Centre for International
Governance Innovation

Canada in International Law at 150 and Beyond | Paper No. 8 — February 2018

Canada's International Tax System: Historical Review, Problems and Outlook for the Future

Brian J. Arnold

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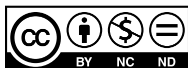

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About the Series

Marking 150 years since Confederation provides an opportunity for Canadian international law practitioners and scholars to reflect on Canada's past, present and future in international law and governance. "Canada in International Law at 150 and Beyond/Canada et droit international : 150 ans d'histoire et perspectives d'avenir" is a series of essays, written in the official language chosen by the authors, that provides a critical perspective on Canada's past and present in international law, surveys the challenges that lie before us and offers renewed focus for Canada's pursuit of global justice and the rule of law.

Topics explored in this series include the history and practice of international law (including sources of international law, Indigenous treaties, international treaty diplomacy, subnational treaty making, domestic reception of international law and Parliament's role in international law), as well as Canada's role in international law, governance and innovation in the broad fields of international economic, environmental and intellectual property law. Topics with an economic law focus include international trade, dispute settlement, international taxation and private international law. Environmental law topics include the international climate change regime and international treaties on chemicals and waste, transboundary water governance and the law of the sea. Intellectual property law topics explore the development of international IP protection and the integration of IP law into the body of international trade law. Finally, the series presents Canadian perspectives on developments in international human rights and humanitarian law, including judicial implementation of these obligations, international labour law, business and human rights, international criminal law, war crimes, and international legal issues related to child soldiers. This series allows a reflection on Canada's role in the community of nations and its potential to advance the progressive development of global rule of law.

"Canada in International Law at 150 and Beyond/Canada et droit international : 150 ans d'histoire et perspectives d'avenir" demonstrates the pivotal role that Canada has played in the development of international law and signals the essential contributions it is poised to make in the future. The project leaders are Oonagh Fitzgerald, director of the International Law Research Program at the Centre for International Governance Innovation (CIGI); Valerie Hughes, CIGI senior fellow, adjunct assistant professor of law at Queen's University and former director at the World Trade Organization; and Mark Jewett, CIGI senior fellow, counsel to the law firm Bennett Jones, and former general counsel and corporate secretary of the Bank of Canada. The series will be published as a book entitled *Reflections on Canada's Past, Present and Future in International Law/Réflexions sur le passé, le présent et l'avenir du Canada en matière de droit international* in spring 2018.

About the International Law Research Program

The International Law Research Program (ILRP) at CIGI is an integrated multidisciplinary research program that provides leading academics, government and private sector legal experts, as well as students from Canada and abroad, with the opportunity to contribute to advancements in international law.

The ILRP strives to be the world's leading international law research program, with recognized impact on how international law is brought to bear on significant global issues. The program's mission is to connect knowledge, policy and practice to build the international law framework — the globalized rule of law — to support international governance of the future. Its founding belief is that better international governance, including a strengthened international law framework, can improve the lives of people everywhere, increase prosperity, ensure global sustainability, address inequality, safeguard human rights and promote a more secure world.

The ILRP focuses on the areas of international law that are most important to global innovation, prosperity and sustainability: international economic law, international intellectual property law and international environmental law. In its research, the ILRP is attentive to the emerging interactions among international and transnational law, Indigenous law and constitutional law.

About the Author

Brian J. Arnold is senior adviser at the Canadian Tax Foundation in Toronto. He is a graduate of Harvard Law School, and taught tax law at a Canadian law school for 28 years. He has been a consultant to various governments (Australia, Canada, New Zealand, South Africa), the Organisation for Economic Co-operation and Development, and the United Nations. He was a visiting professor at Harvard Law School from 2005 to 2011 and at New York University School of Law in 2005 and 2012; he also teaches international tax courses at the University of Sydney and the University of Melbourne. He is the co-editor of the *Bulletin for International Taxation* and the author of several books and articles on tax issues, including (with Hugh J. Ault) *Comparative Income Taxation: A Structural Analysis,* 3rd edition (Kluwer, 2010) and *International Tax Primer*, 3rd edition (Kluwer, 2016).

Introduction

This paper provides an overview and assessment of the international aspects of Canada's income tax system at the time of Canada's sesquicentennial. The timing for such a review is particularly appropriate because 2017 was also the 100th anniversary of the Income Tax Act and because the international community, including Canada, has recently completed a major overhaul of the international tax rules to prevent base erosion and profit shifting (BEPS), an overhaul that the Organisation for Economic Co-operation and Development (OECD) calls the most significant tax reform of the past century.[1]

The timing is also appropriate because in late December the United States adopted a major tax reform with important changes to its international tax rules. These US changes, including the deep reduction in the US corporate tax rate from 35 to 21 percent, are game-changing for Canada and many other countries, and Canada needs to respond quickly.

After this brief introduction, the paper describes the three basic structural parts of Canada's international tax system: the taxation of non-residents on their Canadian source income; the taxation of Canadian residents on their foreign source income; and tax treaties. Special administrative issues that arise with respect to the international aspects of a country's tax system are also mentioned briefly.

The paper then describes the historical development of Canada's international tax system from 1917 to the present.[2] It situates the Canadian system in the broader international context of intersecting national tax systems, tax and trade agreements, the influence of the United States, and the efforts of international organizations to promote greater coherence and harmonization with respect to international tax. Against this background, the paper provides a summary of the existing Canadian tax rules for dealing with cross-border issues and an assessment of those rules. This assessment leads inevitably to speculation about how Canada's international tax system is likely to change in the future, the impetus for change and the major constraints on change. A final section of the paper examines Canada's contribution to international tax policy and legislation and is followed by a brief conclusion.

This paper is neither a primer on Canada's international tax rules, nor a detailed technical analysis of those rules, nor a comprehensive tax policy analysis of those rules.[3] It takes a broad approach to Canada's international tax system, hitting only the highlights. Thus, readers must be cautioned that, as is always the case with tax issues, the devil is in the details. The paper is intended for readers with a basic understanding of income tax concepts, and some familiarity with international tax issues would also be useful. Finally, the paper focuses primarily on the taxation of multinational corporations because these entities pose the greatest challenges to domestic tax systems.

