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More on Services PEs—What Is a Connected Project?

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PRÉCIS

Depuis les premiers jours des conventions fiscales, on admettait généralement que les bénéfices d'entreprise gagnés par un résident d'un État dans un autre État seraient imposés dans l'État source seulement si le résident gagnait ces bénéfices par l'intermédiaire d'un « établissement stable » (ES) dans cet État source. Jusqu'aux années 70, on entendait généralement par ES un établissement physique réel. Depuis 1969, les Nations Unies ont commencé à envisager d'étendre le concept d'« établissement stable » afin d'inclure la simple prestation de services pendant un certain temps. Dans la plupart des cas (mais non dans tous), les conventions qui sont étendues de cette façon exigent que les services soient fournis à l'égard d'un projet ou d'un « projet connexe ». Le présent article tente d'analyser l'historique et l'essence du terme « projet connexe ». L'article en vient à la conclusion qu'il répond à deux fins distinctes mais liées : limiter le droit d'un État source d'imposer les bénéfices gagnés par la prestation de services et empêcher les résidents étrangers de fractionner et de raccourcir artificiellement les contrats de service dans le but d'éviter de fournir des services pour la durée requise par la convention pour créer un ES.

ABSTRACT

From the earliest days of tax treaties, it was agreed generally that business profits earned by a resident of one state in another state would be taxed in the source state only if the resident earned those profits through a permanent establishment (PE) in that source state. Until the 1970s, a PE generally meant an actual, physical, establishment. Starting in 1969, the United Nations started to consider the possibility of expanding the "permanent establishment" concept to include the mere provision of services for a certain length of time. In most (although not all) cases, treaties that contain such an expansion require that the services be provided in respect of a project or a "connected project." This article attempts to analyze the history, purpose, and meaning of the term "connected project." The article concludes that the connected project requirement serves two separate but related purposes: (1) to limit a source state's right to tax profits earned from the provision of services, and (2) to prevent foreign residents from splitting up and shortening service contracts artificially so as to avoid providing services for the period of time required under the treaty to create a PE.

KEYWORDS: PERMANENT ESTABLISHMENT ■ SERVICES ■ LIMITATIONS ■ ANTI-ABUSE

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INTRODUCTION

In 1933, Mitchell B. Carroll, at that time an adviser to the US Treasury department, published his seminal study on the question of when one country ("the source state") should tax the business profits earned in that state by an enterprise of another country ("the residence state").[1] His conclusion was that, to prevent double taxation and encourage cross-border trade and investment, the source state should

1 Mitchell B. Carroll, *Taxation of Foreign and National Enterprises*, vol. 4, *Methods of Allocating Taxable Income*, League of Nations doc. C.425(b).M.217(b).1933.II.A (Geneva: League of Nations, 1933) (http://setis.library.usyd.edu.au/oztexts/parsons.html—item 5).

tax the enterprise only if, and to the extent that, the profits earned by the enterprise in the source state could be allocated to the enterprise's permanent establishment (PE) in the source state. The residence state would then provide a tax credit to the enterprise for the tax it paid to the source state on those profits.

The PE concept was adopted by the Fiscal Committee of the League of Nations in the league's early model tax treaties and by the league's successors, the Organisation for European Economic Co-operation (OEEC) and the Organisation for Economic Co-operation and Development (OECD), in their model treaties.[2] It is now used throughout the world and appears in all, or almost all, tax treaties.

However, Carroll's proposal had what some countries perceived to be a flaw. Starting in 1969, developing countries noted that, in most cases,[3] the definition of a PE required a bricks-and-mortar establishment. That meant that a foreign enterprise could provide services in the source state, even over a long period of time, and could earn significant profits from those services, without the source state being able to tax those profits, so long as the enterprise did not provide the services through a PE in the source state. This has become even more possible given the increase in mobility and virtualization in our high-tech world.[4]

In 1979, in conjunction with the objective of enhancing trade between developing and developed countries,[5] the United Nations (UN) drafted and in 1980 published a model income tax treaty[6] that contained a provision—article 5(3)(b)—that was designed to create a PE (a "services PE")[7] in such situations. Under the services PE

2 In 1958, the OEEC began to publish a model income tax convention with commentaries to explain the meaning and purpose of each article in the model. Both the OEEC and, earlier, the Fiscal Committee of the League of Nations had been working on a model treaty for many years. The OEEC was renamed the OECD in 1961. Starting in 1963, the OECD published a model income tax convention ("the OECD model treaty"). The OECD model treaty was accompanied by commentary ("the OECD commentary") on the meaning of each article in the model. The OECD model treaty and the OECD commentary have been revised frequently since then. As well, the United Nations, the United States, and other jurisdictions have followed the format of publishing a model treaty accompanied by commentary thereon, updated more or less frequently.

3 The agency PE being the exception.

4 See Michael Wichmann, "The Taxation of Services: Is the Permanent Establishment the Appropriate Threshold?" (2004) 58:5 *Bulletin for International Fiscal Documentation* 201-4.

5 For a discussion of Canada's tax treaty policy toward developing countries, including the use of a services PE provision, see Kim Brooks, "Canada's Evolving Tax Treaty Policy Toward Low-Income Countries," in Arthur J. Cockfield, ed., *Globalization and Its Tax Discontents: Tax Policy and International Investments* (Toronto: University of Toronto Press, 2010), 189-211, at 197.

6 United Nations, Department of International Economic and Social Affairs, *United Nations Model Taxation Convention Between Developed and Developing Countries*, UN publication no. ST/ESA/102 (New York: United Nations, 1980) (herein referred to as "the UN model treaty") and the accompanying commentary ("the UN commentary").

7 The earliest tax treaty I can find that contains a services PE provision is the 1973 Indonesia-Netherlands income tax treaty. That treaty also is the earliest to use the concept of a "connected project" in this context. The earliest treaty that refers to connected projects having to form a "coherent whole" (albeit in the construction PE context) is the 1975 Singapore-Switzerland

provision, an enterprise of the residence state will be deemed to have a PE in the source state if it provides services in the source state through a single employee who is present in the source state for more than 183 days in any 12-month period, or if two or more employees are present collectively in the source state for more than 183 days in that period and provide services on the same project or on two or more "connected" projects. As has been noted, this services PE provision has the effect of lowering the degree of economic activity required to form a PE as compared with the traditional definition of a PE contained in the OECD model tax treaty.[8] Such lowering is done deliberately, to enhance the ability of developing countries to tax profits earned within their jurisdiction.

To date, the exact purpose and meaning of the concept of a "connected project" in this context has not been determined. The purpose of this article is to explore the history, purpose, and meaning of that phrase. I have attempted to identify the two key policy objectives that have been put forward to justify the use of the phrase in the services PE provision. I have also attempted to draw some conclusions as to the facts that should be taken into account in determining whether two or more projects are connected.

In brief, the idea of taxing the enterprise when it meets the 183-day threshold, not just on a single project, but even if those days are attributable to two or more connected projects, is supported by two policy objectives. The first is that the source state should not be able to tax the enterprise unless the enterprise has a substantial enough connection to the source state to justify taxation under international tax policy. Accordingly, the source state should not be able to aggregate days spent on unrelated and unconnected projects, no one of which would create a substantial enough connection, so as to reach the 183-day threshold. Seen in this light, the "connecting" requirement is a *limiting* factor on the source state; it protects the enterprise from taxation when there is no real, substantial connection to the source state, or at least not enough of a connection to justify source state taxation.

The second policy objective is to prevent abuse: the connected project concept prevents an enterprise from splitting up a project into two or more artificial components and spending less than 183 days on each component.

As discussed in more detail below, the first policy objective appears to have been the original impetus behind the connected project concept as developed by the UN. The anti-abuse policy was considered to apply by some developing countries and has been adopted by the OECD. Although these policy objectives appear to be mutually exclusive, my view is that they are not competing but are corollaries of each

income tax treaty. The earliest Canadian income tax treaty appears to be the 1976 Canada-Pakistan treaty, which also uses the "connected project" rule.

8 See Armando Lara Yaffar and Michael Leonard, "An Introduction to the Updated UN Model (2011)" (2012) 66:11 *Bulletin for International Taxation* 590-97, at 593. Perhaps it would be more accurate to say that the services PE does not lower the degree of economic activity required to create a PE, but rather lowers the degree of (some would say, eliminates the need for a) physical connection to the source state required to create a PE.

other: both should be considered valid, and a court or a revenue authority should consider both at the same time when determining whether any two projects are connected. I have developed this theory more below.

AN EXAMPLE

To focus the discussion and to concentrate particularly on Canada's most important trading partner, assume that a US corporation ("USco") is engaged by a Canadian corporation ("Canco") to provide services in Canada in respect of several of Canco's projects. From time to time, pursuant to a services agreement between USco and Canco, USco sends its employees to Canada to perform the required services. When the employees work at Canco's Canadian offices, they are not given any designated space but must work wherever space is available, at Canco's direction. The employees' names are not listed in any phone book or other directory associated with Canco. The employees are not provided with keys to the buildings in which Canco has its offices. In short, the employees have no control over their work space, are not associated in any way with that work space, and are not permitted to carry out any business in that space other than the work for which USco has been retained for that particular project. They stay at hotels while in Canada.

Assume that no one employee works in Canada for more than 183 days in any 12-month period. However, collectively the USco employees work in Canada for more than 183 days in a 12-month period.

Is USco Taxable in Canada?

From this relatively simple scenario, numerous tax issues arise with respect to both income tax and goods and services tax/harmonized sales tax (GST/HST), but for the purposes of this article, the most important issue is whether USco is taxable on its profits earned in Canada.

The Income Tax Act

Because USco provides services in Canada to Canco under the services agreement, USco is carrying on business in Canada for the purposes of the Income Tax Act.[9] Therefore, pursuant to clauses 150(1)(a)(i)(B) and (ii)(B), USco must file a Canadian income tax return within six months after the end of its taxation year, regardless whether its business income is exempt from Canadian taxation under an income tax treaty.

Under a combination of paragraph 2(3)(b), subparagraph 115(1)(a)(ii), paragraph 3(a), and subsection 9(1), USco must report its "profit" from its Canadian business. The word "profit" is not defined in the Act; it means, essentially, the net Canadian business income of a taxpayer, computed on an accurate basis, under any reasonable method. This will equal USco's gross receipts receivable under the services agreement, minus

9 Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

all of its expenses allocable to the Canadian business—that is, all expenses incurred directly or indirectly in the course of providing the services under the agreement.[10]

The Treaty

The above conclusion is based on the provisions applicable under the Act. However, those provisions may be overridden by an income tax treaty. Article VII(1) of the Canada-US income tax treaty[11] provides that a person who meets the definition of a US "resident" in article IV and who comes within the limitation-on-benefits provision in article XXIX A is not taxable in Canada on business income earned in Canada unless that income is earned through a PE in Canada, and then only to the extent of the profits "attributable" to that PE, net of expenses allocable to that PE. Article VII(2) further provides that profits and expenses are to be determined as if the PE were a distinct and separate person engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with a Canadian resident and with any other person related to the resident. Article VII(7) states that the profits attributable to a PE "include only those profits derived from the assets or activities of the [PE]." Accordingly, the treaty does not have a "force-of-attraction" provision similar to article 7(1)(c) of the UN model treaty, under which the profits to be taxed may include not only profits attributable to the PE but also profits from other business activities carried on in the other state of the same or a similar kind as those effected through the PE.[12]

Article V defines a PE for the purposes of the treaty. The definition provides that a PE may exist under several different scenarios. These include a fixed place of business ("fixed-base PE"), a construction site ("construction site PE"), and a PE created through services rendered in the other contracting state.

10 *Canderel Ltd. v. Canada*, [1998] 1 SCR 147; *Toronto College Park Ltd. v. Canada*, [1998] 1 SCR 183.

11 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 (herein generally referred to as "the treaty").

12 The US Treasury department issues a plain-English "explanation" for each US treaty (a "technical explanation"). The technical explanations of the treaty and each of its protocols have been given significant weight by the Canada Revenue Agency (CRA) and Canadian courts in interpreting the treaty, because Canada has expressed its agreement with them. See, for example, the United States, Department of the Treasury, "Technical Explanation of the Protocol Done at Chelsea on September 21, 2007, Amending the Income Tax Convention Between the United States of America and Canada" (herein referred to as "the technical explanation of the fifth protocol"), released July 10, 2008; and Canada, Department of Finance, "Canada Supports U.S. Technical Explanation of the Fifth Protocol to the Canada-United States Income Tax Convention," *News Release* 2008-052, July 10, 2008. The absence of a force-of-attraction principle in the treaty is confirmed by the technical explanation of article VII(7) and by the CRA's *Income Tax Treaties Reference Manual* (Ottawa: CRA), 94 ITC 100, which states, "Paragraph 7 clarifies that business profits attributable to a PE shall include only those profits derived from the assets or activities of the PE. This paragraph ensures that the 'force of attraction' rules in the US will not apply since they do not meet the 'attributable to' rules of this paragraph."

On the basis of the facts in the example, it is likely that USco does not have a fixed-base PE in Canada.[13]

Under article V(3) of the treaty, a building site or construction or installation project constitutes a construction site PE "if, but only if, it lasts more than 12 months." Article V(3) does not say to whom the project must belong, but the OECD commentary on article 5(3) of the OECD model treaty suggests that the PE belongs to the non-resident contractor enterprise that comes into the country where the project is located in order to build the project. If the foreign enterprise works on a project in the source state for more than 12 months, that enterprise will have a construction site PE in the source state. In that situation, the number of employees working on the project and the number of days that they spend in the source state in the 12-month period are irrelevant.

The OECD commentary goes into some detail about what constitutes a "construction project" for this purpose. Essentially, if work is done in various places, or at various times, or by various employees, but all of the work is done to create a single "unit"—that is, a coherent whole—from a commercial and geographical point of view, then it is a single project.[14]

Even assuming that Canco has some construction projects and that USco provides services in connection with them, provided that no single project or coherently whole group of projects lasted for more than 12 months, USco would not have a construction site PE under article V(3).

13 See *The Queen v. Dudney*, 2000 DTC 6169 (FCA). Proposed changes to the commentary on article 5 of the OECD model treaty suggest that *Dudney* was wrongly decided. See Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, July 2010); *OECD Model Tax Convention: Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment)* (Paris: OECD, October 19, 2012), at paragraphs 11-14; and Siobhan Goguen and Marc Darmo, "Permanent Establishment Update," paper presented at the International Fiscal Association (Canadian branch) International Tax Seminar, May 23-24, 2013, at slide 12. Nevertheless, a Canadian court would be required to follow *Dudney* on similar facts. See *Dysert v. The Queen*, 2013 TCC 57, at note 3. The OECD commentary should not be controlling: see by analogy *McKesson Canada Corporation v. The Queen*, 2013 TCC 404, at paragraph 120(2); under appeal. This is true particularly because nothing in recent amendments to the text of the OECD or UN model treaties or to the Canada-US treaty was designed to overrule *Dudney* as far as a fixed-base PE was concerned. See United States, Staff of the Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada*, JCX-57-08 (Washington, DC: Joint Committee on Taxation, July 8, 2008) (hereinafter cited as "JCX-57-08"), at part VI, chapter A, "Permanent Establishment by Virtue of Services."

Compare *Dudney* with *Convergys v. Director of Income Tax* (2013), 15 ITLR 939 (Delhi ITAT) and *Renoir Consulting Ltd. v. DDIT* (ITA no. 4323/Mum/2011, ITA no. 4125/Mum/2011, ITA no. 5298/Mum/2009) (April 2014). In *Renoir*, the tribunal held that there was a fixed-base PE in the client's offices, although others have suggested that the hotel was the PE. See PWC, "Hotel Stay + Business = Permanent Establishment," http://www.moneycontrol.com/news_html_files/news_attachment/2014/pwc_news_alert_22_april_2014_renoir_consulting_limited[1].pdf.

14 See paragraph 18 of the OECD commentary on article 5.

Services PE

That leaves the possibility of USco's having a services PE in Canada.[15] Article V(9) of the treaty, added by the fifth protocol in 2007, states:[16]

9. Subject to paragraph 3, where an enterprise of a Contracting State provides services in the other Contracting State, if that enterprise is found not to have a permanent establishment in that other State by virtue of the preceding paragraphs of this Article, that enterprise shall be deemed to provide those services through a permanent establishment in that other State if and only if:

(a) Those services are performed in that other State by an individual who is present in that other State for a period or periods aggregating 183 days or more in any twelve-month period, and, during that period or periods, more than 50 percent of the gross active business revenues of the enterprise consists of income derived from the services performed in that other State by that individual; or

(b) The services are provided in that other State for an aggregate of 183 days or more in any twelve-month period with respect to the same or connected project for customers who are either residents of that other State or who maintain a permanent establishment in that other State and the services are provided in respect of that permanent establishment.

9. Sous réserve du paragraphe 3, lorsqu'une entreprise d'un État contractant fournit des services dans l'autre État contractant, s'il est déterminé qu'elle n'a pas d'établissement stable dans cet autre État en vertu des paragraphes précédents du présent article, cette entreprise est réputée fournir ces services par l'intermédiaire d'un établissement stable dans cet autre État dans les seuls cas où :

a) ces services sont fournis dans cet autre État par une personne physique qui y séjourne pendant une période ou des périodes totalisant 183 jours ou plus au cours d'une période quelconque de douze mois et, pendant cette période ou ces périodes, plus de 50 p. 100 des recettes brutes tirées d'une entreprise exploitée activement de l'entreprise consistent en un revenu tiré des services fournis dans cet autre État par la personne physique; ou

b) les services sont fournis dans cet autre État pendant une période totale de 183 jours ou plus au cours d'une période quelconque de douze mois relativement au même projet ou à un projet connexe pour des clients qui soit sont des résidents de cet autre État, soit y maintiennent un établissement stable, et les services sont fournis relativement à cet établissement stable.

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15 For a more general review of how service providers may have a PE in a source state other than pursuant to a services PE provision, see Sandra P. McGill and Lowell D. Yoder, "From Storefronts to Servers to Service Providers: Stretching the Permanent Establishment Definition To Accommodate New Business Models" (2003) 81:3 *Taxes: The Tax Magazine* 141-62.

16 As noted below, article V(9) may have been based on article 5(3)(b) of the UN model treaty. For a detailed discussion of the UN services PE provision, see Edwin van der Bruggen, "International Tax Aspects of Providing Consulting Services on the Premises of the Client" (2001) 21:2 *ABAC Journal* (Assumption University of Thailand) 1-27.

SOME PRELIMINARY THOUGHTS ON ARTICLE V(9)

Is There a Typo?

The very first question one must ask about article V(9)(b) is, "Is there a typographical error in the English version?" It says, "with respect to the same or connected project," whereas the French version says, "au même projet ou à *un* projet connexe" (for the same project or for *a* connected project—emphasis added). If a difference in meaning was intended between the two versions, it is not apparent what that difference is. It may be that the missing article "a" in the English version has led some to believe that "connected project" should be "connected projects," as it is in some treaties.[17] However, on the basis of the French version, it appears that the article was inadvertently left out of the English version.[18]

Where Does Article V(9) Come From?

As discussed in more detail below, the OECD model treaty does not contain a services PE provision, but the following wording is suggested in the commentary on article 5:

> Notwithstanding the provisions of paragraphs 1, 2 and 3, where an enterprise of a Contracting State performs services in the other Contracting State
>
> a) through an individual who is present in that other State for a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual, or
>
> b) for a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for connected

17 See Brian J. Arnold, "The New Services Permanent Establishment Rule in the Canada-United States Tax Treaty," in *Globalization and Its Tax Discontents*, supra note 5, 280-304, at 294. The term "connected projects" is used, for example, in the 2009 Poland-Norway income tax treaty. See Błazej Kuźniacki, "The Service PE Concept in Light of the Poland-Norway Income Tax Treaty (2009)" (2014) 54:1 *European Taxation* 16-28.

18 Most of Canada's income tax treaties that contain a services PE provision use the term "same or a connected project." Thailand uses "same or connected projects," and New Zealand uses "same project or for connected projects." Azerbaijan, Tanzania, and the United States use "same or connected project." The treaties of a number of countries (for example, Chile and Argentina) do not refer to "connected project" at all. It is interesting to note that the diplomatic notes to the fifth protocol of the Canada-US treaty (infra note 30), the technical explanation of the fifth protocol (supra note 12), and JCX-57-08 (supra note 13) all use the term "connected projects." One supposes it is possible that there are in fact three typographical errors: the use of the article "un" and the word "projet" instead of "projets" in the French version and the missing "s" in the word "project" in the English version. This seems more far-fetched than supposing that there is a missing "a" before "connected" in the English version, and one can only assume that the diplomatic notes, etc., were merely using loose language in referring to "connected projects."

projects through one or more individuals who are present and performing such services in that other State

the activities carried on in that other State in performing these services shall be deemed to be carried on through a permanent establishment of the enterprise situated in that other State, unless these services are limited to those mentioned in paragraph 4 which, if performed through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph. For the purposes of this paragraph, services performed by an individual on behalf of one enterprise shall not be considered to be performed by another enterprise through that individual unless that other enterprise supervises, directs or controls the manner in which these services are performed by the individual.[19]

As can be seen, article V(9) is worded very similarly to the OECD's suggested services PE provision. While there is nothing that says so officially, it has been suggested[20] that the similarity means that the former was based on the latter and that therefore the 2008 OECD commentary is instructive in interpreting article V(9).[21] The similarity is also noted in the explanation of the fifth protocol to the Canada-US treaty that was prepared by the Staff of the Joint Committee on Taxation,[22] and published in 2008, in anticipation of a meeting of the US Senate Committee on Foreign Relations.[23] However, the foreign relations committee report notes that article V(9) is somewhat narrower than the OECD provision:

19 Paragraph 42.23 of the commentary on article 5 of the OECD model treaty.

20 See Brian J. Arnold, "The New Services PE Rule in the Canada-U.S. Treaty Protocol" (2008) 51:2 *Tax Notes International* 189-200, at 192-93, note 25 and the accompanying text; and Arnold, supra note 17, at 283-84.

21 It is not clear which came first. It is generally assumed that article V(9) is taken from the OECD's version of a services PE provision. See Martin B. Tittle, *Permanent Establishment in the United States: A View Through Article V of the U.S.-Canada Tax Treaty* (Lake Mary, FL: Vandeplas, 2007), at 215. Indeed, as discussed in more detail below, the OECD first discussed a services PE provision as early as 2004. But the fifth protocol was being discussed as early as 1999. See Allan R. Lanthier and Kerry L. Plutte, "International Hybrids: Pitfalls and Practice," in *Report of Proceedings of the Fifty-First Tax Conference*, 1999 Conference Report (Toronto: Canadian Tax Foundation, 2000), 46:1-38, at 46:24. If indeed the OECD commentary was written after Canada and the United States had already negotiated the services PE provision in the fifth protocol, then perhaps the former was based on the latter rather than the reverse—in which case, the OECD commentary should not be relied on at all when interpreting article V(9). It is interesting to note that, in any event, the CRA has suggested that because of the difference in wording between the OECD's proposed version of the services PE provision and article V(9), the OECD commentary cannot be relied on in interpreting the treaty provision. See Giancarlo Di Maio and James A. Hutchinson, "Cross-Border Potpourri Issues for Small and Mid-Sized Businesses," in *2012 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 2012), 3:1-49, at 3:6-8, note 17 and the accompanying text; and "Canada Revenue Agency and Revenu Québec Round Table," in *Report of Proceedings of the Sixty-Third Tax Conference*, 2011 Conference Report (Toronto: Canadian Tax Foundation, 2012), 4:1-24, at 4:2. I predict that the CRA, practitioners, and courts will not adhere to this suggestion in the future.

22 JCX-57-08, supra note 13.

23 Held July 10, 2008.

> Mr. Mundaca.
>
> I should also note that some other variants of this provision, one that the OECD is considering is broader than we have provided here. They do not have the restriction we have in our provision regarding the geographic coherence. That is, if you are not providing services in one place, our rule doesn't apply. The OECD rule is broader in that extent.[24]

It is possible that article V(9) is based on article 5(3)(b) of the UN model treaty rather than the OECD's suggested version, or at least was not specifically based on the OECD's version. Thus, while it may be instructive to have regard to the OECD commentary when construing article V(9), that commentary is not necessarily binding.

Overruling Dudney

Another preliminary matter to note is that the report of the US Senate's foreign relations committee confirms that article V(9) was inserted to overrule (or perhaps more accurately, to render irrelevant) the decision in the *Dudney* case.[25] There is no doubt that many people (mostly within the Canada Revenue Agency [CRA]) were surprised by the *Dudney* decision, and a valid argument could be made that the case was wrongly decided. As noted above, recent proposed amendments to the OECD commentary on article 5 appear to be intended to suggest that it *was* wrongly decided.[26] However, at least in Canada, the decision would have to be followed by any future court unless the Supreme Court of Canada overruled it. Canada's approach appears to have been to import a services PE provision into the treaty as a way to get around *Dudney*.[27]

Counting Days

Article V(9) requires services to be provided in Canada for 183 days. In terms of what is required to count as a day on which services are provided, the treaty does not provide any clue. It appears that physical presence of an employee in the source state is required, but days of preparation in the residence state do not count. The foreign relations committee report, in words adopted by the technical explanation of the fifth protocol, states:

> Paragraph 9 only applies to services that are performed or provided by an enterprise of a Contracting State within the other Contracting State. It is therefore not sufficient that the relevant services be merely furnished to a resident of the other Contracting State. Where, for example, an enterprise provides customer support or other services

24 S exec. rep. no. 110-15, 110th Cong., 2d sess. (September 11, 2008), at 123.

25 Ibid., at 4, note 5 and the accompanying text; *Dudney*, supra note 13.

26 See supra note 13.

27 See Tittle, supra note 21, at 212 et seq.

> by telephone or computer to customers located in the other State, those would not be covered by paragraph 9 because they are not performed or provided by that enterprise within the other State. Another example would be that of an architect who is hired to design blueprints for the construction of a building in the other State. As part of completing the project, the architect must make site visits to that other State, and his days of presence there would be counted for purposes of determining whether the 183-day threshold is satisfied. However, the days that the architect spends working on the blueprint in his home office shall not count for purposes of the 183-day threshold, because the architect is not performing or providing those services within the other State.[28]

Paragraph 42.36 of the 2008 OECD commentary on article 5 discusses how days should be counted for the purposes of the 183-day test in the equivalent provision to article V(9)(a). The commentary suggests that the principles applicable to the computation of days of presence for the purposes of article 15(2)(a) of the OECD model treaty (which deals with the taxation of cross-border employees) are also applicable for the purposes of the 183-day test. Under article 15(2)(a), any part of a day in which a person is physically present in the source state counts as a day.[29]

What Is an "Enterprise"?

Another introductory question is, "What is an 'enterprise' for the purposes of article V(9)?" That term used to be, but is no longer, defined in the treaty, and it is not used elsewhere in the treaty. Unless "enterprise" has a meaning that is intended to be applied only with reference to the treaty, article III(2) provides that the term should take its meaning from the law of the country that is applying it—in this case, Canada.[30] However, "enterprise" is not defined in the Act or in any related Canadian domestic tax legislation, so article III(2) is of no use here. It has been suggested that the inclusion of the term in article V(9) was a drafting mistake that arose because article V(9) was based on the OECD commentary, and because the OECD model treaty uses the term.[31] This possibility is enhanced when one notes that article V(9) applies

28 Supra note 24, at 25; technical explanation of the fifth protocol, supra note 12, at article 3, "Paragraph 9 of Article V."

29 See Kuźniacki, supra note 17, at 24-25.

30 See Diplomatic Notes to Fifth Protocol (Annex B), which provides:

> *1. Meaning of undefined terms*
> For purposes of paragraph 2 of Article III (General Definitions) of the Convention, it is understood that, as regards the application at any time of the Convention, and any protocols thereto by a Contracting State, any term not defined therein shall, unless the context otherwise requires or the competent authorities otherwise agree to a common meaning pursuant to Article XXVI (Mutual Agreement Procedure), have the meaning which it has at that time under the law of that State for the purposes of the taxes to which the Convention, and any protocols thereto apply, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

31 See Arnold, supra note 17, at 284-85.

only if the enterprise does not have a PE under the other paragraphs in article V. But those other paragraphs are directed at determining whether a "resident" of a contracting state has a PE. Thus, in my view, in the context of article V(9), an "enterprise" simply means a "resident."[32]

If that interpretation is not correct, then the term must be defined. In previous versions of the treaty, the word "enterprise" sometimes meant an entity and sometimes meant the business carried on by the entity.[33] The CRA has opined that the term combines those two concepts:

> Our view is that the term "enterprise" refers to a resident of a contracting state but only in reference to a particular line of business carried on by such resident. Therefore where a resident of a contracting state carries on two lines of business, that resident may have a permanent establishment in the other contracting state by reference to one of such lines of business but not the other.[34]

Given that article V(9) deems the enterprise to have a PE, it appears that in this context an "enterprise" must refer to an entity itself and not merely an activity of an entity. Potentially, however, it means that it is a particular line of business of an entity, rather than the entity as a whole, that has the PE.[35]

What Are "Services"?

Article V(9) applies only if the enterprise provides "services," a term that is not defined in the treaty. As with "enterprise," unless "services" has a meaning that is intended to be applied only with reference to the treaty, the term should take its meaning from the law of the country that is applying it—in this case, Canada.

The Act does not define "services." Subsection 123(1) of the Excise Tax Act[36] defines "service" to mean

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32 See Tittle, supra note 21, at 218.

33 Brian J. Arnold and Marc Darmo, "Summary of the Proceedings of an Invitational Seminar on the Attribution of Profits to Permanent Establishments" (2001) 49:3 *Canadian Tax Journal* 525-52, at 538-39.

34 CRA document no. 2008-0300941C6, December 9, 2008. For a discussion of the term, see Marsha Reid, "The New Services PE Provision of the Canada-US Tax Treaty" (2010) 58:4 *Canadian Tax Journal* 845-96, at 865 et seq.

35 See the definition of "enterprise" in the first protocol to the 1942 Canada-US tax treaty (Convention Between Canada and the United States of America for the Avoidance of Double Taxation and the Establishment of Rules of Reciprocal Administrative Assistance in the Case of Income Taxes, signed at Washington, DC on March 4, 1942, as amended by the protocols signed on June 12, 1950, August 8, 1956, and October 25, 1966), as discussed in *Abed Estate v. The Queen*, 82 DTC 6099 (FCA). There is a large body of work on the meaning of "enterprise" in the OECD model treaty. See, for example, Guglielmo Maisto, ed., *The Meaning of "Enterprise," "Business" and "Business Profits" Under Tax Treaties and EU Tax Law* (Amsterdam: IBFD, 2011).

36 RSC 1985, c. E-15, as amended.

> anything other than
> (a) property,
> (b) money, and
> (c) anything that is supplied to an employer by a person who is or agrees to become an employee of the employer in the course of or in relation to the office or employment of that person.

It has been suggested that this and similar definitions in value-added tax legislation are too broad for the purposes of the services PE provision.[37] With respect, I disagree.[38] Given that article V defines a PE to exist in various situations other than those involving the provision of services, it appears that article V(9) is intended to be exactly the same sort of catchall provision that the definition of "services" in the Excise Tax Act is intended to be.[39] I agree with the following discussion of "services" in a treaty context:

> Based on these broad interpretations, any process or activity which involves useful labour and gives rise to economic or commercial value for the recipient, but does not produce a tangible commodity or intangible property, will probably be considered a "service." Consequently, a "service" will not only include traditional activities, such as marketing, employee training, information technology support and acting as a broker, but it will also include financial and/or automated activities such as financial guarantees, the provision of insurance and electronically delivered services, including the transmission of communications, database access, website hosting and online gaming.[40]

37 Ariane Pickering, "General Report," in International Fiscal Association, *Enterprises Services*, Cahiers de droit fiscal international vol. 97a (The Hague: Sdu Uitgevers, 2012), 17-60, at 25.

38 Kuźniacki also appears to disagree: see Kuźniacki, supra note 17, at note 36 and the accompanying text.

39 Notably, Tittle discusses article V(9) under the heading "Services Catchall": Tittle, supra note 19, at 203.

40 Yi-Wen Hsu and Claire M.C. Kennedy, "Canada," in *Enterprises Services*, supra note 37, 169-90, at 172. Space does not permit a full discussion of the meaning of "service." Relevant authorities may include People's Republic of China, State Administration of Taxation, "Notice on Issuing the Interpretation of the Articles of the Agreement Between the Government of the People's Republic of China and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and the Protocol Thereof," *Notice* no. 75 (2010), July 26, 2010; paragraph 42.29 of the OECD commentary on article 5; Danuše Nerudová and Marlies Steindl, "Reflections on the Service PE Concept in the Double Taxation Treaty Between Austria and the Czech Republic" (2013) 41:11 *Intertax* 604-13, at 611; Canada Revenue Agency, *Technical Information Bulletin* B-090, "GST/HST and Electronic Commerce," July 2002 under "Characterization of Supplies"; United States Internal Revenue Code of 1986, section 7701(e); Treas. reg. section 1.861-18; and *Garcia v. CIR*, 140 TC no. 6 (2013); 16 ITLR 61. Services that are supplied as part of a sale or lease of property to ensure that the property works properly are probably not services for the purposes of article V(9) but rather part of the sale or lease of the property.

What Does It Mean To "Provide" Services?

Under article V(9), the services must be "provided." In a CRA technical interpretation,[41] USco 1 entered into a contract to perform services for Canco, a customer resident in Canada. USco 1 engaged USco 2 to carry out the services on behalf of USco 1 that USco 1 was obligated to perform under the contract with Canco. The services were performed over a period of more than 183 consecutive days. USco 1 and USco 2 were residents of the United States and not of Canada for the purposes of the treaty. Many employees of USco 2 were involved in performing the consulting services. Canco, USco 1, and USco 2 were controlled by a common parent company. The CRA opined that USco 1 "provided" consulting services to Canco through the agency of USco 2 and therefore was deemed to have a services PE in Canada under article V(9)(b) of the treaty. This suggests that "provided" means nothing more than "performs" or "carries out," whether directly or through an agent or contractor.

Article 5(3)(b) of the UN model refers to services being "furnished." As discussed in more detail below, it has been suggested that this word permits services to be provided from outside the source state while still creating a services PE inside the source state. But the case law does not support that interpretation, and neither does the UN commentary to date.

Providing Services to Related Enterprises

Another introductory question is whether article V(9) can apply to services provided by an enterprise to a related or affiliated entity. Suppose USco and Canco were related or affiliated in some way. Would that mean that USco could not fall into article V(9), even if it otherwise met its conditions?

The OECD commentary on article 5 suggests that that would be the case. It states:

> The provision applies to services performed by an enterprise. Thus, services *must be provided by the enterprise to third parties*. Clearly, the provision could not have the effect of deeming an enterprise to have a permanent establishment merely because services are provided to that enterprise. For example, services might be provided by an individual to his employer without that employer performing any services (*e.g.* an employee who provides manufacturing services to an enterprise that sells manufactured products). Another example would be where the employees of one enterprise provide services in one country to *an associated enterprise under detailed instructions and close supervision of the latter enterprise*; in that case, assuming the services in question are not for the benefit of any third party, *the latter enterprise does not itself perform any services to which the provision could apply*.[42]

41 CRA document no. 2010-0391541E5, April 13, 2011.

42 Paragraph 42.30 of the commentary on article 5 of the OECD model treaty (emphasis added).

Similarly, the technical explanation of article V(9) states:

> Paragraph 9 applies only to the provision of services, and *only to services provided by an enterprise to third parties*. Thus, the provision does not have the effect of deeming an enterprise to have a permanent establishment merely because services are provided to that enterprise.[43]

The CRA does not believe that USco would be kept out of article V(9) merely because it provided services to a related party. In 2008, the CRA stated:

> Question 3 A2 Part I: Would CRA define what a "third party" is for purposes of this provision [article V(9)]?
>
> Question 3 A2 Part II: Are related parties considered third parties? . . .
>
> Answers to Question 3 A2:
>
> Question 3 A2 Part I: It is our view that the term "third party" used in paragraph 9 of Article V of the Treaty should be interpreted to mean any person other than the person operating the enterprise in question.
>
> Question 3 A2 Part II: A related person in reference to a particular person is considered a "third party" for purposes of paragraph 9 of Article V of the Treaty.[44]

Various authors have noted that there is an apparent difference between the CRA's broad interpretation of article V(9) and that set out by the joint committee, which stated:

> According to the Technical Explanation, paragraph 9 applies only to services provided by the enterprise to third parties, *and not to services provided to that enterprise (i.e., inter-company services)*.[45]

It has been suggested that "[i]f the US adopts this interpretation of Article V(9), it would likely take the position with Canada that a US resident should not be deemed to have a permanent establishment in Canada under Article V(9) by providing services in Canada to its Canadian affiliate."[46]

However, the CRA itself does not see a discrepancy between its position and the joint committee's:

43 Technical explanation of the fifth protocol, supra note 12, at article 3, "Paragraph 9 of Article V" (emphasis added).

44 CRA document no. 2008-0300941C6, December 9, 2008.

45 JCX-57-08, supra note 13, at 42 (emphasis added).

46 Douglas Cannon and Jeff Oldewening, "Article V(9) of the Canada-US Tax Convention, 1980: An Update on the 'Services PE' Deeming Rules" (2009) 8:2 *Toronto Centre CRA & Professionals Consultation Group Newsletter*.

> [Question]
>
> Is there a discrepancy between the CRA's position that subparagraph 9(b) of Article V of the Treaty could apply where services are rendered between related parties and the US Joint Committee on Taxation's statement in their report entitled "Explanation of the proposed Protocol to the Income Tax Treaty Between the United States and Canada" (JCX-57-08) dated July 8, 200[8]? In their explanation, the Joint Committee summarized a statement in the TE [the technical explanation of the fifth protocol] as follows: paragraph 9 only applies to services provided by the enterprise to third parties and not to services provided to that enterprise (i.e. inter-company services).
>
> CRA Response
>
> The CRA continues to be of the view that a related party may be a "third party" and therefore paragraph 9 of Article V can give rise to a permanent establishment where the services in question are rendered to a related party. The CRA agrees with the comment in the TE to the effect that paragraph 9 of Article V cannot give rise to a PE for an enterprise when services are rendered to that enterprise. It is not clear to the CRA that its views are contrary to the views of the U.S. Joint Committee.[47]

Looking at just the text of article V(9), there is nothing to suggest that a service provided by an associated or related enterprise would not fall within that provision.[48] It appears that the OECD commentary and the joint committee report may lead to confusion. Both state merely that a service provided "to" the foreign enterprise is not a service provided "by" that enterprise to its customers in the source state. Nothing in those publications suggests that a service provided to a legally separate but related entity would be outside article V(9). The purpose of the extract from the OECD commentary quoted above appears to be simply to note that if the employees of an enterprise travel to a source state and perform services for the enterprise in that state, a PE is not thereby created in the source state.[49] The phrase "inter-company services," in the context in which it used by the joint committee as quoted above, appears to be a reference to services provided *to* the foreign enterprise in the source state, not services provided *by* the enterprise in the source state.

This conclusion appears to be confirmed by the following statement in the OECD commentary on the suggested services PE provision, in the context of discussing whether the performance of services relating to a preliminary or auxiliary matter could create a PE:

> This alternative provision will not apply if the services performed are limited to those mentioned in paragraph 4 of the Article 5 which, if performed through a fixed place of

47 CRA document no. 2009-0319441C6, August 5, 2009.

48 As noted by Kuźniacki, supra note 17, at 20, the phrase "third parties" does not distinguish between related and unrelated parties.

49 See Arnold, supra note 17, at 284.

> business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph. *Since the provision refers to the performance of services by the enterprise and this would not cover services provided to the enterprise itself*, most of the provisions of paragraph 4 would not appear to be relevant.[50]

My suggested reading of article V(9) is supported by *DIT v. Morgan Stanley*.[51] The taxpayer ("MS") was a US company that retained an Indian company ("MSAS") to do certain work. MS sent its employees to India to oversee MSAS's staff in performing the work ("stewardship activities") and also sent employees on secondment to MSAS. MS was assessed in India on the basis that both the stewardship and the secondment activities created a services PE under article 5(2)(l) of the India-US tax treaty.[52]

The stewardship activities involved briefing MSAS's staff to ensure that the output met MS's requirements. These activities included monitoring of the outsourcing operations at MSAS. The stewards were not involved in day-to-day management or in any specific services to be undertaken by MSAS. The India Supreme Court held that in respect of these activities, it could not be said that MS was rendering services to MSAS; it was merely protecting its own interests in the competitive world by ensuring the quality and confidentiality of MSAS's services.

In *Re Golf in Dubai, LLC*,[53] the taxpayer was a UAE company that was in the business of organizing golf tournaments. It organized two tournaments in India and paid rental fees for the golf courses. It was held that the taxpayer had not provided services to anyone, and hence did not have a services PE.

In *Deputy Director of Income Tax v. Tekmark Global Solutions LLC*,[54] the taxpayer ("Tekmark") was a tax resident of the United States and had entered into an arrangement with Lucent Technologies Hindustan Pvt. Ltd. ("Lucent") for the deputation of personnel. Under the agreement, Tekmark was responsible for deputing personnel to Lucent under Lucent's supervision and control. The deputed personnel were to be under Lucent's direction, supervision, and control, but they would remain on Tekmark's payroll and Lucent would reimburse Tekmark for their deputation costs.

Since Tekmark considered that it had not rendered any services through its personnel, it treated the amount reimbursed by Lucent as business income that was not earned through a PE in India. The deputy director of income tax argued that Tekmark rendered services to Lucent through its personnel in India and thus created a services PE under article 5(2)(l) of the India-US tax treaty.

50 Paragraph 42.48 of the commentary on article 5 of the OECD model treaty (emphasis added).

51 (2007), 9 ITLR 1124 (India SC).

52 The Convention Between the Government of the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Together with a Related Protocol, signed at New Delhi on September 12, 1989.

53 (2008), 306 ITR 374 (AAR).

54 (2010), 38 SOT 7 (Mumbai ITAT).

The Income Tax Appellate Tribunal held that because Tekmark had provided personnel only to work under Lucent's control and supervision and did not render any technical services to Lucent through these personnel, the deputation of such personnel could not be considered to create a services PE.

These cases indicate that to have a services PE, the foreign enterprise must be providing the services to a person in the source state.

What About Seconded Employees?

An issue that arises when services are performed by one company across a border for another company is whether employees of the first company who actually travel to do the work remain employees of the first company, in which case they may create a services PE if they meet the days-of-presence test, or whether they become employees of the second company through a secondment, in which case a services PE will not be created.

In *Income Tax Technical News* no. 44 (ITTN no. 44),[55] the CRA stated that where a US enterprise was merely reimbursed for the amount of its compensation costs in respect of an employee that was seconded to a resident of Canada and the employee was under the supervision of the Canadian resident, the US enterprise would not be seen as providing services in Canada. The employee would be seen as performing his or her duties of employment in his or her capacity as an employee of the Canadian resident only. On the other hand, where a US resident seconded one of its employees to its Canadian subsidiary to provide services in Canada to a Canadian client, the employee remained on the US payroll, but the US company charged the Canadian subsidiary 85 percent of the employee's regular per diem rate for the use of the employee's services and the employee was under the supervision of the Canadian subsidiary's executive team, the US resident would have a services PE in Canada.

In ITTN no. 44, the CRA did not refer to *Morgan Stanley*. In that case, with respect to the seconded employees, the court held that an employee of MS, when "deputed" (seconded) to MSAS, did not become MSAS's employee. A "deputationist" (a seconded employee) had a "lien" on his employment with MS. As long as the lien remained with MS, MS retained control over the deputationist's terms and employment. The court held that on request/requisition from MSAS, MS deputed its staff. The request came from MSAS depending on its requirement. A deputationist under such circumstances was expected to be experienced in banking and finance. On completion of his tenure, he was repatriated to his parent job with MS in the United States. He retained his lien when he came to India. He lent his experience to MSAS in India as an employee of MS, and accordingly there was a services PE under article 5(2)(1).[56]

55 Canada Revenue Agency, *Income Tax Technical News* no. 44, April 14, 2011.

56 There was no need to discuss connected projects in this case because there was only one project.

Morgan Stanley was followed in *Centrica India Offshore Pvt. Ltd.*[57] The taxpayer ("CIOP") was an Indian, wholly owned subsidiary of Centrica plc, a UK company. British Gas Trading Ltd. and Direct Energy Marketing Limited, Canada ("the overseas entities") were also subsidiaries of Centrica plc. The overseas entities were in the business of supplying gas and electricity to consumers in the United Kingdom and Canada. The overseas entities outsourced their back-office support functions (for instance, debt collections/consumers' billings/monthly jobs) to third-party vendors in India. CIOP was established to ensure that the Indian vendors complied with the overseas entities' quality guidelines. CIOP was to act as a service provider to the overseas entities. CIOP entered into a service agreement with the overseas entities to provide local-based interface between them and their Indian vendors. CIOP's services included (1) providing management assistance for outsourced supplies in India and facilitating efficient interface back to Centrica plc; (2) ensuring that the vendors adhered to best practices and shared them on an optimal basis; (3) providing expert advice on widening the scope of potential services in India; and (4) such other services as might be requested by Centrica plc from time to time.

During its initial year of operation, CIOP required some employees on secondment from the overseas entities. It entered into an agreement with the overseas entities in which the latter seconded some employees for a fixed tenure. Under the secondment agreement, the employees were to work under CIOP's direct control and supervision. Conversely, the overseas entities were not responsible for any seconded employee's error or omission committed or omitted in the course of his work for CIOP. CIOP bore all risks and rewards associated with the work performed by the seconded employees. CIOP was required to enter into individual agreements with a predetermined format with each employee. The employees' families and financial affairs remained in their home countries, to which they intended ultimately to return after the completion of the CIOP assignment. The employees remained on the overseas entities' payrolls. CIOP reimbursed the overseas entities for their salaries.

The issue was whether the overseas entities were subject to withholding in India on "royalties," defined in the India-UK and India-Canada income tax treaties to include the provision of technical services. The Indian tax authority argued that CIOP was required to withhold on the reimbursement payments made to the overseas entities.

CIOP argued that the secondment agreement conclusively established that CIOP was the real and economic employer of the seconded employees and that they were acting for CIOP in the performance of their jobs and were not placed there to perform services for CIOP. CIOP relied on the concept of economic employment as opposed to legal employment and argued that the formal legal relationship of employer and employee as between the seconded employees and the overseas entities was irrelevant. It argued that it was the real employer because the content of the work or

57 *Centrica India Offshore Pvt. Ltd. v. CIT* [W.P.(C) no. 6807/2012], available at http://www.indiankanoon.org/doc/79087507/; on appeal from *Centrica India Offshore Pvt. Ltd. v. CIT* (2012), 348 ITR 45 (AAR).

employment, the entire direction and supervision over the seconded employees' work, and the pay and emoluments were borne by it. For convenience, the pay was disbursed by the overseas entities, but that amount was reimbursed to them.

The court agreed that it should look at the substance of the employment relationship and not the form. It agreed that the seconded employees were to be integrated into CIOP's operations for the agreed period and were subject to its supervision and control. CIOP's employment rules, regulations, policies, and other practices were applicable to the seconded employees. CIOP dictated the seconded employees' duties and functions. They had to perform the duties assigned with due diligence in accordance with CIOP's applicable laws and regulations, standards and practices, and control. The overseas entities were not responsible for any errors or omissions of such seconded employees or for their work. CIOP bore all risks in relation to the work of the seconded employees, and reaped the benefit from their output. CIOP also bore the cost of monthly remuneration and reimbursement of the cost of the seconded employees.

Despite all this, the court held that the employees remained employees of the overseas entities and were delivering services to CIOP, rather than performing services for the overseas entities as CIOP's employees. In the court's view, the crucial points were that the seconded employees retained their entitlement to participate in the overseas entities' retirement and social security plans and other benefits in terms of their applicable policies, and their salaries were payable by the overseas entities, which claimed the money from CIOP. There was no purported employment relationship between CIOP and the seconded employees. CIOP could not terminate the secondment arrangement. Furthermore, there was no entitlement or obligation, clearly spelt out, whereby CIOP had to bear the employees' salaries. That is, the employees could not sue CIOP for default in payment of their salary. All direct costs of the seconded employees' basic salaries and other compensation, cost of participation in the overseas entities' retirement and social security plans, and other benefits in accordance with the applicable policies and other costs were paid by the overseas entities. CIOP had the right to terminate the secondment (in its agreement with the overseas entities), but that would not alter or affect the services of the employees vis-à-vis the overseas entities. That employment relationship remained independent, and beyond CIOP's control.

In short, the court held that while CIOP may have had operational control over the seconded employees in terms of their daily work, and may have been responsible (in terms of the agreement) for their failures, these "limited and sparse factors" could not displace "the larger and established context of employment abroad."[58] As a result, the overseas entities were subject to withholding in India.

A similar conclusion, albeit in a different context, was reached in *IBM Canada Ltd. v. Ontario (Finance)*.[59] The issue was IBM's liability for Ontario employer health tax

58 Supra note 57 [W.P.(C) no. 6807/2012], at paragraph 35.

59 (2008) ONCA 216; leave to appeal denied [2008] SCCA no. 255.

in respect of employees who worked for IBM's affiliated companies abroad. An employee of IBM could take a fixed-term assignment to work for one of IBM's foreign affiliates, during which time the employee lived in the foreign country and worked exclusively for the foreign affiliate. IBM paid the expatriate employee's salary, bonuses, and allowances from Ontario, while the foreign affiliate reimbursed IBM for those payments. IBM continued to provide coverage for the expatriate's pension, medical, and dental plans while the expatriate worked abroad. The expatriate was guaranteed employment with IBM in Canada after completing the assignment. Ontario's minister of finance assessed IBM for employer health tax in respect of amounts paid to expatriates. IBM appealed, arguing that (1) the expatriates were not IBM's employees while working abroad; and (2) even if they were, IBM did not "remunerate" them since they worked exclusively for the foreign affiliate and the affiliate reimbursed IBM for all payments made to the expatriates.

The Ontario Court of Appeal held that the relationship between IBM and the expatriates remained one of employer-employee, stating that the reimbursements made by foreign affiliates "in no way diminish[ed] IBM Canada's direct obligation to the expatriate."[60]

On the issue of remuneration, the court held that while it could be argued that the foreign affiliate was the primary beneficiary of the expatriate's services, IBM's payments to expatriates were made "in the context of an ongoing employer/employee relationship"[61] and pursuant to a contractual obligation. The fact that the foreign affiliate reimbursed IBM was irrelevant, since that was merely a private arrangement between IBM and the affiliate, and was irrelevant to the employee's right to claim compensation from IBM for services performed. The Court of Appeal held that "the *Act* looks to the nature of the payment as between the employer and the employee and not to the source of the funds or to any arrangement which may exist between a third party and the employer for reimbursement."[62]

A very recent case dealing with the issue of whether a secondment can avoid a services PE is *DDIT v. JC Bamford Excavators Limited*.[63] The taxpayer was a UK company that owned, developed, and manufactured excavators. In 2004, the taxpayer entered into a technology transfer agreement ("the TTA") with its wholly owned subsidiary, JCB India Ltd. In 2005, the taxpayer entered into an international personnel assignment agreement ("the IPAA") with JCB India, which was effective from January 1, 2004. In total, the taxpayer seconded eight employees to JCB India. The taxpayer claimed to have received royalties/fees for technical services from JCB India

60 *IBM*, supra note 59 (ONCA), at paragraph 37.

61 Ibid., at paragraph 47.

62 Ibid., at paragraph 49.

63 ITA No. 540/Del/2011, March 14, 2014, ITAT (Delhi). On April 19, 2013, the Chinese State Administration of Taxation issued the "Announcement on Issues Concerning Enterprise Income Tax on Services Provided by Non-Resident Enterprises Through Seconding Personnel to China," which deals with secondments and PEs.

in consideration for the grant of exclusive rights to manufacture and market excavator loaders in India. JCB India withheld 15 percent tax in respect of royalties and fees for technical services under article 13(2) of the India-UK income tax treaty.

The assessing officer (AO) noted that the taxpayer was required to send its personnel to JCB India's plant for solving problems relating to the licensed products. He decided that the IPAA was entered into to formalize the broader terms set out in the TTA for the sending of the technical and other personnel.

The AO rejected the taxpayer's contention that the employees seconded to JCB India became the employees of JCB India on their assignment and hence ceased to have any relation with the taxpayer. Accordingly, in view of the secondment of these eight employees for a period of more than 90 days during the previous year relevant to the assessment year under consideration, the AO held that they constituted a services PE of the taxpayer under article 5(2)(k)(i) of the treaty. The AO relied on *Morgan Stanley*. He took the position that that the taxpayer carried on its business in India through the services PE and that the royalties/fees for technical services received from JCB India were effectively connected with that PE. Accordingly, under article 13(6) of the treaty, he assessed the taxpayer on the basis that the royalties/technical fees were subject to tax under article 7 rather than as royalties under article 13(2). Since the taxpayer either did not keep or did not furnish details of its expenses relating to its income, the AO allowed a deduction of 20 percent of the royalties/fees and assessed the taxpayer for tax on the remaining 80 percent of the royalties/fees.

On objection, the commissioner of income tax agreed with the taxpayer that the seconded employees became the employees of JCB India. Accordingly, the taxpayer was not providing any services to its subsidiary and therefore had no services PE in India. The AO appealed to the Income Tax Appellate Tribunal.

The tribunal held that, under the IPAA, the personnel to be provided by the taxpayer to JCB India were to act under the latter's direction. The subsidiary was to indemnify the taxpayer for any and all claims, liabilities, costs, and expenses resulting from or arising out of actions of the eight personnel while under its direction. JCB India was required to pay compensation to the taxpayer for providing these personnel. As a whole, contrary to the decision of the commissioner of income tax on objection, the tribunal held that the IPAA was not an independent agreement but simply formalized the terms for the supply of personnel by the taxpayer to JCB India under the TTA, and that the IPAA was nothing but an elaboration of the terms for the provision of such personnel by the taxpayer to JCB India; it was, essentially, an addendum to the TTA.

The tribunal held that, on the basis of the facts in their entirety, there remained "absolutely no doubt that these eight personnel deputed from JCB UK to JCB India on assignment basis remained employees of the assessee and never became the employees of JCB India."[64] The IPAA provided that JCB India desired to utilize the services of the employees on a "secondment basis." The tribunal held that the term "secondment"

64 *JC Bamford*, supra note 63, at paragraph 6.11.12.

means that the employee remains an employee of his existing employer, but by virtue of some agreement between the employer and a third person, the employee has to perform the duties for the benefit of such third person. At no time does the employee become an employee of the third person.

