
Hugh Ault is one of the leading thinkers in the field of international taxation. In this brief article, he reflects upon the origins of the current international tax principles; identifies some of the reasons for the growing problem of double non-taxation; explains the role of the Organisation for Economic Co-operation and Development (OECD) and its recent work on transparency, exchange of information, and base erosion and profit shifting (BEPS); and offers insights on solving the problems of BEPS.

Ault traces the sources of the current international tax principles to the work of the League of Nations in the 1920s. In particular, he quotes the following statement in a 1927 report prepared by the league’s Committee of Experts on Double Taxation and Tax Evasion: “The most elementary and undisputed principles of fiscal justice, therefore, required that the experts should devise a scheme whereby all incomes would be taxed once and only once.” Ault notes, however, that subsequent developments focused more on providing for the relief of double taxation than on ensuring that double non-taxation does not take place. Tax competition among countries is one of the reasons for such developments. According to Ault, some countries welcomed the creation of tax-planning structures that reduced the tax burden on their multinational enterprises operating in foreign countries, and they facilitated double non-taxation in order to enhance tax competitiveness.

Ault points out that it was only recently that the problem of double non-taxation caught the attention of politicians. Companies such as Starbucks, Amazon, Google, General Electric, and other non-US-based companies were identified by the media as having very low effective tax rates. This occurred at a time when governments were enacting austerity programs, facing budget deficits, and raising value-added tax rates on ordinary consumers. Political leaders in the Group of Eight (G8), the Group of Twenty (G20), and the OECD, with affiliations across the political spectrum, generally agree on the need for change in international tax rules and on giving the

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1 At 1195, quoting from the report prepared by the Committee of Experts on Double Taxation and Tax Evasion (League of Nations Publications, 1927), at 23.
OECD a timetable to produce technical analyses and proposed plans of action. Notably, the OECD took relatively little time to generate its recent BEPS report.²

How can countries address the BEPS problem? In Ault’s view, the OECD is the appropriate forum to which to turn for a solution, even though it lacks the political breadth of the United Nations (UN). As Ault points out, the UN does not have the necessary technical knowhow or experience to carry out the difficult technical analysis that the BEPS issues demand. It is necessary to go back to some fundamental and unresolved questions regarding the basis on which taxing rights are allocated. For example, what is the scope of source taxation? More particularly, what constitutes “source” for tax purposes? At present, there is no clear economic definition or well-defined legal concept of source. Ault suggests that

what we really should have is an updated set of the “Four Wise Men” who are credited with the development of the basic pattern of rules that we have been operating under since the League of Nations work in the 1920s.³

J.L.


The report on revised section E on safe harbours in the OECD’s transfer-pricing guidelines, approved for release in May 2013, provides new guidance on safe harbours to enable countries to reduce transfer-pricing compliance costs. It also provides greater certainty for cases involving smaller taxpayers or less complex transactions.

According to the OECD, this report represents a change in the OECD’s stance on the use of safe harbours. Its previous guidance had a somewhat negative tone regarding transfer-pricing safe harbours. That tone, however, did not accurately reflect the practice of OECD member countries, a number of which have chosen to include safe-harbour provisions in their transfer-pricing regimes. The new guidance set out in the report encourages the use of bilateral or even multilateral safe harbours in order to minimize compliance costs without creating problems of double taxation or double non-taxation. To facilitate negotiations between tax administrations, the report includes sample memorandums of understanding (MOUs) for competent authorities to establish bilateral safe harbours for transfer-pricing cases involving low-risk manufacturing services, low-risk distribution services, and low-risk research and development (R & D) services.


³ At 1201. The “four wise men” were Professor Edwin Seligman (of the United States), Sir Josiah Stamp (of the United Kingdom), Professor G.W.J. Bruins (of the Netherlands), and Professor Luigi Einaudi (of Italy).
A “safe harbour” in the context of a transfer-pricing regime is defined as

[a] provision that applies to a defined category of taxpayers or transactions and that relieves eligible taxpayers from certain obligations otherwise imposed by a country’s general transfer pricing rules.4

It is a substitute for more complex obligations under the general transfer-pricing regime. For example, a safe harbour could allow taxpayers to establish transfer prices by applying a simplified transfer-pricing approach provided by the tax administration. A defined category of taxpayers or transactions may be exempted from the application of all or part of the general transfer-pricing rules, such as documentation requirements. However, the report clearly states that safe harbours do not include administrative simplification measures that do not directly involve determination of arm’s-length prices, such as simplified documentation requirements, or exemption from such requirements, in the absence of a pricing determination.