Basic Aspects of Canada's International Tax System

What Is International Tax Law?

There is no such thing as international tax law in the sense of some supranational law that overrides a country's domestic tax laws. Even tax treaties, which appear to be the most obvious manifestations of international tax law, are essentially products of domestic law, at least in Canada. Although tax treaties are binding agreements between sovereign nations, they do not confer any rights or obligations on taxpayers unless and until they are enacted into Canadian law. Therefore, what is referred to, for convenience, as international tax law is simply the

1 According to OECD Secretary-General Angel Gurria, "The measures we are presenting today represent the most fundamental changes to international tax rules in almost a century." See "OECD Presents Outputs of OECD/G20 BEPS Project for Discussion at G20 Finance Meeting" [OECD, "Outputs"], online: OECD, <www.oecd.org/ctp/oecd-presents-outputs-of-oecd-g20-beps-project-for-discussion-at-g20-finance-ministers-meeting.htm>.

2 For a more detailed history, see Brian J Arnold, "The Canadian International Tax System: Review and Reform" (1995) 43:5 Can Tax J 1792.

3 For technical and policy analysis of Canada's international tax rules, see Jinyan Li, Arthur Cockfield & J Scott Wilkie, *International Taxation in Canada* (LexisNexis, 2006); Jean-Pierre Vidal, ed, *Introduction to International Tax in Canada* (Toronto: Carswell, 2015); Brian J Arnold, *Reforming Canada's International Tax System* (Toronto: Canadian Tax Foundation, 2009); and Nick Pantaleo & Michael Smart, "International Considerations" in Heather Kerr, Ken McKenzie & Jack Mintz, eds, *Tax Policy in Canada* (Toronto: Canadian Tax Foundation, 2012).

provisions of Canada's and other countries' domestic tax laws that affect cross-border transactions.

The international aspects of the Canadian income tax system are incredibly complex from the perspective of tax policy and legislation, and are crucial to the functioning of the income tax system as a whole. Obviously, the taxation of non-residents on their Canadian source income is an important source of tax revenue — for example, in 2016, income taxes on non-residents represented 2.2 percent of total government revenues.[4] An equally important function of Canada's international tax regime is to prevent base erosion. For example, although Canada does not collect much tax from Canadian corporations on their foreign source income, many of the rules with respect to foreign source income are not designed to raise revenue, but rather to protect the Canadian domestic tax base from erosion.

Structural Features of Canada's International Tax System

In accordance with the international norms for jurisdiction to tax, Canada's international tax system is based on the residence of taxpayers and the geographical source of income. Both residents and non-residents are subject to tax on their income derived from sources in Canada, and residents of Canada are also subject to tax on their income derived from sources outside Canada. Thus, residents are taxable on their worldwide income and non-residents are taxable only on their Canadian source income.[5] Individuals are considered to be resident in Canada if they have close economic and social ties to Canada based on all the facts and circumstances. Corporations and trusts are considered to be resident in Canada if they are managed and controlled in Canada, although corporations incorporated in Canada after April 26, 1965, are deemed to be resident in Canada for tax purposes.

Canadian taxation of the worldwide income of its residents is largely theoretical. Foreign source income is often subject to foreign tax, and the international consensus is that the source country's tax has priority over the residence country's tax. Accordingly, Canada provides a credit for foreign income taxes paid by Canadian residents on their foreign source income. Canadian residents can also often avoid or defer Canadian tax on foreign source income simply by establishing a foreign corporation to earn the income.

Another important factor with respect to Canadian taxation of both residents and non-residents is the nature of the income. The tax consequences differ significantly for active business income and passive, investment-type income. For non-residents, business income is subject to Canadian tax on a net basis (that is, deductions are allowed for expenses incurred in earning the income); however, passive income, such as dividends, interest and royalties, is taxable by withholding taxes imposed at a flat rate (currently 25 percent) on the gross amount of the payment. For residents owning shares of foreign affiliates, active business income earned by these foreign affiliates is either completely exempt from Canadian tax, both when earned by the affiliates and when repatriated to Canada as dividends, or is taxable only when repatriated to Canada as dividends, with relief for foreign taxes.[6] In practice, most active business income earned by foreign affiliates of Canadian corporations is exempt from Canadian tax. Passive income (referred to in the Income Tax Act[7] as "foreign accrual property income" [FAPI]) earned by foreign affiliates is taxable when repatriated to Canada as dividends, except that any FAPI of a foreign affiliate controlled by Canadian residents is subject to immediate Canadian tax when it is earned by an affiliate (whether or not repatriated as dividends).

Another important factor with respect to Canadian taxation of both residents and non-residents is the legal form used by a taxpayer to earn income. Non-residents can earn Canadian source income directly or they can establish a Canadian corporation to earn the income. If non-residents establish a Canadian corporation to carry on business in Canada or to earn income, the corporation is subject to Canadian tax as a resident of Canada. Therefore, for example, amounts derived by Canadian corporations owned by non-residents, which would be subject to withholding tax if received by the non-residents directly, are instead subject to ordinary Canadian tax on the net income of the corporations. For residents of Canada, business income earned outside Canada through a foreign branch is subject to current Canadian tax with a credit for any foreign tax on the income. In contrast,

4 Annual Financial Report of the Government of Canada, Fiscal Year 2016, online: <www.fin.gc.ca/afr-rfa/2016/report-rapport-eng.asp>.

5 Li, Cockfield & Wilkie, *supra* note 3 at 49.

6 These rules are described in more detail below, under the heading "Taxation of Canadian Residents on Worldwide Income."

7 *Canada Income Tax Act*, RSC 1985 c 1 (5th Supp) [*ITA*].

active business income earned by a foreign affiliate owned by Canadian residents is not subject to current Canadian tax, and, if the foreign affiliate is resident in a treaty country, is completely exempt from Canadian tax even where it is repatriated to the Canadian shareholders in the form of dividends.

