International Tax Policy Directions: Some Thoughts on Recent Canadian Experience

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[N]o country today is an island, sufficient unto itself. Rather, each is a part of the whole and consequently is influenced, directly and indirectly, by what happens elsewhere. At the same time, the precise manner in which such influences are reflected in fiscal change will doubtlessly continue to depend upon a wide range of social, political, historical, and institutional factors peculiar to each country.[1]

[G]overnments will lose some autonomy in taxing powers. . . . [G]lobal economic integration has precisely this impact: governments are constrained in what they can do. Central governments in countries such as Canada . . . are thus doubly pressured on the one hand, from below to "decentralise" in response to the upsurge of regionalism . . . and on the other hand, from international competition to cut the costs of taxation and harmonise.[2]

1 Richard M. Bird, "Experience from a Century of Change," in Herbert Stein, ed., *Tax Policy in the Twenty-First Century* (New York: John Wiley & Sons, 1988), 17-32, at 23.

2 Richard M. Bird and Jack M. Mintz, "Future Developments In Tax Policy" (1994), vol. 22, no. 3 *Federal Law Review* 402-13, at 410.

Tax Policy, Tax Practice, and Contemporary Business Developments

International influences of the sort mentioned above are always in the background of tax policy and practice. Increasingly, however, their practical significance is becoming more acute and perhaps pervasive. Historically, the presence of international business in a jurisdiction was readily apparent because of, and its effects on public policy and regulatory developments in the jurisdiction were as a practical matter limited by, a variety of institutional, physical, industrial, and geographic factors that relate largely to how typical business was and generally in fact only could be conducted in relation to the jurisdiction. Consequently, to be responsive to the influence of external business factors, domestic tax policy did not have to be terribly refined. In any event, those forces tended to be most relevant at the margins of tax policy and practice and even then within regulatory paradigms that, it was perceived, were well understood. An outgrowth, or perhaps element, of business internationalization, however, is that there is often no need to be "anywhere" to access economic opportunities that originate in a jurisdiction—to have the same fundamental "economic presence" in a country as is typified by the characteristics of the business infrastructure that underlies most countries' tax rules. When business and economic exigencies threaten to emasculate the significance and utility of even the most rudimentary markers of tax jurisdiction—effectively of the way in which countries appropriate a measure of the "international tax base" to fund government—we are compelled to reconsider the depth of our understanding of international tax concepts and imperatives that perhaps have been taken for granted as adequate reflections, broadly, of how taxpayers behave. This is so not only in a "large" public policy sense, but also in practice as tax policy choices and pressures become reflected, notably in the international area, in complex legislation that incorporates not only domestic tax policy imperatives but also, implicitly, reactions to similar developments elsewhere. Uncertainty about how to make sound, insightful, and practical judgments about the interpretation and application of the tax law that affects complex transborder transactions and commercial relationships is not a surprising consequence.

The general "internationalization" of business, and more importantly the *way* it has become internationalized, has raised the stakes on the need for a country to develop a coherent international tax policy that is more or less consistent with the policy of its major trading partners. While countries presumably are not prepared to cede economic and social choices implemented with the assistance of their tax systems to the vagaries of international economic and fiscal competition, neither, as the commentators to which we refer at the outset note, can they ignore economic and tax policy choices elsewhere even if fundamentally they reflect societal choices that are not necessarily consistent or easily reconciled with their own. There is a premium accordingly on taxpayers and advisers being aware of the conceptual directions of such tax policy in order to be able to

deliver technical and perhaps more importantly strategic tax advice to international business interests to understand with the necessary insight the implicit characteristics and scope of international tax rules.

The modest goal of this commentary is to reflect broadly on a variety of contemporary tax policy developments in the Canadian setting in a way that makes their themes and possible significance more accessible to those in practice who are dealing with them and their underlying influences whether they realize it or not. These comments are offered from the vantage point of a tax practitioner who is interested in tax policy, not that of a tax policy scholar or fiscal prophet. Hence, these comments are presented with the healthy trepidation that they have failed to reflect, and indeed have oversimplified, the richness and complexity of tax policy that necessarily underlie its legislative formulations. It is hoped, nevertheless, that the personal reflections offered here will help to stimulate practical discussion of international tax developments in Canada, reaching beyond complicated, and for practitioners arcane, theoretical public finance notions that are the preserve of a few, while at the same time not being constrained in the deliberate expansiveness of these observations by specific analyses of recent legislative developments that manifest evolving international tax policy. The interesting objective here lies in identifying and collecting the threads of Canadian tax policy development with a view to enlivening debate about the evolution of Canadian tax rules in the international area.[3]

The Beginning of the Beginning

What is the watershed for increasing interest in international tax policy issues? Forces in that direction have been gaining momentum for some time, certainly

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3 For perspectives on these issues, see Jack M. Mintz, "The Future of Canadian Tax Policy or 'What the Minister of Finance Can Look Forward To,'" in Richard M. Bird, Michael J. Trebilcock, and Thomas A. Wilson, eds., *Rationality in Public Policy: Retrospect and Prospect, A Tribute to Douglas G. Hartle*, Canadian Tax Paper no. 104 (Toronto: Canadian Tax Foundation, 1999), 61-78; Jeffrey Owens, "Emerging Issues in Taxing Business in a Global Economy," in Richard Varn, ed., *Taxing International Business: Emerging Trends in APEC and OECD Economies* (Paris: Organisation for Economic Co-operation and Development, 1997), 25-66; Joseph Guttentag, ibid., 67-84; Jack M. Mintz, "Is National Tax Policy Viable in the Face of Global Competition?" (July 5, 1999), vol. 19, no. 1 *Tax Notes International* 99-107; Richard M. Bird, "A View From the North" vol. 49, no. 4 *Tax Law Review* 745-57; John F. Avery Jones, *Are Tax Treaties Necessary?* Tillinghast Lectures on International Taxation (New York: New York University School of Law, 1997); Richard M. Bird and J. Scott Wilkie, "Source vs. Residence-Based Taxation in the European Union: The Wrong Question?" Discussion Paper no. 10 (Toronto: University of Toronto, Joseph L. Rotman School of Management, International Centre for Tax Studies, 1997), as revised to be published in Sijbren Cnossen, ed., *Taxing Capital Income in the European Union: Issues and Options for Reform* (Oxford: Oxford University Press, forthcoming June 2000); Sijbren Cnossen, "Company Taxes in the European Union: Criteria and Options for Reform" (November 1996), 17 *Fiscal Studies* 67-97; and Malcolm Gammie, "Taxation Issues for the European Company" (1998) *EC Tax Review*.

from the mid-to-late 1980s. Interestingly, since 1995, however, when the Organisation for Economic Co-operation and Development (OECD) revised its transfer-pricing guidelines, the fiscal world's attention has been more and more directly focused on the reliability with which international income may be measured and associated with any particular jurisdiction using traditional tax concepts, in terms of the basis for asserting tax jurisdiction and the utility of traditional tax accounting and income allocation devices applied in respect of typical organizational units to connect income with the jurisdictions in which it arises.[4] There is increasing scepticism about the practical effectiveness of typical limits adopted by established tax regimes to assert tax claims.[5] They are perceived to have been impaired in practice by changing business patterns and the absence to any meaningful degree of what innocently is described as international tax harmonization. This same discussion now also takes place in the guise of subjects such as "harmful tax competition," "permanent establishment," jurisdictional nexus, the scope and reliability of "controlled foreign corporation" (CFC) rules, and a variety of other specific subjects, foreshadowing a continuing and increasingly intensive re-examination of fundamental income and other tax principles and practices in light of the pressure exerted on them by international commercial and business freedom commonly associated with the term "globalization."[6] Essentially, a collision is taking place between business activity exemplified by "free trade"—less and less restricted by institutional, regulatory, physical, and

4 The attention that has been paid to transactional profit methods for testing transfer prices by the OECD in *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 1995) (looseleaf) in chapter 4 reflect this. A similar development is found in the recently published transfer-pricing guidelines of Revenue Canada in *Information Circular* IC 87-2R, September 27, 1999. Article 9 of the *OECD Model Tax Convention on Income and Capital* (Paris: OECD) (looseleaf) focuses on profit or income, a net concept, and inevitably measures of pricing, whether on a transactional basis or not, are destined to test the adequacy of reported income according to the arm's-length standard.

5 The present debate surrounding the application of traditional income tax principles to electronic commerce largely concerns the seeming inadequacy of typical jurisdictional tests to adequately capture the kinds of "activity" that underlie the conduct of business electronically. Indeed, however, it may be that the modern communication medium of the Internet simply illustrates inherent weaknesses in jurisdictional tests that have long been taken for granted but were not tested too severely because of the dependence of traditional trade on physical connections to the jurisdiction in which business was conducted.

6 As Mintz succinctly notes in *Tax Notes International*, supra footnote 3, globalization connotes both factor mobility and increased integration of business activity. As the official discussions of electronic commerce published by various governments, notably the United States, Australia, and Canada (see Canada, *Electronic Commerce and Canada's Tax Administration: A Report to the Minister of National Revenue from the Minister's Advisory Committee on Electronic Commerce* (Ottawa: Revenue Canada, April 1998), at chapter 3) indicate, there is considerable concern about the adequacy of traditional income tax concepts to describe the way in which modern business is conducted, although perhaps "globalization" is too preoccupied with the medium of business rather than its implicit characteristics.

geographic constraints—and the essential "sovereignty" of tax jurisdictions, which has rested easily on constraints of the sort that traditionally have characterized the necessary business and personal connections of economic actors to jurisdictions from whose economies they profit.[7]

Canada, too, seems to be engaged in a re-examination of its "international tax policy." This may or may not be systematic or deliberate, rather than merely evolutionary, but it is occurring. There are some basic themes and patterns that, in our view, reflect significant international developments. Fundamentally, however, they are all associated with a re-examination of how the international income tax base should be shared, if it should be shared at all.[8] In fact, as the ability to define the connection of business with and in a jurisdiction becomes more difficult, fundamental questions that essentially concern why any sharing is appropriate are emerging, if only in veiled form.

The development of tax policy is generally a domestic exercise that expresses itself in the formulation of specific legislative rules to assist governments in influencing patterns of economic behaviour and to fund public expenditures. Apart from rather modest opportunities, primarily through bilateral income tax conventions, taken by countries cooperatively to organize the way in which their tax systems encounter each other, there is no systematic mechanism by which countries actively cooperate in the development of international tax policy. Accordingly, as a platform for our consideration of international tax policy developments in Canada, we consider briefly what we mean by international tax rules. We then comment on broad international developments as we perceive them, organize recent Canadian changes in this light, and then offer some observations as to what the future may hold.