As to the pros and cons of safe harbours, the report identifies the benefits of safe harbours as including simplification of compliance, greater certainty, and administrative simplicity. The main concerns with the use of safe harbours include inconsistency with the arm’s-length principle in reporting taxable income, increased risk of double taxation or double non-taxation when such provisions are adopted unilaterally, facilitation of inappropriate tax planning, and issues of equity and uniformity. In cases involving smaller taxpayers or less complex transactions, however, the report maintains that the benefits may outweigh the problems. It recommends that countries manage any concerns through the negotiation of bilateral or multilateral safe harbours.

The report includes three sample MOUs that are intended to facilitate bilateral safe-harbour negotiations. Each sample contains the following key elements:

- a preamble;
- a description of a “qualifying enterprise” that specifies what the enterprise shall not or may not do;
- a description of “qualifying transactions”;
- determination of the taxable income of the qualifying enterprise on the basis of a percentage (within a specified range) of the total costs of a low-risk manufacturing services enterprise or a low-risk R & D services enterprise, or a percentage of the total net sales of a low-risk distribution services enterprise;
- agreement between the competent authorities that the qualifying enterprise in one contracting state does not give rise to a permanent establishment of its associated enterprise resident in the other contracting state;
- elections and reporting requirements; and
- conditions for termination of the agreement.

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4 Paragraph 4.100 of the revised section.
The new guidance on safe harbours should be welcomed by taxpayers, especially contract manufacturers, contract distributors (or commissionaires), and contract R & D providers. There has been increasing concern about the use of these arrangements to shift profits away from the country where activities are conducted.

J.L.


The OECD prepared this report at the request of the G8 for the Lough Erne summit in June 2013. It outlines four concrete steps needed to put in place a global, secure, and cost-effective model of automatic exchange of information (EOI). The G20 finance ministers had already endorsed such a model as the new standard, at their meeting in April 2013. The rationale seems to be clear: since tax evasion is a global issue, a global solution is required. A global model minimizes costs of administration and compliance, and is in every country’s interest.

The four steps set out in the report are as follows:

1. enacting broad framework legislation to facilitate the expansion of a country’s network of partner jurisdictions;
2. selecting the legal basis for automatic EOI;
3. adapting the scope of reporting and due diligence requirements, and coordinating guidance; and
4. developing consistent or compatible information technology standards.

Each step has a potential time frame. As to step 2, the report suggests that the Convention on Mutual Administrative Assistance in Tax Matters and bilateral tax treaties should provide a clear legal basis for comprehensive automatic EOI with safeguards protecting confidentiality. Within the European Union, directives provide a specific legal framework for automatic EOI regarding interest income and certain other types of income between EU members.

The proposed new standard of automatic EOI is part of the global initiative in addressing the problem of tax–base erosion through profit shifting by multinational corporations. The OECD sees itself as having a clear mandate from the G8 and the G20 to take a leadership role in this area.5

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5 See the discussion in the review of Ault’s article above, and supra note 2.

Starbucks is one of several multinational corporations that have recently come under public scrutiny with respect to their strategies for shifting income to low-tax jurisdictions—or, as Kleinbard puts it, creating “stateless income.” In this article, Kleinbard uses Starbucks as an example of stateless-income tax planning to show how income may be subject to tax (if at all) only in a jurisdiction that is neither the source of the factors of production through which the income was derived nor the country of residence of the corporate group’s parent company. In particular, Kleinbard demonstrates the central role that intangibles play in stateless-income tax planning, and the ease with which multinational firms can turn a simple business model into intangible assets for which royalties must be paid:

The idea that a subsidiary can own intangibles developed by the parent and harness them to commercial use without subjecting the income they generate to tax where the business and customers actually are located is the core reason that base erosion cannot be addressed unless the OECD member states dismantle their traditional institutional acquiescence to conspicuously non-commercial modes of business organization.6

Kleinbard draws two lessons from the Starbucks case study. The first lesson is quite alarming: If Starbucks can organize itself as a successful stateless-income generator, any multinational firm can. Kleinbard notes that as a roaster, marketer, and retailer of specialty coffee, Starbucks follows a classic bricks-and-mortar retail business model and is not driven by hugely valuable identifiable intangibles that are separate from its business model. The second lesson relates to the fundamental opacity of international tax planning. According to Kleinbard, neither investors in a public firm nor the tax authorities in any particular jurisdiction have a clear picture of what that firm is up to. Indeed, it is not even realistic to expect a source country (the United Kingdom in the case of Starbucks) to evaluate the probative value of a multinational enterprise’s claim that its intragroup dealings necessarily reflect the arm’s-length principle by virtue of alleged symmetries in tax treatment of expense and income across the group’s affiliates.

