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• STRUCTURE OF TAX TREATIES •

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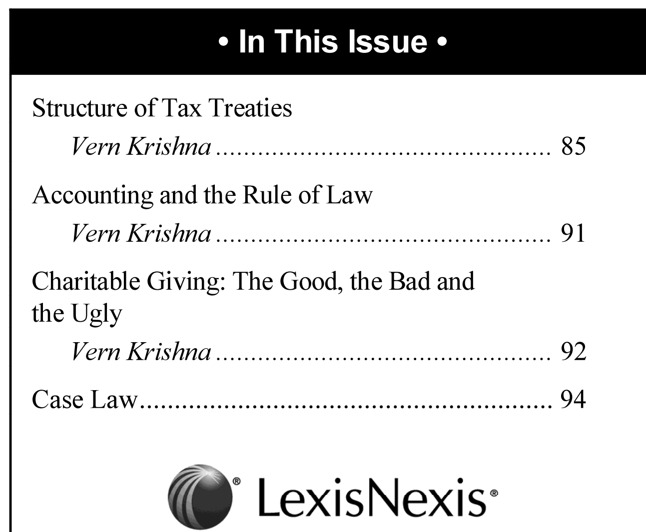
It is well-accepted law that sovereign states do not enforce the revenue laws of foreign countries. There is no universal jurisdiction in tax law. Thus, Canada neither enforces foreign revenue laws nor should it expect foreign jurisdictions to enforce its taxing statutes.[1] This rule, which has ancient antecedents that may not be entirely appropriate in the 21st century, creates problems in modern global economies. Multinational Enterprises ("MNEs") are now the norm in business.



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Hence, we need a mechanism to ameliorate the frictions that can arise from the interaction of different tax systems. Typically, such frictions arise in the form of double taxation, double non-taxation of income, tax avoidance, and tax evasion. *Income Tax Treaty* and *Tax Information Exchange Treaty* attempt to address these problems, but only with limited success, through various dispute resolution processes such as mutual agreement procedures, arbitration, and exchanges of information.

Compared to European countries, Canada was relatively slow in getting into tax treaties, although once off the mark, it became active in negotiating such treaties. Understandably, given the trading and economic relationship between Canada and the United States, the *Canada-U.S. Tax Convention* ("*Canada-U.S. Treaty*") is our most significant and complex treaty. However, Canada has tax treaties with most developed, and some developing, countries. The structure of each treaty depends upon the model used (OCED, UN or U.S.) to negotiate each treaty.

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Double Taxation of Income

Double taxation of income is the greatest threat to MNEs and individuals engaged in international business. Double non-taxation of income is the greatest threat to federal treasuries. Double taxation is the imposition of comparable taxes in two states on the same taxpayer in respect of the same subject matter and for identical periods. Double taxation commonly arises because countries may assert taxing jurisdiction on the basis of different criteria. For example, countries can tax such income based upon source of the income, situs of the property that gives rise to the income, residence of the taxpayer who receives the income, or the taxpayer's nationality or citizenship.

We refer to multiple tax claims as "juridical double taxation."

Example

Assume that Hank Jones (a U.S. citizen), an entertainer, is a resident of England and a non-resident of Canada. He performs in Canada for FC, a foreign corporation incorporated and resident in England. Jones is paid $100,000 for his performances from a bank account maintained in England. Jones could potentially be liable for tax in three countries: for Canadian income tax as a non-resident if he is considered to be "employed in Canada," for tax in England on the basis of his residence in that country, and in the U.S. on the basis of his citizenship. Tax treaties attempt to resolve such difficulties.

To be sure, a country can always unilaterally relieve against double taxation of international income through its domestic tax rules. For example, a country can provide tax relief through a deduction for foreign taxes paid, an exemption of foreign source income,[2] a credit for foreign taxes,[3] or restricted taxation of income on certain forms of income.

There is, however, a financial limit to the amount of unilateral relief that a country can provide. Foreign tax credits, deductions, and exemptions involve a loss of revenue to the granting country by diminishing their taxable base.

Unilateral solutions also have other economic implications. The exemption method, for example, is non-neutral if the income derives from a country that is a tax haven. Similarly, credits create problems with the principle of capital export neutrality. The generally accepted criterion for tax neutrality is capital-export neutrality—that is, the taxation of foreign and domestic profits at the same total rate. Capital-export neutrality results in the most efficient international allocation of capital resources in a manner that maximizes world production. It is also considered to be an "equitable" principle because taxpayers with the same worldwide income pay the same total amount of total tax. Thus, capital export neutrality reflects the principle that a dollar is a dollar no matter where it is earned.

