Centre for International
Governance Innovation

Canada in International Law at 150 and Beyond | Paper No. 15 — March 2018

Taxing Transnationals
Canada and the World

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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

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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

Allison Christians is the H. Heward Stikeman Chair in the Law of Taxation at the McGill University Faculty of Law, where she teaches and writes on national, comparative and international tax law and policy. She focuses especially on the relationship between taxation and economic development, the role of government and non-government institutions and actors in the creation of tax policy norms, and the intersection of taxation and human rights. She has written numerous scholarly articles, essays and book chapters, as well as editorials, columns and articles in professional journals, addressing a broad array of topics, and has been named one of the "Global Tax 50" most influential individuals in international taxation. Recent research focuses on evolving international norms of tax cooperation and competition, the relationship between tax and trade, and evolving conceptions of rights in taxation. Allison also engages on topics of tax law and policy via social media with her *Tax, Society, and Culture* blog and on twitter @profchristians.

Introduction

As 2017 marks 150 years of nation building by an independent Canada, it also marks the anniversary of a significant event that indelibly shaped Canada's social, economic and cultural development as a nation and a people. This event was the adoption of national income taxation in 1917. While perhaps not as universally celebrated as the sesquicentennial of the post-colonial federation, the adoption of income taxation at the federal level charted a course for Canada's development, both internally and as a force in the world. Today, the income tax system is under pressure from technological and financial globalization and innovation, which have altered the government's fiscal grip on transnational transactions and companies. Yet a look back at Canada's experience with income taxation demonstrates that globalization and innovation have always created both challenge and opportunity for the country.

Income taxation has long been a key component of Canada's involvement in global affairs — in terms of war, trade and diplomacy. The first national income tax was adopted for the purpose of financing Canada's engagement in World War I and was intended to be temporary. But the tax endured. Indeed, it became a signature mechanism for Canada's ongoing participation in the global economy and for Canada's diplomatic relations with other countries on matters of finance, trade and investment.

Canada's reputation as a stable member of the international community of states, its long-term relationships with key trading nations and regions, and its membership in the key global networks, especially the G7, Group of Twenty (G20) and the Organisation for Economic Co-operation and Development (OECD), have helped the nation become an important contributor to the development of international consensus on the key components of income taxation. As the global economy has become increasingly interconnected through the rise and dominance of transnational corporations, Canada has both shaped and been shaped by this international involvement.

Canada is currently poised to be a key participant in an overhaul of the international tax system that is being spearheaded by the OECD. This overhaul is evolving into a more globally inclusive venture that is sure to be reconfigured, reimagined and reiterated in the coming years.[1] A major impetus for the overhaul, known to tax professionals as the "Base Erosion and Profit Shifting" initiative (or by its now-ubiquitous acronym, BEPS), is an illustration that across the world, the income tax is faltering in its essential purpose.[2]

This essential purpose is to enable nations to raise revenues in a fair and effective way.[3] The idea of identifying and eliminating BEPS arose following rising popular perception that governments are no longer obligating transnational corporations to pay their fair share of income taxation. This narrative has been fed through media dissemination of events, such as the Lux Leaks and Panama Papers disclosures, as well as stories on the tax affairs of specific companies that sell popular consumer products and services.[4] An increasingly agitated public has responded to the news with calls for corporate accountability to the broader public, public sanction of companies accused of "tax dodging,"

1 Allison Christians, "BEPS and the New International Tax Order" (2016) 6 BYUL Rev 1603.

2 See Allison Christians & Stephen Shay, "Assessing BEPS: Origins, Standards, and Responses" (2017) 102:A Intl Fisc Assoc Cahiers 19 [Assessing BEPS]; Yariv Brauner, "What the BEPS" (2014) 16:2 Fla Tax Rev 55.

3 Income taxation has long been favoured compared to other forms of tax owing to its capacity to distinguish taxpayers according to their relative ability to pay, which is viewed as a just allocation of the tax burden. Ability-to-pay theory can be attributed to any number of sources, but scholars tend to point to Adam Smith, who said that individuals "ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities": Adam Smith, *An Enquiry Into the Nature and Causes of the Wealth of Nations* (1776) at Book V, c II, online: <www.gutenberg.org/ebooks/3300>. Ability to pay is compelling because it encapsulates numerous theories of equity, including the utilitarian notion of "equal sacrifice." Thus, John Stuart Mill explained, "all are thought to have done their part fairly when each has contributed according to his means, that is, has made an equal sacrifice for the common object; in like manner should this be the principle of compulsory contributions: and it is superfluous to look for a more ingenious or recondite ground to rest the principle upon": John Stuart Mill, *Principles of Political Economy* (London: WJ Ashley, 1929) at Book V, c II, s 2.

4 See Allison Christians, "Tax Activists and the Global Movement for Development through Transparency" in Miranda Stewart & Yariv Brauner, eds, *Tax, Law and Development* (Cheltenham, UK: Edward Elgar, 2013) at 288 [Christians, "Tax Activists"]; Robert Dover, "Fixing Financial Plumbing: Tax, Leaks and Base Erosion and Profit Shifting in Europe" (2016) 51:4 The Intl Spectator 40; Shuyi Oei & Diane Ring, "Leak-Driven Law" (2017) Tulane Public Law Research Paper No 17-1, Boston College Law School Legal Studies Research Paper No 442.

and legislative reforms designed to crack down on tax planning by major transnational firms.[5]

Canada, together with its OECD partners, is in the midst of addressing these calls through the implementation of BEPS and related measures. Even so, there is continued pressure on the tax system to achieve a sustainable balance between raising revenue and fostering economic productivity, and between treating each member of the population fairly and protecting the overall economic interests of the nation. The more turbulent the external environment becomes, the more tenuous the balance also becomes. Mediating these often-conflicting goals has been a constant theme in Canada's experience with income taxation over the past century.[6] This experience positions the nation to be a thought-leader and voice of reason in international debate regarding the taxation of transnational corporations going forward.