Administrative Issues

The international aspects of Canada's income tax raise two difficult administrative issues that do not arise with respect to purely domestic tax issues:

- gathering information about non-residents earning income in Canada and about the foreign source income of Canadian residents; and
- collecting tax effectively from non-residents who are outside Canada.

In recent years, significant improvements have been made in the exchange of information between countries and assistance in the collection of tax. These administrative aspects of international tax are, however, beyond the scope of this paper.

Background: A Brief History of Canada's International Tax System (1917 to 2017)

The first Canadian federal income tax legislation was enacted in 1917. It applied to the worldwide income of Canadian residents and the Canadian source income of non-residents. Originally, relief from double taxation was provided by means of a deduction for foreign taxes when computing the worldwide income of residents, although a limited foreign tax credit was introduced in 1919. A limited exemption for certain dividends received by Canadian public corporations from their wholly owned foreign subsidiaries was adopted in 1938. From 1938 to 1972, both the foreign tax credit and the dividend exemption were gradually broadened. In 1972, the government enacted the combined exemption/credit system for dividends from foreign affiliates of Canadian corporations that applies today.

Non-residents employed in Canada or carrying on business in Canada were subject to tax from the beginning. A crude transfer-pricing rule to deal with the manipulation of prices in cross-border transactions between related parties was introduced in 1924. The first interim withholding taxes were imposed in 1927 on rent and royalties paid to non-residents, and in 1933 the first final withholding taxes were imposed on dividends, interest and royalties. From 1933 to 1972, withholding taxes were extended to many other payment amounts, and a branch tax was imposed on non-residents carrying on business in Canada.

In 1966 the Carter Commission issued its famous report on the comprehensive tax base.[8] Although the report was hugely influential, many of its international tax recommendations were seriously flawed and inconsistent with international norms,[9] and were largely rejected by the government. Nevertheless, the 1972 tax reform, which followed from the Carter Report, made several major changes to the international tax rules, including the adoption of thin capitalization rules, the combined exemption/credit system for dividends from foreign corporations,[10] the FAPI rules and the taxation of capital gains realized by non-residents from the disposition of "taxable Canadian property." Other aspects of the 1972 tax reform, such as the taxation of capital gains and the integration system for taxing Canadian corporations and their shareholders, also had important consequences for international tax.

Canada entered into its first tax treaty with the United States in 1942, and over the next 30 years entered into only 15 additional treaties. In 1972, when the exemption for dividends from foreign affiliates of Canadian companies was limited to dividends paid out of the exempt surplus of foreign affiliates resident in treaty countries, the government committed to expanding Canada's tax treaty network aggressively. From 1972 to 2017, the number of Canadian tax treaties

8 *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966) (Carter Report).

9 For criticism of the Carter Commission's international recommendations, see Donald JS Brean, "The International Dimension of Canadian Tax Policy: Contributions of Carter and Subsequent Developments" in W Neil Brooks, ed, *The Quest for Tax Reform* (Toronto: Carswell, 1988) at 265; see also BJ Arnold, "The Taxation of Foreign Source Income: Dividends from Foreign Corporations and Anti-Tax Haven Measures," in Brooks (*ibid* at 277).

10 The Carter Commission had recommended that the dividend exemption be eliminated entirely.

expanded from 16 to 93, including all Canada's major trading partners, many of its minor trading partners and many low-tax jurisdictions.

The International Context

Canada's ability to determine its international tax policies is constrained by several factors, including taxpayer behaviour, the tax systems of other countries and the prevailing norms of international taxation. Canada has a small, open economy; it needs to attract foreign investment in a globalized world where capital is geographically mobile and sensitive to many factors, including tax. In addition, tax competition is rampant; countries compete fiercely for foreign direct investment through tax and other incentives. On a micro level, taxpayers, especially multinational enterprises, are adept at using a variety of avoidance strategies to avoid national taxes. International tax avoidance is a serious problem for Canada and other high-tax countries.

Although Canada's beginnings as an English colony might suggest that the United Kingdom would have had significant influence on the international aspects of Canada's income tax system, in fact, the United States has played the dominant role in shaping that system, especially in modern times. The US influence on the international aspects of Canada's income tax system is evident in several ways. For example, concerns over profit shifting and transfer pricing have required Canadian corporate tax rates to be maintained at the same level as US rates or lower. The 2007 Fifth Protocol to the Canada-United States treaty provides a complete exemption from source-country tax on interest paid to a resident of the other state, even where the payments are made to a related party.[11] This is the only Canadian treaty, but not the only US treaty, that provides a complete exemption from source-country withholding tax on interest.

Mandatory binding arbitration is another example of US influence. In the Fifth Protocol, Canada and the United States agreed to arbitration for the resolution of tax disputes that cannot be settled by the competent authorities within three years. The apparently successful experience with arbitration under the treaty with the United States led Canada to agree to extend arbitration to several other countries through the 2017 Multilateral Convention sponsored by the OECD.[12] Canada has also enacted many provisions based on American international tax concepts over the years, including the FAPI rules, the indirect foreign tax credit, the domestic tax benefit provision in Canadian tax treaties, foreign tax credit generator rules, non-resident trust rules and foreign investment fund rules.

Perhaps the most telling indicator of the US influence is Canada's unfunded dividend tax credit. Individuals resident in Canada who receive dividends from Canadian companies get a dividend tax credit, which, in theory, is supposed to provide relief for the tax already paid by the corporation on its income out of which the dividend was paid; however, the credit is available irrespective of whether the corporation actually pays Canadian tax on its income. If the credit were given only to the extent that the corporation paying the dividend had paid tax on its income, it would clearly be a mechanism to relieve double taxation, and in the negotiation of the Canada-US treaty, the Americans would have demanded that US shareholders of Canadian companies receive the same treatment. But by giving a dividend tax credit even where the Canadian corporation pays no Canadian tax, Canada was able to deny the credit to US shareholders on the basis that it was intended to encourage so-called grass-roots capitalism (that is, to encourage Canadian individuals to invest in Canadian corporations).

