti-globalization reinforce unilateralism in international tax.
- 7 See Fred van Horzen and Andy van Esdonk, “Proposed 3% Digital Services Tax” (2018) 25:4 *International Transfer Pricing Journal* 267-72; Martti Nieminen, “The Scope of the Commission’s Digital Tax Proposals” (2018) 72:11 *Bulletin for International Taxation* 664-75. The United Kingdom had previously published a position paper in 2017, which it updated in 2018. See United Kingdom, HM Treasury, “Corporate Tax and the Digital Economy: Position Paper,” November 22, 2017; and United Kingdom, HM Treasury, “Corporate Tax and the Digital Economy: Position Paper Update,” March 2018.
- 8 See Anna Burchner, “Extracting the Digit: Recent UK Reforms and New Proposals for Taxing the Digital Economy” (2019) 73:6/7 *Bulletin for International Taxation* 316-24; Gunter Mayr, “New Digital Business Tax on Online Advertising in Austria” (2019) 59:7 *European Taxation* 350-53; Adrian J. Sawyer, “Taxing the Digital Economy: Will New Zealand Tread Where Most Will Not Go?” (2019) 95:7 *Tax Notes International* 615-21.
- 9 Spain similarly enacted a digital services tax. See Florentino Carreño and Jaume Perelló, “Plans Regarding Digital Taxes” (2019) 26:2 *International Transfer Pricing Journal* 151-54; Francisco José Nocete Correa, “The Spanish Digital Services Tax: A Paradigm for the Base Enlargement & Profit Attraction (BEPA) Plan for the Digitalized Economy” (2019) 59:7 *European Taxation* 341-49.
- 10 Donald J. Trump, @realDonaldTrump, *Twitter.com*, July 26, 2019: “France just put a digital tax on our great American technology companies. If anybody taxes them, it should be their home

forged that would permit the United States to forestall action pending the development of consensus at the OECD.¹¹ The OECD certainly has its work cut out for it.

In its program of work to deliver such a consensus, the OECD laid out three possible approaches involving the concepts of user participation, marketing intangibles, and substantive economic presence. Each proposal includes some combination of an expansion of nexus in some form, a redefined concept of source, and a reallocation of multinational profits. The user participation proposal seeks to reallocate a portion of global profits by reference to the value created by “highly digitalised businesses” that engage users in order to sell to them as well as solicit data from them.¹² The marketing intangibles proposal seeks to reallocate a relatively smaller portion of global profits of businesses in general (whether highly digitalized or not) by reference to the value created by intangibles that reach users in a market, such as branding, marketing efforts, and customer lists.¹³ The significant economic presence proposal seeks to expand nexus and reallocate total income on a formulary basis, with user participation added to the traditional apportionment factors.¹⁴ The OECD’s secretariat subsequently combined elements of the user participation and marketing intangible approaches in a proposed “unified approach,” which it released for public consultation in October 2019.¹⁵

Country, the USA. We will announce a substantial reciprocal action on Macron’s foolishness shortly. I’ve always said American wine is better than French wine!”

- 11 Emmanuel Macron, @EmmanuelMacron, *Twitter.com*, August 26, 2019: “Some digital players pay very little tax. This is an injustice that destroys jobs. @realDonaldTrump and I have just agreed to work together on an agreement at the @OECD level to modernize international tax rules.” See also Michel Rose, “Macron Defuses French Digital Tax Row, Trump Coy on Wine Threat,” *Reuters.com*, August 26, 2019 (<https://ca.reuters.com/article/businessNews/idCAKCN1VG0N5-OCABS>).
- 12 2019 OECD work program, *supra* note 1, at 11.
- 13 *Ibid.*, at 12; see also Organisation for Economic Co-operation and Development, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, July 2017) (herein referred to as “the OECD transfer-pricing guidelines”), at 27: “An intangible (within the meaning of paragraph 6.6) that relates to marketing activities, aids in the commercial exploitation of a product or service and/or has an important promotional value for the product concerned. Depending on the context, marketing intangibles may include, for example, trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers.” In practice, marketing intangibles are very difficult to define and difficult to distinguish from other intangibles and attributes. See, for example, Shay, *supra* note 4, at 4: the difference between marketing and trade intangibles is “a distinction that is not well defined and not capable of meaningful definition.”
- 14 2019 OECD public consultation document, *supra* note 1, at 16; see also G24 Working Group on Tax Policy and International Tax Cooperation, “Proposal for Addressing Tax Challenges Arising from Digitalization,” January 17, 2019 (www.g24.org/wp-content/uploads/2019/03/G-24_proposal_for_Taxation_of_Digital_Economy_Jan17_Special_Session_2.pdf).
- 15 See the 2019 OECD secretariat unified approach, *supra* note 1.

Each approach contends in some way with the conventional wisdom of international tax. It is therefore useful to consider the OECD work program in light of the consensus it seeks to disrupt. That is the goal of the discussion that follows.

Establishing Presence

One of the broad challenges requiring OECD resolution is that foreign-based multinational firms access local users as customers (which is not a new phenomenon) and turn the customer experience into data that generate independent value (which is), and that they do so while avoiding threshold rules that would make any of these activities taxable in source states.¹⁶ Even though the underlying model of remote sales of goods and services is familiar to tax policy makers, some of the characteristics of digitalized firms, and the kinds of value they derive from their user bases, deviate notably from tradition.

For example, although advertising revenues are nothing new in the international economy, digital media businesses that combine online services with social networks take the potential value generated from advertising to unusual extremes.¹⁷ Value starts building when a firm provides a familiar service (for example a video game platform) but then grows exponentially when the core service is combined with communication services (such as instant messaging). The firm generates revenues through a combination of familiar modes: fees, subscriptions services, and advertising, yet the long-term value of the firm depends on building and expanding its network so as to extract more, and more useful, data. When combined across users and over time and analyzed via increasingly sophisticated algorithms, the relationship between users and firms becomes increasingly complex and increasingly valuable.¹⁸ This is why companies—and not just governments—are busy “collecting it all.”¹⁹

16 For an overview, see, for example, Werner Haslechner, Georg Kofler, Katerina Pantazatou, Alexander Rust, *Tax and the Digital Economy: Challenges and Proposals for Reform* (Alphen aan den Rijn, The Netherlands: Kluwer Law International, 2019).

17 “Digital Media: Worldwide,” *Statista.com*, November 2018: digital video games generated over US\$70 billion in revenue in 2018, while digital video streaming generated US\$28 billion, e-books US\$19 billion, and music US\$12 billion. Social networks are discussed in an EC report as multidimensional digital business models. See European Commission, Directorate-General for Taxation and Customs Union, *Commission Expert Group on Taxation of the Digital Economy: Report* (Brussels: EC, May 28, 2014) (herein referred to as “the 2014 EC Report”) (https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/gen_info/good_governance_matters/digital/report_digital_economy.pdf).

18 This is the model of most social networks, including Instagram, now owned by Facebook, which announced that it had reached 2 million active advertisers in 2017; the company claims to have 500 million active users, thus one advertiser for every 25 users. See “2M Monthly Advertisers on Instagram,” *Business.Instagram.com*, September 25, 2017 (<https://business.instagram.com/blog/welcoming-two-million-advertisers>).

19 Glenn Greenwald, “The Crux of the NSA Story in One Phrase: ‘Collect It All,’” *Guardian*, July 15, 2013. Amazon proves illustrative in its privacy notice, which states that its collection policy is to “receive and store any information” that a user enters on its website or “give[s] us in

Comparison to Barter Transactions

From the perspective of applying the tax system to these phenomena, a conventional way to explain user-generated value is by reference to barter.²⁰ That is, when an individual becomes a user of a platform or a purchaser of a good or service, this interaction provides a set of data points that are collected by the vendor and used to (1) advertise to particular users in hopes of generating additional sales from them; (2) attract new users and advertise to them; and (3) package multiple users' information for sale to third parties, including business partners and unrelated advertisers.

The barter analogy is inapposite, however, when significant value derives from the interaction of multiple users over time and with future applications not yet determined or determinable. This is the case when value derives from network effects and content posting by influential users, who attract other users (the influenced) independent of the platform or company's efforts. It is also the case when firms collect data that are not very valuable at the time of collection but become valuable with the advance of new technological developments.

Integration of Data and Analytics

How much value is generated by these interacting phenomena is difficult to judge, even if it is clear that modern businesses are built on them.²¹ In terms of barter, absent aggregation and analytical tools, the value of a single user's information, network, or content is likely negligible at the time of the transfer. Yet aggregation and analytical tools are obviously also worth very little without the data to feed them, improve on them, and discover new uses for them. The problem is difficult, and data mining is by no means the only source of user-generated value, but it offers a conceptual analogue that tax policy makers can grasp and therefore feed into the existing set of rules.

In recent work, Johannes Becker and Joachim Englisch argue for some restraint in this quest, since in their view most data harvesting is passive on the part of the user, with the business, not the user, producing, storing, and analyzing what they characterize as otherwise useless raw data.²² Becker and Englisch contend that even if the user's data or input is considered independent of whatever the company does

any other way," including the user's location and mobile device: see Amazon, "Amazon Privacy Notice," August 29, 2017 (www.amazon.com/gp/help/customer/display.html?nodeId=468496), under the heading "What Personal Information About Customers Does Amazon.com Gather?"

20 See 2018 OECD interim report, *supra* note 1, at paragraph 145: "[D]igitalisation has reshaped the role of users, allowing the possibility for them to become increasingly involved in the value creation process."

21 This is in no way a revelation. See, for example, Erik Brynjolfsson and Adam Saunders, "What the GDP Gets Wrong and Why Managers Should Care" (2009) 51:1 *MIT Sloan Management Review* (online), noting that "the irony of the information age is that less is known today about the sources of value in the economy than was known 25 years ago."

22 See Johannes Becker and Joachim Englisch, "Taxing Where Value Is Created: What's 'User Involvement' Got To Do with It?" (2019) 47:2 *Intertax* 161-71.

with it, significant change is not warranted because the information is very hard to value in terms of uncompensated labour and is, in any case, often compensated with free or discounted services or with the emotional returns of popularity and influence.²³

This seems plausible, yet states continue to seek tax reform anyway. The reason likely has something to do with the sheer growth of digital retail platforms over the past 20 years, which suggests that the aggregate value of user data must be significant.²⁴ In 2018, some 1.77 billion people around the world purchased over US\$1.5 trillion in consumer goods via digital platforms.²⁵ Amazon went from having 1.5 million active users in 1997 to having 310 million by 2016.²⁶ Whether states with large user bases are actually suffering in terms of losing out on tax revenues to which they are entitled—a debatable proposition, in the view of Becker and Englich, among others—the public spectre of multinational conglomerates accessing so many users without apparently paying much tax anywhere has provided policy makers sufficient reason to call for international reform.

It is clear that collecting, aggregating, analyzing, and deploying user information is a key value driver, if not the *raison d'être*, of many digital businesses. Further, as the increasing value of data appears to permeate the economy, states may fear the consequences of failing to act in an urgent manner. For example, fashion—a decidedly non-digital commodity²⁷—has been identified as the largest and fastest growing business-to-consumer e-commerce market segment because mass personalization, such as custom tailoring by a company in accordance with its end users' tastes and

23 Ibid., at 169, discussing the difficulties involved in assessing the value added by uncompensated labour; see also Allison Christians and Laurens van Apeldoorn, "Taxing Income Where Value Is Created" (2018) 22:1 *Florida Tax Review* 1-39, discussing value creation in the case of undercompensated labour in traditional supply chains.

24 See 2018 OECD interim report, *supra* note 1, at paragraph 8, describing the enormous and growing amount of data generated by users and devices, all of which is being collected by governments and businesses in order to provide "the insights necessary to transform and shape the way people behave and organizations operate."

25 See "Global Digital Report 2018," *Wearesocial.com* (<https://digitalreport.wearesocial.com>).

26 Amazon had 310 million active users at the end of 2016. See "Number of Active Amazon Customer Accounts Worldwide from 1st Quarter 2013 to 1st Quarter 2016 (in Millions)," *Statista.com* (www.statista.com/statistics/476196/number-of-active-amazon-customer-accounts-quarter). Amazon is dwarfed by Alibaba, with 636 million active users at the end of 2018. See Agne Blazyte, "Number of Annual Active Consumers Across Alibaba's Online Shopping Properties from 2nd Quarter 2014 to 2nd Quarter 2019 (in Millions)," *Statista.com* (www.statista.com/statistics/226927/alibaba-cumulative-active-online-buyers-taobao-tmall).

27 Barring wearable technology (which includes smart watches and Fitbits and the like), a small but growing market segment. See, for example, Rachel Arthur, "The Future of Fashion: 10 Wearable Tech Brands You Need To Know," *Forbes*, June 30, 2016 (www.forbes.com/sites/rachelarthur/2016/06/30/the-future-of-fashion-10-wearable-tech-brands-you-need-to-know/). Cisco Systems estimates that there were 593 million connected wearable devices in use in 2018, up from 325 million in 2016. See Shanhong Liu, "Number of Connected Wearable Devices Worldwide from 2016 to 2022 (in Millions)," *Statista.com*, September 19, 2019.

preferences, and recommendation features are among the main benefits for consumers in this market.²⁸ It is axiomatic that personalization requires customer data, while giving recommendations requires comparing customer behaviours. When customer data become a main profit driver even in the most conventional industries, it is not hard to understand why states might seek to assert taxing rights.

These potential user-generated sources of value, and countless others like them, raise questions that seem to perfectly exemplify the fundamental problem that has always plagued international taxation, namely, that international activities and transactions are by their very nature the product of synergistic combinations of labour, capital, and resources across borders. Disaggregating the product of these synergies in order to allocate taxing rights to one jurisdiction or another is a political challenge that has become an essential task for tax policy makers, starting from the threshold problem of nexus and carrying over into the allocation of profit for tax purposes.²⁹

THE ESSENTIAL MALLEABILITY OF NEXUS

Even as states started articulating rationales for taxing foreign digitalized businesses on the basis of user data, a 2014 report on the digital economy rejected the idea that data collection alone should create tax nexus, and called for restoration of nexus provisions through existing rule sets, specifically concerning the definition of “permanent establishment.”³⁰ It is not clear what restoration means in this context. An examination of the concept of nexus shows why clarity will likely remain elusive.

Normative Framing

Nexus is an enduring structural feature of international tax law and policy, but it is an extremely accommodating concept—much like the concept of value creation itself.³¹ Revisiting nexus provides a useful reminder that some concepts viewed as

28 “eCommerce Report 2019,” *Statista.com*, October 2019 (www.statista.com/study/42335/e-commerce-report).

29 Hence the OECD’s recognition that its work to resolve the tax challenges arising from digitalization “may reach into fundamental aspects of the current international tax architecture.” See the 2019 OECD policy note, *supra* note 1, at 2.

30 The 2014 EC report, *supra* note 16. This view is echoed in the policy recommendations of the Business Industry Advisory Council to the OECD. See Business at OECD (BIAC), *Business Principles for Addressing the Tax Challenges of the Digitalizing Economy* (Paris: Business at OECD (BIAC), January 2019), at 2, stating that any reforms should “be based on long-standing and well-founded underlying principles of international taxation,” which are identified as “taxation of net income, nexus, permanent establishment, and transfer pricing based on the arm’s length standard.”

31 See Christians and van Apeldoorn, *supra* note 22; Johanna Hey, “‘Taxation Where Value Is Created’ and the OECD/G20 Base Erosion and Profit Shifting Initiative” (2018) 72:4/5 *Bulletin for International Taxation* 203–8; Susan C. Morse, “Value Creation: A Standard in Search of a Process” (2018) 72:4/5 *Bulletin for International Taxation* 196–202; Michael P. Devereux and John Vella, “Are We Heading Towards a Corporate Tax System Fit for the

conceptually sound are not actually coherent, despite their core significance.³² This is mainly because these concepts are the product of political compromise.

A century ago, as the growing popularity of income taxation worldwide made competing claims over the same income likely to produce double or multiple taxation, the League of Nations struck a committee of four economists to study standards for demarcating tax jurisdiction claims, with a view to ensuring that excessive taxation would not impede international investment.³³ The economists laid out a framework for dividing the tax base that endures today and forms the starting point for virtually every discussion about international taxation. Their report, published in 1923, sought to define the jurisdiction to tax as a function of what they termed “economic allegiance.”³⁴

Economic allegiance arose from the sense that the tax base, as a product of economic activity, must be understood not in terms of a taxpayer’s political or social connections to a country, but by their economic interaction with and within it.³⁵ Conceptually, economic allegiance satisfies some version of benefit theory, connecting the person to the state as a threshold matter by holding the intuitive appeal when thinking about nexus that people should contribute where they receive benefits. But neither economic allegiance nor benefit theory solved the base distribution issues of their day, and they are hard pressed to solve the challenges arising from the digitalization of the economy now. Instead, owing to the practical impossibility of

21st Century?” (2014) 35:4 *Fiscal Studies: The Journal of Public Applied Economics* 449-75; and Krister Andersson, “Should We Use Value Creation or Destination as a Basis for Taxing Digital Businesses? Comments on the 2018 Klaus Vogel Lecture Given by Professor Michael Devereux” (2018) 72:12 *Bulletin for International Taxation* 684-89.

32 See, for example, Edgar and Holland, *supra* note 5, at 532, discussing the implicit preference of the OECD for perceived consistency among various international tax allocation rules, despite the lack of coherent economic rationale and the “element of arbitrariness” that the authors viewed as inherent in any form of allocation.

33 Gijsbert W.J. Bruins, Luigi Einaudi, Edwin R.A. Seligman, and Sir Josiah Stamp, *Report on Double Taxation Submitted to the Financial Committee Economic and Financial Commission*, League of Nations document no. E.F.S.73.F.19 (Geneva: League of Nations, April 5, 1923) (herein referred to as “the 1923 economists’ report”); see also Sunita Jogarajan, “The Conclusion and Termination of the ‘First’ Double Taxation Treaty” [2012] no. 3 *British Tax Review* 283-306; “Prelude to the International Tax Treaty Network: 1845-1914 Early Tax Treaties and the Conditions for Action” (2011) 31:4 *Oxford Journal Legal Studies* 679-708; “Stamp, Seligman and the Drafting of the 1923 Experts’ Report on Double Taxation” (2013) 5:3 *World Tax Journal* 368-92; and *Double Taxation and the League of Nations* (Cambridge: Cambridge University Press, 2018).

34 See the 1923 economists’ report. This was a reasoned step away from the citizen/state relationship traditionally understood to confer jurisdiction in public international law terms, because the state’s ability to tax must inherently extend to non-citizens.

35 The 1923 economists report, at 19.

assigning income to particular geographic sources, dividing the global income tax base was and continues to be a question of political feasibility, not science.³⁶

In thinking about the problems of their day, the economists of the 1920s made the same observation as contemporary economists make today when thinking about digitalized businesses, namely that a dollar produced in the global economy is the product of multiple cooperative interactions among states designed to make international transactions possible. The production of value relied then, as it does now, on a range of international legal and physical structures to allow access to new markets, enforceability of contracts, currency exchange, exchange of labour and knowhow for compensation in multiple states, and so on. The greater economic interdependence that states achieve via the multitude of international agreements on trade, investment, and commercial activity, the harder it is to explain how nexus can be viewed as restricted in any theoretical sense.

Theoretically Unlimited Scope

Given conventional definitions, there is no clear principle that explains why it would be unreasonable for states that developed core infrastructure or that are strategically important to international trade and investment flows to claim much broader taxing rights than they do currently.³⁷ The results would be politically unacceptable but they would be defensible interpretations of the fluid concepts at play. For instance, the United States might make a case for appropriating most tax revenues on digitalized profits wherever generated by virtue of the fact that the digital economy as a whole is a product of the Internet, the initial development of which was underwritten by US government spending.³⁸ Indeed, were it not for high-risk investments by US public sector agencies, tech giants would not even exist.³⁹

36 The 1923 economists report, at 49-50: “[W]e do not see any other form of compromise which is likely to reconcile the conflicting interests and to have any prospect of success upon three points: (1) to reconcile the widely opposed interests of debtor and creditor exchequers; (2) to admit those ideas which, though widely accepted in many countries, are, in our view, in relation to income tax, to a considerable extent economically undeveloped in so far as they ascribe undue importance to origin taxation; and, lastly, (3) to conform to what is, in the experience of fiscal administrations, practically possible in dealing, in such a complex world, with the income of individual persons.”

37 Public international law theorists posit that there are customary constraints on sovereignty that must limit nexus to some degree. For a review of the literature, see Stjepan Gadžo, “The Principle of ‘Nexus’ or ‘Genuine Link’ as a Keystone of International Income Tax Law: A Reappraisal” (2018) 46:3 *Intertax* 194-209; Stjepan Gadžo, *Nexus Requirements for Taxation of Nonresidents’ Business Income: A Normative Evaluation in the Context of the Global Economy* (Amsterdam: IBFD, 2018). Practical experience, however, weighs against this view, even if it is conceptually coherent.

38 See Mariana Mazzucato, *The Entrepreneurial State: Debunking Public vs. Private Sector Myths* (London, UK: Anthem Press, 2013).

39 *Ibid.*, at 87: “[W]ithout the massive amount of public investment behind the computer and Internet revolutions, [Steve Jobs’] attributes might only have led to the invention of a new

By the same token, the Cayman Islands is a financially sophisticated jurisdiction that facilitates capital pooling by individuals and companies across the globe in shared projects—especially hedge funds. Using economic allegiance as the explanation for nexus, the Cayman Islands might plausibly claim that but for its provision of international financial services, much less investment across borders would occur, so anyone buying or selling anything that is ultimately funded through international capital markets might be seen to have nexus in the Cayman Islands.