This paper is organized chronologically. It begins with an introduction of the federal income tax and its early progression in light of burgeoning efforts for international tax coordination. It then addresses the major reforms brought on by the Carter Commission and its assessment of the primary goals underlying income taxation in Canada. Next, it examines Canada's subsequent efforts to position itself in an increasingly competitive international tax environment. Finally, it analyzes the current role of corporate income taxation of transnationals in Canada and the uncertain future presented by a growing popular interest in international tax affairs and dissatisfaction with perceived abuses.

Income Tax: Adopted for War, Adapted for Peace

Introduced as a temporary measure to raise revenue for World War I, Canada's first income tax was imposed on high-income individuals and corporations at a modest rate.[7] As Minister of Finance Sir Thomas White explained before Parliament, the introduction of income taxation in Canada embodied striking a balance between revenue and economic goals:

> Hitherto we have relied upon duties of customs and of excise, postal rates and other miscellaneous sources of revenue. Canada has been, and will continue during the lifetime of those present today, to be a country inviting immigration. I have, therefore, thought it desirable that we should not be known to the outside world as a country of heavy individual taxation. We are, however, confronted with grave conditions arising out of the war. The time has arrived when we must resort to direct taxation.[8]

White stressed the temporary nature of the tax, proclaiming his confidence that while Canadians' patriotism would lead them to "accept the burden and the sacrifice of this additional taxation" for the duration of the war, their future support for the tax was uncertain.[9] Instead, the tax became the single most important revenue raiser in Canada, while simultaneously becoming a mechanism for

5 See e.g. Tax Justice Network, "Tax and corporate responsibility", online: <www.taxjustice.net/topics/corporate-tax/tax-corporate-responsibility>; UK Parliament Public Accounts Committee, "MPs publish report on Google's tax avoidance", online:<www.parliament.uk/business/committees/committees-a-z/commons-select/public-accounts-committee/news/tax-avoidance-google/>; Canadians for Tax Fairness, "Using the Law to Stop Corporate Tax Dodging", online: <www.taxfairness.ca/en/news/using-law-stop-corporate-tax-dodging>.

6 Canada's experience in assessing and evaluating its own evolving tax system has been characterized by a recognition that seeking fairness is an essential and inescapable foundation of the income tax. This was a key principle of the Carter Commission, which fundamentally altered the income tax system in Canada in the 1960s. See e.g. Allison Christians, "Drawing the Boundaries of Tax Justice" in Kim Brooks, ed, *Quest for Tax Reform Continues: The Royal Commission on Taxation Fifty Years Later* (Toronto: Carswell, 2013) at 53. It is also a recurring theme in federally commissioned studies and reports on the corporate and international tax system through the years.

7 *Income War Tax Act*, 1917, SC 1917, c 28 [*Income War Tax Act*]. The Income War Tax Act defined person to include, *inter alia*, individuals, trusts, associations and corporations (*Ibid*, s 2(d) (defining person), s 4 (charging tax on persons)). The act assessed a 4 percent rate and for individuals a surplus graduated tax of 2–25 percent on incomes in excess of CDN$6,000. For residents of Canada, the tax applied to income from any source (domestic and international), and for non-residents the tax applied to business income earned from a Canadian source: (*Ibid*, s 3 (defining income)). See also Brian J Arnold, "The Canadian International Tax System: Review and Reform" (1995) 43:5 Can Tax J 1792.

8 House of Commons Debates, 12th Parl, 7th Sess, No 4 (25 July 1917) at 3760 (Hon Sir Thomas White).

9 *Ibid*. Accordingly, the legislation placed no time limit on the measure, but White "placed upon Hansard the suggestion that, a year or two after the war is over, the measure should be reviewed by the minister of finance of the day, with a view of judging whether it is suitable to the conditions which then prevail."

centralizing power in the federal government that had previously been reserved to the provinces.[10]

It was not long before the adoption of income taxation drew Canada into international diplomacy over the question of which country has a primary right to tax a given income earner. This is because income taxation jurisdiction overlaps arise in parallel with trade and investment among countries. Thus, just as Canada sought to tax all of the income earned by its residents and Canadian-source business income earned by non-residents, the United States and the United Kingdom, its major trading partners, did the same. Unless relieved by either a domestic measure or a negotiated agreement among the relevant countries, a resident of a foreign country investing in Canada would face a tax in Canada as well as at home, while a resident in Canada would face the double taxation by investing abroad.

In 1919, the United States stood alone in providing a comprehensive foreign tax credit, which unilaterally relieved US taxation in favour of source country taxation.[11] Acting as a first mover to respect source taxation, the United States was seen as offering a "present of revenue" to capital-importing countries like Canada.[12] The United Kingdom provided a much more restricted foreign tax credit, generally preserving its own tax jurisdiction over that of source countries.[13] Other European nations, especially Italy and France, relied on source-based taxation and therefore vigorously defended the US position of ceding residence-based taxation to that of source.[14] As a member of the Commonwealth, Canada benefited from the narrow tax credit of the United Kingdom.[15] But as a net capital importer at the time, Canada benefited from the US position as well.[16]

The conflicting views of the United States and the United Kingdom about the proper method for relieving double taxation prompted several years of debate in the International Chamber of Commerce (ICC) and the League of Nations.[17] As a member of both institutions, Canada contributed to the consensus that finally formed. This consensus assigned the primary right to impose "personal taxation" to residence countries and "impersonal taxation" to source countries. These terms would be defined and implemented after long and contentious negotiations, held under the auspices of the League of Nations.

Ultimately, the League promulgated a model tax treaty under which countries agreed to restrict their source-based taxation of passive income items, such as dividends and interest, in favour of

10 See e.g. Rosa Mulé, *Political Parties, Games and Redistribution* (Cambridge: Cambridge University Press, 2001) at 52–81 (explaining the electoral incentives for using the tax system to redistribute income in Canada and the centralization of power in Ottawa that the success of the income tax thereby afforded).

