The Evolution of Canada's Tax Treaty Policy Since the Royal Commission on Taxation

Alexander J. Easson

Follow this and additional works at: http://digitalcommons.osgoode.yorku.ca/ohlj

Citation Information
http://digitalcommons.osgoode.yorku.ca/ohlj/vol26/iss3/3

This Article is brought to you for free and open access by the Journals at Osgoode Digital Commons. It has been accepted for inclusion in Osgoode Hall Law Journal by an authorized editor of Osgoode Digital Commons.
THE EVOLUTION OF CANADA'S TAX TREATY POLICY SINCE THE ROYAL COMMISSION ON TAXATION*

By Alexander J. Easson**

I. INTRODUCTION

Probably the least innovative and stimulating part of the Carter Commission Report is that dealing with international taxation. Re-reading the Report twenty years on, one is left with the impression that, except insofar as international factors impinged upon the overall grand design — especially where they raised questions of equity between different classes of Canadian taxpayers — the Commission was not really interested. The major object of the Commission was to achieve tax neutrality,¹ since, in the international sphere, it concluded that "perfect tax neutrality is neither administratively feasible nor necessarily economically desirable,"² the Commission seems to have contented itself with making a few specific recommendations dealing with the extraterritorial aspects of its main domestic proposals before passing on to matters of greater moment. The section of the chapter dealing with tax treaties is

---

* Copyright, 1988, Alexander J. Easson.

**Faculty of Law, Queen's University.


²Ibid.
especially disappointing. Apart from concluding that tax treaties are a good thing, especially insofar as they assist in countering tax avoidance and evasion, and that Canada should have more of them, it really has very little to say about the subject.

Nevertheless, the Royal Commission's Report—or at any rate those parts of it that ultimately came to be implemented—did have a substantial impact upon Canada's tax treaty policy. The aim of this paper is to trace the subsequent evolution of that policy, to identify the major factors that have determined or influenced that evolution, and to suggest the directions which that policy might take in the years to come.

Canada's first tax treaty was entered into in 1928, with the United States of America, and was of a limited nature, concerned as it was only with the taxation of shipping profits. A number of other such agreements, restricted to shipping and transportation or, in the case of the 1935 agreement with the United Kingdom, to agency profits, were entered into in the period before the Second World War. Canada's first income tax agreement of general scope was that with the United States, entered into in 1942. This was followed, in 1946, by the agreement with the United Kingdom, which extended to a number of the then British colonies. By the time of the Royal Commission Report in 1966, Canada had concluded a total of fifteen income tax treaties.

Compared with the situation twenty years later, this may seem a rather small total. Indeed, to some commentators it appeared inadequate at that time. Certainly it did to one of

---

3 Ibid. c 26 at 566-70.


6 At the time of writing of the Report, thirteen treaties were in force and a further three were awaiting ratification. Two of these three were ratified before the end of 1966. The other, with Belgium, was substantially modified and did not receive ratification until 1975. A number of estate and succession duty treaties had also been concluded. These are not considered further in this paper.
Canada's pioneers in the field of international taxation who, speaking at the Tax Foundation Conference in 1970, held Canada's "puny participation" in bilateral tax treaties up to ridicule. Nevertheless, it is important to remember that the countries covered by tax treaties included the United States (and this is undoubtedly the most important single tax treaty in the world in terms of the volume of income flows that it affects), the United Kingdom, several other European countries (including the Federal Republic of Germany, France and the Netherlands), Japan, Australia, and New Zealand. In other words, a good three-quarters of income flowing into and out of Canada was already subject, by 1966, to one or another of our tax treaties.

Of more concern than the number of Canada's treaties was their vintage, a matter scarcely commented on at all by the Royal Commission. The treaty with the United States had been modified four times since 1942, and the one with France was almost twenty years old and did not take into account the major French reforms of 1965. The United Kingdom treaty had been terminated in 1965 and replaced in the following year by a new one, excluding from its scope the various colonies that had been covered by the 1946 agreement. Prior to its replacement, it had been hopelessly out of date and lopsided.

