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Canada's Evolving Tax Treaty Policy toward Low-Income Countries

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The Importance of Tax Treaty Design for Low-Income Countries

International trade and international flows of investment have mushroomed, and an extraordinary amount of the world's goods and services and annual investment capital flows cross international borders. The tax treatment of almost all of the income that results from these cross-border transactions is affected by tax treaties. Well over 2,000 bilateral tax treaties are now in force between the countries of the world. Canada alone has almost 100 tax treaties in force. Tax treaties have thus become a major interest to legislators, tax practitioners, and tax scholars and writing about them has become a cottage industry in large segments of the international tax community. As one indication of the interest they have generated, massive books are now being written about each article in these treaties; for example, a 415 page book has been published about Article 13 of OECD Model Convention, which deals with the taxation of capital gains and which is less than 20 lines of print long in the model treaty.²

In part because they are so important, like substantive tax law itself, examining the design of the tax treaties a country enters into should tell us a good deal about the balance of interest group power in that country, the prevailing ideas, the ambitions of its politicians, the institutions of government, and the other variables that might influence public policy making in the country. Although the policy of tax treaties is thus multi-faceted and complex, this paper takes only one aspect of that larger picture and examines it in some detail; namely, Canada's evolving tax treaty policy toward low-income countries.

This small slice of tax treaty policy is examined in this chapter for two reasons. First, this aspect of tax treaty policy is important in its own right. The revenue that low-income countries are able to raise from the income earned in their countries on cross border trade and investment flows is often significant and is critical for the development of their economy and for raising the standard of living of their impoverished residents. Second, and just as importantly for the purposes of a collection paying tribute to Alexander Easson, it was a subject that greatly interested Alex. Throughout much of his career he acted as a tax advisor to the governments of low-income countries and he was keenly aware of the importance of the design of tax treaties for them.

It is commonly asserted that the purpose of income tax treaties is to facilitate international trade and investment by providing for the avoidance of double taxation where two countries seek to tax the same income, by avoiding excessive taxation at

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² Stefano Simontacchi, *Taxation of Capital Gains under the OECD Model Convention: With Special Regard to Immoveable Property* (Leiden: Kluwer Law International, 2007).

source, by prohibiting a country from discriminating against a business owned by residents of the other country, and by providing an efficient mechanism for resolving disputes that might arise between tax administrators over the interpretation of the treaty.³ However, although this is the generally advanced objective of tax treaties, it is well known that in most treaties this objective is achieved in part by effectively reducing the tax base of the source country (usually the low-income country) and thus increasing the tax take of the residence country (usually the high-income country).⁴ This is done primarily, first, by reducing the scope for the source taxation of business income through the definition of a permanent establishment as a requirement for source taxation, and second, by reducing the withholding tax rate on passive income earned in the source country. Some cynics have suggested that transferring revenues from low-income to high-income countries has not been an unintentional side effect of treaties but rather has been an unstated goal.⁵

The story of the development of modern tax treaties is a familiar one and will not be repeated here except to note that in large part the extent to which a country's tax treaty policy favours low-income countries or not depends upon the extent to which the country is prepared to adopt provisions from the UN model treaty as opposed to the OECD model treaty.⁶ In 1963, the Organisation for Economic Co-operation and Development published a draft model tax treaty (that was not published in an official version until 1977). That model treaty, drafted by representatives of the major western industrialized countries, has gone through a number of minor iterations and is the one upon which almost all tax treaties are based. Concerned that it resulted in too large a reduction in source country tax, in 1980 an expert group assembled by the United Nations published the alternative UN model treaty. Although it is based upon the OECD model, the UN model retains much greater source country taxation. When negotiating with low-income countries, many countries are prepared to adopt some provisions from the UN model and the extent to which they are is some indication of their concern that low-income countries be able to retain their tax base in cross-border transactions.

In examining Canada's evolving tax treaty policy towards low-income countries, this essay proceeds as follows. In 1988, Alex Easson published a paper that he had written for a conference, "The Royal Commission on Taxation: 20 Years Later" that was descriptively titled, "The Evolution of Canada's Tax Treaty Policy Since the Royal

³ An equally important objective of tax treaties is to prevent cross-border tax evasion. Arguably, treaties have been less successful in achieving this objective than in removing impediments to trade and investment and thus investment flows between countries have probably been encouraged beyond what they would be if all income were taxed at the appropriate rates.

⁴ See, for example, Reuven S. Avi-Yonah, *International Tax as International Law: An Analysis of the International Tax Regime* (Cambridge: Cambridge University Press, 2007), ch. 9.

⁵ Tsilly Dagan, 'The Tax Treaties Myth,' *Journal of International Law and Politics* 32:939 (2000) ("[tax treaties] serve...much more cynical goals, particularly redistributing tax revenues from the poorer to the richer signatory countries.")

⁶ For a brief history of the development of the model tax treaties see Kim Brooks, 'Tax Treaty Treatment of Royalty Payments from Low-Income Countries: A Comparison of Canada and Australia's Policies,' *eJournal of Tax Research* 5 (2007): 168-197 at 171 – 176.

Commission on Taxation.”⁷ The article exemplifies much of Easson’s work: it is well written, logically organized, and brings clarity to a broad area of tax law and policy; it provides a strong analytical foundation for the developments in tax treaty policy; it contains a good deal of pragmatism in its prescriptions; and, it reflects Easson’s enthusiasm for design questions in tax treaties with low-income countries. Thus, to provide a baseline for examining the recent evolution of Canada’s tax treaty policy, the following section provides an overview of Easson’s article. In effect, he states the policy as of 1988.

The next part of the chapter examines three aspects of Canada’s tax treaties entered into since 1988 that might increase the scope for source-based taxation. First, the important ways in which the scope for expanding the source taxation of business income in treaties is examined: for example, by lowering the threshold for taxation of business profits, expanding the scope of what profit should be allocated to an enterprise, allowing the taxation of technical or management fees with minimal connection to the source state, and permitting the taxation of gains on the alienation of real property. Second, those treaty provisions that limit the withholding tax rates on passive investment income earned in the source country, including the withholding tax rates on payments of interest, dividends, and royalties, are reviewed. Third, the accommodations that Canada has made since 1988 through tax sparing provisions for tax incentives enacted in low-income countries are noted.

