GLOBALIZATION AND ITS TAX DISCONTENTS

Tax Policy and International Investments

Edited by

ARTHUR J. COCKFIELD

GLOBALIZATION AND ITS TAX DISCONTENTS:
TAX POLICY AND INTERNATIONAL INVESTMENTS

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Globalization and Its Tax Discontents

Tax Policy and International Investments

ESSAYS IN HONOUR OF ALEX EASSON

Edited by Arthur J. Cockfield

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Preface

I am privileged to have known the late Alex Easson, both as his student and, later, as his colleague. In the early 1990s, I took two courses with Professor Easson: Business Associations and Tax Policy. For the latter, a seminar course, I wrote a paper on policy responses to tax haven developments, and I recall that Professor Easson provided extensive and insightful comments on my work, on which I subsequently relied when I pursued graduate studies in international tax law. After I joined the Faculty of Law at Queen's University in 2001, Professor Easson (then retired) was kind enough to continue to help me with my research and to invite me to his home, where I first met his wife Trudie. I will always remember his cheerful demeanour and his obvious passion and devotion to the life of a scholar.

This book draws from essays given at a symposium held in honour of Professor Easson at Queen's Law on 29 February 2008. The symposium brought together a range of experts on the topic of tax policy and international investments, which served as Professor Easson's main research focus. During the symposium itself, at the reception at the Agnes Etherington Art Centre, and at a dinner at the University Club, which Professor Easson frequented to share a drink with his mates, we remembered with fondness his life and achievements.

We are grateful for the financial support for these events provided by the Faculty of Law, KPMG LLP, and an anonymous private donor. I am also very appreciative of the organizational and other assistance offered by my symposium co-chair Gabe Hayos. I would like to thank, in addition to the chapter contributors, those who helped out as panel chairs or paper commentators at the symposium: Mary Anne Bueschkens, David Duff, David Kerzner, Lori McMillan, Mark Meredith, Brian Mustard,

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I also wish to thank Adam Freedman and Shannon Nelson for their assistance with the preparation of this book. Finally, I am grateful for the editorial assistance of Jennifer DiDomenico at the University of Toronto Press and for the helpful input provided by four anonymous referees selected by the Press.

This book is dedicated to Trudie Easson.

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April 2009
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PART I

Designing Tax Rules for Foreign Direct Investment

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1 Introduction: The Last Battleground of Globalization

ARTHUR J. COCKFIELD

1.0 The Battle for International Investments

The topic of globalization and tax is an ancient one. Writings in the area date back at least 2,500 years to the work of Herodotus, the ancient Greek scholar who coined the term 'history.'[1] In *The Histories*, Herodotus tells us of an era when ancient peoples came increasingly in contact with one another through cross-border trade and investment as well as warfare. He was writing during the so-called Greek Enlightenment, a time of relative peace and prosperity for the Greeks who, a generation before, had successfully defended their lands against invasion by the Persians. Intensely interested in foreign developments, the Greeks reviewed the tax systems within the great Persian and Egyptian empires to see what lessons they could learn: for instance, Herodotus tells us that, in 594 BC, Solon the Athenian copied the Ancient Egyptian practice of forcing citizens to declare how much wealth they had for tax purposes.[2]

In an era of enhanced global economic interdependence, modern governments, like those of the ancients, increasingly study the tax policies in place elsewhere. In contemporary terms, they are seeking to ensure their tax rules governing the treatment of cross-border investments are 'competitive' with those of foreign tax regimes, a much friendlier battle than the real ones of earlier eras. In recent years, governments in the United States, the United Kingdom, Germany, Italy, Australia, New Zealand, Sweden, and elsewhere have discussed reforming their tax systems so that they encourage (or at least do not inhibit) international investments.[3] In 2007, the Canadian minister of finance appointed an Advisory Panel on Canada's System of International Taxation to 'improve the fairness, economic efficiency and competitiveness of Cana-

da's international tax regime.'[4] In December 2008, the Advisory Panel published a report recommending that Canada exempt from taxation all foreign-source active business income.[5]

This book draws from papers prepared for a symposium on 'Globalization and the Impact of Tax on International Investments,' held at Queen's University, Kingston, Ontario, on 29 February 2008. The symposium was held in honour of the late Alex Easson (1936–2007), a scholar who devoted a significant portion of his professional life to the study of international tax.

Easson was born in Bradford, England, in 1936. Like Herodotus, he lived in an era of relative peace and affluence that followed a period of devastating warfare, though perhaps Easson's life was touched more directly by war: during his childhood, the Luftwaffe were bombing his country. After graduating from Oxford University's Exeter College and the London School of Economics, Easson first taught at the University of Southampton. In 1974 he moved to the Faculty of Law at Queen's University – a permanent appointment followed in 1976 – where he remained until his retirement in 2000.

Over the course of his productive career, Easson published more than twelve books and more than fifty articles and chapters. The breadth of his scholarship is evident in his willingness to tackle non-tax areas such as business associations law and family law.[6] Even within tax law, he wrote in diverse areas: he published the first tax law casebook in the United Kingdom in 1973 (subsequent editions continue to be published by different authors),[7] and his publications include discourses on space taxation,[8] family law tax issues,[9] and the different ways that governments determine the source of income for tax purposes.[10]

Within his main research focus on tax policy and international investments, Easson reviewed how globalization – the tying together of nations through economic and other activities – was driving international tax policy developments. He noted that, from the perspective of the taxation of international investments, the main relevant features of globalization are:[11]

- the increasing activity of multinational companies;
- the internationalization of the way in which these companies organize their business;
- the increasing number of countries that act as both importers and exporters of investment capital;
- the increasing complexity of cross-border transactions; and

- the shrinking of geographical constraints to international business activities as a result of the information and communication technology revolution.

Easson bore more direct witness to the globalization process through his travels to more than forty countries, often accompanied by his wife Trudie, during his work as an international tax consultant for the Organisation for Economic Co-operation and Development (OECD), the International Monetary Fund, the Australian Agency for International Development, and the World Bank, among others. In particular, he studied how tax reform could improve the plight of individuals in the poorer countries, and he helped to design new tax laws for places such as Bosnia, Mauritius, St Kitts, St Lucia, and Sierra Leone.

To Easson, tax could play a significant role in helping those who had yet to benefit from globalization. Countries mired in war and terrible poverty represent a paradox of globalization: economic development has pulled much of the world out of poverty, yet a significant part of humanity remains untouched by these developments.[12] In addition, economic interdependency has so deepened that developments such as the recent global financial crisis now flow with ease across the borders of both the developed and developing world.

2.0 The Increasing Sensitivity of Cross-border Investment to Tax

What factors have contributed to this deepening of global economic linkages? In recent decades, the increase in international trade and investment – direct investment into and out of Canada increased by roughly five hundred per cent between 1986 and 2007 – likely has been encouraged by the falling of tariff and non-tariff barriers.[13] However, countries have refused to negotiate binding multilateral tax agreements, so that tax remains one of the last barriers to the integration of global capital markets.[14] As a result, investment decision-making is becoming increasingly sensitive to national tax differences. The essays in this book explore how globalization has highlighted a number of international tax policy challenges. For example,[15]

- the current international tax regime permits countries to maintain different tax rules, which encourages multinational firms to shift the location of their investments and operations to countries that impose relatively lower (or nil) tax burdens;[16]

- multinational firms shift more and more paper profits through sophisticated tax-planning strategies to investments in countries that impose relatively lower (or nil) tax burdens, which often reduces taxes collected in relatively high-tax countries;[17] and
- it is becoming progressively more difficult to determine which country should assess the appropriate tax liability (along with enjoying the resulting tax revenues) on globally integrated products and services derived through cross-border investments.[18]

For a sense of the policy challenges, consider the tax issues surrounding one such globally integrated product: the 2007 international blockbuster film *300*, loosely based on Herodotus's account in *The Histories* of the Battle of Thermopylae (circa 480 BC), where King Leonidas led his 300 Spartan warriors, as well as other Greek troops, against a Persian army of overwhelming numbers.[19] The film highlights the complexities of taxing modern, globally integrated products. It was produced by a major U.S. film studio, but almost entirely filmed on digital video in a green-screened warehouse outside Montreal. A Montreal special effects company subsequently added digital effects, so that the movie appears to have been filmed in an exterior setting. To date, the movie has earned worldwide revenues of more than US$500 million.

As to the first tax concern, about the impact of tax on investment location, *300* was filmed and edited in Montreal in large part due to film and video production tax credits offered by the Canadian and Quebec governments.[20] Does it matter that Canada attracted this international investment in part as a result of tax incentives? Do such tax incentives distort cross-border investment decision-making in an unproductive manner, as some argue?[21] The Canadian government justifies these incentives in part as a way to encourage film works that protect and enhance Canadian culture. Should Canada be prohibited from attracting investments through its tax regime by some international tax organization?[22]

In terms of the second international tax concern, about the use of tax planning to shift income to reduce global tax liabilities, it is difficult to assess whether such planning played a role in the financing or operations of *300*. A typical movie industry tax-planning strategy involves shifting studio overhead costs to profitable movies (such as *300*) since they can be deducted against gross revenues to reduce taxable profits. In this way, studios protect their investments against the fact that many movies lose money – the box office winners subsidize the losers. The

problem is that, although Canadian and U.S. tax laws (as well their bilateral tax treaty) generally do not permit tax losses in a corporation in one country to be offset against profits in the other, they allow two related corporations in the same country to undertake this loss offsetting.[23] These rules encourage multinational firms to engage in sophisticated tax planning to ensure their investments remain viable. They can achieve additional tax savings by shifting their profits to a jurisdiction (such as a tax haven) with low or nil taxes. In the case of *300*, because the U.S. studio sold the film rights to distributors around the world, it might have been possible to shift some of the profits from these sales, as well as any resulting tax revenues, away from countries with relatively high taxes, such as Canada and the United States.

As for the third tax concern, about ensuring that governments collect an appropriate share of tax revenues from the profits of multinational firms, assuming that *300* generated taxable profits, which country should enjoy a greater share of the tax revenues? The matter is complicated because *300* is, in tax parlance, a unique, intangible asset that will continue to enjoy streams of cross-border royalty income from the sales of rights to use the asset. Most of the film's initial creative input occurred in the United States: it was adopted from the work of a U.S. writer, and the director and several screenwriters were also American. Should this fact entitle the U.S. government to tax a greater share of the global profits from sales to movie distributors, as well as subsequent royalties? Does the fact that most of the actual filming and editing of the movie took place in Canada warrant greater taxation by the Canadian government? Did Canada, through its film and video production tax credit, voluntarily give up its right to tax the film's profits in exchange for other benefits, such as fostering and maintaining a skilled workforce in Canada?

The tax policy issues that arise from this scenario are vexing indeed. And this is just one of seemingly countless examples – automobiles, cell phones, software, toys, call centres, to name a handful – of globally integrated products and services to which these conundrums apply.

3.0 The Need for Diverse Scholarly Tools to Address Policy Concerns

How should international tax reform efforts address the challenges of globalization? On the one hand, globalization encourages flows of cross-border investments; on the other hand, it constrains policy options as

countries find they can no longer 'go it alone' and develop international tax policy positions as they see fit.[24] Because tax is interwoven with the fabric of society, as Solon the Athenian realized long ago, these policy decisions are of critical importance in determining each country's vision of a just society. Governments have already ceded policy control over many other areas, such as international trade; now they are struggling to determine the appropriate policy responses that will let them maintain democratic control over their tax systems while recognizing that globalization makes this control increasingly illusory.[25]

International tax reform is thus one of the last policy battlegrounds of globalization. Indeed, like some unruly beast, international tax policy refuses to be tamed by traditional international law principles.[26] Developments considered passé in other areas of public international law seem almost radical when considered for implementation within the international tax regime. For instance, governments have only recently begun seriously to contemplate cross-border tax law mechanisms such as binding arbitration for certain international tax disputes, the reciprocal enforcement of cross-border tax debts, or even the distant possibility of a multilateral tax treaty – tax law 'innovations' that have been in place in some shape or form for more than a half-century in international trade.

And so it goes with respect to the taxation of international investments: the tax law and treaty rules that govern the taxation of these investments remain much the same today as the ones advocated by League of Nations' experts almost a hundred years ago.[27] Because of the politically charged nature and glacial pace of international tax reform, some long-time tax observers maintain, as Alex Easson did, that international tax policy analysis should try to integrate current thinking about economic theory with an understanding of the broader realities that dictate whether tax reform measures will succeed. To these observers, the main policy challenge is to develop effective international tax rules and processes within what is essentially a non-cooperative government setting.

This perspective helps to illuminate the main theme the chapters in this book reveal, which is that, to promote optimal international tax policy outcomes with respect to taxing international investments in a non-cooperative setting, scholars need to account for economic interests as well as relevant political, social, historical, and other interests. The book's contributors consider tax policy concerns from different angles, including international tax economics, gender theory, historical perspectives, and international relations theory. The diversity of these

approaches shows the potential for international tax analysis to tease out the complexities and constraints that might be frustrating the attainment of the best possible policy outcomes.

4.0 Outline of the Book

The book is divided into four parts that strive to identify the ways international tax policy can confront the reality of taxing enhanced cross-border investment flows in a non-cooperative government setting. Part I examines in a general way the role that tax laws and policies play in inhibiting or encouraging foreign direct investment (FDI) – that is, entrepreneurial investments that involve the creation of new businesses in foreign markets. Part II examines how, in an environment in which economies increasingly are intertwined, tax laws and international tax agreements help to decide which countries and individuals win and lose on revenues associated with taxing international investments. Part III focuses on the important role that bilateral tax treaties (along with their negotiation) play in determining rules for taxing international investments, and how the status quo might be harming the interests of developing countries. Part IV considers the taxation of cross-border services and service providers in recognition of the fact that globalization is driving many economies to focus on services as a relatively larger portion of overall economic activity. The interaction among different national income and consumption tax systems is hence playing a greater role in influencing the provision of cross-border services as well as the allocation of cross-border investments in service industries.

4.1 Designing Tax Rules for FDI

By looking to the works of Alex Easson, in Chapter 2 ('Taxing Foreign Direct Investment in a Non-cooperative Setting: Contributions by Alex Easson') I review the main policy issues implicated by the taxation of FDI. The chapter also helps to set up the main theme developed in this book, as many of Professor Easson's writings emphasize the need to integrate economic concerns with broader policy concerns so that international tax policy developments can respond effectively to a non-cooperative government setting.

In Chapter 3 ('China's Tax Incentive Regime for Foreign Investors: An Eassonian Perspective'), Andrew Halkyard and Ren Linghui consider Chinese attempts in recent decades to attract international investment through tax policy, including the introduction of tax laws in

2008 that depart from the traditional approach. These efforts remain controversial, however, as China continues to use tax as a policy tool to favour investments by foreigners over those by locals. A review of past Chinese practices reveals a drawback of the current international regime: as long as there is no global tax institution to bind participating countries to international tax rules, governments can deploy tax incentives (such as the Canadian film and production tax credits) as they see fit, which could distort cross-border investment decision-making in a manner that is economically inefficient, leading to overall reductions in global wealth (and corresponding reduced standards of living).

In recent years, some governments have changed their tax systems to exempt from tax all foreign-source active business income. This development has led to the paying of increased academic and policy attention to tax rules that permit interest deductions to fund foreign investments and operations that are exempt from residence-country tax. These interest deductions for exempt foreign-source income, in fact, are responsible for one of the biggest holes in the global fiscal web, since they reduce taxable profits and revenues in countries that maintain relatively high taxes. Thus, in Chapter 4 ('Outbound Direct Investment and the Sourcing of Interest Expenses for Deductibility Purposes'), Tim Edgar explores how governments are changing their tax laws to prevent excessive interest deductions to finance foreign operations and investments, and considers recent Canadian reforms in this area.

To evaluate the ongoing battle for international investments, policy analysts sometimes refer to studies of the marginal effective tax rate (METR) and the average effective tax rate (AETR) that try to measure the influence of tax on cross-border investment decision-making. Chapter 5 ('Assessing the Foreign Direct Investment Response to Tax Reform and Tax Planning'), by W. Steven Clark, describes the assumptions that traditional METR/AETR studies can incorporate in estimating the impact on cross-border investment decisions of tax reform and tax planning, which such studies typically ignore but which can influence significantly the amount of taxes owed on an international investment. Here, Clark contributes to our understanding of the potential and limits of METR/AETR studies for international tax policy analysis.

4.2 The Impact of Globalization

In an era of global production of (often) highly integrated goods and services, it is becoming difficult to slice up the international tax pie so

that countries can tax an appropriate share of international transactions. In Chapter 6 ('Improving Inter-nation Equity through Territorial Taxation and Tax Sparing'), Jinyan Li reviews theoretical perspectives on the issue of inter-nation equity to see whether existing tax rules promote a fair division of revenues among nations, with an emphasis on policy concerns relating to developing countries as well as challenges presented by the lack of collective government action in the international tax sphere. In her view, the trend toward exemption (or territorial) tax systems offers an opportunity to enhance the fair sharing of tax revenues among nations

There is increasing recognition that processes that preserve a government's sovereign control over its tax system to the greatest extent possible might be the only effective way to promote helpful reform. For instance, the European Union has been debating the need to harmonize its national corporate income tax systems for more than a half-century with little progress thus far, its member countries having refused to pass unanimously, as required by the EC Treaty, binding agreements that would compel harmonization. In Chapter 7 ('Harmonizing Corporate Income Taxes in the United States and the European Union: Legislative, Judicial, Soft-Law, and Cooperative Approaches'), Charles E. McLure, Jr scrutinizes U.S. and EU efforts to develop mechanisms that would lead to greater unity among these systems without the need to adopt the same tax rates. In Europe, in particular, certain international tax reform processes might be best understood as 'soft law' processes or the promotion of informal and non-binding agreements among nations. Nevertheless, McClure argues that 'enhanced cooperation' by as few as nine EU countries is likely the only way to harmonize the EU corporate income tax bases.

In Chapter 8 ('Missing Women: Gender-Impact Analysis and International Taxation'), Kathleen Lahey discusses how enhanced globalization is influencing the way multinational corporations hire and invest in employees, leading to certain disadvantages for women. Lahey deploys a gender impact analysis to inform our understanding of how international tax rules can promote or harm the interests of women, and she shows how non-traditional analytical tools can shed insight on previously neglected policy concerns. She concludes that, although a lack of tax data currently inhibits gender-based analysis, this approach nevertheless should be accorded more emphasis in the study of international tax policy.

Globalization does not necessarily encourage all countries to arrive at the same policy stance. The history, geography, and political cir-

cumstances of individual states (or regions within countries) continue to encourage diverse outcomes. In Chapter 9 ('Globalization and the Hong Kong Revenue Law System'), Richard Cullen and Antonietta Wong review the historical developments – including the deeper roots of globalization in the British Empire – that promoted enhanced economic integration and influenced over a century's worth of tax law developments in Hong Kong. They also discuss why Hong Kong's tax policy continues to differ from that of many similarly situated governments. They conclude that a non-cooperative setting gives at least some countries the opportunity to develop tax systems that, in the long run, might promote more efficient and fairer outcomes for their citizens and residents. Cullen and Wong also explain that many governments are reluctant to engage in binding multilateral processes as they fear that closer tax ties could restrict potentially innovative reforms and harm important national interests.

4.3 *The Impact of Tax Treaties*

Another area of policy concern is the nature of tax treaties – the most important of which is the OECD model treaty – that were initially developed, and subsequently revised, by countries that generally were wealthy net exporters, rather than importers, of capital and that thus favour their interests at the expense of those of capital-importing, often poorer countries. In Chapter 10 ('Canada's Evolving Tax Treaty Policy toward Low-Income Countries'), Kimberley Brooks reviews how tax treaty policy often harms the interests of poorer countries, and discusses Canada's uneven record with respect to addressing this issue. She shows how resistance to solutions involving collective action can harm economically vulnerable countries that do not have the resources to implement or police bilateral tax treaties to protect their own interests.

In Chapter 11 ('Tax Treaties and the Taxation of Non-residents' Capital Gains'), Rick Krever sets out the case for countries to adopt deviations from the OECD and United Nation model treaties to take better account of the fact that, under globalization, foreign investors increasingly use sophisticated strategies to ensure they do not pay tax on the sale of real estate assets. He discusses how negotiators, especially those from developing countries, need to ensure that treaties protect the source country's right to tax any gains related to these sales. He notes that, in treaty negotiations, experienced countries with greater expertise tend to protect themselves better than those that are less endowed

with such attributes. His discussion of the treatment of capital gains in double tax treaties provides a graphic illustration of this phenomenon.

As mentioned, international tax law differs from most other areas of public international law in that it typically does not involve the use of binding multilateral agreements; instead, the income tax rules that govern international investments generally can be found in the more than two thousand bilateral tax treaties that have sprung up over the past century. The situation might seem bleak, but most of the provisions of these treaties are based on those in the model treaties of the OECD and the United Nations. In Chapter 12 ('Tax Treaty Templates'), Victor Thuronyi discusses how the current approach could be improved through the adoption of a central tax treaty template to promote more consistency among the provisions of these treaties and to facilitate the adoption of new provisions by participating countries. The template would serve as another example of possible ways to encourage helpful tax reform processes given the reality of a non-cooperative setting.

4.4 Taxing Cross-border Services and Service Providers

Why should aspects of international tax policy differ so dramatically from international trade policy? In Chapter 13 ('Tax Discrimination and Trade in Services: Should the Non-discrimination Article in the OECD Model Treaty Provide the Missing Link between Tax and Trade Agreements?'), Catherine Brown queries why traditional international tax policy permits governments to discriminate in favour of domestic investment in services industries, which discourages cross-border investments in these industries. In her view, the OECD model treaty should be amended to inhibit such discriminatory treatment.

Even in the era of globalization, the relationship between Canada and the United States is characterized by their high degree of economic integration, and the two countries' trade flows are the largest in history. In 2007, the Canada-United States tax treaty was modified to reflect these heightened investment and trade ties. In Chapter 14 ('The New Services Permanent Establishment Rule in the Canada-United States Tax Treaty'), Brian Arnold reviews how Canadian and U.S. tax treaty policy is evolving to take into consideration heightened investments in cross-border services industries and provision, and considers the likelihood that this new approach could be adopted in the treaty networks of other developed countries that seek to cooperate more effectively in taxing cross-border services providers.

Although tax scholars often focus on cross-border income tax issues, cross-border consumption taxation has been rising to a greater extent than have income taxes over the past several decades. Of the OECD's thirty members, only the United States does not now deploy some kind of national value-added tax or goods and services tax. In Chapter 15 ('Consumption Taxation of Cross-border Trade in Services in an Age of Globalization'), Walter Hellerstein reviews the changing legal environment for taxing cross-border services, another policy area undergoing significant reform in both the OECD and the EU, which serve as examples of ways that different cooperative processes can address cross-border tax issues. He concludes that the troublesome policy challenges in this area will command the attention of those concerned with tax policy and tax administration for some time to come. One could echo a similar sentiment about the many thorny tax policy challenges the contributors to this volume discuss.

Notes

1 Robert B. Strassler, ed., *The Landmark Herodotus, The Histories*, trans. by Andrea L. Purvis (New York: Pantheon Books, 2007).

2 Ibid. at 201, 250. Under this early form of self-assessment, citizens could be punished by death if they failed accurately to assess their wealth (or if they revealed that 'his livelihood was not a just and honest one'). In a sentiment that presumably would be shared only by the coldest-hearted modern tax authority, Herodotus declared that this was 'an admirable law, and may it always remain in force.'

3 Arthur J. Cockfield, *Examining Policy Options for the Taxation of Outbound Direct Investment* (Ottawa: Advisory Panel on Canada's System of International Taxation, Sept. 2008) at 22–35.

4 Canada, Advisory Panel on Canada's System of International Taxation, *Consultation Paper* (Ottawa: Department of Finance, April 2008) at 1.

5 Canada, Advisory Panel on Canada's System of International Taxation, *Final Report* (Ottawa: Department of Finance, December 2008) at 19.

6 See A.J. Easson, 'Gifts in Consideration of Marriage' (1971) 121 New L.J. 1018; A.J. Easson and D.A. Soberman, 'Pre-Incorporation Contracts: Common Law Confusion and Statutory Complexity' (1992) 17 Queen's L.J. 414; and J.E. Smyth, D.A. Soberman, and A.J. Easson, *The Law and Business Administration in Canada*, 11th ed. (Toronto: Prentice Hall, 2007). The latter publication, co-authored with former Queen's Law Dean Dan Soberman,

continues to be widely adopted by law and business school students at Canadian universities.

7 A.J. Easson, *Cases and Materials in Revenue Law* (London: Sweet and Maxwell, 1973); see also David Salter and Joan Sharpe, *Easson: Cases and Materials on Revenue Law* (London: Routledge, 2004).

8 Alex Easson, 'Space Taxation in Canada' in William Lee Andrews III, ed., *The Taxation of Space Commerce* (The Hague: Kluwer Law International, 2001) at 97.

9 A.J. Easson, 'Estate Duty Aspects of the Matrimonial Property Question' (1971) 356 British Tax Rev.

10 Alex Easson, 'Common Law Approaches to the Determination of the Source of Income: Pragmatism over Principle' (2006) 60 Bulletin for Int'l Fiscal Documentation 495.

11 A.J. Easson, *Taxation of Foreign Direct Investment: An Introduction* (London: Kluwer Law International, 1999) at 156–7.

12 For example, as documented by UNESCO, while economic development has enhanced the wealth of citizens of many countries, glaring economic disparities remain: more than 10 million children under age five die each year from preventable causes, roughly 145 million children in developing countries suffer from malnutrition, and more people – mainly females – live in a state of chattel slavery today than ever before. See Aaron Schwabach and Arthur J. Cockfield, '*The Role of International Law and Institutions*' in *Knowledge Base for Sustainable Development: An Insight into the Encyclopedia of Life Support Systems*, vol. III (Oxford: UNESCO Publishing-Eolss Publishers, 2002) at 611, 618, 623.

13 See Statistics Canada, *The Daily* (6 May 2008), indicating that foreign direct holdings in Canada reached roughly C$500 billion in 2006, an increase of 14.4 per cent from the previous year.

14 See Vito Tanzi, *Taxation in an Integrating World* (Washington, DC: Brookings Institution, 1995) at 140 (indicating it may be time to develop a world tax institution); Richard Bird, 'Shaping a New International Tax Order' (1988) Bulletin for the Int'l Bureau of Fiscal Documentation at 292, 293 (calling for heightened cooperative reforms efforts to address the present 'patchwork structure that makes little sense in terms of its purported objectives').

15 For a discussion of these challenges, see Alex Easson, *Tax Incentives for Foreign Direct Investment* (The Hague: Kluwer Law International, 2004) at 52–5.

16 While there is an ongoing debate on the impact of tax on FDI location decisions, empirical studies increasingly suggest that these investment decisions are influenced by tax. The different national tax regimes likely

distort cross-border investment decision-making in a manner that is not considered economically efficient, discouraging international investments and reducing global welfare; see Chapters 2 to 5, and 13 in this volume.

17 Studies increasingly show that the substitution of intra-group equity and debt financing, as well as the location of external debt, occurs in situations of perfect (or near-perfect) substitutability; see Chapters 4 and 5 in this volume.

18 A related concern is the 'fair' sharing of tax revenues among governments from taxing these globally integrated products and services; see Chapters 6 to 15 in this volume.

19 The movie enjoys an interesting pop culture pedigree. In 1962, a Hollywood movie called *The 300 Spartans* was seen by a young Frank Miller, who eventually went on to reproduce aspects of the film in his graphic novel *300.* The recent film was based on this book, with Miller acting as a consultant and executive producer. See Frank Miller and Lynn Varley, *300* (Milwaukie, OR: Dark Horse Books, 1998).

20 '"We went to Montreal especially for the fantastic tax incentive that is offered by Quebec to filmmakers – that's not only a production incentive, it's also a visual effects incentive," said *300* producer Jeffrey Silver. "Compared with other Canadian provinces, Quebec offers an extra 20 per cent labour-based visual effects tax credit for foreign producers"' (quoted in Melora Koepke, 'Montreal proves a worthy opponent: While T.O.'s film industry ails, Quebec's advantages have a special effect,' *Toronto Star*, 7 March 2007). The Canadian and provincial tax credits are available to domestic as well as foreign film producers.

21 See, for example, Chapters 2, 3, 6, 7, and 13 in this volume.

22 This has occurred in other limited areas, such as the OECD's Harmful Tax Competition project, which prohibits the use of tax incentives for international investments in financial and other services, and the EU's non-binding Business Code of Conduct; see Chapters 2 and 7 in this volume.

23 In Canada, tax laws generally prohibit one corporation's losses to be offset against a related corporation's profits. The Canadian tax authorities, however, have allowed certain tax planning strategies that enable loss offsetting to take place; see Canada Revenue Agency, *Income Tax Technical News* 30 (21 May 2004). Under U.S. tax law, corporate loss offsetting is generally permissible (when ownership equals or exceeds 80 per cent of common shares).

24 For example, in the United Kingdom, which traditionally has deployed a residence-based tax system, government policy papers have proposed changing to exemption tax systems. See United Kingdom, HM Treasury

and HM Revenue and Customs, 'Taxation of the Foreign Profits of Companies: A Discussion Document' (London: HM Treasury, 2007). In contrast, in 2009, the recently elected U.S. administration proposed to strengthen its residence-based tax system.

25 I explored these themes in earlier work; see Arthur J. Cockfield, *NAFTA Tax Law and Policy: Resolving the Clash between Economic and Sovereignty Concerns* (Toronto: University of Toronto Press, 2005) at 4 (discussing how the views of the economic historian Karl Polanyi can help us to understand the tension inherent in globalization with respect to international tax developments).

26 Traditional international law mechanisms arguably apply to international tax matters in limited circumstances; see Reuven S. Avi-Yonah, *International Tax as International Law* (New York; Cambridge University Press, 2007) at 2 (claiming that parts of international tax law are binding as customary international law even in the absence of treaties).

27 See Professor Bruins et al., *Report on Double Taxation Submitted to the Financial Committee* (Geneva: League of Nations, 1923) (discussing different alternatives to the taxation of cross-border business profits and recommending exclusive residence-based taxation); and Technical Experts to the Financial Committee of the League of Nations, *Double Taxation and Tax Evasion: Report and Resolutions* (Geneva: League of Nations, 1925) (advocating the residence-based taxation of business profits along with foreign tax credits for taxes paid to source countries). The League of Nations rejected the views of the earlier report in favour of those of the second, preferring to support a regime in bilateral tax treaties that had been in place since the nineteenth century.

2 Taxing Foreign Direct Investment in a Non-cooperative Setting: Contributions by Alex Easson

ARTHUR J. COCKFIELD

1.0 Introduction

Alex Easson's scholarly contributions to the ongoing debate about the effect of tax law and policy on foreign direct investment (FDI) appear in a wide variety of articles, chapters, and books.[1] A theme running through many of these works is that, to discern optimal policy with respect to taxing FDI in a non-cooperative setting, tax law scholars should integrate into their policy analysis both the underlying economic theories and the relevant political, historical, cultural, or other realities. Accordingly, in this chapter, I develop the main theme of this volume and introduce a number of issues that are explored in greater depth in subsequent chapters.

In the next section, I review how economic theory (which often emphasizes the need for international tax rules that promote global welfare maximization) must be tempered by the reality of a lack of collective action by governments (and their corresponding emphasis on national welfare maximization). Given a non-cooperative setting, I then discuss how governments can design optimal tax incentives for FDI, and assess the so far limited cooperative efforts to constrain certain international tax incentives, including the recent emphasis on tax information exchange agreements as a way to counter tax evasion and aggressive tax avoidance. I conclude by noting that Easson's 'hopeful pessimism' accepts the futility of discerning the most theoretically pure tax solution in favour of developing pragmatic rules, policies, and processes to constrain the more harmful effects caused by the interaction of different national tax systems. This approach seeks to encourage cooperative solutions within a fundamentally uncooperative game.

2.0 Policy Implications of a Non-cooperative Setting

2.1 Evaluating Tax Reform Proposals Given Existing Political Constraints

Easson began to explore the role that tax plays with respect to cross-border investments in the context of regional economic integration in Europe: at the time, his views were characterized as 'trail-blazing' and 'probably the most comprehensive guide' to the subject.[2] Through this research, Easson came to appreciate the need to tailor tax laws to the political preferences of the different EU Member States while striving to reduce tax as a barrier to the efficient working of the internal market. In 1981, for instance, Easson noted that '[g]overnments guard their fiscal sovereignty jealously, surrendering it only when they have to … Nevertheless, the eventual objectives of the [European] Community must be kept in mind to ensure that such progress as is possible is not inconsistent with these goals.'[3]

Over time, Easson refined his views on the need to factor in existing political realities when developing policy prescriptions, in part to ensure that such efforts had a reasonable chance of success.[4] Are traditional international tax policy principles, such as the need to promote inter-nation equity, still the way to divide the international income tax pie? Alas, Easson was not confident that, while a helpful concept in many ways, inter-nation equity would offer a way out. Despite decades of attention to the concept, Easson noted, no real consensus existed on what is a fair division of the international income tax base, in part because of the difficulties associated with deciding what is the true 'source' of particular types of income (see Chapter 6 in this volume).

With respect to international tax reform processes, Easson noted that theoretical considerations concerning the 'fair' division of the international income tax base between two countries are frequently downplayed in favour of efforts to develop bilateral tax treaties to resolve 'competing tax grabs by national tax administrators [rather] than a principled attempt to allocate the tax base appropriately.'[5] As a result, '[n]otions of inter-nation equity generally fail to provide much in the way of specific guidance.'[6]

Instead, Easson developed his own evaluative criteria that focused to a greater extent on the political feasibility of implementing reform projects. In his view, international tax reform processes should strive to meet the following conditions:[7]

- the reform efforts should not involve too great a change in total tax yield;
- the efforts should not require major re-negotiation of existing tax treaties;
- the efforts should not be excessively complex to draft or difficult to apply; and
- the efforts should be capable of being implemented unilaterally.

According to Easson, the 'fatal flaw' in many reform proposals is that the country that first implements the reform loses out to its neighbours and competitors; thus, adoption has to be universal and simultaneous for the reform to work. 'By contrast, realistic reform measures are those which a country, or a relatively small group of countries, might adopt alone, without being dependent upon other countries taking similar action.'[8] Easson's views on optimal international tax policy were clearly tempered by his understanding of the actual practice of tax legislators and tax authorities. He envisioned 'contextual' tax solutions that draw from a pragmatic understanding of the ways that countries develop, implement, and enforce their laws to tax international investments.[9] In his view, the proposals must also take account of efficiency considerations, a topic to which we now turn.

2.2 *How Should Rules Promote Neutral Tax Treatment of Cross-border Investments?*

Easson accepted the need to promote neutral tax rules that reduce the tax distortion of cross-border economic activity. Because tax influences the returns that firms and investors derive, tax burdens can distort decision-making in an economically unproductive manner if decisions are made for tax reasons, not out of economic rationales. These distortions could reduce domestic and global wealth and, ultimately, standards of living. In the traditional view, a tax system should not distort the choice between investment at home or abroad, following the principle of capital-export neutrality (CEN). Alternatively (or in addition), a tax system should not distort the choice facing savers to invest at home or abroad, following the principle of capital-import neutrality (CIN), which could be promoted by the exclusive source taxation of cross-border income. CEN is the principle many international tax experts – in particular, tax economists – espouse, in part because firms are thought to be more sensitive to tax differences, so such differences distort firms' economic activities to a greater extent than those of investors and savers. In other

words, CEN is more likely to promote global welfare (that is, income) maximization (for a more detailed discussion of these concepts, see Chapters 4 and 6 in this volume).

CEN is promoted by residence-based income tax rules that strive to tax the worldwide income of tax residents but, as Easson and others recognized, in practice, it is difficult to achieve.[10] For instance, countries provide foreign tax credits only to the extent that the source country does not impose a higher tax rate than the residence country; no country provides tax refunds for the payment of higher foreign taxes. Moreover, all countries permit deferral of the taxation of foreign-source income earned in foreign subsidiaries until and unless these subsidiaries distribute profits back to their parent corporations based in residence countries; CEN would require the accrual taxation of these foreign earnings, even if no profit repatriation took place.

There is also the practical reality that foreign-source income is often difficult to tax – particularly in light of taxpayers' adoption of avoidance and evasion strategies – and, thus, to the extent that source-based taxation is inhibited, the income will remain untaxed by the residence country. Easson worried that an emphasis on residence-based taxation of business profits earned through FDI would lead to the phenomenon of 'double non-taxation' due to difficulties associated with taxing international mobile capital: 'In reality, the choice may be between source-country taxation and no taxation at all.'[11]

More problematic, in Easson's view, were the difficulties associated with obtaining CEN for tax-exempt investors, which form a significant part of the investment community in many OECD countries. For example, Easson noted that, in most of these countries, the majority of shares of listed companies are held by tax-exempt entities such as pension funds or by financial institutions that might be subject to a special taxation regime.[12] Because tax-exempt investors are not subject to tax by the home country, CEN would require a host country also to exempt such investors, which governments understandably refuse to do since the foreign investor's tax-exempt status was the result of a foreign government's policy objective that might differ significantly from that of the home country. The tax-exempt investor thus has a greater incentive to invest domestically, thus inhibiting CEN.

Moreover, Easson worried whether tax rules that followed CEN would unduly discourage outward FDI:

> [W]hat is important is not to be at a disadvantage vis-à-vis competitors. The principal objective of both capital export neutrality and capital import

> neutrality is to promote the free movement of capital, undistorted by considerations of taxation. If the enterprises of one country are disadvantaged in the markets of other countries due to differences in their total tax burden, then capital mobility is impeded. If the competitive disadvantage is such that enterprises of a particular country are effectively excluded from other markets, then consideration of capital export neutrality becomes irrelevant. That is to say, the fact that the residence-country tax rules are neutral as between investing at home or abroad is unimportant if those same rules have the effect of making outward foreign investment uncompetitive. … All of which points to the conclusion that the more appropriate goal in the case of direct investment is capital import neutrality.[13]

For these reasons, to promote CIN, Easson supported the exemption (or territorial) method of taxation for taxing FDI, especially where the host and home countries have comparable tax rates (for example, the Canadian 'exempt surplus' tax regime achieves this result) instead of residence-based taxation of foreign business income along with a foreign tax credit for foreign taxes paid (the system in place under U.S. tax law).[14] Consistent with this view, some governments are now adopting or broadening systems that exempt from taxation all foreign-source active business income (see also Chapter 4 in this volume).

As mentioned, Easson also accepted that tax laws should encourage tax neutrality to the greatest extent possible. In addition to the general source-based taxation of FDI, he suggested that the withholding tax on cross-border dividends should be abolished when the dividends are paid to foreign parent companies (as has occurred for European businesses under the Parent/Subsidiary Directive[15]). More controversially, Easson suggested that, to encourage further tax neutrality, source countries should deny deductions for non-arm's-length payments of cross-border interest, rents, and royalties (the revenue increase associated with these deduction denials would offset, in Easson's view, any revenue losses associated with the ending of withholding taxes on cross-border dividends).

Easson recognized that a tax system that tried to promote CEN and/or CIN would run up against a major problem posed by existing cross-border tax allocation rules and practices. Multinational firms enjoy returns on their cross-border investments in many different forms – for example, as branch profits, dividends, interest, rents, royalties, and capital gains – each of which attracts different tax treatment under the traditional rules of most bilateral tax treaties (and as advocated by the

OECD model treaty; see Chapters 10, 11, and 12 in this volume).[16] In particular, the significant difference in tax treatment of dividends and interest distorts financing decisions and provides an incentive for the use of aggressive tax-avoidance plans that lead to further distortions of economic activity. The elimination of withholding taxes on dividends combined with the denial of deductions for non-arm's-length payments, in Easson's view, would go a long way toward reducing these tax distortions.

3.0 Designing Tax Incentives in a Non-cooperative Setting

3.1 Tax Incentives and FDI: Theoretical and Pragmatic Considerations

A major focus of Easson's work was the potential impact on FDI of special tax incentives, which he defined as 'a special tax provision granted to qualified investment projects that represents a *statutorily favorable deviation* from a corresponding provision applicable to investment projects in general.'[17] From this definition, it is clear that Easson meant to emphasize legal and non-arbitrary tax incentives for FDI, as opposed to incentives such as informal tax holidays, which some tax authorities negotiate with foreign investors.

Easson recognized that theorists and international bodies that advise on tax matters almost universally dismiss tax incentives, a view whose theoretical underpinnings he traced in several works.[18] Tax incentives are often portrayed as 'bad' because they distort investment decision-making and, since the tax rules interfere with the workings of the market, they promote efficiency losses. Moreover, tax incentives can distort competition between domestic and foreign firms, potentially harming local firms that do not receive the tax breaks.

A more pragmatic argument against these incentives is that they likely do not work. At times, for instance, a tax incentive merely rewards a foreign company for engaging in an activity that would have been conducted even in the absence of the incentive. In this situation, the host country simply loses out on revenues it would otherwise have collected. Moreover, because the cost of the incentive often exceeds the value of its benefits, it produces a kind of 'winner's curse,' a phrase used to describe the plight of auction winners who, in an environment of aggressive bidding, overestimate the value of the good.[19]

Similarly, tax competition via tax incentives can lead to a so-called race to the bottom as countries respond to competition by offering ever-

larger tax breaks to the point where the reduction in tax revenues makes it difficult to fund needed public goods and services. In addition, competition that leads to lower tax burdens on mobile cross-border capital might increase tax burdens on less-mobile factors of production, such as workers, leading to an overall more regressive income tax system.

For these reasons, many theoreticians worry that unrestricted tax competition could reduce national and/or global welfare (see section 4 of this chapter for a discussion of emerging collective action responses to this policy concern). Due to countries' historic reluctance to engage in (binding) multilateral cooperative processes, Easson worried that this competition ultimately would lead to a tax burden of zero on cross-border capital (as predicted by many economic models). In fact, over the course of his career, Easson witnessed an explosion in these tax incentives around the world. In 1996, for instance, 103 countries reportedly offered tax incentives for FDI; a subsequent study showed that 30 to 40 new incentives were being introduced each year until 2002.[20] Easson himself saw the growth of incentives in his case studies of the tax systems of dozens of countries (see also Chapters 3, 5, and 9 in this volume).[21]

Why do countries continue to adopt tax incentives despite the clear theoretical opposition to doing so? Easson offered three main explanations for this apparent puzzle.[22] First, governments feel pressure to offer incentives and maintain a tax-hospitable environment for foreign investors because 'everyone else does it.' Second, policy-makers do not follow the expert views because they remain unconvinced of many of the purported problems associated with tax incentives. Government officials in certain countries have daily experience with foreign investors who bargain hard to obtain special tax breaks for their investments. These officials, who are responsible for promoting FDI, often try to take credit for securing investments through the incentives they offer. Easson recognized that an element of self-deception might surround the belief in the effectiveness of tax incentives for FDI, but also that one needs to understand the bureaucratic mindset to promote a fuller understanding of the reasons tax incentives remain popular with so many governments.

Third, many governments perceive tax incentives as one of their few options to attract foreign investors. Developing countries, in particular, might not have the financial resources to offer grants and low-interest loans to foreign firms. Moreover, in such countries, it is often costly to improve infrastructure or politically infeasible to fight corruption to make the environment more amenable for foreign firms. Easson ob-

served that '[b]y contrast, tax holidays can be introduced at the stroke of a pen, and at no apparent cost.'[23]

While recognizing that some types of taxes can have more influence than others over investment decision-making, Easson somewhat unusually focused on the effect of tax administration on FDI flows.[24] Easson argued that, although it might not play a major part in the initial decision to invest, a country's tax administration can be decisive in the choice of whether to re-invest or expand the initial investment. Once the initial investment has taken place, investors learn over time whether the tax laws will be applied in an arbitrary or inconsistent manner (they also learn whether their investments can attract special tax breaks or pre-approvals through advance tax rulings). If the investment climate is hampered by tax uncertainty promoted by incompetent or corrupt tax officials, investors might become reluctant to risk more capital.

Easson challenged the prevailing wisdom, however, when it came to the use of special incentives versus general corporate income tax rate reductions to attract FDI. The conventional story is that, to the extent tax plays a role in investment decisions, it is the general features of the host country's tax system that are more important to potential investors than the special incentives. Easson noted that the only tax that might have an effect on foreign investors is the actual tax they will be required to pay, whether the rate is a 'standard' corporate income tax rate or a 'special' rate for investments in, say, manufacturing (see Chapter 5). From his survey of how different tax systems attract FDI and the responses of investors to these efforts, Easson concluded that it mattered little whether the tax incentive was offered through the standard or special rate.

Easson reframed the debate by asking: given the existence of a reasonable general tax system, do special incentives still have a role to play in influencing cross-border investment flows?[25] He noted, for instance, an excessive revenue loss could result from a reduction in overall corporate income tax rates to attract FDI (and mainly promote a windfall benefit to all existing investors). Whether a special tax incentive is preferred is a 'difficult question to answer' that depends on the circumstances of the would-be host country and the types of investment it hopes to attract (see Chapter 3).

3.2 *Targeting and Designing Tax Incentives*

In Easson's view, the use of tax incentives to attract FDI will remain an important aspect of the international tax policy positions of many

governments, particularly in countries with developing or transitional economies.[26] He emphasized that, once the decision has been made to deploy incentives, perhaps *the* most important consideration is how to design and implement the tax rules. In his view, not all tax incentives are created equal, and he gave much thought to the questions policy-makers should answer in designing an effective tax incentive (or, at least, an incentive that will cause the least amount of harm).[27]

For instance, the incentive ought to be structured so as to target effectively the investors or investments that qualify for the preferential tax treatment. In Easson's view, a narrowly targeted incentive could reduce its costs while bringing in the types of investment the host country wishes to attract. He accepted the view that certain types of FDI (such as financial, research and development, or marketing centres) are more likely than others to be influenced by tax considerations. To avoid a scenario in which a tax incentive simply gives a break to investors who would have invested even in its absence, a properly designed tax incentive should offer tax reductions to the desired marginal investments only. While it might be impossible to restrict investments to those by firms who would not have otherwise invested, Easson believed that precise targeting of tax incentives could reduce the number of free-riders.

Governments should take into account a host of other considerations as well, Easson argued, in considering their use of targeted tax incentives: Should they try to attract new investors or new investments by foreign firms with existing operations? Should they try to attract investments only of a significant amount or in particular sectors? Should they offer incentives to locate investments in a particular region? Should they offer tax breaks that apply only once stipulated performance levels – such as a certain level of employment or exports – are obtained?

A drawback of targeting, in Easson's view, is that it might increase tax distortions. Resources could be misallocated to the extent that the tax incentive brings in particular desired forms of economic activity, and competition between firms that enjoy the incentives and those that do not might be distorted. In addition, targeted tax incentives could increase the complexity of the tax law regime, leading to a corresponding increase in compliance costs for firms and administrative costs for tax authorities. Easson cautioned, moreover, against the use of a large variety of targeted incentives, each in pursuit of different objectives that might overlap or conflict, reducing their effectiveness.

Once the target investment or investor has been decided upon, a series of considerations needs to be factored into the design of a tax incentive. Should the reform of tax laws focus on corporate income tax rates alone or aspects of the tax base or both? Should a tax holiday be offered instead? Easson was pessimistic that tax holidays could be effective (see also Chapter 6 in this volume). He noted a number of disadvantages, including the revenue losses associated with the holiday, the fact that many foreign firms move their operations once the holiday expires, the delaying of expenditures by firms until after the end of the holiday period so that the expenses can be deducted from taxable profits, and the formation of new companies – rather than the expansion of operations – to take advantage of additional holidays. In his view, the tax holiday is 'an extremely crude instrument that is ill suited to achieve most of the objectives for which it is granted.'[28]

Once the design features of a tax incentive have been put forward, governments need to implement the incentive properly. Administrative considerations include the need to promote automatic or discretionary entitlement to the incentive and the possibility of advance rulings on potential foreign investments. Additional administrative steps are needed to monitor compliance to anticipate and prevent abuse of the tax rules, including phenomena such as 'round-tripping' (where domestic investment is disguised as foreign investment to take advantage of the incentive) and 'fly-by-night operations' (where foreign investors shift their investments to another country as soon as the tax incentive expires).

Administrative considerations are of particular importance in developing countries, where poorly designed tax incentives can do the most harm. Easson noted:

> Tax laws are only as effective as their administration. It is especially important to keep this in mind when designing tax policies for less developed countries where, in practice, complex [corporate income tax] provisions cannot be administered at all … It is more than possible that the failure of tax incentive programmes in some countries has owed more to unsuitable design and poor administration than to any inherent general defect in tax incentives.[29]

For these reasons, Easson discussed how tax laws that provide for FDI incentives in developing countries should possess three characteristics: simplicity, predictability, and stability.[30]

4.0 Collective Action Responses

4.1 External Constraints on Tax Incentives

International tax law and policy differs from other areas of public international law, such as trade, because countries generally have refused to engage in traditional international law-making via multilateral cooperation that could impose binding tax rules on the participants (see also Chapters 7 and 12 in this volume). Indeed, over time, as they have reduced their non-tax barriers to international trade and investment through binding multilateral agreements, countries have become correspondingly more keen to protect their tax sovereignty – one of the few remaining measures over which they can exert near complete political control. Another challenge arises from the fact that certain countries currently benefit (or at least they perceive they are benefiting) from the tax competition, and those that perceive net economic losses or other detriments if competition were to be tamped down invariably will resist these measures.

Nevertheless, since the 1990s, there have been ongoing reform efforts to address these challenges through enhanced cooperation among national governments.[31] Easson generally supported efforts to impose limited constraints on international tax laws but, as explored in the next section, he also feared that the interests of developing countries could be harmed to the extent that they were downplayed or ignored in the reform process.

Most prominently, since 1998 the OECD's tax competition project has sought to curtail the use of income tax systems to attract a particular type of FDI – namely, mobile financial and other services investments (see Chapter 7 in this volume).[32] First, the OECD tried to inhibit the deployment of 'preferential tax regimes' by Member States and drafted a list of tax measures in these countries that allegedly infringed its rules: the OECD now claims that no Member States are now non-conforming. More recently, the OECD has targeted the 'harmful tax practices' of tax havens, drafting an initial 'blacklist' of thirty-five tax havens. Over time, the OECD project has come to emphasize the need for tax system transparency along with tax information exchanges between OECD member countries and these tax havens; in 2002, the OECD created a model cross-border tax information exchange agreement (TIEA) to be used as the basis of negotiation for similar agreements between OECD Member States and non-OECD states.

The European Union has also adopted limited constraints on FDI competition through its Code of Conduct (see Chapter 7 in this volume). The Code is not a legally binding and enforceable agreement but rather a set of principles agreed upon by the EU Member States. The Code applies only to business taxation and sets out criteria for determining whether a particular tax regime should be eliminated as 'harmful.' The World Trade Organization (WTO) also has had a limited impact on the development of tax incentives to attract FDI.[33] In 1999, for instance, a dispute resolution panel held that the United States' foreign sales corporation regime violated WTO rules on the use of tax incentives to promote exports. In addition, the WTO agreements provide for the non-discriminatory tax treatment of goods and services that emanate from foreign countries (see Chapter 13 in this volume).

4.2 *Evaluating the Collective Action Responses*

In a series of works, Easson traced the problems these reform efforts pose for the interests of developing countries.[34] In particular, he decried the hypocrisy of the refusal of certain developed countries to abide by policies and practices they were trying to thrust upon poorer countries. In 1998, he presciently noted with respect to the OECD project that, '[o]nly the recommendations on exchange of information and bank secrecy are likely to incur strong opposition and that is because they relate also to the elimination of harmful practices within the member countries themselves.'[35] As of this writing, OECD members such as Switzerland and Luxembourg continue to refuse to strike down their banking secrecy laws or to engage in meaningful tax information sharing with other countries (although political pressure by the EU and the United States has resulted in limited information exchanges where tax fraud has been alleged).

In Easson's view, the OECD's more recent emphasis on TIEAs might not promote beneficial results, for several reasons. First, TIEAs between developed and developing countries (especially tax havens) have not been particularly successful in the past. Developing countries that do not maintain income tax systems also do not keep records of income returns and hence have little of use that can be shared with tax authorities of developed countries. In addition, it remains to be seen whether the OECD's efforts to encourage tax regime transparency – for example, through tax laws that identify the beneficial owners of tax haven accounts – will support more meaningful tax information exchanges.

Easson also worried that, even if a developed and developing country did negotiate a TIEA, the latter could not fully implement and enforce the agreement. A TIEA does not contain reciprocal benefits, as are found in a full-blown tax treaty, and thus does not provide any real benefits for the developing country or contain incentives to cooperate and enforce its provisions.[36] Easson feared, in other words, that many tax havens have paid lip service to signing TIEAs without any real intention of abiding by or enforcing the provisions of such agreements. One could rationalize their reluctance to implement TIEAs fully on the basis that they were forced into these agreements by more powerful economies, some of which have refused to abide by the agreements themselves. In addition, targeted tax havens continue to view the initial lack of consultation between them and the OECD as an affront to their sovereignty.[37] In Easson's view, effective tax reform efforts with developing countries must include broad and ongoing consultation with the governments of these countries.[38]

In his last book on tax and FDI, Easson concluded that recent initiatives to impose external constraints on tax incentives increasingly should be taken into account in the design of tax incentives. He wrote, 'What remains to be seen is whether those constraints may have the effect of reversing the trend toward more, bigger and better incentives.'[39] Countries might simply alter their tax policies to conform with the new rules while continuing efforts to attract FDI through tax inducements. For instance, instead of offering a tax holiday to attract export-oriented industries, more and more countries might simply exempt foreign-source active business income from taxation (see Chapter 1 in this volume). Similarly, to avoid charges of 'ring-fencing,' countries might alter their legislation so that any tax breaks are granted to both foreign and domestic investors, especially if these countries have few domestic economic activities to fence off (see Chapter 3 in this volume). Others might engage increasingly in 'fair' competition by lowering their general corporate income tax rates. Another worry is that countries might increase their offers of non-tax incentives such as direct grants or other incentive packages, which generally remain untouched by reform efforts even though 'financial and fiscal incentives are to some extent interchangeable and should be considered together.'[40]

5.0 Conclusion

Alex Easson's many scholarly contributions in the area of tax and foreign direct investment make possible only a brief summary of some of

his main ideas, which necessarily cannot be an effective substitute for Easson's own writings. Perhaps, however, it can serve as an intriguing appetizer that whets the reader's appetite for the main course.

Over the course of his career, Easson dished up a variety of works critically examining the law and policy issues surrounding the theory and practice of taxing FDI. These works often sought to integrate current economic thought with a pragmatic or contextual understanding of the nature of international tax reform and the political and other trade-offs associated with attempting to attract inward FDI via tax regimes. He believed that, given the reality of a non-cooperative government setting, governments would continue to use these regimes, including the development of tax incentives, to attract FDI, at least for the foreseeable future. As a result, he focused on the appropriate design features that need to be built into tax laws. A properly designed tax incentive, he argued, could reduce efficiency losses caused by the distortion of cross-border economic activity and might be a more desirable policy option than, say, broad corporate income tax rate reductions.

In his writings on tax and FDI, Easson often focused on the plight of developing and transitional economies, where tax incentives for FDI have proliferated in recent decades. By taking account of the economic, political, cultural, and other factors of these countries, tax reform efforts could be tailored to their specific needs and be better able to help them attract much-needed international capital. Still, Easson worried that, in the process of international tax reform, the interests of these countries too often are downplayed in favour of the interests of wealthier economies. Despite these misgivings, in what appears to be a widely shared sentiment among veterans of the international tax policy scene, Easson remained a hopeful pessimist: he felt, for instance, that the very real barriers to effective tax reform with developing countries might be overcome through enhanced consultation.

Notes

1 He summarized many of his views in two main works. See Alex Easson, *Tax Incentives for Foreign Direct Investment* (The Hague: Kluwer Law International, 2004); and idem, *Taxation of Foreign Direct Investment: An Introduction* (The Hague: Kluwer Law International, 1999).

2 See David Williams, 'Book Review of *Taxation in the European Community* by A.J. Easson' (1994) 19 European L.R. 337. The two books were A.J. Easson, *Tax Law and Policy in the EEC* (London: Sweet and Maxwell, 1980);

and idem, *Taxation in the European Community* (London: Athlone Press, 1993).

3 See Alex J. Easson, 'Fiscal Policy' in Dominik Lasok and Panayotis Soldatos, eds., *The European Communities in Action* (Brussels: Bruylant, 1981), 419 at 436–7; idem, 'EEC Directives for the Harmonisation of Laws: Some Problems of Validity, Implementation and Legal Effects' (1981) Year Book of European Law 1; idem, *Tax Law and Policy in the EEC* at 401; idem, 'Fiscal Discrimination: New Perspectives on Article 95 of the EEC Treaty' (1981) 18 Common Market L.R. 521; and idem, 'The British Tax Reforms: A Step towards Harmonization' (1971) 8 Common Market L.R. 325.

4 For an accessible and thorough review of European reform efforts from 1957 onward, see Alex Easson, 'Harmonization of Direct Taxation in the European Community: From Neumark to Ruding' (1992) 40 Can. Tax J. 600.

5 Alex Easson, 'Company Tax Reform and the Inter-Nation Allocation of Tax Jurisdiction' in J.G. Head and R. Krever, eds., *Company Tax Systems* (Melbourne: Australian Tax Research Foundation, 1997) at 285 (considering the international allocation of corporate income tax revenues). See also A. Easson, 'Taxing International Income' in R. Krever, ed., *Tax Conversations: A Guide to the Key Issues in the Tax Reform Debate* (London: Kluwer Law International, 1997) at 419 (discussing the existing international tax base allocation rules and the feasibility of reform alternatives).

6 See Easson, *Taxation of Foreign Direct Investment: An Introduction* at 35–6, 39–40; see also idem, 'Taxing International Income' at 429–30, 441–3.

7 See Easson, 'Company Tax Reform' at 318; see also idem, 'A New International Tax Order: Responding to the Challenge' (1991) 45 Bulletin for Int'l Fiscal Documentation 465 (arguing that direct investment reform efforts should focus on achieving CIN).

8 Easson, *Taxation of Foreign Direct Investment: An Introduction* at 179.

9 This view by Easson and other 'Contextualists' influenced my claim that international tax analysts can be classified broadly into different categories that emphasize certain modes of analysis that ultimately influence policy prescriptions. See Arthur J. Cockfield, 'Purism and Contextualism within International Tax Law Analysis: How Traditional Analysis Fails Developing Countries' (2007) 5 eJournal of Tax Res. 199.

10 Easson, 'Company Tax Reform' at 296.

11 Alex Easson, 'Fiscal Degradation and the Inter-National Allocation of Tax Jurisdiction' (1996) 5 EC Tax Rev. 5 at 112–3.

12 Easson, 'Company Tax Reform' at 294–6.

13 Ibid. at 300.

14 Ibid. at 301. In contrast to the taxation of FDI, Easson suggested that foreign-source portfolio income should continue to be taxed on a residence-based basis along with credits for foreign taxes paid to the source country.
15 See Council Directive of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (90/435/EEC).
16 Easson, 'Company Tax Reform' at 303.
17 Easson, *Tax Incentives for Foreign Direct Investment* at 3 [emphasis in original].
18 Ibid. at 12–33.
19 Ibid. at 102.
20 Ibid. at 85.
21 See, for example, A.J. Easson, *The Design of Tax Incentives for Direct Investment: Some Lessons from the ASEAN Countries* (Toronto: Ontario Centre for International Business, 1993); Alex Easson and David Holland, *Taxation and Foreign Direct Investment: The Experience of the Economies in Transition* (Paris: Organisation for Economic Co-operation and Development, 1995); Alex Easson, 'Duty-Free Zones and Special Economic Zones in Central and Eastern Europe and the Former Soviet Union' (1998) 16 Tax Notes Int'l 445 (examining the use of tax incentives, duty-free zones and special economic zones to attract FDI); Howell H. Zee et al., *Vietnam: An Assessment of the Major Taxes* (Washington, DC: International Monetary Fund, 2004) (assessing five areas of Vietnam's tax system, including corporate income tax and investment tax incentives).
22 See Easson, *Tax Incentives for Foreign Direct Investment* at 85–7.
23 Ibid. at 86.
24 Ibid. at 59–60.
25 Ibid. at 81.
26 A.J. Easson, 'Tax Competition and Investment Incentives' (1997) 2 EC Tax J. 63 (arguing that there is greater justification for the use of tax incentives by less-developed countries, at least for a limited period, than by developed countries).
27 See, especially, Alex Easson, 'Tax Incentives for Foreign Direct Investment, Part I: Recent Trends and Countertrends' (2001) 55 Bulletin for Int'l Fiscal Documentation 266 (reviewing the types of investments that tax incentives are designed to attract); idem, 'Tax Incentives for Foreign Direct Investment, Part II: Design Considerations' (2001) 55 Bulletin for Int'l Fiscal Documentation 365 (analysing the inefficient and ineffective design characteristics of various types of tax incentives).
28 For an evaluation of tax holidays, see Easson, *Tax Incentives for Foreign*

Direct Investment at 134–142 (concluding that tax holidays are among the least effective and least efficient of all types of tax incentives).

29 A.J. Easson, 'Tax Incentives for Foreign Direct Investment in Developing Countries' (1992) 9 Australian Tax Forum 435 (analysing the types of tax incentives that are most likely to be successful in attracting FDI to developing countries).

30 Ibid. at 435–7.

31 For a general review of external constraints, see, for example, Easson, *Tax Incentives for Foreign Direct Investment* at 199–229.

32 For discussion, see, for example, Easson, 'Harmful Tax Competition: The EU and OECD Responses Compared' (1998) 3 EC Tax J. 1.

33 See Easson, *Tax Incentives for foreign Direct Investment* at 200–7.

34 A.J. Easson, 'State Aid and the Primarolo List' (2001) 5 EC Tax J. 111; idem, 'Harmful Tax Competition: An Evaluation of the OECD Initiative' (2004) 34 Tax Notes Int'l 1037 (concluding that the project is failing its original objective to constrain preferential tax regimes).

35 Easson, 'Harmful Tax Competition: The EU and OECD Responses Compared' at 13.

36 See Alex Easson, 'Do We Still Need Tax Treaties?' (2000) 54 Bulletin for Int'l Fiscal Documentation 623.

37 See Easson, 'Harmful Tax Competition: An Evaluation' at 1062–3.

38 Ibid. at 1045.

39 See Easson, *Tax Incentives for Foreign Direct Investment* at 200.

40 Easson, 'Tax Competition and Investment Incentives' at 87.

3 China's Tax Incentive Regime for Foreign Direct Investment: An Eassonian Analysis

ANDREW HALKYARD AND REN LINGHUI

1.0 Introduction

Tax incentives are commonly used as a policy tool to attract and retain foreign direct investment (FDI). As a report by the Organisation for Economic Co-operation and Development (OECD) puts it, tax incentives are 'measures designed to influence the size, location or industry of an FDI investment project by affecting its relative cost or by altering the risks attached to it through inducements that are not available to comparable domestic investors.'[1] Alex Easson took a broader view, which we adopt in this chapter, explaining that tax incentives confer benefits on foreign investors in the form of tax expenditures that represent a statutorily favourable deviation from the normal benchmarks of a country's tax system.[2] Compared to direct financial incentives, such as loan schemes, grants, and subsidies,[3] tax or fiscal incentives are a more realistic policy tool for developing countries with which to attract FDI, because there is no immediate need for governments to find cash to fund relevant new investment projects (see also Chapter 2 in this volume).[4]

China was neither an exception nor a laggard in granting tax incentives to promote FDI. Its tax incentive regime took full shape in 1991 with the enactment of the *Income Tax Law of the People's Republic of China Concerning Enterprises with Foreign Investment and Foreign Enterprises* (hereafter referred to as FEITL).[5] Most of the usual forms of tax incentives can be found in this law and its Implementing Rules.[6] Some of the more important included tax holidays and reduced rates for enterprises engaged in production; tax refunds for reinvesting profits; accelerated depreciation; and a virtual smorgasbord of 'tax breaks' for many

geographic zones and regions as well as for advanced technology, export-oriented industries, and infrastructure projects, to name but a few. Although it is debatable whether tax incentives were an important factor influencing foreign investment in China, the fact remains that China has experienced a rapid growth of FDI in the years since the law was promulgated,[7] which Chinese tax researchers generally accept can be attributed partly to the attractiveness of the country's tax incentive regime.[8] Indeed, the fundamental characteristic of that regime prior to 2008 is that it was virtually all FDI-specific. As we will see, this is not the case today.

Following the *Enterprise Income Tax Law of the People's Republic of China*, which took effect on 1 January 2008 (the '2008 EIT Law'),[9] the landscape of China's tax incentive regime changed dramatically. Previously, foreign investors enjoyed a panoply of tax incentives that were not available to domestic investors. Under the 2008 EIT Law however, tax incentives were extended to domestic enterprises but their scope was significantly reduced. In short, tax preferences are now restricted to supporting China's economic and, to a lesser extent, social policies in a limited range of areas, notably developing infrastructure and agriculture, promoting acquisition and innovation of technology, natural resources conservation, environmental protection, and public welfare.

Will these changes to China's tax incentive regime influence foreign investment in China? Will this new framework be able to support the types of FDI that China wants to attract and retain? And what are the challenges facing its tax system as China becomes more selective in using incentives to attract FDI? We attempt to answer these questions in this chapter. In doing so, our ultimate aim is to analyse China's tax incentive regime under the 2008 EIT Law to determine its ability to promote and attract FDI that matches the policy goals set for it. We do this specifically by applying an analytical framework pioneered by Alex Easson,[10] who argues that it is unrealistic to expect the wholesale abolition of special tax incentives, as many critics advocate. Indeed, properly designed, special incentives might be more cost efficient than the commonly suggested alternative: a general tax rate reduction and base broadening. Adopting this conclusion as our starting point, we detail the policy goals and content of China's tax incentive regime prior to and since 2008 and evaluate its effectiveness in encouraging economic development. We then consider whether the design of China's current tax incentives match the goals the country has set for FDI, emphasizing the role that good administration must play in the realization of these goals.

Having introduced the Eassonian analytical framework, we then introduce the tax incentive regime that existed in China from the early 1980s until the 2008 EIT Law took effect. We argue that the development of, and experience emanating from, the tax incentive regime over the past three decades form the basis on which China's drastically changed tax incentive regime exists today. We further examine how foreign investors have reacted to this regime, and consider whether the policy goals set before the tax incentives were granted have been achieved.

In the third part of the chapter, we describe and evaluate China's tax incentive regime under the 2008 EIT Law, and analyse whether the stated policy goals can be achieved and whether the incentives are appropriately designed. In the final part, we set out our conclusions.

2.0 China's Tax Incentives Prior to 2008

What were the conditions leading to the establishment and continuation of the tax incentive regime in China's enterprise income tax system? To answer this question, we need to distinguish three stages of development: first, the regime's origin in the early 1980s;[11] second, the enactment of the FEITL and its Implementing Rules in 1991 (replacing the *Joint Venture Income Tax Law* and the *Foreign Enterprises Income Tax Law*); and, third, the enactment of the 2008 EIT Law (replacing the FEITL and its Implementing Rules).

2.1 The Origin of China's Tax Incentive Regime: From the Early 1980s to 1991

The major characteristics of China's tax incentive regime from the early 1980s to 1991 can be broadly summarized as follows. Tax incentives mainly took four forms: tax holidays, reduced enterprise income tax rates, tax refunds for reinvested profits, and a portfolio of tax incentives under location-specific and industry-specific regulations. The *Joint Venture Income Tax Law* and the *Foreign Enterprises Income Tax Law* essentially provided tax incentives to all foreign invested enterprises (FIEs) – although they could differ depending on the form of FIE established – while the tax incentives contained in administrative regulations and local legislation were applicable only to FIEs incorporated in specified districts, such as the Special Economic Zones (SEZs) and certain designated coastal cities.[12] Tax incentives were granted to enterprises with advanced technology, those engaged in agriculture, forestry, animal husbandry, communications, energy, infrastructure construction,

service trades with a relatively large amount of investment, those with a long contractual life, as well as those that were capital intensive and production and export oriented. Looked at in the round, China's policy of fostering its developing economy through tax incentives targeted at FDI could hardly be described as miserly.

But all this came at a cost. Throughout the 1980s, the number of regions that provided preferential tax treatment increased greatly, and internal tax competition flourished. This led to a heavy concentration of FDI in those areas (which has continued to this day[13]) to the detriment of less fiscally rewarded locations. This striking array of tax incentives in the period from the early 1980s to 1991 formed the basis on which the FEITL was drafted. Yet, as rich and appealing as all this might have appeared to foreign investors, the totality of this tax incentive regime was extremely complex and confusing. In particular, location-specific tax incentives were Byzantine in their nature, scope, and application, and they changed rapidly.[14]

2.2 Tax Incentives for FDI under the FEITL from 1991 to 2007

The FEITL did not change the fundamental structure and framework of the tax incentive regime that existed from 1980 to 1991. Rather, it inherited virtually all those incentives that previously were scattered in a multitude of taxation laws, administrative regulations, and local regulations. The incentives consolidated in the FEITL represented the most common forms in international use, and their breadth sent a clear signal to foreign investors of China's continued commitment to provide a tax-friendly FDI environment.

At the beginning of 1991, when the FEITL took effect, China did not expressly specify detailed policy goals for its tax incentives regime in the new law, apart from art. 6, which provided the broad basis for many of the tax preferences noted above: 'The State shall, in accordance with its industrial policies, guide the orientation of foreign investment and encourage the establishment of enterprises with foreign investment which adopt advanced technology and equipment and export all or a greater part of their products.' Since the FEITL was framed by reference to the experience emanating from the tax incentive regime developed in the 1980s, it is reasonable to assume that it also inherited the policy goals relating to tax incentives reflected by the previous taxation laws, administrative regulations, and local regulations. When the FEITL was in the process of finalization, the Chinese minister of finance summarized these goals as follows:[15]

- promote exports and earn foreign exchange through exports;
- gain access to modern technologies and know-how and promote technological innovation;
- promote foreign investment in accordance with China's industrial policy, particularly in agriculture, forestry, and animal husbandry;
- promote the development of infrastructure projects – including ports, docks, airports, highways, railways, power stations, coal mines, and water conservancy – particularly in designated regions such as the Pudong New Area, Hainan province, and remote areas; and
- promote the development of targeted services trades, particularly financial services.[16]

Following the enactment of the FEITL, administrative regulations were regularly issued to extend further the scope of tax incentives, mainly by expanding regions where they could be applied and by granting them to business activities not initially covered.[17] By and large, these administrative regulations reflected changes in China's policy toward encouraging FDI and further opening up its economy; they did not change the fundamental nature of its tax incentive regime.

One should also appreciate China's economic circumstances during this time. It was a transitional economy,[18] specifically favouring FDI (to the extent of discriminating significantly against domestic enterprises in terms of higher tax rates and granting tax incentives), maintaining an expectation that FDI would be focused on producing for export (and not for competition in the domestic market),[19] and promoting certain geographic regions for development (particularly southern and coastal China) to the detriment of other areas (particularly the hinterland). Overall, it seems well accepted that FDI contributed significantly to China's economic growth[20] – with all its attenuated benefits such as promoting China's emergence as a dynamic and competitive exporter, the development of huge infrastructure and an untold number of building projects, and a marked increase in imported technology. From these perspectives, it seems clear that the policy goals enumerated above, all of which relate to economic development, have been assisted by the multitude of tax incentives China offered to encourage FDI in the three decades prior to 2008.[21]

Later in the chapter, however, it will become clear that, since China's accession to the World Trade Organization (WTO) in 2001 as part of its transition to a developed economy, the dismantling of many barriers to FDI, and the opening up of its economy to allow FIEs to compete in the

domestic market, its taxation policy for FDI has, of necessity, changed toward tax neutrality. Generally, the 2008 EIT Law applies to FIEs and domestic enterprises alike, while the tax incentives now on offer have been significantly reduced.