A Simple Thesis: "Foreign Tax Credit" Writ Large

What does it mean to "share the international tax base"? Our thesis is simple and has three main elements. First, what commonly are referred to as "international tax rules" generally arise as a consequence of countries' needs to anticipate how freedom from physical and legal restrictions on trade across the national borders should affect what would otherwise be a jurisdiction's primary sovereign claim

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7 See Bird and Wilkie, supra footnote 3, for a discussion of issues in this area. See also H. David Rosenbloom, "What's Trade Got To Do With It?" (1994), vol. 49, no. 4 *Tax Law Review* 593-98, where Rosenbloom reflects on the connection between taxation and the funding of government in considering the unlikelihood that countries will cede "tax sovereignty." By the same token, Bird, supra footnote 3, Bird and Wilkie, supra footnote 3, and Rosenbloom address the possibility of practical solutions to the harmonization conundrum, which is reflected in an approach that could be characterized as cooperative coexistence without integration.

8 This is a question that no longer is being taken for granted. See, for example, Joint Committee on Taxation, "JCT Reports on International Taxation" (July 5, 1999), vol. 19, no. 1 *Tax Notes International* 69-98.

to tax income of its own and non-resident taxpayers from the affected activity (because of its necessarily close original connection to the country based on how income was earned and where the activity takes place), and in so doing to achieve, or preserve, various underlying fiscal and economic objectives. Accordingly, there is an inherent fundamental antithesis, but at the same time interestingly symbiotic connection, between the limits (and freedom from limits) of trade and the imperatives and exigencies of what we refer to as "international tax rules."

Second, the international tax rules and concepts that at present are commonly incorporated in the tax systems of most developed countries are profoundly innocent in relation to contemporary patterns of commercial trade and related organizational and business relationships. International tax rules, whether manifested in direct foreign tax credit regimes, the specific contractual allocations of the international tax base implemented through bilateral income tax conventions, the authority to revalue transactions framed by transfer-pricing rules, or the allocative and tax credit infrastructure that underlies CFC rules, are all devices adopted by countries, mostly unilaterally, to allocate the international tax base based on norms and expectations of trade and, more generally, international flows of capital. Essentially, these devices are intrinsic parts of a foreign tax credit regime that functions as a whole system to define and condition choices about the allocation of the international tax base. It is their function to determine the qualitative circumstances in which and the quantitative degree to which deference should be extended to the primacy of another jurisdiction's tax claim (typically referred to as the source jurisdiction's tax claim), whether by way of rate reduction, direct compensation for foreign tax, or an a priori renunciation of the inclusion of income in the domestic tax base (which is in the basic nature of foreign tax credit).[9] Heretofore, the requirement, or at least the expectation, that conducting business in relation to a jurisdiction entailed certain physical and personal connections limited the need to be very precise about the qualitative characteristics of business that, for example, tax treaty notions of "permanent establishment" and "business income" are meant broadly to reflect.[10]

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9 See Mintz in *Tax Notes International*, supra footnote 3, for his consideration of factor mobility.

10 Most jurisdictional rules are constrained by physical measures of business presence. This is common in tax treaties' definitions of "permanent establishment" and implicit in the "force of attraction" notion that treaties adopt to attribute business income to a permanent establishment. This approach is also reflected in CFC legislation; see, for example, the measure of investment business adopted in 1995 in the Income Tax Act (RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"); unless otherwise stated, statutory references in this paper are to the Act). This measure is fundamentally physical, including those aspects that measure the qualitative characteristics of business in terms of human intervention (the more than five employees test). In this connection, it will be interesting to observe the impact of electronic commerce on the utility of such tests to measure business presence even though intrinsically the relevant activity will be as much "business" as any more typically physical enterprise.

However, the commercial and institutional freedom with which trade increasingly may be conducted without regard to national borders or typical connections within or to a jurisdiction illustrates incipient weaknesses in the theoretical and practical maturity and incisiveness of established jurisdictional rules, at least as they are typically perceived.

Third, embedded, for example, within notions of "harmful tax competition," "permanent establishment," and other current topics on the international tax agenda, the international tax policy discussion at present taking place is increasingly gravitating toward addressing whether and to what extent, in a modern business environment, countries will be prepared or indeed are compelled in tax policy terms to extend foreign tax credits by any of the traditional means or at all.[11] This entails a determination whether the assertion of tax jurisdiction, let alone a relaxation of that jurisdiction, reliably and verifiably can take place in support of domestic wealth creation as a conceptual, substantive, or administrative matter. As the discussion at the conclusion of the session at which the ideas in this paper were presented suggested, it may also entail a reconsideration of the "tax mix,"[12] meaning the relative use of income, consumption, and other taxes in order to generate revenues necessary to support public expenditures and direct economic activity.

It is suggested that much of what appears to be a multifaceted international tax policy study essentially involves two basic elements: a review of countries' foreign tax credit policies and, in a manner of speaking, an evolution toward consistent international tax policy responses to a number of common tax allocation problems among countries through a "convergence" of their tax policies and rules in the direction of common international tax policy without, however, an overt or even covert harmonization of countries' tax legislation.

International Tax Rules

International tax rules are those provisions of a country's domestic tax legislation that deal with international flows of portfolio and business capital, both into

11 See Bird and Wilkie, supra footnote 3, for a discussion of the source-residence debate that is reflected in much of the contemporary discussion concerning the impact of globalization on the allocation of the international tax base.

12 See Bird and Mintz, supra footnote 2, and Mintz, supra footnote 3 in *Tax Notes International*. Inevitably, one of the responses in tax policy discussions that identify fundamental shortcomings in the capacity of the income tax rules to capture business activity and income is to consider the utility of consumption and other tax systems. Fundamentally of concern is the ability to administer the tax system by way of resident consumers being proxy tax collectors as well as the need, perhaps, to adopt new measures of how much value is absorbed or funded by citizens of a jurisdiction. Whether this approach could ever fairly displace the Haig-Simons notion of income is an interesting question. Consumption and other transactional taxes do not capture, and systemically may unfairly prefer, savers.

and out of the jurisdiction. Their essence is a consensual sharing of a finite "tax base" (that is, a zero sum game of allocating international income) among contending national claimants through the adoption, for the most part unilaterally, of allocative devices in the form of CFCs (foreign affiliates), direct foreign tax credits, and tax treaty regimes that in many respects reflect certain common international expectations and characteristics. It is trite, though not trivial, to observe that even in more or less formally developed zones of economic interest such as the European Community, there is no overt sharing of a multicountry tax base or more particularly general harmonization of countries' tax rules.[13] Nevertheless, the existence of these allocative mechanisms adopted as part of a country's tax regime reflects both a sensitivity among contending tax jurisdictions to the possible pre-eminence of another country's (in a business setting, the source country's) primary tax claim, particularly insofar as the taxation of business income is concerned, as well as the assertion of primary hegemony with respect to income that just as easily could have been earned domestically as internationally in the sense that it reflects no special economic attachment to or dependence on a source jurisdiction.

The latter distinction is closely associated with the imperfect notions of capital export, capital import, national welfare neutrality, and international equity that are the traditional foundation of discussions about jurisdictional tradeoffs in the international tax area. A tax system is said to be "export neutral" when it reflects limited institutional preferences in the degree to which income is taxed based on its source. "Capital import neutrality" prevails when there is no bias against investment in a particular jurisdiction induced by tax costs that all participants in the jurisdiction are not required to bear. "National welfare neutrality" is a notion more closely associated with intrinsic social and economic requirements of a jurisdiction that in part are funded by public expenditures generated by taxation; normally it would be asserted that any degree of credit extended by a country in relation to taxes of another would not be justifiable necessarily in terms of promoting national economic welfare. This is balanced by the recognition that countries should fairly share the international tax base

13 It is interesting to consider developments in the European Community. There is no overt harmonization of direct tax systems in the European Community even though arguments can be raised that the freedom of establishment and non-discrimination aspects of the Treaty of Rome would sustain such a development. Even so, however, the issue may not have so much to do with harmonization as with reinforcing the inherently territorial system for taxing business income by rationalizing the tax treatment of various forms of corporate distributions, avoiding the intervention in capital income flows of "free riders" in the form of tax-exempt entities or low-tax jurisdictions and reforming the integrated taxation of corporate income (which involves addressing the impact of taxation on fixed and mobile production factors). See Bird and Wilkie, supra footnote 3, and Cnossen, supra footnote 3. Gammie also considers these issues, supra footnote 3; he and Cnossen consider the significance of corporate taxation for resolving issues associated with "harmonization."

among themselves and in particular should give way to the primary claims of other countries only when there are compelling connections of income and the income-earning activity to the contender jurisdiction.[14]

The origin and continuing significance of international rules in the present setting is perhaps informed by considering conceptually the development of allocative techniques in international tax treaties.[15] Broadly, in a commercial context, international rules are the outcome of a need to avoid income tax impediments to the free flow of business capital or, to put it another way, unrestricted trade in property and services on which domestic economies and more generally open international economies depend.[16] In contemporary terms, however, the rules also reflect a kind of dialectic between traditional notions of domestic tax sovereignty and so-called free trade. As, for example, a comparison of the United Nations and OECD model tax conventions shows, tax treaties anticipate the primary tax claim of a jurisdiction that hosts foreign business enterprise and accordingly try to ensure that particular manifestations of this business reflect a suitable requisite connection in the host jurisdiction to support a tax claim commensurate with the economic opportunities enjoyed by the enterprise in the jurisdiction and the demands that it places on that jurisdiction's economic infrastructure. For example, the limited presence that may be required for a business site to constitute a permanent establishment, particularly in countries that would be disadvantaged by the ability of business enterprises from developed countries to minimize a typical business presence in the host jurisdiction, essentially constitutes a notion of presence in a jurisdiction that is basic and inherently economic from the perspective of what access to the host jurisdiction affords the non-resident in terms of exploitable economic opportunity.[17]

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14 See the discussion in chapter 6 of Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998) (herein referred to as "the Mintz committee").

15 These are primarily in the "permanent establishment" and "business income" articles of tax treaties. Underlying both is a concept of "business presence" in a jurisdiction that typically requires a degree of even temporary permanence or fixedness that justifies the assimilation of a non-resident engaged in commercial activity in a jurisdiction essentially to the same position of a resident in respect of income from that activity. Approached this way, it is not obvious that merely the manifestations of trade, rather than its inherent characteristics, have changed. This does not derogate, however, from serious enforcement issues that arise if there is not an easily taxable-identifiable presence in a jurisdiction.

16 For a discussion of recent cases that address some of these issues in a concrete way, see Joel Nitikman, "Current Tax Treaty Cases of Interest" (September 20, 1999), vol. 19, no. 12 *Tax Notes International* 1089-1109.

17 Compare article 5(3) of the *United Nations Model Double Taxation Convention Between Developed and Developing Countries*, UN Publication no. ST/ESA/102 (New York: UN, 1980) and its counterpart in article 5(3) of the OECD's model tax convention, supra footnote 4. The United Nations model assimilates a 6-month rather than a 12-month period for a site to have the status of a permanent establishment regardless of any other positive tests in the

By design and in result, there is an impetus to limit exploitation of host economies by enterprises from developed countries that are able to manipulate and control the nature of a business presence in the host jurisdiction, notably where a particular physical manifestation of the business is not very instructive of how profitable in economic terms the visiting enterprise is in that jurisdiction or, to put it more objectively, what economic benefit enures to it from the presence there.