Both of these assertions must be wrong, but neither economic allegiance nor the benefit theory explains why. In practice, the United States does not overtly attempt to claim nexus on the basis of its past investment in key infrastructure (but may bring that view of its taxing rights to many tax negotiation scenarios), while nexus claimed by the Cayman Islands undergoes near constant scrutiny for being artful rather than substantive. Indeed, the history of OECD work on harmful tax practices has been a challenging definitional exercise with the goal of denying taxing rights to countries like the Caymans, on the grounds that the real or substantive economic activity is elsewhere, without similarly invalidating other forms of tax competition in use by OECD member states. Relying on the idea of economic allegiance or benefit theory as the explanation of nexus for digital services revisits these notorious difficulties.

Precedents, Challenges, and an Uncertain Future

The conclusion to be drawn is that today's search for new rationales for nexus is made possible precisely by yesterday's acceptance of a broad standard susceptible to vastly different interpretations.⁴⁰ The broad standards of the past were controlled by limiting the discussion topics and the range of possible actions to those considered politically viable by the OECD member states. Against the theoretically unlimitable scope of nexus, the attempt to demarcate taxing rights by reference to value creation thus seems simply to compound the number of ideas that will have to be explained.

This confirms that there is a deeply political nature to the decision to open an international discussion about what nexus and value creation might mean, but to do so in the limited language of the digital economy. Lacking a scientific or technically correct answer to most questions about nexus and profit division leaves policy makers to defend a weak rule set. Hence the current discussion about whether nexus needs to be redrawn is fundamentally about which states stand to gain, and which to lose, once the next political compromise is forged.

toy—not to cutting-edge revolutionary products like the iPad and iPhone which have changed the way that people work and communicate.”

40 In explaining its intention to develop “conceptually underpinned methods” to assign new taxing rights, the OECD posits only one criterion—namely, “the principle of avoiding double taxation.” Limiting burdens on tax administrations and taxpayers and assessing other administrability issues are included as additional “issues and options” to be explored. See the 2019 OECD work program, *supra* note 1, the box “1.1 new profit allocation rules.”

DEFINING AND ASSESSING A NEW TAXING RIGHT

Given the above, redrawing nexus to accommodate the digital economy is not likely to satisfy any coherent normative standard. As currently framed, the discussions underway at the OECD will in effect demarcate a position from which to meet the political aims that a specific set of states view as urgent without exposing the overall residence and source bargain to critical debate. This might allow for a faster redesign of the jurisdictional reach of taxation for the current digital era, but it potentially does so at the expense of systemic coherence going forward, thus resetting the 1920s compromise without actually improving on it.

Four Approaches, Four Constituencies

Each of the OECD documents and reports is clear in regard to the targets of reform: states in which digital services businesses connect with many users without having any physical presence, that is, market jurisdictions. In particular, pillar 1, laid out in the 2019 OECD work program, aims to outline a new taxing right for these states by revising profit allocation and nexus rules.⁴¹ As introduced above, this is expected to be undertaken by reference to one of three approaches, based on concepts of user participation, marketing intangibles, and significant economic presence.

The three concepts converge in the sense that each would allot a greater portion of multinational profits to market jurisdictions.⁴² What sets them apart is the amount of tax base redistribution each contemplates. Defining these as the only possible measures, the OECD sheds light on an emerging dynamic of preferences and interest groups at play in global tax governance, highlighting divisions in country groupings and exposing how old and new players in contemporary world politics work within the structures of international tax—as well as how the OECD reacts, manages, and adapts to their strategic actions.⁴³ The three main groups of market countries in this

41 Ibid., at paragraph 39: “The work programme will explore the development of a concept of remote taxable presence (i.e. a taxable presence without traditional physical presence) and a new set of standards for identifying when such a remote taxable presence exists. The work programme will also consider a new concept of taxable income sourced in (i.e. derived from) a jurisdiction. This taxing right would generally not be constrained by physical presence requirements.”

42 Ibid., at paragraph 40: “Developing a new non-physical presence nexus rule to allow market jurisdictions to tax the measure of profits allocated to them under the new profit allocation rules.”

43 See Mindy Herzfeld, “The Case Against BEPS: Lessons for Tax Coordination” (2017) 21:1 *Florida Tax Review* 1-59, at 24: “[T]hese global power shifts are evident in the role the OECD adopted for itself in the BEPS project. While historically the OECD was organized to address the concerns of its member countries, primarily drawn from the wealthier countries in Western Europe and North America, it expanded its agenda as part of the BEPS project to make its work more relevant to emerging market economies. At the same time, its primary allegiance remains to its member countries, who fund the organization.”

round of tax coordination seem to be, roughly, the European Union, the United States, and a group of key emerging economies (especially Brazil, India, and China).⁴⁴

EU Preference: User Participation

The first proposal, focused on the concept of user participation, expresses the preference of certain European states to tax large digital companies. The direction of the user participation proposal is to attribute value to user data, whether collected for internal use (for example, to sell goods and services to existing users, to attract new users, or to sell advertising space on digital platforms) or to package and sell on to third parties.⁴⁵ Since most of the major multinational companies that collect, use, and sell data in this way are US-based, notably Google, Amazon, Facebook, and Apple, this is viewed as an aggression from the US perspective.⁴⁶

US Preference: Marketing Intangibles

The United States proposed a second option: taxing rights based on marketing intangibles.⁴⁷ This proposal would be expected to shift profits from Europe back to marketing intangibles located in the United States.⁴⁸ Proposals by major multinational firms such as Johnson & Johnson and Uber are evidence of a prevailing view that it is difficult to define marketing intangibles and that a workable plan would require simplifying proxies and calculations.⁴⁹

Both the user participation and the marketing intangibles proposals focus on changing the allocation of so-called residual profits. Residual profits are those that exceed the expected routine return to a given set of transactions or activities. Estimating expected routine profits is an imperfect art.⁵⁰ A recent study describing the

44 On the BRICS's evolving role in international tax, see Peter Antony Wilson, *BRICS and International Tax Law* (Alphen aan den Rijn, the Netherlands: Kluwer Law International, 2017).

45 The 2019 OECD public consultation document, *supra* note 1, at 9.

46 See Ruth Mason and Leopoldo Parada, "Digital Battlefield in the Tax Wars" (2018) 92:12 *Tax Notes International* 1183-97.

47 *Corporate Taxation in the Global Economy*, *supra* note 3, at paragraph 89.

48 See United States, Internal Revenue Service, "IRS Accepts Settlement Offer in Largest Transfer Pricing Dispute," *News Release* IR-2006-142, September 11, 2006 (www.irs.gov/pub/irs-news/ir-06-142.pdf), cited in Reuven S. Avi-Yonah and Ajitesh Kir, "India's New Profit Attribution Proposal and the Arm's-Length Standard" (2019) *Tax Notes International* 1183-90, at 1184, note 6.

49 See the letter submitted by Johnson & Johnson to the Organisation for Economic Co-operation and Development, Centre for Tax Policy and Administration, Tax Policy and Statistics Division, on March 3, 2019 (www.oecd.org/tax/beps/public-comments-received-on-the-possible-solutions-to-the-tax-challenges-of-digitalisation.htm); and Francois Chadwick, "International Tax Rules for the Digital Era" (2019) 95:8 *Tax Notes International* 709-22, regarding the global digital tax proposal by Uber's vice-president of finance, tax, and accounting.

50 *Corporate Taxation in the Global Economy*, *supra* note 3, at paragraph 95, stating that there is a high concentration of residual profits among a small number of companies headquartered in a

battle between the United States and Europe over such residual profits shows that high-tax countries tend to concentrate their efforts on reallocating profits from one another, because this is more feasible, cheaper, and faster than, for example, combating the allocation of profits to low-tax regimes or jurisdictions.⁵¹

Group of Twenty-Four Preference: Significant Economic Presence

The third proposal is more radical: instead of reallocating residual profits alone, it seeks to replace the arm's-length standard with a "fractional apportionment method," which would be used to allocate global profits among all states in which a digitalized business has a significant economic presence. This proposal would define "significant economic presence" by reference to various factors involving digital interaction with a jurisdiction.⁵² It has the greatest potential to redefine how countries share the corporate income tax base between residence and source states.⁵³ This approach was featured in a recent Indian public consultation document on amending rules for profit attribution to permanent establishments, signalling that this proposal originated in India.⁵⁴

small number of countries (United States, United Kingdom, Japan, China, and Hong Kong) and that "[m]any countries may currently collect less revenue than they would by fully taxing routine returns." Residual profit is described in the OECD transfer-pricing guidelines, *supra* note 13, at 29-30: "An analysis used in the profit split method which divides the combined profit from the controlled transactions under examination in two stages. In the first stage, each participant is allocated sufficient profit to provide it with a basic return appropriate for the type of transactions in which it is engaged. Ordinarily this basic return would be determined by reference to the market returns achieved for similar types of transactions by independent enterprises. Thus, the basic return would generally not account for the return that would be generated by any unique and valuable assets possessed by the participants. In the second stage, any residual profit (or loss) remaining after the first stage division would be allocated among the parties based on an analysis of the facts and circumstances that might indicate how this residual would have been divided between independent enterprises."

51 See Thomas R. Tørsløv, Ludvig S. Wier, and Gabriel Zucman, *The Missing Profits of Nations*, NBER working paper no. 24701 (Cambridge, MA: National Bureau of Economic Research, June 2018).

52 Avi-Yonah and Kir, *supra* note 48, at 1184.

53 *Ibid.*, at 1190; see also Shay, *supra* note 4, at 1: "[T]he greatest potential to achieve a meaningful realignment is the 'significant economic presence' proposal in the first pillar, provided that it is not linked exclusively to digital activity (which in concept it is not or need not be)."

54 See Government of India, Ministry of Finance, Department of Revenue, Central Board of Direct Taxes, "Public Consultation on the Proposal for Amendment of Rules for Profit Attribution to Permanent Establishment-reg," document no. F. no. 500/33/2017-FTD.I, April 18, 2019, and accompanying documents (herein referred to as "the India consultation document") (www.irs-officeronline.gov.in/Documents/OfficialCommunique/118042019150655.pdf); see also Avi-Yonah and Kir, *supra* note 48, at 1185, stating that the Indian proposal "presumably inspired the third OECD option."

The Indian public consultation document proposed that user participation be a fourth factor added to the traditional three-factor formula for profit allocation—namely, that based on sales, employees (usually counted in terms of payroll), and assets.⁵⁵ Characterizing the authorized OECD approach based on functions, assets, and risk as detrimental to the interests of source countries, this report argued that the Indian formula gives proper weight to demand-side value drivers while addressing digital economy issues.⁵⁶

Pascal Saint-Amans, director of the OECD's Center for Tax Policy and Administration, confirmed these observations in an OECD Tax Talk in October 2019.⁵⁷ Setting out the possible combinations of nexus and allocation methods involved in the three approaches, Saint-Amans attributed the user participation proposal to the United Kingdom, the marketing intangibles proposal to the United States, and the significant economic presence proposal to the group of developing countries, including China, India, and Brazil, that make up the G24.⁵⁸

That a group of mostly non-OECD member states can now make their voices heard with some meaningful impact could be seen as a reason for celebration. Nevertheless, the 2015 BEPS final report stated that “fractional apportionment” is too extreme and unconventional,⁵⁹ while the 2019 OECD public consultation document focused on the common ground between the user participation and the marketing intangibles proposals.⁶⁰ This signals that the significant economic presence proposal has a much lower likelihood of ultimate adoption.

Even if the proposal were to succeed in building consensus, however, it would not necessarily promote pure source taxation. Within the OECD's framing of the discussion, the allocation keys would still have to reflect the attributes of market

55 The India consultation document, *supra* note 54, at 74–76.

56 *Ibid.*, at 47–54.

57 Organisation for Economic Co-operation and Development, Centre for Tax Policy and Administration, “OECD Tax Talks no. 13,” *OECD.org*, October 9, 2019 (www.oecd.org/tax/beps/tax-talks-webcasts.htm).

58 See Intergovernmental Group of Twenty-Four, “Members” (www.g24.org/members). See also G24 Working Group on Tax Policy and International Tax Cooperation, *supra* note 14.

59 The 2015 BEPS final report, *supra* note 1, at paragraph 288: “It is important to note that the domestic laws of most countries use profit attribution methods based on the separate accounts of the PE, rather than fractional apportionment. In addition, fractional apportionment methods would be a departure from current international standards. Furthermore, pursuing such an approach in the case of application of the new nexus would produce very different tax results depending on whether business was conducted through a ‘traditional’ permanent establishment, a separate subsidiary or the new nexus. Given those constraints, fractional apportionment methods were not pursued further.”

60 The 2019 OECD public consultation document, *supra* note 1, at 9: “To date, the discussion has focused primarily on two of these proposals, the user participation proposal and the marketing intangible proposal, where a number of commonalities emerged. A detailed discussion of the concept of significant economic presence is also taking place, but this concept was revisited more recently.”

jurisdictions,⁶¹ which may or may not align with the value contributions of each G24 member, or other developing countries.⁶²

OECD Secretariat: Unified Approach

In October 2019, the OECD secretariat released its own proposal for a “unified approach” under pillar 1, which it developed taking into consideration the “different positions of the members of the Inclusive Framework.”⁶³ Notably, the unified approach is the OECD staff’s own proposal, and not a representation of member state views per the usual OECD process.⁶⁴ During the broadcasted announcement of the proposal, Pascal Saint-Amans introduced its principal drafter as Richard Collier, a former partner at PricewaterhouseCoopers, and since early 2019 a senior tax adviser at the OECD.⁶⁵

The OECD secretariat’s proposal builds on a number of ideas introduced in the pillar 1 consultation document. The primary components are a specific scope of application, a new non-physical nexus rule, a hybrid profit allocation rule that includes traditional transfer-pricing and new sales- or user-based allocation components, and a three-tier mechanism aimed at increasing tax certainty. The various components are articulated as three amounts, each of which represents a designated portion of the combined net profit of a multinational group that makes up its total global tax base. All of the terms are still to be defined, including the determination of the members of the group and the construction of the multinational’s consolidated income for tax purposes, but the secretariat’s proposal neatly lays out a framework for further discussion with these three tax base amount categories.

The first of the categories, “Amount A,” presents the most significant structural reform, given that it relies on a newly established (non-physical) nexus and introduces a new (sales-based) allocation formula for attributing some group profit

61 2019 OECD work program, *supra* note 1, at paragraph 23: “[T]hey all allocate more taxing rights to the jurisdiction of the customer and/or user—hereafter, the ‘market jurisdictions’—in situations where value is created by a business activity through (possibly remote) participation in that jurisdiction that is not recognised in the current framework for allocating profits.”

62 See India consultation document, *supra* note 54, at 48, stating that developing countries are “where the market and consumers are located.” This may be true for India, as well as China and Brazil, but it is not the case for all G24 countries. See, for example, Tommaso Faccio and Valpy Fitzgerald, “Sharing the Corporate Tax Base: Equitable Taxing of Multinationals and the Choice of Formulary Apportionment” (2018) 25:2 *Transnational Corporations* 67-89, at 73, stating that “unlike developed countries, the gains for tax bases in developing countries from the different models of apportionment do depend crucially on the weights given to the factors in the respective formulae.”

63 The 2019 OECD secretariat unified approach, *supra* note 1, at 2.

64 *Ibid.*, at 2: “The proposals included in this consultation document have been prepared by the Secretariat, and do not represent the consensus views of the Inclusive Framework, the Committee on Fiscal Affairs (CFA) or their subsidiary bodies.”

65 *Supra* note 57, referring to Mr. Collier as “the brain behind the unified approach under Pillar 1.”

to jurisdictions in which such a new nexus may be found. The tax base to be reallocated seems likely to be relatively modest. Using simplifying conventions to split a multinational's worldwide profits into "routine" and "non-routine" portions, the secretariat proposes that only a portion of the residual (non-routine) profit be reallocated among market jurisdictions. Residual profit derived from factors such as trade intangibles, capital and risk, and innovative algorithms and software are to be excluded from the reallocation exercise.⁶⁶

The second and third tax base categories are referred to as "Amounts B and C." Each of these would be calculated using existing profit allocation rules based on physical presence, but applying simplifications to reduce disputes. These amounts are not necessarily related to digitalization, but they support the OECD's parallel project on international binding arbitration—an initiative that has to date faced resistance from some less-developed countries.⁶⁷ Amount B presents an agreed fixed-return method (possibly varying by industry or region) for determining "baseline" (routine) marketing and distribution functions. In broad strokes, this resembles Brazil's prefixed/predetermined profit margin approach.⁶⁸ In turn, Amount C would allow market jurisdictions to use the arm's-length standard to go beyond the prescribed Amount B when warranted to create more tax base in the market jurisdiction in cases involving additional profits or local functions in addition to marketing and distribution.

The OECD secretariat's plan is definitionally complex but limited in application, albeit going beyond strictly digitalized economy firms. According to the scope section of the proposal, the new rules would reach only "large digital centric/highly digitalized

66 A recent study analyzed the likely distributional impacts of the secretariat's unified approach using country-by-country reports and other data sources and concluded that low-tax jurisdictions stand to lose some tax base but little or none of this would shift to the developing countries of the G24 and G77. See Alex Cobham, Tommaso Faccio, and Valpy FitzGerald, "Global Inequalities in Taxing Rights: An Early Evaluation of the OECD Tax Reform Proposals: Preliminary Draft," October 2019, at 23 (<https://osf.io/preprints/socarxiv/j3p48>), stating that "[a] watered-down OECD approach, in which perhaps only 20% of an identified 'residual' profit is apportioned by sales, would yield much smaller benefits—just a fraction of a percentage point of current corporate income tax revenues for lower-income countries compared to 2 per cent for OECD countries on average and almost 4 per cent for the US; or from 8 cents to 18 cents per capita for lower-income country groups on average, compared to \$8 per capita for the US.").

67 See Annagabriella Colón, "Developing Countries Wary of Dispute Resolution Proposal" (2019) 96:4 *Tax Notes International* 367, reporting on the Secretariat's unified approach.

68 The OECD has conditioned membership accession talks with Brazil on reforms to these rules to adapt to OECD standards. See Tatiana Falcão, "Ask Not What the OECD Can Do for Brazilian Transfer Pricing . . ." (2019) 96:2 *Tax Notes International* 163-70; Rogerio Abdala Bittencourt Jr. and Antonio José Ferreira Levenhagen, "Brazil's Road to OECD Accession: Tax Transparency and BEPS Standards" (2019) 95:9 *Tax Notes International* 851-53; Marcelo Ilarraz, "Drawing upon an Alternative Model for the Brazilian Transfer Pricing Experience: The OECD's Arm's Length Standard, Pre-Fixed Profit Margins or a Third Way?" [2014] no. 2 *British Tax Review* 218-35.

and other consumer-/user-facing businesses,” possibly over a minimum revenue threshold of €750 million. Likewise, the proposed standalone nexus rule would use revenue thresholds adapted to market size for activities such as online advertising as the indicator of “sustained and significant involvement in a jurisdiction.” Finally, targeted carveouts are proposed for extractive industries and commodities, while financial services and other sectors may also be excluded from scope.

Distributional Implications

Ultimately, the digitalization program is concerned with states of destination (where the customers or users are situated), and not states of production, resource extraction, labour inputs, and so on. Without identifying market jurisdictions by name, the proposals provide that the definition would cover the location of users either by virtue of their acquisition of goods or services directly from the remote seller or by virtue of the remote seller providing services to another business—namely, advertising that targets such users.⁶⁹ This seems universal: all jurisdictions seem to be locations of markets and consumers. Yet the threshold requirement of significance—together with the measures that will be introduced to simplify matters and provide certainty to taxpayers—may ultimately exclude most developing countries from the picture.

This possibility does not sufficiently occupy the attention of policy makers, even though it is a source of instability in the international tax regime.⁷⁰ The risk of overlooking disparate impacts of policy choices is that the current consensus will continue to produce distributive outcomes that many states view as unfair to them.

This reaction was foreshadowed in the broad divergence of views among states regarding the OECD’s work to address digitalization—including with regard to the need for any change at all, as reported through 2018.⁷¹ Yet in January 2019, the

69 The 2019 OECD work program, *supra* note 1, at 23, note 4. The emphasis on market jurisdictions aligns in some respects with proposals to switch to destination-based cash flow taxes. See Alan Auerbach, Michael P. Devereux, Michael Keen, and John Vella, *Destination-Based Cash Flow Taxation*, Oxford University, Saïd Business School RP 2017-09 (Oxford: University of Oxford, Saïd Business School, February 2017); Michael P. Devereux and John Vella, “Gaming Destination-Based Cash Flow Taxation” (2018) 71:3 *Tax Law Review* 477-514; Michael P. Devereux and John Vella, “Implications of Digitalization for International Corporate Tax Reform” (2018) 46:6/7 *Intertax* 550-59; Johannes Becker and Joachim Englisch, “Unilateral Introduction of Destination Based Cash Flow Taxation,” October 26, 2018 (<https://ssrn.com/abstract=3273409>); Paul Oosterhuis and Amanda Parsons, “Destination-Based Income Taxation: Neither Principle Nor Practical?” (2018) 71:3 *Tax Law Review* 515-50; Wei Cui, “Destination-Based Cash-Flow Taxation: A Critical Appraisal” (2017) 67:3 *University of Toronto Law Journal* 301-47; and Reuven S. Avi-Yonah and Kimberly A. Clausing, “Toward a 21st-Century International Tax Regime” (2019) 95:9 *Tax Notes International* 839-49.

70 See, for example, Tarcisio Diniz Magalhaes, “What Is Really Wrong with Global Tax Governance and How To Properly Fix It” (2018) 10:4 *World Tax Journal* 499-536, at 502, calling for “a more radical perspective that takes struggles in the international tax arena seriously.”

