Canada at the Crossroads of International Tax Reform: Between Harmonization and Tax Competition

In this article for the 75th anniversary issue of the Bulletin for International Taxation, Nathan Boidman and Michael Kandev provide their thoughts on Canada’s response to the proposed reform of international taxation as suggested by the OECD/G20 Base Erosion and Profit Shifting Project and succeeding initiatives.

1. Introduction

This article provides an assessment of what Canada has done and what Canada may do in response to external pressures to reform its tax law. In the first part of the article (section 2.), we review the outputs of OECD/G20 Base Erosion and Profit Shifting (BEPS) and Pillars harmonization projects, and consider Canada’s reaction to these initiatives. In the second part of the article (section 3.), we review certain international tax trends, with a focus on tax competition, and examine Canada’s position in relation to these developments. The objective is to distill some conclusions as to Canada’s path to future tax reform. The article ends with our conclusions in section 4.

2. Tax Harmonization

2.1. Background

Historically, the development of international tax policy typically occurred in the backrooms of national bureaucracies. There, anonymous public servants quietly and without political or media fanfare – and mostly on a unilateral and uncoordinated basis – stitched together an international tax framework that sought to achieve the following principal outcomes:

- avoid double tax through unilateral or treaty-based limitations on domestic tax nexus rules or by way of credit or exemption for foreign taxes;

- allocate profits between related parties through “transfer pricing” rules using the arm’s length principle;

- prevent undue “earnings stripping” through intercompany financing arrangements by applying “thin capitalization” rules;

- promote the interests of domestic multinationals by exempting foreign subsidiary business profits both when earned and upon repatriation; and

- prevent the use of foreign subsidiaries to avoid or defer tax on passive and certain highly mobile business income through controlled foreign company (CFC) rules.

This era was not marked by much focus on countering cross-border tax planning (including double non-taxation) that survived the basic constraints imposed by the tax architecture outlined above, although, starting in the 1990s, the United States led resistance to treaty shopping with the inclusion of limitation on benefits (LOB) provisions in its tax treaties and, with the enactment in 1997 of section 894(c) of the US Internal Revenue Code (IRC), a hybrid entity-based planning.

That era began coming to an end in the late 1990s and the first decade of the 21st century with the European Union and the OECD leading initiatives against harmful tax competition posed by tax havens. The harmonizing accelerated after the financial crisis of 2007–2008 left public coffers empty. During that period, non-governmental organizations (NGOs), the media and, ultimately, politicians, started focusing on the intricate and often obscure mechanisms of the tax plans of large multinationals, i.e. “a double Irish with a Dutch sandwich”. This spurred the G20 major economies, together with the OECD, to reform international taxation with a principal focus on extracting more tax from large multinationals based on

4. First formalized by the United States in 1968 with its “482 regs.”
5. See the first fully mechanical debt-equity ratio limitations adopted by Canada in 1972.
6. By 2009, the United States was the only major country using the credit method upon repatriation of foreign subsidiary profits (the United Kingdom and Japan having abandoned the credit method in that year).
a broad consensus among subscribing countries – now called the Inclusive Framework – which was committed to implementing such reforms in their domestic and treaty law. This initiative began in earnest in 2013 under the name “Base Erosion and Profit Shifting”, and, from 2019 onwards, has been ongoing as the “Pillars” project with the Inclusive Framework, now numbering almost 140 countries.

Sections 2.2 and 2.3 summarize the output of the BEPS tax harmonization initiative. These sections also consider what Canada has done and what Canada may do in response to the OECD/G20-driven external pressure to reform its tax law.

2.2. BEPS 1.0

2.2.1. Opening remarks

On 12 February 2013, the OECD released its background report “Addressing Base Erosion and Profit Shifting”9 and in July of that same year it issued the “Action Plan on Base Erosion and Profit Shifting”10 listing 15 action items (“Actions”) to be studied and developed into recommendations for an international tax reform. In 2015, the OECD published detailed reports on each Action.11 The following discussion in sections 2.2.2. to 2.2.8. focuses on the substantive Actions, with those of a mostly procedural relevance being touched on only briefly in section 2.2.9.

2.2.2. Action 1: Challenges of the digital economy

Action 1 of the OECD/G20 BEPS Project addressed the tax challenges of the digital economy. Prior to 2013 and as early as the mid-1990s, the emergence of “electronic(e)-commerce” in the late 1980s and early 1990s as a force to be reckoned with gave rise to studies by various countries and organizations, like the OECD, of relevant tax considerations.

This situation was also seen in Canada in 1998 in a dual dimension explained below. The central issues, if not the solutions, were easy enough to see in the context of primitive e-commerce models then extant. Using the Canadian tax system as an illustrative reference point, there were the following central issues where a non-resident engaged in e-commerce with a Canadian.

First, as a matter of liability to Canada’s domestic mainstream income tax, if the non-resident was selling goods to a Canadian through the Internet, the basic issue is whether the contract of sale was consummated in Canada, so as to engage common law “carrying on business in Canada” tax nexus. If this was not the case, a follow-up issue is whether the process through the Internet constitutes “an offer” made in Canada, so as to engage, under section 253(b) of the Income Tax Act (Canada) (ITA),2 deemed the carrying on of business in Canada, or, instead, was it merely an “invitation to treat”3 that did not engage Canadian tax nexus. To the extent that domestic mainstream income tax liability would arise, the issue is whether the seller could claim treaty protection on the basis that it has no permanent establishment (PE) in Canada. These questions required the application of notions developed for in-person, bricks-and-mortar situations to scenarios in which the only nexus factor was the Internet hosted on computer servers.