For example, if the Royal Bank of Canada is taxed at 45 per cent on its Canadian profits, and its U.K. subsidiary pays 25 per cent tax to the British government, Canada would have capital-export neutrality if the Canadian government levied a net tax of only 20 per cent on the bank's U.K. profits. In this scenario, the Canadian corporation and its foreign subsidiary would be taxable on the same basis, regardless of where it earned its income.

There are two types of tax credits: (1) a direct credit for all taxes paid on the foreign income remitted to the home country or (2) an indirect

credit for the foreign enterprise's underlying foreign tax ("UFT"). Indirect credits usually take the form of tax relief for the foreign enterprise's taxes paid in another country.[4]

The following is an example of a direct tax credit. Assume that a domestic parent company with a foreign operation earns income and pays tax as follows:

Example 1

	Domestic	Foreign	Total
Income	$400,000	$600,000	$1,000,000
Tax rates (assumed)	35%	30%	
Foreign tax		$180,000	
Domestic tax WWI	$350,000		
Foreign tax credit	$180,000		
Net domestic tax	$170,000		
Total tax			$350,000

Example 2

	Domestic	Foreign	Total
Income	$400,000	$600,000	$1,000,000
Tax rates	35%	50%	
Foreign tax		$300,000	
Domestic tax WWI	$350,000		
Foreign tax credit	$210,000		
Net domestic tax	$140,000		
Total tax			$440,000
Additional tax			$90,000

In the above examples, the home country has two choices: it can provide an unlimited tax credit for the full amount of foreign taxes paid or it can limit the foreign tax credit to a maximum of the domestic tax rate applicable on such income.

In Example 2, by limiting the foreign tax credit to the maximum domestic rate of 35 per cent, the taxpayer pays an additional tax of 15 per cent x $600,000 = $90,000. Thus, the limitation on the tax credit violates the principle of capital export neutrality. However, the limitation of 35 per cent preserves the domestic tax base. Any higher rate would, in effect, subsidize the foreign country's tax base.

Indirect taxes paid by foreign subsidiaries of domestic corporations also create problems if there is no relief for the underlying foreign tax paid by the subsidiary.

Example 3

Assume two situations:

(a) Company A pays direct tax on its corporate profits at a rate of 50 per cent.

(b) Company B pays no direct taxes but pays indirect taxes of an equal amount.

Both companies distribute their after-tax income to their respective parent companies, which are resident in a country that levies tax at a rate of 35 per cent on dividends.

	Company A	Company B
Revenues	$1,000	$1,000
Costs (incl. indirect taxes)	800	900
Net income before tax	$200	$100
Direct corporate tax	100	0
Net income after tax	$100	$100
Parent Companies:		
Dividend received	$100	$100
Gross-up for UFT	100	0
	$200	$100
Corporate tax @ 35 per cent	$70	$35
Less relief for UFT at lesser of two rates	70	0
Net additional tax	$0	$35
Net cash available after tax	$100	$65

The parent of Company B is penalized because it does not receive any credit for the indirect taxes of $100 that its subsidiary paid in the foreign country. Hence, its net return is reduced by $35.

Clearly, none of the above options is entirely satisfactory to prevent double taxation of income. We need a supplemental solution. This typically takes the form of negotiated bilateral double tax conventions between countries to reduce the incidence of double taxation and disclosure of information.

There are two broad categories of treaties: (1) double tax treaties ("DTTs") to mitigate double taxation of income and capital and (2) tax information exchange agreements ("TIEAs") to control tax avoidance and evasion.

DTTs primarily focus on the prevention of juridical double taxation of income by allocating the exclusive jurisdiction to tax to one of the Contracting States or by stipulating agreed-upon source rules and maximum tax rates. Such a system promotes trade co-operation between countries by fostering an atmosphere of fiscal certainty in international transactions.

However, taxpayers can also use DTTs to avoid tax by treaty shopping for low–tax rate countries. For example, taxpayers can exploit differential tax rates between countries or channel specific sources of income to particular jurisdictions in order to minimize withholding taxes. Hence, a treaty designed to prevent double taxation can become a vehicle for tax avoidance.

There are two basic approaches to counter such tax avoidance: domestic legislation (such as the general anti-avoidance rule)[5] and specifically negotiated anti-avoidance or anti-treaty shopping provisions within the DTT. The interplay between these two mechanisms raises interpretational difficulties and inconsistencies.