Interestingly, these considerations may be closely identified in broad terms with contemporary questions concerning whether a less physical but just as significant economic presence, such as a regular but transient presence of a service consultant or the kind of presence that is manifest by a Web page on a server, should constitute a "permanent establishment." In a sense, the startling implications of electronic commerce for the reliable and verifiable operation of income tax rules is just an updated version of the old permanent establishment issue concerning building sites that we mention above. The concerns being expressed about the practical integrity of the jurisdiction in this context are inherently an expression of concern about avoiding exploitation of a host country—the gratuitous and in a sense selective depletion of its tax base merely because the income-generating activity can take place, the same economic presence can occur, and the same benefit be engaged without an extensive or continuous physical presence. The objective is the same—to preserve a tax claim where sufficient economic "activity" takes place where, perhaps expressed differently, there is a fundamental dependence of the profitability of an enterprise on exploiting opportunities even if the activity is relatively modest in terms of its immediate or continuing physical presence. Another way of looking at this issue is to ask where the economic "value added" is created or matures as a business outcome. Is it at physical manifestations of business in a jurisdiction, or perhaps through less evidently tangible connections (that nevertheless indirectly may sustain or advance the business regardless of their direct connection to the tested taxpayer)? These sorts of connections reflect economic viability in the sense of the economic benefit that implicitly manifests a dependence on custom originating in the jurisdiction. On the other hand, jurisdictions that persist in tax policy that is not sensitive to developments elsewhere risk compromising the economic and fiscal contributions of modern business that can, by the

article, notwithstanding the fact that other provisions dealing with dependent and independent agents would treat service professionals or consultants in themselves as constituting a permanent establishment on the basis of a 6-month aggregate presence within 12 months in a jurisdiction. In this connection, it is interesting to speculate about the evolving standards of the Canadian revenue authorities as to what constitutes a business presence. Notwithstanding an expressed reservation about their substantive significance, Revenue Canada recently published new withholding waiver guidelines with respect to the application of regulation 105, which strongly suggest that even a modest transient presence may be sufficient, in the spirit of what constitutes a permanent establishment, to constitute a taxable business presence.

absence of physical constraints, afford to be more responsive to the effects of taxation on locational decisions.

Typically, the jurisdictional markers on which the original jurisdiction and primacy of income tax systems depend are oriented around notions of "source," "residence," "carrying on business," and "permanent establishment."[18] These limiting concepts were developed and adopted when international trade was less common or at least less complicated commercially and more modest in volume as well as more tied to traditional business and legal forms. The combination of reliance by traditional business on a geographic presence, coupled with a limited volume of international business, mitigated the significance of the innocence of those rules—their need to be refined or precise, or perhaps even to be too significant a concern about administering an income tax on non-residents. These concepts persist as the principal outline of sharing the international tax base. Indeed, they merely effect an artificial though practical reliance for tax jurisdiction on the manifestations of business presence out of which their current interpretation grew, reflecting the incapacity of business generally to be conducted without a typical presence in a jurisdiction.

As more and more attention is paid to economic allocations of income to guide the determination of tax income, it is interesting to observe, though it is not often so perceived, that even in their present form the established jurisdictional compromises are inherently formulaic as a regime for allocating the international tax base. For example, in the notions of "carrying on business" and "permanent establishment" as reflected in articles 5 and 7 of a typical tax treaty is found what is essentially a three-factor formula for apportioning business profits. The permanent establishment article relies fundamentally on an identification of human and physical associations with a jurisdiction; the business profits article, through its profit attribution notion, associates revenue with those physical emanations of business.[19] This is somewhat akin, in a slightly more developed sense, to a formulaic allocation of business income not dissimilar in its fundamental respects to that found in part 4 of the Income Tax Regulations.

These considerations are important in assessing the significance of the developing international tax "order" and indeed for thinking beyond the common established connotations of present tax policy paradigms. Tax regimes are essentially

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18 See the extended discussion on these subjects in Bird and Wilkie, supra footnote 3, as well as the consideration of these and related issues in the sources to which Bird and Wilkie refer.

19 The transfer-pricing rule in the OECD model tax convention, on which the Canadian derivatives are based, speaks in terms of an income (net) notion and not in terms of transactional revenue and expenses. Arguably, in a less sophisticated commercial environment, where the degree of factor mobility and multinational corporate integration was less, there was a likely, though perhaps rough, correspondence between income and transactional revenue offset by expenses. Nevertheless, the focus is on income.

national and in a sense primarily inward-looking in policy terms notwithstanding their adoption of international aspects. Income tax regimes generate the revenue necessary to fund "public goods" (that is, collective consumption by citizens of a jurisdiction) and may be designed to direct economic behaviour to serve national objectives. Largely based on these considerations, it is commonly accepted that the harmonization of income tax systems, whether in the context of a commercial free-trading zone or otherwise, is an unlikely possibility. This would involve limitations on the manner in which domestic economic policy generally would be formed and implemented merely because of the device adapted to fund public expenditures.[20] On the other hand, even within the expectations and limitations of income tax systems, are practical accommodations to the reality of international business occurring in ways that in fact may help the existing tax models to operate notwithstanding their historical antecedents and inherent limitations?

The Thrust of Contemporary Tax Policy and the Business Income Tax Base

Notice can reasonably be taken that developed countries generally are engaged in re-examining the need and their willingness, given the impact of contemporary business practices and their ability to establish reliable connection to economic activity, to extend foreign tax credit in respect of income earned outside their borders and to limit tax claims that arise from insolvent investment. Furthermore, to the extent that there is not a close association of business income with, or a dependence of the earning capacity of business on the characteristics of, a "developed" tax jurisdiction, it would not be surprising if countries became increasingly willing effectively to renounce or limit their right to tax foreign income at all. This is reflected in Canada, among other ways, in an embryonic reconsideration of the foreign affiliate rules, developments that have taken place with respect to section 17 of the Act, modest refinement of the direct foreign tax credit rules that deal with uneconomic sources of income, and in a variety of other areas.

This reconsideration is taking place within theoretical limits established by traditional international tax neutrality notions. Fundamentally, though, it may encompass more deep-seated concerns about the adequacy of typical tax policy

20 As Bird and Wilkie, supra footnote 3, and Rosenbloom, supra footnote 7, discuss, the subsidiary principle bound up in the notion of tax sovereignty essentially concerns the entitlement of a country to make and fund public choices without being accountable to other countries for those choices through criticism or institutional limitations on tax policy. This is likely the reason that the non-discrimination article of Canada's tax treaties is generally not terribly effective in requiring Canada to provide equal tax treatment to Canadian and non-Canadian enterprises. See Richard Lewin and J. Scott Wilkie, "Canada," in *Non-Discrimination Rules in International Taxation*, proceedings of a seminar held in Florence in 1993 during the Forty-Seventh Congress of the International Fiscal Association (Deventer, the Netherlands: Kluwer, 1993).

responses to deal with difficult allocation issues that pertain to international income, coupled with the systematic attempt to define and control an increasingly fluid and independent tax base that resists confinement according to typical jurisdictional terms. In short, a much more persuasive case needs to be made in order to support the extension of foreign tax credit or limitation of tax jurisdiction in respect of income earned in relation to activity in a host country.

There are several basic tax policy imperatives that seem to influence the taxation of international business income. First, an important characteristic of business income tax regimes, concerning both branch and entity taxation, is their inherently territorial nature notwithstanding an institutional pretension generally to worldwide taxation. The "exemption" aspect of the Canadian foreign affiliate system is essentially a renunciation of tax jurisdiction by way of a blanket foreign tax credit in favour of jurisdictions where business income is earned even if the jurisdiction is not one with which Canada has a tax treaty. Similarly, the computational devices associated with calculating foreign branch income and direct foreign tax credit essentially distinguish between Canadian and foreign business income sources and associated expenses. Second, there is an underlying expectation, which is becoming more prominent in international tax policy discussions, that international trade and investment should proceed in an unrestricted fashion without undue impediments imposed by income and other taxation. This presupposes, however, an ability to identify and characterize trade flows and distinguish business from portfolio investment, which increasingly is difficult in light of the decreasing dependence of modes of business activity on traditional business presences within a jurisdiction with which traditionally the marking of tax jurisdiction has been associated. A third expectation is that income will be subjected to taxation on a "normative" basis somewhere.[21] Underlying much of the present international discussion associated with "harmful tax competition" is a realization by developed tax jurisdictions that it matters not so much which jurisdiction has the pre-eminent taxing authority as it does that the income should be taxed somewhere.[22] What "normative" means, however, is an important question: Rates and bases that are relatively approximate? Something other than tax haven status? Reasonable comprehensiveness and sophistication of tax legislation regardless of differences in the degree of taxation

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21 See the discussion in Jeffrey Owens and Jacques Sasseville, "Emerging Issues in Tax Reform," comments of two senior members of the Fiscal Affairs Directorate at the OECD, presented in India in 1997 at the Annual Congress of the International Fiscal Association, as well as Organisation for Economic Co-operation and Development, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD, 1998).

22 See Bird and Wilkie, supra footnote 3, where the authors conclude with speculation about whether much of the concern about the transience of the international tax base could be addressed by rationalizing the taxation of various manifestations of corporate distributions (that is, the deductibility of some distributions but not others) and eliminating the possibility

attributable to domestic fiscal, social, and economic priorities? Finally, there is an evident theme of "containment" associated with an expectation that eventually the "capital" benefit of international investment will inure to the sponsoring economy and that therefore any modifications in the reach of the domestic tax system are essential only to the extent that the return on the international investment exceeds the present value of the forgone tax.

Reflective of these underlying considerations are two groups of policy issues in play internationally including those in relation to the Canadian system. In a technical sense, these issues merely frame in contemporary terms fundamental questions about whether and how direct or indirect foreign tax credit should be extended and more broadly about the adequacy of the "tax mix" in terms of the suitability of and reliance on income as opposed to consumption or other forms of taxation to describe and capture the value added generated by international enterprise in relation to a particular jurisdiction.

The first is identified with initiatives directed at refining the territorial taxation of business income through attention to the permanent establishment and business profits articles of tax treaties, the scope of CFC rules, and refinements of direct foreign tax credit rules. Included here are aspects of corporate taxation generally, in particular concerning the manner in which corporate income is measured and taxed on its distribution. There is seemingly a "convergence" in the common reactions of tax jurisdictions to these international tax issues. This falls short of a harmonization of tax systems, although in practice it may reflect a similar outcome.