Second, as a matter of liability to Canadian final withholding tax, if the non-resident was providing to a Canadian, through the Internet, access to or use of an electronic software or book or song recording, the issue would be whether the overall arrangements entail a royalty or a payment merely for use (not use and ownership). In the latter case, this situation would give rise to the application of withholding tax on a gross basis that possibly would be reduced or exempt under tax treaty.4

Such questions, with local variations, presumably would arise in any market country. Other issues would relate variations of this situation, where planning focused on avoiding a PE nexus.5

Prior to 2013, what tax rules had developed, and what was the mandate given by Action 1? In an article published in December 2013,6 after pointing to a host of prior developments,7 we concluded as follows (including original footnotes):

In summary, the position expressed in the 1998 taxation framework conditions and the conclusion of the CFA’s subsequent work on the tax treatment of e-commerce was that existing taxation principles properly apply to e-commerce and that no fundamental changes are required. Arguably, nothing has changed in this regard, except maybe for the appetite of some countries to expand their tax bases. Moreover, if it is correct to assume that most e-commerce businesses are still based in OECD member countries, any expansion of market country taxation of e-commerce would essentially result in OECD countries cannibalizing each other’s tax base. Hence, a debate over the taxation of e-commerce will inevitably pit typical residence countries against each other. In this regard, the French government has been mulling a proposal for a virtual PE, based on the idea that Internet sales

13. See the decision of the Canadian Federal Court of Appeal (CFCA) in CA: CFCA Sudden Valley Inc v. the Queen, 76 DTC 6178 (FCTD) aff’d 76 DTC 6448 (FCA).
14. Unless a domestically defined PE was involved. If there was such a PE, would it be the same or differ from any applicable treaty PE?
15. An issue now seen in the Pillar One debates taking place and referred to further below.

© IBFD

BULLETIN FOR INTERNATIONAL TAXATION NOVEMBER/DECEMBER 2021 | 705

Exported / Printed on 21 Jan. 2022 by danny@dannydarussalam.com.
also involved an accommodating country such as Luxembourg.

A notable example of a hybrid entity that actually had two sources (one judicial and one legislative) initially involved a partnership and then a form of company (a limited liability company) all united by the fact that the US tax system gave greater weight to economic substance than other countries, including Canada, than to the legal effects of formalities. The starting point, illustrated in the Canadian-US context, was that both countries generally treated a partnership (whether limited or general) as not a separate person, but one whose activities would be attributed to and taxed in the hands of its members. But then the two countries went their separate ways when US courts and/or the US Treasury and/or Internal Revenue Service (IRS) began to ask whether the particular partnership had “corporate” characteristics – such as continuity of life, central management, limited liability for some partners or free transferability of interests – and if so more than two, in which case the partnership would be treated as a corporation for US purposes. Neither Canada nor most other countries followed suit so that differing and/or hybrid characterization arose. However, this split was only exacerbated when the United States decided to rationalize the area by allowing taxpayers to not only elect flow-through or separate corporation status for entities formed under partnership statutes, but to permit such an election where the statute under which the entity was formed (such as a limited liability company statute in the United States or a corporate law statute in Canada that provided for “unlimited liability”) allowed a choice of characteristics that could be seen as those predominately of a corporation or a partnership.

A notable example of a hybrid instrument that could involve the United States or Luxembourg, at one end, and Canada, at the other, was a preferred share of a corporation that would retain its share characterization in Canada, but be treated as a partnership (whether limited or general) as not a separate person, but one whose activities would be attributed to and taxed in the hands of its members. But then the two countries went their separate ways when US courts and/or the US Treasury and/or Internal Revenue Service (IRS) began to ask whether the particular partnership had “corporate” characteristics – such as continuity of life, central management, limited liability for some partners or free transferability of interests – and if so more than two, in which case the partnership would be treated as a corporation for US purposes. Neither Canada nor most other countries followed suit so that differing and/or hybrid characterization arose. However, this split was only exacerbated when the United States decided to rationalize the area by allowing taxpayers to not only elect flow-through or separate corporation status for entities formed under partnership statutes, but to permit such an election where the statute under which the entity was formed (such as a limited liability company statute in the United States or a corporate law statute in Canada that provided for “unlimited liability”) allowed a choice of characteristics that could be seen as those predominately of a corporation or a partnership.

The basic objective of using such hybrids would be to reduce income in one country by a payment that is not taxed in another country (deduction – non-inclusion) or a payment deducted in two different countries (double deduction). Prior to 2013, there already was some experience with rules targeting hybridity. This was first seen in the United States with the enactment in 1997 of section 894(c) of the IRC that attacked treaty benefits (see section 2.1.). Then there was a regulation under section 894(c) of the IRC that disallowed a deduction. Next the Protocol (2007) to the Canada-United States Income and Capital Tax Treaty (1980) brought in both relieving and puni-