11 H David Rosenbloom & Stanley I Langbein, "United States Tax Treaty Policy: An Overview" (1981) 19 Colum J Transn'l L 359; Michael J Graetz & Michael M O'Hear, "The 'Original Intent' of U.S. International Taxation" (1997) 46 Duke LJ 1021 at 1023 [Graetz & O'Hear]. Had Canada not enacted a similar provision, Canada's source tax would not have dampened US investment into the country because the United States would reduce its own taxation accordingly, while Canadian investment into the United States would have been discouraged because the resulting double taxation would not have been relieved by Canada. See e.g. Richard E Caves, *Multinational Enterprise and Economic Analysis*, 2nd ed (Cambridge: Cambridge University Press, 1996) ("Neutrality depends on who pays what tax, not which government collects it" at 190).

12 Edwin RA Seligman, *Double Taxation and International Fiscal Cooperation* (New York: Macmillan, 1928) at 133–35 n 10.

13 The United Kingdom's view was supported by the Netherlands. Both countries were primarily capital-exporting nations and thus the importance of preserving residence-based taxation was high. The United States was also a capital-exporting nation at the time, but favoured source-based taxation as a matter of policy. See Graetz & O'Hear, *supra* note 11.

14 Graetz & O'Hear, *supra* note 11.

15 *Finance Act, 1920* (UK), 10 & 11 Geo V, c 18, s 27, providing relief for income tax paid in any dominion of the United Kingdom.

16 For comprehensive historical data concerning Canada's international investment position see BW Wilkinson, *Historical Statistics of Canada, Section G: The Balance of International Payments, International Investment Position and Foreign Trade* (Statistics Canada, 1999), online: <www.statcan.gc.ca/pub/11-516-x/sectiong/4147439-eng.htm>. Canada became a net capital exporter beginning in 1997, thus altering its tax policy perspective, as observed by two committees convened to study various aspects of the federal tax system. Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, 1998) [Mintz Report] at 1.6; Advisory Panel on Canada's System of International Taxation, *Final Report: Enhancing Canada's International Tax Advantage* (Ottawa: Department of Finance, 2008) [Advisory Panel] at 6.6.

17 Discussions began in the newly formed ICC in 1920. In 1921, the ICC adopted a resolution that taxing jurisdiction turned on the nature of the tax, with distinctions being made between "super" and "normal" taxes. However, the United States rejected this resolution and endorsed closer adherence to the US system, with exceptions made for particular kinds of income, including that from international shipping (as to which residence-based taxation was to be preserved) and from sales of manufactured goods (to be apportioned under formula). The ICC synthesized the views of the United States and 14 other countries and produced a new resolution in Rome in 1923. The League of Nations began to take over the discussions in 1923, using the Rome resolutions as a basis for discussion. The compromise of the ICC as to super and normal taxes resurfaced in League of Nations discussions. See Graetz & O'Hear, *supra* note 11 at 1067–70.

the residence country,[18] and to assign the primary right to tax business income to the source country.[19] Countries would continue to assert source jurisdiction over passive income items by way of gross withholding taxes, but at a lower rate than under domestic law.[20] The League of Nations model treaty further evolved within the OECD beginning in 1963 and has been updated periodically since then.[21] The OECD Model is the standard upon which Canada's tax treaties are generally based.[22]

This evolution of tax policy internationally suited Canada's internal policy-making decisions in terms of the balance sought for achieving fairness and economic goals with an income tax. Just two years after introducing the tax, Canada enacted a foreign tax credit on income taxes paid to Great Britain and to other countries that granted a reciprocal credit. In doing so, Canada aligned its system with that of its major trading partners and thus entered the discourse on an international level at the beginning of the conversation.[23] This timely positioning carried through the following decades as Canada continuously refined its income tax to cope with an ever-more integrated economic environment for its corporate taxpayers.

During the inter-war years, while there was relatively little cross-border investment, Canada continued to refine its international tax regime. It entered into several tax treaties with its major trading partners (although most of these agreements concerned the taxation of shipping profits) and added a transfer pricing rule and withholding taxes for passive income items paid out to foreign investors.[24] In 1938, in keeping with the general international trend and its own attitude in favour of source taxation of active business income, Canada introduced a tax exemption for dividends paid to Canadian corporations by their wholly owned foreign subsidiaries from active foreign income.[25] Lacking a mechanism to look through corporate ownership for income earned abroad but effectively controlled by Canadian taxpayers, however, this reform meant that Canada's income tax on all forms of foreign income could easily be avoided. A Canadian company could simply incorporate a subsidiary in another jurisdiction, capitalize the company and acquire foreign assets, and then repatriate the profits earned with tax-exempt dividends, thus eliminating Canadian taxation on its foreign earnings without restriction.[26]

After World War II, Canada's outbound foreign investment and cross-border trade increased dramatically. Fostering this surge was a strong international interest in coming to accord on international peace through international trade, culminating in the Bretton Woods meetings and the establishment of the General Agreement on Tariffs and Trade (GATT), which later became the World Trade Organization (WTO).[27] Canada gradually became a capital exporter, alongside its historical position as capital importer.[28] This reinforced the need for a more sophisticated tax

18 *Ibid* at 1086–87 (citing the strong role of the United Kingdom in producing this result); Reuven Avi-Yonah, "The Structure of International Taxation: A Proposal for Simplification" (1996) 74 Tex L Rev 1301 at 1306.

19 Graetz & O'Hear, *supra* note 11 at 1023. The League of Nations first produced a model treaty in 1928.

20 Because passive income is taxed at source on a gross basis while active income is taxed on net income, the effective tax rate on the former would often be higher than on the latter.

21 The most recent is the 2014 version, publicly released in October 2015 and online: <www.oecd.org/ctp/treaties/model-tax-convention-on-income-and-on-capital-2015-full-version-9789264239081-en.htm>.