Although tax treaties are bilateral agreements, their interpretation is much more complex than ordinary domestic contracts between two parties. Since they are international treaties, the rules of interpretation of the *Vienna Convention* (1969) apply. Canada applies the provisions of the *Vienna Convention* in good faith in accordance with the ordinary meaning of their words in their context and in light of its objects and purpose.[6] However, not all countries (most notably, the United States) have ratified the *Vienna Convention*, and therefore, we need to look elsewhere for interpretational guidance. Should Canada apply an international interpretational convention to a treaty partner that is not a signatory of the treaty? It certainly does so in many instances with the United States because the U.S. tacitly accepts the terms of the *Vienna Convention*. Under its Constitution, the United States cannot allow its domestic law to be subservient to a foreign treaty.

Treaty Override

The doctrine of "treaty override" refers to the status of subsequently enacted domestic legislation that conflicts with obligations undertaken in a prior binding treaty. As a general principle of international law, a state should not legislate in breach of its own international obligations. Article 60 of the *Vienna Convention* provides, for example, that a material breach of a treaty is grounds to terminate the treaty.

Article 60(3) defines a "material breach" as a repudiation of the treaty or the violation of one of its essential provisions. Article 27 goes on to state that "a party may not invoke the provisions of its internal law as justification for its failure to perform a treaty …."

Countries have different approaches to the status of treaty override under international law. A country can, for example, constitutionally entrench treaty supremacy into its law. Or, at a lower level, it can enact enabling legislation that incorporates the treaty into domestic law and

stipulate that the treaty stands superior in event of conflict between domestic law and treaty provisions. Some countries, for example, the United Kingdom, operate on the presumption in favour of the treaty in the absence of a clear intention to override it.[7]

The United States has a constitutionally entrenched treaty override power and has not ratified the *Vienna Convention on Treaties*. Thus, generally, the relationship between its treaty and statute law is determined by ordinary rules of interpreting laws of equal dignity. For example, s. 7852(d) of the *Internal Revenue Code* [*IRC*] states:

> For purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law.

Examples of Override by U.S.

- Foreign Investment in *Real Property Act* (FIRPTA) of 1980 — Act provided that after five years it would apply without regard to any relief provided by treaty
- Branch Profits Tax[8]

Arm's Length Principles

A fundamental principle underlying treaties is that the income of non-residents should be allocated to countries on the basis of "arm's length principles." This implies that the taxable profits of a business enterprise, whether operated in a particular country through a subsidiary or a branch, will be subject to tax as if the enterprise conducted its business independently in that country.

Similarly, it is assumed for most treaty purposes that products purchased by a business enterprise from related parties (for example, by a subsidiary from its parent corporation) would be priced as if the products were purchased from an unrelated third party. Thus, both the jurisdiction to tax the business enterprise and the prices at which it is presumed to transact with related parties are premised on the notion that the enterprise operates on an arm's length and independent basis. These concepts are the heart of transfer pricing between related parties.

The arm's length principle implies that a country should assess foreigners and foreign income only in respect of income that arises in the country. Although the method by which a country determines foreign income may refer to a formula, the jurisdiction to tax the taxpayer rests on the arm's length principle. The formula, if any, merely facilitates the calculation of income to reasonably approximate the amount that the country would arrive at in an arm's length calculation.

Breach of Treaty

In international law, breach of a treaty does not *per se* give a private citizen a right of action. Treaties are negotiated agreements between two countries. However, Canada implements its tax treaties as part of its domestic law. Hence, a taxpayer can invoke the provisions of a Canadian tax treaty through an action in Canadian tax courts.

There is no appeal to an international court or tribunal. In the event of an inconsistency between the provisions of a treaty and the *Income Tax Act*, the provisions of the treaty prevail to the extent of the inconsistency. Thus, in a sense, Canada's tax treaties are "elevated" domestic law.

Resolution of Conflicts

A taxpayer who is deprived of treaty rights should contact the "competent authority" of the country where he resides. The competent authorities are designated in the Treaty.

A taxpayer should request competent authority consideration of a disputed issue when the domestic revenue authority has developed its tax audit to a point of certainty. Although formal assessment by the revenue authority is not a prerequisite for a request for competent authority intervention, the audit itself should have developed to a stage of considerable certainty.