71 The 2018 OECD interim report, *supra* note 1, at paragraphs 25-29.

members of the Inclusive Framework are said to have agreed that it is a “fact” that all countries are “free to set their own tax rates or not to have a corporate income tax system at all,” while at the same time noting that unilateral actions to attract or protect a tax base will have “adverse consequences for all countries, large and small, developed and developing.”⁷² The inverse proposition is that a single consensus would benefit all, but this is seemingly impossible given that reallocation will shift income from some jurisdictions to others in an effort to preserve a zero-sum game so as to avoid double or multiple taxation.⁷³

The questions are: Which states stand to benefit from the reallocation in the form of revenue generation, and from which states will tax base be deducted? The states that have already passed unilateral taxes seem likely to be captured in the first category, but another way to estimate is to consider relative consumption levels across countries.⁷⁴ As a starting point, available OECD and World Bank data from 2017 provide a fairly clear picture of which states are the largest consumer markets. They are the United States, Europe, and China by a wide margin, followed by Japan, India, and Brazil, with Canada and Australia another step removed. (See figure 1.)

This distribution of the consumer base reflects a reality that has always shaped the relationship between international taxation and national interests: that even though lower-income states are associated with source, while relatively more affluent ones are associated with residence, states can have both residence and source interests, depending on the economic context.⁷⁵ This observation offers important lessons about why the digitalization discourse avoids the use of broader expressions like “source taxation,” which could incorrectly signal a shift of attention toward the international tax priorities that are of urgent concern to lower-income countries.⁷⁶

72 The 2019 OECD policy note, *supra* note 1, at 2.

73 See the 2019 OECD work program, *supra* note 1, at 23, note 4, emphasizing throughout that the goal is reallocation from one jurisdiction to another.

74 A complete analysis should, of course, also take into account differences in multinational enterprises, economic sectors, geographic regions, and other factors. The OECD has pledged to carry out an economic analysis and impact assessment of its proposals that includes levels of distribution of tax revenues across jurisdictions, taking into account differences between countries.

75 See, for example, *Corporate Taxation in the Global Economy*, *supra* note 3, at paragraph 34, noting that the IMF recognizes the “longstanding tussle for taxing rights between ‘source’ and ‘residence’ countries—a critical issue for low income countries, which are primarily ‘source’ countries”; see also Shay, *supra* note 4, at 2, noting that “longstanding issues in the international tax system . . . have restricted the claim of source countries to tax economic activity that derives value from the source country and accordingly results in over allocation of income to residence countries,” and observing that “[i]n recent decades, the ‘residence’ country often is a low-tax intermediary country.”

76 Such expressions appear more often in relation to pillar 2, which deals with anti-base erosion measures rather than tax reallocation. As the OECD explains, its “GloBE proposal,” like the BEPS project, would restore source-based taxation. See, for example, 2019 OECD work

FIGURE 1 Largest Consumer Markets Worldwide, by Consumption Expenditure

Source: Authors' depiction of data from World Bank, *World Bank Development Indicators 2017* (Washington, DC: World Bank, 2017).

Using the term “market jurisdictions” instead allows a strategic narrowing of scope while maintaining a broad enough terrain to accommodate the residence and source interests of OECD members and other key consumer market states. A focus on the consumer base as the market is a metric that, by definition, tends to favour the biggest consumer markets in relation to small-market, low-income countries—for example, those that heavily rely on exports of natural resources—which stand to be apportioned the least.⁷⁷

program, *supra* note 1, at paragraph 73: “The second key element of the proposal is a tax on base eroding payments that complements the income inclusion rule by allowing a source jurisdiction to protect itself from the risk of base eroding payments.” But see Lucas de Lima Carvalho, “GLOBE and the Supranational ‘Nudges’ Affecting Domestic Tax Policy” (2019) 95:5 *Tax Notes International* 421–25, at 424: worrying that GloBE might be too intrusive on tax sovereignty, putting an extra layer of pressure on developing countries that, wishing to comply with World Trade Organization rules, “may be nudged into compliance with [OECD] rules that do not serve their social and development interests.”

77 This worry is confirmed in a number of recent studies. See International Monetary Fund, *Spillovers in International Corporate Taxation*, IMF Policy Paper (Washington, DC: IMF, May 9, 2014), at 40: “Advanced economies generally gain tax base whichever factor is used, while substantial tax base moves out of conduit countries; emerging and developing economies clearly gain base only if heavy weight is placed on employment”; *Corporate Taxation in the Global Economy*, *supra* note 3, at paragraph 80, stating that a global profit allocation framework tied to

Given the disparate levels of consumption across the globe, a market-based system would mostly benefit relatively more affluent countries and, in the best-case scenario, some emerging ones. Accordingly, no matter which of the proposals prevails, the result will be the reinforcement of a new global consensus on tax allocation that seems destined to favour the companies and governments of relatively affluent states.

Connection to Global Economic Development Targets

Reallocating the tax base should be seen as a “strong [political] imperative to act,” as the OECD declares.⁷⁸ But it is difficult to justify urgent action solely because some relatively affluent states might be facing revenue losses because of digitalization. Instead, it is imperative to come to terms with the distributional impacts of the flawed system that the tax policy architects of the early 20th century forged to satisfy the political preferences of their day. The digitalization of the economy is a new phenomenon, and it clearly poses challenges for taxation in all states. The imperative to better allocate tax revenues has always been a live issue.

In particular, it seems unlikely that source states will, as a monolithic group, stand to benefit from the attention of global policy makers to the tax challenges arising from digitalization. It is more likely that some production- and resource-based source countries will have their urgent concerns put aside for another day. This is unfortunate, given that the United Nations, the OECD, the International Monetary Fund, the World Bank, and other key policy-making bodies, in addition to taking notice of the rise of digitalization as a global phenomenon, have simultaneously identified the need to mobilize revenue in developing countries in order to meet targets for sustainable and inclusive growth and development.⁷⁹

sales would benefit advanced economies, while emerging economies could gain from employment and sales, but lower-income ones would benefit only from employment); see also Independent Commission for the Reform of International Corporate Taxation, *A Roadmap To Improve Rules for Taxing Multinationals: A Fairer Future for Global Taxation* (Washington, DC: ICRIC, February 2018), at 10, confirming these findings; contra, see Shafik Hebous, Alexander Klemm, and Saila Stausholm, *Revenue Implications of Destination-Based Cash-Flow Taxation*, IMF Working Paper no. WP/19/7 (Washington, DC: IMF, January 2019), at 6.

78 The 2018 OECD interim report, *supra* note 1, at paragraphs 27, 408, and 514; and the 2019 OECD work program, *supra* note 1, at paragraph 11.

79 Organisation for Economic Cooperation and Development, “Countries Must Strengthen Tax Systems To Meet Sustainable Development Goals,” February 14, 2018 (www.oecd.org/tax/countries-must-strengthen-tax-systems-to-meet-sustainable-development-goals.htm); International Monetary Fund, “IMF and the Sustainable Development Goals,” March 19, 2019 (www.imf.org/en/About/Factsheets/Sheets/2016/08/01/16/46/Sustainable-Development-Goals); and World Bank, *Taxation & SDGs: First Global Conference of the Platform for Collaboration on Tax, February 14–16, 2018, New York: Conference Report* (Washington, DC: World Bank, 2019), at 10: “Mobilizing domestic resources is not simply about taxing more, it’s also about taxing better by expanding the tax base.”

Surprisingly, these goals seem nowhere to be found among the various discussions surrounding the urgent need for action in redefining taxing rights in the name of fairly sharing the tax base among all members of the Inclusive Framework. There exist some alternative approaches to allocation, such as location savings or fixed-margin pricing, that might produce distributional results different from those destined to be produced according to concepts such as user participation and marketing intangibles. Proposals to develop or expand the use of these alternatives have underlying rationales that are relevant to the discussion of nexus and profit allocation, yet these approaches seem destined to be sidelined even as the OECD seeks appropriate principles in its search for consensus.

CONCLUSION

Google, Amazon, Facebook, Microsoft, and Apple are household names that reach into countries around the world engaging billions of active users, deploying billions of advertisements, representing \$3 trillion in market capitalization, and generating half a trillion dollars in revenue per year. That these five digital giants also notoriously pay very little in tax on a global basis is perhaps the main reason why the international tax community is addressing the notions of user-generated and data-driven value creation by urgently designing a reset of conventional nexus, source and allocation rules.

To date, however, the digitalization discourse has had little to do with determining what a principled allocation of taxing rights among nations would look like. Instead, in a re-enactment of the original consensus that built today's international tax regime, the development of a new global tax deal for the digital age has involved mostly affluent states organizing themselves around what they view as feasible, and what they are willing to do and how far they are willing to go to maintain their historical privileges. The claims of less-developed countries that more taxing rights should be allocated to places where resources are extracted and where production takes place seem destined to remain subordinate to apparently more urgent concerns.

The OECD has stated that the need to alter the distribution of current taxing rights among states requires the support of underlying principles that would explain why the expected distributive impacts should be broadly accepted. The avoidance of double taxation has been suggested as the paramount principle, with adherence to traditional concepts of nexus or arm's-length pricing suggested as corollaries. What has not been identified is the need for a principle regarding the distributional impact of any and all approaches to international tax coordination.

Accordingly, regardless of which proposal is ultimately adopted, it is likely that multiple states will benefit minimally or not at all from the consensus developed in today's digitalization project. Since it is not reasonable to expect states to continuously go along with a consensus that does not benefit them, this omission is significant.

What is needed instead is to reconsider the overall structure of the rules that allocate taxing rights among residence and source states. This is a long-term project

to build a sustainable international tax system that would take significantly more time and effort than the OECD has given itself for solving the tax challenges arising from digitalization. It is a project that requires analysis and collaboration across the disciplines of law, political theory, economics, and accounting. It will require recursive development, testing, and assessment of various models with an eye not only to economic impacts and incentives and administrative feasibility but also to the core question of fairness. A commitment to tackling these challenges is the key to building an authentically new tax deal for the digital era.

Sharing Tax Information in the 21st Century: Big Data Flows and Taxpayers as Data Subjects

Arthur J. Cockfield*

PRÉCIS

Au cours des 10 dernières années, les gouvernements ont entrepris plusieurs réformes pour échanger automatiquement entre eux des blocs de renseignements sur les contribuables (principalement par l'entremise de la *Foreign Account Tax Compliance Act*, la Norme commune de déclaration, et la déclaration pays par pays). Ce partage accru des renseignements fiscaux a été incité tant par les changements technologiques, y compris la numérisation, les mégadonnées, et l'analyse des données, que par les tendances politiques, y compris les efforts des gouvernements pour réduire l'évasion fiscale à l'étranger et l'évitement fiscal international abusif. Dans certains cas, cependant, les protections juridiques de la vie privée et des autres intérêts des contribuables ne sont pas assez solides pour faire face à ce nouveau cadre international de partage de renseignements. Sur le plan conceptuel, les contribuables devraient être considérés comme des « personnes visées » dont les droits sont protégés proactivement par les lois et les politiques de protection des données, y compris des pratiques d'information équitables. Un régime optimal, qui équilibrerait les intérêts des contribuables et ceux des administrations fiscales, devrait inclure une déclaration multilatérale des droits des contribuables, une retenue fiscale transfrontalière pouvant être imposée au lieu de l'échange de renseignements, et un registre financier mondial qui permettrait aux gouvernements d'identifier les propriétaires effectifs d'entreprises et d'entités juridiques.

ABSTRACT

In the last 10 years, governments have initiated several reforms to automatically exchange bulk taxpayer information with other governments (mainly via the Foreign Account Tax Compliance Act, the common reporting standard, and country-by-country reporting). This enhanced sharing of tax information has been encouraged both by technological change, including digitization, big data, and data analytics; and by political trends, including governments' efforts to reduce offshore tax evasion and aggressive international tax avoidance. In some cases, however, legal protections for taxpayer privacy and other interests are insufficiently robust for this emerging international

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sharing framework. Conceptually, taxpayers should be seen as “data subjects” whose rights are proactively protected by data protection laws and policies, including fair information practices. An optimal regime, which would balance the interests of taxpayers against those of tax authorities, should include a multilateral taxpayer bill of rights, a cross-border withholding tax that could be imposed in lieu of information exchange, and a global financial registry that would allow governments to identify the beneficial owners of business and legal entities.

KEYWORDS: TAX EVASION ■ TAX AVOIDANCE ■ TIEA

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INTRODUCTION

In recent years, data leaks from tax havens, including the Panama papers and the Paradise papers, have suggested that the problem of offshore tax evasion and aggressive international tax avoidance, along with the related revenue losses, may be more serious than previously suspected.¹ At the same time, technology trends—ongoing digitization and the rise of big data, data analytics, and artificial intelligence (AI)—have facilitated government efforts to share and analyze “bulk” taxpayer information across borders. Beginning with the 2010 passage by the US Congress of the Foreign Account Tax Compliance Act (FATCA), governments are increasingly participating in the bulk transfers of tax and financial information across borders. More recently,

1 Arthur J. Cockfield, “Big Data and Tax Haven Secrecy” (2016) 18:8 *Florida Tax Review* 483-539.

global agreements contemplate the automatic exchange—through the Organisation for Economic Co-operation and Development/Group of Twenty (OECD/G20) common reporting standard (CRS) and country-by-country reporting (CBCR)—of financial account information and of detailed tax and other financial information regarding a multinational company's activities in every country where it operates. These processes (sometimes referred to as the “exchange of information” [EOI]), which now involve cross-border big data flows, pose a challenge to traditional legal protections for taxpayers' privacy, confidentiality, and other rights.

The policy challenge is important: tax and financial information is among the most sensitive and personal information that one can collect on individuals and business entities such as corporations. Yet it remains unclear whether the legal framework that is emerging to protect these taxpayer rights is sufficient. In this paper, I connect several broad topics in order to demonstrate that taxpayers should be viewed as “data subjects” governed by proactive data protection laws and policies (including fair information practices). Building on the views of Tim Edgar, who emphasized that government coordination can improve the efficiency of outcomes, I review some ways in which governments could cooperate to create a more effective regime for the cross-border exchange of tax information.²

This paper comprises three parts. In the first part, which follows this introduction, I provide context, discussing the technological and political trends that are encouraging the automatic exchange of “big tax data.” In the second part, I discuss the need to protect taxpayers' liberty, privacy, and confidentiality, and I show how the current legal regime governing these interests suffers from a number of drawbacks, including the legal gaps created when different bilateral or regional agreements offer inconsistent and, at times, inferior legal protections. In the paper's last section, I review the elements that would be included in an optimal regime for promoting efficient and fair EOI: a multilateral taxpayer bill of rights, a cross-border withholding tax in lieu of information transfer, and a global financial registry.

CONTEXT: THE PUSH FOR AUTOMATIC EXCHANGE OF INFORMATION

Taxpayers may currently be increasing their use of tax havens in order to evade taxes, launder drug money, or finance terrorist activities. According to some estimates, US residents are evading between \$40 and \$100 billion each year through the use of tax havens.³ A wide range of estimates exist regarding the total amounts maintained in the world's tax havens; studies suggest that these havens may hold between \$5 and \$38 trillion in undisclosed financial assets.⁴ A common problem for governments is the significant difficulty of identifying how much of their residents'

2 See 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.

3 Cockfield, *supra* note 1, at 494.

4 *Ibid.*

taxable income is generated within foreign countries. To address this problem, governments enter into agreements to collect and share tax information with each other via EOI. In what follows, I describe how technological and political trends are encouraging the use of automatic EOI in order to curb the revenue losses associated with offshore tax evasion and aggressive international tax avoidance.

Technological Trends

Moving from Analogue to Digital Technologies

Developments in technology—in particular, big data, data analytics, and artificial intelligence (AI)—have provided new tools to tax authorities, enabling them to collect and share detailed tax and financial information at an unprecedented scale and speed. Methods of tax collection have evolved in parallel with the technological change; in the 1960s, paper-based analogue systems began evolving into digital ones.⁵ Apprehensions about the interaction between technology and taxpayer privacy have existed for some time. In the 1970s, concerns arose about the use of electronic records; in the 1980s, about the movement from analogue to digital storage; in the 1990s, about online return filing and software audits; and, more recently, about the collection of taxpayer information in order to tax global digital goods and services.

Once converted into a digital format, tax records share the same attributes as any other “information good”; the fixed cost of amassing the information in the first place may be high, but the marginal cost of replicating and distributing it approaches zero.⁶ At one time, tax authorities stored tax returns and other paper records in dusty cabinets where they were often difficult to access and mail to other domestic agencies (let alone to a foreign tax authority). Now, a tax authority can, at virtually no cost, (1) design software to automatically access a taxpayer’s detailed personal information, (2) cross-index this information against other government and private sector records, and (3) copy and transmit the information across borders.

These developments have enabled governments to share ever greater amounts of tax information with each other in order to help enforce their residence-based tax regimes. This cross-border sharing began to gather real steam in the 1990s. In 1997, for example, under the US Internal Revenue Code’s (IRC’s) qualified intermediary program,⁷ Canada and the United States began exchanging bulk taxpayer data regarding interest income on bank deposits earned by residents of either country. As disclosed under access-to-information requests, the Canadian government transfers roughly 1 million information slips and records to the United States each

5 Arthur Cockfield, Walter Hellerstein, and Marie Lamensch, *Taxing Global Digital Commerce*, 2d ed. (The Netherlands: Wolters Kluwer Law & Business, 2019), at 515-518.

6 Arthur J. Cockfield, “The Law and Economics of Digital Taxation: Challenging Traditional Tax Laws and Principles” (2002) 56:12 *Bulletin for International Fiscal Documentation* 606-619.

7 Internal Revenue Code of 1986, as amended (herein referred to as “IRC”).

year.⁸ In 2014, Canada agreed to transfer to the Internal Revenue Service (IRS), via FATCA (discussed below), bulk taxpayer data on “US persons” that have Canadian bank accounts. In the two years following this agreement, the amount of transferred information grew by almost 100 percent (from roughly 150,000 information slips and records to roughly 300,000 information slips and records).

Big Data, Data Analytics, and Recent Technology Trends

Most recently, the combination of three related technology developments has enabled governments to contemplate exchanging and analyzing taxpayers’ personal information at levels previously unheard of.⁹ In the first development, governments increasingly amass big data concerning their taxpayers’ activities. Three features are sometimes seen as defining big data: (1) the data set is large and diverse; (2) the information is generated on a “flow” or ongoing basis (rather than as a static data set); and (3) the data are capable of being subjected to analytics.

Data analytics, the second technological development, involves using the computer analysis of big data to reveal patterns or other information that is useful to governments (or other parties).¹⁰ Data analytics provides insights by combining data points in order to reveal new information or connections among these data points that would otherwise be obscure to the human mind.

The third development involves AI, machine learning, and blockchain. By AI, I simply mean very powerful computers that are capable of processing and storing (including via the Cloud)¹¹ large amounts of data. (I do not mean sentient machines that will one day overthrow their human masters.) Machine learning allows tax authorities to craft their own algorithms more effectively in order to detect risks of taxpayer non-compliance. (The software, by examining its own track record of success or failure, will over time improve its ability to detect non-compliance.) A debate is currently underway concerning the implications of such algorithms, which may have biases (regarding race and gender, for example) built into their coding.¹² Blockchain, the other component of this development, provides a distributed digital ledger, and it enables the registration, storing, and sharing of unprecedentedly large amounts of taxpayer information. It also offers the possibility that taxpayers can register and verify the accuracy of their own stored personal tax information.

8 Arthur J. Cockfield, “Policy Forum: Examining Canadian Offshore Taxation” (2017) 65:3 *Canadian Tax Journal* 651-680, at 674.

9 Cockfield, Hellerstein, and Lamensch, *supra* note 5, at chapter 2.

10 Kimberly A. Houser and Debra Sanders, “The Use of Big Data Analytics by the IRS: Efficient Solutions or the End of Privacy as We Know It?” (2017) 19:4 *Vanderbilt Journal of Entertainment and Technology Law* 817-72.

11 Orly Mazur, “Taxing the Cloud” (2015) 103:1 *California Law Review* 1-65.

12 Frank Pasquale and Arthur J. Cockfield, “Beyond Instrumentalism: A Substantive Perspective on Law, Technology, and the Digital Persona” [2018] no. 4 *Michigan State Law Review* 821-68.

Although it is clear that bulk taxpayer information is increasingly being exchanged across borders, it is less clear whether tax authorities have yet harnessed the technologies involved in AI, machine learning, and blockchain. At the domestic level, there are ever more examples of big data and data analytics being used. For instance, a number of US state governments analyze large amounts of data in order to determine whether taxpayers have filed tax returns to generate fraudulent refunds. State tax authorities cross-reference a taxpayer's refund request against billions of records from public and commercial databases in order to catch the tax cheats. In 2010, for example, the New York Department of Taxation and Finance decreased revenue losses by \$1.2 billion through this approach.¹³ More recently, the Canada Revenue Agency (CRA) introduced a big data program that examines data sources related to a Canadian taxpayer's global income in order to determine whether the taxpayer is complying with tax law.

A barrier to enhanced EOI is the concern that new technologies, which enable the mass storage and transmission of detailed taxpayer information, will violate privacy laws, policies, and interests.

Political Trends

In what follows, I briefly examine how the revelations from tax haven data leaks, along with OECD and G20 reforms, have encouraged governments to adopt enhanced cross-border tax information exchanges.

Tax Haven Data Leaks

Governments and non-governmental groups have long worried about the role of tax havens within the international tax regime. On the one hand, governments seem to embrace these tax havens: some tax laws explicitly encourage their use.¹⁴ Similarly, the business communities in many countries have long advocated for the use of tax havens and other low-tax jurisdictions in order to promote the tax competitiveness of resident companies relative to companies that are based in countries that offer tax breaks when their companies "go global." On the other hand, governments worry that the use of tax havens may be leading to significant revenue losses. Moreover, tax havens can be used by criminals to facilitate global financial crimes such as offshore tax evasion, international money laundering, and, potentially, terrorist financing.

Public engagement with the issue of offshore tax evasion has been sparked by recent data leaks from tax havens.¹⁵ Earlier leaks from Lichtenstein and Switzerland

13 JoAnne Bourquard and Cassandra Kirsch, "Big Data = Big Benefits" (2014) 40:8 *State Legislatures* 32-34.

14 For instance, under Canadian tax law, a double-dip cross-border financing structure, with the use of a financing affiliate based in a tax haven, has been enabled by a recharacterization provision within subparagraph 95(2)(a)(ii) of the Income Tax Act since the 1970s.