22 See e.g. Lara Friedlander & Scott Wilkie, "The History of Tax Treaty Provisions—And Why It Is Important to Know About It" (2006) 54 Can Tax J 907. A parallel model developed by the United Nations to effectuate more appropriate sharing of tax revenue in treaties between developed and developing nations while generally following the structure of the OECD model has also influenced Canada's treaties. See Kim Brooks, "Canada's Evolving Tax Treaty Policy Toward Low-Income Countries" in Arthur Cockfield, ed, *Globalization and Its Tax Discontents: Tax Policy and International Investments* (Toronto: University of Toronto Press, 2010) at 189–211.

23 *Income War Tax Act*, *supra* note 7 at s 4(5).

24 J Harvey Perry, "A Fiscal History of Canada: The Postwar Years" (1989) Canadian Tax Foundation Paper No 85 at 1019; Arnold, *supra* note 7.

25 Perry, *supra* note 24 at 1015. Perry notes that this exemption was gradually extended via 28(1)(d) *Income Tax Act*, SC 1952, c 29. Thereafter, through 1972, Canada followed a "clear and consistent policy of extending both the exemption for dividends from foreign corporations and the foreign tax credit", Arnold, *supra* note 7.

26 Sandra Slaats & Penny Woolford, "The Evolution of the International Tax Rules" (2010) 58 supp Can Tax J 225.

27 See e.g. *The Canadian Encyclopedia*, "GATT", online: <www.thecanadianencyclopedia.ca/en/article/general-agreement-on-tariffs-and-trade/> ("GATT was established in 1948 to regulate world trade. It was created as a means to boost economic recovery after the Second World War by reducing or eliminating trade tariffs, quotas and subsidies.…[T]he Allies believed that a multilateral framework for world trade would loosen the protectionist policies that defined the 1930s and create an economic interdependency that would encourage partnership and reduce the risk of conflict"). The GATT was signed in 1947 by 23 countries, including Canada, and came into effect in 1948; the WTO superseded it in 1995. See WTO, *The Text of the General Agreement on Tariffs and Trade* (Geneva: WTO, 1986), online: <www.wto.org/english/docs_e/legal_e/gatt47_e.pdf>.

28 See Mintz Report, *supra* note 16.

regime for inbound and outbound investments. While not specifically aimed at achieving these goals, a review of the entirety of the Canadian income tax system commissioned by the government in 1962 introduced measures that would bring about fundamental changes to Canada's corporate tax regime.

The Carter Commission and a New Era for the Taxation of Transnational Companies

In 1962, Prime Minister John Diefenbaker convened the Royal Commission on Taxation — named colloquially after its chairman, Kenneth LeMesurier Carter — to undertake a pragmatic task: to examine the existing tax system in Canada and make recommendations to ensure a steady flow of revenue.[29] In laying out the parameters of this task, the prime minister asked the commission to consider "changes that may be made to achieve greater clarity, simplicity, and effectiveness in the tax laws."[30] The scope clearly focused on finding new sources of tax in a time of public demand for expanding the welfare state.

The panel determined, however, that it could not answer the pragmatic question without first coming to terms with the essential foundations of the nation's exercise of taxation. The Carter Commission report thus turned quickly to the issue of fairness, stressing on its first page and repeatedly throughout its six volumes that above all other observations, the Canadian tax system as it was then constituted did not "afford fair treatment for all Canadians."[31]

Following this assertion, the commission proceeded to address virtually every policy question it was asked to consider from the perspective that the pursuit of fairness had to be the primary goal in the design of the tax system. The commission explained this as evident from the fact that taxation is a matter of choice for any state: "[W]e have consistently given the greatest weight to the equity objective. Taxation is one method of transferring command over goods and services from individuals and families to the state. If equity were not of vital concern taxes would be unnecessary. The state could simply commandeer what it needed. The burden of a reduced private command over goods and services would then be borne by those individuals and families who happened to be within easy reach of the state."[32]

This lays out the commission's first key principle: taxation is only necessary in a society that concerns itself with fairness.[33] The commission asserted that the state could only pursue fairness by first identifying a normatively justified tax base and then explaining any deviation therefrom.[34] After undertaking a comprehensive review of Canada's tax system, the commission called for, *inter alia*, a number of significant structural changes in the federal tax regime, which would ultimately impact the taxation of transnational companies. After much debate and a legislated response that significantly departed from many of the commission's recommendations, a number of new tax policies were introduced beginning in 1972.[35]

Among these were a key set of rules addressing the tax treatment of income earned by and through foreign affiliates of Canadian companies, which became effective in 1976. Although tweaked and amended over the years, these rules became a mainstay of the Canadian corporate tax system as it applies to transnationals. The

29 Canada, *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966) [Carter Commission] vol 4, Part D.

30 Order in Council, PC 1962-1334, reprinted in Carter Commission, *ibid*, vol 1 at v.

31 Carter Commission, *supra* note 29, vol 1 at 1.

32 *Ibid*, vol 1 at 4.

33 The principle stated was that if the state need not concern itself with fairness, it need not tax at all, so that if it does choose to tax, it must necessarily do so out of an express duty to pursue fairness.

34 Among its criticisms, the Carter Commission (*supra* note 29, vol 1 at 1) noted two key failures: "People in essentially similar circumstances do not bear the same taxes, [and] people in essentially different circumstances do not bear appropriately different tax burdens." The commission laid out a formula to remedy these injustices by allocating the tax burden based on relative ability to pay. The Committee believed that ability to pay principles "would be achieved when taxes were allocated in proportion to the discretionary economic power of tax units....For this purpose we have found it useful to think of discretionary economic power as the product of the tax unit's total economic power and the fraction of the total economic power available for the discretionary use of the unit" (*ibid*, vol 3 at 5).

35 EJ Benson, *Proposals for Tax Reform* (Ottawa: Queen's Printer, 1969).

foreign affiliate rules replaced the broad dividend exemption and distinguished among three types of revenue. First, only active business income earned in a designated country would henceforth be exempt from Canadian tax.[36] This was to relieve Canadian-based transnationals of Canadian tax liabilities when competing in foreign markets, but only where the foreign market was expected to impose income taxation on such taxpayers. The income thus earned, dubbed "exempt surplus," would be repatriated freely.