Canada's international tax policy is also constrained by prevailing international tax norms. These norms are reflected in the fundamental aspects of developed countries' tax systems, in the OECD and United Nations Model Conventions,[13] and increasingly, in the soft-law guidance issued by the

11 *Protocol Amending the Convention between the United States and Canada with Respect to Taxes and Income on Capital*, 21 September 2007, art 11 (entered into force 15 December 2008). The exemption of interest from withholding applies for payments of interest after January 1, 2009.

12 OECD, *Multilateral Convention to Implement the Tax Treaty Measures to Prevent Base Erosion and Profit Shifting* [OECD, *Multilateral Convention*], online: OECD <www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm>. Arbitration decisions are not published, so it is difficult to assess how successful arbitration has been.

13 *United Nations Model Double Taxation Convention Between Developed and Developing Countries* (New York: United Nations, 2011). For a description of the committee and its work, see paras 8–11.

OECD.[14] International tax norms are broad and vague and include consensus on several basic concepts:

- countries are limited to taxing on the basis of the residence of taxpayers or the geographical source of income;
- international double taxation should be eliminated by the residence country through a foreign tax credit or an exemption for foreign source income;
- non-resident corporations are treated as taxable entities separate from their shareholders (subject to controlled foreign corporation rules);
- the arm's length standard is used to determine the profits of associated or related enterprises from intercompany transactions; and
- source countries are entitled to tax the business profits of non-resident enterprises only if a high threshold (permanent establishment) is met.

As a member of the OECD, Canada has committed at a political level to respect these international norms and it has generally done so. As discussed below, the international consensus on these basic concepts of international tax has been subject to pressure as a result of the growth of both the digital economy and international tax avoidance and evasion.

Canadian international tax policy is also constrained by its extensive network of tax treaties. In these tax treaties, Canada agrees to give up some of its taxing rights in consideration for reciprocal reductions in the other countries' taxes. In general, Canadian tax treaties prevail over the provisions of domestic law in the event of a conflict. Since Canada has a large tax treaty network and tax treaties typically last for several years, these treaties effectively prevent Canada from changing its domestic law in ways that would conflict with its treaties.

A notable — but often overlooked — feature of Canadian tax treaties is that they do not affect provincial income taxation. Under the Constitution, the power to impose income taxes is shared by the federal and provincial governments and the federal government cannot infringe on the taxing authority of the provinces. Nevertheless, the potential problem of provinces imposing income taxes contrary to the provisions of Canada's tax treaties has been largely resolved by the provinces (except Ontario) adopting unilateral tax reductions and exemptions to match those agreed to by the federal government in its tax treaties.

The provinces are not generally considered to have constitutional authority to enter into treaties with foreign countries, although Quebec entered into an income tax treaty with France in 1987.[15] This paradox was resolved by a uniquely Canadian solution: the Canada-France treaty was amended to include a provision authorizing Canadian provinces to enter into tax treaties with France as long as the provisions of those treaties are consistent with the provisions of the Canada-France treaty.[16]

Canada's international tax policy is also directly influenced by the actions of the OECD and the Group of Twenty (G20). The best example of this type of influence is the recent OECD/G20 BEPS Project.[17] This project consists of 15 action items involving minimum standards that countries must adhere to, common standards, best practices and other recommendations. Another important OECD/G20 initiative is the 2017 Multilateral Convention,[18] which allows countries to incorporate the BEPS treaty recommendations into their bilateral tax treaties without the need to renegotiate those treaties. Canada signed the Multilateral Convention on June 7, 2017, to amend 75 of its tax treaties to implement the BEPS minimum standards with respect to treaty abuse and the improvement of the mutual agreement procedure.[19]

14 Since 2016, such guidance has been backed up by the monitoring of country practices through a peer review process and public shaming as a deterrent for non-compliance. See e.g. OECD, "Global Forum on Transparency and Exchange of Information for Tax Purposes", online: OECD <www.oecd.org/tax/transparency/>.

15 *Quebec-France Income Tax Convention*, signed 1 September 1987.

16 *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,* 2 May 1975, (entered into force 1 January 1976; amended by a protocol signed 16 January 1987 adding art 29(7), renumbered as art 29(10) by a second protocol signed 30 November 1995).

17 The BEPS final reports and other related information concerning the implementation of the BEPS measures are available online: <www.oecd.org>.

18 OECD, *Multilateral Convention*, *supra* note 12.

19 See Department of Foreign Affairs, Trade and Development, "Status of List of Reservations and Notifications at the time of Signature", [DFATD], online: OECD <www.oecd.org/tax/treaties/beps-mli-position-canada.pdf>.

The Current Situation: Canada's International Tax System in 2017

As explained above, Canada's international tax system is a complex mix of conflicting tax policy objectives and highly technical tax rules buttressed by an array of specific anti-avoidance rules. This section describes the current Canadian rules for taxing non-residents on their income derived in Canada and Canadian residents on their worldwide income.

Taxation of Non-residents on Canadian Source Income

Canada imposes income tax on virtually all amounts derived from Canada by non-residents, including income from employment exercised in Canada, income from business carried on in Canada and gains from the disposition of Canadian taxable property.[20] For this purpose, carrying on business in Canada is defined broadly to include any activities of a business nature taking place in Canada, without any monetary or time threshold or without a place of business in Canada.[21] "Taxable Canadian property" is defined broadly to include immovable property located in Canada, interests in Canadian entities owning such immovable property, substantial shareholdings in Canadian public corporations and shares in Canadian private corporations.[22] In addition, non-residents are subject to withholding taxes on a wide variety of amounts received from residents of Canada, such as dividends, interest, rent and royalties.[23]

Usually, Canada gives up some of these domestic taxes on non-residents through the provisions of its tax treaties. For example, the 25 percent rate of domestic withholding tax is typically reduced to 15, 10 or 5 percent, or even eliminated entirely, depending on the nature of the amount paid (for example, dividends, interest, rent, royalties) and the treaty. In addition, Canada typically agrees in its treaties to tax residents of its treaty partners on their business profits only if they have a permanent establishment in Canada.