15 Cockfield, *supra* note 1.

involved bank employees who stole account information and provided it to authorities. Much larger data leaks ensued, involving millions of stolen documents. Beginning in 2013, the International Consortium of Investigative Journalists (ICIJ), a journalist organization based in Washington, DC, revealed a series of data leaks, including (1) the 2013 leak of over 2.5 million documents from Cook Islands, Singapore, BVI, Caymans; (2) the 2016 “Panama papers” leak of over 11 million documents; (3) the 2016 Bahamas leak of over 1.5 million documents; and (4) the 2017 Paradise papers leak (Bermuda) of over 13.4 million documents.¹⁶

In some countries, these leaks heightened public anxiety that global financial opacity—that is, the inability of governments to access information on the behaviour of taxpayers—may be contributing to income inequality by allowing criminals and high-income taxpayers to move and hide monies offshore.¹⁷

Tax scholarship recognizes the importance of the less tangible cultural and social influences in promoting taxpayer compliance. These influences, which are sometimes referred to, collectively, as “taxpayer morale,” include whether a taxpayer feels patriotic toward his or her country and whether the taxpayer thinks that he or she is getting a more or less fair return on a tax payment. The tax policy concern, with respect to financial opacity, is that average taxpayers will become less compliant over time if they feel that multinational corporations are not paying their fair share of taxes or that high-net-worth taxpayers are greatly reducing their legal tax payments and getting away with it.

Most sensationally, the recent leaks have provided evidence of global financial crimes, such as offshore tax evasion and international money laundering. The leaks have also highlighted how trillions of dollars flow from developing or middle-income countries to wealthier (mainly OECD) states. In some cases, this capital flight is contributing to human rights violations, as assets or profits are shifted offshore and ordinary citizens are left with far fewer resources.

The leaks have also revealed details concerning how multinational firms engage in aggressive tax planning. For instance, LuxLeaks showed how the Luxembourgian government provides such firms with private advance tax rulings so that they can reduce their global tax liabilities.¹⁸ Google, Apple, and other large multinational firms were identified in the leaks as having deployed corporate subsidiaries in tax havens in order to (legally) reduce their global tax liabilities. In addition, the leaks have given rise to concerns among multinational taxpayers that adverse media coverage could harm a company’s brand, goodwill, and reputation, and possibly reduce its long-term share value. These taxpayers increasingly assess the risk that aggressive

16 For more information on data leaks, see International Consortium of Investigative Journalists (www.icij.org).

17 Arthur J. Cockfield, “Shaping International Tax Policy in Challenging Times” (2018) 54:2 *Stanford Journal of International Law* 223–40, at 236–37.

18 Omri Marian, “The State Administration of International Tax Avoidance” (2017) 7:1 *Harvard Business Law Review* 1–65.

international tax planning could attract negative media coverage down the road and lead to reputational damage.

Perhaps most importantly, the leaks placed political pressure on governments to take steps to curb areas of alleged abuse. In particular, the leaks encouraged global cooperation in the CRS (discussed below).

The EOI Reforms and Privacy Protections

In this section, I briefly outline three recent EOI initiatives: FATCA, the CRS, and CBCR.

All US citizens and residents must pay US taxes on their worldwide income.¹⁹ US policy makers worry that many of these individuals fail to report this income, resulting in revenue losses to the government of billions of dollars each year.²⁰ Accordingly, the FATCA legislation was passed in 2010, with a view to raising revenues by taxing the undisclosed offshore income of US citizens and others.²¹ Many foreign governments complied, agreeing to enter into an intergovernmental agreement (IGA) with the US government to implement FATCA: under the general approach, tax authorities amass financial account information collected by banks, and then transfer this information to the IRS.

Partly as a result of FATCA, the G20 and OECD endorsed the CRS as the global standard.²² A related multilateral agreement contemplates the automatic sharing of bulk taxpayer information across borders.²³ Under this approach, a participating country such as Singapore is supposed to pass laws that mandate (1) the automatic collection by banks of foreign investors' account information and (2) the transference of this information to the Singaporean government and, subsequently, to other participating countries.

In 2013, the OECD also began an ambitious plan to counter base erosion and profit shifting (BEPS) by multinational firms. BEPS refers to the many international

19 See IRC section 61(a): "gross income means all income from whatever source derived."

20 Martin A. Sullivan, "US Citizens Hide Hundreds of Billions in Cayman Accounts" (2004) 103:8 *Tax Notes* 956-64.

21 The initial legislation, entitled the Foreign Account Tax Compliance Act (FATCA), was not enacted. See HR rep no. 3933, 111th Cong., 1st sess. (2009). The legislation was subsequently passed within a large omnibus legislative package that was mainly directed at job creation. See Hiring Incentives To Restore Employment Act of 2010, Pub. L. no. 111-147. The provisions to implement FATCA are now contained in sections 1471 to 1474 of the IRC (Sup. 2011).

22 See Organisation for Economic Co-operation and Development, *Standard for Automatic Exchange of Financial Information in Tax Matters* (Paris: OECD, 2014) (<http://dx.doi.org/10.1787/9789264216525-en>). A second edition was released in 2017.

23 Ibid., at 215, annex 1. The OECD agreement, in turn, is based on article 6 of an earlier multilateral agreement. See Organisation for Economic Co-operation and Development, Convention on Mutual Administrative Assistance in Tax Matters, signed at Strasbourg on January 25, 1988, as amended by the Protocol Amending the Convention on Mutual Administrative Assistance in Tax Matters, signed at Paris on May 27, 2010.

tax-avoidance plans that firms adopt in order to legally reduce their global tax liabilities, often by shifting paper profits to tax havens. After two years of reform efforts, the OECD produced its final recommendations, including a recommendation that all participating countries adopt CBCR.²⁴ Under CBCR, multinational firms for the first time need to disclose their tax and other payments to their domestic tax authority and to the foreign tax authorities in every country where these firms operate.²⁵ CBCR applies only to very large multinational firms with annual consolidated group revenues that exceed €750 million (that is, roughly US\$850 million). Unlike the FATCA and CRS initiatives, which try to reveal hidden bank accounts in order to combat offshore tax evasion, CBCR aims to help governments identify risks of aggressive international tax avoidance for possible auditing.

Summary

New initiatives—most prominently FATCA, CRS, and CBCR—contemplate the exchange of bulk (or big data) tax and financial information on an automated basis. The exchanges are facilitated by technology changes such as data analytics, AI, and blockchain, which allow the collection, analysis, and disclosure of vast amounts of detailed personal information. Moreover, global political cooperation has been encouraged by a series of data leaks from tax havens, which have heightened public anxiety that undue revenue losses are resulting from (legal but non-compliant) aggressive international tax avoidance and (criminal) offshore tax evasion. A corresponding worry is that these concerns, in an era of growing income inequality wherein many people believe that the system is rigged in favour of the wealthy and powerful, may delegitimize democratic practices.

LIBERTY AND PRIVACY INTERESTS

In what follows, I review concerns about taxpayers' liberty, privacy, confidentiality, and other interests, and I provide an overview of related legal protections. I also show how the legal framework that is emerging to protect these interests does not provide sufficient safeguards.

Taxation and Liberty

Before proceeding to discuss specific taxpayers' rights, such as privacy, let us step back and consider the broader liberty interests that are at stake when a government exercises its monopoly on the coercive power to extract a portion of a taxpayer's income or assets. Historically, tax developments helped define the relationship

24 Arthur J. Cockfield and Carl MacArthur, "Country-by-Country Reporting and Commercial Confidentiality" (2015) 63:3 *Canadian Tax Journal* 627-60.

25 Dries Lesage and Yusuf Kaçar, "Tax Justice Through Country-by-Country Reporting: An Analysis of the Idea's Political Journey," in Jeremy Leaman and Attiya Waris, eds., *Tax Justice and the Political Economy of Global Capitalism, 1945 to the Present* (New York: Berghahn, 2013), 262-82 (<http://hdl.handle.net/1854/LU-4214980>).

between the state and the individual. In some countries, these developments provided the basis for later claims regarding the need to protect taxpayer privacy, lawyer-client confidentiality, commercial and trade secrecy, and other interests.

The relationship between tax policy and the state is ancient, of course. Over 2,000 years ago, Herodotus traced the influence of Ancient Egyptian tax policies on Ancient Greece. In the Anglo-American context, the development of tax policy has been influenced by (1) a historical pattern of reaction against taxation and (2) the norms underlying the political philosophy of liberalism, which is the basis of modern democracies.

The year 1066, in which the Normans conquered England and slew the last Anglo-Saxon king, Harold II, marked a clear turning point in the Anglo world. The new king, William the Conqueror, immediately embarked on cruel tax policies in governing his Anglo-Saxon subjects. The English lords were required, for the first time, to record their names, property holdings, property yields, and other details as tax records within the Domesday (“doomsday,” in modern English) Book, which served as a final judgment of tax liabilities from which no appeal was available. From that point on, tax inspectors would scrutinize a lord’s property and farm yields to ensure that he was paying the appropriate amount of tax. These tax measures threatened to stir rebellion, which was averted only by William’s death and by the laws introduced by his younger brother, Henry I—in particular, the precedent-setting Charter of Liberties (1100) and Grant of Tax Liberties to London (1133).²⁶

Subsequent English conflicts over taxation similarly resulted in new tax laws that provided for procedural protections against oppressive taxation measures—perhaps the most famous being the conflict between the country’s overtaxed barons and King John that led to the signing of the Magna Carta in 1215. Over centuries, these tax debates influenced the development of norms regarding taxation, such as the view of 17th-century philosopher John Locke that every individual is entitled to keep the fruits of his or her labour and that the only acceptable and moral political system is one in which the people *consent* to government regulation and the taxation of their properties.²⁷ The prevalence of such views, along with tax disputes between King George III and American colonists, played an important role in the founding of the United States, in 1776, as the modern world’s first democracy (though one must keep in mind that the franchise was initially extended only to white, male property owners).

As a result of these developments, the state’s coercive power to tax has generally been considered a necessary albeit sensitive political element of liberal democracies. Many democracies now have a rigorous rule of law, along with a variety of taxpayer protections. The tension between liberty and taxation is more acute in autocratic

26 Arthur J. Cockfield and Jonah Mayles, “The Influence of Historical Tax Law Developments on Anglo-American Law and Politics” (2015) 5:1 *Columbia Journal of Tax Law* 40-68.

27 Arthur Cockfield, “Income Taxes and Individual Liberty: A Lockean Perspective on Radical Consumption Tax Reform” (2001) 46:1 *South Dakota Law Review* 8-71.

regimes, whose residents often transfer monies offshore to protect them against improper seizure by their home governments. Such claims to liberty call for legal protections, such as a withholding tax in lieu of EOI, when the claims are made by individuals who need anonymous global investments in order to protect the security of their own persons (along with the security of family members) against arbitrary state action. Moreover, the Lockean “natural rights” view later developed into human rights claims to the protection of an individual’s privacy, which, in turn, became the foundation for later claims to taxpayer privacy—a topic to which I now turn.

Taxpayer Privacy

Owing, in part, to historical developments and to fears about tax agents breaking into homes to seize tax payments, taxpayer information (along with financial information) has traditionally been considered one of the most sensitive areas of privacy.²⁸ Tax information may include detailed personal information about an individual’s identity and behaviour. (For example, tax return information can include information about, among other things, an individual’s income, dependents, health and disability status, and political donations.) In addition, tax information about income can generate security concerns (for example, the children of the wealthy may be kidnapped), public envy, and political reprisals.

Deploying the technological developments noted above, governments amass ever greater amounts of detailed personal information on individuals in order to protect against the risk of criminal tax evasion and non-compliant tax avoidance.²⁹ To the same end, they also collect non-tax personal data. For example, the Australian government cross-indexes a taxpayer’s insurance premiums against his or her income in order to analyze risks, and the Greek government has flown helicopters over personal residences in order to better assess taxpayers’ true wealth. These efforts may be effective, but they give rise to increased privacy concerns.

The increase in the collection and cross-border sharing of taxpayers’ big data raises concerns, including concerns that transferred information (1) will not be protected to the extent provided by the law of the transferring country; (2) may be misused for political purposes, such as helping domestic companies compete against foreign competitors; (3) may be misused to sanction taxpayers for political reasons, which could lead to human rights violations;³⁰ (4) may be illegally accessed or altered

28 Cynthia Blum, “Sharing Bank Deposit Information with Other Countries: Should Tax Compliance or Privacy Claims Prevail?” (2004) 6:6 *Florida Tax Review* 579-648.

29 Arthur J. Cockfield, “How Countries Should Share Tax Information” (2017) 50:5 *Vanderbilt Journal of Transnational Law* 1091-1132.

30 United Nations, General Assembly, Human Rights Council, “Report of the Special Rapporteur on Extreme Poverty and Human Rights, Magdalena Sepúlveda Carmona,” 22 May 2014, Document no. A/HRC/26/28; and International Bar Association’s Human Rights Institute Task Force, *Tax Abuses, Poverty and Human Rights: A Report of the International Bar Association’s Human Rights Institute Task Force on Illicit Financial Flows, Poverty and Human Rights*, Task Force rapporteur, Lloyd Lipsett (London, UK: IBA, October 2013).

by third parties; and (5) may be inaccurate, which could lead to foreign investigations that target innocent taxpayers.

These are serious concerns, of course. Yet the near-anonymity that the current global financial regime affords global financial transactions and investments is problematic.³¹ The main beneficiaries of this lack of transparency are large multinational corporations, ultra-high-net-worth individuals (typically defined as individuals with at least \$50 million in assets), and individuals engaged in global financial crimes such as offshore tax evasion, international money laundering, and terrorist financing. The main losers are average citizens, whose governments sustain losses in tax revenue because of aggressive international tax avoidance and offshore tax evasion. This state of affairs, in turn, encourages the view that the global financial system is rigged in favour of the wealthy and powerful (as discussed above). Situations where cross-border tax laws and financial privacy laws are used to frustrate the interests of average citizens call for a nuanced legal analysis of distributive justice concerns (as I have discussed elsewhere).³²

Confidentiality and Trade Secrets

The privacy rights of corporate taxpayers have attracted less attention from academics and policy makers than have individual taxpayer rights. This is partly because substantive privacy rights are generally associated with individuals. The nature of these privacy rights arises from the potential for intimate harm (for example, kidnapping) created by the disclosure of an individual's personal information. Such concerns are less evident in the case of corporate taxpayers.³³

Notwithstanding the relative lack of emphasis on corporate privacy rights, it is clear that taxpayer confidentiality and trade secrecy remain important and valid privacy concerns for multinational enterprises.³⁴ Under article 26(2) of the OECD model tax treaty,³⁵ tax authorities must maintain the confidentiality of tax information that they receive. Under the general approach, disclosure of such information is limited to persons or authorities involved in the assessment, collection, enforcement, prosecution, and determination of appeals. Pursuant to paragraph 19.2 of the OECD commentary on article 26, a trade or business secret is "generally understood to mean facts and circumstances that are of considerable economic importance and

31 Cockfield, *supra* note 1.

32 For such an analysis, see Cockfield, *supra* note 29.

33 Joshua D. Blank, "Reconsidering Corporate Tax Privacy" (2014) 11:1 *New York University Journal of Law and Business* 31-121, at 40.

34 Cockfield and MacArthur, *supra* note 24.

35 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Full Version 2017* (herein referred to as "the OECD model tax treaty") (Paris: OECD, 2019) (<https://doi.org/10.1787/g2g972ee-en>).

that can be exploited practically and the unauthorised use of which may lead to serious damage (e.g., may lead to severe financial hardship).³⁶

The revelation of a commercial or trade secret could harm the ability of a multinational enterprise to compete effectively in the marketplace, which could reduce national and global welfare. For example, if a firm fears the revelation of an important intellectual property right, it may be reluctant to transfer this resource via a licensing agreement with a related foreign affiliate, which could ultimately interfere with the efficient allocation of resources throughout the global economy. Importantly, none of the financial information mandated by CBCR would constitute confidential information (for example, trade secrets, business secrets, or other secrets) as defined by the OECD within the commentary to its model tax treaty.³⁷

Problems with the Existing Legal Framework

A complex patchwork of domestic laws, constitutional protections, bilateral tax treaties, and multilateral treaties governs and protects privacy and other taxpayer interests. First, governments pass domestic tax laws that prohibit unauthorized access to, or transfer of, taxpayer information.³⁸ Non-tax domestic laws, such as corporate laws, often allow the identity of the true (or beneficial) owners of business entities to remain hidden.

Second, certain countries (such as Canada and the United States) have additional constitutional protections (such as prohibitions against unreasonable government searches, which include investigations of taxpayer information). In this context, the Supreme Court of Canada has emphasized the importance of protecting individuals' personal information, repeatedly recognizing the right to privacy as a fundamental human right aimed at protecting the dignity, autonomy, integrity, and security of individuals.³⁹ In the broader context, certain provisions of the European Union (EU) Convention on Human Rights offer similar human rights protections against governments' abusive access to, use, or disclosure of tax information.⁴⁰ Such protections

36 See paragraph 19.2 of the commentary on article 26 of the OECD model tax treaty.

37 The OECD has explicitly stated that any information transferred under CBCR should ensure that there is no public disclosure of "confidential information (trade secrets, scientific secrets, etc.) and other commercially sensitive information." See Organisation for Economic Co-operation and Development, *Action 13: Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting* (Paris: OECD, February 6, 2015), at paragraph 44.

38 Jinyan Li, "Taxpayers' Rights in Canada" (1997) 7:1 *Revenue Law Journal* 89-137. Li notes that, while privacy and confidentiality rights were built into tax systems, such as the Canadian one, at inception, in the 1980s there began to be increasing recognition—and increasing legal protection—for these rights. See *ibid.*, at 89-90.

39 *R v. Dymnt*, [1988] 2 SCR 417; *R v. O'Connor*, [1995] 4 SCR 41; and *R v. Mills*, [1999] 3 SCR 668.

40 Philip Baker and Pasquale Pistone, "BEPS Action 16: The Taxpayers' Right to an Effective Legal Remedy Under European Law in Cross-Border Situations" (2016) 25:5-6 *EC Tax Review* 335-45, describing the impact of "European law," including the European Convention on

are also provided by the United Nations (UN), including in recent documents that try to inhibit the privacy harms caused by governments' mass surveillance of very particular personal data (data that do not specifically reference tax matters).⁴¹ The increased linkage between human rights and the protection of taxpayer data demonstrates the need for data protection laws and policies to protect the taxpayer as a data subject (see below).

Third, bilateral tax treaties typically provide for a series of protections for privacy and commercial confidentiality (generally based on article 26 of the OECD model tax treaty). Commercial and trade secrets are thus protected by both domestic rules and tax treaty rules. Domestic tax laws provide for the maintenance of confidentiality with respect to any non-public tax information, including commercial and trade secrets. Tax treaties generally contain a provision that lets the tax authority of one country request tax information from the tax authority of another country, mainly to assist with audits. Under the general rule in article 26(3)(c) of the OECD model tax treaty, a government can deny an information request on the basis that the request violates the taxpayer's right to maintain commercial and trade secrecy. In the FATCA context, the bilateral IGAs between the United States and other countries offer additional protections.

Fourth, multilateral agreements increasingly bind participating countries to privacy protections. For example, under the CBCR reforms (discussed above), governments must agree to provide and enforce legal protections for the confidentiality of reported information that are equivalent to the protections provided under an income tax treaty or other EOI agreement.⁴² Further, the automatic transmission of CBCR information is limited to those countries that satisfy these requirements. Regional agreements also exist, such as the EU Directive on Administrative Cooperation, which was extended in 2014 to include automatic EOI among member states.

Although the global tax framework for EOI is currently evolving, a number of observers have suggested that this regime still provides insufficient legal protections

Human Rights; Clement Endresen, "Taxation and the European Convention for the Protection of Human Rights: Substantive Issues" (2017) 45:8/9 *Intertax* 508-26, discussing how the convention does not normally apply to substantive tax issues—appropriately, given the national sovereignty concerns. But see *Sommer v. Germany*, no. 73607/13 (April 27, 2017) (ECHR), holding that the German government's search of a lawyer's financial information records violated article 8 of the Convention.

41 United Nations, General Assembly, "Universal Declaration of Human Rights," resolution 217A, December 10, 1948. In December 2013, the UN General Assembly adopted resolution 68/167, which expressed concern over the negative impact that the surveillance and interception of communications may have on human rights. While the resolution focused on mass surveillance techniques, it would also apply to the possible misuse of bulk tax information exchanged across borders. See United Nations, General Assembly, "Resolution Adopted by the General Assembly on 18 December 2013: 68/167, the Right to Privacy in the Digital Age," document no. A/RES/68/167, January 21, 2014.

42 See paragraphs 14 to 19.9 of the commentary on article 26 of OECD model tax treaty.

for taxpayer privacy and other rights.⁴³ First, elements of the current regime, such as FATCA, do not operate on a reciprocal basis; the privacy protections go only one way. Second, the existence of so many different domestic and now international agreements gives rise to “legal gaps,” which occur when particular countries have not signed onto measures to protect taxpayer interests in ways that are required by transferring countries. Third, the enforcement of EOI measures is significantly uneven, which can lead to concerns that transferred tax information will be used for improper, illegal, or abusive purposes. Fourth, many countries have financial secrecy laws that mask the true identities of owners of cross-border investments made by wealthy or criminal taxpayers, leaving less well-resourced taxpayers at the mercy of the uneven legal regime.