Second, active business income earned in a non-treaty country, dubbed "taxable surplus," would be subject to Canadian tax with the normal tax credit for foreign taxes available upon repatriation. Finally, "foreign accrual property income," or "FAPI,"[37] would be taxed to specified Canadian shareholders of specified controlled foreign affiliate companies, with double tax relieved by foreign tax credit. The FAPI rules constituted a specific anti-avoidance regime aimed at preventing the shift of paper profits to foreign jurisdictions. These rules were "vigorously opposed by Canadian multinationals and their advisers."[38] But they were in line with the policies of Canada's most important trading partner, the United States, which had adopted similarly focused rules a decade earlier.[39]

In addition to the FAPI and other foreign affiliate rules, the statutory withholding tax on income earned by non-treaty-country foreign transnationals investing in Canada increased from 15 percent to 25 percent.[40] This change put pressure on the use of treaties by third parties (a phenomenon colloquially referred to as treaty-shopping), an issue that later became a major component and has recently been at the forefront of the BEPS initiative.[41]

Finally, "taxable Canadian property" rules were enacted to impose greater taxation on inbound investors, and Canada became among the first countries to introduce thin capitalization rules to prevent companies from shifting profits out of Canada via inter-company debt featuring high interest rates paid to foreign entities.[42] At first, Canada's thin capitalization rules were not overly restrictive, given the high debt-to-equity ratio permitted (3:1), but later amendments tightened the rules.[43]

After adopting these rule changes, Canada vastly expanded its treaty network over the course of the 1970s and 1980s. Its negotiation position changed considerably with the reforms, because it was now working from a baseline of higher withholding rates, more taxes on Canadian source gains and more safeguards.[44] The main focus on these reforms seemed to be on eliminating barriers to trade and improving Canada's competitive position, while also protecting the tax base from easily implemented avoidance schemes involving non-resident companies.

36 At first, Canada maintained a list of countries where active business income earned was exempt. In 1994, this list was restricted to "designated treaty countries." See Canada, *Report of the Auditor General of Canada to the House of Commons 1992* (Ottawa: Supply and Services, 1992) at Exhibit 2.1; *Income Tax Regulations*, CRC, c 945, r 5907(11). The exempt surplus regime now includes double taxation and exchange of information treaties and countries with which Canada is currently negotiating such a treaty, provided that one is signed within five years. An advisory panel formed in 2007 to study the international tax system recommended abolishing geographic restrictions on exempt surplus. See Advisory Panel, *supra* note 16 ("The federal government should maintain the existing system for the taxation of foreign-source income of Canadian companies and extend the existing exemption system to all active business income earned outside of Canada by foreign affiliates" at 19).

37 This mostly includes passive income.

38 Arnold, *supra* note 7.

39 See e.g. Robert J Peroni, "Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules" (1997) 51 U Miami L Rev 975, 987 (explaining the evolution of the US-controlled foreign corporation rules).

40 Carter Commission, *supra* note 29 ("a similar alleviation of the tax on dividend distributions to non-residents would result in a cost to the Canadian treasury which would largely accrue to the benefit of foreign treasuries" at 483). See also Alex Easson, "The Evolution of Canada's Tax Treaty Policy Since the Royal Commission of Taxation" (1988) 26:3 Osgoode Hall LJ 495.

41 Assessing BEPS, *supra* note 2.

42 Arnold, *supra* note 7.

43 Mintz Report, *supra* note 16 at 6.26.

44 Easson, *supra* note 40 at 503.

Evolving Tax Strategy in an Increasingly Competitive Environment

Following the measures and safeguards introduced after the Carter Commission, Canada's taxation of transnational companies continued to invigorate scholarly and policy debate. A general tax reform of 1987 refrained from introducing major changes that would affect transnational companies, but acknowledged again the delicate balance being forged by Canadian law makers in respect of the corporate tax: "It is important that our tax system not place Canadians at a competitive disadvantage in domestic or international markets. We must recognize the competitive reality of tax systems in other countries. At the same time, the tax system must remain sensitive to the Canadian commitment to greater regional equality through economic development."[45]

By the 1990s, however, concerns about tax base erosion and harmful tax competition created by international planning and arbitrage began to take centre stage in Canadian tax policy discourse.[46] In 1996, the minister of finance appointed a technical committee on business taxation to review the Canadian business taxation system. The committee, chaired by Jack M. Mintz, released its report in 1997.[47] The Mintz Report repeated the ubiquitous issue of balance for the Canadian tax system, stating, "Tax policies related to inbound and outbound investment are driven by two important objectives: domestic economic growth and job creation on the one hand, and protection of the Canadian revenue base on the other. The Committee recognizes that there are often tensions between these two objectives."[48]

The Mintz Report observed that Canada derives "considerable benefit" from the existence of Canadian-headquartered transnationals, specifically that "foreign multinationals operating in Canada provide capital, management and expertise for the development of key sectors of the economy."[49] The report therefore prioritized "the expansion of such companies, and their foreign investment, with foreign and domestic investors being placed on a similar footing."

Even while thus proclaiming national support for transnationals in Canada, the report noted that such companies tended to use international financial structures to shift deductible expenses into Canada, "thereby eroding the tax base."[50] The report dedicated a section to denouncing aggressive tax competition and the perils of a race to the bottom with the tax system.[51] Even so, the committee concluded that Canada's foreign affiliate regime was "fundamentally sound and should be maintained."[52] Like most studies produced by economists throughout the age of modern taxation, the report advocated a lower corporate tax rate offset by a broader base. Although the report suggested various amendments to the international tax regime,[53] it took many years before any reforms consistent with its recommendations were seriously considered by Parliament.[54]

One section of the report dealt briefly with the possibility of effectuating a major structural change to the Canadian tax system through the adoption of various alternatives to the corporate tax, such as a "cash flow" type tax.[55] The report considered the likely costs and benefits of switching from a corporate income to a cash flow tax and ultimately rejected the idea as undesirable owing to the probability that such a change would fundamentally destabilize the entire income tax structure in Canada, as well as introducing a rift with Canada's major trading partners.