Kleinbard suggests that the remedy begins with genuine transparency. National governments should recognize their common interest in combatting stateless-income tax planning and require their tax and securities agencies to promulgate rules providing a uniform worldwide disclosure matrix for actual tax burdens by jurisdiction. Kleinbard makes it clear that tax transparency is not a substitute for substantive reform of the international tax regimes, but argues that it would awaken the public and politicians to the massive amounts of tax avoidance known only to tax specialists today. As far as the United States is concerned, as a starting point, the geographic source-of-income rules should be developed to reflect the economic source of income

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6 At 1526.
and should be protected “at every turn from tax slicing and dicing through arbitrary intragroup structures for the siting of group intangibles or capital.”

J.L.


Drawing on the literature on optimal tax theory and Weisbach’s extension of the theory to line drawing in the tax law, this paper proposes four principles to deal with the problem of behavioural distortion and illustrates the application of those principles to the problems of income shifting by multinational corporations. Seto raises some interesting points for consideration in undertaking substantive tax reforms.

Seto identifies four specific problems of distortion in the current US taxation of multinational corporations that have resisted solution for decades. First, with respect to the rules that apply where a multinational group distributes any part of its earnings upstream, the US tax law appears to treat multinationals with a US parent less favourably than their foreign competitors. Second, the US tax law provides significant incentives for multinational corporations to locate plant, personnel, and other productive capacity offshore. Third, the law creates strong incentives to use transfer pricing and other income-shifting techniques to move income artificially from US to foreign members of the multinational group. Fourth, the 35 percent tax on repatriation of foreign subsidiary income to US parents clearly inhibits such repatriation.

What are the possible causes of and solutions to the above problems? Seto suggests that the cause is the violation by the current rules of the principle of relative indifference and its corollaries. For example, while multinational corporations are indifferent as to where the parent company is incorporated, the tax law uses place of incorporation as a basis for claiming tax jurisdiction. The solution is to subject all multinational groups to the same US rules. Similarly, while multinational corporations are indifferent as to which member of the group earns the income, the tax law attributes income to each member, and that is why transfer pricing has long been, and remains, a major problem. The solution is to subject corporate profits to the same taxes regardless of where within the group profits are formally located.

Seto proposes a structure for the tax system that ignores factors to which multinationals are relatively indifferent and instead taxes whatever it is that multinationals seek to maximize. One factor that multinationals want to maximize is sales.

7 At 1535.
The four principles he proposes are the following:

1. Tax liability should not turn on factors to which the taxpayer is relatively indifferent.
2. The least distortive tax base for any taxpayer is whatever that taxpayer would seek to maximize in the absence of taxation.
3. If what the taxpayer would seek to maximize in the absence of taxation is a number already computed for non-tax purposes, tax administration costs will be minimized if the tax base equals that reported number.
4. Taxpayers should be classified for tax purposes by reference to whatever it is that they would seek to maximize in the absence of taxation.

Seto maintains that consistent application of the above principles should result in rules that minimize distortions and sheltering of income. The idea that tax should be imposed on what taxpayers actually care about is intuitively appealing. The current international tax rules, such as transfer pricing, are divorced from business reality by attaching a premium to factors that taxpayers would not care much about in the absence of taxation.

J.L.


These two papers discuss possible responses to the problem of international income shifting from a US perspective.

The paper by Gravelle provides a good overview of the problems of income shifting by US-based multinational enterprises and tax evasion by US citizens. Gravelle identifies the key US tax rules relied upon by taxpayers in tax planning, such as the “check-the-box” provisions. According to Gravelle, most proposed reforms to address profit shifting would involve

- changing the tax law, such as repealing or limiting deferral;
- limiting the ability of the foreign tax credit to offset income;
- reforming the check-the-box provisions; or
- adopting formulary apportionment.