3.0 The Tax Incentives Regime in the 2008 EIT Law

3.1 The Law's Major Changes

The 2008 EIT Law and its Detailed Rules took effect on 1 January 2008.[22] Apart from unifying the tax rate (at 25 per cent) and tax treatment for FIEs and domestic enterprises across the board, the law's other major features concerning tax incentives were as follows:

- Most pre-2008 tax incentives for industry and business classifications were cancelled. For example, subject to transitional provisions, the previous two-plus-three-year exemption and tax reduction for production-orientated FIEs was replaced by a tax holiday of three years followed by a 50 per cent reduction in income tax payable in the following three years, but only for enterprises involved in public infrastructure projects (including pier and dock construction, airports, roads, railways, transportation, and power plants) supported by the state, and for qualified projects relating to environmental protection, energy, and water conservation, commencing in the first revenue-producing year.[23]
- Other important incentives available under the FEITL, such as those for export-oriented FIEs and for reinvesting profits, were also abolished. Likewise, the withholding tax rate of zero for profits remitted to foreign investors by FIEs was replaced by a rate of 10 per cent and the scope of tax-exempt income generally was clearly defined.[24]
- By way of contrast, preferential tax treatment for investment in agriculture, forestry, animal husbandry, and fisheries not only was retained but their scope was expanded and particularized in greater detail. For example, income from cultivating basic crops and agricultural products (including grain, vegetables, and natural Chinese medicines), animal husbandry, and certain fishery operations are exempt from EIT. Income from planting flowers, tea, other beverage crops and spice crops, seawater fish farming, and freshwater fish farming enjoy a 50 per cent reduction in the EIT rate.[25]
- Preferential tax treatment for income earned by enterprises from

transfers of technology was extended to FIEs. Specifically, the first RMB 5 million of income earned in a taxable year from transferring ownership of technology is exempted from EIT, and any excess amount is taxed only at one-half the normal 25 per cent rate. Contrary to the text of earlier drafts of the Detailed Rules, it appears that a transfer of technology between related parties is eligible for this preferential treatment.[26] The preferential tax rate of 15 per cent applicable to eligible 'high and new technology enterprises' was retained, but only if they receive priority support from the state and possess substantial or key ownership of core proprietary intellectual property rights. Additional requirements, which basically aim to ensure that qualified enterprises are sufficiently devoted to promoting the use and development of the technology, must also be met.[27]

- The research and development (R&D) super-deduction rule of 150 per cent for qualifying expenditure was retained.[28]
- Enterprises are now entitled to an extra income tax deduction of up to 100 per cent of the current year's wages paid to disabled employees and other employees whom the state encourages enterprises to hire.[29]
- Accelerated depreciation for certain capital assets was retained.[30]
- Additional preferential tax treatment was granted to venture capital enterprises investing in small and medium-sized high-technology enterprises (a deduction of 70 per cent of the total investment is now allowed against an enterprise's annual taxable income in the year after its initial two-year holding period)[31] and to enterprises that use resources in an environmentally friendly and health-conscious way.[32]
- The pre-2008 system of a host of preferential tax rates for qualified FIEs located in special zones and regions was abolished, with limited exceptions.[33] One special dispensation was that enterprises located in more remote areas where the state has encouraged development (such as the Western Development Region) would continue to enjoy concessionary tax rates.[34] Furthermore, autonomous regions were granted more discretion in deciding whether or not to exempt or reduce the local portion of tax revenue shared with the central government.[35] An intriguing question in this regard is whether local governments[36] can provide a 'tax break' on their own volition. It should be noted, first, that 'local tax' and the 'local portion of EIT' referred to above are different concepts. The 2008 EIT Law does not embody the concept of 'local tax,' unlike the FEITL, in

which it was 3 per cent but which was commonly waived by local governments to attract FDI. The new EIT rate is 25 per cent, and no local tax is levied on enterprises. Second, regarding the 'local portion of EIT,' the 2008 EIT Law does not, and was not intended to, address problems of fiscal federalization. Since the issue of *Guofa* (State Council directive) [2001] No. 37 concerning reforms involving sharing corporate income tax revenue between the central and local governments, the sharing ratio has been fixed at 60:40. It is still unclear whether and when the central government will change this ratio. Third, it is for local governments to decide the reduction or exemption of the local portion of tax revenue they are entitled to receive.[37]

- Finally, as a catch-all provision, art. 36 of the 2008 EIT Law provides that '[w]here the national economic and social development so requires ... the State Council may formulate special preferential policies concerning [this law] and submit them to the Standing Committee of the National People's Congress for archival purpose.' Among the first to benefit from the additional tax incentives based on this article were enterprises engaged in software production and integrated circuit design. Incentives granted under this notice include tax holidays, reduced rates of tax, accelerated depreciation, and even a reinvestment incentive.[38]

In summary, the new regime adopts a 'predominantly industry-oriented, limited geography-based' tax incentive policy, a significant change from the thrust of China's tax incentive regime before 2008. The 'industry-oriented' incentives are aimed at encouraging investments in those sectors and projects whose development is encouraged and supported by the state – namely, technological development, environmental protection, energy conservation, production safety, venture capital, agriculture, forestry, animal husbandry, fishery and infrastructure development.[39] With limited exceptions, it seems clear that China has shifted from using tax policy as a broad and fairly blunt instrument to attract FDI over many different industries and for many favoured geographic areas, to one that is more in line with international tax norms and more focused in supporting national economic priorities. Li Jinyan put it thus:

> Several domestic and international factors seem to have influenced China's decision [effective from 2008] to abolish FDI tax incentives and to adopt a generally lower corporate income tax rate. Domestically, the Chi-

> nese government decided in 2005 to upgrade China's economic development model from that of FDI-led manufacturing and export to one of technology-driven, sustainable economic development. The [pre-2008] tax incentives were geared to promote the former model of development and were thus outdated. By 2007, the Central Government's fiscal position had been relatively strong to afford the general reduction of corporate tax rate. The increasing integration of FDI with the domestic economy made it very difficult for the government to justify preferential tax policy towards FDI. There were also serious doubts about the effectiveness of tax incentives in attracting 'real' foreign investment to China that help China develop a sustainable economy.[40]

3.2 The Effects of Changes to the Tax Incentive Regime on FDI in China

Although difficult to predict with certainty, one can be fairly confident that the changes to China's tax incentive regime will not have a major influence on FDI in China (see Chapter 4 in this volume for a review of the effect of tax on FDI). This is certainly the view of the Chinese government, as illustrated by this statement from the former minister of finance, Jin Renqing, in his explanation of the draft 2008 EIT Law: 'International experience has shown that political stability, sound economic development, big market, rich human resources, constantly improving legal environment and government services are main factors for absorbing foreign investment, and the tax preference is only one factor. Therefore the new Tax Law will not exert a great impact on foreign investment.'[41]

Jin underscored his comments by noting that the new EIT tax rate of 25 per cent is relatively low and internationally competitive and will be conducive to enhancing enterprise competitiveness and attracting foreign investment. Clearly, China has not abandoned its commitment to attracting FDI through the use of taxation policy (see Chapter 5 in this volume for a discussion of tax planning and tax incentives). Indeed, it seems that the new regime aims to influence the shape, rather than the volume, of FDI activity. Furthermore, although the final form of the 2008 EIT Law was debated vigorously in China, and it was clear for some time that many tax incentives for FDI would be abolished after China joined the WTO,[42] the appetite for foreign investment in China has not diminished. Moreover, international reaction to the 2008 EIT Law has been generally positive except for criticism that the law and its Detailed Rules simply are not detailed enough![43]

3.3 *Will the New Regime Help China to Attract and Retain the FDI It Wants?*

3.3.1 The Use of Tax Holidays

The FEITL's widespread use of tax holidays was inherited from the tax incentive regime of the 1980s, in which they played a major part in China's tax policy in attracting foreign investors to preferred regions, particularly the SEZs. It is widely accepted, however, that tax holidays are the least effective and efficient form of tax incentive, and that they serve no specific purpose and typically are unfocused.[44] The major pitfalls of tax holidays are, first, that they can be administratively burdensome, although at first sight they are a simple form of tax incentive; second, that they are prone to manipulation, resulting in revenue loss that cannot be predicted in advance; third, that they are rarely effective in attracting long-term projects; and, fourth, that some normal incentives are able to achieve the same effects as tax holidays but with controllable revenue loss, thus making tax holidays inefficient.[45]

Turning specifically to the tax holidays provided by the 2008 EIT Law, China has moved from a blanket exemption – commencing in the first profit-making year – for two years plus a 50 per cent reduction in tax for the next three years, for all production-oriented FIEs scheduled to operate for at least ten years, to a more targeted set of exemptions. Now, there is an exemption for three years, followed by a 50 per cent reduction in the tax rate for the next three years, for enterprises involved in environmental protection, resource conservation, and infrastructure projects, commencing in the first revenue-producing year. Certain agricultural activities, including forestry, animal husbandry, and fishing operations, are exempt from EIT. All these areas reflect key Chinese economic policies aimed at promoting the development of large-scale and long-term public infrastructure and primary industry.

Dealing first with agriculture and related activity, according to statistics on sectoral distribution of FDI in China provided by the Ministry of Commerce, the cumulative contract value of FDI in agriculture, forestry, animal husbandry, and fishery accounted for only about 2 per cent of China's cumulative FDI inflow as of 2006.[46] Nonetheless, these sectors are a core concern of the central government, and arguably justify preferential tax treatment for what typically is a longer-term investment.

The 2008 EIT Law also grants tax holidays to enterprises engaged in infrastructure projects receiving key support from the state. Previously,

construction was promoted particularly in areas given development priority, such as the Pudong New Area, Hainan SEZ, and remote areas. In theory, the advantages of granting tax holidays to enterprises engaging in these projects seem plausible. Infrastructure projects normally require a relatively large capital injection in their start-up years, a sometimes lengthy period during which these enterprises generally operate at a loss. Even when they start to become profitable, for tax purposes the losses they incur in the start-up years can be carried forward (up to five years according to art. 18 of the 2008 EIT Law) to offset taxable income earned during later years. By the time they start making profits, of course, the carry-forward period might have expired, so that this interaction with the loss-carry-forward provisions might reduce the cost of this incentive.

A long-term tax holiday – namely, the three-year exemption plus the three-year 50 per cent reduction that applies in this area – can help large-scale construction enterprises neutralize the tax effects described above. To the extent that an enterprise engaged in infrastructure projects does not manipulate its profits to avoid tax, such as through aggressive transfer pricing, an extended tax holiday can operate in a positive way to encourage it to invest more in the start-up period of the project and thus speed up the development of long-term activities that the central government has encouraged and supported. From a design perspective, the fact that the tax holiday now commences when an enterprise starts to earn revenue means that it is less prone to abuse than in the former system, when the tax holiday commenced only from the first profit-making year.

Extended tax holidays are also arguably helpful in assisting the economic development of remote areas. In practice, however, the benefits of this tax incentive are doubtful. According to statistics provided by the Ministry of Commerce, the cumulative FDI inflow into western China accounted for only 4.25 per cent of China's total FDI by the end of 2006, with realized investment of around US$30 billion spread over 36,902 projects (accounting for only 6.21 per cent of the total number of investment projects).[47] This percentage is extremely low if one considers that western China includes more than one-third of the country's provincial administrative regions. Furthermore, in recent years, FDI inflow into western China actually has decreased,[48] with most of the investment in infrastructure projects directly financed by the central government.[49] On a positive note, however, the average realized investment in a single investment project in western China is about US$0.8 million, just

slightly lower than the US$1.2 million figure that prevails in eastern China.

Given their questionable influence, the 2008 EIT Law abolished tax holidays targeted specifically at remote areas, with very limited exceptions. China now seems to be adopting a more focused approach to promoting economic development in its underdeveloped regions. The geographic scope of these regions is now strictly defined as the five autonomous regions and autonomous prefectures and counties in other provinces. As well, the central government now allows local governments to decide whether or not to provide further tax incentives to enterprises at the cost of their portion of EIT revenue collected. It is likely that the central governments will still assume the major role in promoting economic development in these remote areas, especially for financing large infrastructure projects, while local governments provide only supplementary funds.

Under the FEITL, short tax holidays were also available for high-technology enterprises, and the holidays could be extended if the enterprise remained in that sector. But their effect in promoting technology progress throughout China was largely limited by the requirement that, to be eligible for the tax holiday, the enterprise had to be established in a High Technology or New Technology Development Zone. Under the 2008 EIT Law, however, tax holidays are available for all qualifying transfers of technology, but restricted by a cap of RMB 5 million on income earned in a taxable year from the transfer of ownership of technology, with the excess subject to a 50 per cent reduction of the normal tax rate. Tax holidays are also now available for qualifying software production and integrated circuit design enterprises.[50]

In conclusion, the tax holidays available under the 2008 EIT Law suggest that the substantially reduced and more focused activities in which China seeks to encourage FDI by virtue of this incentive are not egregious from a tax policy perspective, particularly given the transitional state of China's economic development. They should assist in helping achieve China's policy goals – as far as they can be deduced – by allowing its taxation system to encourage FDI for government-supported activity. The encouraged projects generally seem to be long term in nature. All this, however, raises the question of whether, in China's next phase of tax reform, tax holidays are the most cost-effective means of pursuing those goals and whether they could be better assisted in a more efficient and transparent way. For instance, in terms of tax policy generally and tax incentive design specifically, with respect to pro-

moting investment in remote areas, it might be more appropriate and efficient to enhance deductions for employment costs generally and accelerate deductions for purchasing capital equipment. With respect to promoting technology transfer, it might be more appropriate to have an expanded super deduction for R&D expenses and investment credits for purchasing necessary capital equipment. Simply put, there does not seem to be sufficient evidence to show that the activities targeted for tax holidays in the 2008 EIT Law are those that are particularly – as distinct from generally – sensitive to taxation so as to render them the most effective and efficient tax incentive.

3.3.2 A Reduced Enterprise Income Tax Rate

Incentives taking the form of reduced corporate income tax rates seem less liable to the harsher criticisms directed at tax holidays. But they came under sustained attack in China prior to 2008 when, as indicated above, they applied only to a small group of enterprises (that is, FIEs) but not to domestic enterprises. Furthermore, since different preferential tax treatment could apply to FIEs according to the locations or industries in which they operated, criticism also arose because the profits of the same type of entity could be taxed at different rates.

Both these criticisms have been largely met by the 2008 EIT Law, which taxes all enterprises, both domestic and FIEs, on the same basis. Furthermore, the scope of tax rate reductions under the law has been cut down significantly and now focused on the key areas of certain agricultural and technology-related operations. As a general matter, a reduced rate of income tax in these priority areas creates a modestly incentivised tax environment for FIEs and does not seem unreasonable from a tax policy perspective, provided that the relevant authorities ensure the enterprises meet, and continue to meet, the conditions established to qualify for this incentive.[51]

3.3.3 Accelerated Depreciation

Accelerated depreciation for certain capital assets can be regarded as a form of tax incentive. It allows the cost of acquiring the asset to be written off more quickly than would be allowed under the normal depreciation schedules, and thus it defers tax.[52] For some initial investments, however, the benefit of this incentive might not be fully realized if any resultant losses are unable to be carried forward within the statutory five-year period. Thus, it would seem more meaningful if an enterprise were able to start using accelerated depreciation methods after the ini-

tial investments were completed and the enterprise commenced making profits.

Since the availability of accelerated depreciation is normally targeted to accelerate purchases of new equipment and to promote capital investment, modernization, and growth,[53] and is not simply restricted to new investors, it does not seem inappropriate for the 2008 EIT Law to continue allowing enterprises that need to upgrade their equipment frequently to adopt accelerated depreciation methods. This incentive, while not likely by itself to increase FDI in China, seems a reasonable measure to help promote investment in areas the central government deems desirable.

3.3.4 Reinvestment Incentives

Although the main objective of granting a tax incentive for reinvestment of profits to foreign investors is to retain foreign investment in the host country, the 2008 EIT Law abolished both this incentive and the former exemption from withholding tax for dividends paid by FIEs.[54] This abolition accords with Alex Easson's conclusion that, '[p]rovided that the host country has a reasonably generous system of depreciation allowances, there would seem to be little need to provide a further inducement. Moreover, the international system itself provides a built-in incentive to reinvest profits where they are made, rather that repatriating them: reinvesting profits avoids withholding tax in the host country and usually also avoids tax liability in the host country.'[55]

3.3.5 Favourable Deduction Rules

The super-deduction rule for R&D expenses, which the 2008 EIT Law retains, is intended to promote the development of technology in China. The benefit of promoting R&D through tax incentives is that they encourage business to perform R&D while leaving it to the recipient and to market forces to determine the projects undertaken.[56] However, citing Zhongguancun High-Technology Park in Beijing as an example during the period when the FEITL was effective, one of the 'Big 4' accounting firms noted that none of the companies in this high-technology incubator had obtained approval for the R&D incentive since the policy became effective several years ago.[57] According to the authors' experience, the effectiveness of the incentive suffers from major flaws and cannot achieve its goal of promoting technology innovation, for several reasons. First, the super-deduction rule is not well coordinated with China's loss-carry-forward rules (as was the case with the accelerated depreciation incentive noted above). Indeed, this is acknowledged

in a circular by the Chinese State Administration of Taxation, which states 'the super accrued portion in excess of an FIE's taxable income may not be deducted or carried forward.'[58] Thus, taxpayers may benefit from the incentive only if they have taxable income in the relevant year after offsetting operating losses carried forward from previous years. Second, the administrative process of approving the super deduction is complicated by the stringent documentation requirements imposed by the local tax authorities.[59] Third, the content of the rules is thin and various technical points have not been clarified by the local tax authorities.[60] Thus, it seems unlikely for this incentive by itself to attract increased FDI to China, but it is not unreasonable to assume that it might help to promote the development of the more technologically advanced economy that the central government wishes to encourage.

3.4 Summary

In summary, the tax incentives regime introduced in the 2008 EIT Law is more focused and better targeted, and tries to address criticisms levelled at previous incentives. This does not mean that the new regime definitely will attract and retain the forms of FDI that China wants to encourage. Notwithstanding its shortcomings, however, progress has been made; China's tax incentives are now better designed and better serve China's policy goals.

4.0 Conclusions

The 2008 EIT Law marks a long-awaited and fundamental change to enterprise income tax in China. One of the most dramatic changes relates to tax incentives, which, while now available to both domestic and foreign enterprises alike, have been significantly reduced. It is important to appreciate, however, that these changes are evolutionary and mainly reflect China's economic development, reform, and internationalization, from its 'opening up' in the late 1970s to the present day. Also, the new law retains a degree of continuity since many changes are couched in vague terms, and it is not inconceivable that the former practices of interpretation and application, by analogy, will be continued at the discretion of the relevant authorities.[61]

Turning specifically to the new tax incentives regime, this is now much more carefully targeted than previously. Incentives are now restricted in both their application and their focus on the types of investment that China seeks to encourage – namely, the development and acquisition of new and high-technology, infrastructure, agriculture,

and certain other selected industries. Indeed, it seems fair comment that China is now trying to shape specific forms of sustainable economic development through FDI at least partly by relying on its tax policies. This was not the case under the FEITL, where the totality of the tax incentives granted appeared to prioritize the volume of FDI generated, rather than its structure.

On the other hand, whether the regime is appropriately selective, in the sense that the overall cost should be justifiable and efficient, is much harder to judge, since most of the targeted incentives do not appear to be focused on mobile investment that would not otherwise take place without them. This is particularly true in the case of the much-maligned tax holidays, which lack detailed analysis as to whether they are the most cost-effective and appropriate incentive to match the policy goal set for them. The new package of tax holidays, however, do benefit from a focus on desirable longer-term investment and projects, rather than on the more mobile, export-oriented, across-the-board, production-oriented activity supported by the FEITL.

We would be remiss if we were not to acknowledge the difficulties and limitations we faced in appraising these tax incentive packages (a matter strongly emphasized in Chapter 5 in this volume). Indeed, in assessing the cost and effectiveness of China's tax incentives regime on FDI, we encountered major problems in obtaining relevant data that could provide a statistical and empirical basis to support our analysis. The publicly available data relating to FDI in China (mainly provided by the Ministry of Commerce) is not comprehensive and, where available, is in many cases incomplete. In any event, as W. Steven Clark pertinently notes in Chapter 5,

> much work remains to determine what tax measures investors tend to factor in when making their cross-border investment decisions. The analysis does, however, raise some concern that estimates of the inbound/outbound FDI response to tax policy reform based on standard approaches and measures might be less than reliable on account of both questionable estimated tax-elasticity values and considerable uncertainty about the percentage change in [average effective tax rates] that accompany tax reform, taking into account tax-planning considerations.

In terms of design, it is apparent that many of the incentives, particularly those related to qualified transfers of technology and those applying to new and high-technology enterprises, are not fully explained in

the Detailed Rules. This is still a work in progress, and further regulations, circulars, and pronouncements undoubtedly will be issued to clarify many details relating to their implementation.[62] As the 2008 EIT Law is currently drafted, it appears that the degree of discretion involved before an incentive is granted is overly wide and the criteria that must be satisfied not yet transparent. For example, what is 'technology which meets the relevant requirements'? What is the scope of the 'ownership' requirement for the new and high-technology incentive to be granted? And what is intended by the phrase 'core intellectual property rights'?[63]

The fact that discretion has been granted to local governments to approve EIT reductions might also give rise to concerns of transparency and accountability. To date, however, the discretion has been granted only to autonomous regions, so overall costs and appropriate implementation of any reductions are thus capable of being well monitored by the central government. Presumably, the rationale for granting this discretion is to promote economic development in areas that historically have been underdeveloped. It is to be hoped, therefore, the central government will not grant such power arbitrarily to other regions without reasonable justification. Indeed, it would be in China's long-term interest to ensure that another round of tax competition or, to use Easson's analogy, a 'race to the bottom,' does not take place among the designated areas. In any event, since local governments can reduce only the local portion of EIT, they are responsible for any misuse of that portion. And, if tax competition became a matter of serious concern, the central government still has the power to adjust the EIT revenue-sharing ratio to limit the cost of granting the discretion.

Gradually, a set of interpretations will develop that should help ameliorate the problems and uncertainties associated with the new tax incentives regime. In many cases, it should not be necessary to reinvent the wheel, since the new law retains some of the basic tax policies that informed the legislation China lived with for much of the past two decades. Perhaps the greatest challenge in this area for Chinese tax authorities is to ensure that the tax incentives operate fairly and transparently since, in former times, it was widely recognized that FDI tax incentives were misused and abused at the local level. Where the tax incentives legislation and rules still provide a great deal of discretion to tax and other authorities to approve tax incentives, any lack of transparency and accountability in administering them could come at a high cost.[64]

How would Alex Easson have critiqued China's new tax incentives regime? On the basis of our analysis, we doubt he would have approved entirely. Generally, he took the view that tax incentives are ineffective because tax is not the decisive factor influencing investment decisions, because it is hard to administer tax incentives properly, and because tax incentives often fall short of the policy goals set by the countries that provide them, particularly if other countries provide similar incentives. Easson also believed, however, that incentives that are well targeted, transparent, and tailor made to support the policy goals of the host country can work. But they require that the host country that provides them really knows what kind of investment it wants to attract and promote.

We feel that, for China, the lack of consistent and long-term policy goals in attracting FDI (or investment in general) has been an obstacle to the design of well-targeted tax incentives. China is still in a transitional period of economic development, and its policy goals in this complex area might change rapidly, as they have in recent times. It is no easy task for the Chinese government to adjust, in a timely way, its tax incentives regime to reflect and promote those changing goals. Bearing this in mind, we recall Art Cockfield's description (in Chapter 2 of this volume) of Alex Easson as a 'hopeful pessimist,' and we are confident that he would have been looking forward to the next round of reform and improved design of tax incentives in China. Indeed, China could hardly do better than adopt his legacy.[65]

Notes

1 See Organisation for Economic Co-operation and Development, *Checklist for Foreign Direct Investment Incentive Policies* (Paris: OECD, 2003) at 13.

2 See A. Easson, *Tax Incentives for Foreign Direct Investment* (The Hague: Kluwer Law International, 2004) at 63. For an assessment of tax incentives in China from a tax expenditure perspective, see Li Jinyan, 'The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates' Comparative Research in Law and Political Economy Research Paper 5/2008 (Toronto: Osgoode Hall Law School, 2008).

3 An example of a non-fiscal incentive available in China involves the China Development Bank, which has provided preferential loans, with an extended loan period or lower interest rate, to enterprises engaged in construction and other infrastructure projects in the western regions of that country.

4 See Easson, *Tax Incentives for Foreign Direct Investment* at 1–2.
5 Promulgated by the National People's Congress on 9 April 1991 and taking effect on 1 July 1991.
6 Promulgated by the State Council on 30 June 1991 and taking effect on 1 July 1991.
7 See United Nations Conference on Trade and Development, *World Investment Report 2007* (New York and Geneva: UNCTAD, 2007); see also Huang Yasheng, 'The Benefits of FDI in a Transitional Economy: The Case of China' in Organisation for Economic Co-operation and Development, *New Horizons for Foreign Direct Investment* (Paris: OECD, 2003). See, however, Li Jinyan, 'The Rise and Fall of Chinese Tax Incentives' at 16, 17, and 26, who, while concluding that 'China has been generous to a fault in granting tax incentives to foreign investors,' cautions that '[u]sing the FDI growth as a basis for asserting the effectiveness of tax incentives is unreliable' and that '[i]t is unclear as to the extent of FDI that was actually attracted by tax incentives.'
8 See Li Jinyan, 'Development and Tax Policy: Case Study of China' Comparative Research in Law and Political Economy Research Paper 27/2007 (Toronto: Osgoode Hall Law School, 2007), who, in analysing China's tax incentives available from the late 1970s to 2007, considers their utility in attracting FDI to China and assesses their impact on the development of China's market economy. Li examines generally the role of tax policy and the goals of tax policy design for China's economic development, noting that most Chinese academic commentators consider tax incentives to be important in attracting FDI. She concludes (at 43) that 'tax policy has [particularly in the earlier years] played an important, but somewhat mixed role in economic development [and attracting FDI to China] ... In recent years, however, the negative impact of the tax incentives and the discriminatory policy against domestic enterprises has become more serious.'
9 Promulgated by the National People's Congress on 16 March 2007 and taking effect on 1 January 2008.
10 The basis for this framework was set out by Alex Easson as long ago as 1993 in *The Design of Tax Incentives for Direct Investment: Some Lessons from the ASEAN Countries* (Toronto: Ontario Centre for International Business, 1993). Its culmination appeared in his landmark work, *Tax Incentives for Foreign Direct Investment*.
11 See, generally, A. Easson and Li Jinyan, 'The Evolution of the Tax System in the People's Republic of China' (1989) 23 Stanford J. of Int'l L. 399, which discusses the first major amendments to the Chinese tax laws since 1950, including those relating to foreign business and investment: the *Joint Venture Income Tax Law* (18 December 1980) and the *Foreign Enterprises In-*

come Tax Law (13 December 1981). See also M. Moser and W. Zee, *China Tax Guide*, 2nd ed. (Hong Kong: Oxford University Press, 1993) chaps 1, 4, and 5.

12 See Jiang Zhaodong, 'China's Tax Preferences to Foreign Investment: Policy, Culture and Modern Concepts' (1998) 18 Northwestern J. Int'l Law & Bus. 549.

13 See Li, 'Development and Tax Policy.'

14 Compare S. Nelson, 'People's Republic of China – New Unified Tax Law Governing Foreign Investment Enterprises and Foreign Companies' (1991) Tax Notes Int'l (June) 606.

15 See Wang Bingqian, 'Explanation on the Draft Income Tax Law for Enterprises with Foreign Investment and Foreign Enterprises' speech delivered at the Fourth Session of the 7th National People's Congress, Beijing, 2 April 1991.

16 Even though they were not particularly generous, the FEITL reduced tax incentives previously available for foreign investors engaged in service trades such as travel and commercial services (but not financial services). It should be appreciated, however, that, even in the preferred areas, tax holidays were more theoretical than practical. The reason is that, prior to China's accession to the WTO, many services industries were closed to foreign investors. See China, Ministry of Commerce, *Compilation of the Legal Instruments on China's Accession to the World Trade Organization* (Beijing: China Law Press, 2001) at 700–59.

17 A good example is the super-deduction rule for research and development expenses. Initially, this applied only to domestic enterprises and was made available to FIEs only well after the FEITL was enacted

18 See also A. Easson, 'Tax Incentives for Foreign Direct Investment, Part II: Design Considerations' (2001) 55 Bulletin for Int'l Fiscal Documentation 365 at 372; and D. Holland and R. Vann, 'Income Tax Incentives for Investment' in V. Thuronyi, ed., Tax Law Design and Drafting, vol. 2 (Washington, DC: International Monetary Fund, 1998) at 987, who argue that, during the early stages of the transition to a market economy, tax holidays for foreign investors might be appropriate while a country's general tax system undergoes reform.

19 Dealing specifically with export promotion, conventional opinion suggests that short tax holidays are generally ineffective in attracting investment except for export-oriented activities and for short-term and mobile investments. See Easson, *Tax Incentives for Foreign Direct Investment* at 69; and idem, 'Tax Incentives for Foreign Direct Investment, Part II' at 371. This is

probably true in China's case, because in the past two decades it has experienced a rapid growth in exports, which was led by FIEs.

20 See W. Tseng and H. Zebregs, 'Foreign Direct Investment in China: Some Lessons for Other Countries' IMF Policy Discussion Paper PDP/02/3 (Washington, DC: International Monetary Fund, February 2002), who claim that FDI has played a major role in China's economic reform. See also Li, 'Development and Tax Policy' at 13, who states that there is a strong sense expressed in the Chinese literature that well-designed tax incentives are important to China's economic development.

21 Compare Li, 'Development and Tax Policy' at 17, who, after explaining the dual-track tax system (whereby foreign and domestic enterprises were taxed entirely separately), and examining the economic reforms in China during the period from the 1980s to 2007, concludes that tax policy 'played a positive role in facilitating the economic transition.' Li was not uncritical of China's tax incentive regime, however, and states (at 22–4) that China's tax preferences have caused serious distortions to investment for several reasons, including discriminatory treatment of domestic enterprises, the encouragement of the 'wrong' type of investment as distinct from encouraging long-term commitment, worsening the problem of regional disparities, and promoting the use of 'phantom' FDI through round tripping.

22 It should be appreciated that, even though the Detailed Rules were promulgated by the State Council on 6 December 2007, they are far from comprehensive, and it seems inevitable that they will be supplemented by further regulations, State Administration of Taxation ('SAT') circulars, and other guidance. See R. Chang and J. Kadet, 'China Issues Implementation Rules on Tax Unification' (2007) Tax Notes Int'l (17 December) 1099. Transitional provisions for continuing tax incentives applying to pre-2008 FIEs are mainly set out in *Guofa* [2007] No. 39. See also *Caishui* [2008] No. 21, which sets out the applicable tax rates where an FIE qualifies for grandfathering of both a tax holiday and the 15 per cent incentive rate available under the FEITL; and *Guoshuifa* [2008] No. 23, which provides for continuing withholding tax exemptions for certain interest and royalty payments made to foreign enterprises. See further J. Kadet and K. Zhu, 'China Issues Plethora of New Tax Rules' (2008) Int'l Tax Rev. (April) 57; and R. Chang and A. Tam, 'The New Era in China Taxation: The Implementation Rules and Guidelines' (2007) 11 Asia-Pacific J.Tax. 82 at 84–5, 87.

23 2008 EIT Law, art. 27 paras 2–3; Detailed Rules for the EIT Law, arts 87–9. The commencement of the tax holiday, taking effect from the 'first revenue producing year,' is a major change from the much more generous provi-

sion in the FEITL, which referred to the 'first *profit* making year.' Contrast, however, the two-plus-three-year tax holiday provided to software production and integrated circuit design enterprises and the five-plus-five-year tax holiday provided to long-term and more capital-intensive integrated circuit design enterprises set out in *Caishui* [2008] No. 1, which, as was the case under the FEITL, commences from the 'first profit making year.'

24 2008 EIT Law, arts 26–7; Detailed Rules for the EIT Law, arts 82–5 and art. 91. The United States considered that many of the former incentives enjoyed by export-oriented enterprises were export subsidies that violated WTO rules. On 29 November 2007, China and the United States signed a Memorandum of Understanding that nine such tax incentives and three import substitution subsidies would not be included in the 2008 EIT Law; see 2007 WTD 232-18.

25 2008 EIT Law, art. 27 para. 1; Detailed Rules for the EIT Law, art. 86.

26 2008 EIT Law, art. 27 para. 4; Detailed Rules for the EIT Law, art. 90. It seems likely that the SAT will issue a circular to clarify this matter.

27 2008 EIT Law, art. 28 para. 2, Detailed Rules for the EIT Law, art. 93. See further *Caishui* [2008] No. 1, which, consistent with the state's encouragement of the development and acquisition of high technology, provides a package of tax incentives to software production and integrated circuit design enterprises, including a 15 per cent EIT rate for the latter.

28 2008 EIT Law, art. 30 para. 1; Detailed Rules for the EIT Law, art. 95.

29 2008 EIT Law, art. 30 para. 2; Detailed Rules for the EIT Law, art. 96.

30 2008 EIT Law, art. 32; Detailed Rules for the EIT Law, art. 98.

31 2008 EIT Law, art. 31; Detailed Rules for the EIT Law, art. 97.

32 2008 EIT Law, arts 33-34; Detailed Rules for the EIT Law, arts 99–100.

33 An intriguing 'exception', although labelled as a 'transitional provision,' is set out in *Guofa* [2007] No. 40 (cited by Kadet and Zhu, 'China Issues Plethora of New Tax Rules' at 57–9). This notice continues, albeit to a limited extent, the prior geographic focus of China's tax incentives by providing a two-plus-three-year tax holiday from EIT, commencing in the first revenue-producing year, to new and high-technology enterprises established in Pudong and the SEZs on or after 1 January 2008.

34 See *Guofa* [2007] No. 39, promulgated by the State Council on 26 December 2007, noting that preferential tax treatment granted to enterprises investing in the vast Western Region prescribed in *Caishui* [2001] No. 202 will be effective until 2010. See also *Caishui* [2008] No. 1, which provides an enhanced reinvestment tax refund for establishing a new software production, or integrated circuit design enterprise in the Western Region.

35 2008 EIT Law, art. 29; Detailed Rules for the EIT Law, art. 94.

36 'Local government,' in this context, refers to governments at all levels below the central government.

37 In order to examine the 'tax breaks' that can be granted under art. 29 of the 2008 EIT Law, one should first refer to China's current tax-revenue-sharing system, specifically the EIT sharing system that came into effect in 2002 (see *Guofa* [2001] No. 37). As indicated in the text above, this system allows the central government and local governments to share EIT at a predetermined ratio, which has been fixed at 60:40 since 2003. Thus 40 per cent of EIT collected is retained and can be disposed of by local governments. There are two exceptions, however: (1) EIT collected from railway transportation enterprises, the national post, seven state-owned banks, and offshore oil and natural gas enterprises is retained solely by the central government; and (2) EIT collected from certain enterprises that operate across different (provincial-level) local taxing jurisdictions and adopt a consolidated tax-reporting system and from local financial institutions is shared among relevant regions according to a predetermined formula decided by the Ministry of Finance. See *Guofa* [2001] No. 37; *Caiyumingdian* [2001] No. 3; *Caiyu* [2002] No. 5; *Caiyumingdian* [2002] No. 3; and *Caiyu* [2003] No. 452.

38 See *Caishui* [2008] No. 1, a useful summary of which is provided by Kadet and Zhu, 'China Issues Plethora of New Tax Rules' at 57–9. Basically, this package of incentives is provided to assist new software production and integrated circuit design enterprises and is not materially different from the incentives previously available under the FEITL. To encourage the growth of Chinese securities investment funds, the notice also 'temporarily' provides tax holidays for income earned, and distributed, by such funds.

39 See 2008 EIT Law, art. 25; and Jin Renqing, 'Explanation on the Draft Enterprise Income Tax Law' (speech by the former Minister of Finance at the Fifth Session of the Tenth National People's Congress, Beijing, 8 March 2007). The full text of this speech is available in English online: <www.china-embassy.org/eng/gyzg/t302221.htm> (last visited 10 January 2008).

40 See Li, 'Development and Tax Policy' at 33.

41 Jin, 'Explanation on the Draft Enterprise Income Tax Law.'

42 Such as non-WTO-compliant export preferences and the general discrimination against domestic enterprises, which, while WTO compliant, was a major irritant to Chinese businesses.

43 See 'Agency says new tax rule not to affect foreign direct investment in China' BBC Monitoring Asia Pacific (March 2007); and B. Foley, 'Unified

China Corporate Income Tax Law Effective January 1, 2008 – Tax Accounting Considerations' (2007) 11 Asia-Pacific J.Tax. 76.

44 See Easson, 'Tax Incentives for Foreign Direct Investment, Part II' at 371.

45 See, generally, Easson, *Tax Incentives for Foreign Direct Investment* at 134–8; Y. Margalioth, 'Tax Competition, Foreign Direct Investments and Growth: Using the Tax System to Promote Developing Countries' (2003) 23 Virginia Tax Rev. 161; and A. Nov, 'Tax Incentives for Foreign Direct Investment: The Drawbacks' (2005) Tax Notes Int'l (18 April) 207.

46 See China, Ministry of Commerce, 'Sectoral Distribution of Cumulative FDI as of 2006' (Beijing, 30 September 2007), online: <http://www.fdi.gov.cn/pub/FDI_EN/Statistics/AnnualStatisticsData/AnnualFDIData/FDIStatistics,2006/t20070930_85393.htm>.

47 China, Ministry of Commerce, 'FDI Utilized by East, Central and West Parts of China as of 2006' (Beijing, 2007), online <www.fdi.gov.cn/pub/FDI/wztj/lntjsj/wstzsj/2006nzgwztj/t20070927_85203.htm>.

48 Ibid.

49 See, generally, Wang Luolin and Wei Houkai, 'The Progress and Effect Evaluation of Western Region Development in China' (2003) 10 Finance & Trade Economics 5.

50 See *Caishui* [2008] No. 1.

51 The criteria for enterprises qualifying for new and high-technology status were published on 14 April 2008 in *Guo Ke Fu Huo* [2008] No. 172. A useful commentary on this notice is provided by S. Tan, D. Lu, and J. Kadet, 'China Outlines Criteria for High-Tech Companies' (2008) Tax Notes Int'l (5 May) 369.

52 See Easson, 'Tax Incentives for Foreign Direct Investment, Part II' at 372.

53 A. Christians, 'Tax Treaties for Investment and Aid to Sub-Saharan Africa' (2005) 71 Brook. L.Rev. 639.

54 An exception applies to software production and integrated circuit design enterprises. These enterprises remain entitled to a reinvestment refund in a similar manner to that previously available under the FEITL; see *Caishui* [2008] No. 1.

55 Easson, 'Tax Incentives for Foreign Direct Investment, Part II' at 372.

56 See Organisation for Economic Co-operation and Development, *Science, Technology and Industry Scoreboard 2007* (Paris: OECD, 2007), which states that, since 1995, an increasing number of countries are encouraging R&D through tax breaks while, at the same time, the government share of direct expenditures on business R&D costs is declining.

57 See J. Lee and A. Lan, 'PRC's R&D Super Deduction: Incentive or Myth?' (2002) Tax Notes Int'l (23 September) 1511.

58 *Guoshuifa* [1999] No. 173.

59 See Lee and Lan, 'PRC's R&D Super Deduction' at 1514.

60 Ibid. at 1515.

61 Compare N. Sharkey, 'China's New Enterprise Income Tax Law: Continuity and Change' (2007) 30 U. of New South Wales L.J. 835 at 842.

62 Although certain SAT Circulars containing the relevant catalogues for preferential tax treatment were issued to support the implementation of, and to flesh out, various vague provisions in the Detailed Rules, such as arts 88, 93, and 101, they are not intended to resolve the key issue of what constitutes 'qualified transfers of technology.'

63 Compare Chang and Kadet, 'China Issues Implementation Rules on Tax Unification' at 1102. Some, but not all, of these questions were answered *retrospectively* in *Guo Ke Fu Huo* [2008] No. 172; see Tan, Lu, and Kadet, 'China Outlines Criteria for High-Tech Companies' at 369–73.

64 The authors are grateful to Tim Gelatt for these insights, albeit written in a different context. As with Alex Easson, he is remembered by Andrew Halkyard with huge affection.

65 In light of the rapidly changing landscape arising from the publication of various SAT Circulars relating to the tax incentives now available in China, it is necessary to conclude this chapter by recording that the law and practice is stated as it was understood at 1 May 2008. It is still the case, unfortunately, that, even by the first half of 2010, the uncertainties and shortcomings we have sought to explain with respect to evaluating the effectiveness of China's tax incentives remain.

4 Outbound Direct Investment and the Sourcing of Interest Expense for Deductibility Purposes*

TIM EDGAR

1.0 Introduction

A major international tax policy issue is the recognition by residence countries (that is, the country in which an investor is considered to be resident) of the prior taxing right of source countries (that is, the country in which the income is considered to be earned). The choice is conventionally framed as one between a territorial system, under which foreign-source income is exempt, and a worldwide system, under which all such income is taxed by the country of residence either as earned or on repatriation, with a credit for source-country tax. Although somewhat of a simplification, concern over the competitiveness of domestically based multinationals apparently has caused a shift away from the credit to the exemption method of relief as the dominant country practice (see Chapter 1 in this volume).[1] This shift has also been driven, in part at least, by the recognition that there might not be much substantive difference between an exemption system and a system of deferral with credit.[2] At the same time, the case for restrictions on the deduction of interest expense linked to outbound direct investment seems to be gaining some traction.[3] Under either the exemption or credit method of double tax relief, the unrestricted deduction of interest expense can reduce the tax rate on foreign-source income earned through a controlled foreign corporation (CFC) below zero. It is somewhat surprising, therefore, that deductibility restrictions, even where they exist, tend to be weak or non-existent in the context of outbound direct investment.[4]

Since 1976, Canada has used an exemption system for the active business income of a foreign affiliate of a Canadian-resident corporation,

provided the affiliate is resident in a treaty country.[5] Before the March 2007 federal budget,[6] the Department of Finance had resisted restrictions on the deductibility of interest expense linked to the earning of exempt foreign-source income.[7] Without any indication that the issue was even under consideration, the tax community was understandably surprised by the inclusion of proposals to deny the deduction of interest expense that can be traced to the earning of such income.[8] After considerable lobbying pressure, these proposals were narrowed in May 2007 to limit the range of affected interest expense to that which can be traced to the earning of exempt income in 'double-dip' and other 'tax-efficient' financing structures.[9] This proposal, which was enacted legislatively,[10] was the subject of considerable criticism in submissions made to the Advisory Panel on Canada's System of International Taxation.[11] The final report of the Advisory Panel included a recommendation to repeal the deductibility restriction,[12] which the Department of Finance did in the January 2009 budget.[13]

This brief flirtation with some form of restricted interest-expense deduction in the context of outbound direct investment is broadly consistent with the recent adoption of comprehensive deductibility restrictions by some other jurisdictions. Most notably perhaps, Australia applies the thin-capitalization concept to restrict the deduction of interest expense in the context of outbound direct investment.[14] New Zealand has also recently adopted the same approach as part of its general move to an exemption system.[15] Deductibility restrictions adopted in Denmark, Germany, and Italy follow the same broad pattern, but an interest-coverage ratio, characteristic of earnings-stripping legislation, is used to specify the permissible level of interest expense.[16]

This chapter argues that competing normative frameworks and incomplete empirical evidence both conspire to make the case for deductibility restrictions anything but clean, which probably leaves an Australian-style thin-capitalization regime as the best that can be done in the short to medium term, given the continued pursuit by tax policy-makers of the maximization of national welfare.[17] The most appealing feature of such a regime might be its broad conceptual consistency with transfer-pricing practices. The next section briefly frames the relevant policy analysis in an attempt to move beyond the intuitive appeal of an approach that, in the context of outbound direct investment, matches interest expense with foreign-source income and limits its deduction to reflect the residence-country tax rate on such income.[18] The third and fourth sections apply a consequential or welfare perspective to articu-

late the case for a thin-capitalization restriction in the context of outbound direct investment.

2.0 Behavioural Margins Implicated by an Unrestricted Interest-Expense Deduction

The deduction of interest payments on debt used to finance outbound direct investment permits the reduction of residence-country tax on domestic-source income. Where the source-country rate is lower than the residence-country rate, the intra-group equity capitalization of a CFC carrying on business in the source country permits the substitution of source-country tax for residence-country tax (in whole or in part), with any repatriation of income taking the form of non-deductible dividend payments.[19] Source-country taxation can also be eliminated by substituting tax-deductible intra-group debt for equity. In the extreme, both residence-country and source-country taxation can be replaced with a low-tax or a no-tax regime by routing taxable profits to a group member in a country with such a regime.[20] Structures that are intended to realize this result implicate three behavioural margins with associated revenue and efficiency effects.[21] One is the choice of intra-group debt or equity financing. Another is the choice of the location of external debt. A third is the choice of investment location. Behaviour along the first two margins can lower the effective tax rate on foreign direct investment (FDI), which can affect the choice of investment location (see Chapters 2 and 5 in this volume).

Very generally, the available empirical evidence suggests that the substitution of intra-group equity and debt financing, as well as the location of external debt, occurs predominantly in instances of perfect (or near-perfect) substitutability,[22] with no or little efficiency losses attributable directly to the substitution itself. In these circumstances, both of the financing choices implicated by an unrestricted interest-expense deduction in the context of FDI would give rise primarily to revenue effects. Efficiency effects would arise indirectly as the location of investment responds to differences in effective country tax rates produced by an unrestricted interest-expense deduction. In this respect, there is a substantial body of empirical evidence regarding the responsiveness to taxation of the location of a range of FDI.[23] There is also a growing body of empirical evidence supporting a characterization of outbound direct investment as a complement to domestic investment,[24] although it re-

mains difficult to disentangle the effects of general economic conditions on the level of both outbound direct investment and domestic investment and thereby to isolate the relationship between the two.[25] These two separate bodies of empirical evidence support the proposition that there is a range of outbound direct investment that responds to differences in taxation in the choice of location among source countries other than the home jurisdiction of the capital exporter.

Indeed, effective rate reductions, realized through looseness of deductibility rules such as those for interest expense, are often used to compete for mobile investment. The result might be both revenue loss and efficiency effects where the chosen location is suboptimal in terms of its non-tax attributes (that is, it is an imperfect substitute for an otherwise preferred higher-tax location). Both the theoretical and the empirical literature fail, nonetheless, to account in any comprehensive manner for tax competition in this particular form; nor is there any empirical evidence bearing directly on the dimensions of any revenue and efficiency effects attributable to changes in effective tax rates realized through an unrestricted interest-expense deduction. Tax policy-makers are left with only two broad propositions in which they can have some confidence:

- The choice of intra-group debt or equity financing, as well as the choice of the location of external debt, is highly responsive to differences in tax rates.
- The choice of investment location is responsive to differences in tax rates for a range of FDI.

In a non-cooperative setting with imperfectly mobile capital, the direction of the substitution of the location of direct investment is an unacknowledged, but significant, factor in the choice of interest-expense sourcing rules for the purposes of deductibility restrictions. In fact, the perceived direction of the substitution shapes the design features of any deductibility restrictions intended to limit the revenue and efficiency effects of an unrestricted interest-expense deduction. From the perspective of capital-exporting/residence countries, the relevant empirical issue is whether outbound direct investment complements or substitutes for domestic investment. A related question is whether national tax policy-makers should adopt a world welfare or national welfare benchmark in shaping their policy choices.

3.0 National Welfare, Ownership Neutrality, and Interest Deductibility

Much of the international tax debate has revolved around capital-export neutrality (CEN) and capital-import neutrality (CIN) as guiding principles (see also Chapter 2 in this volume).[26] CEN focuses on the maximization of world welfare, where world income is the welfare criterion. In a cooperative setting, all countries agree to tax the foreign-source income of their residents consistent with the taxation of their domestic-source income. Consistency of treatment generally means recognition of foreign-source income by residents on an accrual basis, with a refundable credit for any source-country taxes if those taxes exceed the residence-country tax on the income. Residents thus face the same after-tax return on investments, which should ensure that the pre-tax returns on investments in different locations are not disturbed as compared to a no-tax world. In a non-cooperative setting, the same residence-based approach arises as the standard policy prescription, but a much different recognition of foreign taxes is dictated by the attempt to maximize national welfare – that is, the sum of domestic taxes and the after-tax returns of nationals – from foreign-source income. Pursuit of this goal requires the attempt by a single capital-exporting country to equate the pre-tax returns from domestic investment with the returns on foreign investment, after any source-country tax, by taxing the pre-tax foreign-source income of residents on an accrual basis and providing a deduction from such income for any source-country taxes.[27]

If the choice of investment location is held constant, these competing policy prescriptions are seen to change, with CIN emerging as the dominant efficiency criterion. In contrast with CEN, CIN is concerned with the maintenance of 'intertemporal exchange efficiency,'[28] whereby the savings decision – that is, the choice between current and deferred consumption – is not distorted in a cross-border context. In a simple two-country model with the savings decision responsive to after-tax rates of return, investors resident in the country with the higher tax rate will save too little compared with investors resident in the country with the lower tax rate.[29] World welfare could be increased if returns from savings were transferred from residents of the low-tax country to residents of the high-tax country. The standard policy prescription for the realization of intertemporal exchange efficiency is an exclusively source-based jurisdiction to tax, with investors in a particular location

taxed at the same rate, which equates after-tax returns to savings invested in that location.

Some analysts draw on the concept of CIN, not as a criterion focused on intertemporal exchange efficiency, but as tantamount to a requirement of equality of after-tax returns to ensure the competitiveness of multinational firms headquartered across different countries. For example, Frisch[30] and Hufbauer[31] argue that increased capital mobility means that portfolio investment flows determine the allocation of savings worldwide, with direct investment no longer serving this allocative function. In an effort to capture spillover benefits associated with outbound direct investment, tax policy-makers should adopt an exclusively source-based system, thereby ensuring the 'competitiveness' of multinational firms headquartered in a country and therefore seen as 'national.' In effect, when shifting to a non-cooperative setting, the same source-based approach associated with CIN arises as the standard policy prescription dictated by the attempt to maximize national welfare, which is seen to require exemption by a single capital-exporting country in order to capture perceived spillover benefits associated with the location of headquarters operations in the country.

In a series of recent papers, Desai and Hines[32] have repackaged this 'competitiveness' argument in the form of 'ownership neutrality' as an alternative welfare benchmark to both CEN and CIN.[33] Since assets are not equally productive as owned and employed by different multinational firms, they argue that international tax policy should take account of who owns capital and not just where it is employed (the location of investment) and how much is available (the amount of savings). In a no-tax world, assets will be owned in a pattern that maximizes income or, more particularly, is Pareto-optimal in the sense that no change in the pattern of ownership can increase income without an offsetting loss. Desai and Hines articulate 'capital-ownership neutrality' (CON) and 'national-ownership neutrality' (NON) as conceptual tools to assess the welfare effects of international tax systems. In a cooperative environment in which maximization of world welfare is the goal, CON could be realized if all countries adopted an exclusively source-based system of taxation of income from outbound direct investment. CON could also be realized if, consistent with CEN, all residence countries required the accrual taxation of income of resident investors from outbound direct investment while providing credit for source-country taxes. Provided that differences in residence-country tax rates were in fixed proportion as among investors, every investor would have an in-

centive to maximize pre-tax returns, and assets would be owned by multinational firms that could use them most productively. In a non-cooperative environment in which national policy-makers attempt to maximize national welfare, NON is the relevant welfare benchmark, and is said to support exclusively source-based taxation of income from FDI, consistent with CIN.

Each of these welfare benchmarks is premised on assumptions about the responsiveness of behaviour to differences in international tax systems. It is well recognized, in particular, that, in a world of different country tax rates applied to investment and savings, CEN and CIN cannot be realized simultaneously unless demand for capital (investment location) or the supply of capital is completely inelastic.[34] As the newest welfare benchmark articulated in the literature, CON suffers from many of the same empirical ambiguities as CEN and CIN. In fact, ownership neutrality holds as an exclusive welfare benchmark (whether focused on world welfare or national welfare) only if savings pooled with a multinational firm, as well as the location of investment, are held constant. Desai and Hines acknowledge, for example, that an exclusively source-based system intended to realize CON would distort the choice of investment location if source-country tax rates differ, and there is a range of FDI that is mobile and thus responsive to these rate differences. In this case, some countries might move to a system of residence-based taxation with a credit for foreign taxes in an effort to reduce the distortion, but any reduction would be purchased at the cost of some distortion of the pattern of asset ownership where some countries continue to tax on an exclusively source basis. Similarly, NON is based on the empirical premise that outbound direct investment complements domestic investment, and an exemption system for income from the former does not result in a reduction of the latter.

Given the mixed state of the relevant empirical evidence, the compromise position for outbound direct investment traditionally has been the deferral of the residence jurisdiction until repatriation of foreign-source income. Compared to this compromise position, an exclusively source-based system of exemption for business income tends to be seen as the outcome of successful lobbying by multinationals with headquarters in those countries that adopt such systems. In short, exemption tends to be seen as suspect in tax-policy terms, even where maximization of national welfare is an appropriate goal of policy-makers. As noted already, however, the empirical literature suggests that FDI is becoming increasingly mobile as non-tax barriers to the movement of capital

break down. Moreover, as also noted, there is a growing body of evidence that, in a world of bi-directional capital flows, outbound direct investment might complement, rather than substitute for, domestic investment. The combination of these two strands of the empirical literature make exemption an attractive proposition for national tax policy-makers intent on maximizing national welfare. But this attraction does not necessarily imply an unrestricted interest-expense deduction.

A negative residence-country rate is the result of the combination of an exemption system and an unrestricted interest-expense deduction. This negative rate effectively lowers the source-country rate and is the equivalent of a revenue transfer from a residence country to a source country,[35] which can induce a broader range of substitutions of foreign for domestic investment, with welfare losses. Some form of sourcing rule for the purposes of restricting the deduction of interest expense against domestic-source income is defensible, therefore, where outbound direct investment substitutes for, rather than complements, domestic investment. It is not clear, however, what form of deductibility restriction should be chosen to realize some perceived optimal rate.[36] At most, all that can be concluded with any confidence is that some form of restriction might be chosen, subject to considerations of an unavoidable trade-off between simplicity and robustness against taxpayer manipulation.

Where outbound direct investment complements, and does not substitute for, domestic investment, the case for some form of deductibility restriction is less clear. An unrestricted interest-expense deduction lowers the effective tax rate on outbound direct investment structured as a leveraged financing of a CFC. It is unclear, however, whether an unrestricted interest-expense deduction enhances national welfare in the context of outbound direct investment. Pursuit of national welfare might suggest an unrestricted deduction only if policy-makers can be confident that the forgone revenue is less than any increase in national income, including increases from spillover benefits associated with outbound direct investment.[37] In arguing that the pursuit of either CON or NON dictates rejecting rules that would allocate any portion of overhead expenses of a multinational group, including interest expense, to the earning of foreign-source income, Hines echoes (and extends) the earlier argument of Hufbauer.[38] This argument is premised on an acceptance of the private law integrity of transactions that otherwise source overhead expenses. In effect, Hines asserts that no portion of overhead expenses, which otherwise can be considered to have been

incurred domestically, should be allocated against foreign-source income. With interest expense, he apparently assumes that the place of residence of a borrower determines the place of incurrence and should determine the sourcing of the expense.

On this assumption, allocating a portion of otherwise deductible interest expense against foreign-source income and denying its deduction in the country of residence of a borrowing corporation results in an undesirable increase in the tax rate on outbound direct investment. The efficiency effects are those associated with the resulting distortion of the pattern of ownership of assets in the source country. An unrestricted interest-expense deduction sourced on the basis of the place of residence of a borrowing corporation is seen to equate marginal after-tax returns from investment at home or abroad. Because an interest deduction would be permitted in the former instance, consistent treatment of the latter is required to maintain equivalence of after-tax returns.

Hines acknowledges, however, that transfer-pricing rules are required generally to constrain tax-driven allocations of both revenue and expenses. He also acknowledges that the source of marginal funds for tax purposes has policy relevance in a purely domestic context such that a rule of non-deductibility would be applied at the margin to equate returns on debt-financed and equity-financed investment. It is simply difficult to identify the source of marginal funds with any confidence for the purposes of a rule of non-deductibility. But, as Hines emphasizes, his policy prescription of sourcing interest expense on the basis of unqualified acceptance of the integrity of private law transactions holds only if outbound direct investment complements domestic investment and if revenue loss from the sourcing of interest expense domestically is compensated fully by an increase in the tax base from an increase in domestic investment. Where these two extreme conditions do not hold, policy-makers intent on maximizing national welfare from outbound direct investment would want to limit the sourcing of interest expense that otherwise results from unqualified acceptance of the integrity of private law transactions. As noted already, the empirical evidence suggests that policy-makers probably could have some confidence that there is an element of uncompensated deductions that should be the target of a non-deductibility rule. The difficult design question is how to identify tax-driven sourcing results following from either the substitution of intra-group debt for equity or the location of external debt. Rough judgment must also be exercised as to the extent that even this range of tax-driven sourcing results might be acceptable

because of offsetting spillover benefits from additional outbound direct investment. The empirical evidence is not even remotely complete enough to support precise calibration on either issue. Given this informational constraint, it seems all too obvious that an analogue to the arm's-length overlay in a transfer-pricing context is required equally to constrain the tax-driven sourcing of interest expense.

4.0 The 'Middle Ground' Appeal of a Thin-Capitalization-Deductibility Restriction

By allocating revenue and expenses between residence and source countries, sourcing rules operationalize the current compromise division of the jurisdiction to tax.[39] Ideally, there should be some correspondence between the rationale for assertion of jurisdiction to tax and the specifics of sourcing rules that operationalize that rationale. As many commentators have emphasized,[40] however, the notion of a geographic source of revenue and expenses lacks any well-defined economic content. This feature is common to any attempt to allocate net income as a tax base among jurisdictions since, as Ault and Bradford point out, it is unclear that the geographic source of income is a coherent concept.[41] The lack of coherence can be attributed to the fact that there is no obvious connection or close correlation between the policy basis for the allocation of net income to a particular jurisdiction and the specifics of the rules, including sourcing rules, that implement the necessary allocation.[42] When it comes to its sourcing, interest expense does not differ from other expenses in exhibiting an inevitable element of arbitrariness as a factor in the allocation of net income as a tax base among countries. In this respect, the literature identifies two principal approaches for the sourcing of interest expense: tracing and formulary apportionment.

Tracing sources interest expense by physically tracing the use of borrowed funds by a taxpayer (that is, following a paper trail).[43] Interest expense is sourced on the basis of the identified use. Where borrowed funds are traced to the earning of domestic-source income, the associated interest expense is considered domestic source and is deductible against that income. Where borrowed funds are traced to foreign-source income, the interest expense is considered foreign source and is deductible against that income, which, if exempt, cannot support a deduction.

As an alternative to tracing, interest expense can be sourced on some formulary basis, such as relative asset value or gross revenue. Concep-

tually, this approach recognizes the fungibility of money; however, the observation that money is fungible does not lead to the conclusion that formulary apportionment is somehow theoretically correct.[44] Formulary apportionment simply posits factors, such as asset value or gross income, which can be used to link interest expense with domestic- or foreign-source income. Nothing about these factors suggests that they correctly source interest expense with domestic- or foreign-source income, while tracing the use of borrowed funds serves the same function incorrectly.

In fact, tracing is not without merits as a sourcing rule.[45] Perhaps most important, it is considered relatively simple to apply. In a cross-border context, the simplicity of tracing is attributable in large part to its acceptance of the private law integrity of intra-group transactions as the basis for physically linking funds borrowed by a particular group member to either a domestic or a foreign source of income. Tracing is commonly criticized, however, for its lack of robustness against taxpayer manipulation, which is seen to undermine the accepted division of the income tax base as between residence and source countries. More particularly, the formalism of tracing, which makes it simple to apply, is seen to permit multinational groups to source deductible interest expense in a manner that maximizes the value of the deduction by minimizing the effective tax rate on both inbound and outbound investment. As a general proposition, this result is realized by ensuring that funds that group members borrow can be traced to the earning of revenue subject to tax in high-tax-residence or source jurisdictions.

This particular criticism of tracing is much the same as the principal criticism levied against relying on a separate-entity/transactional approach to source the revenue and expenses of a multinational group. The sourcing function in this particular context is executed primarily by the concept of corporate residence and acceptance of the private law integrity of transactions into which group members enter. In effect, revenue and expenses are attributed to taxing jurisdictions based on the transactions that a group member enters into with independent parties and other group members. The sourcing of revenue and expenses (and the income allocation that results from this acceptance of private law transactions) is overlaid by the application of the arm's-length principle.

Accordingly, an acceptance of the private law integrity of transactions entered into by a group member resident in a jurisdiction deter-

mines, in the first instance, the sourcing of revenue and expenses. The income allocation resulting from that acceptance can be changed, however, by altering the price associated with intra-group transactions to conform to the arm's-length standard. Application of the same arm's-length standard to the sourcing of interest expense on the basis of tracing does not affect the ability of a multinational group to maximize the value of the interest deduction by physically linking borrowings with high-tax revenue. The standard is commonly seen to affect only the price charged for a loan in the form of the interest rate. Purpose-based anti-avoidance rules can be used to constrain perceived taxpayer manipulation of tracing, but the effectiveness of such approaches is unclear.[46] Moreover, whatever revenue and efficiency gains are realized through robust application of anti-avoidance rules come at the cost of a loss of administrability associated with the attendant uncertainty of application of a tracing approach.

Formulary apportionment sources interest expense effectively by piggybacking on the sourcing rules that are used for either assets or gross revenue. To the extent that these sourcing rules are seen to be anchored in a sound economic nexus to a jurisdiction, formulary apportionment tends to be characterized in the same positive manner, especially when contrasted with the apparent formalism of tracing, which makes it susceptible to taxpayer manipulation. This argument in favour of formulary apportionment is, in fact, nothing more than the proposition that this kind of approach is more robust against taxpayer manipulation, primarily because it ignores the form of borrowing transactions in the context of multinational groups as determinative of the sourcing of interest expense.

The argument is a familiar one, evident in the literature on formulary apportionment as a method to allocate the income tax base associated with cross-border transactions generally among jurisdictions.[47] As with tracing in the more specific context of the sourcing of interest expense, formulary apportionment in the more general context of the allocation of the income base is seen as preferable to the separate-entity/arm's-length method of allocation, which is similarly seen to be susceptible to taxpayer manipulation because of its acceptance of the private law integrity of intra-group transactions, even with the overlay of the arm's-length principle.

As with the case for formulary apportionment of group income generally, the proposition that this approach is robust against taxpayer

manipulation as an interest-expense sourcing rule is largely unproven. Only the United States has any experience with the use of formulary apportionment, and that use is only for the purpose of the foreign tax credit limitation.[48] But even accepting that formulary apportionment is relatively more robust than tracing, the approach suffers from two principal difficulties. One is that, compared to tracing, formulary apportionment requires a complicated set of second-order design rules focused primarily on the definitions of asset value or gross revenue as sourcing factors. The details of these kinds of rules are well known in the literature and are not repeated here. Suffice it to say that the U.S. experience with asset apportionment for foreign tax credit limitation purposes illustrates starkly the kinds of legislative and administrative complexities that must be addressed.

These administrative and compliance costs must be traded off against perceived revenue and efficiency gains attributable to a sourcing rule that is much tighter than tracing in the sense that it would characterize a greater amount of interest expense as foreign source and thereby subject to deductibility restrictions. The cost of increased complexity might be even clearer in the specific context of the sourcing of interest expense than it is in the more general context of the arm's-length principle, since the latter is applied at the cost of considerable complexity associated with the articulation of transfer-pricing methods. However, as already noted, the need to use anti-avoidance rules to bolster tracing as a sourcing rule would introduce an element of uncertainty, with administrative and compliance costs that can make formulary apportionment more attractive.

The more significant difficulty with formulary apportionment is probably its lack of acceptance by countries as a sourcing rule for interest expense for deductibility purposes. In this environment, the use of formulary apportionment by a single country (or a relatively small set of countries) could result in the double counting of interest expense for deductibility purposes or its non-deductibility by both residence and source countries, with undesirable revenue or efficiency costs.[49] Without evidence of inconsistent sourcing results arising from the interaction of formulary apportionment and tracing, it is impossible to acquire a sense of the direction and significance of the revenue and efficiency effects. Largely as the result of policy-making inertia, tracing emerges as a preferable sourcing rule for deductibility purposes.

The ability to manipulate a deductibility restriction based on the

tracing of borrowed funds even becomes a positive attribute, since it permits the rearrangement of borrowing transactions to ensure deductibility in at least one of a residence or a source country. However, if it is suitably modified to account for both intra-group debt and external debt, a thin-capitalization regime can maintain these desirable features without the formalism of tracing, which renders it a weak deductibility restriction.

Thin-capitalization legislation is conventionally limited to the sourcing of interest expense through the use of intra-group debt in the context of inbound direct investment. The definition of the problem in typical thin-capitalization regimes is limited, therefore, to the use of intra-group debt as an equity substitute. In something of a conceptual breakthrough, New Zealand's thin-capitalization regime was the first to extend a sourcing limitation to the external debt of a resident corporation controlled by a non-resident.[50] This result is realized generally by limiting the interest deduction of a corporation resident in New Zealand but controlled by a non-resident where the debt to the corporation's New Zealand assets exceeds the greater of: (i) 75 per cent, and (ii) 110 per cent of the worldwide debt percentage of the worldwide group. Deduction of interest on excess debt of a New Zealand–resident corporation is denied, with no distinction made between external debt and intra-group debt. Australia's thin-capitalization regime generally follows the lead of the New Zealand regime in denying the deduction of interest on debt of an Australian-resident corporation controlled by a non-resident, to the extent that the amount of such debt exceeds the same 75 per cent debt-to-assets ratio.[51]

Once conventional thin-capitalization legislation is extended to external debt, thereby becoming a comprehensive sourcing rule, it does not seem much of a conceptual leap to apply the same deductibility restrictions in the context of outbound direct investment. The unique genius of the Australian legislation is this simple conceptual leap. For a resident corporation that earns foreign-source income through a CFC, the legislation effectively limits the amount of debt that can be sourced domestically for interest-deductibility purposes to the greater of: (i) 75 per cent of Australian assets, and (ii) 120 per cent of the leverage of the worldwide group. Although a matter of speculation only, it might be that an apparent congruence of the imperative to pursue the maximization of national welfare and the maintenance of an unrestricted interest-expense deduction in the context of outbound direct invest-

ment explains the behaviour of policy-makers better than the lack of any 'eureka moment' necessary to make the conceptual connection with inbound direct investment.

It is not just a matter of semantics in emphasizing that, as applied to the Australian legislative model, the term 'thin capitalization' is a misnomer, at least as it is conventionally understood in international tax dialogue. By limiting the leverage of a resident corporation to that of the multinational group of which it is a member, these regimes, in reality, are modified asset apportionment formulas for the sourcing of interest expense for deductibility purposes.[52] The added feature of a fixed safe-harbour leverage ratio provides the appearance of a conventional thin-capitalization regime and is used for many of the same reasons. That is, the safe harbour is used as a proxy for an arm's-length capital structure within which the integrity of private law transactions can be respected for sourcing purposes.

The principal appeal of an Australian- or New Zealand–style thin-capitalization-deductibility restriction probably lies, therefore, in its ability to combine the potential strictness of formulary apportionment as a bulwark against revenue erosion with the simplicity gains otherwise associated with a respect for the integrity of private law transactions as determinative of the sourcing of interest expense for deductibility purposes. In other words, these legislative regimes impose an outer limit on the sourcing of interest expense, either indirectly through the use of intra-group debt or directly through the location of external debt, without all the administrative and compliance complexities associated with formulary apportionment or the use of anti-avoidance rules under a tracing regime.

It is arguable, however, that the Australian and New Zealand legislative models should not be followed when it comes to specification of a permissible leverage ratio. The available empirical evidence suggests that a 2:1 or even 1.5:1 ratio would provide a better proxy for a wide range of sectors (other than financial and real estate), and could be seen to realize a more appropriate, albeit imprecise, balance between revenue maintenance and realization of NON as a welfare benchmark.[53] Indeed, an overly generous leverage ratio provides the equivalent of an unrestricted deduction for all practical purposes, and is really nothing more than an elaborate signalling mechanism used by national policy-makers to indicate a willingness to cooperate in the international tax arena while continuing to subsidize outbound direct investment. For this purpose, a thin-capitalization regime is hardly worth the bother,

and relatively weak restrictions that are based on tracing are probably just fine.

5.0 Conclusion

An Australian- or New Zealand–style thin-capitalization regime is far from perfect as a restriction on the deductibility of interest expense in the context of outbound direct investment. But it is better than any of the available alternatives, especially when it is unclear what a 'perfect' restriction would look like in any event. If suitably modified to account for external debt, as well as intra-group debt, this type of restriction would serve as an outer limit on the sourcing of interest expense for deductibility purposes.

By otherwise accepting the private law integrity of transactions and, in particular, the sourcing results they realize, a thin-capitalization regime might best reflect the mixed state of the relevant empirical evidence, which is bound up in disagreement over an appropriate welfare benchmark. Depending on the specific design details – particularly the specification of a safe-harbour leverage ratio – such a regime is also likely to be more robust against taxpayer manipulation than tracing as a sourcing rule, yet it would avoid some of the complexity of formulary apportionment and, as a result, might be more administrable than this particular sourcing alternative. A thin-capitalization regime would also be more consistent with existing transfer-pricing practices, which can serve an important signalling function by national tax policy-makers who seek to maximize national welfare.

Notes

* This chapter draws, in part, from an earlier work; see Tim Edgar, Jonathan Farrar, and Amin Mawani, 'Foreign Direct Investment, Thin Capitalization, and the Interest Expense Deduction: A Policy Analysis' (2008) 56 Can. Tax J. 803.

1 On repatriation as a dividend, just over two-thirds of OECD countries exempt this category of income from tax. With the exception of New Zealand, the others subject such income to tax but with a credit for foreign taxes paid; see United States, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* (Washington, DC: U.S. Government Printing Office, 2005) at 243. For countries other than six specified high-tax countries, New

Zealand taxes foreign-source active business income as it is earned by a controlled foreign corporation. New Zealand, however, has recently committed to move away from its branch-equivalent approach to a deferral-plus-exemption system. See New Zealand, *New Zealand's International Tax Review: A Direction for Change* (Wellington: Inland Revenue, Policy Advice Division, 2006). The UK Treasury has also recently proposed a move to an exemption system for active business income; see United Kingdom, 'Taxation of the Foreign Profits of Companies: A Discussion Document' (London: HM Treasury, 2007). The proposal reverses the earlier position of Inland Revenue, which defended the foreign-tax-credit system on the basis of neutrality for the decision to invest at home or abroad; see United Kingdom, *Double Taxation Relief for Companies* (London: Inland Revenue, 1999).

2 Two common aspects of credit systems ensure that source-country tax on the income is predominant. First, foreign-source income earned through a foreign corporation is generally not taxed by a residence country until repatriation to a resident investor. Second, although the amount of the credit is limited to residence-country tax that is otherwise payable on the income, an element of averaging of high-tax and low-tax foreign-source income is commonly permitted. Combined with deferral of residence-country tax, the ability to use excess foreign tax credits to offset any residual tax on low-taxed foreign-source income means that the functional difference between exemption and credit countries is much less than the formal difference would suggest. See, for example, United Kingdom, 'Taxation of the Foreign Profits of Companies' at 10 (indicating that little revenue is raised by the taxation with foreign tax credit system); and United States, *Simple, Fair, and Pro-Growth* at 104 (noting that the deferral-plus-credit system raises little revenue at a high cost attributable to its complexity and differential impact on U.S.-based multinationals).

3 For example, most advocates of exemption in the United States apparently assume that it would include some form of interest deductibility restrictions; see, in this respect, United States, *Simple, Fair, and Pro-Growth* at 241 (proposing the adoption of an exemption system for business income with a non-deductibility rule for interest expense of overleveraged U.S. corporations). See also Michael J. Graetz and Paul W. Oosterhuis, 'Structuring an Exemption System for Foreign Income of U.S. Corporations' (2001) 54 Nat'l Tax J. 771 at 780–2; and Harry Grubert, 'Enacting Dividend Exemption and Tax Revenue' (2001) 54 Nat'l Tax J. 811 at 819–22. The UK proposals to move to an exemption system are notable in their rejection of interest-expense allocation in favour of a largely unrestricted interest-expense deduction that would be subject only to some targeted anti-avoid-

ance rules. See also United Kingdom, 'Taxation of the Foreign Profits of Companies' at 25–6.

4 See, for example, Organisation for Economic Co-operation and Development, *Tax Effects on Foreign Direct Investment: Recent Evidence and Analysis*, Policy Study Series 17 (Paris: OECD, 2007) at 107 (noting the perceived ease with which a deductibility limitation can be avoided when it is based on tracing as the means to link borrowed funds with the earning of foreign-source income). An important exception is the United States, which uses a set of sophisticated formulary apportionment rules to source the interest expense of resident corporations. Some country practices are usefully surveyed in Sandra Slaats, 'Financing Foreign Affiliates: An Overview of the Canadian Proposals and the Rules in Selected Countries' (2007) 55 Can. Tax J. 676 at 693–709.

5 After 19 March 2007, the category of exempt income was extended to business income earned by foreign affiliates resident in non-treaty countries; see Canada, Department of Finance, *2007 Budget* (Ottawa: Department of Finance, 2007), supplementary information and notice of ways and means motions, 19 March 2007, resolution (31). The extension recognizes that the presence of a tax treaty has become a poor proxy for a level of tax in another country that would justify exempt treatment. See, in this respect, Brian J. Arnold, 'Unlinking Tax Treaties and the Foreign Affiliate Rules: A Modest Proposal' (2002) 50 Can. Tax J. 607.

6 See Canada, Department of Finance, *2007 Budget*.

7 For a review of the relevant history, see Slaats, 'Financing Foreign Affiliates' at 681–6.

8 Canada, Department of Finance, *2007 Budget*, resolutions 24–9, supplementary information and notice of ways and means motions. The proposed restrictions were to apply generally after 2007 in respect of debt incurred after 19 March 2007.

9 Canada, Department of Finance, News Release 2007-041 (Ottawa: Department of Finance, 2007). The May proposals provide for a transition period to 2012. These proposals were codified in draft legislation released by the Department of Finance on 2 October 2007, which was tabled in the House of Commons on 13 November 2007 as a notice of ways and means motion.

10 *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), as amended, section 18.2 applicable in respect of interest and other borrowing costs paid or payable in respect of a period or periods that begin after 2011. Unless otherwise stated, statutory references are to the Act.

11 Canada, Advisory Panel on Canada's System of International Taxation, *Enhancing Canada's International Tax Advantage* (Ottawa: Department of Fi-

nance, December 2008) at 53 (noting that 'interest deductibility was raised as an issue at every consultation meeting and in many submissions to the Panel' and that 'Members of the business community strongly oppose any restriction on interest expense incurred to invest in foreign affiliates').

12 Ibid.

13 Canada, Department of Finance, *2009 Budget* (Ottawa: Department of Finance, 2009), supplementary information and notice of ways and means motions, 27 January 2009 at 325 and resolutions (23) and (24).

14 *Income Tax Assessment Act, 1997*, Division 820. The Australian thin-capitalization regime applies, with some necessary modifications, equally to outbound and inbound FDI.

15 New Zealand, *New Zealand's International Tax Review: Developing an Active Income Exemption for Controlled Foreign Companies* (Wellington: Inland Revenue, Policy Advice Division and Treasury Department, 2007) at 57–68; and idem, *New Zealand's International Tax Review: An Update: Developing an Active Income Exemption* (Wellington: New Zealand Inland Revenue, Policy Advice Division, 2007).

16 Some countries' practices are surveyed in Slaats, 'Financing Foreign Affiliates' at 693–709; see also International Fiscal Association, *New Tendencies in Tax Treatment of Cross-Border Interest of Corporations*, Cahiers de droit fiscal international, vol. 93b (Amersfoort, Netherlands: Sdu Uitgevers, 2008).

17 For a similar conclusion, see Alan R. Lanthier and Jack M. Mintz, 'Seeking a More Coherent Approach to Interest Deductibility' (2007) 55 Can. Tax J. 629 (endorsing an Australian-style thin capitalization regime because of its ability to strike an appropriate balance between maintenance of the Canadian revenue base and the competitiveness of Canadian-based multinationals). See also generally Edward D. Kleinbard, 'Throw Territorial Taxation from the Train' (2007) 114 Tax Notes 547 at 555 (noting the sterility of the traditional framing of the international tax debate, which has tended to produce proposals that reflect nothing more than the 'pre-existing intentions' of particular authors characterized as 'a fair balancing of irreconcilable objectives').

18 The same perspective is emphasized by Daniel N. Shaviro, 'Does More Sophisticated Mean Better? A Critique of Alternative Approaches to Sourcing the Interest Expense of U.S. Multinationals' (2001) 54 Tax L.Rev. 353, but for the purpose of analysing the sourcing of interest expense for foreign tax credit purposes, not for deductibility purposes. Shaviro acknowledges that the analysis might be quite different for deductibility purposes, which is the singular policy issue under exemption systems.

19 Under a dividend-exemption system, the residence-country tax is, of course, zero. Under a deferral-with-credit system, the residence-country tax is somewhere between zero and the rate applicable to domestic-source income.
20 These structures were the apparent target of the deductibility restriction in former section 18.2. Much the same result can be realized, without the need for a third-country financing affiliate, through the use of hybrid-instrument and hybrid-entity-financing structures.
21 See, for example, OECD, *Tax Effects on Foreign Direct Investment* at 119–48 (reviewing the effects of tax planning on the computation of 'forward-looking' effective tax rates in estimating the impact of corporate tax reforms on FDI flows).
22 See, for example, Mihir A. Desai, C. Fritz Foley, and James R. Hines Jr., 'A Multinational Perspective on Capital Structure Choice and Internal Capital Markets' (2005) 59 J.Fin. 245 (finding that: (i) 10 per cent higher tax rates are associated with 2.8 per cent greater affiliate debt as a fraction of assets; (ii) the tax elasticity of internal debt (0.35) is greater than that of external debt (0.19); and (iii) 1 per cent higher interest rates in local capital markets are associated with a decline of external borrowing by affiliates of 1.3 per cent of assets, while internal borrowing from parent corporations increased by 0.8 per cent of assets).
23 This literature is comprehensively reviewed in OECD, *Tax Effects on Foreign Direct Investment*, chap. 2. The review reports the findings of a meta analysis undertaken by de Mooij and Edverveen; see R.A. deMooij, 'Explaining the Variation in Empirical Estimates of Tax Elasticities of Foreign Direct Investment,' Discussion Paper 108/3 (Amsterdam: Tinbergen Institute, 2005); and R.A. deMooij and S. Edverveen, 'Taxation and Foreign Direct Investment: A Synthesis of Empirical Research' (2003) 10 Int'l Tax & Pub. Fin. 673. See also D. Hajkova, G. Nicoletti, L. Vartia, and K.Y. Yoo, 'Taxation, Business Environment and FDI Location in OECD Countries,' Economics Department Working Paper 502 (Paris: OECD, 2006).
24 For a brief review of this literature, see James R. Hines Jr., 'Reconsidering the Taxation of Foreign Income,' Working Paper (University of Michigan, November, 2007) at 19–20.
25 But see, in this respect, Mihir Desai, C. Fritz Foley, and James R. Hines Jr., 'Foreign Direct Investment and Domestic Economic Activity,' NBER Working Paper 11717 (Cambridge, MA: National Bureau of Economic Research, 2005) (using foreign GDP growth rates, interacted with lagged firm-specific geographic distributions of foreign investments, to suggest that 10.0 per cent greater foreign capital investment is associated with a 2.2 per cent

greater domestic investment, while 10.0 per cent greater foreign employee compensation is associated with a 4.0 per cent greater domestic employee compensation).

26 Much of the relevant literature in the context of FDI is surveyed in United States, *The Deferral of Income Earned through U.S. Controlled Foreign Corporations: A Policy Study* (Washington, DC: Office of Tax Policy, Department of the Treasury, 2000) at 23–42.

27 This particular residence-based system is commonly associated with the concept of 'national neutrality' and the work of Peggy Musgrave; see Peggy B. Musgrave, *United States Taxation of Foreign Investment Income* (Cambridge, MA: Harvard Law School, 1969); and Peggy B. Richman (Musgrave), *Taxation of Foreign Investment Income: An Economic Analysis* (Baltimore: Johns Hopkins Press, 1963). See also Gary C. Hufbauer, *A Guide to Law and Policy: U.S. Taxation of American Business Abroad* (Washington, DC: American Enterprise Institute, 1975).