The final part of the paper briefly reviews the major changes to the Canada-U.S. income tax convention proposed in the fifth protocol, signed on September 21, 2007, and raises the implications for Canada’s tax treaty policy toward low-income countries.

Alex Easson’s Assessment of Canada’s Tax Treaty Policies up to 1988

Although not focused only on Canada’s tax treaty policy with low-income countries, Easson nevertheless devotes a significant portion of his article to Canada’s tax treaties with developing countries and his observations more generally have particular applications for low-income country negotiations. The article sets out the history of Canada’s tax treaty policy prior to Canada’s Royal Commission on Taxation (the Carter Commission), which reported in 1966. He highlights the limited number of treaties Canada had negotiated and attempts to explain why Canada negotiated so few treaties around the time of the Carter Commission and immediately following it. He then provides an overview of changes to the domestic Canadian tax system that would have influenced Canada’s tax treaty negotiations in the period following the release of the Carter Commission report. A country’s domestic tax design inevitably influences its tax treaty negotiating position. For example, on the one hand, a low-income country that defines income for tax purposes broadly in its domestic legislation and that wishes to raise revenue from non-resident investors in the country will undoubtedly seek to ensure that its tax treaties do not detract significantly from its ability to collect taxes on income with a source in its jurisdiction. On the other hand, low-income countries that provide

⁷ Alexander J. Easson, ‘The Evolution of Canada’s Tax Treaty Policy Since the Royal Commission on Taxation,’ *Osgoode Hall Law Journal* 26 (1988): 495.

generous exemptions from taxation for non-residents in their domestic legislation in the hope of attracting additional investment will try to use their tax treaties to secure protection for their tax incentives.

In his 1988 piece, Easson reviews four major changes to Canada's domestic tax regime following the release of the Carter Commission report, each of which would have had an impact on Canada's tax treaty negotiating position with low-income countries. First, he discusses the introduction of foreign affiliate rules, rules designed to tax the income of Canadian residents earned by investing in foreign corporations, which allowed Canadian corporations to receive dividends free from Canadian tax if the foreign corporation was resident in a country with which Canada had a tax treaty. These rules would have created an incentive for low-income countries to enter into tax treaties with Canada. If, for example, a low-income country offered either a low- or no-tax regime for business activities as a means of attracting foreign investment, that tax incentive would be preserved under these rules. The design of Canada's foreign affiliate rules ensured that active business income earned through a foreign affiliate could be repatriated to Canada without any additional Canadian tax.

Second, the increase in the statutory withholding tax rate on cross-border investment income from 15 to 25 percent also created an incentive for low-income countries to enter into tax treaties with Canada. If a low-income country wanted to collect additional revenue from withholding, it might be able to convince Canada to agree to a withholding tax rate higher than 15 percent. In the alternative, if the low-income country wanted a low withholding tax rate to encourage some forms of investment, it would need to enter into treaty negotiations with Canada to achieve a lower withholding tax rate in return.

Third, Easson discusses the introduction of a capital gains tax in Canada in the years following the release of the Carter Commission report, which required a change in Canada's tax treaty position to one that sought to preserve the source jurisdiction's ability to tax capital gains. This change to Canada's domestic tax rules would have been useful where the low-income country wanted to advocate for broad taxing scope for some capital investment, for example, in natural resources.

Finally, the enhancement of Canada's dividend tax credit, which allowed Canadian resident shareholders to partially offset underlying corporate tax paid on corporate distributions might have created additional bargaining power for all countries, including low-income countries. Canada has always refused to extend its dividend tax credit to non-resident investors, and as a consequence it has been pressed to give other concessions to its treaty partners.

Although the domestic tax systems of the treaty partners informs many of the discussions about the way a tax treaty between them can be used to integrate the two countries' systems, the form of the tax treaty itself, without question, is driven by the tax treaty designed and promoted by the OECD. At the time Easson published his article, the 1977 model treaty was the most recent version of the OECD model. Easson noted some of Canada's reservations to the OECD model treaty, including its reservations on

withholding tax rates (Canada reserved the right to impose a higher rate of withholding tax than that proposed by the OECD model), capital gains (Canada reserved the right to tax a wider range of dispositions than the OECD model suggested), and pension income (Canada reserved the right to tax pension income at source). Canada continues to reserve on several articles of the current OECD model treaty. It has added a reservation that enables Canada to tax income from the alienation of real property (not just income from the real property). However, Canada has removed its reservations on the withholding tax rates that apply to dividends, interest, and royalties, and has removed its reservations on capital gains and pensions.

Despite Canada's long-standing membership in the OECD, and its general adherence to the OECD model tax treaty, since the Carter Commission report in particular Canada has recognized that it has a role to play in ameliorating the capital-exporting bias of the OECD tax treaty in its tax treaties with low-income countries. Therefore, in addition to continuing to register reservations on the OECD model treaty, Canada will often negotiate tax treaties with low-income countries that follow parts of the UN model tax treaty. As mentioned above, that tax treaty was originally released in 1980. Although it follows the OECD model closely, in some regards it allows greater source taxation, therefore (relative to the OECD model) providing some additional taxing jurisdiction to capital importing countries.

Generally speaking, as recounted by Easson, entering into tax treaties with low-income countries requires three kinds of changes to the standard tax treaty Canada enters into with capital exporting (high-income) countries. First, tax treaties with low income countries often reflect an enlargement of the source taxation of business income. Second, they increase the amount of tax that the source country is permitted to claim by withholding from passive investment income (relative to the source taxation permitted under the standard OECD model treaty). Third, they often include tax sparing provisions that preserve the capital importing country's tax incentives.

Easson reviews Canada's concessions to low-income countries on each of these bases. In terms of enlarged source country taxation, Canada's treaties in this period revealed a willingness to expand the definition of permanent establishment (the threshold for business taxation), and to increase the rate of withholding tax for passive income. He also notes that although prior to the Carter Commission report Canada had not granted any tax sparing provisions (provisions that preserve the specific tax incentives offered by low-income countries), after the release of that report Canada was willing to enter into tax sparing provisions with a number of low-income countries.