The paper by Grubert and Altshuler evaluates various proposals for the reform of the US international tax system, including
- dividend exemption;
- full current inclusion;
- a type of dividend exemption (modelled on the approach adopted in Japan) with an effective tax rate test subject to an exception for an active business;
- a dividend exemption coupled with a minimum tax; and
- repeal of the check-the-box rule.

In particular, Grubert and Altshuler consider two versions of dividend exemption with a minimum tax: a country-by-country minimum tax, and a minimum tax based on overall foreign income. To compare these proposals with the current law, the authors re-evaluate the efficiency cost of the dividend repatriation tax and find that the burden of avoiding repatriation is higher than that found in previous studies, particularly for profitable high-tech foreign businesses. They find that the minimum tax with expensing for real investment has many advantages. The minimum tax is basically a tax on large excess returns in low-tax jurisdictions, and it would be more effective in discouraging income shifting than repeal of the check-the-box rule. Between the two versions of minimum tax, Grubert and Altshuler suggest that the overall version deserves serious consideration, since it is much simpler.

The minimum tax on multinational corporations is an interesting idea. This type of tax has been imposed in a domestic context as an anti-avoidance measure in Canada and other countries. It will be interesting to see if it receives the kind of consideration in the United States that is suggested by Grubert and Altshuler.

J.L.


This article is a thoughtful examination of the meaning of “intangibles” and “ownership” in the context of transfer pricing generally and, in particular, the OECD’s 2012 discussion draft on revisions to the treatment of intangibles under its transfer-pricing guidelines.9

The meaning of “intangibles” and “ownership” is of fundamental importance in international tax law. In the ordinary world of business or economics, corporations enter into transactions in the marketplace with a view to maximizing their own profit. The prices fixed through contracts represent the value of the exchange and the bargain agreed to by parties that have adverse interests. In such a world, contractual prices, transactions, and ownership of property are important to the parties,

and are recognized and protected by law. The law provides the framework for the integrity of the exchange and protects the value of such exchange. Tax law takes the profits of each corporation as a starting point.

Different considerations come into play in the world of transfer pricing, where transactions take place between members of a multinational corporate group. In that world, it is not the price of intragroup transfers or the profit of individual members that matters, but rather the overall profit of the composite firm. Even though members of the firm may use contracts and enter into transactions, the contractual prices do not necessarily represent the value of the exchange. While the firm is indifferent as to prices or the resulting profit to each specific member, tax law focuses on the profit of each member. When the firm’s profit arises from something of value that only the firm possesses, such as goodwill or knowhow (“intangibles”), national tax laws struggle with determining the appropriate value and allocating it to the relevant jurisdictions.

The OECD’s transfer-pricing guidelines10 suggest ways to capture the economic value that is inherent in a firm even though that value may not necessarily be transferred according to typical transactions on which transfer-pricing analysis generally depends. The guidelines use terms, such as “intangibles” and “ownership,” that may not be easily transplanted into national tax laws, which generally defer to private law for the meaning of such terms. In this article, Wilkie unpacks the meaning of “intangibles” and “ownership” “inside the box” (according to the OECD transfer-pricing paradigm), explains the relevance of the meaning of these terms “outside the box” (in general law), and identifies ways of interpolating “the box” into the domestic tax laws of OECD member countries.

Wilkie describes the transfer-pricing paradigm as “the practical encapsulation of the arm’s length standard given its contemporary and conventional existence by the Transfer Pricing Guidelines.”11 He suggests that the paradigm rests on two fundamental propositions:

1. Observable “transactions” take place between counterparts that convey a property or limited rights to the use of that property from one party to the other, or that involve the provision of services.
2. Such transactions should take place without distortions induced by common ownership of the parties.

The paradigm adopts various guidelines to test related parties’ dealings according to independent “like” arrangements thought to be comparable. The paradigm requires the existence of transactions, and will hypothesize the existence of transactions if they would not otherwise exist.

11 Wilkie, at 226.
The transfer-pricing “box” seems to contain three dimensions:

1. What is a “transaction”?
2. What is the object of that transaction?
3. What does “transfer” mean?

In the context of transfer pricing,

a “transaction” is a legally effective exchange between two parties through a contract of some kind, by which each part with and acquires something that in the mind of the other is of equivalent value.\(^{12}\)

The “something” is an element of “property”—either an object of a typical kind or “rights” in relation to such an object. That object can be defined such that the contracting parties can identify it and access to it by others is excluded. There is a generally acknowledged and observed concession that rights to an object are not “at large.” Thus, a “transaction” involving property seems to have three hallmarks: the existence of property, transferability by way of compensated exchange, and exclusivity of interest or entitlement.