Canada's rules for taxing non-residents on their Canadian source income have been remarkably stable over time. However, a clear trend has emerged over the past two decades for Canadian withholding taxes to be reduced or eliminated, either unilaterally or through treaties. For example, withholding tax on interest paid to arm's-length non-residents was unilaterally eliminated in 2008, and withholding tax on interest paid to non-arm's-length residents of the United States was eliminated pursuant to the treaty in 2007.

Taxation of Canadian Residents on Worldwide Income

Canadian residents are taxable on their worldwide income, which includes income earned both inside and outside Canada. Income includes income derived from employment, business and property, and other amounts included in income under the provisions of the ITA, such as one-half of capital gains.

Foreign source income earned by Canadian residents is usually also subject to tax by the foreign country in which it is earned. In order to eliminate double taxation, Canada as the residence country typically provides a credit (the foreign tax credit) against Canadian tax payable on foreign source income for any foreign income tax imposed on that income to the extent that the foreign tax does not exceed the Canadian tax on the income.[24] This foreign tax credit system applies to business income earned by Canadian residents directly through foreign branch operations and to passive investment income, such as dividends, interest, rent and royalties.

An important exception to the taxation of Canadian residents on their worldwide income with a credit for foreign taxes on foreign source income applies where Canadian residents earn foreign source income through foreign corporations. In this situation, Canadian tax is deferred (subject to the FAPI rules described below) until the Canadian-resident shareholders of the foreign corporations receive dividends. The reason for this deferral is that foreign corporations are considered to be separate taxable entities in accordance

20 *ITA*, *supra* note 7, s 2(3).

21 *Ibid*, s 253.

22 *Ibid*, s 248(1), the definition of "taxable Canadian property."

23 *Ibid*, Part XIII.

24 *Ibid*, s 126. In limited circumstances, only a deduction is allowed for foreign tax paid in computing income. (See *ibid,* ss 20(11) and (12)).

with international norms.[25] Moreover, for most income earned through foreign corporations, Canadian tax is not just deferred, but eliminated entirely, because most dividends received by Canadian corporations from their "foreign affiliates" are exempt from Canadian tax.

A foreign affiliate of a Canadian corporation is a foreign corporation in which the Canadian corporation owns at least 10 percent of the number (not votes, value or capital) of shares of any class of the foreign corporation.[26] Dividends received from foreign affiliates are subject to a complicated combined exemption/credit system, which operates in practice as a complete exemption system. Dividends out of the "exempt surplus" of a foreign affiliate are not subject to Canadian tax.[27] Exempt surplus is active business income earned by a foreign affiliate resident in a country with which Canada has concluded a tax treaty or a tax information exchange agreement (TIEA),[28] as well as one-half (the exempt portion) of capital gains and dividends out of the exempt surplus of other foreign affiliates.[29] As of August 2017, Canada had tax treaties in force with 93 countries and TIEAs in force with 22 countries.[30] These countries include virtually all countries in which Canadian corporations have significant investments.

Dividends that are not paid out of a foreign affiliate's exempt surplus (that is, paid out of hybrid surplus or taxable surplus) are subject to Canadian tax, with an effective credit for both any foreign withholding tax on the dividends and any underlying foreign corporate tax on the income out of which the dividends are paid.[31] Other dividends (called dividends out of pre-acquisition surplus) are treated as a recovery of cost; they are tax-free but reduce the cost base of the shares.[32]

The foreign affiliate system is intentionally designed to be favourable for Canadian corporations. Dividends are considered to be paid first out of an affiliate's exempt surplus and only thereafter out of hybrid, taxable or pre-acquisition surplus. In practice, Canadian corporations repatriate exempt surplus of their foreign affiliates, but retain and reinvest other surplus offshore.[33]

This generous system for taxing (or, more accurately, not taxing) active business income earned through foreign affiliates necessitates several anti-avoidance rules to protect the system from abuse. For example, the FAPI rules are designed to prevent Canadian residents from using "controlled foreign affiliates" (foreign corporations that are controlled by a small group of Canadian residents)[34] to earn passive income and other amounts that erode the Canadian tax base. These amounts are taxable in the hands of the Canadian shareholders of a controlled foreign affiliate when they are earned, without waiting for them to be distributed as dividends. In addition, since non-resident trusts can also be used as substitutes for controlled foreign affiliates, complex rules apply to prevent the deferral or avoidance of Canadian tax through non-resident trusts.[35] Similarly, since the FAPI rules apply only to controlled foreign affiliates and only to Canadian residents that own 10 percent or more of the shares, rules are necessary to prevent the use of widely owned foreign investment entities by Canadian residents to defer Canadian tax on passive foreign income.[36]

25 Foreign corporations are not resident in Canada; therefore, they are subject to Canadian tax only on their income earned in Canada. Canadian shareholders of foreign corporations, even controlled shareholders, are not taxable on the income of those foreign corporations because those corporations are separate taxable entities; they are taxable only when they receive dividends from those corporations.

26 *ITA*, *supra* note 7, s 95(1), the definition of "foreign affiliate."

27 All dividends are included in income under section 90, but dividends out of exempt surplus are deductible in computing a Canadian corporation's taxable income under paragraph 113(1)(a), effectively making them tax-free.

28 TIEAs are agreements with countries that do not impose tax or impose taxes at low rates. Comprehensive tax treaties with such countries to reduce or eliminate their taxes are not necessary.

29 *ITA*, *supra* note 7, Regulation 5907(1), the definition of "exempt surplus."

30 See Department of Finance Canada, "Tax Treaties: In Force", online: <www.fin.gc.ca/treaties-conventions/in_force–eng.asp>.

31 *ITA*, *supra* note 7, para 113(1)(a.1), (b) and (c).