28 Rosanne Altshuler, 'Recent Developments in the Debate on Deferral' (2000) 20 Tax Notes Int'l 1579 at 1581.

29 Ibid. at 1580–1.

30 Daniel J. Frisch, 'The Economics of International Tax Policy: Some Old and New Approaches' (1990) 47 Tax Notes 581.

31 Gary C. Hufbauer, *U.S. Taxation of International Income: A Blueprint for Reform* (Washington, DC: Institute for International Economics, 1992). See also Donald J.S. Brean, 'Taxation and Canadian Direct Investment Abroad' in Steven Globerman, ed., *Canadian-Based Multinationals* (Calgary: University of Calgary Press, 1994).

32 Mihir A. Desai and James Hines Jr., 'Evaluating International Tax Reform' (2003) 56 Nat'l Tax J. 487; Mihir A. Desai, 'New Foundations for Taxing Multinational Corporations' (2004) 82 Taxes 39; Mihir A. Desai and James Hines Jr., 'Old Rules and New Realities: Corporate Tax Policy in a Global Setting' (2004) 57 Nat'l Tax J. 937.

33 See, for example, J. Clifton Fleming Jr. and Robert J. Peroni, 'Exploring the Contours of a Proposed U.S. Exemption (Territorial System) Tax System' (2005) 109 Tax Notes 1557 (arguing that the concept of ownership neutrality amounts to nothing more than a repackaging of the arguments for an exemption system associated with CIN).

34 See, for example, Michael J. Graetz, 'Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies' (2001) 54 Tax L.Rev. 272.

35 This point is emphasized by Michael J. Graetz, 'A Multilateral Solution for the Income Tax Treatment of Interest Expenses' (2008) 62 Bulletin of Int'l

Taxation 486 (arguing that the interest expense of a multinational group should be allocated using an asset-based formula equally in the context of outbound and inbound direct investment).

36 Under a deferral-with-credit system, interest-deductibility restrictions can be used as a means to ensure that the tax rate on foreign-source income lies somewhere between zero and the rate on domestic income in the residence country.

37 See, in this respect, Hines, 'Reconsidering the Taxation of Foreign-Source Income' at 22 (suggesting that an unrestricted interest-expense deduction does not simply generate uncompensated deductions, but might trigger additional domestic investment and a larger domestic tax base).

38 Ibid. at 20–4; and Hufbauer, *U.S. Taxation of International Income* at 136–8 (suggesting that all headquarters expense, other than interest expense, attributable to headquarters activity in the United States be deductible for U.S. income tax purposes).

39 This accepted division allocates the principal jurisdictional right to tax portfolio income to the country in which an investor is resident. Countries in which the income is considered to arise are granted a limited ability to impose gross withholding taxes on the income streams, and the country of residence is required to credit such source-country taxes. In contrast with the treatment of portfolio income, the principal right to tax income from direct investment is allocated to source countries, with the country of residence of the investor required to provide recognition of source-country taxation either by exempting the income from residence-country tax or crediting source-country tax. This division of the jurisdiction to tax international income has been referred to as the 'international tax compromise.' The early development of this compromise is described in Michael J. Graetz and Michael M. O'Hear, 'The "Original Intent" of U.S. International Taxation' (1997) 46 Duke L.J. 1021.

40 See, for example, Stephen E. Shay, J. Clifton Fleming Jr., and Robert J. Peroni, 'What's Source Got to Do with It? Source Rules and U.S. International Taxation' (2002) 56 Tax L.Rev. 81; and Hugh J. Ault and David P. Bradford, 'Taxing International Income: An Analysis of the U.S. System and Its Economic Premises' in Assaf Razin and Joel Slemrod, eds., *Taxation in the Global Economy* (Chicago: University of Chicago Press, 1990) at 11.

41 Ault and Bradford, 'Taxing International Income' at 12.

42 For example, Shay, Fleming, and Peroni ('What's Source Got to Do with It?' at 90–3) argue that a rationale for source-country taxation of business profits that is based on market access does not require that the cost of government benefits be quantified and charged to a particular non-resident.

Instead, the level of taxation is effectively constrained by the relation between demand for access to the relevant market and the source-country tax level that is the 'price' charged for such access relative to those charged by other source countries. Use of net income as a basis for the assessment of the relevant charge for market access thus results in an imprecise correlation between the amount of the charge and the benefits of market access. In short, once a sufficient connection to a jurisdiction is established in the sense that there is a presence perceived to justify taxation, any correlation between the precise allocation of the income tax base to the jurisdiction and the benefits derived by the relevant taxpayer in the form of market access is largely random.

43 See, for example, Shaviro, 'Does More Sophisticated Mean Better?' at 389–407 (emphasizing the acceptance of tracing as the sourcing 'rule of the road' for interest expense).

44 Ibid. at 379–84.

45 See Michael J. McIntyre, *International Income Tax Rules of the United States*, 2nd ed. (Salem, NH: Butterworth Legal, 1992) at 3-123–3-128 (describing criteria against which sourcing rules should be assessed).

46 See, for example, Canada, Department of Finance, *2007 Budget*, resolution 26 (defining 'interest relating to an investment in a foreign affiliate' to include indirect financings); and United Kingdom, 'Taxation of the Foreign Profits of Companies' at 25–6 (proposing the strengthening of anti-avoidance rules applicable for interest-deductibility purposes generally).

47 But see, in this respect, Julie Roin, 'Can the Income Tax Be Saved? The Promise and Pitfalls of Adopting Worldwide Formulary Apportionment' (2008) 61 Tax L.Rev. 169 (critically reviewing the perceived robustness of formulary apportionment in the face of some familiar tax-avoidance techniques).

48 For taxation years beginning after 31 December 2008, a U.S.-resident corporation of a worldwide affiliated group may make a one-time election whereby interest expense is allocated to foreign-source income only if the leverage of U.S. members exceeds the leverage of foreign members; see *The American Jobs Creation Act of 2004*, PL 108-357, section 401(c), adding IRC, section 864(f)(1)(B). The election attempts to modify the application of formulary apportionment in much the same manner of an Australian-style thin-capitalization regime for deductibility purposes.

49 See Hines, 'Reconsidering the Taxation of Foreign-Source Income' at 21–2 (noting the higher effective tax rate on outbound FDI that results from the allocation of interest expense incurred domestically to foreign-source income where the allocation is not accepted by the source country for de-

ductibility purposes). See also United Kingdom, 'Taxation of the Foreign Profits of Companies' at 25 ('a move to exemption cannot of itself justify the introduction of interest apportionment or matching rules').

50 The U.S. earnings-stripping legislation in section 163(j) of the *Internal Revenue Code* provides a safe harbour for foreign-controlled corporations with a leverage ratio of 1.5:1 or less. For the purpose of the safe harbour, all debt and equity of the corporation are taken into account. The rule of non-deductibility under the legislation is limited, however, to interest expense owed to related persons.

51 A leverage ratio in excess of the 3:1 ratio can be supported if it is considered consistent with an arm's-length capital structure.

52 See, in this respect, Harry Grubert and Rosanne Altshuler, 'Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income' in J. Diamond and G. Zodrow, eds., *Fundamental Tax Reform: Issues, Choices and Implications* (Cambridge, MA: MIT Press, 2008) (characterizing as 'worldwide fungibility' the allocation of interest expense by reference to the worldwide debt-to-assets ratio of a corporate group).

53 See, for example, Shee-Boon Law, 'The Choice of Fixed Accounting Ratios as Safe Harbours in Thin Capitalization Rules – Some Guidance from Commercial Debt Contracts' (2006) 21 Australian Tax Forum 363 (comparing the leverage ratios under the Australian, New Zealand, and U.S. legislation with accounting ratios used in commercial debt contracts).

5 Assessing the Foreign Direct Investment Response to Tax Reform and Tax Planning

W. STEVEN CLARK*

1.0 Introduction

In a globalized world with heightened cross-border investments, multinational firms increasingly are engaging in sophisticated international tax-planning strategies to lower their global tax liabilities. Accordingly, studies that try to estimate the effect of tax on cross-border investment decision-making need to take this tax planning into account.

This chapter considers the use of 'forward-looking' effective tax rates to estimate the impact of corporate tax reform on flows of foreign direct investment (FDI), and signals the need to address increasingly common strategies multinationals use to minimize host- and home-country tax when attempting to model representative financing and repatriation structures.[1] The chapter develops average effective tax rate (AETR) and marginal effective tax rate (METR) formulas under a neoclassical (user cost of capital) framework extended to incorporate various corporate tax-planning strategies, and derives illustrative results to shed light on possible effects when moving away from standard financing and repatriation assumptions.

The results suggest that AETRs/METRs based on standard assumptions need to be reconsidered in tax planning, as effective tax rate values might be significantly lower in certain cases. A central question is whether investors take tax planning into account when making investment decisions. It might be that they account only for basic tax provisions, with tax-minimizing strategies developed only after investment decisions are made, to maximize after-tax rates of return.[2] Where this is generally the case, then effective tax rate measures exclusive of tax-planning effects might be appropriate for empirical work estimating

the sensitivity of FDI to taxation. Effective tax rate measures *exclusive* of tax planning also might be suitable for empirical work if such measures are correlated with those *inclusive* of tax planning.[3]

Although the framework developed in this chapter illustrates the possible effects of tax planning on AETR and METR values, it does not provide formulas for 'representative' effective tax rates for different cases, as it remains unclear how prevalent various tax-planning strategies are and how aggressively they are applied. In other words, much work remains to determine what tax measures investors tend to factor in when making their cross-border investment decisions. The analysis does, however, raise some concern that estimates of the inbound/outbound FDI response to tax policy reform based on standard approaches and measures might be less than reliable on account of both questionable estimated tax-elasticity values and considerable uncertainty about the percentage change in AETRs that accompany tax reform, taking into account tax-planning considerations.

Studies by the Organisation for Economic Co-operation and Development (OECD) and others that compute forward-looking effective tax rates have adopted financing and repatriation assumptions that appear to be increasingly inconsistent with recent developments. These include the growing use of intermediary tax-haven finance subsidiaries and new financial instruments that encourage reliance on inter-affiliate interest, royalty, and other payments deductible at source as means to pay out active business income (see Chapter 1 in this volume).[4] Unlike dividends, these payments reduce the amount of host-country corporate tax and are particularly attractive where they attract no or minimal further income tax. Such is the case where the recipient is an intermediate affiliate in a no- or low-tax jurisdiction, where the host country imposes no or low withholding tax on returns to the intermediary, and where the parent company is not subject to (or is able to avoid) anti-deferral or anti-exemption rules in the home country that would tax such income on a current basis. Even under a direct (non-intermediated) holding structure, home-country tax might be avoided on inter-affiliate interest where hybrid securities, rather than conventional debt, are used.

The next section begins with a review of the basic partial-equilibrium approach policy analysts use to assess the FDI response to corporate tax reform, paying particular attention to their financing and repatriation assumptions. The review considers, as an example, an application of the United Kingdom's APTAX model to estimate the response of inbound and outbound FDI to tax reform that lowers the statutory corpo-

rate income tax rate. The example is representative of the 'state of the art' of AETR applications employed in OECD countries to assess tax policy effects on FDI flows.

The third section presents data that suggest the need to address tax-planning opportunities when modelling after-tax returns on FDI. Unfortunately, information is limited on cross-border financing structures, including data showing the use and growth of 'triangular' structures involving tax-haven finance affiliates, which might explain in large part why empirical studies of tax effects on FDI continue to assume conventional financial and repatriation policies. A growing literature, however, most notably from U.S. sources, provides insights into developments in this area.[5] This section also presents data on the level and growth of earnings of controlled foreign companies in low-tax countries used by U.S. parent companies, which highlights the scale of offshore financial intermediation in the U.S. case.

The fourth section presents results from an investigation of the implications of tax planning on AETR and METR measurement, under a stylized set of tax and non-tax parameters chosen for illustrative purposes. The various tax-planning considerations addressed include thin capitalisation of high-taxed subsidiaries, 'double-dip' financing and the use of hybrid securities in place of conventional debt, and the use of tax-haven finance affiliates and hybrid instruments to avoid home-country corporate income tax. The tax-burden values are shown to be highly dependent on financing and repatriation assumptions, with negligible AETR values and negative METR values under more aggressive forms of tax planning. The finding that AETR/METR results are sensitive to financing assumptions is not new; what is perhaps striking is how different the values might be.

The final section reconsiders the AETR analysis presented in the second section, and discusses the sensitivity of results to financing and repatriation assumptions. The possibility that AETR values and estimated investment responses to adjustments in AETRs following tax reform might be considerably different than predicted under a standard model (particularly when examining FDI from countries with dividend-credit systems) suggests that more work is required to assess the need to incorporate tax-planning implications into forward-looking effective tax rate measures that are used to infer the effects of tax reform on FDI. Such work could usefully draw on the insights and findings of Harry Grubert, who analyses the effects on tax planning of backward-looking tax-burden measures.[6]

2.0 The Basic Approach to Assessing the FDI Response to Tax Reform

The basic approach under a partial-equilibrium assessment of the FDI response to corporate tax reform is to combine an estimate of the sensitivity (elasticity) of FDI to the AETR on returns on FDI with a measure of the change in the AETR resulting from tax reform.[7] The basic approach can be represented as follows:

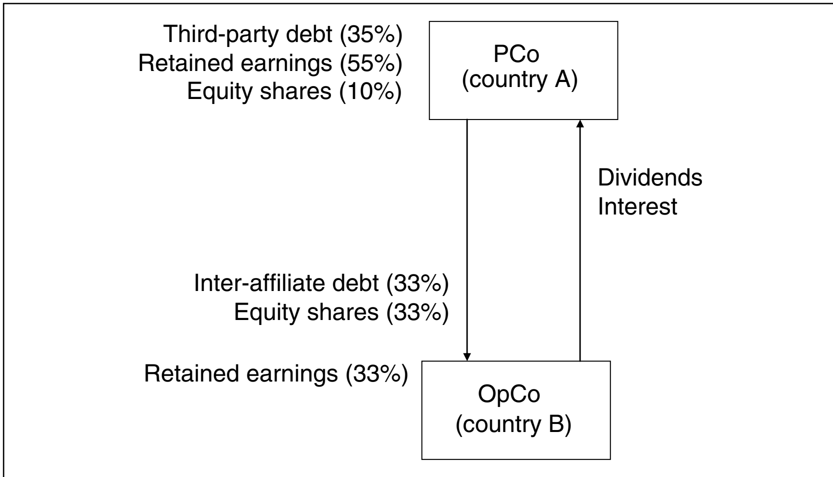
$$\frac{FDI_1 - FDI_0}{FDI_0} = \varepsilon^s x(AETR_1 - AETR_0)\ , \qquad (1)$$

where subscripts 0 and 1 show pre- and post-reform values; FDI measures a bilateral FDI flow – say, from country A (the home country) to country B (the host country); AETR is a forward-looking average effective tax rate on FDI from country A to country B; and ε^s is a semi-elasticity estimate of the percentage change in the FDI flow that accompanies a one percentage point increase in the AETR.[8] Equation (1) applies at the bilateral level, with AETRs depending on country-specific host- and home-country tax rules in national legislation and (overriding) provisions in a bilateral tax treaty agreement (if one exists) between country A and country B.

Applications of equation (1) include an assessment by policy-makers in a given (host) country B of the inbound FDI response to one or more corporate tax policy changes in country B that alter the AETR on inbound investment from country A as well as from other countries. For example, consider a corporate tax reform in country B that lowers the AETR on FDI into country B from country A from 30 per cent to 25 per cent. Application of a mean semi-elasticity ε^s value of –5.9 would predict that FDI into country B from country A would increase by 29.5 per cent.[9] An assessment of the impact on total inbound FDI from all countries (not just country A) would require that this exercise be repeated for each (significant) foreign country that invests in A, measuring in each bilateral case the applicable AETR.[10]

An example of this approach is the United Kingdom's APTAX-international model, which calculates AETRs/METRs for cross-border investment based on standard financing and repatriation assumptions. In this model, as depicted in Figure 5.1, a parent company (denoted PCo) resident in country A raises capital through some combination of borrowed funds (third-party debt), retained earnings, and new equity,

Figure 5.1. Standard-Financing Structure



and invests the funds directly in a manufacturing subsidiary (OpCo) resident in country B, using some combination of inter-affiliate debt and new equity. The subsidiary uses the injected capital, plus its own retained earnings, to finance the purchase of productive (physical) capital. Furthermore, standard practice is to assume immediate payout of earnings and, thus, immediate application of home-country tax rules (that is, tax deferral is ignored).[11]

Results from an application of the APTAX model are presented in Table 5.1, which considers the estimated *inbound FDI response* of parent companies in low-tax (LowTax) and high-tax (HighTax) countries to tax reform in a middle-tax (MiddleTax) host country that reduces the statutory corporate income tax (CIT) rate from 30 per cent to 25 per cent.[12] Under the direct (non-intermediated) holding structure, foreign earnings are assumed to be distributed immediately to investors (that is, to the parent companies) as earned.

The table shows pre- and post-reform AETR values for FDI by a parent company resident in LowTax, where the CIT rate is 15 per cent, and by a parent company resident in HighTax, where the CIT rate is 40 per cent, considering both dividend-exemption- and dividend-credit-system cases. Pre- and post-reform AETR values are applied to estimate the impact of the CIT rate cut in MiddleTax on inbound FDI using the estimating formula (1) and a semi-elasticity value for AETR of 5.9 per cent ($\varepsilon^s = -5.9$).

Table 5.1. Tax Reform Effects on Inbound FDI into MiddleTax

	Home-Country Tax System	AETR Pre-reform (CIT = 30%)	AETR Post-reform (CIT = 25%)	% Change in FDI into Middle Tax
		(per cent)		
FDI from LowTax (CIT = 15%)	exemption	24.26	20.10	24.54
FDI from HighTax (CIT = 40%)	exemption	25.92	21.78	24.43
FDI from LowTax (CIT = 15%)	credit	24.26	20.10	24.54
FDI from HighTax (CIT = 40%)	credit	32.66	32.05	3.60

Source: United Kingdom, HM Revenue and Customs, APTAX model.

Consider, first, the results for inbound FDI. Where both LowTax and HighTax operate dividend-exemption systems, MiddleTax (host-country) taxation of distributed profit is final, as dividends from MiddleTax are received tax free under exempt treatment. On the other hand, interest paid on inter-affiliate loans is subject to home-country taxation, with a higher CIT rate applied to inter-affiliate interest received in HighTax. Thus, the AETR on FDI from HighTax is higher than that on FDI from LowTax (25.92 per cent versus 24.26 per cent).

As taxation at source of profits on FDI in MiddleTax is final, the CIT rate reduction in MiddleTax lowers the AETR on inbound investment for investors from both LowTax and HighTax. For investors from LowTax, the CIT rate reduction lowers the AETR from 24.26 per cent to 20.10 per cent, implying an increase of 24.54 per cent in inbound FDI from investors in LowTax. For investors from HighTax, the same CIT rate reduction lowers the AETR from 25.92 per cent to 21.78 per cent, implying an increase of 24.43 per cent in inbound FDI from investors in HighTax – about the same percentage change as predicted for investors in LowTax.

Consider, next, results for FDI from countries that operate a dividend-credit system. For FDI from LowTax, the model finds unchanged results from the exemption-system case. This occurs as, once again, host-country taxation is final, but for a different reason. In this case of excess foreign tax credit, investors in LowTax are able to fully offset home-country tax on foreign dividends using foreign tax credits. (With

the CIT rate in LowTax less than that in MiddleTax, creditable foreign tax is in excess of the amount required to offset LowTax tax liability on profits earned in MiddleTax.) Interest on inter-affiliate loans to MiddleTax subsidiaries continues to be taxed at the 15 per cent LowTax CIT rate. The predicted effects of the tax reform are thus the same as in the dividend-exemption case (the CIT rate reduction lowers the AETR from 24.26 per cent to 20.10 per cent, implying an increase of 24.54 per cent in inbound FDI from investors in LowTax).

However, a very different outcome is predicted when addressing inbound FDI from investors resident in HighTax where a dividend-credit system. is applied In this case, home-country (HighTax), rather than host-country, tax rates determine the combined host- and home-country tax burden on FDI, implying that the rate reduction in MiddleTax has a muted effect. As the corporate tax burden in MiddleTax is relatively low, the foreign tax credit (pre- and post-reform) available to parent companies in HighTax matches and thus offsets the host-country corporate tax burden (pre- and post-reform). Thus, the drop in the corporate tax rate in MiddleTax, while reducing corporate tax paid in MiddleTax, also reduces the available foreign tax credit for parent companies in HighTax, and thus increases the amount of corporate tax paid in HighTax – in effect, the home-country tax adjustment offsets the host-country tax reduction. As a result, the AETR on inbound investment from investors in HighTax is predicted to fall only marginally, from 32.66 per cent to 32.05 per cent, implying a model FDI increase of 3.6 per cent.

One can also apply equation (1) in considering the *outbound FDI response* to tax reform – for example, in certain cases, to gauge possibly higher outbound FDI by investors in MiddleTax following a reduction in the CIT rate from 30 per cent to 25 percent.[13]

Consider, first, the results in Table 5.2, where MiddleTax is assumed to operate a dividend-exemption system. A lowering of the CIT rate in MiddleTax has no effect on the tax burden on dividends from LowTax or HighTax, with underlying profits subject to host-country taxation alone. However, the reform lowers the tax rate on interest received by a parent company in MiddleTax on loans to foreign affiliates. At the same time, the reform, by reducing the value of interest deductions, increases the after-tax cost of third-party debt capital raised by parent companies. Under the assumed finance weights, these effects – the first tending to lower the AETR on outbound FDI and the second tending to increase it – cancel out, implying no predicted FDI response.

Table 5.2. Tax Reform Effects on Outbound FDI from MiddleTax

	Middletax (Home-Country) TAx System	AETR Pre-reform (CIT = 30%)	AETR Post-reform (CIT = 25%)	% Change in Outbound FDI from Middle Tax
		(per cent)		
FDI into LowTax (CIT = 15%)	exemption	11.96	11.96	0
FDI into HighTax (CIT = 40%)	exemption	32.02	32.02	0
FDI into LowTax (CIT = 15%)	credit	22.48	18.98	20.65
FDI into HighTax (CIT = 40%)	credit	32.02	32.02	0

Source: United Kingdom, HM Revenue and Customs, APTAX model.

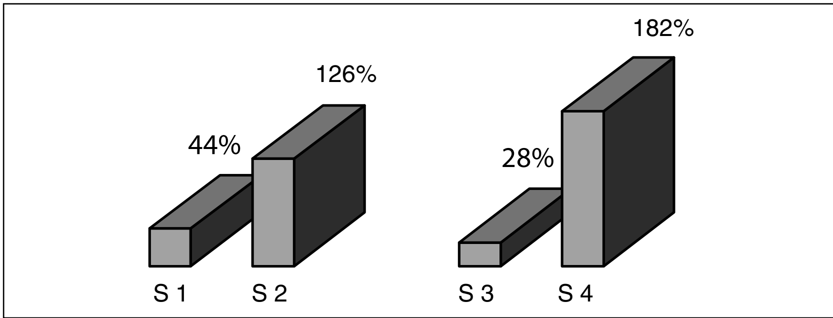
Where MiddleTax instead operates a dividend-credit system, the AETR on FDI into HighTax is also unaffected by the MiddleTax CIT rate reduction. The reason is that there is, in effect, no home-country tax on foreign dividends from HighTax since such tax is fully offset by foreign tax credits, both pre- and post-reform. Underlying profits are thus taxed at the HighTax rate. The reduced CIT rate lowers the taxation of foreign earnings received as inter-affiliate interest, but also increases parent companies' cost of debt finance. These effects offset one another, leaving FDI unchanged.

The one case where the MiddleTax CIT rate reduction is predicted to affect outbound investment is FDI into LowTax, where the parent is in an insufficient foreign-tax-credit position and the effective tax rate on foreign earnings is determined by the home-country tax rate. The five percentage point CIT rate reduction is shown to lower the AETR from 22.48 per cent to 18.98 per cent, leading to a 20.65 per cent increase in FDI outflows to LowTax. As reviewed below, this result might overstate the outbound FDI response where the effective tax rate on foreign profit is determined more by host-country than by home-country tax rates under tax planning that limits home-country taxation.

3.0 Cross-border Financing Developments

In this and the next sections, I reflect on financing and repatriation assumptions underlying the standard approach to estimating tax re-

Figure 5.2 Growth Activity of CFCs of U.S. Parent Companies in Major Low-Tax Countries, 1996–2000



form effects on FDI, and consider possible departures consistent with strategies of multinationals to minimize host- and home-country tax. A central question raised in this context is how common it is for multinationals to tax plan – for example, by using no- or low-tax jurisdictions as locations for financial intermediaries. And is tax planning becoming increasingly common over time, as might be expected with reductions in associated costs and an apparent weakening (rather than tightening) of anti-deferral rules? Although there has been increased attention in policy circles and the media in recent years to the offshore 'tax-haven' activities of multinationals aiming to minimize their global corporate tax bill, unfortunately very little information is publicly available on the scale and growth of the corresponding financial stocks and flows. This paucity of information reflects in part the different approaches countries use to measure and report transactions with tax-haven finance affiliates (also referred to as 'special purpose vehicles').

Available data suggest, however, the need to attempt to account for tax-haven activities and, more generally, the tax-planning behaviour of multinational firms when assessing the tax burden on cross-border investment. Figure 5.2 shows growth in the scale of activities of controlled foreign companies (CFCs) of U.S. parent companies in major low-tax countries over the period 1996–2000, as reported in *Tax Notes International*.[14] The first bar shows growth in total pre-tax earnings of all CFCs (in all foreign countries); the second bar shows growth in pre-tax earnings of CFCs in seven major low-tax countries used by U.S. parent companies: Bermuda, the Cayman Islands, Ireland, Luxembourg, the Netherlands, Singapore, and Switzerland. In 2000, total pre-tax earnings of all CFCs stood at US$231 billion, of which earnings in the seven

low-tax countries accounted for US$86 billion, or 36 per cent. Over this period, dividends CFCs received in these countries grew by more than 200 per cent, accounting for about one-third of the total pre-tax earnings growth, with the remaining two-thirds reflecting growth in other receipts connected to tax planning, as well as growth in real activity.

The third bar in Figure 5.2 shows growth in total tangible capital assets (plant, equipment, plus inventories) of all CFCs, while the fourth bar shows growth in tangible capital assets in five major holding company low-tax countries (Bermuda, the Cayman Islands, Luxembourg, the Netherlands, and Switzerland). By 2000, holding companies in these countries accounted for about 15 per cent of all capital held abroad by U.S. parents.

Much of the growth in capital assets in these low-tax countries is through hybrid structures, where, under U.S. 'check-the-box' rules, operating entities in high-tax countries are designated as branches of holding company CFCs in low-tax countries. Thus, real capital of these operating entities shows up as real capital of the consolidated group based in low-taxed countries. Payments to holding company CFCs under the hybrid structure are 'invisible' for U.S. tax purposes.

To the extent these data reflect a global trend, attempts are called for to account for tax planning in representative tax-burden measures.

4.0 Cross-border AETR/METR Analysis: A Focus on Tax-Planning Effects

This section explores the implications for cross-border AETR/METR measures of six tax-planning cases, including thin capitalization of high-taxed subsidiaries, 'double-dip' financing and hybrid instruments, and the use of tax-haven finance affiliates and hybrid structures to avoid home-country CIT.

The six cases reflect a subset of financing (and repatriation) policies that could be followed. The objective of the analysis is limited to signalling the sensitivity of AETR/METR results to financing assumptions and to suggesting the need to reconsider these in analytical work – in particular, whether they are representative of particular host- and home-country combinations.

The analysis derives AETR and METR measures for dividend-exemption (territorial) and dividend-credit (worldwide) systems in a framework that considers the net present value of investment in a foreign subsidiary, with the present value of pre-tax economic profit

assessed on the basis of an assumed average pre-tax rate of return on capital. In each case, the net present value of pre-tax economic profit depends on the optimal capital stock, where the latter scale decision (the optimal amount to invest in a location) depends on an assessment of after-tax marginal costs and returns on investment, with reference to METRs. Where a parent company's decision about where to locate subsidiary operations is based on a comparison of the net present value of investment across competing locations, scale decisions and location decisions are taken simultaneously.[15] To make the model tractable, it is assumed that investment in a foreign subsidiary in a given location, if made, proceeds immediately to the optimal steady-state capital stock (K*) for that location (with the determination of K* based on an assessment of marginal returns and costs).[16]

For each case examined, the first step considers the net present value of investment under a given financing and tax structure, expressed as a function of an assumed average pre-tax rate of return variable and optimal capital stock value. The next step considers the equilibrium condition that determines the optimal capital stock and the corresponding METR value. The third step considers various measures of net present value – including expressed as a function of the AETR on investment – to illustrate the influence of taxation on net present value (and location choice).[17]

Table 5.3 gives the illustrative AETR and METR results for the six cases under a stylized set of tax and non-tax parameters (which can be varied within the model). The CIT rate in the home country is 30 per cent, in the high-tax host country 40 per cent, and in the low-tax country 15 per cent. The pre-tax rate of return is set at 20 per cent, while the pre-tax rate of return on bonds (representing the opportunity cost of funds) is set at 10 per cent. A single homogeneous capital asset is assumed (although multiple capital assets can be built into the model), with tax depreciation set equal to true economic depreciation at a declining-balance rate of 20 per cent. The non-resident withholding tax rate on interest and dividends is set at 5 per cent.

4.1 Base Case Results

Case 1, the base case, considers straight equity financing, where a parent company invests retained earnings in new equity shares of a foreign subsidiary that is assumed to distribute its after-tax earnings (net of replacement investment) in full at the end of each period.

Table 5.3. AETR/METR under Alternative Financing and Repatriation Assumptions

Home-Country CIT = 30%	AETR on FDI into HighTax (Host-Country CIT = 40%)	AETR on FDI into LowTax (Host-Country CIT = 15%)	METR on FDI into HighTax (Host-Country CIT = 40%)	METR on FDI into LowTax (Host-Country CIT = 15%)
	(per cent)			
Dividend-credit system				
Case 1 (RE → NE)	42.3	30.0	42.2	30.0
Case 2 (RE → NE + BS)	35.7	30.0	33.2	30.0
Case 3 (BP → NE)	27.5	15.0	17.3	0
Case 4 (BP → NE + BS)	20.8	15.0	–2.4	0
Case 5 (BP → NE + HY)	20.8	15.0	–2.4	0
Case 6 (BP → NE → NE + BS)	18.0	0.5	–14.1	–29.2
Dividend-exemption system				
Case 1 (RE → NE)	42.3	19.0	42.2	18.8
Case 2 (RE → NE + BS)	40.1	19.0	39.4	18.8
Case 3 (BP → NE)	27.5	4.1	17.3	–16.0
Case 4 (BP → NE + BS)	25.2	4.1	11.5	–16.0
Case 5 (BP → NE + HY)	20.8	1.6	–2.4	–25.0
Case 6 (BP → NE → NE + BS)	18.0	0.5	–14.1	–29.2

Notes: RE = retained earnings; NE = new equity; BP = bond finance parent; BS = bond finance subsidiary; HY = hybrid instrument.
Cases 2 and 4: leverage parameters for sub $\beta = 0$; case 5: $\beta = 0.35$ for exemption, $\beta = 0$ for credit; case 6: $\beta = 0.50$.
Source: Author's calculations from methodology derived in OECD, *Tax Effects on Foreign Direct Investment*, chap. 5.

For FDI in the high-tax country, the AETR is shown as 42.3 per cent under both dividend-credit and dividend-exemption treatment (for a discussion of residence-based and exemption-tax systems, see Chapter 4 in this volume). The AETR exceeds the 40 per cent host-country CIT rate on account of host-country withholding tax on dividends.[18] No home-country tax is collected, and tax on dividends is offset by foreign tax credits in the dividend-credit system or, of course, exempt in the dividend-exemption system. For FDI in the low-tax country, the AETR of 30 per cent captures the additional home-country tax under a credit system on foreign dividends taxed at source at 15 per cent, under the standard assumption applied in AETR/METR analysis that the subsidiary immediately pays out its after-tax earnings (the possibility of deferral is ignored). Under a dividend-exemption system, the AETR is only 19 per cent inclusive of dividend withholding tax.

4.2 Thin Capitalization of High-Taxed Subsidiaries

A central tax-planning consideration is tax savings from thinly capitalizing (leveraging) subsidiaries resident in countries with relatively high statutory corporate tax rates, where the amount of tax relief tied to a given interest deduction depends on the statutory tax rate applied to the relevant tax base. Considering inter-affiliate debt, the incentive of a parent that loans funds to capitalize a foreign subsidiary with debt rather than equity depends on the relative setting of statutory corporate tax rates in the home versus host country, the home-country tax treatment of foreign dividends (credit versus exemption system) and interest paid out of active business income, and possible pooling of income for the purposes of foreign tax credits (see Chapter 4 in this volume).

With a dividend-credit system that allows pooling of foreign dividend and interest income paid out of active business income, 'excess' foreign tax credits on high-taxed foreign dividends – that is, credits in excess of an amount required to eliminate home-country tax on foreign dividends – may be used to shelter from home-country tax foreign interest (and royalty) income received from foreign affiliates. When taking this consideration into account, the tax burden on FDI under a dividend-credit system might be *lower* (not higher, as is often presumed) than that under a dividend-exemption system.

Case 2 allows for leveraging (inter-affiliate debt financing) of a foreign subsidiary. Where the host-country corporate tax rate is relatively high, exceeding the home-country rate, leveraging is attractive under

an exemption system as it converts foreign dividend income taxed at a relatively high host-country rate into foreign interest income taxed at the relatively low home-country rate (free of host-country tax).[19]

Under a dividend-credit system, in contrast, reliance on inter-affiliate loans is also generally attractive, but only at low leveraging values, where a parent company is able to shelter home-country tax on interest using excess foreign tax credits on dividend income. Once leveraging reaches a critical value such that the parent moves from an excess to an insufficient foreign tax credit position, increased leveraging reduces not only host-country tax but also the allowable foreign tax credit, implying no tax savings overall. Therefore, where the host-country tax rate is relatively high, greater leveraging of a foreign subsidiary might be expected under a dividend-exemption system, despite the greater tax relief that initial leveraging can bring at low leverage values under a dividend-credit system.[20]

Partial leveraging of a foreign subsidiary (35 per cent debt, 65 per cent equity) in the high-tax country is shown to lower the AETR from 42.3 per cent to 35.7 per cent under dividend-credit treatment. The reduction in the AETR to 35.7 per cent results from host-country tax relief from an interest deduction and no offsetting home-country tax, with inter-affiliate interest sheltered from home-country tax by excess foreign tax credits on dividend income. At a sufficiently high (optimal) leverage value, foreign earnings paid out as interest would no longer be sheltered at the margin (with excess credits fully utilized). In general, the higher is the host-country corporate tax rate relative to the home-country rate, the higher is the optimal leverage value.

With a dividend-exemption system and the same degree of leveraging (35 per cent), the AETR also falls but not by as much, from 42.3 per cent to 40.1 per cent. The reduction is less, as tax relief from the interest deduction in the host country is partially offset by increased home-country tax, with foreign interest income subject to tax. (The AETR on FDI under an exemption system could be lowered further with leverage beyond 35 per cent, assuming an absence of, or ineffective, host-country thin-capitalization rules, which increases the fraction of foreign earnings taxed at the relatively low home-country rate of 30 per cent.)

In the opposite case, where the host-country statutory tax rate is a relatively low 15 per cent, a parent company subject to a dividend-exemption system would be expected to make very limited (if any) use of inter-affiliate debt to a foreign subsidiary *held directly*, given the low tax rate on earnings repatriated as dividends of 15 per cent (versus 30 per

cent on interest). Similarly, where a dividend-credit system applies, the parent is in an insufficient foreign tax credit position, and with foreign dividends taxed at a combined rate of 30 per cent (with host-country tax fully offset by foreign tax credits), reliance on inter-affiliate loans would be expected to be limited, based on tax considerations alone (with host-country tax reductions from interest expense offset by reduced foreign tax credits in the home country).

As Table 5.3 shows, under a credit system, leveraging provides no overall tax savings where host-country tax relief from the interest deduction is simply offset by a reduced foreign tax credit. Under an exemption system, leveraging is unattractive as it converts dividend income taxed at the low host-country rate of 15 per cent into interest taxed at the relatively high home-country rate. With these considerations in mind, the AETRs for case 2 assume no leveraging of the foreign subsidiary (that is, the leveraging parameter $\hat{a}$ is set to 0).

4.3 Double-Dip Financing

Another consideration is the mix of external and internal funds parent firms use to fund outbound FDI and whether the standard assumption of a fixed set of financing weights for parents in different home countries and over time is representative. In some contexts, double-dip financing – involving two interest deductions on funds that finance FDI – might be attractive and be used to lower effective tax rates on FDI dramatically (see also Chapter 4 in this volume).

Reliance by a parent company (or other affiliate) on third-party debt to finance FDI can reduce AETRs on FDI significantly. At the same time, home-country rules might limit interest deductions on amounts borrowed to fund outbound FDI (and that might generate little domestic tax revenue). Countries differ quite markedly in the restrictions they apply on interest deductions on amounts borrowed to fund FDI. Some rely on tracing rules, which allow such deductions to be made only against net domestic taxable income (if any) on FDI. Tracing rules can be circumvented, however, given the fungible nature of capital. Where tracing or similar rules do not apply, or where they do but are routinely circumvented, parent companies or other affiliates in high-tax countries might be expected to rely heavily on debt finance to fund outbound FDI. Other countries have interest-allocation rules that might be more effective in limiting the amount by which interest deductions on debt-financed FDI offset domestic taxable income.[21]

Case 3 illustrates how the AETR on FDI can be reduced significantly in the absence of constraints on interest deductions on third-party debt financing of outbound FDI. The illustration takes the limiting position where a parent company's source of funds to finance a new equity injection into a foreign subsidiary is entirely third-party debt finance. As in Case 1, possible leveraging of a foreign subsidiary is initially ignored (double-dip financing is examined in Case 4). Comparing the results of Cases 1 and 3, the AETR on FDI into the high-tax country falls from 42.3 per cent to 27.5 per cent under both credit and exemption systems. The AETR on FDI into the low-tax country falls by half (30 per cent to 15 per cent) where the home country operates a credit system. Where an exemption system applies, however, the AETR reduction is more pronounced (falling from 19 per cent to 4.1 per cent), as earnings are taxed at the low host-country CIT rate, while interest on the loan that finances the investment is written off at the relatively high home-country rate.

Case 4 considers 'double-dip' financing where two interest deductions are taken to finance FDI. The first dip (interest deduction), resulting from borrowing by the parent company to fund FDI, reduces the AETR in both high- and low-tax countries and under both credit and exemption systems, as discussed in Case 3. A second dip, arising where the parent company loans some fraction of its borrowed capital to the subsidiary, is attractive in reducing tax on FDI into a high-tax country. As in Case 2, leveraging converts relatively high-taxed foreign dividend income into foreign interest income taxed at the relatively low home-country tax rate under an exemption system. Under a credit system, returns in the form of interest are free of both home- and host-country tax up to some optimum leveraging position (at which point, taxation at the relatively low home-country rate would apply).

The results, with the foreign subsidiary leveraged with 35 per cent debt (65 per cent equity), show the AETR falling from 27.5 per cent in Case 3 to 25.2 per cent in Case 4 under an exemption system and to 20.8 per cent under a credit system with excess credits sheltering interest. In contrast, a second dip does not result in tax savings when considering (direct) FDI into a low-tax country, for the reasons considered in Case 2 (reduced foreign tax credits under a dividend-credit system and replacement of exempt dividends with taxable interest under a dividend-exemption system). Thus, the Case 3 results are repeated in Case 4 where leveraging the subsidiary is an option but not one taken due to the negative tax consequences.

4.4 A Hybrid-Instrument Financing Structure

Case 5 considers the use of a hybrid instrument, where double-dip arrangements might be attractive in certain cases where conventional debt would not, with returns regarded by the home country as dividend income exempt from home-country tax. Similar results are obtained as with conventional debt where interest can be sheltered. Inclusion in the home-country tax base of interest income on an inter-affiliate loan to an operating subsidiary assumes the use of conventional debt, rather than a hybrid instrument, meaning a security that is regarded as conventional debt by one country (that is, the host country of an operating subsidiary that issues the hybrid security) and as an equity security by another country (the home country of a parent company that purchases or invests in the security). This asymmetry achieves tax relief similar to that under a triangular or hybrid-entity structure, examined below.[22]

Consider a hybrid instrument issued by an operating company (OpCo) in country B to its parent (PCo) in country A. Payments on the hybrid instrument are treated by the host country B as interest expense and are thus deductible against the host (country B) tax base. With returns on investment in a hybrid security treated by country A as dividends, the returns would be exempt if the home country (country A) operates a dividend-exemption system or if the home country operates a dividend-credit system and the parent PCo is in an excess foreign tax credit position and is able to use foreign tax credits on dividends received from OpCo to offset home-country tax on the hybrid instrument. In general, an excess foreign tax credit position would apply if the host-country corporate tax rate on profit is high relative to the home-country tax rate.[23]

The possible implications of hybrid instrument financing are presented in Table 5.3 as Case 5, where the AETR, at 20.8 per cent when investing in the high-tax country under a credit system, is the same as that for Case 4 with conventional debt, where excess credits fully shelter foreign interest on conventional debt from home-country tax. In this case, the hybrid offers no special tax advantages (with returns received tax free in both cases). However, a hybrid instrument is attractive relative to conventional debt under an exemption system that taxes interest on conventional debt as ordinary income while treating returns on the hybrid as exempt dividend income. With the foreign subsidiary leveraged 35 per cent by a hybrid security (65 per cent equity), the AETR falls from 25.2 per cent to 20.8 per cent under an exemption system.

When capitalizing a foreign subsidiary in a low-tax country, a hybrid instrument once again holds no particular advantage if the home country operates a credit system and the foreign subsidiary is held directly. With the parent subject to home-country tax on pre-tax earnings, whether distributed as dividends on conventional equity, as interest, or as returns on a hybrid and with host-country tax and thus creditable foreign tax unchanged when a hybrid security is used as opposed to conventional debt, the AETR results are unchanged from Case 4. Again, however, the hybrid offers advantages under an exemption system, with returns on the hybrid, unlike returns on conventional debt, avoiding home-country tax. The AETR in this case is a low 1.6 per cent.

4.5 A Triangular Financing Structure

Under a direct (non-intermediated) holding, interest, royalties, and certain other payments by a foreign subsidiary to its domestic parent are deductible, thereby reducing host-country tax. However, receipts of these amounts normally attract home-country tax, with possibly some scope under a dividend-credit system to shelter foreign interest and royalty income from home-country tax using excess credits on high-taxed dividend income (assuming such pooling of income for foreign tax credit purposes).

Triangular structures involving an intermediate affiliate located in a tax haven, providing inter-affiliate financing and possibly other conduit services, can fundamentally alter financing and repatriation options and tax results. As noted above, capitalizing a foreign subsidiary held directly with an inter-affiliate loan is attractive as a tax-minimizing strategy if the host-country tax rate is relatively high. In such cases, replacing equity with an inter-affiliate loan converts the effective tax rate on foreign earnings from the host-country rate to the relatively low home-country rate, assuming the home country operates an exemption system. If, instead, the home country operates a dividend-credit system, reliance on inter-affiliate loans is even more attractive to the extent that interest income can be sheltered from home-country tax by excess foreign tax credits (for leveraging up to some optimal point). If, however, the host-country tax rate is relatively low, then in general replacing equity with an inter-affiliate loan offers no tax relief. Under an exemption system, leveraging converts the effective tax rate on foreign earnings to the relatively high home-country rate, while, under a credit system, host-country tax reductions resulting from interest deductions

on an inter-affiliate loan are fully offset by reductions in foreign tax credits.

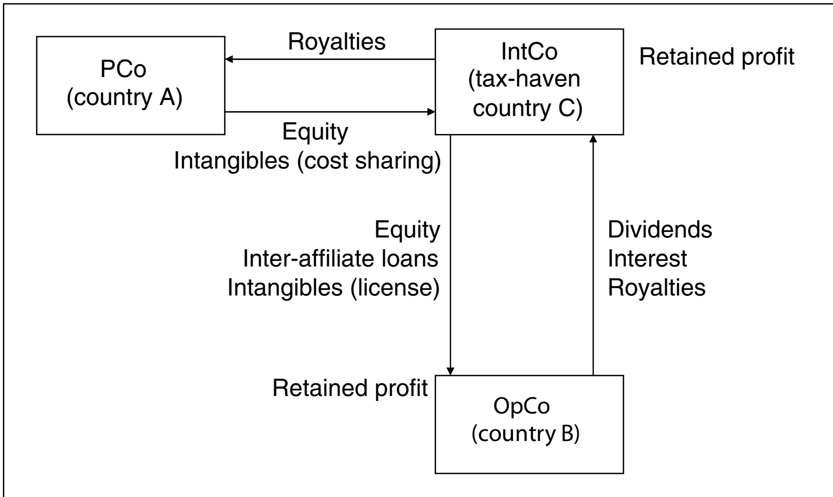
With a triangular structure, as illustrated in Figure 5.3, financing and repatriation strategies that reduce the host-country tax base are generally more attractive, with the taxpayer able to avoid offsetting home-country taxation. In the illustration, a parent company (PCo) in country A injects equity capital to establish a wholly owned intermediate subsidiary (IntCo) in a 'tax haven' (country C), to provide conduit financing. The intermediary is capitalized by the parent with equity (rather than debt) to avoid home-country tax on interest income. IntCo invests the funds in an operating subsidiary (OpCo) in country B using a combination of equity shares and inter-affiliate loans, with the funds used to purchase plant, property, and equipment. IntoCo is also shown to license to OpCo intangible property (for example, a patent), which might have been transferred to IntCo under a cost-sharing arrangement where the 'buy in' for IntCo's rights to the intangible reflects only a fraction of the R&D cost used to create it.

The intermediated structure provides tax savings to PCo on its multinational operations where it enables the avoidance of home-country tax on foreign interest, royalty, and other payments deductible against the host-country corporate tax base, implying both host- and home-country tax savings. As noted, under a direct-holding structure, while such payments are deductible at source, they may attract home-country tax. The intermediated structure also allows PCo, if resident in a country operating a dividend-credit system, to avoid home-country tax on low-tax foreign source dividend income.

Given these considerations, incentives are created to capitalize foreign operating subsidiaries more thinly using inter-affiliate loans provided by tax-haven finance intermediaries. The incentive to strip out earnings applies whether the home country operates a dividend-exemption or a dividend-credit system, and regardless of the relative setting of statutory corporate tax rates in the home and host countries. Incentives are also created to overcharge (use non-arm's-length prices) on interest and royalties paid to IntCo, to provide greater host-country tax savings. An important observation is that tax savings under the triangular structure *do not* require the use of non-arm's-length prices, as tax-base shifting from OpCo to IntCo is achieved even where arm's-length prices are used.[24]

Case 6 considers FDI financed through a triangular structure, where a parent borrows funds to capitalize an offshore finance subsidiary

Figure 5.3. Triangular Structure



with equity, which is injected in an operating subsidiary using a combination of inter-affiliate debt and new equity. To simplify the analysis and illustrate results possible with indefinite deferral of home-country taxation, foreign operating earnings received by the tax-haven subsidiary are assumed to be held offshore indefinitely, invested in passive assets. The results, which assume the absence of anti-deferral/anti-exemption provisions, serve to highlight possibly very low effective tax rates on FDI compared with possible effective tax rates on domestic investment.[25] With no offsetting home-country tax effects (for example, no switching from an excess to an insufficient foreign tax credit position under a credit system), the foreign subsidiary is assumed to be leveraged 50 per cent with debt and 50 per cent with equity.

The most pronounced effects arise when considering investment in a low-tax country where the home country operates a credit system. (For FDI in a high-tax country where home-country tax does not apply, either under a credit or a dividend system, there is no home country tax to avoid). The avoidance of home-country tax, combined with additional stripping of the host-country tax base, causes the AETR to fall from 15 per cent to 0.5 per cent. The same AETR value is shown under a dividend-exemption system. If home-country taxation of returns is removed from the equation, effective taxation under either a dividend-credit or a dividend-exemption system is essentially the same.

4.6 A Hybrid-Entity Financing Structure

Triangular structures facilitating tax avoidance on returns on FDI may be countered by CFC anti-deferral/anti-exemption legislation in the home country that attributes to resident companies certain types of income passively received by a tax-haven affiliate, including dividends, interest, and royalties paid out by operating subsidiaries.[26] In practice, however, the reach of CFC rules may be limited (for example, due to international competitiveness concerns) to certain forms of passive income – in particular, returns on portfolio assets – and may exclude dividends, interest, royalties, and other amounts paid out of active business income of a foreign affiliate. Where such amounts are excluded, considerable scope remains to lower host-country profit tax without offsetting home-country tax consequences. In other words, depending on the scope of CFC legislation, it may or may not interfere with tax planning of the type reviewed in the preceding section with reference to Figure 5.3.

Even where CFC rules are in place with a broad reach that taxes PCo (in the previous example) on a current basis on foreign dividend, interest, and royalties paid by OpCo and received by the tax-haven finance affiliate IntCo, so-called hybrid entities may be used to circumvent the application of the CFC rules.[27] To take an example, CFC rules in the United States normally would tax PCo on a current basis on the dividend, interest, and royalty payments by OpCo to IntCo. With the introduction in 1998 of so-called check-the-box provisions, however, a U.S. parent may elect to have OpCo treated as a branch of IntCo for U.S. tax purposes. As a result of this designation, payments by OpCo (the hybrid entity) to the tax-haven finance subsidiary IntCo would be disregarded and OpCo and IntCo would be treated as a single corporate entity for U.S. tax purposes. OpCo is a 'hybrid' entity in the sense that, while it is regarded by the home country (country A) as a branch of IntCo, its articles of incorporation are such that OpCo is regarded by the host country (country B) as a separate legal entity (a subsidiary, rather than a branch, of IntCo). As a result, interest and royalty payments by OpCo to IntCo would be deductible in the computation of the country B corporate tax base. This treatment restores the tax savings described in the preceding section under the standard triangular structure free of CFC rules.

Aside from the possible application of CFC rules, a further consid-

eration is that certain other provisions might be in place to safeguard host- and home-country tax bases from the base erosion depicted in Figure 5.3. The host country might have thin-capitalization rules that limit the degree of leveraging of OpCo by IntCo, and thereby protect the host-country tax base (depending on the design of the rules and the scope for tax planning to push the boundaries).

Additionally, the home country might have interest-allocation rules that limit interest deductions by PCo on funds borrowed to capitalize IntCo (see Chapter 4 in this volume). Such rules generally aim to limit interest deductions against domestic taxable income, where tax planning results in limited inclusion of foreign income in the home-country tax base. For example, certain countries allocate interest expense of resident companies between domestic and foreign income on a *pro rata* basis based on domestic and foreign assets. Other countries limit the offset to home-country tax by assigning on a *pro rata* basis some portion of interest expense to deemed foreign income, so that the limitation operates through foreign tax credit limitation calculations. Another approach that some countries follow is to rely on tracing rules that attempt to identify the use of borrowed funds (which is difficult to prove, given the fungibility of capital) and assign interest expense on funds used to finance FDI to foreign income.

METR results (relevant to scale decisions) corresponding to the various cases reviewed above are also presented in Table 5.3. METRs provide a measure of the tax distortion to the decision of how much to invest in a host country, should it be chosen as a location for FDI on the basis of a comparison across competing locations of the net present value of investment, where the relevant tax burden measure is the AETR. METR values, like AETR values, depend on the financial structure of the investment. METR values are reduced or unchanged across the six financing cases, for the reasons that the AETR values are reduced or unchanged, as discussed above.[28] In Cases 1 and 2, the METR values in the four blocks of results (high-tax credit, high-tax exemption, low-tax credit, low-tax exemption) are similar to the corresponding AETR values. Results diverge in the remaining cases, with negative METR values shown (indicating a tax distortion to invest more in a host country chosen as an investment location, relative to the no-tax case) in a number of cases, with the most pronounced tax distortions found under triangular structures and also with the use of hybrid instruments, at least in certain cases.

5.0 Factoring Tax Planning into Assessments of the FDI Response to Tax Reform

The illustrative results reviewed above should encourage policy analysts to consider whether, in principle, standard approaches to measuring cross-border AETRs/METRs and assessing tax effects on FDI should be revised to take account of corporate tax planning. In particular, financing and repatriation assumptions commonly used might be unrealistic, at least in certain cases, suggesting that further work is needed to determine when this is the case and how modelling approaches and applications in econometric work might be improved. Such work might improve estimates of the response of inbound/outbound FDI to domestic tax reform and tax reform in other countries.

When measuring AETRs/METRs on FDI, the standard modelling practice is to assume a direct (non-intermediated) holding structure, with immediate earnings payout to the parent (that is, with no scope for deferral or avoidance of home-country tax) and the use of conventional types of finance with fixed weights applied for all host- and home-country combinations. In light of some of the considerations addressed above, to what extent does this standard modelling practice, as represented by the results in Tables 5.1 and 5.2, hold?

A first observation is that, for a given tax elasticity of FDI (ε^s), the standard approach might *understate* significantly the inbound FDI response to a corporate tax cut from investors resident in relatively high-tax dividend-credit countries. In Table 5.1, the five percentage point reduction in the CIT rate in MiddleTax is shown to have a relatively minor impact on the AETR on inbound FDI from HighTax operating a credit system, falling only slightly from 32.66 per cent to 32.05 per cent, with a corresponding 3.6 per cent increase in FDI.

This result rests on the assumption that foreign profits of parent companies in HighTax effectively are taxed at the home-country (HighTax) rate, which is unchanged by tax reform in MiddleTax. The estimated FDI response would be much higher than that predicted – approximately seven times higher, at 24 per cent – if home-country taxation of foreign profit is avoided. In other words, to the extent that, in practice, the home-country tax burden on FDI does not differ significantly between dividend-credit and dividend-exemption countries when taking tax planning into account, a more pronounced AETR change and FDI response could be expected from investors in relatively high-tax dividend-credit countries.

In other cases, the standard approach might *overstate* the FDI response. With reference again to Table 5.1, the five percentage point corporate rate cut by MiddleTax is shown to reduce the estimated AETR on inbound FDI by four percentage points in the three cases where MiddleTax taxation of dividend income is final (that is, the two exemption cases and the excess foreign tax credit case). But the estimated AETR reduction depends on the amount of profit taxed at source by MiddleTax. To the extent that profits are stripped out free of corporate tax pre- and post-reform (for example, through the use of loans from a tax-haven finance affiliate, hybrid instruments, and/or other channels) implying a less pronounced AETR change, the smaller is the predicted FDI response.

While these considerations suggest that 'true' AETR and FDI effects of tax reform might differ from what is predicted under a standard modelling approach, they do not point to a necessarily more accurate set of estimates for the various cases examined. Indeed, as the discussion of tax-planning considerations earlier in the paper suggests, there is a wide range of possible AETR values for a given host- and home-country combination (implying a wide range of possible FDI impact values), depending on the underlying financing and repatriation policies.

Even if one assumes that corporate tax planning largely eliminates home-country taxation of returns on FDI – so that only host-country taxation of returns on FDI matters – this does not mean that one can focus exclusively on host-country tax parameters. This follows from the fact that the tax burden on FDI depends on the tax treatment of the cost of finance, including interest on third-party debt raised by the parent company to fund FDI. Thus, even if one ignores home-country taxation of returns on FDI, it remains necessary to consider the percentage of FDI funded by external debt raised by foreign parent companies (or other foreign affiliates) and the foreign CIT rates at which the interest expense on that debt can be written off.

Moreover, without detailed information on financing and repatriation policies at the firm level, attempts to factor in tax planning might understate 'true' AETR values (as ignoring tax planning might overstate values). While, in principle, certain financing and repatriation structures, if adopted, might largely eliminate host- and home-country tax, in practice such aggressive structures are only partly followed, based on an assessment of marginal benefits and marginal costs (such as professional fees) of alternative structures. As these benefits and costs are firm specific and unknown to the modeller, so too is the (internal) so-

lution to the optimal tax-planning structure at the firm and aggregate level. A further complication is that the relevance of tax planning to FDI decisions might vary (to an unknown degree) depending on the type of investment and the particular host country.[29]

Furthermore, even if a 'typical' financing and repatriation structure is known, it might not be straightforward to model. To take an example, in Table 5.1, exactly the same pre- and post-reform AETR values and FDI results are calculated for FDI into MiddleTax from LowTax both where LowTax operates a dividend-exemption system and where it operates a dividend-credit system. In both cases, the tax reform in MiddleTax reduces the AETR on inbound FDI from 24.26 per cent to 20.10 per cent (and is predicted to increase inbound FDI by 24.54 per cent). The identical AETR values signal that interest on loans by parents in LowTax to subsidiaries in MiddleTax are treated in the model as being taxed at the 15 per cent home-country rate. This treatment follows from the modelling approach taken to simplify calculations.[30] Simplifying approaches, however, might leave out certain aspects that are important to actual tax burdens. For example, in dividend-credit systems that allow pooling for foreign tax credit purposes of foreign dividend and interest income received from a foreign subsidiary, it is possible to partially shelter foreign interest using excess foreign tax credits on dividend income. This means that, where LowTax operates a credit system, a lower AETR results than under a dividend-exemption system. As well, the use in empirical work of AETR measures that systematically overstate (or understate) the AETR on FDI could tend to bias tax elasticity estimates (ε^s) and, thus, estimates of the FDI response to tax reform.[31] To the extent that percentage differences in AETRs are also affected, so too would be estimated FDI response rates to tax reform.

The overall implication is that estimates of the FDI response to tax reform must be used with considerable care. The possibility that AETR values and estimated AETR adjustments following tax reform might be considerably different than are predicted under a standard model (particularly when examining FDI from countries with dividend-credit systems) suggests that more work is needed to investigate the implications of tax planning to forward-looking effective tax rate analysis that is used to infer tax reform effects on FDI. Such work usefully could draw on the insights of work that analyses the effects on tax planning of backward-looking tax-burden measures.[32]

Notes

* The views in this chapter are the author's own and do not necessarily reflect the views of the Organisation for Economic Co-operation and Development (OECD).

1 This chapter draws from analysis by the author in an earlier work. See OECD, *Tax Effects on Foreign Direct Investment: Recent Evidence and Analysis*, OECD Tax Policy Studies 17 (Paris: OECD, 2007), chap. 5.

2 Another possibility is that tax planning tends to be factored in only where host-country tax rates are relatively high.

3 Increasing (convex) costs of tax planning suggest that multinationals generally find it efficient to tax plan only up to some degree. In general, tax planning can be expected so long as the resulting tax savings (that is, reduction in host- and home-country tax) exceed the associated costs, including obtaining professional tax-planning advice. See H. Grubert and J. Mutti, *Taxing International Business Income: Dividend Exemption versus the Current System* (Washington, DC: AEI Press, 2001); and H. Grubert and R. Altshuler, 'Corporate Taxes in the World Economy: Reforming the Taxation of Cross-Border Income,' Department of Economics Department Working Paper 200626 (New Brunswick, NJ: Rutgers University, 2006). Where planning typically systematically results in some partial reduction (say, 50 per cent) in the effective tax rate on FDI, without tax planning effective tax rates might closely track those with tax planning factored in (implying that effective tax rates without tax planning might be reliable instrumental variables for 'true' effective tax rates where the latter include tax-planning effects). If tax planning is targeted mainly at FDI where effective tax rates are relatively high, such tax rates, with or without tax planning, tend not to move together. The consideration of various FDI cases later in this chapter suggests that tax planning is less attractive in certain cases (for example, where a taxpayer resident in a credit country invests in a relatively low-tax host country).

4 See for example OECD, *Taxing Profits in a Global Economy: Domestic and International Issues* (Paris: OECD, 1991); L. Chennells and R. Griffith, *Taxing Profits in a Changing World* (London: Institute for Fiscal Studies, 1997); and D. Hajkova et al., *Taxation, Business Environment and FDI Location in OECD Countries* (Paris: OECD, 2006).

5 See, for example, R. Altshuler and H. Grubert, 'The Role of Governments and MNCs in the Race to the Bottom' (2006) 41 Tax Notes Int'l 459.

6 See H. Grubert, 'The Tax Burden on Direct Cross-Border Investment: Com-

pany Strategies and Government Responses,' in P.B. Sorensen, ed., *Measuring the Tax Burden on Labour and Capital* (Cambridge, MA: MIT Press, 2004) 129.

7 AETR measures are relevant to FDI location decisions (whether or not to invest, where to invest among competing locations), while METR measures are relevant to scale decisions (how much to invest in a given location). Thus, where tax is a determinant of FDI flow, total FDI flows depend on both AETR and METR values. Where location decisions have a greater impact on total FDI flows than scale decisions, AETRs might provide a better indicator of tax burden than METRs to explain possible tax effects on changes in FDI flows.

8 The semi-elasticity ε^s is defined as $\partial \ln(FDI)/\partial AETR$. When using an ordinary elasticity, measuring the percentage change in FDI resulting from a 1 per cent change in AETR ($\partial \ln(FDI)/\partial \ln AETR$), the right-hand-side tax rate difference term in equation (1) would measure percentage change $(AETR_1 - AETR_0)/AETR_0$.

9 This elasticity estimate is the typical (mean) estimated elasticity value of a broad range of empirical studies, where AETR is used as a explanatory variable to assess empirically the influence of tax on FDI; see OECD, *Tax Effects on Foreign Direct Investment*, table 2.7.

10 In principle, elasticity estimates used in equation (1) to measure the impact on FDI flows from A to B should be based on regressions of FDI from A to B on the corresponding AETR. In practice, elasticity estimates specific to separate bilateral FDI flows are not available. Empirical work tends to be specific to certain countries, often ignores home-country taxation (it assumes host-country taxation is final), and explains how host-country FDI responds to host-country tax reform without regard to the source of the capital flow. In practice, available values (such as mean values of estimates drawn from different studies) are applied.

11 The standard approach is also to assume a fixed set of financing weights for conventional sources of finance, and to hold these weights fixed for each home- and host-country combination and over time. The first internationally recognized publication to report bilateral cross-border METRs for OECD countries was OECD, *Taxing Profits in a Global Economy*, which assumes that outbound FDI is financed 35 per cent by borrowed funds, 55 per cent by retained earnings, and 10 per cent by new equity capital. At the level of the subsidiary, the financing of investment in physical capital is held fixed at 33 per cent for inter-affiliate loans, retained earnings, and new equity shares to the parent. The same weights are used in a number of subsequent studies; see, for example, Chennells and Griffith, *Taxing Profits*

in a Changing World; and Hajkova et al., *Taxation, Business Environment and FDI Location in OECD Countries*.

12 The APTAX model incorporates standard finance weights for a parent company for the three conventional types of finance: 35 per cent debt, 55 per cent retained earnings, and 10 per cent new equity (as in Figure 1). The same weighting structure is assumed to apply at the foreign subsidiary level.

13 In principle, elasticity estimates used in equation (1) should be consistent with the relevant outbound FDI flows.

14 See Altshuler and Grubert, 'Governments and Multinational Corporations in the Race to the Bottom.'

15 As the AETR for a particular investment (in a foreign subsidiary in a given location) depends on the optimal capital stock for that location, a comparison of AETRs across alternative locations requires that the METR optimal capital stock for each location be determined simultaneously.

16 Convex adjustment costs for real capital are ignored. Also ignored are financing strategies that switch from one form of finance to another – where a parent injects an initial amount of new equity capital into a newly created subsidiary, and then relies on (lower opportunity cost) retained earnings of the subsidiary to finance the adjustment to the optimal capital stock.

17 AETR and METR formulas for the six cases are available from the author.

18 To focus on tax-planning effects, tax depreciation is assumed to match actual economic depreciation. Thus, differences between the AETR and statutory CIT rate do not reflect differences between tax and economic depreciation. Similarly, non-zero METR values do not reflect differences between tax and economic depreciation.

19 Under a dividend-exemption system, foreign dividends are subject to host-country profit tax alone, while earnings paid out as interest (deductible against the host-country base) are subject to home-country profit tax. The analysis in this section, however, ignores possibly different rates of non-resident withholding tax on dividends and inter-affiliate interest (and royalties. This complication is addressed in the METR/AETR analysis, which considers optimal leveraging strategies under different host- and home-country tax-rate scenarios, and credit versus exemption systems.

20 Thin-capitalization (base-protection) rules in the host country might constrain the degree of leveraging of the foreign subsidiary in the dividend-exemption (dividend-credit) case.

21 The United States, for example, uses interest-allocation rules that operate through foreign tax credit provisions. In particular, interest expense is al-

located *pro rata* to foreign income (with regard to foreign versus domestic assets), which reduces the deemed amount of U.S. tax on foreign income, thereby limiting foreign tax credits.

22 While the use of a hybrid instrument, like the use of a tax-haven finance subsidiary, provides a means for a parent company to avoid home-country tax on inter-affiliate interest, it should be remembered that a tax-haven subsidiary enables avoidance across many income types (such as royalties and profits shifted offshore through transactions with a tax-haven subsidiary at non-arm's-length prices), not just interest.

23 As with conventional debt, at some leveraging of a foreign subsidiary using a hybrid, foreign tax credits on earnings distributed as dividends would be insufficient to fully offset home-country tax (at this point, increased reliance on hybrid financing offers no additional combined host- and home-country tax savings).

24 Overcharging OpCo on funds loaned to it and on intangibles licensed to it only adds to the amount of base shifting. Thus, transfer-pricing rules requiring the application of arm's-length prices on inter-affiliate transactions help contain – but by themselves do not eliminate – tax-base shifting.

25 It should be pointed out that the assumption that *all* foreign earnings of a foreign subsidiary are held offshore is unrealistic, given the costs associated with tax planning, as a result of which a multinational would be expected to retain earnings offshore up to the point where the savings at the margin from deferral (avoidance of repatriation tax) are not more than offset by the costs incurred at the margin in keeping funds offshore (implying that some fraction of foreign earnings may be repatriated). The analysis in case 6 takes the limiting case of no repatriation.

26 Many countries have not yet introduced CFC-type legislation. For those that have, the anti-avoidance rules may not apply to dividends or interest paid out of active business income, targeting instead income of foreign affiliates earned on portfolio holdings and possibly other (for example, foreign base company) income. Moreover, where active business income passively received by an intermediary is attributed to the parent, it may be taxed at a preferential rate, rather than the basic corporate tax rate. Finally, as elaborated in the main text, where CFC rules tax at full rates current interest and royalties paid out of active business income and passively received by a tax-haven affiliate, hybrid entities may enable avoidance of these rules.

27 The hybrid-entity structure is attractive in its treatment of interest and royalties. As an example of an application involving intangibles, con-

sider a U.S. parent company that wishes to employ a patent in a German manufacturing affiliate. The intangible may have been developed in the United States with the assistance of research and development tax credits. Selling the intangible to the manufacturing affiliate (or to an intermediary) would generate taxable domestic sales (export) income. Licensing the intangible directly to a foreign subsidiary generates taxable royalty income, possibly sheltered in part by excess foreign tax credits on high-tax dividend income. Tax planning could involve charging royalties for the use of the intangible that are above (below) an arm's-length price where the host-country statutory corporate tax rate exceeds (is less than) the U.S. rate. An alternative structure achieving possibly considerably greater tax savings would be for the U.S. parent to establish a licensing company in a no- or low-tax country and to transfer the intangible to the intermediary, which then licenses the intangible to the German manufacturing affiliate designated as a hybrid entity under U.S. 'check-the-box' provisions. The advantage is avoidance of U.S. tax, while maintaining a royalty deduction in Germany.

28 The illustrative results presented in Table 5.3 assume that tax depreciation matches true economic depreciation and investment tax credits are not provided. Thus, non-zero METR values reflect instances where the (combined host- and home-country) effective tax rate on foreign earnings paid out as dividends and/or interest on related-party debt differs from the effective tax rate at which the cost of funds is deducted (the home-country tax rate in the case of FDI funded by third-party debt, a zero rate in the case of FDI funded by retained earnings of the parent).

29 Tax considerations including tax planning are likely to be more important to investment location decisions involving more geographically mobile business activities (that is, the less location specific is business profit). Further, evidence of tax planning does not necessarily imply its relevance to location choice: a location decision might ignore tax planning (for example, where host-country tax considerations are similar), with tax planning subsequently considered to achieve a tax-efficient (tax-minimizing) result.

30 The APTAX AETR values reported in Tables 5.1 and 5.2 are an average of AETR values computed separately for each of the various financing combinations arising from the assumed sources of finance, then weighted (at the foreign subsidiary level, 55 per cent retained earnings, 10 per cent new equity issued to the parent, and 35 per cent inter-affiliate loan from the parent; at the parent level, 55 per cent retained earnings, 10 per cent new equity issued to shareholders, and 35 per cent third-party debt). Given this

approach, where a foreign subsidiary is financed by equity or inter-affiliate loans, foreign tax credit mixing possibilities for returns on equity and debt do not arise.

31 While the AETR level might be overstated significantly by ignoring foreign tax credit mixing possibilities, estimates of the percentage change in the AETR might not be affected significantly. Where it is not, this implies that the consideration raised in this paragraph (scope for pooling of dividend and interest income) tends to distort estimates of the FDI response to tax reform solely through a biased elasticity value.

32 See, for example, Grubert, 'The Tax Burden on Direct Cross-Border Investment.'

PART II

The Impact of Globalization

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6 Improving Inter-nation Equity through Territorial Taxation and Tax Sparing

JINYAN LI*

> There is no real agreement as to what would be a proper division of the [international] tax base, nor is there any obvious principle of fairness that can be invoked to justify any particular distribution of revenue. The present division has been a more or less accidental result of the attempt to eliminate double taxation, and is principally a product of the various model double taxation treaties that have been adopted over a period of some 60 years. Since the principal architects of these model treaties have been the major capital-exporting countries, it seems reasonable to suppose that, to the extent that the existing arrangements are inequitable, they operate to the prejudice of countries that are primarily importers of capital … and as the great majority of lesser-developed countries fall into this category, there is the further consideration that some redistribution in favour of source countries would on balance be desirable and would promote a form of vertical equity among nations.
>
> – Alex Easson[1]

1.0 Introduction

The current international tax system allocates the taxation of cross-border income by reference to the residence of the taxpayer and/or the source of income. The governing rules are contained in domestic tax laws and bilateral tax treaties. As noted by Alex Easson, the current regime of allocation is not based on any real agreement between nations and cannot be rationalized by any 'obvious principle of fairness.' In fact, it is biased in favour of the capital-exporting nations that devised the rules of the game. In order to improve fairness, Easson considered it desirable to have some 'redistribution' in favour of less-developed,

net-capital-importing nations – indeed, he was one of the few legal scholars[2] who have emphasized the importance of inter-nation equity. The international tax literature, however, recently has been preoccupied with efficiency and welfare maximization,[3] predominantly from a one-country perspective.[4]

This chapter joins Easson in his pursuit of inter-nation equity. The main argument is that inter-nation equity, in the sense of the fair allocation of the tax base as well as international redistribution, should be taken seriously in future tax reforms. It aims to demonstrate, at a conceptual level, that inter-nation equity can be improved through adopting a territorial system of taxing business income and redesigning the tax-sparing system whereby a credit for foreign taxes is deemed paid for the purposes of a taxpayer's claiming foreign tax credit in the country of residence. The main goal of the chapter is to tease out the conceptual challenge of identifying inter-nation equity without suggesting any specific mechanism or process by which it might conceivably be resolved.

The chapter proceeds as follows. Part 2 provides a brief overview of the concept of inter-nation equity in terms of the allocation of the international tax base and a modest element of redistribution of the tax base among nations. Part 3 makes the case for taking inter-nation equity seriously in current international tax reforms. Part 4 demonstrates that a territorial system of taxing business profit is more equitable in sharing the tax base between the source country and the residence country of the capital owner. It also demonstrates that a well-designed tax-sparing system can function as a meaningful redistribution system among countries. The chapter ends with some general conclusions.

2.0 Inter-nation Equity

2.1 The Concept

Peggy Musgrave adopted the term 'inter-nation equity' in her work published in the 1960s. In *United States Taxation of Foreign Investment Income* (1969)[5] she writes that 'international revenue sharing, as an aspect of the taxation of foreign investment, is a matter of inter-nation equity,' and that '[a]lthough this problem is of little interest to the private investor, it is a major concern of the countries involved.'[6] Over the years, inter-nation equity has been variously described by Peggy and/or Richard Musgrave as an 'equitable division of the tax revenue between

countries,'[7] 'the problem of tax shares in international business,'[8] and an equitable 'allocation of national gain and loss.'[9] For their part, legal scholars have described inter-nation equity as the 'distribution among countries of the competence to tax,'[10] and have noted that '[a] major goal of international tax rules should be to provide each country of the world with a fair share of the tax revenues available from income generated by transnational activities of domestic and foreign taxpayers.'[11]

As such, inter-nation equity differs from the other, and better known, notion of 'equity' in the sense of inter-individual equity based on the ability-to-pay principle. Inter-individual equity is concerned with the sharing of the tax burden among taxpayers in a country (which can be understood as 'intra-nation equity'), whereas inter-nation equity is an international problem and is concerned with the sharing of the tax base among nations. Inter-nation equity also differs from international neutrality (capital-import or capital-export neutrality) and from international efficiency (see Chapter 4 in this volume). Peggy Musgrave defines international tax neutrality toward investment as 'a situation in which the pattern of taxation does not interfere with or affect the taxpayer's choice between investing at home and investing in foreign countries' and is 'called for in the interests of world efficiency in resource allocation.'[12] Leaving aside patriotism, taxpayers are directly affected by inter-individual equity and international neutrality, but not by inter-nation equity.

2.2 Tax Entitlement and the Allocation of the International Tax Base

According to Peggy Musgrave, the notion of 'national entitlements' is the basis for inter-nation equity. In her early work, Musgrave regarded inter-nation equity between home and host countries in terms of an equitable division of national gain and loss.[13] A taxpayer's income from foreign investment is part of the home country's national gain because the home country has an initial interest in all of its taxpayers' capital and income. An income tax imposed by a host country thus results in a national loss to the home country. Whether the home country also experiences a loss of revenue or 'treasury loss' depends on the method it uses to prevent double taxation. If the home country uses the exemption method or credit method, the host country's tax diminishes the home country's treasury, thus resulting in a national loss. The home country's national loss is a national gain to the host country.

Musgrave's recent work focuses more on the tax entitlements of both

the residence country and the source country and the notion of sovereignty. In discussing the tax entitlement of the residence country, she states that 'countries will wish to retain a degree of sovereignty over the tax treatment of the income-earning activities abroad of their residents.'[14] She advances several principles in support of the residence country's tax entitlements. One is economic allegiance: 'residents are held to owe tax allegiance in return for the rights and privileges that they receive as residents.' Another is the ability-to-pay principle: 'exercise of tax sovereignty over foreign source income is also necessary to achieve equitable tax treatment of resident taxpayers by making all income, wherever earned, subject to tax, consistent with the accretion principle.' A third is the benefit principle: 'as a payment for productivity-enhancing benefits provided by the country of residence to its own factors of production prior to transfer abroad and for the rights and privileges afforded the corporation by its country of registration.'[15] National interest also might be relevant in determining whether outflow of capital should be encouraged or discouraged. Ultimately, the residence country's tax entitlement is only residual. As a residual taxing authority, however, the residence country has control over the total tax burden of the foreign-source income of its resident taxpayers. An exemption system would leave the foreign income taxed solely by the source country, whereas a credit system could result in some tax payable to the residence country if the foreign tax is lower. In the absence of cooperation, the principal consideration in making the choice is equitability.

Source countries are entitled to tax income arising within their borders, including that accruing to foreign investors. Musgrave regards this entitlement to tax at source as 'the bedrock of most international tax treaties.'[16] A country is permitted 'to share in the gains of foreign-owned factors of production operating within its borders, gains that are generated in cooperation with its own inputs, whether they be natural resources, an educated or low-cost workforce, or proximity to a market.'[17] She rationalizes the source country's entitlements on the basis of economic rent – the source country's tax 'may be thought of as a national return to the leasing of these complementary factors to nonresident investors or temporary workers.' She also thinks of source-country tax in benefit terms, as a quid pro quo payment for cost-reducing, profit-enhancing services provided by the source country.[18]

Musgrave's formulation of inter-nation equity suggests that source entitlement and residence entitlement stand on equal footing. Any inter-nation tax conflicts should be resolved through international co-

ordination, as opposed to tax competition. Her primary issue in inter-nation equity is the source country's share of international income arising within its borders.