The tribunal supported its decision by looking at the JCB international assignment policy UK manual. It provided that "once an expatriate has completed three years under the terms of an expatriate posting package, ordinarily they will be transferred to local terms and conditions, repatriated to their home country" (JCB UK). It also stated that

> [d]uring the expatriate posting grievances and appeals relating to local conditions or local disciplinary matters should be referred in the first instance to International Home Resources Manager and/or the Group HR Director,

and that

> [u]pon completion of an expatriate posting, expatriates, their accompanying family, their personal effects and household goods will be repatriated. The home company will use its best endeavors to find a position in the home country to a level no less favorable to that which the expatriate left to take up the expatriate posting.

On the basis of this manual, the tribunal held that the employees continued to be the taxpayer's employees during the term of service for JCB India on secondment.

Perhaps most importantly, clause 4.5 of the TTA stated that the

> personnel of the Licensor [the taxpayer] and the Licensee [JCB India] during the time they are present on the premises of the other party shall be subject to all rules and regulations prevailing on such premises, but shall not be considered as employees of the other party. Subject to the provisions of this Agreement the Licensor and the Licensee shall each be responsible for the payment of all salary compensation and expenses of their respective personnel.

According to the tribunal, this clause made it clear that the eight persons who were sent on secondment to India continued to remain on the taxpayer's payroll and "maintained their lien" (that is, the lien of employment) on the taxpayer. The tribunal held that it was irrelevant that the taxpayer recovered its costs of such employees from JCB India. It also held that it was "quite natural" that when the employees were deputed to JCB India for a given consideration, they were bound to work under the direction of JCB India and could not have worked for the benefit of the taxpayer.[65] There was no material to indicate that the taxpayer ever terminated their services.

These cases make it clear that achieving a "true" secondment is difficult: in most cases, the employer's wish to avoid a services PE will conflict with and may become

65 Ibid., at paragraph 6.11.10.

subservient to the employee's wish to remain a true employee of his or her home company and not be an employee of the foreign affiliate. A detailed review of the employee's terms of service, any employment manuals, and all terms connected to the secondment must be carried out, to eliminate any reference to the worker's remaining an employee of the home company and to eliminate the employee's lien on the home company.

WILL ARTICLE V(9)(b) APPLY IN THE EXAMPLE?

Since no individual USco employee spends more than 183 days in Canada, USco will not have a PE in Canada under article V(9)(a). That leaves article V(9)(b) to be considered. Collectively, USco's employees spend more than 183 days in Canada in a 12-month period. The questions then are these:

1. What do the words "Subject to paragraph 3" mean?
2. Do the employees spend their time on "the same or [a] connected project"?

"Subject to Paragraph 3"

The meaning of the words "Subject to paragraph 3" is not perfectly clear. One author suggests that the phrase merely means that if services are performed on a building site or a construction or installation project that lasts for more than 12 months, then article V(3) will create a PE even if the 183-day test in article V(9)(b) is not met.[66] Others suggest that it means that if the services are performed in connection with a construction site, then one must ignore article V(9) altogether and focus only on article V(3).[67] The second explanation appears to be correct, on the basis of both the wording and the legislative history of article V(9).[68] While the technical explanation of article V(9)[69] does not address this issue, the joint committee explanation states:

> As stated above, paragraph 9 is subject to the provisions of paragraph 3 of Article V of the treaty. Paragraph 3 provides that a building site or construction or installation project constitutes a permanent establishment if, but only if, it lasts more than twelve months. *Thus, paragraph 9 does not apply to construction services that do not meet the requirements of paragraph 3 for a permanent establishment*. On the other hand, paragraph 9 is not subject to the provisions of paragraph 4 of Article V of the treaty. Paragraph 4 provides that the use of an installation or drilling rig or ship in a treaty [country] to explore for or exploit natural resources constitutes a permanent establishment if, but

66 Reid, supra note 34, at 863.

67 Di Maio and Hutchinson, supra note 21, at 3:3-4; and Lorna Sinclair, "The Services PE Provision of the Canada-US Income Tax Treaty," in *Report of Proceedings of the Sixty-First Tax Conference*, 2009 Conference Report (Toronto: Canadian Tax Foundation, 2010), 22:1-29, at 22:2.

68 See Tittle, supra note 21, at 19.

69 Technical explanation of the fifth protocol, supra note 12.

only if, such use is for more than three months in any twelve-month period. Thus, drilling services that do not meet the requirements of paragraph 4 for a permanent establishment may still give rise to a deemed permanent establishment if the requirements of paragraph 9 are met.[70]

This interpretation of "Subject to paragraph 3"—that time spent by USco's employees on any Canco construction project does not count toward the 183-day test in article V(9)(b)[71]—is supported by the OECD commentary's suggested version of the services PE rule (reproduced above), the opening words of which are "Notwithstanding the provisions of [paragraph] . . . 3." Obviously, this is meant to convey the opposite—"Subject to [paragraph] . . . 3"; that is, even if time spent on a construction site does not meet the 12-month threshold required by paragraph 3, the time may still count toward the 183-day threshold in the services PE article.[72]

What Is a "Project"?

The treaty does not define a "project." In a different context, the CRA noted that

> [t]he word "project" is not defined in the Act. The Concise Oxford Dictionary, 8th Edition, defines "project" in part as:
>
> 1. a plan, a scheme; 2. a planned undertaking.
>
> The Oxford English Dictionary, 2nd Edition, defines the word "project" in part as:
>
> 1. a plan, draft, scheme, or table of something; a tabulated statement; a design or pattern according to which something is made . . . 5.(a) something projected or proposed for execution; a plan, scheme, purpose; a proposal.[73]

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70 JCX-57-08, supra note 13, at 45 (emphasis added). See also Brian J. Arnold, "The New Services PE Rule in the Canada-U.S. Treaty Protocol" (2008) 51:2 *Tax Notes International* 189-200, at 192-93, concluding that no day spent on a construction site counts toward the 183-day test in article V(9); and J. Scott Wilkie, "Services Permanent Establishments and the Canada-United States Income Tax Treaty" (2012) 19:3 *International Transfer Pricing Journal* 179-85, at 182.

71 See, however, paragraph 42.26 et seq. of the commentary on article 5 of the OECD model treaty, which takes the opposite approach (as noted by Lance B. Gordon, Alicia N. Peressada, and Lilo A. Hester, "Analysis of Construction PEs Under U.S. Income Tax Treaties" (2009) 20:9 *Journal of International Taxation* 32-41, at 40, note 31 and the accompanying text; and Arnold, supra note 17, at 285-86).

72 See paragraphs 42.26 to 42.28 of the commentary on article 5 of the OECD model treaty. Paragraph 42.28 provides that "[s]ome States, however, may consider that paragraph 3 should prevail over the alternative provision and may wish to amend the provision accordingly." Obviously, this is what Canada and the United States did in article V(9).

73 CRA document no. 2002-0119355, February 12, 2002, citing *Ainsworth Lumber Co. Ltd. v. The Queen*, 2001 DTC 496 (TCC). This definition was cited by Yves-André Grondin and Patrice Lareau, "Entreprises de services faisant affaire au Canada et à l'étranger," in Association de planification fiscale et financière, *Congrès 2009* (Montréal: APFF, 2010), paper 10, at section 2.3.7.3. Article III(2) of the treaty would allow Canada to adopt a domestic definition of "project" in the absence of a treaty definition. In CRA document no. 2013-0474851I7, April 11,

These definitions appear to convey the intended meaning of the word "project" in article V(9).[74] Accordingly, any plan or scheme or undertaking owned by Canco for which USco is retained to provide services will be considered to be a "project" for this purpose.

What Is "[a] Connected Project"?

Article V(9)(b) requires that services be supplied for more than 183 days "with respect to the same or [a] connected project." Clearly, this means that if the services are supplied for more than 183 days to a single project or to two or more projects that are "connected," then there is a PE. To understand the purpose and meaning of the adjective "connected" in this context, it is necessary to review material associated with the UN model treaty, the OECD commentary, the technical explanation of the treaty, the diplomatic notes to the treaty, the case law, and various textbooks and other publications.

Origins of the UN Provision

The concept of a services PE provision, though not the actual terms of such an article, appears to have originated in the discussions of the first report of the UN's Ad Hoc Group of Experts on Tax Treaties Between Developed and Developing Countries.[75]

The services PE provision, as it now exists in the UN model treaty, originated in the ad hoc group's second report.[76] Article 5(3)(b) of the UN model treaty states:

> 5(3) The term "permanent establishment" also encompasses: . . .
> (b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned.

2014, the CRA looked at the construction PE provision in article 5(3) of the 1975 Canada-France income tax treaty and referred to an earlier (unnamed) technical interpretation that had given the word "project" as used in article 5(2)(g) of the 1978 Canada-UK income tax treaty a "broad meaning," without specifying exactly what that meaning is. See the discussion of this memorandum in the text below at note 128 and following.

74 See Arvid A. Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Deventer, the Netherlands: Kluwer Law and Taxation, 1991), at 353.

75 Although no specific services PE provision was proposed in this first report, it is clear that developing countries wanted to broaden the concept of a PE as compared with the OECD definition. See United Nations, Ad Hoc Group of Experts on Tax Treaties, *Tax Treaties Between Developed and Developing Countries: First Report*, UN publication no. ST/ECA/110 (New York: United Nations, Department of Economic and Social Affairs, 1969), part 1, at paragraph 33 et seq., and part 2, at paragraph 145.

76 See United Nations, Ad Hoc Group of Experts on Tax Treaties, *Tax Treaties Between Developed and Developing Countries: Second Report*, UN publication no. ST/ECA/137 (New York: United Nations, Department of Economic and Social Affairs, 1970), part 1, at paragraph 70.

The reason for the new provision was explained as a requirement to broaden the definition of a PE, so as to allow developing countries to tax profits earned from services provided in their jurisdiction where there would otherwise be no PE:

> As a matter of legal analysis, it is customary to characterize income from industrial or commercial services as industrial or commercial profits. The same would seem to apply to professional and semi-professional services, at least in those countries which characterize all income of corporations and other commercial entities as business income. The example of corporations that are exclusively or predominantly engaged in rendering services demonstrates the problem of limiting the concept of business income to profits from manufacturing or activities of purchase and resale.
>
> On the other hand, the characterization of service income as industrial or commercial profits would preclude the taxation of that income by the developing countries unless the income is attributable to, or "effectively connected" with, a permanent establishment situated in their territory. As far as income from services performed in that area is concerned, it might be considered to broaden the concept of permanent establishment so as to include therein the performance of substantial services, similar to the rule of some treaties which give this effect to the maintenance of substantial equipment in the other treaty country. The substantiality of the services could be measured in terms of their duration, the compensation paid for them, or a combination of both factors.[77]

This proposal was further developed in the 1979 *Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries*.[78] It appears that there was a debate between developed and developing countries over the breadth of the term "royalties" as defined in the proposed UN model treaty. The developed countries felt that technical services should not be taxed as royalties, while developing countries thought they should. As a compromise, it was agreed that such services would be taken out of the definition of royalties but that a new services PE provision would be inserted to capture such services if they lasted for more than 12 months:

> In order to solve the problem of the definition of royalties the Group agreed to consider income from such activities as business profits and to include in guideline 5, paragraph 3, a new subparagraph (b) which provides that the term permanent establishment should likewise encompass "the furnishing of services, including consultancy services, by an enterprise through employees or other personnel, where activities of that nature continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any twelve-month period."[79]

77 Ibid., part 2, at 39.

78 United Nations, Department of International Economic and Social Affairs, *Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries*, UN publication no. ST/ESA/94 (New York: United Nations, 1979).

79 Ibid., at 77. See Edwin van der Bruggen, "Source Taxation of Consideration for Technical Services and Know-How" (2001) 7:3 *Asia-Pacific Tax Bulletin* 42-60, at 52, note 103 and the accompanying text.

The "Connected" Requirement Is a Limitation

Although developing countries wanted to be able to tax profits from services provided in their jurisdiction through the new services PE rule, it was recognized that international tax policy required the foreign enterprise to have a substantial connection to the source state before that state would have the "right" to tax its profits. If the services PE rule provided that any provision of services for more than 183 days would create a PE, then that would merely create situations where a foreign enterprise might be saddled with a PE despite having relatively little connection to the source state in respect of any one project. To avoid this possibility, the UN drafted the provision to require that the 183 days be spent on a single project or on two or more connected projects.

In other words, the connected project rule was inserted as a *limitation*, to ensure that the services PE provision did *not* capture service income from unrelated projects.[80] The ad hoc group's second report explained:

> Some members from developed countries thought that the time-limit approach was an acceptable solution if the words "for the same or a connected project" were inserted after the word "continue," since they thought it undesirable to add together unrelated projects in view of the uncertainty that step involved and the undesirable distinction it created between an enterprise with, say, one project of three months' duration and another with two projects, each of three months' duration, one after the other. In this regard, other countries found the injection of a "project" limitation as either too easy to manipulate or too narrow in that it might exclude a continuous number of separate projects, each of four or five months duration.[81]

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80 One author has noted that, from the point of view of a developed country negotiating a services PE provision with a developing country, under the domestic law of many developing countries gross service income is taxed at source, with no threshold. Therefore, while developed countries would prefer not to have a services PE provision at all, such an article at least has the benefit of ensuring that service income is taxed as business income on a net basis. See M.S. Feinburg, "United States Views on Selected Aspects of Developing Country Tax Treaty Issues," in International Fiscal Association, *Double Taxation Treaties Between Industrialised and Developing Countries; OECD and UN Models, a Comparison: Proceedings of a Seminar Held in Stockholm in 1990 During the 44th Congress of the International Fiscal Association* (Deventer, the Netherlands: Kluwer Law and Taxation, 1992), 39-46, at 43 and 45. Although Feinburg did not cite this source, H. David Rosenbloom made the same comment in "Trends in Tax Treaties Between the United States and Developing Countries," in International Fiscal Association, *UN Draft Model Taxation Convention: Trends in Income Tax Treaties Involving Developing Countries, with Special Reference to the UN Group of Experts on Tax Treaties Between Developed and Developing Countries: Proceedings of a Seminar Held in Copenhagen During the 33rd Congress of the International Fiscal Association* (Deventer, the Netherlands: Kluwer Law and Taxation, 1980), 18-21, at 20. See, for example, *WorleyParsons Services Pty. Ltd. v. CIT* (2008), 301 ITR 54 (AAR), where the taxpayer argued, and the Authority for Advance Rulings agreed, that the taxpayer had a services PE in India and therefore was taxable only on its net business income rather than on a gross royalty basis under article 12 of the relevant treaty.

81 ST/ECA/137, supra note 76, part 1, at paragraph 71.

It has been argued that the connected project limitation on the services PE rule is not justified in policy. Arnold argues that 183 days of physical presence in the source state creates enough of an economic connection to that state to justify its taxation of the profits from those services, even if the days are spent on 183 separate projects for one day per project.[82] With respect, I disagree. It is clear from the other kinds of PEs defined by article 5 that mere presence in a state, no matter how long, has never been sufficient to create the kind of economic connection required to justify taxation in that state. That is why there must be a fixed base. And if there is to be a PE based on time alone, then that time must be spent on a single project, such as a construction site. Admittedly, the agent PE rule is an exception, in that the mere presence of the agent is sufficient to create a PE, even while the presence of the agent's principal, performing the same functions as the agent, would not be. But in my view that is the proverbial exception that proves the rule; the anomaly presented by the agent PE rule should not be expanded to services generally by eliminating the connected project requirement. Nevertheless, many countries are of the same view as Arnold, and their treaties do not contain the limitation found in the UN model.

The concept that the connected project rule is a limitation on the scope of article V(9) is supported by a number of cases that have held that even without such a phrase, interrelated projects could meet the time threshold for a construction site PE. If that is correct, then the "connected project" term in article 5(3)(b) of the UN model treaty must be there for a different purpose: to limit the ability to create a services PE merely by time alone.

A case that suggests the opposite is *C.J.M. v. Belgische Staat*,[83] where the Belgium Court of Appeal was presented with a situation involving the construction site PE provision of the Belgium-Netherlands income tax treaty (1970). The taxpayer, resident in the Netherlands, carried out several contracts throughout Belgium for the same principal in Belgium. No single contract took more than nine months to complete, but it took more than nine months to carry out the work from the start of the first contract to the end of the last. The tax authorities of the two countries had agreed on certain interpretive rules for the construction site PE provision. The Court of Appeal rejected these rules and held that they were inconsistent with the terms of the construction site PE provision. Because the contracts covered several different locations and the relevant treaty provision referred only to a "place" and not to "places," there was no single construction site and hence no PE.

The *C.J.M.* case was referred to in *BV A.A. v. Belastingadministraitie*,[84] which involved the same treaty and the same provision. The taxpayer was a company performing several contracts in Belgium, directly and through a subsidiary, and in several locations.

82 See the expanded online version of Brian J. Arnold, "The Taxation of Income from Services Under Tax Treaties: Cleaning Up the Mess" (2011) 65:2 *Bulletin for International Taxation* 59-68.

83 A decision of the Lower Court of Antwerp, June 29, 1982, published in (1983) 2:20 *Fiscale Jurisprudentie/Jurisprudence Fiscale* 34.

84 A decision of the Antwerp Court of Appeal, April 12, 1984, published in (1984) 12 *Algemeen Fiscaal Tijdschrift* 223.

Although no single contract took more than nine months to complete, as a whole the contracted work took more than nine months. The court held that the contracts were not interrelated, and therefore there was no construction site PE. In contrast to the *C.J.M.* decision, the court held that if two or more of the contracts had been interrelated, then there could have been a PE, even if the contracts were performed at different locations.

Two German cases appear to have reached opposite conclusions on somewhat similar facts. In a decision dated April 21, 1999,[85] the Federal Tax Court in Munich held that several construction projects were one connected project and thus formed a construction site PE under the 1971 Germany-Switzerland tax treaty, because they formed a coherent whole, commercially and geographically. In particular, the projects formed a commercial whole because they had similar functions and were carried out close in time to each other.

On the other hand, in a decision of the same court on May 16, 2001 under the 1977 Germany-Hungary tax treaty,[86] the court held that various construction projects did not form a coherent whole because the projects were not related to each other and were carried out at different sites, even though they were all carried out at the same time and were of the same nature.

These cases indicate that the word "project," if used by itself in article V(9)(b), would include a series of related projects, suggesting that the deliberate use of the term "[a] connected project" is to limit that rule and ensure that a services PE exists only where two or more projects meet the conditions for being "connected" as discussed below.

The ad hoc group did not discuss the services PE provision in its subsequent (third to eighth) reports, but the provision appeared originally as article 5(2)(h) in the 1974 guidelines[87] and then finally as article 5(3)(b) of the 1980 UN model treaty. A services PE rule also appears as article 5(3)(b) in the 2001[88] and 2011[89] versions of the UN model treaty. The 1974 guidelines, in words repeated in the 1979 UN manual[90] and the 2003 UN manual,[91] explain the purpose of the provision as follows:

85 Case I R 99/97, published in [1999] *Bundessteuerblatt Part II* 694.

86 Case I R 47/00, published in [2002] *Bundessteuerblatt Part II* 335.

87 United Nations, *Guidelines for Tax Treaties Between Developed and Developing Countries*, UN publication no. ST/ESA/14 (New York: United Nations, Department of Economic and Social Affairs, 1974).

88 United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention Between Developed and Developing Countries*, UN publication no. ST/ESA/PAD/SER.E/21 (New York: United Nations, 2001).

89 United Nations, *United Nations Model Double Taxation Convention Between Developed and Developing Countries* (New York: United Nations, 2011) (www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf).

90 ST/ESA/94, supra note 78.

91 United Nations, Department of Economic and Social Affairs, *Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries*, UN publication no. ST/ESA/PAD/SER.E/37 (New York: United Nations, 2003).

> Management and consultancy services were not covered specifically in the OECD Draft Convention, because they were not as important now as at the time when the Convention was finalized. However, at the current time, the furnishing of consultancy and similar services in developing countries by corporations of industrialized countries often involves very large sums of money. The Group felt that profits from such services should be taxed by the developing countries in certain circumstances.[92]

In terms of discussion, the commentary on article 5 of the 1980 UN model treaty repeats paragraph 71 from the second report of the ad hoc group, quoted above.[93]

In 1980, the ad hoc group was renamed the Ad Hoc Group of Experts on International Cooperation in Tax Matters. In its eighth report, the ad hoc group adopted the final version of the 1980 model treaty and the commentary thereon. With respect to the services PE provision in article 5(3)(b) of the model, the commentary confirmed that the overall purpose of the provision was to tax profits that were otherwise not earned through fixed-base PEs or other types of PEs, but that the "connected project" condition was inserted to limit the ability to tax such profits arising from unrelated projects. The ad hoc group summarized its discussions on this point as follows:

> Article 5, paragraph 3, of the United Nations Model Convention contains a new subparagraph (b) dealing with the furnishing of services, including consultancy services which are not covered specifically in the OECD Model Convention in connexion with the concept of permanent establishment. The Group felt that management and consultancy services should be covered because the provision of such services in developing countries by corporations of industrialized countries often involved very large sums of money. The Group was of the opinion that profits from such services should be taxed by developing countries in certain circumstances. However, some members from developing countries proposed the inclusion in that paragraph of another criterion based on the amount of remuneration for the furnishing of services. Such criterion would constitute the subject of an additional subparagraph, namely subparagraph 3(c), which would be worded as follows:
>
> > "(c) The furnishing of services including consultancy services by an enterprise, but only where the remuneration for activities of that nature (for the same or a connected project) derived from a resident of a Contracting State or a permanent establishment or a fixed base situated therein exceeds in the fiscal year an amount of . . . (an amount to be established through bilateral negotiations)."
>
> . . .
>
> Some members from developed countries thought that the time-limit approach would be an acceptable solution if the words "for the same or a connected project" were inserted after the word "continue," since they thought it desirable to add together unrelated projects in view of the uncertainty which that step involved and the

92 ST/ESA/94, supra note 78, at 18.

93 See the text accompanying note 81, supra.

> undesirable distinction it created between an enterprise with, for example, one project of three months' duration and another with two projects, each of three months' duration, one following the other. In that respect, other members found that the injection of a "project" limitation would be either too easy to manipulate or too narrow in that it might preclude taxation in the case of a continuous number of separate projects, each of four or five months' duration.[94]

It is also clear from the commentary on article 12 (royalties) that article 5(3)(b) was inserted to ensure that foreign service providers would be entitled to report "net" services income (that is, income net of expenses incurred to earn that income) as business profits under articles 7 and 5 rather than be subject to withholding tax under article 12. The ad hoc group

> recognized the difficulty involved in the definition of royalties but agreed to consider income from such activities as business profits and to include in article 5, paragraph 3, a new subparagraph (B) [sic "(b)"] which provided that the term permanent establishment should likewise encompass "the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only where activities of that nature continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any 12-month period."[95]

Starting with the 2001 revision to the UN model treaty and the commentary thereon, the passages from the commentary quoted by the ad hoc group above were replaced with paragraph 12 of the commentary on article 5, which again confirmed that the connected project rule was inserted as a limitation on the source state's right to tax profits from unrelated projects:

> 12. Subparagraph (b) encompasses service activities only if they "continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any 12-month period." The words "for the same or a connected project" are included because it is not appropriate to add together unrelated projects in view of the uncertainty which that step involves and the undesirable distinction it creates between an enterprise with, for example, one project of three months' duration and another with two unrelated projects, each of three months' duration, one following the other. However, some countries find the "project" limitation either too easy to manipulate or too narrow in that it might preclude taxation in the case of a continuous number of separate projects, each of 120 or 150 days' duration.[96]

94 United Nations, Ad Hoc Group of Experts on International Cooperation in Tax Matters, *Tax Treaties Between Developed and Developing Countries: Eighth Report*, UN publication no. ST/ESA/101 (New York: United Nations, Department of Economic and Social Affairs, 1980).

95 Ibid.

96 Commentary on article 5 of the UN model treaty.

"Connected" as an Anti-Abuse Rule

At the time the ad hoc group's eighth report was written, some countries were concerned that an enterprise might split up a single project artificially into two or more projects so as to escape the 183-day threshold. As noted above, the commentary on article 5 later incorporated the following statement:

> However, some countries find the "project" limitation either too easy to manipulate or too narrow in that it might preclude taxation in the case of a continuous number of separate projects, each of 120 or 150 days' duration.[97]

This concept of using "connected project" as an anti-abuse rule was not, in 1980, and still is not, referred to in the commentary on article 5(3)(b) of the UN model treaty. Nevertheless, the concern expressed above by some countries did not disappear. In 2004, the ad hoc group was again renamed, as the Committee of Experts on International Cooperation in Tax Matters. The committee discussed the services PE article in a number of reports. Specifically, at its second and third meetings, the committee discussed the services PE article in the context of abuse of treaties and took a very different approach than the UN had taken originally. The committee suggested that the connected project concept was really an anti-abuse rule, designed to prevent "contract splitting," which would allow non-residents to perform services in the source state while avoiding the 183-day rule.[98] In the committee's report on its sixth session, issued in 2010, the committee agreed to continue to adopt paragraph 12 of the commentary on article 5, with the revisions noted above, and that

97 Ibid. At the Third Session of the Committee of Experts on International Cooperation in Tax Matters, Geneva, October 29-November 2, 2007, a paper was prepared by the Subcommittee on Definition of Permanent Establishment (coordinator, Mr. Sollund) entitled *Proposal for Amendments to Article 5 of the United Nations Model Double Taxation Convention Between Developed and Developing Countries*, UN publication no. E/C.18/2007/CRP.3 (New York: United Nations, 2007). In that paper, this sentence was changed slightly, and the revised sentence now appears in the commentary on article 5 of the 2011 UN model treaty. The revised sentence states, "However, some countries find the 'project' limitation either too easy to manipulate or too narrow in that it might preclude taxation in the case of a continuous number of separate projects, each of four or five months' duration." It does not appear that these changes embody any substantive difference from the former version.

98 See United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Proposal for Amendments to Article 5 of the United Nations Model Double Taxation Convention Between Developed and Developing Countries*, UN publication no. E/C.18/2006/4 (New York: United Nations, 2006), at paragraph 20. See also United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Treaty Abuse and Treaty Shopping*, UN publication no. E/C/18/2006/2 (New York: United Nations, 2006), at paragraph 70 et seq.; United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Supplementary Note to Treaty Abuse and Treaty Shopping*, UN publication no. E/C/18/2006/2/Add.1 (New York: United Nations, 2006); and United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Improper Use of Treaties*, UN publication no. E/C.18/2007/CRP.2 (New York: United Nations, 2007), at paragraph 95 et seq.

commentary appears as paragraph 12 of the commentary on article 5 of the 2011 UN model treaty.[99]

There the matter stayed, until recently. At the committee's seventh session,[100] in 2011, the consensus was to move forward with studying services, but the meaning of connected project was not discussed. However, a paper was requested on the topic, as follows:

> It was necessary to clarify in paragraph 12, the meaning of the word "connected" to describe projects that were sufficiently related to be added together, and it was decided to include that question in the catalogue of issues.[101]

So far as I can determine, no UN tax committee has explored any further the issue of whether the connected project rule is a limitation or an anti-abuse rule. The OECD's perspective is discussed below.

The possibility of viewing the connected project rule as an anti-abuse rule is supported by *Assistant Director of Income Tax, International Taxation, Circle 2(2), Mumbai v. Valentine Maritime (Mauritius) Ltd.*[102] Valentine was a company established and resident in Mauritius. It was in the business of marine and general engineering and construction. It carried on several projects in India, in connection with which it provided construction services in India for various customers.

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99 United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Proposed New Commentary on Article 5: Paragraphs 1 to 15.3*, UN publication no. E/C.18/2010/5 (New York: United Nations, 2010), annex, at paragraph 12.

100 United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Provisional Agenda*, UN publication no. E/C.18/2011/1 (New York: United Nations, 2011), at item 5(f).

101 United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Report on the Seventh Session*, UN publication no. E/2011/45-E/C.18/2011/6 (New York: United Nations, 2012), at paragraph 31. In 2012, the committee's Subcommittee on Services commissioned Brian Arnold, a noted Canadian tax expert, to write two reports on the treatment of services. See United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Note on the Taxation of Fees for Technical and Other Services Under the United Nations Model Convention*, prepared by Brian J. Arnold, UN publication no. E/C.18/2012/4 (New York: United Nations, 2012) and his *Follow-Up Note on the Taxation of Fees for Technical and Other Services and Comments on That Note*, UN publication no. E/C.18/2012/CRP.4 (New York: United Nations, 2012). However, Arnold's reports did not discuss the meaning of "connected project."

102 (2010), 38 DTR 117 (Mumbai ITAT). Some services PE and construction site PE cases are reviewed in Jean Schaffner, *How Fixed Is a Permanent Establishment?* Series on International Taxation vol. 42 (Alphen aan den Rijn, the Netherlands: Kluwer Law International, 2013), at 105 et seq. Others are discussed in Radhakishan Rawal, *The Taxation of Permanent Establishments: An International Perspective* (London: Spiramus, 2006), chapter 20, and in Ekkehart Reimer, Nathalie Urban, and Stefan Schmid, eds., *Permanent Establishments: A Domestic Taxation, Bilateral Treaty and OECD Perspective*, 3d ed. (Alphen aan den Rijn, the Netherlands: Kluwer Law International, 2012). There are summaries of other cases dealing with construction site PEs in article 5 of Michael Edwards-Ker, ed., *The International Tax Treaties Service*, vol. 1 (Dublin:

Under article 5(2)(i) of the India-Mauritius tax treaty,[103] a PE included "a building site or construction or assembly project or supervisory activities in connection therewith, where such site, project or supervisory activity continues for a period of more than nine months." None of the taxpayer's Indian projects individually exceeded nine months, but collectively they did.

The Income Tax Appellate Tribunal held that in the absence of abuse, each project had to be tested separately. According to the tribunal, abuse would exist where various business activities of the enterprise in different locations were so inextricably interconnected that they were required to be viewed as a coherent whole. With respect to the OECD commentary that requires the projects to be a "coherent whole commercially and geographically,"[104] the tribunal held that "geographically" means a situation in which the very nature of a construction or installation project may be such that the contractor's activity is to be relocated continuously or at least from time to time (as is the case, for example, in the construction of roads and canals, the dredging of waterways, or the laying of pipelines), where the activities performed at each particular location in a single project must be regarded as a single unit and hence a single "place" of business. In short, so far as geographical coherence is concerned, the tribunal held that what is really to be seen is whether different locations where activities are carried out by an enterprise in the other contracting state are one place of business or different places of business. If it is concluded that they are different places of business, the matter ends there. However, if these different locations are seen as one place of business, the next thing to be ascertained—commercial coherence—is whether the work done at these sites constitutes one business venture, consisting of one or more contracts, or different business ventures altogether. The true test is whether the activities performed by the enterprise in various projects or at various sites are interconnected and must be considered a coherent whole,

In-Depth) (looseleaf) (discontinued 1997), especially the cases from Belgium/Netherlands June 29, 1982; Belgium/Netherlands April 12, 1984; Belgium/Germany March 24, 1987, and Netherlands/Germany February 4, 1970. There are various references in some publications to an early Indian case on the subject, but searches have not revealed what it is. Hans Pijl, "Interruptions in Building Site Permanent Establishments To Be Interpreted Under the Limited Inclusion Theory" (2013) 67:7 *Bulletin for International Taxation* 331-43, at note 2 and the accompanying text, suggests that there are 30 cases on construction site PEs dealing with the connected project concept. For a discussion of the connected project concept in the context of construction site PEs from the German point of view, see Georg Seitz, "The Construction Clause in Article 5(3) of the OECD Model" (2013) 67:9 *Bulletin for International Taxation* 450-59, at 457 et seq. For a discussion of the concept in the context of a particular industry, see Jan de Goede and Ruxandra Vlasceanu, "Permanent Establishment Implications for Coordination Centres in the Oil and Gas Industry" (2013) 67:9 *Bulletin for International Taxation* 466-73, at 469 et seq.

103 The Convention Between the Government of the Republic of India and the Government of Mauritius for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, signed at Port Louis on August 24, 1982.

104 Commentary on article 5 of the OECD model treaty, at paragraph 18.

regardless whether the activities so carried out by the enterprise are for the same principal or different principals.

The ratio set out in the *Valentine* decision is as follows:

> It is thus clear that the justification for aggregation of time spent by the assessee on different project sites, for applying [the] threshold of duration test, is not sustainable. Neither the work having been carried out for the same principal is sufficient to justify the aggregation of time spent on all the projects, nor the fact that this work was carried out in the same area, which is a huge geographical area anyway, is sufficient to invoke that exercise. Even if these projects are commercially coherent in the sense that these projects are for the same organization directly or through a sub contractor, and geographically coherent in the sense that these are on nearby locations, these two factors would not necessarily mean that these projects are to be necessarily seen as a coherent whole—geographically and commercially. The true test, as we have noted above, is in interconnection and independence—in addition to geographical proximity and commercial nexus.[105]

On the facts, the tribunal held that this test was not met:

> There is no finding, nor even a suggestion, by any of the authorities below to the effect that the three contracts are inextricably interconnected, interdependent or can only be seen only as a coherent whole in conjunction with each other. As a matter of [sic] all the three contracts are for three different purposes—for charter of accommodation barge, for use of barge in domestic are [sic] and for replacement of decks. None of these contracts are such that these can be viewed as interconnected or interdependent.[106]

105 *Valentine*, supra note 102, at paragraph 17.

106 Ibid. The US Treasury department's technical explanation of article 5(3) (construction sites) of the United States Model Income Tax Convention of November 15, 2006 states that two projects will be viewed together for the purposes of determining whether the time limit in that article is met when those projects are "interdependent both commercially and geographically." The use of "interdependent" rather than "coherent whole" is supported by the decisions in *Valentine*, supra note 102, and a similar case involving a sister company discussed below (see infra note 113 and the accompanying text). The phrase "interdependent both commercially and geographically" appears to have been used first in the US technical explanation to the US-Romania income tax treaty, in force February 26, 1976, 1976-2 CB 492. In the technical explanation of the 1982 US-Philippines income tax treaty, 1984-2 CB 384, the Treasury department stated that the use of that phrase applied to construction site PEs and "[i]n that respect, it is similar to the furnishing services rule." This confirms my view, expressed elsewhere in this article, that geographical as well as commercial coherence is required for two projects to be connected. In the technical explanation to the 1987 US-China income tax treaty, 1988-10 IRB 8, the Treasury Department suggested that an example of two projects forming a single construction site PE would be a "turnkey" project in which a facility is constructed and equipment installed. In the technical explanation to the 1994 US-Mexico income tax treaty 1994-34 IRB 4, another example given was the construction of a housing development even though each house may be constructed for a different purchaser. It will be noted that, as discussed elsewhere, this example indicates that the interdependence of two projects should be determined from the service provider's point of view, since clearly each separate purchaser would not view his or her house as being connected to any other purchaser's house.

Although *Valentine* did not cite *J. Ray McDermott Eastern Hemisphere Ltd. v. Joint Commissioner of Income-Tax-Special Range 21*, *Mumbai*,[107] it appears that the reasoning in the former case was taken directly from the latter.[108] The tribunal in *Valentine* did cite *Sumitomo Corpn. v. DCIT*[109] and *Joint Director of Income Tax (International Taxation) v. Krupp UHDE Gmbh*.[110] In *Sumitomo*, the taxpayer was a Japanese-resident company. It had a liaison office in India and had liaison suboffices at Mumbai, Chennai, Bangalore, and Calcutta. Sumitomo started expanding its activities in India. It established project offices for two projects with the Karnataka Power Corporation: the Basin Bridge project and the paint and assembly shop for Maruti Udyog Ltd.

The issue was whether Sumitomo had a construction site PE in India, which under the India-Japan treaty was defined as follows:

> 5(4) An enterprise shall be deemed to have a permanent establishment in a Contracting State and to carry on business through that permanent establishment if it carries on supervisory activities in that Contracting State for more than six months in connection with a building site or construction, installation or assembly project which is being undertaken in that Contracting State.[111]

The Income Tax Appellate Tribunal held that each project performed by Sumitomo was independent and the projects did not complement each other. Sumitomo was not the only person rendering supervisory services. The sites were located at different places (assembly floor, paint shop, or weld shop). It could not be said that all contracts put together formed a coherent whole, commercially or geographically.[112]

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107 (2010), 39 SOT 240 (Mumbai ITAT).

108 In *J. Ray*, the Income Tax Appellate Tribunal held that none of the taxpayer's construction projects met the test of commercial and geographical coherence, so they could not be added together to meet the nine-month construction test. The tribunal remitted the matter to the appeals officer to determine whether any one project was more than nine months long. The appeals officer said no, and the tribunal dismissed the Revenue's appeal from that decision: ITA no. 2089/Mum/2011, October 12, 2012.

109 (2007), 17 SOT 197 (Delhi ITAT).

110 (2009), 26 DTR 289 (Mumbai ITAT) (discussed below in the text at note 124 and following).

111 The Convention Between the Government of Japan and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at New Delhi on March 7, 1989.

112 The Income Tax Appellate Tribunal released additional reasons in *Sumitomo* on February 27, 2014, available at http://indiankanoon.in/doc/168545514/. From these reasons, it appears that the taxpayer had appealed the initial decision of the tribunal to the High Court. On April 6, 2009, that court remanded the case to the tribunal for a determination of whether the income earned by the taxpayer could be taxed in India as royalties under article 12 of the relevant treaty. Specifically, the question as remanded by the High Court was as follows: "Whether in the facts and circumstances of the case 'fee for technical services' received by the assessee from M/s Maruti Udyog Ltd was taxable under Article 12(2) or Article 12(5) read with Article 7(3) of DTAA?" By its decision in 2014, the tribunal held that the taxpayer had no PE in India and therefore article 12(2) applied.

On the same day that *Valentine* was decided, the same tribunal decided a case involving roughly the same facts and the same issue for a sister company, *Valentine Maritime (Gulf) LLC v. Assistant Director of Income Tax*.[113] Although the word "abuse" is not used in the reasons for judgment, one may speculate that the tribunal had that concept in mind when it said:

> In our considered view, the only other situation in which aggregation of time spent of [sic] various activities is to be done is when the activities are so inextricably interconnected or interdependent that these are essentially required to be viewed as a coherent whole.[114]

The tribunal suggested that the test set out in the commentary on the US (UN?) model treaty, that projects will be connected only when they are "interdependent both commercially and geographically," was to be preferred to the OECD commentary's test of commercial and geographical coherence.

"Connected" from Whose Perspective?

In discussing whether two projects are "connected," one must ask, "From whose perspective—the foreign enterprise, or the person in the source state for whom the services are provided?"

There was an extensive discussion of connected projects at the UN committee of experts' eighth session in October 2012. In a note prepared for the Subcommittee on Services and tabled at that session,[115] it was recommended that paragraphs 42.39 through 42.41 of the OECD commentary on article 5 (which relate to the alternative provision on the taxation of services) be adopted as the UN commentary on the services PE provision. Under paragraph 42.40 of the OECD commentary, the determination of whether an enterprise is performing services for "the same project" is to be interpreted from the perspective of the enterprise that provides the services. The paragraph gives as an example an enterprise that is to provide both tax advice and training in an area unrelated to tax to a single customer. The paragraph concludes that while these may be related to a single project of the customer, one should not consider that the services are performed for the same project. Notably, the UN commentary does not say from whose perspective the connected concept should be determined.

The note indicates that some members of the subcommittee expressed the view that the "perspective of the service provider" rule should apply only to the "same

113 ITA no. 2879/Mum/05 (Mumbai ITAT).

114 Ibid., at paragraph 14.

115 See United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Note on United Nations Model Tax Convention Article 5: The Meaning of "Connected Projects,"* prepared by Claudine Devillet, UN publication no. E/C.18/2012/CRP.5 (Geneva: United Nations, September 2012).

project" aspect of article 5(3)(b) and not to the "connected project" aspect. The note suggested that the entire committee would have to debate this.[116] In the committee's report, this issue was further debated, and the author of the note (Claudine Devillet) was instructed to prepare a revised note.[117]

In August 2013, the secretariat of the committee of experts published a note on issues for consideration[118] in preparation for the committee's ninth session to be held on October 21-25, 2013. The note indicates that the topic of connected projects would be discussed at the ninth session and that Devillet would deliver an update of her 2012 paper. The note provides some background to the upcoming revised paper. The background indicates that at the eighth session there were two main areas of debate, the second of which was whether the determination of whether two or more projects were connected should be regarded from the point of view of the enterprise furnishing the service or from the perspective of the consumer, or both.[119]

On this issue, the committee was divided. A majority of the members appear to have thought that the determination should be made from the service provider's point of view. They suggested that if an enterprise provides services to a consumer for two different projects through two different departments using different personnel, then the two projects are not related and the same or connected project provision cannot be applicable. Looking at the matter from the service provider's point of view would ensure that result. A minority of the committee members thought that the purpose of the same or connected project provision was to avoid a situation where an enterprise that did not want to have a PE in a country where it

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116 Ibid., at 3.

117 United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Report on the Eighth Session*, UN publication no. E/2012/45-E/C.18/2012/6 (New York: United Nations, 2013), at paragraph 75.

118 United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Model Tax Convention: Issues for Consideration by the Committee*, UN publication no. E/C.18/2013/3 (New York: United Nations, August 2013).

119 The issue was whether the enterprise providing the services in the other state must have a physical presence through its personnel there, or whether a services PE could exist under the wording of article 5(3)(b) of the UN model treaty without such presence. The majority of the committee thought that a physical presence was required. For a discussion, see Arnold, supra note 17, at 284. Article V(9)(b) of the Canada-US treaty requires the services to be provided "in" the other state. If the wording were "provide services to" someone in Canada, no physical presence would be required, but it is difficult to understand how USco could provide services "in" Canada without having a physical presence there. It has been suggested that "furnishing of services" in UN article 5(3)(b) is wider than "provides": see Kuźniacki, supra note 17, at 20-21, and "Canada Revenue Agency and Revenu Québec Round Table," in the 2011 Conference Report, supra note 21, 4:1-24, question 1, at 4:1-2. But see *Linklaters LLP v. ITO* (2010), 132 TTJ 20 (Mumbai ITAT), which held that "provides" services and "furnishes" services are equivalent expressions (the force-of-attraction aspect of the case was not followed in *Clifford Chance v. Asst. DIT (IT)*, May 13, 2013 (Mumbai ITAT)). The French version of article V(9) is "les services sont *fournis* dans cet autre État [emphasis added]," so even the language equates providing and furnishing services.

provided services would just split up projects into different parts and seek to avoid the threshold of 183 days in any 12-month period. With this in mind, it seems logical to look at the provision from the point of view of the consumer, rather than that of an enterprise that is trying to avoid the provision.

Yet another minority of the committee members argued that the difficulties and restrictions implied by using the wording "the same or a connected project" could be avoided by simply not including such wording in article 5(3).

In my view, the majority is correct. An analogy may be drawn to the issue of whether a worker is an employee of or an independent contractor for a particular principal. At least in Canada, one of the factors that is looked at in making that determination is whether the worker is "integrated" into the principal's business. The rule is clear that that factor is to be considered from the worker's point of view, not the principal's, because from the principal's point of view, everyone he hires to work for his business is an integral part of that business.[120] The real question is whether the worker is carrying on his own business, and that can be determined only from his perspective. Similarly, if the test is whether two or more projects are connected, then, in our example, from Canco's point of view, all of its projects are connected: it is a single company carrying on a single business and paying all of USco's fees from a single fund. The real test is whether it is "fair" in tax policy terms for Canada to tax USco on its Canadian-source income on the basis that USco is providing services in Canada in respect of two or more interdependent projects for more than 183 days—and that can be determined only by examining interdependence from USco's point of view.

Is Geographical Coherence Required?

The updated paper to be delivered at the ninth session of the UN committee of experts was issued on October 14, 2013.[121] The paper contains proposed revisions to the commentary on the services PE provision in the UN model treaty. Under the proposed revisions, three points are made:

1. It is not clear from the wording of article 5(3)(b) of the UN model treaty whether the workers must be present physically in the source state for a services PE to be created, and either the text or the UN commentary should make that clear.
2. There is no consensus on the manner of determining whether two projects are connected—that is, whether the determination should be made from the point of view of both the service provider and the customer, or merely from one or the other's point of view. The majority of the subcommittee appears to believe that it should be only from the provider's view, while the committee

120 See *Precision Gutters Ltd. v. Canada (Minister of National Revenue)*, 2002 FCA 207, at paragraph 31.

121 United Nations, Economic and Social Council, Committee of Experts on International Cooperation in Tax Matters, *Article 5: The Meaning of "The Same or a Connected Project,"* UN publication no. E/C.18/2013/CRP.2 (New York: United Nations, 2013).

as a whole is prepared to say that both views should be taken into account, and that a real difference in those viewpoints would arise only where a provider performed different services on different projects, all for the same customer. In that case, the customer might well view all of the projects as being connected, but the provider would not.

3. In determining whether two projects are connected, only commercial coherence is required, and not geographical coherence.

It has been suggested to me by a member of the committee that this last point is based on the view that article 5(3)(b) constitutes a limited extension of the fixed-base PE definition in article 5(1) of the UN model treaty. It is an extension because geographical coherence is not required. It is only a limited extension because it requires, through the same or connected project condition, that commercial coherence exist among the activities taken into consideration. Accordingly, taking into account the purpose of the services PE rule as well as the examples provided in paragraphs 42.25 through 42.28 (especially 42.28) of the commentary on article 5 of the OECD model, the OECD services PE provision does not require geographical coherence in order to determine that projects are connected; only commercial coherence is required. If this were not the case, the services PE rule would be particularly narrow and would cover primarily cases already covered under the fixed-base PE rule in article 5(1). Where an enterprise performs services in the source state through a particular location constituting a coherent whole commercially and geographically, at which its personnel are present for more than 183 days, such location will in most cases constitute a fixed place of business.

On the basis of my review of the origins and purpose of the services PE provision and the original OECD commentary on construction site PEs as set out below, and with due respect, I disagree entirely with this suggestion. Simply, it is wrong to say that the services PE rule is somehow an "extension" of the fixed-based PE rule with geographical coherence removed.[122] The services PE provision was intended to be a completely new and separate rule that would create a PE where none otherwise existed.[123] More importantly, the concept of a connected project was intended to be a limiting factor that would narrow the circumstances under which a services PE would be created: it is only where projects are so closely intertwined that it would be "fair" in tax policy terms to view them as establishing a close enough connection for the source state to tax the related profits that a PE should exist.

122 See Liselott Kana and Ron van der Merwe, "The Commentary on Article 5—The Changes and Their Significance" (2012) 66:11 *Bulletin for International Taxation* 603-7, at 605: "There was no disagreement with the 'self-standing' nature of article 5(3)(b) [of the UN model] with respect to the services PEs."

123 See Jürgen Lüdicke, "Recent Commentary Changes Concerning the Definition of Permanent Establishment" (2004) 58:5 *Bulletin for International Fiscal Documentation* 190-94, at 192: "Thus, a 'services permanent establishment' under the UN Model is independent of any 'fixed place of business.' "

My view that geographical coherence should be required before two projects may be said to form a coherent whole is supported by the decision in *Krupp UHDE Gmbh*.[124] The issue in that case was whether the taxpayer, a German resident, had a construction site PE in India under the treaty between those two countries. The taxpayer was in the engineering business and provided technical knowhow, engineering services, and supervisory activities in connection with the construction or installation of machinery. The Income Tax Appellate Tribunal held, applying *Sumitomo*,[125] that the taxpayer's different construction projects had no "effective interconnection" with each other: they were different contracts with different parties in respect of different independent projects located at different places. Hence, they did not form a coherent whole in any respect, and there was no construction site PE.

IRS Interpretation

There appears to be only one US technical publication on point.[126] In this memorandum, it was held that where a contract driller's work activity is controlled under a two-year contract by one customer ("B"), even though the driller's work location within a relatively large geographic area (approximately 200 miles wide) changes frequently, the principle of a commercially and geographically coherent whole in the OECD commentary should be applied to the driller's work activity. It was held that the drilling activity under the contract for 26 months in an outer continental shelf area along the coasts of two contiguous states constituted a single commercially and geographically integrated project.[127]

The CRA has recently released a detailed analysis of commercial and geographical coherence in the context of a construction site PE. In a CRA district office memorandum,[128] the Rulings Branch was asked by a CRA auditor to consider the construction

124 Supra note 110.

125 *Sumitomo*, supra note 109.

126 Internal Revenue Service, General Counsel Memorandum 39373, March 1, 1985, which formed the basis for Technical Advice Memorandum 8526005, March 8, 1985.

127 One author has suggested that the "more flexible" approach of the IRS toward geographical integration as shown in this memorandum is questionable in light of the inconsistency with certain other authorities. See Richard E. Andersen, *Analysis of United States Income Tax Treaties* (online, current through 2013, Thomson Reuters Tax and Accounting), at note 80. Another author, in discussing GCM 39373, suggests that the following factors may be relevant to determining whether two construction projects (and, presumably, two service projects) may form a coherent whole: "identity of contract, separate bidding and negotiation of contracts, separate invoicing, identity of clients, interruptions between projects, lack of technical connection between projects, independent pricing, separate delivery or acceptance and whether a reasonable business person would not have entered into one of the agreements for the terms agreed on without also entering into the other agreements." See Gordon et al., supra note 71, at note 23 and the related text.

128 CRA document no. 2013-0474851I7, supra note 73. The memorandum was issued in French; the (unofficial) translation here is my own.

site PE provision in article 5(3) of the 1975 Canada-France income tax treaty.[129] Canco, a Canadian corporation, entered into a series of contracts with Franceco, a French corporation with which Canco was dealing at arm's length. There was no single, comprehensive agreement or contract between the parties; Canco's decision to retain Franceco for any particular contract was made on a case-by-case basis under a formal tender process. The series of contracts provided for Franceco to integrate new equipment at Canco's plant in Canada. Franceco provided various services under the contracts, including the receipt, delivery, assembly, and installation of specialized equipment, the supervision of employees, and the training needed to use the equipment. The contractual arrangements between the parties were recurrent. Under the contracts, many of Franceco's employees and subcontractors visited Canco's premises to attend to the delivery and assembly of the equipment, to oversee its installation, and to provide training to Canadian operators.

The contracts were let under tender at various times. The presence of Franceco's employees in Canada was essential to the projects because no local company had the technical knowledge related to the installation of equipment, optimization of the equipment, and training of Canadian operators.

The CRA auditor had determined that Franceco was carrying on business in Canada and had no other PE in Canada. The auditor considered that although no one contract lasted for more than 12 months, the series of contracts together formed a coherent whole, commercially and geographically, that lasted for more than 12 months.

With respect to the duration of the construction project, the CRA noted that it was the actual duration of the project that counted, regardless of what the contract said, and that all facts and circumstances should be taken into account in determining the duration of the project:

> The duration of the project, and not the contract is crucial in analysis of a situation for the purposes of paragraph 3 of Article 5 of the Convention. All facts and circumstances must be considered in order to determine whether the duration of the project exceeded twelve months, as required by the Convention.[130]

In my view, these comments apply equally to article V(9) of the Canada-US treaty.

With respect to whether several different projects could be connected to each other, the CRA noted that the first task was to identify each "project." That term was not defined in the Canada-France treaty, and the CRA suggested that the term should have a wide meaning, based on an unnamed earlier publication concerning the Canada-UK income tax treaty:

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129 Convention Between Canada and France for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed at Paris on May 2, 1975, as amended by the protocols signed on January 16, 1987, November 30, 1995, and February 2, 2010.

130 CRA document no. 2013-0474851I7, supra note 73.

> The term "site" is not defined in the Convention, the Income Tax Act Interpretation Act, the OECD Model Convention or the OECD commentary. But [as] we established [in (redacted)] the term "project" used in the English version of the tax treaty between Canada and the United Kingdom should be interpreted broadly, according to its usual meaning.[131]

With respect to geographical coherence, the CRA suggested that

> since all equipment covered by the contracts (including that of the Project) have been installed in the factory located at Canco's plant located at [redacted], it seems that geographical coherence could be established between different projects, as appropriate.[132]

However, with respect to commercial coherence, the CRA suggested that it was lacking sufficient details to make a determination. It suggested a non-exhaustive list of factors that should be taken into account in making this determination:

> However, information available in respect of agreements contracted between the parties does not allow us to provide a determination on the mounting of various projects that occurred during the period under audit, or on the commercial coherence between these different sites, as appropriate.
>
> Based on the OECD commentary and other works on the subject, we believe that the following criteria can be taken into consideration in establishing a commercial coherence between different installation projects:
>
> - Existence of a single contract covering the different assembly projects;
> - Signature of different assembly contracts at the same time;
> - A predictable conclusion of additional contracts;
> - Uninterrupted periods between contracts;
> - Works, objectives and activities of the same nature [for each project];
> - Services provided by the same company or related companies;
> - Services provided by the same individuals;
> - Single billing [for all projects].
>
> Please note that this list of criteria is not exhaustive, nor cumulative. In addition, the analysis for the determination of whether separate projects have commercial and

131 Ibid. The word "project" appears in article 5(2)(g) of the 1978 Canada-UK income tax treaty, which includes, as one possible type of PE, "a building site or construction or assembly project which exists for more than 12 months." (Convention Between the Government of Canada and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, signed at London on September 8, 1978, as amended by the protocols signed on April 15, 1980 and October 16, 1985.) I understand from my discussions with the CRA that the redacted reference was to a technical interpretation (in English) given by CRA Rulings to a CRA taxation services office that looked at the meaning of "project" in the *Oxford Dictionary* and the *Webster Third New International Dictionary*, and determined on the basis of those dictionaries that the word should be given a broad meaning.

132 CRA document no. 2013-0474851I7, supra note 73.

> geographical coherence must be made case by case, depending on the facts and circumstances of the situation under study.[133]

Again, in my view, these comments could apply to article V(9)(b) of the Canada-US treaty.[134]

It is clear from the case law and administrative material that both commercial and geographical coherence are required for two or more construction projects to form a coherently whole project for the purposes of the 12-month test in article 5(3) of the OECD model treaty. It is difficult to see why geographical coherence is not also required when determining whether two or more projects are connected for the purposes of the 183-day test in the services PE rule.

As for a definition of geographical connection, there is none. In fact, on the basis of a German case involving the 1958 Germany-Luxembourg tax treaty,[135] it appears clear that there is no rule of thumb that may be applied to determine whether projects are geographically connected. The taxpayer was a German-resident individual. He was retained as a contractor in Luxembourg by a telephone company there to connect telephone cables laid by other contractors. Each assignment was a separate assignment awarded after a separate tender. The projects covered all of Luxembourg. All the projects were completed at roughly the same time.

The court held that all relevant facts and circumstances must be taken into account in deciding whether two or more projects form a coherent whole. In this case, the court held that since the projects were carried out throughout the whole country, there was no geographical coherence. In particular, the court rejected the tax authority's rule of thumb that geographical coherence existed automatically if two projects were less than 50 kilometres apart as the crow flies.