Summary

In the modern world, countries’ tax systems are inextricably interwoven with normative views of justice and of the appropriate relationship between citizen and state. In many countries, the government’s power to take away a portion of the fruits of one’s labours (along with unearned wealth accumulated via gifts and bequests) is attenuated by legal and constitutional protections for privacy rights, commercial confidentiality, and trade secrets. Individuals who are dealing with autocratic governments—living in countries where taxpayers’ personal information is more at risk of being improperly accessed, used, and disclosed—rely on the current global environment of fiscal opacity to protect their taxpayer rights when they transfer monies offshore. The problem with this environment is that governments worldwide, including liberal ones in which the rule of law is robust, generally know little to nothing about their residents’ foreign-based assets or income.

To inhibit revenue losses associated with offshore tax evasion and aggressive international tax avoidance, governments have initiated new EOI measures such as FATCA, CRS, and CBCR. Critics of these initiatives note that the legal framework currently emerging to protect taxpayer privacy and other rights suffers from a number of deficiencies that could be addressed through better laws and policies. I discuss such laws and policies in the next part of this paper.

43 For a comprehensive review, see Filip Debelva and Irma Mosquera, “Privacy and Confidentiality in Exchange of Information Procedures: Some Uncertainties, Many Issues, but Few Solutions” (2017) 45:5 *Intertax* 362-81, at 377, advocating a multilateral agreement for privacy and confidentiality; and Irma Mosquera et al., *The Rule of Law and the Effective Protection of Taxpayers’ Rights in Developing Countries*, WU International Taxation Research Paper series no. 2017-10 (Vienna: Vienna University of Economics and Business, 2017). See also Baker and Pistone, *supra* note 40, discussing how the rules of certain surveyed countries do not sufficiently protect the right to confidentiality and privacy; Menita Giusy De Flora, “Protection of the Taxpayer in the Information Exchange Procedure” (2017) 45:6/7 *Intertax* 447-60, at 448-50 and 458, advocating for “a clear and common set of rules”; Niels Diepvens and Filip Debelva, “The Evolution of the Exchange of Information in Direct Tax Matters: The Taxpayer’s Rights Under Pressure” (2015) 24:4 *EC Tax Review* 210-19.

OPTIMAL REFORMS

Two discrete but related elements are involved in effective cross-border exchanges of tax and financial information.⁴⁴ First, the legal regime for such exchanges needs to be efficient, in the sense that it should promote low costs for taxpayer compliance and low costs for administration by tax authorities. Second, the exchange should be fair, in the sense that any information transferred is afforded a requisite level of protection for privacy and other rights (normally equivalent to the legal protections set out in a country's domestic law). The two elements—efficiency and fairness—are related in the sense that governments will be reluctant to engage with other countries in exchanges of big tax data (or to implement existing agreements in a meaningful way) unless they have legal assurances that the rights of their taxpayers will not be violated. In the remainder of this paper, building on the views of Tim Edgar, I discuss how to achieve an appropriate balance between taxpayers' privacy concerns and tax authorities' need to access foreign-based taxpayer information.

On the Need for Coordinated Responses

When should governments cooperate for the purposes of international tax policy? Tim Edgar examined this issue in a variety of contexts. In particular, a 2003 article by Edgar titled "Corporate Income Tax Coordination as a Response to International Tax Competition and International Tax Arbitrage" focused on optimal forms of cooperation, including limited coordination among governments, as a response to vexing challenges posed by tax competition and tax arbitrage.⁴⁵ Elaborating on his seminal contribution to the taxation of financial instruments,⁴⁶ Edgar noted that competition and arbitrage pose similar problems: both challenges can be defined in terms of the identification, by taxpayers, of the perfect or near-perfect substitutability of a lower-taxed transaction for a higher-taxed transaction.

For both competition and arbitrage, according to Edgar, taxpayers seek out the most lenient tax system—the one that provides for reduced levels of taxation for a given tax base. In essence, Edgar claimed that some limited coordination among governments with respect to tax base issues could inhibit the harmful effects of

44 For a more detailed discussion, see Arthur J. Cockfield, "Protecting Taxpayer Privacy Under Enhanced Cross-Border Tax Information Exchange: Toward a Multilateral Taxpayer Bill of Rights" (2010) 42:2 *UBC Law Review* 419-71, at 428-37.

45 Edgar, *supra* note 2. I previously relied on these views in using game theory to model NAFTA. See Arthur J. Cockfield, *NAFTA Tax Law and Policy: Resolving the Clash Between Economic and Sovereignty Interests* (Toronto: University of Toronto Press, 2005), at 166-74. In the North American context, coordination versus full-blown harmonization may be the preferred route, because larger economies, such as the US one, gain a disproportionate share in pay-offs derived through cooperative behaviour. See *ibid.*, at 171-72.

46 Edgar, *supra* note 2, at 1083. Edgar's work on the taxation of financial instruments focused to a large extent on transaction substitutability. Tim Edgar, *The Income Tax Treatment of Financial Instruments: Theory and Practice*, Canadian Tax Paper no. 105 (Toronto: Canadian Tax Foundation, 2000), at 29-35.

competition.⁴⁷ That is, by agreeing to remove tax incentives associated with different tax bases, governments could cooperate in removing tax incentives for the migration of capital and (to a lesser extent) of labour.

Similarly, governments should coordinate in the exchange of tax information in order to identify how taxpayers are engaged in tax planning that involves seeking out regimes that enable the substitution of a lower-taxed transaction for a higher-taxed transaction. CBCR would appear to be a straightforward response to this challenge. For affected taxpayers, this new regime would allow tax authorities to better understand whether tax payments in foreign countries have driven aggressive international tax planning. This type of tax reporting helps tax authorities meet the challenge of information asymmetry, whereby the taxpayer knows exactly what sorts of tax payments it makes around the world whereas the tax authority generally knows only what it is told by the taxpayer. The cross-border exchange of tax information is often a starting point for the kind of tax coordination that Edgar envisions.

The situation differs with respect to criminal behaviour. In a sense, criminal tax evaders substitute a more leniently regulated country for their residence country, where they have committed a crime. A criminal who shifts monies out of his or her country for the purposes of tax evasion will be subject to the same tax burden no matter what the foreign tax base or rate may be (assuming that his or her activity is discovered and a tax liability is assessed by the residence country). Approximating tax bases will not discourage such activity (although, in theory, the harmonization of tax rates across all nations could remove some of the incentives to shift illegal income abroad); criminals launder their monies in zero-tax jurisdictions so that the seemingly legitimate monies will not be subject to tax. What is required is a system of government coordination to help ferret out the criminals.

The following discussion provides an overview of such a system, whereby governments cooperate to inhibit resident criminals from identifying countries more leniently regulated than their own and shifting their capital to them. As per Edgar, the system focuses on limiting governments' coordination to the greatest extent possible in order to promote political feasibility. However, Edgar himself might protest that the system I propose, unlike his own prescriptions, requires an unrealistic level of political cooperation.

Multilateral Taxpayer Bill of Rights

As has been discussed in detail elsewhere,⁴⁸ governments should consider adopting a broad, multilateral taxpayer bill of rights that would provide assurances to participating countries that any tax or financial information that they transfer will be

47 Edgar, *supra* note 2, at 1157-58. The form of coordination, according to Edgar, should differ for competition and arbitrage despite their conceptual similarities. See *ibid.*

48 See Cockfield, *supra* note 44; Philip Baker and Anne-Mieke Groenhagen, *The Protection of Taxpayers Rights—An International Codification*, editor, Graham Mather (London: European

accorded some minimum level of legal protection. Such a global agreement would address the concerns noted above, such as the legal gaps that result from the application of inconsistent bilateral and regional legal protections.

This global agreement could also implement data protection laws and policies in recognition of the fact that, given the current technological and political trends (set out above) and given the critical role of taxpayer liberty and privacy in the context of human rights, a taxpayer today is increasingly viewed as a data subject. Accordingly, the agreement could emphasize widely accepted fair information practices (including requirements in respect of notice, consent, access, the specification of collection purpose, and the accuracy and security of data) that would seek to proactively protect the interests of data subjects. These practices were initially developed by the OECD in 1980, and they are reflected in (1) the EU's General Data Protection Regulation, (2) the privacy laws of countries such as Canada (via the Personal Information Protection and Electronic Documents Act),⁴⁹ and (3) the administrative guidelines of nations such as the United States (via the Federal Trade Commission's data privacy guidelines).

These fair information practices are used to smooth over conflicts that arise from the interaction of different national privacy laws when personal information is transferred across borders. These practices were recently used in the 2016 EU-US Privacy Shield, which is designed to protect the privacy rights of individuals when their personal data are transferred from European companies to US ones.⁵⁰ Given the changes in technology and the enhanced EOI efforts, building fair information practices into an international agreement would mean that taxpayers—specifically, those individuals who are subjected to personal information collection techniques from businesses and other entities—would be treated in the same way as data subjects.

Withholding Tax for Non-Cooperative States

As briefly discussed above, a cross-border withholding tax on global investments could help tax authorities enforce their tax laws and protect the liberty and privacy interests of taxpayers who reside in autocratic regimes.

Policy Forum, 2001); Adrian J. Sawyer, "A Comparison of New Zealand Taxpayers' Rights with Selected Civil Law and Common Law Countries—Have New Zealand Taxpayers Been 'Short-Changed'?" (1999) 32:5 *Vanderbilt Journal of Transnational Law* 1345-1400.

49 SC 2000, c. 5, as amended.

50 Under this agreement, the United States provided the EU with binding assurances that the US government authorities' accessing of transferred personal information for national security purposes will be subject to clear limitations, safeguards, and oversight mechanisms. In addition, EU citizens are offered a mechanism by which to seek redress if their rights appear to be violated, and an annual joint review will monitor the implementation of the commitments. See European Commission, Guide to the EU-U.S. Privacy Shield 9-19 (2016). See European Commission, "European Commission Launches EU-U.S. Privacy Shield: Stronger Protection for Transatlantic Data Flows," *Press Release*, July 12, 2016 (https://europa.eu/rapid/press-release_IP-16-2461_en.htm).

A challenge to be addressed, as the new EOI initiatives gain steam, is that certain countries are either refusing to participate in the initiatives or signing onto them but not cooperating in their implementation in a meaningful way. As Avi-Yonah has discussed, as long as there is one non-participating or non-cooperating country, undisclosed investment monies can flow to this outlier.⁵¹ Avi-Yonah's proposed solution resembles the now-defunct EU Savings Directive in that it prescribes (1) the automatic exchange of information about non-resident portfolio interest payments; or (2) that if EOI does not occur, the country where the investment takes place taxes the interest and sends the bulk of the resulting tax revenues to the residence country.⁵² Accordingly, this EOI measure ensures tax payment via withholding tax or provides the government with another source of financial information to compare with the taxpayer's filings. Elsewhere, building on these views, I have outlined how tax authorities could use online technologies—an "extranet" shared by participating countries—in order to impose such a withholding tax.⁵³

As well as promoting enforcement, this measure would serve to protect taxpayers' liberty and privacy interests. Taxpayers that reside in countries with autocratic governments and weak rules of law, or that deal with such governments, may not trust these governments to protect their privacy and other rights. Such taxpayers could choose a country with a non-participating or non-cooperative government as the base for their global investments, such that their cross-border investments would be subject to the withholding tax.

Global Financial Registry

A major challenge to the EOI initiatives is that governments often cannot identify the ultimate (or beneficial) owners of cross-border investments because corporate laws provide ownership anonymity (by permitting business entities to own investments without disclosing the true owners of these entities). To address this problem, academics and governments have discussed the need for financial registries that mandate the disclosure of the beneficial owners of business entities (such as corporations) and of legal entities (such as trusts and foundations).⁵⁴

A fully searchable public financial registry, which some governments and commentators espouse, would be highly problematic because it would intrude excessively on taxpayer privacy rights and could inhibit global capital flows, reducing

51 Reuven S. Avi-Yonah, "Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State" (2000) 113:7 *Harvard Law Review* 1573-1676, at 1667-69.

52 European Union, Council Directive 2003/48/EC of 3 June 2003 on Taxation of Savings Income in the Form of Interest Payments. The EU abandoned this approach to join the Common Reporting Standard initiative.

53 Arthur J. Cockfield, "Transforming the Internet into a Taxable Forum: A Case Study in E-Commerce Taxation" (2001) 85:5 *Minnesota Law Review*, 1171-1266, at 1235-63.

54 Gabriel Zucman, "Taxing Across Borders: Tracking Personal Wealth and Corporate Profits" (2014) 28:4 *Journal of Economic Perspectives* 121-48 (<http://dx.doi.org/10.1257/jep.28.4.121>).

overall economic growth.⁵⁵ However, a global financial registry that would be accessible only by government tax authorities might be politically feasible. Such a registry would help government investigators by addressing one of the main disadvantages facing governments with respect to information—namely, their inability to identify the beneficial owners of cross-border investments. In addition, the registry would help governments determine whether their resident firms had paid tax on worldwide income.

Governments might consider the government-to-government exchange of entity and ownership information if they were provided with sufficient privacy safeguards, including a multilateral taxpayer bill of rights. Still, non-participating or non-cooperative states would presumably develop new business or legal entities that would not be covered by the new disclosure obligations. In addition, the entity and ownership information is often recorded by offshore service providers, and the governments of tax haven countries do not currently have access to this information.⁵⁶ Problematically, governments such as Canada and the United States maintain “on-shore” financial secrecy laws that mask the identities of beneficial owners (although, in the last two years, reforms to Canadian federal and provincial corporate laws have reduced shareholders’ ability to lie hidden). Further, many low-income countries lack the human and technological resources needed for the effective collection, use, and disclosure of tax information within an EOI regime.

Finally, the global registry will not cover the non-participating or non-cooperative states discussed above in connection with the withholding tax (such countries will presumably not sign on). In lieu of disclosure under a global registry, a payment made by someone living in a non-cooperative state to someone living in a participating state will be subject to the withholding tax. There would need to be a way to identify the jurisdiction of the beneficial owner of the payment, so that this country could enjoy the revenues associated with the withholding tax.

CONCLUSION

In recent years, academics have begun a more careful study of automatic cross-border EOI. EOI is being driven by technology developments (for example, the transition from analogue systems to digital systems, big data, data analytics, and AI) and by political developments (for example, tax haven data leaks and the OECD/G20 BEPS reforms). In particular, FATCA, the CRS, and CBCR all contemplate automatic cross-border exchanges of bulk tax and financial information. Under this regime, taxpayers’ rights and interests are protected by a complex patchwork of domestic law, constitutional protections, bilateral tax treaties, and, increasingly, multilateral agreements.

Despite these measures, concerns are ongoing about the EOI initiatives that involve cross-border big data flows. These concerns relate to problems such as lack of reciprocity, legal gaps, uneven enforcement, the lack of administrative resources for

55 Cockfield, *supra* note 29.

56 Cockfield, *supra* note 1.

the meaningful implementation of the initiatives, and the ongoing impact of offshore and onshore financial secrecy laws. In addition, the effective cross-border sharing of tax information will be inhibited to the extent that the exchanges are not perceived to be fair because of insufficient protections for taxpayer privacy.

A multilateral taxpayer bill of rights could set out widely accepted fair information practices and promote legal certainty as well as the effective implementation and enforcement of EOI measures. It could be accompanied by a global financial registry, accessible only by governments, that would allow tax authorities to discern the real identities of taxpayers. To further protect the liberty and privacy of taxpayers (and to account for the fact that some states will not cooperate in the regime), the proposed regime could provide for a withholding tax in lieu of EOI—an alternative that would protect the concerns of taxpayers who reside in countries with autocratic governments, or who have to deal with such governments.

FINANCES OF THE NATION

TAXING WAGES IN CANADA, 2001-2018

Ken McKenzie*

The “Finances of the Nation” feature presents annual surveys of provincial and territorial budgets and data-driven analyses of taxation and public expenditures in Canada. This series is a successor to the annual monograph titled Finances of the Nation (and, previously, The National Finances), published from 1954 to 2013 by the Canadian Tax Foundation.

The key data sets prepared for the Finances of the Nation project are available for download at <https://financesofthenation.ca>.

In this article, Ken McKenzie presents calculations of the tax burden based on average wages in Canada’s provinces and territories, using the methodology adopted by the Organisation for Economic Co-operation and Development in its Taxing Wages publication.

KEYWORDS: WAGES ■ TAXATION ■ TAX BURDEN ■ CANADA ■ OECD ■ COMPARATIVE ANALYSIS

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INTRODUCTION

What is the tax burden on an average wage earner in Canadian provinces and territories? How does that burden vary across provinces and territories? How does it vary by family type? How does it compare with the tax burden in other countries? The purpose of this article is to present calculations of various tax burden metrics that address these questions.

Every year the Organisation for Economic Co-operation and Development (OECD) releases a publication called *Taxing Wages*.¹ The data presented in this publication provide information on the income tax paid by workers on their wages, the social security contributions paid by both employees and employers, and some of the family benefits paid out as cash transfers in each country. The publication reports

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1 Organisation for Economic Co-operation and Development, *Taxing Wages 2019* (Paris: OECD, 2019) (https://doi.org/10.1787/tax_wages-2019-en).

various marginal and average effective tax burden metrics for different household types, such one- and two-earner families at different income levels, and with and without children.

The *Taxing Wages* publication is a widely used data source that enables a comparison of the effective tax burdens on wages across countries. Both central and subnational taxes and benefit programs are included in the effective tax burden calculations; however, the calculations are based on a “representative” subnational jurisdiction for each country. This is typically the largest subnational jurisdiction; in Canada, this is Ontario. While this is a reasonable approach when dealing with 36 OECD countries, it can be misleading when taxes and average earnings vary across subnational jurisdictions, as is the case for Canadian provinces and territories.

In this article, I present comparable calculations using the *Taxing Wages* methodology for each of Canada’s 13 provinces/territories. Calculations are presented for the years 2001–2018. This enables a comparison of the effective tax burden on wages across all provinces/territories, in relation to each other and also to other countries.²

As discussed in more detail below, the approach followed in this article differs in an important way from an alternative approach to comparing tax burdens across jurisdictions. Under the alternative approach, the tax burden is determined for the same income levels in each jurisdiction, and differences in tax burdens arise solely because of differences in the underlying tax/benefit system. That is not the approach taken here. Rather, I follow the OECD methodology and calculate various tax burden metrics based on the average earnings from wages in each province/territory, which differ across jurisdictions. Thus, the tax burden metrics can vary across provinces/territories not only because of differences in the underlying tax/benefit systems, but also because of differences in average earnings.

The results are interesting and in some cases differ significantly from the approach of using the same income levels in all provinces/territories for comparison purposes. For example, the tax burden on an average taxpayer is higher in Alberta than in British Columbia, Saskatchewan, and Ontario, in large part because average wages are higher in Alberta. Also, from an international perspective, Canadian provinces/territories emerge as being relatively low-tax jurisdictions, especially for married couples with children.

METHODOLOGY

As indicated above, an important feature of the OECD’s approach to measuring effective tax burdens is the reference income levels used to calculate the effective tax burden in each jurisdiction. Notably, the OECD uses the average earner in each

2 As indicated in the headnote at the beginning of this article, the analysis presented here is part of a broader data-driven project. The intention is to periodically update and maintain the “Taxing Wages in Canada” data set over time. This article presents only some of the effective tax burden calculations, for illustrative purposes; a more extensive set of data can be found at <https://financesofthenation.ca>.

jurisdiction as the base case.³ As a result, tax burdens may differ across jurisdictions not only because of differences in tax and benefit rates, but also because of differences in average earnings. Thus, one jurisdiction (A) may have a lower tax burden than another jurisdiction (B) for the same income levels, but the effective tax burden in A could be higher than the tax burden in B because average earnings in A are higher. The idea behind the OECD's approach is therefore to calculate the effective tax burden for the base case of the average wage earner in each jurisdiction, which will differ across jurisdictions, and then to modify the base case for other income and family circumstances.

As noted above, this approach to calculating tax burdens differs from what is perhaps a more common approach, which computes tax burdens across provinces/territories for the same levels of income. The two approaches address different questions. The standard approach focuses exclusively on the underlying structure of the tax/benefit system and ignores local labour market conditions, which manifest themselves in higher or lower wages and/or the cost of living. The approach taken here is to compare tax burdens across average wage earners, taking local labour market conditions into account. The two approaches thus address different questions. They can be thought of as reflecting different views on the extent to which higher wages are capitalized into higher costs and prices, and the mobility of labour across provinces/territories.

The OECD's *Taxing Wages* data set presents average and marginal effective tax burden metrics for the following eight household types:

1. single individual earning 100 percent of average provincial earnings;
2. single individual earning 67 percent of the average provincial earnings;
3. single individual earning 167 percent of average provincial earnings;
4. single individual earning 67 percent of average provincial earnings, two children;⁴
5. married couple, principal earner earning 100 percent of average provincial earnings, no spouse earnings, no children;
6. married couple, principal earner earning 100 percent of average provincial earnings, spouse earning 33 percent of average earnings, two children;
7. married couple, principal earner earning 100 percent of average provincial earnings, spouse earning 67 percent of average earnings, two children;

3 Consistent with the OECD's approach, I calculate average provincial earnings as average weekly hours $\times$ average hourly wages $\times$ 52, for sectors B-N in the United Nations, *International Standard Industrial Classification of All Economic Activities: Revision 4* (New York: United Nations, Department of Economic and Social Affairs, Statistical Division, 2008). Average hourly wages are from Statistics Canada table 14-10-0063-01, "Employee Wages by Industry, Monthly, Unadjusted for Seasonality." Average weekly hours are from Statistics Canada table 14-10-0034-01, "Usual Hours Worked by Industry, Monthly, Unadjusted for Seasonality."

4 In the scenarios with two children, both children are assumed to be under six years of age.

8. married couple, principal earner earning 100 percent of average provincial earnings, spouse earning 33 percent of average earnings, no children.

Taxing Wages calculates several average and marginal effective tax burden metrics. All of the average effective tax burden metrics are expressed relative to gross earnings, which consist of personal earnings from wages plus employer social security contributions, which in Canada consist of employer-paid Canada Pension Plan/Quebec Pension Plan (CPP/QPP) contributions and employment insurance (EI) premiums.⁵ Cash benefits include programs such as the Canada workers benefit (CWB) and the Canada child benefit (CCB), and their provincial counterparts.