The second is identified with the common concern about where and how business income is earned, its characteristics, and who owns it given the attenuated relevance of and reliance on traditional business forms, traditional forms of property ownership, and typical business presences in earning income. It is necessary to reflect only momentarily on the capacity of a supplier of retail goods located outside Canada to earn business income that in rough terms depends on Canadian custom without having a Canadian business presence simply by "inviting Canadian customers to treat" and then, through traditional distribution mechanics that do not amount to a "permanent establishment," distributing the goods to Canadian customers to understand how infirm in many respects the rudimentary elements of a tax system in fact may be.[23] A related

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that international interaffilite capital income flows can be diverted into situations where no tax is payable and yet the tax base of the paying jurisdiction is depleted because of the deductibility of the charge. See the discussion in Nick Pantaleo and J. Scott Wilkie, "Taxing Foreign Business Income," in *Corporate Management Tax Conference 1998* (Toronto: Canadian Tax Foundation, 1998), 8:1-44.

23 The ineffectiveness, perhaps, of traditional income tax jurisdictional concepts to capture transient business activity conducted via the Internet has drawn attention to "outsourcing" more normative business, taking advantage, for example, of the generosity of Canada's tax

development is the increased prominence of "transactions" as taxpayers.[24] While there always has been a transactional and a personal element to the generation of income in relation to the tax base, it is increasingly evident that legal personality may be less indicative of where and how income is earned than ever before. This has a number of implications. Aside from the reliance of tax systems for jurisdictional purposes on the identification of legal personality and its characteristics in relation to jurisdictional nexus, a transactional presence is inherently more transient and not dependent in any respect on typical jurisdictional characteristics.

International Income Measurement and Allocation

We have identified several conceptual tax policy issues that are made more prominent by the demands and influences of global business. But what specific areas are being considered?

1) A main aspect of any reconsideration of the adequacy of domestic foreign tax credit principles involves evaluating the reasonable scope of foreign affiliate or CFC rules and in particular the essential characteristics of business income and the necessity of that income's being taxable somewhere in order to sustain domestic relief. This involves two main considerations: limits on the capacity to move this income among entities within the multinational corporate group from one jurisdiction to another and retrenchment in the extent to which "passive" international income escapes taxation if earned indirectly.[25]

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treaties to tolerate considerable physical and human presence in Canada without giving rise to a permanent establishment. Recognizing the reality of substantial international "free trade," the Canada-US income tax convention is perhaps the most generous in this regard. Seemingly, a US resident could have an entire distribution network in Canada and with some care avoid being considered to be carrying on business in Canada through a permanent establishment.

24 Hugh J. Ault explores this and related jurisdictional issues in "Corporate Integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices" (Spring 1992), vol. 47, no. 3 *Tax Law Review* 565-608. The notion of a transaction as a taxpayer takes on much more significance as the operation of income tax systems increasingly cannot reliably depend on the personal characteristics of taxpayers and indeed must contend with divisions of international income which increasingly must reflect underlying economic factors outside the limitations contemplated by traditional business manifestations of such economic factors. It is interesting to consider the evolving willingness of revenue authorities to acknowledge the measurement of income, in a transfer-pricing setting, using profit splits to appreciate that the focus is on economic activity—the transactions—themselves for which taxpayers may simply be a lightening rod. This is notably the case where there is no necessary relationship between the creation of value by way of an income-earning activity and the physical facilities (including taxpayers' personal characteristics) in a jurisdiction to support the income-earning activity. See also Vito Tanzi, *Taxation in an Integrating World* (Washington, DC: Brookings Institution, 1995); and Joel B. Slemrod, "Free Trade Taxation and Protectionist Taxation" (1995), 2 *International Tax and Public Finance* 471-89.

25 See, for example, the OECD's report on harmful tax competition, supra footnote 21, and the comments of OECD officials Jeffrey Owens and Jacques Sasseville, supra footnote 21.

2) Related to the first group of questions is an evaluation of the extent to which, within the confines of a territorial system for taxing business income, there ought to be direct association of deductible charges and the revenue that indirectly is earned with the benefit of those charges. Primarily, this concerns the sustainability in tax policy of domestic interest deductibility on funding raised for foreign incorporated enterprise.

3) In a very basic sense, transfer pricing reflects through the implicit allocation of tax base the same allocative considerations that are more directly implicit in the determination of when and to what extent foreign tax credit should be extended. To the extent that transfer-pricing rules associate taxable income with a jurisdiction, there is an implicit recognition of a primacy to tax that is at the core of a foreign tax credit determination as an allocative device with respect to sharing international income and the associated tax base.

In some respects indeed a transfer-pricing analysis makes these issues easier to understand than the more arcane dimensions of foreign tax credit. In the main, transfer pricing is concerned with developing a reasonable and principled correspondence between economic, and financial or tax, income with reference to the location of business activity that adds value to and within an integrated corporate enterprise. Historical notions of transfer pricing relied heavily on the implications of separate entity accounting in respect of the financial results of legal members of a corporate group—that is, traditional business forms and presence in relation to discrete transactions. Essentially, however, modern transfer-pricing law and guidelines attach less significance to lines of organizational and transactional occurrence than to the measurement of value added in relation to economic enterprise that takes place *in relation to* particular jurisdictions. Hence, there is a guarded recognition of, for example, transactional profit methods for conducting a transfer-pricing analysis.[26]

4) Another area that is attracting attention is the extent to which direct foreign tax credit should be extended in relation to activities that generate only modest income.[27] This is in a sense a version of the credit combination or homogenization issue, which other countries have dealt with in a much more prescriptive and extensive fashion.

5) The electronic commerce debate has inspired considerable analysis of when business activity is sufficient to entail the existence of a taxable presence—a "permanent establishment." Although overtly a jurisdictional issue, again the main concern is whether and to what extent a non-resident has a sufficient presence

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26 See, for example, chapter 4 of the OECD transfer-pricing guidelines, supra footnote 4, and part 3 of *Information Circular* 87-2R, supra footnote 4.

27 See the OECD's comments on harmful tax competition as well as the observations of Owens and Sasseville, supra footnote 21.

in, or economic dependence on, a jurisdiction to warrant the application of domestic tax rules to income that in some sense is generated within that jurisdiction or otherwise arises from ties with or custom originating in the jurisdiction. In foreign tax credit terms, the question is whether such a presence is sufficiently prominent in relation to that of the taxpayer in its principal tax jurisdiction to warrant the home jurisdiction's giving up the tax base to the other. Historically, the requisite connections have largely been physical, although these connections have only ever been proxies for what amounts to a formulaic allocation of income based on measurements, then current, of a degree of economic connection with the jurisdiction that more or less is the essence of a profit-making activity.

As is noted in the Canadian government's response to the issues posed by electronic commerce, much work remains to be accomplished in determining whether and to what extent traditional notions of business connection that persist as the main determinants of the basis on which Canada, or any other jurisdiction, will assert a primary jurisdiction to tax. The present debate may be likened to the discussion taking place with respect to harmful tax competition; developed tax jurisdictions have an interest in resolving these issues in a common way and more particularly in a way that, among themselves, preserves as much international tax basis as possible for normative tax jurisdictions in relation to those whose systems are either less developed or more prone to formulation to attract tax-exempt business.[28]

In summary, these areas all present fundamental considerations of foreign tax credit in the large sense and, more broadly, questions concerning the extent to which domestic tax regimes should indirectly subsidize the export of capital income. Foreign tax credit, whether delivered directly or indirectly through the manner in which foreign incorporated business income is taxed, effectively conveys an export subsidy for capital income. To the extent that a country adopts an exemption or a full (or substantial) foreign tax credit approach to recognizing the pre-eminence of a foreign tax regime, it is effectively subsidizing the export of economic activity. Ultimately, the expectation is that wealth will be created for the domestic economy as a result of this public expenditure through exertion that uniquely needs to take place outside the typical ambit of a domestic economy and its regulatory institutions. For example, the international debate about harmful tax competition concerns both deliberate schemes to alter the balance of international taxation and, interestingly, the tectonic interaction of normative tax regimes simply because of their inherent characteristics without any malevolent intentions by any country in relation to the tax rules of another. The OECD's harmful tax competition report identifies the elimination of the international tax base through rules such as subparagraph 95(2)(a)(ii) (though not by name) of the Act. That rule does not exist, of course, as a deliberate

28 See Bird and Wilkie, supra footnote 3.

attempt on the part of Canada to exploit other developed tax systems for its benefit. Nevertheless, in some instances, that rule does have the effect of facilitating the depletion of treasuries of other countries without a corresponding increase in taxation elsewhere. Similarly, the Canadian direct foreign tax credit rules historically, although in a limited fashion, have essentially permitted a foreign tax credit to be generated in relation to activities that do not produce meaningful Canadian income.

Recent Canadian Experience

How do these international tax policy influences find their way into recent Canadian experience?

1) There are embryonic indications of limitations on access to "international business tax consolidation" through the foreign affiliate regime even with respect to the taxation of foreign business income. Implicitly, a CFA, or foreign affiliate regime to a significant degree is fundamentally a foreign tax credit device. To the extent that the regime defers to the primacy of taxation by another country, it is effectively providing a domestic foreign tax credit with respect to another country's income tax subject to quantitative and qualitative limitations.[29]

2) There are initiatives to bolster the taxation of foreign portfolio income that concentrate more precisely on the distinction between "portfolio" income and income associated with income activity. Fundamentally, these proposals are targeted at containing subsidies of foreign tax or an absolute renunciation of taxation where certain offshore jurisdictions are convenient—that is, the export of capital income otherwise facilitated by a foreign tax credit regime. In tax policy terms, this is primarily a concern where there is no intrinsic dependence of the income or income-earning activity on the inherent commercial or industrial characteristic of a host jurisdiction or economic environment.

3) There is some modest attention being paid, in Canada and internationally, to the need to recognize multinational corporations' tax groups' reorganizations without generating tax on what amounts to "phantom" income or amounts that are simply distributed between entities within a multinational group through various media but do not implicitly have the requisite pedigree to constitute income of the group.

4) Specific attention is being paid, notably in the transfer-pricing area, to income-measurement principles generally and the associated jurisdictional limits by which that income is allocated among contending countries. This includes analysis of complex transactions, entailing bundled elements in order to determine their inherent economic and legal characteristics and consequently their primary jurisdictional associations.

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29 See Pantaleo and Wilkie, supra footnote 22.

At the core of these issues are the basic aspects of an inherently territorial system for taxing business income with a decided expectation that the Canadian tax base should be shared only in situations where a genuinely primary tax claim may be asserted elsewhere. Important questions concern the equivalence of direct foreign tax credit in respect of income earned by a taxpayer through a direct presence in another jurisdiction and the foreign tax credit that is available indirectly through a CFC of the foreign affiliate regime. For example, resolving how to match interest and other expenses that ultimately benefit foreign income-earning activity with the revenue generated by that activity is fundamental in determining the equivalence, or neutrality, of the tax policy to the manner in which foreign income is earned and measured.[30]

It is also interesting to observe an aspect of harmony, or coordination short of harmonization, in present developments. In international tax policy parlance, this manifests a "convergence" of tax policy development and perhaps implicitly of tax administration.[31] This does not require or even foreshadow an overt meshing of countries' income tax regimes. Essentially, a systematic international awareness of tax policy changes and concerns among countries with common interests is evident, accompanied by a natural gravitation, not necessarily in an organized or deliberate way, toward "common" responses without ceding "tax sovereignty."