The CRA and the UN Model

Although it is clear that the services PE rule originated with the UN model and not with the OECD model, the CRA does not appear to place much, if any, importance on the UN material. At a Tax Executives Institute conference, the following question was put to the CRA:

> Paragraph 2 of Annex B to the Protocol . . . states that projects are considered "connected" if they constitute a coherent whole, commercially and geographically. Will

133 Ibid.

134 As an aside, it is interesting to observe that CRA Rulings relied on the OECD commentary on article 5(3) as it read in 1975 at the time the Canada-France treaty was signed, rather than on later commentary, contrary to the CRA's usual approach. The memo noted (supra note 73), "Although some changes have been made in paragraph 17 of the OECD Commentary on Article 5 of the Model since the adoption of the Convention, we believe that the comments above mentioned are applicable in this case."

135 No parties named, Case I R 3/02, a decision of the Hof Van Beroep/Cour d'Appel, Antwerpen/Anvers, November 19, 2003.

CRA provide specific examples of what it considers to be the "same or connected project"?[136]

In response, the CRA referred to the technical explanation and the OECD commentary on article 5 of the OECD model, and suggested that the examples in the technical explanation and the OECD commentary would be instructive. The CRA did not refer to the UN commentary, although it is difficult to know how much to read into that. Perhaps the absence of any such reference simply reflects the fact that the CRA is a member of the OECD and is not represented on the UN committee, and consequently looks mostly or solely at OECD material, rather than being some definitive indication that the CRA does not agree with the UN commentary.

In summary, the UN model and commentary do not define a connected project but appear to view this requirement as a limitation on the ability to create a PE, while noting that some countries view it as an anti-abuse rule designed to prevent the foreign enterprise from splitting up a project into artificial segments in order to avoid the 183-day test.

The OECD

The work of the OECD on a services PE provision is much more recent than the UN's work, and can be traced back to as late as 2004. In that year, the OECD's Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits issued a final report that discussed whether the current treaty rules for taxing business profits were appropriate for e-commerce.[137] Section 4(A)(g) of the report considered whether the OECD model treaty should include a services PE provision similar to the UN provision discussed above, and concluded that it should not.

Following that report, in December 2006, Working Party No. 1 on Tax Conventions and Related Questions of the OECD Committee on Fiscal Affairs issued a public discussion draft on the tax treaty treatment of services.[138] The draft set out proposed changes to the OECD commentary on article 5 of the OECD model treaty, including the possibility of adding a services PE provision to any particular treaty. It included commentary that suggested wording for a services PE provision that states could include in their tax treaties.[139]

136 CRA document no. 2008-0300941C6, December 9, 2008.

137 Organisation for Economic Co-operation and Development, *Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce? Final Report* (Paris: OECD) (www.oecd.org/tax/treaties/35869032.pdf). The report is undated but was presented to the OECD in June 2004.

138 Organisation for Economic Co-operation and Development, *The Tax Treaty Treatment of Services: Proposed Commentary Changes: Public Discussion Draft* (Paris: OECD, December 8, 2006) (www.oecd.org/tax/treaties/37811491.pdf).

139 For a comparison of the UN and the OECD versions of the services PE provision, see Sriram P. Govind, "The International Tax Treatment of Cross-Border Services," published in the online version of (2012) 66:1 *Bulletin for International Taxation*.

With respect to the concept of projects or connected projects, the 2006 commentary stated:

> The reference to "connected projects" is intended to cover cases where the services are provided in the context of separate projects carried on by an enterprise but these projects involve the provision of services of the same or of a similar nature and within the framework of contracts concluded with the same enterprise or with associated enterprises. [The Working Group invites comments in particular on the meaning of "connected projects."][140]

A Coherent Whole, but Only Commercially?

In response to that invitation, a number of people suggested that the concept of a connected project in the services PE context should be based on the "coherent whole" concept used in the construction site PE context to determine whether two or more construction contracts should be viewed together in determining whether the 12-month time limit had been exceeded.[141]

The OECD adopted that suggestion (somewhat). The 2006 update was finalized on July 18, 2008.[142] Paragraph 42.11 and following of the 2008 commentary includes the discussion of a services PE provision, as well as a number of examples of how that provision would be applied to different situations.

Paragraph 42.11 of the OECD commentary on article 5 reiterated Carroll's rule from 1933 that a foreign enterprise carrying on business in the source state should

140 *Tax Treaty Treatment of Services*, supra note 138, at paragraph 42.40 of the proposed commentary.

141 See Hans Pijl, "The OECD Services Permanent Establishment Alternative" (2008) 49:9 *European Taxation* 472-76, at 476, note 34 and the accompanying text, and the comments from David Ward, Radhakishan Rawal, and Hans Pijl (available at www.oecd.org/tax/treaties/publiccommentsonthediscussiondraftonthetaxtreatytreatmentofservices.htm).

142 Organisation for Economic Co-operation and Development, *The 2008 Update to the OECD Model Tax Convention* (Paris: OECD, July 18, 2008) (www.oecd.org/tax/treaties/41032078.pdf). In addition to the *2008 Update*, the OECD published a detailed response to the comments submitted on earlier OECD reports that made up the final *2008 Update*. See *Response of the Committee on Fiscal Affairs to the Comments Received on the April Discussion Draft on the 2008 Update to the Model Tax Convention* (Paris: OECD, July 18, 2008) (www.oecd.org/ctp/treaties/41032122.pdf). The *Response* states, ibid., at 3: "The Committee, however, has noted that some States (including some OECD countries) do not share that view. These States use various treaty approaches to preserve source taxation rights, in certain circumstances, with respect to the profits from such services. The Committee has considered that it was important to circumscribe the circumstances in which States could do so and has therefore decided to include in the Commentary an alternative provision that these States could use for that purpose and that would ensure that the additional taxation rights that would be granted to a State using the provision would not extend to services performed outside the territory of that State, would apply only to the profits from these services (as opposed to gross payments for them) and would not apply unless a certain threshold of physical presence in that State had been met." The phrase "would not extend to services performed outside the territory of that State" suggests that even the OECD does not interpret "furnishing of services" to permit the performance of the services from outside the source state. See the discussion of this point at note 119 above.

be taxable by that state on business profits earned in that state only when those profits are earned through a PE in that state, because it is only then that the enterprise can "be regarded as participating in the economic life of that State to such an extent that it comes within the taxing jurisdiction of that other State."[143] Paragraph 42.11 emphasizes that this basic rule applies to profits earned from supplying services, as well as any other kind of business profits.

Paragraphs 42.14 through 42.22 of the OECD commentary on article 5 note that, notwithstanding the administrative difficulties that the taxation of service profits entails, as discussed in paragraphs 42.12 and 42.13, some countries believe that service profits earned in their state should be taxable in their state, even without a PE, because the source of the profit is obviously in their state. To balance this need against the general PE rule expressed in paragraph 42.11, the commentary at paragraph 42.23 suggests wording to create a services PE provision (which, for convenience, is reproduced here):

> Notwithstanding the provisions of paragraphs 1, 2 and 3, where an enterprise of a Contracting State performs services in the other Contracting State
>
> a) through an individual who is present in that other State for a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual, or
>
> b) for a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for connected projects through one or more individuals who are present and performing such services in that other State
>
> the activities carried on in that other State in performing these services shall be deemed to be carried on through a permanent establishment of the enterprise situated in that other State, unless these services are limited to those mentioned in paragraph 4 which, if performed through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph. For the purposes of this paragraph, services performed by an individual on behalf of one enterprise shall not be considered to be performed by another enterprise through that individual unless that other enterprise supervises, directs or controls the manner in which these services are performed by the individual.

It is clear from paragraph 43.22 that one of the key policies behind the wording of the suggested rule is that taxation by the source state is permissible only when there is a "minimum level of presence" in the source state.

The 2008 Commentary defined a connected project as follows:

> 42.41 The reference to "connected projects" is intended to cover cases where the services are provided in the context of separate projects carried on by an enterprise but these projects have a *commercial coherence* (see paragraphs 5.3 and 5.4 above). The

143 Ibid., commentary on article 5, at paragraph 42.11.

determination of whether projects are connected will depend on the facts and circumstances of each case but factors that would generally be relevant for that purpose include:

— whether the projects are covered by a single master contract;
— where the projects are covered by different contracts, whether these different contracts were concluded with the same person or with related persons and whether the conclusion of the additional contracts would reasonably have been expected when concluding the first contract;
— whether the nature of the work involved under the different projects is the same;
— whether the same individuals are performing the services under the different projects [emphasis added].

In terms of examples of connected projects, the 2008 commentary states:

42.44 The following examples illustrate the application of subparagraph b) (assuming that the alternative provision has been included in a treaty between States R and S): . . .

— Example 3: ZCO, a resident of State R, has outsourced to company OCO, which is a resident of State S, the technical support that it provides by telephone to its clients. OCO operates a call centre for a number of companies similar to ZCO. During the period of 1 January 00 to 31 December 00, the employees of OCO provide technical support to various clients of ZCO. Since the employees of OCO are not under the supervision, direction or control of ZCO, it cannot be considered, for the purposes of subparagraph b), that ZCO is performing services in State S through these employees. *Additionally, whilst the services provided by OCO's employees to the various clients of ZCO are similar, these are provided under different contracts concluded by ZCO with unrelated clients: these services cannot, therefore, be considered to be rendered for the same or connected projects* [emphasis added].

It is notable that the OECD commentary does not require that two projects have any geographical coherence before being considered connected projects, but merely that they have commercial coherence. As discussed above, under the 2013 UN proposed revised commentary, the most recent UN discussion has suggested that that view is correct. Yet, as noted below, that singular approach has not been followed in the diplomatic notes to the fifth protocol of the Canada-US treaty. One might assume that the diplomatic notes hark back to the initial purpose of the connected project rule, which is to limit the circumstances under which a services PE would exist. I suggest that the absence of the requirement for geographical coherence in the OECD commentary is a mistake: the earliest references to coherence in the context of a connected project rule clearly state that both commercial and geographical coherence are required.[144]

144 The earliest mention appears to be in Organisation for Economic Co-operation and Development, *Permanent Establishment: Second Report by Working Group No. 1 on Potential Amendments to Article 5 and to the Commentary Thereon*, document no. DAF/CFA/2697 (Paris:

The OECD Adopts an Anti-Abuse Perspective of the Connected Project Rule—Or Does It?

With regard to the policy behind the connected project rule, one may start by noting that paragraph 18 of the OECD commentary on article 5, dealing with construction site PEs, considers that the 12-month rule applicable to such PEs may be open to abuse by the splitting of projects:

OECD, May 18, 1973) (www.taxtreatieshistory.org), at paragraph 8(d), which stated, "The criterion of the 12-month-time limit applies to each individual site or project. The duration of several sites or projects operated by the same enterprise in the same State should not be calculated cumulatively if—and this is the decisive condition—the projects are at different locations and in no factual connection. This principle may be contested by claiming that the above approach would allow an enterprise to do business in another State for more than 12 months by operating a building site or construction project without being liable to tax in that State, provided that the projects are independent of each other. This is true, of course, but if building sites and construction/assembly projects of shorter duration were to be calculated cumulatively, this would lead to an element of uncertainty for the enterprise as far as the tax treatment of its activities is concerned; this uncertainty would clearly be incompatible with the spirit of close international co-operation in the economic field. If, for instance, an enterprise initially operates a building site which exists for 4 months, its calculations (for tax purposes) being based on the assumption that such site is not a PE, and if the same enterprise subsequently operates a site which exists for, say, 9 months, the cumulation of such periods of time would lead to retroactive changes in the taxation of the enterprise. A building site will have to be regarded as a single unit, even if it is based on several contracts, provided that it forms *a coherent whole from the point of view of location and subject matter*. Subject to this proviso, a building site forms a single unit even if the orders have been placed by several persons (e.g. for terraced houses) [emphasis added]." The terminology was changed to "coherent whole commercially and geographically" in Organisation for Economic Co-operation and Development, Working Party No. 1 of the Committee on Fiscal Affairs on Double Taxation, *Revised Report on Article 5 (Permanent Establishment)*, document no. CFA/WP1(74)(6) (Paris: OECD, August 30, 1974) (www.taxtreatieshistory.org), at paragraph 8(c): "The 12 months-test applies to each individual site, project or installation. In determining how long the site or project has existed no account should be taken of the time previously spent by the contractor concerned on other sites or projects if they are totally unconnected with it. A building site should be regarded as a single unit, even if it is based on several contracts, provided that *it forms a coherent whole commercially and geographically*. Subject to this proviso, a building site forms a single unit even if the orders have been placed by several persons (e.g. for a row of houses) [emphasis added]." In Working Group No. 1's *Third Report on Article 5 (Permanent Establishment)*, October 13, 1975, CFA/WP1(75)6, at 13, this commentary was inserted as paragraph 17: "The 12 months-test applies to each individual site or project. In determining how long the site or project has existed no account should be taken of the time previously spent by the contractor concerned on other sites if they are totally unconnected with it. A building site should be regarded as a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically. Subject to this proviso, a building site forms a single unit even if the orders have been placed by several persons (e.g. for a row of houses)." The same paragraph 17 appeared on page 12 of Working Group No. 1's *Fourth Report on Article 5*, April 7, 1976, CFA/WP1(76)6. The omission of any explanation in the current OECD commentary for not requiring geographical coherence to connect two projects for the purposes of the services PE provision appears to be an error in light of these previous commentaries. For a discussion of these various reports, see Pijl, supra, note 102.

> The twelve month test applies to each individual site or project. In determining how long the site or project has existed, no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it. A building site should be regarded as a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically. Subject to this proviso, a building site forms a single unit even if the orders have been placed by several persons (*e.g.* for a row of houses). *The twelve month threshold has given rise to abuses; it has sometimes been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period less than twelve months and attributed to a different company which was, however, owned by the same group*. Apart from the fact that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules, countries concerned with this issue can adopt solutions in the framework of bilateral negotiations [emphasis added].

Paragraph 42.45 of the OECD commentary on article 5 then adopts paragraph 18 in the context of the services PE rule:

> The 183-day thresholds provided for in the alternative provision may give rise to the same type of abuse as is described in paragraph 18 above.

It may appear from this that the connected project rule is designed to prevent such abuse. But paragraph 42.45 goes on to say, "[A]s indicated in that paragraph [18], legislative or judicial anti-avoidance rules may apply to prevent such abuses." It appears, therefore, that the OECD was not of the view that the connected project rule is itself an anti-abuse rule; if it were, then there would be no need to suggest separate legislative or judicial anti-abuse rules. Accordingly, it appears that for the OECD, the connected project rule is based on a policy simply of ensuring that interrelated projects are counted together toward the 183-day test, without assuming that separate but related projects were established as an abusive attempt to avoid that test.

The OECD has issued subsequent updates to its commentary on article 5, but none address the services PE provision.[145]

The Treaty's "Definition" of a Connected Project—A Coherent Whole, Commercially and Geographically

While the Canada-US treaty does not contain a definition of "connected project," the diplomatic notes to the fifth protocol state:

145 Organisation for Economic Co-operation and Development, *OECD Model Tax Convention: Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment)* (Paris: OECD, October 19, 2012).

2. *Meaning of connected projects*

For the purposes of applying subparagraph (b) of paragraph 9 of Article V (Permanent Establishment) of the Convention, it is understood that projects shall be considered to be connected if they constitute a coherent whole, commercially and geographically.[146]

While there is no direct evidence on this point, it seems obvious[147] that this definition is taken from the OECD commentary on article 5(1) on fixed-base PEs and on article 5(3) on construction site PEs, which states:

5.1 Where the nature of the business activities carried on by an enterprise is such that these activities are often moved between neighbouring locations, there may be difficulties in determining whether there is a single "place of business" (if two places of business are occupied and the other requirements of Article 5 are met, the enterprise will, of course, have two permanent establishments). As recognised in paragraphs 18 and 20 below a single place of business will generally be considered to exist where, in light of the nature of the business, a particular location within which the activities are moved may be identified *as constituting a coherent whole commercially and geographically* with respect to that business. . . .

18. The twelve month test applies to each individual site or project. In determining how long the site or project has existed, no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it. A building site should be regarded as a single unit, even if it is based on several contracts, *provided that it forms a coherent whole commercially and geographically*. Subject to this proviso, a building site forms a single unit even if the orders have been placed by several persons (*e.g.* for a row of houses). The twelve month threshold has given rise to abuses; it has sometimes been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period less than twelve months and attributed to a different company which was, however, owned by the same group. Apart from the fact that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules, countries concerned with this issue can adopt solutions in the framework of bilateral negotiations. . . .

20. The very nature of a construction or installation project may be such that the contractor's activity has to be relocated continuously or at least from time to time, as the project progresses. This would be the case for instance where roads or canals were being constructed, waterways dredged, or pipe-lines laid. Similarly, where parts of a substantial structure such as an offshore platform are assembled at various locations

146 Diplomatic notes, supra note 30, at paragraph 2.

147 See J. Ross MacDonald, "'Songs of Innocence and Experience': Changes to the Scope and Interpretation of the Permanent Establishment Article in U.S. Income Tax Treaties, 1950-2010" (2010) 63:2 *Tax Lawyer* 285-414, at 379, note 322 and the accompanying text. Paragraph 42.40 of the 2006 draft OECD commentary on services PEs did not refer to "commercial coherence"; this reference was added to the final 2008 OECD commentary only after several commentators suggested doing so in response to the OECD's request for comments on the 2006 draft.

within a country and moved to another location within the country for final assembly, this is part of a single project. In such cases, the fact that the work force is not present for twelve months in one particular location is immaterial. *The activities performed at each particular spot are part of a single project*, and that project must be regarded as a permanent establishment if, as a whole, it lasts more than twelve months [emphasis added].[148]

Taking the diplomatic note definition into account, the report of the US Senate's foreign relations committee and the technical explanation of the fifth protocol both contain the following discussion of "connected projects":

> For purposes of determining whether the time threshold has been met, subparagraph 9(b) permits the aggregation of services that are provided with respect to connected projects. Paragraph 2 of the General Note provides that for purposes of subparagraph 9(b), projects shall be considered to be connected if they constitute a coherent whole, commercially and geographically. The determination of whether projects are connected should be determined from the point of view of the enterprise (not that of the customer),[149] and will depend on the facts and circumstances of each case. In determining the existence of commercial coherence, factors that would be relevant include: 1) whether the projects would, in the absence of tax planning considerations, have been concluded pursuant to a single contract; 2) whether the nature of the work involved under different projects is the same; and 3) whether the same individuals are providing the services under the different projects. Whether the work provided is covered by one or multiple contracts may be relevant, but not determinative, in finding that projects are commercially coherent.
>
> The aggregation rule addresses, for example, potentially abusive situations[150] in which work has been artificially divided into separate components in order to avoid meeting the 183-day threshold. Assume for example, that a technology consultant has been hired to install a new computer system for a company in the other country. The work will take ten months to complete. However, the consultant purports to divide the work into two five-month projects with the intention of circumventing the rule in subparagraph 9(b). In such case, even if the two projects were considered separate, they will be considered to be commercially coherent. Accordingly, subject to the additional requirement of geographic coherence, the two projects could be considered to be connected, and could therefore be aggregated for purposes of subparagraph 9(b).

148 The concept of a "coherent whole" can be traced back to, at least, the OECD's *Permanent Establishment: Second Report by Working Group No. 1*, supra note 144.

149 It will be noted that this is different from the OECD commentary.

150 In an early draft of this article, I was tempted to say that this is simply wrong because, as discussed above, the connected project rule was inserted into the UN model treaty as a limitation, to ensure that a PE was not created merely by services being performed anywhere in the source state for more than 183 days. However, on reflection, I do not think that is completely correct. Applying "connected" as an anti-abuse concept arguably is brought in through paragraph 11 of the commentary on article 5(3)(b) and paragraph 96 of the commentary on article 1 of the UN model.

> In contrast, assume that the technology consultant is contracted to install a particular computer system for a company, and is also hired by that same company, pursuant to a separate contract, to train its employees on the use of another computer software that is unrelated to the first system. In this second case, even though the contracts are both concluded between the same two parties, there is no commercial coherence to the two projects, and the time spent fulfilling the two contracts may not be aggregated for purposes of subparagraph 9(b). Another example of projects that do not have commercial coherence would be the case of a law firm which, as one project[,] provides tax advice to a customer from one portion of its staff, and as another project provides trade advice from another portion of its staff, both to the same customer.
>
> Additionally, projects, in order to be considered connected, must also constitute a geographic whole. An example of projects that lack geographic coherence would be a case in which a consultant is hired to execute separate auditing projects at different branches of a bank located in different cities pursuant to a single contract. In such an example, while the consultant's projects are commercially coherent, they are not geographically coherent and accordingly the services provided in the various branches shall not be aggregated for purposes of applying subparagraph 9(b). The services provided in each branch should be considered separately for purposes of subparagraph 9(b).[151]

It may be noted that whereas the 2008 OECD commentary refers only to commercial coherence, the diplomatic notes and the technical explanation refer to both commercial and geographical coherence.

In summary, the diplomatic notes set the criteria under which two projects may be connected, but do not define those criteria.

SUMMARY AND CONCLUSIONS ON CONNECTED PROJECTS

Under article 5(1) of both the UN and the OECD model treaties, a PE requires a fixed place of business. In the late 1960s, developing countries voiced their concern that developed countries would often send employees to perform services and earn large profits over a long period of time, but without creating a fixed-base PE, and so would not be taxable in the source state on the profits. To fix that problem, the services PE rule was created. It deems a PE to exist solely on the basis of the length of time during which services are performed in the source state.

Originally, some countries suggested that a services PE should exist whenever the employees from the resident state spent more than 183 days in the source state on any project or projects. But others felt that this would be unfair and would create a PE even when a project lasted only a short time and did not create a real connection to the source state. Accordingly, the services PE rule was developed so that the 183 days had to be spent on a single project or on two or more projects that were "connected." The majority of countries appear to view the connected project condition

151 See S exec. rep. no. 110-15, supra note 24, at 25-26; technical explanation of the fifth protocol, supra note 12, at article 3, "Paragraph 9 of Article V."

as a limitation on the source state's right to tax the business profits earned by the enterprise in the source state from performing services in that state; a minority of countries appear to view the connected project requirement as an anti-abuse rule, to prevent enterprises from artificially splitting a single project into several projects.

Although the word "connected" is not defined in the model treaties or related materials, it is clear that it was intended to mean two projects that were so interdependent and closely intertwined that it would be fair in tax policy terms to treat them as one single project and to create a PE on the basis of those two intertwined projects.

It has been suggested to me that the OECD commentary on services PEs requires no geographical coherence to determine whether projects are connected because if it were required, the services PE rule would be unduly narrow and would cover primarily situations already covered under the fixed-base PE rule. I disagree. It is true that in some cases, if employees are present in the source state for more than 183 days, there may be a fixed-base PE. But as shown in the *Dudney* case, that will not always be true. So the services PE rule is *not* an extension of the fixed-base PE rule; it is, and has always been intended to be, a completely new and different rule.[152]

As noted above in the context of a construction site PE, which is also an alternative to (and not an extension of) the fixed-base PE rule, the original OECD commentary[153] provided that the 12-month threshold in that rule would apply to connected projects—that is, projects that formed a coherent whole, both commercially and geographically. The commentary shows that the OECD understood "coherent whole" to mean both commercially and geographically connected. The current OECD commentary on services PEs is simply wrong in focusing only on commercial connections and leaving out geographical connections. That mistake arises from ignoring both the purpose of the services PE rule and the historical commentary from the OECD.

The case law from around the world on services PEs and construction site PEs shows that both commercial and geographical connections are required before it will be considered fair in tax policy terms to treat two projects as one large project for PE purposes.

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152 Paragraph 42.24 of the OECD commentary on article 5 states that the suggested services PE provision is an "extension" of the "permanent establishment definition that allows taxation of income from services provided by enterprises carried on by non-residents." However, it is clear from the preceding paragraphs in the commentary that, in this context, "extension" means a new rule. In particular, paragraph 42.11 states clearly that service profits are not taxable in the source state unless earned through a "permanent establishment" in that state as defined in article 5 of the OECD model. Indeed, paragraph 42.25 states, "The [services PE] provision has the effect of deeming a permanent establishment to exist where one would not otherwise exist under the definition provided in paragraph 1 and the examples of paragraph 2. . . . Since the provision simply creates a permanent establishment when none would otherwise exist, it does not provide an alternative definition of the concept of permanent establishment."

153 See supra note 144.

Limitation Versus Anti-Abuse Rule

There appears to be a debate as to whether the connected project requirement is a limitation created to protect the enterprise from an overeager source state, or to protect a source state from a conniving foreign enterprise. The determination to be made is whether the projects are sufficiently related or intertwined such that, in tax policy terms, it is fair to combine the time worked on them in determining whether the 183-day test is met. Another aspect to be looked at is whether two projects have been split artificially so as to avoid the 183-day rule; however, in my view, this is not a separate test, but merely a corollary of the first test. In other words, my view is that any such debate is sterile.

The original intention of the PE concept as a whole was to ensure that a foreign enterprise should be taxed in the source state whenever it has a "close enough" connection to that state to justify taxation by that state of the enterprise's profits earned in that state. Accordingly, as a limitation rule, the connected project concept ensures that enterprises having only a slight attachment to the source state will not be taxed.[154] As an anti-abuse rule, the concept ensures that enterprises that try to disguise their real connection to the source state will be taxed.

So regardless how one views the purpose of the connected project rule, the criteria that one should use to determine whether that rule is met are the same. Perhaps only in a case where the facts are exactly balanced between two projects being connected or not would the purpose of the rule be a factor in the decision, but such cases are likely to be so rare as not to be worth discussing. Perhaps the important point is that a revenue authority or a court should not have a presumption one way or the other as to whether two projects are connected: one should neither assume that all projects are connected unless proved otherwise (the anti-avoidance perspective), nor assume that no two projects are connected unless proved otherwise (the limitation perspective). One should start with the fact that there are, at least ostensibly, two projects and then ask whether they exhibit the necessary conditions to be regarded as connected.

In making that determination, the following rules apply:

1. The test of whether the two projects are related sufficiently to create a PE is based on whether they form a coherent whole, both economically and geographically—that is, whether they are intertwined and interdependent both commercially and geographically. Another way of saying the same thing is to ask if the separate projects form a comprehensive overall project, or to ask if the foreign enterprise's various business activities on apparently different projects are so inextricably interconnected that they are required to be viewed as a coherent whole.

154 Tittle, supra note 21, at 208, notes 697 and 698 and the accompanying text.

2. Whether the test is met is to be determined from the point of view of the foreign enterprise, not from the point of view of the person to whom the services are provided.
3. To borrow a phrase from another context, the issue of whether two projects are connected is a "practical, hard matter of fact."[155] All relevant facts must be considered in making the "connected or not" determination. Other cases, or OECD or technical explanation examples, may give guidance but do not create legal precedents. There are no rules of thumb that determine whether two projects are interconnected either geographically or commercially.
4. Even if two projects are commercially coherent in the sense that the work is done for one customer, and geographically coherent in the sense that the projects are carried out at the same or nearby locations, these two factors alone do not mean that the projects are necessarily to be seen as a coherent whole. The true test is whether the projects have sufficient interconnection to be viewed as a single project. Put another way, a commercial connection does not exist just because the enterprise carries out two projects for two different departments of a multifaceted customer, or because two different departments of the same enterprise perform work for the same facet of a single client.
5. There is no fixed list of factors that must be looked at to determine whether two projects are connected, but some factors that one would normally consider include the following (in no particular order, with no particular weight assigned to any factor, and with no absolute requirement that all factors or any one factor be considered in any particular case):
   a. whether the services are provided at the same or different locations;
   b. whether the services are provided under a single master contract or different contracts;

155 *Nathan v. Federal Commissioner of Taxation* (1918), 25 CLR 183, at 189 (HC), deciding what was the geographical source of income in a specific fact situation. It is perhaps worth noting both the full quotation: "The Legislature in using the word 'source' meant, not a legal concept, but something which a practical man would regard as a real source of income. Legal concepts must, of course, enter into the question when we have to consider to whom a given source belongs. But the ascertainment of the actual source of a given income is a practical, hard matter of fact." In the concurring reasons for judgment of Burchett J in *Thorpe Nominees Pty Ltd. v. Federal Commissioner of Taxation* (1988), 19 ATR 1834 (FCFCA), at 1846, he said, "Practical reality is not a test so much as an attitude of mind in which the court should approach the task of judgment. Reality, like beauty, is often in the eye of the beholder. . . . What the cases require is that the truth of the matter be sought with an eye focused on practical business affairs, rather than on nice distinctions of the law. For the word 'source,' in this context, has no precise or technical reference. It expresses only a general conception of origin, leading the mind broadly, by analogy. The true meaning of the word evokes springs in grottos at Delphi, sooner than the incidence of taxes. So the exactness which the lawyer is prone to seek must be consciously set aside; indeed, with respect to a choice between various contributing factors, it cannot be attained. The substance of the matter, metaphorically conveyed when we speak of the source of income, is a large view of the origin of the income—where it came from—as a businessman would perceive it." Much the same may be said about whether two projects are connected for the purposes of article V(9)(b) of the Canada-US treaty.

c. whether the services are provided for the same or different customers;
d. whether the nature of the services provided is the same or different;
e. whether the services are provided continuously or at different times;
f. whether the client's request for services in respect of the second project would reasonably have been expected when concluding the contract for the first project;
g. whether the same individuals are performing the services under the different projects;
h. whether the projects would, in the absence of tax-planning considerations, have been concluded pursuant to a single contract;
i. whether the projects are billed separately or together in the same invoice;
j. whether the services are performed by the same or different personnel;
k. whether there was separate bidding and negotiation on the projects or whether the projects all resulted from the same discussion;
l. whether the results of the projects (the so-called deliverables) are independent of each other or whether one deliverable is somehow connected to or dependent on another deliverable;
m. whether the deliverables under each project are capable of separate delivery or acceptance;
n. whether there are uninterrupted periods between contracts; and
o. whether a reasonable business person would have entered into the contract for one project by itself or whether the business person would have done so only because the other contracts for the other projects were also to be granted.

WHERE DO WE GO FROM HERE?

Although cross-border services among treaty residents from different nations constitute a trillion-dollar industry, it seems unlikely that we will ever see a services PE article in the actual text of the OECD model treaty. This is for two reasons. First, the OECD's recent BEPS (base erosion and profit shifting) project appears to have diverted all attention away from changes to the OECD model and its commentary, and diverted attention to the integration of treaty concepts into a potential BEPS multinational treaty. Second, it seems that the appearance of the suggested services PE provision in the OECD commentary on article 5 was a compromise: many countries (and commentators) did not want it at all; some wanted it in the model itself. In the OECD's 2008 detailed response to its 2006 draft services PE rule, the OECD said:

> As indicated in the changes, the Committee considers that the provision of services should, as a general rule subject to a few exceptions for some types of service (*e.g.* those covered by Articles 8 and 17), be treated the same way as other business activities and, therefore, the same permanent establishment threshold of taxation should apply to all business activities, including the provision of independent services. This conclusion is supported by various policy and administrative considerations described in the new paragraphs of the Commentary.

> The Committee, however, has noted that some States (including some OECD countries) do not share that view. These States use various treaty approaches to preserve source taxation rights, in certain circumstances, with respect to the profits from such services. The Committee has considered that it was important to circumscribe the circumstances in which States could do so and has therefore decided to include in the Commentary an alternative provision that these States could use for that purpose and that would ensure that the additional taxation rights that would be granted to a State using the provision would not extend to services performed outside the territory of that State, would apply only to the profits from these services (as opposed to gross payments for them) and would not apply unless a certain threshold of physical presence in that State had been met.
>
> The decision to include such a possible alternative in the Commentary was a difficult one for the Committee. The Committee as a whole does not support the use of such a provision and many member countries have clearly indicated that they would resist its inclusion in their bilateral treaties. The Committee, however, concluded for various reasons that it was better to acknowledge the existence of a minority treaty practice in this area.[156]

Nevertheless, Canada now has a services PE provision in 35 or so different income tax treaties, with each one referring to a connected project (or connected projects). So the concept is here to stay. One assumes that sooner rather than later the Tax Court of Canada will have to grapple with some or all of the issues raised in this article.

POSTSCRIPT

After this article was prepared but before it went to press, the CRA released further comments on the services PE question.[157] In the memo, the Rulings Branch of the CRA opined on a series of questions posed by a local CRA auditor relating to a US corporation, USco. USco was part of a worldwide group of corporations and provided services related to the planning and executing of construction projects to other members of that group. USco's services were of the "intellectual, planning and supervisory" type, performed by engineers, advisers, and coordinators; USco did not perform physical construction activities. For example, USco provided the following services with respect to the projects: technological assistance, general advice on strategy development, advice on business controls, development planning, engineering, design, and project execution.

Certain of USco's Canadian affiliates were in the process of working on several multi-year projects in Canada. The major projects were subdivided into separate phases, with each phase lasting more than 12 months.

156 *Response of the Committee on Fiscal Affairs*, supra note 142, at 3.

157 CRA document no. 2013-0475161I7, "Whether USco Has a PE in Canada," February 25, 2014. (Originally, the memo was posted on CCH Protos on May 28, 2014. A slightly revised version was posted at the CRA's request on June 2, 2014.)

USco provided its services to the Canadian affiliates pursuant to a master services agreement. That agreement governed both USco's services provided to the affiliates in respect of the projects discussed in the memo and those provided to other Canadian affiliates not discussed in the memo, even though the agreement was not signed by those other Canadian affiliates that carried on those other projects.

To provide its services, USco sent employees to Canada. Most of the services were provided at the Canadian affiliates' offices, at various third-party contractors' offices, at other project participants' offices, or in hotels. The employees' presence in Canada totalled 183 days or more in a 12-month period.

It appears that some of USco's employees may have been seconded to the Canadian affiliates, although whether they were is not explored in detail in the memo. USco also retained subcontractors in Canada to provide some of its services. The memo noted that in prior rulings the CRA had opined that subcontractors' days spent in Canada counted toward the 183-day total in article V(9)(b) of the Canada-US treaty.

The memo assumed that USco had no fixed-base PE in Canada. In making this assumption, the CRA cited *Dysert*, where the court said, "[B]ased upon the extensive evidence before this Court, it appears that I would have been bound to follow and apply the Federal Court of Appeal's decision in *Dudney v. The Queen*, 2000 DTC 6169 (FCA), [2000] 2 C.T.C. 56 (FCA)."[158] This supports my theory, noted above, that Canadian courts and the CRA are bound to follow *Dudney* even though the OECD commentary on article 5(1) of the OECD model treaty suggests that it was decided incorrectly.

The memo then considered whether USco had either a construction site PE or a services PE in Canada.

The memo first noted that if USco's employees had been seconded to the Canadian affiliates, then their services could not be counted in determining whether USco had either a construction site PE or a services PE. As noted above, the case law suggests that a true secondment is difficult to achieve.

The memo then noted that there is nothing in the words of article V(3) of the Canada-US treaty to indicate whether services rendered in respect of the construction site have to be rendered at the site and noted that the CRA had found no case law on this point. However, after consulting various textbooks and papers, the CRA concluded that this must be the case.

Next, the memo noted that the Canadian affiliates were paying USco at cost. Given this, the memo suggested that the issue of whether USco had a PE was moot, since there was no net income to tax (although not cited in the memo, this follows clearly from the wording of subsection 247(2), which does not permit the minister to assess the PE of a non-resident so as to increase its profits from services rendered to a Canadian resident). However, the memo noted that the PE could still be

158 *Dysert*, supra note 13, at note 3.

relevant as far as USco's employees go, because their taxation under article XV depended on whether a Canadian PE was bearing (that is, deducting) their salaries.

The memo noted that article V(3) overrides article V(9) (because it says "Subject to paragraph 3"). Therefore, if the construction site lasted more than 12 months, USco would have a construction site PE, but only with respect to services rendered at the construction site. Services rendered in Canada but away from the construction site would be covered by article V(9). This appears to be a correct interpretation of the opening words of article V(9).

However, the memo then stated:

> However, if USCo does not have a PE under paragraph 3 of Article V, then all of the services rendered in Canada, *including those rendered at the construction site*, can be considered when making a determination under paragraph 9 [emphasis added]. The TE [technical explanation] to paragraph 9 implies that days of services on-site would be counted for purposes of paragraph 9. It says,
>
> > Another example would be that of an architect who is hired to design blueprints for the construction of a building in the other State. As part of completing the project, the architect must make site visits to that other State, and his days of presence there would be counted for purposes of determining whether the 183-day threshold is satisfied.

I disagree with this interpretation. As explained earlier in this article, my view is that the words "Subject to paragraph 3" in article V(9) mean that construction site days count only toward the 12-month rule. The quotation above from the technical explanation is part of an extended comment on paragraph 9, which reads as follows:

> Paragraph 9 applies only to the provision of services, and only to services provided by an enterprise to third parties. Thus, the provision does not have the effect of deeming an enterprise to have a permanent establishment merely because services are provided to that enterprise. Paragraph 9 only applies to services that are performed or provided by an enterprise of a Contracting State within the other Contracting State. It is therefore not sufficient that the relevant services be merely furnished to a resident of the other Contracting State. Where, for example, an enterprise provides customer support or other services by telephone or computer to customers located in the other State, those would not be covered by paragraph 9 because they are not performed or provided by that enterprise within the other State. Another example would be that of an architect who is hired to design blueprints for the construction of a building in the other State. As part of completing the project, the architect must make site visits to that other State, and his days of presence there would be counted for purposes of determining whether the 183-day threshold is satisfied. However, the days that the architect spends working on the blueprint in his home office shall not count for purposes of the 183-day threshold, because the architect is not performing or providing those services within the other State.[159]

159 Technical explanation of the fifth protocol, supra note 12, at article 3, "Paragraph 9 of Article V."

In my view, this quotation was not addressing the interaction of articles V(3) and (9), and the memo is using the architect example to support a proposition for which it is not used in the technical explanation itself.

After dealing with whether various (later) changes to the OECD commentary on construction PEs could be taken into account in interpreting an earlier treaty (to which question the CRA's answer was yes), the memo then addressed services PEs. First, the memo looked at the meaning of "enterprise" in article V(9). The taxpayer argued that each of its different divisions was a separate enterprise, so that the test was whether each enterprise, rather than USco as a whole, met the 183-day test. According to the memo,

> [i]n the taxpayer's view, each of the [redacted] different functions should be treated as a separate enterprise because each function:
>
> 1. constitutes a separate division in USCo,
> 2. is led by a separate vice president and managers;
> 3. has distinct and separate staff;
> 4. has separate financial and accounting results; and has separate budgets.

The memo cited an earlier CRA ruling and agreed with the taxpayer:

> Our view is that the term "enterprise" refers to a resident of a contracting state but only in reference to a particular line of business carried on by such resident. Therefore, where a resident of a contracting state carries on two lines of business, that resident may have a permanent establishment in the other contracting state by reference to one of such lines of business, but not the other.

On the basis of this definition, which is supportable but in my view likely incorrect, the memo noted that each of USco's functions would constitute separate enterprises if they could be considered to constitute separate "lines of business." Since the term "line of business" is not defined in the treaty or the technical explanation, the memo suggested that it means the same thing as "separate businesses," so that the decision in *Dupont Canada Inc. v. Canada*[160] and the analysis in *Interpretation Bulletin* IT-206R[161] would be relevant. The memo set out a long list of factors that could be taken into account in determining whether USco had one single business or separate lines of business. The memo noted that the basic test from *Dupont* is whether the aspects of the company's operations that are characteristic of a single integrated business are more substantial than the aspects that are characteristic of separate businesses.

Turning to article V(9), the memo noted that the issue, assuming that USco had only one line of business, and therefore constituted only one enterprise, was whether its various operations in Canada constituted one project, several connected projects, or several unconnected projects. For this purpose, the memo adopted the statement

160 2001 FCA 114.

161 *Interpretation Bulletin* IT-206R, "Separate Businesses," October 29, 1979.

in the technical explanation that only days on which services are provided are to be counted toward the 183-day test; non-working days do not count.

As the memo correctly (and obviously) noted, if USco were providing services for only one "project" (which, as the memo noted, is undefined), then the issue of whether any two projects were connected was irrelevant. The memo suggested that USco had only one contract with one related group to provide one type of product (intellectual services) in one industry in one country (Canada) on a continuous basis, so that an argument could be made that all of those services constituted one project in Canada.

However, the memo noted that the CRA auditor was of the view that the Canadian affiliates operated (at least) two separate projects, so the issue was whether, from USco's point of view, the projects were connected. (Normally, this "point-of-view" rule would assist a non-resident taxpayer in avoiding a PE; here, it seemed to hurt USco because, as the memo noted, from USco's point of view the projects might be connected even though the Canadian affiliates viewed them as being separate projects.)

USco argued that, for the following reasons, the projects were unconnected:

- Each project is run separately.
- The projects are not integrated.
- Each project was managed by a separate team.
- Each project had a separate capital budget.
- Each project had a different scope.
- Each project was executed by a different team.
- Separate project codes were set up.
- USco may be heavily involved in one project, but may not provide services again in a subsequent project.

The memo examined a number of factors in USco's situation but stated that more facts were needed before it could be decided whether the projects formed a coherent whole commercially.

The memo also noted that although the OECD commentary on its suggested services PE provision did not require geographical coherence, geographical coherence was required under article V(9). I agree.

In this context, the memo suggested that even if different projects were in different cities (and presumably, in different provinces?), that by itself would not mean automatically that there was not geographical coherence. The memo suggested that such a rule may apply to fixed-base PEs but that article V(9) should not be interpreted so restrictively: "We believe that the purpose of paragraph 9 [of article V] would not be met by applying a restrictive interpretation."

The memo then adopted this passage from Reimer et al.:

> Geographical diversification does not necessarily create two (or more) sites or projects. As long as two or more building lots in one country, form a coherent whole, that

> is, are operated at one place or for one and the same ordering party, for related parties or for parties who act jointly and in coordination, these places should be aggregated and treated as one single unit for the determination of the minimum period.[162]

Once again, the quotation cited by the memo is incomplete. The quotation continues as follows:

> The OECD Commentary acknowledges one building site for a row of houses, even if the orders have been placed by several persons. Similarly, a mutual agreement between Belgium, Germany and the Netherlands endorses that principle; with regard to works accomplished at entirely different places, provided that they belong to a comprehensive overall project.[163]

In other words, if one project requires construction at a range of locations, there may (or may not) be geographical coherence, but the fact that two projects are carried out by one enterprise for two different (albeit related) customers at different sites on different projects should not, by itself, create geographical coherence.

The memo then concluded that a large area could represent a geographic whole, depending on the nature of the business, provided that it had "some relevant defining physical characteristics." I agree with this.

Lastly, the memo found that there was geographical coherence, but for reasons that, in my view, are completely wrong:

> If the projects in [redacted] and in [redacted] area constitute a coherent whole commercially, then in our view, they would also constitute a coherent whole geographically, since each of the connected projects require services to be provided at the same two geographic areas. Accordingly, all the days of service can be added together for determining whether the thresholds in paragraph 9 of Article V have been met. . . .
>
> We do not have enough information to determine if the various sites are a coherent whole commercially. We have recommended a methodology for you to use to make the determination, based on your knowledge of the taxpayer. If the projects in the [redacted] area and [redacted] area in [redacted] are a coherent whole commercially, then they would also be a coherent whole geographically.

This is simply wrong because it says that if there is commercial coherence, then there must be geographical coherence. The two concepts are distinct and distinguishable. I acknowledge that they may be interrelated, that some factors that apply to one may apply to the other, and that the fact that there is commercial coherence

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162 Ekkehart Reimer, Nathalie Urban, and Stefan Schmid, eds., *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective*, 3d ed. (Alphen aan den Rijn, the Netherlands: Kluwer Law International, 2012), at paragraph 212.

163 Ibid. (footnotes omitted).

may in some cases suggest geographical coherence and vice versa; but to say that *because* the projects form a commercial whole, they must also form a geographic whole is a mistake. I simply do not understand the intended meaning of the phrase "since each of the connected projects require services to be provided at the same two geographic areas." This obviously begs the question by assuming that the projects are connected.

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Estimates of the Number of Guaranteed Income Supplement Recipients Who Receive Income from Registered Retirement Savings Plans

Michael R. Veall*

PRÉCIS

Un bénéficiaire du supplément de revenu garanti (SRG) subira une récupération au taux marginal minimum de 50 pour cent de tout revenu provenant d'un régime enregistré d'épargne-retraite (REER). Ainsi, les taux de rendement effectifs des REER pendant la retraite peuvent souvent être bas ou même négatifs comparativement à la solution d'encaisser le REER avant l'âge de 65 ans. Cette étude présente de nouvelles estimations fondées sur les données de contribuables et indique qu'environ 15 pour cent à 30 pour cent de tous les aînés ont reçu un revenu à un moment donné qui provenait de leur REER et qui était soumis à la récupération du SRG. Cette fourchette est légèrement inférieure à l'estimation de 2003 faite par Richard Shillington basée sur un examen des actifs détenus par des personnes approchant de l'âge de la retraite. Il en va de même pour un revenu provenant d'un régime de pension agréé. Compte tenu des politiques actuelles, de nombreux ménages qui seront bientôt bénéficiaires du SRG ou d'un programme de prestations connexe pourraient grandement bénéficier d'une la planification fiscale.

* Of the Department of Economics, McMaster University, Hamilton, Ontario (e-mail: veall@mcmaster.ca). This article is a shortened and somewhat revised version of a Canadian Labour Market and Skills Researcher Network (CLSRN) working paper that was funded through a grant to CLSRN by Human Resources and Social Development Canada (HRSDC) (which has since been restructured and renamed). For assistance on this project, I thank Habib Saani of Statistics Canada for his work on the longitudinal administrative databank (LAD) and Brian Murphy for his help in facilitating access and overall counsel. I also thank Habib Saani, Marllena Ifrim, and Joe Wilkinson of Statistics Canada for access to their unpublished series on registered retirement income flows. A number of colleagues from HRSDC, especially Alex Grey and Nathalie Martel, made useful comments, along with participants at a CLSRN workshop held in Waterloo, Ontario in October 2011 and at the CLSRN/HRSDC conference "Challenges for Canada's Retirement Income System" held in Ottawa in April 2012. Helpful comments were also received from two anonymous referees, Deb Fretz, Kevin Milligan, Tammy Schirle, and Richard Shillington. Steve Bonnar, Ross Finnie, Alan Macnaughton, John Stapleton, Marcel Théroux, Paul Thompson, and Vivien Morgan provided useful information in related discussions. Finally, I am grateful to Qing Li and Wei Yang for research assistance.

ABSTRACT

A guaranteed income supplement (GIS) recipient will have at least 50 percent of any registered retirement savings plan (RRSP) income clawed back on the margin. Resulting RRSP effective rates of return during retirement can often be low or even negative relative to the alternative of cashing out the RRSP before age 65. This study presents new estimates from taxfiler data indicating that approximately 15 percent to 30 percent of all seniors have received income at some time that originated from their RRSPs and is subject to GIS clawback. This range is slightly lower than the 2003 estimate by Richard Shillington based on an examination of asset holdings of near-seniors. The same issues can apply to registered pension plan income. Given current policies, many households that will soon be recipients of the GIS or its related allowance programs may benefit substantially from tax planning.

KEYWORDS: GUARANTEED INCOME SUPPLEMENT ■ REGISTERED RETIREMENT SAVINGS PLAN ■ REGISTERED PENSION PLAN ■ RETURNS ■ EFFECTIVE RATES ■ TRANSFER PAYMENTS

CONTENTS

INTRODUCTION

A guaranteed income supplement (GIS) recipient whose registered retirement savings plan (RRSP) income increases from zero to $1,000 will typically gain only an extra $500 after the effect of the 50 percent GIS clawback is taken into account. In some income ranges, the GIS clawback can be 75 percent. Provincial income supplements can also have clawbacks. For example, for low-income seniors receiving both GIS and the guaranteed annual income system (GAINS) transfer in Ontario, the total clawback on additional income is often 100 percent and can exceed 100 percent.[1] There are also some GIS recipients who will pay personal income tax on RRSP income.

1 Thanks to an anonymous referee for pointing out that in Ontario, the total clawback rate can exceed 100 percent for a couple receiving a GAINS transfer, GIS, and the related transfer known as the allowance (paid when one of the couple is aged 65 or over and a GIS recipient, and the other is aged 60 to 64): Ontario, Ministry of Finance, *GAINS Benefit Rate Tables Summary for the Guaranteed Annual Income System (GAINS)* (Toronto: Ministry of Finance, 2013) (www.fin.gov.on.ca/en/lists/gains/pdf/1934.pdf), at table 4. This high clawback rate occurs when annual family income is between $6,592 and $8,832. Stapleton describes a case where he suggested that an individual defer her Canada Pension Plan benefits at age 65 because the GIS/GAINS clawback was 100 percent: John Stapleton, "A Story of Two Poor Seniors: Linda and Doris Are the Highest Taxed People in Ontario," *Open Policy Ontario*, January 21, 2014 (http://openpolicyontario.com/a-story-of-two-poor-seniors-linda-and-doris-are-the-highest-taxed-people-in-ontario).

Even with a clawback of "only" 50 percent, RRSP effective rates of return can be low or even negative during retirement as compared with the alternative of cashing out the RRSP before age 65. This problem is common: this study presents new estimates from taxfiler data indicating that approximately 15 percent to 30 percent of all seniors will at least once receive income from their RRSPs (including registered retirement income funds [RRIFs]) that is subject to GIS clawback. It is estimated that in about three-fifths of these cases, the clawback will be in excess of $1,000. In addition, GIS clawbacks apply to registered pension plan (RPP) income: it is estimated that at least 30 percent of all seniors will at least once receive RRSP, RRIF, or RPP income that is subject to GIS clawback.

The range of estimates in this study is somewhat lower than, but broadly consistent with, Shillington's estimate of a GIS clawback for 32 percent of recipients of RRSP/RPP income.[2] Shillington derived his estimate from Statistics Canada survey data for 1999 on near-senior households (where the older spouse was aged 55 to 64) with retirement savings greater than zero but less than $100,000.[3] Shillington defined retirement savings as the sum of the value of RRSPs and the estimated value of RPPs. The number $100,000 was chosen because "an annuity purchased with $100,000 will pay approximately $10,000 per year (varying with age, sex, and type of annuity), which is generally not enough to make a senior ineligible for GIS."[4]

There are two main questions regarding Shillington's estimate. First, is his interpretation correct that if there is RRSP (or RRIF) income coincident with GIS income and hence subject to clawback, the senior has necessarily made a mistake? To clarify the issue, the next section of this article gives a simple example of how GIS clawbacks can lead to an RRSP contribution yielding a negative effective rate of return. A subsequent section describes some further examples. While in many cases GIS recipients should collapse their RRSPs by age 64, there are some circumstances in which continuing the RRSP can be advantageous because the tax sheltering of the accumulation of interest income is large enough to offset the clawback. However, I will argue that such circumstances are unlikely to be representative and that the continuation of an RRSP at age 64 by a prospective GIS recipient is infrequently the right choice.

2 Richard Shillington, *New Poverty Traps: Means-Testing and Modest-Income Seniors*, C.D. Howe Institute Backgrounder no. 65 (Toronto: C.D. Howe Institute, April 2003). On his website (www.shillington.ca), Shillington gives his study a more provocative title—"How Lower-Income Canadians Are Defrauded by RRSPs." Shillington's position shares similarities with that taken by Jonathan Kesselman and Finn Poschmann in *A New Option for Retirement Savings: Tax-Prepaid Savings Plans*, C.D. Howe Institute Commentary no. 149 (Toronto: C.D. Howe Institute, February 2001) and a number of Canadian financial commentators. For example, an oral interview with Malcolm Hamilton (particularly answer 8) includes the advice that saving usually does not make sense for those nearing retirement with low incomes: "How Should You Plan for Retirement?" *Globe and Mail*, October 15, 2009 (www.theglobeandmail.com/report-on-business/retirement/malcolm-hamilton-offers-retirement-planning-advice/article1325008).

3 Statistics Canada, *1999 Survey of Financial Security* (Ottawa: Statistics Canada, 2001).

4 Shillington, supra note 2, at note 5.

The second question is whether Shillington's estimate accurately predicts the number of seniors who will receive GIS and RRSP (or RRIF) income at the same time, and hence be subject to the clawback. For example, the $100,000 cutoff is somewhat arbitrary, and those with RRSP assets may withdraw them entirely at age 64, before GIS eligibility.

I study this question using taxfiler data in Statistics Canada's longitudinal administrative databank (LAD). The data are described later in this article, followed by presentation of the results obtained from directly estimating the prevalence of GIS clawbacks associated with RRSP, RRIF, and RPP income on an annual basis. I also explore a related longitudinal analysis. It appears that the number of seniors subject to the clawback on their RRSP income is significant. Hence, in the concluding section, I argue that many near-seniors who will be GIS-eligible would benefit greatly from tax planning. (Some seniors may not even realize that they have been subject to the clawback, given that it is possible that an RRSP/RRIF withdrawal can precede the actual GIS reduction by as much as 18 months.) In addition, I argue that there is a case for considering policy changes that would reduce the clawback for low-income seniors who have saved for their retirement.

This study uses data up to 2008 and hence does not consider tax-free savings accounts (TFSAs), which were introduced in the 2008 budget and came into effect on January 1, 2009. Future research will examine the impact of the introduction of TFSAs on the use of RRSPs by low-income individuals.

A Simple Hypothetical Example

While more realistic cases will be considered in subsequent sections, I will begin by considering a simple example to illustrate the problem with the clawback. Suppose that individual *A* contributes $1,000 to an RRSP for the first time at age 64. *A* has a marginal tax rate of 20 percent and so receives a personal income tax refund of $200 associated with the RRSP contribution. *A* saves the $200 outside the RRSP. Interest rates are 5 percent, so that one year later, at age 65, *A* has $1,050 inside the RRSP and $210 from saving the refund (assuming for simplicity that the interest on that saving is entirely untaxed).

Suppose that *A* is a GIS recipient at age 65 and withdraws the RRSP holding that year. Because the RRSP withdrawal will count as income for GIS purposes, it will be subject to a GIS clawback of 50 percent. Hence, *A* will have 50 percent left from the $1,050, or $525, plus the $210 from saving the refund. The total of these amounts ($735) is less than the $1,000 original contribution. The effective rate of return to *A* on the RRSP contribution is *minus* 26 percent.

The effective rate of return is negative because RRSP withdrawals are counted as income for the purposes of the GIS clawback. But in this case $1,000 of the withdrawal is deferred income from the previous year. The deferral leads to a refund at the time of contribution, but the funds are taxed at the time of withdrawal. Because the GIS clawback rate of 50 percent exceeds the marginal personal income tax rate at the time of contribution, a negative effective rate of return is possible.