It was fairly obvious, then, at the time of the Royal Commission's Report, that Canada's tax treaty network would have to be expanded and brought up to date. What happened in fact,

---


9 The Report did call for keeping existing treaties under review and up to date: supra, note 1 at 577. See, however, the comments of McKie, supra, note 7 at 292-93.

10 McKie, ibid. at 293.
however, was that nothing happened. It was not until 1975 that Canada entered into another tax treaty. The reasons for this inaction are not difficult to find. First, there was the uncertainty surrounding the Report of the Royal Commission itself. Which of its numerous recommendations would eventually be implemented? Canada's own tax administrators were largely preoccupied with domestic reform, as the Commission itself had been. Other countries were in no hurry to enter into negotiations with Canada, knowing that major changes were shortly to be adopted, but uncertain what those changes might be. Consequently, nothing could be done; indeed no real start could be made toward drawing up a comprehensive tax treaty program until after the tax reform package of 1971 was announced. At that time it was sanguinely expected that a new treaty network would be in place by 1974; in reality, things took much longer.

Since 1974, however, the situation has changed dramatically. By the end of 1986, tax treaties with some forty-nine countries had been signed and were either in force or awaiting ratification. Of at least equal importance is the fact that only five of the pre-1967 treaties still remain in force today. With these exceptions, and that

---

11 See the comments of R.A. Short, "Tax Treaties - Recent Developments" in Proceedings of the 21st Tax Conference - 1968 (Toronto: Canadian Tax Foundation, 1969) 414, who stated, "If this paper were restricted to recent developments in Canada's tax treaty arrangements, I could conclude my assignment quite simply by sitting down," ibid. at 414.


14 J.S. Peterson, writing in 1975, lists thirty-eight countries with which Canada intended to negotiate or renegotiate treaties: "Canada's New Tax Treaties" (1975) 23 Can. Tax J. 315 at 317-18. In all but three cases this has been done: Mexico, Portugal, and Senegal. A number of treaties have also been concluded with countries not on his list, notably Romania, the USSR, and the People's Republic of China.

15 With Denmark (1955), Finland (1959), Ireland, Norway, and Trinidad and Tobago. These last three were all concluded in 1966 and were, consequently, based upon the Draft Double Taxation Convention on Income and Capital (Paris: OECD, 1963) [hereinafter 1963 Model]. (Only in these five treaties, by the way, is the exemption for visiting teachers and
of the treaty with South Africa, which was terminated for essentially political reasons in 1986, all the treaties existing at the time of the Royal Commission Report have been replaced. In addition to expanding its treaty network with most of its fellow members of the OECD, Canada has concluded treaties with a considerable number of developing countries\(^\text{16}\) and with three socialist countries.

The next Parts of this paper will attempt to review the major features of Canada's tax treaty policy and to examine the most important influences thereon.

II. THE REPERCUSSIONS OF DOMESTIC REFORM

Of the changes made in Canada's domestic tax system as part of the 1971 reforms, and thus directly or indirectly attributable to the Royal Commission Report, four in particular had an important impact upon Canada's tax treaties.

A. The Foreign Affiliate Rules

Prior to the 1971 reforms, dividends received by Canadian corporations from foreign affiliated corporations were received tax-free by virtue of what was then section 28(1)(d) of the Income Tax Act. Concern was expressed by the Commission that this rule provided opportunities for tax avoidance on a large scale by the use of subsidiaries established in tax haven countries.\(^\text{17}\) The new system, introduced in 1971 (though it did not take effect until 1974), made a distinction between dividends received from treaty countries,\(^\text{18}\) which it was assumed would normally have been taxed at rates not radically different from those imposed in Canada, and which

---

\(^{16}\) Some twenty to thirty countries seem to fit this category.

\(^{17}\) Report, supra, note 1 at 486.