In some respects, the tax sovereignty issue is the most important aspect of the present evolution of international tax policy. Countries neither wish to nor are in a position necessarily to forgo primary influence over the development of tax rules generally or international tax rules in particular. Implicitly, this would involve, if not a modification of, certainly limitations on how governments fund public expenditures and otherwise use tax systems to effect domestic social and economic policy. On the other hand, it is evident—for example, in tax policy discussions that are taking place in many countries as well as at supranational organizations such as the OECD—that developed tax regimes are contending with common responses to jurisdictional and other issues of the sort that we discuss here. This is occurring in part because the tax policy concerns and the commercial and economic influences to which they must respond are common and in part because of the perceived need to confine as much as possible the taxable income base internationally to jurisdictions with typical or normative tax regimes—in other words, to staunch the inevitable race to the bottom that is a natural outcome of competitive tax practices.

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30 See Brian J. Arnold, "The Deductibility of Interest To Earn Foreign Source Income," in *Report of the Proceedings of the Forty-Eighth Tax Conference*, 1996 Conference Report, vol. 2 (Toronto: Canadian Tax Foundation, 1997), 45:1-23, and the discussion in this regard in Pantaleo and Wilkie, supra footnote 22.

31 The notion of "convergence" is compellingly discussed by Anne Marie Slaughter in "The Real New World Order" (1996), vol. 76, no. 5 *Foreign Affairs* 183-97.

Canadian International Tax Policy Responses

Since 1995, but in a more concerted fashion since 1997, an effective refinement of Canadian international tax policy, in step with the international developments and influences of the sort that we have discussed above, has been underway. In a manner of speaking, it was begun in 1995 with changes to the foreign affiliate rules that restrict more precisely the application of the exemption aspect of that system to business income. This was accomplished essentially by codifying income that lacked a business character. In these changes were seeds of continuing refinement to more carefully deny investment income any deferral advantage or other tax preference and in addition, by implication, to restrict Canada's acknowledgement of other countries' primary tax jurisdiction to income that fundamentally has a business nature and a close intrinsic connection to such a jurisdiction. These changes, however, operated within the traditional limits of the foreign affiliate system, reinforcing the distinction between business and property income in relation to the extent to which foreign taxability of income should be recognized and at the same time the extent to which Canada should modify otherwise current taxation of the income. In 1996, changes with a similar direction were announced with respect to taxpayer migration and the nature of taxable Canadian property. Technical as those changes are, they quite directly amount to an appropriation of the international tax base according to a perception of where economic value or wealth is created; implicitly they amount to a redrawing, from Canada's perspective, of the lines upon which the international tax base conventionally has been divided.[32]

Since 1997, more comprehensive adjustments to the taxation of foreign income have been introduced. Fundamentally, these developments target the circumstances in which Canada should be prepared to renounce tax jurisdiction, even temporarily, in favour of the primary tax jurisdiction of another country. As we have tried to reflect in our earlier discussion, the contemporary tax policy debate mainly concerns the means by which this development has evolved.

1997 Developments

In September 1997, initiated by a budgetary proposal in February of that year, Canada broached the enactment of modern transfer-pricing rules in section 247 coupled with a restatement of its administrative practices in the transfer-pricing area. The legislative proposal was enacted in June 1998, and in September 1999 the revised administrative guidelines were published. Historically, transfer pricing has been associated with rather mundane examinations of the transactional pricing of transfers of goods and services. Increasingly, as important factor

32 Robert Raizenne and Angelo Nikolakakis, "Taxable Canadian Property," in 1996 Conference Report, supra footnote 30, 46:1-72.

inputs in international business enterprise become manifestations of financial capital—money and intangible property (either so-called organizational or transactional intangibles)—and as transfers lose their typical transactional characteristics either because of the intrinsic complexity—the "bundling" of implicit transfers—or because of the elusive associations to tax jurisdictions as a result of the prominence of money and intangibles in or with respect to such transfers, the old-fashioned focus on transactional pricing has been displaced by attention to its essence—namely, the allocation of international income based on where value is added within an integrated multinational enterprise. It is almost trite to observe that separate entity accounting in respect of the legal entities within a multinational organization is not necessarily instructive about where income is earned. Contemporary transfer-pricing standards, generated by the requirements of article 9 of the OECD model tax convention, indirectly attempt to apportion profit among contending tax jurisdictions albeit using analytical tools that are closely identified with transactional revenue measurement. The OECD guidelines admit that the fundamental objective of article 9 of the OECD model tax convention is the measurement and allocation of income or profit in a manner that is consistent with what would have risen in the context of unrelated party dealing. It would not have been surprising, when traditional business forms and transactions were pre-eminent, to expect a close correspondence between gross flows of revenue (and underlying expenses) and net profit. The analysis becomes murkier to the extent that intangible property and money contribute significantly to how income is earned and where it might be apportioned. The goal remains, however, to apportion profit and to justify an appropriation of the international tax base.[33]

The Canadian transfer-pricing rules purport to adopt the international standard advocated by the OECD, which, despite some analytical differences, is essentially compatible in all its fundamental respects with the transfer-pricing rules of all OECD countries including the United States. The guarded acceptance of transactional profit methods for measuring income in default of the traditional methodologies' capacity to apply in the presence of intrinsic or insidious transactional factors that inhibit "comparability" is an indication of the direction in which transfer-pricing analysis, and perhaps the tax policy more generally, must go.[34] Indeed, the Canadian guidelines seemingly reflect an expectation, in many

33 This is at the heart of trying to apply typical income measurement and apportionment concepts to the income generated by "global dealing." Leaving aside how problematic it may be to define and describe the relevant commercial and economic circumstances, the apportionment issues presented by continuous and seamless international transactions provoke the adoption of transactional profit or other global techniques to establish a reasonable and verifiable, or at least plausible, correspondence between economic and financial income in relation to a jurisdiction.

34 See *Information Circular* 87-2R, supra footnote 4.

instances, that at least a high-level profit split will be required in order to effect the analysis that the transfer-pricing rules require.

Also in 1997, although published in 1998, came the Mintz committee report. Chapter 6, which deals with international income, proceeds from a consideration of certain fundamental international tax notions associated with traditional neutrality principles. In this respect, the examination by the Mintz committee is very much in line with an analysis in this area that was recently reflected, for example, in the study by the US Joint Committee on Taxation as a precursor to a re-examination by the United States of its CFC rules.

At their core, however, the international recommendations of the Mintz committee simply reinforce the intrinsic territoriality of the system for taxing foreign incorporated international business income.[35] First, the committee recommended what amounts to the restoration of a system for taxing business income that existed before 1972: essentially to limit expenses from being deducted except in relation to the foreign business revenue to which they pertained. Hence, the committee recommended that interest not be deductible on financing undertaken by Canadian members of a multinational group in order to capitalize the business activities of foreign members of that group. This is not a radical recommendation and indeed, as we note, would restore the balance of income measurement that existed before the introduction of the foreign affiliate rules in their modern form. More to the point, the implementation of such a recommendation in the context of contemporary international tax policy discussion would effectively limit the extent to which a domestic tax system subsidizes the export of foreign capital through the foreign tax credit regime, directly or indirectly (through the interest deduction), to reinforce the allocative principle underlying foreign tax credit regimes. A renunciation of domestic taxation in favour of a foreign tax regime should occur only to the extent that the income-earning activity satisfies certain qualitative requirements and then only to the extent of the tax generated in relation to that foreign business income.

A corollary recommendation targeted the use of provisions such as subparagraphs 95(2)(a)(i) and (ii) effectively to eliminate taxation entirely of foreign business income. As we perceive the foreign affiliate rules, those provisions are dimensions of Canada's foreign tax credit regime. They acknowledge the pre-eminence of the right of tax jurisdictions in which business income-generating activities occur to tax business income regardless of the medium by which this income may be transmitted from entity to entity within a foreign

35 See Pantaleo and Wilkie, supra footnote 22, and J. Scott Wilkie, Robert Raizenne, Heather I. Kerr, and Angelo Nikolakakis, "The Foreign Affiliate System in View and Review," in *Corporate Management Tax Conference 1993* (Toronto: Canadian Tax Foundation, 1994), 2:1-72, for a consideration of the basic characteristics, conceptual underpinning, and historical development of this system.

multinational group. However, the Mintz committee recognized that there is no reasonable tax policy basis for extending the benefit of the exemption regime to foreign income—for adopting a devise that effectively subsidizes foreign taxation to the extent that as a consequence of the manner in which such income is moved within a multinational group, the international tax basis is absolutely depleted. At that point, a regime that has as its fundament the delivery of foreign tax credit loses its significance.

While these proposals inspired considerable comment by the Canadian tax community and indeed some controversy, their tax policy significance is far from untenable and is in line both with the broad objectives that underlie Canada's international tax rates and with present directions of the refinement of such rules. It is particularly interesting to consider these recommendations in light of observations by the OECD in its harmful tax competition report about the effect of rules such as this[36] and also discussion taking place in the United States about whether and in what circumstances foreign tax credit reasonably should be extended to foreign business income if that income qualitatively is not business income or otherwise is not subject to taxation somewhere.[37] This takes us back to the original premise of our observations about international tax policy developments. There is an expectation that underlies allocative decisions (and concessions) made by countries with respect to the international tax base that the base should not simply disappear as a result of how multinationals organize activities.

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36 See the report on harmful tax competition, supra footnote 21, at 15, where the OECD notes: "Harmful effects may . . . occur because of unintentional mismatches between existing tax systems, which do not involve a country deliberately exploiting the interaction of tax systems to erode the tax base of another county." Hence, the third recommendation in the report "that countries that apply the exemption method to eliminate double taxation of foreign source income consider adopting rules that would ensure that foreign income that has benefited from tax practices deemed as constituting harmful tax competition do not qualify for the application of the exemption method" (ibid., at 43). Thinking in the same general direction is found in the *Report of the Technical Committee on Business Taxation*, supra footnote 14, and it is this point broadly that Bird and Wilkie explore, supra footnote 3. In these comments is an incipient expectation that normative allocative decisions concerning the international tax base demand that income is taxed somewhere. What the normative standard of taxation is, however, is very difficult to decide. Aside from risking intrusion on the public expenditure policies of countries, it is very difficult to decide what is normative merely from a superficial analysis of the most obvious characteristics of a tax system. The equivalence of tax systems in terms of the demands that they make on countries' taxpayers requires consideration of the underlying social and economic choices that are funded and otherwise supported by the tax system and the benefit that those taxpayers enjoy from public consumption.

37 See the report of the US Joint Committee on Taxation, supra footnote 8, as well as the discussion on international competitiveness of planning involving CFCs in the United States. The considerations in play are, however, of universal interest. See Pantaleo and Wilkie, supra footnote 22, at 8:4, footnote 58, and related discussion.