32 *Ibid*, para 113(1)(d).

33 Until 2011, when upstream loan rules were enacted, foreign affiliates with hybrid or taxable surplus without sufficient foreign tax to eliminate any Canadian tax on the dividends could simply loan the funds interest-free to the Canadian parent corporation without any adverse Canadian tax consequences.

34 *ITA*, *supra* note 7, s 95(1), the definition of "controlled foreign affiliate."

35 See *ITA*, *supra* note 7, s 94.

36 *Ibid*, s 94.1.

Measures to Protect the Domestic Tax Base

Canada has been consistently vigilant in protecting the Canadian tax base from tax avoidance. The list of anti-avoidance rules is impressive:

- thin capitalization rules;
- transfer-pricing rules;
- rules with respect to interest-free or low-interest loans to non-residents;
- surplus-stripping rules;
- rules with respect to benefits and loans to non-resident shareholders of Canadian corporations;
- controlled foreign corporation rules (the FAPI rules);
- non-resident trust rules;
- foreign investment fund rules;
- upstream loan rules;
- foreign affiliate dumping rules; and
- back-to-back arrangement rules.

All these measures are intended to prevent the avoidance of Canadian tax on Canadian source income by both Canadian residents and non-residents.

In contrast, Canada has not been as concerned about preventing the avoidance of tax on the foreign source income of Canadian-resident corporations. The FAPI rules, non-resident trust rules and foreign investment fund rules are intended to prevent the diversion of certain Canadian source income to foreign corporations; they target passive income, such as dividends, interest, rent, royalties and capital gains, and certain business income, such as income from transactions with Canadian residents and income earned in Canada. However, the Canadian tax system exempts foreign active business income earned by foreign corporations in which Canadian corporations have significant (10 percent or greater) interests. In effect, Canada has a territorial system for taxing active business income of Canadian corporations — such income is exempt from Canadian tax if earned outside Canada by a foreign affiliate of a Canadian corporation.[37]

Furthermore, certain aspects of the FAPI and foreign affiliate rules are clearly designed to subsidize foreign investment by Canadian corporations and to facilitate the avoidance of foreign tax by Canadian corporations. Canadian corporations are allowed to deduct interest expenses incurred to acquire shares of foreign affiliates even where the income earned by those affiliates will never be subject to Canadian tax. The deduction of such interest is an unjustified subsidy for foreign investment. Section 93 of the Income Tax Act is an example of a provision that facilitates the avoidance of foreign tax by Canadian corporations. Under section 93, Canadian corporations are entitled to elect to treat capital gains from dispositions of shares of foreign affiliates as dividends rather than as proceeds of disposition. This deemed dividend allows the conversion of what would otherwise be a taxable capital gain subject to Canadian tax into a tax-free dividend out of exempt surplus (assuming that the foreign affiliate has exempt surplus) without the need for a foreign affiliate to pay a dividend, which would result in foreign withholding tax.

Another example is paragraph 95(2)(a), which allows payments by a foreign affiliate that are deductible when computing its active business income to be treated as active business income in the hands of the recipient foreign affiliate. Thus, the payments are not subject to the FAPI rules and are included in the recipient's exempt surplus so that they can be repatriated tax-free to the Canadian parent corporation. In effect, the rules with respect to inter-affiliate payments allow certain amounts, such as interest and royalties, to be moved from a foreign affiliate in a high-tax country where the payments are deductible to a foreign affiliate in a low-tax country (that is, to avoid foreign tax) without any adverse Canadian tax consequences. This type of tax planning has been widely used by Canadian multinationals for many years.

37 As noted above, under the legislation only dividends out of the active business income of foreign affiliates resident in countries with which Canada has a tax treaty or a TIEA are exempt, but since Canada has such treaties with about 120 countries, virtually all the active business income earned through foreign affiliates of Canadian companies is exempt from Canadian tax.

Canadian Tax Treaties

Canada's large network of tax treaties generally follows the basic pattern of the OECD Model, with a few notable exceptions. Canadian tax treaties have an important impact on both the taxation of non-residents on their Canadian source income and residents on their foreign source income.

The Future

Predicting the future of Canada's international tax system would be foolhardy. Moreover, speculating about the future of the international tax system is a waste of time, since governments rarely engage in long-term tax policy planning. Nevertheless, thinking about what the international aspects of the Canadian income tax system might look like in 20 or 30 years is good fun and difficult to resist on special occasions such as Canada's sesquicentennial and the 100th anniversary of Canadian income tax legislation.

The hazards of predicting the future of Canada's international tax system can be seen if we cast our minds back to the end of the last millennium and compare what tax commentators were predicting then with what actually happened. At that time, many tax theorists predicted the imminent demise of the corporate tax and even income tax entirely.[38] However, corporate tax revenues as a percentage of GDP have stabilized in Canada and in most developed countries. Reports of the death of corporate tax have been greatly exaggerated; despite all its flaws, it has proven to be resilient, both as an important source of tax revenue and as a backstop for the personal income tax and the taxation of non-residents. The corporate tax will still exist in its current form 30 years from now.

Another example of unexpected developments was the OECD's Report on Harmful Tax Competition,[39] released in 1998, which called for robust countermeasures against uncooperative tax havens and a peer review process to ensure that OECD member countries eliminated their harmful tax regimes. The report, along with the European Union's Code of Conduct on Harmful Tax Competition[40] in 1997, seemed to signal that developed countries had finally realized that international cooperation was the only way to protect their domestic tax base from aggressive tax planning, preferential tax regimes and tax havens. Nevertheless, and counter to all expectations, the Harmful Tax Competition project suffered a humiliating defeat at the hands of an unlikely coalition: the then-new US Bush administration concerned about a loss of sovereignty, tax havens (predictably), the Black Caucus of the US House of Representatives (less predictably) and some right-wing think tanks.