If the example is altered so that the $1,000 is already in the RRSP at age 64 rather than a fresh contribution, the same arithmetic argues that the $1,000 should, if possible, be withdrawn immediately from the RRSP rather than left until age 65, after which any withdrawal will be subject to clawback.

SOME OTHER SCENARIOS

Suppose that a prospective GIS recipient chooses not to cash out her or his RRSP at age 64 in order to avoid the clawback. In contrast to the hypothetical example described above, it could be that the individual will continue the RRSP (rolling it into an RRIF) for many years, gaining such advantage from the ability of RRSPs/RRIFs to shelter cumulative investment gains that there is a higher effective rate of return to maintaining the RRSP/RRIF, even if withdrawals are subject to GIS clawback.[5]

In a related paper published in 2013,[6] I worked out in detail a number of scenarios along these lines. One of the examples under RRIF scenario II of that paper considers a case with assumptions that strongly favour maintaining the RRSP. The annual interest rate is 5 percent, the marginal tax rate at age 64 is 40 percent, and the individual transfers all RRSP funds to a RRIF at age 70, thereafter making only the minimum, legally required withdrawals (under the rules in place in 2008) until a given age, at which point the balance is withdrawn. If there are no personal income taxes applicable after age 64, this strategy will pay a higher effective return than saving in the same assets outside an RRSP, provided that the age of final withdrawal is 73 or greater.

While a threshold of age 73 makes the strategy of keeping the RRSP seem reasonable, there are a number of reasons why this example should not mitigate concerns about the interaction of RRSPs and the GIS system.

First, most prospective GIS recipients will have lower marginal tax rates at age 64. If the individual's marginal tax rate at age 64 is 30 percent, the breakeven age jumps from 73 to 83; if the marginal tax rate at age 64 is 20 percent, the breakeven age is over 94. Life expectancy at age 65 is about 83.5 years for men and 86.6 years for women. Also, the example leans heavily on the individual's being able to attain an interest rate of 5 percent in interest-bearing securities. If the interest rate is lower, or if funds can be saved outside the RRSP/RRIF with some tax sheltering of returns (for example, through investments in equities), again the breakeven age will be pushed up.

5 It also may be that the individual decides not to cash out because she or he expected a different set of circumstances—for example, sufficient income past age 65 to be above the GIS threshold. While I believe that many near-seniors do not collapse their RRSPs because they do not understand or anticipate the clawback, this study will focus on consequences rather than reasons. The study will also not address the possibility that an individual is prepared to accept the subnormal returns of maintaining the RRSP because the RRSP is a commitment device for saving.

6 Michael R. Veall, *Estimating the Number of Guaranteed Income Supplement Recipients Who Have Mistakenly Saved in Registered Retirement Savings Plans and Registered Pension Plans*, Canadian Labour Market and Skills Researcher Networker Working Paper no. 119 (Vancouver: CLSRN, April 2013), appendix (www.clsrn.econ.ubc.ca/workingpapers/CLSRN%20Working%20Paper%20no.%20119%20-%20Veall.pdf).

Second, in many cases, the individual will need to access more funds earlier than this maximum-holding-period scenario allows, and this will tend to increase the relative advantage of cashing out the RRSP at age 64. In a later section, I will show that a significant number of GIS recipients received RRSP income between the ages of 65 and 70, before they were legally required to take such income. Further, as discussed in the introduction, in many cases the clawback rate is higher than 50 percent.[7]

In passing, I also note that, under current law, *all* RRSP recipients who would be subject to GIS clawback and who face at age 64 a marginal tax rate of less than 50 percent will receive larger returns if they transfer as much as possible from their RRSPs to their TFSAs at age 64. This does not appear to be well known.

Withdrawal from an RRSP at age 64 is not always possible. It may be that the individual cannot cash out the RRSP before age 65 because the funds are locked in—for example, as a result of a transfer from an RPP. In the following analysis, income from life income funds and from annuities from locked-in RRSPs is included as part of RRSP income, and income from locked-in retirement income funds is included as part of RRIF income. The data do not separate these payments out. Regardless, these situations are still examples of RRSP saving yielding low effective rates of return during the retirement period.

The same logic that applies to RRSP holdings applies to RPP assets. In many cases, it may be that GIS recipients with RPPs that can be cashed out at age 64 should take advantage of this opportunity. It might also be argued that RPPs would provide more equitable effective rates of return to their low-income members if they permitted cashing out of small pensions at age 64 to those plan members who will be GIS-eligible.[8]

In later sections of this article, I will return the focus to estimating the number of individuals who receive income from an RRSP, RRIF, or RPP that is subject to GIS clawback.

DATA USED IN THE STUDY

The data source for the study—the LAD—is an anonymized, annual 20 percent sample of taxfilers for Canada from 1982 to 2009. The analysis in this study begins in 1992, the first year for which all required variables (particularly the variable including

7 If the clawback rate is 75 percent or higher, or if personal income tax is applicable to the RRSP income, the breakeven age is always 94 or greater. While I do not investigate this scenario, in some cases it can be advantageous to contribute to an RRSP after age 65 (when eligible) in order to maximize GIS payments. See, for example, Preet Banerjee, "How RRSP Payments Can Help Seniors with Benefits," *Globe and Mail*, February 24, 2012 (www.theglobeandmail.com/globe-investor/personal-finance/how-rrsp-payments-can-help-seniors-with-benefits/article548651).

8 For a discussion of the interaction of pension plans and the old age security (OAS)/GIS system more generally, see Deborah Fretz, Alan Macnaughton, and Michael R. Veall, *Policy Approaches To Promote Private and Occupational Old-Age Provision in Canada* (Washington, DC: Bertelsmann Foundation, January 2002) (www.bertelsmann-stiftung.de/cps/rde/xbcr/SID-13A7B63C-80444CD4/bst/BST-VS-4-CAN.pdf), at 4.

GIS receipt) were available, and ends in 2008, the last year available at the time the calculations for this study were completed. LAD coverage expanded substantially in 1990, when the goods and services tax credit and the child tax benefit were introduced, resulting in an increase in the number of taxfilers. Coverage is therefore very close to complete, and there is no attrition except, for example, as a result of death or emigration. All records are linked longitudinally. There is also household linkage: in this study, couples include common-law partners.[9] In some cases, the LAD creates this linkage by address matching.

In a 2012 paper, Finnie and Gray[10] discuss how GIS benefits are reported in the LAD as the sum of GIS and the spouse's allowance (the latter now called "the allowance" and paid to those aged 60 to 64 whose spouse is 65 or over and a GIS recipient). In this study, I include in GIS the allowance and the allowance for the survivor, which is the allowance extended for someone aged 60 to 64 who has received the allowance and whose spouse has died. Recipients in the allowance programs also faced clawbacks, in many cases at a rate of 75 percent rather than 50 percent. Finnie and Gray also note that GIS receipt may be underreported in the LAD before age 67.

SOME EMPIRICAL RESULTS: ANNUAL

Table 1 examines the coincidence of GIS receipt and various types of retirement income for 2008. (In a longer working paper,[11] these values are computed and graphed from 1992 to 2008. The values vary, but those for 2008 are not unusual.)

A serious data shortcoming needs to be highlighted. What is called "RRSP income" in this study is derived from line 129 of the T1 federal personal income tax form and includes ordinary withdrawals from an RRSP, RRSP annuity income, and (likely unimportantly for this analysis), since 1995, repayments not made under a home buyers' plan.[12] But critically, it does not include RRIF income, which is included with RPP income, as will be discussed below.

Using this definition of RRSP income, we can see from row 1 in the table that 8 percent of couples who received GIS in 2008 also received RRSP income and were

9 The analysis throughout excludes from any yearly count or sum those who die in that year or those whose spouse has died in that year. Anyone not currently married or currently in a common-law relationship is treated as single.

10 Ross Finnie and David Gray, "Guaranteed Income Supplement (GIS) Status Amongst the Retired Population—An Analysis of the Incidence and the Dynamics," draft paper prepared for the CLSRN/HRSDC project "Challenges for Canada's Retirement Income System" (2012).

11 Veall, supra note 6.

12 RRSP income from line 129 of the general income tax return consists of the following T4RSP slip entries: box 16 (RRSP annuity payments), box 18 (refund of payments), box 28 (payments triggered by such circumstances as the acquisition of an ineligible investment within an RRSP or by using property within an RRSP as a loan), box 20 (withdrawal of excessive premiums), box 22 (withdrawal), and box 26 (payments upon deregistration). It also includes box 34 (amounts deemed or received upon death), but this should not matter here since those who die, or whose spouse dies, in the particular year have been excluded from the sample.

TABLE 1 RRSP Income, RRIF Income, and RPP Income, Personal Income Taxes and GIS Recipients, 2008

	Percentage of GIS recipients with positive value			As a percentage of all GIS income received		
Variables	Couples	Single women	Single men	Couples	Single women	Single men
1. RRSP income	8	3	3	6	3	3
2. Personal income taxes (from those also receiving RRSP income)	5	2	2	2	1	1
3. Sum of RRIF and RPP income	49	31	28	58	25	21
4. Personal income taxes (from those also receiving RRIF or RPP income)	23	12	8	12	4	4
5. Sum of RRSP, RRIF, and RPP income	78	42	27	61	30	24
6. Personal income taxes (from those also receiving RRSP, RRIF, or RPP income)	25	14	14	13	5	5
7. Sum of RRSP and RRIF income (not available by marital status/gender)		12			10	

GIS = guaranteed income supplement.
RPP = registered pension plan.
RRIF = registered retirement income fund.
RRSP = registered retirement savings plan.

Notes: (1) "Receiving" in relation to a couple means received by either spouse. (2) RRSP income does not include RRIF income. (3) The first three columns give the percentages of GIS recipients with positive values for the corresponding variable, while the last three columns give the value of the variable as a percentage of GIS income received. For example, the column 1 "Couples" entry in the row "RRSP income" gives the percentage of couples receiving GIS who also received positive RRSP income, while the column 4 "Couples" entry in the same row gives RRSP income received by GIS-receiving couples as a percentage of all GIS income received by couples. The column 1 "Couples" entry in the row "Personal income taxes (from those also receiving RRSP income)" gives the percentage of couples receiving GIS who also received RRSP income and paid personal income taxes, while the column 4 "Couples" entry in that column gives the amount of such taxes as a percentage of GIS income received by couples. In all cases, personal income taxes include both federal and provincial taxes paid, with those for Quebec being estimated. (4) Couples receiving GIS are defined as those in married or common-law relationships in which at least one partner received GIS income. Single women and single men are GIS recipients other than those in a married or common-law relationship.

therefore subject to the clawback. The fourth column of that row indicates that RRSP income was about 6 percent of all GIS income received by couples. The values for single women and single men are smaller.[13]

Row 2 of the table shows that of the 8 percent of GIS recipient couples who (from the previous row) received RRSP income in 2008, the majority (5 percent of all GIS recipient couples) also paid provincial and federal personal income tax. The rest of the row gives smaller values for single men and single women, and shows that for all couples receiving both GIS and RRSP income, total federal and provincial personal income tax paid was only 2 percent of total GIS payments received.

Rows 3 and 4 are comparable to rows 1 and 2 except that here the income in question is RRIF income plus RPP income. RRIF income and RPP income cannot be disentangled because both are included in income reported at line 115 on the federal T1 personal income tax form (along with Saskatchewan pension plan income and some other items that are probably unimportant for most GIS recipients, such as income from a deferred profit-sharing plan or from a foreign public or private pension plan).[14] This category also does not include income from a supplemental employment retirement plan (whether or not the plan is set up as a retirement compensation arrangement). For simplicity, I will refer to this category as "RRIF + RPP" income. It can be seen that 49 percent of couples who received GIS also received positive RRIF + RPP income, with smaller percentages for single men and women.

Rows 5 and 6 are again comparable to rows 1 and 2, this time indicating, for example, that about 78 percent of all couples receiving GIS were also recipients of positive RRSP + RRIF + RPP income, with about one-third of these paying personal income tax. The comparable value for single women is 42 percent (with one-third of these paying personal income tax); for single men, it is 27 percent (with about one-half of these paying personal income tax). Aggregating these data without regard to gender and marital status, it turns out that approximately 50 percent of all GIS recipients received RRSP, RRIF, or RPP income, of whom a little more than one-third paid personal income tax. For this group, personal income taxes totalled a little less than 10 percent of their GIS receipts.

13 As part of the calculations, this analysis was repeated with thresholds to check whether there was an inordinately large clustering at near-zero values. Taking 2008 values for illustration, of those who received GIS, about 82 percent of couples received at least $2,000 and about 90 percent of single individuals received at least $1,000. Of those households that received GIS and RRSP income, about 93 percent of couples and single individuals received RRSP income of at least $500, more than 95 percent of couples received RRSP income of at least $200, and more than 97 percent of single individuals received RRSP income of at least $100.

14 In terms of slip entries, line 115 includes from a T4A slip, box 16 (pension or superannuation), box 24 (life annuities purchased, for example, with refunded RRSP premiums, from the proceeds of a life income fund, or from a deferred profit-sharing fund but not from a life insurance policy or within an RRSP), and box 28 (variable pension benefits); from a T4RIF slip, box 16 (standard RRIF payments) and box 20 (RRIF payments upon deregistration); from a T3 slip, box 31 (qualifying pension income); and from a T5 slip, box 19 (accrued annuities from a life insurance policy).

Row 7 represents an attempt to isolate RRSP + RRIF income (that is, to remove RPP income from the values in row 5). For this purpose, unpublished estimates of total RRIF outflows for all individuals are used.[15] The number of GIS recipients with RRIF income is then estimated by assuming that the ratio of the number of GIS recipients with RRIF income to GIS recipients with RRSP income is the same as the overall ratio of RRIF income recipients (from the unpublished estimates, where those who have died are excluded) to RRSP income recipients (available in the LAD). A similar technique is used to estimate the RRIF income received by GIS recipients by assuming that the ratio of GIS-recipient RRIF income to GIS-recipient RRSP income is the same as the overall ratio of RRIF income (from the unpublished estimates) to RRSP income (available in the LAD). It is not possible using this method to differentiate between couples, single women, and single men, so estimates are based on total individuals.[16] I note in passing that these estimates could be refined significantly if the LAD were linked to Statistics Canada's Survey of Financial Security.[17]

The estimates indicate that on an annual basis, about 12 percent of all GIS recipients received either RRSP or RRIF income. This may be an overestimate because the method unavoidably double-counts those who have both RRSP *and* RRIF income. Hence, I estimate the value at 10 percent. This is double the estimate for RRSP income alone from row 1, where converting the couple and single figures yields an estimate that about 5 percent of all GIS recipients overall received RRSP income.

To summarize so far, with respect to RRSP income (remembering that this does not include RRIF income), *on an annual basis* for 2008 the GIS clawback appears to affect about 8 percent of couples receiving GIS and 3 percent of single men and women receiving GIS, or in total about 5 percent of all GIS recipients. More than half of these individuals faced personal income tax in addition to the GIS clawback. Including RRIF income in these calculations approximately doubles the number of individuals subject to GIS clawback, to about 10 percent of all GIS recipients. If one considers the number of individuals subject to GIS clawback as a result of receiving RRSP, RRIF, or RPP income, this is close to 80 percent of GIS-recipient couples (with about one-third paying personal income taxes), over 40 percent of single female GIS recipients (with about one-third paying personal income taxes), and over 25 percent of all single male GIS recipients (with about one-half paying personal income taxes). This is approximately 50 percent of all GIS recipients, with a little more than one-third of these also being subject to personal income tax on RRSP, RRIF, or RPP income.

15 These were kindly provided to me by Marllena Ifrim, Habib Saani, and Joe Wilkinson of Statistics Canada.

16 An anonymous referee pointed out that this probably tends to overstate the coincidence of GIS and RRIF income, since those who move their funds into RRIFs are likely on average richer than those who do not. This is one reason why this study essentially uses the RRSP-alone results as a lower bound.

17 The impact on underlying consumption behaviour could also be analyzed if the LAD were linked to the Statistics Canada Survey of Household Spending.

Hence, very roughly five times as many GIS recipients reported RRSP, RRIF, or RPP income each year as reported RRSP or RRIF income alone.

SOME EMPIRICAL RESULTS: LONGITUDINAL

Shillington's estimate suggests that 32 percent of all seniors will be affected by the GIS clawback on income from registered savings. That does not mean that they will be affected on an annual basis, but rather at least once during their retirement. GIS recipients may withdraw their RRSP or RRIF savings all at once or slowly: in either case, the clawback is applicable.

Hence, to explore Shillington's estimate further, table 2 uses the longitudinal feature of the LAD to look at the RRSP income history (including a spouse's RRSP income) back to age 60 of all seniors (not necessarily GIS recipients) who were aged 65 to 76 in 2008 and who had filed continually.[18] (The cutoff of age 76 was used so that problems related to attrition, mostly because of death, would not be severe. Because, during this sample period, an RRSP was required to be closed at age 70 and either converted to an annuity or a RRIF, RRSP income that appears initially at an age above 70 will largely be from those who missed the initial deadline or will be a withdrawal by a younger spouse.) Continuing RRSP income after age 70 will largely be RRSP annuity income (recalling the caveat that RRSP income does not include RRIF income).

The first column of the table gives the percentage of those between ages 65 and 76 in 2008 who, during at least one year when they were aged 60 to 64, received both RRSP and GIS income in the same year. There are two ways to be counted for GIS receipt at this age. One way is to receive GIS income through either the allowance or the allowance for the survivor, which requires being aged 60 to 64 and to have a spouse who is a GIS recipient, or to be the widow or widower of a spouse who was a GIS recipient. The other way is not to be receiving any GIS income through an allowance but nonetheless to have a spouse who is a GIS recipient. In either case, the RRSP income received by such individuals is subject to GIS clawback.

It can be seen that this percentage is around 4 percent to 5 percent for all ages as of 2008. This is just under a third of those who received some GIS from age 60 to 64. To compare, during the ages 60 to 64 about two-fifths of those who did not receive any form of GIS made RRSP withdrawals. Mawani and Paquette[19] explore pre-retirement RRSP withdrawals more extensively.

The second column of the table shows that a stable 3 percent to 3.7 percent of those aged 65 to 76 in 2008 received both GIS and RRSP income in the year in which they turned 65.

18 If the requirement for continual filing is dropped, the values in table 2 fall slightly, with the largest difference being the age 76 value in the third column, which falls from 13.6 to 11.9.

19 Amin Mawani and Suzanne Paquette, "Pre-Retirement RRSP Withdrawals" (2011) 59:2 *Canadian Tax Journal* 183-219.

TABLE 2 Percentages of Seniors in 2008 by Current Age Who Received RRSP Income in the Same Year as GIS Income, Ages 65 to 76

Age in 2008	Percentage with GIS and RRSP income in the same year when 60 to 64	Percentage with GIS and RRSP income when 65	Percentage with GIS and RRSP income in the same year from age 66 to year 2007	Percentage with GIS and RRSP income in 2008
65	4.3	3.0	na	3.0
66	4.2	3.1	na	2.4
67	4.0	3.3	2.6	2.4
68	4.8	3.5	4.5	2.4
69	4.4	3.5	6.1	2.4
70	4.4	3.4	8.5	2.4
71	4.9	3.2	9.8	1.4
72	4.8	3.5	10.4	1.4
73	4.8	3.2	11.2	1.2
74	4.8	3.8	11.5	1.2
75	4.9	3.6	12.2	1.1
76	4.9	3.7	13.6	1.2

GIS = guaranteed income supplement.
RRSP = registered retirement savings plan.
na = not applicable.
Notes: (1) "Received" includes received by a spouse. (2) "Age in 2008" means the age of the taxfiler as of December 31, 2008. The "Percentage with GIS and RRSP income in the same year when 60 to 64" for each given age in 2008 is the percentage of those at that given age in 2008 who received RRSP income and GIS at least once in the same year when they were any age between 60 to 64. The "Percentage with GIS and RRSP income when 65" for each given age in 2008 is the percentage of those at that given age in 2008 who received RRSP income when they were 65. The "Percentage with GIS and RRSP income in the same year from age 66 to year 2007" for each given age in 2008 is the cumulative percentage of those at that given age in 2008 who received RRSP income and GIS at least once in the same year before 2008 when they were age 66 or greater. (3) All entries in the table are based only on seniors that age who filed taxes continually from age 60. (4) RRSP income does not include RRIF income.

The third column is perhaps the most interesting. It gives the cumulative percentage of those at each given age in 2008 who, sometime after age 65 and before 2008, received both GIS and RRSP income in the same year (that is, were subject to the clawback at least once after age 65 and before 2008). Hence, it can be seen that about 2.6 percent of those aged 67 in 2008 received GIS and RRSP income when they were 66. About 4.5 percent of those aged 68 in 2008 received GIS and RRSP income when they were either 66 or 67. About 6.1 percent of those aged 69 in 2008 received GIS and RRSP income when they were either 66, 67, or 68. This value continues to increase toward the bottom of the column such that for those who were 76 in 2008, about 13.6 percent received RRSP income at least once between 1998 and 2007, when they were aged 66 to 75.

The fourth column shows that 1.2 percent of those aged 76 in 2008 received both GIS and RRSP income. This is about 3 percent of all those who received GIS in that year.

Hence, it is estimated that at least 13.6 percent of seniors who were 76 in 2008 at least once received RRSP income (or their spouses received RRSP income) in the same year as GIS income was received, and as a result were subject to GIS clawback. Since the calculation was up to age 75 and did not include occurrences when aged 65, it seems likely that the lifetime estimate is higher. I will conservatively set it at 15 percent.

Are the amounts subject to clawback significant? Table 3 shows that the values in table 2 do not fall off much when the restriction that both GIS income and RRSP income must exceed $500 is added. As shown in the third column of table 3, 11.6 percent of those aged 76 in 2008 received more than $500 of GIS and $500 of RRSP income in the same year in at least one year when they were older than 65 and younger than 76. Table 4 shows that this number falls to 6.9 percent if the threshold is raised to $2,000 (implying a clawback of at least $1,000). My view is that the clawback is a substantial sum for low-income seniors; the result suggests that about three-fifths of the individuals who do have simultaneous GIS and RRSP income receipt have a financial penalty that is at least this significant. Note that if RRSP income is greater than $2,000, the personal income tax pension income amount will have been maximized, in many cases increasing the effective rate of income tax that may be paid on the RRSP income.

As a final exercise, table 5 repeats the approach of table 2 except that rather than using RRSP income alone, individuals are included if they received RRSP, RRIF, or RPP income. The third column shows that 31.1 percent of all those aged 76 in 2008 had received both GIS and RRSP, RRIF, or RPP income sometime during ages 66 to 75. This is very close to Shillington's estimate of 32 percent, but does not include RRSP, RRIF, or RPP recipients who faced clawback only at ages 60 to 64, at age 65, or ages 76 or greater. While there is no allowance for attrition and table 4 suggests that the effects on some individuals are small, this is nonetheless a striking result.

Hence I estimate, I believe conservatively, that about 15 percent of seniors will have GIS clawback applied to their RRSP income (not including RRIF income) sometime during their lives. Earlier results (discussed under table 1) suggest that this number would be up to twice as large if estimates of RRIF income were included, indicating a range of 15 percent to 30 percent. The 30 percent value may be high because it is only slightly lower than the 31 percent value when RRSP, RRIF, and RPP income are all included, this last value being essentially equal to Shillington's estimate.

CONCLUSIONS

On the basis of data on asset holdings by near-seniors, Shillington estimated that 32 percent of near-seniors were saving for retirement with RRSPs that would yield income that would likely be subject to GIS clawback, as well as potentially to personal income tax. While Shillington argued that the 32 percent were making a

TABLE 3 Percentages of Seniors in 2008 by Current Age Who Received RRSP Income > $500 in the Same Year as GIS Income > $500, Ages 65 to 76

Age in 2008	Percentage with GIS and RRSP income both >$500 in the same year when 60 to 64	Percentage with GIS and RRSP income both >$500 when 65	Percentage with GIS and RRSP income both >$500 in the same year from age 66 to year 2007	Percentage with GIS and RRSP income both >$500 in 2008
65	3.6	2.1	na	2.1
66	3.7	2.3	na	2.0
67	3.7	2.5	2.2	2.1
68	4.1	2.4	3.7	2.0
69	3.9	2.6	5.1	2.2
70	4.0	2.5	7.0	1.9
71	4.1	2.4	8.3	1.2
72	4.3	2.6	8.8	1.1
73	4.2	2.4	9.4	1.0
74	4.3	2.5	10.0	1.0
75	4.4	2.6	10.3	1.0
76	4.3	2.6	11.6	1.0

GIS = guaranteed income supplement.
RRSP = registered retirement savings plan.
na = not applicable.
Notes to table 2 apply except that for an individual to be counted as a GIS and RRSP recipient in this table, both GIS and RRSP income had to exceed $500 for at least one year during the range of ages considered in each column.

mistake, could it be that individuals are gaining so much from tax-free accumulation within RRSPs as to offset the clawback? The current study, along with my earlier research,[20] considers the possibility but suggests that this is an unlikely explanation for many individuals, particularly when considering the alternative of cashing out an RRSP at age 64 to avoid the clawback.

Shillington's estimate was based on examination of the data on asset holding by near-seniors. The empirical focus of this study is the LAD, which is taxfiler data. The estimation is somewhat hampered by the fact that the LAD does not provide direct information on RRIF income, a defect that could be mitigated if the LAD were linked with Statistics Canada's Survey of Financial Security. In any case, this study concludes that between 15 percent and 30 percent of all seniors will likely receive GIS and RRSP/RRIF income in the same year at least once in their retirement, and hence will be subject to GIS clawback. It is further estimated that approximately three-fifths of these recipients will be subject to a clawback of at least $1,000 on their income for the year.

20 Supra note 6.

TABLE 4 Percentages of Seniors in 2008 by Current Age Who Received RRSP Income > $2,000 in the Same Year as GIS Income > $2000, Ages 65 to 76

Age in 2008	Percentage with GIS and RRSP income both >$2,000 in the same year when 60 to 64	Percentage with GIS and RRSP income both >$2,000 when 65	Percentage with GIS and RRSP income both >$2,000 in the same year from age 66 to year 2007	Percentage with GIS and RRSP income both >$2,000 in 2008
65	2.5	0.9	na	0.9
66	2.6	1.0	na	0.9
67	2.5	1.0	1.1	1.0
68	2.9	1.0	2.0	0.9
69	2.7	1.1	3.0	1.0
70	2.8	1.0	4.2	0.8
71	2.8	1.0	5.1	0.4
72	3.0	1.1	5.4	0.4
73	2.9	1.0	6.0	0.3
74	3.0	1.0	6.3	0.3
75	3.1	1.0	6.4	0.3
76	2.9	1.0	6.9	0.3

GIS = guaranteed income supplement.
RRSP = registered retirement savings plan.
na = not applicable.
Notes to table 2 apply except that for an individual to be counted as a GIS and RRSP recipient in this table, both GIS and RRSP income had to exceed $2,000 for at least one year during the range of ages considered in each column.

Compared with most RRSP/RRIF income, RPP income is often much less discretionary. Nonetheless, the clawback is paid on RPP savings as well, and if RPP income is included in the analysis along with RRSP and RRIF income, the estimate of the percentage of seniors who are subject to clawback on RRSP, RRIF, or RPP income at least once is at least 30 percent. Overall, despite a number of caveats to this study's estimates that have been detailed in earlier sections, it is clear that there are many RRSP savers and RPP members who end up being subject to GIS clawback, and it is likely that many of them would have been better off if at least some of their saving had been in other forms.

The policy implications of this research are affected by the presence of TFSAs, which became available in 2009, after the data period for this study. The introduction of this alternative savings mechanism strengthens the view that low-income seniors could benefit greatly from tax planning because, although they face large effective tax rates, there are other tax-saving opportunities to be considered. A significant number of near-seniors who are likely to be GIS recipients are contributing to or holding RRSPs. They should be investing in TFSAs. The federal government should consider distributing information to taxpayers, particularly as they approach retirement, about the relative benefits of RRSP and TFSA saving, with mention of the

TABLE 5 Percentages of Seniors in 2008 by Current Age Who Received RRSP, RRIF, or RPP Income in the Same Year as GIS Income, Ages 65 to 76

Age in 2008	Percentage with GIS and RRSP, RRIF, or RPP income in the same year when 60 to 64	Percentage with GIS and RRSP, RRIF, or RPP income when 65	Percentage with GIS and RRSP, RRIF, or RPP income in the same year from age 66 to year 2007	Percentage with GIS and RRSP, RRIF, or RPP income in 2008
65	8.8	11.7	na	11.7
66	9.1	12.5	na	11.4
67	9.4	13.5	12.0	12.0
68	10.0	13.6	15.4	12.7
69	9.6	14.5	18.5	13.6
70	10.0	14.3	23.1	14.9
71	10.2	14.3	26.4	16.2
72	10.4	14.9	28.1	16.3
73	10.3	14.8	29.1	16.2
74	10.4	15.2	30.2	16.4
75	10.4	15.2	31.0	16.5
76	10.6	15.0	31.1	16.5

GIS = guaranteed income supplement.
RPP = registered pension plan.
RRIF = registered retirement income fund.
RRSP = registered retirement savings plan.
na = not applicable.
Notes to table 2 apply except that instead of RRSP income alone, the table reports results for RRSP, RRIF, or RPP income.

interaction with the GIS clawback.[21] It would also be useful if tax practitioners spread this idea more widely in ways that may reach prospective GIS recipients.

It might also be argued that RPPs would provide more equitable effective rates of return to their low-income members if they permitted cashing out of small pensions at age 64 to those plan members who will be GIS-eligible.

Policy consideration could also be given to a small exemption of RRSP and RRIF income for the purposes of GIS calculation, analogous to the $3,500 exemption that has been given to labour income earned during retirement. It has been estimated in this study that about 180,000 GIS recipients (10 percent of the total of 1.8 million GIS and allowance recipients) receive RRSP or RRIF income in the year. A $1,000 exemption is worth $500 to each individual, and hence it could cost the federal

21 It has been suggested that a switch from RRSP to TFSA contributions has an immediate positive effect on the government budgetary balance, although Robbins and Veall argue that this conclusion is simplistic and misleading: Jenna Robbins and Michael R. Veall, *Future Taxes on Pension Savings as a Government Asset*, C.D. Howe Institute Backgrounder no. 63 (Toronto: C.D. Howe Institute, October 2002).

treasury \$90 million annually (\$500 × 180,000)—though this very rough calculation does not take into account the likelihood that some individuals would not be able to use the entire exemption and that the exemption would create new GIS claimants. In any case, these considerations would be swamped by extending any exemption to RPP income. There is a good argument for the latter reform, but it would increase the cost to the treasury—possibly (as suggested earlier in this article) by a factor of five. Regardless, these numbers are only offered as ballpark values to facilitate judgment as to whether firmer estimates based on more detailed modelling and better data would be valuable. But they do reinforce the view that the GIS clawback on RRSP and RPP income is in aggregate quite costly to the affected group: low-income, GIS-recipient seniors who sacrificed consumption in order to save for their retirement.

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GAAR Revisited: From Instinctive Reaction to Intellectual Rigour

Pooja Samtani and Justin Kutyan*

PRÉCIS

Au cours des 25 ans qui se sont écoulés depuis l'entrée en vigueur de la règle générale anti-évitement (RGAE), les possibilités et les dangers de l'évitement fiscal ont suscité bien des débats. On traite beaucoup moins ouvertement des considérations subjectives qui touchent la résolution des cas sur la RGAE et de l'incertitude que créent de telles influences. Le présent article examine les aspects plus importants, mais moins concrets, de l'analyse de la RGAE. Il cherche à déterminer si les cas décidés jusqu'à présent peuvent être rationalisés de façon à révéler certains thèmes juridiques récurrents, bien que les décisions aient été prises dans des circonstances factuelles diverses. Les auteurs examinent la portée de la RGAE relativement aux principaux facteurs, objectifs et autres, qui ont façonné son application. En particulier, ils explorent une approche interprétative à la RGAE qui demeure ancrée dans la rigueur intellectuelle, même lorsqu'elle est influencée par une réaction instinctive.

ABSTRACT

In the 25 years since the general anti-avoidance rule (GAAR) came into effect, the possibilities and perils of tax avoidance have given rise to much debate. Less openly discussed are the subjective considerations that affect the resolution of GAAR cases and the uncertainty that such influences create. This article reviews the more significant, but less tangible, aspects of the GAAR analysis. It seeks to determine whether the cases decided to date can be rationalized so as to reveal certain recurring legal themes, even though the decisions were made in varying factual circumstances. The authors examine the scope of GAAR with reference to the driving factors, objective and otherwise, that have informed its application. In particular, they explore an interpretive approach to GAAR that remains grounded in intellectual rigour, even when influenced by instinctive reaction.

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The thesis of this article originated, in part, from a panel discussion on GAAR at the 2009 Canadian Tax Foundation annual conference. For a full transcript of that discussion, see Hon. Donald G.H. Bowman, Deen Olsen, Wayne Adams, Al Meghji, and Wilfrid Lefebvre, "GAAR: Its Evolution and Application," in *Report of Proceedings of the Sixty-First Tax Conference*, 2009 Conference Report (Toronto: Canadian Tax Foundation, 2010), 2:1-23.

KEYWORDS: GAAR ■ TAX AVOIDANCE ■ ANTI-AVOIDANCE ■ STATUTORY INTERPRETATION ■ TAX PLANNING ■ TAX LITIGATION

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> *This is one of those paradoxes where the sheer complexity of the series of transactions involving many players tweaks the nose upward on that least scientific of analysis known, in tax vernacular, as the smell test, yet legislation and case precedent guide analysis down a more structured and deliberate path past the olfactory sense and into the more certain realm of reason, though less precise purview of policy, where the GAAR debate, in this case, rages.*
>
> *Canada Trustco Mortgage Company v. The Queen*, 2003 TCC 215, at paragraph 93, per Miller J.

INTRODUCTION

Last year marked the 25th anniversary of the general anti-avoidance rule (GAAR).[1] It is fair to say that our understanding of this rule has evolved over time. Although tax avoidance has long been a feature of the Canadian fiscal scene, its limits in relation to GAAR are far from well defined.

Long before GAAR was enacted, and since then, despite its overriding effect, taxpayers have been encouraged to capitalize on tax-saving opportunities.[2] The operating assumption has always been that such planning will be reviewed objectively by the courts, if not by the tax authorities. Courts have been hard pressed, however, to strike the perfect balance between regulating abusive practices and preserving certainty in tax planning.

1 Section 245 of the Income Tax Act, RSC 1985, c. 1 (5th supp.), as amended, came into effect on September 13, 1988.

2 *Lipson v. Canada*, 2009 SCC 1, at paragraph 21; and *Copthorne Holdings Ltd. v. Canada*, 2011 SCC 63, at paragraph 65.

This struggle has borne itself out in the jurisprudence. Taxpayers have been told, on the one hand, to rely on the provisions of the Income Tax Act[3] and to take full advantage of the benefits that those provisions confer.[4] On the other hand, the courts have been equally clear that the application of GAAR requires the exercise of judgment,[5] and that "[t]his analysis *will* lead to a finding of abusive tax avoidance when a taxpayer relies on specific provisions . . . in order to achieve an outcome that those provisions seek to prevent."[6] In other words, there are limitations on what courts have considered to be effective, as opposed to merely clever, tax planning.

Confronted with such limitations, taxpayers have tended to perceive GAAR as imposing a degree of subjectivity, and even a measure of morality, in the tax-planning context. Underlying this perception is the unstated presumption that the application of GAAR is reactive in nature and not as rigorous as its terms would suggest. In short, the GAAR analysis essentially amounts to a glorified smell test.

The anniversary of GAAR presents an opportunity to set the record straight. To date, much has been said, and even more implied, regarding the variable nature of GAAR and the uncertainty that it exemplifies. What has routinely been taken for granted is that GAAR was never intended, nor has it operated, to impede legitimate tax planning on moral grounds or otherwise.

In any given GAAR case, the challenge lies in determining whether the underlying expectations of the law have been met in the context of enforceable legal relationships or whether those expectations have somehow been frustrated. The interpretive inquiry is one that must be conducted within the finite boundaries of the Act, with a view to establishing what the law truly means, not only by reference to what it explicitly says, but also in light of what it is intended to achieve in particular circumstances. It is therefore hardly surprising that intuition often is, and generally has been, a useful point of departure for the GAAR analysis.

In examining judicial responses to abusive tax avoidance, the focus has traditionally been on the "how" as opposed to the "why." Efforts have been made to reconcile apparent contradictions and to identify rules of general application, but the cases have rarely been analyzed as a reflection of judicial enterprise. This article endeavours to fill the gap. It examines, by reference to recent Canadian jurisprudence, the exacting but equally flexible framework within which GAAR cases are decided. Through this examination, it shows that developments in the jurisprudence have been as organic as the attitudes of those who render these decisions and that the application of rigour remains as reliable a safeguard as any to ensure certainty in tax planning.

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3 Supra note 1, herein referred to as "the Act." Unless otherwise stated, statutory references in this article are to the Act.

4 *Placer Dome Canada Ltd. v. Ontario (Minister of Finance)*, 2006 SCC 20, at paragraph 21; and *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54, at paragraph 31.

5 *Lipson v. The Queen*, 2006 TCC 148, at paragraph 29.

6 *Canada Trustco*, supra note 4, at paragraph 45 (emphasis added).

The importance of rigour in the GAAR analysis suggests two of the central themes of this article. First, GAAR cases are fact-driven. They are not decided in the world of the abstract, and it is simply unrealistic to assume otherwise. Second, the interpretive process engaged by GAAR is fundamentally legal. A provision of this nature, although general in its scope, does not exist to override the law, but to ensure that its requirements have been satisfied. It is therefore incumbent upon those who view the GAAR analysis as a platform for moral guesswork to realize that there is a lot more to this provision than meets the eye.

This article also challenges common perceptions of the judicial function in the GAAR context. There is often a tendency to assume, particularly when applying GAAR, that the Act will reveal a coherent and uniform scheme of policies that can readily be construed. Like most other generalizations, this is only partly true. While there may be accepted approaches to interpreting the Act, in applying GAAR, courts are inevitably confronted with competing visions of the statute. It is precisely in this context that notions of equity can, and often do, influence the direction of GAAR cases. It nonetheless remains that such disputes must be resolved in a rigorous manner and on a principled basis.

STRUCTURAL OVERVIEW OF GAAR

GAAR embodies a very specific legal standard that must be met before a particular transaction or series of transactions will be considered to result in abusive tax avoidance. For GAAR to be engaged, there are three conditions that must be fulfilled:[7]

1. a "tax benefit" must result, directly or indirectly, from a "transaction" or series of transactions;[8]
2. the transaction(s) giving rise to the tax benefit must include an "avoidance transaction";[9] and
3. the outcome of the transaction(s) must reflect a misuse of the provisions relied upon or an abuse of the Act read as a whole.[10]

Tax Benefit

"Tax benefit" is broadly defined to include a reduction, avoidance, or deferral of tax or other amount payable under the Act. The threshold for determining the existence

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7 The burden is on the taxpayer to refute the first and second requirements, and on the Crown to establish the third. *Canada Trustco*, supra note 4, at paragraphs 63-65.

8 The meaning of "tax benefit," as defined in subsection 245(1), is discussed below. A "transaction" is defined in subsection 245(1) to include an arrangement or event.

9 Defined in subsection 245(3), and discussed below.

10 Subsection 245(4) makes it clear that GAAR will also apply to an avoidance transaction that results in a misuse or abuse of the provisions of the Income Tax Regulations, the Income Tax Application Rules, a tax treaty, or any other enactment that is relevant in computing tax or some other amount payable or refundable under the Act.

of a tax benefit has therefore been regarded as not particularly high.[11] In the vast majority of cases, courts have simply identified a comparable transaction in which the taxpayer would have paid more tax, and have concluded that a benefit exists on that basis. In other, less common circumstances, courts have imposed a more stringent test by requiring that the comparable transaction be one that the taxpayer would, but for tax reasons, actually pursue.[12] In all such cases, however, the comparable transaction must be one that "might reasonably have been carried out but for the existence of the tax benefit."[13]

Avoidance Transaction

In general terms, an avoidance transaction is defined as any transaction that gives rise to a tax benefit, unless it was undertaken or arranged primarily for bona fide purposes other than to obtain a tax benefit.[14] It follows that if a transaction is not primarily tax-motivated (for example, the transaction is undertaken principally for economic, investment, commercial, or estate-planning reasons), it cannot be characterized as an avoidance transaction.

If, on the other hand, the primary purpose of one transaction within a series is to obtain a tax benefit, it will constitute an avoidance transaction,[15] even if every other transaction within the same series is undertaken for bona fide non-tax purposes. It is important to note, however, that a transaction will not be an avoidance transaction merely because an alternative transaction that might have achieved an equivalent non-tax result would have resulted in more taxes.[16]

11 *Canada Trustco Mortgage Company v. The Queen*, 2003 TCC 215, at paragraph 55.

12 A transaction will not be regarded as comparable if it is "theoretically possible but, practically speaking, unlikely in the circumstances": *Canadian Pacific Ltd. v. The Queen*, 2000 CanLII 265, at paragraph 12 (TCC).

13 *Copthorne Holdings*, supra note 2, at paragraph 35, quoting David G. Duff, Benjamin Alarie, Kim Brooks, and Lisa Philipps, *Canadian Income Tax Law*, 3d ed. (Markham, ON: LexisNexis Butterworths, 2009), at 187.

14 Under the reporting regime contained in section 237.3, taxpayers are required to assist tax administrators by identifying avoidance transactions with certain hallmarks.

15 *Canada v. MacKay*, 2008 FCA 105, at paragraph 21.

16 *Copthorne Holding Ltd. v. Canada*, 2009 FCA 163, at paragraphs 54-55; and *Spruce Credit Union v. The Queen*, 2012 TCC 357, at paragraph 69, currently under appeal. See also the explanatory notes to section 245, which state, "Subsection 245(3) does not permit the 'recharacterization' of a transaction for the purposes of determining whether or not it is an avoidance transaction. In other words, it does not permit a transaction to be considered to be an avoidance transaction because some alternative transaction that might have achieved an equivalent result would have resulted in higher taxes." Canada, Department of Finance, *Explanatory Notes to Legislation Relating to Income Tax* (Ottawa: Department of Finance, June 1988), at clause 186. This passage was quoted with approval by the Supreme Court in *Canada Trustco*, supra note 4, at paragraph 30.

Misuse or Abuse

Given the low threshold for establishing the existence of a tax benefit and avoidance transaction, the focus in most GAAR cases is on determining whether the transaction results in a misuse or abuse of particular provisions or of the Act read as a whole. The so-called misuse or abuse test is often regarded as the single most important limitation on GAAR since the minister (of national revenue) must demonstrate that the overall impact of the transaction or series is clearly abusive within the scheme of the Act, notwithstanding that each of its elements is otherwise unimpeachable.[17]

The concept of abusive tax avoidance, when considered in the abstract, appears relatively straightforward. Unless the avoidance transaction in question clearly frustrates the purpose of the provisions conferring the tax benefit, it should not be regarded as abusive under GAAR. Construing the provisions of the Act, however, is an inherently flexible exercise in statutory interpretation. It requires the minister, and in turn a court, to discern legislative intent and give effect to policy choices embedded in legislation.

When the minister invokes GAAR, the minister effectively concedes that the words of the Act are inadequate to address the perceived misuse or abuse.[18] More particularly, the minister seeks to deny a tax benefit, not by reference only to the text of the relevant provisions, but with regard to some underlying policy of the Act that appears to have been frustrated.[19]

To deny a tax benefit where there has otherwise been strict compliance with the provisions of the Act requires that the relevant "context" and "purpose" of those provisions be detectable and detected—in other words, that their underlying rationale or policy be clear and unambiguous.[20] As simple as this threshold may seem at first blush, the reality is that perceptions of policy often differ. What may be clear to the minister may not be so clear to a court, and what appears clear to the court may be far from clear when viewed by the taxpayer. But there is more to the misuse and abuse analysis than perception.

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17 It is rare, though not impossible, for a court to conclude the GAAR does not apply to an "arguably abusive" transaction because the taxpayer has succeeded in demonstrating that there was no avoidance transaction. See, for example, *Spruce Credit Union*, supra note 16, at paragraph 109, per Boyle J: "The requirements of the GAAR require there to be an avoidance transaction, regardless of an arguably abusive result."

18 *Copthorne Holdings*, supra note 2, at paragraph 109.

19 To demonstrate that there has been a misuse or an abuse under the Act, the minister must be able to identify a statutory scheme to establish the underlying policy of the relevant provisions and may do so by reference to extrinsic evidence (for example, statements from the Department of Finance or Parliament coincident with the issuance of draft legislation). In defending against a GAAR assessment, the Crown must disclose in its pleading the "policy" (that is, the object, spirit, and purpose) underlying the relevant provisions relied upon by the minister in raising the assessment. See *Birchcliff Energy Ltd. v. Canada*, [2013] 3 CTC 2169 (TCC).

20 *Canada Trustco*, supra note 4, at paragraph 41.

Words have meanings that are informed by the context in which they are used and, accordingly, may have different meanings in different contexts. There is a difference, however, between discerning the meaning of a provision and defining its underlying policy. In the latter situation, the text of a provision may be clear but its underlying rationale may not be captured by the bare meaning of the provision itself. As arcane as the GAAR analysis may therefore appear when examined in isolation, its application fundamentally hinges on purposive interpretation. Courts are obliged in applying GAAR to ground their perceptions of policy in the relevant provisions of the Act through a "process of reasoned elaboration."[21]

Whatever else may be said of the misuse or abuse analysis, it is critical to appreciate that this analysis is almost entirely fact-driven.[22] It comes as little surprise in reviewing the jurisprudence that the most egregious of cases have involved arrangements that were concocted, circular, unduly complex, or devoid of commercial purpose, or that tended to disclose a "degree of artificiality, boldness, vacuity or audacity."[23] Tax purists may insist that, in deciding these cases, the courts were unaffected by the facts, no matter how offensive the arrangement in question or how controversial its impact. But it would be naïve not to recognize that judicial outcomes in the GAAR context have varied far more with the facts than with the judges who rendered these decisions.

FISCAL MORALITY: THE IMPACT OF INSTINCT

Courts have the power to make interpretive choices, and are called upon to exercise it, when deciding GAAR cases. Choice in this context is both endemic and integral to the decision-making process. This power represents much more than judicial creativity or innovation. It is, in essence, the process by which a court translates the requirements of the Act into legal principles or the basis for those principles and, once the facts of the case have been determined, ultimately arrives at its decision.

Neither fairness nor fiscal morality tend to be given as reasons for the choices made by the courts. Judges may say, for example, that they do not accept a particular proposition to be correct in law because to do otherwise would be absurd or unrealistic, but they do not openly reject it on the basis that it is unfair or immoral. Having reasoned through the issues, a judge may at times add a comment to the effect that the decision has the advantage of coinciding with the merits or has the impact of doing justice as between the parties. But judges, including those who admit to the existence of fiscal morality as a factor in the analysis, rarely admit that they have

21 Henry M. Hart Jr. and Albert M. Sacks, *The Legal Process: Basic Problems in the Making and Application of Law* (Cambridge, MA: Harvard University Press, 1958), at 162-68.

22 *Mathew v. Canada*, 2005 SCC 55, at paragraph 59.

23 *Collins & Aikman Products Co. v. The Queen*, 2009 TCC 299, at paragraph 109. See also *McNichol et al. v. The Queen*, 97 DTC 111 (TCC), and *RMM Canadian Enterprises Inc. et al. v. The Queen*, 97 DTC 302, at 312 (TCC), per Bowman J (as he then was): "It is easier to recognize an abuse or a misuse than to formulate a definition that fits all circumstances."

reached a certain decision because it is morally appealing. Morality, it seems, is a more subtle agent in the interpretation of GAAR and its application.

The suggestion that morality might have some undefined part to play in the GAAR analysis is hardly novel and certainly not groundbreaking. It has long coexisted, either implicitly or explicitly, with GAAR itself.[24] In more recent times, however, the concept has received public attention.[25] It has become increasingly fashionable to use terms such as "aggressive" or "unacceptable" tax avoidance and to intimate that such practices demonstrate a lack of morality in tax matters.

While it is all too easy to suggest that, in deciding a GAAR case, a court might be influenced by its own sense of morality, there is no statutory basis for applying a moral standard in determining the outcome of a tax dispute. Taxpayers are, of course, obligated to pay taxes to finance public goods and services, but morality has very little to do with this, particularly since there is no general agreement as to the meaning of morality or its role in this context:

> In quantifying a taxpayer's tax liability under the *Income Tax Act* . . . is it ever necessary to evaluate the morality of the taxpayer's conduct? As a matter of general principle, the answer should be no. The *Income Tax Act* is intended to raise revenue for the use of the federal government. It also contains provisions intended to facilitate the distribution of social benefits according to standards established by Parliament, or to encourage or discourage certain industries or commercial practices in the public interest as perceived by Parliament from time to time. But nothing in the *Income Tax Act* expressly permits or requires the Minister of National Revenue, or the Courts, to apply the *Income Tax Act* differently depending upon the morality of the taxpayer's conduct.[26]

The legitimacy of avoiding tax, at least as a matter of principle, can be traced to a series of cases that are epitomized by the *Duke of Westminster*.[27] In that case, the

24 It has been suggested that notions of fiscal morality are inherent in the words "misuse and abuse." See Sheldon Silver, "Ethical Considerations in Giving Tax Opinions," in *Report of Proceedings of the Forty-Sixth Tax Conference*, 1994 Conference Report (Toronto: Canadian Tax Foundation, 1995), 36:1-16, at 36:15: "What does appear to be clear, however, is that GAAR does raise or revive certain ethical considerations. There is a concept of morality inherent in the words 'misuse' and 'abuse,' and it remains to be seen whether these words raise new ethical considerations and will encourage practitioners to apply a 'smell' test." But see also *Copthorne Holdings*, supra note 2, at paragraph 65, where the Supreme Court explicitly states otherwise.

25 In connection with a report released by the UK Public Accounts Committee on December 3, 2012, committee chair Margaret Hodge stated, "We consider that paying an appropriate amount of tax in the country in which profits are made is not only a matter of basic economics. It is also a matter of morality." See United Kingdom, Public Accounts Committee, "Committee Publishes Findings on HMRC's Accounts 2011-12," December 3, 2012 (www.parliament.uk/business/committees/committees-a-z/commons-select/public-accounts-committee/news/hmrc-accounts-2011-12-report).

26 *Canadian Imperial Bank of Commerce v. Canada*, 2013 FCA 122, at paragraph 1, per Sharlow JA.

27 *Commissioners of Inland Revenue v. Westminster (Duke)*, [1936] AC 1 (HL) (herein cited as *Duke of Westminster*).

House of Lords declared that "[e]very man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be."[28] The House of Lords was similarly explicit on this point in another leading case, stating that no man "is under the smallest obligation, moral or other, so to arrange his legal relations . . . as to enable the Inland Revenue to put the largest shovel into his stores."[29]

Canadian courts have generally kept pace with their English counterparts in recognizing that tax may permissibly be avoided and that this is not "tax avoidance" in the pejorative sense.[30] The Supreme Court has repeatedly stated that "taxpayers are entitled to arrange their affairs to minimize the amount of tax payable,"[31] and has consistently rejected the absence of economic substance or business purpose as a basis for finding abusive tax avoidance.[32] Perhaps for this reason, taxpayers, in structuring their affairs, have paid little attention to what a court might consider to be the (morally) correct course of action.

The concept of fiscal morality, particularly in the GAAR context, is not an absolute. Under any conception of GAAR, however, there are arrangements that even the most aggressive taxpayer would recognize as too good to be true.[33] Although GAAR was never intended to be a barometer for morally acceptable conduct, tax administrators are generally disinclined to endorse arrangements that result in the fisc being unduly deprived of its due. Court dockets are thus replete with cases where taxpayers have failed to properly execute "an ingenious strategy devised by clever tax practitioners,"[34]

28 Ibid., at 19, per Lord Tomlin. But see *Furniss v. Dawson*, [1984] STC 153, at 157 (HL): "[T]he ghost of the *Westminster* case and of [the Duke's] transaction, be it noted a single and not a composite transaction, with his gardener and with other members of his staff, has haunted the administration of this branch of the law for too long. I confess that I had hoped that that ghost might have found quietude. . . . Unhappily it has not. Perhaps the decision of this House in these appeals will now suffice as exorcism."

29 *Ayrshire Pullman Motor Services and D.M. Ritchie v. The Commissioners of Inland Revenue* (1929), 14 TC 754, at 763 (Scot. Ct. Sess.).

30 *Jabs Construction Ltd. v. The Queen*, 1999 CanLII 520, at paragraph 48 (TCC), per Bowman J (as he then was): "Section 245 is an extreme sanction. It should not be used routinely every time the Minister gets upset just because a taxpayer structures a transaction in a tax effective way, or does not structure it in a manner that maximizes the tax." This passage was cited with approval by Binnie J in *Lipson*, supra note 2, at paragraph 62.

31 *Canada Trustco*, supra note 4, at paragraph 11. See also *Lipson*, supra note 2, at paragraph 54; and *Copthorne Holdings*, supra note 2, at paragraph 65.

32 *Canada Trustco*, supra note 4, at paragraphs 14 and 57. See also *Lipson*, supra note 2, at paragraph 38; *Stubart Investments Ltd. v. The Queen*, [1984] 1 SCR 536, at 575; and *Continental Bank Leasing Corp. v. Canada*, [1998] 2 SCR 298, at paragraph 51.

33 *Campbell v. Commissioners of Inland Revenue* (1968), 45 TC 427, at 448 (CA), per Harman LJ: "It is a splendid scheme. . . . It is almost too good to be true. In law quite too good to be true. It won't do."

34 *Antle v. The Queen*, 2009 TCC 465, at paragraph 38.

or have executed a series of transactions that, although not abusive when viewed in isolation, somehow still frustrated a specific policy within the Act.[35]

In reviewing these cases, the question necessarily arises: Why is it that, 25 years after its enactment, and after approximately 50 appeals, GAAR still harbours uncertainty? To what extent in these decisions are notions of fiscal morality—implied by the courts and embraced by those affected by the decisions—really to blame? Alternatively, if each of the cases can be justified on a principled basis, what role (if any) does morality have to play?