The Mintz committee also identified a need for a more direct prescriptive distinction between foreign portfolio (or passive) investment income and foreign business income. It was this question to a significant degree that inspired the earlier changes in 1995 to the distinction between investment and business income that was based largely on a legislative description of what is *not* business income. The committee recommended a further review of the extent to which the Canadian tax rules should tolerate deferred taxation of investment income. Again, this is in line with the OECD and with the US developments in this area. Based on the neutrality principles that are said to underlie a decision to extend foreign tax credit to foreign incorporated business income, there is a limited basis on which to defer or forgive the taxation of foreign investment income according to where the portfolio that generates the income happens to be located. The OECD has recommended a review, in conjunction with the re-examination of the taxation of foreign business income, of the taxation of foreign portfolio income.[38] Underlying the comments of the US Joint Committee on Taxation is a similar concern. Interestingly, as we discuss below, the Canadian government has recently reacted in a parallel manner.

Canada evidently was at this juncture engaged in the first stages of a very direct re-examination of whether and in what circumstances the Canadian tax system will deliver foreign tax credit for tax actually or notionally paid in respect of investment in foreign business activities. This reflects a retrenchment, common internationally, in the extent to which, without very precise and clear guidelines, a country will be prepared to renounce tax jurisdiction or to tolerate an allocation of the international tax base in favour of another jurisdiction. In part, this may in turn reflect a lack of confidence in, or the inherent limitations of, the allocative devices found in tax treaties. More generally, it is an indication of the essential characteristics of foreign tax credit as a device applied domestically to apportion the international tax base. To the extent that the assertion of tax jurisdiction elsewhere cannot be reliably demonstrated, there is no reason to continue to apply tax base allocation devices as if patterns of business and the reliability of jurisdictional connections to income had not changed.

1998 Developments

In 1998, the minister of finance announced legislative proposals that amounted to the "filling out" of an international tax "code" in the Act. Essentially, the proposals reflect a tax policy perception that tax relief should only extend to taxable international income. This is reinforced legislatively by a distinction between treaty-protected and non-treaty-protected income of non-residents in relation to the deployment of capital in Canada and similarly the income of

38 See the OECD's report on harmful tax competition, supra footnote 21, as well as the comments of Owens and Sasseville, supra footnote 21.

Canadian residents with respect to economic activities in which they engage outside Canada.[39] These categories amount to distinctions between "high-tax" and "low-tax" income[40] and are grounded in several specific changes that essentially concern Canada's willingness to recognize and subsidize foreign tax claims. From the standpoint of inbound investment, these changes prevent the reduction of taxable non-treaty-protected income by losses or other credits or preferences associated with income that is protected by treaty. From the outbound point of view, the revised foreign tax credit rules severely limit foreign tax credit in circumstances where only modest economic income would arise to the Canadian taxpayer from the affected activity or, in certain instances, involve securities transactions from which no economic income is generated. Anti-dividend-stripping rules were implemented in respect of immigrating corporations, and a specific rule for reporting income that is nevertheless protected from taxation based on the application of a tax treaty was enacted. Perhaps, with the benefit of hindsight, the most controversial changes in this direction were the proposed amendments to section 17, on which we comment later. But, the effect of these rules in their present legislative form is to severely limit the extent to which the Canadian tax system will subsidize the "free" export of capital by loans and other indebtedness incurred by non-residents in favour of Canadian suppliers of capital.

In 1998, proposals were also advanced to refine Revenue Canada's approach to treaty-based waiver of withholding tax under regulation 105.[41] Developments in this area, which are now contained in newly announced guidelines, essentially reflect an expectation of what constitutes a "substantial business presence" in Canada in circumstances in which the affected taxpayer lacks the traditional trappings of a Canadian business presence. In light of the permanent establishment and related business presence debate now ongoing, notably with respect to electronic commerce, these guidelines take on special significance far beyond creative compliance. The substantial business notion that underlies these guidelines contemplates a limited or transient connection to Canada over a seven-year period; it hardly needs to constitute a "substantial" intervention of a non-resident

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39 See, for example, paragraph 115(1)(b.1), which is to be replaced by new paragraph 115(1)(b), which is proposed as part of the taxpayer migration package and most recently restated in Canada, Department of Finance, "Revised Legislative Proposals and Explanatory Notes on Taxpayer Migration," *Release*, no. 99-112, December 17, 1999, as well as subsections 126(4.1) to (4.4).

40 For example, the rules referred to in footnote 39 attempt to confine Canadian tax relief, either in the form of typical preferences or in the form of sponsorship of foreign tax through the foreign tax credit, to situations in which the affected income is material and effectively exposed to material taxation.

41 Revenue Canada, *Guidelines for Treaty-Based Waivers Involving Regulation 105 Withholding* (Ottawa: Revenue Canada, International Tax Directorate, November 15, 1999).

in the Canadian business future. These new guidelines, on their face, purport not to advance defirmitive or substantive conclusions about when a permanent establishment should be considered to exist. In fact, however, it is hard to deny the direction in the government's thinking that the guidelines manifest. Where taxpayers are essentially in control of what fundamentally is the transient business presence that is the activity itself, the traditional jurisdictional tests based on a distinction between "business" and "establishment" (the latter requiring the former but more in terms of some material degree of physical connection) may not be effective. The delivery of services is a case in point. Hence, the Canadian authorities implicitly assume the existence of a taxable business presence absent a formal demonstration by a non-resident to the contrary in a treaty-based return.[42]

At one level, many of these changes may be characterized as merely technical. At another more profound level, they contribute to an ongoing rethinking of Canada's view of the international tax order—a kind of protectionist circling of the wagon—consistent with tendencies elsewhere in the world. Absent compelling considerations to the contrary, there is an increasing reluctance to share tax jurisdiction except in the clearest cases and, as Canada's new migration rules provide, to capture that base at least at the point at which it "leaves."

What does this succession of changes suggest about Canada's international tax policy? There is a deliberate focus that underlies these changes on the adequacy of decisions made within the Canadian tax system with respect to the allocation of the international tax base away from Canada; whether because of the way business is conducted or because of the nature of the efficient income, there is an embryonic recognition of the need to limit the circumstances in which the Canadian tax system will subsidize the export of capital income that is not clearly and directly associated with earning business income in a normative foreign tax jurisdiction. These changes reflect specific enhancements of the direct foreign tax credit system and the manner in which non-residents will be taxed on income earned directly by engaging in Canadian commercial activities; they also reflect—for example, in the changes to section 17—an expectation of economic benefit to Canada through Canadian control of a foreign corporate group as a condition to that group's being treated as a consolidated enterprise entitled to benefit from fundamental relief for the taxation of foreign income. More generally, these changes seem to evidence a retrenchment, increasingly common internationally, from a qualitatively unstructured sharing of the international tax base in favour of a more clear and rigorous definition of the expectations that underlie such a sharing and, in international tax policy terms,

42 See subparagraph 150(1)(a)(ii). Accompanying various substantive recommendations internationally is the advice that taxpayers be required to file tax returns in which they claim the benefit of tax treaties.

the need to share such a tax base only in circumstances where business income is earned and taxed elsewhere.

1999 Developments

The tax policy developments in 1999 continued the tendencies of changes that had begun in 1997 and 1998, and indeed before in 1995. Severe limitations are proposed on the extent to which tax on income earned through investments in foreign investment funds or through foreign trusts should be deferred and otherwise limited. Essentially, the February 1999 federal budget anticipates the implementation of a comprehensive regime to capture foreign passive income, even if earned in a business context, to the extent that taxation of foreign accrual property income (FAPI) does not apply. Interestingly, the budget proposals anticipate the enactment of what is essentially a prescriptive and in some respects "rough" regime for identifying activities that are considered to have an investment quality and for measuring income that arises from them regardless how the income would otherwise be measured. What seems likely is something in the nature of a parallel FAPI regime that will be more comprehensive or less refined than the existing rules in the Act, which in many respects depend on the identification of a taxpayer's purpose and less relevantly on "control" as a determinant of when income earned through non-Canadian vehicles should be taxed on an accrual basis. With the enactment of these rules, coupled with the changes to section 17 and the continuing application of the FAPI rules, there will essentially be a comprehensive regime for taxing passive income on a current basis, recognizing only underlying foreign tax to the extent of withholding tax on amounts distributed to Canadian residents. Furthermore, strict definitional limitations will apply comprehensively to prevent investment income from being cast as business income.

While in some respects a dramatic refinement of the Canadian tax rules, these changes will essentially round out a reorganization of the Canadian foreign rules that was begun with inquiries initiated by the auditor general in 1992, parliamentary hearings in 1993, and legislative changes in 1995 that had as their main effect a more specific determination of the difference between business and investment income. The proposed foreign investment fund, foreign trust rules, and section 17 rules in a sense will implement a form of "rough justice" with respect to foreign investment income. In some respects, their integration with each other may or perhaps can be expected to be less than complete. However, the comprehensiveness in tax policy terms of the initiatives, or at least their potential effect, is clear. The Act will still recognize the primacy of foreign jurisdictions that are actually asserting tax jurisdiction to include foreign business income within their share of the international tax base. In all other circumstances, however, any association of income with a foreign, in contrast with the Canadian, tax jurisdiction essentially will be considered to be at best tenuous and not supported by normative tax policy principles that are loosely associated with tax neutrality concepts. Consequently, either by curtailing the extent to which foreign tax

credit will be extended or by limiting the entitlement of other countries, based on Canadian domestic rules, to share the international income tax base, Canada is refining its view concerning the obligation to extend foreign tax credit.

Some General Comments

In this discussion, we can usefully focus on the interest deductibility rules, "consolidation" rules in subsection 95(2), and changes to section 17 as indicative of the direction of these changes. It is easy to become lost in the detail of each of these areas and as a consequence to lose sight of their thrust. They all reflect more systematic attention to territorial income measurement for foreign business income in keeping with international concern about differential tax treatment of different forms of corporate distributions. In the latter respect, they may implicitly also reflect the underlying puzzlement about why various forms of distributing corporate revenue (or income) should be deductible, particularly where that distinction has the effect of permanently eroding the international tax base. This observation, which most closely concerns subsection 95(2), mirrors the development of a theory that underlies the effective consolidation rules in section 95, which can best be encapsulated by a notion of the "Canadian cone." The Canadian cone essentially describes foreign enterprise directly or indirectly owned by Canadians. It also describes a Canadian view of its proper share of international income and tax base ultimately owned by Canadians in relation to the legitimacy of competing tax claims of other countries. It has been the longstanding position of Canadian finance authorities that foreign incorporated business income owned by Canadian enterprises can and should benefit from the exemption aspect of the foreign affiliate rules but that those rules arguably should not extend to business income of others that by the terms of subparagraph 95(2)(a)(ii) is effectively transformed into business income of foreign affiliates of Canadian taxpayers.[43] A sentiment of this nature underlies important recommendations of the OECD with respect to harmful tax competition.