The next part of this chapter reviews Canada's tax treaty policy, particularly as it applies to middle- and low-income countries from the post-1988 period, building on Easson's observations of Canada's willingness to lower the threshold for source taxation, increase the rates of withholding tax, and protect tax incentives where its treaty partner is a low-income country.

Canada's Tax Treaty Policy toward Low-Income Countries: 1988 – 2008

The last twenty years have seen the continued expansion of Canada's tax treaty network. Between 1988 and June 2008, Canada signed and has brought into force 53 comprehensive tax treaties.⁸ These treaties have broadened the global reach of Canada's tax treaties significantly. Six were signed with countries in Africa, 13 with countries in Asia, 26 with countries in Europe, five with countries in South America, and three with North American countries. As Easson predicted, Canada expanded its reach to include more former socialist countries, including Armenia, Azerbaijan, Croatia, Kazakhstan, Kyrgyzstan, Moldova, and Uzbekistan.

To try to convey a sense of Canada's policy towards low-income countries since 1988, the countries with which Canada has entered into treaties over this period are divided into three categories: high-income, middle-income, and low-income. A country is classified as high-income if it had GDP per capita in excess of \$20,000 per year (US, PPP, 2005); middle-income if it had GDP per capita between \$10,000 and 19,999 per year; and low-income if it had GDP per capita of less than \$10,000 per year.⁹ By this standard, of the 53 tax treaties signed and brought into force in this twenty-year period, 15 were with high-income countries, 17 were with middle-income countries, and 21 were with low-income countries.

All 53 treaties were examined to determine the extent to which they expanded (or not) the scope for the source taxation of business income, the policy they reflect on withholding tax rates on passive investment income, and their use of tax sparing provisions. The results are described below. To spare the reader copious footnoting, and since these provisions are numbered the same in almost every treaty, treaty articles have not been footnoted.¹⁰

Expanding the Scope for Source Taxation of Business Income

Lowering the Threshold for a "Permanent Establishment"

Easson noted that prior to 1988 Canada was willing to negotiate tax treaties with low-income countries that lowered the threshold of activity required before a non-resident would be subject to tax in a low-income country on its business activities in that country. At least in theory, a country could decide to tax the profits earned by a non-resident enterprise simply because that enterprise sells goods and services in the country. However, no country has managed to conclude a tax treaty that sets the threshold for taxation of business income that low, although when a group of experts met under the

⁸ It has also signed three treaties which have not come into force (Lebanon, Gabon, and Italy) and twelve protocols/amendments.

⁹ Income data was drawn from United Nations Development Programme, "Human Development Report (2007-2008) table 14," United Nations Human Development Report, http://hdr.undp.org/en/media/hdr_20072008_en_complete.pdf.

¹⁰ Readers interested in the details of each treaty described are welcome to contact the author at kimberley.brooks@mcgill.ca

auspices of the United Nations to draft the UN model convention they contemplated the possibility of such an approach.¹¹

Both the OECD model convention and the UN model employ the permanent establishment concept to delineate the degree of contact a non-resident enterprise carrying on business in a jurisdiction requires before it is subject to tax there. The OECD model tax treaty standard definition of a permanent establishment is based primarily on the idea of some physical presence and includes a place of management, a branch, an office, a factory, a workshop, and a mine, an oil or gas well, a quarry or other place of extraction of natural resources, and a building site or construction or installation project that lasts more than twelve months.

The OECD model tax treaty also provides for some exclusions from the definition of permanent establishment. These exclusions are generally designed to remove from the scope of source-based taxation the use of facilities simply for storage or delivery, the maintenance of a stock of goods without more, the maintenance of a fixed place simply for purchasing goods, and the maintenance of a fixed place solely for a preparatory or auxiliary reason. In essence, these exclusions remove casual or temporary business activities from the scope of source-based taxation.

The UN model convention departs from the OECD model's definition largely by broadening the definition of activities that might be sufficient for an enterprise to be found to have a permanent establishment. Six of the major departures, and the extent to which Canada has followed them in its treaties with low-income countries, are reviewed here. First, the UN model convention reduces the amount of time required for a building site or construction or assembly project to exist to be considered a permanent establishment. Engaging in a construction or assembly project in a country would generally be considered to be 'carrying on business' in a country and therefore under many country's domestic tax systems (including Canada's) the enterprise would be subject to tax. According to the OECD model convention, such a project will be considered to be a permanent establishment only if it exists for more than twelve months. Under the UN model convention, such a project may be a permanent establishment if it exists for six months. Canada is more likely to grant a lower time period before a building site, construction or assembly project may be a permanent establishment where the treaty partner is a low-income country. In negotiating with its high-income treaty partners, Canada has agreed to the standard OECD term of 12 months with 13 of them, and a shorter term of six months with only two. In its negotiations with middle-income countries, Canada agreed to a term of 12 months in seven treaties, six months in nine treaties, and three months in one treaty. In its treaties with low income countries, Canada agreed to the OECD period in only seven treaties, reducing the time to nine months in one treaty (Armenia), six months in ten treaties (Bulgaria, Ecuador, India, Jordan, Mongolia, Peru, Tanzania, Venezuela, Vietnam, Zimbabwe), three months in two treaties (Algeria, Nigeria), and in its treaty with Senegal no time period is required. It is clear, then, that Canada is much more likely to grant shorter periods in this part of the

¹¹ Stanley S. Surrey, 'United Nations Group of Experts and the Guidelines for Tax Treaties Between Developed and Developing Countries,' *Harvard International Law Journal* 19 (1978): 1 at 11.

permanent establishment article if the country is a middle- or low-income country than it is to deviate from the OECD-suggested period of time for high-income countries.