\(^{18}\) Actually, from those countries listed in Reg. 5407(11) of the Income Tax Regulations, C.R.C., c. 945. The list includes the countries with which Canada has concluded tax treaties. See further D.A. Ward, Taxation of Income of Foreign Affiliates (Toronto: Carswell, 1983).
consequently need not be taxed again (exempt surplus), and those received from non-treaty countries, which included the most popular tax haven countries, which in future were to be taxable (taxable surplus) subject to credit for any source-country tax actually paid. These reforms made it very desirable for Canadian corporations with foreign subsidiaries, and for countries seeking to attract Canadian investment, that there be an applicable tax treaty. Exemption avoids the sometimes hideously complex foreign tax credit computations and, where the tax burden in the other country is lower than that in Canada, there will be a reduction, or at least a deferral, of tax paid.

B. Withholding Taxes

One of the most important recommendations of the Commission concerning the international aspects of Canada's tax system was that there should be an increase in the rates of withholding tax levied on certain types of income, in particular dividends, interest, and royalties, paid from Canadian sources to non-residents. The prescribed rate at that time was generally 15 percent — relatively low by international standards. The Royal Commission felt that foreign investors were not contributing sufficiently to Canada's economy, and that the main beneficiaries of the low rates were foreign governments. Yet the actual increase, to 25 percent, which was introduced in 1971, probably had relatively little impact upon either the Canadian or foreign treasuries since, as previously remarked, 75 percent or more of income flowing out of Canada was destined for countries with which Canada had a tax treaty. Invariably the treaty would stipulate the maximum rate of tax to be withheld (commonly 15 percent) and, in consequence, the new

---


20 The Commission recommended a standard rate of 30 percent: Report, supra, note 1 at 488.

21 The corresponding rates in the United Kingdom at that time were from 40 to 47 percent: see McKie, supra, note 7 at 293.

22 Since the lower the Canadian rate, the lower the amount of foreign tax credit given by the other country.
increased rate did not apply. It did, however, have an important impact upon Canada's subsequent tax treaty policy and its relations with those countries with which it had not yet concluded a tax treaty.

Hitherto, there had been little real pressure upon Canada to negotiate tax treaties. Canadians receiving foreign-source income benefited from a relatively generous foreign tax credit system, and so were not overly concerned about negotiating reductions in foreign tax rates unless these were especially high. Most of Canada's early tax treaty negotiations, in fact, seem to have been initiated by the other country. But as Canada's standard 15 percent rate of withholding tax was no higher than the rate specified in most treaties, there was no great advantage to be gained by foreign investors from a treaty with Canada, insofar as withholding tax was concerned.

Increasing the rate to 25 percent made it more important for foreign investors to have the benefit of a tax treaty with Canada, and at the same time improved Canada's bargaining position. The previous standard rate, available to all foreign investors, became the new concessionary rate to be bestowed only on treaty partners. In fact, the 15 percent rate became a firm negotiating position and Canada generally declined to accept rates lower than that. Indeed Canada appeared to be moving in the opposite direction from most other countries, increasing its withholding tax rates at a time when others were reducing theirs.

---

23 As they were, for example, in the United Kingdom. See J.F. Harmer, "Canada's Income Tax Treaties" in *Proceedings of the 12th Tax Conference - 1958* (Toronto: Canadian Tax Foundation, 1959) 222 at 233; Smith, supra, note 4 at 291; McKie, supra, note 7 at 293.

24 See Brown, supra, note 5.

25 Peterson referred to it as a "sacred cow": supra, note 14 at 320. There has been some softening in this position recently. Royalties are frequently reduced to 10 percent. The new Canada–United States treaty reduces the rate for intra-affiliate dividends to 10 percent and this has been followed in the 1987 protocol with France and the recent (1986) treaties with Japan, the Netherlands, and China. Withholding tax rates on interest payments have also been reduced in some of Canada's recent treaties, notably those with China and Japan.