The OECD saved face by turning the Harmful Tax Competition project into a project to improve and expand the exchange of information for tax purposes. The resulting Global Forum on Transparency and Exchange of Information received an unexpected boost from a series of scandals involving widespread tax evasion promoted by banks, tax planners (and in some cases, government officials) in Switzerland, Luxembourg and Panama. Today, the Global Forum has 142 member countries and bank secrecy has been or is being eliminated worldwide. The UBS scandal caused the United States to take unilateral action (the Foreign Account Transactions Compliance Act [FATCA]) to force foreign financial institutions to report information to the Internal Revenue Service concerning the accounts of their US clients. Using the US experience with FATCA, the Global Forum recently adopted automatic exchange of information pursuant to the Common Reporting Standard as the international standard for exchange of information. No one could have predicted these developments 20 years ago: no one would have even fantasized about Switzerland giving up bank secrecy.

Based on the success of international cooperation on exchange of information, the OECD and the G20 launched the BEPS Project in 2012 with 15 action items to combat aggressive international tax planning by multinational enterprises. The BEPS final reports were issued in 2015 and the project has now moved into an implementation phase; this phase includes a multilateral convention to implement changes to tax treaties to prevent treaty abuse and

38 See e.g. Jack M Mintz & Duanjie Chen, "Will the Corporate Income Tax Wither?" in *World Tax Conference Report 2000* (Toronto: Canadian Tax Foundation, 2001); see also Graeme Cooper, "The Future of the Income Tax," in *World Tax Conference Report 2000* (Toronto: Canadian Tax Foundation, 2001).

39 OECD, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD, 1998).

40 European Commission, "A Package to Tackle Harmful Tax Competition in the European Union", Communication from the Commission of the European Communities, Brussels, 1997, COM (97) 564 final.

to improve the mutual agreement procedure for resolving tax disputes, a peer review process to monitor compliance with the international standard for exchange of information, changes to the OECD Transfer Pricing Guidelines and ongoing studies of thorny issues such as the digital economy.

It would be easy, but wrong, to accept the OECD's claims about the importance and revolutionary nature of the BEPS Project.[41] Looking past the packaging and marketing, the changes made to the international tax system by the BEPS Project are relatively modest. Work on many of the action items was under way before the BEPS Project began, difficult issues such as the digital economy remain unresolved and the taxation of indirect transfers, services, rent and royalties, and tax incentives were not dealt with at all.

Nevertheless, the BEPS Project is a significant achievement with important implications for the future of international tax, for two main reasons. First, it has raised the profile of international tax issues with the public and government leaders — international tax issues are now regularly on the agendas of the meetings of the leaders and the finance ministers of the G7 and G20. Second, the implementation phase of the BEPS Project led to the 2016 formation of the (unimaginatively named) Inclusive Framework as the body to monitor the implementation of the BEPS measures. Membership in the Inclusive Framework is open to all countries that commit to the BEPS minimum standards.

Currently, the Inclusive Framework has more than 100 member countries. Is the Inclusive Framework a nascent world tax organization that some tax commentators have pleaded for periodically?[42] It may be, but the development of an effective international tax organization with supranational authority to allocate tax revenues among nations, enforce national and international tax rules and resolve tax disputes is not something that is likely to happen in the next 20 or 30 years — barring some crisis that none of us can foresee.

41 See OECD, "Outputs", *supra* note 1.

42 See e.g. Vito Tanzi, *Does the World Need a World Tax Organization?* (New York: Cambridge University Press, 1999) at 173–86; Adrian J Sawyer, *Developing a World Tax Organization: The Way Forward* (Birmingham: UK: Fiscal Publications, 2009); and Frances M Horner, "Do We Need an International Tax Organization?" (2001) 24 Tax Notes Intl 179.

As a member of the G7, G20 and the OECD, Canada is committed to the work of these bodies on international tax. However, as of late 2017, the BEPS Project has had little impact on Canada's international tax system. Although Canada signed the Multilateral Convention to implement the BEPS minimum standards, it reserved its position on all the other treaty abuse measures in the convention.[43] Moreover, Canada has not made any changes to its domestic law to implement the recommendations of the BEPS final reports, other than adopting country-by-country reporting.

Canada's reaction to BEPS may reflect its future attitude to the actions of the OECD, the Global Forum and the Inclusive Framework. Canada will support, but not play a leading role in, the work of these international tax bodies, and it will adopt measures emanating from them if they are adopted by all member countries or if they are considered to be in Canada's best interests.

For the foreseeable future, the United States will continue to be the dominant influence on Canada's international tax policy. Canada can try to moderate US influence through the OECD and other international bodies, but realistically it must keep one eye on the United States and the other eye on the rest of the world.

For many years, Canada has occupied a unique position between major OECD member countries and developing countries; however, this position has never extended to tax issues. The United Nations Committee of Experts on International Cooperation in Tax Matters, which is the custodian of the United Nations Model Convention, is intended to represent the tax interests of developing countries as well as developed countries. This committee has 25 members nominated by their governments and selected by the Secretary-General of the United Nations to serve in their personal capacities (not as country representatives) for four-year terms. Surprisingly, Canada has never had a member on the committee and is not seriously involved in its work. Instead, the role of neutral bridge between developed and developing countries has been taken over by Chile, New Zealand and Norway. It is arguable that Canada should take a more active role in the UN

43 See DFATD, *supra* note 19.

Committee of Experts, and there is a chance that this could happen in the next 20 to 30 years.[44]

With respect to the substance of Canada's international tax system, it can be predicted that in 20 to 30 years it will look surprisingly similar to the current system. Canada will continue to tax non-residents on their Canadian source income through the corporate tax and withholding taxes, although the trend for the gradual reduction and elimination of withholding tax on interest and other amounts on a reciprocal basis in Canadian tax treaties will continue.