Second, the UN Model convention expands the definition of permanent establishment to include the general furnishing of services, including consultancy services, by an enterprise through employees or other personnel where the activities continue for the same or a connected project within the country for more than six months, or a lesser period, within any twelve month period. Under the OECD model such activities alone would not necessarily constitute a permanent establishment. The rationale for this expansion of the permanent establishment concept in the UN treaty was that such services were analogous to building site or other construction project activities.¹² Canada has been willing to include this services provision in its tax treaties where the treaty partner is a middle- or low-income country. In contrast to its treaties with high-income countries (only two of which include the services provision), Canada agreed to add this provision in eight of its treaties with middle-income countries and in 12 of its treaties with low-income countries (Algeria, Armenia, Ecuador, India, Jordan, Kazakhstan, Mongolia, Peru, Senegal, Tanzania, Vietnam, and Zimbabwe). Generally speaking, the period of time before the services may constitute a permanent establishment ranges from 3 months (two treaties) to twelve months (two treaties). The treaty with Jordan does not include a time period before the services will be held to be a permanent establishment if the services are related to the exploitation of natural resources.

Third, the OECD model treaty lists six circumstances in which even though the enterprise has a fixed place of business, it is not a permanent establishment since the activities are preparatory or ancillary in nature; the UN model eliminates the ‘delivery of goods’ from this exclusion list. Under the OECD model, if an enterprise simply uses facilities for the delivery of goods or maintains a stock of goods in that jurisdiction for delivery, that activity alone is not sufficient to constitute a permanent establishment. Under the UN model convention, the delivery of goods exclusion is not listed as an exception to the permanent establishment definition. It has been relatively unusual for Canada to agree to remove the mere delivery of goods or merchandise from the rule that deems such activities not to be a permanent establishment. However, it has followed this UN-proposed change in one treaty with a middle-income country (Oman), and with six low-income countries (Algeria, Armenia, India, Senegal, Vietnam, and Zimbabwe).

As an alternative to setting up an office or other fixed place of business, an enterprise may conduct business in a country by sending an agent to act on its behalf. Whether or not that agent constitutes a permanent establishment depends largely on the degree of independence of the agent. As a fourth change to the OECD definition of permanent establishment, the UN model convention expands the concept of a dependent agent. Under the OECD model convention, if an enterprise has a dependent agent who is able to

¹² See also the explanation in the UN Commentary to Article 5, paragraph 3 that “management and consultancy services should be covered because the provision of such services in developing countries by corporations of industrialized countries often involves very large sums of money.” United Nations, *Commentary on the Articles of the 1980 United Nations Model Double Taxation Convention Between Developed and Developing Countries*. (New York: UN, January 1, 1980).

habitually exercise the authority to conclude contracts in the name of the enterprise, that agent will constitute a permanent establishment. Under the UN model convention, a dependent agent is an agent who *either* (1) concludes contracts on behalf of the developing country enterprise or (2) has no authority to conclude contracts, but who regularly delivers goods or merchandise on behalf of the enterprise. In other words, the UN model convention expands the definition of permanent establishment by including an agent who habitually maintains in the state a stock of goods or merchandise from which he or she regularly delivers goods or merchandise on behalf of the enterprise. For high- and middle-income countries, Canada has been unlikely to include language similar to that suggested by the UN that expands the circumstances in which a dependent agent will be deemed to be a permanent establishment. One tax treaty with a high-income country (Kuwait),¹³ and two with middle income countries (Lithuania and Trinidad and Tobago) include this provision. However, Canada has agreed to this extension of the concept of permanent establishment in six of the 21 tax treaties it negotiated with low-income countries since 1988 (Armenia, India, Nigeria, Senegal, Vietnam, and Zimbabwe).

Fifth, the UN model convention considers independent agents to be a PE where their activities are wholly or almost wholly devoted to the enterprise and the conditions for their relationship are different from those that would have been made between independent enterprises. This provision is not present in the OECD model convention. Since 1988, Canada has included this provision in two of its tax treaties with high-income countries (Kuwait and the United Arab Emirates), in eight of its tax treaties with middle-income countries, and in six of its tax treaties with low-income countries (Azerbaijan, India, Jordan, Peru, Tanzania, Vietnam).

Sixth, the UN model expands the definition of permanent establishment to include insurance activities that would not constitute a permanent establishment under the OECD model convention. Under the OECD model treaty, insurance premiums are only taxable in the source country if the insurance enterprise has an agent authorized to conclude contracts on its behalf. Expanding the definition of permanent establishment, the UN model convention provides that if an insurance company collects premiums in a country or insures risks in the country through an employee or dependent agent in the country, then the insurance company has a permanent establishment in that jurisdiction, and the permanent establishment may be subject to tax. Canada has included this provision in one tax treaty with a high-income country (Belgium), four with middle-income countries (Argentina, Chile, Mexico (signed 1991)), and Mexico (signed 2006), and in seven treaties with low-income countries (Armenia, Azerbaijan, Moldova, Peru, Senegal, Tanzania, and Vietnam).

This brief review of the expansion of the concept of permanent establishment in Canada's tax treaties with middle- and low-income countries reveals that Canada has continued to

¹³ Canada's treaty with Kuwait also (and unusually) includes two additional provisions: one that deems a dependent agent to be a permanent establishment if the person secures orders exclusively or almost exclusively for the enterprise itself or for such enterprise and other enterprises which are controlled by it or have a controlling interest in it; or if the person manufactures goods or merchandise belonging to the enterprise.

be willing to enlarge source jurisdiction for many of those countries, but certainly not all. No larger trend was apparent over the 20 year period since Easson wrote his article on Canada's tax treaty policy, nor is any other generalization possible about when Canada will adopt some of the UN model's modification to the permanent establishment concept and when it will not.

Expanding the Profit Allocated to Entities with a Permanent Establishment

In addition to defining the concept of permanent establishment, the OECD model convention provides the basis on which the activities associated with a permanent establishment will be subject to tax. Generally speaking, the OECD model suggests that an enterprise should only be taxable in the source jurisdiction on the profits it earns that relate to its permanent establishment and those profits should be calculated in the same way they would be for domestic business activities – income tax should be applied to the permanent establishment's net profits. In terms of calculating the profits to be subject to tax, the UN model makes two significant suggested changes.