26 See infra, notes 64-66 and accompanying text.
C. Capital Gains

The introduction of a tax on capital gains also compelled Canada to examine its existing treaties and to formulate a negotiating position with respect to future treaties. At the time of the Royal Commission Report, taxation of capital gains, internationally, was probably the exception rather than the rule. The United States had for many years included capital gains in the definition of income, but the U.K. Capital Gains Tax was introduced only in 1965, and many other countries either excluded capital gains from tax entirely or taxed only certain types of gain. This diversity was reflected in Canada's tax treaties, in that only six of them contained specific provisions dealing with capital gains. These six, in turn, reflected a variety of positions, which is scarcely surprising since the provisions had presumably been designed principally to meet the needs of Canada's treaty partners and could have had little or no importance to Canada's negotiators. The treaties with Finland, the Federal Republic of Germany, the United Kingdom, and the United States contained a restricted right to tax in the source country; those with the Netherlands and Sweden generally exempted the gains of non-residents. In the case of the other treaties, which contained no specific provision dealing with capital gains, there was also some confusion, since Canada's right to impose the new tax upon residents of those states depended upon the general wording of the treaty in question.

Tax reform radically altered Canada's international position. From being a country that did not tax capital gains and whose interest, insofar as it had displayed any, was to minimize capital gains taxation at source so as to protect its own residents from a tax that it did not impose on residents of other countries, Canada became a


country with a relatively comprehensive tax on gains,\(^{29}\) asserting an unusually wide jurisdiction to tax the gains of non-residents. In consequence, Canada's negotiating position also changed and it now sought to protect, so far as possible, its right to tax gains arising in Canada.\(^{30}\)

D. Corporate Taxation

One of the most interesting and radical recommendations of the Royal Commission was the complete integration of corporate and personal income taxes, whereby shareholders would receive full credit for the tax paid by the corporation in respect of dividends received by them. Until 1949, Canada had applied the 'classical system' to corporations, taxing a corporation on its profits and the shareholder on his or her dividends, with no recognition of the fact that those dividends had been paid from after-tax profits.\(^{31}\) In 1949, a tax credit of 10 percent of the dividend\(^{32}\) received was introduced, though it was restricted to Canadian resident shareholders of taxable Canadian corporations. The credit, apparently, had a dual motive: to give some measure of relief from the effects of 'economic double taxation', and to encourage investment by Canadians in Canadian equities. The 1971 reforms, predictably, did not go as far as the Commission had advocated, yet nevertheless substantially increased the degree of integration between corporation and shareholder by


\(^{30}\)This is reflected in the reservation expressed to art. 13 of the OECD 1977 model treaty. \textit{Model Double Taxation Convention on Income and Capital} (Paris: OECD, 1977) [hereinafter \textit{1977 Model}]. See text accompanying note 68; and see Broadhurst, \textit{supra}, note 27.


\(^{32}\)Increased to 20 percent in 1953.
raising the level of the dividend tax credit. As before, the credit was restricted to Canadian residents.

Arguably, then, the tax reforms had not brought about any fundamental change. Ever since 1949 Canada had operated a system of 'partial integration', and had never extended its tax credit to non-resident investors in Canadian corporations. Nevertheless, Canada had moved, in a series of steps and, one might say, almost by stealth, from a 'classical' system like that employed by the United States to an 'integration', or 'imputation', system similar in many respects to those that had recently been introduced, or were about to be introduced, in France, the Federal Republic of Germany, the United Kingdom and other members of the European Community. In so doing, it stepped right into the thick of an international row.

The origins of the dispute seem to date from the mid-1960s, when France revised its corporate tax system, introducing the précompte (the effect of which is somewhat similar to Canada's dividend tax credit), at the same time as its tax treaty with the United States was being renegotiated. There was, to say the least, a suspicion in the United States that the adoption of the new system by France had been a deliberate act to improve the French bargaining position and to secure an increased share, for the French treasury, of the profits accruing to U.S. investment in France. Nor was this suspicion confined to American commentators. As one British parliamentarian remarked: "The imputation system was invented by the French to be beastly to the Americans."