There are five average tax burden metrics:

1. Average total tax wedge (ATTW): Personal income tax (PIT) + Employee and employer CPP/QPP and EI premiums – Cash benefits
2. Average personal tax rate (APTR): PIT + Employee CPP/QPP and EI premiums
3. Average net personal tax rate (ANPTR): PIT + Employee CPP/QPP and EI premiums – Cash benefits
4. Average personal income tax rate (APITR): PIT
5. Average employee social security rate (ASSR): Employee CPP/QPP and EI premiums

There are two marginal effective tax burden metrics, which calculate the incremental tax arising from a small increase in the earnings of the principal earner:

1. Marginal total tax wedge (MTTW), which uses the taxes and benefits in the ATTW measure
2. Marginal net personal tax rate (MNPTR), which uses the taxes and benefits in the ANPTR measure

The tax burdens are calculated using the Canadian Tax and Credit Simulator (CTaCs), developed by Milligan.⁶ Seven tax burden metrics applied to eight family types for 13 provinces/territories gives rise to 728 tax burden metrics for each year from 2001 to 2018. This data set is clearly too large to include in this feature. In the

5 There is an issue as to whether CPP/QPP contributions should be included in tax burden measures, either as a tax or as part of gross earnings. This comes down to the question of whether such contributions are a tax or a benefit analogous to private insurance. I follow the OECD's approach so as to maintain comparability with its calculations. Of course, my inclusion of CPP/QPP contributions does not affect interprovincial comparisons, since these contributions are the same across provinces, but it does affect the overall level of the tax burdens reported.

6 Kevin Milligan, "Canadian Tax and Credit Simulator: CTaCS," version 2019-1 (<http://faculty.arts.ubc.ca/kmilligan/ctacs/>). Any errors are mine alone.

next section, I present and discuss some selected results. The entire data set can be accessed at the Finances of the Nation data portal.⁷

SELECTED RESULTS

I focus on the average total tax wedge (ATTW) and its marginal counterpart, the marginal total tax wedge (MTTW), because they are the broadest measures of the tax burden and include cash benefits. I emphasize again that differences in the effective tax burden can occur because of differences in tax/benefit rates across provinces and territories, and differences in average earnings, and that both metrics include both employee and employer contributions to CPP/QPP and EI.

Figure 1 presents the ATTW for a single earner for various levels of income in 2018 by province/territory. Immediately evident is the fact that for a single individual with two children earning 67 percent of average earnings (the 67-2 scenario), the ATTW is negative, and substantially so in some provinces/territories. This is because the cash benefits, in particular the CWB and the CCB, exceed total income and social security taxes paid in this case. The ATTW for this scenario is lowest in Quebec, at almost -40 percent, and highest in the Northwest Territories, at -9 percent. For single lower income earners with no children (ATTW 67), British Columbia has the lowest ATTW, at 21 percent, while Manitoba has the highest, at 25 percent. For average earners (ATTW 100), Nunavut has the lowest ATTW, at 24 percent, followed by the Northwest Territories at 26 percent, and British Columbia and Newfoundland and Labrador at 27 percent; Quebec has the highest rate, at 31 percent. For high earners (ATTW 167), the lowest rate is in Nunavut and in Newfoundland and Labrador, at 27 percent, with Quebec again having the highest rate, at 34 percent. As indicated above, these results differ from what we might expect using the same income levels across provinces and territories. Calculations based on this approach typically find that Alberta has a low tax burden on wages for lower- and higher-income individuals.⁸ As discussed above, because average earnings are higher in Alberta than in other provinces, the tax burden on the average Albertan is higher owing to the progressivity of the tax system.

Figure 2 presents the ATTW for various married couple scenarios. In all cases, there are two children and the principal earner earns the provincial/territorial average wage. Three scenarios are presented for spousal earnings: zero earnings (ATTW 0), 33 percent of average earnings (ATTW 33), and 67 percent of average earnings (ATTW 67). Again, the importance of the CCB is evident: we observe very low (close to zero and in some cases slightly negative) ATTWs in the zero spousal earnings scenario in many provinces. Again, the higher rates for this scenario in Alberta, and also in the territories, reflect higher average earnings. For a married

7 See *supra* note 2.

8 See, for example, Kenneth McKenzie, "Altering the Tax Mix in Alberta" (2019) 12:25 *SPP Research Papers* [University of Calgary, School of Public Policy] 1-40.

FIGURE 1 Average Total Tax Wedge (ATTW), Single Individual, Various Earnings, 2018

ATTW 67-2 = single, two children, 67 percent of average earnings; ATTW 67 = single (no children), 67 percent of average earnings; ATTW 100 = single, average earnings; ATTW 167 = single, 167 percent of average earnings.

FIGURE 2 Average Total Tax Wedge (ATTW), Married Couple with Two Children, Principal Earner with Average Earnings, Various Spousal Earnings, 2018

ATTW 0 = spouse with no earnings; ATTW 33 = spouse with 33 percent of average earnings; ATTW 67 = spouse with 67 percent of average earnings.

couple with two children and a spouse earning 67 percent of the average wage, British Columbia and Ontario have the lowest ATTW, at 16 percent, while the highest rates are in Alberta and the Northwest Territories, at 21 percent and 22 percent respectively.

Figures 3 and 4 present the MTTW for, respectively, the single and the married couple scenarios. The marginal burdens measure the increase in taxes paid associated with a \$100 increase in the income of the principal earner, divided by \$100. Looking at figure 3 for single taxpayers, perhaps most striking is the fact that the MTTW is much higher for lower income earners (67 percent of the average) with children than for average and higher income earners. The rate for a single lower income earner with two children (MTTW 67-2) ranges from a low of 42 percent in Prince Edward Island to a high of 81 percent in British Columbia. It is important to emphasize again that reference average earnings in each province vary and that the MTTW includes employee and employer CPP/QPP and EI contributions. In this connection, lower income earners will pay CPP/QPP and EI premiums on incremental earnings because they are below the upper thresholds for these payments, unlike higher income earners, who are above the thresholds. Finally, and importantly, the calculations also reflect the clawback of the CWB and CCB. All of this combines to generate an MTTW that is very high for low income earners. For single average earners with no children (MTTW 67), the rate ranges from a low of 28 percent in Nunavut, followed by 30 percent in the Yukon and 31 percent in Alberta and in Newfoundland and Labrador, to a high of 54 percent in Quebec. For higher income earners (MTTW 167), the rate ranges from a low of 26 percent in Newfoundland and Labrador to a high of 38 percent in Manitoba and the Northwest Territories. Figure 4 for married couples shows similar patterns, with quite high MTTWs for married couples with a single average earner, again reflecting the CWB and CCB clawbacks.

The emphasis so far has been on comparing tax burdens across provinces and territories in 2018. Also of interest is the evolution of the tax burden over time. Figure 5 presents the ATTW for the provinces and territories for an average single individual with no children for 2001 through 2018. The calculations for the other income levels and family types (and other effective tax burden metrics) are available at the data portal.

Finally, because I follow the *Taxing Wages* methodology, it is interesting to consider the tax burden on wages in Canada in comparison with that of other OECD countries. As indicated above, the approach in the OECD publication is to use a representative subnational jurisdiction (Ontario in the case of Canada).⁹ Figure 6 shows the ATTW for Canadian provinces and territories and selected OECD countries for single and married average earners (the latter assuming two children and a

9 My effective tax burden calculations for Ontario are lower than the reported OECD calculations. I have not been able to ascertain precisely why this is the case; however, I suspect it is because the OECD seems to overstate the tax burden owing to the employer share of social security contributions.

FIGURE 3 Marginal Total Tax Wedge (MTTW), Single Individual, Various Earnings, 2018

MTTW 67-2 = single, two children, 67 percent of average earnings; MTTW 67 = single (no children), 67 percent of average earnings; MTTW 100 = single, average earnings; MTTW 167 = single, 167 percent of average earnings.

FIGURE 4 Marginal Total Tax Wedge (MTTW), Married Couple with Two Children, Principal Earner with Average Earnings, Various Spousal Earnings, 2018

MTTW 0 = spouse with no earnings; MTTW 33 = spouse with 33 percent of average earnings; MTTW 67 = spouse with 67 percent of average earnings.

FIGURE 5a Average Total Tax Wedge, Single Individual with Average Earnings, Atlantic Provinces, 2001-2018

FIGURE 5b Average Total Tax Wedge, Single Individual with Average Earnings, Central Provinces, 2001-2018

**FIGURE 5c Average Total Tax Wedge, Single Individual with Average Earnings,
Western Provinces, 2001-2018**

**FIGURE 5d Average Total Tax Wedge, Single Individual with Average Earnings,
Territories, 2001-2018**

FIGURE 6a Average Total Tax Wedge (ATTW), Single Individual with Average Earnings, Canadian Provinces and Territories and Selected OECD Countries, 2018

FIGURE 6b Average Total Tax Wedge (ATTW), Married Couple with Two Children, Principal Earner with Average Earnings, Spouse with 33 Percent of Average Earnings, Canadian Provinces and Territories and Selected OECD Countries, 2018

spouse earning 33 percent of average earnings). It is notable that the ATTW in Canada as a whole, and in some provinces in particular, is quite low relative to the selected OECD countries included in the figure, most particularly for married couples with children.

CONCLUDING COMMENTS

In this article, I have presented tax burden calculations using the OECD's *Taxing Wages* methodology for all Canadian provinces and territories. Calculations are presented for the years 2001-2018. The tax burden metrics are based on average wage earnings in each province/territory, which may differ across these jurisdictions; differences in the tax burden thus reflect both differences in the underlying tax/benefit system and differences in average earnings. The Finances of the Nation feature will update these calculations in future issues of this journal, and also will present alternative tax burden metrics.

INTERNATIONAL TAX PLANNING

Co-Editors: Ken Bottenham and Ian Bradley*

THE FOREIGN AFFILIATE SURPLUS RECLASSIFICATION RULE

*Gwendolyn Watson***

Bill C-48, the Technical Tax Amendments Act, 2012, introduced, among other things, several significant changes to the foreign affiliate surplus rules, including the adoption of the surplus reclassification rule in regulation 5907(2.02). The surplus reclassification rule is a broadly worded specific anti-avoidance rule that can apply to reclassify a foreign affiliate's exempt earnings (and exempt surplus) into taxable earnings (and taxable surplus) when the exempt earnings arise from certain tax-motivated dispositions of property. On the basis of a textual, contextual, and purposive interpretation of this provision, the author maintains that the rule should apply only in circumstances involving foreign affiliate surplus stripping—that is, tax-free transactions designed to convert low-taxed taxable surplus into exempt surplus that can be distributed or otherwise relied on to achieve Canadian tax savings.

KEYWORDS: FOREIGN AFFILIATES ■ SURPLUS ■ SURPLUS STRIPPING ■ ANTI-AVOIDANCE ■ PURPOSE

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PERSONAL TAX PLANNING

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GETTING A GRIP ON NEW PASSIVE INVESTMENT RULES AND INTEGRATION

*Dino Infanti, Deepk Jaswal, and Sonam Toor******

This article discusses integration in the Canadian tax system and describes how legislation originating from changes announced in the 2018 federal budget affects Canadian-controlled private corporations. The authors point out that refundable dividend tax on hand is now split into two pools, one for eligible refundable dividend tax on hand and one for non-eligible refundable dividend tax on hand. As well, the authors discuss two recent changes to the small business deduction rules: (1) the reduction of the small business deduction where passive investment income exceeds a specified limit and (2) the expanded application of the rules for sharing the small business limit among corporations within a corporate group.

KEYWORDS: INTEGRATION ■ REFUNDABLE DIVIDEND TAX ON HAND ■ PASSIVE INVESTMENT INCOME ■ CANADIAN-CONTROLLED PRIVATE CORPORATIONS ■ CCPC ■ SMALL BUSINESS DEDUCTION

CORRIGENDUM

There is a correction to the article by Dino Infanti, Deepk Jaswal, and Sonam Toor, “Getting a Grip on New Passive Investment Rules and Integration,” *Personal Tax Planning* feature (2019) 67:4 *Canadian Tax Journal* 1267-85. On page 1276, the second paragraph should read as follows:

In general, the NERDTH pool consists of the total of

- the least of:
 - 30.67 percent of a CCPC’s aggregate investment income²⁰ (AII) minus the amount of the foreign tax deduction if this exceeds the 8 percent of foreign investment income;

(Continued on the next page.)

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- 30.67 percent of the total taxable income that exceeds the SBD limit, foreign tax deduction, and foreign tax credits deducted by the relevant factor for the year; and
- the corporation's tax for the year payable under part I;
- the total taxes payable under part IV by the corporation for the year less the amount determined for the ERDTH balance; and
- the NERDTH balance from the preceding year

that exceeds the portion of the corporation's dividend refund from its NERDTH determined for its preceding taxation year.

PLANIFICATION FISCALE PERSONNELLE

Co-rédacteurs de chronique : Brian J. Anderson*, Sonia Gandhi**,
Dino Infanti*** et Jim MacGowan****

POUR MIEUX SAISIR LES NOUVELLES RÈGLES SUR LES PLACEMENTS PASSIFS ET L'INTÉGRATION

*Dino Infanti, Deepk Jaswal et Sonam Toor******

Cet article traite de l'intégration dans le régime fiscal canadien et décrit l'effet de la législation découlant des modifications annoncées dans le budget fédéral de 2018 sur les sociétés privées sous contrôle canadien. Les auteurs soulignent que l'impôt en main remboursable au titre de dividendes est maintenant divisé en deux catégories, une pour l'impôt en main remboursable au titre de dividendes déterminés et une pour l'impôt en main remboursable au titre de dividendes non déterminés. De plus, les auteurs discutent de deux changements récents apportés aux règles relatives à la déduction accordée aux petites entreprises : 1) la réduction de la déduction accordée aux petites entreprises lorsque le revenu de placements passifs dépasse un plafond déterminé, et 2) l'application élargie des règles sur le partage du plafond des affaires entre les sociétés membres d'un groupe.

MOTS CLÉS : INTÉGRATION ■ IMPÔT EN MAIN REMBOURSABLE AU TITRE DE DIVIDENDES ■ REVENU DE PLACEMENTS PASSIFS ■ SOCIÉTÉ PRIVÉE SOUS CONTRÔLE CANADIEN ■ SPCC ■ DÉDUCTION ACCORDÉE AUX PETITES ENTREPRISES

CORRIGENDUM

Une correction est apportée à l'article rédigé par Dino Infanti, Deepk Jaswal et Sonam Toor, « Pour mieux saisir les nouvelles règles sur les placements passifs et l'intégration », article dans la chronique Planification fiscale personnelle (2019) 67:4 *Revue fiscale canadienne* 1287-1307, aux pages 1297 et 1298. Le second paragraphe devrait se lire comme suit :

(Continué à la page suivante.)

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En général, le compte d'IMRTDND est composé du total des éléments suivants :

- le moindre de :
 - 30,67 pour cent du revenu de placement total d'une SPCC (RPT) moins le montant de la déduction pour impôt étranger si ce montant excède 8 pour cent du revenu de placement étranger;
 - l'excédent de 30,67 pour cent du revenu imposable total sur le plafond de la DAPE, la déduction pour impôt étranger, et les crédits pour impôt étranger déduits du facteur de référence pour l'année;
 - l'impôt payable en vertu de la partie I pour l'année de la société;
- l'excédent du total des impôts à payer par la société en vertu de la partie IV pour l'année sur le montant déterminé pour le solde d'IMRTDD; et
- l'excédent du solde d'IMRTDD de l'année précédente

sur la partie du remboursement au titre de dividendes de la société provenant de l'IMRTDND établi pour son année d'imposition précédente.

SELECTED US TAX DEVELOPMENTS

Co-Editors: Peter A. Glicklich* and Michael J. Miller**

GUIDANCE ON QUALIFIED SHAREHOLDERS OF REITS STILL LACKING

*Peter A. Glicklich and Heath Martin**

The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) imposes tax and withholding requirements with respect to gain realized by a foreign person on the disposition of an interest in real property located in the United States. The Protecting Americans from Tax Hikes Act of 2015 created two new exemptions from FIRPTA, one for foreign pension funds and another for “qualified shareholders,” which are essentially foreign publicly traded real estate investment trusts (REITs). In order to qualify for the exemption for qualified shareholders, a foreign REIT would likely need to be designated by the Internal Revenue Service as a “qualified collective investment vehicle,” but no guidance has been provided on how a foreign REIT may obtain such designation. In the absence of such guidance, the exemption for qualified shareholders is effectively unavailable, and as time passes, taxpayers are losing their ability to take advantage of the exemption in current- or prior-year tax returns. The authors suggest that a foreign publicly traded REIT be allowed to “self-designate” as a qualified collective investment vehicle if it meets certain requirements.

KEYWORDS: REIT ■ EXEMPTIONS ■ FIRPTA ■ REAL ESTATE ■ PUBLIC COMPANIES ■ INTERNATIONAL TAXATION

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CURRENT TAX READING

Co-Editors: Robin Boadway, Kim Brooks, Jinyan Li, and
Alan Macnaughton*

Bev Dahlby, “Reforming the Federal Fiscal Stabilization Program” (2019)

12:18 *SPP Briefing Papers* [University of Calgary School of Public Policy]

1-20 (<https://doi.org/10.11575/sppp.v12i0.68076>)

The federal-provincial fiscal transfer system both redistributes from high- to low-fiscal-capacity provinces and insures provinces against unexpected fiscal shocks. Fiscal redistribution in Canada is accomplished by (1) the equalization system, which is based on provinces’ revenue-raising capacities; and (2) federal health transfers and social transfers, which are given on an equal per capita basis. Insurance against fiscal shocks, which is the focus of Dahlby’s study, is provided by the equalization system and by the federal stabilization program (FSP). However, such insurance works better for some provinces than for others. Only those provinces that receive equalization can rely on it to cushion shocks to their revenue-raising capacity. The FSP augments equalization for provinces that suffer declines in their own-source revenues, but it does so only up to a cap of \$60 per capita. Moreover, reductions in natural resource revenues trigger much less in FSP transfers than do reductions in non-resource revenues.

Owing to a combination of these factors, Alberta gets virtually no fiscal insurance despite the fact that its revenues are very volatile relative to other provinces’. Equalization is of no insurance value to Alberta, since it is not an equalization recipient. In addition, as Dahlby points out, the FSP is of limited value to this province because (1) most of its volatility is caused by fluctuations in resource revenue, (2) the cap of \$60 per capita precludes sizable insurance payouts when provincial revenues fall, and (3) FSP payments are based on single-year revenue reductions, so those sustained over several years are not covered.

Dahlby proposes reforming the FSP so that it is based on standard insurance properties. A reformed program would be based on three core principles. First, only large unanticipated losses should be covered. Second, to preserve incentives to avoid losses, the program should cover only losses that are in excess of a deductible, and co-insurance should apply in such a way that only a proportion of eligible claims

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are covered. Third, the reformed FSP should be based on simple contracts with streamlined claims-adjustment processes.

Dahlby's proposed FSP program would take the following form. Entitlements for FSP payments would be based on shortfalls of all current-year own-source revenues, as opposed to an average of own-source revenues in the previous five years, reduced by a deductible. The fiscal stabilization would be some proportion of the shortfall, referred to as the "coverage rate." There would be no distinction between resource and non-resource revenues, and there would be no cap. The formula would include actual own-source revenues, not potential revenues as in the equalization program. Three alternative programs are considered: program A, with a deductible of 5 percent and coverage of 50 percent; program B, with a deductible of 5 percent and coverage of 75 percent; and program C, with a deductible of 3 percent and coverage of 66 percent. FSP payments would be received in the event of revenue shortfalls, but revenues in excess of previous years would not be taxed back, and there would be no analogue of an insurance premium.

Dahlby illustrates his proposal by calculating what the annual FSP payouts would have been between 1986-87 and 2017-18 for Alberta, Saskatchewan, and Newfoundland and Labrador, and then comparing these payouts with what payouts would be from the existing system if the cap were not enforced. For Alberta, programs B and C would provide significantly more than would the current formula without a cap, and program A would provide roughly the same. For Saskatchewan, only program C would provide more than the current formula. For Newfoundland and Labrador, all three programs would provide a much larger payout than the current system does. Thus, while the existence of the cap is a significant problem with the current FSP, it is not the only problem. The discriminatory treatment of natural resource revenues is also a significant problem.

R.B.

Richard Eccleston and Ainsley Elbra, eds., *Business, Civil Society and the "New" Politics of Corporate Tax Justice: Paying a Fair Share?*

(Northampton, MA: Edward Elgar, 2018), 318 pages

(<https://doi.org/10.4337/9781788114974>)

What constitutes paying a fair share of taxes and how to assess whether that share has, in fact, been paid are perennial concerns in tax policy. The growing interest of civil society groups in the tax collected from multinationals around the world is, perhaps, the old concern with a new flavour.

This collection features work by various authors on the topic of citizen engagement and the role of civil society in the contribution that corporations should make to the fisc. The chief claim of the book is that much of the emerging pressure on multinational corporations to pay their "fair share" is driven not (as one might expect) by governments but, rather, by tax justice activists and non-governmental organizations (NGOs) that have inspired the public to speak out about what they expect from multinationals. The authors' way of framing that claim connects it with the

literature on tax governance; they note that this book (1) contributes to debates about the effectiveness and legitimacy of private governance (that is, of a system in which private firms respond to marketplace pressures instead of to government legislation); (2) evaluates the effectiveness of civil-society groups in promoting international tax reform; and (3) assesses the likelihood that governments will be able to compel corporations to pay their fair share.

The authors hail from Australia, the United States, the United Kingdom, and Canada (Allison Christians and Lynn Latulippe). The collection is divided into three parts and comprises 12 chapters, each of which should be relatively accessible to a non-technical audience. The first part (chapters 1 through 3) sets out the context for the problem. The authors begin with the early tax campaigns and end with the Organisation for Economic Co-operation and Development's (OECD's) base erosion and profit shifting (BEPS) project. The responses of civil-society groups are described within that historical context.