First, the UN model suggests a modification that more closely aligns the calculation of the permanent establishment's taxable income with the 'force of attraction' principle – in other words, once an enterprise has a permanent establishment in a jurisdiction, all income derived by the enterprise in the jurisdiction should be subject to tax there. Under the UN model convention, in addition to profits of the permanent establishment that are calculated in the same way as under the OECD model treaty, the profits of the permanent establishment will include profits that are attributable to (1) sales of goods or merchandise of the same or similar kind as those sold through the permanent establishment and (2) other business activities carried on of the same or similar kind as those carried on through that permanent establishment. Two of Canada's tax treaties with middle-income countries (Argentina and Mexico (1991)) and six of Canada's tax treaties with low-income countries (India, Jordan, Kazakhstan, Nigeria, Tanzania, and Zimbabwe) have included this expansion to the taxing jurisdiction of the source country. In recent years, Canada seems to have become less likely to grant this expansion, having agreed to the provision in only two treaties since 1996 (Armenia and Oman).

Second, both the OECD and the UN model allow generally for the deduction from business profits of head office expenses incurred for the purpose of the business of the permanent establishment including executive and general administrative expenses, even if they are incurred in the non-source state; however, the UN model denies a deduction for head office expenses where those expenses are payments for royalties, fees, interest, and commissions for specific management services. Therefore, the UN model provides for a significant expansion of the taxation of business profits earned at source. Canada has been quite willing to grant this kind of expansion to low-income countries, having done so in over 50 percent of the tax treaties with low-income countries it has negotiated since 1988 (Armenia, Algeria, India, Jordan, Kazakhstan, Moldova, Nigeria, Ukraine, Uzbekistan, Venezuela, and Vietnam). It has been less likely to grant the extension to middle-income countries (only three middle-income country treaties include the

extension – Chile, Mexico (1991), and Mexico (2006)). It has also granted the extension to a high-income country, Kuwait.

Allowing for the Taxation of Technical Fees.

If business income escapes taxation as business profits because the taxpayer lacks a permanent establishment, generally speaking, the income is exempt from taxation at source. However, in some cases, Canada has negotiated a technical or management fees article that allows the source country to impose a withholding tax on technical or management fees even in the absence of a permanent establishment.¹⁴ The definition of what constitutes a technical or management fee varies among the three tax treaties negotiated since 1988 that include such an article, but generally each permits a withholding tax be charged by the source country where there is a payment of any kind to any person in consideration for any service of an administrative, technical, managerial or consultancy nature. The Zimbabwe (1994) and Trinidad and Tobago treaties (1995) set a maximum rate of 10 percent. The Tanzania treaty (1997) raises that rate to 20 percent.

Allowing for Taxation on the Alienation of Real Property

As noted above, since the time that Easson published his article, Canada has registered a reservation on the OECD model treaty article that addresses the taxation of income from real property. The OECD model tax treaty provides broad protections for source-based taxation of income (but not alienation) from real property, presumably on the basis that such property has a strong economic connection to the source state. Therefore, the source state does not need to demonstrate that the taxpayer has a permanent establishment in order to tax income from immovable property, including income from agriculture or forestry. The article addressing the taxation of real property also provides that that article applies to income derived from the direct use, letting, or use in any other form of immovable property. Canada has reserved on the OECD model convention to preserve its right to tax not only the income derived from real property but also the gains on the alienation of that property under the real property article. Indeed, in all but eight of the 53 tax treaties negotiated between 1988 and 2008 the ability to tax non-residents on the disposition of real property is preserved. In other words, Canada feels strongly enough about the ability to tax income from the alienation of real property in Canada that it has been willing to include expanded source taxation on this basis in its treaties regardless of the income status of its negotiating partner.

Permitting Higher Withholding Tax Rates for Passive Income

Non-business forms of investment income, namely, interest, royalties, and dividends, are each addressed in separate articles of the OECD and UN model tax treaties and in Canada's tax treaties. However, in most cases, their treatment is the same: jurisdiction to tax the income is shared between the source and residence states. The source state is

¹⁴ Canada also permits the source taxation of fees that might be characterized as management fees in some articles that address other types of income, for example, it allows for the source taxation of technical assistance in the Argentina tax treaty.

permitted to tax the income using a withholding tax applied to the gross payment, limited to a particular rate. The residence state is permitted to tax the residual. When Easson authored his article in 1988, he observed that Canada adhered to a 15-15-15 model (15 percent withholding tax on each of interest, royalties, and portfolio dividends). He noted that for low-income countries, Canada was often willing to permit a higher rate of withholding tax. Easson's observation that Canada is willing to permit a higher rate of withholding tax where the country is a low-income country remains true; however, there appears to be a significant trend toward lower withholding tax rates generally.

Interest Income

The OECD proposes a withholding tax on interest of 10 percent. The UN model convention does not set a particular rate, but it is assumed that a higher rate might be appropriate where the treaty partner is a lower-income country. Canada has negotiated withholding tax rates of 10, 12.5, or 15 percent, depending on the treaty partner. The rate was set at 10 percent for all high-income countries with which Canada has negotiated treaties since 1988. For the 21 low-income countries, in 12 treaties the rate is 10 percent, in one treaty it is 12.5 percent, in seven treaties it is 15 percent, and in one treaty the rate is non-reciprocal: Senegal can impose a withholding tax of 20 percent on "bons de caisse" interest and 16 percent on other interest, and Canada can set a rate of 15 percent.

In addition to low withholding rates, exemptions from the taxation of certain types of interest income will also erode the tax revenues of source countries. Canada offers relatively few exemptions from withholding tax on interest in its tax treaties. All of the treaties negotiated since 1988, except those with Chile, Croatia, and Peru, include an exemption for government-related interest payments. Treaties with high-income countries also frequently include exemptions for pension related entities, exemptions for credit sales of equipment and merchandise, and exemptions for late payment penalties. These exemptions are less common in the tax treaties negotiated with low-income countries. Aside from government-related interest payments, in Canada's tax treaties with low-income countries only four include an exemption for interest income, and in each case it is for pension-related entities (Moldova, Tanzania, Ukraine, and Zimbabwe). This low number of exemptions might be compared to the 11 tax treaties with middle-income countries that include an exemption for some type of interest payment (other than the government-related interest payments).