2.3 Inter-nation Redistribution

The notion of inter-nation equity emphasizes fair allocation of the tax base among countries. The Musgraves did raise a concern, however, about distributional consequences: '[w]ith a highly unequal distribution of resource endowments and per capita income among countries and in the absence of an adequate method for dealing with the problem, an appropriate pattern of tax-imposed national gains and losses might be used to secure some degree of adjustment.'[19] They suggested a mechanism for redistributing wealth internationally: an internationally agreed rate schedule for corporate tax and withholding tax wherein tax rates would relate inversely to per capita income in the source country and directly to per capita income in the residence country.[20]

The Musgraves did not provide any theoretical foundation for inter-nation redistribution but, in recent years, John Rawls's theory of justice has been applied to inter-nation distributive justice despite Rawls's own reticence in this regard. His central argument for domestic distributive justice is that individuals should not be disadvantaged on account of arbitrary factors such as their social class, natural endowment, or misfortune.[21] Global egalitarians add that neither should individuals be at a disadvantage due to an accidental fact such as their country of birth.[22] If distributive justice is motivated by the need to mitigate the effects of contingencies that are 'arbitrary from a moral point of view' on people's life chances, this also presents a consideration for global distributive justice.[23] Some legal scholars recognize that globalization has increased the need for inter-nation redistribution and argue that there appears to be no sound theoretical reason to restrict redistribution to members of any single tax jurisdiction.[24] Others argue, however, that effective redistribution needs a world government;[25] in the absence of such world government, however, a systematic redistribution is unlikely.[26] Nonetheless, redistribution among nations is becoming an increasingly important concern, and the tax system has a role to play.

3.0 Why Should Equity Be Taken Seriously Now?

Inter-nation equity, in terms of allocating the international base in accordance with each country's tax entitlements and redistributing na-

tional income in accordance with distributive justice, should be taken seriously in international tax reforms for two main reasons. First, it provides an important, and perhaps superior, policy framework than the principle of neutralities to guide future reforms. Second, inequities in the international tax system are difficult to justify, let alone perpetuate, in the age of globalization. Inter-nation equity provides both a rationale and a goal for reforms to reduce such inequities. The beginning of the new millennium is the right time to act.

3.1 Important Policy Criteria

Tax equity has been an important policy objective in domestic income tax policy. However, recent proposals for reform of the international tax system coming from Australia, Canada, New Zealand, the United Kingdom, and the United States have focused on economic efficiency, almost to the exclusion of all other values, as a criterion for international tax policy.[27] For example, the Advisory Panel on Canada's System of International Taxation suggests the policy framework should include attractiveness to foreign investment, competitiveness, simplicity, and fairness (see Chapter 1 in this volume). It recognizes that the theories of capital-export neutrality (CEN), capital-import neutrality (CIN), and capital-ownership neutrality (CON) might influence the choice between an exemption system and a foreign-tax-credit system (see also Chapters 2 and 5 in this volume). Recent debates about the two systems have been described as the 'Battle of the Neutralities';[28] for its part, the Advisory Panel expresses a preference for the exemption system over the credit system, mainly on the grounds of CIN and CON.[29]

Relying on CEN, CIN, and CON as guiding principles for international tax policy, however, suffers from several shortcomings. First, as the Advisory Panel recognizes, 'fulfilling the three neutrality standards with a single set of tax rules is impossible.'[30] Either a credit system or an exemption system violates at least one of the principles.

Second, the conflicts between CEN and CIN/CON cannot be reconciled in the absence of harmonization of every country's tax rates. Canada's 1966 Royal Commission on Taxation (the Carter Commission) argued that neutrality requires tax harmonization between nations so that each individual is unaffected, from a tax viewpoint, by citizenship, residence, and the locations of property, business, and employment.[31] Of course, such harmonization is possible only if all countries provide the same public expenditures mix, finance with the same taxes at the same rates, and adjust the taxes simultaneously. Since at least one of

these criteria is unlikely to be met in practice, international neutrality cannot be achieved. Even if tax harmonization were possible, the Commission noted, tax revenues still must be allocated between source and destination countries, and in a world of other distortions international neutrality might not be a sensible goal.[32]

Third, there are disagreements as to what is needed to satisfy CIN or CEN. Traditionally, CEN is considered satisfied by the accrual-taxation or deferral-plus-credit system,[33] and CIN is satisfied by the exemption system. Recently, some scholars have argued that exclusive source-based taxation (or territorial taxation) 'seems to be a theoretically, practically, and politically superior means for achieving CEN.'[34]

Fourth, the practical implications of CIN and CEN are not as significant as they appear. OECD countries generally impose some sort of accrual taxation of foreign portfolio income similar to Canada's foreign-accrual-property-income (FAPI) system. The apparent difference between a deferral-plus-credit (CEN-based) system and an exemption (CIN-based) system results in little real difference if foreign business income earned through a foreign corporation is not repatriated – that is, if the deferral lasts long enough. In certain circumstances, because of the time value of money, the credit system produces tax results that are better than the exemption system.[35]

Therefore, the neutrality principles justify almost any proposal of reform; as Edward Kleinbard notes, 'every traditional discussion concludes by asserting that whatever policy is being proposed represent a fair balance between those two irreconcilable objectives [CIN and CEN], in every case based largely on the author's preexisting intentions.'[36]

In contrast, the ability-to-pay and tax-entitlement principles that underlie inter-nation equity are more coherent internally and offer a more rational framework for the debate. For example, ability-to-pay has been accepted as a guiding principle in the development of personal income taxation, even though the level of progressivity might be controversial. Furthermore, tax entitlement (although much less debated in the tax literature) forms the bedrock of the current tax treaty network.[37] At a minimum, the ability-to-pay and tax-entitlement principles should be considered.

3.2 Equity as a Benchmark for Reducing International Tax Inequities

Inter-nation equity can function as a benchmark for measuring inequities in the current international tax system. These inequities have been well identified in the literature – for example, Easson noted that the

tax treaty rules have been developed by the major capital-exporting countries and operate to the prejudice of capital-importing and developing countries.[38] Indeed, the bias against capital-importing countries is evident in the history of the world's tax treaties.[39] Originally these treaties were developed – largely by OECD countries – primarily to eliminate double taxation in order to facilitate cross-border trade and investment. Treaty rules have the appearance of fairness because they are reciprocal, but between a developing and a developed country such reciprocity exists only in name, because the developing country is a net-capital-importing country. As such, any limitation on source taxation reduces the capital-importing country's tax base.[40] In the case of business income and income from real estate, where the tax entitlement of a source country is overwhelmingly strong, inter-nation equity would require exclusive taxation of such income in the source country.

As Peggy Musgrave argues, some redistribution of income between countries is necessary in order to reduce the inequity that results from allocating the international tax base in accordance with tax entitlements because of the unequal natural endowments of, for example, resources.[41] Indeed, the need for such international redistribution is increasing because of the growing income gap between high- and low-income countries. International inequity is evidenced by the fact that 23 per cent of the world's inhabitants absorb a whopping 82 per cent of the world's wealth as measured by gross domestic product, leaving 77 percent of the world to divide the remaining 18 percent of wealth.[42] As Brian Barry notes, such inequity 'dwarfs into relative insignificance' the domestic distributive problem.[43] Since income tax has been used as an effective instrument for redistributing income at a national level through progressive taxation and various social tax expenditures, international income tax policy could be used as a distributive instrument, albeit at a modest level. Tax treaties are able to redistribute the tax base through a high-income (residence) country's transferring its jurisdiction to tax to a low-income (source) country (by, for example, imposing high withholding tax rates for investment income or granting a tax sparing).

3.3 *An Opportune Time*

The wheels of international tax reform churn slowly. At the beginning of the new millennium, however, there appear to be forces that might speed up the reform. One force is the increasing influence of the OECD

as a de facto world tax organization.[44] The OECD can play a significant role in coordinating the domestic tax policies of its member countries, but its influence goes far beyond its membership. Through providing technical assistance to non-member countries (such as China), maintaining and updating the OECD Model and Commentaries, developing transfer-pricing guidelines, and publishing policy papers, the OECD exerts a great deal of influence on the tax policies of non-member countries. Should the OECD recognize the importance of inter-nation equity, it could mobilize forces to do something about it.

Another force for change is domestic tax reform. Major reform initiatives in Canada and other OECD countries are likely to shift the system of taxing foreign business profits towards an exemption or territorial system, which, as discussed below, should have positive implications for inter-nation equity. Recent developments in corporate tax reform in the EU suggest that equity and fairness in sharing the international corporate tax base is being taken seriously.[45] Moreover, tax reforms in low-income, capital-importing countries demonstrate a maturing of their international tax policy. For example, at the beginning of 2008, China abolished tax incentives that were designed in the 1980s and 1990s to attract FDI and replaced them with general lower rates and tax incentives designed to promote sustainable economic development (see Chapter 3 in this volume).[46] The new Chinese tax law also emphasizes the protection of the tax base through specific and general anti-avoidance rules (including transfer pricing and thin capitalization) as well as defining the Chinese source of income on the basis of economic activities to reflect the Chinese view of tax entitlement.

There is also an emerging body of tax scholarship on inter-nation equity,[47] where the principle has been applied to the analysis of international tax problems such as the taxation of corporate income,[48] tax jurisdiction,[49] tax sparing,[50] and redistribution across borders.[51] Some of these academic insights could be translated into reforms of domestic and or treaty law to achieve more equity.

4.0 Tax Reforms towards Inter-nation Equity

4.1 The Role of High-Income Countries

Any improvement in inter-nation equity should be initiated and supported by capital-exporting countries because they have both the obligation and the ability to do so. There is a growing awareness that the

North-South divide 'lies at the heart of the rich world's current troubles, including terrorism, immigration pressures, and environmental threats.'[52] These global problems cannot be resolved by the South alone. Indeed, United Nations members have agreed unanimously that inequities must be addressed internationally, and have pledged to achieve the UN's Millennium Development Goals by 2015. Although developed countries have not fulfilled their obligations, there is no denying that they recognize the need for global justice and intend to do something about it (see Chapter 8 in this volume); moreover, reducing inequity ultimately will serve their own interests as well. Many developed countries are sympathetic to the claim for more source-based taxation by developing countries and have adopted the provisions of the UN Model Convention to various degrees, including those on tax sparing.

Low-income countries have not played any meaningful role in developing the current international tax system, and have no institution, such as the OECD, that can represent their tax interests effectively – the United Nations has not functioned as a world tax organization in any sense. Moreover, low-income countries compete with each other in offering tax incentives to FDI,[53] even if the effectiveness and efficiency of many tax incentives are doubtful. It seems difficult for these countries, as a group, to end the race-to-the-bottom type of tax competition on their own. One bright note is the OECD's initiative on harmful tax competition, which, although motivated mostly out of the self-interest of its member countries, seems to have encouraged some tax-haven countries to cooperate with OECD member countries (see Chapters 2 and 7 in this volume).[54] In terms of actually implementing reforms, however, only developed countries have the capacity. As mentioned earlier, the OECD is the closest thing we have to an international tax organization:[55] OECD member countries provide homes for about three-quarters of the world's multinational enterprises and their citizens account for well over half of the world's income and wealth. In short, 'the rich hold the key to taxation reform.'[56]

4.2 Territorial Taxation of Business Income

The current system of international taxation recognizes the tax entitlement of the source country in respect of business profits derived from activities carried on in that country. Foreign business profits earned directly by a domestic corporation are taxable in the source country under bilateral treaties to the extent that they are attributable to a per-

manent establishment in the source country.[57] Whether such profits are taxed again in the residence country depends on that country's domestic tax law (see also Chapters 4 and 5 in this volume). In 'credit' countries (such as Australia, Canada, Japan, the United Kingdom, and the United States), the profits are taxable, subject to a foreign tax credit for the source country's tax.[58] In 'exempt' countries (mostly in continental Europe), such profits are exempt from domestic taxation. As a result, the only difference between the credit system and the exempt system is whether the residence claims 'residual' taxation over the foreign business profits. Therefore, if the residence country adopts a credit system and limits the credit to the amount of domestic tax otherwise payable, it implicitly allows the source country to tax income at the 'soak-up' rate – that is, a rate equal to that in the residence country. If the residence country adopts an exemption system, it gives the source country exclusive jurisdiction to tax.

Where foreign business profits are earned through a foreign corporation owned by domestic residents, such profits are taxable solely in the source country. The residence country of the shareholder does not tax such profits on a current basis, irrespective of whether the country has a credit system or an exempt system. However, when the profits are repatriated to the shareholders by way of a dividend, the taxation of the dividend differs between a credit-system country and an exempt-system country. The former would tax the dividends, subject to a direct and indirect foreign tax credit for the foreign dividend withholding tax and underlying corporate income tax. The latter would exempt the dividends from domestic taxation. Canada has a hybrid credit-and-exemption system: the latter applies only to business profits earned in a treaty country. However, the credit or exempt treatment is limited to the corporate shareholder of the foreign corporation. When the domestic parent corporation distributes the dividends received from its foreign subsidiary to individual shareholders, the dividends are generally taxable under personal income tax. In this sense, both credit and exempt countries share the taxation of business profits, albeit on a deferred basis, by taxing individual shareholders on the repatriated profits.

The exemption system is gaining support in economic literature and is a feature of many international tax reform recommendations in Australia, Canada, New Zealand, United Kingdom, and the United States (although more recent U.S. tax reforms recommend strengthening residence-based taxation; see Chapters 1 and 3 in this volume). In principle, the exemption system allows business profits to be subject to

territorial taxation, which is consistent with the tax-entitlement theory and promotes inter-nation equity. Business profits earned in the source country are taxed exclusively at source at the corporate level and again at the individual shareholder level in the residence country. Assuming that the source rules and allocation rules are designed to reflect the economic origin of business profits, the countries that are entitled to tax such profits (that is, the source country and the residence country of the individual investor) share the taxation of business profits. One drawback of a territorial tax system, however, is the risk of encouraging tax competition among source countries, because the level of corporate tax is determined exclusively by the source country.[59] A territorial system allows the foreign investor to benefit directly from the tax incentives granted by a source country, whereas a credit system 'cancels' the benefits of tax incentives by taxing the business profits in the absence of a tax-sparing credit.

Although territorial taxation of business profits would promote inter-nation equity, the same cannot be said of territorial taxation of investment income.[60] The tax-entitlement claims of the source country over investment income are not nearly as strong as over business income – in fact, the residence country of the investor has a much stronger claim. The goal of inter-nation equity would be met, however, if the residence country has the dominant, if not exclusive, tax claim over international portfolio income. As such, the Canadian FAPI regime, the U.S. Subpart F regime, and similar anti-deferral or imputation systems of taxing foreign passive income earned by controlled foreign corporations do not violate inter-nation equity.[61]

4.3 Tax Sparing as a Mechanism of International Redistribution

As a credit for foreign taxes deemed paid for the purposes of claiming foreign tax credit in the residence country (see also Chapter 10 in this volume), a tax-sparing credit naturally is relevant only when the residence country adopts a credit system of taxing foreign income. If the residence country adopts a territorial system of taxation for business profits, the tax-sparing credit would be relevant only in the case of international portfolio income. Otherwise, it would be relevant for both foreign business income and portfolio income.

The country that grants a tax-sparing credit recognizes the tax entitlement of the source country and supports the use of tax incentives by forgoing its residual tax claim over the income that was exempt from tax

in the source country. In other words, this is a cross-border tax subsidy that explicitly benefits the taxpayer who invests in the source country, but implicitly benefits the source country by, in effect, subsidizing the investment. Because a tax-sparing credit is generally given by a high-income capital-exporting country to a low-income capital-importing country through treaty negotiations, it can be viewed as international redistribution mechanism.

There is a significant debate about the merits of tax-sparing credits. The mechanism has been criticized for its lack of transparency and accountability, the potential for abuse, and lack of a sunset clause.[62] These criticisms, however, seem to point to technical design issues, not to the theoretical rationale. In fact, until an explicit international redistribution system is established, abolishing tax sparing would remove the only mechanism we have of international redistribution.[63] Instead of abolishing tax sparing, capital-exporting countries should redesign the mechanism to deliver aid more effectively to 'worthy' countries in respect of worthy investment activities.[64] For example, tax sparing could be targeted at the incentives used to jump start an economy in the form of FDI or the transfer of technology. Such a mechanism would be an effective way of assisting developing countries without unduly encouraging harmful tax competition.

5.0 Conclusions

One can draw a number of conclusions from the discussion in this chapter. First, although inter-nation equity – in the sense of sharing the international tax base fairly – is the foundation of the current international tax system, the system exhibits significant inequities towards net-capital-importing countries. Moreover, inter-nation equity in the sense of redistribution among nations has not been taken seriously. Second, inter-nation equity, in theory, does not adversely affect either the allocation of resources or investors' behaviour; therefore, there appear to be no sound reasons to regard world tax efficiency and world tax equity as mutually exclusive. Third, in the age of globalization, many international problems can be addressed effectively only by international efforts. To that end, as part of the international legal system, the tax system has a role to play. High-income countries have both the means and the obligation to affect changes to the international tax system – including adopting a territorial system of taxation and the use of effective tax-sparing credits – that would help to achieve equity.

Notes

* This chapter is dedicated to the memory of Professor Alex Easson, who supervised the author's LLM thesis and introduced her to the fascinating world of international tax research. This chapter benefits greatly from the comments received from participants in 'Globalization and the Impact of Tax on International Investments: A Symposium in Honour of the Memory of the Late Alex Easson' at Queen's University, 29 February 2008. The author thanks He Huang (LLM candidate) and Shane Latvick (BLG Fellowship) for their research assistance.

1 Alex J. Easson, *International Tax Reform and the Inter-Nation Allocation of Tax Revenue* (Wellington, NZ: Victoria University Press, 1991) at 20.

2 See, for example, Nancy Kaufman, 'Fairness and the Taxation of International Income' (1998) 29 Law and Policy in Int'l Bus. 145; Klaus Vogel, 'World-wide vs. Source Taxation of Income: A Review and Reevaluation of Arguments' in Klaus Vogel, ed., *Influence of Tax Differentials on International Competitiveness: Proceedings of the VIIIth Munich Symposium on International Taxation* (Deventer, Boston: Kluwer Law and Taxation Publishers, 1991) at 160–1; Jinyan Li, *Taxation in the Age of Electronic Commerce: A Comparative Study* (Toronto: Canadian Tax Foundation, 2003), chap. 12.

3 This has been noted by legal scholars such as J. Clifton Fleming, Jr, Robert J. Peroni, and Stephen E. Shay, 'Fairness in International Taxation: The Ability-to-Pay Case for Taxation of Worldwide Income' (2001) 5 Florida Tax Rev. 299; and Michael J. Graetz, 'Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfied Policies' (2001) 26 Brooklyn J. Int'l L. 1357.

4 For an overview of the literature on international tax neutrality, see James R. Hines Jr, 'The Case against Deferral: A Deferential Reconsideration' (1997) 52 Nat'l Tax J. 385; Fadi Shaheen, 'International Tax Neutrality: Reconsiderations' (2007) 27 Virginia Tax Rev. 203; and Mihir A. Desai and James R. Hines Jr, 'Evaluating International Tax Reform' (2003) 56 Nat'l Tax J. 487.

5 Peggy B. Musgrave, *United States Taxation of Foreign Investment Income: Issues and Arguments* (Cambridge, MA: Harvard Law School, 1969) at 130–3.

6 Ibid. at 130, 133.

7 Peggy B. Richman (Musgrave), *Taxation of Foreign Investment Income: An Economic Analysis* (Baltimore: Johns Hopkins Press, 1963) at 49; and Richard A. Musgrave, *Fiscal Systems* (New Haven, CT: Yale University Press, 1969) at 238.

8 Peggy B. Musgrave, 'International Tax Base Division and the Multinational

Corporation' (1972) 27 Pub. Fin. 394; idem, 'Interjurisdictional Equity in Company Taxation: Principles and Applications to the European Union' in Sijbren Cnossen, ed., *Taxing Capital Income in the European Union: Issues and Options for Reform* (Oxford: Oxford University Press, 2000) at 47–77; idem, 'Consumption Tax Proposals in an International Setting' (2000) 54 Tax L.Rev. 77; idem, 'Sovereignty, Entitlement, and Cooperation in International Taxation' (2001) 26 Brooklyn J. Int'l L. 1335; and idem, 'Combining Fiscal Sovereignty and Coordination: National Taxation in a Globalizing World' in Inge Kaul and Pedro Conceicao, eds., *The New Public Finance Responding to Global Challenges* (Oxford: Oxford University Press, 2006) at 167.

9 Peggy B. Musgrave and Richard A. Musgrave, 'Inter-Nation Equity' in Richard M. Bird and John G. Head, eds., *Modern Fiscal Issues* (Toronto: University of Toronto Press, 1972) at 68; and idem, 'Fiscal Coordination and Competition in an International Setting' in L. Eden, ed., *Retrospectives on Public Finance* (Durham, NC: Duke University Press, 1991) at 65–6.

10 Kaufman, 'Fairness and the Taxation of International Income'; and Vogel, 'World-wide vs. Source Taxation of Income.'

11 Brian J. Arnold and Michael J. McIntyre, *International Tax Primer*, 2nd ed. (The Hague: Kluwer Law International, 2002) at 4.

12 Musgrave, *United States Taxation of Foreign Investment Income* at 109.

13 See Musgrave and Musgrave, 'Inter-Nation Equity' at 70–1.

14 Musgrave, 'Combining Fiscal Sovereignty and Coordination' at 168.

15 Ibid.

16 Ibid. at 172.

17 Ibid.

18 Musgrave considers source-country tax competition as highly problematic for developing countries because of the damaging effects of such competition on domestic tax equity and badly needed tax revenue: 'The share of the tax base and the tax rate applied by source countries to income accruing to others should be viewed as a matter of international equity, calling for international cooperation' (ibid. at 173).

19 Musgrave and Musgrave, 'Inter-nation Equity' at 71–2.

20 Ibid. at 74. Peggy Musgrave further argues that such a scheme would be of particular interest in the relation between developed and developing countries; see 'Interjurisdictional Equity in Company Taxation' at 59.

21 John Rawls, *A Theory of Justice* (Cambridge, MA: Harvard University Press, 1971) at 15.

22 See Charles R. Beitz, *Political Theory and International Relations* (Princeton, NJ: Princeton University Press, 1979), part III; Thomas W. Pogge, *Realizing Rawls* (Ithaca, NY: Cornell University Press, 1989), part III. See also Allen

Buchanan, *Justice, Legitimacy, and Self-Determination: Moral Foundations for International Law* (Oxford: Oxford University Press, 2004), chap. 4; Simon Caney, *Justice Beyond Borders: A Global Political Theory* (Oxford: Oxford University Press, 2005); and Koh-Chor Tan, 'The Boundary of Justice and the Justice of Boundaries: Defending Global Egalitarianism' (2006) 19 Can. J.L. & Jurisprudence 319.

23 Tan, 'The Boundary of Justice.' Anti-global distributive justice scholars do not reject the duty of humanitarian assistance or the duty of rescue, and denounce the current global economic arrangement as unacceptable because many people continue to be deprived of basic and urgent needs under this arrangement. However, they argue that the boundary of distributive equality is inherently limited by the boundaries of states. See, for example, Richard W. Miller, 'Cosmopolitan Respect and Patriotic Concern' (1998) 27/3 Phil. & Pub. Affairs 202; David Miller, 'Against Global Egalitarianism' (2005) 9 J. Ethics 55; Thomas Nagel, 'The Problem of Global Justice' (2005) 33 Phil. & Pub. Affairs 113; John Rawls, *The Law of Peoples* (Cambridge, MA: Harvard University Press, 1999), part III; and Samuel Freeman, *Justice and the Social Contract: Essays on Rawls* (New York: Oxford University Press, 2006). See also Jim Chen, 'Fugitives and Agrarians in a World without Frontiers'(1996) 18 Cardozo L.Rev. 1031 at 1040 ('The nation state ... excels at *redistributing* wealth through complex decisions to tax and to subsidize'); and Edward B. Foley, 'The Elusive Quest for Global Justice' (1997) 66 Fordham L.Rev. 249 at 260 ('[T]he demands of global justice can never be as extensive as the demands of social justice within each nation-state').

24 See, for example, Michael A. Livingston, 'Blum and Kalven at 50: Progressive Taxation, "Globalization," and the New Millennium' (2000) 4 Florida Tax Rev. 731. See also Reuven Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State' (2000) 113 Harvard L.Rev. 113 1649; and Karen B. Brown, 'Can Cross-Border Distribution Serve the Caribbean Region?' (14 November 2007), online: <http://taxprof.typepad.com/taxprof_blog/2007/11/brown-delivers-.html> (arguing that cross-border tax policy should encompass cross-border distributive justice goals). A similar sentiment was expressed by Easson in *International Tax Reform*.

25 Some argue that it is not even desirable to have a world government because it would likely become a dictatorship. In the absence of a world government, the freedom, independence, and economic welfare of people vary from nation to nation; see Graetz, 'Taxing International Income at 278.

26 There is no global authority or government to enforce the terms of distributive justice in the global arena. As Tan notes, 'covenants, without the sword, are but words' ('The Boundary of Justice' at 322).

27 See, for example, Australia, Department of the Treasury, 'Review of International Taxation Arrangements: A Consultation Paper' (Parkes, NSW: Department of Treasury, 2002); Canada, Advisory Panel on Canada's System of International Taxation, *Enhancing Canada's International Tax Advantage* (Ottawa: Department of Finance, 2008); New Zealand, Inland Revenue Department, Policy Advice Division, *New Zealand's International Tax Review: A Direction for Change* (Wellington: Inland Revenue Department, 2006); idem, Inland Revenue Department, Policy Advice Division, and New Zealand Treasury, *New Zealand's International Tax Review: Developing an Active Income Exemption for Controlled Foreign Companies* (Wellington: Inland Revenue Department, 2007); United Kingdom, HM Treasury and HM Revenue and Customs, 'Taxation of Companies' Foreign Profits: Discussion Document' (London: HM Treasury, 2007); and United States, Department of the Treasury, Office of Tax Policy, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century* (Washington, DC: Department of the Treasury, 2007). For an overview, see Sandra Slaats, 'Financing Foreign Affiliates: An Overview of the Canadian Proposals and the Rules in Selected Countries' (2007) 55 Can. Tax J. 676. The focus on neutralities and competitiveness in international tax reform can be traced to the 1960s, when the current U.S. Subpart F rules were debated, which provided a blueprint for other OECD countries' controlled foreign corporation rules.

28 This term is borrowed from Edward D. Kleinbard, 'Throw Territorial Taxation from the Train' (2007) 114 Tax Notes 547 at 555.

29 CEN generally requires current taxation of foreign income with a full credit for foreign taxes paid. To the extent that foreign taxes are less than domestic tax, the tax base is shared between the source country and the residence country of the shareholder. CIN and CON call for the primary or exclusive taxation of business income in the source country. This is often referred to as the 'exemption' system or territorial system. In practice, no country has adopted a pure credit system or a pure exemption system. The mix of the two systems attempts to balance between CEN and CIN/CON.

30 Canada, Advisory Panel on Canada's System of International Taxation, *Enhancing Canada's International Tax Advantage* at 11.

31 Canada, Royal Commission on Taxation, *Report*, vol. 4 (Ottawa: Queen's Printer, 1966) at 483–4, 491–6.

32 Ibid.

33 See Musgrave, *United States Taxation of Foreign Investment Income* at 121 (arguing that only unlimited foreign tax credit system satisfies CEN). Others have defended 'deferral plus credit' (with limitations) on grounds of CEN; see, for example, United States, Department of the Treasury, *The Deferral*

of Income Earned through U.S. Controlled Foreign Corporations: A Policy Study (Washington, DC: Department of the Treasury, 2000) at 23–6.

34 According to Shaheen, the pure residence-based worldwide taxation system satisfies CEN only when global uniformity with respect to tax systems is achieved ('International Tax Neutrality' at 225–8).

35 See Lawrence Lokken, 'Territorial Taxation: Why Some U.S. Multinationals May Be Less than Enthusiastic about the Idea (and Some Ideas They Really Dislike)' (2006) 59 S.M.U. L.Rev. 751 (discussing why the credit system often allows U.S. multinational corporations to achieve U.S. tax results more favourable than they could obtain under an exemption system). Lokken attributes such favourable results to the numerous tax-minimization techniques used by U.S. corporations, including one to separate foreign income taxes from income on which those taxes were imposed through the use of hybrid entity under check-the-box rules.

36 Kleinbard, 'Throw Territorial Taxation from the Train' at 555.

37 Peggy G. Musgrave, 'The OECD Model Tax Treaty: Problems and Prospects' (1975) 10 Columbia J. World Bus. 29.

38 Easson, *International Tax Reform* at 20. This view is consistent with observations in the general regulatory competition literature that states seeking to form international regimes might purchase consensus among key actors through biasing the distribution of benefits and burdens to their advantage; see Robert O. Keohane, *Power and Governance in a Partially Globalized World* (Routledge: London, 2002).

39 Tax treaties are primarily based on the OECD Model, which itself was largely based on the structure and concepts developed by the League of Nations. See, for example, Frank J. Garcia, 'Trade and Inequality: Economic Justice and the Developing World' (1999) 21 Mich. J. Int'l L. 975 at 982–4. For League of Nations and Organisation for European Economic Co-operation (predecessor of the OECD) material on income tax conventions, see United States, Joint Committee on Internal Revenue Taxation, *Legislative History of United States Tax Conventions* (Washington, DC: U.S. Government Printing Office, 1962), vol. 4, 'Model Tax Conventions,' online: <http://setis.library.usyd.edu.au/oztexts/parsons.html>, items 3 and 4.

40 To achieve inter-nation equity, Peggy Musgrave suggests that reciprocity should apply to both withholding taxes and business profits tax ('Combining Fiscal Sovereignty and Coordination' at 176).

41 Ibid.

42 See Thomas Franck, *Fairness in International Law and Institutions* (Oxford: Oxford University Press, 1995) at 413–4. More recent studies confirm that the income gap between the world's rich and poor countries is persistent

and widening; see, for example, Donghyun Park, 'Trends in the Income Gap between Developed Countries and Developing Countries, 1960–1995,' Nanyang Business School Working Paper 09-99 (Singapore: Nanyang Technical University, 1999), online: <http://www3.ntu.edu.sg/nbs/sabre/working_papers/09-99.pdf>.

43 Brian Barry, *The Liberal Theory of Justice* (Oxford: Clarendon Press, 1973) at 129–30. Since income taxation has been a major tool of redistribution in a domestic context in developed countries, in the age of globalization it is worth exploring ways of using the income tax system to achieve international distributive justice.

44 See Arthur J. Cockfield, 'The Rise of the OECD as Informal "World Tax Organization" through National Responses to E-Commerce Tax Challenges' (2006) 8 Yale J.L. & Tech. 136.

45 See, for example, Joann Martens-Weiner, *Company Tax Reform in the European Union: Guidance from the United States and Canada on Implementing Formulary Apportionment in the EU* (New York: Springer-Verlag New York, 2007).

46 See Jinyan Li, 'Fundamental Enterprise Income Tax Reform in China: Motivations and Major Changes' (2007) 61 Bulletin for Int'l Fiscal Documentation 519; and Jinyan Li and He Huang, 'The Transformation of Chinese Enterprise Income Tax: International Tax Norms Hybridized with Chinese Innovations and Traditions' (forthcoming) 62 Bulletin for Int'l Fiscal Documentation.

47 See works cited in notes 1 and 2.

48 See, for example, Mitsuo Sato and Richard Bird, 'International Aspects of the Taxation of Corporations and Shareholders' (1975) 22 International Monetary Fund Staff Papers 384; Hugh Ault, 'Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices' (1991) 47 Tax L.Rev. 565; and Anne Schäfer and Christoph Spengel, 'The Impact of ICT on Profit Allocation within Multinational Groups: Arm's Length Pricing or Formula Apportionment?' Discussion Paper 03-53 (Mannheim, Germany: Centre for European Economic Research, 2003) at 6–7.

49 See, for example, Kaufman, 'Fairness and the Taxation of International Income'; and Vogel, 'World-wide vs. Source Taxation of Income.'

50 Deborah Toaze, 'Tax Sparing: Good Intentions, Unintended Results' (2001) 49 Can. Tax J. 879 (stating that, since the late 1960s and early 1970s, most OECD members have included tax-sparing provisions in at least some of their tax treaties, on the basis that it is a component of an overall foreign aid policy aimed at promoting industrial, commercial, and scientific activi-

ties in developing countries). See also Joseph P. Crockett, 'Tax Sparing: A Legend Finally Reaches Print' (1958) 11 Nat. Tax J. 146; Damian Laurey, 'Reexamining U.S. Tax Sparing Policy with Developing Countries: The Merits of Falling in Line with International Norms' (2000) 20 Virginia Tax Rev. 467; and Samuel C. Thompson, Jr, 'The Case for Tax Sparing Along with Expanding and Limiting the Subpart F Regime' (2003) 35 Geo. Wash. Int'l L.Rev. 303.

51 See, for example, Avi-Yonah, 'Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State'; Brown, 'Can Cross-Border Distribution Serve the Caribbean Region?'; and Easson, *International Tax Reform*.

52 Reuven S. Avi-Yonah, 'Bridging the North/South Divide: International Redistribution and Tax Competition' (2004) 26 Mich. J. Int'l L. 371 at 371.

53 See Yoram Margalioth, 'Tax Competition, Foreign Direct Investments and Growth: Using the Tax System to Promote Developing Countries' (2003) 22 Virginia Tax Rev. 161; Avi Nov, 'Tax Incentives to Entice Foreign Direct Investment: Should There Be a Distinction between Developed Countries and Developing Countries?' (2004) 23 Virginia Tax Rev. 685; idem, 'The "Bidding War" to Attract Foreign Direct Investment: The Need for a Global Solution' (2006) 25 Virginia Tax Rev. 835.

54 For example, the OECD's position may have some influence on the elimination of Chinese tax incentives earmarked for foreign investors; see Jinyan Li, 'The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates' CLPE Research Paper 5/2008 (Toronto: Osgoode Hall Law School, York University, 2008).

55 A similar view is expressed by Cockfield, 'The Rise of the OECD as Informal "World Tax Organization".'

56 Robert T. Kudrle and Lorraine Eden, 'The Campaign against Tax Havens: Will It Last? Will It Work?' (2003) 9 Stanford J.L.Bus. and Fin. 37.

57 OECD Model Convention, art. 7.

58 For an overview, see Peter Mullins, 'Moving to Territoriality? Implications for the United States and the Rest of the World' IMF Working Paper WP/06/161 (Washington, DC: International Monetary Fund, 2006).

59 Peggy Musgrave recognizes this problem and suggests more international coordination; see 'Sovereignty, Entitlement, and Cooperation in International Taxation.'

60 Drawing the line between business profits and investment income is extremely difficult in some cases. It is beyond the scope of this paper to explore this issue fully.

61 In addition, such regimes enhance inter-nation equity from the perspective of the residence country that adopts the ability-to-pay principle; see

Clifton Fleming, Jr, Robert J. Peroni, and Stephen E. Shay, 'Fairness in International Taxation: The Ability-to-Pay Case for Taxation Worldwide Income' (2001) 5 Florida T. Rev. 299.

62 OECD, *Tax Sparing: A Reconsideration* (Paris: OECD, 1998). For more discussion, see Toaze, 'Tax Sparing.'

63 In terms of redistribution from high-income residence to low-income source countries, it was suggested that, where a source country taxes the profit from a foreign investment but provides no relief for the loss, there is an implicit transfer from the residence country to the source country. The residence country bears the burden of recognizing the loss. The divergence between the tax treatment of the profit (where the source country taxes the upside of a risky investment while the residence country bears the burden of relief for the downside) is a crude tool for directing implicit transfers to the neediest recipients, and favours net capital importers. Another example of implicit wealth transfers to poor countries is where a developed country's tax policy encourages research and development that might lead to the discovery of, say, new drug treatments that ultimately are shared with poorer nations under a favourable pricing regime. See Michell Kane, 'Risk and Redistribution in Open and Closed Economies' (2006), online: <http://taxprof.typepad.com/taxprof_blog/files/Kane.doc>.

64 See, for example, Flemming, Peroni, and Shay, 'Fairness in International Taxation' at 344–6; and Thompson, 'The Case for Tax Sparing.'

7 Harmonizing Corporate Income Taxes in the United States and the European Union: Legislative, Judicial, Soft-Law, and Cooperative Approaches

CHARLES E. McLURE, JR*

1.0 Introduction

In an age of globalization, differences in national tax systems can distort cross-border investment decisions. This problem may be especially serious when countries are closely linked under regional economic integration.

Indeed, the existence of 27 distinct national corporate tax systems based on separate accounting and the arm's-length standard (SA/ALS) poses serious obstacles to the creation of a single market within the European Union (EU). These include complexity, manifested especially – but not only – in the need to document and monitor transfer prices, the possibility of double taxation, and the general inability to offset losses incurred in one member state against income earned in another. Moreover, income can be shifted from member states where it would be taxed relatively heavily to others where it would be taxed more lightly.[1] In addition, the European Court of Justice has found that, *as implemented by some Member States*, certain common features of Member State tax systems, including some often associated with SA/ALS (such as thin-capitalization rules, imputation systems, and exit taxes) are inconsistent with a single market.

To overcome these obstacles, the European Commission has suggested that EU Member States consider adopting a Common Consolidated Corporate Tax Base (CCCTB).[2] Under the CCCTB, a group of related companies could opt to use a formula to divide the group's consolidated income among the Member States where the group operates in proportion to the fraction of the group's economic activity occurring there. Taxable income, the consolidated group, and the apportionment

formula would be defined uniformly throughout the EU. Jurisdiction to tax is generally not addressed in discussions of the CCCTB, it apparently being assumed, usually implicitly, that it would continue to be based on the existence of a permanent establishment. Tax harmonization is not intended to encompass harmonization of statutory tax rates.[3] It is widely assumed that it would be impossible to achieve the unanimous vote of all Member State representatives to the Council of the European Union required to adopt the CCCTB. Thus, the European Commission has suggested that a subset of Member States might adopt the CCCTB through 'enhanced cooperation,' which allows as few as nine Member States – eight before the Lisbon Treaty became effective in December 2009 – to agree formally to 'go faster.'[4] Some might wonder whether 'soft-law' approaches, which underlie some recent Commission tax initiatives, might be used to achieve harmonization. The next section examines the possibility of employing legislative, judicial, and soft-law approaches or enhanced cooperation to harmonize corporate income taxes in the EU.

In the United States, as in the Canadian provincial context, state taxation of most corporate income has long been based on formula apportionment. The EU has thus looked to U.S. experience for lessons regarding how to structure the CCCTB.[5] The feature of U.S. state corporate income taxes that perhaps most surprises European observers – and one not to be emulated – is the extent to which these taxes are not harmonized. Section 3 describes whether and how legislative, judicial, and cooperative approaches have – or have not – been used to harmonize corporate income taxes.[6] The final section offers a summary comparison and commentary on the situation in the EU and the United States.

2.0 Corporate Tax Harmonization in the EU

2.1 Potential Means of Harmonization

Legislation. Under Article 94 of the Treaty Establishing European Community (EC Treaty), the Council of the European Union, in theory, could adopt directives that would harmonize the corporate income taxes of Member States. But, because that article requires unanimous agreement on tax provisions to be applied throughout the EU and a number of Member States (notably Ireland and the United Kingdom, but also Cyprus, Latvia, Lithuania, Malta, and Slovakia) have expressed opposi-

tion to the CCCTB, there is little hope that the Council would enact a directive mandating the CCCTB.

Judicial decisions. While the European Court of Justice has achieved a degree of proscriptive harmonization by outlawing certain tax practices, proscription can never create a truly harmonized system, as that would require the Court to legislate on the myriad details that comprise a tax code. Moreover, the Court reacts passively to cases brought before it; it does not take the initiative in harmonization. Thus, the European Commission has suggested resort to enhanced cooperation.

Soft law. Before turning to enhanced cooperation, it is convenient to dispose of 'soft law,' usefully defined as '[r]ules of conduct that are laid down in instruments which have not been attributed legally binding force as such, but nevertheless may have certain (indirect) legal effects, and that are aimed at and may produce practical effects.'[7] The best-known example of soft law in the tax field, the Code of Conduct on Business Taxation, involves proscriptive harmonization: the agreement of EU Member States not to engage in tax practices identified as harmful (see Chapter 2 in this volume). Soft law could not produce the detail and legal certainty required for the CCCTB, and Member States that oppose the CCCTB are unlikely to participate in a soft-law initiative to introduce it. Enhanced cooperation thus seems to offer the best – and perhaps the only – hope for introducing the CCCTB.

Enhanced cooperation. The European Commission has promised to produce a proposal for the CCCTB, but presumably does not expect the proposal to gain unanimous support. Thus, once the Council of the European Union has rejected the proposal, the Commission presumably will propose that enhanced cooperation be used to start the CCCTB ball rolling – provided it is asked by at least nine Member States to do so and believes that it can muster the qualified majority required to approve the exercise of enhanced cooperation. The Commission has created the CCCTB Working Group, composed of tax experts from Member States, to assist it in ironing out the many details of the CCCTB, including the crucial administrative details that economists seldom consider, and perhaps to build support for the CCCTB among member states. The Commission envisages use of the comitology procedure[8] to deal with many details, especially of procedure.

The role of the European Commission in tax policy. Under the EC Treaty, the Commission has sole responsibility for forwarding legislative proposals, including those for enhanced cooperation, to the Council of the European Union (or, regarding most non-tax issues, to the Council and the European Parliament). As 'guardian of the Treaties,' the Commission initiates infringement cases before the European Court of Justice, and may support the position of other (Member State or private) litigants. (It may argue that certain tax provisions violate the EC Treaty or that they constitute state aids.) The Commission has sometimes used this power to gain Member State support for initiatives or to induce harmonized solutions.

2.2 *Prospects for Enhanced Cooperation*

It is unclear whether nine or more Member States will favour adopting the CCCTB via enhanced cooperation and whether the required qualified majority of Member States will vote to allow it. After all, enhanced cooperation does not produce soft law that lacks binding legal effect; for Member States that choose to participate, laws enacted under enhanced cooperation are binding in the same way as directives, and they will cast a long shadow, likely forming the basis for future harmonization. Support may depend, *inter alia*, on the strength of business support for the CCCTB and the effects on revenues, output, and welfare that the various Member States expect to experience. These are likely to depend, in turn, on details such as the apportionment formula chosen and, especially, on whether corporate participation in the CCCTB is mandatory or voluntary, as mandatory participation would limit opportunities for tax planning – an issue of concern to some Member States as well as to taxpayers.

2.2.1 Business Support

A recent survey of tax officials of 403 large corporations doing business in more than one EU Member State suggests there is substantial business support for the CCCTB. Although details of the scheme have not been made public, 78 per cent of respondents favoured its adoption. Even in Ireland, whose government is adamantly opposed to the CCCTB, half or respondents favoured adoption. Only 15 per cent of interviewees thought harmonization would never occur, 66 per cent thought the CCCTB would be in place by 2015, and 85 per cent expect-

ed to see it by 2020.[9] Of course, it is one thing to view positively a pig in a poke and another actually to buy it. Once the European Commission has introduced its proposal, business support could change.

2.2.2 Revenue and Other Effects

Several attempts have been made to estimate the revenue effects of replacing the present system with the CCCTB. Unfortunately, while results of these studies show some qualitative similarity, quantitative estimates of revenue effects vary widely because of differences in methodologies, assumptions, and data. Moreover, for the most part, they attempt to estimate the revenue effects for each Member State and in the aggregate, assuming that all 27 participate. It would be more useful to know the revenue effects if only a limited number of Member States were to adopt the CCCTB via enhanced cooperation.

Using data on outbound foreign direct investment for German firms, employing an apportionment formula that accords equal weight to payroll, profits, and sales, and assuming mandatory corporate participation, one study estimates, for the 15 pre-2004 EU Member States, a 20 per cent aggregate loss of corporate tax base of the multinational companies in its sample. Belgium, Ireland, and the Netherlands are big losers, presumably because the CCCTB would limit income shifting. Other Member States are estimated to lose substantial amounts of revenue primarily because of the ability under the CCCTB to offset cross-border losses.[10]

Another study, however, analysing data from a sample of more than 400,000 EU companies, reaches quite different conclusions. It finds that aggregate revenues in 22 of the 25 pre-2007 Member States would fall by 2.5 per cent if corporate participation were voluntary and would increase by about 1 per cent if participation were mandatory.[11] (If, as proposed, corporate participation is optional, Member States almost certainly will experience revenue losses.) Using a similar methodology, still another study estimates aggregate revenues would fall by 4.45 per cent in 23 of the pre-2007 Member States if participation were compulsory and by 4.57 per cent if it were optional.[12]

Estimates of the effects on aggregate revenue are relatively insensitive to the choice of apportionment factors, but the estimated distribution of revenue changes among Member States is not – the inclusion of the number of employees in the apportionment formula being particularly important in this regard. Moreover, the estimated effects on the revenues of particular Member States, most notably Ireland and the Netherlands, depend crucially on whether corporate participation

is voluntary or mandatory. Under mandatory corporate participation, profits shifted to those Member States under SA/ALS would be apportioned among all member states. Corporations that currently shift large amounts of profits to avoid taxes presumably would not participate in the CCCTB if it were voluntary. But making corporate participation optional, while perhaps necessary for political reasons, would substantially reduce the benefits of the CCCTB, especially the reduction of income shifting.

Using a sophisticated computable general equilibrium model to estimate, for the 25 pre-2007 Member States, the effects on gross domestic product (GDP), welfare, and revenues of tax-base coordination with and without harmonization of tax rates, at either the weighted or unweighted average, one study finds that, in the aggregate, harmonization increases GDP and welfare, but, depending on the alternative examined, has a relatively small negative or insignificant effect on aggregate revenues.[13] Of more relevance for present purposes, effects on GDP and welfare and on revenues of individual Member States move in opposite directions, suggesting that it might be difficult for 'winners' (however defined) to compensate 'losers.' Unfortunately, these estimates are based on separate accounting and do not include the effects of consolidation, including cross-border loss offset, or of formula apportionment. Thus, they might not be comparable to the other estimates reported here and might not accurately and fully indicate the expected effects of adopting the CCCTB. While cross-border loss offset might cause revenues to be affected more negatively than estimated, the prevention of profit shifting inherent in consolidation might reduce (or reverse) revenue losses, except in Member States that currently benefit from profit shifting. Loss offsetting also might contribute to economic efficiency and, thus, to GDP and welfare. As the study notes, coordination would reduce costs of compliance and administration, adding further to GDP and welfare; these costs savings, which the authors (like others) do not attempt to estimate, would be greater under consolidation.

Since the CCCTB is unlikely to be adopted unanimously, especially in a compulsory form, the relevant question is whether nine or more Member States likely would want to participate in enhanced cooperation. (A subsidiary issue, possibly crucial because of its precedential importance, is whether those pioneering Member States would make corporate participation mandatory.) That probably depends in part on the revenue effects they expect to experience if they were to participate. It is difficult, however, to infer much about this from the results mentioned above. It also seems senseless to analyse the revenue effects

of all possible combinations of nine or more Member States. The most promising approach might be to analyse the revenue effects for nine Member States with relatively similar economies (especially corporate profitability, compared to payroll, profits, and sales) and tax systems (in terms of tax rates, existing provisions for cross-border loss offset, and absence of preferential regimes), taking due account of public announcements regarding the CCCTB – especially opposition to it – by political leaders.

One study examines the revenue effects in the six original Members of the EC, plus Denmark and Austria, 'two countries that already allow for international loss consolidation,' if only those nine Member States were to engage in enhanced cooperation.[14] With voluntary participation, there would be a 1.5 per cent reduction in aggregate revenues. By comparison, there would be a slight aggregate gain in revenue if participation were mandatory, but, in that case, the Netherlands would experience a substantial loss in revenue. It seems unlikely, of course, that the Netherlands would engage in enhanced cooperation with mandatory corporate participation. Another study estimates the effects of tax harmonization on GDP, welfare, and revenues under enhanced cooperation among the euro group (and for the 15 pre-2004 member states of 'old Europe'), and suggests that the dispersion of effects would be somewhat smaller than for the 25 pre-2007 Member States.[15]

2.2.3 The Dynamics of Enhanced Cooperation

The possibility of using enhanced cooperation to initiate harmonization creates an interesting dynamic.[16] EU Member States that oppose harmonization might not be able to prevent its being initiated via enhanced cooperation, but corporate tax harmonization begun in this way almost certainly would form the basis for future harmonization. Thus, even Member States that oppose the CCCTB have an incentive to participate in the CCCTB Working Group, if only to prevent the inclusion of provisions (especially compulsory corporate participation) that they find objectionable. Consistent with this conjecture, representatives of all 27 Member States have been participating in deliberations of the Working Group.

3.0 Corporate Tax Harmonization in the United States

State corporate income taxes in the United States resemble in broad outline the type of system that would make sense for the EU, but differ

from it in important respects.[17] Moreover, reliance on legislative, judicial, and cooperative approaches in the two unions differs substantially, sometimes only in theory but sometimes also in practice.

3.1 Substantive Issues[18]

Definition of income. The existence of federal income tax and the federal Internal Revenue Service (IRS) is an important force for tax harmonization in the United States. Conformity of state corporate income taxes to the federal tax code contributes to uniformity, thereby reducing compliance costs and the possibility of gaps and overlaps in the tax bases of the various states. State reliance on the IRS to take the 'first cut' at tax administration contributes further to uniformity and cost reduction. The states' adoption of the federal definition as their starting point in defining taxable income was the result of pressure from the business community, which decried the complexity of dealing with diverse definitions. Continued conformity is threatened, however, by the federal government's tendency to modify its definition of taxable income significantly from time to time without consulting the states, which might 'decouple' for revenue reasons.

Consolidation. Although some states require groups of corporations involved in a unitary business to file a combined report – the state equivalent of consolidation – many do not.[19] Moreover, the U.S. Supreme Court has ruled that there is no single definition of what constitutes a unitary business. There is thus little uniformity – and a substantial amount of litigation – regarding this aspect of state taxation.

Apportionment. The formulas the states use to apportion business income are not uniform. In 1978, all but one state used a three-factor formula that placed equal weight on payroll, property, and sales; now, almost 80 per cent of states that tax corporate income assign at least half the weight to sales, nine states use only sales to apportion income, and an additional six states intend to phase in sales-only apportionment. Moreover, states do not treat sales other than those of tangible products consistently.

Jurisdiction to tax. A federal law, Public Law (P.L.) 86-272, prohibits states from taxing the income of potential taxpayers whose only activity in the state is solicitation for sales of tangible products to be

delivered from outside the state. Of course, much of modern commerce does not involve tangible products. Since there are no federal or judicial guidelines for jurisdiction to tax in this crucial area, state practice exhibits substantial diversity. (The U.S. Supreme Court refused to hear a case where a decision would have provided guidance.)

3.2 *Means of Coordination*

Legislation. The Commerce Clause of the U.S. Constitution gives Congress plenary power to regulate interstate commerce.[20] Although states have no power to veto (or even to have a direct say in) federal legislation affecting state taxation, they can attempt by political means to prevent or modify such legislation. In fact, only once has Congress enacted legislation (P.L. 86-272) that seriously restricts state corporate taxation.

Judicial decisions. Although the U.S. Constitution contains no provisions equivalent to the 'freedoms' (of movement of people, goods, and capital and of establishment) found in the EC Treaty, the U.S. Supreme Court's interpretation of the Commerce Clause creates essentially the same effect. While the Court has outlawed many specific details of state taxation, it has generally given the states considerable latitude regarding big-picture issues such as the definition of income, consolidation, and formula apportionment. In particular, it has not required uniformity, which would be tantamount to legislating from the bench.

Soft law. Soft law, as that concept is understood in the EU, does not exist in the United States; law that is not 'hard' – that is, legally binding, being enshrined in legislation or in court decisions – is not law. Even so, interstate cooperation sometimes takes on attributes of soft law, as defined above.

Interstate cooperation. The U.S. Constitution does not provide for anything resembling enhanced cooperation. Rather, the Compact Clause authorizes states to enter into compacts of any kind with the consent of Congress, and states can join compacts, even without congressional consent, as long as doing so does not expand their powers at the expense of federal powers.

The states have rarely engaged voluntarily or successfully in cooperative efforts to harmonize their corporate income taxes. They gener-

ally have acted only when faced with the prospect of federal legislation that would restrict their taxing powers. The states initially showed little interest in the most important such effort, the *Uniform Division of Income for Tax Purposes Act* (UDITPA), a model law drafted in 1957. When federal legislation was introduced in the mid-1960s that would have regulated state taxation of corporate income, a subset of states quickly created the Multistate Tax Compact, which incorporates UDITPA, and the Multistate Tax Commission (MTC). Among the stated purposes of the Compact is to 'promote uniformity or compatibility in significant components of tax systems.'[21]

UDITPA is not hard law; it is a model law that states can adopt or not – and repeal – as they wish. Although most income-tax states have adopted statutes that incorporate UDITPA or are patterned after it, many deviate from that model law in significant ways. A key element of UDITPA, the equally weighted three-factor apportionment formula, has been seriously eroded by the increased (or exclusive) weight many states, including members of the Multistate Tax Compact, now place on sales. Moreover, as its name indicates, UDITPA deals only with the division of income; it does not address the definition of the income to be divided or the issues of jurisdiction to tax or combination. A recent effort to revise and modernize UDITPA was abandoned because of opposition from both business and the states. The MTC subsequently took up this effort, but it seems unlikely that much progress will be made on the big-picture harmonization issues of jurisdiction to tax, combination, and the apportionment formula.

No 'guardian of the Constitution.' In the United States, no organization is the 'guardian of the Constitution' as the European Commission is the 'guardian of the Treaties' in the EU. That is, no U.S. governmental institution is charged with formulating and advocating legislation that is consistent with an internal market.

4.0 Summary Comparison and Commentary

Whereas the European Commission has urged EU Member States to replace their diverse corporate tax systems, which are based on SA/ALS, with a uniform system based on consolidation and formula apportionment, U.S. states have long had apportionment-based systems, albeit systems that are defective and far from uniform in many important respects (see Table 7.1 for a summary comparison of the two regimes).

Table 7.1. Comparison of the Legal Context for Corporate Tax Harmonization in the European Union and the United Sates

	European Union	United States
Historical status of EU Member States and U.S. states and their tax systems	Independent nations with tax systems typical thereof	State tax systems developed in a federal context
Legal framework for harmonization	EC Treaty, EU regulations and directives, and interpretations thereof by the European Court of Justice	U.S. Constitution, federal statutes, and U.S. Supreme Court interpretations thereof
Key provisions of EC Treaty and U.S. Constitution	Unanimity rule and enhanced cooperation; freedom of movement of people, capital, and goods and of establishment; role of the European Commission	Commerce Clause (for federal legislation) and negative Commerce Clause (for judicial decisions) regarding state taxation
Ability of individual EU Member States and U.S. states to control EU and U.S. federal legislative initiatives limiting their taxing powers	Unanimity rule gives each member state veto power over EU tax policy initiatives	States have no direct control over federal legislation limiting their taxing power
Judicial influence over tax policies of EU Member States and U.S. states	In proactively defending EC Treaty freedoms (movement of people, capital, and trade and of establishment), the European Court of Justice outlaws many existing tax policies of Member States	U.S. Supreme Court outlaws many specific state infringements of the Commerce Clause, but takes a relatively hands-off stance toward major issues (such as the choice of apportionment formula and the definition of a unitary business)
Defender of the EC Treaty and the U.S. Constitution?	European Commission, as ‘guardian of the Treaty,’ proposes EU legislation and initiates infringement proceeding against member states	There is no ‘defender of the Constitution’

The U.S. Congress has the constitutional power to legislate uniformity, but generally has not used it, in part because of the political opposition of both the states and business. While the EC Treaty confers similar legislative powers on the Council of the European Union, any Member State can veto the exercise of those powers. Enhanced cooperation, by as few as nine Member States, is thus the most likely mechanism for initiating the CCCTB.

The U.S. Supreme Court has accorded states wide latitude in the exercise of fiscal sovereignty over big issues in corporate taxation, while proscribing many specific practices that discriminate against interstate commerce. By comparison, the European Court of Justice has issued decisions that render certain tax practices off limits; of course, it has had no occasion to rule on the CCCTB. Enactment of the CCCTB by directive would make the Court's job relatively straightforward, and its role would change dramatically, from a quasi-constitutional court interpreting the freedoms to a supreme court making sure that directives are interpreted in a uniform manner throughout the EU. By comparison, initiation of the CCCTB via enhanced cooperation could raise thorny questions of compatibility with the EC Treaty, for example, because activities in participating and non-participating Member States would not be treated in the same way.

While interstate cooperation can and does occur in the United States, there is no concept in U.S. law similar to enhanced cooperation, which creates hard law that is binding on EU Member States that participate in it. Moreover, in the United States, no institution plays a role analogous to that of the European Commission as 'guardian of the Treaties.' Of potentially great importance, the Commission champions the CCCTB. These two differences – plus the increasing cost that reliance on SA/ALS will impose on the economies of the EU as economic integration proceeds – seem conducive to, but do not guarantee, enactment of the CCCTB, if only by a subset of Member States. It seems likely that, if once created via enhanced cooperation, the 'CCCTB club' would gradually expand to produce a system that exhibits more uniformity than state corporate income taxes in the United States. It could be that broader international tax reform along the same lines will one day follow suit as a way to address the pressure of globalization that encourages heightened cross-border flows of investments that are increasingly sensitive to national tax differences.

Notes

* This chapter was originally published in (2008) 9 CESifo Forum 46. It draws on Charles E. McLure, Jr, ‘Legislative, Judicial, Soft Law, and Cooperative Approaches to Harmonizing Corporate Income Taxes in the US and the EU’ (2008) 14 Columbia J. European L. 377. It has benefited from comments by Michael Devereux, Clemens Fuest, Walter Hellerstein, Reinald Koch, Adolfo Martín, Matthias Mors, Andreas Oestreicher, and Peter Birch Sørensen.

1 See Commission of the European Communities, *Company Taxation in the Internal Market* (Luxembourg: Office for Official Publications of the European Communities, 2002). See also Charles E. McLure, Jr, ‘Harmonizing Corporate Income Taxes in the European Community: Rationale and Implications’ in James Poterba, ed., *Tax Policy and the Economy* (Chicago: University of Chicago Press, 2008) 151.

2 Commission of the European Communities, ‘Towards an Internal Market without Tax Obstacles: A Strategy for Providing Companies with a Consolidated Corporate Tax Base for Their EU-Wide Activities – A Communication from the Commission to the Council, the European Parliament, and the Economic and Social Committee’ COM (2001) 582 (Brussels, 23 October 2001).

3 On the basic features the CCCTB might exhibit, see Ana Agúndez-García, ‘The Delineation and Apportionment of an EU Consolidated Tax Base for Multi-jurisdictional Corporate Income Taxation: A Review of Issues and Options’ European Commission, Directorate-General Taxation & Customs Union, Taxation Papers, Working Paper 9 (Luxembourg: Office for Official Publications of the European Communities, 2006). See also McLure, ‘Harmonizing Corporate Income Taxes in the European Community.’ See also Documents of the CCCT Working Group, online: Taxation and Customs Directorate-General of the European Commission < http://ec.europa.eu/taxation_customs/index_en.htm>.

4 Commission of the European Communities, ‘Tax Policy in the European Union – Priorities for the Years Ahead – A Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee’ COM (2001) 260 (Brussels, 23 May 2001) at 23.

5 For some such lessons, many of them negative, see Walter Hellerstein and Charles E. McLure, Jr, ‘The European Commission’s Report on Company Income Taxation: What the EU Can Learn from the Experience of the US States’ (2004) 11 Int’l Tax and Pub. Fin. 199. See also idem, ‘Lost in Translation: Contextual Considerations in Evaluating the Relevance of US Experi-

ence for the European Commission's Company Taxation Proposals' (2004) 58 Bulletin for Int'l Fiscal Documentation 86; and Joann Martens Weiner, *Company Tax Reform in the European Union: Guidance from the United States and Canada on Implementing Formulary Apportionment in the EU* (New York: Springer Business & Media, 2006).

6 See also Adolfo J. Martín Jimenez, *Towards Corporate Tax Harmonization in the European Community: An Institutional and Procedural Analysis* (The Hague: Kluwer Law International, 1999).

7 Linda Senden, *Soft Law in European Community Law* (Oxford: Hart Publishing Co., 2004) at 112.

8 Comitology in the EU refers to the committee system that overseas the delegated acts implemented by the Commission.

9 KPMG, 'EU Business Wants Single, Pan-European Tax System, Says KPMG International Study,' online: KPMG <http://www.kpmg.com/Press/09.25.2007.htm>.

10 Clemens Fuest, Thomas Hemmelgarn, and Fred Ramb, 'How Would the Introduction of an EU-wide Formula Apportionment Affect the Distribution and Size of the Corporate Tax Base? An Analysis Based on German Multinationals' (2007) 14 Int'l Tax and Pub. Fin. 605.

11 Michael Devereux and Simon Loretz, 'The Effects of EU Formula Apportionment on Corporate Tax Revenues' Working Paper 07-06 (Oxford: Oxford University Centre for Business Taxation, 2008).

12 Andreas Oestreicher and Reinald Koch, 'The Revenue Consequences of Using CCCTB to Determine Taxable Income in the EU Member States' Working Paper 07-001 (Göttingen: Georg-August-Universität, 2007).

13 Jen Brøchner, Jesper Jensen, Patrik Svensson, Peter Birch Sørensen, 'The Dilemmas of Tax Coordination in the Enlarged European Union' (2007) 53 CESifo Economic Studies 561.

14 Devereux and Loretz, 'The Effects of EU Formula Apportionment.'

15 Brøchner, Jensen, Svensson, and Sørensen, 'The Dilemmas of Tax Coordination.'

16 For a theoretical analysis of the dynamics of enhanced cooperation, see Massimo Bordignon and Sandro Brusco, 'On Enhanced Cooperation' (2006) 90 J.Pub. Econ. 2063.

17 See Charles E. McLure, Jr, 'The Long Shadow of History: Sovereignty, Tax Assignment, Legislation, and Judicial Decisions on Corporate Income Taxes in the US and the EU' in Reuven S. Avi-Yonah, James R. Hines, and Michael Lang, eds., *Comparative Fiscal Federalism: Comparing the European Court of Justice and the U.S. Supreme Court's Tax Jurisprudence* (Deventer: Kluwer Law International, 2007) 119.

18 For more detail on these issues, see Jerome R. Hellerstein and Walter Hellerstein, *State Taxation*, 3rd ed. (Boston: Warren, Gorham & Lamont, 2007).

19 Some states provide for elective 'consolidation,' which generally follows the federal consolidation rules. These rules define a group wholly by reference to ownership. On the distinction between mandatory combination based on the unitary business principle and elective consolidation, see ibid., para 8.11[1].

20 See Walter Hellerstein, 'The U.S. Supreme Court's State Tax Jurisprudence: A Template for Comparison' in Avi-Yonah, Hines, and Lang, eds., *Comparative Fiscal Federalism* 67.

21 On this history, see Hellerstein and Hellerstein, *State Taxation*, Introduction to Part IV; see also Charles E. McLure, Jr, 'Understanding Uniformity and Diversity in State Corporate Income Taxes' (2008) 61 Nat. Tax J. 141.

8 Missing Women: Gender-Impact Analysis and International Taxation

KATHLEEN LAHEY

1.0 Finding Women in International and Tax Law

Tax law, like corporate, commercial, and regulatory law, speaks of 'persons,' 'corporations,' 'states,' and 'taxpayers' – but, particularly in international taxation, there are few real people anywhere in sight. Add to that the self-conscious gender neutrality of liberal legal discourse, and women merge conceptually with men in every legal category, be it 'related persons,' 'spouses,' or 'parties not dealing at arm's length.'[1] Because women continue to be disadvantaged in every country in the world,[2] it has become urgent to break through genderless depictions of issues and policy options to grapple with the ways in which women's continuing disadvantages are perpetuated.

But where to start? There are few women in lead roles in government international affairs departments or in the boardrooms of the multinational corporations that carry out the complex negotiations forming and engaging with international tax rules.[3] The tax justice movement, which has gradually raised awareness of how existing international tax practices can exacerbate disparities between high- and low-income regions of the world, has focused more on the state level than on the human level.[4] And in any event, there is considerable institutional opposition to treating international tax rules as creating tax expenditures that should be scrutinized for their distributional effects (see also Chapter 6 in this volume).[5] Gender-based analysis of international transactions and even of tax issues generally tends to focus on home-country questions, such as the gender impact of trade agreements or of domestic tax rules.[6]

The purpose of this chapter is to identify the types of international

transactions that touch and concern women, whether directly or indirectly, and to inquire into the data that are relevant to gender-impact analysis of this area of tax policy. Because all transnational transactions potentially affect women in each country involved, whether transactions are market based or carried out by governments, this chapter considers the gender impact of both overseas development and aid and foreign direct investment (FDI) transactions on women in all countries involved in such transfers. While many questions remain to be answered, this chapter tentatively concludes that, where women are found in international taxation, available data suggest they may be marginalized and segregated in precarious positions compared with men.[7]

2.0 The Gender Impact of Overseas Development and Aid Programs

Government overseas development and aid is relatively small compared with the sheer volume of FDI. For example, Canada's total Official Development Aid (ODA) for fiscal year 2004/05 came to just C$4.1 billion, equivalent to just 1 per cent of the total overseas investment held that year by Canada's corporate sector in foreign affiliates.[8] Nonetheless, aid expenditures still affects women in two ways. Most obviously, development and aid activity can either improve or detract from the status of women in aid-receiving countries. Less apparent is the effect on women in donor countries, who continue to earn, on average, significantly less than men. From the perspective of women in such countries, overseas aid represents government revenues that could be allocated to meeting their needs but that is being redirected to those in developing countries or in situations of crisis for humanitarian purposes. This raises questions of gender equity in both domestic and overseas development work.

In the context of overall governmental spending allocations, funding for overseas development raises questions about whether donor governments are taking steps to ensure that, as a minimum, their overseas development and aid programs promote gender equality both at home and in client countries. Further, it should also be possible to inquire into how the operation of government aid agencies affects women as opposed to men in this sector of the public service, and how the method of funding development affects women in recipient countries. Finally, there are questions about the gender efficacy of services delivery that uses the voluntary sector as a partner in governance. Funnelling assist-

ance through tax-exempt voluntary organizations that also receive tax-creditable charitable donations adds another layer of gender impact, as does giving multinational corporations tax credits for charitable contributions that fund programs designed to complement their ongoing business operations and enhance their brand value.

2.1 Gender-Based Analysis in Development Programs

Compared to other international actors, national development agencies such as the Canadian International Development Agency (CIDA) set a high standard for explicit gender-based analysis of their transnational operations, in terms of both program design and accounting for program outcomes. Historically, CIDA has been at the forefront of gender-impact analysis as overseas assistance policy was reshaped to increase aid.[9] Despite this, however, it might be surprising to learn that only a relatively small share of CIDA's ODA actually goes to gender-equal or gender-integrated projects, and that projects do not necessarily have to be devoted exclusively to meeting the needs of women in order to be classified as either 'gender equal' or 'gender integrated.'[10]

Despite CIDA's explicit and largely transparent gender-mainstreaming structures, it falls short in a number of ways. First, CIDA still does not have the administrative capacity to screen all of its programs for gender issues.[11] And such screening as is done is on quite a superficial level, often by merely scanning for gender terms in project documents.

Second, only a small percentage of CIDA's total ODA allocations are classified as 'gender-equality-specific programming,' and even within that category most gender-related funding is allocated to the category of 'integrated programming.' Thus, in the six-year period ending in 2005, gender-equal funding fell from a high of 1.8 per cent of all ODA gender-aware programs in 1999 to a low of 0.8 per cent by 2005. During the same period, CIDA's gender-related funding (as a percentage of total ODA) fell from 4.7 per cent in 1999 to 4.1 per cent in 2005.[12]

Third, and possibly of greatest concern, CIDA's use of gender-based analysis does not fully reflect contemporary feminist research on the gender impact of tax laws and financing vehicles. For example, Lebanon received CIDA funding to implement a value-added tax system – a form of consumption taxation that might disproportionately burden women's incomes compared with men's.[13]

Finally, CIDA includes a number of microcredit financing programs under the heading 'reducing inequalities in access to and control over

the resources and benefits of development.' This type of development support has been found to be particularly risky for women, who have more difficulty paying off such debts when their businesses are not successful.[14]

The latter two points are of particularly concern because, when funding for gender-equal or gender-integrated programming is so scarce to begin with, it is a serious policy error to use such funding for programs known to have negative gender effects all on their own.

2.2 Gender-Based Analysis in Private and Voluntary Development

Governmental development and aid programs often operate in tandem with the corporate sector and with non-governmental voluntary organizations. Despite this close connection, the Canadian government does not require the same degree of transparency and accountability in its private sector and voluntary development activity. As they are not under the direct management and control of government agencies, and in the long-standing absence of direct government regulation requiring gender equality in development operations, corporations and charitable organizations traditionally are less focused on gender than are government agencies. 'Tying' clauses are often used in development funding agreements to lock recipient countries and organizations into binding contracts that require them to obtain material and services from donor-country corporations or voluntary organizations. The charitable tax-exempt voluntary sector has long acted in partnership with governments, and even when government development and aid funding is not funnelled through such organizations, governments indirectly fund them by extending tax deductions or credits to individual and corporate taxpayers that make contributions to their operations.

CIDA also has long-standing relationships with domestic and international voluntary and private organizations through its Canadian Partnership Program. Moreover, the amount of funding it makes available for direct partnership allocations is much larger than that for all its gender-based program funding, despite the cross-cutting nature of gender issues, with the average share running from 8 per cent to 15 per cent of CIDA's ODA in recent years. Voluntary and private organizations also receive funding through other CIDA programs and, within the category of gender-equal programming, they receive some 18 per cent of CIDA's gender-focused funding.

Beginning in 2005, CIDA developed policy guidelines for its partner-

ship program to provide detailed guidance in assessing gender results.[15] These guidelines incorporate by reference the gender-equality guidelines of the Development Cooperation Directorate of the Organisation for Economic Co-operation and Development (OECD). Although CIDA cannot monitor compliance with gender-based analysis by private and voluntary organizations to the same extent that it can assess its own program activities and results, many of the voluntary organizations with which CIDA partners – and many of the countries with which it deals directly – have developed their own policies and procedures with respect to gender-based analysis in response to the Beijing *Platform for Action*.[16] Currently, the focus of gender-based analysis in these organizations tends not to be concerned with sources and forms of financing, but with the substantive missions of the organizations themselves.

On the positive side, these organizations operate within the same gender-aware structure as does CIDA and parallel CIDA's gender programming, which itself is more substantively focused on gender in development than on gender in financing. This means that, if CIDA can maintain or expand its gender-equal capacity and programming, further development of gender-based analysis can be expected in the voluntary and charitable sector as well, even though the standard applied likely will not reach the same level as that applied to CIDA's ODA funding.[17]

3.0 Domestic Taxation of Outward FDI

In 2005, Canadian-owned FDI was valued at C$465.1 billion,[18] 99 per cent of which was private sector FDI transactions. Because there are no actual 'international taxes,' international tax rules are found in the interplay between domestic tax, corporate and investment laws, and various types of bilateral and multilateral agreements such as tax treaties and regional trade agreements. Multilateral organizations such as the OECD are also playing a growing role in norm setting in international taxation (see Chapter 2 in this volume). Domestic tax laws on both sides of transactions – in both investor and host countries – play an important role in shaping FDI, trade, and employment arrangements.

All these systems affect the international political economy of women. As with domestic women's economies, the global female economy is characterized by women's continued under-representation in private and public decision-making, the realities of the 'double day,' unequal distribution of income between women and men, women's

fragile attachment to well-paid work, unequal pay, their larger share of global poverty, and disproportionate responsibility for all types of caregiving.[19]

In this context, changes to any element of domestic, transnational, and multinational laws and practices have a gender-specific impact on women. For example, reducing the domestic tax burden of resident owners of FDI reduces the fiscal capacity of governments in capital-exporting countries to address gender issues and that of governments in other countries through a reduction of development and aid funding. At the same time, women in capital-importing countries might receive a disproportionately small share of the increased wealth associated with new foreign investment activity. If host countries reward inflowing FDI with tax cuts and other fiscal benefits (see Chapter 3 in this volume), they might give up part of their fiscal capacity to meet the needs of women who live there in the expectation that everyone will be better off with any type of FDI.

Because most FDI takes place between non-state actors, there are, at present, no laws or policies requiring investors engaged in tax-favoured FDI and trade to carry out gender-based analysis of their projects or to account for the gender impact of their operations. Although the UN Millennium Development Goals and Financing for Development processes and the OECD aid effectiveness program have opened up many of these private sector issues for discussion,[20] concrete expectations of gender-based analysis and gender budgeting in the taxation of FDI outflows are not likely to be put into place for some time to come.

3.1 Domestic Tax Benefits for Outward FDI

In the past, Canadian FDI has been driven by the quest for new markets, cheaper resources and labour, and geographic expansion, among other reasons. In the past two decades, however, tax competition – not just by 'tax-haven' countries but even by Canada itself – has given low tax rates a growing role in the calculation of potential profits from FDI. Thus, investors in countries such as Canada enjoy tax rules that tax FDI profits very lightly, if at all.

Corporations can avoid income tax liability on FDI profits in several different ways, but one of the most effective remaining techniques is to use a combination of foreign affiliates and tax havens to avoid domestic corporate tax liability at every step of the way, and even to trigger eligibility for dividend tax credits for taxes assumed to have been paid on the ultimate distribution to Canadian shareholders.

These results can be obtained because Canada's corporate tax rules are built around a series of interlocking legal fictions:

- all corporations pay taxes in their tax homes;
- all countries impose similar rates of corporate taxes;
- when corporate affiliates 'repatriate' profits, they are post-tax profits because the affiliate has already paid tax on them to the overseas country in which they were earned;[21] and
- when the parent corporation passes those foreign affiliate profits on to their Canadian shareholders, the underlying corporate taxes assumed to have been borne by the parent corporation (in this situation, the taxes assumed to have originally been paid on those profits by the foreign affiliate) ought to be reflected in dividend tax credits that those shareholders can claim.[22]

These legal fictions have been developed over time as the view that 'double' taxation of corporate-source profits unfairly penalizes private investors. In Canada, this perceived problem has been solved by permitting foreign profits from foreign affiliates to be repatriated to the parent corporation as tax-exempt distributions and then to shareholders as creditable dividends. This approach 'integrates' the corporate tax system with the personal tax rates shareholders pay on income from non-corporate sources, and treats shareholders as having earned the profits directly themselves, in terms of eventual net tax liability on their share of profits. Foreign accrual property income (FAPI) rules in Canadian income tax legislation limit this treatment only to profits from *bona fide* active business operations, and deny them to investment operations.[23]

In a sense, these legal fictions and the assumptions they reflect are similar to those built into nominal concepts of gender equality: so long as all women/corporations are treated the same, the outcome will be 'equality.' The problem with these fictions and assumptions is that certain 'tax-haven' countries have tax treaties with Canada but also have special low tax rates (sometimes as low as 1 per cent[24]) that enable affiliate income to escape Canadian corporate income taxation almost completely.