The next part (chapters 4 through 7) explores the role of particular actors. To that end, the authors join forces with a growing body of scholarship that is interested in the effects that a particular individual or group might have on global tax reform projects. The authors look at the role of, among other sources of influence, the Tax Justice Network, the media, tax professionals, and the responses of corporations.

Finally, in the third part, the collection offers five chapters (8 through 12) that put the previous discussions in a theoretical context. These chapters consider what we can learn by using concrete case studies (for example, those provided by the Extractive Industries Transparency Initiative, the Fair Tax Mark, the Forestry Stewardship Council, and investigative journalism) of the consequences of emerging modes of tax governance.

Richard Eccleston and Ainsley Elbra's thoughtful conclusion closes the volume. They attempt an assessment of whether the various civil-society initiatives have had a notable effect on the behaviour of firms (the short answer is sometimes yes, sometimes no), and they speculate about whether other mechanisms might be more effective. Ultimately, they conclude that action by civil society alone is unlikely to result in transformative change; for that, political leadership will also be necessary.

K.B.

Mattia Anesa, Nicole Gillespie, A. Paul Spee, and Kerrie Sadiq,
"The Legitimation of Corporate Tax Minimization" (May 2019)

75 *Accounting, Organizations and Society* 17-39
 (<https://doi.org/10.1016/j.aos.2018.10.004>)

Pierre Bourdieu probably did not imagine that his work would be used to inform a methodological framework for the analysis of how corporate tax-minimization strategies are legitimated, and yet that is precisely the authors' aim in this article. Bourdieu's work has inspired a generation of sociologists keen to understand the way in which power and social capital are transferred and maintained.

The central question in this article is how the practice of tax minimization is maintained in the face of threats to its legitimacy. The authors' work was carried out between September 2014 (when the Australian chapter of the Tax Justice Network, together with the trade union United Voice, released a report offering a list of effective tax rates paid by Australia's largest 200 public companies) and the time, near the end of November 2017, when the Senate inquiry into corporate tax avoidance was due to report.

The authors' research included an inductive mapping of the tax field. They reviewed a range of documents (including news materials on corporate tax minimization) as well as conducting 77 interviews in which the dynamics within the tax field were discussed. Through this mapping process, the authors identified 19 actors with influence over tax-minimization strategies: "government, politicians, the ATO [Australian Tax Office], the judiciary, treasury, corporates, business associations, accountants, professional bodies, shareholders, the OECD, advocacy groups, unions, investment banks, academics, think-tanks, media, customers and citizens."¹ The authors regrouped these actors into eight main categories according to their similarities with regards to habitus (to oversimplify, their dispositions) and capitals (economic, symbolic, cultural, and social).

Ultimately, the analysis suggests that actors in certain clusters—the "corporates," advisers, investors, or governance actors—were highly influential; the media and intellectuals less so; and the civil society and public actors even less so. These findings may be unsurprising. More surprising, perhaps, is the authors' discovery that all of the actors outside the "influential/power circle," despite their openly critical stance regarding corporate tax minimization, actually contributed to maintaining—and even reinforcing—the legitimacy of current tax-minimization strategies. This occurred because these critiques from outside the power circle adopted the language and mindset of those that they criticized, and, in doing so, failed to provide a plausible alternative to current tax-minimization practices. The authors also found that actors in the field of corporate tax minimization were likely to discount their agency in that field, despite their influential role in maintaining the status quo.

This article is fascinating, although it will undoubtedly prove dense reading for those without some prior exposure to Bourdieu.

K.B.

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)

The Tax Cut and Jobs Act (TCJA), enacted in the United States in 2018, presents significant challenges to Canada. The combination of major corporate tax cuts, a

1 At 22.

reform of depreciation and interest deductions, and a movement away from a worldwide tax system makes investment in—and profit shifting to—the United States more attractive. The immediate response of the Canadian federal government was to make the capital cost allowance (CCA) significantly more attractive for all depreciable assets. No doubt this is not the end of the matter. Many of the TCJA reforms were temporary, and, depending on how they evolve in the future, there could be more fundamental Canadian responses in the offing. In this commentary, McKenzie and Smart evaluate the consequences of the TCJA for investment and tax revenues in Canada, and they argue convincingly that now is a good time to think about more fundamental reforms to the corporate tax system. The two reforms that they consider are a reduction of the corporate tax rate and a reform of the tax base to make it less distorting, or more neutral.

McKenzie and Smart begin by outlining the four main features of the TCJA: a reduction of the federal statutory corporate tax rate from 35 percent to 21 percent; a replacement of the gradual depreciation of equipment by immediate expensing; a limitation of interest deductions to 30 percent of adjusted taxable income; and a movement from a worldwide system of taxation toward a territorial system. The latter involves exempting the repatriated earnings of US multinationals from domestic taxation while introducing a global intangible low-taxed income (GILTI) tax on foreign-source income, with a partial credit for foreign taxes. The authors judge that these changes are likely to increase investment and productivity in the United States in the long run. However, although the TCJA moves toward a neutral rent tax system, it does so very imperfectly. Investment expensing is permitted only on equipment, not on other investments, and interest deductions remain for some firms and not for others. Moreover, the expensing provisions are for a limited period of time. Nonetheless, the changes will erode Canada's tax competitiveness.

McKenzie and Smart proceed to assess in more detail the likely impact of the TCJA on tax revenues and investments in Canada. They first observe that since 2000, the Canadian corporate tax rate has fallen sizeably, but tax revenues have been roughly constant. Their explanation for this is that the corporate tax base has increased sufficiently to offset the effect of lower tax rates on tax revenues. The authors argue that much of the increase in the tax base can be attributed to profit shifting from higher-tax jurisdictions—particularly the United States—to Canada. The fall in the US tax rate resulting from the TCJA will have the opposite effect, according to the authors. Citing empirical evidence on the semi-elasticity of taxable income with respect to the corporate tax rate, they calculate that the TCJA will result in losses of up to \$2.4 billion in Canadian corporate tax revenues.

McKenzie and Smart turn next to the effect that the TCJA might have on real investment decisions, and they use two measures of effective tax rates as indicators. The marginal effective tax rate (METR) measures the taxes incurred by marginal investments of different kinds, and it indicates the size of the incentives that the tax system gives for the level of investment. The average effective tax rate (AETR) measures the total taxes as a proportion of investment income for representative investments. It measures the incentives for firms to undertake discrete investments in

one jurisdiction rather than another. For each of these effective tax rates, McKenzie and Smart compare values for Canada with those for the United States pre- and post-TCJA. Before TCJA, the average METR was 20 percent in Canada as compared with 33 percent in the United States. Since the TCJA's enactment, the average US METR has fallen to 17 percent for firms that are able to take full advantage of (1) the expensing of equipment investment and (2) the interest deductions. Much of the TCJA's effect on US METRs is owing to the expensing of equipment investment rather than to changes in the corporate tax rate or interest deductions.

Similar patterns are evident for the AETR. Before the TCJA, the average Canadian AETR was about 22 percent, and the US AETR was about 35 percent. Since the TCJA, the US AETR has fallen to roughly the same level as Canada's. Most of the change is owing to the reduction in the US corporate tax rate.

Despite these stark changes in relative METR and AETR rates in Canada and the United States, McKenzie and Smart argue that the effect of the TCJA will mostly be higher investment in the United States, with relatively little change in Canadian investment, because rates of return that determine Canadian investment are largely determined on the basis of international capital markets rather than by US rates of return. The GILTI tax may provide an exception to this effect, making it less attractive for US multinationals to invest in Canada. The authors argue that the quantitative effect of the GILTI tax is difficult to determine.

The remainder of the paper deals with Canada's response. McKenzie and Smart calculate METRs and AETRs for three alternative reforms. One reform is the Accelerated Investment Incentive (AII), announced in Canada's 2018 fall economic statement and applicable to all new investments. This reform eliminates the half-year rule in the year in which an asset is purchased and increases the CCA deduction in the first year by a factor of 1.5. The second alternative would be a 10 percentage point reduction in the federal corporate tax rate, which would reduce the average federal-provincial rate from 27 percent to 17 percent. The third alternative would be to change the corporate tax base to a cash flow tax by eliminating interest deductions and allowing the immediate expensing of all investments. These three reforms are compared with the existing corporate tax system and with the TCJA reforms enacted in the United States.

The average METR declines more under all three reforms than it does under both the existing Canadian system and the TCJA system in the United States. The decline is by far the largest under the cash flow tax, whose average METR is close to zero. This is not surprising, given that the cash flow tax eliminates almost all investment distortions. The METR declines less under the corporate tax rate cut, and much less under the AII. These results suggest that investment would be encouraged most by a move to the cash flow tax, and least by the AII. McKenzie and Smart are quick to point out that these reforms are not revenue-neutral. All are likely to reduce corporate tax revenues.

The pattern of changes in average AETRs is much different. AETRs fall significantly under the corporate tax rate cut, but they change very little under either the AII or the cash flow tax, for both of which the AETR is almost the same as under

the US TCJA. The large decline in the AETR under the tax rate cut enhances the incentive for corporations to operate in Canada as opposed to the United States. In addition, the rate cut itself will encourage profit shifting into Canada and the additional tax revenues that such shifting entails.

In their review of these options, McKenzie and Smart opt for the fundamental corporate tax reform represented by the cash flow tax rather than “tinkering with depreciation allowances and/or the statutory tax rate.”² The cash flow tax removes the main distortion from the corporate tax system and significantly encourages investment. As the authors note, there exist alternatives to the cash flow tax—for example, the CCA tax or the allowance for corporate equity (ACE) system—that accomplish the same objective of taxing rents. They also recognize that a movement from the existing income-based corporate tax to some version of a rent tax would be a major reform that could not be undertaken lightly. Therefore, they recommend a comprehensive review of the tax system. In this recommendation they are not alone: the International Monetary Fund has also recommended that a major tax review be undertaken.

R.B.

Shu-Yi Oei and Leigh Z. Osofsky, “Constituencies and Control in Statutory Drafting: Interviews with Government Tax Counsels” (2019) 104:3 *Iowa Law Review* 1291-1360 (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3203657)

Despite the urging of many in the legal academy, legal scholarship has remained remarkably impervious to the rise in popularity of empirical methods. And while some scholars—for example Ben Alarie—have made strides in changing that unreceptiveness in the quantitative realm, few legal scholars have undertaken research projects that involve qualitative methods such as interviews. For that reason alone, Oei and Osofsky’s piece is worth reading.

The article asks questions about the process of drafting tax law, on the hypothesis that knowing more about this process may help us better understand why tax statutes are hopelessly complex. The authors interviewed 26 current and former government counsels who had participated in the drafting of tax law (through the Joint Committee on Taxation, the Senate Finance Committee, the House Ways and Means Committee, the Department of Treasury, the Internal Revenue Service [IRS], the Senate Office of Legislative Counsel, and counsels to individual members of Congress). Most interviewees were lawyers. The interviewees’ length of drafting experience varied substantially; about half of them had been involved in the drafting of tax legislation since before the major US reforms of 1986.

The study reaches several fascinating (if perhaps predictable) conclusions. First, tax drafters worry less about readability than they do about conveying substantive

2 At 21.

meaning accurately. Second, drafters see themselves as writing for tax experts, regulation writers, and (perhaps less predictably) software companies—not for taxpayers. Third, when tax law is reformed, the maintenance of previous provisions is highly valued because their amendment is seen as disrupting the known order of things (an inclination described as “inertial tendencies”).³ Fourth, the process of drafting remains largely unscrutinized. (As an aside, we note that the story about the influence of one drafter in particular—Ward Hussey—is illuminating.)⁴

A fascinating part of the article is the authors’ explanation of the design practices that can cause tax law rules to become complicated. Part II.B of the paper explains drafting choices, which are described in terms of (1) rules versus exceptions, (2) narrow rules with defined terms versus broad general rules with large exceptions, and (3) freestanding provisions versus intra-section drafting. This way of parsing tax provisions helps make sense of the sometimes byzantine design choices reflected in tax laws around the world. These drafting choices matter for another reason: the authors find that the drafting conventions affect the way in which the law develops.

Part of what makes this article so compelling is that the authors take their research a step further and speculate about why their findings matter. On a doctrinal level, they suggest that their results may argue for a greater interpretive range in judicial decision making (given their finding that members of Congress pay little attention to the drafting details, and that even the drafters themselves view their word choices as idiosyncratic). On a more theoretical level, the authors’ findings raise questions about drafting legitimacy (given its relative obscurity within the democratic process).

K.B.

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>)

The TCJA of 2017 represents the first major reform of US income taxes in 30 years. Slemrod provides a timely critique of the TCJA and an overview of its consequences. He begins by comparing the TCJA with the Tax Reform Act of 1986. Both reforms lowered the corporate and personal tax rates and significantly raised the standard deduction, and both broadened the personal income tax base. But while the 1986 reform reduced the tax depreciation rate and eliminated the investment tax credit, thereby increasing the cost of capital, the TCJA moved—temporarily, at least—in the direction of a cash flow tax by allowing the immediate expensing of equipment and by reducing the extent of interest deductibility. The TCJA, unlike the earlier reform, moved from a worldwide system of corporate income taxation toward a territorial system. Further, the Tax Reform Act of 1986 was meant to be revenue-neutral and distributionally neutral, while the TCJA was neither.

3 At 1296-97, 1322, and 1340-41.

4 At 1328-30.

Slemrod attributes the momentum for US tax reform, and the direction of several of its changes, to the international environment. Since the 1980s, the US economy had become more integrated into the world economy. Corporate tax rates in many OECD countries had fallen dramatically. Income inequality in the United States had increased significantly since the 1980s. Intangible capital had increased in importance, and with it the ability to shift profits to low-tax countries. Finally, the ratio of debt to gross domestic product (GDP) had increased considerably.

Many of the various blueprints for tax reform that preceded the TCJA called for corporate and personal tax reductions, and for the abandonment of the worldwide taxation of US corporations. In 2016, a Tax Reform Task Force established by House Republicans issued an influential report that proposed reducing top individual tax rates, repealing the estate tax, and reducing the tax rate on passthrough entities, which are widely used in the United States. Most radically, it recommended adopting a cash flow corporate tax to be applied on a destination basis (by deducting export sales and including imports in the corporate tax base). The TCJA moved haltingly in the direction of this earlier Republican blueprint.

Slemrod summarizes in broad outline the effects of changes in the corporate and personal income taxes. In the case of the corporate tax, he focuses on two areas affected: investment and income shifting. Investment could potentially be stimulated in two ways. First, the cost of capital should decrease, mainly because of the immediate expensing of equipment investment. Second, the reduction in corporate tax rates should improve corporate cash flows, thereby relaxing financial constraints on investment. The reduction in tax rates should reduce the shifting of income to foreign locations, unless other countries respond by reducing their tax rates. However, the move toward a territorial system could have the opposite effect.

Another form of income shifting induced by the TCJA is shifting between corporate and personal taxes. Prior to the TCJA, personal tax rates were, on average, lower than the corporate tax rate, and this induced many businesses to classify themselves as passthrough entities, mostly in the form of so-called S corporations, which pay tax at the personal rather than at the corporate tax rate. The TCJA would have the opposite effect, since it makes the corporate tax rate lower than personal tax rates. Slemrod argues that this has implications for the distribution of income, especially for the amount of income going to top income earners, although he chooses not to quantify the importance of this implication.

Changes in the individual income tax were less momentous, but consequential nonetheless. Under the TCJA, the rate structure became less progressive, and the standard deduction was nearly doubled. In addition, some other, less substantive base-broadening measures were implemented under the TCJA. The increase in the standard deduction simplified the tax system by encouraging a higher proportion of taxpayers to take the standard deduction rather than to itemize deductions (a feature of the US tax system that does not apply in Canada).

Slemrod outlines what the TCJA did not do. Base-broadening was minimal because the TCJA did not touch some of the biggest tax expenditure programs, such as those associated with employer-provided health insurance and income tax preferences for

owner-occupied housing. The TCJA did not increase the federal gasoline tax or implement a carbon tax. It did not abolish the estate tax. More generally, it did not move to a highly different tax system, such as a personal consumption tax or a value-added tax. Nor did it adopt the destination-based cash flow tax that had been a centrepiece of the 2016 Republican proposal.

Slemrod's most pointed criticism concerns what the TCJA got wrong. First, it was not a revenue-neutral reform. It would provide short-term stimulus that was not needed, and it would increase the US public debt, thus reducing budget flexibility in the future as well as burdening future generations with higher tax liabilities. Second, it would be highly regressive, with more than half the benefits of tax cuts going to the top 10 percent of income earners. In Slemrod's view, a massive tax cut for the rich is the "wrong direction for policy."⁵ The overall distributive impact of the TCJA depends on who bears the incidence of the corporate tax, a topic that remains controversial among public finance economists. Recent evidence suggests that a significant proportion of corporate taxation is borne by workers. If so, they stand to benefit from reductions in the corporate tax rate, at least in the long run.

R.B.

James Alm, "Is the Haig-Simons Standard Dead? The Uneasy Case for a Comprehensive Income Tax" (2018) 71:2 *National Tax Journal* 379-98 (doi.org/10.17310/ntj.2018.2.07)

This article provides a traditional take on an age-old issue in taxation: What form should the income tax base take? In particular, should the ideal be the Haig-Simons (H-S) comprehensive income tax? Alm presents three arguments. First, he observes that a fully comprehensive income tax has never been applied and is therefore "dead" from the point of view of relevant, real-world tax policy. Second, the death of H-S standard is appropriate, since a good case can be made for the extensive use of the exemptions, deductions, and adjustments to taxable income that one finds in virtually all tax systems. Finally, there is no one-size-fits-all—or best practices—income tax base. What is best for a given country depends on the country's specific circumstances. The author makes these points in a discursive way, from a mostly US perspective. Almost no account is taken of the past 50 years' vast literature on optimal tax policy design—for example, the Mirrlees review in the United Kingdom or the Henry report in Australia, let alone the influential earlier policy reports such as the Meade report in the United Kingdom or the Carter report in Canada⁶—or the tax commissions that have drawn on such studies.

5 At 88.

6 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: Oxford University Press, 2011) (herein referred to as "the Mirrlees review"); Australia, Department of the Treasury, *Australia's Future Tax System* (Canberra: Commonwealth of Australia, 2010) (herein referred to as "the Henry report"); Institute for Fiscal Studies, *The*

The paper begins with a simple summary of the H-S comprehensive income base and some of the issues that it must address, such as the treatment of capital gains, imputed income, in-kind income, and transfer income. The normative arguments for comprehensive income are recounted. It is taken to be the best measure of ability to pay, and to meet several objectives of taxation. To Alm, these objectives include adequacy and elasticity of revenue raising; equity, both horizontal and vertical; efficiency, or neutrality; simplicity of collection and compliance; political acceptability; and suitability for the stabilization function. He suggests that these objectives can largely be collapsed into three main goals: adequacy, equity, and efficiency. He argues that the H-S tax base achieves these goals sufficiently well, and that therefore its appeal is understandable.

Alm then documents how actual tax bases depart from the H-S standard, and he uses the US case as an example. Deviations include not only tax evasion but also the many exclusions, adjustments, deductions, and exemptions that are summarized in the government's document on tax expenditures. All countries, including Canada, have tax bases that depart from the H-S standard, but they do so in very different ways. For example, the largest personal income tax expenditures in the United States are (1) the exclusion of employer contributions for medical insurance and care, (2) the exclusion of imputed rental income, and (3) the preferential treatment of capital gains. On the basis of the number and size of tax expenditures, Alm concludes that the H-S comprehensive tax base is dead in terms of real-world relevance.

Alm next turns to the reasons for departures from the H-S standard, and he argues that most of the departures are justified. Some special treatment makes tax liabilities more reflective of individual characteristics, and therefore equitable. He includes in this category the personal exemption, deductions for unexpected expenditures such as medical expenditures and property losses, deductions for the cost of earning income, and deductions for child care and education. Other deductions and exemptions are justified on the basis of legitimate efficiency reasons, including items that are costly to administer (imputed income, unrealized capital gains), and deductions for charitable donations. Alm also argues that deductions for capital income and bequests—deductions that are meant to encourage saving—are justified on dynamic efficiency grounds, although this argument is theoretically suspect. The case for the preferential treatment of capital income (as opposed to labour income) has been widely studied in the taxation literature, and it has been carefully documented in the Mirrlees review and its background studies. In fact, the preferential treatment of capital income is probably the largest single difference between real-world tax systems and the H-S standard. But this subject is barely touched on in this paper. The

Structure and Reform of Direct Taxation: Report of a Committee Chaired by Professor J.E. Meade (London: Allen & Unwin, 1978) (herein referred to as "the Meade report"); and Canada, *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966) (herein referred to as "the Carter report").

author also argues that some types of income are less responsive to taxation than others and that the preferential treatment of them could improve the efficiency of taxation.

Alm concludes by claiming that a strong case exists for deviating even more from the H-S standard than current practices do. If exemptions, deductions, and exclusions were used more judiciously, taxes could be both better aligned with ability to pay and more efficient. However, the appropriate approach must be specific to each situation and country. Any attempt to reduce actual tax policy principles to best practices is, according to the author, “fundamentally misguided.”⁷ Moreover, citing some well-known papers in the literature, Alm argues that no consensus exists among tax theorists regarding what an optimal tax system should be. At one extreme, it is argued that the optimal marginal tax rate should decline at high incomes; that the tax should be flat, with a uniform refundable credit; and that capital income should be exempt from taxation. At the other extreme, it is argued that high incomes should face high and rising marginal income tax rates, that earnings of low-income workers should be subsidized, and that capital income should be taxed.

R.B.