45 Canada, Department of Finance, *The White Paper: Tax Reform 1987* (Ottawa: Department of Finance, 18 June 1987) at 4.

46 Slaats & Woolford, *supra* note 26.

47 Mintz Report, *supra* note 16.

48 *Ibid* at 6.1.

49 *Ibid* at 6.1–6.2.

50 *Ibid* at 6.3. For an explanation of several of the mechanisms by which companies continue to effectuate profit shifting, see Angelo Nikolakakis, "Outbound Foreign Direct Investment: 25 Years of Searching for the Right Balance—The Parameters of the Canadian Cone, the Canadian Hourglass, and the Canadian Tax Base" (2013) 61 supp Can Tax J 311.

51 Mintz Report, *supra* note 16 at 6.3, 6.35.

52 *Ibid* at 6.10. This sentiment was affirmed by the advisory body later convened to review the soundness of Canada's overall approach to taxing international income. See Advisory Panel, *supra* note 16.

53 For example, for withholding taxes to cover back-to-back loans, Mintz Report, *supra* note 16 at 6.26.

54 See e.g. Nikolakakis, *supra* note 50.

55 See Mintz Report, *supra* note 16, Annex A at A8–A12.

Aligning with trading partners, especially the United States, has remained a constant theme in Canadian corporate tax policy making. Recently, legislators in the United States raised the possibility that they could adopt a cash flow tax, similar to that discussed in the Mintz Report.[56] The prospect of future reform along the same lines raises anew the Mintz commission's concerns about the stability of the Canadian tax system in such an event.[57] These concerns are justifiable, given a century of tailoring Canada's corporate tax rules to a world in which Canada has focused on making itself a competitor to its much more economically powerful neighbour.

The overall lesson of the Mintz Report for Canadian corporate tax policy appears to be that for maximum efficacy in a world replete with strong competition for the factors of economic growth and productivity, Canada's best strategy is to remain stable and consistent in the fundamentals with its major trading partners, and to work to achieve a competitive edge within the confines of global consensus as it may evolve.[58] The Mintz Report predicted some of the risks to Canada's achievement of incremental gains from modest tax competition; these risks loom large as the international tax regime continues to evolve.

56 Paul Ryan, *A Better Way: Our Vision for a Confident America* (24 June, 2016), online: <abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf> (sketching the contours of a possible destination-based cash flow tax (DBCFT) as a replacement for the corporate income tax in the United States). Under this proposal, the six main features of the DBCFT would be to include revenues from domestic sales in the tax base, to exclude revenue from foreign sales from the tax base, to exempt dividends from foreign subsidiaries, to eliminate deductions for all foreign costs and net interest, and to immediately expense allowable domestic costs (eliminate capitalization). The tax would function as, effectively, a value added tax with a wage subsidy, which would have the effect of taxing imports on a gross basis while taxing domestic products on a net basis.

57 For a discussion, see e.g. Paul Seraganian & Ramin Wright, "The U.S. 'Big Border Tax': A primer for Canadians" (16 February 2017), online: Osler, Hoskin & Harcourt LLP <www.osler.com/en/resources/cross-border/2017/the-u-s-big-border-tax-a-primer-for-canadians>.

58 This position has been affirmed by Canadian tax professionals, such as those submitting input in the later-convened advisory panel on international taxation. For example, Deloitte & Touche LLP stated that "Canadian companies compete against enterprises based in countries whose international tax systems … facilitate lower effective tax rates on foreign earnings. Although some countries have introduced a comprehensive interest deductibility rule (for example, Australia, Germany), it is not yet a widespread development. If more countries shifted their tax systems to this type of rule, and if the United States tightened its international tax system, Canada might then consider similar changes. In the meantime, there is little to be gained by moving early." Advisory Panel, *supra* note 16 at 4.150.

Another Century for Corporate Income Tax?

As the new century dawned, Canada again sought to reflect upon the efficacy of its corporate tax system in international terms. In 2007, the minister of finance established the Advisory Panel on Canada's System of International Taxation with a mandate to recommend ways to improve its "competitiveness, efficiency and fairness."[59] Consistent with the findings of the Mintz committee, the advisory panel concluded, "the Canadian international tax system is a good one that has served Canada well."[60]

Accordingly, the panel sought "not to reform but rather to improve" the system. It did so mainly by advocating for reforms that would situate the Canadian rules squarely within international norms. This made practical sense on grounds that "systems that deviate too much from international norms carry a steep cost."[61] While not stating so explicitly, this report strongly implies that the Canadian approach to corporate taxation depends heavily on US tax policy, including in terms of weaknesses in the latter creating opportunities for Canada to attract investment.[62]

While some of the reforms suggested by the 2008 advisory panel report ultimately made their way into legislation, the global economic recession quickly changed the politics of tax competition in Canada and across the world. The juxtaposition of cutbacks in popular social programs and headline news stories about low tax rates paid by blue chip transnational corporations such as Google, Apple, Starbucks and Amazon ushered

59 Advisory Panel, *supra* note 16 at 1.

60 *Ibid* at 1.12.

61 *Ibid* at 3.15.