Over time, Canada's rates of withholding on interest have been declining. The third protocol to the Canada-US tax treaty, signed in 1995, marked the reduction of withholding tax rates on interest to 10 percent from the 15 percent that was common when Easson authored his article. In the 2007 federal budget, Canada announced its intention to remove altogether its domestic withholding tax on interest payments to unrelated foreign lenders. This is a significant change to Canada's withholding tax policy. It was contingent on the entry-into-force of Canada's newly revised tax treaty with the United States, and is now in force.¹⁵ The new Canada-United States treaty includes the additional benefit that non-arm's length lenders will also be exempt, with the

¹⁵ *Income Tax Act*, R.S.C. 1985 (5th Supp.), c.1, s. 212(1)(b).

only exception to the exemption being participating debt interest, which is subject to the same withholding tax rate as portfolio dividends.

Royalties

The OECD model treaty proposes a zero rate of withholding on royalty payments. Canada has always deviated from this position. Since 1988, Canada has negotiated tax treaties with rates of 10, 12.5, 15, and 20 percent rates. For all high-income countries the rate is 10 percent. For low-income countries, Canada has negotiated a rate of 10 percent in 14 tax treaties, of 12.5 percent in one tax treaty, of 15 percent in 5 tax treaties and of 20 percent in one tax treaty (with Tanzania in 1995). It appears that Canada has become increasingly likely to negotiate a rate of 10 percent with all countries (regardless of their income status), given that it has not granted a rate other than 10 percent since the Senegal treaty was signed in 2001.

The royalties articles also often contain exemptions from withholding tax. Canada frequently negotiates exemptions (or lower rates of withholding tax) for royalties related to cultural goods (for example, literary works), patents, information concerning industrial, commercial, or scientific experience, and computer software. Many of these exemptions are presumably requested because Canada grants an exemption from withholding tax in its domestic tax law for these kinds of payments. Canada is much more likely to include exemptions from royalty withholding in its tax treaties when the treaty partner is a high-income country. For example, only three tax treaties with high-income countries contain no exemptions, compared to nine treaties with middle-income countries and 17 treaties with low-income countries. Although 17 treaties with low-income countries do not include exemptions from withholding tax payments on royalties, eight (Azerbaijan, Ecuador, Mongolia, Trinidad, Uzbekistan, Venezuela, Vietnam,¹⁶ Zimbabwe) include reductions from the standard withholding tax rate provided for in the treaty for some kinds of royalty payments, thereby reducing the tax revenues collected by the source country from income from those kinds of royalty payments.

Dividends

Both the OECD and UN model treaties provide for split rates of withholding tax for dividend payments. If the taxpayer has a significant investment in the corporation paying the dividend the withholding rate is typically lower than if the taxpayer is only holding a so-called portfolio investment. It is therefore necessary to distinguish between a significant investment, to which the lower rate will apply, and a portfolio investment. In making this distinction the OECD model treaty has a much higher ownership threshold (25 percent) than the UN model (10 percent). Canada's tax treaties set the threshold for portfolio dividend treatment at different levels, but usually the rate is set at either 10 percent (in 10 tax treaties with high-income countries, eight with middle-income countries, and 10 with low-income countries) or 25 percent (in two tax treaties with high-income countries, eight with middle-income countries, and four with low-income

¹⁶ Vietnam's treaty includes a lower rate not for one of the standard exemptions, but rather for the provision of technical fees, which is captured in the royalties provision of that treaty.

countries). In one case, Vietnam, there are three possible rates (5 percent when the taxpayer has more than 70 percent of the voting shares, 10 percent when the owner has between 25 and 70 percent, and 15 percent when the owner has less than 25 percent of the voting shares). In three cases, all low-income countries (Algeria, Kyrgystan, and Senegal), there is no differential rate (ie. the withholding tax rate is the same regardless of the share ownership).

In terms of the withholding tax rates for significant investments, Canada is more likely to negotiate higher withholding tax rates with low-income countries. Canada has negotiated withholding tax rates for significant investment of 5 percent (with 14 high-income countries, 9 middle-income countries, and eight low-income countries), 10 percent (with one high-income country, eight middle-income countries, and six low-income countries), 12.5 percent (with one low-income country), 15 percent (with four low-income countries) and 20 percent (with one low-income country, Tanzania).

In terms of the withholding tax rates for portfolio investments, Canada traditionally negotiated a withholding tax rate of 15 percent, except in four low-income country cases, where the portfolio withholding rates were set at 16 percent (Senegal), 20 percent (Zimbabwe), and 25 percent (India and Tanzania). Senegal is the latest of these treaties to have been signed (in 2001). The other three were signed in the early/mid-1990s. This perhaps suggests that Canada's treaty negotiators have moved to a firmer position on a 15 percent maximum withholding tax rate for dividends.

As was the case for interest payments, in a few instances, Canada has agreed to non-reciprocal withholding tax rates: in the Zimbabwe treaty the rate is 15 percent for payments from Canada and 20 percent for payments from Zimbabwe and in the Senegal treaty the rate is 15 percent for payments from Canada and 16 percent for payments from Senegal.

Generally no exemptions are provided from dividend withholding tax; although Canada has negotiated four tax treaties that contain an exemption – in the case of Denmark, Luxembourg, and Oman for shares owned by pension-related entities and in the case of Norway for shares held by governments.

In an effort to ensure equality of treatment between branch operations and separately incorporated entities, Canada imposes a branch tax of 25 percent on unincorporated branches carrying on business in Canada.¹⁷ Since the OECD model treaty expressly prohibits taxes on undistributed profits of a non-resident company, Canada has registered a reservation to the taxation of dividends article to preserve its ability to impose the branch profits tax. Canada's tax treaties reduce the rate of the branch profits tax to the lowest dividend rate, which means that to the extent that the withholding tax rate on dividends has been declining for low-income countries, the withholding tax rate on branch taxes has been reduced as well. This is not likely significant for low-income countries, since few of them presumably collect a branch profits tax.

¹⁷ *Income Tax Act*, R.S.C. 1985 (5th Supp.), c.1, s. 219.