Multinational corporations and their political supporters have successfully staved off meaningful inquiry into the general fiscal impact of these policies. The Auditor General of Canada began expressing concern about the use of tax-avoidance arrangements by the corporate sector in 1986,[25] and the following year, the Department of Finance

undertook to scrutinize tax avoidance in international corporate transactions.[26] By 1992, tax officials had concluded that overseas corporate operations were being used to generate 'hundreds of millions of dollars' in corporate tax reductions through complicated offshore tax-planning mechanisms,[27] but neither the Auditor General nor the tax authorities had access to enough financial data to calculate the cost of these arrangements in lost tax revenues. There was, however, every indication that large chunks of potential corporate income tax revenue were indeed being lost. Information returns revealed that these tax-haven affiliates paid some C$600 million in dividends in 1990, all of which entered Canada on a tax-exempt basis and were then distributable to Canadian shareholders eligible for the full benefit of the federal and provincial layers of the dividend tax credit, wiping out a great deal of income tax liability at the shareholder level.[28]

In 1998, the OECD reported that, among just the G7 countries, the amount of FDI funnelled through tax-haven countries had increased 500 per cent between 1985 and 1994.[29] By that time, Canada had made some small adjustments to the FAPI rules to restrict the types of tax-haven profits eligible for tax-exempt repatriation,[30] but as further reports by the Auditor General demonstrate, those changes have had no visible impact on the continued growth of haven-based FDI business organizations. In 2000, the Canada Revenue Agency (CRA) found that foreign-affiliate investments had more than doubled (from C$200 billion to more than $450 billion) between 1996 and 2000, and that the value of dividends and interest received in Canada from those investments in 2000 alone was C$3.1 billion – C$1.5 billion of which was received virtually tax free as dividends from foreign affiliates located in Barbados and distributable to shareholders with full federal and provincial dividend tax credits.[31] The Auditor General was not able to calculate the revenue costs of such arrangements, but did cite a 1994 Technical Committee estimate that Canada's total tax revenue shortfalls from overseas investments was on the order of C$3.5 billion.[32]

By 2001, the Canadian federal government had begun to investigate and challenge some of these offshore arrangements. In 2005, the CRA reported that more than 16,000 Canadian corporations reported transactions with a foreign affiliate valued at more than C$1.5 trillion,[33] but federal anti-avoidance activities had reached very little of the revenue that could have otherwise been raised through those transactions.[34] In 2007, the Auditor General concluded that lack of international cooperation and Canada's own privacy laws made it impossible for the federal government to obtain the data needed to evaluate the amount or rev-

enue impact of FDI outflows in Canada.[35] The Department of Finance continues to raise the technical objection that it cannot define 'normal' taxation of FDI and thus cannot produce meaningful data even if those problems could be solved.[36]

The cumulative effect of the OECD harmful tax competition project, recommendations of parliamentary committees,[37] and the Auditor General's repeated demands for data and new policy was the reluctant introduction in 2007 of a single limitation on tax-haven tax planning (concerning interest deductions, not the tax-free flow of distributions[38]) and the promise to begin placing constraints on tax treaty negotiations with countries that obviously are willing to impose tax rates as low as zero to accommodate overseas investors. These changes would have required any new tax treaties to include the new OECD standards with respect to exchange of information, to deem non-treaty countries that agree to these OECD standards to be treaty countries, and, in the meantime, to provide that income currently in the hands of the Canadian shareholders but earned by foreign affiliates in countries that neither have a tax treaty nor have agreed to exchange tax information with Canada will be taxed. This latter initiative would deny Canadian shareholders the tax benefit of deferral or exemption through accrual in the hands of foreign affiliates located in low- or no-tax countries.[39]

Following the recommendations of the Advisory Panel on Canada's System of International Taxation, however, the 2009 Canadian federal budget proposed new tax laws that would remove restrictions on domestic interest deductions that fund tax-exempt foreign projects as well as so-called double-dip financial arrangements that often involve related financing affiliates based in tax havens (see Chapter 4 in this volume). The Advisory Panel also recommended that Canada adopt a full-blown exemption system that would exempt from taxation all active business profits derived by foreign affiliates irrespective of where they are located – that is, there would no longer be a need for a foreign affiliate based in a treaty partner or a country that has negotiated a tax-information-exchange agreement with Canada (see Chapter 1 in this volume).

While these changes inch their way through complex political and bilateral processes, all that can be said with any certainty is that the current tax treatment of outward FDI in Canada generates significant tax reductions for Canadian residents with international investments. Moreover, tax laws permit cross-border structures that often reduce tax revenues in host countries – for example, the second 'dip' or interest rate deduction within a double-dip transaction is often taken in a for-

eign (typically) high-tax country on the same (economically) item of income. With Canadian outward FDI in 2004 of some C$124.6 billion,[40] Canada and its host countries could well have forgone revenue of approximately C$1.9 billion in 2004, even on conservative estimates.[41] This represents a very large chunk of potential revenue by any measure.

3.2 The Gender Impact of Taxation of Outward FDI

One key commitment Canada made when it adopted the Beijing *Platform for Action* was to develop detailed statistical data on women at all ages in order to analyse accurately the impact of all economic, tax, and financial policies and programs on women on a continuing basis.[42] Despite this commitment, the federal government has taken no steps to identify male and female interests in FDI or the gender impact of FDI taxation.

In such a situation, gender-budgeting methods still can be used to identify probable gender impact along with some basis for assessing the rationale on which that policy choice is based. The goal of gender budgeting is to produce documentation that provides specific gender breakdowns for each line of the government's usual budget, including details on the shares of projected spending expected to benefit women as compared with men, allocation of revenues between women and men, and distributional impact by key demographic markers. Budget documents are also expected to provide analytic evidence-based information on the logic behind major spending, revenue, and surplus/deficit decisions,[43] and the tax expenditures that are increasingly important elements of Canadian fiscal policy.[44]

The probable gender impact of the tax benefits Canada gives to owners of FDI can be approximated by using CRA income statistics to provide some indication of relative male and female ownership of corporate shares. While Canadian income tax law allows spouses/partners to blur the boundaries of legal ownership of corporate shares, the raw data in taxation statistics suggest that, in 2004, men received nearly 63 per cent of all taxable dividends.[45] Assuming that untaxed or lightly taxed foreign-affiliate retained earnings make their way back to Canada as taxable dividends with full rights to dividend tax credits, then men's share of the (estimated) C$1.9 billion tax expenditure that flows from the untaxed status of such payments would be roughly C$1.2 billion.

Is this the best use of C$1.9 billion in potential revenue? Particularly because the international financial community is starting to take a development approach to the taxation of international investment, a

gender-development approach might compare this FDI tax expenditure with what Canada spends on ODA, which, in fiscal year 2004/05 amounted to C$3.15 billion. The 'gender' share of this ODA allocation was just C$129 million (4.1 per cent of total ODA), while the allocation to gender-specific programs – primarily designed to improve the status of women overall – was just $25 million (0.8 per cent of total ODA).[46]

Another point of comparison can be made in the domestic spending context, where Canada continues to provide few tax expenditures to promote women's equality. In fiscal year 2004/05, it spent C$1.2 billion on the dependent spouse/partner credit, which actually forms fiscal barriers to women's paid work,[47] but only C$0.6 billion on the child care expense deduction for women who need child care if they are to work for pay.[48]

4.0 Developing-Country Taxation of Inward FDI

Not all developing countries are tax havens and not all tax havens are developing countries. As increasing numbers of developing and developed countries are pushed into competing via taxation for inward FDI,[49] there continue to be little reliable data on the true costs of such tax competition, as is the case with the revenue costs of outward FDI. Commentators now posit the establishment of a global 'shadow' economy[50] in which capital moves invisibly from one tax-favoured location to another, often leaving nothing but fiscal crisis in its wake as the only sign of movement. As focus on the harmful effects of international tax competition has begun to converge with international concern over 'financing for development' in pursuit of the UN's Millennium Development Goals, there is growing interest in both qualitative analysis of developing-country tax concessions and quantitative measures of their fiscal impact. The search for the gender impact of international taxation, however, brings researchers right to the edge of scholarly studies, as little work on this aspect of tax competition in developing countries has been published. Some of the directions this work is taking are sketched out in this chapter, but this analysis should be read more as an agenda for research than as anything more concrete.

4.1 Developing-Country Tax Benefits for Inward FDI

The most ambitious attempt to identify the revenue costs to developing countries of tax competition for inward FDI was carried out by Oxfam in 2000. Using figures from the United Nations Committee on Trade

and Development on developing-country FDI, which totalled US$1.2 billion in 1998, Oxfam estimated that tax competition for inward FDI then cost developing countries some US$35 billion each year in forgone tax revenues.[51] Adding this figure to the estimated US$15.4 billion lost to developing countries because of the trend toward not imposing withholding taxes on interest, Oxfam estimated that developing countries were losing some US$50 billion each year in tax revenues.[52] Oxfam described this developing-country tax expenditure as 'the development impact' of tax concessions for FDI. To put these tax expenditures into the development budgetary context, Oxfam compared them with the US$73 billion annual cost of providing health care for all low- and medium-income countries.[53]

4.2 The Gender Impact of Tax Benefits for Inward FDI

Without detailed country data showing the fiscal cost of tax concessions to overseas investors and accurate data on domestic income and revenue, it is difficult to measure the gender impact of tax expenditures on inward FDI. Anecdotal reports, however, have reached conclusions that are consistent with the larger body of research on international taxation, trade agreements, and gender. At the very least, these studies make it clear that, while most development/tax analysis does not consider gender impact, these tax concessions cannot be assumed to have the same effects on women as they do on men in developing countries.

One such study that includes data on the gender impact investigates the effects of tax competition in the East African flower industry.[54] It finds that, with the encouragement of international financial agencies, East African countries offered massive tax incentives to the floriculture industry, including ten-year holidays on corporate income taxes, withholding taxes on dividend and other overseas payments, perpetual exemption from VAT and customs import duty on inputs and stamp duty, and subsidized loans.[55] The study concludes that, although this new industry has produced some 50,000 new jobs and high levels of corporate profits,[56] the 'real winners' have been the large foreign multinational corporations that have been 'reaping huge tax free profits' while the countries in the region 'bend over backwards' to attract this investment. The study reports that these companies have used the threat of relocation to demand government subsidies once they have erased all tax liabilities, forcing countries in the region not just into a 'race to the bottom,' but into a 'race at the bottom.'[57] At the same time, the study

finds that, while labour negotiators lack access to financial information that would enable them to make the case for fairer wages, local governments are strained by the influx of new workers and shrinking local tax revenues, little collateral or technological development has taken place, and environmental damage has escalated through lack of meaningful controls. The usual justification for such heavy trade-offs is that providing new local employment improves the quality of life for workers and their families. However, the study finds no such effects, concluding instead that more than 75 per cent of new jobs were for casual labourers earning '33 cents above the one dollar per day poverty level margin.' As women form more than 70 per cent of the casual labour pool, it appears that, in East Africa at least, FDI has reinforced and might even have intensified gender hierarchies.[58]

5.0 Conclusions

Developing a comprehensive gender analysis of the impact of the taxation of international economic transactions on women is a long-term project that will require greater transparency at every level. This chapter has discussed how (primarily Canadian) overseas development and aid programs, as well as traditional international tax rules on international transactions, determine taxes collected by home and host countries and correspondingly impact large numbers of women.

From the corporate actors that have captured growing shares of overseas development funding to the corporations that drive increasingly one-sided bargains with developing countries, the continuing male dominance of multinational corporations everywhere suggests that the corporate sector itself will not produce solutions to this overall problem. At the same time, the lack of data on gender impacts of transnational exchanges and the lack of political will to address in a meaningful way the complex gender effects of corporate taxation, international taxation, and, from host-country perspectives, domestic taxation of inward FDI, make it difficult for detailed gender-impact analysis or gender budgeting to be carried out.

Similarly, the pro-poor movement in international development economics and critiques of economic relations between investors and host countries often ignore the very real differences between women and men at every stage of the analysis. Initial research shows that the existing international tax regime and its treatment of international investments produce adverse effects on women. It is to be hoped that other

analysts will sharpen their focus on the gender impact and develop the data that are needed to question the way legal policy in this area is formulated and applied.

Notes

1 For feminist perspectives on how uncritical use of gender-neutral legal concepts obscures the realities of women's resources and needs, see Ruth Lister, 'Citizenship and Gender' in K. Nash and A. Scott, eds., *The Blackwell Companion to Political Sociology* (Malden, MA: Blackwell, 2001).

2 See, for example, United Nations Development Programme, *Human Development Reports*, online: <http://hdr.undp.org/en/reports>. This series includes an annual Gender-related Development Index that documents the disadvantaged status of women in each country.

3 For a discussion of the absence of women in corporate and foreign affairs decision-making positions, see Kathleen A. Lahey, 'International Transactions, Taxation, and Women: CEDAW, Sex Equality, and Gender Analysis' National Business Centre Working Papers Series (Vancouver: Faculty of Law, University of British Columbia, 2009).

4 The Tax Justice Network for Africa has carried out several studies of these disparities; further information can be obtained via email: africa@taxjustice.net.

5 See Canada, Department of Finance, *Tax Expenditures and Evaluations 2006* (Ottawa: Department of Finance, 2006), table 2.

6 For an excellent history of trade-related issues and feminist critiques, see Valentine M. Moghadam, *Globalizing Women: Transnational Feminist Networks* (Baltimore: Johns Hopkins University Press, 2005); see also Janet G. Stotsky, 'How Tax Systems Treat Men and Women Differently' (1997) Fin. and Dev. (March) 30 (who succinctly identifies the negative gender impact of common tax instruments).

7 For an overview of the political economy of women, particularly in developing and post-socialist transition states, see Valentine Moghadam, 'The Feminization of Poverty and Women's Human Rights' SHS Papers in Women's Studies/Gender Research 2 (Paris: United Nations Educational, Scientific and Cultural Organization, 2005).

8 Canadian International Development Agency, *Statistical Report on Official Development Assistance – Fiscal Year 2004-2005* (Ottawa: CIDA, 2006), tables A and B. Some 75 per cent of this funding is allocated to CIDA, which funds targeted geographic programs, multilateral programs that link into

the UN and other international financing and development organizations, and a small Canadian partnership program with the voluntary sector. The balance of the funding goes to other federal departments, agencies, and institutes such as Rights in Democracy and the International Development Research Centre, which fund in-house and contracted development projects that focus more on human rights and governance issues than on increasing economic capacity. See also Marcus Pistor, 'Official Development Assistance Spending' *In Brief: Parliamentary Information and Research Service* (22 August 2007) 1.

9 CIDA began using gender-based analysis in 1976, when it adopted its initial policy guidelines on Women in Development (WID); in 1984, it established the WID Directorate. See CIDA, 'Chronology of CIDA's Commitment to Gender Equality,' online: CIDA <http://www.acdi-cida.gc.ca/CIDAWEB/acdicida.nsf/En/REN-218124915-PBF>.

10 CIDA calls gender-equal programs 'equality between women and men specific programming.' This programming has as its principle objective and result equality between women and men, and includes programs designed to raise awareness of women's human rights, women's participation in civil society, and women's access to health care. Gender-integrated programs are 'equality between women and men integrated programming.' These programs must have equality between women and men as one of their objectives and must identify at least one related 'equality between women and men specific programming' result as being explicitly relevant to the investment. For example, general relief funding for civil society in Lebanon that expressly requires that a certain number of women receive university scholarships would be classified as gender-integrated programming.

11 According to the OECD, only 94 per cent of CIDA's sector programs receive this screening. See OECD, 'Canada' in *Aid in Support of Gender Equality and Women's Empowerment, 2004-2005* (Paris: OECD, 2006).

12 These figures are derived from CIDA, 'CIDA's Investment in Equality between Women and Men,' online: CIDA <http://www.acdi-cida.gc.ca/CIDAWEB/acdicida.nsf/En/JUD-31195111-KF2>. See also CIDA, *Statistical Report on Official Development Assistance*, table B, for fiscal years 1998/99 to 2004/05, online: CIDA <http://www.acdi-cida.gc.ca/CIDAWEB/acdicida.nsf/En/JUD-4128122-G4W>.

13 CIDA, 'Lebanon,' online: CIDA <http://www.acdi-cida.gc.ca/lebanon#1>.

14 For the gender impact of microcredit financing, see CIDA, 'Examples of Current Projects,' online: CIDA <http://www.acdi-cida.gc.ca/CIDAWEB/acdicida.nsf/En/JUD-31111120-LSV>.

15 CIDA, 'Gender Equality Guidelines for Partners,' online: CIDA <http://www.acdi-cida.gc.ca/CIDAWEB/acdicida.nsf/En/8525711600526F0A85257119006213E6?OpenDocument>.
16 See the Beijing Declaration and the Platform for Action in United Nations, *Report of the Fourth World Conference on Women* (New York: United Nations, 1995), online: Woman Watch <http://www.un.org/womenwatch/confer/beijing/reports>.
17 See Inter-Agency Standing Committee, *Guidelines for Gender-based Violence Interventions in Humanitarian Emergencies (Field Test Version)* (Geneva: IASC, 2005).
18 Canada, Department of Foreign Affairs and International Trade, *Canadian Direct Investment Abroad (Stocks)*, CANSIM table 376-0051, online: Foreign Affairs and International Trade Canada <http://www.international.gc.ca/eet/pdf/FDI-Outward-Stocks-Country-2006-R2-en.pdf>.
19 Moghadam, 'The Feminization of Poverty' at 3.
20 See United Nations, General Assembly, *Millennium Development Goals* (New York: UN, 2000); idem, *Report of the International Conference on Financing for Development, Monterrey, Mexico* (New York: UN, 2002), chap. 1, resolution 1, annex; and *Paris Declaration on Aid Effectiveness: Ownership, Harmonization, Alignment, Results and Mutual Accountability* (Paris: OECD, 2005), paras 1, 15.
21 *Income Tax Act*, R.S.C. 1985 (5th Supp.), c. 1, ss. 91–96, 126. This exemption is available only if the foreign affiliate income is earned in a country with which Canada has a tax treaty on the further assumption that all tax treaties will provide for corporate tax rates similar to those imposed by Canada.
22 Ibid. s. 121.
23 This approach to corporate income taxation grew out of the discussion of double taxation and the recommendations made in the Royal Commission on Taxation, *Report* (Ottawa: Queen's Printer, 1966).
24 See Frédéric Beauregard-Tellier and Marc-André Pigeon, 'Tax Havens' (Ottawa: Library of Parliament, 2004), 11, note 33.
25 Canada, Auditor General of Canada, *1986 Report* (Ottawa: Office of the Auditor General of Canada, 1986), chap. 4.
26 Canada, Auditor General of Canada, *1992 Report* (Ottawa: Office of the Auditor General of Canada, 1992), chap. 2, para. 2.33.
27 See ibid. paras 2.35–2.56. These transactions were found to involve everything from double dipping interest deductions to conversion of taxable corporate earnings into tax-exempt capital gains and avoidance of nearly all corporate tax liability on foreign-affiliate profits even when repatriated to Canada.

28 Ibid. para. 2.57.

29 OECD, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD, 1998), para. 35.

30 *Income Tax Act*, ss. 95(2)(a.1)–(a.4) and 95(2)(l) were added in 1994 to restrict the scope of 'active business income' in certain offshore transactions.

31 Canada, Auditor General of Canada, *2002 Report* (Ottawa: Office of the Auditor General of Canada, 2002), chap. 11, paras 4.9, 11.97.

32 Ibid. para. 11.67.

33 Canada, Auditor General of Canada, *2007 Report* (Ottawa: Office of the Auditor General of Canada, 2007), chap. 7, intro.

34 In 2001, the CRA had reassessed just C$770 million in corporate income and thus collected C$300 million in additional revenues; by 2006, C$941 million in reassessments generated additional tax revenues of C$749 million. See Canada, Auditor General of Canada, *2007 Report*, para.7.29.

35 Ibid. para.7.47.

36 Canada, Department of Finance, *Tax Expenditures and Evaluations 2006*, table 2.

37 Canada, House of Commons, Standing Committee on Public Accounts, 'Twelfth Report' in Canada, Auditor General of Canada, *1993 Report* (Ottawa: Office of the Auditor General of Canada, 1993), appendix C.

38 Prohibiting the deduction of interest paid on loans to foreign affiliates, except to the extent that distributions are received in a year from the affiliates.

39 Canada, Department of Finance, *Budget* (Ottawa, 19 March 2007).

40 Francois Lavoie, 'Canadian Direct Investment in "Offshore Financial Centers"' Analysis in Brief 21, cat. 11-621-MWE2005021 (Ottawa: Statistics Canada, 2005), table note x, 2, 10.

41 Assuming a conservative 5 per cent return on equity, this would produce operating profits on the order of C$6.2 billion and taxable income of C$3.1 billion, using Canadian tax rates in effect in 2004.

42 UN, *Report of the Fourth World Conference on Women*, Platform for Action, Strategic Objectives A.1, A.4 and H.3, esp. para. 67(a), (b) and 206.

43 See Debbie Budlender, 'A Global Assessment of Gender Responsive Budget Initiatives' in Debbie Budlender et al., eds., *Gender Budgets Make Cents* (London: Commonwealth Secretariat, 2002).

44 Most gender budgets and training materials concentrate on direct expenditures. See Feridoun Sarraf, 'Gender-Responsive Government Budgeting' Working Paper WP/03/83 (Washington, DC: International Monetary Fund, 2003).

45 Canada, Canada Revenue Agency, *Income Statistics 2006* (Ottawa: CRA,

2006) (for the 2004 taxation year), table 4, lines 11 (taxable amount of dividends) and 60 (dividend tax credit).

46 Allocating that C$1.9 billion to ODA and other development/aid programs would also have brought Canada much closer to the 0.7 per cent of GDP it pledged several decades ago to devote to this purpose.

47 See Susan L. Averett, H. Elizabeth Peters, and Donald M. Waldman, 'Tax Credits, Labor Supply, and Child Care' (1997) 79 Rev. Econ. and Statistics 125; and Tim Callan et al., 'A Cross-Country Study of the Effects on Married Women's Labour Supply' CLS Working Paper 99-02 (Aarhus, Denmark: Centre for Labour Market and Social Research, 1999).

48 Canada, Department of Finance, *Tax Expenditures and Evaluations 2006*, tables 1, 2.

49 See Oxfam, *Tax Havens: Releasing the Hidden Billions for Poverty Eradication* (London: Oxfam, 2000) at 4, for a critique of terms such as 'offshore financial centres' and 'tax havens' versus preferential tax regimes in non-haven countries. Oxfam takes the position that international tax competition is a matter of degree, not an either-or phenomenon. In this regard, it is useful to look at Canada's 'Tax Advantage' program, instituted in 2002, which advertises how much lower its business tax rates are than those in the United States, online: Department of Finance <http://www.fin.gc.ca/toce/2003/cantaxadv_e.html>.

50 Jan Martens, 'What if developing countries could finance poverty eradication from their own resources?' *Social Watch* (2006), online: Social Watch <http://www.socialwatch.org/en/informesTematicos/111.html>.

51 Oxfam, *Tax Havens* at 9, note 10. In making these estimates, the Oxfam report assumes a 20 per cent rate of return on invested capital and an average corporate income tax rate of 35 per cent.

52 Ibid. 10.

53 Ibid. citing World Bank estimates for health care.

54 Alvin Mosioma, 'Tax Competition: The Role of Tax Incentives in Encouraging Harmful Tax Competition in the East African Flower Industry' (Nairobi: Tax Justice Network for Africa, 2007), available via email: africa@taxjustice.net.

55 Ibid. 1.

56 Ibid. 2.

57 Ibid.

58 Ibid. 4.

9 Globalization and the Hong Kong Revenue Regime

RICHARD CULLEN AND ANTONIETTA WONG*

1.0 Introduction

When one thinks about globalization, one tends to consider it a post–World War Two phenomenon that has gathered truly significant pace as the communications technology revolution has unfolded over the past two decades. This modern version of globalization has deep foundations, however, within the type of integrated global economy that developed for well over a hundred years prior to World War One, during the colonial era. Primarily, the colonial era involved European-based colonizers and non-European colonized jurisdictions. In terms of scope and political and economic durability, the British Empire was the preeminent product of this period of world development (notwithstanding the loss of most of Britain's North American colonies in the American Revolutionary War). Today, apart from a handful of tiny territories such as Gibraltar, little of the former British Empire remains within the control of the United Kingdom.

Until 1997, the Crown colony of Hong Kong also remained in British hands. On 1 July of that year, however, sovereignty over Hong Kong reverted to the People's Republic of China (PRC) and the former British territory became the Hong Kong Special Administrative Region (HKSAR) of the PRC.[1] The HKSAR acquired, at this time, a new constitution, the Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China (hereafter referred to as the 'Basic Law').[2]

Prior to the arrival of the British in 1841, Hong Kong was home to a series of scattered Chinese fishing and farming communities. For over 150 years, the British maintained Hong Kong as an enclave,

plainly separated from mainland China in many ways. It is now more than 12 years since Beijing resumed dominion over what is now the HKSAR, but notwithstanding Hong Kong's return to the 'Motherland,' the bustling city at the mouth of the Pearl River remains a very separate enclave within China. Hong Kong today operates as a city-state within the most populous nation on Earth and within the largest one-party state the world has ever seen.[3] As we shall see, the HKSAR today is even more fiscally separated from the Chinese mainland[4] than Hong Kong was from the United Kingdom.

Hong Kong has had to grapple with all manner of challenges over the past hundred-plus years, relying, for the greater part, on its own minimal local resources. The most striking of these, of course, is the large deepwater harbour that so attracted the British in the 1840s. Then there is Hong Kong's geographical location: around 50 per cent of the world's population resides within four hours' flying time. Hong Kong's most significant asset, though, is its largely Chinese population.

Our aim in this chapter is to explain how the taxation regime in Hong Kong has developed over the course of its remarkable modern history. Throughout this history, the taxation regime has been notably shaped by the power of globalization, and this continues to be the case today.

2.0 The Evolution of Hong Kong's Political Structure

2.1 Colonial Power within the British Empire

Following the loss of most of its American colonies, Britain's political system progressively underwent a series of fundamental changes. The then still politically active monarchy was deeply discredited by defeat in America. After the 'Glorious Revolution' of 1688, Parliament had notably asserted itself at the expense of the monarchy, but in the eighteenth century, the monarch was still a key political actor, especially in foreign affairs, while Parliament remained a comparatively weak institution in many respects. The judiciary, however, was by then well established as an institution enjoying significant independence.[5]

Over the decades following the defeat in America (and especially after the death of George III in 1820), power moved markedly from the monarchy to Parliament. More significantly, it moved to the executive government within Parliament. Westminster, or parliamentary government, thus emerged as the product of a remarkable 'measured revolution' as the new political model for the United Kingdom.

Despite these radical developments within Britain itself, this new political model was not immediately exported throughout the British Empire. Instead, as its colonial governance template, Britain mostly retained what might be termed the 'George III model': a powerful executive, a comparatively weak legislature, and a separate judiciary.

2.2 The Crown Colony of Hong Kong

Following Britain's seizure of Hong Kong Island in 1841, Hong Kong became a Crown colony with a constitution provided in the Letters Patent (and Royal Instructions) issued through the Privy Council in London.[6] This was the customary method the British used to provide constitutional underpinnings to such colonies, which remained subject to the operation of the direct application of UK law in certain circumstances, while their own law-making powers normally were limited to legislation that had effect only within the colony itself. Larger, usually 'white' colonies, such as those in Australia and Canada, eventually were given Westminster-enacted constitutions and full parliamentary systems of elected government, although their legislative powers long remained restricted.

Notwithstanding the addition of a fair amount of modern political embroidery (especially after World War Two), the British retained the essence of this eighteenth-century system of governance in Hong Kong until the handover in 1997.[7] The task of governing the colony remained in the hands of a London-appointed governor working with a civil service notable, particularly at its top layer, for its high level of political engagement.[8] The fusion of politics and administration in the colonial model of government downplayed the importance of politics and political participation in policy-making.

The governance system that ultimately evolved in Hong Kong under British rule was something of a hybrid: part presidential, part parliamentary, and embedded in a colonial tradition. As in the United States, in British Hong Kong a great deal of power resided outside the legislature – that is, in the hands of the governor. That said, the dominant influence was, and remains, the UK parliamentary tradition, which explains why Hong Kong's Legislative Council (LegCo) has been able, over time, to build a de facto capacity to hold government to account in a partly parliamentary manner.

Despite the lack of democracy, Hong Kong was allowed, after World War Two, to develop under British rule into the freest society in East

Asia. The press and the media generally were able to flourish[9] and the rule of law, implemented primarily through an independent judiciary, put down deep roots.[10]

2.3 The Governance Structure of the HKSAR

Currently, the HKSAR has what might best be described as a US-style presidential system of government (with a separate executive and legislature), heavily decorated with time-honoured colonial characteristics. Under the Basic Law, the HKSAR leader, the chief executive, is selected by an 800-member Election Committee rather than by universal suffrage. No members of this committee (all of whom must come from Hong Kong) are elected; all are appointed (as is the chief executive) by Beijing. For its part, LegCo consists of a single house with 60 members, half of whom are elected by universal suffrage and half by functional constituencies (FCs), another British inheritance. Several FC members stand unopposed in each LegCo election, due mainly to the extremely narrow franchise (below 500 voters) that applies in certain FC seats. For all FCs, the franchise is very small compared with that which applies to directly elected LegCo seats.[11]

3.0 Revenue Regime Development in Hong Kong

3.1 The Initial Phase

The early development of what remains to this day a fundamental aspect of the operation of the Hong Kong Revenue Regime, land-transaction revenues, derived from the assertion by the very first Hong Kong government that it owned the superior title to all land.[12] As Brown and Loh explain,

> [a]t the outset, the administration decided that any interests in land sold to the private sector should be leasehold interests, rather than the freehold interests that could have been offered. The only practical way of releasing land was through auction and the first auctions were held in the 1840's. Commentators were already describing the frenetic bidding from the merchants and volatility of the market. To prevent abuse, the leasehold interests were granted with terms attached limiting the types of usage, which eventually became the key determinant in assessing the economic value of a piece of land.[13]

Almost from the outset, property rates were also imposed on the new property (leasehold) owners.[14] Another early (and continuing) impost was stamp duty, introduced in Hong Kong in 1866.[15] The collection of estate duty effectively came to an end in the HKSAR in early 2006, but prior to this it had applied (albeit just on property situated within Hong Kong) from fairly early in the twentieth century.[16] Excise duties (for example, on hydrocarbon oil, alcoholic drinks, and tobacco products) have also been imposed in Hong Kong for a long time,[17] while an entertainments tax has applied since 1930. Hong Kong's establishment as a free port, however, meant that there have never been any duties on goods entering the territory.[18]

A further, rather grim source of revenue arose from fees and charges that applied to the opium trade. Indeed, it was primarily disputation with China about Britain's right to export opium that led to the First Opium War and the seizure of Hong Kong Island in 1841.[19] The Hong Kong government benefited from this trade for many decades – as late as 1917, up to one-third of all revenues in Hong Kong were related to opium-trading activities.[20]

Another early source of revenue was taxes and fees related to gambling. The Hong Kong Jockey Club was founded in 1884 to run and promote horse racing and came to acquire monopoly rights over all legal gambling activities in the colony. Betting duties were introduced in 1931 and, since World War Two, the club has become both Hong Kong's biggest single taxpayer and most significant charitable contributor.

3.2 Overview of the Current Revenue Regime

Hong Kong has long prided itself on its low and simple tax regime. Indeed, its direct taxes on business profits and earned income remain among the lowest in the developed world.[21] Today, the tax regime encompasses the following key features:[22]

- a narrow taxation base;
- low taxation rates;
- separate schedules applying separately identified taxes to different classes of income – no general income tax;
- no taxation of income derived from outside Hong Kong regardless of the residence status of the taxpayer (source-based taxation);
- virtually no taxation of capital gains;
- no general sales or consumption taxes;

- no customs duties or tariffs and only limited excise duties;
- simple and relatively stable taxation laws;
- retention of stamp duties in the system; and
- almost no use of double taxation treaties.[23]

Moreover, the HKSAR has comparatively constrained government spending, very little government borrowing, infrequent (until recently) deficit budgeting, and massive accumulated fiscal reserves.

Nearly a hundred years after the founding of British Hong Kong, a major change was introduced into the revenue regime: the colony's first income tax. It met with immense resistance from the business community, but a form of limited, schedule-based income tax was finally agreed to in 1940, driven by the threat of Japanese invasion. After the war, the need to find a new revenue source to fund reconstruction of the ravaged colony meant that the income tax was retained, from 1947, in the form of the new Inland Revenue Ordinance. In both its guises, however, the income tax was designed to retain low rates and be quite limited in its application. Today, the main taxes imposed (Hong Kong source only, using separate schedules) are those on profits, salaries, and property.

Despite this low tax regime, Hong Kong still manages to provide public housing on a massive scale and to finance excellent transport and communications systems and comparatively sound education and health systems.[24] At the same time, it has amassed public foreign currency reserves of over US$150 billion.[25]

The explanation for this continuing, apparent fiscal miracle has a number of facets. First, the Hong Kong government has had access to a revenue source rarely available in the modern age to most governments: land. At around 1,000 square kilometres, Hong Kong is very small, and from the colony's inception the British allowed virtually no sale of freehold land.[26] Instead, land was normally made available on a long-term leasehold basis. Moreover, the practice grew of restricting the availability of land for development, which tended to drive up both the price of land and revenue receipts.[27] Indeed, the reliance on land-related revenues in Hong Kong followed a pattern the British established by early in the nineteenth century. In essence, this system sought to fund the establishment of new colonies by relying significantly on the disposal of appropriated or discount-purchased Crown land by colonial governments.[28]

Second, the Hong Kong government has long taken a large fiscal bite

from many secondary market transactions. Strict usage conditions are stipulated in each government lease. If a developer purchases an old building with a view to replacing it with a higher structure, a variation on the purchased lease is required, for which the developer pays the government a substantial 'land premium.' Added to the profits tax paid by developers and all the others involved in construction, transaction-based stamp duties, and salaries tax paid by those working in the sector, in recent years these land-transaction-based revenues have accounted for about half of the HKSAR government's income.[29] The collapse of property prices after the Asian financial crisis of the late 1990s and the 2003 SARS health crisis, however, had a devastating impact on the revenue flow to the HKSAR government, which came to rely over a period of years (and for the first time in living memory) on substantial deficit financing to meet current expenditures.[30] Although mass market residential property prices have recovered significantly since the low point in 2003, it is now recognized that Hong Kong's narrow, land-revenue-related tax base is a serious systemic fiscal flaw that eventually will have to be fixed.[31]

The third aspect of Hong Kong's apparent fiscal miracle is that, historically, the government has been able to control expenditures quite effectively. Cultural-economic reasons provide an important part of the explanation for this. Briefly, Hong Kong people have long relied heavily on family and related networks to cope with a multitude of life's exigencies. Moreover, from the 1960s until the 1990s, Hong Kong maintained high economic growth rates that sustained full employment. Also important was the long-established reluctance of the government to introduce more comprehensive programs to tackle endemic social justice deficiencies.[32]

This combination of factors meant that the Hong Kong government was under significantly less pressure to develop a 'welfare state' of the complexity typically encountered in most other developed economies. Instead, what has evolved is a system described as a 'residual welfare state.'[33]

In short, for the first hundred-odd years of its existence, British Hong Kong maintained a successful revenue system without any need to rely on income tax at all. Since 1947, Hong Kong has continued to maintain remarkable revenue reliance with the single key addition of a limited-impact, source-based, low-tax taxation regime originally derived from the income tax system in place in the United Kingdom in the early 1800s. Furthermore, unlike most other developed jurisdictions,

Hong Kong imposes no tax on capital gains,[34] only very limited taxes on fringe benefits,[35] and no general tax on the provision of goods and services.[36] A key reason Hong Kong has been able not only to fund public spending, but also to put away substantial fiscal reserves, while relying on such a taxation system, has been the major revenue streams from land-related transactions, where the government has deliberately positioned itself as monopoly supplier of this vital 'commodity.' Moreover, in difficult years, such as those after 1997, when revenues have fallen short of spending, the government has been able to cover shortfalls by accessing accumulated reserves – a process that has not required LegCo spending approval.

Hong Kong has survived and, indeed, thrived into the twenty-first century while relying on a revenue regime that would not have been out of place in the nineteenth century.

3.3 The Fiscal Firewall

One crucial role of the Basic Law is to provide for a high degree of separation of the HKSAR from the Chinese mainland (the so-called Two Systems in One Country). Particular effort has been put into drafting provisions in the Basic Law designed to install a constitutional, 'fiscal firewall' between the two revenue regimes. Article 106 of the Basic Law provides that '[t]he Hong Kong Special Administrative Region shall have independent finances[,] ... shall use its financial revenues exclusively for its own purposes, and they shall not be handed over to the Central People's Government. ... The Central People's Government shall not levy taxes in the Hong Kong Special Administrative Region.' Moreover, Article 108 of the Basic Law provides that '[t]he Hong Kong Special Administrative Region shall practise an independent taxation system [and] ... shall, taking the low tax policy previously pursued in Hong Kong as reference, enact laws on its own concerning types of taxes, tax rates, tax reductions, allowances and exemptions, and other matters of taxation.' The Basic Law, in its Preamble, also stresses the need to preserve the prosperity and stability of Hong Kong.

4.0 Conclusion

Consider the Imperial British perspective in the mid-to-late eighteenth century: it was their Empire, so surely they could tax it as they wished. Most controversially, this attitude led to taxing the American colonies.

The long-distance taxes that London attempted to impose on the American colonies included stamp duties and other indirect taxes. Favourable (to the East India Company) arrangements related to the selling of tea were also imposed on the American colonies that proved to be no less inflammatory to colonial political sentiment. War followed, leading to Britain's consequent defeat.

By 1841, the British were well recovered from their Imperial humiliation in America, but they had learned lessons that were to have an important impact on the preferred form of revenue regime to be used in new British colonies. Most notable was the shunning of direct, London-imposed taxation and an emphasis on creating stand-alone, locally anchored revenue regimes. A mainstay of this revised approach was, if at all possible, to place land sales, land-transaction charges, and land taxes at or close to the pivot of each new colonial financing strategy.

When, in 1841, the British established on Hong Kong Island the foothold adjacent to China they had long coveted, the attractions of a land-focused revenue regime were amplified by the decision, from the outset, to make Hong Kong a free port. This choice, however, denied Hong Kong access to customs duties, another traditional bastion of colonial finances. For the first hundred years of British Hong Kong, the revenue regime installed during the colony's founding years remained largely unchanged. In addition to income from land sales, property rates, and land-transaction imposts, the colony relied on a limited range of other funding sources, including certain fees and charges, excise duties, stamp duties, and opium-trade-related revenues.

When one considers that, in the hundred years between 1841 and 1940, the population grew a hundred-fold from under 8,000 to more than 800,000, to have maintained such a stable revenue regime was quite a feat. How was this managed?

First, the total area comprising the Crown colony increased greatly, initially in 1860 and then in 1898. This expansion explains part of the population increase. A key explanatory factor of the durability of the early revenue regime was the land-as-commodity funding that was a central feature of the system. The expansion of Hong Kong increased the public 'land bank' greatly.

A second key factor was the comparatively low cost of providing government services. Services were limited, in keeping with nineteenth-century practice, but even more so given the remarkable self-reliance (repeated examples of dire poverty notwithstanding) of the majority Chinese population. Moreover, the significant defence costs for Hong

Kong, an outpost far from London, were borne primarily by the British government.

A third factor was the remarkable economic success of the new free port. For many decades, a great deal of that success pivoted around the appalling industrial-scale shipment of opium to China by the British from India. The Hong Kong government benefited directly from this trade through licence fees and other charges. As late as 1917, the Colonial Office noted that up to one-third of all revenue in Hong Kong was derived from opium-trading activities.[37] On these foundations, however, was built an extraordinarily successful trading economy that was not opium reliant.[38] Hong Kong's very high level of economic activity has been an important factor in maintaining sufficient revenues using a minimalist taxing approach. That minimalist approach, in turn, has amplified the attractiveness of Hong Kong as a trading centre.

One truly major change to the Hong Kong revenue regime was the introduction of income tax a hundred years after the colony's founding. The tax was kept low and limited in its application, however, through the use of source-based, schedular taxation, laying the foundation for the modern approach.

Although Hong Kong has been a First-World city-state for some decades, its revenue regime differs little from that which applied more than 60 years ago. It is genuinely difficult to think of many other developed jurisdictions where this is so. Moreover, once one removes income tax from the frame, the structure of Hong Kong's revenue regime retains a look that is not all that different from the basic structure of a hundred years ago. The HKSAR's new-found interest in double tax treaties might modify the overall look of the revenue regime to a degree over the coming decades, but the impact of such changes is likely to be fairly marginal. A more drastic change that does look possible within a decade or two is the introduction of a general consumption tax – that is, a value-added tax or goods and services tax.

As we consider the interaction between the phenomenon of globalization and the shaping of national tax systems, Hong Kong presents a most interesting, though rather special, case. Distinctive factors related to Hong Kong include:

- the special viability (due to Hong Kong's confined size) of the land-as-commodity revenue scheme;
- the cross-generational, consistent, energy, hard work, intelligence, and remarkable self-reliance of the local population;[39]

- the income-generating (and capital-wealth-building) role of decades of involvement in the opium trade;
- basically sound, long-term institutional development;
- the geographic location generally and proximity to China in particular; and
- Victoria Harbour.

Hong Kong, it turns out, also made the most of its 'first-mover advantage' as East Asia's premier free trade port. Later trumpet players may emulate and even show notably greater technical skill than Louis Armstrong, but no matter how good they may be, only Louis Armstrong can be Louis Armstrong.

All of this suggests that any lessons Hong Kong might offer in terms of comprehensive tax policy development are limited. Some broad lessons are nevertheless suggested by the Hong Kong experience. First, long-term active and consistent engagement with a globalized world can be used to help drive remarkable local advantage. Next, this kind of engagement can assist in shaping and sustaining a durable, comparatively simple revenue regime. Another way of looking at this is to ask if there are any other modern jurisdictions demonstrating anything like the long-term, political-economy success of Hong Kong (absent substantial, readily exploitable natural resources) without being very open to international free trade. To the authors' knowledge, there are none. International (free) trade was the lynchpin of British Hong Kong's success from the outset. One fundamental reason the revenue regime has been able to retain such a simple (almost primitive) structure is that trade has generated massive numbers of transactions per capita. The lesson that may be drawn from this is that where an economy facilitates many commercial transactions, even a simple, narrow-based, comparatively unchanging tax system might be able to generate sufficient long-term public revenue.

Finally, Hong Kong's low tax-related transaction costs come at the expense of equity and revenue leakage, but, in the final squaring of the ledger, the question is at least raised whether this approach might, in the long run, promote greater cost effectiveness (and, thus, arguably a certain level of enhanced fairness) than more modern, more complex systems. Tax systems such as those found in Canada and Australia, to take two examples, have been much developed in the quest to achieve improved equity and fairness. Yet, individual taxpayers in Hong Kong typically spend less than 5 per cent of the time and money devoted to

completing an annual tax return than is the case in Canada or Australia. And that is only if they pay tax! Around 60 per cent of wage and salary earners in Hong Kong encounter zero tax-transaction costs: they are liable for zero tax, because they do not earn enough to trigger any tax liability. True, the very well off do especially nicely in Hong Kong (no dividend tax is most helpful in this regard). But, on certain measures, the Hong Kong revenue regime is clearly more equitable for the least well off than regimes in Canada and Australia – and this is even before one factors in the serious, overall economic benefits of having a revenue regime that applies such comparatively low tax-transaction costs on every conceivable form of regular enterprise.

Notes

* This chapter draws from certain earlier works by Richard Cullen, and provides a précis of the longer, full paper presented at the Alex Easson Symposium held at Queen's University on 29 February 2008. Copies of the full paper are available from Richard Cullen. We would like to thank Ms. D.W. Choy, Faculty of Law, The University of Hong Kong, for her editorial assistance.

1 Hong Kong consists of Hong Kong Island, the Kowloon Peninsula situated on the mainland opposite Hong Kong Island, the New Territories comprising the area north of Kowloon up to the Shenzhen River, and 235 islands.

2 The Basic Law was adopted by the National People's Congress of the PRC on 4 April 1990 and came into force on 1 July 1997. The Court of Final Appeal, the pinnacle of the judicial process in the HKSAR found in 1999 that the Basic Law enjoys constitutional status within the HKSAR (*Ng Kar Ling & Others v. Director of Immigration* [1999] 1 Hong Kong Law Reports & Digest 315). See also Johannes M.M. Chan, H.L. Fu, and Yash Ghai, eds., *Hong Kong's Constitutional Debate: Conflict over Interpretation* (Hong Kong: Hong Kong University Press, 2000).

3 The Chinese one-party state is still primarily organized politically according to principles laid down by Lenin. Thus, only the Chinese Communist Party is permitted to exercise any meaningful political power. Economically, the PRC has abandoned, to a very large extent, Marxist principles of economic organization and regulation. For a review of this phenomenon, see J.A.G. Roberts, *A History of China*, 2nd ed. (Basingstoke: Palgrave-MacMillan, 2006), chap. 7.

4 We use the term 'mainland' to indicate the PRC, excluding the HKSAR,

the Macau SAR, and Taiwan. These four entities are sometimes collectively referred to as 'Greater China.' Both the HKSAR and the Macau SAR are recognized as component jurisdictions within the PRC enjoying a special level of autonomy within the unitary state. Taiwan has remained entirely separated from the PRC in an operational sense since the end of the Chinese Civil War in 1949, although few nations recognize Taiwan as a separate country at international law. Beijing regards Taiwan as a 'renegade province' of the PRC. For a short historical overview of the history of the Chinese unitary state and the relationship of the components of Greater China to that state, see Richard Cullen, 'Political Reform in Hong Kong within Greater China' (2007) 59 Politika Ann.J.

5 See 'Parliament of Great Britain' in David M. Walker, ed., *The Oxford Companion to Law* (Oxford: Clarendon Press, 1980).

6 The history and important operational aspects of Hong Kong's constitutional documentation under British rule are explained well in Yash Ghai, *Hong Kong's New Constitutional Order*, 2nd ed. (Hong Kong: Hong Kong University Press, 1999), chap. 1.

7 This same system was used to form the primary HKSAR governance institutions that are embodied in the Basic Law.

8 An alternative meaning given in the *Chambers 21st Century Dictionary* (Edinburgh: Chambers, 1996) for the term 'bureaucracy' is 'a country governed by officials.' Hong Kong was, and still largely is, a bureaucracy in this sense. For further discussion of the structure and operation of Hong Kong's system of government, see Christine Loh and Richard Cullen, 'Political Reform in Hong Kong: The Principal Officials Accountability System – The First Year (2002-2003)' (2005) 14 J. Contemporary China 153.

9 Michel Bonnin, 'The Press in Hong Kong: Flourishing but Under Threat' (1995) 1 China Perspectives 48.

10 See Yash Ghai, 'Praise is not enough' South China Morning Post (22 March 1998); see also Carol Jones, 'Politics Postponed' in Kanishka Jayasuriya, ed., *Law, Capitalism and Power in Asia* (London: Routledge, 1999), chap. 3.

11 For a detailed overview of the operation of Hong Kong's political system since 1997, see, for example, Carine Lai and Christine Loh, *From Nowhere to Nowhere* (Hong Kong: Civic Exchange, 2007). For a thorough review of the operation of the functional constituency system, see Christine Loh and Civic Exchange, eds., *Functional Constituencies* (Hong Kong: Hong Kong University Press, 2006); see also Richard Cullen, 'Hong Kong: The Making of a Modern City-State' (2006) 13 Murdoch E-Law J. 24, online: <http://elaw.murdoch.edu.au/issues/2006/1/eLaw_Cullen_13_2006_03.pdf>.

12 Stephen Brown and Christine Loh, 'Hong Kong: The Political Economy of

Land,' online: Civic Exchange <http://www.civic-exchange.org/eng/upload/files/200206_PoliticalEconomyofLand.pdf>.

13 Ibid. at 8.

14 Roger Nissim, *Land Administration and Practice in Hong Kong*, 2nd ed. (Hong Kong: Hong Kong University Press, 2008) at 11.

15 See Jianbo Lou, 'Hong Kong: An Offshore Financial Centre in the Far East – Its Present and Future' (1998) 52 Bulletin for Int'l Fiscal Documentation 297.

16 This came in the form of the Estate Duty Ordinance (1932). See also Hong Kong, Inland Revenue Department, 'Abolition of Estate Duty – Inland Revenue Department Press Release,' online: Inland Revenue Department <http://www.ird.gov.hk/eng/ppr/archives/07042501.htm>.

17 See 'Hong Kong: Customs Excise,' online: Hong Kong – The Facts <http://www.gov.hk/en/about/abouthk/factsheets/docs/customs.pdf>.

18 See Hong Kong Legislative Council, 'Hong Kong Legislative Council Minutes, 27 March 1941,' online: Hong Kong Legislative Council <http://www.legco.gov.hk/1941/h410327.pdf>.

19 See Kristianna Tho'Mas, 'Opium War of 1838–42: How Britain Stole Hong Kong from China' Workers World (10 July 1997), online: Workers World Service <http://www.hartford-hwp.com/archives/55/044.html>.

20 Ellen N. La Motte, *The Opium Monopoly* (New York: MacMillan, 1920), chap. 7.

21 See Alan Reynolds, 'Hong Kong's Excellent Taxes' Townhall.com (2 June 2005), online: <http://www.cato.org/pub_display.php?pub_id=3793>.

22 This outline of the current Hong Kong revenue system summarizes and updates a more comprehensive review of the taxes applying in the HKSAR in Richard Cullen, 'Revenue Law in Hong Kong: The Future' in Raymond Wacks, ed., *The New Legal Order in Hong Kong* (Hong Kong: Hong Kong University Press, 1999), chap. 12.

23 Hong Kong's approach to double taxation treaties has been changing since 1997, however. The HKSAR government has signed a limited number of such treaties (not carrying active investigation and disclosure regimes) with, for example, Belgium and Thailand. The HKSAR has also signed a double tax arrangement with the PRC mainland.

24 Cullen, 'Revenue Law in Hong Kong.'

25 'Foreign Reserves' The Economist (24 January 2008), online: The Economist <http://www.economist.com/markets/indicators/displaystory.cfm?story_id=10568635>. These fiscal reserves are known officially as the Exchange Fund, which essentially comprises the fiscal reserves (money saved from revenues raised but not spent over previous decades) of the

government's General Revenue Account (roughly 40 per cent of the Exchange Fund) and the balance of government foreign currency reserves that back the Hong Kong dollar (HKD) (roughly 60 per cent of the Exchange Fund). The Exchange Fund is managed by the Hong Kong Monetary Authority, which also manages the quasi-currency board pegging of the HKD to the U.S. dollar. That part of the Exchange Fund that backs the HKD covers about 240 per cent of all HKD notes and coins in circulation plus certain other securities, but only about 30 per cent of all HKD deposits.

26 An exception is the Hong Kong Anglican Cathedral, which occupies freehold land.

27 In fiscal year 1995/96, as the real estate bubble was approaching its peak during the last years of British rule, the Hong Kong government derived some 32 per cent of total revenues from land-related transactions (including sales, lease modification premiums, and stamp duties, but not profits tax or salaries tax arising directly from the real estate sector); see Christine Loh, 'The Government's High-Land-Price Policy: Can Hong Kong People Afford it?' online: Citizens Party <http://www.citizensparty.org/housing/landpric.html>.

28 See, for example, Keith C. Hooper, 'Substance but not Form: Capital Taxation and Public Finance in New Zealand (1840–1859),' online: <www.findarticles.com/p/articles/mi_qa3933/is_200311/ai_n9326384>; R. Cole Harris, *Making Native Space: Colonialism, Resistance and Reserves in British Columbia* (Vancouver: University of British Columbia Press, 2002), chap. 1.

29 Andrew Halkyard, 'The Hong Kong Tax Paradox' (1998) 8 Revenue L.J. 1.

30 Thomas Crampton, 'Hong Kong moves to curb deficit' International Herald Tribune (9 January 2003), online: International Herald Tribune <http://www.iht.com/articles/2003/01/09/a7_6.php>. Note that this deficit spending has been funded by relying on Hong Kong's massive reserves rather than through borrowing, reducing any adverse credit-rating impact significantly. For a full review of the onset and impact of the SARS crisis in Hong Kong, see Christine Loh and Civic Exchange, eds., *At the Epicentre: Hong Kong and the SARS Outbreak* (Hong Kong: Hong Kong University Press, 2004).

31 The HKSAR government acknowledges this problem in 'The Economy: Public Finance: Need to Broaden Tax Base' in *Hong Kong Yearbook 2004*, online: <http://www.info.gov.hk/yearbook/2004/en/03_05.htm>. See also the proposals put forward by the British Chamber of Commerce in Hong Kong, online: The British Chamber of Commerce in Hong Kong <http://www.britcham.com/asp/ArticleDetail.asp?ArticleId=259>; and Stephen Brown et al., 'The Budget and Public Finance in Hong Kong,' online: Civic

Exchange <http://www.civic-exchange.org/publications/2003/BudgetReport.pdf>.

32 Leo F. Goodstadt, *Uneasy Partners* (Hong Kong: Hong Kong University Press, 2005).

33 Hong Kong has been characterized by a somewhat paradoxical combination of heavy public involvement in financing and provision of direct public goods (for example, housing and general, educational, and health infrastructures) while at the same time maintaining comparatively low overall government spending (compared with revenues); see Eliza Wing-Yee Lee, 'The Politics of Welfare Developmentalism in Hong Kong,' online: United Nations Research Institute for Social Development <http://www.unrisd.org/unrisd/website/document.nsf/0/B764A113DEE628D4C125706D0032DA66?OpenDocument>.

34 Section 14 of the Inland Revenue Ordinance, which imposes profits tax, specifically excludes capital profits from assessment of that tax. It does tax 'trade,' however, and the case law – and the Inland Revenue Ordinance definitions section (Section 2) – stipulate that this term includes 'an adventure in the nature of trade.' Thus, one-off transactions can still be regarded as 'trading' in certain circumstances (normally fairly rapid reselling of real estate) and taxed accordingly. See Cullen, 'Revenue Law in Hong Kong.'

35 Reduced taxes apply to the provision of employee housing and certain education and share benefits. Otherwise, the 'cash-convertibility' rule applies. This rule, which is based on old English case law, provides that, as long as an employee fringe benefit is not paid in cash and cannot be converted to cash by the employee, it will not be considered a perquisite that can be taxed as part of salary (see Cullen, 'Revenue Law in Hong Kong').

36 It is arguable that the Hong Kong government's long-established, high-land-price policy has imposed a de facto consumption tax on all consumers in Hong Kong. Inflated land prices (which have benefited the government most of all) have driven up the costs of doing almost every sort of business in Hong Kong because of high rents or high initial land-purchase costs. These input costs have then been passed on to all consumers in the setting of prices for goods and services.

37 See La Motte, *The Opium Monopoly*.

38 Against remarkable odds and as a product of an agreement between the United Kingdom and Qing Dynasty China, wholesale trade in opium to (and within) China was finally reduced to very low levels between 1907 and 1917; see ibid., chap. 15.

39 There is claim, possibly apocryphal, that Friedrich Hayek once observed that socialism is an excellent system – for up to 12 people.

PART III

Tax Treaties

10 Canada's Evolving Tax Treaty Policy toward Low-Income Countries

KIM BROOKS*

1.0 The Importance of Tax Treaty Design for Low-Income Countries

International trade and international flows of investment have mushroomed in recent decades, and an extraordinary amount of the world's goods and services and annual investment capital flows across international borders. The tax treatment of almost all of the income that results from these cross-border transactions is affected by tax treaties. Well over twenty-five hundred bilateral tax treaties are now in force between the countries of the world; Canada alone has almost a hundred tax treaties in force. Tax treaties have thus become a major interest to legislators, tax practitioners, and tax scholars, and writing about them has become a cottage industry in large segments of the international tax community. As one indication of the interest they have generated, massive books are now being written about each article in these treaties; for example, a 415-page book has been published about Article 13 of the OECD (Organisation for Economic Co-operation and Development) Model Convention, which deals with the taxation of capital gains and which is less than 20 lines of print long in the model treaty (see also Chapter 11 in this volume).[1]

In part because tax treaties, like substantive tax law itself, are so important, examining the design of the treaties a country enters into should tell us a good deal about the balance of interest-group power in that country, the prevailing ideas, the ambitions of its politicians, the institutions of government, and other variables that influence public policy-making in the country. Although the policy of tax treaties is thus multi-faceted and complex, this paper takes only one aspect of that larger picture – namely, Canada's evolving tax treaty policy to-

ward low-income countries – and examines it in some detail, for two reasons. First, this aspect of tax treaty policy is important in its own right. The revenue that low-income countries are able to raise from the income earned in their jurisdiction on cross border trade and investment flows is often significant and critical for the development of their economy and for raising the standard of living of their impoverished residents. Second, and just as important for the purposes of a collection paying tribute to Alex Easson, it was a subject that greatly interested Alex. Throughout much of his career, he acted as a tax advisor to the governments of low-income countries, and he was keenly aware of the importance of the design of tax treaties for them.

It is commonly asserted that the purpose of income tax treaties is to facilitate international trade and investment by providing for the avoidance of double taxation, where two countries seek to tax the same income, by avoiding excessive taxation at source, by prohibiting a country from discriminating against a business owned by residents of the other country, and by providing an efficient mechanism for resolving disputes that might arise between tax administrators over the interpretation of the treaty (see Chapters 11, 12, and 13 in this volume).[2] However, although this is the generally advanced objective of tax treaties, in most treaties this objective is achieved in part by effectively reducing the tax base of the source country (usually the low-income country) and thus increasing the tax take of the residence country (usually the high-income country).[3] This is done primarily, first, by reducing the scope for the source taxation of business income through changing the definition of a permanent establishment (the threshold for business taxation) and, second, by reducing the withholding tax rate on passive income earned in the source country. Some cynics have suggested that transferring revenues from low-income to high-income countries has not been an unintentional side effect of treaties but, rather, an unstated goal (see Chapters 2, 6, 8, and 11 in this volume).[4]

The story of the development of modern tax treaties is a familiar one and does not need repeating here except to note that, in large part, the extent to which a country's tax treaty policy favours low-income countries depends upon the extent to which the country is prepared to adopt provisions from the United Nations model treaty as opposed to the OECD model treaty.[5] In 1963, the OECD published a draft model tax treaty (not published in an official version until 1977) that was crafted by representatives of the major western industrialized countries. Since then, the model treaty has gone through a number of minor

iterations and is the one upon which almost all tax treaties are based. Concerned that the OECD model treaty resulted in too large a reduction in source-country tax, in 1980 an expert group assembled by the United Nations published an alternative model treaty. Although it is based upon the OECD model, the UN model retains much greater source-country taxation. When negotiating with low-income countries, many countries are prepared to adopt some provisions from the UN model, and the extent to which they are is some indication of their concern that low-income countries be able to retain their tax base in cross-border transactions.

In examining Canada's evolving tax treaty policy toward low-income countries, this chapter proceeds as follows. In 1988, Alex Easson published a paper he had written for a conference, 'The Royal Commission on Taxation: 20 Years Later,' that he descriptively titled 'The Evolution of Canada's Tax Treaty Policy since the Royal Commission on Taxation.'[6] The paper exemplifies much of Easson's work: it is well written, logically organized, and brings clarity to a broad area of tax law and policy; it provides a strong analytical foundation for the developments in tax treaty policy; it contains a good deal of pragmatism in its prescriptions; and it reflects Easson's enthusiasm for design questions in tax treaties with low-income countries. Thus, to provide a baseline for examining the recent evolution of Canada's tax treaty policy, the following section provides an overview of Easson's paper, which, in effect, states the policy as of 1988.

The next part of the chapter examines three aspects of Canada's tax treaties entered into since 1988 that might increase the scope for source-based taxation. The first aspect is the important ways in which the scope of source taxation of business income in treaties is increased – for example, by lowering the threshold for taxation of business profits, expanding the scope of the profit that should be allocated to an enterprise, allowing the taxation of technical or management fees with minimal connection to the source state, and permitting the taxation of gains on the alienation of real property. The second aspect is treaty provisions that limit withholding tax rates on passive investment income earned in the source country, including withholding tax rates on payments of interest, dividends, and royalties. The final aspect is the accommodations Canada has made since 1988 through tax-sparing provisions for tax incentives enacted in low-income countries.

The final part of the paper briefly reviews the major changes to the Canada-United States income tax convention proposed in the Fifth

Protocol, signed on 21 September 2007, and raises the implications for Canada's tax treaty policy toward low-income countries.

2.0 Alex Easson's Assessment of Canada's Tax Treaty Policies to 1988

Although not focused only on Canada's tax treaty policy with low-income countries, Easson nevertheless devotes a significant portion of 'The Evolution of Canada's Tax Treaty Policy since the Royal Commission on Taxation' to Canada's tax treaties with developing countries and his observations more generally have particular applications for low-income country negotiations. He sets out the history of Canada's tax treaty policy prior to the Royal Commission on Taxation (the Carter Commission), which reported in 1966. He then highlights the limited number of treaties Canada had negotiated and attempts to explain why Canada negotiated so few treaties around the time of the Carter Commission and immediately following it. Finally, he provides an overview of changes to the domestic Canadian tax system that would have influenced Canada's tax treaty negotiations in the period following the release of the Carter Commission report.

A country's domestic tax design inevitably influences its tax treaty negotiating position. For example, on the one hand, a low-income country that defines income for tax purposes broadly in its domestic legislation and that wishes to raise revenue from non-resident investors in the country undoubtedly will seek to ensure that its tax treaties do not detract significantly from its ability to collect taxes on income with a source in its jurisdiction. On the other hand, low-income countries that provide generous exemptions from taxation for non-residents in their domestic legislation in the hope of attracting additional investment will try to use their tax treaties to secure protection for their tax incentives.

In his 1988 piece, Easson reviews four major changes to Canada's domestic tax regime following the release of the Carter Commission report, each of which would have had an impact on Canada's tax treaty negotiating position with low-income countries. First, he discusses the introduction of foreign-affiliate rules, designed to tax the income of Canadian residents earned by investing in foreign corporations, which allowed Canadian corporations to receive dividends free from Canadian tax if the foreign corporation was resident in a country with which Canada had a tax treaty. These rules would have created an incentive for low-income countries to enter into tax treaties with Canada. If, for

example, a low-income country offered either a low- or no-tax regime for business activities as a means of attracting foreign investment, that tax incentive would be preserved under these rules. The design of Canada's foreign-affiliate rules ensured that active business income earned through a foreign affiliate could be repatriated to Canada without any additional Canadian tax.

Second, the increase in the statutory withholding tax rate on cross-border investment income from 15 to 25 per cent also created an incentive for low-income countries to enter into tax treaties with Canada. If a low-income country wanted to collect additional revenue from withholding, it might be able to convince Canada to agree to a withholding tax rate higher than 15 per cent. In the alternative, if the low-income country wanted a low withholding tax rate to encourage some forms of investment, it would need to enter into treaty negotiations with Canada to achieve a lower withholding tax rate in return.

Third, Easson discusses the introduction of a capital gains tax in Canada in the years following the release of the Carter Commission report, which required a change in Canada's tax treaty position to one that sought to preserve the source jurisdiction's ability to tax capital gains. This change to Canada's domestic tax rules would have been useful where the low-income country wanted to advocate for broad taxing scope for some capital investment, for example, in natural resources.

Finally, the enhancement of Canada's dividend tax credit, which allowed Canadian resident shareholders to partially offset underlying corporate tax paid on corporate distributions, might have created additional bargaining power for all countries, including low-income countries. Canada has always refused to extend its dividend tax credit to non-resident investors and, as a consequence, it has been pressed to give other concessions to its treaty partners.

Although the domestic tax systems of the treaty partners informs many of the discussions about the way a tax treaty between them can be used to integrate the two countries' systems, the form of the tax treaty itself, without question, is driven by the tax treaty designed and promoted by the OECD. At the time Easson published his paper, the 1977 model treaty was the most recent version of the OECD model. Easson noted some of Canada's reservations about that treaty, including those on withholding tax rates (Canada reserved the right to impose a higher rate of withholding tax than that proposed by the OECD model), capital gains (Canada reserved the right to tax a wider range of dispositions than the OECD model suggested), and pension income

(Canada reserved the right to tax pension income at source). Canada continues to have reservations on several articles of the current OECD model treaty – for example, it also now reserves the right to tax income from the alienation of real property (not just income from the real property). Canada has removed its reservations, however, on the withholding tax rates that apply to dividends, interest, and royalties, and on capital gains and pensions.

Despite Canada's long-standing membership in the OECD and its general adherence to the OECD model tax treaty, since the Carter Commission report in particular it has recognized that it has a role to play in ameliorating the capital-exporting bias of the OECD tax treaty in its tax treaties with low-income countries. Therefore, in addition to continuing to register reservations about the OECD model treaty, Canada often negotiates tax treaties with low-income countries that follow parts of the UN model treaty. Although it follows the OECD model closely, in some regards the UN model allows greater source taxation, thus providing some additional taxing jurisdiction (relative to the OECD model) to capital-importing countries.

Generally speaking, as Easson recounts, entering into tax treaties with low-income countries requires three kinds of changes to the standard tax treaty Canada enters into with capital-exporting (high-income) countries. First, tax treaties with low-income countries often reflect an enlargement of the source taxation of business income. Second, they increase the amount of tax that the source country is permitted to claim by withholding from passive investment income (relative to the source taxation permitted under the standard OECD model). Third, they often include tax-sparing provisions (which preserve the specific tax incentives offered by capital-importing, typically low-income, countries).

Easson reviews Canada's concessions to low-income countries on each of these bases. In terms of enlarged source-country taxation, Canada's treaties in this period reveal a willingness to expand the definition of permanent establishment and to increase the rate of withholding tax for passive income. Easson also notes that, although prior to the Carter Commission report Canada had not granted any tax-sparing provisions, after the release of that report Canada was willing to enter into such provisions with a number of low-income countries.

The next part of this chapter reviews Canada's tax treaty policy, particularly as it applies to middle- and low-income countries since 1988, building on Easson's observations of Canada's willingness to lower the threshold for source taxation, increase the rates of withholding tax, and protect tax incentives where its treaty partner is a low-income country.

3.0 Canada's Tax Treaty Policy toward Low-Income Countries since 1988

Over the past two decades, Canada's tax treaty network has continued to expand, with the signing and bringing into force of 53 comprehensive tax treaties between 1988 and June 2008.[7] These treaties have broadened the global reach of Canada's tax treaties significantly, with six signed with countries in Africa, 13 with countries in Asia, 26 with countries in Europe, five with countries in South America, and three with North American countries. As Easson predicted, Canada has expanded its reach to include former socialist countries, including Armenia, Azerbaijan, Croatia, Kazakhstan, Kyrgyzstan, Moldova, and Uzbekistan.

Of these 53 treaties, 15 were signed with high-income countries (those with annual per capita gross domestic product, GDP, in excess of US$20,000 at 2005 purchase-power-parity rates), 17 were with middle-income countries (per capita GDP of US$10,000–19,999), and 21 were with low-income countries (per capita GDP of less than US$10,000).[8] All 53 treaties were examined to determine the extent to which they expanded the scope for the source taxation of business income (if at all), the policy they reflect on withholding tax rates on passive investment income, and their use of tax-sparing provisions. The results are described below. To spare the reader copious notes, and since these provisions are numbered the same in almost every treaty, treaty articles have not been noted.[9]

3.1 Expanding the Scope for Source Taxation of Business Income

3.1.1 Lowering the Threshold for a Permanent Establishment

Easson noted that prior to 1988 Canada was willing to negotiate a tax treaty with a low-income country that lowered the threshold of activity required before a non-resident would be subject to tax on business activities in that country. At least in theory, a country could decide to tax the profits earned by a non-resident enterprise simply because the enterprise sells goods and services in that country. No country, however, has managed to conclude a tax treaty that sets the threshold for taxation of business income so low, although when a group of experts met under the auspices of the United Nations to draft the UN Model Convention, they contemplated the possibility of such an approach.[10]

Both the OECD Model Convention and the UN model employ the permanent-establishment concept to delineate the degree of contact a

non-resident enterprise carrying on business in a jurisdiction requires before it is subject to tax there. The OECD model's standard definition of a permanent establishment is based primarily on the idea of some physical presence and includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry or other place of extraction of natural resources, and a building site or construction or installation project that lasts more than twelve months.

The OECD model also provides for some exclusions from the definition of permanent establishment. These exclusions are generally designed to remove from the scope of source-based taxation the use of facilities simply for storage or delivery, the maintenance of a stock of goods, and the maintenance of a fixed place simply for purchasing goods or solely for a preparatory or auxiliary reason. In essence, these exclusions remove casual or temporary business activities from the scope of source-based taxation.

The UN Model Convention departs from the OECD model's definition largely by broadening the definition of activities that might be sufficient for an enterprise to be found to have a permanent establishment. Of the major departures from the OECD model, six are of interest here.

First, the UN model reduces the amount of time required for a building site or construction or assembly project to exist to be considered a permanent establishment. Engaging in a construction or assembly project in a country generally would be considered to be 'carrying on business' in a country and, therefore, under many countries' domestic tax systems (including Canada's), the enterprise would be subject to tax. According to the OECD model, such a project would be considered to be a permanent establishment only if it existed for more than twelve months, while under the UN model, the period is only six months. In negotiating with high-income treaty partners since 1988, Canada has agreed to the standard OECD term of twelve months before a building site, construction, or assembly project is considered to be a permanent establishment in thirteen cases and to a term of six months in only two. In negotiations with middle-income countries, Canada has agreed to a term of twelve months in seven treaties, six months in nine treaties, and three months in one treaty. In its treaties with low-income countries, Canada has agreed to the OECD period in only seven treaties, reducing the time to nine months in one treaty (with Armenia), six months in ten treaties (with Bulgaria, Ecuador, India, Jordan, Mongolia, Peru, Tanzania, Venezuela, Vietnam, and Zimbabwe), three months in two treaties (with Algeria and Nigeria), and no time in one treaty (with Sen-

egal). Clearly, Canada is much more likely to grant a shorter period if the country is a middle- or low-income country than it is to deviate from the OECD's suggested period of twelve months for high-income countries.

Second, the UN model expands the definition of permanent establishment to include the general furnishing of services, including consultancy services, by an enterprise through employees or other personnel where the activities continue for the same or a connected project within the country for more than six months, or a lesser period, within any twelve-month period. Under the OECD model, such activities alone would not necessarily constitute a permanent establishment. The rationale for this expansion of the permanent-establishment concept in the UN treaty was that such services were analogous to building site or other construction project activities.[11] In contrast to its treaties with high-income countries (only two of which include the services provision), Canada has agreed to add this provision in eight treaties with middle-income countries and in twelve with low-income countries (Algeria, Armenia, Ecuador, India, Jordan, Kazakhstan, Mongolia, Peru, Senegal, Tanzania, Vietnam, and Zimbabwe). Generally speaking, the period of time before the services constitute a permanent establishment ranges from three months (two treaties) to twelve months (also two treaties). Only one treaty (with Jordan) does not include a time period before the services are held to be a permanent establishment, but only if the services are related to the exploitation of natural resources.

Third, the OECD model lists six circumstances in which, even though the enterprise has a fixed place of business, it is not a permanent establishment since the activities are preparatory or ancillary in nature. The UN model, in contrast, eliminates the 'delivery of goods' from this exclusion list. Under the OECD model, if an enterprise simply uses facilities for the delivery of goods or maintains a stock of goods in that jurisdiction for delivery, that activity alone is not sufficient to constitute a permanent establishment. Under the UN model, the delivery-of-goods exclusion is not listed as an exception to the permanent establishment definition. For the most part, Canada has not agreed to exclude the mere delivery of goods or merchandise from the rule that deems such activities not to be a permanent establishment, but it has followed this UN-proposed change in its treaty with middle-income Oman and with six low-income countries (Algeria, Armenia, India, Senegal, Vietnam, and Zimbabwe).

As an alternative to setting up an office or other fixed place of business, an enterprise may conduct business in a country by sending an agent to act on its behalf. Whether or not that agent constitutes a permanent establishment depends largely on the agent's degree of independence. As a fourth change to the OECD definition of permanent establishment, the UN model expands the concept of a dependent agent. Under the OECD model, if an enterprise has a dependent agent who is able to exercise the authority to conclude contracts habitually in the name of the enterprise, that agent will constitute a permanent establishment. Under the UN model, a dependent agent either concludes contracts on behalf of the developing-country enterprise or has no authority to conclude contracts but regularly delivers goods or merchandise on behalf of the enterprise. In other words, the UN model expands the definition of permanent establishment by including an agent who habitually maintains in the state a stock of goods or merchandise from which he or she regularly delivers goods or merchandise on behalf of the enterprise. Since 1988, Canada has followed the UN model in only one treaty with a high-income country (Kuwait)[12] and in two with middle-income countries (Lithuania and Trinidad and Tobago). In contrast, six of the 21 tax treaties it has negotiated with low-income countries (those with Armenia, India, Nigeria, Senegal, Vietnam, and Zimbabwe) include this expanded definition of permanent establishment.

Fifth, the UN model considers an independent agent to be a permanent establishment if the agent's activities are wholly or almost wholly devoted to the enterprise and if the conditions of the agent's relationship differ from those that would have been made between independent enterprises. This provision is absent from the OECD model. Since 1988, Canada has included this provision in tax treaties with two high-income countries (Kuwait and the United Arab Emirates), eight middle-income countries, and six low-income countries (Azerbaijan, India, Jordan, Peru, Tanzania, and Vietnam).

Sixth, the UN model expands the definition of permanent establishment to include insurance activities that would not constitute a permanent establishment under the OECD model, which taxes insurance premiums in the source country only if the insurance enterprise has an agent authorized to conclude contracts on its behalf. In contrast, the UN model provides that, if an insurance company collects premiums in a country or insures risks in the country through an employee or dependent agent in that country, the insurance company is considered to

have a permanent establishment that may be subject to tax in that jurisdiction. Canada has included this provision in just one tax treaty with a high-income country (Belgium), in four with middle-income countries (Argentina, Chile, and in 2001 and 2006 treaties with Mexico), and in seven with low-income countries (Armenia, Azerbaijan, Moldova, Peru, Senegal, Tanzania, and Vietnam).

Thus, Canada has been willing to expand the concept of permanent establishment in many of its tax treaties with middle- and low-income countries but certainly not all. No larger trend is apparent over the two decades since Easson's paper on Canada's tax treaty policy, and no other generalization is possible about whether or not Canada will adopt some of the UN model's modifications to the permanent-establishment concept.

3.1.2 Expanding the Profit Allocated to Entities with a Permanent Establishment

In addition to defining the concept of permanent establishment, the OECD model provides the basis on which activities associated with a permanent establishment should be subject to tax. Generally speaking, the model suggests that an enterprise should be taxable in the source jurisdiction only on the profits it earns that relate to its permanent establishment, and those profits should be calculated in the same way they would be for domestic business activities – that is, income tax should be applied to the permanent establishment's net profits.

In contrast, the UN model suggests two significant changes to the calculation of the profits that should be subject to tax. First, it aligns more closely the calculation of the permanent establishment's taxable income with the 'force-of-attraction' principle: once an enterprise has a permanent establishment in a jurisdiction, all income derived there should be subject to tax there. The UN model calculates the profits of the permanent establishment in the same way as the OECD model does, but it also includes (1) profits that are attributable to sales of goods or merchandise of the same or similar kind as those sold through the permanent establishment and (2) other business activities carried on of the same or similar kind as those carried on through that permanent establishment. Two of Canada's tax treaties with middle-income countries (Argentina and the 1991 treaty with Mexico) and six with low-income countries (India, Jordan, Kazakhstan, Nigeria, Tanzania, and Zimbabwe) include this expansion of the taxing jurisdiction of the source country. Since 1996, however, Canada seems to have become less

likely to grant this expansion, having agreed to it only in two treaties (with Armenia and Oman).

Second, both the OECD and the UN models generally allow for the deduction from business profits of head-office expenses incurred for the purpose of the business of the permanent establishment, including executive and general administrative expenses, even if they are incurred in the non-source state. The UN model, however, denies a deduction for head-office expenses that are payments for royalties, fees, interest, and commissions for specific management services, thus significantly expanding the taxation of business profits earned at source. Since 1988, Canada has granted this provision in more than half the treaties it has negotiated with low-income countries (those with Armenia, Algeria, India, Jordan, Kazakhstan, Moldova, Nigeria, Ukraine, Uzbekistan, Venezuela, and Vietnam). In contrast, Canada has granted the extension in only three treaties with middle-income countries (Chile and the 1991 and 2006 treaties with Mexico) and in one with a high-income country (Kuwait).