62 For example, the report recommends retaining Canada's exemption system for foreign tax paid on active business income, in contrast to the credit method used by the United States, which allows indefinite deferral until repatriation: see *ibid* at 4.19ff and Appendix C. More generally, the report frequently refers to US rules in its assessment of Canada's tax position. See e.g. *ibid* at 12, 51, table 5.2 and paras 4.127, 4.158, 5.33, 5.41, 6.8, 7.40ff, 8.16.

in a new era of social awareness regarding the contours of the international tax system.[63]

The public response to this juxtaposition in many countries has been resistance, with public protests linking low corporate taxation to specific cuts in social safety nets. A vivid example of this phenomenon is the campaign by UK Uncut to link the taxation affairs of Starbucks in Europe to the loss of women's health services in the United Kingdom.[64] In Canada, stories about the tax affairs of transnational companies have not occupied the news headlines with the same frequency and urgency as they have elsewhere, but a series of media reports have nevertheless brought international corporate taxation to sustained public attention, forging connections to an emerging discourse on corporate social responsibility.

Perhaps the most salient of these has been the so-called Panama Papers leak, which highlighted the use of Panama as a tax haven. While much of the media attention focused on the use of Panama by wealthy Canadians seeking to evade Canada's personal income tax, some of the coverage sought to expose Canada as a tax haven to the extent that it allows transnational companies to minimize their global taxes by using Canadian structures and transactions.[65] Other journalists have engaged in more focused efforts to examine the tax affairs of Canadian-based transnational companies.

For example, journalists engaged in an investigative report of the tax affairs of Gildan Activewear, a Canadian-headquartered apparel company with its operations in Barbados and elsewhere throughout the Caribbean.[66] The journalists took issue with the extension of the exempt surplus rule to low-tax jurisdictions like Barbados and concluded that Canada's law makers have undertaken policy decisions specifically designed to release transnational companies from Canadian taxation, creating tax opportunities of which Canadian businesses have taken "full advantage."[67]

The tax-planning strategies at issue in much of the Panama Papers leaks and other investigative reports, such as Gildan, ultimately involve a public perception of companies exploiting the legal system to their maximum advantage. Their actions do not generally constitute tax evasion, but might be described as tax avoidance at its most sophisticated. The public may object, but arranging affairs to minimize taxation is a well-established right in Canada, as it is elsewhere. Thus, in the infamous 1936 case involving the Duke of Westminster, which has resonated through the years in Canadian tax history, Baron Thomas Tomlin wrote: "Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax."[68]

The same principle has been affirmed to be fully in effect more than six decades later, and it applies equally to corporate taxpayers as to individuals, as Chief Justice Beverley McLachlin reiterated in a 1999 decision involving tax planning by Shell Canada: "It is not the courts' role to prevent taxpayers from relying on the sophisticated structure of their transactions, arranged in such a way that the particular provisions of the Act are met, on the basis that it would be inequitable

63 For a review and analysis of the growing international social movement to reform corporate taxation in response to this awareness, see Christians, "Tax Activists", *supra* note 4.

64 See e.g. Roxanne Escobales & Tracy McVeigh, "Starbucks hit by UK Uncut protests as tax row boils over", *The Guardian* (8 December 2012), online: <www.theguardian.com/business/2012/dec/08/starbucks-uk-stores-protests-tax>.

65 See e.g. Dave Seglins, Rachel Houlihan & Zach Dubinsky, "'Tax haven' Canada being used by offshore cheats, Panama Papers show", *CBC News* (24 January 2017), online: <www.cbc.ca/news/investigates/panama-papers-canada-tax-haven-1.3950552>.

66 Joe Castaldo, Mark Brown & Matthew McClearn, "Gildan Activewear: How the government made it easier to avoid paying taxes", *Canadian Business* (27 February 2014), online: <www.canadianbusiness.com/companies-and-industries/gildan-activewear-taxes/>.

67 *Ibid*. See also Canada, House of Commons, Standing Committee on Finance, *The Canada Revenue Agency, Tax Avoidance and Tax Evasion: Recommended Actions, Report of the Standing Committee on Finance* (October 2016) (Chair: Wayne Easter), discussing a tax scheme promoted by KPMG for high-net-worth Canadian individuals to avoid taxation through arrangements in the Isle of Man. Although this controversy did not concern transnational corporations directly, it contributed to bringing international tax-planning issues to the forefront of public debate and led to the addition of new resources for auditing transnational corporations for tax avoidance; see Canada, Department of Finance, "Growing the Middle Class" (22 March 2016) at ch 8; Ottawa, Department of Finance, "Building a Strong Middle Class: Budget 2017" (22 March 2017) at ch 4.

68 *Duke of Westminster v IRC*, [1936] 19 DTC 490, [1936] AC 1 at 520 (Canada); see also *Ayrshire Pullman Motor Services and Ritchie v IRC*, [1929] 14 DTC 754 (Canada): "No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores" at 763).

to those taxpayers who have not chosen to structure their transactions that way."[69]

In the United States, the same doctrine is famously stated by Learned Hand in *Helvering v Gregory*, as follows: "Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury. There is not even a patriotic duty to increase one's taxes."[70] These judgments might be taken as a simple restatement of the fundamental idea that it is not illegal to strictly and even formalistically obey the law, even if the obedience is calculated and highly sophisticated.

In a more recent important Canadian tax case following Canada's adoption of a general anti-avoidance rule, McLachlin observed that taxpayers must abide by the spirit and purpose of the law and not only its technical strictures.[71] This observation may not offer much solace to those dissatisfied with the status quo: as the various tax commissions and panels over the years have shown, Canadian law makers have sent undeniably mixed signals about the spirit and purpose of the corporate tax law by repeatedly raising the problematic issue of balance among mutually exclusive policy goals and then often choosing a balance that appears to prioritize tax minimization as a preferred strategy for Canadian-based transnationals.