20. The quote is from Brett York, attorney-adviser with the Office of International Tax Counsel at Treasury, during a panel discussion September 20 at the American Bar Association Sections of Taxation and Real Property Fall CLE Meeting in San Francisco, as reported by Alex M. Parker in his article "U.S. Officials Blast 'Virtual PE' Concept, Saying VAT Might Capture Online Sales," Bloomberg BNA, Daily Tax Rep. (24 Sept. 2013).
21. Id.
22. This does not exclude country specific initiatives, such as the adoption of a digital (or bit) tax; see the French proposals. Also note that, in 1998, a bit tax was rejected in Canada's Report on Electronic Commerce, supra n. 17, at para. 4.1.3.1.
23. Significantly, international business representatives met with the OECD's Business and Industry Advisory Committee to provide comments on the OECD's action plan for dealing with BEPS on October 1, 2013. The OECD and business representatives seemed to agree on not developing separate rules for the digital economy, since all businesses use some aspects of the digital economy. However, there was also acknowledgement that, if differentiation cannot be made, there will be a higher challenge to make the rules work well for all sectors. The difficulty with the Action One leading to any material changes was exacerbated when the United States decided to rationalize the area by allowing taxpayers to not only elect flow-through or separate corporation status for entities formed under partnership statutes, but to permit such an election where the statute under which the entity was formed (such as a limited liability company statute in the United States or a corporate law statute in Canada that provided for “unlimited liability”) allowed a choice of characteristics that could be seen as those predominately of a corporation or a partnership.
27. Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital (26 Sept. 1980), Treaties & Models IBFD.
tive anti-hybrid rules in articles IV(6) and (7) with regard to withholding taxes.  

The 2013 Action Plan\(^{29}\) called for the following:  
- counter undue treaty benefits arising from hybridity (see the two pre-2013 instances detailed in section 2.1);  
- deny a deduction for a payment that is not taxable in the hands of the recipient (see the one pre-2013 instance detailed in section 2.1);  
- deny a deduction for a payment that is deductible in another country; and  
- deny domestic exemptions for receipts that are deductible in the hands of the payer.

Two years later, in the Final Report on Action 2\(^{30}\) issued in 2015, not only were those recommended but as well an initiative against so called “imported” hybrid arrangements. Such a situation generally arises where a payment is deductible by an entity resident in one country and included in the ordinary income of a recipient entity resident in a second country, but then that ordinary income is set off by a deduction under a hybrid mismatch arrangement between the second entity and an entity resident in a third country. A supplement to the Final Report on Action 2 recommended additional rules to address branch mismatch arrangements, which generally produce mismatches similar to hybrid mismatch arrangements.

We previously thought\(^{31}\) that these proposals could hurt Canada’s multinationals in respect of the financing of their US operations,\(^{32}\) but they should be viewed as largely unnecessary from a Canadian inbound standpoint and would not see the light of day in Canada. And for several years that proved true. But in its 2021 Budget, Canada’s government proposed to adopt the basic regime of Action 2. More specifically, payments made by Canadian residents under hybrid arrangements will not be deductible in Canada to the extent they give rise to a further deduction in another country or are not included in the ordinary income of a non-resident recipient. As well, hybrid related deductible payments by foreign persons would either not be also deductible in Canada or a Canadian recipient would be taxable.

The proposed rules to address hybrid arrangements will be implemented in two separate legislative packages. The first package would comprise rules to neutralize a deduction and/or non-inclusion mismatch arising from a payment in respect of a financial instrument and would apply as of 1 July 2022. The second legislative package would deal with the remaining Action 2 proposals and apply no earlier than 2023.

In our opinion, Canada’s tardy adoption of Action 2 reflects a desire by Canada to be a good OECD/G20 club member rather than a reaction to serious tax leakage, except perhaps in one US inbound to Canada situation that we have discussed elsewhere.\(^{33}\)

### 2.2.4. **Action 3: Strengthen CFC rules**

The title of our 2013 article, “BEPS: OECD Discovers America”,\(^{34}\) was no more apt than with respect to Action 3 of the OECD/G20 BEPS Project. After all, the United States invented CFC rules in 1962 and Canada emulated the United States ten years later, with its adoption of the foreign affiliate system in 1972 (effective from 1976) with one major improvement – the participation exemption for foreign affiliate dividends in most circumstances (which the United States did not have).

But, sadly, the innocuous material in the 2013 Action Plan and in the Final Report on Action 3 of 2015\(^{35}\) has since given way to the radical 2017 adoption of “Global Intangible Low-Taxed Income” (GILTI) as part of President Trump’s landmark tax reform legislation, the Tax Cuts and Jobs Act (TCJA) of 2017, and now the ongoing development of Pillar Two minimum tax. GILTI of course betrayed those, who had been pushing for an exemption for CFC dividends to produce a territorial system, by pulling the rug on one of the two pillars of such a system, i.e. no tax on undistributed active business profits of a CFC. The GILTI regime, contrary to international norms, imposed such a tax\(^{36}\) and now the BEPS Inclusive Framework is promoting agreement on a progeny of GILTI, the Pillar Two minimum tax, GLOBE. How Canada is responding to Pillar Two is discussed later in this article.

### 2.2.5. **Action 4: Limit base erosion via interest deductions and other financial payments**

As far back as 1972, Canada adopted comprehensive thin capitalization rules followed in the next 40 years by many countries. Canada and others used debt-equity ratios, while the United States used a combination of ratios and earnings stripping concepts; Germany, Italy and Spain used the latter, and the United Kingdom imposed a group worldwide ratio test. The OECD/G20 BEPS initiative resulted in the Final Report on Action 4 of October 2015, entitled “Limiting Base Erosion Involving Interest Deductions and Other Financial Payments”.\(^{37}\) The Report recommended a limitation based on a percentage of earnings, i.e. earnings before interest, taxes, depreciation and amortization (EBITDA) with the rate being 10% to 30%. Almost six years later, Canada has announced in its 2021 Budget, for

---

28. See OECD, Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues (OECD 2012), Primary Sources IBFD, which pointed to domestic responses in seven countries.

29. See OECD, Action Plan, supra n. 10.

30. OECD, Neutralising the Effects of Hybrid Mismatch Arrangements – Action 2: Final Report 2015 (OECD 2015), Primary Sources IBFD.