A request for competent authority consideration should be made only after the taxpayer presents all of the facts in support of his or her position to the revenue authorities and gives the authorities an opportunity to consider the facts. Hence, a taxpayer should request competent authority consideration only after revenue authorities fail to give satisfaction.

Canadian residents can apply for competent authority consideration by writing to the Canada Revenue Agency to the attention of the Director, Tax Avoidance and Foreign Operations Division, and should provide the following information:

- taxpayers involved
- control and business relationship between the Canadian taxpayer and the other person
- taxation years or periods under review
- nature of the double taxation problem
- status or the tax liability of the taxpayer or related person in the other jurisdiction
- action taken by the taxpayer to obtain a corresponding or correlative assessing adjustment and the reasons why such action was unsuccessful

Mutual Agreement Procedures are intended to resolve treaty disputes. However, they are arduous and take a long time. Some treaties provide for binding arbitration.

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1 *Holman v. Johnson* (1975), 1 Cowp. 341. This principle was confirmed and applied by the Supreme Court of Canada in *United States of America v. Harden*, [1963] S.C.J. No. 38 (S.C.C.).

2 See, for example, the Canada *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), s. 149(1)(a) (employees of foreign governments).

3 See, for example, *ibid.*, s. 126 (foreign tax deduction).

4 See, for example, *United States Internal Revenue Code* [*IRC*], s. 902.

5 See s. 245 of the *Income Tax Act*, *supra* note 2.

6 See, for example, *Beame v. Canada*, [2004] F.C.J. No. 237 (F.C.A.).

7 See *IRC v. Collco Dealings Ltd.* (1961), 39 T.C. 509 (H.L.). Legislation enacted in 1955 applied to a company resident in Ireland despite earlier exemptions in tax treaties of 1926 and 1947 Treaties for Irish residents. Generally, statutes should not abrogate international obligations but the wording of the 1955 enactment was unambiguous and prevailed over the treaty.

See also *Woodend (K.V. Ceylon) Rubber & Tea Co. Ltd. v. CIR*, [1971] A.C. 321 (P.C.) (1959 UK legislation imposing 33 1/3 per cent tax on non-residents conflicted with the non-discrimination clause in Article XVIII of Tax Treaty. Domestic legislation prevailed because language was clear and did not exclude non-residents of treaty country).

8 Section 884(a) of the *IRC*.

• ACCOUNTING AND THE RULE OF LAW •

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The acquittal of three senior executives (Frank Dunn, Douglas Beatty, and Michael Gollogly) on allegations of accounting fraud and manipulation of financial statements to affect public markets illustrates the fluidity of accounting principles and the difficulties of discharging the burden of proof in criminal fraud prosecutions. The decision, which ends a nine-year saga of criminal investigations by the RCMP, the SEC, the U.S. Justice Department, and the Ontario Securities Commission, also highlights the rule of law in Canada. In a learned treatise, Ontario Superior Court Judge Frank Marrocco outlines the requirements of the burden of proof and the principles of estimating accrued liabilities as well as their role in financial statements. The judgment should be mandatory reading in business schools.

Discouraging as the financial disasters of the last decade have been, corporate capitalism rests on moral principles and will not tolerate those who undermine the integrity of its basic tenets. However, it also relies on the rule of law, which requires criminal prosecutors to establish their cases beyond a reasonable doubt, which they clearly failed to do in *Nortel*.

"Enron" is a synonym for corporate greed, fiduciary deception, and accounting malfeasance. To be sure, the financial debacles of Livent, Madoff, WorldCom, Adelphia, Tyco, Bre-X, and YBM—to name just a few—are but a stepping stone in the long history and future of financial and accounting frauds. They should not be seen, however, as typical of the moral standards of the business community. Indeed, if anything, they represent a small minority of cases in which a few bad apples usurped the limelight, but which did not justify the regulatory overkill that followed.

It is not that governments do not act: they do, but always late and with a heavy hand. *Sarbanes-Oxley* [*SOX*] is the classic example of regulatory over-reaction in political panic. The cost of implementing the rules that the United States Congress legislated in *SOX* is enormous by any standards. The average large company is losing 70,000 hours to complying with the requirements of the statute—costs that consumers must eventually pay.

Are the incremental compliance costs producing the beneficial results that the legislators blindly assumed would flow naturally from enhanced regulatory compliance? In evaluating the effectiveness of *SOX*, it is important to remember that almost all of the high-profile prosecutions for criminal fraud involved activities that existing accounting rules and corporate fiduciary law clearly prohibited.