Compliance with legal rules is, however, not the only influential factor in decision making by transnational companies. The growing popular interest in the tax affairs of transnationals, such as those exposed in the Panama Papers and the Gildan investigation, suggests that the Canadian public is increasingly unsatisfied with the balance being struck in Canada's international tax policy and seems willing to impose a social cost on companies in the form of "name and shame" campaigns.[72]

Taxation may consequently become a factor for corporate managers to consider in social responsibility terms instead of solely in terms of profit impact. One question is whether Canada's corporate managers are empowered to make tax-planning decisions based on factors other than the maximization of shareholder returns, consistent with their statutory fiduciary duties. Based on some recent Canadian corporate law cases, there is reason to affirm this possibility.[73] For example, in a 2008 case involving the treatment of debt-holders in a corporate restructuring plan, the Supreme Court found: "In considering what is in the best interests of the corporation, directors may look to the interests of, *inter alia*, shareholders, employees, creditors, consumers, governments and the environment to inform their decisions. Courts should give appropriate deference to the business judgment of directors who take into account these ancillary interests, as reflected by the business judgment rule."[74]

The court went on to explain the business judgment rule to mean that courts will defer to director's business decisions so long as they lie "within a range of reasonable alternatives," on the principle that directors are typically in the best position to determine what is in the best interests of the corporation.[75] This lays the foundation for Canadian-based transnationals to engage in a different kind of self-help than that which is normally associated with tax planning, namely, by reducing the vigour with which they embrace generous tax rules enacted by Parliament.

The likelihood that they will do so seems small, despite the observation of the 2008 advisory panel on international tax reform regarding the essentially cooperative nature of Canadian companies.[76] The panel observed, "To call for businesses to be reasonable in their tax planning and for tax administrators to be less suspicious may be perceived as naïve. The panel believes that mutual responsibility and

69 *Shell Canada Ltd v Canada*, [1999] 3 SCR 616, 1998 CanLII 19117 (SCC), at para 45.

70 *Helvering v Gregory*, 69 F2d 809 at 810 (2d Cir 1934).

71 See e.g. *Canada Trustco Mortgage Co. v Canada*, 2005 SCC 54, [2005] 2 SCR 601.

72 See Allison Christians, "How Starbucks Lost its Social License — And Paid £20 Million to Get it Back" (2013) 71 Tax Notes Intl 637.

73 *Peoples Department Stores Inc (Trustee of) v Wise*, [2004] 3 SCR 461 (finding that "all the circumstances may be scrutinized to determine whether the directors and officers have acted honestly and in good faith with a view to the best interests of the corporation" at para 39); *BCE Inc v 1976 Debentureholders*, [2008] 3 SCR 560 [*BCE*]; see also Ed Waitzer & Johnny Jaswal, "Peoples, BCE, and the Good Corporate 'Citizen'" (2009) 47:3 Osgoode Hall LJ 439.

74 *BCE*, *supra* note 73, at para 40.

75 *Ibid*, citing *Maple Leaf Foods Inc. v Schneider Corp*, 1998 CanLII 5121 (ON CA), 42 OR (3d) 177 (CA); *Kerr v Danier Leather Inc.*, 2007 SCC 44, [2007] 3 SCR 331.

76 Advisory Panel, *supra* note 16 at 3.29.

cooperation will help achieve real efficiency and simplicity within the tax system."[77]

To the extent that Canadian companies are not yet ready to engage in social cooperation to the degree potentially sought by the public, there is likely little legal recourse. A company's failure to consider corporate social responsibility norms may have little consequence in fiduciary terms.[78] Even so, to the extent that national and international efforts to strengthen the international income tax system fail to deliver different results than have been observed in the past, the demand for companies to cooperate with public expectations is likely to increase. It remains to be seen how this latest test of balance in Canadian tax policy making will play out.

Conclusion

Most historical accounts identify war as the main or even the sole explanation for the adoption of income taxation in Canada. Today, globalization and innovation are seen as income taxation's main threat or opportunity, depending on one's perspective. There is little doubt that war was the impetus, but the technological capacity to implement a national tax, the usefulness of the tax in centralizing power, and its efficacy in raising revenues for other purposes all made the income tax a permanent fixture on the Canadian landscape. In turn, developing a modern tax system, which has unavoidably impacted international commerce and trade, brought Canada to the fore in international dialogues on trade and fiscal policy, practically from the moment of its enactment. Income taxation has been a major part of Canada's development as a nation and as a member of the international community.

Today, the architects of the income tax in Canada continue to seek a balance between the perceived power this tax holds to impact locational decision making by transnational firms and its perceived impact on fundamental notions of fairness among the populace. Managing prospective upheavals, such as technological innovation and structural changes that may be adopted by its major trading partners, will force Canada to further reflect upon its past tax policy choices. As it did in the initial forging of the international tax system and throughout the evolution of international taxation to date, Canada stands poised to take a leadership role in the next iteration of international tax governance.

Author's Note

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77 *Ibid* at 3.30.

78 See *Piedra v Copper Mesa Mining Corp*, 2011 ONCA 191, 332 DLR (4th) 118 at para 82 (Ontario Court of Appeal finds that the failure to consider corporate social responsibility initiatives is not a source of liability for corporate directors).

on Canada's Past, Present and Future in International Law

Reflections
Réflexions

sur le passé, le présent et l'avenir du Canada en matière de droit international

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

Marking 150 years since Confederation provides an opportunity for Canadian international law practitioners and scholars to reflect on Canada's rich history in international law and governance, where we find ourselves today in the community of nations, and how we might help shape a future in which Canada's rules-based and progressive approach to international law gains ascendancy. These essays, each written in the official language chosen by the authors, provide a critical perspective on Canada's past and present in international law, survey the challenges that lie before us and offer renewed focus for Canada's pursuit of global justice and the rule of law.

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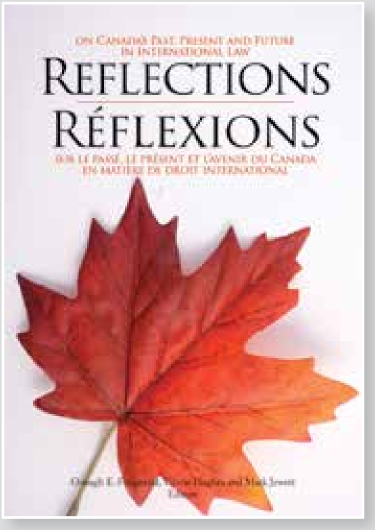

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