What happens when one or more of the hallmarks are missing—for example, the object of exchange cannot be seen, or there is no exchange in the conventional sense, or an exchange occurs in a mélange of mutual exchanges that might be said to constitute the essence of a firm? The solution seems to lie in hypothesizing transactions, or “squeezing the proverbial round peg into the square hole.”\(^{13}\) In relation to certain notions of intangibles, there is an acceptance of underlying property-law tenets without much inquiry about them—what they mean, their origins, the context in which they could have meaning, their suitability, and other like considerations that are necessary, given the significance of that law for ordering otherwise potentially limitless and disputatious conduct in relation to a relevant object. Wilkie writes:

The result is a kind of hybrid analytical framework that employs the language of commercial law and accounting convention when it may really be indifferent to them or, because of an absence of adversity of interests or other underlying intrinsic features of them, has no need for them, and in fact is concerned with something else entirely—detecting “value transfers” and then finding a home for them in a country’s fiscal law, on the assumption that there is an expected and reasonable correspondence between the allocation of income according to “transfer pricing” and a fiscal allocation of tax income.\(^{14}\)

\(^{12}\) Ibid., at 228.

\(^{13}\) Ibid., at 229.

\(^{14}\) Ibid., at 229-30.
According to Wilkie, the OECD discussion draft correctly discerns that “intangibles” includes the kinds of rights to which the law gives definition and affords protection (patents, trademarks, copyright, etc.) as well as some notions of value that the law may not recognize (such as “goodwill,” “knowhow,” or even “marketing intangibles”).

Drawing on Roman-law and English-law precedent, Wilkie suggests that

- an intangible is a right of some kind;
- that right must be given definition and significance in some fashion that allows it to exist; and
- the right must be capable of being owned.

In law, “ownership” may mean “the entirety of the powers of use and disposal allowed by law,” or the “bundle of rights,” including “the right of indefinite use, the right of unrestricted disposition and the right of enjoyment unlimited in duration.” However, the law offers no general statement of what a “right” is as an abstraction or what “ownership” means in relation to it. Further, the notion of ownership is useful only in relation to the objects and objectives of its use. In an adversarial or regulatory context, the notion of ownership has a use to assist in establishing the relative entitlements of adverse parties and adjudicating disputes. In the transfer-pricing context, such notion of ownership may have no place, since there is no adversity or dispute, and transfer pricing is not concerned with the adjudication of rights. Transfer pricing deals with the question of measuring, detecting, and avoiding distortions of profit where profit may be manipulated because there are no rights to be contested and there is no external discipline on potential manipulation.

Context matters. In the context of transfer pricing, the OECD discussion draft focuses on transfers of “economic value.” Contracts are regarded as relevant, but not controlling; “entitlement” is not limited to legal conventions; “intangibles” may be, but are not necessarily, property in a legal sense; and “ownership” is a relevant notion.

The OECD, essentially, envisages an “intangible” and “ownership” to connote what is necessary to explain the outcome of a functional analysis measuring “entitlement” to “intangible” related “returns” based on the integrated conduct of the members of the whole “firm” to the generation of profits.

The “intangible” is thus a manifestation of functions performed as part of an integrated, multiparty, composite “firm” or business. Wilkie is sympathetic to the OECD’s approach. He agrees that transfer pricing establishes its own purposes, which condition the responses to intercompany transfers.

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15 Ibid., at 231.
16 Ibid., at 238.
In recognition of the fact that the OECD offers only “guidelines,” not “laws,” the OECD notions of “intangibles” and “ownership” need to be bridged with domestic tax laws in order to take effect. Wilkie considers several ways of bridging, including a legal interpretation approach (the Canadian approach) and the adoption of the OECD transfer-pricing guidelines as domestic tax laws (the UK and Australian approach). In conclusion, Wilkie notes that accommodating the OECD’s approach into domestic laws is significant not just in the transfer-pricing context, but also in the context of asserting source-country tax jurisdiction.

J.L.