In an ideal world, morality would serve no such role. A nebulous concept of this kind can hardly assist in navigating the already complex and uneven terrain of the Act. If anything, it can only serve to compound the uncertainties that are now characteristic of GAAR and its scope. That said, one can readily acknowledge the fact that the law is not an end in itself. It exists to do justice and therefore cannot be divorced from the courts' perception of what is fair or appropriate. As the distinguished American appellate court judge, Richard A. Posner, has observed, "judges are not moral or intellectual giants (alas), prophets, oracles, mouthpieces, or calculating machines."[36] Many of their difficult decisions are influenced by *other* internal aspects, such as personality, policy intuitions, and professional and life experiences.[37]

These personal factors, whether consciously or not, play an important role in GAAR cases. In fact, it would be impossible for tax administrators, as well as the courts, to approach the task of applying GAAR without being affected by their own impressions of those who operate at the edge of the envelope. This is not to suggest that, in resolving GAAR disputes, visceral reactions should dictate the analysis, but merely to acknowledge that the law is not analyzed in a moral vacuum:

> I think that there is a strong subjective element in GAAR. But I also think that GAAR is essentially a very complex codification of what some might refer to as a judicial sense of when a situation is within the reasonable contemplation of the law, and has been properly implemented, and when it isn't and hasn't. Some might refer to this as a "smell test." I suppose it might look that way, and sometimes the reasons for a decision might not reflect the full step-by-step thinking leading to an outcome. But judges have

35 *Lipson*, supra note 2, at paragraph 48. See also *Copthorne Holdings Ltd. v. The Queen*, 2007 TCC 481, at paragraph 25, per Campbell J: "The transactions in this appeal are numerous and at first glance lengthy and complex. If one looks at these transactions in conjunction with the governing provisions contained in the Act, it is not immediately apparent why any of the corporate undertakings should have attracted the application of GAAR. However, as the saying goes 'that would not be seeing the forest for the trees [sic].' When I step back and look at the big picture of what occurred here, the [transactions] resulted in [abusive tax avoidance]."

36 Richard A. Posner, *How Judges Think* (Cambridge, MA: Harvard University Press, 2008), at 7. See also Hon. John I. Laskin, "What Persuades (or, What's Going on Inside the Judge's Mind)" (2004) 23:1 *Advocates' Society Journal* 4-9, at 7: "Many unseen forces guide our thoughts and actions—our likes and dislikes, our moods, instincts, emotions, habits, and convictions."

37 Posner, supra note 36, at 11 and 369-70.

> a sense that is informed by their experience with the law, within the framework that counsel set out to argue a case, and just because the reasons for a decision might appear results-based doesn't mean that they are. By the same token, human nature plays a role in everything, and inevitably there will be cases that provoke one or another kind of initial reaction—though good judges get beyond that in their application of the law, with the benefit of their experience.[38]

Recent GAAR decisions are a testament to the fact that the appetite for tax gamesmanship is much reduced.[39] Although it is difficult to attribute the change in temperament to any one cause, there is no denying that tax avoidance is no longer the competitive sport it once was. Be it the fallout of the financial scandals that are now synonymous with corporate powerhouses such as Enron, or the aftermath of the global economic crisis, the current era has been defined by deficits and general decline. In the wake of these events, it is possible that the courts, being a reflection of society, have been less than eager to condone aggressive measures.

The public profile of tax has also changed dramatically in recent years. Previously tax had very little connection to corporate governance and reputational risk. The mandate of the tax director was to ensure that compliance obligations were fulfilled, tax positions were disclosed for accounting purposes, and sufficient legal and financial support was provided for estimates. Today tax is on the radar screens of executive officers, shareholders, and other interested stakeholders, including governments, regulators, and the public.

Corporate taxpayers are less inclined in current times to engage in tax planning that might be construed as "unacceptable" simply because they do not want to be labelled as "high risk" by the tax authorities or targeted by the press as engaging in unethical tax behaviour. Given, however, that tax planning can be considered by some to be acceptable in certain situations and by others to be unacceptable in similar circumstances, the concept of "acceptable" tax avoidance, by its own terms, raises the ultimate question, "Acceptable to whom?"[40]

There is no easy answer to this question, and there may never be. But once we accept, as logic dictates we must, that judges face a multiplicity of choices in deciding cases, the focus rightly shifts away from the perspectives of particular judges and centres on the process by which such choices are exercised. It has already been

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38 Hon. Donald G.H. Bowman with Al Meghji and J. Scott Wilkie, "A Fireside Chat with the Chief Justice of the Tax Court of Canada" (2010) 58, special supp. *Canadian Tax Journal* 29-40, at 34.

39 See, for example, *Antle*, supra note 34 (aff'd. 2010 FCA 280; application for leave to appeal to the Supreme Court of Canada dismissed).

40 To echo the sentiments of the House of Lords, "[t]he fact that steps taken for the avoidance of tax are acceptable or unacceptable is the conclusion at which one arrives by applying the statutory language to the facts of the case. It is not a test for deciding whether [an anti-avoidance rule] applies or not." See *MacNiven v. Westmoreland Investments Limited*, [2001] UKHL 6, at paragraph 62.

noted that a close examination of the facts is essential to this process. Some judges will instinctively seek to fit the facts within the law and assume, or hope, that justice has been achieved in the abstract. Others will first find the facts and then adapt the law accordingly so as to do justice in the circumstances. In either scenario, the sense of fair play that most judges seek to achieve can be assured only if they come to the task of deciding GAAR cases with a certain amount of discretion, and exercise an equal amount of discipline in conducting the requisite analysis.

Likewise, the task for practitioners in advising clients, and for the tax authorities in raising assessments, is to remain cognizant that the application of GAAR is inherently a legal issue.[41] To imply that there is an element to this analysis that hinges on whether the taxpayer is getting away with something places far less faith than is required in both the integrity of GAAR and the courts' ability to administer this rule.[42]

STATUTORY INTERPRETATION: THE REQUIREMENT OF RIGOUR

In determining whether the provisions of the Act have been misused or abused in particular circumstances, the reviewing court necessarily engages in statutory interpretation. Accordingly, any reasoned examination of GAAR compels a critical review of the courts' approach to interpreting the Act.

The Act was historically subject to the strict or literal approach to statutory interpretation. Recognizing the Act to be a highly detailed, meticulously drafted, and integrated piece of legislation, courts placed greater emphasis on the text of various provisions as opposed to their context or purpose. This conservative approach to interpreting the Act facilitated efforts to defend tax-avoidance schemes and provided the requisite certainty in planning them.

The purposive approach was first clearly endorsed by the Supreme Court in *Stubart*.[43] In that case, Estey J, writing for a unanimous court, considered the rule of strict construction as it had historically applied to taxing statutes, but then referred to the Act, stating it was "no longer a simple device to raise revenue."[44]

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41 G.S.A. Wheatcroft, "The Attitude of the Legislature and the Courts to Tax Avoidance" (1955) 18:3 *Modern Law Review* 209-30, at 218: "[W]hatever may be the personal sympathies of a judge who tries a revenue case, his decision has to be based on purely legal and technical grounds." See also Alan M. Schwartz and Kevin H. Yip, "Policy Forum: Defending Against a GAAR Reassessment" (2014) 62:1 *Canadian Tax Journal* 129-46.

42 *Pezzelato v. The Queen*, 96 DTC 1285, at 1290 (TCC), per Bowman J (as he then was): "Visceral reaction, however much it may form the inarticulate premise upon which judicial decisions are sometimes founded, is not . . . a substitute for legal analysis." See also *ACM Partnership v. Commissioner*, 157 F. 3d 231, at 265 (3d Cir. 1998), per McKee Circuit Judge (in dissent): "The fact that [the taxpayer] may have 'put one over' [on the tax authority] in crafting these transactions ought not to influence our inquiry. Our inquiry is cerebral, not visceral."

43 *Stubart*, supra note 32, at 575.

44 Ibid.

Under the traditional rule, interpretive ambiguities in charging provisions would generally be resolved in favour of the taxpayer, and the opposite was true for exempting provisions. However, the court in *Stubart* dispensed with this rule and concluded that it would be appropriate in future cases to adopt a purposive approach in interpreting statutory provisions.[45]

The interpretive guidelines established in *Stubart* were poised to place substantial limits on the ability of taxpayers to engage in abusive tax avoidance. However, those limits never came into being. Parliament introduced GAAR, which it viewed as a more robust mechanism. It may be that the government chose to react legislatively just at the time that the Supreme Court had offered tax administrators the necessary interpretive tools to effectively deal with abusive practices; however, those tools were likely not regarded as effective enough.[46]

The purposive approach resurfaced, this time in full force, when the Supreme Court rendered its decision in *Canada Trustco* two decades after *Stubart*. In *Canada Trustco*, McLachlin CJ and Major J confirmed for a unanimous court that where the text of the Act was precise and unequivocal, the ordinary meaning of words would play a dominant role in interpreting its provisions. However, the court also observed that, even where the ordinary meaning of a provision did not appear to be ambiguous at first glance, statutory context and purpose could reveal latent ambiguities. To resolve such ambiguities, the court stated, courts would be required to undertake "a unified textual, contextual and purposive approach to statutory interpretation."[47]

Decisions of the Supreme Court subsequent to *Canada Trustco*, including, most recently, *Copthorne Holdings*, have consistently affirmed the principles of construction expressed in that case.[48] In fact, if these decisions are any indication, it is no longer sufficient (if it ever was) for a taxpayer to demonstrate that it has complied with the text of the Act, particularly where the transaction in issue appears to be inconsistent with the legislative rationale underlying the relevant provisions.[49]

The textual, contextual, and purposive approach, of course, continues to demand that judges scrupulously review the text to determine whether it sheds light on what the provisions were intended to achieve (versus what they might appear to permit),

45 Ibid., at 575-76.

46 Judith Freedman, "Converging Tracks? Recent Developments in Canadian and UK Approaches to Tax Avoidance" (2005) 53:4 *Canadian Tax Journal* 1038-46, at 1043-44.

47 *Canada Trustco*, supra note 4, at paragraph 47.

48 See *Placer Dome Canada Ltd.*, supra note 4, at paragraphs 21-23; and *Imperial Oil Ltd. v. Canada; Inco Ltd. v. Canada*, 2006 SCC 46, at paragraphs 27-29.

49 The modern approach to GAAR was foreshadowed by the decision in *OSFC Holdings Ltd. v. Canada*, 2001 FCA 260. See, for instance, ibid., at paragraph 65, per Rothstein J: "I do not lightly distinguish the pointed statements of the Supreme Court of Canada in cases such as *Shell* . . . and *Antosko* . . . that where the words of the *Income Tax Act* are clear they must be applied. However, in none of the cases in which the Supreme Court has set out this view did the Minister invoke section 245 as it now reads. . . . [T]hese statements of the Supreme Court cannot be said to apply to a misuse and abuse analysis under subsection 245(4)."

and to be cautious when straying from the clear meaning of words.[50] However, this approach requires judges to read the Act in a way that provides the most coherent interpretation of the legislative process as a whole. What it also requires is that this examination be openly articulated. The fact that it must be an open process disciplines the exercise of judicial power.

Where GAAR is concerned, it is simplistic to assume that any one judicial approach will yield dispositive solutions to controversial issues of interpretation. The application of GAAR is much too debatable for that. While it is therefore easy to suggest that courts should adopt a conservative stance in relation to GAAR and, when faced with ambiguities, defer to Parliament, any such suggestion (well intended as it may be) fundamentally mistakes the nature of the judicial function in the GAAR context:

> A statute may indicate or require as its justification a change in the policy of the law, although it expresses that change only in the specific cases most likely to occur to the mind. The Legislature has the power to decide what the policy of the law shall be, and if it has intimated its will, however indirectly, that will should be recognized and obeyed. The major premise of the conclusion expressed in a statute, the change of policy that induces the enactment, may not be set out in terms, but it is not an adequate discharge of duty for courts to say: We see what you are driving at, but you have not said it, and therefore we shall go on as before.[51]

The only way in which Parliament can express its intention to impose income tax is through the Act. If Parliament has so intended to impose tax, courts should be trusted in interpreting the Act to discern that intention.[52] Surely, when confronted with abusive conduct, courts are not at liberty to assert principles that are not explicit in the Act or necessarily implied. Nor are they permitted to divine any overarching policy that supersedes the limits of specific provisions. But, aside from these caveats, there is no reason why, in defining the scope of GAAR, courts should refrain from construing the provisions of the Act in a reasoned manner, drawing upon accepted principles of interpretation and, indeed, upon common sense.[53]

To the contrary, it is incumbent upon the judiciary in such cases, as it is in the tax context generally, to exercise judgment in making the statute coherent.[54] This is not

50 *Canada Trustco*, supra note 4, at paragraph 11. See also *Copthorne Holdings*, supra note 2, at paragraph 88; and *Toronto-Dominion Bank v. Canada*, 2011 FCA 221, at paragraph 61.

51 *Johnson v. United States*, 163 F 30, at 32 (1st Cir. 1908).

52 Leonard Hoffmann, "Tax Avoidance" [2005] no. 2 *British Tax Review* 197-206, at 203.

53 *United States v. Standard Oil Co.*, 384 US 224, at 225 (1965): "[W]hatever may be said of the rule of strict construction, it cannot provide a substitute for common sense, precedent, and legislative history." See also *United States v. Brown*, 333 US 18, at 25 (1948): "The canon in favor of strict construction is not an inexorable command to override common sense and evident statutory purpose."

54 Ronald Dworkin, *Law's Empire* (Cambridge, MA: Belknap Press, 1986), at 313-14.

merely because a court can do so, or because its opinion is automatically right, but because no court can properly answer any question of statutory construction without relying at the deepest level on what it believes to be the most appropriate reflection of legislative intent.[55] Stated differently, a court is permitted, in choosing one interpretation over another, to develop a working conception of the law, provided that it does so in the right direction:

> The judge should try to think his way as best he can into the minds of the enacting legislators and imagine how they would have wanted the statute [to be] applied to the case at bar.
>
> Now it is easy to ridicule this approach by saying that judges do not have the requisite imagination and that what they will do in practice is assume that the legislators were people just like themselves, so that statutory construction will consist of the judge's voting his own preferences and ascribing them to the statute's draftsmen. But the irresponsible judge will twist any approach to yield the outcomes that he desires and the stupid judge will do the same thing unconsciously.[56]

If courts fail to exercise a responsible role in assuring the integrity of the Act, the notion of permissible tax avoidance is reduced to nothing more than a game, in which the well advised win and the rest pay taxes.[57] To suggest, therefore, that courts should leave it entirely to Parliament is to minimize their function in the GAAR context. It may be that a court, in construing GAAR, should apply the Act as the court finds it, and it may also be true that there are no uniquely right answers in GAAR cases. In either event, it would be a disservice to Parliament, the tax authorities, and taxpayers in general if courts did not labour to decide such cases on a principled basis.

55 Brian J. Arnold, "Policy Forum: Some Thoughts on the Supreme Court's Approach to the Determination of Abuse Under the General Anti-Avoidance Rule" (2014) 62:1 *Canadian Tax Journal* 113-27.

56 Richard A. Posner, "Statutory Interpretation—In the Classroom and in the Courtroom" (1983) 50:2 *University of Chicago Law Review* 800-22, at 817.

57 Robert Thorton Smith, "Interpreting the Internal Revenue Code: A Tax Jurisprudence" (1994) 72:9 *Taxes: The Tax Magazine* 527-58, at 555. See also *Latilla v. Commissioners of Inland Revenue* (1943), 25 TC 107, at 117 (HL), per Lord Simon: "Judicial dicta may be cited which point out that, however elaborate and artificial such methods may be, those who adopt them are 'entitled' to do so. There is, of course, no doubt that they are within their legal rights, but that is no reason why their efforts, or those of the professional gentlemen who assist them in the matter, should be regarded as a commendable exercise of ingenuity or as a discharge of the duties of good citizenship. On the contrary, one result of such methods, if they succeed, is, of course, to increase *pro tanto* the load of tax on the shoulders of the great body of good citizens who do not desire, or do not know how, to adopt these manoeuvres."

THE ACTUAL GAAR ANALYSIS

It is often argued, and with good reason, that GAAR should be applied in a manner that affords taxpayers relative certainty in tax planning. Certainty depends, after all, upon the ability to plan, and taxpayers are entitled (at least in theory) to plan on the basis that like cases will be decided in like ways. There are, of course, a good many who believe that visceral influences are determinative in any GAAR analysis and that judicial attitudes toward tax avoidance have at least as much to do with judgments about fiscal morality as with what the law dictates. But the application of GAAR, despite belief to the contrary, remains a question of statutory construction in each case:

> In a traditional statutory interpretation approach the court applies the textual, contextual and purposive analysis to determine what the words of the statute mean. In a GAAR analysis the textual, contextual and purposive analysis is employed to determine the object, spirit or purpose of a provision. Here the meaning of the words of the statute may be clear enough. *The search is for the rationale that underlies the words that may not be captured by the bare meaning of the words themselves. However, determining the rationale of the relevant provisions of the Act should not be conflated with a value judgment of what is right or wrong nor with theories about what tax law ought to be or ought to do.*[58]

Decisions based upon individual perceptions of policy (as they often are in the GAAR context) make decision making unpredictable, to say the least. What is required at a minimum, therefore, in construing the policies of the Act is an objective assessment of the law as opposed to an instinctive reaction to the facts. Perceptions of equity or fairness may affect the decision-making process, but such influences neither require nor justify a departure from the rigour that the GAAR analysis demands.

Through the lens of rigour, the vast majority of GAAR disputes can be seen to raise similar legal considerations, despite the differing factual circumstances in which they arise. These considerations provide a framework within which such cases can, and should, be analyzed. What follows is an examination of the more significant considerations that inform the application of GAAR.

Identifying the Real Transaction

The first, and most critical, consideration in the GAAR analysis is whether the transaction resulting in the contested tax benefit has been correctly characterized. The

58 *Copthorne Holdings*, supra note 2, at paragraph 70, per Rothstein J (emphasis added). See also Brian Arnold, Judith Freedman, Al Meghji, Mark Meredith, and Hon. Marshall Rothstein, "The Future of GAAR," in *Report of Proceedings of the Fifty-Seventh Tax Conference*, 2005 Conference Report (Toronto: Canadian Tax Foundation, 2006), 4:1-16, at 4:4, where Justice Rothstein observed, "GAAR has an overriding effect. Whenever judges are faced with a general overriding provision, they will be cautious. When we look at the detailed structure of the Act, we want to be very careful, when it comes to applying the general overriding provision, that we are correct. . . . *As judges, we have to always keep in mind that it is Parliament—not the minister, and certainly not the courts—that imposes income tax, so we will want to be careful not to impose our subjective judgment as judges as to what constitutes a misuse or an abuse* [emphasis added]."

need for this inquiry is rooted in the definition of "avoidance transaction," which requires, as a preliminary step, that the transaction be identified.

It is well settled that, in identifying the transaction, legal relationships must be respected. Courts are accordingly obliged to first assess these relationships and then characterize them for tax purposes. Any such assessment requires a meticulous examination, not only of how the disputed arrangement was configured in formal terms, but also of what the reasonable expectations of the taxpayer were as to its significance. This is an inherently legal analysis, although it may depend in part on what is revealed by the evidence.[59]

If each of the steps in a transaction (or transactions in a series) has been properly documented, and the taxpayer intends to assume the consequences of its dealings in a manner that is consistent with their documented form, the transaction will be regarded as legally effective and generally not be disturbed, subject to the application of specific anti-avoidance provisions and GAAR. For the purposes of GAAR, the "transaction" can be understood as the legal rights and obligations that the parties have created for themselves, notwithstanding the terms that have been used to describe them:

> This leads logically to the next question: *did the appellants enter into the various transactions that they purported to, or was the elaborate series of steps . . . a mere camouflage for what was in substance a single event*. . . . In cases of this type expressions such as sham, cloak, alias, artificiality, incomplete transaction, simulacrum, unreasonableness, object and spirit, substance over form, *bona fide* business purpose, step transaction, tax avoidance scheme and, no doubt, other emotive and, in some cases, pejorative terms are bandied about with a certain abandon. *Whatever they may add, if anything, to a rational analysis of the problem*, apart from a touch of colour in an otherwise desiccated landscape, *they do not exist in separate watertight compartments*. They are all merely aspects of an attempt to articulate and to determine where "acceptable" tax planning stops and fiscal gimmickry starts.[60]

It is important to appreciate that, under Canadian law, the "transaction" is not an economic analogue of the legal transaction that the taxpayer purported to implement.[61] Nor does identifying the "transaction" require a court to reconstruct the transaction actually undertaken by the taxpayer and convert it into something that in law it was not.[62] It is *the* transaction that was implemented, with all of its legal and

59 J. Scott Wilkie and Heather Kerr, "Common Links Among Jurisdictions: Informing the GAAR Through Comparative Analysis," in *Report of Proceedings of the Forty-Ninth Tax Conference*, 1997 Conference Report (Toronto: Canadian Tax Foundation, 1998), 34:1-30, at 34:13 and 34:28.

60 *Continental Bank of Canada et al. v. The Queen*, 94 DTC 1858, at 1866-67 (TCC).

61 Wilkie and Kerr, supra note 59, at 34:8.

62 *Lipson*, supra note 2, at paragraph 87, per Binnie J (in dissent): "Moreover, it is not sufficient, in my view, for the Minister to offer a general 'overall' conclusory snapshot of the series of transactions without regard to the legal relationships thereby created."

economic characteristics. In other words, the focus is on the legal character of a transaction rather than the label given to it:[63]

> *So here the substance is that which results from the legal rights and obligations of the parties ascertained upon ordinary legal principles*. . . . There may, of course, be cases where documents are not *bona fide* nor intended to be acted upon, but are only used as a cloak to conceal a different transaction. No such case is made or even suggested here.[64]

In interpreting the provisions of the Act, a court will be guided by prevailing canons of statutory construction. But in characterizing transactions there is little available in the way of guidance, except for experience and common sense. In Canada, the debate in relation to characterization has always focused on form versus substance: that is, whether, and to what extent, a court should be bound by the form in which a transaction has been cast, or whether the court may look instead to some economic equivalent—a variant on the one actually implemented—and attach the appropriate tax consequences to that variant. The real challenge, however, lies in notionally setting aside the concept of series (or the perception that each step in a chain of circumstances is a transaction) and actually examining the entire arrangement, with each of its legally enforceable elements.[65] This was acknowledged by the Supreme Court, most recently in *Copthorne Holdings*, when it stated:

> While the focus must be on the transaction, where it is part of a series, it must be viewed in the context of the series to enable the court to determine whether abusive tax avoidance has occurred. In such a case, whether a transaction is abusive will only become apparent when it is considered in the context of the series of which it is a part and the overall result that is achieved.[66]

63 *Ben Nevis Forestry Ventures Ltd v. CIR*, [2008] NZSC 115, at paragraph 48. See also *Evans v. The Queen*, 2005 TCC 684, at paragraph 35.

64 *Duke of Westminster*, supra note 27, at 20-21 (emphasis added). See also *Commr. of Inc.-Tax v. B.M. Kharwar* (1968), 72 ITR 603, at 607 (India SC): "The taxing authority is entitled and is indeed bound to determine the true legal relation resulting from a transaction. If the parties have chosen to conceal by a device the legal relation, it is open to the taxing authorities to unravel the device and to determine the true character of relationship. But the legal effect of a transaction cannot be displaced by probing into the 'substance of the transaction.' "

65 Under the common-law definition of the concept, a series involves a number of preordained transactions that are intended to produce a given result, with "no practical likelihood that the subsequent transaction or transactions will not take place": see *OSFC Holdings*, supra note 49, at paragraph 24, per Rothstein J. Subsection 248(10) expands this definition by deeming any related transaction to be a part of the series if it is completed "in contemplation of" that series. See *Canada Trustco*, supra note 4, at paragraph 26. In applying the expanded definition, a court is only required to consider whether the series was taken into account when the decision was made to undertake the related transaction, in the sense that the transaction was undertaken "in relation to" or "because of" the series. The "because of" or "in relation to" test requires more than a "mere possibility" or a connection with "an extreme degree of remoteness": *MIL (Investments) SA v. The Queen*, 2006 TCC 460, at paragraph 62.

66 *Copthorne Holdings*, supra note 2, at paragraph 71.

Provided that the transaction reflects the legal rights and obligations created by the taxpayer, the Act generally applies as anticipated. Otherwise, the Act must be applied to the transaction on the basis of its legal character, and this may be inferred from the manner in which the taxpayer conducted itself. To be clear, as others have said, GAAR does not permit the minister (or a court) to tell the taxpayer:

> You used one legal structure but you achieved the same economic result as that which you would have had if you used a different one. Therefore I shall ignore the structure you used and treat you as if you had used the other one.[67]

Recognizing the Significance of Substance

The second most significant consideration in the GAAR analysis relates to the role of commercial or economic substance.[68] Although not cast in such terms, GAAR seems to have imported this concept into the Act by requiring in the definition of "avoidance transaction" that the particular transaction may reasonably be considered to have been undertaken primarily for a non-tax purpose:

> [W]here a transaction takes place primarily for a non-tax purpose, there will be no avoidance transaction. In the absence of an avoidance transaction, the fact that a transaction may have a secondary tax benefit purpose will not trigger the GAAR. . . .
>
> Where corporate reorganization takes place, the GAAR does not apply unless there is an avoidance transaction that is found to constitute an abuse. Even where corporate reorganization takes place for a tax reason, the GAAR may still not apply. It is only when a reorganization is primarily for a tax purpose and is done in a manner found to circumvent a provision of the *Income Tax Act* that it may be found to abuse that provision. And it is only where there is a finding of abuse that the corporate reorganization may be caught by the GAAR.[69]

The use of the words "may reasonably be considered" indicates that the test is an objective one and that subjective intent or motive is largely immaterial.[70] A transaction

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67 *Continental Bank*, supra note 60, at 1871. See also *Shell Canada Ltd. v. Canada*, [1999] 3 SCR 622, at paragraph 45: "[A] taxpayer is entitled to be taxed based on what it actually did, not based on what it could have done"; and Wilkie and Kerr, supra note 59, at 34:5-6.

68 For a detailed review of the economic substance doctrine, see Jinyan Li, "'Economic Substance': Drawing the Line Between Legitimate Tax Minimization and Abusive Tax Avoidance" (2006) 54:1 *Canadian Tax Journal* 23-56.

69 *Copthorne Holdings*, supra note 2, at paragraphs 120-121.

70 *OSFC Holdings*, supra note 49, at paragraph 46, per Rothstein J: "The words 'may reasonably be considered to have been undertaken or arranged' in subsection 245(3) indicate that the primary purpose test is an objective one. Therefore the focus will be on the relevant facts and circumstances and not on statements of intention." See also *Copthorne Holdings*, supra note 2, at paragraph 59; and *Canadian Pacific*, supra note 12, at paragraph 15, per Bonner J: "It should be noted that the words 'may reasonably be considered' imply that the . . . purpose test is objective in nature. That is understandable having regard to the slippery and unreliable quality of statements of subjective intent as a basis for arriving at tax results."

is not "abusive" because it lacks an economic or commercial purpose. However, the case law establishes that motivation and economic substance *are* of consequence in considering whether the transaction has frustrated the purpose of the relevant statutory provisions.[71] In other words, a purposive analysis of the disputed provisions may dictate that a particular tax benefit is available only in respect of transactions with a certain economic, commercial, family, or other non-tax purpose. The absence of such considerations may then militate toward a finding that the transaction was devoid of substance.

In considering the application of GAAR, courts are required to consider the surrounding commercial and economic realities in which taxpayers have utilized specific provisions. Thus, the question is whether the transaction, viewed in the context of such realities,[72] relies on specific provisions in a manner that is consistent with their purpose:

> That is not to say that purpose is to be equated with the motive of the taxpayer or the motives of the architects of the arrangement. It is well established that motive is not determinative, although it may be evidence which sheds light on a purpose of tax avoidance and so is not wholly irrelevant.
>
> Tax avoidance occurs when the object or end in view or design of an arrangement is alteration of the incidence of tax and that object is not incidental to a business purpose. *Such assessment does not entail reconstruction of the arrangements entered into. It requires realistic assessment of their purpose or effect.*[73]

Since the provisions of the Act are intended to apply to transactions with real economic substance,[74] abusive tax avoidance may be found where a transaction lacks substance relative to the policy of the provisions that confer the tax benefit, or where the transaction achieves an outcome that is wholly dissimilar to what is contemplated by those provisions.[75]

71 *Canada Trustco*, supra note 4, at paragraph 57; and *Lipson*, supra note 2, at paragraph 38.

72 See, for example, *Canada v. Global Equity Fund Ltd.*, 2012 FCA 272, at paragraphs 67-68, per Mainville JA: "The Tax Court judge found that the transactions at issue in this case were 'vacuous' and 'highly artificial.' I agree. Like the proverbial rabbit out of the magician's hat, the loss which occurred as a result of these transactions was pulled out of thin air. These transactions are nothing more than a paper shuffle carried out with the purpose of creating an artificial business loss for the purpose of avoiding the payment of taxes otherwise owed on the profits resulting from the real-world business operations of [the taxpayer]. *There is no air of economic or business reality associated with the loss* [emphasis added]." See also *Triad Gestco Ltd. v. Canada*, 2012 FCA 258, and *1207192 Ontario Limited v. Canada*, 2012 FCA 259.

73 *Ben Nevis*, supra note 63, at paragraphs 8-9 (emphasis added).

74 *Explanatory Notes*, supra note 16, at clause 186.

75 *Canada Trustco*, supra note 4, at paragraphs 56-60.

The GAAR analysis hinges in this regard on determining whether the underlying expectations of the Act have been defeated, notwithstanding that the requirements of specific provisions have been satisfied. Granted that there is no one-size-fits-all approach to making this determination, what is clear is that commerciality and artificiality (among other criteria) can only go so far in satisfying the level of rigour required:

> Legal reality may often be trying to reflect some sort of commercial or economic reality but it will not achieve this in every case. This does not mean that the legal distinctions created are unreasonable and that taxpayers relying upon them are acting reprehensibly, since the entire system is based on legal distinctions and needs to be in order to operate. Sometimes this seems to operate in favour of the Revenue and sometimes the taxpayer, but since it is the foundation of the tax system, it cannot be eliminated. Artificiality alone cannot be said to be a hallmark of avoidance when so much about tax is artificial.[76]

Many bona fide commercial arrangements are highly complex and are significantly influenced by tax considerations. This does not, in and of itself, imply that such arrangements are offside. Any arrangement with tax consequences is in one sense artificial, in that the taxpayer may have structured its affairs differently had it not been for those consequences. However, many arrangements go further than this and are carried out in artificial ways to secure unintended tax results.[77] In all such cases, the applicability of GAAR lies in a rigorous analysis of the facts:

> How do I approach deciding a case? *First of all, I try to find out what the facts are. That's very important. At that point, I have probably reached a conclusion as to which way I am going to go.* Before I look at any law, I think, "What is the fair commonsense result?" and at that point I start looking around for the arguments that I need to achieve that result. Is this a fair reading of the statute? What jurisprudence do I have? So I look at judgments of other courts, and I try to find judgments that will support me—and believe me, the law is not consistent. You know, you can find for every proposition of law an opposite proposition.[78]

76 Judith Freedman, "Defining Taxpayer Responsibility: In Support of a General Anti-Avoidance Principle" [2004] no. 4 *British Tax Review* 332-57, at 343.

77 In metaphorical terms, one might say, "[Y]ou can pick up tax gold if you find it in the street while going about your business, but you cannot go hunting for it": Mark P. Gergen, "The Common Knowledge of Tax Abuse" (2001) 54:1 *SMU Law Review* 131-47, at 140.

78 Bowman, supra note 38, at 32.

The importance of the facts in the GAAR analysis cannot be overstated.[79] The facts inform every aspect of the inquiry.[80] Is there a tax benefit? Is there a series? Which transactions make up the series? Does the tax benefit result from the series? Is the primary purpose of each transaction in the series something other than to obtain that benefit? And, finally, does the avoidance transaction result in an abuse or misuse of the Act? Each of these questions requires that the transaction be viewed in its factual context, and if (but only if) it is considered to be abusive, that it be recharacterized to determine the reasonable tax consequences.

Minding Legislative Gaps

Once the facts have been determined, the analysis then proceeds to the interplay between GAAR and other specific provisions. A finding of abusive tax avoidance may ensue in circumstances where a taxpayer has relied on specific provisions to achieve an outcome that those provisions seek to prevent.[81]

In conducting this analysis, the court will generally start by examining the relevant provisions. If each provision is found to apply on its terms, that should be the end of the analysis. But life is seldom so simple. In many cases, the provisions in issue may not explicitly address, or even implicitly contemplate, the results that have been achieved in the particular situation.

In such cases, it is not the job of GAAR, any more than it is of the courts, to compensate for the failure of Parliament to express its purpose in enacting a provision. But where Parliament *has* clearly expressed its purpose, and specified precisely what conditions must be satisfied to achieve a particular result, a taxpayer is entitled to rely on those conditions to achieve the result that they prescribe.[82] In short, the minister cannot discharge the burden of establishing abusive tax avoidance by asserting

79 See Hon. Donald G.H. Bowman, Deen Olsen, Wayne Adams, Al Meghji, and Wilfrid Lefebvre, "GAAR: Its Evolution and Application," in *Report of Proceedings of the Sixty-First Tax Conference*, 2009 Conference Report (Toronto: Canadian Tax Foundation, 2010), 2:1-23, at 2:15, where Meghji notes that the GAAR analysis "is very much a factual exercise, and that's why, out of the 15 cases that have gone to the Federal Court of Appeal, the court has upheld the Tax Court's analysis on misuse or abuse approximately 14 times; that is, in virtually all of the cases, the Federal Court of Appeal accepts the views of the Tax Court on what constitutes a misuse or abuse. And the reason that happens is because the trial judge is very influenced by the facts, by the story that comes out. This is in some respects a morality play, and most morality plays are resolved by reference to the facts. What's the story? The Tax Court judges are hugely influenced by the story, and they seem to rely on the facts in most instances. But judges, of course, come to the task with different experiences, different visions, and different ideas."

80 *Copthorne Holdings*, supra note 2, at paragraph 34.

81 *Canada Trustco*, supra note 4, at paragraph 45. See also *Lipson*, supra note 2, at paragraph 40; and *Copthorne Holdings*, supra note 2, at paragraph 72.

82 *Canada Trustco*, supra note 4, at paragraph 11. See also *Evans*, supra note 63, at paragraph 29.

that the taxpayer has managed to avoid the "shoals and traps" of the Act or has succeeded in exploiting a legislative gap.[83]

With respect to significance of subsequent amendments in relation to such loopholes, the courts have taken differing approaches over time. Under the current state of the law, however, such amendments are simply a relevant consideration in determining the policy of the particular provision.[84] Accordingly, the subsequent enactment of a specific anti-avoidance rule that may apply to defeat a tax-avoidance strategy challenged under GAAR does not in itself indicate that the strategy was abusive. Instead, the subsequent enactment must be considered along with all other relevant materials to ascertain the object, spirit, and purpose of the former provision.

In this context, it goes without saying that GAAR need not be invoked if a specific anti-avoidance provision applies. However, an abuse may result from an arrangement that circumvents (or has the effect of circumventing) the application of such provisions in a manner that frustrates their object, spirit, or purpose.[85] In other words, GAAR may apply where the underlying policy is clear from the scheme of relevant provisions, both ordinary and anti-avoidance, and where strict or literal compliance with those provisions nevertheless results in a misuse or abuse of that scheme.[86]

GAAR was found to apply in *Mathew*,[87] for instance, where the minister successfully established that there was an overriding policy in the Act against the transfer or sharing of losses between unrelated taxpayers, even though the transactions complied with the specific requirements of each of the relevant provisions. The result in *Mathew* can be contrasted in some respects with that in *Landrus*,[88] where the issue was whether certain provisions that prevented taxpayers from claiming losses on transfers to related persons evidenced a general policy in the Act regarding dispositions to related persons.

In finding for the taxpayer, the Tax Court reasoned in *Landrus* that the Act contained a detailed series of provisions to deny losses that would otherwise be allowed,[89] and that the provisions cited by the minister fell short of evidencing such a general policy. The Federal Court of Appeal affirmed these reasons, concluding that GAAR did not apply because a "real economic loss" resulted from the transactions under review and the underlying scheme of the Act allowed for the deduction of that

83 *Geransky v. The Queen*, 2001 CanLII 480, at paragraph 42 (TCC). See also Hoffmann, supra note 52, at 205: "It is one thing to give the statute a purposive construction. It is another to rectify the terms of highly prescriptive legislation in order to include provisions which might have been included but are not actually there."

84 *Gwartz v. The Queen*, 2013 TCC 86, at paragraphs 54-57.

85 Ibid.

86 *OSFC Holdings*, supra note 49, at paragraph 117.

87 Supra note 22.

88 *Canada v. Landrus*, 2009 FCA 113.

89 Paragraph 40(2)(e), subsection 85(4), and subsection 85(5.1).

loss.[90] The court also commented more broadly on the role of specific anti-avoidance provisions, stating that if such provisions can be demonstrated not to apply in a particular situation, this does not, in and of itself, indicate that the result was condoned by Parliament.[91]

The Federal Court of Appeal affirmed this approach in *Lehigh Cement*[92] when it considered whether a series of transactions resulted in a misuse or abuse of the withholding tax exemption in former subparagraph 212(1)(b)(vii). Sharlow JA, writing for a unanimous court, stated that the fact that an exemption could "be claimed in an unforeseen or novel manner . . . [did] not necessarily mean that the claim [was] a misuse of the exemption."[93] Her reasoning was that the court could not (at least on the extrinsic evidence before it) discern from the provision itself, the surrounding statutory scheme, or any other provision of the Act, a clear policy that would deny the exemption claimed. This was a curious result to the extent that the Court of Appeal expressly acknowledged in *Lehigh Cement* that *any* statutory exemption, even one as detailed and specific as the one in question, could not possibly describe every transaction within the intended scope of the exemption.

These decisions are arguably difficult to reconcile with other cases where GAAR *has* rounded out the rough edges of specific provisions, the most recent example being *Copthorne Holdings*.[94] There were several issues at play in this case, including whether certain transactions entered into by the taxpayer for the purpose of "preserving" (or, as the lower courts found, "duplicating") paid-up capital[95] were part of the same series of transactions as a tax-free redemption of shares made by the taxpayer's non-resident shareholder two years later, and whether that series offended certain provisions in the Act respecting the calculation of paid-up capital.[96] Despite the various technical arguments that were raised and considered in relation to each of the thresholds under GAAR, all three levels of court concluded that the transactions circumvented the purpose of a specific provision (that is, achieved a result

90 *Landrus*, supra note 88, at paragraph 68.

91 Ibid., at paragraph 47.

92 *Lehigh Cement Limited v. Canada*, 2011 FCA 124.

93 Ibid., at paragraph 37.

94 Supra note 2.

95 Paid-up capital represents capital invested in a class of shares of the corporation by its shareholders. When that class of shares is redeemed by the corporation in whole or in part, the amount paid by the corporation to the shareholders in excess of the paid-up capital attributable to the redeemed shares is deemed to have been paid as a dividend that must be included in the income of the recipient shareholder. However, the portion relating to paid-up capital need not be included in the income of the recipient shareholder because it is viewed as a return of capital to the shareholder.

96 The notion of paid-up capital in subsection 89(1) derives from the notion of "stated capital" found in many Canadian corporate statutes and is adjusted for specific transactions.

that the provision was intended to prevent)[97] and therefore abused the statutory scheme reflected in that provision.

What do these cases tell us about the scope of GAAR as it relates to other, specific provisions? First, specific provisions are meant to work in tandem with GAAR: each provides a context that assists in determining the scope of the other. Second, taxpayers *can* enter into transactions that have been structured to take advantage of specific provisions. The purpose of GAAR, although broadly expressed, is not to outlaw transactions that simply involve the use of such provisions. Third, there cannot be abusive tax avoidance if the only allegation is that a taxpayer abused some broad policy that is itself not grounded in the provisions of the Act. And finally, where the transactions in issue do not otherwise conflict with the policy of the provisions relied upon, and a specific anti-avoidance provision fails to provide a precise remedy, GAAR may not be used to fill the gap.

Making the Right Choices

The last of the more significant considerations in the GAAR analysis relates to the reach and impact of GAAR in circumstances where a taxpayer is faced with economically equivalent choices. The case law establishes that, in such circumstances, the taxpayer is not required to structure its affairs in a manner that results in the least favourable tax consequences.[98]

The decision in *Canada Trustco* exemplifies this principle. That case involved a leveraged sale-leaseback transaction in which capital cost allowance (CCA) was claimed on depreciable property that was acquired in an arrangement in which the taxpayer had only minimal risk. The Crown asserted that the taxpayer was not entitled to the deductions claimed because the structure of the arrangement contravened the policy of the CCA regime. The Crown argued that this regime was intended to permit deductions based only on the "real" or "economic" cost incurred by the taxpayer, and not on the "legal" cost (the purchase price paid by the taxpayer).

The Supreme Court disagreed, concluding that the CCA regime used "cost" in a sense that was well established and that it permitted the deduction of CCA based on that meaning of cost. Moreover, the Tax Court, after considering all of the circumstances, had found that the transactions were not so dissimilar to an ordinary sale-leaseback arrangement as to take them outside the policy of the CCA regime.[99]

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97 Subsection 87(3).

98 *Rousseau-Houle v. The Queen*, 2001 CanLII 695, at paragraph 50 (TCC). See also *Geransky*, supra note 83, at paragraph 40, per Bowman J (as he then was): "What is a misuse or an abuse is in some measure in the eye of the beholder. The Minister seems to be of the view that any use of a provision is a misuse or an abuse if the provision is not used in a manner that maximizes the tax resulting from the transaction. . . . I see no reason whatever why a taxpayer is obliged to follow that route." The logic of this proposition is grounded in the concept of tax neutrality, which dictates that functionally equivalent transactions be taxed in the same fashion and requires the equal treatment of taxpayers in similar circumstances.

99 *Canada Trustco*, supra note 11, at paragraph 89.

The taxpayer could have implemented a standard sale-leaseback transaction, and it would have been entitled to deduct CCA if it had done so. Therefore, the fact that the arrangement would not have been undertaken by the taxpayer but for the availability of CCA did not detract from its characterization as a legitimate, commercial arrangement.[100]

In defining the constraints that GAAR invariably imposes on taxpayer choices, the decision in *Lipson* is also apposite. In that case, the Supreme Court examined a series of transactions that were carried out entirely for tax purposes and that achieved exactly the outcome that the provisions in issue were intended to prevent. The taxpayer in *Lipson* sold shares of a family corporation to his wife, who, in turn, funded the purchase with loan proceeds. The very next day, the taxpayer and his wife purchased a home with the funds that the wife had used to acquire the shares. The taxpayer and his wife took out a mortgage on the home, and the mortgage proceeds were used to repay the original share-purchase loan. In computing his income, the taxpayer included in his income the dividends attributed to him from the shares that his wife purchased, and deducted interest on the mortgage.

In affirming the lower court decisions, LeBel J for the majority of the Supreme Court concluded that the transactions in issue, which were conceded to be avoidance transactions, were abusive because the overall result of the series frustrated the policy of the attribution rules. Binnie J, writing in dissent (Deschamps J concurring), would not have applied GAAR. He was of the view that the Crown had failed to identify any specific policy that was clearly frustrated by the series of transactions. Having reviewed each step in the series and the purpose of the relevant provisions, he concluded that the description provided by the majority of what those provisions were designed to prevent was actually what they were designed to permit. Rothstein J separately dissented on the basis that GAAR is a residual provision and should not have applied since a specific anti-avoidance rule was applicable.[101]

Although the Supreme Court was divided in *Lipson*, it confirmed the interpretive framework set out in *Canada Trustco*. That approach has been applied in subsequent decisions, and was reaffirmed by the Supreme Court in *Copthorne Holdings*, as discussed above. The disputed paid-up capital in that case arose from funds invested in a Canadian parent company and in its subsidiary, giving rise to paid-up capital on the shares of both companies. A reorganization was later undertaken, which involved an amalgamation. Had the amalgamation been implemented in vertical form, the shares of the subsidiary and the corresponding paid-up capital would have been eliminated for corporate-law and tax-law purposes.[102] Accordingly, the decision was made to sell the shares at fair market value to another corporation in the group, allowing for a horizontal amalgamation.

100 Ibid., at paragraph 85, per Miller J: "The tax did drive the deal, but it was a financing deal."

101 Subsection 74.5(11).

102 Subsection 87(3).

On appeal, the taxpayer argued that the lower courts had engaged in a results-oriented analysis and ignored the legal form of the transactions, treating an amalgamation that was horizontal both in fact and in law as a constructive vertical amalgamation. There was nothing in the Act, the taxpayer argued, to deprive it of the choice between the two forms of reorganization and required it to fritter away a valuable tax attribute by implementing a vertical amalgamation. However, the Supreme Court unanimously held in favour of the Crown and concluded that GAAR applied to deny the benefit of that tax attribute to the taxpayer.

The court focused on subsection 87(3), which provides, in its parenthetical clause, that the paid-up capital of the shares of an amalgamating corporation held by another amalgamating corporation is cancelled. In this case, the sale that allowed for the horizontal amalgamation circumvented the application of that parenthetical clause and, in the context of the overall series, achieved a result that the provision was intended to prevent. As a result, the taxpayer was found to have defeated the underlying rationale of the scheme pertaining to the cancellation of paid-up capital upon an amalgamation.

What can we conclude from a review of these decisions? For one thing, the general principle remains in effect:[103] A taxpayer is still entitled to select between creative courses of action that will minimize its tax liability[104] and, if challenged, is required to be taxed on the basis of what it actually did, as opposed to what it could have done or what a less sophisticated taxpayer might have done.[105] As with all principles of general application, however, there are exceptions. Indeed, the less than forgiving outcomes of recent decisions indicate that the hallmarks of legitimate tax planning are not as abstract as the rhetoric of GAAR may suggest. If nothing else, a healthy dose of skepticism should ensure that taxpayers are not caught off guard when engaged in the sort of planning that tax administrators are likely to contest.

CONCLUSION

To apply as intended, GAAR must distinguish clearly between legitimate and abusive tax avoidance. Not as clear, however, are the grounds on which that distinction should be made. It is easy enough to assert that taxpayers should engage responsibly in tax planning and steer clear of those borderline cases that are susceptible to scrutiny. But the Act has not yet succeeded, and may never succeed, in framing its limits

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103 See *Spruce Credit Union*, supra note 16, at paragraph 93, per Boyle J: "The act of choosing or deciding between or among alternative available transactions or structures to accomplish a non-tax purpose, based in whole or in part upon the differing tax results of each, is not a transaction. Making a decision cannot be an avoidance transaction."

104 *Copthorne Holdings*, supra note 2, at paragraph 65, per Rothstein J: "The terms 'abuse' or 'misuse' might be viewed as implying moral opprobrium regarding the actions of a taxpayer to minimize tax liability utilizing the provisions of the *Income Tax Act* in a creative way. That would be inappropriate."

105 *Shell*, supra note 67, at paragraph 45.

in such a precise way. Advocating for a more pragmatic approach to GAAR does not guarantee that, in any given case, a court will not prefer an interpretation of the Act that best reflects its own perceptions. Nor is there any reason to assume that, in choosing between competing interpretations, courts will remain immune to subjective considerations. However, morality has a limited role to play in the resolution of GAAR cases. In this context, courts may well be inclined, and may even be driven on occasion, to achieve results that observers would commend as sensible. It nonetheless remains that their decisions must be grounded in the facts and supported by reasons that are justifiable in principle.

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Policy Forum: Editors' Introduction— Addressing Base Erosion and Profit Shifting

On February 12, 2013, the Organisation for Economic Co-operation and Development (OECD) released a report on the subject of base erosion and profit shifting (BEPS) by multinational enterprises (MNEs).[1] The reduction of this important subject to yet another tax acronym may not end up as the only—admittedly trivial—result of the ambitious policy project that the OECD has initiated. The report provides a general discussion of a range of issues associated with BEPS, and its significance at a general level probably lies in the signal it sends that the OECD is willing to undertake a serious reconsideration of many of the features of the current international tax regime that have resulted in very low levels of tax payable by MNEs from their cross-border operations. In fact, the OECD's commitment to the BEPS project was made clear in a detailed action plan released on July 19, 2013.[2] The plan describes 15 different areas of study, with each one being assigned to an OECD working group established for this sole purpose. Relatively short timelines are provided for the release of discussion drafts by these working groups as the basis for consultation, and by the spring of 2014, the process was well advanced in some areas.

We believe it is not an overstatement to suggest that the BEPS project is one of the most ambitious and potentially significant tax policy projects undertaken recently by the OECD. As with all OECD initiatives, realization of tangible results will ultimately depend on the response of national policy makers and member governments. It is notable that some countries have already acted unilaterally with limited initiatives in advance of completion of the BEPS project. In this respect, Canada's Department of Finance released proposals addressing treaty shopping in the February 11, 2014 federal budget.[3] The budget announcement also invited input from stakeholders on issues related to international tax planning by MNEs.[4] The apparent intention is to use this input to help guide the federal government's participation in the BEPS project.

1 Organisation for Economic Co-operation and Development, *Addressing Base Erosion and Profit Shifting* (Paris: OECD, 2013).

2 Organisation for Economic Co-operation and Development, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013).

3 Canada, Department of Finance, 2014 Budget, Budget Plan, February 11, 2014, at 349-57.

4 Ibid., at 347-49.

It is probably not just a coincidence that the BEPS project was initiated by the OECD after the public spotlight had been focused by civil society and tax justice organizations on the cross-border tax planning engaged in by a number of prominent MNEs to drastically reduce their tax liability. Not surprisingly, this became a highly charged political issue in the wake of the financial crisis of 2007-2009 and the revenue imperative it created. Following high-profile hearings in the United Kingdom and the United States on the problem of international tax avoidance, the Group of Twenty decided to commission the OECD to study the issue. A much more public spotlight could create an intriguing policy-making dynamic. In short, the international tax policy-making process initiated with the OECD's BEPS report and action plan may unfold transparently in the arena of public opinion, rather than within the confines of the usual small community of policy makers, private sector actors, and tax practitioners. This dynamic could ensure that the general thrust of the BEPS project is not derailed, but instead results in national legislative outcomes that are intended to shore up source-country corporate income tax bases. If this does occur, the project could be the impetus for what might be a sustainable sea change in policy direction, with a consequent rejection (or at least softening) of the perceived imperative to enhance the attractiveness of national tax systems for cross-border investment. The latter has unquestionably been the dominant policy mantra in the area of international taxation for at least the last 20 years.

The three articles that follow—from, respectively, an Australian legal academic, an American academic economist, and a Canadian tax practitioner—consider various aspects of the BEPS project. Each of these invited contributors has spent a considerable portion of his career working in the area of international taxation.

In the first article, Richard Vann observes that both the BEPS report and the subsequent action plan provide little discussion of the relevant tax policy issues. He argues that this is at least curious, given that the BEPS project represents a policy contradiction relative to much of the corporate tax policy work undertaken by the OECD over the past two decades. Most of that work has highlighted the inefficiencies of the corporate income tax as articulated in the economic literature. The policy lesson taken up by the OECD has been the need to reduce reliance on corporate income taxes in national tax mixes, in favour of more efficient taxes such as the value-added tax. Vann emphasizes, however, that the economic literature is motivated by the development of simplistic models that should not be the basis of such categorical policy prescriptions. He welcomes the BEPS project as an opportunity to revive the corporate income tax as a well-designed policy instrument that can measure returns to capital in their various forms and locate them appropriately in the jurisdictions where value is added and should be taxed.

James Hines Jr., on the other hand, wonders in the second article, not whether BEPS is too large, but why it seems to be so small. His approach to the question is largely empirical, and based on the magnitudes of the impact of corporate taxation on multinational firm decisions. In terms of both firm financing decisions and within-firm pricing decisions that influence the location of profits, Hines finds that corporate tax differentials do affect corporate decisions, but that the magnitudes are not sizable. He also notes that the current system effectively allows for lower tax burdens for internationally active firms than for domestically focused firms. If BEPS reforms were successful, there might be pressure to lower corporate income tax rates to compete for internationally active firms. This would also change the tax payable by domestically focused firms and could lead to lower overall tax collections from the corporate sector.

In the third article, Scott Wilkie suggests that the general thrust of the BEPS initiative can be seen in prior unrelated work of the OECD and that, in some important respects, the project simply consolidates much of that work. Nonetheless, he suggests, the new political dynamic has provided a fresh policy imperative. In terms of the substantive focus of the BEPS project, Wilkie argues that the various points of study ultimately share the common feature of a reconsideration of the sourcing of income for tax purposes. At a more refined level of detail, he argues that there must be a movement away from the location of risk management as a dominant variable determining the sourcing issue to a focus on other variables, such as the location of sales, the involvement of employees, and the deployment of assets—all of which are more commonly associated with systems of formulary apportionment as an approach to the sourcing question.

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Policy Forum: The Policy Underpinnings of the BEPS Project—Preserving the International Corporate Income Tax?

Richard Vann*

KEYWORDS: BEPS ■ CORPORATE TAXES ■ INTERNATIONAL TAXATION ■ TAX POLICY

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INTRODUCTION

The OECD/G20 *Action Plan on Base Erosion and Profit Shifting*[1] (BEPS) is receiving significant attention from taxpayers and national governments. The subsequent release in January 2014 of the OECD's discussion draft on transfer-pricing documentation along with the template for country-by-country reporting, which was just 20 pages long, attracted 1,200 pages of submissions.[2] Even before the action plan was

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1 Organisation for Economic Co-operation and Development, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013) (herein referred to as "the action plan"). See the general OECD BEPS website, which provides links to the various OECD documents and other resources, at www.oecd.org/tax/beps.htm. As noted in the Editors' Introduction, the action plan is the product of an OECD study commissioned by the Group of Twenty (G20) and was issued five months after the release of the OECD's initial report on base erosion and profit shifting (infra note 4). The BEPS project is also supported by the Group of Eight (G8).

2 Organisation for Economic Co-operation and Development, *Discussion Draft on Transfer Pricing Documentation and CbC Reporting* (Paris: OECD, January 30, 2014), available at the general BEPS website, supra note 1, along with the submissions on the draft.

released, a number of countries, including Australia, Canada, and the United Kingdom, had announced tax changes in their 2013 budgets that were subsumed under the BEPS umbrella. After the action plan was released, two of the countries that seemed to be targeted by it, Ireland and Switzerland, took defensive action: Ireland announced that it would no longer be possible for an Irish incorporated company to be tax-resident nowhere, and Switzerland signed the OECD's Multilateral Convention on Mutual Administrative Assistance in Tax Matters.[3]

Because the action plan is about action, it contains little discussion of the tax policy questions involved, though these issues were discussed to some extent in the OECD's earlier BEPS report, released in February 2013.[4] One of the less-noticed aspects of the plan is action 11. From its heading and most of its content, action 11 seems to be largely about collecting data on BEPS, but it also involves the underlying policy—specifically, "developing an economic analysis of the scale and impact of BEPS (including spillover effects across countries) and actions to address it."[5] It is understood that the tax policy body at the OECD, Working Party 2 of the Committee on Fiscal Affairs, will undertake work on the policy issues as well as the collection of data. That is perhaps not surprising, since there is an inherent contradiction between the action plan and much of the policy work on corporate taxation undertaken by the OECD over the last 25 years.

In this short article, I will discuss the policy conflict and make the case for a more balanced view of the international corporate income tax.