3.1.3 Allowing for the Taxation of Technical Fees

If business income escapes taxation as profits because the taxpayer lacks a permanent establishment, generally speaking the income is exempt from taxation at source. In some cases, however, Canada has negotiated a technical or management fees article that allows the source country to impose a withholding tax on technical or management fees even in the absence of a permanent establishment.[13] The definition of a technical or management fee varies in the three tax treaties Canada has negotiated since 1988 that include such an article, but generally each permits the source country to charge a withholding tax if there is a payment of any kind to any person in consideration of any service of an administrative, technical, managerial, or consultancy nature. The treaties with Zimbabwe (1994) and Trinidad and Tobago (1995) set a maximum rate of 10 per cent; in the treaty with Tanzania (1997), the rate is 20 per cent.

3.1.4 Allowing for Taxation on the Alienation of Real Property

Since Easson's paper, Canada has registered a reservation on the OECD model's article that addresses the taxation of income from real property. The OECD model provides broad protections for source-based taxation of income (but not alienation) from real property, presumably on the basis that such property has a strong economic connection to the source state (see Chapter 11 in this volume). Therefore, the source state need

not demonstrate that the taxpayer has a permanent establishment in order to tax income from immovable property, including income from agriculture or forestry. The OECD model also provides that the article addressing the taxation of real property applies to income derived from the direct use, letting, or use in any other form of immovable property. Canada, however, reserves its right to tax not only the income derived from real property but also the gains on the alienation of that property under the real property article. Indeed, Canada preserved the ability to tax non-residents on the disposition of real property in 45 of the 53 tax treaties it negotiated between 1988 and 2008. In short, Canada feels strongly enough about the ability to tax income from the alienation of real property in Canada that it has been willing to include expanded source taxation on this basis in its treaties regardless of the income status of its negotiating partner.

3.2 Permitting Higher Withholding Tax Rates for Passive Income

Non-business forms of investment income – namely, interest, royalties, and dividends – are addressed in separate articles of the OECD and UN model tax treaties and in those Canada has negotiated. In most cases, however, the treatment of such income is the same: jurisdiction to tax the income is shared between the source country and the country of residence. The source country is permitted to tax this income using a withholding tax applied to the gross payment, limited to a particular rate, while the country of residence may tax the residual. In his 1988 paper, Easson observed that Canada adhered to a 15-15-15 model – that is, 15 per cent withholding tax on each of interest, royalties, and portfolio dividends. He also noted that Canada was often willing to permit a higher rate of withholding tax in treaties with low-income countries, an observation that remains true, although there appears to be a significant trend toward lower withholding tax rates generally.

3.2.1 Interest Income

The OECD model proposes a withholding tax on interest of 10 per cent. The UN model does not set a particular rate but assumes that a higher rate might be appropriate where the treaty partner is a lower-income country. In its tax treaties since 1988, Canada has negotiated withholding tax at various rates, depending on the treaty partner. For all high-income countries, the rate has been set at 10 per cent; in twelve treaties with low-income countries, the rate is 10 per cent, in one it is 12.5 per

cent, in seven it is 15 per cent, and in one (with Senegal) the rate is non-reciprocal: Senegal can impose a withholding tax of 20 per cent on *bons de caisse* interest and 16 per cent on other interest, while Canada can set a rate of 15 per cent.

In addition to low withholding rates, exemptions from the taxation of certain types of interest income also erode the tax revenues of source countries. Canada offers relatively few exemptions from withholding tax on interest in its tax treaties. All the treaties negotiated since 1988 (except those with Chile, Croatia, and Peru) include an exemption for government-related interest payments. Treaties with high-income countries also frequently include exemptions for pension-related entities, for credit sales of equipment and merchandise, and for late-payment penalties. These exemptions are less common in the treaties negotiated with low-income countries. Aside from government-related interest payments, only four of Canada's tax treaties with low-income countries (Moldova, Tanzania, Ukraine, and Zimbabwe) include an exemption for interest income, in each case for pension-related entities. In contrast, eleven treaties with middle-income countries include an exemption for some type of interest payment (other than government-related interest payments).

Over time, Canada's rates of withholding on interest have been declining. The Third Protocol to the Canada-United States tax treaty, signed in 1995, marked the reduction of withholding tax rates on interest to 10 per cent from the 15 per cent that was common at the time of Easson's 1988 paper. In the 2007 federal budget, Canada announced its intention to remove altogether its domestic withholding tax on interest payments to unrelated foreign lenders. This significant change to Canada's withholding tax policy came into force upon recent revisions to its tax treaty with the United States.[14] That treaty includes the additional benefit that non-arm's-length lenders are also exempt, although participating debt interest is subject to the same withholding tax rate as portfolio dividends.

3.2.2 Royalties

The OECD model treaty proposes a zero rate of withholding on royalty payments, a position from which Canada has always deviated. Since 1988, in all of Canada's tax treaties with high-income countries and fourteen with low-income countries, the rate has been set at 10 per cent. In one treaty with a low-income country, the rate is 12.5 per cent, in five it is 15 per cent, and in one (with Tanzania in 1995), the rate is 20 per

cent. Canada, in fact, has not granted a rate other than 10 per cent in any tax treaty since the one signed with Senegal in 2001.

The articles on royalties in the tax treaties Canada has negotiated also often contain exemptions from withholding tax (or lower rates of tax), particularly with respect to cultural goods (such as literary works), patents, information concerning industrial, commercial, or scientific experience, and computer software. Treaty partners presumably request many of these exemptions because Canada grants them for these kinds of payments in its domestic tax law. Canada is much more likely to include exemptions from royalty withholding in its tax treaties when the treaty partner is a high-income country; only three treaties with high-income countries contain no exemptions, compared with nine treaties with middle-income countries and 17 with low-income countries. Eight other treaties with low-income countries (Azerbaijan, Ecuador, Mongolia, Trinidad and Tobago, Uzbekistan, Venezuela, Vietnam,[15] and Zimbabwe) include reductions from the standard withholding tax rate for some kinds of royalty payments, thereby reducing the tax revenues collected by the source country from income from such payments.

3.2.3 Dividends

Both the OECD and UN model treaties provide for split rates of withholding tax for dividend payments. If the taxpayer has a significant investment in the corporation paying the dividend, the withholding rate is typically lower than if the taxpayer is holding only a so-called portfolio investment. It is therefore necessary to distinguish between a significant investment, to which the lower rate will apply, and a portfolio investment. In making this distinction, the OECD model has a much higher ownership threshold (25 per cent) than the UN model (10 per cent). Canada's tax treaties usually set the threshold for portfolio dividend treatment at either 10 per cent (in ten tax treaties with high-income countries, eight with middle-income countries, and ten with low-income countries) or 25 per cent (in two tax treaties with high-income countries, eight with middle-income countries, and four with low-income countries). Its tax treaty with Vietnam, however, contains three possible rates (5 per cent when the taxpayer has more than 70 per cent of the voting shares, 10 per cent when the owner has between 25 and 70 per cent of the shares, and 15 per cent when the owner has less than 25 per cent). In three treaties with low-income countries (Algeria, Kyrgyzstan, and Senegal), there is no differential rate – that is, the withholding tax rate is the same regardless of the share ownership.

In terms of withholding tax rates for significant investments, Canada is more likely to negotiate higher rates with low-income countries. Withholding tax rates of 5 per cent for such investments are in fourteen treaties with high-income countries, nine with middle-income countries, and eight with low-income countries). A rate of 10 per cent applies in one treaty with a high-income country, in eight with middle-income countries, and in six with low-income countries. In addition, a 12.5 per cent withholding tax rate applies in a single treaty with a low-income country, a 15 per cent rate applies in four treaties with low-income countries), and a 20 per cent rate applies in Canada's tax treaty with low-income Tanzania.

In terms of withholding tax rates for portfolio investments, Canada traditionally has negotiated a rate of 15 per cent, except in four treaties with low-income countries where the rate was set at 16 per cent (Senegal), 20 per cent (Zimbabwe), and 25 per cent (India and Tanzania). The treaty with Senegal, signed in 2001, is the most recent; the other three were signed in the early to mid-1990s, perhaps suggesting that Canada's negotiators have moved to a firmer position on a 15 per cent maximum withholding tax rate for dividends.

As was the case for interest payments, Canada has agreed in a few instances to non-reciprocal withholding tax rates. In its treaty with Zimbabwe, the rate is 15 per cent for payments from Canada and 20 per cent for payments from Zimbabwe; in the treaty with Senegal, the rate is 15 per cent for payments from Canada and 16 per cent for payments from Senegal.

Generally, no exemptions are provided from dividend withholding tax; however, the tax treaties with Denmark, Luxembourg, and Oman exempt shares owned by pension-related entities, while the treaty with Norway exempts shares held by governments.

In an effort to ensure equality of treatment between branch operations and separately incorporated entities, Canada imposes a tax of 25 per cent on unincorporated branches carrying on business in Canada.[16] Since the OECD model expressly prohibits taxes on undistributed profits of a non-resident company, Canada has registered a reservation to the article on the taxation of dividends to preserve its ability to impose the branch profits tax. Canada's tax treaties reduce the rate of the branch profits tax to the lowest dividend rate, which means that, to the extent that the withholding tax rate on dividends has been declining for low-income countries, the withholding tax rate on branch taxes has been reduced as well. This is not likely significant for low-income countries, since few of them presumably collect a branch profits tax.

3.3 Preserving the Tax Incentives of Low-Income Countries

Easson was an international expert on the design of tax incentives, and his 1988 paper reviews Canada's use of tax sparing to preserve the effectiveness of tax incentives offered by low-income countries (see Chapters 2 and 6 in this volume). Tax-sparing provisions require the high-income country to give a tax credit for the taxes that would have been paid had the incentive not been granted. In the absence of such a treaty provision, if a low-income country forgoes taxes on certain income earned in its jurisdiction in an effort to attract foreign investment, the high-income country, if it taxes income earned by its residents on a world-wide basis, would simply tax its resident on the full amount of that income without having to provide any offsetting tax credit, thereby removing altogether the effect of the tax incentive offered by the low-income country.

Easson observed that, until 1988, Canada routinely granted tax-sparing provisions to low-income countries. Since then, however, Canada has agreed to a tax-sparing provision in eleven tax treaties, four with middle-income countries and seven with low-income countries (Algeria, Bulgaria, India, Mongolia, Nigeria, Tanzania, and Vietnam). In 1998 the OECD released a report that urged countries to reconsider the use of tax-sparing provisions in their tax treaties, but did not outright argue that such provisions should be abandoned.[17] On the basis of this report, in 2000, the OECD modified its Commentary on tax sparing,[18] which now emphasizes that tax sparing is 'very vulnerable to taxpayer abuse,'[19] cautions that it might not be an effective means of promoting development, and underlines that tax-sparing provisions might facilitate the erosion of the tax bases of other countries. The Commentary also suggests that tax sparing only be used by countries whose economic level is significantly below that of the OECD tax treaty partner. Since the release of the 2000 Commentary, Canada has agreed to a tax-sparing provision only once, in a 2002 treaty with Mongolia, and the scope of that provision preserved a discrete tax incentive for a limited period of time.

It might be noted, however, that the popularity of tax-sparing provisions in Canada's tax treaties prior to the release of the 2000 OECD Commentary is somewhat curious.[20] As discussed above, Canada provides an exemption for dividends received from foreign affiliates if the dividend is paid from active business income earned in a country with which Canada has a tax treaty. Consequently, so long as a Canadian multinational carries on its foreign business activity through

a foreign affiliate and so long as the country in which the business income is earned has a treaty with Canada, no Canadian tax is payable, and thus the effect of a tax incentive offered by a low-income country is preserved even without a tax-sparing provision. In addition, in the 2007 federal budget, Canada extended the exemption treatment of active business income earned in a non-treaty country if that country has a tax information exchange agreement with Canada, a change that could affect the negotiation of future comprehensive tax treaties. If an information exchange agreement is sufficient to obtain exemption from Canadian tax, businesses or low-income countries might not press Canada to negotiate a comprehensive treaty. Instead, if a low-income country offers a business tax incentive from which Canadian multinationals can benefit, so long as the business is carried in that country through a foreign affiliate of the Canadian firm the incentive will be preserved if the country has a tax information exchange agreement with Canada.

4.0 Future Directions in Canada's Tax Treaty Policy toward Low-Income Countries

Easson concluded his 1988 paper by forecasting issues that likely would influence future tax treaty negotiations. He predicted that

- countries would continue to expand their tax treaty networks, including in Latin America and the Middle East;
- the number of multilateral treaties between clusters of countries would grow;
- concerns about tax treaty abuse would grow;
- countries would increase efforts to combat avoidance and evasion;
- interest in unitary taxation would grow; and
- domestic tax reforms would continue to influence the design of tax treaties.

In some respects Easson's predictions have proven correct. Canada certainly has continued to expand its tax treaty network. Also, along with other OECD countries, it has become increasingly concerned about the use of tax treaties as a mechanism for avoidance, conscious of the importance of tax treaties as a means of facilitating information exchanges, and cognizant of the need for more effective means of dispute resolution. In other respects, however, Easson appears to have been too optimistic. Although many scholars have been enthusiastic about the

promise of unitary taxation, it does not appear to be any closer to realization than it was in 1988 (see Chapter 7 in this volume). Furthermore, the number of multilateral treaties has not grown significantly over the past twenty years.

In this chapter, I am not so bold as to make predictions, as Easson did, but I would note that the 2007 Protocol to the Canada-United States Tax Convention (see Chapter 14 in this volume) could signal a change in Canada's tax treaty policy that has significant implications for low-income countries. The Protocol, the fifth since the Canada-United States treaty was signed in 1980, marks a significant change in Canada's tax treaty policy with the United States and, by implication, to Canada's tax treaty policy generally. In particular, four changes, and their potential implications for low-income country treaty negotiations, should be highlighted.

First, the Protocol extends Canada's newly enacted domestic withholding tax exemption on interest to non-arm's-length interest payments. This change and its treaty extension could put downward pressure on withholding tax rates, making it increasingly difficult for low-income countries to raise tax revenues from non-business foreign investment. Different rates for interest, royalties, and dividend payments could also put pressure on the characterization of repatriations from low-income countries, although, in many cases, the rates imposed on these sources of income are already different.

Second, some jurisdictions include provisions in their tax treaties that are designed to prevent individuals who are not *bona fide* residents of one of the two treaty countries but of a third country from indirectly taking advantage of the benefits provided under the treaty. Unlike the United States, which usually negotiates a limitation-of-benefits provision in its tax treaties, Canada historically has taken the position that its general anti-avoidance rule should be sufficient to combat tax-treaty shopping.[21] That view, however, appears to be changing: in the past several years, Canada has included more limited provisions in the 'miscellaneous' articles of its treaties that attempt to restrict the use of tax treaties where there are preferential tax regimes for non-residents.[22] More dramatically, the Fifth Protocol to the Canada-United States tax treaty includes Canada's first mutual limitation-of-benefits provision.[23] If such provisions become a norm in Canada's tax treaty negotiations, low-income countries could see additional pressure on their tax administrations to police, for example, access-to-tax incentives that are preserved by treaty provisions or treaty design.

Third, the Protocol now deems services provided by individuals to

constitute a permanent establishment (see Chapter 14 in this volume). If an individual who performs services is not a permanent establishment under the standard definition, the rule now deems the individual to have a permanent establishment if he or she performs services in the country for a period of 183 days or more in any twelve-month period and if, during that period, more than 50 per cent of the gross active business revenues of the enterprise consists of income derived from services performed in the country by the individual. The deeming rule also applies if the services are provided for the same period of time with respect to the same or connected project for customers who are residents of, or maintain a permanent establishment in, the source country and the services are provided in respect of that permanent establishment.

Low-income countries might watch this development with interest given the importance of taxing business income and the difficulty of establishing that an enterprise has a permanent establishment in the jurisdiction. In that sense, it is like the provisions in tax treaties with middle- or low-income countries that enable the taxation of an enterprise for which a dependent agent furnishes services. In many cases, the period required for taxation under such provisions in Canada's tax treaties with low-income countries exceeds 183 days. Presumably the new Protocol suggests that Canada now may be willing to agree to services provisions more frequently and with shorter periods.

Finally, the Protocol requires that disputes between competent authorities be resolved by compulsory arbitration. Tax treaties generally include either an article that addresses the resolution of disputes or a mutual agreement procedure. Although the OECD initially resisted arbitration as a means of resolving disputes between competent authorities and/or between competent authorities and taxpayers, throughout the 1980s and 1990s, pushed by the business community,[24] its popularity grew. In 1992, the OECD added commentary to the exchange-of-information provision of its model treaty that recognized arbitration as an option for dispute resolution, and in 2007 the OECD Committee on Fiscal Affairs incorporated a mandatory and binding arbitration procedure.[25] It is perhaps not surprising that such arbitration has grown since Easson's 1988 paper. Indeed, Canada has included arbitration provisions in 12 treaties with high-income countries, 14 with middle-income countries, and 17 with low-income countries.

The Canada-United States Protocol is not the only signal of a change in Canada's tax treaty policy. An advisory panel to review Canada's system of international taxation (see Chapters 1 and 6 in this volume),

set up as part of the 2007 federal budget provisions, has released a consultation report indicating it is considering major changes in Canada's domestic legislation, which would have significant consequences for tax treaty policy.[26] For example, the panel has identified inbound treaty shopping, expanding the exemption system for active business income, and broadening withholding tax exemptions as issues for consideration.

Easson's 1988 paper focused on the Carter Commission report as a marker for change in Canada's tax treaty policy. It seems that, with the new Protocol to the Canada-United States tax treaty and the striking of the advisory panel on international taxation, Canada is embarking on a new period of tax treaty policy change. One hopes that, as it considers these changes, Canada will not ignore the special circumstances of low-income countries or that critics will be given grounds to claim that the real purpose of the changes is simply to shift investment and revenue from low-income countries to Canada.[27]

Notes

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1 Stefano Simontacchi, *Taxation of Capital Gains under the OECD Model Convention: With Special Regard to Immoveable Property* (Leiden: Kluwer Law International, 2007).

2 An equally important objective of tax treaties is to prevent cross-border tax evasion. Arguably, treaties have been less successful in achieving this objective than in removing impediments to trade and investment and, thus, investment flows between countries probably have been encouraged to grow beyond what might have been the case if all income hade been taxed at the appropriate rates.

3 See, for example, Reuven S. Avi-Yonah, *International Tax as International Law: An Analysis of the International Tax Regime* (Cambridge: Cambridge University Press, 2007), chap. 9.

4 Tsilly Dagan, 'The Tax Treaties Myth' (2000) 32 J. Int'l L. and Politics 939 (2000) ('[tax treaties] serve … much more cynical goals, particularly redistributing tax revenues from the poorer to the richer signatory countries').

5 For a brief history of the development of the model tax treaties, see Kim Brooks, 'Tax Treaty Treatment of Royalty Payments from Low-Income

Countries: A Comparison of Canada and Australia's Policies' (2007) 5 eJ. Tax Res. 168 at 171–6.

6 Alexander J. Easson, 'The Evolution of Canada's Tax Treaty Policy since the Royal Commission on Taxation' (1988) 26 Osgoode Hall L.J. 495.

7 It has also signed three treaties that have not come into force (with Gabon, Italy, and Lebanon) and twelve protocols/amendments.

8 Income data drawn from United Nations Development Programme, *Human Development Report, 2007–2008* (New York: UNDP, 2008), table 14, online: <http://hdr.undp.org/en/media/hdr_20072008_en_complete.pdf>.

9 See online: <www.mcgill.ca/tax>.

10 Stanley S. Surrey, 'United Nations Group of Experts and the Guidelines for Tax Treaties between Developed and Developing Countries' (1978) 19 Harvard Int'l L.J. 1 at 11.

11 See also the explanation in the UN Commentary to Article 5, para. 3, that 'management and consultancy services should be covered because the provision of such services in developing countries by corporations of industrialized countries often involves very large sums of money'; United Nations, *Commentary on the Articles of the 1980 United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: UN, 1 January 1980).

12 Canada's treaty with Kuwait also (and unusually) includes two additional provisions: one that deems a dependent agent to be a permanent establishment if the person secures orders exclusively or almost exclusively for an enterprise or other enterprises controlled by that enterprise or in which the enterprise has a controlling interest; or if the person manufactures goods or merchandise belonging to the enterprise.

13 Canada also permits the source taxation of fees that might be characterized as management fees in some articles that address other types of income; for example, it allows for the source taxation of technical assistance in its tax treaty with Argentina.

14 *Income Tax Act*, R.S.C. 1985 (5th Supp.), c.1, s. 212(1)(b).

15 The treaty with Vietnam includes a lower rate not for one of the standard exemptions but for the provision of technical fees, which is captured in the treaty's royalties provision.

16 *Income Tax Act*, s. 219.

17 Organisation for Economic Co-operation and Development, *Tax Sparing: A Reconsideration* (Paris: OECD, 1998).

18 OECD, 'Model Tax Convention on Income and on Capital' (Paris: OECD, 1992, amended in 1994, 1997, and 2000), loose-leaf; the revised Commentary is reflected in paras 72–78.1.

19 Ibid.; see para. 76 of the 2000 Commentary.

20 Canada agreed to tax-sparing provisions in 36 of its tax treaties.

21 See United States, Department of Treasury, 'Protocol Amending the Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital' (Washington, DC: Department of the Treasury, 26 September 1980), as amended by the protocols of 14 June 1983, 28 March 1984, 17 March 1995, and 29 July 1997. See para. 3 of the general explanation in the Technical Explanation to Article 29A of the Canada-U.S. Convention.

22 Article 27, para. 3 of the Canada, Trinidad and Tobago 1995 Income Tax Convention, 8 February 1996; income subject to withholding tax, from 1 April 1996; other provisions, from 1 January 1996. The paragraph states: 'This Convention shall not apply to any company, trust or partnership that is a resident of a Contracting State and is beneficially owned or controlled directly or indirectly by one or more persons who are not residents of that State, if the amount of the tax imposed on the income or capital of the company, trust or partnership by that State is substantially lower than the amount that would be imposed by that State if all of the shares of the capital stock of the company or all of the interests in the trust or partnership, as the case may be, were beneficially owned by one or more individuals who were residents of that State.' See also Article 28.

23 A limitation-of-benefits provision was included in the Third Protocol to the Canada-U.S. treaty, but it was designed to apply only for the purposes of the United States.

24 The International Chamber of Commerce, for example, endorsed compulsory arbitration in 1984; see International Chamber of Commerce resolution of 16 June 1984, annexed to International Fiscal Association, *Resolution of Tax Treaty Conflicts by Arbitration* (Deventer, Netherlands: Kluwer, 1994) at 97.

25 For a critique of the OECD proposal, see Michael J. McIntyre, 'Comments on the OECD Proposal for Secret and Mandatory Arbitration of International Tax Disputes' (2006) 7 Florida Tax Rev. 622.

26 Advisory Panel on Canada's System of International Taxation, 'Enhancing Canada's International Tax Advantage: A Consultation Paper (Ottawa, April 2008) at 1.4,' online: <http://www.apcsit-gcrcfi.ca/05/cp-dc/pdf/Rpt-eng.pdf>.

27 One anonymous reviewer of this chapter helpfully suggests that the Department of Finance might be urged to lend an elite team of treaty negotiators to work with low-income countries to ensure that those countries receive the negotiating advice and expertise they (in many cases) badly need.

11 Tax Treaties and the Taxation of Non-residents' Capital Gains

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1.0 Introduction

One of the many significant contributions Alex Easson made to tax thinking looking forward to the twenty-first century was a renewal of skepticism of the benefit of double tax treaties.[1] He argued that if the key problem to be addressed in international taxation was, as the title of the treaties suggests, the avoidance of double taxation, the solution lay not in the treaties but in national tax legislation. Indeed, the treaties themselves were incapable of offering a direct solution – they could merely require signatories to provide relief by way of credit or exemption in domestic legislation. But this relief can be, and inevitably always is, offered in domestic legislation whether or not a treaty applies to income. Treaties are wholly redundant in this aspect.

If the notional purpose of tax treaties – relief from double taxation – is largely a smokescreen, what is their real purpose? Their principal function is to allocate taxing rights, primarily in favour of residence countries over source countries.

Jurisdictions are willing to give up taxing rights over non-residents in treaties for a variety of reasons.[2] In the case of capital-exporting countries, there will be a rough treaty reciprocity with other capital-exporting jurisdictions, so abandoning taxing rights involves no revenue cost. The policy does come at a theoretical cost for capital-importing nations, but some might conclude there is no real revenue cost to voluntarily relinquishing taxing rights if administrative capacity is weak and the jurisdiction cannot actually tax non-residents effectively. Alternatively, capital-importing jurisdictions might believe that surrendering taxing rights will attract more foreign investment or that trading off

taxing rights will yield different non-tax strategic benefits from treaty partners.

The model tax treaties of both the Organisation for Economic Co-operation and Development (OECD) and the United Nations initially allocate the bulk of taxing rights to the residence country where a resident of one signatory derives income from a source in the other signatory (see Chapters 6 and 10 in this volume). Subject to some important exceptions, Article 7 of the treaties gives the residence country the exclusive right to tax *profits* of an *enterprise* sourced in the other country.[3] The terms 'profits' and 'enterprise' are interpreted broadly, the effect of which is to severely constrain the taxing rights of source countries over local profits derived by non-residents. For capital-importing nations, this initial allotment of taxing rights to the residence country places significant pressure on the exceptions to the general rule found in subsequent treaty articles.

The exceptions allow source countries to retain two types of taxing rights. One is capped rights, which allow a source jurisdiction to impose a withholding tax up to a stipulated cap on interest, royalties, and dividends. The other is wider rights that allow a source country to impose its domestic tax rules fully on some specified types of income, including employment income, income derived by a non-resident through a permanent establishment located in the source country, and gains from the disposal of real property in the jurisdiction. Tax concessions and investments to attract foreign investment often erode any taxing rights retained over business income derived by a non-resident through a permanent establishment. The retained taxing rights over gains on the disposal of real property, therefore, can be important to the remaining tax base, particularly for natural-resources-rich jurisdictions.

The model treaty provision that protects the full taxing rights of source countries over gains realized by non-residents on the disposal of local real property is Article 13 (see Chapter 12 in this volume). While all the articles in the model treaty raise a host of questions, Article 13 seems to raise more than some others, and there is a wide divergence of views about the appropriate responses to those issues. As a consequence, there is a broad spectrum of variations of Article 13 both in practice and in the domestic legislation that Article 13 is intended to protect. Article 13 stands out not only in terms of its diversity in practice from country to country but also in respect of any one country's treaties – the norm is for a country to have different – sometimes greatly different – versions of the article in almost all its treaties.

An inappropriate form of Article 13 in a treaty can have significant revenue implications for source jurisdictions. This is particularly true for developing and transitional jurisdictions not fully familiar with the many techniques residents of capital-exporting countries use to slip outside the scope of Article 13 and thus fall back into Article 7, which insulates them from local taxation.

This chapter considers the difficulties faced by jurisdictions that seek to retain in their tax treaties the right to tax gains related to the disposal of local real property. The next section reviews briefly the reasons jurisdictions seek to retain rights to tax these gains even when they abandon the power to tax non-residents on the disposal of other assets connected to the jurisdiction. The subsequent four sections explore some of the technical issues that should be considered by jurisdictions before agreeing to the wording of a proposed treaty Article 13. These deal with the type of gains subject to Article 13, the meaning of real property, what happens when real property is held through an interposed entity, and how older tax treaties might operate if the gains realized by non-residents on the disposal of real property are later brought into the domestic tax base.

Finding the optimal construction for Article 13 is a challenge, but anything less than optimal might eliminate a jurisdiction's right to tax gains wholly attributable to real property in the country. This chapter could serve as a checklist of some key points that developing and transitional jurisdictions might wish to consider when reviewing proposed Article 13 drafts.

2.0 Why Land?

However strong the conceptual case might be for source-country taxing rights over income generated in that country, practical issues can erect insurmountable barriers to assessment or collection of taxes. This explains in part the significant retreat in many countries from full-source taxation of active business income.[4] Jurisdictions such as Canada now make little or no attempt to collect tax from non-residents who derive business income in the country without access to a permanent establishment.[5]

These problems generally do not apply to real property. The transfer of property is completed only when the transaction is registered in a local government office, so that there is a written record that can trigger the assessment process. In the event of tax default, there is an as-

set available for seizure to guarantee payment, particularly if the onus for remitting tax is transferred to the purchaser.[6] And unlike the case of charges for the use of intangible assets or goods and services supplied in the course of related-party business transactions, it is generally not difficult to establish an actual market value for real estate, thus bypassing the risk that tax liability would in any case be avoided through transfer-pricing arrangements.

Nor can there be any conceptual confusion about the source of gain from the sale of real property. However difficult it might be to pinpoint the source of gain from cross-border sales of goods or services or exploitation in a jurisdiction of intangible property rights created or owned in another state, there can be no doubt that a rise in the value of real property must be attributable primarily to conditions in the state where the land is situated, whether the rise is due to improved infrastructure, increased demand, inflation, or any other factors. Foreign currency fluctuations might yield a gain or loss in the currency of the non-resident owner's jurisdiction in respect of a price-stable asset, but changes in the value of the source country's currency must be attributable to source-country factors, reinforcing the theoretical case for source-country taxation of gains realized in respect of real estate.

At the same time, the customary rationale often advocated for lightly taxing foreign direct investment (see Chapter 2 in this volume) seems not to apply to investments in real property. Rightly or wrongly, there is a growing perception that taxes affect the level of foreign direct investment,[7] and jurisdictions that wish to attract mobile capital that is not seeking location-specific rents increasingly are forgoing taxing rights over that income. The concern motivating concessions for capital-seeking mobile rents cannot apply to real estate investments, inherently the most location-specific investments possible.

All these factors help to explain why even jurisdictions that are content to exempt or lightly tax most types of investment income and business income not associated with a local permanent establishment might choose to tax non-residents on gains they derive from the disposal of local real property. They similarly explain why the OECD, with its strong bias towards residence-basis taxation, provides for the retention of that power in its model double tax agreement.

Do these rationales extend to gains on the disposal of any other assets owned by non-residents with a strong nexus to a jurisdiction? The international view appears to be shifting slowly to 'no.' A number of European countries, Canada, Japan, and other jurisdictions continue to tax

capital gains derived by non-residents on the disposal of other selected assets,[8] such as shares in private companies, shares in public companies above a minimum ownership threshold, and capital interests in local trusts. There has been some retreat, however, from the broader tax base over the past decade.[9] Australia, for example, followed the Canadian model in 1985 when it brought capital gains into the income tax base but in 2006 changed direction and narrowed the capital gains tax base for non-residents to gains on real property and interests in some land-rich interposed entities as well as assets of permanent establishments.[10] Countries that assert a very broad jurisdiction to tax non-residents on gains realized on the disposal of local property other than real property could soon be seen as outliers from the norm.

One exception to this broad generalisation might be countries that do not provide for deemed dispositions upon emigration or that provide for deemed dispositions but defer the tax liability until the time of disposal. To protect the local tax base, these countries sometimes assert a right to tax former residents on gains realized on disposals of substantial shareholdings in local companies, usually within a fixed period such as five years or even ten years after ceasing to be resident. These countries often negotiate an additional paragraph to Article 13 of double tax agreements to protect their domestic post-emigration taxing rights.[11]

The broad jurisdiction to tax claimed by countries such as Canada or Japan in their domestic law is, in many cases, hypothetical. At the practical level, there are obvious difficulties in assessing non-residents in respect of gains realized on the disposal of assets that might have no connection to any tangible property in these countries. Even larger impediments loom at the legal level, given these countries' extensive tax treaty networks. Countries such as Canada and Japan that claim broad taxing rights in domestic law often find they are able to negotiate only limited powers to tax capital gains under Article 13. Thus, while capital gains on assets other than real property and interests in entities deriving value from underlying real property might be taxable under domestic legislation, that power is negated by double tax treaties. The gains generally fall into the 'profits' basket of Article 7 and are immune from source-country taxation unless the taxpayer derives them through a permanent establishment. Alternatively, if they are derived by individuals outside the context of an enterprise, they are treated as 'other income' within the meaning of Article 21, and the country of residence is given exclusive taxing rights over the gains (see further section 3.2, below).

The legitimacy of attempts by source jurisdictions to assert broader taxing rights over gains on the disposal of assets apart from land with a connection to the jurisdiction is problematic given the difficulty of establishing a nexus between the gains and the alleged source country. And, even if a theoretical case can be made for source-country taxation of gains derived by non-residents, for many developing and transitional countries, subjecting gains on the disposal of assets owned by non-residents other than land to tax might fall into the too-hard basket. The focus for these countries at least should be on retaining effective taxing rights over gains from the disposal of real property. There are enough challenges to overcome with this more focused objective.

3.0 Gains and Capital Gains

Gains derived on the disposal of real property fall into three broad categories: gains from the sale by an enterprise of real property that is not inventory of the enterprise, gains from the sale by an enterprise of real property that is inventory of the business, and gains from the sale of real property by a person outside the context of any enterprise.

The application of the treaty to the first type of gain is fairly straightforward. If the taxpayer derives a gain from the sale of real property, the property is owned through an enterprise but is not inventory of the enterprise, and the enterprise has no permanent establishment in the jurisdiction where the land is situated, Article 7 removes the source country's right to tax the gain. The denial of taxing rights is contingent on no other articles applying to the gain, however, and Article 13, applying to gains realized on the disposal of real property, fully restores the source country's right to tax the gain.

Slightly less straightforward is the case where the taxpayer disposes of property held through an enterprise where the property is inventory of the enterprise. Once again, Article 7 removes the source country's right to tax the gain. There is a question, however, as to whether Article 13 will always operate to restore the source country's taxing rights in this case. Whether Article 13 can save the source country's jurisdiction to tax might depend on how the article is phrased – in particular, whether the 'gains' to which it applies include or exclude business profits realized on the disposal of inventory.

Also less straightforward is the case where the taxpayer disposes of real property not held through an enterprise. In this case, Article 7 has no application to the gain. Instead, if the gain escapes the operation of

Article 13, it could fall under Article 21, which applies to 'other income' not addressed in previous articles. Article 21 grants the jurisdiction in which an investor is resident exclusive rights to tax income not addressed in a previous article. If gains realized on the sale of real property outside the context of an enterprise slip outside the scope of Article 13, the source jurisdiction could lose its right to tax the gain following the application of Article 21.

3.1 Sale of Real Estate Inventory

Unless it falls under Article 13, a gain derived by a non-resident enterprise with no permanent establishment in the jurisdiction is excluded from the local tax base by Article 7. That article applies to business 'profits' of an enterprise, while Article 13, at least according to its title, applies to 'capital gains.' It is sometimes argued that capital gains are a special subset of business profits that does not include ordinary business income from the sale of inventory. If it is true that Article 13 applies only to capital gains and capital gains do not include ordinary income from the sale of inventory, the article does not have the effect of restoring the source country's right to tax these gains. Capital gains realized on the sale of real property not held as inventory could be taxed in the jurisdiction in which the land is situated, but profits realized on the sale of real property held as inventory could not be taxed in the source country.

Whether Article 13 can apply to gains realized on the disposal of real property inventory of an enterprise turns on two questions – first, whether the article applies to all gains realized on the disposal of real property or, as the title indicates, only to a particular type of gain known as capital gains and, second, if it applies only to a particular type of gain known as capital gains, whether this category of gain can include business profits from the sale of inventory.

What, then, are 'capital gains' and how do they differ from 'gains'? The term was first used in the context of the predecessor to the OECD treaty – a League of Nations model – by the chief U.S. treaty architect, who used the expression to describe gains realized on the alienation of what he referred to as 'capital assets.' Through its eventual incorporation into the OECD model treaty, it entered the international tax lexicon. The exact intended meaning of the term, however, remained uncertain.[12]

One reason for the uncertainty was the parallel import of the term

'capital gains' into the tax terminology of continental Europe in jurisdictions that had neither a statutory definition of capital gains (as in the United States) nor a meaning of capital gains derived from equity law and trust doctrines (as in other English common law jurisdictions). As a consequence, almost every continental jurisdiction that adopted the term had a different understanding of what it meant. For corporate taxpayers, the term was usually understood to refer to gains realized by a company on the alienation of shares or sometimes gains on the alienation of shares and immovable property. There were more variations in respect of what capital gains meant for natural persons. In some continental countries, it had a meaning similar to that applied to companies. In some schedular countries, it came to mean gains derived by individuals that fell outside the statutory boundaries to the schedules. In another group of continental countries where the boundaries of the personal income tax schedules were set largely by reference to judicial concepts, the term was used to refer to gains derived by individuals that fell outside those judicial boundaries.

While there was no shared understanding of exactly what constituted capital gains, there was general agreement as to what was excluded from the concept – namely, trading gains from the alienation of inventory. There remained differences as to the boundary between inventory and other business or investment assets, and the basic rule was subject to many variations, but references to capital gains were generally understood to exclude business income from the turnover of inventory held for sale.

There is thus a plausible argument that, if Article 13 applies only to capital gains realized on the sale of real property, business profits derived from the sale of real property inventory fall outside the scope of the article. In this case, a source-country signatory would lose all rights to tax gains on the sale of real property inventory by non-resident enterprises with no permanent establishments in the jurisdiction. But this argument is tenable only if it can be shown that Article 13 applies strictly to capital gains and not to gains generally. This argument appears to rest primarily on the inclusion of the term 'capital gains' in the title to Article 13 in the OECD model treaty and in the title to the corresponding articles in some, but not all, actual treaties. Some treaties have no headings at all to articles; others use different phrases. Somewhat ironically, the OECD 'capital gains' terminology is used in the title to Article 13 in double tax agreements of many continental jurisdictions that have no domestic historical basis for the phrase,[13] while some agreements

between jurisdictions that use the English common law/equity law legal system from which the phrase originated deliberately avoid using the term.[14]

Interestingly, the only reference to 'capital gains' in the OECD model treaty is found in the heading to Article 13; the text of the article itself speaks only of 'gains.' The clearest indication of the intention of treaty signatories to include all gains from the disposal of real property, whatever their legal character, in the scope of Article 13 is found in the few treaties between English common law jurisdictions in which capital gains are excluded from the judicial concept of income. To ensure that Article 13 applies to both trading gains from the sale of inventory ('ordinary income' in these jurisdictions) and gains realized on the disposal of real property that is not inventory (capital gains), common law jurisdictions might replace the term 'gains' used in the OECD model treaty with the phrase 'income, profits or gains' from the disposal of real property.[15] This construction assumes that the term 'gains' alone could be interpreted as applying to capital gains in the common law sense and thus exclude gains on the disposal of real estate inventory, which would fall under the umbrella of ordinary income rather than capital gains.

The scope of Article 13 is at best ambiguous. There is a plausible basis for taxpayers to argue that if the term 'gains' is used on its own in the body of the article, it is intended to mean 'capital gains' as is sometimes found in the title to the article. This argument appears to have traction even in English common law jurisdictions that deliberately adopt a different term in the title to the article. If taxpayers can argue that Article 13 does not apply to ordinary business income or to profits from the disposal of real property inventory, a door is opened for avoiding local taxation. Non-resident taxpayers merely have to argue they had the requisite purpose and method to make the property part of their inventory, albeit long-term inventory in the case of lengthy holding periods.

As noted, however, none of the various rationales for allocating all taxing rights in respect of business income to the residence country where there is no permanent establishment applies to gains realized on the disposal of real property that is physically situated in the source jurisdiction. Whether the land is held as inventory or as non-inventory investment property is simply not relevant to the policy rationale for source jurisdiction taxation.

To avoid any risk that Article 13 might not apply to all gains on the disposal of real property, care should be taken to draft the article so that

it explicitly applies to all gains on the disposal of real property in the source jurisdiction. If there is any risk that local courts could exclude from 'gains' in Article 13 business profits on the sale of real estate inventory, an alternative phrase that unambiguously includes inventory gains should be inserted.

3.2 Capital Gains That Are Not Business Profits of an Enterprise

The sale of real property by an enterprise raises the question whether, in Article 13, 'gains' means capital gains that exclude business profits from the sale of inventory. A different question arises if real property is sold outside the context of an enterprise. If the source country is not allocated taxing rights over the gain realized outside an enterprise by Article 13, the gain might fall under Article 21 and be taxable only in the residence country.

An example of a gain that could fall outside the scope of Article 13 is the gain realized by an individual who sells an interest in a second home that is held through a company. Gains on the sale of shares in an interposed entity holding a residential home most likely would not be considered business profits of an enterprise, so Article 7 has no application. The only potentially relevant articles are Article 13, applying to gains on the disposal of real property, and Article 21, applying to other income.

Depending on its construction, Article 13, in fact, might not apply to the gains in this example, as explained below. Many versions of the article apply only to direct disposals of real property and not to indirect disposals by way of the sale of shares if the property is held through an interposed entity.

Article 21 is a sweep-up article, denying source countries any taxing rights over income not covered by a previous article. On its face, a treaty containing Article 21 thus strips a source country from taxing rights related to gains on the disposal of real property that are not covered by Article 13. A saving argument, however, is that Article 21 might apply only to 'income' not described in previous articles, so it would not apply to gains from the disposal of property if those gains could be characterized as capital gains.[16] The argument rests on the assumption that 'income' does not include a subset called 'capital gains'; rather, capital gains are some sort of economic betterment wholly outside the scope of income.

This argument strikes many as peculiar – most European and all U.S.

observers intuitively respond to it by asserting that capital gains are, of course, a type of income, as 'income' is synonymous with profit and gains in many Europeans' minds and the term encompasses all realized gains in U.S. concepts. At the same time, the argument that an *income* article cannot apply to *capital gains* sounds intuitively plausible to many from English common law jurisdictions other than the United States, where the judicial distinction between capital gains and income remains a foundation building block for tax concepts and principles.

The mystical and total segregation of capital gains and income in the tax concepts of these countries is a classic example of the transplantation of English common law doctrine. The distinction originally was developed in trust law to segregate gains derived by a trustee into those to which a trust life beneficiary (known as an 'income' beneficiary) was entitled and those gains to which the remainder or 'capital' beneficiary was entitled.[17] Its transplantation into income tax law and, more importantly, the conclusion by judges that the ability-to-pay principle in income taxation was not intended to apply to gains of the type flowing to a particular class of trust beneficiary seems almost bizarre to observers from countries with other legal traditions. It is, however, a core principle of English common law tax concepts and one that legislatures in such jurisdictions followed when they eventually broadened their tax bases to assess capital gains. When capital gains were brought into the UK tax base, for example, Parliament enacted an entirely separate tax statute to tax these amounts. Australia included capital gains in its income tax base, but the part of the legislation that does so is known as the capital gains tax, not the capital gains portion of the income tax.

Based on the complete separation between capital gains and income gains in English common law, some commentators argue that an 'income' article could not apply to capital gains.[18] Others, however, conclude that the 'better view' is that capital gains are included within the ambit of the term 'income' for the purposes of Article 21, even if they fall outside the income concept for domestic tax purposes.[19]

The issue is clearly a matter of debate. At the end of the day, however, despite their unwavering adherence to the mystical capital gains/income divide for domestic tax purposes, courts in English common law jurisdictions are likely to interpret the term 'income' far more liberally in the context of a double tax agreement. Recognizing the importance of comity in international treaty law, they generally strive to interpret terms in treaties on the basis of their common international meaning.[20] It is very unlikely that tax authorities could convince such a court that

capital gains derived by individuals outside the context of an enterprise fall completely outside the scope of *income* under Article 21 and, as a result, outside international tax agreements in general, leaving them to be taxed under local law.

It follows, therefore, that common law jurisdictions that wish to retain the right to tax these gains must ensure they are brought within Article 13. This means care must be taken to avoid the pitfalls that allow non-resident taxpayers to escape the application of Article 13 – namely, inappropriate definitions of real property, inadequate definitions of interests in interposed entities, and insufficient tracing powers for interposed entities – if the taxing powers are to be retained.

4.0 Real Property

Article 13 of the OECD model treaty, using civil law terminology, speaks of gains realized from the alienation of 'immoveable property.' That term is defined for the purposes of the treaty in Article 6, which gives source countries full taxing powers over income from the use or exploitation (as opposed to disposal) of this type of property. The civil law terminology is often retained in treaties signed by common law countries, although many common law signatories prefer conventional common law 'real property' language.[21]

The definition of real (or immoveable) property in the OECD model treaty commences with a cross-reference to the meaning in national laws of a treaty's signatories, followed by a slight expansion in Article 6. This definition is often expanded further in actual treaties, sometimes directly in Article 6 and sometimes indirectly through the extension of Article 13 to gains on the disposal of assets that substitute for real property such as interests in an interposed entity holding real property.

There are remarkably wide variances in the different definitions used, with some jurisdictions accepting a relatively narrow interpretation based on the OECD model and others expanding it significantly. As a general rule, civil law jurisdictions seem content to limit the meaning of immovable property, at its narrowest going little beyond actual tangible real estate, while natural-resources-rich common law countries have the broadest definitions. The narrowest definitions, therefore, tend to be in treaties between two civil law jurisdictions with limited resources while the broadest can be found in treaties between two common law jurisdictions both of which enjoy ample natural resources.

Even the narrowest definitions have some deemed expansion, not to achieve a broader scope for taxing gains on the disposal of variations of real property, but because the definition was designed for another purpose – namely, the allocation under Article 6 of taxing rights over income generated by property retained (and not disposed of) by a taxpayer. In the OECD model, immovable property is defined for Article 6 purposes (and by cross-referencing Article 13 purposes as well) to include, *inter alia*, livestock and equipment used in agriculture and forestry and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources, and other natural resources. Income from the right to payments may be taxed in the source jurisdiction under Article 6, while the expanded definition leaves gains from the transfer of the underlying rights subject to potential taxation within the scope of Article 13.

The potential scope of Article 13 with respect to interests in natural resources properties is naturally of relatively little concern for jurisdictions with limited cross-border investment in this sector of the economy. Countries with significant cross-border investment, by way of contrast, are well aware of how narrow the OECD definition sometimes used can be. This is particularly true of common law jurisdictions, where real property is not something that can be kicked or staked off with a fence but, rather, comprises a bundle of infinitely divisible rights. The value of the property depends on just what rights are held, and natural-resources-rich common law jurisdictions will try to ensure they retain full taxing rights over gains from the disposal of those rights. Key rights, such as the right to explore for natural resources, fall outside the OECD definition and that used by many countries with limited cross-border resources investment.

The extent to which the definition is broadened in other cases depends on the relative bargaining power and sophistication of the treaty partners. Canadian treaty practice reflects the impact of the latter factor in particular. Two years after the fall of communism in Mongolia, with Canadian mining companies anxious to invest in that country's gold mines specifically and the mining sector more generally, Canada entered into a double tax agreement with Mongolia that picked up the standard OECD definition of immovable property.[22] Depending on how Mongolia structures its mining industry, the agreement could have the effect of denying the Mongolians, who had almost no experience in negotiating double tax treaties at that time, the right to tax gains from the disposal of many natural resources rights where the owners of

intangible rights are Canadian firms with no permanent establishments in Mongolia.

By way of contrast, when dealing with common law jurisdictions that understand how the value of natural resources properties may be sliced, and particularly jurisdictions that attract Canadian investment, Canada has had to concede to its partners much broader taxing rights over gains from the disposal of ancillary property rights. The Canada-Australia treaty, for example, leaves Article 6 (addressing income from real property) with a relatively narrow scope but then expands Article 13 so the source country retains the right to tax gains from the disposal of much broader ancillary property rights including exploration rights left out of the Canada-Mongolia treaty.[23] Importantly, there is two-way mining and exploration investment between Canada and Australia, while investment is all in one direction in the case of Canada and Mongolia. In the former case, Canada had an interest in agreeing to the much broader definition; in the latter case, the narrow definition worked entirely to Canada's advantage. The relative interests of the jurisdictions may explain why the treaty between Canada and Australia's close neighbour New Zealand[24] has a more limited definition of real property subject to Article 13 than that found in the Canada-Australia treaty.

The broad range of definitions of real property used in treaties reflects the difficulty of capturing in words the sweep of property rights that comprise real property in the common law and, more important, the flexibility all modern legal systems offer in terms of the ability to hold underlying economic interests through a raft of different legal arrangements or instruments. Countries have attempted with some success to address this problem in domestic legislation, extending the local tax base to encompass any and, the drafters hope, all types of rights that ultimately reflect value in underlying real property.[25] While there have been innovative expansions of the definition of real property in some tax treaties – for example, the United Kingdom-Spain treaty refers to time-share interests, in recognition of the extent to which UK residents have purchased time-shares in Spain – treaties often fail to operate as broadly as domestic legislation, and domestic legislation itself may struggle to keep up with new an innovative forms of de facto property owners, including the use of rights, options, or derivatives. Countries seeking to retain domestic taxing rights through Article 13 must ensure, first, that domestic law is sufficiently robust to capture all gains related to real property realized by resident and non-resident taxpayers and, second, that Article 13 in their tax treaties is equally broad.

5.0 Interposed Entities

Jurisdictions that impose tax on gains realized by non-residents from the disposal of land within the jurisdiction commonly extend the definition of land or extend the scope of the charging provision to include interests in interposed entities owning land in the jurisdiction and, less commonly, to interests in rights that derive value from real property in the jurisdiction.

Without the interposed entity extensions, non-resident taxpayers could easily avoid provisions that assess gains on the disposal of land by holding land through an interposed company or trust. In jurisdictions in which departing partners are subject to tax on sales of partnership interests, rather than their *pro rata* interest in partnership property, they could hold land through partnership interests to avoid taxation on the direct disposal of land.

Somewhat surprisingly, until recently the OECD model treaty did not extend the reach of Article 13 from gains from the disposal of real property to gains on the sale of interests in interposed entities holding real property. The change to the model treaty in 2003 to include these derivative gains was largely a catch-up exercise, following in the footsteps of the model UN double tax agreement and a very large number of bilateral treaties that had moved well beyond the scope of the OECD model.

Unless Article 13 is extended to include gains on the disposal of interests in interposed entities, treaty signatories wishing to impose tax on gains derived by non-residents on the sale of real property in their territory are truly impotent: a rule that limits taxing rights to gains on the direct alienation of land paves the path to avoidance. But attempts to widen the application of the treaty to capture gains on the disposal of interests in interposed entities are themselves fraught with difficulties. One is the obvious difficulty of enforcing a rule where interests in intangible assets such as ownership rights are traded offshore. Reported cases show, however, that administrative challenges are not always insurmountable.[26] Three legal issues may be more problematic. The first is whether expanded rules can catch multiple tiers of interposed entities. The second is whether expanded rules can catch all forms of interposed arrangements and entities. The third is whether gains attributable to the source jurisdiction can and should be segregated when an interest in an interposed entity is sold.

5.1 Looking through Tiers

Surprisingly, many treaties entered into before the OECD model was broadened to include derivative gains failed to anticipate the possibility of multiple tiers and only referred to gains on the disposal of interests in an entity that directly held real property. The success of the Dutch taxpayer in the 1997 Australian *Lamesa* case[27] alerted many tax authorities to the importance of claiming taxing rights with respect to gains realized on the disposal of interests in higher-tier entities. In this case, the taxpayer had interests in Australian real property through a tier of companies and disposed of interests in a higher-tier company. The taxpayer successfully resisted an Australian assessment on the basis that the wording used in the Netherlands-Australia treaty applied only to gains on the disposal of interests in companies that directly owned real property in Australia.

Following *Lamesa*, many treaty negotiators looked for language that would extend Article 13 to interests in higher-tier companies. The 1980 UN model treaty had already referred to interests in a company where the company's property consisted 'directly or indirectly principally of immovable property.' The language was ambiguous, however, and it is not entirely clear that it included an interest in a company where the property of that company was shares in another company that, in turn, owned real property. A similar formulation was used in the 1999 revision of the UN model treaty.

Until 2003, the OECD treaty had no look-through rule, but when it was revised to include such a rule, more logical language was used, with the OECD article referring to alienation of shares that derive 'more than 50 per cent of their *value* directly or indirectly from immovable property (emphasis added)' in a contracting state. The reference to shares that derive their value directly or indirectly from underlying immovable property is similar to the language used in the 'interpretative provision' (the Australian euphemism for a treaty override provision) that Australia adopted in 2000 to overcome the effect of *Lamesa.*

The Australian legislative amendment sought to avoid any ambiguity by explicitly referring to the value of interests attributable directly or indirectly *through one or more interposed companies or other entities* to underlying real property.[28] This broad language, in turn, is derived from treaty precedents such as the 1980 Canada-Australia treaty, which even more explicitly referred to value derived 'directly or indirectly (*includ-*

ing through one or more interposed entities, such as, for example, through a chain of companies), from real property' (emphasis added).

It is now clear that the single-level interposed entity extensions in many older treaties are of little or no practical use given the ease with which taxpayers can slip outside the scope of these rules through a higher-tier company. Whether the language 'more than 50 per cent of their value directly or indirectly' found in the 2003 OECD model will be sufficient to protect gains realized on the sale of interest in interposed entities in the taxing rights in newer treaties remains to be seen.

Resources-rich countries with expanded definitions of land that hope to preserve their domestic taxing rights no doubt will try to reinforce any extension of Article 13 with broader look-through language. It is unusual for treaties to go as far as the Canadian approach and include a 'for example' clause, but this probably reflects Canadian awareness of the ability of common law judges to frustrate intended policy outcomes through literalist interpretations if the language is capable of a narrower construction.

5.2 Forms of Interposed Entities and Interest

Inserting an entity between an investor and ownership of real property is an obvious and simple way to avoid the application of a charging provision that subjects non-residents to tax on gains from the disposal of real property. Countries that wished to assess these gains not surprisingly extended the charging provision to interests in land-rich interposed entities, and the UN and later the OECD model treaties followed suit.

Neither model, however, extends taxing rights as far as the domestic law of resources-rich countries. Civil law lawyers tend to think of companies when they think of interposed entities, and the OECD model is limited to gains on the alienation of shares. Many treaties go further and speak of gains on the disposal of shares or 'comparable' or 'other' interests in companies, broadening the scope of taxing rights slightly but still missing the obvious substitutes of partnerships and trusts. The UN model treaty goes still further and speaks of 'an interest in a partnership, trust, or estate,' although the reference to interests in companies is limited to 'shares.'

However sympathetic a court may be to a state's attempt to protect the integrity of the taxing powers it seeks to retain through Article 13, at the end of the day it must side with the taxpayer who successfully

manoeuvres ownership of land outside the terms of the article. It is not difficult for a taxpayer to note that there are plenty of examples of alternative constructions, so a national authority clearly would have had the capacity to seek a broader version if it wished to do so. The deliberate adoption of a narrower version, whatever the reason for accepting it, could be taken a signal of implicit acceptance of reduced taxing rights.

An effective Article 13, therefore, should anticipate the alternatives that investors might use to hold real property through an interposed entity. Attention should be paid to two issues: the types of entities or relationships that can be used and the types of interests in these entities or arrangements that might be held. A viable Article 13 should apply to all types of interposed entities and arrangements taking the form of legal persons (companies) and common law or civil law contractual or equitable arrangements such as partnerships and trusts.

Equally important, Article 13 should reach all interests in an entity or arrangement that derive value from real property, whether directly or through any number of interposed entities or arrangements. Addressing one side of the equation but not the other opens a path to slide outside the coverage of Article 13. Thus, for example, extending the coverage to interests in companies, trusts, and partnerships but limiting the type of interest in companies to shares invites taxpayers to hold land through interposed companies and to substitute other instruments, such as convertible debt or options for direct share ownership.

The Canada-United States treaty provides an example of incomplete responses, on the one hand stretching Article 13 to include interests in partnerships and trusts as well as in companies, but on the other hand limiting designated interests in companies to direct share ownership. The Canada-Mexico treaty is slightly broader, applying to interests in partnerships and trusts and 'shares, participations or other rights in the capital of a company,' but it still misses many potential forms of indirect ownership. Even the widest formulation adopted in Canada's treaties, such as the language employed in the Canada-Australia treaty, between two common law jurisdictions with courts that have periodically adopted strict and literal interpretation doctrines, may be insufficient. That treaty speaks of 'any shares *or other interests* in a company' and 'an interest *of any kind* in a partnership, trust, or other entity (emphasis added). It might be argued, however, that a convertible debt or option, for example, does not constitute an interest in a company, but merely a claim to a company's property in the former case or a right over a shareholder or the company in the latter. These treaties are use-

ful starting points, but broader language for Article 13 is needed to fully protect the interests of source countries.

5.3 *Measuring Gains on the Disposal of an Interest in an Interposed Entity*

When a double tax agreement extends a state's taxing rights over real property gains to include gains on the disposal of interests in interposed entities, the question arises as to whether the gains should be pro rated when part is attributable to other assets of the interposed company. Most treaties that extend Article 13 coverage to interests in interposed entities adopt the approach used in both the OECD and UN model treaties and allow countries to assess gains from the alienation of shares where more than half the value of the shares is attributable to land in the contracting state regardless of the source of the gain on the shares. The result, some observers argue, may be wholly inappropriate if a taxpayer satisfies the 50 per cent threshold test but the gains are attributable to another jurisdiction or other assets.[29]

The problem can be illustrated with an extreme example of the interposed company's investment portfolio comprising two pieces of land with all appreciation taking place outside the jurisdiction that is given taxing rights under the treaty. Consider the case of a company owning two blocks of land, one worth $90 in country A and the other worth $10 in country B. After a period, the value of land in country A has declined so the block is only worth $80 while the value of land in country B has risen so it is now worth $79. The value of the land portfolio (and the value of the shareholder's interest in the company) has risen from $100 to $159, but the gain is entirely due to appreciation in country B, where the land has risen in value by $69 while it has declined $10 in country A.

It is arguable that country A's taxing rights over the shareholder should be limited to the proportion of gain attributable to land in that country (zero in this case). There is no plausible rationale for allowing country A, which generated none of the increase in value of land or shares, to have full taxing rights over the gain realized by the shareholder in this example. And yet, under the OECD model and all tax treaties using the threshold approach, this is precisely what tax treaties allow.

A variation of the proportionate approach has emerged recently, but rather than attribute taxing rights on the basis of where gains are generated, this approach attributes taxing rights on the basis of where the

total land value is found. The 2003 U.S.-Japan treaty is an example of this approach. If this treaty were applied to the facts set out above but the land was owned through a trust or partnership, country A, which accounts for 50.3 per cent of the value of the interposed entity, would be able to tax investors on 50.3 per cent of their gain even though all of the gain is attributable to land found in country B. In this particular example, the outcome is marginally more acceptable than the first-past-the-post taxing-rights formula found in the OECD model, but still perverse in terms of conventional source analysis.

Importantly, the proportionate approach based on the relative value of land in the jurisdiction has been applied to interests in entities and arrangements other than companies. The U.S.-Japan treaty, for example, applies this approach to interests in an interest in a partnership, trust, or estate, while retaining the conventional first-past-the-post approach to interests in companies.

To date, calls for reform to the model treaty to restrict the taxing rights of a contracting country to gains attributable to property in that jurisdiction have generated relatively little interest. This might be because of the limited number of countries that actually assert these rights in domestic tax laws or the limited ability of jurisdictions that impose tax under domestic law and retain taxing rights under the treaty to enforce the domestic provisions on non-residents with interests in interposed entities. Alternatively, it might reflect an international consensus that potential overtaxation by source countries in these circumstances will be sorted out in the international wash, which includes many investments in the other direction. Or, it could be that the treaty formula and the proportionate alternative described above are just plain wrong, in which case there is no persuasive reason for not reforming the treaty.

6.0 Applying Pre-capital Gains Treaties

Unless Article 13 applies to capital gains, the source country loses the right to tax those gains under Article 7 if they are business profits of a non-resident enterprise with no local permanent establishment or under Article 21 for gains that are not business profits.

However, a unique fallback argument regarding a source country's right to tax capital gains outside the scope of Article 13 might be possible in common law jurisdictions that added capital gains taxation to their income tax systems after entering into tax treaties. These countries might be able to argue that the income tax treaties do not apply to

capital gains tax adopted after the treaties entered into effect. If capital gains fall outside a double tax treaty, they cannot be excluded from source-country taxation by either Article 7 or Article 21 – the treaty has no application at all on the source jurisdiction's right to tax these gains.

This argument largely turns on the effect of Article 2, which names the existing taxes to which the treaty applies. Normally, the article states that the treaty applies to 'income taxes' imposed under the correct name for each signatory's income tax law. Under the conventional ambulatory approach to interpreting tax treaties, references to the treaty applying to the country's 'income tax' law[30] include the capital gains component of that law tax where the 'capital gains tax' is actually only a set of measures inserted into the income tax law after the treaty has come into effect. This is not the case, however, if the capital gains component of the income tax law is thought to impose a fundamentally different type of tax from an income tax. In that case, it could be argued that the parties could not possibly have been contemplating the application of the treaty to the capital gains rules, whether they were implemented by way of a discrete piece of legislation or measures inserted into an existing act.

To an observer from outside the English common law world, it might seem odd that a tax authority would argue that a tax treaty applying to an income tax act could not possibly have been intended to apply to base-broadening amendments added to the act. Yet this position sounds plausible to an advocate from a common law jurisdiction imbued with the mysticism of the capital gains-income dichotomy.[31] As noted earlier in the discussion on the scope of Article 21, the conceptual difference between capital gains and income remains as strong in the common law tradition outside the United States as it was prior to the inclusion of capital gains in the tax base. And, as also noted earlier, the resistance to regarding capital gains as an element of income was so great in the United Kingdom that legislators in that country could not bring themselves to include capital gains in the income tax law when capital gains were finally brought into the tax net in 1965. Instead, the gains were subject to tax under a separate capital gains tax. Canada in 1972, Australia in 1985, and South Africa in 2000 partially added capital gains to the tax bases of their respective income tax laws, but in all three cases did so by way of discrete capital gains tax provisions in those laws, reinforcing the perception of a magical divide between capital receipts and income receipts.

Certainly tax authorities have tried to raise the argument that tax treaties cannot apply to subsequently enacted capital gains rules[32] and on this basis strip away the treaty shield. However, taxpayers who have adopted the contrary argument – that an ambulatory reading of pre-capital gains tax treaties would lead to the application of these treaties to subsequently enacted capital gains provisions where the capital gains rules were inserted in the main income tax act – have found tribunals sympathetic to this view.[33] It is a somewhat ironic outcome given the central role of the courts in establishing the distinction between capital gains and income in the first place, but the case for the ambulatory reading is strong.[34]

The issue might be somewhat moot for most taxpayers with the retreat of jurisdictions from the taxation of gains realized by non-residents on the disposal of assets apart from immovable property and assets associated with a permanent establishment.[35] One of the few common law jurisdictions in which a tax authority might seek to argue that capital gains are not shielded by a tax treaty is Canada, which has retained broad taxing powers over capital gains. However, the capital gains provisions in the Canadian income tax legislation predate almost all relevant treaties, leaving almost no scope for this argument to be raised today in that country. It remains to be seen whether it re-emerges as an important issue if common law countries, such as New Zealand, that currently do not tax capital gains introduce capital gains rules with wide-ranging liabilities for non-residents.

7.0 Looking Forward

While many jurisdictions are retreating from the full imposition of local capital gains tax rules on non-resident investors, all countries appear anxious to retain taxing powers over gains on the disposal of real property. The OECD model treaty generally strips away these taxing rights from source countries unless they are explicitly shielded by a carefully drafted Article 13. Secondary arguments raised by tax authorities seeking to deflect the application of Article 21 or the income tax treaties in general to capital gains are problematic; the most direct route to retaining taxing powers is to ensure that Article 13 covers fully the right of source countries to assess gains on the disposal of real property. The article should extend to all ancillary rights deriving from real property and all forms of indirect ownership through interposed entities. Developed market economies with inbound foreign investment have gone

to great lengths to ensure their taxing rights are protected in treaties. Developing and transitional economies have fared less well in this respect. In an era of globalization that has witnessed a rise in cross-border investments in real property, negotiators from these jurisdictions should devote greater attention to the terms of Article 13 in tax treaty negotiations.

Notes

* This chapter draws upon a comment by the author on a presentation by Stefano Simontacchi to a conference on 'Source versus Residence' organized by the Institute for Austrian and International Law at the Vienna University of Economics and Business Administration in autumn 2007. For Simontacchi's presentation and the comment, see Michael Lang, ed., *Source versus Residence: Problems Arising from the Allocation of Taxing Rights in Tax Treaty Law and Possible Alternatives (*Alphen aan den Rijn, Netherlands: Kluwer Law International, 2008).

1 Alex Easson, 'Do We Still Need Tax Treaties?' (2000) 54 Bulletin for Int'l Fiscal Documentation 619.

2 Motivations for tax treaties are explored in some detail in Thomas Rixen, 'A Politico-Economic Perspective on International Double Taxation Avoidance' (2007) 49 Tax Notes Int'l 599.

3 Unless otherwise specified, all treaty 'article' references in this paper are the model OECD double tax Convention.

4 One of the most significant shifts is to be found in the United States; see S. Shay, J. Clifton Fleming, Jr, and R. Peroni, '"What's Source Got to Do with It?": Source Rules and U.S. International Taxation, The David R. Tillinghast Lecture' (2002) 56 Tax L.Rev. 81.

5 Alex Easson, 'Common Law Approaches to the Determination of the Source of Income: Pragmatism over Principle' (2006) 60 Bulletin for Int'l Taxation 495.

6 Somewhat surprisingly, this approach is not universal, perhaps because it is impossible for the purchaser to know the gains realized by the vendor, thus necessitating an option for the vendor to file a return and seek an adjustment of tax withheld if it is too high. For an example of this approach see *Income Tax Act*, R.S.C. 1985 (5th Supp.), c. 1, s. 116(5), imposing a withholding liability on the purchaser, and s. 116(1), allowing the vendor the option of filing a 'notice' in lieu of a return and paying the lower amount of tax payable on the actual gain.

7 See generally Alex Easson, *Taxation of Foreign Direct Investment* (The Hague: Kluwer, 1999) at 18.

8 Gains on these assets are assessable by virtue of the inclusion of the assets in the definition of 'taxable Canadian property' in *Income Tax Act*, s. 248(1). A handy English-language guide to Japanese taxes is the summary found at Japan, Ministry of Finance, 'Comprehensive Handbook of Japanese Taxes 2006,' online: Ministry of Finance Japan <http://www.mof.go.jp/english/tax/taxes2006e.htm>.

9 Developments in Spain in respect of substantial holdings are described in Aurora Ribes Ribes, 'Taxation of Capital Gains in Spanish Tax Treaties: The Belgium-Spain Double Taxation Convention on Income and Capital' (2004) 32 Intertax 486. For developments in Italy, see Stefano Serbini, 'Italy Eases Up on Non-residents' (2000) 11 Int'l Tax Rev. 20.

10 See the definition of 'taxable Australian property' in *Income Tax Assessment Act 1997*, s. 855-15; see also Ken Spence and Richard Shaddick, 'Capital Gains Tax Has Narrower Scope but Longer Arm' (2006) 17 Int'l Tax Rev. 59; and Jock McCormack & David Anderson, 'CGT and Non-residents: Alignment with Prevailing OECD Tax Practice' (2005) 9 The Tax Specialist 67.

11 Some of the issues raised by the inclusion of this rule in Article 13 are discussed in J.W.J. de Kort, 'Levy upon Emigration of a Substantial Participation Holder: An Infringement of Article 13 of the OECD Model Convention?' (2003) 13 Intertax 102.

12 In his leading study on Article 13, Stefano Simontacchi explains how the 'capital gains' heading first slipped into discussions of the predecessor drafts to the OECD treaty in the middle of the twentieth century and later into the OECD treaty itself; see Stefano Simontacchi, *Taxation of Capital Gains under the OECD Model Convention* (Alphen aan den Rijn, Netherlands: Kluwer, 2007). Some of the materials under heading 3.2 are drawn directly from Richard Krever, 'Discussion of Stefano Simontacchi 's Paper on Article 13 OECD Model Convention' in Lang, ed., *Source versus Residence*.

13 See, for example, Article 13 in the France-Sweden double tax agreement, which is headed 'Gains en capital' in French, the official language of the treaty. Interestingly in the Italy-Germany treaty, Article 13 is headed 'Utili di capitale' (capital gains) in the Italian version while the German version avoids the term by titling the article 'Gewinne aus der Veräußerung von Vermögen' (profits from the sale of assets).

14 See, for example, the Canada-United States treaty or the United Kingdom-United States treaty, in which Article 13 is simply headed 'gains.'

15 See, for example, Article 13 of the Canada-Australia double tax agreement.

This terminology is sometimes used in treaties between common law and civil law jurisdictions as well. See, for example, Article 13(1) of the France-Australia double tax agreement.

16 A variation of this position is taken by the Australian Taxation Office.

17 See Richard Krever, 'Interpreting Income Tax Laws in the Common Law World' in M. Achatz et al., *Steuerrecht Verfassungsrecht Europarecht* (Vienna: Facultas Verlagsund Buchhandels AG, 2007) 354; idem, 'Studying Taxation Law' in Cynthia Coleman et al., *Principles of Taxation Law* (Sydney: Thomson, 2008). See also John F. Avery Jones et al., 'Treaty Conflicts in Categorizing Income as Business Profits Caused by Differences in Approach between Common Law and Civil Law' (2003) 57 Bulletin for Int'l Fiscal Documentation 237; R. Parsons, 'Income Taxation: An Institution in Decay' (1986) Australian Tax Forum 233, reproduced in (1986) 12 Monash U. L.Rev. 77 and later in a slightly revised version in (1991) 13 Sydney L.Rev. 435.

18 See, for example, R. Gibson, 'The New Canada-Australia Income Tax Convention' (1981) 31 Canadian Tax J. 688.

19 See D. Lane, 'Australia's Double Tax Agreements: Gains from the Sale of Shares by Non-Residents' (1999) 2 J. Australian Taxation 1 at 14.

20 See *Federal Commissioner of Taxation v. Lamesa Holdings BV* (1997), 36 A.T.R. 589, 97 A.T.C. 4752 (Full Federal Court) under the heading 'The Interpretation of the Agreement as an International Treaty.'

21 Many of Canada's double tax agreements with common law countries, including the United Kingdom, use the civil law terminology 'immovable property'; the treaty with Australia, in line with Australia's normal practice, uses the term 'real property.'

22 Article 6 of the 2002 Canada-Mongolia treaty defined immovable property to include the right to work mineral deposits, sources, and other natural resources.

23 In the 1980 Canada-Australia treaty, taxing rights were established primarily in Article 13, which left a less comprehensive definition of real property in Article 6 but extended taxing rights beyond the Article 6 definition of real property to 'a right to exploit, or to explore for, a natural resource.' In the 2002 Protocol to that treaty, Article 13 applies to income, profits, and gains from the alienation of real property and Article 6 is expanded included 'a lease of land and any other interest in or over land, whether improved or not, including a right to explore for mineral, oil or gas deposits or other natural resources, and a right to mine those deposits or resources.'

24 The construction of this treaty appears to be somewhat redundant, with an expanded (but not completely wide) definition of real property in Ar-

ticle 6 that is picked up by Article 13, which adds similar language once again. Article 13, inserting the words of Article 6 where Article 13 cross-references to Article 6, says the source state has the right to tax '[i]ncome or gains from the sale or disposition of [from Article 6] the right to operate, any mine, oil well, gas well, or quarry, or for the extraction, removal, or other exploitation of, or the right to extract, remove, or otherwise exploit, standing timber or any natural resource; … or from the sale or disposition of [from Article 13] any right relating to the operation of any mine, oil well, gas well, or quarry so situated or to the extraction, removal, or other exploitation of standing timber or of any natural resource so situated.' Among other things, the awkward construction illustrates the problem of cross-referencing a definition to a definition intended for a very different purpose.

25 The Australian attempts to capture all types of mining interests in domestic legislation provide a useful example of such an exercise. The Australian definition of 'taxable Australian property' in *Income Tax Assessment Act 1997*, s. 885-15 includes taxable Australian real property, which, in turn, is defined in section 885-20 to include natural resource rights in respect of the property; these are then defined in section 995-1 to include 'an authority, license, permit or right under an Australian law to mine, quarry or prospect, … a lease of land that allows the lessee to mine, quarry or prospect, … an interest in such an authority, license, permit, right or lease … and any rights that are in respect of buildings or other improvements … on the land concerned or are used in conjunction with operations on it.'

26 See, for example, *Lamesa*, where Australian authorities assessed Dutch taxpayers on the sale of interests in an interposed Australian company three tiers above the company holding mining rights (deemed to be land under the Netherlands-Australia treaty). The shares were sold on the public stock exchange.

27 Ibid.

28 *International Agreements Act 1953*, ss. 3A(2).

29 The problem is discussed in detail in Simontacchi, *Taxation of Capital Gains*, chap. 4.

30 For example, the Canada-Australia treaty, Article 2(1), states that the treaty will apply to the existing taxes, which include, in the case of Australia, 'the income tax' imposed under the federal law of Australia and, in the case of Canada, 'the income taxes' imposed under the *Income Tax Act*.

31 Leonard Lazar describes the process of shifting receipts from one camp to another as a 'mystical legal process' in 'Finance Act 1965: The Capital Gains Tax' (1966) 29 Modern Law Rev. 181 at 182.

32 When the Australian Taxation Office argued that its pre-capital gains tax treaties did not apply to the capital gains provisions in the Australian income tax legislation, it deliberately labelled the capital gains measures in the law a separate tax; see Australian Taxation Office, Taxation Ruling TR 2001/12, para. 4: 'Australia's tax on capital gains is not a tax to which pre-CGT treaties apply.'

33 See, for example, *Gadsen v. Minister of National Revenue*, [1983] C.T.C. 2132, 83 D.T.C. 127 (Tax Review Board, Canada). In its ruling adopting the opposite conclusion, the Australian Taxation Office sought to distinguish *Gadsen* on the facts of the case.

34 For a review of the arguments, see Tim Flavin, 'Non-Residents, Capital Gains Tax and the Double Tax Agreements' (1991) 2 CCH J. Australian Taxation 48; P. Kennedy, 'CGT and Non-Residents; Part A: Protection under Double Tax Agreements' (1993) 2 Taxation in Australia Red Ed. 27; Dianna Lane, 'Australia's Double Tax Agreements: Gains from the Sale of Shares by Non-residents' (1999) 2 J. Australian Taxation 3; and I. Gzell, 'Treaty Protection from Capital Gains Tax' (2000) 29 Australian Tax Rev. 25.

35 See, for example, s. 2 of the *Eighth Schedule to the Income Tax Act* (South Africa); see also s. 855-15 *Income Tax Assessment Act 1997* (Australia).

12 Tax Treaty Templates

VICTOR THURONYI*

1.0 Introduction

In a 2001 article,[1] I put forward several proposals relating to a multilateral tax treaty. In this chapter, I develop further one of the proposals – namely, a multilateral template for bilateral treaties.[2] The template approach is designed to deal with several deficiencies of the existing bilateral treaty network. Nevertheless, it represents a more modest approach than the proposal for a multilateral treaty since it contemplates maintaining the bilateral structure of double tax treaties. It represents a way to clean up, rationalize, and simplify the network of bilateral tax treaties, and provides a framework for subsequently and periodically updating these treaties. While the template approach does not have all the advantages of a multilateral treaty, it would deal with many of the same problems that the multilateral approach addresses, while at the same time being easier to achieve because it maintains the bilateral nature of existing treaties. Consequently, all of the features of bilateral treaty negotiation are kept. The main difference is that the Organisation for Economic Co-operation and Development (OECD) and United Nations models would become a template and each bilateral treaty would state explicitly how it deviates from the template. Each pair of countries that negotiates a bilateral treaty would remain free to deviate from the template as it wished.

2.0 Problems with the Current Tax Treaty Network

The main problems with the current tax treaty network are well known (see also Chapters 6, 10, and 11 in this volume). The discussion below serves as a reminder.[3]

2.1 *Difficulty of Amendment*

Given the extensive network of treaties, it takes substantial time for updates made to the OECD model to be incorporated in treaties. As John Avery Jones and Philip Baker describe, '[o]ne of the most pressing problems in international tax practice at the present time is how to devise a simple system – consistent with the bilateral nature of existing DTCs [double taxation conventions] and the constitutional traditions of the many countries concerned – for amending the wording of large numbers of bilateral DTCs in a short period of time.'[4] Every amendment of existing treaties to conform to changes in the UN/OECD model takes effort and time and, in the interim (which can be decades), the existing treaties remain deficient. This is simply not an acceptable way to run a tax system.