32. And we did foresee with the US: Tax Cuts and Jobs Act (TCJA) of 2017, together with the regulations made thereunder.


34. Boidman & Kandev, supra n. 16.

35. OECD, Designing Effective Controlled Foreign Company Rules – Action 3: Final Report 2015 (OECD 2015), Primary Sources IBFD.

36. For a detailed discussion of this topic, see N. Boidman, An Illusory Turn to Territorial, 89 Tax Notes Intl. 7, p. 619 (12 Feb. 2018).

37. OECD, Limiting Base Erosion Involving Interest Deductions and Other Financial Payments – Action 4: Final Report 2015 (OECD 2015), Primary Sources IBFD.
reasons that are not fully clear given the evident effectiveness of the thin capitalization rules it has had in place for the last 50 years, that it was adopting – without repealing the pre-existing thin cap rules or foreign affiliate dumping rules – the prescriptions of Action 4. 38

More specifically, the Budget 2021 proposes a new general limitation on the deductibility of interest and similar expenses based on a fixed ratio of the tax EBITDA, starting in 2023. Subject to certain exceptions, the deductibility of interest and other financing-related expenses – both between related and arm’s length parties – would be denied to corporations, partnerships and trusts to the extent these expenses, net of interest and financing-related revenue, exceed a fixed ratio of the entity’s tax EBITDA. For 2023, the ratio is proposed to be 40% and, for subsequent years, it would be reduced to 30% in line with the OECD’s recommendations and, now, the broadly settled international standard.

2.2.6. Action 6: Prevent treaty abuse

Action 6 of the OECD/G20 BEPS Project addresses treaty shopping through treaty provisions whose adoption forms part of a minimum standard that members of the BEPS Inclusive Framework have agreed to implement. It also includes specific rules and recommendations to address other forms of treaty abuse. Specifically, Action 6 identifies tax policy considerations jurisdictions should address before deciding to enter into a tax agreement.

Canada had long been concerned about treaty shopping, especially as it kept losing cases it brought before the courts, and, on 16 August 2013, it issued a consultation paper on point. Accordingly, Canada was particularly interested in the combined effects of the October 2015 Final Reports on Action 641 and Action 15,42 relating to the implementation of the “Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting” (the “Multilateral Instrument” or MLI).43 In that context, having morally bound itself to adopt any “mandatory recommendations” and being intent on countering treaty shopping, Canada has proceeded (at least for now) to adopt, through the MLI, the principal purpose text (PPT) (with all its uncertainties).44

2.2.7. Action 7: PE status

The work carried out under Action 7 of the OECD/G20 BEPS initiative provides changes to the definition of a PE in the OECD Model45 to address strategies used to avoid having a taxable presence in a jurisdiction under tax treaties. Canada has not adopted any of the Action 7’s changes, and, generally, has not been active in this area other than in respect of the Canada–United States Income and Capital Tax Treaty (1980), which saw the inclusion (apparently on Canada’s request) of a services PE concept at article IV(9) under the Protocol (2007).

2.2.8. Actions 8-10: Ensure that transfer pricing outcomes are in line with value creation

Is anything more misunderstood than transfer pricing? From the unintendedly hilarious statement some 25 years ago in the now replaced Canadian business newspaper, the Financial Post, by journalist Diane Francis that “transfer pricing is illegal”46 to the current attempts by the OECD – both before, with and after Actions 8-10 of the OECD/G20 BEPS Project – to take the simple purpose of transfer pricing rules, namely, to allocate, for tax purposes, the profits made by a multinational that involve intercompany transactions to the countries involved even if there is no non-tax reason to make such calculations (thus answering Ms Francis’ challenge) – and turn such rules into a series of anti-avoidance provisions, there is at play a distortion of the pristine beauty of the original 1968 transfer pricing rules, namely, to allocate, for tax purposes, the profits made by a multinational that involve intercompany transactions to the countries involved even if there is no non-tax reason to make such calculations (thus answering Ms Francis’ challenge) – and turn such rules into a series of anti-avoidance provisions, there is at play a distortion of the pristine beauty of the original 1968 transfer pricing regulations derived from section 482 of the IRC, and the copycat OECD transfer pricing guidelines issued

38. For a full discussion, see Boudman & Kandev, supra note 33.


42. OECD, Developing a Multilateral Instrument to Modify Bilateral Tax Treaties – Action 15: 2015 Final Report (OECD 2015), Primary Sources IBFD.

43. Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (July 2017), Treaties & Models IBFD [hereinafter the Multilateral Convention or MLI].


45. Most recently, OECD Model Tax Convention on Income and on Capital (21 Nov. 2017), Treaties & Models IBFD.

46. See, for example, OECD, Preventing the Artificial Avoidance of Permanent Establishment Status – Action 7, 2015 Final Report (OECD 2015), Primary Sources IBFD.

47. D. Francis, Hoping Rae Relents on Corporate Tax, Financial Post (Toronto), 14 Nov. 1990.
in 1977. And beyond those are the subsequent writings of the OECD dealing with financings.

Where will this end up? It depends on what part of Actions 8-10 and the subsequent material one focuses. Is it “accurate delineation”, which seems to be an invitation for tax authorities to, without legal basis, rewrite or recast or re-characterize taxpayers transactions or, as in the case of the “cash box” craze ignoring commercial reality – as we have discussed elsewhere. The emerging ongoing controversies in Canada involving the foregoing and the recent landmark transfer pricing case of Cameco (2018 and 2020), and ominous statements made in the 2021 Canadian Federal Budget are discussed in section 3.