Denzil Davies, M.P., quoted by Kingson, supra, note 34 at 1194. There would seem to be an element of truth in this. Certainly, in choosing the most appropriate harmonized corporation tax system for the EEC, the Van den Tempel report was strongly influenced by the effect upon bargaining positions: see Easson, supra, note 33 at 176.
At this point, a few words of explanation may be appropriate. As already observed, under the so-called classical system as applied in the United States and, until 1949, in Canada, a corporation is taxed on its profits and the shareholders are separately taxed on dividends, which are paid out of after-tax profits. There is, consequently, an element of economic double taxation. Suppose, for example, that corporations are taxed at a flat rate of 40 percent, and that individual shareholders pay tax at 50 percent. A corporation earning a profit of 100 will pay 40 in tax: if it distributes the remaining 60 by way of dividend, the shareholder will pay a further 30 tax, making a total tax burden of 70.

By contrast, the essence of integration or imputation systems consists in the recognition that the tax paid by the corporation, or, more usually, some part of that tax, should be regarded as a having been imposed upon the shareholders and that, when taxed upon their dividends, the shareholders should receive some credit for the tax already paid by the corporation. Assuming that individual tax rates remain unchanged, then in order for the state to secure the same tax revenue from distributed profits the corporate tax rate must be greater under an integration or imputation system to compensate for the credit given to the shareholder. For example, if shareholders received a tax credit of 10 percent of the dividend received, the corporate tax rate would have to be increased from 40 percent to 50 percent in order to yield the same amount of tax revenue. The greater the credit, the higher the corporate tax rate.

None of this matters very much so far as domestic investors are concerned: it is the total tax take, or the net amount of the distribution, that matters and it is of no great consequence whether the exchequer devours its tax in one bite, two bites, or one-and-a-bit. But in an international context the choice of system is

---

36 It will be seen that the classical system taxes undistributed profits only once, and thus discriminates in favour of retentions as opposed to distributed profits.

37 As was the case in Canada from 1949 to 1953.

38 Profit of 100, tax at 50% = tax of 50. Dividend of 50, tax at 50% = tax of 25, less credit of (10% X 50) = 20. Total tax = 70.
important. Suppose that Country A applies the classical system, and Country B the imputation method; the tax rates are those given in the above examples; a withholding tax of 15 percent is imposed on dividends paid to non-residents; and the tax credit is restricted to resident shareholders. In respect of dividends paid to residents of Country B, Country A will collect 40 (corporate tax) plus 9 withholding tax = 49 total. By contrast, Country B will collect 50 (corporate tax) plus 7.5 withholding tax = 57.5 total. A reciprocal system of withholding tax rates (as is normally provided in tax treaties) will benefit those countries using imputation systems and disadvantage foreign investors. Such investors may also claim to be discriminated against since, by being denied a dividend tax credit, they are treated less favourably than domestic investors. Thus, the United States claimed that its investors should also receive a credit for tax paid by corporations in countries using the imputation system. Those countries responded by pointing out that investors in American corporations received no credit at all.

Canada, in the position of having to renegotiate its tax treaties with the major participants in the dispute (France, the Federal Republic of Germany, the United Kingdom and the United States) found itself subjected to a number of conflicting pressures. Within the European Community there were compelling reasons to grant the credit to investors from other member states. France and the United Kingdom were, in varying degrees, willing to extend the

---


40 This is a considerable oversimplification of what is, in practice, a very complex issue: see Kingson, supra, note 34 at 1195ff.