Carl Levin and John McCain, Memorandum to Members of the Permanent Subcommittee on Investigations re Offshore Profit Shifting and the U.S. Tax Code—Part 2 (Apple Inc.) (Senate Homeland Security and Governmental Affairs, May 21, 2013), 40 pages

This fascinating report by a US Senate subcommittee shows how one multinational company—Apple Inc.—has structured its business operations to avoid US and foreign taxes. It is seldom that the public gets a peek into the tax planning of a major company, particularly one as profitable as Apple. The headline finding is that Apple appears to be particularly adept at creating “stateless income”—income that is not taxable in any country. This is a step beyond shifting income to a low-rate jurisdiction and is remarkable also for the huge sums involved. It appears that Apple may be as innovative in avoiding tax as it is in developing technology. It also appears that the major policy problem in international taxation is no longer double taxation but double non-taxation.

This revelation of sizable amounts of stateless income has important implications for tax policy. With respect to tax policy making, the economic and social effects are significant. As the report notes, “[Apple’s] actions disadvantage Apple’s domestic competitors, force other taxpayers to shoulder the tax burden Apple has cast off, and undermine the fairness of the U.S. tax code.” For tax policy research, the implication seems to be that variations in tax burdens across companies may be less a question of deliberate policy choices (such as, in Canada, accelerated class 29 capital cost allowance deductions, which reduce the marginal effective tax rate on manufacturing) and more a question of differences between companies in their tax aggressiveness and their ability to access planning opportunities (for example, for soft drink manufacturers, a significant brand name and other intellectual property can facilitate sophisticated income shifting, similar to that discussed below for Apple).

Apple organizes its business in geographic segments. Operations for North and South America, including the United States, are headquartered in California; operations for the rest of the world, including Europe, the Middle East, India, Africa,

17 For a discussion of stateless income, and a similar example of creative tax planning (in this instance, involving Starbucks), see the article by Edward Kleinbard reviewed above.

18 Subcommittee report, at 5.
Asia, and the Pacific, are headquartered in Ireland. Apple develops its products through R & D conducted primarily in the United States. The materials and components for Apple products are sourced globally. The finished products are typically assembled by a third-party manufacturer in China. Distribution centres are headquartered in the United States and Ireland.

The United States taxes domestic corporations on their worldwide income. However, the US tax code allows companies to defer taxes on active business income until that income is returned to the United States. The subcommittee’s investigation found that Apple has $145 billion in cash, cash equivalents, and marketable securities, of which $102 billion is held offshore (although between 75 and 100 percent of those assets are held in accounts at US financial institutions).

Ireland has been Apple’s favourite jurisdiction for parking offshore income. The two major offshore affiliates discussed in the subcommittee’s report are Apple’s primary offshore holding company, Apple Operations International (AOI), and its primary intellectual property rights recipient, Apple Sales International (ASI).

Apple’s shocking revelation to the subcommittee regarding AOI is that although it has been incorporated in Ireland since 1980, it has not declared tax residence in Ireland, or in any other country. Consequently, it has not paid corporate income tax to any national government in the past five years, despite receiving $30 billion in income between 2009 and 2012. How is this possible? Apple has exploited a difference between Irish and US tax residence rules. Ireland uses a central management and control test to determine tax residence, while the United States determines tax residence on the basis of the entity’s place of formation. Apple explained that although AOI is incorporated in Ireland, it is not a tax resident of Ireland, because AOI is neither managed nor controlled in Ireland. (Rather, AOI’s management and control is located in California.) Apple also maintained that because AOI was not incorporated in the United States, it is not a US tax resident under US tax law either. Further, Apple informed the subcommittee that it does not believe that AOI qualifies as a tax resident of any other country.

The subcommittee raises a question as to the legality of this arrangement. While, as noted, the United States generally determines tax residence on the basis of the place of incorporation, a shell entity incorporated in a foreign tax jurisdiction could be disregarded for US tax purposes in some situations—for example, if that entity is controlled by its parent to such a degree that the shell entity is nothing more than an instrumentality of its parent. The subcommittee holds out some hope that this rule could apply here: “While the IRS [Internal Revenue Service] and the courts have shown reluctance to apply that test, disregard the corporate form, and attribute the income of one corporation to another, the facts here warrant examination.”

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19 Ibid., at 19.
20 Ibid., at 23.
Similarly, ASI, a second Irish affiliate, also pays very little tax. Although Ireland’s corporate tax rate is officially 12 percent (not a high figure), Apple told the subcommittee that through negotiations with the Irish government, it had obtained a special rate, which, for the last 10 years, has been 2 percent or less; in 2011, it was 0.05 percent, or about $10 million on pre-tax earnings of $22 billion. Even this low rate is perhaps more than Apple is legally required to pay: Apple claims that ASI is exempt from tax in Ireland since its central management and control is in the United States. ASI also appears not to be taxable in the United States, for the same reasons discussed for AOI above. Thus, Apple contends that both of its Irish subsidiaries earn stateless income.