With regard to the concept of a cash box, we – prompted by the OECD’s release on 11 February 2020 of the report entitled “Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS: Actions 4, 8-10” – stated in our focus on the commentary as follows:

This commentary considers the cash box notion in light of the February release and asks whether it should play any role in Canadian transfer pricing law. We review the nature of the cash box, how the February guidance further shows the notion is fatally flawed, and the concept fundamentally conflicts with the policy underlying and the structure of Canadian tax law respecting outbound investment and business undertakings by Canadian based multinationals.

2.2.9. Other Actions

Canada has also agreed to adopt the other “mandatory” Actions in the October 2015 package of the OECD/G20 BEPS initiative. These are:

- Action 5 dealing with harmful tax competition, which requires:
  - substantial nexus activity for preferential (for example, patent boxes) regimes;
  - improved transparency; and
  - peer review of preferential regimes;

- Action 13 dealing with country-by-country reporting (CbC), the scope of which is already partly seen in pre-existing Canadian law; and
- Action 14 requiring improved dispute resolution, including a move to mandatory and binding arbitration (already seen in the Canada–United States Income and Capital Tax Treaty (1980) and implemented through the MLI).

Finally, with regard to Action 15, beyond the mandatory elements in the MLI, Canada has subscribed to some optional provisions in the MLI. Principally, Canada has adopted the 365-day holding condition for treaty benefits applying in respect of dividends from a Canadian subsidiary and for non-residents, who realize capital gains on the disposition of shares or other interests that derived their value principally from Canadian immovable property.

2.3. BEPS 2.0

2.3.1. In general

Section 2.2. reviewed the output of the OECD/G20 BEPS of 2013 to the 2015 initiatives, and how, while initially a cautious if not reluctant adopter of the OECD’s prescriptions, Canada now seems to have succumbed to the harmonizing pressures exerted on it. But we noted at least three areas in respect of which BEPS 1.0 opened the door to further developments: (i) Action 1 dealing with the digital economy; (ii) Action 3 dealing with CFC rules; and (iii) Actions 8-10 dealing with transfer pricing. Section 2.3. considers how this led to BEPS 2.0 and the Pillars project.

After the conclusion of the initial OECD/G20 BEPS Project and a brief hiatus, in 2019, the members of the nearly 140–country-strong Inclusive Framework agreed on a “Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitalisation of the Economy” on 31 May 2019 as an effective sequel to the work that took place under BEPS 1.0. This programme provided detailed instructions to the Inclusive Framework and its technical working groups to deliver a solution to the tax challenges that resulted from by digitalization. Such work focused on two “Pillars”, summarized by the OECD as follows:

(1) the first pillar (Pillar One, see section 2.3.2.) relates to the allocation of taxing rights, and seeks to undertake a coherent and concurrent review of the profit allocation and nexus rules; and
(2) the second pillar (Pillar Two, see section 2.3.3.) focuses on the remaining BEPS issues and seeks to develop rules that would provide jurisdictions with a right to “tax back”, where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation.
While work was slowed down by the COVID-19 pandemic, negotiation on the two pillars continued through 2020 and 2021. In October 2020, Blueprints under each pillar were issued, and, on 1 July 2021, the OECD issued a "Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy". This led to, on 8 October 2021, the Inclusive Framework announcing an agreement on the two-pillar solution to address the tax challenges arising from the digitalisation of the economy, which was endorsed by G20 finance ministers and central bank governors on 13 October 2021.

### 2.3.2. Pillar One

Conceptually, under Pillar One, a market country in which a multinational sells or licenses property or renders services through the Internet would be entitled to impose tax that cannot be imposed under current international tax rules developed for the bricks and mortar economy. Here, Canada is in an interesting situation. It is not home to the targeted digital giants so any tax imposed on them by third countries would not affect Canadian tax revenues. Instead, it is mostly a "market country", which, under a Pillar One agreement, would have a tax revenue windfall. Therefore, Canada is not only all for Pillar One, but it is so anxious for it (the windfall) that it will enact a digital services tax (DST) if a Pillar One regime is not, in the near term, agreed by all parties and then legislated by Canada. For Canada, this seems to be win-win.

### 2.3.3. Pillar Two

Contrary to Canada's stance in respect of Pillar One, the Pillar Two minimum tax initiative could be detrimental to Canada's interests, and a conclusion of an agreement along the lines of those agreed by the G7 in June would not be win-win for Canada if we believe in the position of the Canadian government and Canadian tax community since 1972 and vigorously re-endorsed as recently as 2008 by an advisory panel appointed by the government to review Canada's international tax system. That position is that it is good for both the Canadian economy and the Canadian government to minimize or eliminate both Canadian and foreign taxes on the foreign business profits of foreign subsidiaries of Canada's multinationals. That position would be severely undermined by the proposed Pillar Two minimum tax. Unfortunately, the currently ruling Liberal party announced on 1 September 2021 in its electoral platform, that it intends to "Work with our international partners to implement a global minimum tax so that the biggest companies in the world are not able to escape the taxes they owe here in Canada" and, in a release dated 8 October 2021, the Canadian Department of Finance stated:

> Canada strongly supports international efforts to end the corporate race to the bottom and to ensure that all corporations, including the world’s largest corporations, pay their fair share. Today's agreement will ensure a level playing field for Canadian workers and Canadian businesses in the global economy.

> Canada’s strong and essential social safety net is built on a robust national tax base. That is why those who do business in Canada must pay their fair share. Canada has a clear national interest in this multilateral deal, which protects against erosion of the tax base and which will generate additional revenue for Canada.