The rules for the taxation of the foreign source income of Canadian residents should be tightened (the FAPI rules and foreign investment fund rules should be made more robust), made internally consistent (active business income earned through a foreign permanent establishment and a foreign corporation should both be exempt) and simplified (the exemption/credit system for dividends from foreign affiliates should be converted into a complete exemption system),[45] although it is doubtful that much will happen in the next 20 to 30 years. Instead, the government will continue to rely on increased enforcement by the Canada Revenue Agency (CRA) as the primary strategy to protect the Canadian tax base[46] and will adopt specific anti-avoidance rules only sporadically. The deduction of interest by Canadian corporations to finance the acquisition of shares of foreign affiliates will continue to be allowed despite the absence of any Canadian tax on the income earned by those affiliates. Canada will continue to pursue this dubious policy of subsidizing offshore investment by Canadian multinationals in the forlorn hope of spawning Canadian corporate champions on the worldwide stage.

Canada's tax treaty network will continue to expand, although more slowly than in the past. For the next two or three decades, the priority will be the renegotiation of Canada's most important treaties so as to implement the BEPS changes. Canada's treaty policy will continue to adhere to the provisions of the OECD Model, subject to Canada's longstanding reservations. In summary, in 20 or 30 years Canada's international tax system will be recognizable as a continuation of the existing system. It will be modified in modest ways to ensure the protection of the Canadian tax base and will reflect international developments, but any major structural reforms are unlikely. This prediction of a "steady as she goes" future is subject to the caveat that no crisis occurs with direct effects on the Canadian tax system.

Canada's Contribution to International Tax

Any account of Canada's contribution to international tax must start with the Carter Report, which made Canada a world leader in thinking about tax policy. The report's analytical case for a comprehensive income tax base has influenced tax policy thinking worldwide and generated extensive literature. However, as noted above, the international tax recommendations of the Carter Report were flawed and largely ignored.[47]

The Carter Report led to the 1972 tax reform, which also marked Canada as a world leader in international tax policy, especially with respect to protection of the tax base. Canada was the first country to adopt thin capitalization rules and the second country to adopt controlled foreign corporation rules and non-resident trust rules, which it copied from the US rules. Canada's combined exemption/credit system for dividends from foreign affiliates of Canadian corporations was, at the time, a creative solution to a difficult problem. Should such dividends be exempt, as they typically were in European countries, or taxable with a credit for underlying foreign corporate tax and foreign withholding tax on the dividends, as was the case in the United Kingdom and the United States? Canada's novel approach was to exempt dividends from foreign corporations only where the dividends were paid out of active business income that was subject to foreign tax roughly comparable to Canadian tax, and to tax other dividends but with credits for foreign tax.

44 Just prior to the completion of this paper in September 2017, a Canadian, Stephanie Smith of the federal Department of Finance, was appointed to the UN Committee of Experts.

45 See the recommendations in Arnold, *supra* note 3.

46 The federal budgets for 2016 and 2017 provided CDN$444.4 million and CDN$523.9 million, both over five years, to the CRA to combat tax evasion and avoidance.

47 See J Harvey Perry, "Background and Main Recommendations of the Royal Commission on Taxation," in Brooks, *supra* note 9 at 33, stating: "this was one of the areas where we simply ran out of time — or perhaps energy."

Unfortunately, the design of this combined exemption/credit system did not withstand practical realities. Canada expanded its tax treaty network without much concern about the integrity of the exemption for dividends, thus allowing income earned in low-tax treaty countries to qualify for exemption. In 2007, the exemption system was expanded to foreign affiliates resident in countries with which Canada had entered into a TIEA, and Canada has concluded TIEAs with many countries that do not impose income taxes at all. Thus, any link between the exemption for dividends and the foreign tax rates imposed on the income of foreign affiliates has been abandoned. Moreover, the generosity of several aspects of the foreign affiliate rules has resulted in their operating, in practice, as a complete exemption system. Finally, the complexity of the rules for the computation of surplus accounts has imposed needless compliance costs on taxpayers and administrative costs on Canada's tax authorities.[48] Not surprisingly, no other country has copied Canada's combined exemption/credit system.

Since 1972, and with few exceptions, Canada has not been at the forefront of international tax policy and legislation. There have been two government-sponsored studies on the Canadian international tax system since 1972. The 1997 Technical Committee on Business Taxation devoted one chapter of its report to international issues and did not make any recommendations for structural changes.[49] The 2008 Report of the Advisory Panel on Canada's International Tax System was decidedly pro-business.[50] It concluded that the structure of the current system was appropriate, but recommended that the system should be made more generous for non-residents investing in Canada and for Canadian residents investing outside Canada. Its report has been largely ignored both inside and outside Canada.

Conclusion

The underlying policy and basic structure of Canada's international tax system has been remarkably stable since 1972. This stability provides certainty for taxpayers and will likely continue for the foreseeable future. Canada will continue to impose as much tax as it can on non-residents, subject to the constraints imposed by the need for foreign investment, tax treaties and potential retaliation by other countries; and Canada will act vigorously to protect its domestic tax base. In contrast, Canada will continue to subsidize Canadian corporations to invest offshore and to facilitate their avoidance of foreign tax. Finally, Canada will continue to actively participate in efforts to increase international tax cooperation.

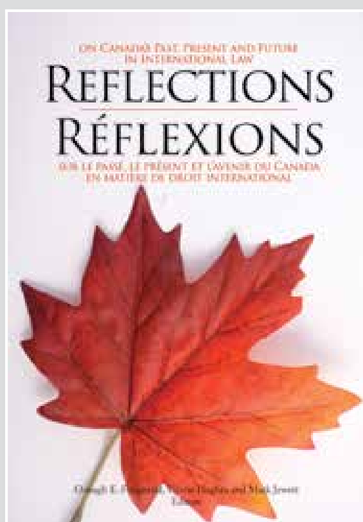
48 "Surplus accounts" were required for the exempt and taxable amounts earned by foreign affiliates on an annual unconsolidated basis and involved a curious combination of Canadian and foreign tax rules.

49 Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, December 1997).

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

SUR LE PASSÉ, LE PRÉSENT ET L'AVENIR DU CANADA EN MATIÈRE DE DROIT INTERNATIONAL

Oonagh E. Fitzgerald, Valerie Hughes and Mark Jewett, Editors



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