In *WorldCom*, for example, the corporation under the stewardship of its CEO Bernie Ebbers (sentenced to 25 years) misclassified nearly US$12 billion of current expenses as assets. By moving the expenses from the income statement to its balance sheet, the company exaggerated its profits, which caused its stock and its options to soar in value. The company's accountants and auditors violated a fundamental accounting principle that any first-year commerce student would have said was wrong and contrary to established standards.

Unlike WorldCom, which was simply a massive accounting fraud in which the company ignored its expenses, Enron was a sleek, modern version

of the Ponzi scheme. Enron's shares fell from a high of $90 per share to less than $1, leaving the company's employees, shareholders, and pensioners to live with the losses. Enron did not technically violate any accounting principles *per se*. The company simply manipulated arcane accounting rules to advantage and misled investors by making up phony profits and hiding debts in offshore partnerships.

If the Enron accounting was complicated, it was only so for the accountants. It took a jury of eight women and four men a mere six days of deliberations to convict Lay and Skilling of 24 counts of fraud and conspiracy, one count of insider trading and four counts of bank fraud.

Nor were the SEC regulators without blame for tolerating the obfuscation of the accountants in describing Enron's partnerships in its public filings as "share-settled costless collar arrangements" and "derivative instruments which eliminate the contingent nature of existing restricted forward contracts."

To be sure, there have been many financial scandals since *SOX* became law in the United States. That, however, merely confuses cause and effect. The prosecutions in all but a few of the cases were proceedings under general fiduciary laws that have been in place for a long time. Indeed, the only major prosecution under *SOX*—that of Richard Scrushy of HealthSouth—ended in his acquittal.

SOX and its tougher new accounting rules are unlikely to stop future frauds. Indeed, the next generation of corporate and accounting frauds resulting from accounting misstatements and inflated profits from non-existent assets in China is percolating in the legal wings of class action lawyers. Ultimately, the judicial system, rather than regulatory zealots, must respond to each generation of accounting frauds to preserve the integrity of our capital markets within the rule of law.

[*Editor's note*: See p. 90 for Vern Krishna's bio.]

• CHARITABLE GIVING: THE GOOD, THE BAD AND THE UGLY •

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Charitable gifting is an altruistic and noble method of reducing taxes, but only if done properly and with true donative intent. The essentials of charitable giving are a valid gift to a legitimate registered charity, a proper valuation of all underlying transactions, and appropriate legal opinions. To understand how charitable donations work for taxpayers, we first need to appreciate the nuanced difference between tax deductions and tax credits.

The difference between a deduction and a credit is that a deduction reduces income, which indirectly reduces tax payable, whereas a credit directly reduces the amount of tax payable without reducing income. Ultimately, however, both deductions and credits put money in the taxpayer's pocket, but they affect individuals differently depending upon their marginal tax rates.

Example

Assume that an individual with a marginal tax rate of 50 per cent earns $100,000. The following example illustrates the effect of a $20,000 deduction from income compared to a credit of $20,000 against tax.

	Deduction from income	*Tax credit*
Income	$ 100,000	$ 100,000
Less: deduction	(20,000)	–
Taxable income	$ 80,000	$ 100,000
Tax at 50%	$ 40,000	$ 50,000
Tax credit	–	(20,000)
Net payable	$ 40,000	$ 30,000

The example illustrates that a dollar of tax credit is worth more to a taxpayer than an equivalent dollar deduction from income. The reason for this is that a deduction is only worth its face value multiplied by the taxpayer's marginal rate of tax. Hence, a $100 deduction to an individual with a marginal rate of 50 per cent is worth $50 tax savings; at a marginal rate of 25 per cent, the saving is only $25. The value of a deduction increases as the marginal rate rises, which means that higher income taxpayers get a larger tax saving. Stated another way, those who pay taxes at a higher rate save more from a deduction than those who pay taxes at lower rates.

In contrast, the value of a tax credit remains constant through all marginal tax rates, which means that all individuals get the same benefit, regardless of how much they pay in taxes. This distinction is important in determining the distributional effect of taxes.

With one notable exception, the *Income Tax Act* [*Act*][1] reduces the value of federal non-refundable credits down to the deduction equivalent of the lowest marginal tax rate of 15 per cent. Hence, for example, for an individual with $42,000 taxable income, a $1000 deduction becomes a $150 tax credit. The rate is neutral between deductions and credits, and the taxpayer is indifferent to which one he gets.