Canada looks forward to working with our international partners to bring this ambitious new tax framework into effect and to legislate its implementation. Canada's priority and preference has always been a multilateral agreement.

While some aspects of the Pillar Two proposals may have this effect, this proposal seems to misunderstand the material adverse effect of the 15% minimum tax proposal on Canadian multinationals.

### 2.3.4. Residual transfer pricing work

It was asserted in section 2.2.8. that Actions 8-10 took positions that were inimical to the proper functioning of transfer pricing law in Canada – which is generally governed by the internationally understood arm's-length principle – and that exacerbates and is exacerbated by particular transfer pricing issues. One of those is the government’s inappropriate response to an initiative, encouraged by the OECD/G20 BEPS Project, to expand beyond its legislative intent a Canadian transfer pricing rule that permits a transaction to be recast if it both would not be undertaken by third parties and had no business purpose. The government’s attempts to use this rule to reallocate all the income of a Swiss marketing and/or distribution subsidiary to its Canadian parent that sold uranium to it for resale to foreign customers and that assisted it in third-party transactions were (properly) rejected by Canadian courts up to the Supreme Court of Canada (SCC),

---


64. See Sec. 247(2)(b) and (d) ITA.
which refused leave to appeal the decision of the Canadian Federal Court of Appeal (CFCA) in *Cameco*.66

Instead of accepting that it was wrong in attacking *Cameco*, the Canadian government, in its Spring Budget 2021, announced that it is considering amending the transfer pricing rules. In our view, that would be uncalled for.

Here, it is interesting to note the relationship between the reference in the discussion in section 2.2.3. regarding hybrids to a 5 July 2019 Canadian Revenue Agency (CRA) notice respecting an inbound from the US hybrid transaction. This notice invoked the recasting rule in section 247(2)(b) of the ITA, the foregoing discussion in this section of the recasting rule in section 247(2)(b) in relation to the decision in *Cameco*, and the government’s Budget announcement of a consultation on Canada’s transfer pricing rules because of *Cameco*.

In the latter context, the following statement in the Budget is of note:

The Federal Court of Appeal [CFCA] decision in *Her Majesty The Queen v Cameco Corporation* has highlighted concerns with the application of Canada’s domestic transfer pricing rules. Taking into account the court’s reasoning, the government believes that, without reform, shortcomings in the current transfer pricing rules can encourage the inappropriate shifting of corporate income out of Canada, artificially reducing corporations’ taxes owed in Canada. If not addressed, this poses a risk to the integrity of Canada’s corporate income tax system. Furthermore, Canada must ensure that there is not a separate set of rules that large corporations can play by.67

The Budget 2021 announces the government’s intention to consult on Canada’s transfer pricing rules with a view to protecting the integrity of the tax system, while, at the same time, preserving Canada’s attractiveness as a destination for new investment and business activity.

In the coming months, the Department of Finance will release a consultation paper to provide stakeholders with an opportunity to comment on possible measures to improve Canada’s transfer pricing rules. The government will also take next steps to strengthen and modernize Canada’s general anti-avoidance rule, as announced in the 2020 Fall Economic Statement.

3. Tax Competition

3.1. Competition for what?

Tax competition has traditionally been understood to refer to:

- a form of regulatory competition, [that] exists when governments use reductions in fiscal burdens to encourage the inflow of productive resources or to discourage the exodus of those resources. Often, this means a governmental strategy of attracting foreign direct investment, foreign indirect investment (financial investment), and high value human resources by minimizing the overall taxation level and/or special tax preferences, creating a comparative advantage.68

Arguably, this type of tax competition, which is often associated with the pejorative notion of "race to the bottom", is currently giving way to another form of tax competition, quite opposite to this one. This "competition" is a race by governments to be first to tax every dollar of income, consumption or capital that they can legitimately claim jurisdiction over, or at least a race to the 15% rate now agreed upon by the Inclusive Framework in respect of Pillar 2.69

True, until the end of the first decade of this century, a general reduction of the rates of personal and corporate income tax was observed among many developed countries, including Canada. This perceived "race to the bottom" may have been spurred by some countries engaging in harmful tax competition by designing ring-fenced low-tax regimes that were intended to attract foreign investment while being unavailable for local parties.

The latter form of tax competition came into focus within the OECD in the late 1990s.70 In our opinion, this spelled the beginning of the end of tax competition as we knew it. With the 2007-2008 financial crisis and, now, the COVID-19 pandemic leaving governments deeply in debt, a new form of tax competition seems to be settling in – governments racing to get a tax cut. This trend is obvious in the Pillars harmonizing projects whereby source (market) countries are proposing to increase their tax take from foreign multinationals under Pillar One, while residence (headquarter) countries propose to tax back foreign undertaxed profits under Pillar Two. In parallel with the OECD Inclusive Framework activities, national governments that are eager to increase their tax receipts have been coming up with uncoordinated bespoke solutions.

In this section, we review some of these trends and consider how Canada has been reacting to them.71 Comparing what Canada has been doing to tax reforms in other countries is inherently imperfect and superficial, considering the vast complexity of tax systems. Accordingly, the following discussion in sections 3.2. to 3.5. focuses only on certain discrete factors (mostly relating to changes in tax rates) that we considered to be the most topical.