42 France grants the credit only in respect of portfolio investment, whereas the United Kingdom also grants a partial credit in respect of direct investment: see Kingson, supra, note 34 at 1197.
credit to investors from the United States and other countries; Germany,\textsuperscript{43} by contrast, was not. France and the United Kingdom were prepared to allow the credit to Canadian investors, who, naturally, had no wish to be treated less favourably than their American counterparts. Just as naturally, however, the French and British suggested that, if they extended their credits to Canadian investors, Canada should give its credit to French and British investors. This Canada was not prepared to do, for the simple reason that it would make it considerably harder to resist demands that Canada's dividend tax credit be extended to American investors. This, indeed, was one of the main bones of contention in the prolonged negotiations for the new treaty with the United States.\textsuperscript{44}

However much it would have liked to assist its investors in France and the United Kingdom, the overwhelming consideration for Canada must always be its position \textit{vis-à-vis} the United States.\textsuperscript{45}

Quite simply, Canada felt that it could not afford to extend the dividend tax credit to U.S. residents and consequently could not allow a credit to investors from other countries.\textsuperscript{46}

The eventual outcome was, ostensibly, highly satisfactory for Canada. France\textsuperscript{47} and the United Kingdom\textsuperscript{48} were persuaded to


\textsuperscript{45}In the words of Kingson, for Canada the treaty with the U.S. is "\textit{the treaty}": \textit{supra}, note 34 at 1256.

\textsuperscript{46}See Short, \textit{supra}, note 13 at 412. Canada also attempted to justify its position by the rather unconvincing argument that its system was \textit{not} an imputation system like those in force in European countries. It was (rightly) pointed out that the dividend tax credit does not depend upon tax having been paid by the corporation and (more speciously) that the purpose of the credit is not to relieve economic double taxation, but rather to promote investment by Canadians in Canadian equities. Generally, see Brown, \textit{supra}, note 5.

\textsuperscript{47}The new treaty with France was concluded in 1975; for comments, see Peterson, \textit{supra}, note 14.
grant credits to Canadian investors without corresponding credits being given by Canada, though those credits were less generous than might have been obtained had Canada agreed to full reciprocal treatment. At the same time, Canada finally succeeded, in 1980, in negotiating a new treaty with the United States without yielding on the dividend tax credit issue. In return, however, the United States was able to persuade Canada to sacrifice its "sacred cow" — the insistence upon a 15 percent rate of withholding tax on dividends paid to non-residents. In the case of dividends paid to affiliated corporate shareholders the rate was reduced to 10 percent. Having thus once abandoned its formerly firm stance on withholding tax rates, Canada has subsequently found itself obliged to make similar concessions to France, the Federal Republic of Germany, the United Kingdom, Japan, and, rather surprisingly, the People's Republic of China.

The corporation tax issue has been emphasized here because it illustrates a number of important factors that influence the negotiation of international tax treaties. First, there is the rather obvious point that changes in the domestic tax system frequently have international repercussions, insofar as they also affect the treatment of non-residents or of foreign-source income. Such changes may alter a country's bargaining position with regard to the negotiation of future treaties (and, as a general rule, it is unfortunately true that the more harshly a country taxes foreign investors or foreign-source income the better its bargaining position becomes) and may necessitate the renegotiation of existing treaties.

Second, the existence of a tax treaty does not constitute a guarantee that tax rules and burdens will not change. A treaty provision which establishes a particular rate of tax to be charged on dividends paid to residents of the other country does ensure that, so


49See supra, note 25.

50In the new Protocol, signed in 1987.