2.2 *The Role of Commentary*

As has been discussed at length in the literature, while there is some legal authority for use of the OECD Commentary to interpret tax treaties, the ground is a bit shaky[5] and it would be better to have a clear position that the commentary is applicable to interpret treaties, including in cases where Commentary language is issued after a treaty has been concluded. Under current conditions, it might be difficult to find acceptance for reliance on the Commentary, given that it is often used, in effect, to make substantive changes to the model. A further practical problem is that each treaty text differs somewhat from the model. Even if it is accepted that the Commentary should be authoritative as to treaties that are identical to the model, the many differences in wording leave doubt as to how the Commentary should apply in interpreting specific treaties, all of which deviate from the model in some ways.

2.3 *Verbiage*

Even though, in broad terms, the existing treaty network is based on the OECD model, if one reads existing treaties more carefully it becomes apparent that each is a separate legal instrument with its own language. The text of existing treaties is not user friendly: most are close to the model, but to ascertain the differences one must read each carefully, word for word. Somewhat related, one can question why it makes sense to have so many texts that are broadly similar, yet differ in many

details of wording. A more uniform wording for the existing treaties surely would be a benefit for both governments and taxpayers.

The verbiage problem is not just one of readability but also of interpretation. As noted above, the problems with using the model's commentary are compounded by the fact that existing treaties differ from the text of the model in numerous and minute ways.

3.0 A Possible Solution

3.1 Restatement

3.1.1 The General Approach

The proposed solution is simple in its basic outline. The existing network of bilateral income tax treaties would be reformulated explicitly using a template that would serve as a point of reference for each individual treaty. The process of reformulating each treaty in terms of deviations from the template, in some cases, would be merely editorial. However, even a purely editorial restatement would enable the features of each treaty to be quickly grasped, given that, in practice, most treaties are negotiated by starting with the OECD model and then changes are made to suit the treaty partners.

The idea of expressing each treaty as deviations from the model is an obvious one and has been identified before. For example, in 1997, John Avery-Jones noted that '[p]ractitioners would save a lot of time if treaties were presented as variations to the Model Treaty; we would not need to read the rest to see whether it has been changed.'[6] In addition, perhaps the main advantage of expressing each treaty as deviations from a template would be to facilitate the uniform interpretation of the template language and to make it easier to update treaties.

The process of expressing each existing treaty in terms of deviations from a template should go further than simply comparing documents in a word-processing program. If the treaty partners came explicitly to confront each instance in which a treaty deviates from the template, they might be able to agree to drop some of these deviations. Some, on reflection, might seem obsolete, or no longer needed, or in any case not worth maintaining, given the countervailing interest in achieving as much international uniformity in treaty language as is realistically possible. Particularly in cases where an existing treaty is based on an earlier version of the model, the parties might readily agree that it made sense to substitute the most recent version.

On the other hand, there would be many instances where the parties would want to maintain provisions of existing treaties. In some cases, the parties might want to maintain existing language that has been subject to court interpretation or that has otherwise acquired a familiar meaning. Some provisions would have to reflect peculiarities of the legal and tax systems of the partners or to embody policy choices. There would be no compulsion to change existing language if the parties did not agree to do so; however, the exercise would be designed to put some pressure on the negotiators to eliminate deviations where there was no good reason for them.

What I envision, in other words, is a process of negotiation where existing treaty partners agree to restate their existing bilateral treaties as a template plus deviations, with a view to minimizing those deviations. As a formal matter, this would mean a restatement of the entire existing treaty network. One would expect that the extent of variation in treaty language that we see today would be substantially narrowed, even if many variations were maintained.

Calling this process a 'restatement' evokes the Restatements of the Law that have been prepared by the American Law Institute. These are efforts to state the common law as it is, but with a view to unifying and rationalizing precedents that have not been fully in harmony. The process of restatement, in other words, is a creative one that seeks to provide greater order and unity. The civil law analogue might be codification (common law lawyers tend to think of codification as more of a clerical process where a law is published with all its intervening amendments, while the production of a civil law code is a much more flexible and creative process). In the restatement, each treaty would be replaced by a new one that would have to undergo the normal ratification process.

There would not necessarily be just one template choice for any given provision. In situations where treaty partners wished to maintain a deviation from the basic model, there might be a separate template for a particular variant. In other words, for a particular paragraph, there might be a version A and a version B. There would be nothing new here: the different versions would reflect existing treaties, where, in practice, we can observe variations of this kind.

Key to the success of this approach would be preparation of an initial template (together with variations) by a small committee. This would greatly facilitate the bilateral work, giving everyone the same starting point. Periodically, the bilateral negotiators could come together to dis-

cuss changes to the template in light of their experience with revising the individual treaties.

The template itself need not have legal standing, but it would have to be the result of a working agreement among the negotiators on a consensual basis. The template would be a common text for the set of bilateral treaties and, accordingly, once ratified, would be the core text of all the treaties. Future amendments to the template would be effected through a multilateral instrument, which would undergo ratification by each signatory.

Once the restatement was completed, the UN and OECD models would become irrelevant, since the template would supersede them.

3.1.2 An Example

The process of restating treaties in template format can be illustrated by means of the following example. More or less picked at random, here is an extract (paragraphs 1–4 and 6–7) from an article of the Australia-Mexico treaty. The question is how one might go about restating the extract in terms of deviations from the model. (For convenience, the corresponding text of the OECD model is reproduced below and the differences are highlighted in italics.)

> Article 13
> Alienation of Property
>
> 1. *Income, profits, or* gains derived by a resident of a Contracting State from the alienation of immovable (*real*) property ... situated in the other Contracting State may be taxed in that other State.
> 2. *Income, profits, or gains derived by a resident of a Contracting State from the alienation of any shares or other interests in a company, or of an interest of any kind in a partnership, trust or other entity, where the value of the assets of such entity, whether they are held directly or indirectly (including through one or more interposed entities, such as, for example, through a chain of companies), is principally attributable to real property situated in the other Contracting State, may be taxed in that other State.*
> 3. *Income, profits, or* gains from the alienation of ... property, *other than immovable (real) property, that* forms part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or ... pertains to a fixed base available in that other State to a resident of the *first-mentioned* State for the purpose of performing independent personal services, including *income, profits, or* gains from

the alienation of *that* permanent establishment (alone or with the whole enterprise) or of *that* fixed base, may be taxed in that other State.
4. *Income, profits, or* gains from the alienation of ships or aircraft operated in international traffic, ... or ... property *other than immovable (real) property* pertaining to the operation of such ships or aircraft ... , shall be taxable only in the Contracting State in which the *enterprise alienating those ships, aircraft, or property is a resident.*
…
6. In this Article, the term 'immovable (real) property' has the same meaning as it has in paragraph 2 of Article 6.
7. The situation of immovable (real) property shall be determined for the purposes of this Article in accordance with paragraph 3 of Article 6.

Article 13 (OECD Model)
Capital Gains

1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.
2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.
3. Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft, or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

The title of the article in the Australia-Mexico treaty, as noted above, is 'Alienation of Property,' while the title of the article in the OECD (and UN) models is 'Capital Gains,' not a great name since the article is not really about capital gains but about gains from the alienation of property. So, one possibility would be to state the title of the template as 'Gains from the Alienation of Property.' Another possibility would be to keep

the title 'Capital Gains' and drop the deviation in the Australia-Mexico treaty on the basis that, since the title does not have legal significance, the deviation should not be insisted on. Alternatively – and in the interest of brevity – one could simply use 'Gains' as the title.

Paragraph 1 contains the expression 'income, profits, or gains' while the model refers only to 'gains.' The two terms appear to be synonymous. Therefore, it should be possible to restate the Australia-Mexico treaty by dropping the deviation and accepting the model.[7]

The other difference between paragraph 1 of the Australia-Mexico treaty and the model is in the form of the cross-reference to Article 6. In this respect, the Australia-Mexico treaty seems to be technically superior to the model in that it contains a separate paragraph 6 defining the term 'immovable property' for purposes of this article by reference to its meaning in paragraph 2 of Article 6. In this case, the template could be revised to conform to the Australia-Mexico treaty. Similarly, a decision could be made as to whether paragraph 7 was needed and should be included in the template.

Moving on to paragraph 2, there is again the issue of the expression 'income, profits, or gains,' which should be resolved in the same way as for paragraph 1. Otherwise, paragraph 2 is not found in the OECD model. However, provisions of this kind are found in numerous treaties. Therefore, in the process of restatement, it would make sense to draft a template paragraph and either make paragraph 2 conform to this paragraph or specify the deviations.[8]

Paragraph 3 corresponds to paragraph 2 of the model. Again, the expression 'income, profits, or gains' should be handled consistently with the decision on paragraph 1. Paragraph 3 also deviates from the model by using the expression 'property, other than immovable (real) property' in place of the model's 'movable property.' The two terms are synonymous, and one would expect the negotiators to be able to agree to drop the deviation.

Next, 'that forms part of' is used instead of 'forming.' Assuming that the Australia-Mexico treaty were restated to use 'movable property,' it should also be possible to conform to the model by using 'forming' ('that forms part of' would reduce the awkwardness of the current treaty but it would no longer be needed if the shorter term 'movable property' were used).

Similarly, the parties should be able to agree to change 'or pertains' to conform to the model ('or of movable property pertaining'), since

no substantive difference would be involved. The same holds for the rest of the language of the paragraph. That is to say, since paragraph 3 of the Australia-Mexico treaty does not substantively differ from, or is not clearly better worded than, the text of the model, the restatement should be able to eliminate the deviations between this paragraph and paragraph 2 of the model.

Paragraph 4 of the treaty corresponds to paragraph 3 of the model; however, this paragraph contains two specific, substantive differences from the model. First, the treaty excludes the reference to boats engaged in inland waterways. Second, the treaty confers taxation rights on the state of residence of the enterprise, while the model confers taxing rights on the Contracting State in which the place of effective management of the enterprise is situated. If the parties wished to keep these deviations, the deviation from the template could be expressed as follows (assuming that 'income, profits, or gains' is changed throughout to conform to the model):

> The following paragraph is substituted for Article 13, paragraph 4:
> Gains from the alienation of ships or aircraft operated in international traffic~~, boats engaged in inland waterways transport~~ or movable property pertaining to the operation of such ships or aircraft ~~or boats~~, shall be taxable only in the Contracting State in which the ~~place of effective management of the~~ enterprise *alienating those ships, aircraft, or property is a resident* ~~situated~~.

One could go further and redraft this provision something like this:

> If an enterprise resident in one Contracting State alienates:
> (a) ships or aircraft operated in international traffic; or
> (b) boats engaged in inland waterways transport; or
> (c) movable property pertaining to the operation of means of transport referred to in paragraphs (a) or (b),
>
> gains from the alienation of property referred to in paragraph (a), (b), or (c) may not be taxed by the other Contracting State.

This restructured form would make it easy for parties that do not want to apply paragraph (b) to simply make a cross reference to this effect.

Summarizing the results of the above discussion, the resulting text might be as follows:

Article 13
Gains from the Alienation of Property

1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.
2. Gains derived by a resident of a Contracting State from the alienation of any shares or other interests in a company, or of an interest of any kind in a partnership, trust, or other entity, where the value of the assets of such entity, whether they are held directly or indirectly (including through one or more interposed entities, such as, for example, through a chain of companies), is principally attributable to immovable property situated in the other Contracting State, may be taxed in that other State.
3. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.
4. If an enterprise resident in one Contracting State alienates:
   (a) ships or aircraft operated in international traffic; or
   (b) boats engaged in inland waterways transport; or
   (c) movable property pertaining to the operation of means of transport referred to in paragraphs (a) or (b),

   gains from the alienation of property referred to in paragraph (a), (b), or (c) may not be taxed by the other Contracting State.

...

6. In this Article, the term 'immovable property' has the same meaning as it has in paragraph 2 of Article 6.
7. The situation of immovable property shall be determined for the purposes of this Article in accordance with paragraph 3 of Article 6.

Agreed deviation for Australia-Mexico:
Art. 13(4) applies without taking into account paragraph (b) thereof.

This example suggests the following. First, many of the deviations between the OECD/UN models and existing treaties are of little substance, so a restatement exercise should be able to eliminate many of

them, if there is were a good faith effort to achieve as much uniformity as possible. Second, in some cases, the restatement should involve changes to the model – that is, where practical experience of treaty negotiation has resulted in language that is better drafted than in the model, then the model should be revised accordingly. To some extent, therefore, the restatement process should become a process of revision of the model. It would not necessarily be a revision from scratch; rather, it would be oriented to take into account the actual provisions of treaties that have been negotiated.

Third, a number of existing treaties include similar provisions that are not in the model. To reflect these, the template could be revised to incorporate them (if the consensus was that they reflect best practice) or they could be recast in terms of the alternative wording of the template. While some might be disturbed by the possibility of alternatives, remember that the idea is just to reflect the reality of the existing network. If this network already includes alternative provisions, then nothing would be lost by standardizing them. Finally, in cases of substantive differences between existing treaties and the model, the parties to each bilateral treaty would have to decide either to conform to the model or to keep their current provisions (or possibly vary them).

The existing model suffers from numerous well-known drafting shortcomings, but there is reluctance to fix these problems, perhaps out of a feeling that doing so would upset the existing treaty network. The restatement exercise, therefore, could be a useful vehicle for facilitating the necessary redrafting. Given that all existing treaties would be revised, it should be possible to reach consensus on changes to the template. Moreover, the need to reconcile the differing wording of existing treaties would provide an impetus for redrafting. A small example of this is paragraph 4 of Article 13 in the text above: the need to provide a handy way for countries to opt out of including boats engaged in inland waterways transport suggests redrafting the language by using paragraphing, which would have the incidental benefit of making the text clearer and easier to read.

The example also shows that the restatement exercise would involve a fair amount of work, but the end product – an updated and substantially harmonized set of bilateral treaties – would be worthwhile.

3.1.3 Participation

Since most tax treaties are concluded among OECD countries, it is difficult to envision a restatement exercise's taking place without a collec-

tive decision by the OECD countries to proceed in that way. It would be possible, of course, for OECD countries to proceed with a restatement exercise only in respect of the treaties they have signed with each other. Such an approach would make little sense, however, since it would be logical for each OECD country to include in its restatement exercise all its treaties – including those signed with non-OECD countries. In turn, the non-OECD countries probably would want to restate all their treaties, a process that would quickly include all countries with double tax treaties (there is probably no country that has treaties only with partners that do not in turn have at least one treaty with an OECD country).

Of course, participation should be voluntary, but most countries likely would sign up if the OECD countries themselves agreed to commence a restatement exercise. This would not mean that treaties currently based on the UN model would be pushed to the OECD model. The restatement would have room for alternative choices in the template, to the extent that they were needed to reflect the diversity of the existing treaty network. To the extent that the UN model differs from the OECD model and provides a basis for existing treaties, its language should be included as a template alternative.

3.1.4 Language

Many current treaties are in English or have an English text in addition to text in one or more other languages. It would be simplest, of course, if all bilateral treaties could be restated in English – analogous to multilateral treaties, which typically are just in English[9] – although there is no reason that the text could not be translated into various languages.

A fallback position would be to restate each treaty in English and to have one or more alternative texts in other languages with equal legal validity. This would mean more work for the negotiators, but it would not pose a substantial problem for the uniformity of the system, since the basic principle would be that each bilateral treaty would have an official version in English. This is all that would be required for uniformity of interpretation of the template language to be possible. The language position would be negotiated by the partners of each bilateral treaty in question, as it is today.

3.2 Future Amendments

Step two would be to set up a process for making future changes. Because each existing treaty would be expressed as a template plus devia-

tions, amendments could be made to the template itself, which would automatically change each existing bilateral treaty. Participating countries wishing to change the template could do so by means of a multilateral treaty, the effect of which would be to amend simultaneously each of the bilateral treaties affected by the template. This multilateral treaty would include a schedule containing conforming amendments to particular bilateral treaties if necessary.

The multilateral amending treaty would go into effect as a separate legal instrument, after signing and ratification, between those parties that had approved it. Countries that disagreed with the amendment (or simply did not get around to agreeing with it) would not sign the multilateral treaty and they would continue to abide by their bilateral treaties with the old text. Obviously, it would be desirable to achieve unanimity on amendments to the template, but countries could go ahead without it if they chose.

3.3 Interpretation

Step three would be to deal with questions of how the template should be interpreted. Given that all the treaties would be restated and re-ratified, it should be fairly straightforward for contracting parties to agree that the Commentary as it exists at the time of restatement would be used as a basis for interpreting the template text. (The Commentary, of course, would have to be revised to conform to the template.)

The main issue would be how to deal with questions of treaty interpretation for the future. Under the existing regime, the OECD has tended to deal with many problems by revising the Commentary, rather than by amending the text of the model. One of the main purposes of restating the treaties in terms of deviations from the model would be to facilitate a process whereby future problems best dealt with as amendments to the model text would be handled in that way. This should remove one of the problems of adopting an ambulatory use of the commentary. Using the Commentary to fix problems with the model text by adopting language that is possibly inconsistent with that text or that does not have much support in the text makes it problematic to apply the Commentary to treaties concluded earlier.[10] If this practice were abandoned – in other words, if future changes to the Commentary were restricted to interpretation of the existing text – it should be much easier to secure agreement to apply the Commentary to previously signed treaties.

From a legal point of view, the template could be established as a multilateral treaty with a process specified for adoption of commentary that interpreted its text. A multilateral instrument could be drafted to give a legal basis for this interpretation process, but it would not be a necessary element of the proposal: the restatement could go forward without it.

3.4 Participation in Interpretation and Amendment

As discussed above, it would be desirable to include non-OECD members in a restatement exercise. From an institutional point of view, this would not be problematic because the restatement would take the legal form of renegotiation of bilateral treaties. Thus, each replacement of an existing treaty by a restated treaty would be done by agreement of the two treaty partners.

From a practical point of view, however, the restatement would have to be a coordinated exercise, requiring all members of the group of countries involved to work together to avoid a chaotic result. This is because the restatement would involve the development of a template, an exercise that would have to be done by consensus. Out of this exercise would emerge a de facto group of countries that are signatories to a restated network of treaties. But how would this group continue to collaborate in the event of questions about amendments to or the interpretation of the template? It might be wise to leave this question open for the moment and simply begin the restatement exercise. By itself, the process – which presumably would take several years – would bring together representatives of countries that participate in the worldwide treaty network. Arrangements for the future might emerge out of this collaboration.

4.0 Conclusion

The proposal I have made here is similar to that of Avery Jones and Baker, who propose an amendment by multilateral instrument coupled with a bilateral declaration by each of the states for which the amendment would enter into effect. The main difference between the two proposals is with respect to the template approach. Avery Jones and Baker would not require a template as a prerequisite, but each amendment of the model would then require each pair of Contracting States to prepare and agree on a declaration as to how to incorporate the amend-

ment into each treaty. By contrast, my approach would require more up-front work by way of preparation of the template, thereby allowing a more streamlined process for future amendments. In most cases, amendments to the template could be made with the multilateral instrument alone. It is only where conforming amendments would have to be made to individual treaties that bilateral instruments or schedules containing the text of those conforming amendments would be needed.

How useful the proposed approach would be in terms of facilitating the treaty update process depends very much on whether the existing approach of avoiding minor wording changes to the model continues. Under existing practice, only rarely are small changes made to the text of the model. Rather, problems of interpretation tend to be dealt with by amendments to the Commentary or by the wholesale replacement of entire articles of the model or the addition of new articles or paragraphs. If this approach were changed in favour of more frequent textual amendments to the model, then the proposal presented in this chapter becomes much more compelling

Traditional international tax processes, including bilateral tax treaty negotiations based on model treaties, can be improved to address the fact that the interaction of different national tax systems might be causing problems in a globalized world that encourages heightened trade and investment ties. While the restatement of existing treaties would be a fair amount of work, it would have the benefit of making more transparent the existing treaty structure and of rationalizing those treaties, improving their drafting, and bringing them up to date. Restatement would facilitate the task of consistent interpretation of treaties. Restatement of the existing treaties using the template approach is also needed for future amendments to work smoothly.

Notes

* The views in this chapter are solely the personal views of the author.

1 Victor Thuronyi, 'International Tax Cooperation and a Multilateral Treaty' (2001) 26 Brooklyn J. Int'l Law 1641.

2 Ibid. at 1643, 1645, 1656–9, 1660–1, 1667–70.

3 For further details, see ibid. at 1648–62.

4 John Avery Jones and Philip Baker, 'The Multiple Amendment of Bilateral Double Taxation Conventions' (2006) 1 Bulletin for Int'l Fiscal Documentation 19.

5 See, for example, David Ward, 'The Role of the Commentaries on the OECD Model in the Tax Treaty Interpretation Process' (2006) 60 Bulletin for Int'l Fiscal Documentation 97; see also Monica Erasmus-Koen and Sjoerd Douma, 'Legal Status of the OECD Commentaries: In Search of the Holy Grail of International Tax Law' (2007) 61 Bulletin for Int'l Fiscal Documentation 339.

6 John Avery Jones, 'Are Tax Treaties Necessary?' (1999) 53 Tax L.Rev. 1.

7 As Rick Krever points out, a reason for use of the term 'income, profits, or gains' is to make clear that any gains from the alienation of property, whether they constitute capital gains or ordinary income, are included (see Chapter 11 in this volume). A cleaner approach, however, would be to use a more generic, simpler term and to make it clear in the commentary that it is intended to mean what it says (in other words, that it is not confined to capital gains). Whatever solution is adopted, one hopes there would not be a need for a deviation from a template.

8 As Rick Krever points out, the language could be tightened up to prevent avoidance (see Chapter 11 in this volume). A generic provision should be drafted in such a way as to preserve the rights of the state in which the immovable property is situated.

9 See Avery Jones, 'Are Tax Treaties Necessary?' at 6.

10 Ibid. at 21–2. This source argues that, where fundamental changes were made via the commentary, only those changes that would be in favour of the taxpayer likely would prevail in court.

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PART IV

Taxing Cross-border Services and Service Providers

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13 Tax Discrimination and Trade in Services: Should the Non-discrimination Article in the OECD Model Treaty Provide the Missing Link between Tax and Trade Agreements?

CATHERINE BROWN

1.0 Overview

The importance of trade in services became a focal point in world trade in the 1990s. The evidence can be seen in the General Agreement on Trade in Services (GATS), in regional trade agreements such as the North American Free Trade Agreement (NAFTA), and in bilateral investment agreements (BITS).[1] Signatory governments made significant commitments with respect to both national treatment and most-favoured-nation (MFN) treatment, as well as a host of other measures designed to ensure the free movement of services and service providers across national borders.

The potential benefits of these trade commitments to services providers, however, have been undercut significantly by broad exceptions for direct taxation measures,[2] including matters involving potential tax discrimination if a tax treaty is in place (see NAFTA, Article 2103; GATS, Articles XIV(d) and XXII(3). The result is that differences in tax treatment between resident and non-resident service providers is entirely permissible under both tax and trade agreements, including measures that might negatively impact the cross-border service provider's ability to compete. Further, and somewhat ironically, because of the manner in which tax and trade agreements interact, non-resident service providers from countries without tax treaties might receive a higher level of protection from tax discrimination than those from countries that share a tax treaty (GATS, Article XIV).

1.1 Why Did This Happen?

Tax law and trade law historically were viewed as distinct (see Chapter

1 in this volume). Their parallel existence created few frictions, however, because each dealt with separate areas of taxation, tax treaties with direct tax (that is, income tax) matters and trade law primarily with indirect taxes and customs duties. These lines between tax and trade obligations could no longer be so clearly drawn in the case of trade in services.

It was therefore no surprise that the issue of tax discrimination became controversial during the GATS negotiations. It was widely acknowledged that tax measures could be used as a barrier to trade and could have just as deleterious effect on trade in services as many of the other non-tariff barriers under negotiation. Tax and trade experts simply could not agree on how the issue should best be managed. Tax experts were clear, however, that it should not be through trade agreements.

The arguments by tax experts for excluding direct tax measures from the discipline of trade agreements were threefold. First, many of the countries that would join the World Trade Organization (WTO) had already entered bilateral tax agreements. It was unpalatable that bilateral concessions made under these tax treaties should extend to all WTO signatories under the MFN obligation. Second, the national treatment obligation was incompatible with important policy reasons for distinguishing between residents and non-residents in tax matters. Third, the issue of non-discrimination had already been addressed in tax treaties, leaving open the potential of jurisdictional conflict between tax and trade agreements.

In the end, the GATS contained both a significant carve-out from both the national treatment and MFN obligations for direct tax matters and an exclusion for tax issues relating to the national treatment obligation that fell 'within the scope of an international agreement' from the WTO's consultation and dispute resolution procedures.[3]

This chapter poses two simple questions: If the matter of tax discrimination in trade in services has been carved out of trade agreements in favour of tax agreements, should tax agreements take up the challenge and fully address tax discrimination in trade in services? If so, should the non-discrimination article in the model tax treaty of the Organisation for Economic Co-operation and Development (OECD) serve that role?

The discussion focuses primarily on the GATS because it is the major multilateral trade agreement governing trade in services and on the OECD model[4] because it is the template for most bilateral tax treaties (see Chapters 6, 10, and 12 in this volume).[5] Moreover, the discussion

is intended to be illustrative, not comprehensive. Similar issues arise under other regional trade agreements and BITS that also rely on the supremacy of tax treaties, although they are not discussed specifically here; however, the conclusions reached here could also apply to tax issues arising under these trade agreements.

The chapter begins with an overview of the obligations assumed under the GATS, the tax carve-outs from the GATS, and the provisions of the non-discrimination article in the OECD model tax treaty. The discussion makes obvious that there is no protection against tax discrimination, despite obligations assumed under the GATS, if the non-resident resides in country with a tax treaty with the source state. Further, the existence of a tax treaty will negate even the limited standard of protection anticipated by the GATS. The chapter's main claim is that, if international agreements such as tax treaties are the designated vehicle to address the matter of tax non-discrimination in trade in services, then the OECD model should acknowledge this important role by expanding the protection provided by the non-discrimination article. The chapter concludes with some proposed solutions. The analysis is timely because the OECD currently is re-examining the non-discrimination article, the Working Party having released a Draft Commentary in May 2007.[6]

2.0 Trade Agreements

2.1 The GATS

The GATS created a new paradigm for international trade in services. It applies to all measures by members 'affecting' all trade in services (Article I(1)) and every possible mode of supply, including the cross-border supply and consumption of services and the cross-border movement of service suppliers through the establishment of a commercial presence or in person (Article 1(2).[7] Additionally, the GATS contains a series of annexes and understandings that provide detailed rules with regard to various types of services, such as financial, air transport, and maritime transport services, and access to telecommunications networks (Article XXIX).

Non-discrimination is one of the basic principles of the GATS and the foundation for the MFN and national treatment obligations generally incorporated into trade agreements. The MFN obligation requires that a host country tax foreign service providers from one country no

less favourably than those from another.[8] The national treatment obligation requires that the host country treat foreign service providers and domestic service providers similarly or comparably. In addition, some trade agreements, such as NAFTA, introduce as a minimum standard of treatment for investors 'treatment in accordance with international law, including fair and equitable treatment' (NAFTA, Article 1105(1)).

2.2 Most-Favoured-Nation Treatment

The GATS MFN obligation requires that Member countries 'accord immediately and unconditionally to services and service suppliers of any other Party, treatment no less favourable than that it accords to like services and service suppliers of any other country.' Deviation from this standard is permitted only if the Member lists such measures in the annex on Article II Exemptions and provided the conditions for such exemptions are met.

Member countries are also exempt from the MFN obligation with respect to direct tax matters[9] if the obligation was assumed under an international agreement such as a tax treaty.[10] However, members may not adopt and enforce treaty-based measures that are inconsistent with the MFN obligation if such measures are 'applied in a manner that would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade' (GATS, Article XIV).

The determination of whether the MFN obligation has been violated under this exception or under the domestic law of a Member State or whether the requirements for a specific claimed exemption under Article II have been met is through the WTO dispute resolution process. The same is not true of an alleged violation of the GATS national treatment obligation.

2.3 National Treatment

The national treatment obligation applies to the extent of a Member's listed commitments and is subject to the specified conditions and qualifications. It requires that, in the sectors listed in a Member's schedule of commitments, 'like' service providers of other Members are to be treated no less favourably than domestic ones (GATS, Article XVII.1). Treatment can be formally identical or formally different, but it will be considered less favourable 'if it modifies the conditions of competition'

(Article XVII.3) in favour of services or service suppliers of the Member compared to like services or service suppliers of any other Member. There are a number of exceptions to this rule, including an exception for certain direct tax measures (Article XXVII (o)).[11]

Specifically, different and discriminatory tax treatment is permitted provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers in other Member countries (Article XIV(d)),[12] and as long as the measure does not constitute 'arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services.'

This exception to the national treatment obligation was critical to the successful negotiation of the GATS. It also recognizes important structural elements of a national tax system, particularly one that is source based. In order to protect the tax base, differences in tax treatment between residents and non-residents generally will be required.

Given the breadth of the exception, one might conclude that there are few tax measures that could violate the GATS national treatment obligation, but this is not the case. The obligation extends to all tax measures except as noted above or as listed in a country's schedule of commitments.[13] As a result, at least five broad categories of tax measures could violate the GATS national treatment obligation.

- The domestic legislation might meet the exception in Article XIV but operate as a disguised restriction on trade in services; for example, the host country might impose an excessive and arbitrary gross withholding tax.
- The legislation might meet the exception in Article XIV but be administered in a manner that is a disguised restriction on trade; for example, the requirements of the source country to obtain a refund of withholding tax on amounts that are exempt under the tax treaty might be arbitrary or unduly onerous.
- The measure might fall outside the permitted list of exceptions in Article XIV and might not be listed as a qualification in the Member's schedule of commitments; for example, the source state could provide an additional tax credit to a tax resident who purchases services from a resident but not from a non-resident service provider.
- The measure might be a disguised tax measure in the form of a penalty, fee, or charge; for example, there might be additional fees associated with non-resident filings or claims for refunds.

- The measure might be in respect of indirect taxes; for example, the source country might impose different and discriminatory indirect taxes such as sales taxes, excise taxes, value-added taxes, and tariffs or other similar charges on non-resident service providers.

If the non-resident service provider is from a Member State that lacks a tax treaty with the source state, the national treatment obligation is violated in any of these circumstances and a remedy may be sought under the WTO dispute resolution process. This is not the case if a tax treaty is in place.

A Member may not invoke the consultation or dispute resolution mechanisms under the WTO in respect of the national treatment obligation if a measure of another Member 'falls within the scope of a tax treaty.' Put differently, the GATS national treatment obligation effectively is negated to the extent that the matter falls within the scope of a tax treaty.

Does the OECD model provide protection from tax discrimination to the non-resident service provider in any of the circumstances described above? The answer is, no it does not.

3.0 The Non-discrimination Article in the OECD Model

The OECD model imposes minimum obligations with respect to non-discrimination in respect of non-resident service suppliers.

A modified form of the national treatment obligation applies if the services are provided through a commercial presence. Specifically, a Contracting State cannot tax a permanent establishment located in that state less favourably than an enterprise of that state carrying on the same activities.[14]

As well, foreign-controlled enterprises residing in the other Contracting State cannot be subjected to any taxation or any requirement connected therewith that is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the other state are or may be subjected.

Finally, there is an obligation to provide a deduction for interest, royalties, and other disbursements paid by an enterprise of one state to a resident of the other; such amounts must be deductible in calculating taxable profits under the same conditions as if they had been paid to a resident of the same state (OECD model, Article 25(7)).[15]

However, there is no applicable non-discrimination principle in the OECD model in respect of a non-resident service provider without a commercial presence. The remaining provision in Article 24 (leaving aside stateless persons) restricts its protection to nationals of a Contracting State who reside in the other Contracting State. Specifically, such resident nationals cannot be subjected to taxation or related requirements that are other or more burdensome than those imposed taxes on nationals of that Contracting State (Article 25(1)).[16] This means that non-residents who provide services described in the GATS as 'through presence of natural persons of a Member in the territory of any other Member' (GATS, Article 2(d)) receive no protection against tax discrimination under the OECD model.

This is not a surprising outcome in the context of the OECD model. As the Working Party points out, '[t]he provisions of Article 24 do not address all forms of possible discrimination: the provisions of Article 24 cover certain specific situations. Apart from these specific cases, different or less favourable treatment is possible. The broader rules against discrimination that are found in other types of conventions have therefore little relevance for purposes of the application and interpretation of Article 24.'[17]

Although the lack of protection from tax discrimination might not be a surprise in a tax treaty context, it is a surprise in the context of the GATS. The carve-out from the GATS national treatment obligation for direct taxes is subject to a minimum standard: the measure must not be arbitrary or a disguised restriction on trade. Further, there is no carve-out in the GATS from the national treatment obligation with respect to indirect taxes.[18] Both the minimum standard for direct taxes and the national treatment obligation in respect of indirect taxes effectively are nullified if the matter falls within the scope of a tax treaty. The determination of scope is made by the Contracting States.[19]

Does the selective nullification of trade obligations through a tax treaty matter in the global context? There are several reasons to suspect the answer is yes. First, expectations around national treatment and trade in services are short-circuited if the non-resident service provider resides in a country with a tax treaty with the source state. Second, it results in differing levels of protection from discrimination among non-resident service providers depending on what falls within the scope of the applicable tax treaty. Finally, the outcome is that a tax treaty serves as an effective tool to circumvent obligations with respect to non-discrimination

against non-resident service providers, a role unworthy of the OECD model treaty. Each of these reasons is discussed in more detail below.

4.0 The Interaction of Tax and Trade Agreements: The Bottom Line

4.1 Legitimate Expectations

As signatories to the GATS, member countries are committed to providing national treatment to service providers in the sectors listed. These same service providers may receive no protection against tax discrimination in respect of either direct or indirect taxes if they are non-residents of the source state and a tax treaty based on the OECD model is in place. Even the minimum standard anticipated in the GATS – that the measure not be a disguised restriction on trade – is effectively negated by the model treaty.

The OECD model also precludes a non-resident service provider from invoking the GATS national treatment obligation in respect of any other tax imposed by the source state, including indirect taxes such as excise, value-added, and sales taxes.[20] But for a tax treaty, such taxes would be subject to the GATS national treatment obligation.

4.2 Differing Levels of Protection

The current interaction of tax and trade agreement results in different levels of protection from tax discrimination for non-resident service providers. The highest level of protection is reserved for non-resident service providers from countries that have no tax treaty with the source state. Such service providers may rely on the GATS national treatment obligation, and there is a potential remedy under the WTO dispute resolution process in the five categories described above.

The next level of protection applies to non-resident service providers from countries with a tax treaty with the source state. At issue is whether the matter falls within the scope of a tax treaty. If not, the GATS national treatment obligation applies (see the discussion below).

The least protection against tax discrimination is provided to non-resident service providers from countries that have a tax treaty with the source state in which the signatories totally insulate themselves from any obligation with respect to discrimination in both direct and indirect

tax matters.[21] This is achieved in the tax treaty by specifying that all matters relating to direct or indirect taxes fall within the scope of the treaty.[22] Under such treaties, there is no remedy against tax discrimination in the five categories described.

4.3 Does the Matter Fall within the Scope of a Tax Treaty?

As stated, whether a non-resident service provider may rely on the GATS national treatment obligation is determined by whether the matter falls within the scope of a tax treaty. This might not be an easy matter to resolve. As the OECD Commentaries point out, 'the phrase "falls within the scope" is inherently ambiguous. While it is clear that a country could not argue in good faith that a measure relating to a tax to which no provision of a tax convention applied fell within the scope of that convention, it is unclear whether the phrase covers all measures that relate to taxes that are covered by all or only some of the provisions of the tax convention.'[23] Some tax treaty partners, therefore, have taken steps to clarify their positions with respect to this issue.[24] For those that have not, the difficulty in determining whether a matter falls within the scope of a tax treaty should not be underestimated. This matter is explored below in two contexts: first, the exception in Article XIV(d) of the GATS and, second, in the case of other direct tax measures that might violate the GATS national treatment obligation.

4.4 The Exception from the National Treatment Obligation in Article XIV(d) of the GATS

If the manner in which the source country applies its tax laws in respect of withholding 'is arbitrary' or 'a disguised restriction on trade' and therefore does not meet the GATS exception, this clearly violates the GATS national treatment obligation. Nonetheless some service providers might have no remedy.

At issue is whether the matter falls within the scope of the applicable tax treaty.[25] If it does, then, despite the GATS, the offending tax measure is excluded from the consultation and dispute resolution process under the GATS (Article XXIII), unless the Contracting States agree otherwise, and is not in violation of the tax treaty. The reason for this conclusion is that the OECD model applies to persons who are residents of one or both of the Contracting States (Article 1), so that all aspects of non-

discrimination with respect to such residents fall within the scope of the tax treaty and there is no obligation of non-discrimination in respect of a national who is a non-resident. The other less defensible view is that because the non-discrimination article does not address itself to the case of non-residents, the matter does not fall within the scope of a tax treaty. Non-residents therefore remain protected by the national treatment obligation in the GATS.[26]

Perhaps in anticipation of such an argument, some Contracting States have taken steps to remove any doubt about the scope of their tax treaties. For example, the Canada-United States treaty (Article 29(6)) provides that, for purposes of the GATS, the Contracting States agree that a measure falls within the scope of the Convention if the measure relates to a tax to which Article XXV (Non-Discrimination) applies. As the non-discrimination article in the treaty applies to all taxes imposed by a Contracting State, it is difficult to argue that a withholding tax on income also does not fall within the scope of the tax treaty.

4.5 Other Direct Tax Measures that Might Violate the National Treatment Obligation

Other direct tax measures also might offend the national treatment obligation. For example, the source state could provide an additional tax credit to a resident who purchases services from a resident, but not from a non-resident, service provider. Assuming the source state has not claimed an exemption in respect of the credit, the threshold question in determining whether the measure violates the non-discrimination principle is again whether the measures fall within the scope of the relevant tax treaty.

The OECD model non-discrimination article addresses the deduction of expenses by a resident enterprise (Article 24(5)). Specifically it provides that, for the purpose of determining the taxable profits of an enterprise, expenses are deductible under the same conditions as if they had been paid to a resident; however, the model does not address a Contracting State's obligation with respect to the use of other tax benefits, such as tax credits, in this context. Can one infer, therefore, that this measure falls within the scope of the tax treaty but that no non-discrimination principle applies? This would be the obvious conclusion under a treaty such as the Canada-United States treaty, because the measure relates to a tax to which the non-discrimination article in

that treaty applies. The answer is not as obvious, however, without this additional language in the tax treaty.

4.6 Circumventing Non-discrimination Obligations

The OECD model also might be used as a tool to circumvent trade obligations – indeed, as taxation is one of the last areas in which discriminatory practices can be used as barriers to trade, this tool could prove significant. Currently, there are few limitations on a country's tax practices: customary international law provides virtually no protection against tax discrimination, and constitutional or national limitations on tax discrimination against non-residents are rare. The primary restraint against egregious tax practices is international goodwill or limitations imposed in integrated agreements, the obvious example being the treaty establishing the European Community.[27]

5.0 Proposed Solution: Expand the Non-discrimination Article

The signatories to the GATS effectively exorcised obligations with respect to non-discrimination and taxation in favour of tax treaties. Should the tax treaty regime respond to the new challenges posed by trade agreements in respect of trade in services?

The answer to this question raises a more fundamental question: What role does the non-discrimination article in the OECD model play? Is it, as an international tax expert opines, to 'reflect the political choice of the contracting states to create as source countries a level playing field for residents of the other country'?[28]

Should the political choice be to match developments in the global trade in services? If so, the obvious place to do so is in the non-discrimination article in the OECD model. At first glance, this might seem an implausible idea. The non-discrimination article is firmly grounded in the principle that resident and non-resident taxpayers are different and that, in general, there is no expectation that non-residents will be protected against potentially discriminatory tax measures in the tax treaty.

The contrary view is that the principles in the non-discrimination article have continued to evolve since the initial OECD Draft Convention was introduced in 1963 and that they should continue to evolve. The current version has remained unchanged, however, since trade in services was widely acknowledged as an important part of global trade.

With the exception of tax measures, machinery has been put in place to implement internationally recognized principles of non-discrimination in respect of trade in services. Perhaps it is time to consider expanding the OECD model non-discrimination principles to keep pace with these other global developments.

Were this to occur, what issues should be addressed? Initial considerations include the economic actors to which an expanded principle should apply, the appropriate standard of treatment, dispute resolution, and grandfathering provisions.

5.1 Which Economic Actors?

Arguably, the non-discrimination principle should apply to all economic actors and to all tax measures that affect their economic activities. This is unlikely to happen soon, however, given the complexities of the issues involved and the high level of consensus that would be required. A good starting point for the expansion of the non-discrimination principle is in respect of trade in services, one of most significant areas where non-discrimination principles in tax and trade agreements remain uncoordinated.

As discussed, the exception to the national treatment obligation in the GATS is 'measures to ensure the effective imposition or collection of taxes,' and the accompanying footnotes to the GATS recognize important structural elements of a national tax system. Yet there is always an element of discrimination in the imposition of such measures. For instance, a gross withholding tax might exceed taxes on net income, lengthy administrative requirements or delays might affect refunds, or a source state might require withholding tax despite a treaty exemption. These are all expected realities in cross-border trade. The mismatch between tax and trade agreements such as the GATS, however, is that the latter provides a minimum standard against which national tax legislation and its administration can be measured. That standard is 'arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services.'

The GATS standard might not be the appropriate standard to include in the OECD model's non-discrimination article, but it is important to find such a standard if for no other reason than to prevent the absurd result that non-resident service providers from countries without tax treaties currently often receive a better level of protection from tax discrimination than those from countries with tax treaties.

5.2 *What Is the Appropriate Standard of Treatment?*

Obtaining consensus on a general and appropriate standard of treatment will not be an easy task. Historically, the non-discrimination principle has been precise, rules based, and applicable only in carefully defined circumstances. There is also the practical reality that an endless number of approaches is possible, with predictable preferences by some contracting states for a standard that is already familiar in their domestic context.[29] Nonetheless, some suggestions are provided below, including approaches that mirror the GATS or borrow from international law.

5.2.1 The GATS Standard

One option is simply to mirror the GATS language. The obvious advantage of such an option is that it would provide the narrowest approach to non-discrimination in trade and services but still meet the internationally expected minimum standard. Such a clause might appear as follows: 'For purposes of Article XIV of the GATS, a Contracting State shall not apply any measure to ensure the effective imposition or collection of taxes in respect of trade in services that is arbitrary or unjustifiable discrimination between countries where like conditions prevail or a disguised restriction on trade.' The commentary could further clarify that a measure would not be considered arbitrary or unreasonable if the difference in treatment was the result of a tax treaty.

5.2.2 Fair and Equitable Treatment

Another approach would be to introduce an internationally accepted minimum level of treatment such as 'fair and equitable treatment.'[30] Although there is some disagreement about the precise meaning of this expression, it is a standard widely used in investment agreements and BITS and its interpretation is becoming well developed through arbitral decisions. Its scope and meaning also have been refined following a decade or more of experience under various trade agreements.[31] The use of such a common standard would offer the advantage of consistency and avoid the further fragmentation of international law standards. The fair and equitable standard would also provide a framework for determining violations, and it is familiar in international arbitrations.

Such a provision in the non-discrimination article might appear as follows: 'Any measure applied by a Contracting State to ensure the effective imposition or collection of taxes as described in Article XIV of

the GATS shall be applied in a manner that is fair and equitable in the circumstances and in accordance with international law.' Alternatively: 'Each Contracting State shall afford fair and equitable treatment to ensure the effective imposition of taxes as described in Article XIV of the GATS. In no case shall a Contracting State accord treatment less favourable than that required by customary international law.' The Contracting States could also confirm their shared understanding of the meaning of 'customary international law.'[32]

A more broadly drafted provision could apply to all tax measures applicable to non-resident service providers and might appear as follows: 'Residents of a Contracting State who are not resident in the other Contracting State shall not be subjected in the other Contracting State to any taxation or connected requirement in the supply of a service (as defined in the GATS) that is not fair or equitable in the circumstances and in accordance with international law.'[33]

5.2.3 The Treaty Establishing the European Community

A third approach would be to adopt principles developed under the treaty establishing the European Community (now the European Union). Because 19 of 30 OECD countries are signatories to that treaty, a standard based on non-discrimination principles developed in case law of the European Court of Justice has obvious appeal. Some have gone so far as to argue that, because so many OECD countries are also Members of the European Union, 'it is not appropriate to put forward changes to the non-discrimination Article or the Commentary that would run contrary to the relevant decisions of the [European Court of Justice] in respect of the EU Treaty.'[34] With respect this seems an incorrect approach, first, because at least a third of the OECD countries are not bound by the commitment of an integrated trade block and, second, because many countries other than those in the OECD use the provisions of the model treaty. EU Members can continue to rely on internal standards under the EU treaty with respect to obligations with other EU Members, as these take priority over tax treaties. Accordingly, EU law will apply where a Member's tax laws create restrictions on trade in services with its EU partners and the provisions of the OECD model will apply with respect to non-member states.

5.2.4 A New Tax Treaty Standard

The Contracting States might prefer to seek consensus on a new and independent treaty standard. One option would be to describe the pro-

hibited treatment as 'arbitrary, unjustified, or unreasonable' and to add a requirement of transparency in both national legislation and its administration.

5.3 Dispute Resolution

One of primary arguments against the addition of a new non-discrimination obligation to the OECD model is its interpretation and application. Non-resident taxpayers ordinarily have access to domestic courts for a determination of whether a violation of the non-discrimination has occurred. As a result, some observers conjecture that key structural elements of their national tax system could be struck down by overzealous judges who are not well schooled in tax matters. This is a plausible concern, but the resolution of issues relating to the proposed non-discrimination provision could be restricted to the competent authorities of the Contracting States concerned. Practically, this would require that the tax administration of the country of residence of the complaining taxpayer support the taxpayer's claim against the other country. This approach would also provide symmetry with trade obligations.[35]

Would such a restriction of the dispute resolution process result in any real change in the current position of non-resident service providers under the tax treaty? In my view, the answer is yes. First, it would introduce a minimum standard in the tax treatment of non-resident service providers. Second, it would require the competent authority to examine closely complaints against its own revenue-collection arm to ensure that, in administering tax measures, a minimum standard was met. Third, it would invite closer examination of national measures against an internationally accepted standard.

Unless the competent authorities of both Contracting States concurred that the relevant measure was not in violation of the non-discrimination provision of the tax treaty, the matter would end. In case of disagreement, the Contracting States could consider the option of binding arbitration under the proposed OECD Mutual Agreement procedure.[36] The possibility of binding arbitration is also a reason to adopt an internationally recognized standard such as 'fair and equitable treatment,' which is familiar in arbitration proceedings.

5.4 Grandfathering Provisions

No doubt it would be necessary to include a grandfathering rule, as

Contracting States likely would not be willing to subject current tax measures to new scrutiny.[37]

6.0 Other Reasons Not to Expand the Non-discrimination Article

There are many other arguments against expanding the non-discrimination article, notwithstanding the challenges posed by trade agreements. One is that tax and trade agreements are based on different principles and serve different purposes; therefore, there is no need for tax treaties to address new issues relating to the taxation of non-residents.

Another argument is that the introduction of a non-discrimination principle tied to trade or investment law would create uncertainty in the tax treaty. For example, what is the meaning of the 'equitable or effective administration of tax'? What is a 'disguised restriction on trade'? Is the competent authority able to make this determination in the context of direct tax measures?[38] The 'fair and equitable' standard is not rules based, and it would introduce a standard not currently found in the OECD model or in the GATS in relation to the taxation of non-residents. Therefore, it would be difficult to interpret and apply.

A third argument is that a non-discrimination principle in respect of trade in services would open a floodgate of demands for a much broader non-discrimination principle. For example, why should other non-residents, such as an investor who earns interest and dividend income, not be provided with similar protection in the non-discrimination article?[39]

A fourth argument is that some countries might not adopt the new provision, further fragmenting the international tax treaty system. In particular, because the EC treaty already provides a minimum standard of treatment, the issue might not be viewed as an important EU problem other than in the context of forum shopping between the protections provide under the non-discrimination article in the tax treaty and EU law.[40]

7.0 Conclusions

This chapter has considered whether an expanded non-discrimination article in the OECD model treaty could, and should, provide the missing link between tax and trade agreements. It has considered this issue in the context of the challenges that result from enhanced global trade (and global investment that encourages more cross-border trade

in services). In the race to insulate tax issues from trade obligations, we might be overlooking an important opportunity to expand the principle of non-discrimination and tax 'fairness' in tax treaties. For these reasons, it is time to consider introducing a new non-discrimination standard in the OECD model treaty.

In fact, the model treaty's non-discrimination article has remained virtually unchanged for three decades. Its provisions are specific and rules based and do not address the domestic use of discriminatory tax measures in a wide range of circumstances – particularly those affecting non-resident service providers. Historically, this has not been a significant issue. Yet, because of the primacy of tax treaties in many trade agreements, tax treaties can now be used as a tool to circumvent international obligations not to discriminate against non-resident service providers. Further, a non-resident service provider from a country with no tax treaty with the source state often receives better protection from tax discrimination than one from a country with a tax treaty in place.

One outcome of this state of affairs is that tax discourages the provision of cross-border services and investment in industries that provide these services, inhibiting global welfare. These are not desirable results. Tax treaties should respond to the challenges posed by trade agreements and provide a minimum level of protection to service providers, including those who are non-residents of the source state. Ideally, this means adding an overarching principle of non-discrimination and fairness – or at least non-arbitrariness – to the non-discrimination rules of the OECD model treaty. While this likely remains only a distant possibility, a good starting point would be the addition of a non-discrimination principle that, at a minimum, mirrors internationally recognized obligations of non-discrimination in trade in services.

Notes

1 See United Nations Conference on Trade and Development, 'Country List of Bilateral Investment Treaties, online: UNCTAD <http://www.unctadxi.org/templates/DocSearch____779.aspx>.

2 In this paper, direct taxes include all taxes on income and capital, such as personal or individual income taxes, corporate income taxes, capital gains taxes, and wealth taxes. Other taxes, such as taxes on the supply of goods, sales, turnover taxes, or excise duties (indirect taxes) also affect cross-border service suppliers.

3 Tax carve-outs can also be found in most BITS; see Australia, Department of Foreign Affairs and Trade, 'Australia-United States Free Trade Agreement, Articles 22.1 and 22.3,' online: Australia, Department of Foreign Affairs and Trade <http://www.dfat.gov.au/trade/negotiations/us_fta/final-text/index.html>.

4 The OECD model treaty was introduced in 1977, revised in 1992, and updated in 1994 and 1995. See OECD, Committee on Fiscal Affairs, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2005) (loose-leaf).

5 This comment is not intended to detract from the importance of UN model treaty.

6 OECD, 'Application and Interpretation of Article 24 (Non-Discrimination): Public Discussion Draft,' online: OECD <http://www.oecd.org/dataoecd/59/30/38516170.pdf>. The commentary to the OECD model treaty does not form part of the treaty itself but is widely used to interpret bilateral tax treaties with articles that derive from the OECD model's provisions.

7 Article 1(2)(a)–(d) defines four modes for trade in services.

8 I do not argue that MFN should extend to service providers.

9 GATS, Article XXVIII(9). This article defines the meaning of direct taxes within the GATS as 'all taxes on income, on total capital or on elements of income or of capital, including taxes on gains from the alienation of property, taxes on estates, inheritances and gifts, and taxes on the total amounts of ages or salaries paid by enterprises, as well as taxes on capital appreciation.'

10 GATS, Article XIV(e) ('or any other international agreement or arrangement by which the Member is bound').

11 'Direct taxes' comprise all taxes on total income, total capital, or elements of income or of capital, including taxes on gains from the alienation of property, taxes on estates, inheritances and gifts, and taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.

12 A footnote to Article XIV(d) clarifies that 'equitable or effective imposition of taxes' includes certain specified measures taken by a member under its taxation system.

13 See Canada's Schedule of Commitments, online: <http://tsdb.wto.org/wto/public.nsf/FSetReportPredifinedAffich?OpenFrameSet&Frame=F_PredefinedReport&Src=_o5trn8rpfe1qm4r39ccn6ssr65so2uo9lcph38p366komcphm74o66p3364p3adj6cdgj0c1n60p6ac9m7t2m8qbk8hnm6tbdcln780_>.

14 This is a narrower standard than that found in the GATS, which applies to 'like' services and service providers.

15 See also Article 25(8), which permits thin-capitalization rules, a clear departure from the national treatment obligation.

16 In general, neither the Canadian nor the U.S. tax system discriminates on the basis of nationality or citizenship, but on the basis of residence or location of activities.

17 OECD, 'Application and Interpretation of Article 24' at 4.

18 Under the GATS (Article XVII), a country could claim an exception in its schedule of commitments.

19 A footnote to Article XXII(3) of the GATS further provides that, if there is disagreement about whether the matter falls within the scope of a tax treaty and the tax treaty was in existence at the time the WTO agreement entered into force, one country cannot unilaterally challenge the issue of the treaty's scope under WTO procedures. Both parties to the existing tax treaty must consent if the WTO dispute resolution procedures (rather than tax treaty procedures) are to be used. However, if future tax treaties are silent on the issue, either tax treaty partner may unilaterally bring a tax dispute based on the jurisdictional issue before the Council for Trade in Services, which may then refer the matter to binding arbitration.

20 This result follows because all taxes fall within 'the scope of a tax treaty.' Although the tax treaty generally applies only to income and capital taxes, paragraph 6 of the non-discrimination article provides that, notwithstanding, it applies to taxes of every kind and description. A note in the Commentary further clarifies this point; see OECD Commentary, Article 24, para. 60.

21 See, for example, Article 25 of the Convention between the United States of America and Canada with Respect to Taxes on Income and Capital, 26 September 1980, U.S.-Can., T.I.A.S. No. 11,087; Protocol Amending the 1980 Tax Convention, 14 June 1983, T.I.A.S. No. 11,087; Protocol Amending the 1980 Tax Convention, 28 March 1984, U.S.-Can., reprinted in 1 Tax Treaties (CCH) P 1942; Protocol Amending the 1980 Tax Convention, 17 March 1995, U.S.-Can., reprinted in 1 Tax Treaties (CCH) P 1946; Protocol Amending the 1980 Tax Convention, 29 July 1997, U.S.-Can., reprinted in 1 Tax Treaties (CCH) P 1949A. A Fifth Protocol was signed on 21 September 2007.

22 The 2006 U.S. model tax treaty further limits the applicability of the GATS as follows:

> Notwithstanding the provisions of subparagraph b) of paragraph 2 of this Article:
>
> i) for purposes of paragraph 3 of Article XXII (Consultation) of the [GATS, which allows signatories to refer unresolved questions to ar-

bitration], the Contracting States agree that any question arising as to the interpretation or application of this Convention and, in particular, whether a taxation measure is within the scope of this Convention, shall be determined exclusively in accordance with the provisions of Article 25 (Mutual Agreement Procedure) of this Convention; and

ii) the provisions of Article XVII of the [GATS, providing for national treatment] shall not apply to a taxation measure unless the competent authorities agree that the measure is not within the scope of Article 24 (Non-Discrimination) of this Convention.

23 OECD, 'Model Tax Convention on Income and Capital (Condensed Version)' (Paris: OECD, July 2005) at 310.
24 See Canada-United States Tax Treaty, Article XXIX(6).
25 Article XXIII of the GATS requires that resolution of this must be directed first to the competent authority under the relevant tax treaty. The OECD Commentary to Article 25 at para. 44.5 includes the following discussion of the scope of a tax treaty: 'the phrase "falls within the scope" is inherently ambiguous, as indicated by the inclusion in paragraph 3 of Article XXII of the GATS both an arbitration procedure and a clause exempting pre-existing conventions from its application in order to deal with disagreements related to its meaning.'
26 In the Canada-United States treaty, this argument appears to have been anticipated and quashed. Article 29(6) provides: 'For purposes of paragraph 3 of Article XXII (Consultation) of the General Agreement on Trade in Services, the Contracting States agree that (a) a measure falls within the scope of the Convention if the measure relates to a tax to which Article XXV (Non-Discrimination) of the Convention applies. As the Non-discrimination Article applies to all taxes imposed by a Contracting State it is difficult to argue that withholding tax does not fall within the scope of a tax treaty.'
27 The same is not true for countries governed by the treaty establishing the European Community. The obligations of member states with respect to direct taxation take priority over obligations in tax treaties or the GATS with other EU Members. Accordingly, EU law will apply where a Member's tax laws create restrictions on trade in services with EU partners. As more than two-thirds of OECD countries are also Members of the EU, this could be one reason there has been no widespread clamour to coordinate the tax treaty non-discrimination article with trade obligations. For the rest of the OECD countries and other countries that adopt the OECD model, the issue remains an important one.

28 Kees Van Raad, 'Non-discrimination in Taxation of Cross Border Income under the OECD Model and EC Treaty Rules: A Concise Comparison and Assessment' (2005) 59 Int'l Bulletin of Fiscal Documentation 137.

29 See, for example, the General Report of the 2008 Congress on Non-Discrimination at the Crossroads of International Taxation, Brussels, where the general reporters, all EU Members, propose a new version of Article 24 based in part on the European Court of Justice interpretation of EU non-discrimination principles. Description found at IFA – Scientific Programme, online: IFA <http://ifa-belgium.4your.net/ScientificProgramme.html>.

30 Fair and equitable treatment has been described as 'an "absolute", "non-contingent" standard of treatment, i.e. a standard that states the treatment to be accorded in terms whose exact meaning has to be determined, by reference to specific circumstances of application, as opposed to the "relative" standards embodied in "national treatment" and "most favoured nation" principles which define the required treatment by reference to the treatment accorded to other investment'; see OECD, Directorate for Financial and Enterprise Affairs, 'Fair and Equitable Treatment Standard in International Investment Law' OECD Working Papers on International Investment 2004/3 (Paris: OECD, September 2004), online: OECD <http://www.oecd.org/dataoecd/22/53/33776498.pdf>.

31 The following provides one example: '1. Each Party shall accord to ... treatment in accordance with the customary international law minimum standard of treatment of aliens, including fair and equitable treatment and full protection and security.' See also Australia-United States Free Trade Agreement, Article 11.5, which reads: 'For greater certainty, the concepts of "fair and equitable treatment" and "full protection and security" do not require treatment in addition to or beyond that which is required by that standard, and do not create additional substantive rights'; see Australia, 'Australia-United States Free Trade Agreement,' online: Australian Government <http://www.fta.gov.au/default.aspx?FolderID=246&ArticleID=193>.

32 For example, 'The Contracting States confirm their shared understanding that "customary international law" generally and as specifically referenced in Article 24 results from a general and consistent practice of States that they follow from a sense of legal obligation. With regard to Article 24, the customary international law minimum standard of treatment of aliens refers to all customary international law principles that protect the economic rights and interests of aliens.' Adapted from Australia-United States Free Trade Agreement, Article 11.5.

33 Under the GATS, Member countries may list qualifications and exceptions to the national treatment obligation. These frequently include tax measures. In order to avoid ambiguity about the application of this clause to those excepted measures an additional sentence could be added: 'For greater certainly nothing in this Article shall affect the rights and obligations of any Party under any trade agreement.' Alternatively, a paragraph could be added to the commentary to further clarify that differences in tax treatment based on listed exceptions to the national treatment obligation in a trade agreement provide circumstances where the tax treatment is fair and equitable.

34 OECD, 'Written Response Submitted on 5 July 2007 by the ICAEW Tax Faculty Relating to the Public Discussion Draft on the Non-Discrimination Article in the OECD Model Convention Issued by OECD (3 May 2007)', online: OECD <http://www.oecd.org/dataoecd/58/56/39450236.pdf>.

35 Service providers or recipients under the GATS can request their national government to take action against another WTO Member government only if they consider they are being discriminated against contrary to the GATS; they may not take direct action on their own behalf in any dispute resolution process.

36 It is proposed that a new paragraph 5 be added to Article 25 (Mutual Agreement Procedure) of the OECD model that would provide for mandatory arbitration of issues arising from cases that the states are unable to resolve within 24 months.

37 This is a simple addition that might appear as follows:

> The provisions of paragraph ... shall not affect the operation of any provision of the taxation laws of a Contracting State:
>
> (a) relating to the effective imposition or collection of taxes which is in force on the date of signature of this Convention (including any subsequent modification of such provisions that does not change the general nature thereof); or
>
> b) adopted after such date by a Contracting State and which is designed to ensure that a person who is not a resident of that State does not enjoy, under the laws of that State, a tax treatment that is more favourable than that enjoyed by residents of that State.

38 There is a substantial body of case law with respect to indirect taxes and trade; see World Trade Organization, 'Dispute Settlement: Index of Dispute Issues,' online: WTO <http://www.wto.org/english/tratop_e/dispu_e/dispu_subjects_index_e.htm#tax>.

39 The question is a good one. However, unlike the case with trade in services, there has been no global pretence at protecting non-resident investors from discrimination in the WTO agreement. In a perfect world, protection against tax discrimination would also extend to investment income, to business income, or to income from any source. The case is not nearly as compelling as one that can be made for trade in services.

40 If individual countries did not want to introduce a general non-discrimination article into their tax treaty they would be free not to do so. The alternative would be to introduce a non-discrimination article with a clear indication of when it would be acceptable to introduce exceptions.

14 The New Services Permanent Establishment Rule in the Canada-United States Tax Treaty

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1.0 Introduction

Canada and the United States enjoy highly integrated economies: investors from the United States, for instance, provide roughly two-thirds of the total investment in Canada. For this reason, changes to the tax treaty between the two countries can have important revenue and other consequences. The Fifth Protocol that amends the 1980 Tax Convention between Canada and the United States was signed on 21 September 2007 after many years of negotiations.[1] As taxpayers and their advisers had widely anticipated, the Protocol deals with hybrid entities and real estate investment trusts, eliminates the withholding tax on cross-border payments of interest, reduces the withholding tax on direct dividends to 5 per cent, and introduces an arbitration provision (see also Chapter 10 in this volume).

The Protocol also contains some surprises, perhaps the biggest of which was Canada's agreeing to the reciprocal application of the limitation on benefits provision (Article XXIXA), which, since 1984, had applied only in respect of the United States. The other surprise, at least to me, was the amendment of the definition of a permanent establishment (PE) to deem services provided by a resident of one country to be a PE in the other country in certain circumstances where the resident does not otherwise have a PE there – that is, does not have a fixed place of business there or a dependent agent with authority to contract on behalf of the resident.

A more basic services PE rule, as I refer to it here, is contained in the United Nations Model Double Tax Convention (hereafter referred to as the 'UN model'),[2] and both Canada and the United States have treaties

with developing countries that contain such provisions.[3] However, a services PE rule is not a feature of U.S. tax treaty policy – it is not found in the U.S. model treaty issued in 2006[4] – nor is it typically found in Canadian tax treaties, except in those with developing countries and presumably at the insistence of those countries.

It is clear that Canada, rather than the United States, wanted the new services PE rule in the Fifth Protocol.[5] The Canadian tax authorities were not pleased with the results in the *Dudney*[6] and *Wolf*[7] cases. In *Dudney*, a U.S. consultant worked at his Canadian client's premises for almost a full year and yet was found not to have a fixed place of business PE in Canada. In *Wolf*, a U.S. engineer worked full time at the same location in Canada for five years but was held not to be resident in Canada, not to be employed in Canada, and not to have a PE in Canada. U.S. consultants working in Canada for more than 183 days in any twelve-month period will be subject to Canadian tax under the new services PE rule in the Fifth Protocol.

This chapter examines the new services PE rule, describes the scope of its coverage, and identifies some interpretive problems. As part of the analysis, the services PE rule in the Fifth Protocol is compared to the services PE rule in the 2008 update to the model treaty of the Organisation for Economic Co-operation and Development (OECD) (hereafter referred to as the 'OECD services PE rule')[8] and to the services PE rule of the UN model treaty (referred to as the 'UN services PE rule'). The new OECD services PE rule does not involve any change to the OECD model treaty.[9] Instead, it involves the addition to the Commentary on Article 5 of an alternative treaty article that countries wishing to expand their taxation of income from services are free to adopt.

2.0 The Services PE Rules in the UN and OECD Model Conventions

In order to facilitate subsequent comparisons with the services PE rule in the Fifth Protocol, the UN services PE rule and the OECD services PE provision in the Commentary on Article 5 of the OECD model are set out here. For the sake of completeness, Article 14(1)(b) of the UN model is also mentioned.

Under Article 5(3)(b) of the UN model, a PE encompasses '[t]he furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for

such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months in any twelve-month period.'

In addition, under Article 14 of the UN model, income from professional and other independent services performed by a resident of one country in the other country may be taxed in the other country if the resident has a 'fixed base' in the other country or if the resident's 'stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned.' Obviously there is some overlap between Articles 5(3)(b) and 14(1)(b) of the UN model, which causes some troublesome issues of interpretation that are beyond the scope of this chapter.[10] This overlap does not occur in the OECD model because Article 14 of that model was deleted in 2000, but even before its deletion the article applied only if the services were provided through a fixed base in the source country.

In the changes to the Commentary on Article 5 contained in the 2008 update, the OECD includes the following provision as an alternative services PE rule that Member States may include in their tax treaties:

> Notwithstanding the provisions of paragraphs 1, 2 and 3, where an enterprise of a Contracting State performs services in the other Contracting State
>
> a) through an individual who is present in that other State for a period or periods exceeding in the aggregate 183 days in any twelve-month period, and more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual, or
> b) for a period or periods exceeding in the aggregate 183 days in any twelve-month period, and these services are performed for the same project or for connected projects through one or more individuals who are present and performing such services in that other State,
>
> the activities carried on in that other State in performing these services shall be deemed to be carried on through a permanent establishment of the enterprise situated in that other State, unless these services are limited to those mentioned in paragraph 4 which, if performed through a fixed

> place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph. For the purposes of this paragraph, services performed by an individual on behalf of one enterprise shall not be considered to be performed by another enterprise through that individual unless that other enterprise supervises, directs or controls the manner in which these services are performed by the individual.[11]

3.0 Article V(9) of the Fifth Protocol

3.1 General Comments

The services PE rule of the Fifth Protocol is contained in Article V(9), which reads as follows:

> Subject to paragraph 3, where an enterprise of a Contracting State provides services in the other Contracting State, if that enterprise is found not to have a permanent establishment in that other State by virtue of the preceding paragraphs of this Article, that enterprise shall be deemed to provide those services through a permanent establishment in that other State if and only if:
>
> a) Those services are performed in that other State by an individual who is present in that other State for a period or periods aggregating 183 days or more in any twelve-month period, and, during that period or periods, more than 50 percent of the gross active business revenues of the enterprise consists of income derived from the services performed in that other State by that individual; or
> b) The services are performed in that other State for an aggregate of 183 days or more in any twelve-month period with respect to the same or connected project for customers who are either residents of that other State or who maintain a permanent establishment in that other State and the services are provided in respect of that permanent establishment.

The striking similarity between Article V(9) and the OECD services PE rule clearly indicates that Article V(9) was based on and strongly influenced by the OECD rule.[12] As a result, it is appropriate to interpret Article V(9) by reference to the Commentary in connection with the OECD services PE rule, at least to the extent that Article V(9) does

not deviate from the OECD provision and to the extent that the OECD Commentary does not differ from the original version issued in December 2006 on which Article V(9) is based.[13]

Article V(9) applies if an enterprise of one Contracting State provides services in the other Contracting State and the enterprise does not have a PE by virtue of the other provisions of Article V. Thus, the services PE rule applies only if a taxpayer does not have a fixed place of business PE under Article V(1) or an agency PE under Article V(5). If Article V(9) applies, the services are deemed to have been provided through a PE in the other country and the profits attributable to the PE are taxable by that country in accordance with the provisions of Article VII.

Article V(9) requires the services to be provided in the other country. Generally, under the tax laws of both Canada and the United States, income from services is considered to be derived from the place where the service provider is present and providing services. Therefore, if a resident of one country is present in the other country and performing services there, the income is considered to be derived from that other country. The question arises whether services can be performed in a country when the service provider is not present in that country. Such situations are likely to be rare in practice, although they might arise more frequently with technological advances.[14] The important point is that the rule operates on the basis of where the services are performed, not where the services are consumed or used.[15]

Further, the services must be performed for other persons, not for the enterprise itself. For example, if a U.S. enterprise has employees who perform services in Canada for the enterprise for more than 183 days, the U.S. enterprise is not deemed to have a PE in Canada under the new rule. Although this point is not obvious from the wording of Article V(9) itself, the Commentary on the OECD rule makes it explicit.[16] The rationale for the limitation of the new rule to services performed for other persons is straightforward. Articles 5 and 7 deal with the taxation of business profits derived by a resident of one country from the other country. Where services are provided by and for the same person, no business profits arise, although they may represent an economic benefit to the person.

Curiously, Article V(9) refers to 'an enterprise of a Contracting State.' This is the phrase used throughout the OECD model, and both the phrase and the term 'enterprise' are defined for purposes of the model (Articles 3(1)(c) and (d)). In contrast, the Canada-United States Conven-

tion uses the terms 'resident' and 'resident of a Contracting State.'[17] Since none of the other provisions of the Fifth Protocol or the convention uses the term 'enterprise,' it would appear that the reference to 'enterprise' and 'enterprise of a Contracting State' in Article V(9) is a mistake, which could cause problems in interpreting and applying the rule.[18] This mistake inadvertently reflects the extent to which Article V(9) is based on the OECD services PE rule.

Article V(9) is subject to the same exception in Article V(6) for preparatory and auxiliary activities that applies to the other PE rules.[19] This result occurs under both the OECD and UN rules.[20] Many of the activities specified to be preparatory or auxiliary, however, are not applicable to services and, given that services provided by an enterprise to itself are not covered by Article V(9), the exemption for preparatory and auxiliary activities is probably not necessary with respect to services.

3.2 *The Relationship between the Services PE Rule and the Construction Site PE Provision*

Article V(9) is explicitly 'subject to paragraph 3.' As a result, the new services PE rule will not apply to construction sites and installation projects that involve the performance of services.[21] The OECD has taken the opposite approach with respect to its alternative services PE rule, which applies 'notwithstanding the provisions of paragraphs 1, 2 and 3.' Under the OECD rule, an enterprise may have a PE under the services PE rule even though there would be no PE under the construction site rule.[22] The OECD acknowledges, however, that some countries might wish to have the construction site provision prevail over the services PE rule, and it indicates that they are free to do so.

The potential conflict between the construction site provision in Article V(3) and the new services PE rule in Article V(9) is obvious because of the different time thresholds in the two provisions. A construction site is a PE if it lasts for at least twelve months whereas under the new services PE rule the performance of services in a country for 183 days or more can result in a PE.[23] Consider, for example, a U.S. enterprise engaged in a construction project at a particular location in Canada that lasted for less than twelve months. In this situation, no PE would be considered to exist under Article V(3) because the minimum threshold of twelve months would not have been met. If, however, the enterprise had employees or subcontractors working at the

site for more than 183 days, a PE would be deemed to exist under Article V(9) (assuming that the construction services were provided to another person, not to the enterprise itself) but for the fact that Article V(9) is subject to Article V(3). In contrast, under the OECD alternative provision, the services PE rule would trump the construction site rule. Whichever provision is considered to prevail, it would seem to make sense to minimize potential conflicts by using the same time threshold for both purposes.[24]

Even though Article V(9) is subject to Article V(3), does this mean that any services performed at a construction site cannot be taken into account for purposes of Article V(9)? For example, if an individual is present and performing services in the other country for 200 days during a year but for 40 of those days the services were performed at a construction site in the other country, does the individual have a PE in that country? It is unclear in this situation whether the phrase 'subject to paragraph (3)' precludes taking the 40 days at the construction site into account for purposes of Article V(9), although that appears to be the intended result.[25] In this regard it is not necessary to distinguish between construction and other services. It is the location where the services are performed that is important. Any services performed at a construction site (assuming that they have some connection to that site) are governed by the construction site provision.

3.3 The Two Aspects of Article V(9)

If an enterprise of one country provides services in the other country, the enterprise is deemed to provide the services through a PE in the other country in two circumstances:

- the services are performed in the other country by a single individual who is resident there for 183 days or more and a gross revenue test is satisfied; and
- the services are performed in the other country by one or more persons for 183 days or more with respect to the same project or connected projects for customers who are residents of the other country or non-residents who have PEs there.

The structure of the OECD alternative provision is fundamentally the same. These two aspects of the rule are analysed in turn below.

3.3.1 Services Performed by a Single Individual: Article V(9)(a)

Although it is not apparent from its literal wording, proposed Article V(9)(a) (and paragraph (a) of the OECD services PE rule) applies in two situations. First, if the enterprise is carried on by the individual performing the services, the enterprise is deemed to have a PE if the individual performs services in the other country and is physically present there for 183 days or more. In this situation, the gross revenue test will almost inevitably be satisfied. That test requires that more than 50 per cent of the enterprise's gross active business revenue for the period during which the individual is present in the other country consists of income from services performed in the other country by the individual. The assumption seems to be that the income derived from services performed by the individual in the other country for the period in which the individual is present there will represent most or all of the gross business revenue of the individual for that period.[26] Note that for the purposes of this rule it does not matter whether the individual performs services for a single client or several clients, whether the services are performed with respect to the same project or a connected project, or whether the services are performed for residents or non-residents.

In effect, any U.S.- or Canadian-resident individual who is present in the other country for 183 days or more and performs any services in that country as a sole proprietor (or, as discussed below, on behalf of a personal services corporation) is deemed to provide those services through a PE in that country. In this situation the existence of a PE is essentially based on physical presence. For example, assume that a resident of Canada spends half the year in Canada (180 days) and half (the winter) in the United States (185 days). While in the United States the individual performs services for a few days for one of his Canadian-resident clients but does not perform any other services in the United States. In this situation the Canadian resident is deemed to have a PE in the United States because:

- the Canadian-resident individual performs services in the United States;
- the Canadian-resident individual is present in the United States for 183 days or more; and
- more than 50 per cent of the individual's gross active business revenue for the time spent in the United States is derived from the services performed in the United States.

Based as it is on physical presence, the application of this aspect of the services PE rule is quite certain: an individual is either present in the other country or not. Presumably, the physical presence test will be interpreted on the same basis as the presence test in Article 15(2) of the OECD model treaty. As a result, all days of presence are counted except days on which the taxpayer intended to leave but was prevented from doing so by accident or illness.[27]

It might be questionable as a matter of tax policy for one country to tax a resident of the other country on services income just because the individual is physically present in the country for 183 days or more. However, Article 15 of both the OECD model and the Canada-United States Convention dealing with employees and the new services PE rule dealing with independent contractors are consistent in this regard. Under Article 15, the source country is entitled to tax any income from employment derived by a resident of the other country from employment exercised in the source country if the resident is present there for 183 days or more, and in the case of Article XV(2) of the Canada-United States Convention, the remuneration exceeds $10,000.[28] Similarly, under the new services PE rule, the source country is entitled to tax any income from services performed in the country by an individual resident in the other country as long as the individual is present for 183 days or more. The difference between the two provisions is that Article 15 allows the source country to tax income from employment derived by a resident of the other country even if the resident is present for less than 183 days, in situations where the remuneration is paid by a resident of the source country or is borne by a PE of a non-resident in the source country (that is, the remuneration erodes the source country's tax base). There is no similar provision in paragraph (a) of the new services PE rule, although there is a base erosion test with respect to paragraph (b) of the rule, as discussed below.

The second situation in which paragraph (a) of the new services PE rule applies is where the individual performs the services on behalf of a corporation, partnership or sole proprietorship. The gross revenue test is important in this context. In the absence of this aspect of the services PE rule, the full impact of the rule could be avoided by individuals who provide their services in the other country as employees of personal corporations, as partners of partnerships, or as employees of sole proprietorships. For example, if A, an individual resident in Canada, forms a corporation, ACo, under the laws of Canada and ACo provides services in the United States through A's acting as an employee of ACo for

more than 183 days, the United States would be entitled to tax A on the employment income but would not be entitled to tax ACo on its income from the services provided in the United States unless ACo had a PE in the United States. A's employment income could be set at an amount significantly less than the full amount of the revenue derived from the services performed by A in the United States. Under the new services PE rule, ACo (the enterprise) would be deemed to provide the services performed by A in the United States through a PE there because the services are performed by an individual (A) who is present in the United States for 183 days or more and more than 50 per cent of ACo's gross revenue from active business for the period that A is present in the United States is attributable to the services performed in the United States by A. As a result, the United States would be entitled to tax A on the employment income and ACo on its income from services performed in the United States by A.