70. See, for example, OECD, Harmful Tax Competition: An Emerging Global Issue (OECD 1998).

### 3.2. Income (direct) taxes

#### 3.2.1. Personal income taxes

**3.2.1.1. Initial remarks**

OECD statistics\(^{72}\) reveal that, while generally a reduction in top personal marginal rates was observed for the period 2000 to 2020, Canada has gradually climbed up the ladder of the highest taxing countries. In 2000, Latvia was the OECD member country with the lowest top personal marginal rate of 25%, while Belgium was top of the list with 60.5%, with all OECD member countries, except for six having top rates of over 40%. Fast forward to 2020, the Czech Republic had a 15% top personal marginal rate, while Japan headed the list at 55.9%, with 12 countries having top personal rates of less than 40%.\(^{73}\)

In the United States, the TCJA reduced the US federal top personal rate from 39.8% to 37%. However, President Biden now proposes to increase this rate and, more significantly and controversially, to eliminate the favourable tax rate on long-term capital gains for wealthy taxpayers.\(^{74}\)

**3.2.1.2. How does Canada compare?**

In Canada, both the federal government and the provinces (but not municipalities) impose personal income tax. Until 2016, top combined personal income tax rates hovered slightly below 50%. After being first elected in 2015, Prime Minister Justin Trudeau’s Liberals quickly increased the top federal personal rate by four percentage points with effect from 2016. This significant tax increase and other provincial changes have resulted in top combined personal income tax rates in Canada’s most populous provinces, Ontario and Quebec, being over 53%. This has resulted in Canada moving from 13th highest taxing jurisdictions in 2000 to 6th in 2020 in the OECD statistics.

While top personal marginal rates do not tell the full story, one additional point is of interest, particularly in relation to the current tax reform debates in the United States. In Canada, capital gains realized by individuals (as well as corporations) are only half-taxed, thereby resulting in effective combined top marginal rates on capital gains in the mid-20s. For several years now, rumours have been in the offing that the governing Liberals may increase the inclusion rate of capital gains as a further move to tax the wealthy. While this has not transpired to date, if Biden’s proposal regarding the long-term capital gains rate is enacted, this may come to pass.

**3.2.2. Corporate income taxes**

**3.2.2.1. Initial remarks**

OECD statistics\(^{75}\) demonstrate that the period 2000-2021 saw a sharp decrease of corporate income tax rates. In 2000, Chile was the OECD member country with the lowest rate of 15%, while Germany was top of the list with a high rate of 51.61%, with all of the OECD member countries except for 12 having top rates of at least 30%. By comparison, in 2021, Hungary is the OECD member country with the lowest corporate income tax rate at 9%, while Portugal topped the list at 31.5%. Significantly, currently only four OECD member countries have combined corporate income rates of 30% or more.

In the United States, the TCJA reduced the US federal corporate income rate by a i.e. very significant 14 percentage points, down to 21%. However, President Biden’s plan is now to raise the rate to 28%, although negotiations with Congress may be leading towards a rate of 26.5%. A trend to possibly reverse corporate income tax rate cuts is similarly seen in the United Kingdom, where the government cancelled the planned decrease of the corporate income tax rate to 17% from 1 April 2020, by instead keeping the rate at 19%.\(^{76}\)

**3.2.2.2. How does Canada compare?**

As with personal taxation, in Canada, the corporate income tax is imposed both federally and provincially. Federally the corporate income “rack” rate is a very high 38%, which is reduced by 10% to give “room” for provincial taxation. Starting in 2000, the federal government implemented a series of rate reductions, bringing the effective federal corporate rate down from 29.12% (including the now repealed 4% surtax) to effectively 15% since 2012. The provinces add on their own corporate income tax currently at between 9% and 16%, thereby resulting in combined general corporate income rates in Canada of between 24% and 31%. Accordingly, Canada currently has a middle of the road corporate income tax rate in comparison to its fellow OECD member countries.

While no general corporate income tax changes have been announced, the Liberals’ last election platform proposes a targeted corporate income tax increase on Canada’s “largest and most profitable financial institutions”.\(^{77}\) It is unclear whether such a discriminatory measure would ever see the light of day beyond electoral posturing.

---


73. Here, it should be noted that the number of OECD member countries increased in that period.


75. See OECD, OECD Stat., supra n. 72.


77. See Liberal, supra n. 63.
3.3. Consumption taxes

3.3.1. Opening comments

OECD statistics demonstrate that current VAT rates in the OECD member countries average 19.3%. While the United States imposes no federal VAT or retail sales tax, public services are notoriously basic. By contrast, many European countries, which have welfare systems much more similar to Canada’s, have VAT rates in excess of 20%, with the Scandinavian countries having rates of around 25%.

3.3.2. How does Canada compare?

Canada imposes a federal VAT called goods and services tax (GST) at the current rate of 5%. Five participating provinces have an add-on to the federal VAT system, while Quebec operates its own independent, but largely harmonized system. The prevailing combined VAT rate in Quebec and Canada’s maritime provinces is 15%, while in Ontario it is 13% and in Alberta, Manitoba, Saskatchewan and British Columbia it is 5%, though these provinces (except Alberta) have retail sales taxes. The current Canadian VAT rates result from the highly controversial GST rate reduction from 7% to 5% implemented in 2006 by former Prime Minister Stephen Harper.

While the substantial debt incurred by Canada during the COVID-19 pandemic may reasonably justify a VAT rate increase, Canadian politicians seem to see this as electoral suicide. Nonetheless, after some initial hesitation, in late 2020, the federal government announced a base expansion of the GST to e-commerce. The 2021 Budget confirmed that, effective from 1 July 2021, non-resident vendors supplying digital products or services, distribution platform operators and all suppliers of short-term accommodation in Canada must register for the GST and/or harmonized sales tax (HST) and collect and remit GST.