The changes to section 17 initiated in the 1998 federal budget and developed in various legislative proposals throughout 1998 and 1999 reinforce the notion of the Canadian cone and indirectly effect changes in the way in which subparagraph 95(2)(a)(ii) will apply.[44] In broad terms, the changes to section 17 effect what amounts to a parallel FAPI regime in the context of a rule that seeks to ensure that Canadian enterprises do not effectively direct income from the exploitation of their resources to persons outside Canada, at least without earning an adequate return from and commensurate with the deployment of those

43 See the discussion in Pantaleo and Wilkie, supra footnote 22, with reference to the *Report of the Technical Committee on Business Taxation*, supra footnote 14.

44 See the comments of Evelyn P. Moskowitz concerning section 17 of the Act in "Financing of Non-Residents and the Recent Amendments to Section 17," which is included in this volume.

resources that Canada taxes. Leaving aside for the moment the fact that the changes to section 17 are not integrated very well with the primary FAPI regime, subsections 17(2) and (3) and their supporting rules entrench the tax policy associated with the Canadian cone and indirectly confine the effective application of subsection 95(2) to multinational corporate groups that are owned entirely by Canadian residents or at least in which Canadian residents have significant economic and legal interests. The inherent significance of section 17 in this regard is indirectly to implement the Mintz committee recommendations with respect to the extent to which foreign business income can benefit from an exempt classification when earned and distributed in circumstances that do not reflect fundamental Canadian ownership.

More generally, in light of the tax policy principles discussed here, this change will effectively ensure that Canadian foreign tax credit effected by way of the exemption aspect of the foreign affiliate system will be available only to the extent that the import and national neutrality principles grounding tax policy development in the foreign area may ultimately generate wealth in Canada. In particular, the expectation that the equity of foreign incorporated groups is controlled by Canadians has the effect of ensuring an economic correspondence between forgoing present tax with respect to foreign business income, even if distributed within the foreign group through the medium of investment income devices, and the ultimate value to the Canadian economy of competing internationally in a meaningful way to earn business income.

Also in 1999 the enactment of changes to the Act to facilitate the financial business being conducted by foreign banks in branch form was announced. Essentially, these proposals will permit Canadian subsidiaries of foreign financial institutions to transform themselves into branches without incurring the tax liability that would typically be associated with the liquidation of an incorporated business and its reconstitution in branch form.[45] On an ongoing basis, these branches will essentially be permitted to compute their income on a formulaic basis with the benefit, among other things, of a deduction for notional funding costs associated with financing the Canadian business. The financial regulatory imperative that underlies these changes may have marked the accompanying tax policy developments, perhaps beyond where they would otherwise have been taken.[46] This development is interesting in light of the transfer-pricing

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45 See Canada, Department of Finance, "Backgrounder on Foreign Bank Entry Bill," *Release*, no. 99-016, February 11, 1999; "Authorized Foreign Banks: Income Tax Rules," *Release*, no. 99-015, February 11, 1999; and "Changes Proposed to Tax Rules Relating to the Conversion of Foreign Bank Subsidiaries into Foreign Branches," *Release*, no. 99-044, May 11, 1999.

46 The Department of Finance has observed publicly that these initiatives are confined to the banking industry. Yet, one can reasonably ask, in principle, why a similar approach should not apply in other sectors, focusing on the implications that underlie these proposed changes for

considerations and other income measurement issues generally in play internationally. These changes effectively will implement a formulaic system for measuring and taxing income of foreign financial institutions in relation to Canada; in so doing, they implicitly reflect a departure from the significance of organizational form as both an income measurement device and, necessarily, an institutional indicator of where income is earned. They also contain an implicit denial of the ultimate significance of organizational form for measuring not only income but also the connection of an income-earning activity to a jurisdiction. The new rules will facilitate the transformation of an incorporated taxpayer to a branch without any of the consequences normally attendant on liquidation and at the same time preserve the activity's tax characteristics as continuing characteristics of the branch. In this change are the seeds not only of taxation based on a prescriptive or brightline allocation of economic income but also of a practical recognition that business factors, at least in certain industries, so lack intrinsic geographic connections that a more economic construction of a share of the international tax base simply is inevitable.

Canadian Tax Policy Directions

It is interesting to consider whether these various developments are harbingers generally of Canada's tax policy future by design or practical imperative. Viewed from a tax policy perspective, all of these changes implement or foreshadow limitations on or refinements of the extent to which "credit," both in technical and in tax policy terms, will be extended in relation to the tax on income in which Canadian enterprises have no meaningful interest, where there is no unique association of (investment) income with a foreign jurisdiction or there is no expectation necessarily that foreign tax will have been paid. Although situations can be identified in which the imperfections of the changes to section 17 evidently impede Canadian business interests, the scope provided for Canadian business enterprise in subsections 17(3) and (8) in particular will essentially leave the foreign affiliate regime unscathed in relation to its delivery of foreign tax credit via tax exemption for foreign incorporated Canadian-owned business activities. On the other hand, to the extent that the Canadian system would otherwise effectively subsidize through unlimited foreign tax credit the earning of income, business or otherwise, by others that are not generally taxable in relation to Canada, the Canadian tax basis will be preserved.[47]

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the contemporary significance of organizational form and financial accounting as determinants of where and by whom business income necessarily is earned.

47 Refinements not only of the system for taxing portfolio income but also of the consolidation rules in section 95, which deals with the taxation of foreign business income, would not be surprising to achieve the objective that only business income that is taxable elsewhere should benefit from what amounts to a full foreign tax credit via the exemption aspect of the foreign affiliate system.

The 1999 budget proposals concerning the taxation of income from foreign investment funds suggest the eventual assimilation to an investment character of the ownership of all forms of investment property. As a consequence, there will in many instances be the implication that a direct or indirect ownership of an interest in this property necessarily will produce investment fund income, taxable on the basis of Canadian principles and practices either directly in relation to the actual underlying foreign income or indirectly through default to a mark-to-market regime. The changes in this area reflect both a basic intolerance for the depletion of the domestic tax base by technical devices to earn passive income outside Canada and, in the context of the thesis of this paper, a determination to limit circumstances in which the taxation of foreign investment income should be deferred or eliminated. Theoretically, there is no principled tax policy basis for preferring the taxation of foreign investment income by another jurisdiction. Current international debate clearly focuses on this as a necessary element of curbing harmful tax competition and on a more technical basis for dealing with international capital mobility. In this regard then, the Canadian tax rules are developing consistently with those in other jurisdictions. Implicitly, changes in this area manifest a prescriptive retrenchment in favour exclusively of domestic taxation of foreign income without drawing subtle or perhaps irrelevant distinctions based on how or by whom this income is earned if ultimately the owner of the income is a Canadian resident. Again, this can be appreciated as a reinforcement of Canada's foreign tax credit regime as an allocative device in relation to the international tax base.

As has been discussed, the notion of "business presence" is another fundamental focus of the international tax debate in various respects. The traditional characteristics of business presence for tax purposes were developed essentially to preserve source taxation of income that originates, in economic terms, in the jurisdiction. These are essentially proxies for business presence, in respect of which there are common manifestations compelled by the nature of business activity.[48] Indeed, when developed, the historical notions of business presence arguably would have been equally compatible to the same ultimate effect with an economic, commercial, or financial analysis; the modes of conducting business would have enforced a consistency or even a synthesis of these concepts as ways of perceiving business connection. A corollary, however, is the need to avoid unreasonable impediments to the movement of property and people in the conduct of international business activity. Generally, there is an expectation that

48 If appreciated this way, there is perhaps more hope for their continuing utility albeit with new connotations. If the focus is on "business presence," then the nature of concepts such as "permanent" and "fixed" and the significance of human intervention may be more malleable as jurisdictional markers than is commonly thought by focusing primarily on the medium of modern business communication and its capacity to facilitate taxation's becoming, if not elective, highly selective at the discretion of taxpayers.

a traditional, physical business presence is required in order to sustain Canadian taxation of business income (and similarly in relation to the business activities of Canadians elsewhere). In particular, the presence in Canada of executive or managerial activities, certain physical activities associated with the advertising of the availability of property and services and the delivery of goods, and indeed even the presence of representatives may not in themselves give rise to a taxable business presence.

Yet in the face of highly mobile business factors and the prominence of financial and intangible factors of production, there seems to be a re-examination of the adequacy of these limitations and importantly the economic tradeoffs that they enshrine. It is interesting to consider whether the new administrative guidelines under regulation 105 foreshadow or reflect changing tax policy as to the nature of permanent establishment and fixed base and therefore changes in Canada's views on the allocation of the international tax base. Leaving aside whether the legal positions underlying the guidelines are sustainable, about which some doubt is justified, the guidelines essentially are protective in nature and reflect practical difficulties in associating certain business activities with the Canadian tax jurisdiction. Indeed, the Canadian presence required to justify a denial of a withholding waiver—that is, the implied qualities of "*substantial*"—may be at best modest, merely "as much presence as needed" to conduct the affected commercial activity.[49] The changes are interesting insofar as they reflect an acknowledgement of the inadequacy of traditional jurisdictional devices to measure, or at least capture in the first instance, the allocation of the international tax base.

Canada's restatement of its transfer-pricing rules reinforces the essence of transfer pricing as a system of analysis to establish and document a reasonable correspondence between economic income of an integrated enterprise that is allocable in relation to Canada on the one hand and entity-based financial or tax income measured in a traditional way. Transfer-pricing rules can be viewed as a particular manifestation of the jurisdictional issue that is also common to CFC and foreign tax credit regimes. Essentially, of concern in all these areas is the development of a modern or sophisticated economic force of attraction rule that also reflects in large measure a degree of international consensus subsumed in the "convergence" notion about how to attribute income to competing national claimants. We hasten to observe, particularly in light of contemporary developments elsewhere in Canadian tax law, that this is not some loose assertion of taxation on the basis of economic reality, although necessarily it is hard to imagine an income tax regime not paying attention to this share. However, it is

49 It is unclear whether these guidelines are necessarily consistent with the expectations that underlie the permanent establishment article of the OECD model tax convention or indeed evolving Canadian law on this subject.

essential in the design and application of income tax rules that there be basic, reliable indicators of the circumstances in which a jurisdiction may assert tax jurisdiction and then preserve it in light of competing claims of other jurisdictions in respect of which the relevant activity has some nexus. Inevitably, this brings into play more directly some notion of "force of attraction," which establishes the pre-eminence of the tax jurisdiction of one jurisdiction in relation to its competitors.[50]

A similar impetus seems to underlie the government's initiative in relation to electronic commerce. Extensive recommendations in the income and commodity tax areas were made in 1998 essentially with respect to the reliability of the jurisdictional characteristics of the Canadian tax system, both in a large conceptual sense from an income tax point of view and in reference to the reliable identification of transactional characteristics from a commodity tax perspective. While enraptured in some respects by the modern medium of business subsumed in the notion of electronic business, from a tax point of view electronic commerce essentially concerns two issues: the character of business income and adequate compliance mechanisms to ensure that income closely associated with the Canadian tax jurisdiction (or perhaps more closely associated than or as closely associated as others) remains within the Canadian tax base. The latter is perhaps the more important and difficult factor. These issues ultimately concern a re-examination of the notions of carrying on business (which affects modern determinations of the source of income) and the association of income with a jurisdiction based on reliable jurisdictional markers.