51In the 1985 Protocol; see Morgan, supra, note 48.
long as the treaty remains in force and observed, that rate of tax will not be exceeded; but it does not in any way guarantee that the burden of tax upon the corporation paying those dividends may not be increased. Consequently, the division of tax revenues agreed upon by two countries can be altered unilaterally by either one of the parties.\(^{52}\)

Third, the normal principle adhered to in negotiating tax treaties has been one of reciprocity. The corporate tax issue, however, demonstrates that, where countries adopt different systems of taxation, the traditional, mirror-image approach may not produce the most appropriate or equitable result.\(^{53}\)

Fourth, and this is perhaps the most significant lesson, a tax treaty between two countries cannot simply be negotiated in isolation. What Country A agrees to with Country B is likely to affect what Country C will also expect of it.\(^{54}\) Consequently, a country may decline to negotiate the most mutually beneficial arrangement in one treaty for fear that to do so might have a 'domino effect' and prejudice its position in future negotiations with other countries. Particularly is this a problem for Canada, since it is both a capital-exporting and a capital-importing nation and, whatever its interests in relation to some other country may be, it can never afford to ignore its position vis-à-vis the United States. The content of Canada's tax treaties, then, is determined and

\(^{52}\)We are not here concerned with the problem of altering the position of residents of other countries by redefining terms employed in domestic legislation, which was considered in the Melford case; see J. McCurt & B. Morris, "The Income Tax Act Conventions Interpretation Act -- Unilateral Treaty Amendment?" (1983) 31 Can. Tax J. 1022; J.F. Avery Jones et al., "The Interpretation of Tax Treaties with particular reference to Article 3(2) of the OECD Model" [1984] Brit. Tax Rev. 14 at 90.


\(^{54}\)A typical example of this phenomenon is Canada's reduction of the withholding rate on dividends in the new (1980) treaty with the U.S.A., followed by similar concessions to a number of other countries. It will be interesting to observe whether or not the reduction in the withholding rate on interest payments, in the 1985 Protocol to the treaty with the United Kingdom, will have similar repercussions: see Morgan, supra, note 48. Rather surprisingly, the rate was not reduced in the new treaty with the Netherlands: see V. Morgan, "The New Canada--Netherlands Tax Treaty" (1986) 34 Can. Tax J. 872.
influenced not only by the changes which are made in domestic tax legislation but also, and probably far more so, by what happens in other countries of the world. The remainder of this paper will examine some of the most significant external developments that have occurred and have had an impact upon Canada's tax treaty policy in the years since the Carter Report.

III. THE OECD MODEL TREATIES

Without doubt the greatest single influence upon tax treaty policy, not only of Canada but of virtually all countries that have entered the tax treaty arena, has been the model treaties formulated by the Organization for Economic Cooperation and Development (OECD).\textsuperscript{55} As has been remarked, "virtually all tax treaty negotiations in the world today start with the OECD draft convention."\textsuperscript{56} It is true that the United Nations Model\textsuperscript{57} has had a considerable influence upon, and is preferred by, many developing countries, but that model itself is essentially a version of the OECD 1977 Model, revised to meet the particular needs of developing countries.\textsuperscript{58}

Various attempts had been made during the first half of this century, particularly under the auspices of the League of Nations, to 'harmonize' the main provisions of bilateral tax treaties,\textsuperscript{59} but the


\textsuperscript{58}Treaties of developing countries are considered in the next Part of this paper.

\textsuperscript{59}A number of model conventions were put forward by League of Nations working groups in 1927, 1928 and 1935: see D.M. Hudson & D.C. Turner, "International and Interstate Approaches to Taxing Business Income" (1984) 6 Nw. J. Int'l L. & Bus. 562 at 567; Rosenbloom & Langbein, \textit{supra}, note 34 at 365. In 1943, in Mexico City, a model convention drawn up by the Fiscal Committee of the League of Nations was adopted by representatives of Canada, the U.S.A., and a number of Latin American countries: See K.C. Wang, "International Double Taxation of Income: Relief through International Agreement" (1945)
first model to gain really widespread acceptance was the OECD 1963 Model.60 At the time of the Royal Commission Report, the 1963 Model had been in existence for a relatively short time and had influenced only the four most recent of Canada's tax treaties.61 A revised version was published in 1977, and it is this model that forms the basis for some two-thirds or more of Canada's current treaties.