Preserving the Tax Incentives of Low-Income Countries

Easson was an international expert on the design of tax incentives and his 1988 essay on Canada's tax treaty policy reviews Canada's use of tax sparing to preserve the effectiveness of tax incentives offered by low-income countries. Tax sparing provisions preserve the tax incentives granted by a low-income country by requiring the high-income country to give a tax credit for the taxes that *would* have been paid had the incentive not been granted. In the absence of such a treaty provision, if a low-income country forgoes taxes on certain income earned in its jurisdiction in an effort to attract foreign investment, the high-income country, if it taxes income earned by its residents on a world-wide basis, would simply tax its resident on the full amount of that income without having to provide any offsetting tax credit, thereby removing altogether the effect of the tax incentive offered by the low-income country.

Easson observed that up until 1988 tax sparing provisions were routinely granted to low-income countries. Since 1988, Canada has agreed to a tax sparing provision in 11 of its tax treaties (four in its tax treaties with middle-income countries and seven in tax treaties with low-income countries (Algeria, Bulgaria, India, Mongolia, Nigeria, Tanzania, Vietnam)). The most recent tax sparing provision was granted in 2002 in Canada's tax treaty with Mongolia. Over this period, however, Canada has become less likely to grant tax sparing provisions. In 1998 the OECD released a report that urged countries to reconsider the use of tax sparing provisions in their tax treaties, but did not outright argue that tax sparing provisions should be abandoned.¹⁸ On the basis of this report, in 2000, the OECD modified their commentary on tax sparing.¹⁹ The revised commentary emphasizes that tax sparing is "very vulnerable to taxpayer abuse",²⁰ cautions that tax sparing may not be an effective means of promoting development, and underlines that tax sparing provisions may facilitate the erosion of the tax bases of other countries. The commentary also suggests that tax sparing only be used by countries where the economic level of the country to which the sparing is granted is significantly below that of the OECD country. Since the release of the 2000 commentary, Canada has agreed to a tax sparing provision in only the treaty with Mongolia, and the scope of that provision preserved a discrete tax incentive for a limited period of time. Canada appears to have ceased granting tax sparing provisions.

It might be noted, however, that the popularity of tax sparing provisions in Canada's tax treaties prior to the release of the OECD's 2000 commentary is somewhat curious.²¹ As discussed above, Canada provides an exemption for dividends received from foreign affiliates if the dividend is paid from active business income earned in a country with

¹⁸ Organisation for Economic Co-operation and Development, *Tax Sparing: A Reconsideration* (Paris: OECD, 1998).

¹⁹ *Model Tax Convention on Income and on Capital* (Paris: OECD) (looseleaf), published in 1992 and amended in 1994, 1997, and 2000. (The revised commentary is reflected in paragraphs 72 through 78.1 of the OECD model convention.)

²⁰ *Model Tax Convention on Income and on Capital* (Paris: OECD) (looseleaf), published in 1992 and amended in 1994, 1997, and 2000. (See paragraph 76 of the 2000 OECD model convention commentary.)

²¹ Canada agreed to tax sparing provisions in 36 of its tax treaties.

which Canada has a tax treaty. Consequently, so long as a Canadian multinational carries on its foreign business activity through a foreign affiliate and so long as the country in which the business income is earned has a treaty with Canada no Canadian tax would be payable and thus the effect of a tax incentive offered by low-income country would be preserved even without a tax sparing provision. In addition, as part of the 2007 budget proposals, the Canadian government announced changes that extend the exemption treatment of active business income earned in a non-treaty country if that country has a tax information exchange agreement with Canada. This change might affect the negotiation of additional comprehensive tax treaties. If an information exchange agreement is sufficient to obtain the exemption from Canadian tax, businesses or low-income countries might not press the Canadian government to negotiate comprehensive treaties. Instead, if a low-income country offers a business tax incentive that Canadian multinationals can benefit from, so long as the business is carried in that country through a foreign affiliate of the Canadian firm, the incentive will be preserved if the country has a tax information exchange agreement with Canada.

Future Directions in Canada's Tax Treaty Policy with Low-Income Countries

Easson concludes his 1988 article by forecasting issues that would be likely to influence future tax treaty negotiations. He predicts:

- countries are likely to continue to expand their tax treaty networks, including in Latin America and the Middle East;
- the number of multilateral treaties between clusters of countries might be expected to grow;
- concerns about tax treaty abuse might be expected to grow;
- countries might be expected to increase efforts to combat avoidance and evasion;
- interest in unitary taxation might be expected to grow; and
- domestic tax reforms will continue to influence the design of tax treaties.

In some respects Easson's predictions have proven correct. Canada has certainly continued to expand its tax treaty network. Also, along with other OECD countries, it has become increasingly concerned about the use of tax treaties as a mechanism for avoidance, conscious of the importance of tax treaties as a means of facilitating information exchanges, and cognizant of the need for more effective means of dispute resolution. In other respects, however, Easson appears to have been too optimistic. Although many scholars have been enthusiastic about the promise of unitary taxation, it does not appear to be any closer to realization than it was in 1988. Furthermore, the number of multilateral treaties has not grown significantly over the last twenty years. This chapter does not conclude as boldly as Easson's article, by making predictions. Instead, it concludes by noting that the signing of Canada's most recent protocol with the United States and suggesting that that protocol might signal a change in Canada's tax treaty policy with significant implications for low-income countries.

Canada signed its fifth protocol to the 1980 Canada-United States tax convention in 2007. That protocol marks a significant change in Canada's tax treaty policy with the United

States, and by implication, to Canada's tax treaty policy generally. In particular, four changes, and their potential implications for low-income country treaty negotiations, might be highlighted. First, as noted above, Canada's treaty with the United States extends Canada's newly enacted domestic withholding tax exemption on interest to non-arm's length interest payments. This domestic change and its treaty extension might be expected to put downward pressure on withholding tax rates making it increasingly difficult for low-income countries to raise tax revenues from non-business foreign investment. Differential rates between interest, royalties, and dividend payments might also be expected to put pressure on the characterization of repatriations from low-income countries, although in many cases the rates imposed on these sources of income are already different.