There is, however, a great difference between the value of a deduction and a credit for higher income taxpayers. For example, for an individual with taxable income of $150,000, a deduction of $1000 would normally reduce tax payable by $290 at a marginal rate of 29 per cent. The *Act*, however, reduces the value of the deduction down to a $150 credit. The conversion of deductions to credits in 1987 was part of tax "reform" to increase the effective rate of tax on higher income taxpayers.

Charitable donation credits are an important exception to the rule. To encourage philanthropy, the statute converts all charitable donations (above $200) to credits at the highest marginal rate of tax. For example, the credit equivalent of a $100,000 donation would be approximately $29,000 at a marginal rate of 29 per cent. Thus, donation credits are incentive provisions designed to support worthwhile causes.

The attractiveness of the donation credit has also attracted a plethora of dubious gifting programs. In these schemes, promoters set up arrangements that appear, through a maze of structures (usually offshore) and valuation gymnastics, to confer greater benefits on so-called "charitable causes" than the donor's actual cash contribution. Hence, for example, an individual donating $2500 to one of these arrangements might end up with a charitable receipt for $15,000, which would be worth a federal tax credit of $4,350. With the provincial credit added, the total tax savings would be approximately $6,900. That is equivalent to a guaranteed immediate cash rate of return of 176 per cent, which is quite attractive in these market conditions.

Understandably, the Canada Revenue Agency ("CRA") has the entire charitable sector under a microscope for potential abusive schemes. Taxpayers should ensure that they are donating to legitimate charities and not just buying credits under the guise of "gifting" to fly-by-night offshore schemes. Taxpayers who do not comply with the rules risk losing their entire deduction, including their actual cash outlay, and being assessed penalties as well as interest. The CRA is also pursuing professional advisors who lend their names to such arrangements with civil and possible criminal sanctions. The key to giving is that the gift must have at least an element of altruism. Otherwise, the good can turn into the bad and become ugly for all.

[*Editor's note*: See p. 90 for Vern Krishna's bio.]

1 R.S.C. 1985, c. 1 (5th Supp.) [*Act*].

• CASE LAW •

Canada v. GlaxoSmithKline Inc.

[2012] S.C.J. No. 52, S.C.C.
McLachlin C.J. and Deschamps, Abella, Rothstein, Cromwell, Moldaver, and Karakatsanis JJ.
October 18, 2012
***The Bottom Line*, No. 2816-001**

FEDERAL INCOME TAX • Corporations • Special rules • Attribution rules • Non–arm's length transactions

Appeal by the Minister of National Revenue from the decision allowing the appeal from a Tax Court of Canada decision to uphold the reassessment that increased the income of GlaxoSmithKline ("Glaxo Canada"). Cross-appeal by Glaxo Canada from the decision of the Federal Court of Appeal to remit the matter to the Tax Court for rehearing and reconsideration. Between 1990 and 1993, Glaxo Canada purchased ranitidine, the active pharmaceutical ingredient in the brand-name anti-ulcer drug Zantac, from Adechsa, a related non-resident company, for between $1,512 and $1,651 per kilogram. Glaxo Canada was granted rights under the patent and trademark for Zantac under a licence agreement and purchased ranitidine from Adechsa under a supply agreement. During the same period, two Canadian generic pharmaceutical companies, Apotex Inc. and Novopharm Ltd., purchased ranitidine from other sources for use in their generic anti-ulcer drugs for between $194 and $304 per kilogram. The Minister reassessed Glaxo Canada for the taxation years 1990–1993, pursuant to the then-applicable s. 69(2) of the *Income Tax Act* on the basis that the prices Glaxo Canada paid to the supplier with which it did not deal at arm's length were greater than an amount that would have been reasonable in the circumstances had they been dealing at arm's length. The reassessment increased Glaxo Canada's income by the difference between the highest price paid by generic pharmaceutical companies and that paid by Glaxo Canada for ranitidine. The Tax Court of Canada upheld the reassessment with one minor revision. The Federal Court of Appeal found that the Tax Court had erred in not considering the licence agreement when determining whether the prices paid by Glaxo Canada for ranitidine were reasonable under s. 69(2). It found that the licence agreement was central to Glaxo Canada's business reality and that it would be so even if the relationship with Adechsa was at arm's length. Therefore, it was a "circumstance" that had to be taken into account when determining whether the prices paid by Glaxo Canada for ranitidine were reasonable.