Hunt Allcott, Benjamin B. Lockwood, and Dmitry Taubinsky, “Should We Tax Sugar-Sweetened Beverages? An Overview of Theory

and Evidence” (2019) 33:3 *Journal of Economic Perspectives* 202-27
(<https://doi.org/10.1257/jep.33.3.202>)

This is a valuable and readable analysis of the case for taxing sugar-sweetened beverages. The article consists of three parts, which provide the following, respectively: (1) background on the consumption patterns for sugar-sweetened beverages; (2) an economic framework, which is essentially a cost-benefit approach to evaluating the tax; and (3) some empirical evidence on the parameters determining the size of the tax. The article concludes with some cryptic advice for policy makers.

Allcott, Lockwood, and Taubinsky begin with some context. They review the use, in the United States, of a tax on sugar-sweetened beverages (seven cities use such a tax), and its use in several other countries around the world. They present some evidence on the consumption of sugar-sweetened beverages in the United States. US consumption (1) is remarkably high, (2) declines with higher household income, and (3) is significantly higher than the world average (although it has been falling in recent years). The authors document evidence on the three main health harms attributable to sugar-sweetened beverage consumption (weight gain, type 2 diabetes, and cardiovascular disease), and they note that sugar consumed through drinks is more harmful than sugar consumed through foods. They also report some estimates of the total health-care costs associated with sugar-sweetened beverage consumption.

7 At 24.

The authors' economic framework for evaluating a sugar-sweetened beverage tax is based on a partial equilibrium approach that is focused on the demand and supply of a sugar-sweetened beverage, whereby consumption has two negative consequences that are not captured in the market. The first consists of conventional externalities: the consumption of sugar-sweetened beverages imposes costs on third parties. Here, the externalities are mainly the health costs that are borne by private or public health-care insurers. The second negative consequence consists of so-called internalities, which are the costs that consumers impose on themselves through imperfect decision making. Internalities may be the result of imperfect information about the health consequences of consumption, or they may be caused by a consumer's problems with self-control or time-consistency, whereby decisions to satisfy short-term desires are harmful to the consumer's long-term welfare.

Imposing a "sin tax" to correct for these externalities and internalities has both benefits and costs. Allcott et al., using a simple diagrammatic approach (which is based on much more elaborate optimal tax-analysis modelling in a related paper), nicely summarize the consequences of using an excise tax to correct for these effects. There is a transfer of resources from the taxpaying consumer to the government that can have a negative net value if the marginal utility of income is higher for the taxpayer than for the government, and vice versa. The presumption is that consumers of sugar-sweetened beverages have lower incomes than average, so this transfer of tax revenue will decrease these consumers' welfare. To the extent that the tax is borne by producers, the net benefit of the revenue transfer is higher, because producers are likely to have higher incomes and therefore lower marginal utilities of income. In addition, the harm from the externality or internality is reduced, which constitutes an unambiguous benefit. The benefit will accrue to the health-care provider in the case of an externality and to the consumers themselves in the case of internalities. The values of these harm-reduction benefits will depend on the marginal utility of income of those whose harm is reduced. The absolute magnitude of the various benefits and costs will depend on the elasticities of demand and supply for the sugar-sweetened beverages.

This cost-benefit analysis of a tax on sugar-sweetened beverages applies equally well to other sin taxes, such as alcohol taxes and tobacco taxes, both of which might result in both externalities and internalities. In contrast, gasoline or carbon taxes result in externalities but not in internalities. Other excise taxes, such as those on luxury goods, fulfill redistributive functions.

Allcott et al. proceed to summarize empirical estimates of the relevant supply-and-demand elasticities and other parameters that determine the optimal size of a sugar-sweetened beverage tax. Demand elasticities are critically important for determining the size of the response to the tax and therefore the welfare gains. The authors stress the difficulty of isolating empirically the causal effects of tax changes on demand, and they discuss empirical strategies for addressing the issue—for example, controlling for factors such as product quality and demand fluctuation, or using an instrumental variable approach. They also caution that data availability is a problem. On the basis of a review of the empirical literature, they suggest that the

price elasticity of demand for sugar-sweetened beverages is about -1.4 , which is sufficiently large to make the benefits of reducing externalities and internalities at least as great as the burden of tax payments.

They then summarize empirical estimates of externality and internality reduction. The average health-cost externality from beverage consumption is estimated to be about 0.9 cents per ounce. The benefits of reducing internalities that involve imperfect information and lack of self-control are particularly challenging to measure. Allcott et al. summarize the various approaches to such measurement before settling on their own estimates—that the average US household would consume about 35 percent less sugar-sweetened beverage if household members had perfect knowledge of the beverage's effects, and perfect self-control.

The authors also discuss the regressivity of a tax on sugar-sweetened beverages. Although internality-reduction benefits are highly progressive, the tax itself is regressive. Allcott et al. argue that, on balance, the net benefits of a tax on sugar-sweetened beverages are roughly even across the income distribution, though they are greater for low-income households. On the basis of these empirical estimates, they suggest that the socially optimal tax rate on sugar-sweetened beverages is about 1.5 cents per ounce. If the benefits of internality effects were eliminated for philosophical reasons, the optimal tax would fall to 0.4 cents per ounce.

Allcott et al. conclude by providing some guiding principles for policy makers, most of which are self-evident. The five main ones are as follows: (1) “focus on correcting externalities and internalities, not on minimizing . . . consumption”; (2) where feasible, “target [tax] policies to reduce consumption among [groups of] people generating the largest externalities and internalities”; (3) “tax grams of sugar, not ounces of liquid”; (4) “tax diet drinks and fruit juice if and only if they also cause uninternalized health harms”; and (5) “when judging regressivity, consider internality benefits, not just who pays the taxes.”⁸

The broad message is that the benefits of taxes on sugar-sweetened beverage taxes likely exceed the costs. Presumably, these principles apply to other sin taxes as well.

R.B.

Bronwyn H. Hall, *Tax Policy for Innovation*, NBER Working Paper no. w25773

(Cambridge, MA: National Bureau of Economic Research, April 2019), 26 pages

This is a readable and short summary of the key issues surrounding the widespread use of tax incentives for innovative activity worldwide, particularly tax credits or deductions and intellectual property (IP) boxes. Although the content of the paper is sketchy, the coverage is broad and includes discussion of (1) the rationale for research and development (R & D) incentives, (2) tax policy design, and (3) empirical evidence regarding the effectiveness of tax incentives in encouraging innovation. The comprehensive list of references is especially useful.

Hall begins with a brief discussion of the forms of firms' innovative spending, which range from spending on basic and applied research, to spending on product development, to investment in technologically advanced capital. She identifies the activities that are likely to give rise to unpriced spillovers and that warrant encouragement. Government policies to encourage innovation can include (1) providing incentives to firms and (2) direct spending. The remainder of Hall's paper emphasizes the former. She focuses on two tax-related measures: (1) R & D tax credits and super-deductions (that is, deductions in excess of the cost of R & D), and (2) IP boxes (that is, reduced tax rates on profits from innovation).

Hall outlines some of the properties of effective tax measures, and she identifies the following features: salience to firms; a matching of the time horizon of subsidized investments with benefits generated; stability; the targeting of spillover-inducing activities and of small and medium-sized firms that face financial constraints; and ease of audit.

Hall presents a summary of tax measures that are likely to influence innovation—for example, the treatment of debt versus equity finance and of accelerated depreciation—and she discusses in detail the design properties of R & D tax credits and IP boxes. This discussion includes (1) the scope of R & D-related activities covered by such measures, (2) loss carryforward provisions, (3) the forms of IP covered by the measures, (4) the treatment of acquired IP versus developed IP, and (5) the relationship between the tax benefits of IP profits and the R & D credits that may have been received in developing IP.

Hall discusses the differences between R & D credits and IP boxes, and when one should be preferred over the other. For example, R & D tax credits target inputs, while IP boxes target outputs and therefore capture windfalls but do not alleviate financing problems. In addition, IP boxes do not cover non-patentable innovation, while R & D tax credits cover only R & D-generated innovation. IP boxes target the most appropriable forms of innovation, which may already receive patent protection, and they also encourage patent trolling. IP boxes also face higher audit costs than R & D tax credits, since revenues and costs must be allocated between IP and non-IP assets. The effectiveness of R & D tax credits depends on the effective corporate tax rate when the R & D is undertaken, which depends on whether the firm is in a taxpaying position.

Hall briefly summarizes the use of R & D tax credits (or super-deductions) and IP boxes worldwide. The former are used in most OECD countries and in a few non-OECD ones. The credits vary widely in form, differing with respect to (for example) whether a credit or deduction is used, whether small businesses receive favourable treatment, whether unused credits can be carried forward, and whether the credit applies to all R & D or only to incremental R & D spending. Far fewer countries use IP boxes, and most of them are in the EU. They vary in the types of IP covered and with respect to whether the reduced tax rate applies to gross or net IP income, whether past R & D credits are recaptured, and whether eligibility is contingent on further development of the IP.

In the paper's final section, Hall reviews empirical findings on the extent to which R & D tax credits and IP boxes stimulate innovation. Evidence suggests that

R & D tax credits increase R & D spending, with elasticities of R & D in excess of unity with respect to tax-adjusted prices. Studies also find that tax-credit-stimulated increases in R & D might increase patenting in firms that are technologically similar. At the same time, some findings suggest that firms receiving R & D tax credits tend to pursue existing research areas rather than to branch out into others. As well, some studies show that at least some of the benefit of R & D credits goes to R & D workers (in the form of higher wage rates) rather than to increasing the quantity of R & D activity.

Studies of patent boxes investigate both their effect on patent transfers to and from a country and their effect on patentable inventions. The location and the transfer of patents respond to lower tax rates on patent income, but the transfer of patents is considerably reduced if eligibility for the patent box tax rate requires further development of existing patents. There is, however, little evidence that patent boxes increase patentable invention or R & D investment.

Finally, there is some US evidence that the socially optimal level of R & D investment is a multiple of actual investment. Hall concludes that incentives for R & D should be larger than they currently are, especially in larger economies.

R.B.

Tarcisio Diniz Magalhães, “What Is Really Wrong with Global Tax Governance and How To Properly Fix It” (2018) 10:4 *World Tax Journal* 499-536

(<https://ssrn.com/abstract=3303213>)

Magalhães is a promising new scholar. In this article, he applies the insights of critical legal theory and international relations theory to explain why global tax governance—as reflected both in current arrangements and in the governance models proposed by those who argue for a reform of the existing one—will inevitably fail low-income countries. He argues that, without radical reform to the “bureaucratic club” model of global tax governance, the problems posed by expertise and power will not be overcome. The alternative to the existing arrangement, he claims, is to embrace multipolarity and pluralism in the design of global tax institutions.

Magalhães pulls no punches in his analysis. In his introduction, for example, he highlights the OECD’s recent efforts to accommodate the voices of low-income countries as part of its BEPS initiative. He summarizes the objective of that initiative as follows:

The announced objective is to stop a global base erosion and profit shifting epidemic, which, however, stems from the very international tax regime . . . [that] those countries [the 35 OECD member-states] themselves set up a century ago, and which they made sure would remain as close as possible to its original intent.⁹

9 At 501.

Following the introduction in part 1, the article comprises three major parts. In part 2, Magalhães focuses on the problems of expertise and power, drawing from the work of legal scholar David Kennedy and political theorist Nancy Fraser. Like other scholars, including Canada's Lisa Philipps,¹⁰ who have identified the role of technical discourse and its challenges in limiting civil society's broad engagement in tax institutions, Magalhães argues that the imposition of technocracies "restricts the flow of ideas," with negative consequences for processes and outcomes.¹¹ In his analysis of the function of power, Magalhães underscores the role of the OECD as a hegemonic actor in the international tax arena. The OECD, given its dominance in setting the international tax agenda, is characterized as supporting international fiscal imperialism.

Part 3 discusses the proliferation of proposed alternatives to the OECD in its role as the standard-setter in the international tax arena. Many of these proposals have been reviewed in previous issues of this feature.¹² Magalhães offers a tour of the proposals advanced by a wide range of scholars and policy makers, including Vito Tanzi, Kofi Annan, Francis Horner, Michael McIntyre, Thomas Rixen, Canadian Peter Dietsch, Douglas Bamford, H. David Rosenbloom, Noam Noked, and Mohamed Helal.

Part 4 sets out Magalhães's proposed way forward. He focuses on input legitimacy, building on the procedural trend in political theory, as reflected in the work of John Rawls and Jürgen Habermas. This focus compels him to rely substantially on the potential for putting interests on an equal footing in the framing of global tax norms and institutions. The end result is that he eschews a global tax organization in favour of multipolar and plural blocks that will diffuse authority and challenge the conventional concentrations of power.

K.B.

Afton Titus, "Designing a General Anti-Avoidance Rule for the East African Community—A Comparative Analysis" (2019) 11:2 *World Tax Journal* 261-301

General anti-avoidance rules (GAARs) have proliferated in countries around the world. In this article, Afton Titus, a faculty member at the University of Cape Town, proposes something novel: a shared GAAR for the East African Community (EAC), to be enacted once the EAC has completed its regional integration project.

The article is a model of comparative study and is worth reading for that reason alone. Three other features of Titus's work merit highlighting for the readership of

10 See, for example, Lisa Philipps, "Discursive Deficits: A Feminist Perspective on the Power of Technical Knowledge in Fiscal Law and Policy" (1996) 11:1 *Canadian Journal of Law and Society/Revue Canadienne Droit et Société* 141-76.

11 At 508.

12 See, for example, the review of Vito Tanzi, *The Ecology of Tax Systems: Factors That Shape the Demand and Supply of Taxes* (Cheltenham, UK: Edward Elgar Publishing, 2018), advocating for a world tax organization; see this feature (2019) 67:2 *Canadian Tax Journal* 487-88, at 487-88.

this journal. First, there has been some debate among academics and policy makers about whether it is sensible to enact GAARs in low- or even middle-income countries. One of the major challenges of a GAAR is effective application, which may require capacity building when it comes to audit, legal analysis, and dispute resolution processes (for example, to ensure that judges are able to understand and effectively apply the GAAR). Afton is among those who believe that GAARs are as important, if not more important, for developing nations as for developed ones. In particular, she argues that a small group of highly skilled individuals may be sufficient for the effective implementation of a GAAR.

Second, with a view to designing a GAAR for the EAC, Afton looks to the legal frameworks and jurisprudence in the EU, Canada, and South Africa. For a Canadian audience, this review will be of interest. The Canadian example is used because of our comparatively long history with a GAAR and our developed jurisprudence in this area, and because Canada has some similarities to the EAC (in terms of having a mixed legal tradition and a dependence on natural resources).

Finally, the article offers a review of GAARs in the current EAC countries, including Kenya, Tanzania, Uganda, and Burundi. It is rare to find a comprehensive review of tax law in these four countries, let alone in a comparative context. For each country, Afton reviews the legal design features of the GAAR, the country's approach to statutory interpretation, and any judicial or administrative guidance.

All of this work is ultimately in aid of Afton's larger project, which is to ready the EAC for a shared GAAR when the time comes.

K.B.

Daisy L.A. Ogembo, "The Tax Justice Network-Africa v Cabinet Secretary for National Treasury & 2 Others: A Big Win for Tax Justice Activism?"

[2019] no. 2 *British Tax Review* 105-17 (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3390820)

There are over 3,000 bilateral income tax conventions, so the fact that low- and middle-income countries have cancelled one or two in the hope of negotiating fairer bargains with higher-income states doesn't seem especially noteworthy. Nevertheless, in an era of rapid (and increasingly public) change in the international tax field, each of these developments merits scrutiny.

Ogembo's current note draws attention to a constitutional challenge brought by the Tax Justice Network in Kenya. The challenge raised three questions: (1) Did the double tax agreement between Kenya and Mauritius increase the risk of revenue loss through treaty abuse in a manner that contravened the constitutional principles of public finance? (2) Is there a difference between bilateral treaties (subject to one ratification process) and bilateral agreements (not subject to the same processes), and was the double tax agreement a treaty or an agreement? (3) Was there sufficient public participation, as required under the constitution?

Although the Tax Justice Network proclaimed the High Court's decision a win, Ogembo argues that it was an opportunity lost. The High Court nullified the notice

that purported to bring the double tax agreement into effect, but it did so only because the mechanism used to bring the agreement into force followed improper procedure; not on constitutional grounds, and not for the more substantive reasons argued by the petitioner.

This piece is a welcome review of the tax-related activities of the Kenyan court. In the last decade, the number of academics and scholars working in international tax who pursued their initial law degrees in African countries has increased, with the happy result that we are increasingly able to read analyses of decisions and legislation from countries outside the OECD member states.

K.B.

Michael C. Durst, *Taxing Multinational Business in Lower-Income Countries: Economics, Politics and Social Responsibility*

(Brighton, UK: Institute of Development Studies for the International Centre for Tax and Development, 2019), 142 pages (www.ictd.ac/publication/taxing-multinational-business-lower-income-countries-economics-politics-social-responsibility)

Michael Durst is a long-time US tax practitioner, in both government and the private sector. In this book, he focuses on the challenge faced by lower-income countries that seek to impose corporate taxes in a world characterized by tax competition. Durst addresses three fundamental questions:

- Would curtailing base erosion and profit shifting in lower-income countries be in the interests of the people of those countries, especially in facilitating the alleviation of poverty?
- What are the political and economic roots of BEPS-style corporate tax planning?
- What policies might lower-income countries realistically pursue to reduce their vulnerability to base erosion and profit shifting?¹³

Addressing the first question, Durst acknowledges the challenges of corruption, but he concludes that corporate tax revenues are likely below socially optimal levels in most lower-income countries and that those revenues should therefore be increased. Regarding the roots of BEPS-style corporate tax planning, Durst assigns responsibility to multinational taxpayers and to governments that have been committed to taking conciliatory measures (through tax exemptions, for example) as a means of attracting investment. He concludes that coordination is the only way to resist what will otherwise inevitably be continued competition. In addition, he espouses the view that corporations need to voluntarily refrain from actively inspiring more tax competition; he sees such self-restraint as a necessary precondition for the success of lower-income countries in raising corporate tax revenue. This “social responsibility” approach is the crux of the book’s final chapter, and it is vital to Durst’s

13 At 4.

overall model for the enhanced raising of corporate tax revenues in lower-income countries.

Finally, Durst offers a range of concrete policy recommendations. Many of his suggestions are predicated on his mantra that the international tax rules must be simplified. In particular, he suggests revisions to transfer-pricing rules (for example, simplifying the search for comparables, and adopting safe harbours), interest deduction limits, and tax treaty policy, and he argues for enhanced capacity building. He advocates the imposition of minimum corporate taxes, and he addresses the particular challenges that countries face in attempting to impose corporate-level taxes on natural resource extraction, electronic commerce, mobile telecommunications, and banking and insurance.

K.B.

Sunita Jogarajan, *Double Taxation and the League of Nations*

(Cambridge, UK: Cambridge University Press, 2018), 342 pages

(<https://doi.org/10.1017/9781108368865>)

Jogarajan's book is the product of her curiosity about the answer to the following question: What led countries to work together internationally to reduce double taxation? The result of her enquiry is this (primarily) historical dive into the foundations of modern treaties: the work by the League of Nations in the 1920s.

Jogarajan's analysis is based on a massive amount of archival work. Although the source material was incomplete and often available only in translation, her book offers a comprehensive account of the drafting of the first model treaties. She relies on this historical account in identifying lessons for future reform efforts.

Jogarajan's book is divided into eight chapters. Chapter 2 sets out the background and context of the League's early efforts to develop a model tax treaty. Much of this background will be familiar to those who have read about the history of taxation and tax treaties; nevertheless, Jogarajan offers a succinct review of the major underlying theories of international taxation, along with an overview of 1920s economics and politics and of the role of the League of Nations in that era.

Chapter 3 focuses on the 1925 resolutions, addressing the period 1923-1925. Jogarajan notes that three of the seven experts involved in the production of these resolutions were the major influencers—D'aroma (the Italian chair), Thompson (the British representative), and Clavier (the Belgian representative). Unlike some accounts, Jogarajan's account characterizes the outcome of the discussions among these experts as striking a relative balance between concessions to source countries and concessions to residence countries. One of this chapter's more fascinating insights stems from Jogarajan's exploration of the original basis for the permanent establishment concept and her review of the general preference for the source taxation of business income, a preference mitigated by a concern for fairness with respect to the head office country.

Chapters 4 through 7 explore the development of the 1928 models. These chapters examine the period 1926-1928; Jogarajan meticulously tracks the positions and

debates on each of the major sources and types of income. Seven experts were involved in the 1925 report, which resulted in the resolutions discussed in chapter 3. To these original seven, experts from an additional six countries were added in an effort to move from resolutions to a draft model treaty. Perhaps surprisingly, these new experts were not influential in shifting the foundations of the model treaty proposed in the 1927 report. Instead, they appear to have felt bound by earlier decisions. Chapter 7 focuses on the three models that were prepared in 1928. Those models were developed by representatives from 27 countries, at a single meeting that lasted 10 days.

The influence of major players is a central focus of Jogarajan's narrative, as she describes the evolution of the models from 1926 to 1928. She identifies the various experts along with other players—the International Chamber of Commerce, Britain, and the United States—that merit analytical attention. Departing from the standard story, she suggests that the International Chamber of Commerce was not especially important in the design of the early treaties (although it was instrumental in the treaty's acceptance). The United States does not appear to have exerted much influence, either. Jogarajan finds evidence that many compromises were made to accommodate the British.

Finally, chapter 8 turns to the lessons from Jogarajan's review that might be applied in the modern context. This chapter, which is brief, highlights the links between some of the early model provisions and the current model, and it offers some truncated reflections on some major international tax policy issues, including the primary goals of tax treaties (to prevent double taxation or to reduce tax evasion?), the balance of source and residence tax, the tension between bilateral and multilateral solutions, the issues for developing countries, and the role of influential experts.

Jogarajan's book is a major contribution to tax treaty history and especially to our understanding of the role of particular actors in the development and adoption of tax policy.

K.B.