Second, some jurisdictions include provisions in their tax treaties that are designed to prevent residents of third countries, who are not *bona fide* residents of one of the two treaty countries, from indirectly taking advantage of the benefits provided under the treaty. Unlike the United States, which usually negotiates a limitation of benefits provision in its tax treaties, Canada has historically taken the position that our general anti-avoidance rule should be sufficient to combat tax treaty shopping.²² However, Canada appears to be changing this view. In addition to the general anti-avoidance rule in its domestic legislation, in the last several years, Canada has also included more limited provisions in the "miscellaneous" articles of its treaties that attempt to restrict the use of tax treaties where there are preferential tax regimes for non-residents.²³ More dramatically, the fifth protocol to the Canada-US tax treaty brought into effect Canada's first mutual limitation of benefits provision.²⁴ If limitation on benefits provisions become a norm in Canada's tax treaty negotiations, low-income countries might anticipate additional pressure on their tax administrations to police, for example, access to tax incentives that are preserved by treaty provisions or treaty design.

Third, the protocol changes the treatment of services provided by individuals to deem those services to constitute a permanent establishment. If an individual performing services is not a permanent establishment under the standard definition, the deeming rule deems the individual to have a permanent establishment if he or she performs services in the state for a period of 183 days or more in any 12-month period and during that period

²² See Protocol Amending the Convention Between Canada and the United States of America With Respect to Taxes on Income and on Capital (Washington: September 26, 1980) as amended by the Protocols done on June 14, 1983; March 28, 1984; March 17, 1995 and July 29, 1997. See para. 3 of the general explanation in the Technical Explanation to Article XXIXA of the Canada-US convention.

²³ Article 27, paragraph 3 of the Canada, Trinidad and Tobago 1995 Income Tax Convention, February 8, 1996; Income subject to withholding tax, from April 1, 1996. Other provisions, from January 1, 1996. See Article 28. (To illustrate, paragraph 3 of Article 27 of the Canada-Trinidad and Tobago Tax Treaty provides: "This Convention shall not apply to any company, trust or partnership that is a resident of a Contracting State and is beneficially owned or controlled directly or indirectly by one or more persons who are not residents of that State, if the amount of the tax imposed on the income or capital of the company, trust or partnership by that State is substantially lower than the amount that would be imposed by that State if all of the shares of the capital stock of the company or all of the interests in the trust or partnership, as the case may be, were beneficially owned by one or more individuals who were residents of that State.")

²⁴ A limitation of benefits provision was included in the third protocol to the Canada-U.S. treaty, but it was designed to apply only for the purposes of the United States.

more than 50 percent of the gross active business revenues of the enterprise consist of income derived from services performed in the state by the individual. The deeming rule also applies if the services are provided for the same period of time with respect to the same or connected project for customers who are either residents of the source state or who maintain a permanent establishment in the source state and the services are provided in respect of that permanent establishment. Low-income countries might watch this development with interest given the importance of taxing business income, and the difficulties establishing that an enterprise has a permanent establishment in the jurisdiction. This provision is like the tax treaties with middle- or low-income countries that include a provision enabling the taxation of an enterprise which has a dependent agent furnishing services. In many cases the time period required for taxation under those provisions in Canada's tax treaties with low-income countries exceeds 183 days. Presumably the U.S. protocol suggests that Canada may be willing to consider agreeing to services provisions more frequently, and with lower time thresholds.

Finally, the new protocol requires that disputes between competent authorities be resolved by compulsory arbitration. Tax treaties generally include an article that addresses the resolution of disputes, or a mutual agreement procedure. Although initially resisted by the OECD, throughout the 1980s and 1990s, pushed by the business community,²⁵ the popularity of arbitration as a means of resolving disputes between competent authorities and/or between competent authorities and taxpayers grew. In 1992, the OECD added commentary to the exchange of information provision of its model treaty that recognized arbitration as an option for dispute resolution and in 2007 the OECD Committee on Fiscal Affairs adopted proposed changes that incorporated a mandatory and binding arbitration procedure.²⁶ It is perhaps not surprising that inclusion of an arbitration provision as a means of resolving disputes between countries about the application of the tax treaty has grown since Easson authored his article. Indeed, Canada has included arbitration provisions in 12 of its treaties with high-income countries, 14 treaties with middle-income countries, and 17 treaties with low-income countries.

The Canada-U.S. protocol is not the only signal of a change in Canada's tax treaty policy. In its 2007 budget, the government announced that it was striking an advisory panel to review Canada's system of international taxation. That committee has released a consultation report that indicates it is considering some potential major changes in direction in Canada's domestic legislation, which would have consequences for Canada's tax treaty policy.²⁷ For example, the advisory panel has identified inbound treaty shopping, expanding the exemption system for active business income, and broadening the withholding tax exemptions as issues for consideration.

²⁵ The International Chamber of Commerce endorsed compulsory arbitration in 1984. See the ICC resolution of June 16, 1984 annexed to International Fiscal Association, Resolution of Tax Treaty Conflicts by Arbitration, proceedings of a seminar held in Florence, Italy in 1993 during the 47th Congress of the International Fiscal Association (Deventer, the Netherlands: Kluwer, 1994) at 97.

²⁶ For a critique of the OECD proposal see Michael J. McIntyre, "Comments on the OECD Proposal for Secret and Mandatory Arbitration of International Tax Disputes," *Florida Tax Review* 7 (2006): 622.

²⁷ Advisory Panel on Canada's System of International Taxation, "Enhancing Canada's International Tax Advantage: A Consultation Paper Issued by the Advisory Panel on Canada's System of International Taxation, April 2008 at 1.4," <http://www.apcsit-gcrfci.ca/05/cp-dc/pdf/Rpt-eng.pdf>.

Easson's article focuses on the Carter Commission report as a marker for change in Canada's tax treaty policy. It seems that with the new Canada-U.S. tax treaty protocol and with the striking of an international tax advisory panel, Canada is likely to be embarking on another period of tax treaty policy change. Hopefully, the special circumstances of low-income countries will not be ignored when these changes are made and thus cynics and others will not be able to claim that the real purpose of the changed policies was simply to shift investment and revenue from low-income countries to Canada.²⁸

²⁸ One anonymous reviewer of this chapter helpfully suggests that the Department of Finance might be urged to lend an elite team of treaty negotiators to work with low-income countries to ensure that those countries receive the negotiating advice and expertise that they (in many cases) badly need.