3 For Ireland, see Ireland, Department of Finance, Budget 2014, Financial Statement of the Minister for Finance, October 15, 2013 (http://budget.gov.ie/Budgets/2014/FinancialStatement.aspx). See also Ireland, Department of Finance, *Ireland's International Tax Strategy* (Dublin: Department of Finance, 2013) (http://budget.gov.ie/Budgets/2014/Documents/Department%20of%20Finance%20International%20Tax%20Strategy%20Statement.pdf). This announcement was clearly a reaction to the Apple tax structure involving Ireland: see Antony Ting, "iTax—Apple's International Tax Structure and the Double Non-Taxation Issue" [2014] no. 1 *British Tax Review* 40-71. For Switzerland, a range of action is being considered. Although making automatic exchange of information the international standard is not strictly part of the BEPS project, that proposal sits alongside the transparency parts of the action plan and is always mentioned in the same context as BEPS at G20 and G8 deliberations on tax issues. Coincidentally, Switzerland signed the multilateral convention on the same day that Ireland announced its corporate residence changes: see Organisation for Economic Co-operation and Development, "Switzerland Signs Multilateral Convention on Mutual Administrative Assistance in Tax Matters," October 15, 2013 (www.oecd.org/tax/exchange-of-tax-information/switzerland-signs-multilateral-convention-on-mutual-administrative-assistance-in-tax-matters.htm).

4 Organisation for Economic Co-operation and Development, *Addressing Base Erosion and Profit Shifting* (Paris: OECD, 2013).

5 *Action Plan*, supra note 1, at 21-22.

THE CONFLICT BETWEEN BEPS AND THE OECD'S PRIOR POLICY FOCUS

The basic BEPS policy problem is defined in the action plan as follows:

> No or low taxation is not *per se* a cause of concern, but it becomes so when it is associated with practices that artificially segregate taxable income from the activities that generate it.[6]

More concretely, at the centre of the concern over BEPS is the recognition that many multinationals, especially those operating in the digital economy, are paying very little corporate income tax. This has both a direct impact on corporate tax revenue and, potentially, indirect impacts on tax revenue generally if, as a result, the tax system falls into disrepute. Apart from revenue issues, BEPS also raises economic efficiency and fairness concerns, since the ability to avoid tax seems to be greater for multinationals than for purely domestic businesses. The main objective of the whole BEPS exercise is thus the protection and restoration of the international corporate income tax base, as is reflected in the subtitle of one part of the action plan, "Establishing International Coherence of Corporate Income Taxation."[7]

Yet the OECD has long sponsored economic research indicating that the corporate income tax is inefficient (particularly because of the mobility of capital and tax competition) and should be replaced by more efficient taxes, such as increases in indirect taxes.[8] Similarly, at the national level, there has been an official acceptance of this line of reasoning.[9] The OECD continually trots out the "reduce inefficient taxes" advice in its reviews of its members' economies.[10] So far, there are only glimmers of

6 Ibid., at 10.

7 Ibid., at 15.

8 See, for example, Organisation for Economic Co-operation and Development, *Taxing Profits in a Global Economy* (Paris: OECD, 1991); and Organisation for Economic Co-operation and Development, *Fundamental Reform of Corporate Income Tax*, Tax Policy Study no. 16 (Paris: OECD, 2007).

9 See Australia, Tax Review Panel, *Australia's Future Tax System: Report to the Treasurer* (Canberra: Australian Treasury, December 2009); and President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals To Fix America's Tax System* (Washington, DC: US Government Printing Office, 2005). In the United Kingdom, with typical eccentricity, major tax review seems now to be left to the private sector, supported by government money, but the same trend is evident: James Mirrlees, Stuart Adam, Timothy 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). See also Advisory Panel on Canada's System of International Taxation, *Final Report: Enhancing Canada's International Tax Advantage* (Ottawa: Department of Finance, December 2008).

10 See Organisation for Economic Co-operation and Development, *OECD Economic Surveys: Canada* (Paris: OECD, 2012), at 44, and *OECD Economic Surveys: Australia* (Paris: OECD, 2012), at 48.

questioning of this underlying policy line, in both OECD and national tax policy circles.[11]

What follows is an attempt to briefly explain some of the various strands of economic literature that seem to underlie this policy stance and to suggest that the international corporate income tax has been unfairly receiving a bad press as a result. As a preliminary matter, I must say that, given the variety of theories and models deployed with always the same message, it is hard to avoid the impression that there is an agenda here. The purpose of this article, however, is not to dismiss the economic literature—a number of lessons for practical tax measures from the literature are noted along the way—but rather to invite a degree of skepticism toward very strong policy recommendations being drawn from very simple and restrictive models.

ARGUMENTS FOR AND AGAINST THE CORPORATE INCOME TAX

The corporate income tax is primarily a source-based income tax,[12] making it vulnerable in two directions: to tax planning aimed at moving the source of the income without moving the activity (the BEPS concern quoted above); and to movement (relocation) of the activity because of the international mobility of capital. The policy conflict revolves around the second of these vulnerabilities, from which the death of the corporate tax has long been predicted by economists (and when the prediction failed to materialize, explanations were offered that the corporate tax was really dead but we just did not realize it).

Although the corporate tax is intended to be a tax on capital income levied at the corporate level, it is helpful to start with individuals in order to understand the kinds of economic arguments involved. There is an influential economic literature developed in the context of individuals arguing that capital income should not be taxed. Although there are various strands, the idea is that, given certain assumptions, in the presence of a labour income tax a capital income tax is either superfluous or positively damaging. Since the assumptions fed into the economic models drive

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11 The most recent discussion emanating from the OECD, while more nuanced, does not suggest that too much questioning of the economic literature is occurring there: Pierre LeBlanc, Stephen Matthews, and Kirsti Mellbye, *The Tax Policy Landscape Five Years After the Crisis*, OECD Taxation Working Papers no. 17 (Paris: OECD, 2013). The Australian Treasury released a BEPS scoping paper in July 2013, *Risks to the Sustainability of Australia's Corporate Tax Base: Scoping Paper* (Canberra: Australian Treasury, July 2013) (www.treasury.gov.au/PublicationsAndMedia/Publications/2013/Aus-Corporate-Tax-Base-Sustainability), which said, at 24: "Overall, the view that corporate income tax collections would inevitably decline over time in response to increased mobility of capital, as countries compete to lower the cost of capital within their jurisdictions, is not borne out by the data to date. . . . Among other things this may reflect the fact that capital is not, in reality, completely mobile and the fact that tax competition impacts countries differently."

12 Richard J. Vann, "Taxing International Business Income: Hard-Boiled Wonderland and the End of the World" (2010) 2:3 *World Tax Journal* 291-346.

their results, it is important to note that those assumptions are very strong, and when they are relaxed, they do not support the zero capital taxation result.[13] At the individual level, the immobility of labour and the mobility of capital have both been overplayed.

In a variety of ways, primarily because (as discussed below) the corporation is modelled as a welfare-maximizing individual, the economic models and theories on corporate taxation focus on capital income and ignore labour income. It is widely agreed that the taxation of labour income is distortive because of the untaxed choices available to individuals, namely, household production and leisure. Optimal tax theory suggests that if there is distortion in one part of the tax system, it is likely not the optimal policy to remove distortions in another part of the system. It is therefore odd that all the analysis of the corporate tax assumes that removal of distortions in relation to the taxation of corporate income is the goal without considering distortions elsewhere in the tax system.[14]

Many of the models in the tax competition literature are similarly built on strong assumptions—in particular, the existence of perfect capital markets and perfect capital mobility; that the marginal investor in a local listed firm is non-resident; that the marginal investor is tax-exempt in the home country; and that labour is completely immobile.[15] It is not surprising that a corporate-source tax is impossible under these assumptions since the standard result will be that tax is shifted from capital to labour. The policy recommendations that are then usually made are to reduce or do away with corporate income tax and taxation of income from capital generally, and to levy taxes on immobile factors, which are taken—depending on the context—to be land, average employees, and consumption. The apparent buoyancy of the corporate income tax over the many years since this kind of analysis was first undertaken and the sense that the whole of the tax was not being shifted to labour was a puzzle—but, apart from shifting to labour, it has been suggested that income shifting from the

13 Two of the assumptions are that all households consist of a single person and not a family unit, and that time is divided between market work and leisure—that is, there is no household production. Apps and Rees have been in the forefront of showing that when realistic households of families involving household production (especially child care) are modelled, the results are turned on their head. See Patricia Apps and Ray Rees, *Public Economics and the Household* (Cambridge, UK: Cambridge University Press, 2009); and Richard J. Vann, "Tax Reform and Tax Expenditures in Australia," in Yariv Brauner and Martin J. McMahon Jr., eds., *The Proper Tax Base: Structural Fairness from an International and Comparative Perspective—Essays in Honor of Paul McDaniel* (Alphen aan den Rijn, the Netherlands: Kluwer Law International, 2012), chapter 4, at 87. See also Peter Diamond and Emmanuel Saez, "The Case for a Progressive Tax: From Basic Research to Policy Recommendations" (2011) 25:4 *Journal of Economic Perspectives* 165-90.

14 For example, this seems to be the reasoning in Mirrlees et al., supra note 9.

15 This kind of model was deployed in Australia in the work of the Business Tax Working Group, which was tasked to look for ways to provide revenue for a corporate tax rate cut. See the discussion in Richard Vann, "Corporate Tax Reform in Australia: Lucky Escape for Lucky Country?" [2013] no. 1 *British Tax Review* 59-75.

unincorporated sector to the corporate sector was occurring (partly because of the implementation in many countries of lower corporate tax rates at the suggestion of the OECD and others), thus disguising the decline of the corporate tax.

No doubt some shifting of the corporate tax to labour occurs, and there is an increasing incentive for the very wealthy to put income in companies (especially as the corporate tax rate goes down, if no measures are in place to deal with the practice), but do these factors really explain the survival and apparent buoyancy of the corporate tax?[16] In Australia in recent years, the inflation of wages in the mining sector owing to labour shortages suggests that shifting is a two-way street. The most surprising aspect of some of the recent work in this area is the persistence of the assumptions in the midst of the global financial crisis involving various capital market failures, and at some points capital market freezes.

Another strand of the economic literature on the corporate tax is to segment the return to firms into three elements: the basic risk-free rate of return, the return to risk, and the return to economic rents.[17] With regard to the first element, one argument is that the risk-free return cannot be taxed because of the availability of unlimited borrowing to remove any tax on that return. Alternatively, it is argued that taxation of the risk-free return distorts the intertemporal choice between consumption and saving, and therefore the return should not be taxed—in everyday language, a consumption tax is better than an income tax, which is often a product of the kinds of models for taxing individuals discussed above. Again, the lessons of the global financial crisis are there for all to see. First, there is no such unlimited borrowing capacity; rather, the appearance of unlimited capacity was in fact a reflection of a fundamental market failure. And second, taxation produces minor effects on saving behaviour as compared with a crisis in the financial markets.

Concerning the second element, the return to risk, it is argued that the tax system should tax risk symmetrically (providing a full refund of losses) to get the right amount of risk-taking behaviour and that, if this occurs, there will be no net tax revenue, since over time, losses and gains will cancel each other out.[18] In this area, another lesson of the modern thinking about taxes is relevant—that it is necessary to view the system as a whole and not just focus on taxation. (This is usually said in relation to the tax and transfer system, but the idea has wider application.) The tax literature on risk assumes that there is nothing but tax involved, whereas we know from daily observation of subsidies for struggling firms, lists of banks that are too

16 See Organisation for Economic Co-operation and Development, *Revenue Statistics 1965-2012* (Paris: OECD, 2013), at table 11, which shows some variability of the share of the corporate tax in total revenue across countries but overall a fair degree of constancy, with, most recently, a dip during the global financial crisis and now the start of a recovery in revenue.

17 A good account of this literature is provided by Wolfgang Schön, "International Taxation of Risk" (2014) *Bulletin for International Taxation* (forthcoming).

18 As Schön explains, ibid., there is a justification for taxing any risk premiums that are associated with risky assets to induce risk-averse investors to bear undiversifiable risk.

big to fail, etc., that a full account of the downside of risk has to take account of much more than taxation.

With regard to the third element, economic rents, the economic view is that they can be taxed more or less without limit. In an international context, with the addition of the assumption of perfect capital mobility, this means that immobile rents can be taxed in a particular country but mobile rents cannot. In the real world, however, it is impossible to observe the line between risk and rents: for example, is a higher than risk-free return from rent, or from a risky activity that has turned out well? Accordingly, we cannot build a tax system based on this distinction, and the attempts to do so in Australia in the form of mineral resource rent taxes (which the recently elected government has pledged to repeal) have shown how difficult it is to try to isolate the rent element—not to mention the problem of how to deal with transitional issues when rents are capitalized into asset prices. In the digital economy in particular, and in the corporate world more generally, it seems plausible that high returns are a mixture of risk and rent, and that the mix changes over time. One of the benefits of the corporate income tax is that it does not generally seek to distinguish between returns to risk and rents.

In another more practical direction, the discussion of the elements of return captured under the corporate income tax has important lessons for the BEPS project. One of the major causes of BEPS has been identified as the current operation of transfer-pricing rules, and no fewer than 3 of the 15 BEPS actions relate to the substantive content of those rules. The premise of much of the recent transfer-pricing work at the OECD has been that all of the return earned by a corporation is from risk taking. Add to that the acceptance of risk shifting by contract, the increasing focus on risk management as the driver of corporate profit (as a result of the OECD's current preoccupation with the finance sector), and the identification of that risk-management profit potential with a very narrow range of people within the firm, and separation of profit from most of the activities of a corporation is inevitable. Once it is recognized that managing risk is only one of the contributors to corporate profit, and often not the major one, it becomes possible to reconfigure the transfer-pricing rules away from the tax-avoidance engine that they have become.[19]

The final assumption that needs to be examined in the modelling of the corporate tax is that the company (firm) is treated as a black box with the attributes of a welfare-maximizing individual. This is no doubt a convenient and often harmless assumption, but in the tax context it produces critical issues. It avoids questions of the incidence of the corporate tax and therefore assumes that the efficiency effects of the tax will not be affected by whoever is ultimately paying the tax. It is hard to see how ignoring incidence does not make a nonsense of the efficiency analysis. The approach also avoids issues of the internal economic dynamics of firms and how they affect corporate behaviour (including, in relation to tax, rent-seeking executives,

19 See Vann, supra note 12.

moral hazard, etc.)—a question that is much discussed in the corporate-law literature but is curiously absent in the international tax literature.

When attention does turn from the company to those who invest in it, the efficient-market theory that was developed for deep public markets in securities is deployed to the effect that the investors cannot achieve better than general market or risk-free rates of return.[20] This leads to proposals to tax a flat low rate of imputed return. One wonders where the economic rents went. More importantly, this line of thinking reinforces the disconnect between the individuals who bear taxes and the firms that pay most of these taxes, and in that sense may be an implicit—and likely wrong—attempt to fix the problem produced by ignoring the investors when modelling tax policy for the firm.

ALTERNATIVES TO THE CORPORATE INCOME TAX

Various alternatives to the corporate tax are proposed in the economic literature, one of which, the allowance for corporate equity, received very short shrift when it was investigated recently by a government committee in Australia.[21] One rising favourite seems to be the corporate cash flow destination tax ("cash flow" meaning that capital outgoings are expensed, and "destination" meaning that exports are exempt from the tax and imports are taxed). The model assumes that the firm is a producer in a perfect competitive open market with no rents, and produces the unsurprising result—given the assumptions—that such a tax is neutral as to the location of production activities (and so deals with location competition). There is no discussion of incidence, but it will come as no surprise that the incidence of the tax is likely to fall on the consumers in the destination country.

There are several-real world problems with such a tax. It requires a global shift of all countries to the system, since one cannot have a corporate income tax in some countries and a corporate cash flow destination tax in others without producing significant double-taxation and double-non-taxation distortions. The tax also moves the tax base from producing countries (primary products, resources, etc.) to consumption countries and hence is very prejudicial to both developing countries and producing countries (such as Australia and Canada). What it amounts to is just an

20 For example, Peter Birch Sørensen and Shane Matthew Johnson, "Taxing Capital Income: Options for Reform in Australia," in *Melbourne Institute—Australia's Future Tax and Transfer Policy Conference: Proceedings of a Conference* (Melbourne: University of Melbourne, Melbourne Institute of Applied Economic and Social Research, 2010) (http://taxreview.treasury.gov.au/content/html/conference/downloads/AFTS_Tax_and_Transfer_Policy_Conference.pdf), 179-235. This paper deploys several of the economic models and theories discussed here and was produced at the request of the Australia's Future Tax System review.

21 See Vann, supra note 15.

increase in the rate of value-added tax (VAT)/goods and services tax (GST) in the destination country (if the incidence falls on consumers), produced in a way that probably only economists understand, and so may be appealing to those who are minded to rely more on GST/VAT but are unwilling to come out and say so.

CONCLUSION

The advent of the BEPS project and its underlying shift in thinking back to the corporate income tax seems to have caught some economists on the hop; but while to some degree the economists are beating a retreat and are now discussing how to fix the income tax, underneath the corporate cash-flow destination tax still seems to be the favourite.[22] Not surprisingly, I remain unconvinced that the corporate tax is doomed in theory or practice, especially for a country like Australia, where it works very well to produce very significant levels of revenue. I leave readers to form their own views about Canada. While this brief article is largely designed to invite skepticism of much of the economic literature, to the extent that it goes straight from simple models to strong policy prescriptions to do away with the corporate income tax, the elements of a case for the corporate income tax also begin to emerge—namely, its ability, if properly designed, to provide a good measure of all forms of corporate return and to locate the tax base in the country where the value is added.

The BEPS project at the moment is mainly focused on the proper design of the corporate income tax internationally to achieve this objective. It is to be hoped that the policy work to be undertaken by the OECD on the project will re-establish the reputation of the corporate income tax as an effective policy instrument for the operation of the income tax internationally.

22 Clemens Fuest, Christoph Spengel, Katharina Finke, Jost H. Heckemeyer, and Hannah Nusser, "Profit Shifting and 'Aggressive' Tax Planning by Multinational Firms: Issues and Options for Reform" (2013) 5:3 *World Tax Journal* 307-24.

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Policy Forum: How Serious Is the Problem of Base Erosion and Profit Shifting?

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KEYWORDS: BASE EROSION AND PROFIT SHIFTING ■ INTERNATIONAL TAXATION ■ TAX AVOIDANCE ■ CORPORATE TAXES

CONTENTS

INTRODUCTION

In recent years, the problem of base erosion and profit shifting (BEPS) by multinational corporations has entered the public consciousness as a potentially important impediment to tax collections. The purpose of this article is to identify the nature of BEPS, consider empirical evidence of its magnitude, and evaluate proposed policy responses.

There is considerable evidence that multinational firms arrange their affairs in a tax-sensitive manner, from which it is easy—indeed, perhaps a little too easy—to infer that BEPS is a serious problem. There are journalistic accounts of apparently spectacular international tax-avoidance schemes used by multinational corporations, though these stories commonly omit or misrepresent important legal and economic elements, making it difficult to know what, if any, conclusion to draw from them. On a serious level, the US Joint Committee on Taxation was recently charged by the US Congress with identifying extreme examples of BEPS among US corporate taxpayers, and produced a report[1] that included six such examples. And

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1 United States, Staff of the Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing*, JCX-37-10 (Washington, DC: Joint Committee on Taxation, July 20, 2010).

statistical studies consistently indicate that multinational corporations report higher profit rates in low-tax jurisdictions than in high-tax jurisdictions, a pattern that is consistent with BEPS.

How important is the problem of BEPS from the standpoint of tax collections? The statistical evidence consistently indicates that the impact on tax revenues is only modest in magnitude. Some of the latest evidence[2] suggests that the semi-elasticity of income reporting is roughly 0.4, which means that a corporation that is located in a country with a 25 percent tax rate, and that has the opportunity to reallocate some of its taxable income to a country with a 15 percent tax rate, will typically arrange its financial and other affairs to reallocate 4 percent of its income to the lower-rate country. Other, rather more persuasive, evidence suggests that multinational firms earning profits in high-tax countries find ways to reallocate 2 percent of those profits to low-tax foreign jurisdictions.[3] For various reasons to be discussed, even these 2 or 4 percent figures probably overstate the potential tax revenue to be had by eradicating BEPS, but on its own terms the potential tax revenue from 2 or 4 percent of pre-tax incomes of multinational corporations would make an extremely modest contribution to the government finances of most countries. The average member country of the Organisation for Economic Co-operation and Development (OECD) in 2011 raised 8.8 percent of its total tax revenue from taxes on corporate profits, only a portion of which represented taxes on multinational corporations,[4] 2 percent of which would be two-tenths of 1 percent of tax revenue. Even if one were to double, or quintuple, this figure, it would amount to less than 1 percent of tax revenue. From this standpoint, it appears that even a complete solution to the problem of BEPS, were one available and implementable, would have little direct impact on government finances.

That the level of concern expressed about the problem of BEPS is inconsistent with the implications of the available statistical evidence suggests either that the problem has been vastly overstated in popular discussion or that there is something amiss with the body of careful empirical work on this issue. Further consideration of even simple pieces of evidence points again, however, in the direction of BEPS being a much smaller problem than is commonly appreciated. The fact that governments

2 See Theresa Lohse and Nadine Riedel, *Do Transfer Pricing Laws Limit International Income Shifting? Evidence from European Multinationals*, Oxford University Centre for Business Taxation Working Paper no. 13/07 (Oxford: University of Oxford, Saïd Business School, Centre for Business Taxation, September 2013); and Dhammika Dharmapala, *What Do We Know About Base Erosion and Profit Shifting? A Review of the Empirical Literature*, Illinois Public Law and Legal Theory Research Paper Series no. 14-23 (Urbana-Champaign: University of Illinois, College of Law, December 2013). Dharmapala's survey of the literature indicates that more recent studies tend to report smaller magnitudes of BEPS.

3 Dhammika Dharmapala and Nadine Riedel, "Earnings Shocks and Tax-Motivated Income-Shifting: Evidence from European Multinationals" (2013) 97:1 *Journal of Public Economics* 95-107.

4 See Organisation for Economic Co-operation and Development, *OECD.StatExtracts* (http://stats.oecd.org).

of high-tax-rate countries collect considerable revenue from taxing the profits of their resident multinational corporations itself indicates that tax avoidance is not as easy or cost-effective as some fear that it is. If firms were able to arrange their affairs in ways that would easily reallocate pre-tax income earned in high-tax locations to alternative locations with zero or very low tax rates, then most would surely do so, and even those corporations without an international business presence would quickly establish operations in low-tax foreign locations in order to reduce their tax obligations. That corporations persist in paying taxes to governments of high-tax countries does not reflect lack of imagination or insufficient profit motive; it reflects the fact that enforcement makes tax avoidance difficult and costly.

Further evidence is available from the location of foreign business activities. Studies consistently find that multinational firms locate more employment, property, plant, and equipment in low-tax locations, and less in high-tax locations, than the structures of these economies would ordinarily warrant. This business activity pattern is itself a form of base erosion from the standpoint of high-tax countries, albeit of a rather mundane form, since it is hardly surprising that high tax rates discourage business activity, whereas low tax rates attract it. From the standpoint of profit shifting, however, this pattern makes it clear that firms are unable to reallocate pre-tax income with impunity. If it were easy to reallocate taxable income, there would be no benefit to locating real business activity in a low-tax country. The profit-maximizing strategy would be to locate business activity wherever it generates the highest pre-tax profits, and use financial or other means to reallocate taxable income to an affiliate located in a zero-tax location. It would be a mistake to let tax rates influence where pre-tax profits are actually earned, since doing so reduces the amount that is ultimately destined to be reported as income by the affiliate in a tax haven. In fact, this is not what firms do: the evidence consistently indicates that multinational firms tend to locate greater real business activity in countries with low tax rates than would otherwise be expected. This is consistent with maximizing after-tax profits only if it is difficult to shift pre-tax income.

Finally, there is evidence from the use of tax haven affiliates by multinational corporations. The tax havens are the countries with the lowest tax rates, and so are the destinations of choice (if one has unfettered choice) for profits to be reallocated from high-tax countries. Among large US multinational firms from 1982 to 1999, only 38 percent had tax haven affiliates,[5] and among German multinational firms from 2002 to 2008, only 20 percent had tax haven affiliates.[6] The majority of US and German firms obviously did not reallocate taxable income to tax havens, since they had no method of doing so, given the absence of legal presence in those countries.

5 Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., "The Demand for Tax Haven Operations" (2006) 90:3 *Journal of Public Economics* 513-31.

6 Anna Gumpert, James R. Hines Jr., and Monika Schnitzer, *The Use of Tax Havens in Exemption Regimes*, NBER Working Paper no. 17644 (Cambridge, MA: National Bureau of Economic Research, December 2011).

The most noteworthy feature of this evidence is that there is nothing that prevents a US or German multinational firm from establishing a tax haven affiliate. The reason not to do so is that it is not worth it—and the reason it is not worth it is that it is too difficult or costly to reallocate taxable income from high-tax countries to tax haven countries.

Consequently, one is left with a puzzle. There is clearly scope for BEPS to reduce tax liabilities, and ample evidence that multinational firms arrange their affairs in a tax-sensitive manner. The empirical puzzle is why there is not more tax avoidance than appears to be the case. The sections that follow review some of the available evidence, which may deepen rather than resolve the puzzle.

FINANCING OF MULTINATIONAL CORPORATIONS

Successful BEPS entails locating taxable income in low-tax jurisdictions and deductible expenses in high-tax jurisdictions. The most straightforward way to be able to report earning taxable income in low-tax jurisdictions is to concentrate economic activity there. To a certain degree this occurs as a matter of course, since, all other things being equal, high tax rates discourage economic activity by reducing after-tax rewards. As a result, economic activity tends to flourish in low-tax environments to a greater degree than in high-tax environments, even in the absence of multinational firms and opportunities to substitute low-tax activities for high-tax activities. In addition, there is the opportunity for such substitution, so one should expect there to be disproportionate income production in low-tax environments. And the available evidence consistently indicates that there is much more multinational activity in low-tax locations than would ordinarily be predicted on the basis of other economic characteristics.[7]

Concern over BEPS is usually directed not at the location of economic activities, but at the location of taxable income contingent on economic activities. Taxable income is the difference between revenues and expenses, and corporate financing operations can offer relatively straightforward methods of placing expenses where they generate the largest tax benefits. Corporations can be financed with either debt or equity, debt offering the advantage that interest payments are generally deductible in calculating taxable income, whereas dividend payments to shareholders are

7 See, for example, James R. Hines Jr. and Eric M. Rice, "Fiscal Paradise: Foreign Tax Havens and American Business" (1994) 109:1 *Quarterly Journal of Economics* 149-82; James R. Hines Jr., "Altered States: Taxes and the Location of Foreign Direct Investment in America" (1996) 86:5 *American Economic Review* 1076-94; Rosanne Altshuler, Harry Grubert, and T. Scott Newlon, "Has U.S. Investment Abroad Become More Sensitive to Tax Rates?" in James R. Hines Jr., ed., *International Taxation and Multinational Activity* (Chicago: University of Chicago Press, 2001), 9-32; James R. Hines Jr., "Tax Sparing and Direct Investment in Developing Countries," ibid., 39-66; Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., "Foreign Direct Investment in a World of Multiple Taxes" (2004) 88:12 *Journal of Public Economics* 2727-44; and Salvador Barrios, Harry Huizinga, Luc Laeven, and Gaëtan Nicodème, "International Taxation and Multinational Firm Location Decisions" (2012) 96:11-12 *Journal of Public Economics* 946-58.

typically not deductible. Since the benefits of interest deductibility rise with tax rates, it follows that firms in higher-tax locations should be expected to use greater amounts of debt than do firms in lower-tax locations, whether or not they substitute borrowing in one location for borrowing in another. In addition, the ability of multinational firms to choose the location of borrowing gives even greater scope for arranging financing in order to locate interest deductions where they will be most valuable.

Governments of high-tax countries are well aware of the benefits of interest deductibility, and have implemented several measures that limit the ability of taxpayers to benefit from strategic debt-location choices. These measures include thin capitalization rules that deny interest deductions once interest expenses are deemed excessive by some (typically rather crude) measure; interest expense allocation rules that require domestic-based multinational companies to allocate a portion of domestic interest expense against foreign income, thereby effectively reducing available foreign tax credits; and controlled foreign corporation rules that subject to home-country taxation certain interest income received by foreign affiliates. Taxpayers often attempt to plan around these rules, but doing so can be costly, a constraint that may explain why multinational firms do not make even more use of borrowing arrangements to reduce their tax obligations.

There is considerable evidence that borrowing by multinational firms is sensitive to local tax rates. Desai et al.[8] offer evidence that among the foreign affiliates of US multinationals from 1982 to 1994, 10 percent higher local tax rates were associated with 2.8 percent higher debt:asset ratios. Huizinga et al.[9] document a similar pattern among the foreign affiliates of European multinationals from 1994 to 2003. Buettner et al.[10] find that, as expected, thin capitalization rules dampen the effect of tax-rate differences on the borrowing behaviour of European multinationals from 1996 to 2004. Froot and Hines[11] consider the impact of the US Tax Reform Act of 1986 on borrowing by US multinational firms. The 1986 Act required US firms to allocate a portion of domestic interest expense against foreign income, effectively removing the tax benefit of domestic interest deductions for firms with excess foreign tax credits; the evidence indicates that the affected firms responded by significantly reducing their domestic borrowing. Tax rates appear to influence many aspects of a

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8 Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., "A Multinational Perspective on Capital Structure Choice and Internal Capital Markets" (2004) 59:6 *Journal of Finance* 2451-87.

9 Harry Huizinga, Luc Laeven, and Gaëtan Nicodème, "Capital Structure and International Debt Shifting" (2008) 88:1 *Journal of Financial Economics* 80-118.

10 Thiess Buettner, Michael Overesch, Ulrich Schreiber, and Georg Wamser, "The Impact of Thin-Capitalization Rules on the Capital Structure of Multinational Firms" (2012) 96:11-12 *Journal of Public Economics* 930-38.

11 Kenneth A. Froot and James R. Hines Jr., "Interest Allocation Rules, Financing Patterns, and the Operations of U.S. Multinationals," in Martin Feldstein, James R. Hines Jr., and R. Glenn Hubbard, eds., *The Effects of Taxation on Multinational Corporations* (Chicago: University of Chicago Press, 1995), 277-307.

multinational firm's borrowing behaviour, including implicit borrowing that takes the form of delaying payment for purchases.[12]

How should one think about the role of corporate borrowing in BEPS activity by multinational firms? Since governments generally permit firms to deduct interest payments in calculating taxable income, these policies acknowledge—at least tacitly—that permitting a tax deduction for some portion of interest expense is acceptable, maybe even desirable. The BEPS concern presumably lies with the abusive use of debt contracts, which is a subset of overall use. In this context, it is perhaps striking that multinational firms do not make better strategic use of debt than they do—that interest deductions are not even more concentrated in high-tax countries.[13] Countries have the ability to impose thin capitalization rules and other methods of limiting the strategic use of debt, and it may be that the rules currently in place account for the limited extent to which multinational firms are able to use interest deductions to reduce their taxable incomes in high-tax countries. These rules could be further strengthened, but this would come at the cost of discouraging corporate activity, reducing the associated employment and other economic benefits that it brings. Consequently, the financing portion of BEPS may represent reasoned trade-offs on the part of taxing authorities around the world.

PROFIT REALLOCATION

International tax avoidance takes many forms, of which tax-motivated cross-border loans represent just one. Other methods of tax avoidance include making tax-sensitive adjustments to the transfer prices used to record transactions between related parties, corporate reorganizations designed to relocate corporate residence to attractive tax jurisdictions, and careful timing of income repatriation to reduce the cost of home-country taxation of foreign income.

Multinational firms generally have incentives to reallocate taxable income from high-tax locations to low-tax locations, since $1 of pre-tax income is obviously more valuable if lightly taxed than if heavily taxed. Firms located in countries that exempt foreign income from taxation face the clearest incentives to relocate taxable income. Suppose, for example, that a firm located in a country with a 30 percent tax rate earns $100 of income at home, where it would normally be subject to tax at 30 percent, but the firm has the opportunity to attribute $50 of that income to its foreign affiliate in a location with a 20 percent tax rate. If the home country does not tax foreign income, then the reallocation reduces domestic tax liabilities by $15 and

12 Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., *Trade Credit and Taxes*, NBER Working Paper no. 18107 (Cambridge, MA: National Bureau of Economic Research, May 2012).

13 Others have noted the puzzle that corporations generally could benefit from the tax savings associated with greater use of debt, but for some reason persist in issuing large amounts of equity. See, for example, John R. Graham, "How Big Are the Tax Benefits of Debt?" (2000) 55:5 *Journal of Finance* 1901-41.

increases foreign tax liabilities by $10, for a net saving of $5. Income reallocation is unlikely to be costless, but if the tax saving of $5 exceeds the after-tax cost of income reallocation, then it will be in the interest of the firm to move taxable income from the high-tax to the low-tax location.

How would the firm in this example reallocate taxable income? In addition to adjusting the volume and location of borrowing, it is possible for firms to adjust the pricing of intercompany transactions. An excessively transparent method of doing so would be to sell a paper clip from the affiliate in the 20 percent tax-rate location to the parent company in the 30 percent tax-rate location, charging a price of $1 million. This transaction would create a tax deduction of $1 million in the home country and taxable income of $1 million in the foreign country, thereby reducing total global tax obligations. Cognizant of these incentives, governments have adopted arm's-length pricing rules dictating that, for tax purposes, the prices used for intercompany transactions must be the same as those that would have been chosen by unrelated parties transacting at arm's length. While the arm's-length pricing standard addresses the problem of $1 million paper clips, there is widespread concern that the difficulty of applying the standard to many ordinary cases, not to mention complex transactions involving sophisticated financial instruments or intangible property such as patents and trademarks, leaves ample opportunity for tax avoidance. Governments, particularly those of high-tax countries, are perfectly well aware of the potential of transfer price manipulation to erode tax collections, and devote considerable resources to enforcing the arm's-length standard, though it is an open question just how effective they are in doing so.

Empirical studies of tax avoidance fall into two general categories. The first category consists of studies that compare reported profit rates in countries with differing tax rates. The idea, of course, is to measure the extent to which unusually high rates of profit are reported in low-tax jurisdictions. This immediately raises the question of what rate of profit should be expected in the absence of tax-motivated income reallocation, and this question has multiple components. There is no presumption that profits measured as a fraction of sales, assets, or some other metric of business activity should be the same in all foreign jurisdictions. As a general matter, one might expect pre-tax profit rates to be lower in low-tax jurisdictions than in high-tax jurisdictions, since after-tax marginal profits of capital will often be lower; but even this presumption confuses marginal and average conditions, and is based on steady-state properties of models that may not be valid for large numbers of taxpayers.

The second category of empirical study in this area investigates observable aspects of specific activities undertaken by taxpayers to reduce their tax liabilities, as well as reactions to changing conditions. These observable aspects include suspicious prices of transactions between related parties, or greater numbers of these transactions; apparently tax-motivated trade imbalances between related parties; relocation of corporate tax homes to tax-advantaged jurisdictions; location of valuable intangible property in low-tax jurisdictions; and dividend repatriation (or the alternative of deferring dividend repatriation) by foreign affiliates of firms located in countries that impose taxes on repatriated profits.

The available evidence points consistently in the direction of tax-rate differences exerting significant influence over the behaviour of multinational firms. Reported profit rates are higher in low-tax jurisdictions than in high-tax jurisdictions, and firms appear to devote significant efforts to activities designed to facilitate income reallocation.

What are the costs of tax avoidance? The costs include administrative and compliance costs, among them the potential penalties that might be imposed by governments that maintain that taxpayers fail to report taxable income accurately. But surely the largest cost is that of business activity undertaken to facilitate income reallocation. Profit reallocation technology entails establishing business operations in locations that firms would otherwise not choose but for the opportunity that is thereby created to reallocate taxable income.

The first generation of modern empirical studies of income reallocation[14] considered the determinants of average profit rates. In theory, low tax rates should be associated with high pre-tax profit rates if firms allocate taxable income to avoid tax liabilities. Hines and Rice[15] find that US multinational firms in 1982 reported significantly higher (pre-tax) profits in low-tax countries than in high-tax countries, after controlling for business inputs of labour and capital, and after controlling for measurable aspects of local economic conditions. There have been many subsequent studies of this variety, most using firm-level data that have many advantages over the aggregate data for US firms used by Grubert and Mutti[16] and Hines and Rice[17] (and more recently by Clausing).[18] Huizinga and Laeven[19] likewise find that reported profit rates are lower in high-tax countries, though their estimated effect—that a 10 percent higher tax rate is associated with 13 percent reduced reported profitability of European firms—is somewhat smaller than the effect reported by Hines and Rice.[20] Lohse and Riedel[21] calculate the effect of tax-rate differences on reported profitability of European firms from 1999 to 2009, controlling more comprehensively for the economic effects of affiliate location, and find profit reallocation

14 For example, Harry Grubert and John Mutti, "Taxes, Tariffs and Transfer Pricing in Multinational Corporate Decision Making" (1991) 68:2 *Review of Economics and Statistics* 285-93; and Hines and Rice, supra note 7.

15 Hines and Rice, supra note 7.

16 Grubert and Mutti, supra note 14.

17 Hines and Rice, supra note 7.

18 Kimberly A. Clausing, "Multinational Firm Tax Avoidance and Tax Policy" (2009) 62:4 *National Tax Journal* 703-25.

19 Harry Huizinga and Luc Laeven, "International Profit Shifting Within Multinationals: A Multi-Country Perspective" (2008) 92:5-6 *Journal of Public Economics* 1164-82.

20 Hines and Rice, supra note 7.

21 Lohse and Riedel, supra note 2.

effects that are smaller than those reported by Huizinga and Laeven: 10 percent higher tax rates are associated with 4 percent reduced reported profitability in Lohse and Riedel's data. Other recent studies, reviewed in Dharmapala,[22] come to similar conclusions.

An important recent contribution to this literature is Dharmapala and Riedel,[23] which looks at the propagation of profits throughout a multinational firm. The idea behind this study is that, in the absence of profit-shifting behaviour, a change in the economic environment that affects a parent company's profitability should have no systematic effect on the reported profitability of the company's foreign affiliates located in low-tax jurisdictions. Consequently, if it is possible to identify economic changes that affect parent company profitability without directly affecting the profitability of foreign affiliates, the extent of profit reallocation can be measured by the contemporaneous effect of the economic changes on reported profitability of tax haven affiliates. For example, a parent company that mines coal might become more profitable if the world price of coal rises, but if the company's shipping affiliate in a tax haven also becomes more profitable, it starts to look as though profits are being reallocated from the parent company. Dharmapala and Riedel report that the profitability of affiliates in low-tax countries does appear to be influenced by events that change the profitability of parent companies, but that the effect is quite small, with something in the neighbourhood of 2 percent, or possibly as much as 4 percent, of parent profits being reallocated to low-tax affiliates.

There is considerable supporting evidence of methods used by multinational firms to avoid reporting profits in high-tax countries. Clausing[24] finds that the foreign affiliates of US multinational firms report trade imbalances with their US parent companies that look suspiciously tax-motivated: affiliates in countries with 10 percent lower tax rates run 4.4 percent higher trade surpluses with their parent companies. In a later study, Clausing[25] offers other suggestive evidence of possible mispricing of commodities traded between related parties, noting systematic differences between prices reported by US companies in trade with related and unrelated parties. Dischinger and Riedel[26] provide evidence that European multinational firms are more likely to hold intellectual property in low-tax than in high-tax locations, and this may facilitate profit reallocation. Further evidence of tax-motivated behaviour

22 Dharmapala, supra note 2.

23 Dharmapala and Riedel, supra note 3.

24 Kimberly A. Clausing, "The Impact of Transfer Pricing on Intrafirm Trade," in *International Taxation and Multinational Activity*, supra note 7, 173-94.

25 Kimberly A. Clausing, "Tax-Motivated Transfer Pricing and US Intrafirm Trade Prices" (2003) 87:9-10 *Journal of Public Economics* 2207-23.

26 Matthias Dischinger and Nadine Riedel, "Corporate Taxes and the Location of Intangible Assets Within Multinational Firms" (2011) 95:7-8 *Journal of Public Economics* 691-707.

appears in the tax-sensitive extent to which US firms repatriate profits from foreign locations[27] and the relocation of corporate homes for tax purposes.[28]

There is little doubt that multinational firms are motivated to avoid taxes and are aware of the available methods. And there is evidence of a limited degree of international tax avoidance—but the question is why there is not more, given the motive and opportunity. That there is considerable scrutiny of transactions between related parties, with stiff potential penalties for non-compliance, is surely part of the answer; but another part may be that the actions necessary to facilitate tax avoidance are sufficiently costly and cumbersome that it is simply not worth it in return for the modest potential tax savings.

POLICY ALTERNATIVES

Concern over the potential for BEPS has prompted extensive reconsideration of the international regime by which company profits are taxed. One radical reform would be to replace the current system of determining the location of profits earned by multinational firms with a formulary method of assigning profits to jurisdictions based on factors such as employment, sales, and capital in place. Advocates argue that these factors are less capable of being manipulated than are prices used in transactions between related parties. Some of the difficulties with formulary apportionment have been widely noted, including the ability of firms to undertake transactions that manipulate the location of formulary factors; furthermore, the inaccuracy of employment, sales, and capital in place as predictors of firm profitability[29] raises the possibility that the use of formulary methods will introduce its own inaccuracy, arbitrariness, and resulting inefficiency into the taxation of multinational firms.

There is a separate issue, that any international reform that successfully reduces the magnitude of BEPS will almost surely put downward pressure on business tax rates around the world. Countries currently choose their corporate tax rates in an environment in which multinational firms are able to engage in BEPS and thereby avoid a portion of what would otherwise be their tax obligations. Reducing BEPS increases tax burdens but does little, if anything, to reduce the competitive pressures that countries face in attempting to attract and foster business activity; as a result, tax rates are likely to decline—possibly by quite a bit. BEPS effectively permits high-tax

27 Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., "Repatriation Taxes and Dividend Distortions" (2001) 54:4 *National Tax Journal* 829-51; and Dhammika Dharmapala, C. Fritz Foley, and Kristin J. Forbes, "Watch What I Do, Not What I Say: The Unintended Consequences of the Homeland Investment Act" (2011) 66:3 *Journal of Finance* 753-87.

28 Mihir A. Desai and James R. Hines Jr., "Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions" (2002) 55:3 *National Tax Journal* 409-40; and Johannes Voget, "Relocation of Headquarters and International Taxation" (2011) 95:9-10 *Journal of Public Economics* 1067-81.

29 See James R. Hines Jr., "Income Misattribution Under Formula Apportionment" (2010) 54:1 *European Economic Review* 108-20.

countries to differentiate among corporate taxpayers, imposing heavier tax burdens on domestic firms that may constitute a less elastic tax base than that provided by multinational firms. If BEPS were eradicated and multinational firms were subjected to exactly the same tax burden as domestic firms, many high-tax countries might face serious declines in their multinational business sector, and feel the need to respond by reducing taxes on everyone. Whether this would ultimately result in greater or lower total tax collections is an open question.

The problem of BEPS easily catches the imagination, particularly given the attention that has attached to several distasteful anecdotes of crass tax avoidance. The empirical evidence is quite consistent with BEPS being a real phenomenon, but one that is notably small in magnitude and unlikely to undermine the sustainability of government finance. There are undoubtedly some potential policy reforms that would improve the efficiency and effectiveness of international tax enforcement, but the danger looms that the international community in its desire to combat BEPS might introduce reforms that could significantly undermine economic efficiency or stimulate tax competition, and ultimately reduce government tax collections. It is questionable whether radical reforms are justified by the very modest size of the BEPS problem. Accordingly, it is to be hoped that any actions undertaken by the international community will reflect thoughtful consideration of the magnitude of BEPS and the costs and benefits of possible reforms.

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Policy Forum: BEPS One Year In—Taking Stock

J. Scott Wilkie*

KEYWORDS: BASE EROSION AND PROFIT SHIFTING ■ JURISDICTION ■ OECD ■ SOURCES ■ TAX POLICY

CONTENTS

"YOU ARE HERE"

The "You are here" arrow on the shopping mall map is an essential point of reference for someone entering that world. The geography of the shopping mall includes separate, self-interested "jurisdictions"—stores—which are connected by a warren of pathways navigated by the mall's "citizens" as they seek to deploy their financial resources as optimally as possible. Common areas, such as food courts, offer those citizens respite to conserve their resources as they formulate strategies for their next forays.

BEPS: WE ARE WHERE?

This short article is meant to be an arrow on the base erosion and profit shifting (BEPS) map.[1] It takes stock of where the BEPS inquiry now stands and how it is expected to unfold in the next several months, but not simply by adding another voice

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1 In this article, "BEPS" refers variously, according to the context, to the phenomenon of base erosion and profit shifting, or to the inquiry or project addressing that phenomenon, discussed

to the conversation as it is presently taking place. These comments offer a perspective on a very familiar tax policy notion seemingly at the core of the BEPS inquiry, undistracted by particular and particularly descriptive characterizations of BEPS symptoms styled as "treaty abuse," "treaty shopping," "hybrids," and "intangibles." The discussion that follows steps back from the rhetoric of the BEPS debate spawned partly by the imprecise term "globalization," to which the vulnerability of international tax rules essentially has been attributed, to consider some of the implications of a, if not the, key underlying BEPS theme: where income has its source and the effects of intangibles on this determination.

As mundane as this question may seem, it is the essence of BEPS. How source is addressed, particularly with reference to the implications of intangibles for the measurement and allocation of income among members of a multinational or global business and the tax claims that countries somehow connected to elements of that business would expect to be able to assert, is the underlying and continuous, though in some respects possibly understated, tax policy issue animating the vigorous BEPS conversation now taking place. It can be expected to affect both perceptions of and expectations for the success of the BEPS project. In any event, thinking about BEPS from this vantage point helps in understanding the coherence of the BEPS action plan, as well as what may be required for it to be influential and fairly effective.

A BEPS CHRONICLE

A little more than a year ago, the tax world's latest concerted examination of international tax rules and practices began in earnest with the publication by the Organisation for Economic Co-operation and Development (OECD) in February 2013 of its study (commissioned by the Group of Twenty [G20]) entitled *Addressing Base Erosion and Profit Shifting*.[2] This study offered sweeping observations about the adequacy of "the international common principles drawn from national experiences to share tax jurisdiction [which] may not have kept pace with the changing business environment,"[3] in the context of widely reported tax-planning practices of

in the text below at note 2 and following. The abbreviation, which has already has found a prominent place in the tax lexicon, is used here for convenience, even though doing so may make it easy to miss or avoid the intrinsic complexity of the issues and circumstances to which the term refers.

2 Organisation for Economic Co-operation and Development, *Addressing Base Erosion and Profit Shifting* (Paris: OECD, 2013).

3 Ibid., at 5. This statement is revealing for several reasons, not the least of which is the expectation, and assumption, that there are "international common principles." Indeed, the OECD is responsible for important guidance offered by its member governments' taxation and finance authorities found, for example, in the OECD *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, July 2010) (herein referred to as "the OECD model tax convention") and the accompanying commentary, and in the *OECD Transfer Pricing*

multinational and global businesses resulting in what has come to be criticized as double non-taxation.

Following closely on the study's heels was the OECD's *Action Plan on Base Erosion and Profit Shifting*.[4] This formidable scoping document was published on July 19, 2013 shortly after the Group of Eight (G8) summit at Lough Erne, Northern Ireland, where the G8 leaders declared their support for the OECD's BEPS work and changes to national laws necessary to give it effect. In a communiqué issued on June 18, 2013, the G8 leaders emphasized

> the importance of the OECD developing an ambitious and comprehensive action plan for the Finance Ministers and Central Bank Governors of the G20 in July . . . look[ing] forward to the OECD recommendations and commit[ting] to take the necessary individual and collective action."[5]

The OECD's agenda provides for the delivery of several important reports in the next year, as it makes firm recommendations on 15 actions to be issued in two stages, in September 2014 and 2015.[6]

Guidelines for Multinational Enterprises and Tax Administrations (Paris: OECD, July 2010) (herein referred to as "the OECD transfer-pricing guidelines"). Whether this guidance, to some extent aspirational, necessarily reflects "principles" that, further, are "common" is perhaps the most formative, but a difficult, question in the dense fabric of BEPS issues, the texture and weave of which, in fact, is increasingly revealed by BEPS work by the OECD and others to reflect elements of inter-nation economic and fiscal self-interest. These elements of self-interest, often dubbed "tax competition," are inherently both difficult to reconcile and in some respects not reconcilable unless national economic interests somehow intersect to spawn a "tax bargain" that mutually and reciprocally serves certain of those interests—in particular, national commercial and trading interests.

4 Organisation for Economic Co-operation and Development, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013) (herein referred to as "the action plan"). The action plan sets out 15 numbered "actions" that governments may consider in addressing BEPS concerns.

5 Group of Eight, "G8 Lough Erne Leaders Communiqué," 2013 Lough Erne summit, Lough Erne, Northern Ireland, June 18, 2013, at paragraph 24. The G8 leaders declared that "[c]ountries should change rules that let companies shift their profits across borders to avoid taxes, and multinationals should report to tax authorities what tax they pay where": Group of Eight, "G8 Lough Erne Declaration," 2013 Lough Erne summit, Lough Erne, Northern Ireland, June 18, 2013, at paragraph 2. (G7 and G8 documents cited herein can be found at www.g8.utoronto.ca.) See also Organisation for Economic Co-operation and Development, *A Step Change in Tax Transparency: OECD Report for the G8 Summit Lough Erne, Enniskillen, June 2013* (Paris: OECD, June 2013).

6 *Action Plan*, supra note 4, at annex A; and Organisation for Economic Co-operation and Development, "OECD Issues Communication on Engagement with Stakeholders," March 12, 2013 (www.oecd.org/ctp/beps-oecd-engagement-with-stakeholders.htm), updated by "OECD Issues Release Dates of BEPS Discussion Drafts and Public Consultations," February 20, 2014 (www.oecd.org/tax/oecd-issues-dates-of-release-beps-discussion-drafts-public-consultations.htm).

CONTEXT AND CONTINUITY MATTER—THE OECD IS NOT JUST STARTING AND IS NOT ALONE

The essential simplicity but the possibly dramatic implications of even the most complex notions may be revealed, even to specialists, when that complexity reaches its outer limits so as to ignite dormant constituencies of self-interest. That is what is happening with BEPS. It is the reason why, despite facing formidable hurdles to translate aspirational guidance on complex international tax subjects into enforceable standards, BEPS is not just another international tax inquiry. In fact, the mere articulation of this guidance is an accomplishment in itself, and one that seemingly has touched, if not awakened, the interest of many organizations. If nothing else, the BEPS inquiry may be expected to raise standards of consciousness and indeed self-consciousness about what prevailing law and guidance actually mean, and, influenced by the texture of the BEPS debate, how they might be construed in a more contemporary context taking account comparatively of the origins of principles, rules, and practices underlying "international taxation."

It would be a mistake in evaluating the direction or prospects of BEPS to think that it has just come upon us. The catchy BEPS acronym may be unique, but the undercurrents of base erosion and profit shifting have been present, for those who would notice, for quite some time. Indeed, meaning no disrespect, there is not that much new in the BEPS discussion except possibly its urgency and the fact that, engendered by widely reported hearings in the United Kingdom and the United States about questionable international tax planning apparently undertaken by certain multinational businesses, BEPS issues are no longer the exclusive preserve of tax specialists.[7] Another critical development, however, is that BEPS is not only, or in fact even, an OECD project, although the OECD is its main instrumentality. The impetus for this work lies in the interest and urging of the G20, 8 of the members of which are not OECD countries but are participating in the BEPS initiative as equals. As part of the project, the OECD is also actively and specifically taking account of the interests of developing as well as more developed countries.

It is worth noting several key aspects of the BEPS pedigree.

Interestingly, in 1991, acknowledging formative work of the League of Nations—the same work to which the recent BEPS reports refer—the OECD addressed BEPS, without actually saying so, in examining corporate income taxation from an international perspective. In a report on the taxation of profits in a global economy,[8] the OECD foreshadowed critical features of BEPS that underlie many, if not most, of the actions and the challenges faced when offering directional guidance meant to be probative in the context of intergovernmental interactions that are not easily or even

7 As a recent example, the Canadian Broadcasting Corporation dedicated the first hour of its Sunday Edition public affairs radio program on March 16, 2014 to multinational tax planning and BEPS.

8 Organisation for Economic Co-operation and Development, *Taxing Profits in a Global Economy: Domestic and International Issues* (Paris: OECD, 1991).

necessarily coordinated. Essential to this inquiry was the development of an understanding of how and where, and by whom, income is earned. The report noted:

> At the international level, the policy issues which arise are more difficult to discuss since *they involve not only the design of domestic tax systems, but also the need to take into account how different national systems interact*. Each government has to address two broad sets of policy issues. *The first is to protect the revenue yield from taxes on profit and to ensure that it gets its fair share of the tax base associated with international transactions*. The second goal is to maintain a favourable tax climate for inward investment and to avoid encouraging an outflow of domestic capital that would otherwise not have taken place.[9]

In 1998, the OECD published its report on harmful tax competition.[10] As that report notes, the Group of Seven (G7) countries had endorsed a particular initiative using language remarkably similar to how the BEPS initiative has been framed. In a communiqué issued at the 1996 Lyons summit, the G7 heads of state said:

> Finally, globalization is creating new challenges in the field of tax policy. Tax schemes aimed at attracting *financial and other geographically mobile activities* can create harmful tax competition between States, carrying *risks of distorting trade and investment* and could lead to the *erosion of national tax bases*. We strongly urge the OECD to vigorously pursue its work in this field, aimed at establishing *a multilateral approach* under which countries could operate individually and collectively to limit the extent of these practices. We will follow closely the progress on work by the OECD, which is due to produce a report by 1998.[11]

The 1998 report was followed by others, principally in 2001, 2004, and 2006, for which the 1998 report was the catalyst. These subsequent reports were similarly directed, though in some respects they reflected an evolution in the OECD's focus on harmful tax practices rather than competition, and in that regard access to information as much as preferential tax regimes and practices.[12]

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9 Ibid., at 13 (emphasis added).

10 Organisation for Economic Co-operation and Development, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD, 1998). The exploration of tax competition as a global phenomenon in chapter 1 and the recommendations enumerated in chapter 3 dealing with it reflect eerie similarities to BEPS as it is unfolding, including a suite of recommendations dealing, variously, with controlled foreign corporations (CFCs), transfer pricing, entitlement to treaty benefits, the interaction of domestic anti-abuse rules and doctrines in tax treaties, harmful tax practices, and tax havens, along with proposals for increased cooperation among tax authorities.