The means by which Apple shifted its income to the two main Irish subsidiaries (AOI and ASI) is perhaps unsurprising, although it is helpful to see these methods documented in some detail. For ASI, one method seems to be straightforward transfer pricing. ASI contracted with Apple’s third-party manufacturer in China to assemble Apple products and acted as the initial buyer of those finished goods. ASI then resold the finished products at a higher price to foreign affiliates around the world. Although ASI is an Irish incorporated entity, only a small percentage of Apple’s manufactured products ever entered Ireland. Rather, title was transferred between the third-party manufacturer and ASI, while the products were shipped directly to the eventual country of sale. Once there, the products were resold by ASI to the relevant Apple distribution affiliate, which then sold the goods to either end customers or Apple retail subsidiaries. Apple’s distribution process suggests that the location of its affiliates in Ireland was designed primarily to facilitate the concentration of offshore profits in a low-tax jurisdiction, and appears to have no business purpose.

For AOI, the main source of income was a cost-sharing arrangement for intellectual property in which the economic rights to Apple’s intellectual property were held in Ireland. The subcommittee noted several questionable aspects of this agreement. First, the bulk of Apple’s R & D efforts are conducted in California, yet under the cost-sharing agreement, a disproportionate amount of the resulting profits remains outside of the United States. Second, the transfer of intellectual property rights to Ireland appears to play no role in the way Apple conducts its commercial operations. Third, the cost-sharing agreement does not in reality shift any risks or benefits away from Apple, the multinational corporation; it only shifts the location of the tax liability for Apple’s profits. Finally, Apple’s transfer of the economic rights to its intellectual property to Ireland has no apparent commercial benefit apart from its tax effects. Although Apple has operations in numerous countries around the world, it does not transfer intellectual property rights to each region or country where it conducts business. Instead, the transfer of economic rights is confined to Ireland alone, where, as noted, the company enjoys an extremely low tax rate.

Canadians should be aware that the effect of Apple’s tax planning is to shift profits out of other developed countries as well. The subcommittee notes that in 2011,

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21 Ibid., at 20-21.
for example, 84 percent of Apple’s non-US operating income was booked in ASI. This left very small earnings, and correspondingly small tax liabilities, in other countries.

In 2011, for example, only $155 million in earnings before taxes were recorded in Apple’s UK affiliates. Apple also had no tax liability in its French and German retail affiliates that same year. Through this foreign profit shifting, Apple is able to reduce its effective foreign tax rate to below 2%.22

In a statement released before the subcommittee hearing, Apple confirmed that AOI and ASI are not tax-resident in either Ireland or the United States. However, Apple noted that AOI’s dividend income receipts are post-tax income, in that they are paid out of funds that have already borne tax in the countries where they were earned. Apple also noted that AOI’s investment income earned on its cash holdings is taxable to Apple Inc. as subpart F income, because AOI is a controlled foreign corporation that is wholly owned by Apple Inc. However, no figures are given for the amount paid in respect of any of these taxes.23 Apple further claimed that it “does not use tax gimmicks”24 and that it “complies fully with both the laws and [the] spirit of the laws.”25 Apple noted that it is “likely the largest corporate income taxpayer in the US, having paid nearly $6 billion in taxes to the US Treasury in [fiscal year 2012].”26 However, again no figures are provided regarding the amount of foreign taxes paid.

A.M.


Both of these studies utilize 2000-2009 data from the T3010 information return required to be submitted to the Canada Revenue Agency by all registered charities in Canada.

22 Ibid., at 40.
24 Ibid., at 2.
25 Ibid., at 1.
26 Ibid., at 2. This is much higher than the $2.5 billion in taxes for fiscal year 2011 reported in the subcommittee report, at 39.
The first study examines returns for all charities, but focuses particularly on small charities (those with total annual revenues under $100,000), which represent 55 to 60 percent of all charities. The intent is to assist the managers of small charitable organizations by providing information on the number and type of fundraising activities undertaken by such charities. The most common fundraising method is the use of collection plates or boxes. Other popular fundraising methods are special events, sales of products, direct mail campaigns, and corporate donations and sponsorships. Approximately 40 percent of small charities use just one method, and another 30 percent use two. Tables are included to show how these results vary across provinces.