3.4. Capital taxes

3.4.1. Estate taxes

In the 1970s, the Canadian federal and provincial governments repealed estate and inheritance taxes and substituted a deemed disposition at fair market value at death for income tax purposes. As such, it has historically been hard to generalize with regard to comparisons of the Canadian death tax burden to that in the United States, which has had an estate tax proper but no deemed dispositions for income tax purposes. But president Biden seems intent on making that comparison easy by adopting a Canadian-style deemed disposition without abolishing the US estate tax. Currently, it is uncertain whether Canada will emulate the United States in reverse by enacting an estate tax while keeping deemed disposition on death.

3.4.2. Wealth taxes

Canada does not have a wealth tax, unlike a limited number of European countries. While the inefficiency of wealth tax systems has been widely written about, there seems to be a growing appetite for such taxes. Based on the apparent premise that the decrease of income taxes over the past decades has allowed the wealthy to amass an “undue” level of capital that should now be clawed back. The last US presidential election saw candidates, such as Elizabeth Warren, being vocal proponents of such tax. While the debate in Canada is much more muted (and civilized), there are regular reports of interest among officials in the tax. It remains too early to tell if a wealth tax is gaining real traction in Canada.

3.5. “New” taxes

As broad-based income or consumption tax rate increases are often seen as political suicide, governments seem to have become increasingly creative in finding new sources of tax revenue with a strong focus on taxing foreign multinationals and foreign and/or wealthy individuals. For instance, the Canadian 2021 Budget proposed to introduce a tax on the retail sale of new luxury cars and personal aircraft priced at over CAD 100,000 and boats priced at over CAD 250,000, effective as of 1 January 2022. The Budget also announced a new annual 1% federal underused housing tax (UHT) that would apply on the value of non-resident, non-Canadian owned Canadian residential property considered to be vacant or underused with effect from 1 January 2022. Both seem to target foreign and/or wealthy individuals, being a politically vulnerable group.

The most significant example of the proliferation of new types of taxes is, however, a DST, targeting the giant digital multinationals, which is taking hold in many countries, famously giving rise to diplomatic tensions between France and the United States. The OECD is promoting its Pillar One work as a harmonized solution to the digitalization issue focused on by DSTs. Nevertheless, the relative simplicity of DSTs seems to have attracted many adopters. While by no means an early mover, Canada announced last year, confirmed at the time of this year’s budget and reconfirmed as recently as 8 October 2021, that it intends to implement a 3% DST “à la française”, unless a Pillar One solution is reached among the OECD Inclusive Framework in the near future. Considering the mind-boggling complexity of the proposed Pillar One system and apparent political difficulties in implementing it in the United

---

79. See G.M. Benson, N. Boidman & P.A. Glicklich, Biden Proposal Would Dramatically Alter Long-standing U.S. Gift and Estate Tax Planning for Wealthy Families, 50 Tax Mgt. Intl. J. 7, p. 352 (2 July 2021), who demonstrate that, for high net worth individuals (HNWI), the comparison may be roughly 70% or higher in the United States, compared to 26.5% in Canada.
83. See OECD supra n. 81.
States, it seems increasingly likely that Canada will have a DST, effective 1 January 2022.

4. Conclusions: Where Does Canada Stand on Tax Reform?

In this article, we have seen how the first two decades of this century saw some powerful trends in international taxation. On the one hand, we have been witnessing an increase in international tax harmonization efforts by the G20, the OECD, the European Union and the OECD Inclusive Framework mostly in reaction to international tax planning by multinationals that operate highly digitized businesses. Initially, in the 2000s, the OECD focused on tax havens and tax information exchange, with the objective of curtailing harmful tax competition and tax confidentiality and secrecy. The pace of harmonization picked up after the 2007-2008 economic crisis and in reaction to the emergence of the enormous profitability of the digital giants and their tax planning. This situation led to the advent of the OECD/G20 BEPS Project in 2013, culminating with the October 2015 Final Reports under the 15-item Action Plan. The persisting concerns with the digitalization of the economy and its effects on taxation led to the currently ongoing BEPS 2.0 project, which aims at shoring up the tax base of market countries, while still permitting residence countries to tax back the undertaxed profits of their multinationals.

On the other hand, in parallel, but very much related, to the above harmonizing trends, the first decade of this century saw significant drops in corporate income tax rates and other tax reductions among developed countries, dubbed by some as a “race to the bottom”. However, most recently, a reversal of this trend seems to be apparent, in conjunction with the Pillar Two work, with governments rushing to replenish their coffers by various conventional or extraordinary taxation methods.

It is in the foregoing context that we sought in this commentary to position the policies and responses of the government of Canada. We saw that Canada – a founding member of the G20 and the OECD – has led in certain areas, such as treaty shopping prevention, while it has been seemingly indifferent to and a cautious adopter of most other OECD prescriptions. Most recently, however, Canada seems to be succumbing under peer pressure to the BEPS harmonization objectives, most notably with the 2021 Budget announcement of the somewhat tardy implementation in Canada of Actions 2 and 4 of the OECD/G20 BEPS Project, despite the lack of any apparent need to do so. With regard to BEPS 2.0, while Canada’s eager interest in an agreement on Pillar One is to be expected, the most recent announcement of the Canadian government that it strongly supports Pillar Two is seemingly inimical to Canadian interests. Finally, in parallel to Canada’s response to these harmonizing trends, Canada has been, like many other developed economies, increasing taxes on foreign multinationals and wealthy and/or foreign individuals in the name of tax fairness.

How the aforementioned trends fully play out and whether, as Canadian financial journalist Terry Corcoran commented tongue-in-cheek, the OECD should be renamed the “Organisation of Economic Contraction and Decline”,84 remains to be seen.