11 Group of Seven, "Economic Communiqué: Making a Success of Globalization for the Benefit of All," 1996 Lyons summit, June 28, 1996, at paragraph 16 (emphasis added).

12 See Organisation for Economic Co-operation and Development, *Towards Global Tax Co-operation: Report to the 2000 Ministerial Council Meeting and Recommendations by the Committee on Fiscal Affairs* (Paris: OECD, 2000); *The OECD's Project on Harmful Tax Practices: The 2001 Progress Report* (Paris: OECD, 2001); *The OECD's Project on Harmful Tax Practices: The 2004 Progress Report* (Paris: OECD, 2004); and *The OECD's Project on Harmful Tax Practices: 2006 Update on Progress in Member Countries* (Paris: OECD, 2006).

There is a notable correspondence between the OECD's 1991 and 1998 reports, including their underlying political impetus, language, and in 1998 the menu of possible action items,[13] and the two BEPS reports in 2013 and their G20 inspiration. With respect to the latter, the similarity is found, most recently, in a communiqué issued by G20 finance ministers and central bank governors at their meeting in Moscow in July 2013,[14] a leaders' declaration and action plan issued at the meeting of G20 leaders in St. Petersburg in September 2013,[15] and a communiqué issued by G20 finance ministers and central bank governors at their meeting in Sydney in February 2014.[16] This continuity with the BEPS project reflects consistent attention to base erosion, in terms that mirror the present BEPS work, on the part of the OECD and its members over at least two decades, extending even to how governments and the OECD conceive of how seemingly problematic issues should be resolved. In important respects, BEPS effectively consolidates more than 20 years of work that, with the benefit of the BEPS spotlight, can be seen to have its own inertia.

Although it might not have been apparent at the time, indications of the onset of BEPS can be found in a number of separate OECD studies on specific tax issues featuring prominently in the BEPS reports[17] and also, not surprisingly, in recent work on innovation and growth[18] and trade.[19] Moreover, it is not only the OECD and the G20 that are midwives to the rebirth of international taxation standards. The International Monetary Fund and the European Union, in particular, have become

13 See supra note 10.

14 Summarized and reported in Organisation for Economic Co-operation and Development, *OECD Secretary-General Report to the G20 Leaders*, St. Petersburg, Russia, September 5-6, 2013 (Paris: OECD, 2013), at annex 1, "G20 Communiqués."

15 Group of Twenty, "G20 Leaders' Declaration," St. Petersburg, September 6, 2013, and "St. Petersburg Action Plan," St. Petersburg, September 2013 (G20 documents cited herein can be found at www.g20.utoronto.ca). See also *OECD Secretary-General Report to the G20 Leaders*, supra note 14.

16 Group of Twenty, "Communiqué: Meeting of Finance Ministers and Central Bank Governors," Sydney, February 23, 2014.

17 These include, for example, Organisation for Economic Co-operation and Development, *Building Transparent Tax Compliance by Banks* (Paris: OECD, July 2009), *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (Paris: OECD, March 2012), *Aggressive Tax Planning Based on After-Tax Hedging* (Paris: OECD, 2013), and *Corporate Loss Utilization Through Aggressive Tax Planning* (Paris: OECD, 2011).

18 Organisation for Economic Co-operation and Development, *Supporting Investment in Knowledge Capital, Growth and Innovation* (Paris: OECD, 2013). See in particular chapter 2, "Taxation and Knowledge-Based Capital," which considers, among other things, cross-border tax planning in ways that intersect with BEPS and the OECD's continuing work on intangibles.

19 Koen D. Backer and Sébastien Miroudot, *Mapping Global Value Chains*, OECD Trade Policy Papers no. 159 (Paris: OECD, 2013).

actively engaged in aspects of this debate, undertaking their own studies.[20] In addition, various countries are responding in one manner or another to BEPS, including the government of the Republic of Ireland (to explain its income tax system in the BEPS context)[21] and the tax authorities of Australia[22] and the United Kingdom[23] (to present their respective governments' views on BEPS issues).

Even the Vatican has commented on issues of world economic order, closely associated with BEPS symptoms if not the actions themselves, that are perceived to threaten spiritual as well as social, economic, and political well-being.[24]

20 See International Monetary Fund, "Issues in International Taxation and the Role of the IMF," June 28, 2013 (www.imf.org/external/np/pp/eng/2013/062813.pdf); International Monetary Fund, "Consultation on Economic 'Spillovers' in International Taxation," February 12, 2014 (www.imf.org/external/np/exr/consult/2014/taxation); International Monetary Fund, *Global Prospects and Policy Challenges: Meetings of G-20 Finance Ministers and Central Bank Governors, February 22-23, 2014, Sydney, Australia* (Washington, DC: IMF, 2014); European Commission, "Speech: Fighting for the Single Market," Speech/14/119, February 11, 2014, by Joaquín Almunia, vice-president of the European Commission responsible for competition policy (http://europa.eu/rapid/press-release_SPEECH-14-119_en.htm); and European Commission, "Proposal for a Council Directive Amending Directive 2011/96/EU on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries of Different Member States," COM(2013) 814 final. See also commentary by Joe Kirwin, "Hybrid Loans, Letterbox Companies Targets of Proposal on EU Parent-Subsidiary Law" (2013) 22:15 *Tax Management Transfer Pricing Report* 911. In addition, the International Bar Association, among others, has drawn attention to larger social and economic policy issues related to BEPS: see International Bar Association, *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* (London: IBA, October 2013).

21 See Republic of Ireland, Department of Finance, *Ireland's International Tax Strategy* (Dublin: Department of Finance, 2014); and the policy paper by two Irish Finance and Revenue officials, Gary Tobin and Keith Walsh, "What Makes a Country a Tax Haven? An Assessment of International Standards Shows Why Ireland Is Not a Tax Haven" (2013) 44:3 *Economic and Social Review* 401-24.

22 See Australian Treasury, *Implications of the Modern Global Economy for the Taxation of Multinational Enterprises: Issues Paper* (Canberra: Australian Treasury, May 2013); Australian Treasury, "Tackling Base Erosion and Profit Shifting," *Media Release*, July 24, 2013; Australian Treasury, *Risks to the Sustainability of Australia's Corporate Tax Base: Scoping Paper* (Canberra: Australian Treasury, July 2013); and Australian Taxation Office, "Base Erosion and Profit Shifting," presentation by Deputy Commissioner Mark Konza, Macquarie University and Deloitte International Tax Forum, November 26, 2013 (www.ato.gov.au/Media-centre/Speeches/Other/Base-erosion-and-profit-shifting).

23 United Kingdom, HM Treasury and HM Revenue & Customs, *Tackling Aggressive Tax Planning in the Global Economy: UK Priorities for the G20-OECD Project for Countering Base Erosion and Profit Shifting* (London: HM Treasury, March 2014).

24 The Vatican, *Apostolic Exhortation Evangelii Gaudium of the Holy Father Francis to the Bishops, Clergy, Consecrated Persons and the Lay Faithful on the Proclamation of the Gospel in Today's World* (Rome: The Vatican, 2013), chapter 2.

THE BEPS ACTION PLAN—WHAT IS IN PLAY, AND WHERE DOES IT STAND?

The action plan represents an ambitious two-year, 15-point recalibration of international taxation principles and corresponding rules, including how to facilitate inter-nation collaboration and accommodations by tax authorities. It focuses in particular on the following concerns:

- jurisdictional issues presented by the earning of business income in the digital economy, and how that income would be allocated in relation to business presences (permanent establishments) in potential taxing countries somehow connected to the income or the taxpayers that earn it;
- the deductibility of payments that are not recognized in a timely manner, or at all, as income in other jurisdictions, including, but not limited to, tax effects arising from hybrid mismatch arrangements as a result of the imperfect intersection of characterization differences facilitated by countries' private-law and tax-law regimes;
- the adequacy and application of controlled foreign corporation (CFC) rules;
- harmful tax practices and treaty abuse; and
- substantive transfer-pricing issues, including, in particular, how to account for intangibles in the computation and allocation of international business income, as well as transfer-pricing documentation and the sharing among tax authorities of taxpayer information by country, to inform the understanding of those authorities of their taxpayers' business families,

as well as other matters to facilitate international tax coherence.

In some respects, the heavy lifting is only now under way, as substantive discussion drafts on various actions are being considered or being released. However, it is reasonable to infer that for actions with a September 2014 deadline—specifically, those dealing with the digital economy, hybrid mismatch arrangements, changes to the OECD model tax convention[25] to address treaty abuse (though recommendations concerning related domestic tax rules have a September 2015 deadline), transfer pricing and value-creation intangibles (but not "risks and capital" and "other high-risk transactions," which also have a September 2015 deadline), and transfer-pricing documentation—the period for reflection and consultation before firm recommendations must be decided will be short.

Much of the focus, so far, has been on general discussions concerning the BEPS action plan as a whole, with particular attention being directed to the OECD's continuing work on intangibles in the transfer-pricing context, which affects a number of the BEPS action items, and to a controversial action concerning how multinational businesses would be expected to acquaint tax authorities with a picture of

25 Supra note 3.

the global business circumstances in which a member operates by making a suite of information available to be shared with tax authorities according to a template for country-by-country (CbC) reporting.[26] To date, either as part of BEPS or in any event, the OECD has released a revised discussion draft on the transfer pricing of intangibles, work on which predates the BEPS initiative but is fundamental to it and affects as many as 7 of the 15 actions.[27] As well, the OECD has requested, with limited response, comments on the artificial avoidance of "permanent establishment" status (action 7). In July 2013, a white paper on transfer-pricing documentation[28] was released for comment; and importantly, in January 2014, the OECD released its discussion draft on transfer-pricing documentation and CbC reporting,[29] which has elicited a voluminous (though seemingly not entirely consistent) response from the business and advisory communities. In March 2014, the OECD released a BEPS consultation document on treaty abuse,[30] requesting comments on the adoption of specific limitation-on-benefits provisions in tax treaties and various other ways in which it may be made clear that treaties intrinsically are not and are not meant to be instruments of tax avoidance (that is, of double non-taxation). Most recently published are OECD discussion drafts on the tax challenges of the digital economy

26 *Action Plan*, supra note 4, action 13 ("Re-Examine Transfer Pricing Documentation"). See Organisation for Economic Co-operation and Development, *Discussion Draft on Transfer Pricing Documentation and CbC Reporting* (Paris: OECD, January 30, 2014) (available at www.oecd.org/tax/beps.htm) and the considerable number of responses to this discussion document posted on the OECD's website under "Taxation" and "Transfer Pricing."

27 Organisation for Economic Co-operation and Development, *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles* (Paris: OECD, July 30, 2013); and *Action Plan*, supra note 4, actions 8 ("Intangibles"), 9 ("Risks and Capital"), and 10 ("Other High-Risk Transactions") in particular. Other actions also touch on transfer pricing in one way or another and might be said to be particularly concerned (even if this is not stated directly) with the effects of intangibles, including how they arise and how they are deployed; see action 6 ("Prevent Treaty Abuse"), action 7 ("Prevent the Artificial Avoidance of PE Status"), action 12 ("Require Taxpayers To Disclose Their Aggressive Tax Planning Arrangements"), and action 13 ("Re-Examine Transfer Pricing Documentation"). It is notable, and noted (as the comments in this article reflect), that these actions, among the others, all touch on aspects of the source of income, including determining where that source is and whether, as a result, a business presence exists, and then providing sufficient tax reporting to allow this determination to be made and verified. Notions threading through these actions are also found in or underlying the discussion in the OECD's *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles*, supra.

28 Organisation for Economic Co-operation and Development, *White Paper on Transfer Pricing Documentation* (Paris: OECD, July 30, 2013).

29 *Discussion Draft*, supra note 26.

30 Organisation for Economic Co-operation and Development, *BEPS Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* (Paris: OECD, March 14, 2014). It is interesting to compare the approach taken by the Canadian Department of Finance in its consultation paper on treaty shopping: see Canada, Department of Finance, *Treaty Shopping—The Problem and Possible Solutions* (Ottawa: Department of Finance, August 12, 2013).

and hybrid mismatch arrangements, relating to two prominent BEPS actions.[31] Each, in its own way, is concerned with where income should be considered to arise—in other words, its source—in the face of complex arrangements, in both legal and commercial terms, that test the utility and reliability of longstanding jurisdictional norms.

BEPS IS ABOUT SOURCE

Even though the substantive development of the BEPS actions is just taking shape, it is not premature to observe that, fundamentally, BEPS is about the source of income. In one way or another, all of the actions have and, on reflection, must have this orientation. Whether the concern is with how commerce in the digital economy affects where business profits should be considered to be earned, how different legal characterizations of taxpayers and transactions (hybridity) affect the existence and recognition of income, intermediation via tax treaties effectively to "re-source" or change the character of income, or transfer pricing to address how income associated with intangible contributions by members of multinational businesses should be compensated, the inherent common issue is where income should be considered to be earned in light of changing patterns of business, and how that determination can reliably be made.

Though the question at the centre of BEPS is really not more complicated than this, because source is so elemental to income taxation, the issue is in fact very complicated, multifaceted, and intricately textured. Not unlike many things that we do for a long time without thinking much about how or why we do them, it turns out that we may not actually know what "source" really means, if we ever did. BEPS confronts us with a relief map—a stark awareness—of how economic elements embedded in transactions seemingly can be and have been unlocked by not particularly sophisticated applications of private law and prescriptive tax law, so as to permit, if not direct, "income" to be "somewhere" for tax purposes other than where it might be expected to be, regardless of what many may accept to be "inevitable" legal outcomes.

As a key, if not possibly the, latent engine of BEPS, source is not very exotic—much less so than the vigorous discussion enlivened by tales of multinational tax planning might suggest. But source *is* at the heart of income taxation and international taxation generally, and percolates beneath and through all the BEPS action plan initiatives and the apparent concerns to which they are directed.

How should the source of income be determined, taking into account various private-law notions that affect the transmission of value between economic actors in different places and therefore between the countries—the tax jurisdictions—that

31 See Organisation for Economic Co-operation and Development, *Public Discussion Draft BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)* (Paris: OECD, March 19, 2014), and *Public Discussion Draft BEPS Action 1: Address the Tax Challenges of the Digital Economy* (Paris: OECD, March 24, 2014).

host them and their income-earning opportunities? We have tended not to think about this very much; perhaps, absent the sorts of corporate tax planning with which the BEPS initiative is so closely identified, there has not been—or at least perceived to be—a need. After all, there is no overarching principle or convention by which the source of income should be determined, and certainly no imperative enforcing any particular approach. To paraphrase the observation of a renowned international tax scholar, expressed in informal conversations and reflected in his writing, "There is no natural law of source."[32] Indeed, countries take different approaches: some, like the United States, adopt complex statutory and regulatory frameworks; others, like Canada, rely on a much less prescriptive approach that more or less takes its cue from inferences drawn from how income-earning activities observably take place and the connotations of parties' legal rights and obligations as determined by the general law and by the contracts between these parties.

The fundamental BEPS question is whether prevailing uncoordinated legal conventions by which the taxable presence and scope of income-earning contributions typically would be determined not only are outmoded but in fact facilitate the "resourcing" of income and changes of its character, as seen and understood according to the parameters of tax regimes. A particular example is, possibly, whether and how intangible manifestations of value may be separated from other elements of business transfers according to intrafirm contracts that determine where entrepreneurial entitlement is owned and risk undertaken.

BACK TO BASICS

This is hardly our first awareness that in the absence of a world tax order or a world tax authority, opportunities exist to limit business costs attributable to taxation while (and in any event as the OECD is apparently prepared to assume) ostensibly operating entirely within the expectations of countries' laws—laws that do not coincide and have no particular reason to do so. This creates an even more significant international economic problem to the extent that it engenders irresistible competitive pressure on businesses to capture available tax-induced cost savings—in effect, as bottom-line returns—or risk falling behind their competitors.

There is a heightened awareness, to which the BEPS initiative contributes by making this awareness impossible to avoid, that countries' private-law regimes, which supply the legal infrastructure for business organization and the plumbing for transactions in goods and services, and countries' tax regimes do not necessarily align, intersect with, or anticipate each other systematically, constructively, or even well. Perhaps more to the point, there is no particular reason why they should or why we should expect that they would, despite various conventions modelled and

32 I attribute this comment to Professor Emeritus Hugh Ault of Boston College, a leading commentator on international tax matters and the work of the OECD.

guidance provided by supranational organizations such as the OECD, which offer a framework for international fiscal comity that commonly also is taken into account by and often reflected in countries' domestic tax laws.

As the OECD's 2013 BEPS reports reflect, modern principles, conventions, practices, and rules associated with international taxation arose effectively for this reason (that is, because of the disjunction between private law and tax law) in the early part of the 20th century when tax work sponsored by the League of Nations was directed to rationalizing and abridging the coincident application of countries' taxation of income and taxpayers who, and the income-earning activities of whom, straddled political borders and geographic expanses.

It is important to note that the league's contribution was not altruistic, nor did it anticipate the harmonization of countries' tax regimes, although certain enduring expectations about—or possibly norms for—the ways in which countries' tax systems should engage with each other without colliding did result and are more or less intact even today.[33] In a world without compelling normative international tax standards, there were at least two principal reasons why countries might limit the exercise of their fiscal sovereignty—or, to put it a little differently, why they might exercise that sovereignty by in fact not exercising it in order to advance their economic self-interest. One reason was to mitigate trade impediments arising from excessive or (as it is more casually expressed) duplicative or double taxation. The other reason was to recognize that countries, as fiscal sovereigns, are entitled to, and will, make and fund institutionally "personal" economic choices particular, if not unique to, each of them, and in so doing spend their fiscal resources as currency, along the way effecting what amount to inter-nation "bargains" for reciprocal and mutual advantage (or, possibly,

33 International taxation largely concerns the income tax. This is reflected in tax treaties, and in deliberate and to some extent arbitrary choices made when model tax treaties were in gestation. (See, for example, John F. Avery Jones, "The David R. Tillinghast Lecture: Are Tax Treaties Necessary?" (1999) 53:1 *Tax Law Review* 1-38, John F. Avery Jones, "Problems of Categorising Income and Gains for Tax Treaty Purposes" [2001] no. 5 *British Tax Review* 382-99, and John F. Avery Jones, "The History of the United Kingdom's First Comprehensive Double Taxation Agreement" [2007] no. 3 *British Tax Review* 211-54, to appreciate some of the factors and history at play in devising treaties' distributive rules and notions of origin and entitlement, associated with source and residence, respectively, that are so important to international taxation as we understand it.) We separate how we tax income and allocate taxing regimes among countries—the legitimacy and scope of countries' tax claims and how they compete with each other—according to where taxpayers exert themselves to earn income—that is, where income-earning activities *of the taxpayer* take place. In short, we distinguish between active and passive (investment or portfolio) income in relation to how a taxpayer earns it. This division is the basic building block for distributive rules in tax treaties, taxation of inbound investment (from carrying on a local business or earning a return subject to withholding tax), and taxation of outbound investment, including the degree to which foreign tax recognition by credit or otherwise offsets domestic taxation of foreign income and the architecture of CFC and offshore investment entity rules widely present in countries' tax regimes.

in order to at least avoid reciprocal and mutual disadvantage) while still satisfying their economic self-interest.[34]

It is also important to note, as the OECD's current work reflects, that formerly there were "natural" jurisdictional barriers on which tax systems effectively could rely to determine where income was earned, because of how trade took place and in fact how it could only take place. Trade was physical; means of communication were limited or cumbersome, and even until relatively recently, could be relied on to have certain geographic connections familiar to tax systems. Those connections are now much less clear because of what the OECD refers to in action 1 as the "digital economy" or the effects of intangibles as contemplated by the OECD principally in actions 8, 9, and 10. There was much less capacity, or indeed propensity, to subdivide "bundles" of transferred value into their tangible and intangible components. In short, formerly transactions were more likely to be what they appeared to be, and to have been undertaken by the parties ostensibly participating in them; source rules and conventions tended to reflect the characteristics of those observable transactions and to be consistent with the typical expectations of their legal forms. Distortions in the expected allocation of income and tax base shared among countries were cruder, but likely corresponded more closely to the expectations of tax treaties' distributive rules—a barometer of international consensus on these sorts of issues—and, for intrafirm transactions, seemingly could be addressed by the most commonly applied comparative methodologies that enlivened transfer pricing's arm's-length standard. In short, in a manner of speaking, source could take care of itself.

REFOCUSING ON THE MEANING OF "SOURCE"

The BEPS actions in one way or another are deliberately reaching out for "new" source conventions that emphasize the significance of observable business activity "of a taxpayer" "in a place" so as necessarily to result in commensurate meaningful income taxation "somewhere." This brings together a number of the BEPS notions, including how to evaluate contributions of or to intangibles in a transfer-pricing context, the amplification of anti-abuse tenets of tax treaties (that is, the prevention of double non-taxation, a deliberate focus of BEPS that previously was more often a subject of academic conversation) that the OECD clearly believes are already woven into the fabric of treaties, and whether and to what extent through the digital economy taxpayers have constructive business presence where typical "physical" or digital products and services are sold.

Faced with the improbable alternative of harmonizing countries' private-law and tax-law rules to address BEPS concerns, the BEPS inquiry instead focuses on the nature of income and how it is earned, to guide reasonable inferences about where income

34 See J. Scott Wilkie, "An International Fiscal Revolution in the Making? Some Musings on Tax Policy and Its Economic Foundations," University of Calgary School of Public Policy blog post, September 26, 2013.

should be considered to have its source cognizable in terms of how tax systems would, at least in the first instance, make such a determination. This focus is particularly acute for intrafirm income in a transfer-pricing context, where the OECD's recent work has perhaps been the most penetrating, venturing to consider how income is earned regardless of any legal or accounting preconceptions about where, otherwise, it might be said by group members to be earned according to the formulation of transfers and therefore accounted for jurisdictionally.[35] If it is not possible to establish a world tax order by legal design, the next best, or perhaps at least the most

35 See *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles*, supra note 27. The commentary underlying actions 8, 9, and 10 is particularly important. In a paragraph beginning with the sentence "Alternative income allocation systems, including formula based systems, are sometimes suggested" (*Action Plan*, supra note 4, at 20), the OECD adverts to the possibility that departures from transfer pricing's arm's-length principle as it has typically been understood may be required via "special measures" that may or may not be accommodated by that principle, to address "intangible assets, risk and over-capitalisation" with reference to flaws in transfer pricing. This, of course, directly implicates determinations about the source of income and resulting tax jurisdiction. This statement has been controversial, since it may be seen to invite by name or design the adoption of formulary methods to apportion income among tax jurisdictions, although the OECD has indicated throughout this process that the arm's-length principle remains the guiding approach for transfer pricing. Even so, particularly as the arm's-length principle applies generally to profit splits and comparisons according to the OECD transfer-pricing guidelines, supra note 3, and particularly in respect of intangibles it may be that the significance, meaning, and application of that principle has changed. See J. Scott Wilkie, "Reflecting on the 'Arm's Length Principle': What Is the 'Principle'? Where Next?" in Wolfgang Schön and Kai A. Konrad, eds., *Fundamentals of International Transfer Pricing in Law and Economics* (Berlin: Springer, 2012), 137-58; Scott Wilkie, "The Definition and Ownership of Intangibles: Inside the Box? Outside the Box? What Is the Box?" (2012) 4:3 *World Tax Journal* 222-48; J. Scott Wilkie, "Intangibles and Location Benefits (Customer Base)," *Bulletin for International Taxation: BEPS Special Issue* (forthcoming); and Robert Couzin, "Policy Forum: The End of Transfer Pricing?" (2013) 61:1 *Canadian Tax Journal* 159-78. See a series of papers by M.C. Durst concerning formulary apportionment, the most recent and last of which is *Analysis of a Formulary System, Part VIII: Suggested Statutory, Regulatory Language for Implementing Formulary Apportionment*, Tax Management Transfer Pricing Report 2014, Bloomberg BNA (April 29, 2014); the others may be found in the following issues of Tax Management Transfer Pricing Report, Bloomberg BNA: part I, May 16, 2013; part II, June 27, 2013; part III, September 5, 2013; part IV, October 17, 2013; part V, November 28, 2013; part VI, January 23, 2014; and part VII, March 20, 2014. The question of formulary apportionment has arisen in the BEPS context through observations focused in particular on the reference to "special measures" in the preamble commentary to actions 8, 9, and 10, foreshadowing situations in which typical transfer-pricing methods—that is, the common approach to transfer pricing's arm's-length principle—may not be sufficient to deal with some of the most difficult pressures on international income allocation among members of global businesses: "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 [that is, flaws in the current system in dealing with these concerns]" (*Action Plan*, supra note 4). In this connection, see, for example, R. Mitchell, *OECD Discussions on Special Measures Still in "Very Early Stages," de Ruiter Says*, Tax Management Transfer Pricing Report 2014, Bloomberg BNA (April 9, 2014).

practical, alternative might be to adopt common standards or expectations concerning the most fundamental notion underlying all income tax regimes—namely, what it means to "earn" income—which inevitably coincides with establishing the source of that income, standards that are agnostic to the interests and features of any particular tax or legal system, but in a manner of speaking are conceptually universal to all of them.

There are indications that BEPS in its various guises has this outlook. In one way or another, BEPS is concerned with detecting and evaluating whether and how income associated with identifiable productive sources—economic, geographic, qualitative, and "legal" sources objectively determined by reference to relevant factors of production, and not merely according to the seeming dictates of contracts—is by force of circumstance or convention being diverted from those intrinsic sources to the detriment of countries that actually host those sources, possibly abetted by countries' fiscal and tax policy formulated to advance their own national economic objectives, including via the medium of their taxpayers, as is commonly associated with tax competition.[36] Put more positively, as the work to date on CbC reporting reflects, the OECD's and G20's emphasis seems to be on where observable business and commercial activities take place, with reference to not particularly arcane measures of business presence such as the involvement of employees, the location of sales, the deployment of assets, and the like.[37]

Is this merely surmise, or are there objective indications, even apart from BEPS, that this is a continuing and consistent focus that has merely been sharpened by BEPS? There seems to be clear enough evidence that functional analysis, akin to that familiar in a transfer-pricing setting but unlimited by legal or accounting rules or conventions, is the expected foundation for determining where income will be considered to be earned—in other words, its source—and that this is the tax notion being renovated by BEPS.

It may seem strange that the determination of source would be disconnected from the kinds of legal standards and accounting guidance that typically inform how source is conceived by a tax system. Yet, as noted earlier, there is no necessary "law of source"; approaches to determining where income is earned, whether prescriptive or otherwise, tend to be developed in response to how transactions are seen to actually take place, subject, of course, to supervening tax policy considerations that modify these otherwise unadulterated outcomes for particular fiscal and tax policy reasons. Put slightly differently, functions (including actual functions associated with capital formation and risk bearing), understood with reference to the forms in which they take place or otherwise are manifest, are already more or less the basis even of the source rules and conventions that we typically rely on. It would not be terribly surprising then, particularly given the absence of normative conventions, if source rules were recalibrated from time to time to take account of changing business

36 See generally the commentary by Wilkie, supra note 34.

37 See *Discussion Draft on Transfer Pricing Documentation and CbC Reporting*, supra note 26.

and commercial influences that affect whether and to what extent those rules accurately capture how income is actually earned—not only according to agnostic commercial, accounting, and legal standards, but also with reference to how businesses are actually organized and operate despite compliance with legal forms of business organization and transactions. However, relegating traditional legal factors or accounting conventions to a subordinate but clearly not irrelevant role[38] is not necessarily a subjugation of taxation to unlimited dictates of "substance." Source rules did not simply spring from nowhere. Lacking, as noted, a normative imperative, in one way or another they always have been influenced by substance, aided or validated by the implications of discernibly relevant legal form, which not surprisingly often tended to align with "substantial" connotations of how income was earned.

A recent indication in already developed OECD tax policy of the increasing significance of functions in determining where income is earned can be found in the reliance on "people functions" to attribute business profits, under article 7 of the model tax convention, to a permanent establishment in accordance with the "accepted OECD approach" set out in the OECD's July 2010 report on the attribution of profits to permanent establishments.[39] Generally, that report adopted the OECD's transfer-pricing guidance for this purpose, and specifically adverted to the relevance of people functions—people being where they are and where they need to be to facilitate the earning of business income—even in situations where risk is being evaluated and managed.[40] It is notable, in gauging Canada's likely reaction to the BEPS action plan, that Canada has adopted this approach for applying its tax treaty with the United States.[41]

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38 See generally *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles*, supra note 27. In its intangibles work and also in chapter IX of the OECD transfer-pricing guidelines, supra note 3, the OECD reflects its general respect for contracts, though only as a starting point for the more involved transfer-pricing analysis that focuses on contributions to income earning made by members of a multinational firm, albeit within the ambit of the methodological approaches set out in chapters I to III of the guidelines that enliven the arm's-length principle; see, in particular, the draft revision of chapter VI of the guidelines in the *Revised Discussion Draft on Transfer Pricing Aspects of Intangibles*, supra, at paragraphs 65, 73-81, and 90. See also Wilkie, "Intangibles and Location Benefits (Customer Base)," supra note 35.

39 Organisation for Economic Co-operation and Development, *2010 Report on the Attribution of Profits to Permanent Establishments* (Paris: OECD, July 22, 2010).

40 Ibid., notably, for example, at paragraphs 14-17, 62, and 68 (including how this sort of analysis applies to risk, with the expectation that being responsible for risk entails being more than contractually responsible and contemplates having the actual resources and facilities to evaluate and manage the assumption of that risk).

41 See paragraph 9 of Diplomatic Notes to Fifth Protocol (Annex B), 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; and "Canada-U.S. Income Tax Convention—Agreement Between Competent Authorities on the Interpretation of Article VII (Business Profits)," agreed June 26, 2012 and announced on July 19, 2012 (www.cra-arc.gc.ca/tx/nnrsdnts/ntcs/cndntdstts-cmptntgrmt-2012-eng.html).

Another indication is found in the most recent revision of the OECD's discussion draft on intangibles, which notably takes on the formidable task of addressing varieties of so-called soft intangibles that uniquely complicate the parsing of where income of a multinational firm is earned and how it would be attributed to the members of that firm. There is a clear and seemingly deliberate focus on where members of multinational businesses make observable and substantial contributions to the earning of group income, even within the "separate entity," transaction-based transfer-pricing paradigm.[42] A collateral but important point is whether and how the members of a multinational firm use their own resources to make contributions commensurate with the income that they ostensibly derive or possibly should derive. The emphasis, in other words, is on the functional source of income. Pointedly, an evaluation of transfers of intangible value is not to be limited or indeed defined by legal standards or accounting conventions of the sort that likely have been pertinent to establish the source of income.[43] The transfer-pricing exercise here is, essentially, addressing source.

Finally, the encouragement of the BEPS initiative by the G20 reflects a noticeable expectation that income will come to rest jurisdictionally where it is functionally earned. As earlier comments in this article reflect, there is a strong connection in the G20's institutional mind between attending to the accurate determination of the source of income and the mobility of certain kinds of income typically associated with financial assets and intangibles. The G20 finance ministers and central bank governors said in their July 2013 Moscow communiqué:

> We acknowledge that effective taxation of *mobile income* is one of the key [BEPS] challenges. *Profit should be taxed where functions deriving the profit are performed and where value is created*. In order to minimize BEPS we call on member countries *to examine how our own domestic laws contribute to BEPS* and to ensure that international and our own tax rules do not allow or encourage multinational enterprises to reduce overall taxes paid by artificially shifting profits to low-tax jurisdictions.[44]

The G20 leaders repeated this sentiment at their September 2013 St. Petersburg meeting, saying in their Declaration:

> *Profits should be taxed where economic activities deriving the profits are performed and where value is created*. In order to minimize BEPS, we call on member countries *to examine how our own domestic laws contribute to BEPS* and to ensure that international and our own tax rules do not allow or encourage multinational enterprise to reduce overall taxes paid by artificially shifting profits to low-tax jurisdictions. *We acknowledge that effective taxation*

42 See supra note 35, and the discussion in *Action Plan*, supra note 4, at 20, relating to "special measures" preceding action 8.

43 See supra notes 38 and 40.

44 G20, "Communiqué: G20 Meeting of Finance Ministers and Central Bank Governors," Moscow, July 20, 2013, at paragraph 18 (emphasis added).

> *of mobile income is one of the key challenges*. We look to regular reporting on the development of proposals and recommendations to tackle the 15 issues identified in the Action Plan and commit to take the necessary individual and collective action with the paradigm of sovereignty taken into consideration.[45]

Most recently, at their February 2014 meeting in Sydney, the G20 finance ministers and central bank governors amplified their Moscow commitment and that of their countries' leaders in St. Petersburg, with this undertaking in their communiqué:

> We are committed to a global response to Base Erosion and Profit Shifting (BEPS) based on sound tax policy principles. Profits should be taxed where economic activities deriving the profits are performed and where value is created. We continue our full support for the G20/OECD BEPS Action Plan, and look forward to progress as set out in the agreed timetable. By the Brisbane summit [in 2014], we will start to deliver effective, practical and sustainable measures to counter BEPS across all industries, including traditional, digital and digitalised firms, in an increasingly globalised economy.[46]

This is ample evidence, not only that source is to be seen in functional terms, but that fundamentally the BEPS project is concerned with assigning the source of income to countries where meaningful, observable contributions to the earning of income take place.[47]

However, for source rules and conventions to accommodate the BEPS direction, it may be insufficient to express only aspirational guidance about where income is earned. As the G20 finance ministers and leaders themselves recognize, countries may need to change their laws to give effect to this guidance and its underlying objectives. This observation may be made about a number of the BEPS actions.[48] It potentially also sheds light on a secondary but substantial potential hurdle to the achievement of a number of the BEPS objectives. Determining the source of income, for example, is critical to the ability to determine whether and to what extent tax treaties apply effectively—that is, whether there is taxation "in accordance with" a tax treaty, and if the answer to this question is negative, whether taxation not in accordance with the treaty can be resolved through a mutual agreement procedure. Fundamental to both those determinations is whether taxation is correctly asserted in the first place under a treaty partner's domestic tax law, a question that most importantly entails determining the source of assessed income and a treaty partner's entitlement within its law to actually make the tax claim.

45 "G20 Leaders' Declaration," supra note 15, at paragraph 50 (emphasis added).

46 G20, "Communiqué," supra note 16, at paragraph 9.

47 See, for example, Backer and Miroudot, supra note 19.

48 See Wilkie, "The Definition and Ownership of Intangibles," supra note 35, and "Intangibles and Location Benefits (Customer Base)," ibid. While these articles address the OECD's work on intangibles, the comments therein concerning the need to activate guidance in countries' relevant law, even if this requires legislative change, are apt here.

There is another consideration with a similar flavour that has been described by a noted Canadian tax commentator as a "first mover" problem.[49] The essence of BEPS, as action 15 concerning a multilateral convention reflects, is the adoption of consistent standards by countries to mitigate base erosion and, presumably, to be able to enforce those standards in relation to each other as well as to taxpayers. This foreshadows a not insignificant need for contemporaneous reactions by countries, which may, for various reasons, be difficult to achieve, particularly if a legislative response is required or tax treaties or their application need to be somehow modified. These challenges are compounded where, as with determining the source of income, important legal questions arise that involve both private-law and tax-law considerations.

TAKING STOCK: A CONCLUDING COMMENT

The OECD's work plan is clear, and discussions have begun within the 15-point framework of the action plan to address particular substantive concerns. The best and the most intense debate, however, is yet to come. Within the next few months, an opportunity will be presented to consider a kaleidoscope of the OECD's analysis of key actions as discussion drafts are presented and commentators engage with the OECD and with each other to consider that analysis.

That said, we do not have to wait to anticipate how the actions may unfold. Fundamentally, the action plan is concerned with reorienting how the source of income is determined. According to the premises of the action plan, this necessarily includes excising unwarranted effects of intermediation between the owners of income and its source, whether these effects arise from the imperfect intersection of countries' private law and tax law, through reliance, for example, on various manifestations of hybridity, from the transfer-pricing practices associated with intangibles, or from arrangements that allow treaties to be invoked where relevant jurisdictional connections are slight.

It is appropriate, as a final thought, to consider where Canada fits in the BEPS world. Key BEPS themes include hybridity and other harmful tax practices; income shifting and domestic base erosion through deductions and CFC (foreign affiliate) rules that abet the erosion of other countries' tax bases without timely (if any) taxation of the eroded income; tax reporting; treaty abuse; and business conducted through digital transactions. It is notable that Canada has taken considered action in all of the BEPS categories, even before the commencement of the BEPS project.

Canada's actions are not altruistic, though no doubt they do take account of expectations that Canada might have of other countries in return. As even the G20 finance ministers and leaders have noted, countries will make their BEPS determinations as sovereigns—collaborative and cooperative sovereigns perhaps, but sovereigns

49 Robert Couzin mentioned this most recently in his remarks as a panel member at a joint seminar sponsored by the International Fiscal Association (Canadian branch) and the Canadian Tax Foundation in Calgary, February 3, 2014, and Toronto, February 5, 2014.

nonetheless. It is recognized that countries develop their tax policy in a larger public economic context, considering how to calibrate tax rules to address important revenue threats and to assist in the achievement of national economic objectives. In other words, a country will pay attention to what matters to it, carefully evaluate important economic and fiscal developments at home and internationally as they may affect its economic course and prospects, and respond accordingly—though not in the same way, necessarily, as would other countries facing their own pressures, possibly activating different economic interests according to their priorities, and operating within different legal regimes.

There is every indication that Canada has been addressing BEPS issues for some time. Several examples suffice to make this point.

Recently, Canada has adopted a targeted response to "foreign tax credit generators" and income-timing and character-transformation arrangements. Together with the important addition of articles IV(6) and (7) to its tax treaty with the United States,[50] Canada has addressed elements of hybridization and flowthrough that it considers important to the integrity of its tax base, including changes to the computation of partnership income and the relevant expenses to be taken into account in the thin capitalization calculation.

Since the mid-1990s, other elements of the foreign affiliate regime (including the deployment of taxable surplus via upstream loans, rules applicable to loans made by Canadians to non-residents, and the thin capitalization rules) have been amended to address aspects of base erosion—that is, to confine certain tax effects within an intended and increasingly well-defined scope that anticipates, for example, the need for substantial degrees of ownership of or involvement by Canadian taxpayers in offshore interests to fully benefit from the territorial effects of the foreign affiliate regime, but also limits the benefits of that system for income that within its terms has a Canadian source where those benefits would inure to non-residents without a commensurate Canadian business or economic interest or presence. One of the most profound limitations on base erosion recently introduced by Canada, which indirectly affects the deductibility of expenses associated with the earning of foreign income but more generally mitigates the appropriation of Canadian tax base by non-residents, is the enactment of the foreign affiliate dumping regime, which in many respects is simply an extension of pre-existing but more limited anti-base-stripping limitations.

These changes, which continue to be refined, correspond to various BEPS actions, including those directed to CFC rules, harmful tax practices, overstatement of deductions, and the like. Key to some of these rules is business functionality, which in certain cases provides relief from limitations for demonstrable business activities consistent with adopted legal form where it can be determined objectively that undue base erosion does not take place and potential national economic benefits exist; a case

50 Supra note 41.

in point is how the foreign affiliate base erosion rules operate as they are changing, particularly, to accommodate how Canadian banks operate internationally.

Canada undertook a considered study of the effects of electronic commerce (reincarnated now as "the digital economy" in the BEPS context) on taxation in the 1990s, and at present is considering treaty shopping, touching at least two of the key BEPS actions. Canada (which, in any event, has undertaken its own examination of treaty shopping, shaped somewhat differently than the OECD's) has experience with the kinds of treaty benefit limits contemplated in the OECD's March 14, 2014 discussion draft on treaty abuse,[51] in the Canada-US tax treaty, and to a lesser extent in a number of Canada's other tax treaties where benefit limitations are expressed more directionally. And, at least since the mid- to late 1990s, Canada has had in place and has continued to refine robust foreign, as well as specific transfer-pricing, reporting regimes that have recently been extended with respect to portfolio investments by Canadian residents.

This list could be extended. The point of noting these examples is to recognize that as we take stock of BEPS, Canada has already taken stock of many of the factors raised by the BEPS project in relation to its national economic, fiscal, and tax interests.

51 *BEPS Action 6*, supra note 30.

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Personal Tax Planning

Co-Editors: Pearl E. Schusheim* and Gena Katz**

TAX COLLECTION: THE RISK OF LESS THAN FAIR MARKET VALUE PROPERTY TRANSFERS

*Paul K. Grower****

ABSTRACT

This article reviews recent and pertinent case law in respect of one of the more powerful collection tools granted to the Canada Revenue Agency (CRA) under subsection 160(1) of the federal Income Tax Act and subsection 325(1) of the federal Excise Tax Act. These provisions extend the collection powers of the CRA beyond the tax debtor, allowing it to potentially pursue any non-arm's-length transferee who has received property from the tax debtor, by making the transferee jointly and severally liable for the tax debtor's debt. The willingness of the CRA to utilize this power, and the very real risk that taxpayers may unwittingly become caught in its grasp, merit a review of these provisions and the recent and relevant case law. The article provides guidance on the breadth and possible limits of the provisions, with a focus on their implications for individuals and for owner-managers of private corporations.

KEYWORDS: ASSESSMENTS ■ TAX COLLECTIONS ■ PAYMENTS ■ TRANSFERS ■ TAX LIABILITY

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Planification fiscale personnelle

Co-rédactrices de chronique : Pearl E. Schusheim* et Gena Katz**

RECOUVREMENT DE L'IMPÔT ET RISQUE DU TRANSFERT D'UN BIEN À UNE VALEUR INFÉRIEURE À LA JUSTE VALEUR MARCHANDE

*Paul K. Grower****

Le présent article passe en revue la jurisprudence récente portant sur l'un des outils les plus puissants accordés à l'Agence du revenu du Canada (ARC) en vertu du paragraphe 160(1) de la Loi de l'impôt sur le revenu fédérale et du paragraphe 325(1) de la Loi sur la taxe d'accise fédérale. Ces dispositions étendent les pouvoirs de recouvrement de l'ARC au delà du débiteur fiscal, en offrant au fisc la possibilité de poursuivre tout bénéficiaire avec lien de dépendance qui a reçu le bien du débiteur fiscal, en le rendant solidairement responsable de la dette fiscale de ce dernier. La volonté de l'ARC d'utiliser ce pouvoir et le risque très réel que les contribuables tombent involontairement dans ses filets justifie un examen de ces dispositions et de la jurisprudence récente pertinente sur le sujet. L'article contient des indications sur la portée et les limites possibles de ces dispositions, en insistant sur leur incidence pour les particuliers et propriétaires-dirigeants de société privée.

MOTS CLÉS : COTISATION ■ RECOUVREMENT DE L'IMPÔT ■ PAIEMENT ■ TRANSFERT ■ OBLIGATION FISCALE

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Selected US Tax Developments

Co-Editors: Peter A. Glicklich* and Michael J. Miller**

SNOWBIRDS FLYING BLIND: BEWARE THE US RESIDENCE TRAP

*Michael J. Miller***

The US tax rules are extraordinarily complex, and they include many unwelcome surprises. One such surprise arises when an alien discovers that he or she has unwittingly become a US resident. An alien's unexpected status as a US tax resident may give rise to substantial tax liabilities and, worse yet, exposure to life-altering penalties. This article discusses the US residence trap and its application to Canadian snowbirds.

KEYWORDS: UNITED STATES ■ RESIDENCE ■ RESIDENT ■ TREATY ■ PENALTIES

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1 With apologies to Canadian readers, in the context of this article, the term "foreign" means non-US.

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Current Tax Reading

Co-Editors: Bev Dahlby, Tim Edgar, Jinyan Li, and Alan Macnaughton*

Alex Himelfarb and Jordan Himelfarb, eds., *Tax Is Not a Four Letter Word: A Different Take on Taxes in Canada* (Waterloo, ON: Wilfrid Laurier Press, 2013), 293 pages, ISBN 978-1-55458-832-9

Richard Swift, ed., *The Great Revenue Robbery: How To Stop the Tax Cut Scam and Save Canada* (Toronto: Between the Lines, 2013), 159 pages, ISBN 978-1-77113-103-2

The political history of Anglo-American democracies over the past three decades is defined by the rising influence of neoconservative ideology in framing national policy, beginning with the Thatcher-led Conservative Party in the United Kingdom and the Reagan-led Republican Party in the United States. Neoconservatism has come to dominate political discourse in both of those countries, as well as—though perhaps more subtly—in Canada. A key message of this version of neoconservative politics is the need to reduce the size and involvement of government in the lives of citizens, in favour of an increased role for private markets, and a critical element of that message is the need to reduce taxes. To realize this result, taxes are relentlessly characterized as dampening economic growth that would otherwise be generated by the private sector, without providing a sufficient offsetting benefit. The political imperative thus becomes the need to deliver tax cuts.

The two collections of papers that are the subject of this review provide an important counterweight to the dominance of the neoconservative message in Canada. The principal point of emphasis is the importance of public goods and services desired by Canadians and the need to increase revenue through increased levels of taxation for reinvestment in these goods and services.

Tax Is Not a Four Letter Word consists of 13 papers, along with an editors' introduction and a brief conclusion. The editors are refreshingly candid in acknowledging up front that they have made no attempt to be even-handed and provide a forum for the anti-tax/anti-government policy agenda. They have instead brought together this set of papers advocating a more balanced public policy debate on taxes through a renewed emphasis on the need for taxation and, in particular, on what taxes purchase.

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The editors concede that the contributors disagree on many important issues, such as the desirable mix of taxes, whether tax levels should increase, or whether tax reforms should be revenue-neutral. Irrespective of these kinds of disagreements, the editors are certainly correct in emphasizing that the contributors (and the editors themselves) agree that Canadians need to have a more balanced public conversation about taxes focused on the consequences and costs of tax cuts.

The papers are organized thematically in four parts. The first and third parts are devoted, respectively, to an examination of issues of public finance generally and tax reform more specifically. The second and fourth parts focus on the politics of the public policy debate about taxes in Canada.

The five papers in part one are grouped under the heading "The Conversation Today." The first paper is written by Jim Stanford, a well-known economist with the former Canadian Auto Workers union (now part of a merged labour organization under the name Unifor). Stanford presents an overview of the economic consequences of taxation and spending policies, emphasizing the positive effects for growth that well-designed policies can provide. He argues that the empirical evidence supports the intuitively obvious link between wise public spending and economic growth, and therefore the need for sound taxation policies to support this link. The second paper, by the public finance academic Robin Boadway, describes the increasing decentralization of tax and spending in Canada, and the consequences of this trend for the ability of the federal government to promote national objectives. Among his set of policy recommendations, one of the more intriguing is that the provinces should vacate the corporate income tax and that a cash flow tax should be adopted at the federal level as a means to tax economic rents. As Boadway points out, the impact of a cash flow tax would be most pronounced for, though not limited to, the resource sector. Following the papers by Stanford and Boadway are two separate but related papers by another well-known economist, Hugh Mackenzie. The first of Mackenzie's papers describes how political discussion of taxes in Canada occurs in a vacuum, with the taxation decision being separated from the spending decision and, in particular, from the goods and services for which tax revenues can be used. The second paper follows logically from the first; it surveys the benefits that taxes purchase in Canada and what is lost when taxes are reduced. The last paper in part one, by polling expert Frank Graves, provides a fascinating tour through data regarding the attitudes of Canadians to taxes.

Part two, titled "How We Got Here," consists of three papers. The first two focus on the takeover of Canadian politics by the neoconservative counterrevolution and explain how this ideological shift has shaped Canadian tax and public policy making. First, Matt Fodor, a doctoral student in political science at York University, Toronto, describes the adoption and modification of the Thatcher and Reagan versions of neoconservatism in Canada. Then two public policy analysts, Eugene Lang and Philip DeMont, examine how neoconservative ideas have shaped Canadian economic policy, resulting in a significant reduction in taxation levels and in the delivery of public goods and services. The third paper in part two, by a former journalist, Trish Hennessy, describes how the political rhetoric of the neoconservative movement evolved and how it has shaped attitudes to taxation among the Canadian electorate.

The four papers in part three are grouped under the heading "A Different Take on Taxes." These papers differ from the papers in the other parts of the book in their focus on specific ideas for tax reform. The first paper in part three is written by two economists at the Canadian Centre for Policy Alternatives, Marc Lee and Iglika Ivanova. They describe an agenda for tax reform intended to make the Canadian tax system more progressive. While that description is light on detail, it includes a proposal to broaden the personal income tax base by taxing both capital gains and most returns to saving at full rates. A number of tax expenditures would be rationalized, including tax assistance for retirement savings, a wide range of broad-based refundable tax credits, the preferential treatment of employee stock options, and tax recognition for donations to registered charities. Lee and Ivanova also advocate increasing the top income tax rate for individuals in the top 1.0 to 0.1 percent of the income distribution, and adopting a wealth transfer tax. Corporate tax rates would be increased, although Lee and Ivanova support movement to a cash flow base focused on economic rents, particularly in the resource sector. Additional revenue generated from these reforms would be devoted to delivery of a basic or guaranteed income. The second paper in part three reviews the standard case for a carbon tax and is notable primarily because it is written by the former leader of the federal Liberal Party, Stéphane Dion. Readers may recall that under his leadership, the Liberals were defeated in the 2008 federal election in no small part because of the inclusion of a carbon tax in the party's campaign platform. The third paper in part three is by the economist Toby Sanger, who outlines the case for a financial transactions tax (FTT). Sanger's views will likely be familiar to readers who are versed in the literature on such a tax; however, this paper may be of particular interest for his critique of many of the standard arguments against the adoption of an FTT. The last paper in part three, by the economist C. Scott Clark, echoes the earlier paper by Lee and Ivanova, although Clark's broad agenda for tax reform is organized around a tax simplification theme. Like Lee and Ivanova, Clark advocates alteration of the tax mix to rely less on consumption taxes and more on income taxes.

Part four of the book, titled "How To Get There," consists of a single paper by two political scientists, Paul Saurette of the University of Ottawa and Shane Gunster of Simon Fraser University. Saurette and Gunster detail and analyze how the neoconservative policy agenda was brought from the margins of popular policy debate into the mainstream of political discourse. Consistent with the title of this part, they lay out the lessons to be learned by progressives favouring higher levels of taxation and increased government involvement in the economy and in Canadian society more generally. The lessons are set out at the end of the paper as a series of recommendations that is notable for its failure to include any use of the New Democratic Party (NDP) to deliver the content of much of the policy message. This omission may reflect the abandonment of the NDP's historical role as a voice for alternative policy ideas. For many on the left of the political spectrum, the NDP has become just another political party trapped in mainstream policy thought in order to advance its political ambitions.

The second book, *The Great Revenue Robbery*, consists of eight papers wrapped within an introduction and a conclusion that are independent papers themselves. As is summarized in the conclusion, written by Murray Dobbin, the president of Canadians for Tax Fairness, the papers in this book collectively argue that governments of the past 20 years have (1) slashed taxes to deliberately reduce government's social and economic capacity, (2) systematically misled Canadians about the reasons for the real impact of tax cuts, and (3) created a level of inequality not seen since the 1920s. Although these themes are broadly similar to those examined in *Tax Is Not a Four Letter Word*, most of the papers in *The Great Revenue Robbery* are quite different in tone and style (as might be expected from the respective titles of the two books). While the papers in the former volume are more formal and academic, with references and citations to the relevant literature, the papers in the latter volume tend to be more impassioned, with much less documentation of related source material. The difference in content and style may reflect the fact that the majority of the contributors to *The Great Revenue Robbery* are social activists, while the contributors to *Tax Is Not a Four Letter Word* are predominantly academics and policy analysts. That said, there is some overlap in contributions and contributors: the papers by Hennessy and Sanger described above appear in both books, while Jim Stanford contributed an original paper to each.

The introduction to *The Great Revenue Robbery*, by Dennis Howlett, the executive director of Canadians for Tax Fairness, lays out a broad agenda for tax reform that is not dissimilar to that described by Lee and Ivanova in *Tax Is Not a Four Letter Word*. In addition to the paper by Sanger on the adoption of an FTT, four other papers focus on the subject of tax reform at a more detailed level. In "The Failure of Corporate Tax Cuts To Stimulate Business Investment," Stanford presents data supporting the argument captured in the title to his paper. He argues that, in the face of the evidence, tax preferences for business investment should be eliminated, and the additional revenue realized as a result should be used to make public investments, especially in much-needed infrastructure. Stanford's paper stands out from the others as evidence-based and academically rigorous. Another paper, by Joe Gunn, "Taxes and Ecological Justice," reviews the case for environmental taxation. There is also a paper on tax havens, titled "The Trouble with Tax Havens: Whose Shelter?" by Peter Gillespie. The focus of this paper is, however, extremely general. At best it can be taken as yet another call for the need for more robust information-reporting requirements and enforcement efforts regarding personal wealth held offshore. The use of tax havens by multinational corporations as a means to achieve international tax-planning objectives is not considered. Finally, there is a unique paper, "Tax Justice and the Civil Economy," by Joe Restakis, on the tax treatment of cooperatives. Unfortunately, it is not entirely clear what the thesis of this paper is.

"Pushing the Envelope: The Overton Window and the Left," by Diane Gibson, analyzes the political ascent of the neoconservative counterrevolution. The term "Overton window" refers to an idea developed by the conservative thinker Joseph Overton. He argued that policy options on a particular issue can be placed on a political spectrum ranging from left to right. The "Overton window" represents those options that are currently politically feasible and are the subject of current public debate. The way to pull the window toward either the left or the right is to start talking outside the window. Overton's principal claim is that new ideas on public policy are developed outside government. After describing how leaders of the neoconservative movement implemented Overton's idea, Gibson maps a similar tactical strategy for progressives in Canada. The conclusion to *The Great Revenue Robbery*, noted above, is more in the nature of an impassioned call to arms to those on the left. This same political perspective is found in a paper by Richard Swift, the editor of the book, titled "The Power of Conventional Thinking." But the focus of Swift's paper is the co-opting of the Canadian media by the anti-tax movement. It is a much-needed contribution that is surprisingly lacking in *Tax Is Not a Four Letter Word*.

T.E.

Brian M. Studniberg, "The Concept of De Facto Control in Canadian Tax Law: Taber Solids and Beyond" (2013) 54:1 *Canadian Business Law Journal* 17-37

This article critically reviews the relevant case law interpreting the concept of de facto control (or "control in fact") of a corporation as provided for in subsection 256(5.1) of the Income Tax Act.[1] Enacted in 1988, this provision is intended to extend the concept of control of a corporation beyond the concept of de jure (or legal) control, which, as developed by Canadian courts, broadly means voting control of a corporation's board of directors. The concept of control in fact is relevant where a provision of the Act uses the phrase "controlled directly or indirectly in any manner whatever" as opposed to a reference to the word "control" unmodified. In defining the concept of control in fact, subsection 256(5.1) provides only that the term includes any fact pattern in which a particular taxpayer or group of taxpayers has "direct or indirect influence that, if exercised, would result in control in fact." In terms of the content of this wording, the subsection provides only a set of specifically excepted, and narrowly defined, fact patterns. Canadian courts have thus been given the task of providing content in a general way to the concept of control in fact.