Although the new rule appears to be targeted primarily at personal service corporations performing services in the other country, literally it applies to any resident enterprise of one of the countries performing services in the other country. As a result, it applies to any person resident in one of the countries who performs services in the other country if the services are provided by an individual. Further, it is irrelevant whether the individual who performs the services is a resident of the country in which the services are provided, the country in which the enterprise is resident, or a third country. The services PE rule gives the source country the right to tax the enterprise deriving income from services provided in the source country if the services are performed by any individual who is present there for 183 days or more. Further, it is irrelevant whether the individual who performs the services is an employee of the enterprise or an independent contractor.[29] For example, if Canco, a company resident in Canada, hires a U.S.-resident individual to perform services in the United Sates on its behalf, Canco is deemed to provide those services through a PE in the United States (assuming, of course, that the U.S. individual is present in the United States for at least 183 days) unless less than 50 per cent of its gross revenue for the relevant period is attributable to the services performed in the United States by that U.S. resident. Therefore, if the income derived from the U.S.-resident individual's services represents more than half of the enterprise's gross active business revenue, the source country (in this example, the United States) is entitled to tax the enterprise.

3.3.2 The Gross Revenue Test in Article V(9)(a)

Several points may be noted about the wording and operation of the gross revenue test. First, the fundamental idea underlying the test is to restrict the application of the rule to enterprises that derive most of their business revenues from the provision of services.[30]

Second, the relevant period for the application of the test is the time during which the individual who performs the services is present in the source country. This period must be at least 183 days because otherwise the services PE rule does not apply.[31] The period of presence may be longer than the period during which services are provided and revenue derived. It is unclear, however, whether the period for purposes of the gross revenue test is the total period during which the individual is present in the other country or any period of 183 days. The words 'that period or periods' in Article V(9)(a) could refer to either period.[32] The former interpretation seems to be a more natural construction and would prevent the tax authorities from selecting any period of 183 days. On the other hand, if a minimum period or periods of presence of 183 days is sufficient to trigger the application of the provision, it would seem logical for the gross revenue test to apply on the basis of the same period. Assuming on the facts of the previous example that the U.S. resident was present in the United States for the entire year, the issue is whether the relevant period for the gross revenue test would be the entire year or any period of 183 days during that year. If the relevant period is the entire year, the rule would apply only if more than 50 per cent of Canco's gross revenue for the entire year is attributable to the services performed by the U.S. resident. If, however, the relevant period is any period of 183 days in the year, the rule would apply if more than 50 per cent of Canco's gross revenue for any such period is attributable to the U.S. resident's services. For example, if the U.S. resident performed services for Canco for only part of the year, the days during which services were not provided could be excluded so that the gross revenue test would be more likely to be met.

Third, only the enterprise's gross business revenues, not its total gross revenue, is taken into account. The term 'gross active business revenues' is not defined in the treaty, so presumably the term has its domestic law meaning under Article 3(2) unless the context of the treaty requires a different meaning. Under Canadian tax law, the term has a reasonably well-defined meaning. The general effect is to exclude investment income from the gross revenue test. However, business income derived from activities other than services is taken into account.

It is unclear from the terms of the proposed services PE rule how the gross revenues or active business income from services are to be computed. In general, profits from a business for purposes of Article 7 are determined in accordance with domestic law.[33] Therefore, in the absence of any explicit words in the treaty, it would appear that both gross active business revenues and income from services for purposes of proposed Article V(9) should be calculated in accordance with the domestic law of the country in which the services are performed. However, the draft OECD Commentary with respect to the alternative services PE rule indicates that gross revenues from active business should be the amounts charged by the enterprise irrespective of the date the amounts are billed or domestic tax rules as to the timing of recognition of the revenues.[34]

Fourth, the wording of the gross revenue test is peculiar.[35] Literally, the test requires a determination of the percentage that the *income* derived by the enterprise from the services performed by the particular individual is of the enterprise's *gross revenue* from active business. This appears at first glance to be a comparison of apples (income) and oranges (gross revenue). Using gross revenue derived by the enterprise from the individual's services rather than income, as is done in the OECD provision, would appear to be much simpler and more appropriate.[36]

The income derived by an enterprise from the services performed by an individual as an employee of the enterprise would presumably be the gross revenue from the services less the expenses incurred in rendering the services. In most cases the largest expense incurred in rendering the services would be the employee's salary. The smaller the employee's salary, the greater the income derived by the enterprise from the services and the more likely it is that that income will represent more than 50 per cent of the enterprise's gross revenue. For example, assume that Canco provides services in the United States through its sole shareholder and employee, who is present in the United States for more than 183 days. The gross fee charged by Canco for the services is $100,000. If the employee's salary is less than $50,000 (assuming that is the only expense incurred by Canco in earning the revenue), then Canco's income from the services will be more than $50,000, the gross revenue test will be met and Canco will be deemed to render the services through a PE in the United States. If, on the other hand, the employee's salary is more than $50,000, then Canco's income derived from the services will be less than $50,000 and the gross revenue test will not be met. It is questionable whether this result makes sense. Although the

United States would be entitled to tax the employee's salary, in these circumstances there is no apparent reason why it should not be entitled to tax the entire income derived in the United States by Canco. However, the reference to income and gross revenue is so clear and contrasts so sharply with the wording of the OECD services PE rule, which refers exclusively to gross revenue, that it seems unlikely that the reference to income was unintentional.[37]

It may be that Canada and the United States decided that, if the income derived by an enterprise resident in one country from the services performed by an individual in the other country is less than 50 per cent of the enterprise's gross revenue from those services, the tax should be shared between the two countries: the source country taxing the individual's employment income and the residence country taxing the enterprise's income. However, if the income derived from the services is more than 50 per cent of the enterprise's gross revenue, the source country is entitled to tax both the individual's employment income and the income derived by the resident of the other country from the services performed in the source country.

Finally, in situations other than those involving one-person corporations, it might be difficult to determine the percentage of an enterprise's gross revenue that is derived from services performed by a particular individual. The gross revenue of a business is typically derived from a combination of its assets (tangible and intangible, including goodwill) and its personnel (employees and other personnel). Determining how much revenue should be considered to be derived from the assets and how much from the employees or other personnel would be difficult in many cases. However, under Article V(9) it is also necessary to determine how much income is derived from the services performed by a particular individual for a particular period. These difficulties perhaps indicate that the new services PE rule is intended to apply only to closely held personal service corporations.

The gross revenue/income test in the new services PE rule of the Canada-United States Convention is different in this regard from the gross revenue test in the OECD services PE rule, which involves a comparison of the gross revenue derived by the enterprise from the services performed by the individual and the total gross revenue from active business derived by the enterprise. Therefore, on the facts of the preceding example, under the OECD provision, the source country would be entitled to tax both the individual and the enterprise even if the employee's salary is more than $50,000.

The need to calculate income derived by an enterprise from services performed by any particular individual makes the new services PE rule in the Canada-United States Convention considerably more difficult to apply than the OECD rule.

3.3.3 Services Generally: Article V(9)(b)

The second aspect (paragraph (b)) of the new services PE rule is broadly similar to Article 5(3)(b) of the UN model. Under Article V(9)(b), an enterprise of one country is deemed to provide services through a PE in the other country if services are provided for 183 days or more in any twelve-month period with respect to the same project or connected projects. The new rule applies on a project-by-project basis except that for this purpose connected projects are aggregated. Moreover, the services must be provided to customers who are residents of the other country or non-residents who have a PE in the other country, and the services must be provided in respect of that PE.

The 183-day threshold period for paragraph (b) of the new services PE rule is fundamentally different from the 183-day period for paragraph (a) discussed above. For paragraph (a) any day during which an individual is present in the other state is counted, whereas for paragraph (b) only the days on which services are provided are counted.[38] A test based on the number of days of physical presence has the advantage of certainty because an individual is either present or not. In contrast, it is more difficult to determine the days on which an individual is actually providing services. For example, an enterprise may provide services in the other country by sending employees there. The employees may be present in the other country on weekends and holidays during which they may or may not work. If an employee or an independent contractor works on a project even for part of a day, that day should be counted as a day on which the enterprise provides services in the other country.[39] For some employees, payroll records may provide evidence as to the days on which services are rendered. For other employees and independent contractors, it may be difficult for the tax authorities to apply the 183-day threshold with much precision.[40] The Commentary on Article 5 in the draft 2008 update indicates that days on which personnel are available on standby should be taken into account as days on which services are performed if the enterprise charges standby fees (paragraph 42.42).

For purposes of Article V(9)(b), it is not necessary for the same individual to provide services for the entire 183-day period. All that is nec-

essary is that some individuals, employees, or other personnel provide services for the enterprise in the other country for 183 days or more in the aggregate. The fact that no particular individual performs services in the country for at least 183 days is irrelevant. By the same token, if multiple individuals are performing services for the enterprise on any particular day, that counts only as one day that the enterprise is performing services.[41]

Like both the UN and OECD services PE rules, Article V(9)(b) of the Fifth Protocol requires not only that the services be provided in the country for at least 183 days, but also that the services be provided for 'the same or connected project.' The use of the singular in 'project' in this regard is a bit puzzling.[42] The use of the plural, as in the OECD rule and Article 5(3) of the UN model ('for the same project or for connected projects'), would seem to be more natural, particularly when the provision goes on to refer to 'customers.' As a result of this connected-project requirement, the provision cannot be applied simply by aggregating the number of days that an enterprise provides services in the country. Thus, an enterprise may perform services in the other country for 180 days for one project and an additional 180 days in the same twelve-month period on a different project without having a PE. In short, the 183-day threshold must be applied on a project-by-project basis in the same way that the six-month minimum time threshold set out in the Commentary on Article 5(1) must be applied to each fixed place of business.[43]

There is no definition of the term 'project' or the more troubling 'connected project.' Presumably, the term 'project' has its ordinary meaning in this context.[44] The Commentary on Article 5(3) of the OECD model suggests that a construction site should be considered to be single place even if it involves several contracts 'provided that it forms a coherent whole commercially and geographically,' and it gives the example of the construction of a row of houses for different buyers (paragraph 18). In addition, the Commentary indicates that construction projects, such as roadwork, that involve the periodic relocation of activities should be regarded as a single site (paragraph 20). The Commentary on Article 5(3)(b) of the UN model simply indicates that the purpose of the reference to connected projects is to avoid aggregating unrelated projects; however, the UN Commentary does not indicate how to determine whether projects are connected.[45] The Commentary on Article 5 in the draft 2008 update indicates that connected projects must have commercial coherence, but does not mention geographical coherence.[46] It seems

inevitable, as the OECD Commentary indicates, that whether services are provided for the same or a connected project or for separate projects must be determined based on the circumstances of each case.[47] Factors that are important, but not determinative, in this regard include:

- whether the services are provided by the same individuals;
- whether the services are provided under the same or different contracts;
- whether the services are provided for the same or related enterprises;
- whether the nature of the services provided is the same or different;
- whether the services are provided at the same or different locations; and
- whether the services are provided continuously or at different times.[48]

Given the uncertainty, it seems likely that taxpayers will try to structure their affairs to have separate projects of less than 183 days' duration.

An exchange of diplomatic notes in connection with the Fifth Protocol indicates that 'projects shall be considered to be connected if they constitute a coherent whole, commercially and geographically.'[49] This test is used in the existing Commentary on Article 5 of the OECD model to determine whether business activities carried on in neighbouring locations can be considered a single place of business.[50] It is not at all clear, however, why geographical coherence, which is obviously relevant for purposes of Article 5(1) because of the reference to a 'fixed place of business,' is relevant (or how it is relevant) for purposes of determining whether service projects are connected, especially in light of the implicit rejection by the OECD Commentary of any requirement for geographical coherence.

Consider the example given in the Commentary on Article 5 of the OECD model of a non-resident consultant who provides training services pursuant to a single contract at various branches of a bank.[51] According to the Commentary, each branch must be considered as a separate geographical place of business, although the project is a coherent whole from a commercial perspective. Initially it would seem that, under new Article V(9)(b), there is a PE in these circumstances because the training of the bank's employees, despite taking place at different locations, constitutes a single project (one contract with the same client) or connected projects (multiple contracts for similar services with the

same client).[52] If, however, the projects must have geographical coherence, as specified in the Exchange of Notes, then presumably the result would be the same as for a fixed place of business (that is, there is no PE because the services are performed at different locations).[53] If geographical coherence is required, the scope of the inclusion of connected projects is quite narrow. Moreover, as noted above, if geographical coherence is also required for a project, then Article V(9)(b) as a whole is much less important than it otherwise would be.

Many other important questions, which could and should be clarified, arise in connection with this aspect of Article V(9)(b). Is the existence of a project to be determined from the perspective of the service provider or the client?[54] Can services provided pursuant to contracts with a related person be considered to be part of the same project or a connected project? The use of the plural term 'customers' in Article V(9)(b) suggests that a single project or connected project can be conducted with multiple clients whether or not they are related. The Commentary on Article 5 in the 2008 update points to 'different contracts ... concluded with the same person or with related persons' as one of the factors to be considered in determining if projects are connected (paragraph 42.41).

Finally, can services provided by a related person be considered to be part of the same project or a connected project? In general, the activities of related persons are not aggregated for purposes of determining the existence of a PE under Article 5 of the OECD model. For example, therefore, if two related enterprises have fixed places of business in a country for less than six months, neither enterprise is considered to have a PE in the country even if, taken together, they have fixed places of business in the country for more than six months. Similarly, if the activities of an enterprise qualify for the exemption for preparatory or auxiliary activities under Article 5(4) of the OECD model, that exemption is not lost if those activities would not be preparatory and auxiliary if aggregated with the activities of a related enterprise. As a result, splitting service contracts among related entities may be a relatively simple means of avoiding a PE under Article V(9)(b) in some circumstances. The OECD Commentary explicitly refers to this problem and suggests that countries can either rely on their domestic anti-avoidance rules to prevent this type of abuse or insert a specific provision in the treaty.[55]

Unlike the OECD services PE rule, Article V(9)(b) specifies that the services must be provided for customers who are residents of the other country or non-residents with a PE in the other country, in which case

the services must be provided in connection with the PE. This aspect of Article V(9)(b) demonstrates a concern about the erosion of the tax base similar to that reflected in Article 15(2) of both the OECD model and the Canada-United States Convention. If the services are provided to a resident of the other country or to a non-resident in connection with the non-resident's PE in the other country, the amount paid or payable for the services presumably will be deductible by the resident or non-resident in computing income under the other country's tax law. Since the source country's tax base is eroded by the service fees, it is appropriate for the source country to tax those fees if the other requirements of Article V(9)(b) are met. On the other hand, if the services are provided to other customers (that is, non-residents who do not have a PE in the other country), the source country does not have the right to tax the service fees even if the other requirements of Article V(9)(b) are met, because those fees presumably will not be deductible by those non-residents for purposes of the source country's tax base.[56] In contrast, under the OECD rule, in these circumstances a PE would be deemed to exist and the source country would be entitled to tax the profits from the services even though there would be no erosion of its tax base. The difference between the OECD provision and Article V(9)(b) appears to reflect concern by Canada and the United States to restrict their source-country taxing rights with respect to services to situations in which the source country's tax base would otherwise be eroded.[57]

The restriction of Article V(9)(b) to services provided to residents of the other country or non-residents with a PE in the other country raises two interpretive issues. First, how is the existence of a PE to be determined for this purpose? For example, if a U.S. resident performs services in Canada for a resident of, say, Germany, Article V(9)(b) gives Canada the right to tax the U.S. resident only if the resident of Germany has a PE in Canada. Is this determination made under the Canada-Germany treaty or the Canada-United States treaty? The former approach would raise some difficult issues, so fortunately, Article V(10) of the Fifth Protocol (previously Article V(9)) provides explicitly that the provisions of Article V apply for purposes of determining whether any person has a PE in any state. Second, the services must be provided 'in respect of' the non-resident's PE. It is curious why such vague language is used. As discussed earlier, the intent seems to be to allow the source country to tax only if the amount payable for the services is deductible in computing the profits attributable to the PE under Article 7. As a result, language similar to that of Article 15(2) ('borne by a permanent

establishment,' which, by virtue of the Commentary, clearly means deductible in computing the profits of the PE) would have been clearer.

As noted earlier, Article V(9)(b) applies to both services provided by employees of an enterprise and by independent contractors hired by the enterprise. The OECD rule is the same in this respect. The UN services PE rule refers to services provided through 'employees or other personnel engaged by the enterprise for such purpose.' Although it is obviously appropriate to eliminate any incentive for non-residents to provide services through independent contractors rather than employees, it is questionable whether the days spent by independent contractors providing services in a country under contract with a non-resident should, in all circumstances, be counted as days in which the non-resident is considered to be providing services in the source country.[58] The OECD rule explicitly provides that services performed by a subcontractor are not taken into account unless the subcontractor is working under the supervision, direction, or control of the non-resident enterprise.[59] Only if the independent contractor is effectively a substitute for an employee should the services it provides be attributed to the non-resident enterprise.

4.0 Conclusion

In a globalized world that encourages enhanced cross-border services, governments are struggling to develop appropriate tax rules that will not inhibit the provision of these services while ensuring there is a fair division of tax revenues resulting from taxing them. The addition of a services PE rule to the Canada-United States Convention is a significant development with respect to tax treaties. Previously, such rules were restricted to treaties with developing countries. However, in 2008, the OECD added an alternative services PE provision to the Commentary so that member countries wishing to include such a provision in their treaties would have a model provision to follow.

The United States opposes the inclusion of a services PE rule in the Commentary on the OECD model. Despite the U.S. opposition, the OECD action and the inclusion of a services PE rule in the Canada-United States Convention legitimizes the use of such provisions by developed countries and can be expected to encourage other developed countries to consider including similar provisions in their tax treaties. The U.S. opposition to the OECD provision is ironic given that the new services PE rule in the Canada-United States Convention is based so

closely on the OECD provision. Moreover, where the new services PE rule in the Canada-United States Convention differs from the OECD rule, the Canada-United States version of the rule appears to suffer in comparison. I will refrain from expressing any opinion on what the new services PE rule would have looked like without any OECD model provision to follow.

Notes

* This chapter draws from and modifies an earlier work by the author that was originally published in (2008) 51 Tax Notes Int'l 189. It has been revised to take into account the Technical Explanation on the Fifth Protocol; see United States, Department of the Treasury, *Technical Explanation of the Protocol Done at Chelsea on September 21, 2007 Amending the Convention between the United States of America and Canada with Respect to Taxes on Income and on Capital Done at Washington on September 26, 1980, as amended by the Protocols Done on June 14, 1983, March 28, 1994, March 17, 1995, and July 29, 1997* (Washington, DC: Department of the Treasury, 10 July 2008) 10 (referred to here as 'Technical Explanation to Article V(9)'). The Canadian Department of Finance accepted the U.S. Technical Explanation as also reflecting the Canadian view of the Fifth Protocol on 10 July 2008. The author would like to thank Hugh Ault and Jacques Sasseville for their comments on an earlier draft.

1 Protocol signed 21 September 2007, Amending the Convention between the United States of America and Canada with respect to Taxes on Income and on Capital, signed at Washington on 26 September 1980 as Amended on 14 June 1983, 28 March 1984, 17 March 1995, and 29 July 1997, online: Canada, Department of Finance, <www.fin.gc.ca/treaties/U.S.A_1e> and United States, Department of the Treasury, <www.treas.gov/offices/tax-policy/library/CanadaProtocol07>. The Protocol entered into force on 14 December 2007 but has yet to be ratified by the United States. Although prepared by the U.S. Treasury, the Technical Explanation to the original 1984 treaty and the four previous Protocols are negotiated documents to which the Canadian Department of Finance has agreed. Thus, the Technical Explanations form part of the context of the treaty within the meaning of Article 31(2) of the Vienna Convention as 'any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.'

2 United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2001).
3 See, for example, Articles 5(2)(l) and 5(3)(b), respectively, of the Canadian and U.S. treaties with India.
4 United States, Department of the Treasury, *United States Model Income Tax Convention*, 15 November 2006, online: United States Department of the Treasury <www.treas.gov/offices/tax-policy/library/model006>.
5 See remarks by Michael Mundaca, Deputy Assistant Secretary for Tax Policy, U.S. Department of the Treasury, indicating that the new services PE rule in the Fifth Protocol is 'a significant change' and previously was included only in treaties with developing countries, quoted in L.M. Nadal, 'New Services PE Rule in Canada-U.S. Treaty Protocol Is Significant Change, U.S. Treasury Official Says' (22 January 2008) Worldwide Tax Daily at 14-4.
6 *Dudney v. The Queen* [2000] 2 CTC 56 (FCA) (leave to appeal was denied by the Supreme Court).
7 *Wolf v. The Queen* [2002] 3 CTC 3 (FCA).
8 See OECD, 2008 Update to the Model Tax Convention (Paris: OECD, 22 July 2008). The changes to the Commentary on Article 5 dealing with services are based on an earlier discussion document; see OECD, 'The Tax Treaty Treatment of Services: Proposed Commentary Changes, Public Discussion Draft' (Paris: OECD: 8 December 2006).
9 OECD, Committee on Fiscal Affairs, *Model Tax Convention on Income and on Capital* (Paris: OECD) (loose-leaf).
10 Note, for example, that Article 5(3)(b) refers to a period or periods of six months and Article 14 refers to a period or periods of 183 days.
11 This alternative provision is found in paragraph 42.23 of the Commentary on Article 5 in the 2008 update.
12 Article V(9) was based on the version of the OECD services PE rule issued in December 2006. The differences between the original version of the OECD services PE rules and the version contained in the 2008 update are minor, except that the original version applied to individuals who are performing services in the other country or who are present for that purpose, while the current version applies only to individuals who are present and performing services; and the last sentence, which was added to clarify that independent contractors will be taken into account only if they are controlled by the enterprise.
13 For purposes of interpreting Article V(9), the December 2006 draft OECD Commentary, even if revised or withdrawn, would constitute *travaux*

préparatoires within the meaning of Article 32 of the Vienna Convention on the Law of Treaties.

14 Arguably, electronic entertainment services such as Internet gambling are provided where the consumer makes use of the data and software.

15 The OECD services PE rule operates on the same basis. See paragraph 42.31 of the Commentary on Article 5 in the 2008 update; see also Technical Explanation to Article V(9).

16 Paragraph 42.30 of the Commentary on Article 5 in the 2008 update; see also Technical Explanation to Article V(9).

17 The term 'resident of a Contracting State' is defined in Article 4; but the term 'resident' is undefined.

18 Surprisingly, there was no attempt made to correct this mistake and other drafting deficiencies in the Technical Explanation to Article V(9).

19 This result is accomplished by amending Article V(6) to add a reference to paragraph 9 so that it applies 'notwithstanding the provisions of paragraphs 1, 2, 5, and 9.'

20 There is no exception, however, for preparatory or auxiliary activities under Article 14 of the UN model.

21 In contrast, Article V(9) is not subject to Article V(1), the fixed place of business PE rule, or to Article V(5), the agency PE rule. However, Article V(9) applies only 'if that enterprise is found not to have a permanent establishment in that other State by virtue of the preceding paragraphs of this Article.' Obviously, the preceding paragraphs include Article 5(3). Therefore, in the absence of the words 'subject to paragraph 3,' a PE could be deemed to exist under Article V(9) even though no PE is deemed to exist under Article V(3). In light of the words 'subject to paragraph 3,' however, the only reasonable interpretation is that Article V(3) trumps Article V(9). As with several other aspects of Article V(9), the drafting is awkward.

22 See paragraphs 42.26–42.28 of the Commentary on Article 5.

23 The different time thresholds can be explained, but not justified, by the history of the PE definition. The twelve-month threshold for construction sites was probably adopted at a time when that period was the general threshold for PEs.

24 As is the case in Article 5(3) of the UN model, which uses a six-month time threshold for both purposes. Since the minimum time threshold for a fixed place of business PE under Article 5(1) is generally six months, the twelve-month period for construction sites under the OECD model appears to be the inappropriate threshold.

25 The Technical Explanation to Article V(9) does not mention the relationship between Article V(9) and Article V(3).

26 An individual can be in only one place at any particular time, so that, while an individual is in the other country performing services, he or she cannot be elsewhere producing gross revenue. Note, however, that, as discussed below, income is net of expenses while gross revenue is not.
27 Paragraph 5 of the Commentary on Article 15. Paragraph 42.36 of the Commentary on Article 5 confirms that this is the appropriate interpretation.
28 It is curious why a similar monetary threshold was not included in Article V(9). Because the threshold for Article V(9)(a) is based on days of physical presence and not days of work, it would seem that, like employees, independent service providers earning small amounts in the other country should be exempt from tax there despite being physically present for 183 days or more.
29 Paragraph 42.32 of the Commentary on Article 5.
30 The Commentary on Article 5 suggests that countries might wish to draft the rule differently. For example, the test could be based on the business profits of the enterprise rather than gross revenues; or it could refer more generally to services provided by the enterprise constituting 'the most important part of the business activities of the enterprise' (paragraph 42.37).
31 Under the OECD rule, the individual must be present for more than 183 days, not 183 days or more. Did the Canadian and U.S. treaty negotiators just want to be different from the OECD in this regard?
32 The OECD Commentary does not provide any guidance on this issue; nor does the Technical Explanation to Article V(9).
33 Paragraphs 4 and 10.2 of the Commentary on Article 3 of the OECD model.
34 Paragraph 42.37 of the Commentary on Article 5.
35 This peculiarity is not a feature of the OECD services PE rule, which refers only to gross revenue.
36 Surprisingly, the Technical Explanation to Article V(9) does not attempt to explain this issue; however, in an example, it assumes that 'income' refers to gross revenue derived by the enterprise from the individual's services.
37 In light of the Technical Explanation to Article V(9), however, the conclusion is more likely that this is simply another mistake.
38 The December 2006 version of the OECD rule also counted days on which an individual is present in a country for the purpose of providing services, although no services are actually provided. The OECD was revised to count only those days on which an individual is present and provides services.
39 An argument can be made that a day should be taken into account only if the individual works for what is customarily considered to be a full work-

ing day (seven to eight hours). Such an interpretation would be inconsistent with the presence test in Article V(9)(a) and Article XV(2), under which presence for any part of a day counts as a day.

40 Paragraph 42.42 of the Commentary on Article 5 does not provide much help in this respect. It suggests that the 183-day threshold should be based on the number of working days. The Technical Explanation to Article V(9) is similarly unhelpful.

41 Paragraph 42.39 of the Commentary on Article 5. The Technical Explanation to Article V(9) takes the same position.

42 The Exchange of Notes between the two governments, discussed below, refers to 'projects.' Also, the Canadian *Interpretation Act*, R.S.C. 1985, c. I-21 as amended, section 33(3) provides that terms in the singular include the plural and vice versa.

43 Paragraph 6 of the Commentary on Article 5 of the OECD model.

44 The *Shorter Oxford English Dictionary* defines 'project' very broadly as 'a planned or proposed undertaking; a scheme.'

45 Paragraph 12 of the Commentary on Article 5 of the OECD model.

46 Paragraph 42.41 of the Commentary on Article 5.

47 Technical Explanation to Article V(9).

48 Paragraph 42.41 of the Commentary on Article 5. The last two factors are not mentioned in the Commentary.

49 Canada, 'Diplomatic Notes: Annex B to the Convention (September 21, 2007), online: Canada <www.fin.gc.ca/treaties/U.S._AnnexBe.html>.

50 Commentary on Article 5, paragraphs 5.1–5.4, 18, and 20.

51 Paragraph 5.4; the same example is used in the Technical Explanation to Article V(9).

52 Assuming, of course, that the consultant performs services in the other country for 183 days or more in the aggregate.

53 The Exchange of Notes deals exclusively with the concept of connected projects. Therefore, it is possible to argue that it is not necessary to have geographical coherence for a single project. In other words, a single project can include services performed at different locations as long as there is commercial coherence. In this regard, reference might be made to paragraph 20 of the Commentary on Article 5 of the OECD model, which treats the assembly of parts of a large structure at various locations and final assembly at a different location as a single project. However, to require geographical coherence for multiple projects but not for a single project seems to be a very strange and inconsistent interpretive approach.

54 The Technical Explanation to Article V(9) makes it clear that the issue must be determined 'from the point of view of the enterprise (not that of the

customer).' Paragraph 42.40 of the Commentary on Article 5 indicates that 'the same project' should be interpreted from the perspective of the service provider, not that of the client. In the December 2006 version of the Commentary, the same interpretive approach applied to the issue of connected projects. The reference to connected projects was deleted from paragraph 42.40.

55 Paragraph 42.45 of the Commentary on Article 5, which contains a sample anti-avoidance provision. The Technical Explanation to Article V(9) is silent on this issue.

56 Assuming that the non-resident is resident in a country with which the source country has a treaty, the non-resident would not taxable by the source country on its business profits because it does not have a PE in the source country. If, however, there is no applicable tax treaty, it is possible that a non-resident could be taxable in Canada or the United States and the service fees would be deductible even where the non-resident did not have a PE in either Canada or the United States. This is because neither country uses the PE concept in its domestic law to determine if non-residents are taxable on business profits.

57 The Technical Explanation to Article V(9) states that 'the intent of this requirement is to reinforce the concept that unless there is a customer in the other State, such enterprise will not be deemed as participating sufficiently in the economic life of that other State to warrant being deemed to have a permanent establishment.'

58 See B.J. Arnold, 'Threshold Requirements for Taxing Business Profits under Tax Treaties' in B.J. Arnold, J. Sasseville, and E.M. Zolt, eds., *The Taxation of Business Profits under Tax Treaties* (Toronto: Canadian Tax Foundation, 2004) 55 at 88–9.

59 This point was clarified in the final version of the Commentary on Article 5 added in the 2008 update.

15 Consumption Taxation of Cross-border Trade in Services in an Age of Globalization

WALTER HELLERSTEIN*

1.0 Introduction

In an era of heightened cross-border flows of investment and trade, the conceptual foundation is being laid for the rules on value-added tax (VAT) or, as in Canada's case, goods and services tax (GST) that govern the tax treatment of cross-border trade in goods and services. These rules generally permit governments to apply their VAT or GST to goods and services that are 'consumed' within their borders, on the principle that consumption should be taxed where it occurs.[1] This seemingly self-evident proposition is widely accepted with respect to the proper place of consumption taxation of cross-border trade. Thus, in explicating the fundamental precepts that should inform consumption taxation,[2] the Committee on Fiscal Affairs of the Organisation for Economic Co-operation and Development (OECD) has declared that '[r]ules for the consumption taxation of cross-border trade should result in taxation in the jurisdiction where consumption takes place.'[3] Likewise, in describing the rules for where taxation of supplies of services under the European Union's VAT should take place, the EU Council observes that 'the place of taxation should, in principle, be the place where the actual consumption takes place.'[4]

What might seem self-evident as a matter of principle, however, can be difficult to implement as a matter of practice. Suppose, for example, that I were to drive from the United States to a symposium in Canada and fill my car's gas tank immediately prior to crossing the Canada-U.S. border. Clearly, as a matter of principle, my consumption of the gasoline purchased in the United States should be taxed in Canada, because Canada is the 'jurisdiction where consumption takes place.'

Just as clearly, as a matter of practice, we know that the gasoline will be taxed in the United States, because that is the only practical place of taxation for a tax on gasoline purchased at the pump, at least in a typical business-to-consumer transaction.[5]

This simple example illustrates a fundamental feature of consumption taxes involving cross-border trade (and one to which most of this chapter is devoted) – namely, that consumption taxes necessarily rely on proxies for determining where consumption occurs in assigning the appropriate place of taxation for transactions involving cross-border trade.[6] Although these proxies often reflect our 'best guess' about where consumption is likely to occur, they nevertheless disavow the quest for a theoretically 'pure' consumption tax that seeks to tax consumption where it actually occurs and instead adopt a more practical approach to determining the place of consumption. Identifying the appropriate place of consumption taxation by the use of proxies for where consumption occurs typically involves a balancing of practical and theoretical concerns. As a practical matter, it is easier to administer a consumption tax by imposing the tax at a place where one can effectively require the vendor or the purchaser to remit it. As a theoretical matter, however, that place might not be where consumption is likely to occur (as in the case of my purchase of gasoline at the Canada-U.S. border).

Moreover, whatever might be the challenge of identifying the appropriate place of taxation with respect to cross-border trade in goods (like gasoline), the challenge of identifying the appropriate place of taxation with respect to cross-border trade in services is considerably more complex.[7] The complexity is due in large part to the enormous growth in recent years in cross-border trade in services, driven by forces of globalization and facilitated by technological change. The traditional rule for determining the place of taxation of services under consumption taxes – the place of performance – made sense in an era when services were a much smaller fraction of economic activity and most services were consumed where they were performed. However, it is ill-suited to a world in which consumption and performance increasingly are disconnected from each other in a territorial sense and the place of performance is not even clear, as when the extended service warranty for my computer is fulfilled by a technician in Bangalore who takes control of my laptop in Athens, Georgia, and resolves the problem through keystrokes performed 8,000 miles away.

This chapter examines recent initiatives to determine the appropriate place of consumption taxation of services in our increasingly globalized

and service-oriented economies. This issue has significant implications for the continuing growth of cross-border trade in services, because inconsistent consumption tax rules can result in substantial tax burdens for business and serious impediments to international trade. It is thus a particularly fitting topic for a symposium devoted to the work of Professor Alex Easson, not only because of his extensive work on the impact of taxation on international trade, but also because of his invaluable scholarship on the world's most significant consumption tax, the EU's VAT.[8]

In substance, this chapter delineates efforts to implement the basic principle that consumption should be taxed where consumption occurs in the context of contemporary cross-border trade in services. By way of background, the second section briefly considers the treatment of the analogous issue in the context of cross-border trade in goods. The third section explores initiatives that the OECD's Committee on Fiscal Affairs and EU Commission have undertaken on behalf of their respective member states to establish the appropriate rules for international trade in services. Section 4 concludes the chapter.

2.0 Taxation of Goods

Implementing the principle that consumption should be taxed where consumption occurs is relatively straightforward with respect to the taxation of cross-border trade in goods. It is generally recognized that this principle can best be achieved by taxing goods at destination,[9] because 'it is reasonable to assume that goods … are consumed at the place of their destination.'[10] The crucial advantage of such a system, as Easson pointed out, is that 'competition between domestic and imported goods is not distorted by differences in national tax rates.'[11]

Accordingly, when the seller of goods is in one jurisdiction and the purchaser is in another, the goods generally are taxed where they are delivered. To accomplish this goal, exported goods are zero rated[12] or exempted[13] and imported goods are taxed at the border.[14] For the most part, border controls provide an effective mechanism for assuring collection of consumption taxes on cross-border supplies of goods at their destination.[15] In addition, the destination principle is often implemented in the business-to-business context, by 'reverse charge' mechanisms pursuant to which registered business purchasers, which are subject to control and audit by taxing authorities at destination, self-assess the consumption tax.

This is not to suggest that the destination principle as applied to goods creates no difficulties. Zero rating of exports can lead to fraud,[16] causing a loss of revenue when goods that are purportedly exported are in fact sold locally and traders claim input tax refunds on the purported exports.[17] If border controls are not airtight, and sometimes even if they are, individual consumers can avoid the destination principle through cross-border shopping, particularly with respect to high-value, easily transported goods, which they illegally (or legally) bring back across the border.[18] And, in circumstances in which there are effectively no borders – or, at least, no fiscal frontiers – between different taxing units, as between member states of the European Union since 1993,[19] U.S. states (and local jurisdictions), and Canadian provinces, one needs to develop other mechanisms for assuring consumption taxes of goods are collected at destination or (in effect) to allow substantial amounts of cross-border trade to go untaxed, at least in the business-to-consumer context.[20]

Despite these difficulties, the destination rule for cross-border trade in goods is a workable, if imperfect, mechanism for taxing consumption by a widely accepted and well understood proxy for where consumption occurs. The same cannot be said for services, which brings me to the main focus of this chapter.

3.0 Taxation of Services

3.1 The Problem

Implementing the principle that consumption should be taxed where consumption occurs is more complicated with respect to the taxation of cross-border trade in services than with respect to cross-border trade in goods. Part of the problem is simply historical: until relatively recently, most services, in fact, were consumed where they were performed.[21] Consequently, the general rule in many jurisdictions – that services should be taxed where the service provider is established[22] – although technically an origin-based rule, functioned satisfactorily as a rule that taxed consumption where it occurred.

But the problem of taxing cross-border trade in services is more than a matter of recognizing that many services (such as downloading music from the Internet) are performed in one jurisdiction and consumed in another and simply changing the place of taxation from origin to destination, although that is certainly a problem that needs to be addressed.

The more fundamental problem is that the enormous growth in services involving suppliers in one jurisdiction and customers in another often involves services that are intangible in nature, making it more difficult both to determine the appropriate proxy for where consumption occurs and to enforce the tax on the basis of that determination. Such intangible services, which might be somewhat circularly defined as services 'where the place of consumption may be uncertain,'[23] include 'consultancy, accountancy, legal and other "intellectual" services; banking and financial transactions; advertising; transfers of copyright; provision of information; data processing; broadcasting; and telecommunications.'[24] The challenge, then, for contemporary consumption tax regimes is to identify the appropriate proxies for where consumption of services occurs when, in contrast to cross-border trade in goods, the place of such consumption cannot be readily identified by reference to physical flows.

3.2 Approaches to the Problem

3.2.1 OECD E-Commerce Initiatives

The OECD Committee on Fiscal Affairs and its technical advisory groups[25] have been in the forefront of efforts to develop conceptual and practical guidance for the application of consumption taxes to international trade in services.[26] These efforts were spawned by concerns over the impact of electronic commerce (e-commerce) on international cross-border taxation, both direct and indirect, which culminated in a 1998 conference in Ottawa and a seminal OECD report, *Taxation and Electronic Commerce*.[27] Among other things, this report delineated the overarching principles that should inform consumption taxes in the electronic age:

- Rules for the consumption taxation of cross-border trade should result in taxation in the jurisdiction where consumption takes place and an international consensus should be sought on the circumstances under which supplies are held to be consumed in a jurisdiction.
- For the purposes of consumption taxes, the supply of digitized products should not be treated as a supply of goods.
- Where businesses and other organizations within a country acquire services and intangible property from suppliers outside the country, countries should examine the use of the reverse charge, self-assess-

ment, or other equivalent mechanisms where this would give immediate protection of their revenue base and of the competitiveness of domestic suppliers.[28]

The first concrete guidelines based on these principles were issued in 2001.[29] Beyond reiterating the basic principles set forth above and emphasizing that their purpose was to prevent double taxation and unintentional non-taxation, the guidelines took the first step in putting some meat on the bones of the rule that consumption should be taxed where consumption occurs in the context of cross-border trade in 'intangible services,' which the guidelines now defined a bit more precisely as 'cross-border supplies of services and intangible property that are capable of delivery from a remote location.'[30] (For ease of exposition, I will continue to refer to these simply as 'intangible services.')

Business-to-business transactions. In delineating the operational rules for taxing cross-border supplies of intangible services at the place of consumption, the OECD guidelines treated business-to-business and business-to-consumer transactions differently, in recognition of the different practical considerations that bear on the application of these rules in the two contexts. With regard to business-to-business transactions, the guidelines' basic proxy for determining where consumption (and hence taxation) occurs was 'the jurisdiction in which the recipient has located its business presence.'[31] 'Business presence' was further defined 'in principle' as 'the establishment … of the recipient to which the supply is made.' The guidelines nevertheless recognized that '[i]n certain circumstances, countries may … use a different criterion to determine the actual place of consumption,' when application of the basic proxy 'would lead to a distortion of competition or avoidance of tax.'[32] In accordance with the Ottawa Framework Conditions, the guidelines also recommended the application of a self-assessment or reverse charge mechanism (when consistent with overall design of the national consumption tax system) in circumstances when the supplying business was not registered or required to be registered for consumption tax in the country of the recipient business.[33]

Business-to-consumer transactions. For business-to-consumer transactions, the OECD guidelines' basic proxy for determining where consumption (and taxation) of cross-border supplies of intangibles occurs was 'the jurisdiction in which the recipient has their usual residence.'[34]

This is analogous to the 'business presence' rule for business-to-business transactions. The guidelines explicitly recognized that the rule it was adopting was *not* designed to determine where consumption actually occurred, but was a convenient proxy for such a determination that was dictated by administrative concerns.[35]

The principal problem with this rule, as the guidelines also recognized, was effective enforcement, at least when the jurisdiction where the recipient has his or her usual residence is not one in which the supplier is registered or, under existing jurisdiction-to-tax rules, can be compelled to register.[36] In contrast to business-to-business transactions, where absence of effective power to require the remote vendor to collect the consumption tax can be addressed by shifting that requirement to the customer, who will ordinarily be registered in 'the jurisdiction in which the recipient has located its business presence,'[37] in the business-to-consumer context, when there is no power in the jurisdiction of the private recipient's usual residence to compel the supplier to collect the tax, relying on private consumers to remit tax on their purchases is notoriously ineffective and, where it is effective, amounts essentially to a 'tax on honesty.'[38] To address this problem, the guidelines suggested a variety of short-, medium-, and long-term options, including simplified registration systems, technology-based solutions, and enhanced international administrative cooperation.

The need for more comprehensive guidance. Notwithstanding the significance of the OECD's initial, pioneering steps in articulating guidelines for taxing services at the place of consumption, it was plain from the outset that they represented only the beginning of the process of addressing the issues involved. First, the guidelines themselves were explicitly confined to intangible services supplied in the context of e-commerce, leaving unaddressed the supply of services (tangible and intangible) in other contexts. Second, particularly in the context of business-to-consumer transactions, perhaps more questions were raised than resolved by settling on a rule that taxed consumption in the jurisdiction of the recipient's usual residence, because of enforcement concerns. Finally, even within the business-to-business context, where enforcement of a rule taxing consumption where it occurs might raise fewer enforcement issues, the guidelines left numerous questions unanswered. For example, while taxing consumption at the establishment of the recipient 'to which the supply is made' presumably would lead to taxation at the place of consumption, the location of a recipient's

establishment to which a supply of global services is made is hardly self-defining. Moreover, the exception for a different criterion better reflecting 'the actual place of consumption' when the main proxy leads to 'distortion of competition or avoidance of tax' without further refinement leaves more uncertainty regarding the scope of the main rule and the exception than might be desirable for tax compliance and administration purposes.

Recognizing that the problem of providing guidance for consumption taxation of international trade in intangible services in the e-commerce context was simply one facet of the broader problem of consumption taxation of international trade in services generally, the OECD Committee on Fiscal Affairs undertook the task of providing broad guidance through the development of international VAT/GST guidelines.[39] This task is a work in progress that at this writing is – and, for the immediate future, will continue to be – the focus of considerable effort on the part of the committee.[40] The work builds on the framework principles for applying consumption taxes to international trade in services and takes account of the specific problems identified by business and governments in implementing these principles in the context of VATs and GSTs. The current status and future direction of this work are described briefly below.

3.2.2 The OECD's International VAT/GST Guidelines

The initial version of the OECD's international VAT/GST guidelines, promulgated in early 2006, incorporated the results of the OECD's earlier work and provided a roadmap for future work. The first chapter of the guidelines sets forth the basic principles reflected in the Ottawa Framework Conditions. However, these principles are now explicitly expanded beyond the e-commerce context for which they were originally designed to the taxation of services generally.[41] At the same time, the principles are more explicitly directed to VATs (and GSTs) as distinguished from retail sales taxes (RSTs).[42] Thus, in addition to reiterating the fundamental principle that '[f]or consumption tax purposes internationally traded services and intangibles should be taxed according to the rules of the jurisdiction of consumption,'[43] the guidelines now give another fundamental principle equal billing – namely, that 'the burden of value added taxes themselves should not lie on taxable businesses except where explicitly provided for in legislation.'[44] The latter principle could not be articulated as categorically if it were intended to apply to RSTs as well as VATs. Future work on the initial chapter will consider

the interaction of VAT/GST with sales, excise, and other transactional taxes.

The VAT/GST guidelines also incorporate (verbatim), as part of an anticipated chapter on taxation of services in specific sectors, the guidelines the OECD developed in the e-commerce context for international trade in intangible services.[45] Perhaps of greatest importance, the VAT/GST guidelines provide a roadmap to the OECD's future work in this area. Although the roadmap is not graven in stone, it does offer valuable insights into the direction that the OECD's work is likely to take. Chapter II will focus on the application of place-of-consumption principles to services in both the business-to-business and business-to-consumer contexts, defining the place of consumption through the use of various proxies (such as customer location and performance); addressing tax collection methods; and considering services characterization issues (such as mixed and bundled supplies). Chapter III will deal with taxation of services in specific sectors, among them telecommunications, financial services, international transport, and gambling (in addition to the work already done on e-commerce). Chapters IV and V will consider, respectively, time of supply and value of supply rules. Chapter VI will address compliance issues, including automated tax collection, simplified administrative procedures, and international tax cooperation. Finally, Chapter VII will focus on the avoidance of double taxation through refund mechanisms, dispute resolution, exchange of information, and the possible instruments to accomplish these goals.

Work on application of place-of-taxation principles in the business-to-business context is now well under way, and the OECD Committee on Fiscal Affairs issued an initial paper for public consultation on 'Emerging Concepts on Place of Taxation' in early 2008.[46] The purpose of the paper was not to propose specific VAT/GST guidelines as such, but to explore the application of the fundamental principles, which the OECD had adopted in its earlier work, to a fairly simple set of hypothetical examples in an effort to assure there was broad consensus on how these principles would apply in practice. In short, the goal was a means of informing the committee as it seeks ways of minimizing double taxation and avoiding unintentional non-taxation, particularly as applied to complex business models.[47]

In implementing the principle that consumption should be taxed where consumption occurs, the consultation paper adopts as its basic proxy the rule that 'the place of consumption should be deemed to be the jurisdiction where the customer is located (the 'main rule').'[48] After

making a number of simplifying assumptions,[49] the paper then elaborates on the main rule that the place of taxation should be based on customer location by declaring: 'The identity and the jurisdiction where the customer to which the supply is made is located will then normally be supported by the relevant business agreement, as it is expected that business agreements generally reflect the underlying transactions and financial flows. Only in specified or exceptional circumstances should the place of taxation vary from the main rule.'[50]

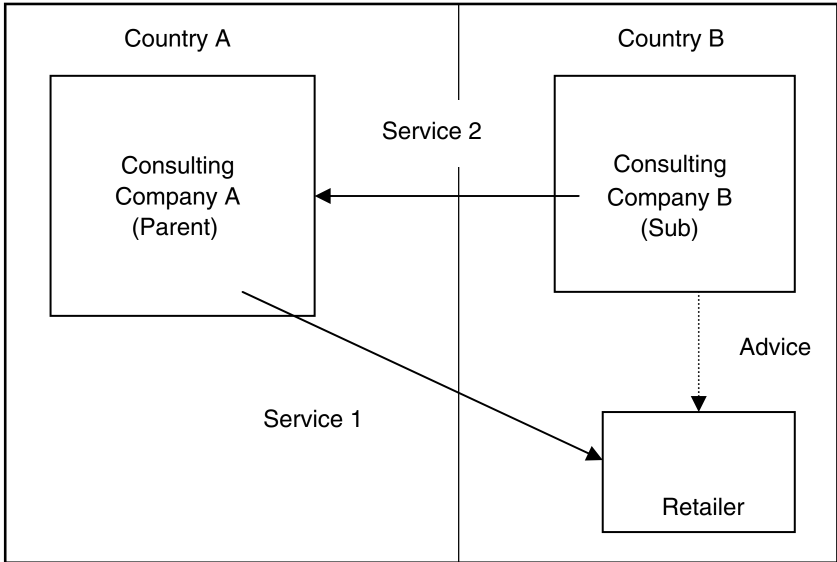
'Business agreement' is further defined as 'any agreement, regardless of form, between persons acting in a business capacity that underlies the provision of a supply. (In most cases, documentation will reflect the existence of the business agreement.)'[51]

In short, the principal focus from a practical standpoint for determining the location of the customer to which the supply is made – and hence the jurisdiction of consumption and taxation – will normally be the business agreement. The examples in the paper proceed to illustrate how various business agreements determine the customer to whom the supply is made and, consequently, the appropriate place of taxation. These agreements include those not only between unrelated suppliers and customers, but also those (whether explicit or implicit) between affiliates of the respective unrelated suppliers and customers, who might be involved in the provision or receipt of the supply. One of the key simplifying assumptions is that all of the agreements in question – even those between related entities – are supported by legitimate and bona fide economic substance.

The basic conclusion that the business agreement ordinarily will be the focus for determining the customer location to which the supply is made is extremely significant, even though this conclusion is admittedly preliminary, conditioned on a number of simplifying assumptions, and subject to variance in 'specified' and 'exceptional' circumstances. It suggests that, at end of the day, the determination of where consumption of business-to-business services occurs will look to the bona fide agreements among the parties, not to other possible indicia of where consumption occurs, such as the physical flows of services between suppliers and customers.

For example, suppose that a consulting firm in country A enters into an agreement to provide advice to a retailer in country B, but arranges with its subsidiary in B (which is more familiar with market conditions there) to render the advice to the retailer.[52] Figure 15.1 represents the contractual services and physical flows. There are two separate busi-

Figure 15.1. An Example of Cross-border Consulting Services



ness agreements, each leading to the supply of services for a consideration. Consulting company A is the supplier and the retailer is the customer under one of the agreements (service 1), and consulting company B is the supplier and consulting company A is the customer under the other agreement (service 2). The place of taxation will be decided for each supply individually. In accordance with the main rule, the place of supply for service 1 will be country B because that is where the customer (the retailer) is located. The place of supply for service 2 will be country A because that is where the customer (consulting company A) is located. The place of taxation is thus determined by the business agreements, not by reference to where or to whom the services are physically rendered.

Although this is only the first step in a long journey toward mature international VAT/GST guidelines, it is an important step that might provide a template for addressing more complex issues, such as a multinational corporation's purchase (through a centralized purchasing company) of global auditing services provided by an international accounting firm. In other words, if we can determine the place of consumption by carefully analysing the relevant business agreement at issue for

simple examples involving international trade in services, as the consultation paper suggests we can, perhaps we can also do the same thing for more complex arrangements, which, ultimately, can be 'deconstructed' into a series of business agreements that permit us to identify the customer to whom the supply is being made and its location.

3.2.3 The EU's Response to Increased Cross-border Trade in Services

Piecemeal measures. The basic place-of-taxation rule for supplies of services in the EU historically has been the location of the supplier.[53] Although it has long been recognized that, as a matter principle, taxation of services should take place in the member state of consumption, it has likewise been recognized that systematically defining the place of consumption as the place of taxation would lead to serious practical problems in some circumstances.[54] Moreover, as noted above, despite the theoretical objections to taxing services at the supplier's location if one's objective is to tax consumption where consumption occurs, that approach works reasonably well to achieve that objective in a universe where most services are consumed where they are provided, as was the case when the basic rule was initially embraced. Accordingly, for many years, the EU (and its predecessor, the European Community) maintained the basic rule, while adopting a number of exceptions for taxing specific services at the customer's (rather than the supplier's) location with the aim of assuring that such services would be taxed where they were consumed.[55]

The most recent example of the EU's piecemeal approach to the problem of taxing international trade in services was its adoption in 2002 of the so-called E-Commerce Directive,[56] which modified the then-prevailing Sixth Directive for certain electronically provided services – from non-EU suppliers to EU customers and from EU suppliers to non-EU customers[57] – to bring the place-of-supply rules in line with the principle that consumption should be taxed where consumption takes place. The E-Commerce Directive maintained the pre-existing reverse charge system for business-to-business transactions, which ensured the correct tax treatment of most such transactions, but imposed a simplified registration and payment obligation for non-EU suppliers engaged in business-to-consumer transactions with private EU consumers.[58] At the same time, the directive made clear that EU suppliers to non-EU customers would not be saddled with a VAT, which would place them at a competitive advantage to non-EU suppliers.

The 2007 VAT package. The European Commission, however, came to recognize that piecemeal changes to the place-of-supply rules for cross-border trade in services to provide, in specified circumstances, for taxation at the place of consumption did not adequately address the 'enormous changes in the volume and pattern in trade in services' that 'globalisation, deregulation and technology change have all combined to create.' Observing that '[i]t is increasingly possible for a number of services to be supplied at a distance,' the Commission declared its intention to undertake a 'more general and thorough review governing the place of supply of services in totality.'[59] In so doing, it announced that the E-Commerce Directive would be the last individual change to its VAT Directive.

After an effort that lasted five years (in part because of internal EU political wrangling that delayed the achievement of the necessary unanimous support for a change in the VAT rules), the Council of the European Union reached political agreement in December 2007 on a so-called VAT package designed to 'ensure that VAT on services accrues to the country where consumption occurs, and to prevent distortions of competition between member states operating different VAT rates.'[60] Effective 1 January 2010, the VAT package changed the basic place-of-supply rule for business-to-business supplies of services from the supplier's location to the location of the customer. For business-to-consumer supplies of services, the place of taxation continues to be where the supplier is established. In both the business-to-business and business-to-consumer contexts, specified rules for particular types of supplies were adopted to reflect the principle of taxation at the place of consumption, when the general rules are inappropriate.[61]

The overarching principles informing the VAT package are (unsurprisingly) quite similar to those informing the OECD's parallel efforts to design guidelines for international trade in services that ensure taxation at the place of consumption. The preamble to the directive[62] declares that, '[f]or all supplies of services, the place of taxation should, in principle, be the place where actual consumption takes place.' It then identifies the basic proxy for business-to-business supplies of services as 'the place where the recipient is established, rather than where the supplier is established.' With respect to business-to-consumer supplies of services, by contrast, the directive states that 'the general rule should continue to be that the place of supply of services is the place where the supplier has established his business.' Although this clearly deviates from the theoretical norm articulated above, the inconsistency might be justified

by administrative concerns, namely, the difficulty of systematically enforcing a tax on services at a customer's location, thus obviating any defence on the merits of the rule. Nevertheless, it is worth observing that there may well be less to this apparent deviation from the basic principle than meets the eye. Indeed, as described below, the directive provides for exceptions to the general rule 'based on existing criteria' that 'reflect the principle of taxation at the place of consumption, while not imposing disproportionate administrative burdens upon certain traders.'[63]

First, in many instances, services provided to private consumers will be consumed in the same jurisdiction in which the supplier is located, so there is no deviation from the rule that consumption should be taxed where it occurs as a matter of substance, even though the directive continues to use the supplier's (rather than the customer's) location as the general place-of-supply rule. Second, the specific place-of-supply rules for services such as sporting events and restaurant services generally ensure that these services will be taxed where they are consumed. Finally, with respect to what may be the most significant categories of business-to-consumer cross-border trade in services – namely, electronically supplied services, telecommunications services, and radio and television broadcasting services – the VAT package does embrace place-of-supply rules that generally look to the customer's, rather than the supplier's, location. With respect to trade that crosses the EU's borders, the VAT package essentially continues the pre-existing customer-based place-of-supply rules with regard to both business-to-business and business-to-consumer trade that are embodied in the E-Commerce Directive.[64] Moreover, effective 1 January 2015, intra-EU business-to-consumer cross-border supplies (as well as extra-EU business-to-consumer cross-border supplies) of these services will be taxable under a general rule establishing the place of supply as the place where the non-taxable person is established.[65] To simplify VAT administration for such services, the VAT package adopts a 'one-stop-shop' system to enable service providers to fulfill in their home member state a single set of obligations for tax registrations, declarations, and payments, including those for taxes on services provided in other member states where they are not established.[66] VAT revenue will then be transferred from the country where the supplier is located to that where the customer is situated.

4.0 Conclusion

If the preceding discussion accomplishes nothing else, it demonstrates that consumption taxation of cross-border trade in services is an issue

of great and growing significance to tax administrations around the globe. The initiatives of the OECD and the EU to address the challenges of taxing services that can be provided remotely reveal the challenges facing tax administrations as they seek to find an approach to taxing such services in a manner that is consistent with basic consumption tax principles and yet capable of practical and effective implementation. Whatever may be the uncertainties as to how these challenges are ultimately addressed, one thing for certain is that they will command the attention of those concerned with tax policy and tax administration for some time to come.

Notes

* I would like to thank Stephane Buydens, Arthur Cockfield, David Holmes, Marcus Jones, Mick Keen, Arthur Kerrigan, Charles E. McLure, Jr, and Rainer Nowak for their helpful comments on an earlier draft of this chapter. All errors or omissions are my own.

1 The 'should' in this sentence is not a statement about the wisdom of taxing consumption. It assumes, as most countries (and some subnational taxing jurisdictions) have determined, that consumption is an appropriate subject of taxation. On that assumption, it simply posits that such taxation should occur in the jurisdiction where the consumption occurs.

2 Consumption taxes may be broadly defined to embrace any levy on the consumption of goods, services, and intangible property, including general sales and turnover taxes, transaction taxes, value-added taxes, retail sales taxes, and targeted excise taxes such as motor fuel and telecommunications taxes. See Richard Doernberg, Luc Hinnekins, Walter Hellerstein, and Jinyan Li, *Electronic Commerce and Multijurisdictional Taxation* (The Hague: Kluwer Law International, 2001) at 94–5; Jerome R. Hellerstein and Walter Hellerstein, *State Taxation*, 3rd ed. (Valhalla, NY: Thomson/RIA, 2008), vol. II at para. 12.01. For purposes of the ensuing discussion, however, the term 'consumption taxes' is used in a somewhat more limited sense to mean broad-based taxes that are designed, at least in principle, to reach 'final' consumption, even though in practice substantial amounts of 'intermediate' consumption may be subject to tax. In other words, the ensuing discussion is directed largely to the VATs now in force in the European Union and in more than 130 countries worldwide (including equivalent goods and services taxes in force in Canada, Australia, and other countries) and to retail sales taxes (RSTs) and similar sales taxes employed in most U.S. states, some Canadian provinces, and in a number of countries. See Or-

ganisation for Economic Co-operation and Development, *Consumption Tax Trends* (Paris: OECD, 2006) at 18.

3 OECD, *Taxation and Electronic Commerce: Implementing the Ottawa Taxation Framework Conditions* (Paris: OECD, 2001) at 5.

4 European Union, 'Council Directive 2008/8/EC of 12 February 2008 amending Directive 2006/112/EC of 28 November 2006 on the common system of value-added tax' (O.J. L. 347, 11.12.2006 p. 1) 'as regards the place of supply of services' (O.J. L. 44, 20.2.2008, p. 11) [hereinafter cited as EU, 'VAT Package Directive'].

5 For commercial truckers, a mechanism is in place designed to assign the tax on gasoline to the jurisdiction in which the gasoline is consumed; see, generally, International Fuel Tax Agreement, described in Charles E. McLure, Jr, Robert C. Pitcher, and Lonette Turner, 'Taxation of Motor Fuel in the US and Canada' (2007) 61 Bulletin for Int'l Taxation 541; and Dwight Dennison and Rex Facer, 'Interstate Tax Coordination: Lessons from the International Fuel Tax Agreement' (2005) 53 Nat. Tax J. 591.

6 One might object to this conclusion on the ground that my purchase of the gasoline would not constitute 'cross-border trade.' Such an argument, however, takes an excruciatingly narrow view of cross-border trade and ultimately 'proves too much,' as lawyers are wont to say. If my purchase of gasoline in the United States for consumption in Canada does not involve cross-border trade (presumably because the 'sale' or 'supply' occurs in the United States rather than Canada), then neither does a Canadian's purchase of an automobile in Detroit for use in Canada. If rules regarding cross-border trade did not apply to the acquisition of items in one jurisdiction for consumption in another, on the theory that the transfer of ownership occurred entirely within the first jurisdiction, then consumption would be taxed not where it occurs but wherever lawyers arranged for transfer of ownership. A more meaningful concept of cross-border trade encompasses any transaction involving the supply of goods or services that has material contacts with more than one jurisdiction.

7 This chapter distinguishes between trade in 'goods' and trade in 'services' as if this embraces the entire universe of trade. While this dichotomy might make sense to those in the EU, which defines a 'supply of services' as 'any transaction which does not constitute a supply of goods' (EU, 'VAT Package Directive' at 1), other jurisdictions distinguish between trade in goods, services, and *intangibles*. Indeed, in the context of direct taxation, the distinction between income from services and income from intangibles is well established. Despite the fact that trade in services and trade in intangibles are treated differently under some consumption tax regimes, for purposes

of this chapter it makes more sense to elide the two categories, because the distinction has no significant bearing on the ensuing discussion and the reference to intangibles would introduce an unnecessary complication.

8 Alex J. Easson, *Taxation in the European Community* (London: Athlone Press, 1993).

9 Liamm Ebrill, Michael Keen, Jean-Paul Bodin, and Victoria Summers, *The Modern VAT* (Washington, DC: International Monetary Fund, 2001) at 176. Although there is some debate about whether it is preferable to tax cross-border consumption purchases in the jurisdiction where the goods or services originate or in the jurisdiction for which they are destined (ibid. at 179–95) the merits of that debate lie beyond the scope of this chapter. Instead, this chapter relies on '[t]he presumption in favor of the destination principle, [which] … is broadly consistent with the professional consensus' (ibid. at 195). See also OECD, *International VAT/GST Guidelines* (Paris: February 2006) at para. 4 (observing that 'the destination principle … is the international norm').

10 Doernberg et al., *Electronic Commerce* at 104.

11 Easson, *Taxation* at 129.

12 Under the EU VAT, for example, if a taxable supply is zero rated, the supplier need not collect VAT on the sale of the supply, and the supply is effectively relieved of VAT altogether at origin, because the supplier can obtain a credit for the payment of any VAT on inputs related to its acquisition or production; see Doernberg et al., *Electronic Commerce* at 101–21.

13 Under the U.S. RST, for example, states generally exempt from tax goods that are exported from the state; see Hellerstein and Hellerstein, *State Taxation* at para 18.02. For readers unfamiliar with both VATs and RSTs, the nomenclature ('zero rated,' 'exempt,' and so on) can be confusing, particularly because there are a number of words, such as 'exemption' or 'taxable person,' that have different meanings (or at least implications) in the two systems.

14 See Walter Hellerstein, 'Jurisdiction to Tax Income and Consumption in the New Economy: A Theoretical and Comparative Perspective' (2003) 38 Georgia L. Rev. 1 at 28.

15 OECD, *Taxation and Electronic Commerce* at 24.

16 Ebrill et al., *The Modern VAT* at 184.

17 International VAT Association, *Combating Fraud in the EU: The Way Forward* (Brussels: International VAT Association, 2007).

18 Ebrill et al., *The Modern VAT* at 184 ('It has been estimated, for instance, that in 1986 about one-quarter of all spirits drunk in the Republic of Ireland were bought in Northern Ireland').

19 In 1993, the original EU VAT system was modified to move the system more in the direction of a single internal market by abolishing existing collection and fiscal controls at the border and replacing them with administrative controls at the enterprise level; see European Union, 'Council Directive 91/680/EEC of 16 December 1991 supplementing the common system of value added tax and amending Directive 77/338/EEC with a view to the abolition of fiscal frontiers.' The current ('transitional') system is based on taxpayer identification, administrative records of the enterprises, and automated exchange of information between tax authorities of member states; see Doernberg et al., *Electronic Commerce* at 105. The so-called definitive system, which would impose a VAT at origin and which assumes a substantial degree of harmonization of rates (if not an EU-wide VAT) as well as revenue sharing (ibid. at 105–7) has never been (and may never be) introduced. Hence the 'transitional' system continues to apply.

20 Indeed, in the United States, one of the gaping holes in the destination-based RST is created by the rule, based on implied constitutional restraints supporting a national common market, that a vendor without physical presence in a state cannot be required to collect a sales or 'use' tax on destination sales to consumers in those states; see *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). Accordingly, many business-to-consumer Internet and mail-order sales from non-physically present remote vendors effectively go untaxed in U.S. states, at a considerable cost to state treasuries. See Donald Bruce, William F. Fox, and LeAnn Luna, 'State and Local Government Sales Tax Revenue Losses from Electronic Commerce' (2009), online: <http://www.streamlinedsalestax.org> (estimating that state and local tax revenue losses from e-commerce sales will grow to US$11.4 billion by 2012 for a six-year total loss of US$52 billion). In Canada, if the provincial GST is harmonized with the federal GST, the federal government collects the entire tax (including the provincial tax) on the interprovincial sale and remits the appropriate provincial tax to the destination province. If the provincial GST is not harmonized with the federal GST, then no provincial GST is collected on business-to-consumer interprovincial imports, except to the extent that consumers comply with self-assessment mechanisms. As for interprovincial RSTs on business-to-consumer transactions, 'provincial sales taxes rely on provisions similar to and probably no more effective than the so-called use tax common in the United States.' See Richard M. Bird, 'Is a State VAT the Answer? What's the Question' (2007) State Tax Notes 821.

21 OECD, *The Application of Consumption Taxes to the Trade in International Services and Intangibles*, CTPA/CFA 34 (Paris: OECD, 2004) at 4 [hereinafter cited as OECD, *Consumption Tax Report*].

22 See EU, 'VAT Package Directive' at art. 43.

23 OECD, *Taxation and Electronic Commerce* at 24.

24 Ibid. 'Tangible services,' including services relating to land and buildings, transport, and physical performance, may be defined (again somewhat circularly) as services 'where the place of consumption can be readily identified' (ibid.). The definitional proposition that the place of consumption of tangible services can be 'readily identified' presumably is based on a combination of two assumptions. First, such services often will not involve cross-border trade at all, because both the supplier and the customer are in the same location, where the service is consumed (for example, restaurant services). Second, even if such services do involve performance in one jurisdiction and consumption in another (for example, if a movie star has her hair coiffed in London in preparation for an appearance at the Cannes film festival, where she may actually 'consume' the hairdressing service), the choice of a practical proxy for consumption (as in the case of my purchase of gasoline at the U.S.-Canadian border) is unproblematic, whatever theoretical difficulties the choice may raise. Nevertheless, tangible services can raise thorny cross-border tax issues. Analysing the example of services provided by a real estate agent in country A to both a buyer resident in country A and a seller resident in country B concerning the sale of land in country B, Rebecca Millar demonstrates that different countries would approach this example in different ways; see 'Cross-Border Services: A Survey of the Issues' in Richard Krever and David White, eds., *GST in Retrospect and Prospect* (Wellington, NZ: Thomson Brookers, 2007) 317. In short, the consumption of such tangible services (at least as defined above) is not always 'readily identifiable' to all observers.

25 OECD committees can involve non-member countries, academics, business representatives, and trade union representatives in their work as 'experts.' This involvement may lead to the creation of technical advisory groups (TAGs), whose role is purely advisory but whose members' knowledge and experience assist the committees in taking their work forward. TAGs have a prescribed role established by a committee mandate, and they are usually discontinued once their work is completed. The Committee on Fiscal Affairs created several TAGs following the Ottawa conference on electronic commerce to help advance the work that resulted from the conference. These TAGs were discontinued in 2001 after their work was completed. The Committee on Fiscal Affairs created a new TAG in 2007 to assist with the task of developing international VAT/GST guidelines.

26 Because the OECD is an organization of countries, including many who

are also members of the EU, a community with special rules regarding intra-community consumption taxation, its guidelines in this context are careful to point out that 'specific measures adopted in relation to the place of taxation by a group of countries that is bound by a common legal framework for their consumption tax systems … may apply to transactions between these countries.' See OECD, *Taxation and Electronic Commerce* at 45; and idem, *International VAT/GST Guidelines* at chap. 1, note 8. Similarly, because some OECD members have subnational taxing jurisdictions whose consumption taxes operate under 'federal' rules governing the internal market, the OECD's guidelines 'are not intended to apply to subnational value-added and general consumption taxes' (OECD, *Taxation and Electronic Commerce* at 45, note 7); but 'attention should be given to the issues presented, in the international context, relating to these taxes' (OECD, *International VAT/GST Guidelines* at chap. 1, note 9).

27 OECD, *Taxation and Electronic Commerce* at 10; the report is set out at 228–34.

28 Ibid. at 231.

29 OECD, Committee on Fiscal Affairs, 'Consumption Taxation of Cross-Border Services and Intangible Property in the Context of E-Commerce' reproduced in OECD, *Taxation and Electronic Commerce* at 44–7 [hereinafter cited as OECD, 'E-Commerce Guidelines'].

30 Ibid. at 44. The guidelines explicitly excluded 'tangible' services from their application, see *supra* note 24, which the guidelines described as including 'services which are not capable of direct delivery from a remote location' (for example, hotel accommodation and vehicle rental); 'circumstances where the place of consumption may be readily ascertained, as is the case where a service is performed in the physical presence of both the service provider and the customer' (for example, hairdressing); and circumstances 'when the place of consumption can more appropriately be determined by reference to a particular criterion' (for example, services related to particular immovable property or goods); see ibid. at 45.

31 Ibid. at 44.

32 Ibid. at 45.

33 Ibid. at 46.

34 Ibid.

35 Ibid. at 45, note 5 ('implementing this Guideline will not always result in taxation in the actual place of consumption ... However … to apply a pure place of consumption test would lead to a significant compliance burden for vendors').

36 Ibid. at 47; see also Hellerstein, 'Jurisdiction to Tax Income' at 51–70.

37 OECD, 'E-Commerce Guidelines' at 44.
38 Hellerstein, 'Jurisdiction to Tax' at 23.
39 OECD, *International VAT/GST Guidelines*; idem, 'Consumption Taxation.'
40 The committee's work is currently being taken forward in part by a TAG.
41 OECD, *International VAT/GST Guidelines* at chap. 1, para. 6.
42 While recognizing that VATs and RSTs share some common features, such as the general aim of taxing consumption and the broad goal of remaining neutral towards cross-border trade, the VAT/GST guidelines observe that there are significant differences as well – namely, that RSTs tend to tax fewer services and that, under RSTs, 'businesses do incur irrecoverable sales tax' (ibid. at par. 4). The exclusion of RSTs from the scope of the VAT/GST guidelines is made even more explicit in subsequent OECD consultation documents. See OECD, 'Applying VAT/GST to Cross-Border Trade in Services and Intangibles, Emerging Concepts for Defining Place of Taxation (Invitation for Comments) (Paris: OECD, January 2008) at para. 2 ('The scope of this paper is limited to VAT/GST taxation of international trade in services and intangibles ... It does not cover other forms of consumption taxes such as sales taxes').
43 OECD, *International VAT/GST Guidelines* at chap. 1, para. 9. The careful reader will note a slight semantic variation from the original articulation of this principle in the Ottawa Framework Conditions, to wit, that '[r]ules for the consumption taxation of cross-border trade should result in taxation in the jurisdiction where consumption takes place' (OECD, *Taxation and Electronic Commerce* at 5). The change implicitly addresses the situation of the United States, the only OECD member state without a VAT. According to the national rules of that country, consumption should *not* result in taxation in the jurisdiction where consumption takes place, because it has no national rules for a broad-based tax on consumption. It may be worth noting, however, that the VAT/GST guidelines also repeat the original language quoted above from the Ottawa Framework Conditions; see OECD, *International VAT/GST Guidelines* at chap. 1, para. 7.
44 OECD, *International VAT/GST Guidelines* at chap. 1, para. 9.
45 Ibid. at chap. 3.
46 OECD, 'Applying VAT/GST to Cross-Border Trade'; the work is being carried forward in part by a TAG. The committee has subsequently issued additional documents for public consultation. See OECD, 'Applying VAT/GST to Cross-Border Trade in Services and Intangibles, Emerging Concepts for Defining Place of Taxation – Second Consultation Document (Invitation for Comments) (Paris: OECD, June 2008); OECD, '"OECD International VAT/GST Guidelines," "International Trade in Services and Intangibles,"

"Public Consultation on Draft Guidelines for Customer Location"' (Paris: OECD, 1 February to 30 June 2010). One can reasonably anticipate a continuing stream of such documents over the next few years.

47 Ibid. (explanatory cover note).

48 Ibid. at para. 4.

49 The paper recognizes that 'in order to ensure common understanding and agreement there are limitations on complexity that need to be observed at this stage' (ibid. at para. 6). These conditions include the following: only business-to-business supplies are considered, all examples reflect legitimate and bona fide economic substance, and all transactions are between separate legal entities (ibid.).

50 Ibid. at para. 9.

51 Ibid. at note 3.

52 This example roughly tracks the example in ibid. at 11.

53 EU, 'Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes – common system of value added tax; uniform basis of assessment' at art. 9.1 (O.J. L. 145, 11.06.1977, p. 1); EU, 'VAT Package Directive' at art. 43; Commission of the European Communities, 'Proposal for a Council Directive amending Directive 77/388/EC as regards the place of supply of services, Explanatory Memorandum' at 2, COM(2003) 822 Final (Dec. 23, 2003) [hereinafter cited as 'European Commission, 'VAT Proposal Explanation']; idem, 'Amended Proposal for a Council Directive amending Directive 77/388/EC as regards the place of supply of services, Explanatory Memorandum' at 7, COM(2005) 334 Final (July 20, 2005) [hereinafter cited as European Commission, 'Amended VAT Proposal Explanation'].

54 For example, attempting to determine where actual consumption of services occurs when a service is used in several jurisdictions or attempting to enforce a tax on cross-border supplies of services supplied by remote service providers in the business-to-consumer context; see European Commission, 'Amended VAT Proposal Explanation' at 7–8.

55 EU, 'Sixth Council Directive' at art. 9.2(e) (O.J. L. 145, 11.06.1977, p. 1) (providing customer-based place-of-supply rules for certain services performed for customers established outside the EU or for taxable persons established in the EU, but not in the same country as the supplier, including transfers of intangible rights; advertising services; consultancy services; banking, financial, and insurance transactions); ibid. at art. 9.3 (providing for application of consumption-based place-of-supply rule for supply of services, based on effective use and enjoyment of services, when modification of normal rule is necessary to avoid double taxation, non-taxation, or

distortion of competition). These provisions currently appear in EU, 'VAT Package Directive' at arts. 56, 58.

56 EU, 'Council Directive 2002/38/EC of May 7, 2002 amending temporarily Directive 77/338/EEC as regards the VAT arrangements applicable to radio and television broadcasting services and certain electronically supplied services; Council Regulation 792/2002, amending temporarily Regulation (EEC), No. 218/92 on administrative cooperation in the field of indirect taxation (VAT) as regards additional measures regarding electronic commerce' (O.J. L. 128, 15.05.2002) [hereinafter cited as EU, 'E-Commerce Directive'].

57 The directive did not affect wholly intra-EU transactions.

58 Specifically, a non-EU supplier making online supplies of digital deliveries to final consumers is required to register, collect, and remit VAT to the relevant EU country under the simplified administrative procedures. Needless to say, serious questions remain regarding the level of compliance with this regime.

59 European Commission, 'VAT Proposal Explanation' at 2.

60 Council of the European Union, Press Release, 2836th Council meeting, Economic and Financial Affairs (Brussels, 4 December 2007).

61 See EU, 'VAT Package Directive' at art. 47 (place of supply of services connected with immovable property is location of property); art. 52 (place of supply of sporting, entertainment, and similar services is place where events take place); art. 53 (place of supply of restaurant and catering services is place where services are physically carried out).

62 The VAT package, in fact, consists of two directives and a regulation, dealing with various aspects of the VAT package. A directive is binding, as to the result to be achieved, upon each member state, but leaves the choice and form of methods to the national authorities; a regulation is binding and directly applicable in all member states; see Treaty Establishing the European Community at art. 249. The references in the text to the directive are to the principal directive that sets forth the basic changes in the place-of-supply rules for services. See EU, 'VAT Package Directive.'

63 Ibid. at 6.

64 Thus, the place of supply of telecommunications services, radio and television broadcasting services, and electronically supplied services to non-taxable persons established outside the EU is the customer's location (EU, 'VAT Package Directive' at art. 59, effective 1 January 2010). Likewise, the place of supply of these services by non-EU suppliers to non-taxable persons in the EU is the customer's location; see ibid. at art. 58 (electronically supplied services) and art. 59b (telecommunications and broadcasting services), effective 1 January 2010.

65 Ibid. at art 58, effective 1 January 2015. Prior to that date, the place of supply for intra-EU business-to-consumer trade in such services continues to be the supplier's location.

66 In effect, this extends the 'one-stop-shop' system originally introduced in connection with the E-Commerce Directive with respect to business-to-consumer supplies from non-EU suppliers to EU customers.

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