Some Concluding Observations

Our objective here has been to sort through various international tax policy trends as they seem to be reflected in issues that are emerging for consideration in Canada. Against the expectations that we stated at the outset and relying on the developments that have in fact occurred in Canada over the last several years, we have a number of observations or predictions that seemingly are in the process already of emerging in the Canadian tax system.

The possibility of departures from qualitative jurisdictional rules in favour of brightline tests for measuring income and effectively attributing it to particular jurisdictions can be foreseen and is perhaps more real. This has both substantive and compliance aspects and could include collecting tax according to a "backup

50 In paragraph 5 of *Information Circular* 87-2R, supra footnote 4, this notion is reflected in Revenue Canada's willingness to consider the application of transfer-pricing principles to the measurement of branch income largely, we would suggest, on the basis that the effect and purpose of branch income computation rules, including those reflected in the business profits article of Canada's tax treaties, is to achieve a measurable degree of correspondence between economic and financial income.

withholding and information reporting" regime that essentially would be an extension of regulations 105 and 805.[51] This is already evident, to our minds, in the attention that is being paid to foreign investment fund rules and transfer-pricing guidelines, for example, but extends beyond this even more subtly to the indications evident from the administered developments in Canada about notions of permanent establishment and fixed base.[52]

This is, of course, a controversial observation. The OECD guidelines and Canada's transfer-pricing practice as reflected in *Information Circular* 87-2R, among others, recite the typical aversion of tax jurisdictions to anything approaching a formulaic measurement or allocation of income. On the other hand, as we observed above, implicit in the notions of "permanent establishment" and "business income" contained in a typical bilateral income tax convention are the seeds of a three-factor formulation for allocating income based on traditional business presences, and the new foreign bank branch proposals are inherently formulaic. While the treaty notions mirrored by these concepts typically would not be analyzed in this way, implicitly, given at least the functions of bilateral tax treaties and the manner in which business presence and attributed income are gauged, this in fact is what is happening.

In a Canadian context, it is interesting to test this prediction by considering the genesis of part IV of the Income Tax Regulations particularly because those allocation rules deal with fluid or transient forms of business or at least transactions that are continuous without typical business connections in any of the provinces. For example, the allocative rules with respect to financial institutions, bus and truck operators, railways, airlines, and others all reflect, presumably, a historical impatience and ultimate frustration with the typical qualitative rules that otherwise apply to most forms of business for the allocation of income among the Canadian provinces—an international tax system in microcosm. Indeed, at the conclusion of the presentation of this paper, the other panel members engaged with us in an interesting discussion about the adequacy of income and commodity tax regimes generally as effective mechanisms, in the tax policy sense, to fund government expenditures. In the main, considerable

51 While a considerable amount of the jurisdictional debate centres on substantive tax concepts, ultimately the tax system needs to be enforceable. If the nexus of the income earners with the taxing jurisdiction is not dependable, perhaps the consumers (in the broadest sense) and their intermediaries (financial or otherwise) will have to fill a tax administration function. This situation is not dissimilar to the enforcement characteristics of consumption and sales, and withholding taxes. One of the attractive features of consumption taxation to deal with some of these perceived jurisdictional shortcomings of income taxation is the enforcement mechanism that involves residents.

52 See the CCRA's new guidelines on waiver of withholding under regulation 105, supra footnote 41.

skepticism was advanced about the adequacy of traditional income tax concepts even if modified to adequately deal with the measurement of international income in respect of any tax jurisdiction's claim to tax. Even then, given the transience of international business and its lack of dependence in important respects on traditional jurisdictional connections, it is increasingly evident that there may be problems associated with actually administering an income tax or even a commodity tax system. In a sense, this is a dangling observation because we, no better than others, can lay claim to a solution for this problem except to note the common interest internationally of tax jurisdictions in re-evaluations of foreign tax credit, which in a sense amounts to a retrenchment in favour of domestic taxation absent compelling reasons to cede taxation in favour of another jurisdiction coupled with the convergence of normative tax jurisdictions' responses to common issues.

We also foresee a general tendency among countries, including Canada, to attempt to retain control over the tax base via a more thoroughgoing "worldwide" tax base model in the absence of clear and precise associations of income and income-earning activity with normative tax jurisdictions in relation to which a meaningful level of taxation can be expected. This tendency is reflected in the recommendations of the Mintz committee, the consequences of the changes to section 17, and the enactment of modifications to section 115 with respect to treaty-protected income, and section 126 with respect to limitations on foreign tax credit in relation to the earning of only modest amounts of income. Another example of this retrenchment is the new "departure tax" regime that was implemented by the changes to section 128.1.[53] These changes conceptually seem to contradict typical expectations for the allocation of international tax bases with respect to unrealized income and can only be explained, in a tax policy sense, by a need to assimilate a portion of the international tax base that historically would have been shared with or ceded to other jurisdictions depending on the sustainability and primacy of the claims of other jurisdictions. The indication, at least for the time being, that Canada is prepared to provide a form of foreign tax credit with respect to foreign tax ultimately levied in relation to income that arises from the sale of property subject to the departure tax charge validates our thesis that countries such as Canada are tending in favour of asserting comprehensive tax jurisdiction and only renouncing it to the extent that in line with domestic tax policy determinations, income is actually taxed elsewhere, and a primary tax claim of another jurisdiction can be established in a manner consistent with domestic tax principles.

It is difficult to predict how international tax policy developments will unfold, but, in light of what clearly seems to be taking place, we should not be surprised

53 See supra footnote 32.

if they entailed several principal characteristics. It is unlikely that in the foreseeable future there will be any measurable degree of income tax harmonization or comprehensive tax reform that would effectively redefine the main elements of international tax regimes to address some of the factors that we see embryonically in evolving tax policy. In that connection, therefore, countries have a number of choices to make. In addition to persevering with refinements of the kinds of tax rules that we have discussed in relation to Canada, we anticipate more general attention being paid to limiting the effects of business income taxation on trading relationships that occur within the context of "normative" taxation somewhere.[54] In addition to more precise constraints on the distinctions between other income and business income and ways to describe the association of business income with a jurisdiction based on its dependence on custom within the jurisdiction, we anticipate an increased focus, even if for expedient reasons, on several basic structural considerations.

The *economic* transactions of the main *economic* actors in defined "economic zones" of interest could be targeted effectively to treat corporate groups more as economic entities despite the legal separateness of their components and the sovereignty of regulatory regimes generally in respect of those components. This would contribute to the establishment of a more systematically harmonious interaction of "freer trading" generally and tax rules that affect the main aspects of that trade. At the same time, this would recognize a practical attractiveness of targeting international tax refinements to a relatively small class of taxpayers whose commercial dealings are prominent in terms of their transactional scope and volume and other economic events that concern the tax system. As experience in the European Community reflects, this would contribute to ensuring that income that has not been realized in an economic sense (for example, that would otherwise arise from dispositions of property in the course of internal group reorganizations or that reflects distributions between entities within a "control group") does not give rise to taxation until these amounts are actually realized in relation to transactions with third parties or are actually distributed outside the corporate group. There is some indirect implicit sensitivity in the Canadian rules to this reflected, for example, in recent changes to subsections 85.1(5) and (6) and 87(8) and (8.1), which essentially broaden the circumstances in which "foreign mergers" and like business combinations may be accomplished on a

54 As we note, this is a difficult notion. In a sense, there is no such thing as normative taxation. There are normative tax rules, as distinguished from rules with a tax expenditure character. But that is not the thrust of comments such as this. The assurance sought is that income is taxable on a meaningful basis. This is what feeds the implicit international bargain underlying so-called international tax rules that a renunciation of jurisdiction in certain cases is justified. It is not justified if the crediting jurisdiction is effectively forgiving tax, and otherwise it can demonstrate a sustainable connection to the taxpayer or the income that the taxpayer earns.

tax-deferred basis for Canadian shareholders as well as in the rules proposed to facilitate the transformation of Canadian bank subsidiaries of foreign banks to branches. One wonders whether taking into account indications of a more economic measurement of income, other changes in this regard would be helpful.

The possibility that distinctions in the tax treatment of various forms of corporate distributions may be limited is also anticipated.[55] This is most directly associated with the tax treatment of deductible charges such as interest and possibly others such as rent and royalties. It also encompasses, however, the integration of corporate- and shareholder-level taxation. Finally, as is reflected, for example, in the international discussion of harmful tax competition, we foresee attention being paid to "free riding" or more specifically the intervention in capital flows of "tax-exempt" persons or nationals of tax-preferred regimes.

In a certain sense, refinements of the sharing of the international tax base present fewer difficult issues insofar as there is expectation of material taxation somewhere. However, when income within the international tax base is effectively depleted by the diversion of what would otherwise be taxable income to jurisdictions in which no tax applies, the assumptions underlying the sharing of international income, which are fundamentally foreign tax credit notions, dissipate. In a sense, this encapsulates our thesis that international tax developments generally are focused on the re-examination of providing foreign tax credit, whether by way of exemption, deferral, or computed credit, without meaningful underlying tax.

This leads us to question the practical viability of an income tax as a taxation regime. On a broader examination, taking into account the discussion that took place at the conclusion of the panel that included our paper, there may be substantial doubt about the adequacy of any income tax regime to accurately, adequately, and reliably capture the tax base. Refinements to devices for measuring business income and associating it with particular enterprises and the activities of enterprises within a jurisdiction may not be very fruitful to the extent that those activities are difficult to describe or define in relation to the jurisdiction, given the increasing mobility of productive factors. The ultimate goal of defining a tax base is to determine a meaningful correspondence between economic and financial income in relation to a jurisdiction. This is at the core of many of the recent tax changes much more directly than may have appeared to be the case with respect to former tax rules. Tax systems necessarily seem to be tending, in the guise of more comprehensive worldwide taxation and less generosity by way of foreign tax credit, in the direction of implicitly acknowledging the need to consider alternative tax bases that measure and make

55 See Bird and Wilkie, supra footnote 3, and Cnossen, supra footnote 3.

claims against economic entitlement with more assurance and control, in part assisted by a systematic adoption of common tax policies and greater cooperation among revenue authorities in evaluating and enforcing them.[56]

56 This could include, as our session concluded, some form of consumption-based taxation. However, developments in this area raise issues at the very foundation of income taxation and the nature of income. How such a system should be structured and various fairness issues resolved, how a rate structure would be developed, and more generally how associated costs and expenses underlying the generation of consumed value would be adequately taken into account are serious imponderables. On the other hand, perhaps such a regime would at the very least help to ensure that the value added/value earned of enterprises whose financial welfare depends on economic activity within a jurisdiction is exposed to taxation by way of the payments made by consumers.