The article begins by examining the "board control test" articulated by the Federal Court of Appeal in *Silicon Graphics Ltd. v. Canada*[2] as one possible approach to the concept of control in fact. Under this approach, control in fact is considered to exist where a taxpayer or a group of taxpayers has a clear right and ability to effect a significant change in a corporation's board of directors or its powers, or to influence the way that shareholders, who would otherwise have the ability to elect the board, behave.[3] This concept of control in fact is firmly grounded in the concept of legal control in the sense that the former is based on the same focus as the latter, but extends to those circumstances in which there is an ability to control the board of directors other than through the ownership of voting shares. Studniberg follows the discussion of *Silicon Graphics* and the board control test with a review of subsequent

1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this feature are to the Act.

2 2002 FCA 260.

3 Ibid., at paragraph 67.

case law articulating an "operational control test" as an alternative approach to the concept of control in fact. Under this alternative, control in fact is considered to exist where a taxpayer or a group of taxpayers has sufficient influence to exert control over the business or other affairs of a corporation. This concept of control is not grounded in any way in the concept of legal control since the focus moves away from a focus on the board of directors. The operational control test thereby potentially extends to a much wider range of fact patterns than that contemplated by the board control test.

Studniberg then goes on to consider the Tax Court of Canada's decision in *Taber Solids (1998) Ltd. v. The Queen*.[4] He argues that the attempt of Miller J in this case to reconcile the board control and operational control tests fails to sufficiently clear up confusion resulting from the case law after *Silicon Graphics*. Miller J in *Taber Solids* concluded that operational control can coexist with board control if operational control is limited to those circumstances in which what would otherwise be board decisions reside elsewhere. Operational control cannot, however, be sufficient on its own to constitute control in fact. Studniberg suggests that this reconciliation of the two tests is based on a misreading of the case law subsequent to *Silicon Graphics*, and that the narrower test of board control should be preferred exclusively in defining the concept of control in fact. He supports this suggestion with a reading of the legislative history of subsection 256(5.1), including the proposition that the enumerated exceptions in the provision for certain relationships concerning operation of a corporation's business suggest only that the "provision proper is not intended to connote such considerations."[5] But given the current state of the case law, Studniberg recommends enactment of a clarifying amendment to subsection 256(5.1) that would ensure that the provision extends only to circumstances that constitute control of a corporation's board of directors consistent with *Silicon Graphics*.

T.E.

Robin Boadway and Michael Keen, *Rent Taxes and Royalties in Designing Fiscal Regimes for Non-Renewable Resources*, CESifo Working Paper no. 4568 (Munich: Center for Economic Studies and Ifo Institute, January 2014) (www.cesifo-group.de/ifoHome/publications/working-papers/CESifoWP/CESifoWPdetails?wp_num=4568&CESifoWP.search=+)

Taxes and royalties from natural resource industries are a major source of revenue for many developing countries and some member countries of the Organisation for Economic Co-operation and Development (OECD), such as Canada, Australia, Norway, and the United Kingdom. Collecting a substantial share of the economic rents generated by natural resource industries, without imposing punitive taxes that distort investment decisions, is crucial for the long-run development prospects of many developing countries, and also Canadian provinces and territories. Without a

4 2009 TCC 527.

5 Studniberg, at 32.

properly functioning tax system, which allows development of the resource base by private-sector investment, governments will instead rely on national oil and mining companies to develop resources. In too many cases this results in inefficient production, inadequate investment, and corruption. It is also important to understand the implications of taxes for mineral and oil and gas exploration and production if sound environmental policies are to be adopted.

Given the importance of this topic, it is not surprising that the International Monetary Fund (IMF), the World Bank, and other international institutions have devoted considerable resources to developing models of the best practices for tax systems for non-renewable resource industries. However, there are still large gaps in our knowledge of how fiscal systems affect resource industries, and more analysis is needed in order to design optimal taxation and royalty systems. This paper by Boadway and Keen, which builds on their previous work,[6] describes the design of cash flow based tax systems and then explains why resource royalties, which are the equivalent of excise taxes on the production of a resource, might be part of an efficient system.

Boadway and Keen provide an elegant model of a firm's investment and production decisions with regard to a resource deposit. This framework is then used to show how cash flow taxation in its various forms—such as an ACE (allowance for corporate equity), a "Brown tax," or an RTT (resource rent tax)—can be implemented. Such taxes can collect the economic rents generated by a resource project without affecting the investment and production decisions that would have occurred in the absence of the tax. To the extent that there are no other market failures, these cash flow based taxes will be economically efficient means of collecting economic rents, and they have been used as models for taxation in the oil sands industry in Canada and the mining sector in Australia.

However, there are many unresolved issues in the design of resource rent taxes, and royalties based on production or revenues are still widely used for collecting revenues from the resource sector. Boadway and Keen use the framework described above to show that royalties will generally reduce extraction rates, lead to premature termination of production, and discourage exploration and development activity. They then consider a number of "complicating factors" that affect the design of cash flow taxes and royalty systems. For example, the public sector may use a different discount rate to value future revenue streams than the private sector, leading to a divergence in the optimal rate of development from the perspective of the firm and that of the government. (However, for small projects this should affect the government's savings and investment profile and not the design of the optimal tax system.) A more important divergence between the public and private sectors may be their ability to handle risk. Boadway and Keen develop a model in which (1) there is uncertainty about the price of the resource and (2) resource revenue streams are risky.

6 Robin Boadway and Michael Keen, "Theoretical Perspectives on Resource Tax Design," in Philip Daniel, Michael Keen, and Charles McPherson, eds., *The Taxation of Petroleum and Minerals: Principles, Problems and Practice* (London: Routledge, 2010), 13-74.

In this model, the public and private sectors can have different valuations of risk as reflected in different coefficients of relative risk aversion. Boadway and Keen show that the cash flow tax rate should be progressive—that is, increase with the price of the resource—if the government is less risk-averse than the private sector. In countries where resource revenues are the major source of funds for the government, it is possible that the public sector may be more risk-averse than the international oil companies that develop the resource, which typically have a broad base of shareholders with well-diversified portfolios of financial assets. In such circumstances, the Boadway and Keen model implies that the cash flow tax rate should decline when resource prices increase and increase when prices decline, a result that seems to be at variance with most tax-rate structures. The implementation of cash flow tax regimes is also constrained by the ability of governments to monitor revenues and costs in the calculation of cash flows. Under a cash flow tax regime, firms will have an incentive to exaggerate costs, perhaps through transfer pricing or "gold plating," and underreport revenues. Using a relatively simple model of this type of distortion, Boadway and Keen show that the optimal system may be a combination of a cash flow tax and a royalty, because a royalty discourages investment and thus offsets the tendency for overinvestment induced by the cash flow tax. Boadway and Keen also develop a model in which firms have unobservable differences in the cost of developing a resource. In this model, which is analogous to the two-person optimal income tax problem, the government may use a combination of cash flow taxes and royalties to efficiently extract rents from the two types of firms.

The final topic concerns the inability of governments to commit to a particular fiscal regime. Given that resource projects usually involve large upfront investments that are irreversible and immobile, governments may be tempted to change the fiscal regime after the firm has sunk its investments into the project. Anticipating such behaviour, firms underinvest in their projects. Boadway and Keen show that in the absence of other distortions, such as asymmetric information, the optimal cash flow tax is time-consistent. That is, the government would not change the cash flow tax rate after investments have been made and production has started to take place. With royalties, a time-consistent royalty regime would require an upfront subsidy for the initial investment.

By extending the basic framework in which cash flow taxes have been analyzed, Boadway and Keen consider a wider array of policy combinations that are reflected in the fiscal regimes that the governments of resource-rich countries have adopted. Much more work needs to be done, especially with regard to incorporating the full array of fiscal instruments that affect non-renewable resource industries, including bonus bid or auction systems, property taxes, and corporate income taxes. The general equilibrium effects of the resource tax system in resource-dependent economies also need to be considered. In addition, more attention needs to be paid to the optimal rate for a cash flow tax and not just the design of the cash flow optimal tax system. Still, this paper provides an excellent starting point for the analysis of these issues.

B.D.

Michael Devereux, Nils Johannesen, and John Vella, *Can Taxes Tame the Banks? Capital Structure Responses to the Post-Crisis Bank Levies*, CESifo Area Conference on Public Economics, April 11-13, 2013 (Munich: Center for Economic Studies and Ifo Institute, 2013), 19 pages (www.cesifo-group.de/portal/page/portal/CFP_CONF/CFP_CONF_2013/Conf-pse13-Van%20der%20Ploeg/Papers/pse13_Johannesen.pdf)

The financial crisis of 2008-9 reinvigorated academic and policy-making interest in the design of prudential regulatory regimes governing the financial sector as a policy instrument intended to moderate financial instability. The crisis also motivated interest in the role of taxation as a complement to these regimes. Yet in practice, the use of tax instruments has been modest, with bank leverage taxes being the instrument of choice of national policymakers. The motivating purpose of these taxes is the raising of sufficient revenue from the financial sector to reimburse taxpayers for the direct fiscal costs of government bailouts. An attractive feature of bank leverage taxes in performing this revenue-raising function is a presumed empirical effect: that is, such taxes should suppress bank leverage ratios and thereby support the goal of prudential regulatory regimes. In effect, policy makers have operated on the empirical assumption that by raising the price of debt, bank leverage taxes would cause affected financial institutions to respond by substituting equity for debt at the margin. This decidedly secondary property of bank leverage taxes may explain, in part at least, why they have been preferred, since the financial crisis, over other possible taxes on the financial sector, such as FTTs (financial transactions taxes).

In this important paper, Devereux et al. test empirically how banks may have responded to the introduction of leverage taxes following the crisis; it is the first study of which we are aware that tests the hypothesis that bank leverage taxes can cause an increase in equity financing. Devereux et al. also test a critical related hypothesis, that bank leverage taxes can cause an increase in the riskiness of bank asset portfolios. The authors use a panel data set of 5,000 European banks in the sample period 2008-2011, which saw the introduction of bank leverage taxes in 13 EU countries. Information regarding these taxes, including their rates, bases, and implementation dates, was collected manually by the authors from various sources. Devereux et al. find that banks in countries introducing bank leverage taxes systematically increased their levels of equity capital, but they also increased the riskiness of their asset portfolios. Moreover, banks subject to larger taxes systematically increased their equity ratios and asset riskiness relative to banks subject to smaller taxes or those not subject to bank leverage taxes. On average, these taxes were found to increase equity-asset ratios by 1.0-1.5 percentage points, but this altered ratio was associated with increased riskiness of bank assets.

Devereux et al. observe that the important policy lesson from their empirical findings is that bank leverage taxes may have interacted with prudential regulatory regimes in unintended ways. In short, these taxes appear to have induced banks to raise more equity capital, but the imposition by prudential regulatory regimes of minimum capital adequacy ratios based on risk-weighted assets appears to have allowed banks to increase the riskiness of their asset portfolios and adjust their risk-return payoff profiles while still complying with these regimes. In this respect, it is notable that Devereux et al. find that the bank leverage taxes in the relevant EU countries had only a modest effect on the riskiness of assets for average banks, whereas the effects were found to be larger for banks that were more likely to be constrained by regulatory capital requirements.

T.E.

John Grahl and Photis Lysandrou, "The European Commission's Proposal for a Financial Transactions Tax: A Critical Assessment"
(2014) 52:2 *Journal of Common Market Studies* 234-49

A financial transactions tax, or FTT, has received some attention in the post-financial crisis literature, as well as in policy-making circles, as a tax instrument intended to recover the direct costs of government-funded bailouts of affected financial institutions. This tax instrument has a relatively lengthy history in the tax literature, dating from the seminal proposal for its application to currency transactions in the spot market articulated by the Nobel economist James Tobin;[7] it has since been the focus of contentious debate in both the academic literature and the arena of public policy. It is therefore perhaps not surprising that the FTT resurfaced as a possible post-crisis tax instrument. Most prominently, the European Commission (EC) recommended adoption by EU member states of an FTT[8] over a tax on some measure of the value added or excess profits of financial institutions proposed by the IMF under the label "financial activities tax" (FAT).[9] The EC also initially supported the adoption of a FAT, but subsequently altered its position in favour of an FTT. The authors of this article provide a novel critique of the particular version of an FTT proposed by the EC, and argue that a FAT is the superior policy instrument.

As Grahl and Lysandrou observe, the EC's rationale for the choice of an FTT was the ability of this type of tax to generate revenue and stabilize financial markets by dampening trading volume. This rationale is the standard one articulated in the tax literature and, in fact, is the focus of much of the contentiousness in the literature, since the impact of an FTT as a revenue-generating policy instrument with desirable efficiency-enhancing properties remains ambiguous. Grahl and Lysandrou correctly emphasize that the standard rationale for an FTT put forward by the EC is based on the premise that all short-term trading of securities, currencies, and other commodities is speculative in nature and therefore a defensible target of the tax because

7 James Tobin, "A Proposal for International Monetary Reform" (1978) 4:3-4 *Eastern Economic Journal* 153-59.

8 European Commission, *Proposal for a Council Directive on a Common System of Financial Transaction Tax and Amending Directive 2008/7/EC*, COM(2011) 594 final, September 28, 2011.

9 See Stijn Claessens, Michael Keen, and Ceyla Pazarbasioglu, eds., *Financial Sector Taxation: The IMF's Report to the G-20 and Background Material* (Washington, DC: IMF, September 2010), reviewed in this feature (2010) 58:4 *Canadian Tax Journal* 1053-68, at 1063-64.

of the associated market instability in performing a valuable price-revelation function. Grahl and Lysandrou note that, even in the presence of a desirable behavioural effect, the choice of an FTT as a response to the 2008-9 financial crisis is odd, since speculative trading was not the cause of the crisis—though this motivating feature of the EC recommendation is emphasized in the post-crisis literature considering the choice of tax instrument to generate revenue to recover the direct fiscal costs of bailouts, while providing a behavioural response that addresses the causes of the crisis. But Grahl and Lysandrou go beyond this observation to critique the FTT proposed by the EC as overinclusive because of its premise that all short-term trading is speculative and is thus implemented either by financial institutions that are peripheral to the financial system, or as a peripheral function of financial institutions that are central to the financial system.

The standard critique of an FTT in the literature assumes that all targeted short-term trading is speculative but that at some point the tax imposes efficiency losses because of a loss of desirable price-revelation function and the provision of market liquidity. In this respect, Grahl and Lysandrou suggest that the FTT proposed by the EC justifiably attempts to distinguish "good" from "bad" trading on the basis of the presence of a link to underlying economic fundamentals. For example, the proposed FTT provides an exception for primary market transactions so as not to undermine the raising of capital by governments and corporations. The relatively low proposed rates for trades in derivatives and securities are also said to have been chosen so as not to affect, in any significant way, long-term buy-and-hold strategies connected to activities in the real non-financial sector. However, Grahl and Lysandrou argue that, even with these refinements, the proposed FTT remains overinclusive because of a failure to go further in distinguishing between "good" and "bad" trades in the secondary market. Their critique focuses on the identity of the market actors involved in high-frequency trading and, in particular, singles out large institutional investors, such as pension funds and mutual funds, as well as regulated banks transacting in the interbank market.

With respect to institutional investors, Grahl and Lysandrou describe how the asset management function performed by these investors has changed dramatically. They emphasize that the conventional distinction between "passive" and "active" portfolio management is no longer valid. Instead, portfolio balancing, which requires continuous algorithmic trading, is required to maintain the representative nature of portfolios defined in terms of benchmarking to specified indexes. They observe that this trend has been driven by structural changes in the asset management industry intended to realize more accountable and efficient intermediation. Grahl and Lysandrou argue that the proposed FTT would undermine this desirable development by taxing algorithmic trading without distinguishing it from the high-frequency trading associated with speculative technical trading of hedge funds that would be a justifiable target of the tax.

With respect to the interbank market, Grahl and Lysandrou argue that the application of the proposed FTT to the repo market, on the grounds that these short-term financing transactions take the legal form of a sale and purchase of securities, would impair operation of the short-term money market. This would result in reduced availability of short-term financing and increased transacting costs, with damaging consequences. Moreover, the negative consequences of the EC's position on the application of the proposed FTT to the interbank repo market are compounded by an illogical intention not to apply the tax to foreign exchange swaps. The illogicality follows from the fact that the economics of a collateralized repo financing in euros in the European interbank market using government securities can be replicated by entering into a foreign exchange swap selling US dollars for euros and then repurchasing US dollars with euros. The transactions can be almost identical, with the only difference being the nature of the collateral—US dollars in the case of a foreign exchange swap and government securities in the case of a repo. Grahl and Lysandrou suggest that inconsistency of treatment under the proposed FTT would cause substitution of foreign exchange swaps using US dollars for repos using European government securities, which could impair the liquidity of the European interbank repo market in euro denominated bonds, while making the liquidity of the European banking system dependent on credit conditions in the United States. This thinning of the repo market would also make it less effective as a transmission mechanism for monetary policy set by the European Central Bank. A subsequent extension of the proposed FTT to spot transactions in currency markets, but not to forward foreign exchange transactions, obviously does not address the inconsistency of treatment of substitutable transactions that would have these effects.

Given the identified weaknesses of the FTT proposed by the EC, Grahl and Lysandrou offer a political economy explanation for its emergence over a FAT. They suggest that it was chosen because of its prominence in the media and in popular opinion as a desirable tax instrument, while in reality it poses much less of a threat to the interests of banks than a FAT, which can be targeted to specific financial institutions. The proposed FTT conveniently allows the EC to respond to popular opinion by maintaining the appearance of getting tough on European banks. Grahl and Lysandrou speculate that European banks were willing to accept the proposed FTT, even though they would be affected the most by its application to the interbank money market, because they know that the refusal of the United Kingdom and certain other national authorities within the European Union to implement the tax would make it unworkable and eventually lead to its repeal. This probable fate is only strengthened by the strong objections of the European fund industry to the proposed FTT.

T.E.

Jonas Frank and Jorge Martinez-Vazquez, *Decentralization and Infrastructure: From Gaps to Solutions*, International Center for Public Policy Working Paper 14-05 (Atlanta: Georgia State University, Andrew Young School of Policy Studies, January 2014) (http://ideas.repec.org/p/ays/ispwps/paper1405.html)

Subnational governments play an important role in the provision of public infrastructure because the benefits are often concentrated in a particular region. Effective provision of infrastructure by subnational governments imposes formidable challenges to governments throughout the world. This paper by Frank and Martinez-Vazquez summarizes the issues and analysis in 14 papers that are to be published in a forthcoming volume. (The individual papers can be downloaded from http://ideas.repec.org/s/ays/ispwps.html.) The range of topics includes the measurement of infrastructure gaps, the quality of infrastructure, assignment of responsibilities, financing issues, grant design, macroeconomic investment cycles, political economy analysis, and corruption concerns that are associated with local infrastructure projects. Frank and Martinez-Vazquez emphasize three main challenges in developing effective local infrastructure spending policies: (1) "coordination matters" across and between levels of government, especially for "network infrastructure" such as roads, bridges, electricity, and water systems; (2) "equity or fairness matters" for improving access to public services and reducing poverty in developing countries; and (3) "efficiency matters" to ensure that the public receives value for money.[10]

The papers summarized by Frank and Martinez-Vazquez deal with the provision of infrastructure in developing and developed countries around the world. Many of the issues discussed are, of course, familiar problems in Canada, where there has been a renewed focus on infrastructure spending and intergovernmental grant programs to address alleged infrastructure deficits. It is interesting to note that while Canadian public infrastructure spending has been increasing in recent years, and has been rated as high quality by surveys from the World Economic Forum, the level of spending in Canada, at less than 4 percent of gross domestic product (GDP), is much lower than that in many developing countries, such as India, but also less than that in Australia.[11] This paper and the 14 other papers that it summarizes should provide a useful resource for policy makers, given the challenges that infrastructure poses in a highly decentralized country such as Canada.

B.D.

Henrik Jacobsen Kleven, Camille Landais, Emmanuel Saez, and Esben Schultz, "Migration and Wage Effects of Taxing Top Earners: Evidence from the Foreigners' Tax Scheme in Denmark"
(2014) 129:1 *Quarterly Journal of Economics* 333-78

The mobility of high income earners has recently been highlighted by the French government's introduction of a 75 percent tax on incomes above €1 million. While the responses of some high-profile taxpayers, such as Gérard Dépardieu, attract media attention, there are few empirical studies of the responsiveness of international migration of high income earners to differences in national tax rates. Kleven et al. address this gap in the literature with an econometric study of the migration responses to a Danish tax provision that lowers, for three years, the average income tax rate of highly paid foreign workers from their "normal" average tax rate of 55 percent (and a marginal rate of 62 percent) to 30 percent. The program

10 Frank and Martinez-Vazquez, at 2-3.

11 Ibid., at 7, figure 1.

became effective in 1991, and the threshold for eligibility for the lower tax rate was restricted to those with annual earnings of more than €100,000 in 2009, which corresponds to the 99th percentile in the earnings distribution in Denmark.

The study found a large migration response to the program. The number of foreign workers earning above the threshold doubled compared to the number earning slightly below the threshold, and the elasticity of migration with respect to the net-of-tax rate (1 minus the average tax rate) was found to be between 1.5 and 2.0. This implies that the number of highly paid foreign workers increased by 80 to 110 percent in response to the reduction in the average tax rate from 55 percent to 30 percent. The study also found evidence that earnings of a high-income foreign worker declined during the scheme but increased after the individual's tax rate rose when the scheme terminated. The authors interpret this as evidence that the earnings of high-income workers are determined in a bargaining framework as a weighted average of the worker's marginal productivity and the worker's reservation wage, with the weight on the marginal product being determined by the bargaining power of the employer and the weight on the reservation wage being determined by the bargaining power of the employee. In this Nash bargaining model, a reduction in the average tax rate reduces the employee's reservation wage and therefore leads to a lower agreed wage as long as employers have some bargaining power. In other words, part of the reduction in average tax rates was shifted to employers through lower wage rates, an effect that is at variance with the standard competitive model, where workers receive all of the benefits of a wage rate reduction either because the supply of labour is very inelastic or because the demand for labour is highly elastic. Econometric estimates of the effect of lower average tax rates on earnings implied that the elasticity of gross earnings with respect to the net-of-tax rate was −0.36. This implies that the gross wage rate declined by about 20 percent in response to a reduction in the average tax rate from 55 percent to 30 percent. The authors point out that a number of European countries—notably Belgium, Finland, the Netherlands, Portugal, Spain, Sweden, and Switzerland—have introduced programs to lower tax rates for high-income foreign workers and that this tax competition may require international coordination and regulation.

B.D.

Alberto Alesina and Francesco Passarelli, "Regulation Versus Taxation"
(2014) 110:1 *Journal of Public Economics* 147-56

Rafael Aigner, *Environmental Taxation and Redistribution Concerns*
(Open Access Publication Server of the ZBW-Leibniz Information Centre for Economics, 2013) (http://hdl.handle.net/10419/79859)

In the first of the two studies reviewed here, Alesina and Passarelli consider an important aspect of environmental policy—the choice between taxes and regulations to reduce the use of products that generate harmful externalities. While the normative question has been addressed in the economics literature, especially in the context where there is uncertainty regarding the costs of abatement and damages, the political economy aspects of the issues have received less attention. Alesina and Passarelli use a simple yet elegant model in which individuals differ in their cost of adjustment to a lower level of an activity that generates a negative externality, to determine the policy instrument that would be adopted under majority voting. Three policy instruments are considered: (1) a rule that puts an upper bound or limit on the amount of the externality-generating activity that an individual can undertake; (2) a quota that imposes the same proportional reduction in the activity on all individuals; and (3) a per-unit tax on the activity with the tax revenues being remitted to all individuals on an equal per capita basis. An individual's preferred rule, quota, or tax rate is the one that equates his or her marginal benefit from reducing the harmful effects of the activity with the marginal adjustment cost that the individual will face in adopting that value for the preferred instrument.

Individuals differ in the amount of the activity that they would undertake in the absence of a policy to limit the activity, and therefore the distribution of the activity among the population is a key determinant of the policy instrument that will be preferred by the majority of the population. Voting is assumed to take place in two stages. At the first stage, the instrument is chosen, and at the second stage, the level of that instrument is chosen. Therefore, the second-stage decision influences the voter's first-stage decision. Alesina and Passarelli show that the quota is generally, though not always, dominated by a either a rule or a tax. Roughly speaking, the majority of individuals will prefer a rule if the median individual's activity level is lower than the average activity level and will prefer a tax when the median individual's activity level is greater than the average. An example of the former would be emissions of greenhouse gases (GHGs) that are concentrated in a few large emitters, and an example of the latter would be emissions from automobiles. In other words, the Alesina and Passarelli model predicts that GHG emissions from electricity generation based on fossil fuel and oil sands production will be subject to regulations that limit emissions rather than a carbon tax that would be paid by everyone, and that automobile emissions will be subject to a tax on gasoline rather than a limit on the volume of emissions.

Alesina and Passarelli also derive the policy instrument that would maximize a utilitarian social welfare function and compare it with the instrument that would be chosen under majority voting. Two interesting propositions emerge from this comparison. First, if the utilitarian solution would be a tax and the majority prefers a rule, then the chosen rule is more restrictive than the rule that would maximize the utilitarian social welfare function. In other words, the majority prefers a rule that is overly restrictive relative to the utilitarian criterion. Conversely, if the utilitarian solution would be a rule and the majority prefers a tax, then the chosen tax rate is lower than the tax rate that would maximize the utilitarian social welfare function. In other words, the majority-chosen tax rate is too lenient relative to the utilitarian criterion. If one applies these propositions to the examples given above, the Alesina and Passarelli model predicts that democratic governments might choose overly restrictive regulations for large emitters of GHGs but levy taxes on motive fuels at rates that are too low.

Two interesting extensions of the model are suggested, although not pursued in the article. First, the overly restrictive policies that would be adopted in the case where there are a few large emitters may be countered by the lobbying activity of those emitters, in which case lobbying may shift the policies closer to the utilitarian maximizing policies. Second, Alesina and Passarelli suggest that assigning the powers of taxation or regulation to regions where large emitters are concentrated might "counter balance the power of the least concerned"[12] and yield more efficient policies. The analysis of concurrent federal and provincial powers over environmental policies might be usefully examined in this framework, although Alesina and Passarelli warn that "implementation problems of such schemes are, however, extremely severe."[13]

The Alesina and Passarelli paper reviewed above did not incorporate two important issues that affect the optimal Pigouvian tax rate: concerns about distributional equity, and the use of distortionary taxes to finance public services and redistribute income. Aigner's study attempts to clarify how these two factors should affect the tax rates that are adopted to reduce the use of commodities that generate harmful externalities. Aigner adopts a standard optimal income tax model with two groups of individuals who earn different wage rates, allocate their consumption spending between a "clean" and a "dirty" commodity, and decide how much labour to supply. The optimal income tax rate, income transfers, and the excise tax rate imposed on the dirty commodity are chosen to maximize a social welfare function that places different weights on the well-being of the high- and low-productivity individuals subject to an exogenous revenue-raising constraint. As is well known, in such models if the self-selection constraint is binding, the labour market decision of the low-productivity workers is distorted, and those workers face a positive marginal tax rate on their earnings. The marginal cost of public funds (MCF) is the reduction in social welfare if the government has to raise an additional dollar of tax revenue. In the model adopted by Aigner, the MCF has a relatively simple form. Aigner shows that the MCF increases in the weight in the social welfare function that is placed on the well-being of low-productivity workers. In other words, the greater society's redistributional concerns, the higher is the marginal tax rate on the earnings of low-productivity workers, the greater the distortion in the labour supply decisions of those workers, and the higher the marginal cost of public funds.

The optimal Pigouvian tax on the dirty commodity is equal to the marginal external damage caused by consumption of the commodity divided by the MCF. This means that a greater concern about distributional equity is reflected in a higher MCF and results in a lower optimal Pigouvian tax rate. Intuitively, if the Pigouvian tax rate were set at the optimal level, equal to the marginal external damage of consumption of the commodity, a reduction in that tax rate would generate consumer

12 Alesina and Passarelli, at 153.

13 Ibid.

benefits that would outweigh the additional damage from increased consumption of the commodity. Or to put it another way, the Pigouvian tax generates revenue and reduces the harmful externality from consumption of the commodity. The more weight that the society places on revenues because of the concern for redistribution, the less importance it will place on reducing the harmful externality. Although the model is highly specialized, the general principle that Pigouvian taxes on a harmful commodity should be lower in societies where the MCF is higher should be an important consideration in developing tax policies to reduce emissions from harmful products.

B.D.

Kim Brooks, ed., *The Quest for Tax Reform Continues: The Royal Commission on Taxation Fifty Years Later* (Toronto: Carswell, 2013), 360 pages, ISBN 978-0-7798-5491-2

It is almost 50 years since the release of the report of the Royal Commission on Taxation[14] ("the Carter report"), yet this publication arguably remains the gold standard when it comes to a comprehensive examination of a national tax system. Indeed, for some tax-policy wonks, the report has attained iconic status. As a partial testament to such status, this collection of 15 papers is the result of a conference held at Dalhousie law school in September 2013 to commemorate the 50th anniversary of the appointment, by order in council, of the commission. For the most part, the papers pick up selected threads of the subjects addressed in the Carter report and revisit those subjects as they are currently understood and framed in both the literature and tax policy debates. The authors and titles are as follows:

- Elsbeth Heaman, "The Politics of Fairness: Income Tax in Canada Before 1917"
- Shirley Tillotson, "The Politics of Carter-Era Tax Reform: A Revisionist Account"
- Allison Christians, "Drawing the Boundaries of Tax Justice"
- Thaddeus Hwong, "Tax Levels, Tax Mixes and Income Redistribution in Canada and Selected OECD Countries Since Carter"
- Kirk A. Collins and Tim Edgar, "The Carter Report's Corporate Income Tax Proposals: Why They Were Rejected and an Assessment of the Current Canadian System as an Imperfect Alternative"
- Kathryn James, "The Carter Commission and the Value-Added Tax (VAT): A Prescient Review of the VAT Before Its Time Had Come"
- Arthur J. Cockfield and Catherine Brown, "Revisiting the Carter Commission's International Tax Work"

14 Canada, *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966) (chair: Kenneth LeM. Carter).

- Michael A. Livingston, “Convergence, Divergence, and the Limits of Tax Globalization: The Canadian Experience”
- Claire Young, “ ‘Beyond Conjugality’: Time for the Tax System To Take That Concept Seriously”
- Tamara Larre, “Views of Dependency in the Tax System: The Minimal Changes over the Past 50 Years”
- Faye L. Woodman, “As the Baby-Boomers Age, How Should They Be Taxed?: The ‘Old’ Age Tax Credit and ‘New’ Age-Dependent Taxation”
- Chris Sprysak, “Taxing Me or We: Yet Another Look at the Carter Commission’s Recommendation for Joint Returns”
- Colin Jackson, “Settlement and Compromise in Canadian Income Tax Law Since Carter”
- Lori McMillan, “Noncharitable Nonprofit Organizations in Canada”
- Carl MacArthur, “Assessing the Fairness of Tax Avoidance: The Need To Consider Economic Substance”

T.E.

Emily Satterthwaite, “Taxing by Default”

(2013) 59:2 *McGill Law Journal* 337-73

This article is notable for its attempt to provide a theoretical framework for the use of tax elections, a subject on which there is very little policy-oriented literature.[15] Satterthwaite argues that the default rule applicable in the absence of an election should be set according to the preferences of the majority of eligible taxpayers. The exception to this policy prescription is the choice of a penalty default structure that conveys valuable information to the government. Satterthwaite illustrates her theoretical argument by applying it to two familiar provisions in the Act providing rollover treatment on a transfer of property: subsection 73(1) (transfer of capital property to a spouse or former spouse), and subsection 85(1) (transfer of eligible property to a taxable Canadian corporation). She concludes that the design of subsection 73(1) is sound, with the default rule of rollover treatment avoiding unnecessary transaction costs for the majority of taxpayers, and no loss of valuable information for the government in setting the default rule in this way. On the other hand, she argues that the design of subsection 85(1) is unsound, with its default rule of fair market value recognition. Satterthwaite characterizes this default rule as “counter-majoritarian” and unnecessary, since the government could obtain the information revealed by an election to apply rollover treatment at lower costs with routine information reporting. She recommends that subsection 85(1) be amended to provide mandatory rollover treatment as the default rule, with an election available for a minority of taxpayers who prefer fair market value recognition.

T.E.

15 See, for example, Heather M. Field, “Choosing Tax: Explicit Elections as an Element of Design in the Federal Income Tax System” (2010) 47:1 *Harvard Journal on Legislation* 21-73.

Arthur J. Cockfield and Jonah Mayles, "The Influence of Historical Tax Law Developments on Anglo-American Laws and Politics"
(2013) 5:1 *Columbia Journal of Tax Law* 40-68

Tax policy implementation tends to involve more than just a bit of politics. This article discusses three important periods in Anglo-American history when the link between tax and politics had profound consequences for the development of political and legal institutions that laid the foundations for modern liberal democracies. Although the events in these periods of history are well known, Cockfield and Mayles provide accounts at a level of detail that is worth reading in its own right, as well as being necessary to advance the thesis of the article.

The article begins with a discussion of the events surrounding Magna Carta and the Charter of Liberties in early medieval England. This period is reviewed because it saw the first restriction on the ability of the monarchy to tax English subjects as the king saw fit. The article then recounts a series of important tax disputes in 17th-century England that ultimately led to the Glorious Revolution and the English Bill of Rights. This period is important for the emergence of the concept of a constitutional monarchy. Finally, the article turns to the role of tax laws in the American Revolution and the subsequent development of the American Republic.

The common theme drawn out from the account of events in these three periods is the political struggle against "bad taxes," which the authors define as unrepresentative taxes without due process protections. The political institutions that followed from this struggle are seen to have resulted in the development of "good tax laws," which the authors define as laws that promoted representative taxes along with procedural protections against arbitrary imprisonment for non-payment. Cockfield and Mayles, however, go beyond this claim and suggest that the relevant developments influenced broader social change, including the development of liberalism as a guiding political philosophy. They emphasize the important role of taxes in the development of liberalism in shaping norms that underlie modern liberal democracies.

T.E.

Arthur J. Cockfield, "The Limits of the International Tax Regime as a Commitment Projector" (2013) 33:1 *Virginia Tax Review* 59-113

This article draws on the literature on transaction costs as a means to conceptualize what the author refers to as the "international tax regime" as a political and legal system addressing transaction costs for cross-border investment. Cockfield claims that the international tax regime has "an uneven record with respect to reducing transaction costs for taxpayers and others."[16] He identifies the international tax regime with the network of bilateral tax treaties based largely on the OECD model treaty. Transaction costs are defined as the costs associated with discerning a price for a given exchange and, when this concept is applied to the international tax regime, are tantamount to the costs of discerning the price of inbound or outbound

16 Cockfield, at 61.

investment. An important component of this price is the tax cost, which is effectively set through the international tax regime as a governmental commitment. Conceptualized in transaction cost terms, the international tax regime is seen to signal credible political commitments that permit taxpayers to reduce transaction costs that would otherwise be necessary to protect against tax risk associated with cross-border investment.

Cockfield argues that, as a "commitment projector," the international tax regime has performed well in eliminating double taxation by residence and source countries. By committing to such elimination, governments reduce the risk that income taxation will reduce cross-border investment. The international tax regime is characterized as a "commitment projector" that enables governments to offer reasonably reliable promises to affected taxpayers, the public, and other governments. Another recently developed component of the international tax regime that also performs well when assessed in terms of a transaction cost analysis, but is only highlighted in the article, is the development of an efficacious and extrajudicial dispute resolution process.

Despite the success of the commitment to eliminate double taxation that was the original motivation for creation of the international tax regime, Cockfield cautions that the regime should not always be seen as an effective means to lower transaction costs through the implementation of credible government promises. Indeed, he claims that in other respects, the international tax regime can be seen to increase transaction costs. He emphasizes, in particular, the uneven acceptance by governments of cross-border tax planning implemented by multinational firms, and the adoption by the United States of the Foreign Account Tax Compliance Act (FATCA).

With respect to cross-border tax planning, Cockfield suggests that the increased transaction costs resulting from the tax-planning effort that is required in the face of uneven and complex anti-avoidance responses of governments remain acceptable to multinational firms because the associated tax savings are greater than those costs. With respect to FATCA, Cockfield suggests that its unilateral adoption by the United States outside the system of information exchange developed as part of the international tax regime may result in longer-term reputational costs for the United States, which could raise transaction costs. But it may also be a factor that causes countries to move more quickly to a system of automatic information exchange as part of the international tax regime. If this turns out to be the case, the US initiative may ultimately prove to be a positive development. These two examples underscore Cockfield's principal assertion that the international tax regime may lower or raise transaction costs, depending on the effect of the context on the credibility of government promises.

T.E.

Michael Devereux and Simon Loretz, "What Do We Know About Corporate Tax Competition?" (2013) 66:3 *National Tax Journal* 745-74

Public concern over corporate tax competition arises from the view that it will lead to a race to the bottom, which will reduce total public tax revenues and shift more of the tax burden to personal income and sales taxes. In response to that concern, over the last 30 years economists have developed theoretical models to study the implications of tax competition, and more recently there has been an upsurge of empirical studies of corporate tax-rate competition. In this article, Devereux and Loretz review the empirical literature and evaluate the implications of its findings. To derive the testable predictions of the theoretical literature, they compare the implications of capital tax competition with three basic models of competition in commodity markets: the Bertrand price competition model, in which there are a large number of firms and prices are driven down to marginal costs of production; the Stackelberg price leadership model, in which a dominant firm sets a price based on the likely responses of a competitive fringe of smaller firms; and the monopoly model, in which a firm has market power because of economies of scale. The Bertrand model of tax competition implies that corporate tax rates are driven to zero. The Stackelberg model applies to large capital-exporting countries, such as the United States, which can influence the corporate tax rates in other countries by providing domestic corporations with a tax credit for foreign corporate taxes up to the domestic corporate tax rate. The monopoly model applies to governments in countries where agglomeration economies create locational rents that can be captured through higher corporate taxes.

Three main predictions emerge from the theoretical literature on corporate tax competition. First, tax competition will lead to the lowering of tax rates, especially by small countries. Second, countries will lower or raise their corporate tax rates in response to lower or higher rates in neighbouring countries. More formally, this means that corporate tax-rate reaction functions will have positive slopes. Third, increases in economic integration will have a non-linear impact on the strength of tax competition; that is, more integration might initially increase agglomeration advantages, leading to greater monopoly power for some countries and higher corporate tax rates, but beyond some point increased integration, because of reduced travel and communications costs, might eliminate the agglomeration advantages, leading to corporate tax-rate reductions.

As Devereux and Loretz point out, testing these propositions is difficult because we lack clear counterfactuals to what would occur in the absence of corporate tax competition, and measuring changes in economic integration is difficult. Furthermore, countries can compete over a variety of parameters that affect after-tax corporate profits. Marginal effective tax rates affect the volume of investment in a particular country, average effective tax rates affect the location of investments, and statutory tax rates affect opportunities for profit shifting through transfer pricing and debt placement.

The authors note that many empirical studies document declines in statutory tax rates, accompanied by base-broadening measures that offset the decline in average effective tax rates on corporate profits, although there is some tendency for countries to reduce average effective tax rates for more internationally mobile firms. Another broad conclusion from the empirical literature is that there appears to be a negative relationship between measures of economic openness and statutory tax rates, as well as ex ante average and marginal effective tax rates, while ratios of corporate tax revenues to GDP remain relatively constant because openness increases corporate profits. Several studies also find that countries' reaction functions with respect to corporate income tax rates have positive slopes. Finally, although the United States may have been the Stackelberg leader in the past, the smaller countries in the European Union are increasingly viewed as the driving force in corporate tax competition.

By summarizing the predictions of a range of theoretical models and discussing the inherent problems in formulating and testing predictions of tax competition, Devereux and Loretz provide a useful review of the state of the art, which will be a valuable addition to reading lists for graduate courses in the economics of taxation.

B.D.

William Gale and Samuel Brown, "Small Business, Innovation, and Tax Policy: A Review" (2013) 66:4 *National Tax Journal* 871-92

Concerns about productivity growth and competitiveness have led OECD countries to adopt a wide range of policies to promote innovation. Often the intended targets of these policies are small startup firms with high growth potential. This article surveys the evidence concerning the links between tax policies that favour small business and the prevalence of entrepreneurship and innovation. Although the authors focus on US studies, much of the discussion is relevant for Canadian public policy. One important issue that is examined is the claim that small business is responsible for the majority of net job creation in the United States. Gale and Brown report on a number of studies that indicate that the link between size of the firm and employment growth is mainly attributable to the fact that new firms start small. It is "newness," not "smallness," that is the characteristic that is linked with net job creation—although the authors note that 40 percent of the jobs created by startups are lost after five years, and "most firms do not grow even as they age; rather most firms start and stay small."[17]

Although the link between small business, startups, and growth is tenuous, governments around the world have adopted tax policies that favour small business. Gale and Brown review the main features of the US tax system that favour small business, including the immediate expensing of equipment, the research and experimentation credit, the qualified production activities income deduction, and other measures such as the small business innovation research program. Gale and Brown also review several studies that document the relatively high compliance costs that the tax system in the United States imposes on small business, but they note that small business is a major avenue for tax evasion. Internal Revenue Service (IRS) data indicated that in 2001 "43 percent of all business income that should have been reported on the income tax form was not reported."[18] Gale and Brown discuss a number of

17 Gale and Brown, at 877.

18 Ibid., at 881.

empirical studies that examine the link between tax rates and individuals reporting self-employment income, which is taken as a proxy for entrepreneurship. An increase in the average tax-rate differential between self-employment income and wage and salary income has been found to increase self-employment income, although a higher differential in the marginal income tax rate reduces self-employment income. The latter effect is interpreted as indicating that "people move to self-employment in part because business ownership may provide opportunities to avoid or evade taxes."[19]

Gale and Brown conclude their review of the literature by emphasizing that it is important for public policies to distinguish between policies to promote innovation and entrepreneurship on the one hand and policies to support small business on the other, and that very little is known about the effectiveness of tax and other policies in promoting startups, financing, investment, and growth of entrepreneurial firms.

B.D.

Lawrence Zelenak, *Learning To Love Form 1040: Two Cheers for the Return-Based Mass Income Tax* (Chicago: University of Chicago Press, 2013), 161 pages, ISBN 978-0-226-01892-8

Elimination of the filing of returns for personal income tax purposes is a reform that has received considerable attention in the literature and has been implemented by several countries. Realization of this reform requires substantive simplification of the personal income tax base so that withholding at source can be sufficiently precise to be final. In particular, various substantive provisions that account for the different personal circumstances of individuals must be eliminated. Realization of this substantive reform is arguably a desirable goal that allows the realization of compliance and administrative savings through the use of withholding at source as final rather than provisional. But in this book, Lawrence Zelenak of Duke University law school defends a return-based personal income tax as an important policy instrument to promote what he calls "fiscal citizenship."

Zelenak's use of the term "fiscal citizenship" has two related but different components. One consists of a substantive element that emphasizes the fiscal dimension of citizenship captured in US Supreme Court Justice Oliver Wendell Holmes's famous remark, "Taxes are what we pay for civilized society."[20] This substantive component ideally means that a citizen is well informed concerning both the revenue-raising and the spending functions of government and is thereby able to participate more effectively in all manner of civic activities. The other meaning, which is in fact the basis for Zelenak's support of a return-based mass income tax, consists of the formalization and recognition of the substantive financial responsibilities of citizenship. Zelenak sees the preparation and filing of a personal income tax return as the principal means by which citizens connect with the US federal government in the fiscal context.

19 Ibid., at 882.

20 *Compania de Tabacos v. Collector*, 275 US 87, at 100 (1927).

Filing of the personal income tax return—form 1040 in the United States—serves what Zelenak characterizes as a highly visible civic ceremony that focuses the attention of an individual taxpayer on his or her status as a purchaser of civilization.

Zelenak acknowledges that this civic ceremony can be rejected in the case of tax protesters or undermined in the case of tax cheaters. In both cases, a return-based personal income tax serves as a vehicle for not paying taxes (in whole or in part), and this ability to choose not to comply tends to be seen as a weakness as compared with sales taxes or return-free income taxes. He suggests, however, that even in these cases there is an important societal dimension that can be framed as a positive feature. In the case of tax protesters, the return-based personal income tax may serve an important safety-valve function. In the case of small-scale cheating, it may perform the same safety-valve function by allowing a taxpayer to feel empowered to resist an overreaching government without resorting to the extreme position of refusing to file and pay any tax. Zelenak also suggests that a vulnerability to small-scale cheating can be framed as a positive feature in that it signals that the taxpayer is trusted by government, and this may foster a reciprocal sense of trust in government.

A separate chapter (chapter five) recounts the extension of the personal income tax in the United States from a tax on high-income individuals to its current mass tax status as a means to finance US expenditures during the Second World War, and subsequently the growth of the welfare state. Zelenak details how the Roosevelt administration strenuously opposed adoption of a retail sales tax as a mass tax to finance the war. It was this opposition that led to a political compromise and conversion of the personal income tax to a mass tax. But even then, a preferred alternative was a personal income tax without return filing and the use of final withholding at source. Zelenak argues that the return-based income tax is, in fact, an accident of history. More particularly, Congress failed to understand the difference between a return-free tax with final withholding and a system whereby the IRS calculates tax liabilities on the basis of information provided by taxpayers. Mistakenly thinking that it was enacting the former, Congress enacted the latter. And although there remains a taxpayer option to have the IRS calculate tax liability, it has been allowed to erode away with its eligibility limitation of gross income of $10,000 or less.

Despite dissatisfaction with the current return-based system with inexact withholding, Zelenak suggests that the system is maintained as an enduring political compromise between proponents of large government, who prefer low-visibility taxes, and proponents of small government, who prefer highly visible taxes. He advances this suggested political compromise as an entirely descriptive claim regarding the maintenance of a return-based personal income tax. As a normative or prescriptive matter, he prefers such a system for its ability to foster fiscal citizenship. He does not, however, favour maintenance of the status quo unaltered. Indeed, in the title to the book, Zelenak awards the return-based personal income tax only two cheers, rather than the traditional three, because he believes that its significance as a ceremony in the exercise of fiscal citizenship could be realized much more effectively. He thus supports the policy goal of substantive rule simplification advocated by proponents of a return-free personal income tax with final withholding at source.

Yet simplification for Zelenak is desirable to address frustration with the complexity now associated with the filing of personal income tax returns. This complexity has driven an explosive growth in the use of tax-return preparers, which Zelenak sees as undermining the return-filing process as a ritual of fiscal citizenship.

In chapter four, Zelenak describes the addiction of the US Congress to personal tax expenditures, which is primarily responsible for the increased complexity of the personal income tax. Not surprisingly, he joins the chorus of those who advocate elimination of many of these spending programs, albeit with different goals in mind. Interestingly, however, Zelenak would retain two relatively large tax expenditure programs—the deduction for charitable contributions and the earned income tax credit (EITC)—as important expressions of fiscal citizenship. He would maintain the deduction for charitable contributions because it enables taxpayers to choose to satisfy their financial obligations to society either by paying a specified amount of tax or by contributing a larger amount to charity. He would maintain the EITC as an anti-poverty program that promotes a sense of economic citizenship by ensuring that all citizens engaged in full-time employment are able to support their families at a minimal level of decency.

The last chapter (chapter seven) makes the case for substantive rule simplification to allow the return-based mass income tax to realize its full potential as a rite of fiscal citizenship. Zelenak therefore rejects simplification as a means to allow a return-free personal income tax with final withholding at source. Nonetheless, he accepts a system of "prefilling" of personal income tax returns that would be based on information on file with the IRS. Such a system was introduced in California in an attempt to realize compliance cost savings.[21] Because taxpayers would be given the opportunity to review and amend their prefilled returns, Zelenak suggests that many of the fiscal citizenship benefits of the current system could be maintained while reducing compliance costs.

Readers may find the separate chapter (chapter six) on the income tax in popular US culture intriguing and amusing. In this chapter, Zelenak examines the treatment of the personal income tax in nearly 100 radio and television sitcoms from the 1940s to the present, as well as in more than 200 cartoons appearing in the *New Yorker* magazine from the 1920s to the present. As expressions of popular culture, these sources are examined in an attempt to get some sense of popular attitudes to the personal income tax. Zelenak finds that, in older sitcoms from the 1940s to the 1960s, the theme of the return-filing process featured prominently and positively as an important instrument of fiscal citizenship. Perhaps not surprisingly, given increased dissatisfaction with the US income tax system, attitudes toward return-based taxation are considerably less positive in more recent sitcoms. This same general trend

21 Prefilled returns have been adopted or used in trials in several jurisdictions, including Quebec. See François Vaillancourt, ed., *Prefilled Personal Income Tax Returns: A Comparative Analysis of Australia, Belgium, California, Québec, and Spain* (Vancouver: Fraser Institute, June 2011), reviewed in this feature (2011) 59:1 *Canadian Tax Journal* 167-82, at 172.

does not appear in the *New Yorker* cartoons. In fact, Zelenak cannot detect any clear deterioration in attitudes to the return-based personal income tax, which he attributes to the different demographic of the audience for the magazine. In contrast with sitcoms, which tend to have a very broad audience, the readership of the *New Yorker* has always been predominantly upper-middle class. For interested readers, Zelenak has previously published some of the results of this creative vein of research in an article in *Tax Notes*.[22]

T.E.

Richard Brooks, *The Great Tax Robbery: How Britain Became a Tax Haven for Fat Cats and Big Business* (London: Oneworld, 2013), 297 pages, ISBN 978-1-85168-935-4

This provocatively titled book provides an entertaining account of the current state and history of tax avoidance in the United Kingdom. It is a story that has many parallels in other countries, including Canada. Corporate tax avoidance, in particular, has been the focus of public anger in the wake of the 2008-9 financial crisis. In the United Kingdom, however, this anger was amplified at the political level with a set of hearings before the House of Commons Committee of Public Accounts in the wake of revelations concerning the settlement of tax disputes by Her Majesty's Revenue & Customs (HMRC) with Vodafone and Goldman Sachs.[23] The author, who is a former UK tax inspector turned journalist, uses these hearings as an entrée into his account of the rich history of tax avoidance in the United Kingdom, providing much-needed context for an understanding of what has become a somewhat notorious current state of affairs. Because of his background, Brooks is able to tell his story in a way that is technically knowledgeable while remaining entertaining and accessible for readers who are not tax practitioners, policy makers, administrators, or academics. There is also a tone of moral indignation and outrage at the excesses of what the author refers to as "the tax avoidance industry." Suffice it to say that tax practitioners, as well as the UK political leadership and the tax administration leadership of HMRC, do not appear in a favourable light.

After an introductory chapter that broadly sketches the present state of the UK tax system, Brooks provides a brief early history of tax avoidance in the United Kingdom up to the 1970s and early 1980s, which were marked by growth in tax-avoidance structures marketed to individuals and which culminated in the so-called Rossminster affair. The next chapter describes the growth through the 1990s and

22 Lawrence Zelenak, "Six Decades of the Federal Income Tax in Sitcoms" (2007) 117:13 *Tax Notes* 1265-88.

23 See United Kingdom, House of Commons, Committee of Public Accounts, *HM Revenue & Customs 2010-11 Accounts: Tax Disputes*, Sixty-First Report of Session 2010-11. See also United Kingdom, House of Commons, Committee of Public Accounts, *Tax Avoidance: The Role of Large Accountancy Firms*, Forty-Fourth Report of Session 2012-13, reviewed in this feature (2013) 61:3 *Canadian Tax Journal* 857-74, at 873-74.

early 2000s of the UK corporate tax shelter industry. As in the corporate tax shelter industry in the United States, these avoidance transactions share the common characteristic of a lack of economic substance in the sense that they were implemented entirely to create or trade a tax attribute. Two chapters are then devoted to offshore planning by UK-based multinationals focused on UK tax benefits. A principal focus is the structure used by Vodafone for its acquisition of the former German conglomerate, Mannesmann AG. The structure is a familiar one to tax practitioners, whereby operating income is stripped out of a source-country subsidiary and channelled through a tax-advantaged holding company. In the Vodafone case, the structure arguably ran afoul of the UK controlled foreign corporation rules, but was settled on very generous terms by the leadership of HMRC. A later chapter details tax-planning structures of UK-based multinationals focused on source-country tax benefits, with an emphasis on the deleterious effects for developing countries in particular. Tax planning for high-wealth individuals is similarly reviewed in a separate chapter, along with another chapter on offshore tax evasion. An especially interesting chapter discusses the close relationship that developed between the leadership of the UK tax administration and large corporate taxpayers and their advisers in the name of the maintenance of "client relationships." One hopes that this situation is unique to the United Kingdom—in which case it will serve as a compelling cautionary tale for other tax administrations that have embraced a culture of taxpayer-friendly service.

The final chapter describes a set of initiatives that, in Brooks's view, could together tame the tax-avoidance industry. The initiatives are in fact familiar fare, and not especially radical. Along with a call for a return to a much more adversarial relationship between large corporate taxpayers and the tax administration, Brooks suggests the adoption of (1) more effective exchange of information between national tax administrations, (2) a personal and corporate minimum tax, and (3) harsh penalties for unsuccessful tax avoidance. He also advocates publication of taxes paid and accounting income of multinationals, broken down geographically. A unique recommendation is a requirement that the European Union act to exclude tax-avoidance corporate structures from the application of the "fundamental freedoms" guaranteed by EU law. This recommendation would be supported by the application of sanctions to member states that facilitate tax avoidance. Brooks fails, however, to recommend the retroactive application of anti-avoidance legislation to targeted structures. In combination with the robust information-reporting requirements that the United Kingdom has adopted for aggressive tax avoidance, this practice could go a long way toward addressing the policy problems presented by such avoidance.[24] The omission is strange, given that Brooks favourably notes the few occasions on

24 For a discussion of the policy case supporting the retroactive application of specific anti-avoidance rules, see Benjamin Alarie, "Retroactivity and the General Anti-Avoidance Rule," in David G. Duff and Harry Erlichman, eds., *Tax Avoidance in Canada After Canada Trustco and Mathew* (Toronto: Irwin Law, 2007), 197-219.

which this approach has been used in the past by policy makers in the United Kingdom. Brooks only briefly mentions, albeit critically, the recent adoption of a general anti-avoidance rule in the United Kingdom, and this cursory treatment is similarly odd, given that he is critical in earlier chapters of past failures to enact such a provision. But these omissions are certainly not fatal to what is in no way an attempt to provide a rigorous policy analysis of tax avoidance and the range of policy options that could be adopted in an effort to constrain it.

T.E.