The second study examines in particular the weaknesses of the T3010 as a source of information about fundraising methods. Methods not tracked by the T3010 are noted, and suggestions are made for ways of improving the form.

A.M.


The Canadian personal income tax is based on the individual as the tax unit. Thus, if one shares the opinion expressed by the authors of this paper—that ability to pay should be based on family income—the current tax system is unfair to single-earner couples. For example, the paper shows that a family with a single earner making $70,000 a year pays 30 percent more in taxes every year than a family with two partners making $35,000 a year. A single-earner family taking in $120,000 a year pays the same amount of income tax as a dual-earner couple making $141,000 between them.

The Conservatives proposed in the 2011 election to introduce changes in the tax law that would allow individuals to transfer up to $50,000 of income from one member of a couple to another, provided that the family had a dependent child under the age of 18. (The new rules would be introduced once the government had returned to a balanced budget.) This, of course, is only one way to implement the idea of using the couple as the tax unit. In particular, it assumes that there are no economies of scale in living together as a couple; in other words, the costs of two people living together are the same as the costs of two people living apart.

Krzepkowski and Mintz are not concerned with the appropriateness of a $50,000 limit or the application of income splitting only to families with minor children,

27 Brouard et al., at 13.
28 Ibid., at 22.
29 Ibid., at 24.
both of which appear to be restrictions that would be hard to maintain over time. Instead, they address the general question of the fairness of income splitting (keeping the no-economies-of-scale assumption).

Interestingly, they conclude that income splitting would give too much of a tax break to single-earner couples. The problem is that those couples would continue to get the spousal credit, which implies that a spouse not in paid employment is a dependant (“another mouth to feed”) rather than a worker providing valuable home production services (child care, home cleaning, etc.)—services that a dual-earner couple would probably have to pay for. Thus, Krzepkowski and Mintz appear to suggest that the spousal credit should not be available to couples using income splitting; instead, the lower-income spouse would be given a new tax credit to be calculated on the basis of his or her employment income. The intent is to allow the lower-income spouse (the secondary earner, in economics terminology) to have at least a small amount of untaxed labour income. The proposal is interesting in that it acknowledges the well-known disadvantage of using the couple as a tax unit, namely, that the lower-income spouse suffers a tax increase and is therefore induced to leave the labour market. No revenue cost estimates are provided.

A.M.


This short report is unique in the literature on tax avoidance in that it focuses on the big four accounting firms and how their business activities are believed to contribute to the problem. Two of its conclusions are particularly notable and controversial.

1. The UK tax authority is no match for the big four:

   HMRC [HM Revenue & Customs] is not able to defend the public interest effectively when its resources are more limited than those enjoyed by the big four firms. . . . For instance HMRC has 65 transfer pricing specialists whereas the big four firms alone have around 250.31

2. When HM Treasury (the UK equivalent of Canada’s Department of Finance) hires the big four for advice on policy, it creates a perception that the big four wield undue influence on the tax system. The committee cites, by way


31 At 6.
of example, one instance where KPMG advised the government on the controlled foreign company and patent box rules, and then produced marketing brochures highlighting the role that its staff had played in advising the government.32 As the committee notes,

we have seen what look like cases of poacher, turned gamekeeper, turned poacher again, whereby individuals who advise government go back to their firms and advise their clients on how they can use those laws to reduce the amount of tax they pay.33

While I have no direct knowledge of what may have happened in the United Kingdom, my own experience is that in the Canadian context, the latter comment is totally offbase. The Department of Finance needs experienced practitioners to contribute their services, and, to my knowledge, no ethical problems have arisen.

A.M.

Department of Finance Canada, Internal Audit and Evaluation Department, 

The content of this internal audit report issued by the Department of Finance is, for the most part, positive and unsurprising. However, one interesting fact is that the number of full-time employees in the Tax Policy Branch fell by 10 percent (from 176 to 159) between 2010-11 and 2011-12.34 Evidently, the federal government’s policy of general containment of public service costs has applied to Finance as well as other departments and agencies.

It is also interesting to note that employees of the Tax Policy Branch seem to be happy with their jobs: 81 percent of branch staff report that they derive satisfaction from their work, compared to 76 percent for Finance staff department-wide, and 76 percent for the federal government as a whole.35

A.M.

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32 At 10.
33 At 4.
34 At paragraph 4.2.4.2.
35 At paragraph 4.2.3.