As the discussion of the corporation tax issue has illustrated, each country, when it embarks upon the negotiation of a tax treaty, normally has a list of the benefits that it hopes to extract from the other country and a list of the concessions that it is prepared to grant in return. In effect, it has its own 'model' treaty.62 Canada's unofficial model may be said to be the OECD 1977 Model, with a number of modifications or reservations.63 The main reservations are:

**Withholding tax rates.** Canada generally reserves the right to impose a 15 percent withholding tax on dividends remitted abroad,
regardless of the degree of ownership by the recipient.\textsuperscript{64} It further reserves the right to tax interest payments at a rate of 15 percent\textsuperscript{65} and to tax most types of royalty payments at a rate of not less than 10 percent.\textsuperscript{66}

*Capital gains.* As previously mentioned,\textsuperscript{67} Canada exercises a relatively broad jurisdiction in respect of capital gains realized by non-residents disposing of property situated in Canada. Even in its treaties, the policy is to reserve a right of taxation larger than that envisaged by the \OECD\textsuperscript{1977 Model}.\textsuperscript{68}

*Pensions.* Again, Canada endeavours to retain a limited right to tax at source pension payments made to non-residents.\textsuperscript{69} Doubtless, this is due to the large number of Canadians who retire to warmer climates and whose pensions are essentially a deferred form of Canadian-source income.

*Developing countries.* In its treaties with developing countries, Canada commonly adheres to a number of the positions recommended in the \textit{United Nations Model} treaty. These are discussed in the next Part of this paper.

### IV. TREATIES WITH DEVELOPING COUNTRIES

As remarked in the Introduction, one of the most significant developments since 1966, at least in relation to the geographical scope of Canada’s tax treaty network and the sheer number of

\textsuperscript{64}The \textit{1977 Model}, \textit{ibid.} at art. 10, provides for a reduced rate of tax where dividends are paid to a parent of an affiliated corporation. As seen above (notes 48-51 and accompanying text), Canada relaxed its position in the new treaty with the U.S.A. and, subsequently, in its tax treaties with a number of other countries.

\textsuperscript{65}Cf. \textit{ibid.} at art. 11.

\textsuperscript{66}Cf. \textit{ibid.} at art. 12. Certain types of royalty payment (e.g., authors’ royalties) are exempt, but this exemption does not extend to motion picture royalties.

\textsuperscript{67}See \textit{supra} text accompanying note 30.

\textsuperscript{68}\textit{Supra}, note 30 at art. 13.

\textsuperscript{69}Cf. \textit{ibid.} at art. 18.
treaties entered into, has been the expansion of that network into the Third World. In 1966, Canada had only one treaty with a 'developing' country— that with Trinidad and Tobago. In the intervening years, treaties have been signed with Morocco, the Dominican Republic, Liberia, Malaysia, Pakistan, the Philippines, Singapore, Jamaica, Korea, Indonesia, Barbados, Bangladesh, Cameroon, Sri Lanka, Tunisia, Egypt, Ivory Coast, Kenya, Brazil, Thailand, Zambia, Guyana, India, and the People's Republic of China. Treaties have also been concluded with Israel, Spain, Romania, Cyprus, and Malta that accord those countries 'developing country' treatment. In virtually all of these cases, Canada has made special concessions.

Until the 1960s, practically all tax treaties had been between the developed nations of western Europe, North America and Australasia. Tax treaties with the developing countries of Africa and Asia were few, except insofar as treaties made with the colonial powers extended to them. It was only then, of course, that most of those countries acquired their independence and the power to enter into their own treaties. But even so, there was no great reason to rush into negotiating tax treaties. The typical tax treaty,

---

70. The treaty of 1946 with the United Kingdom also applied to many British colonies. It was terminated in 1965, and in 1966 replaced by a new treaty. The 1966 treaty did not apply to those other countries, many of which had achieved independence since 1946.

71. The treaty with Trinidad and Tobago was signed in 1966. In some respects, Trinidad and Tobago might be considered unfortunate to be the first developing country with which Canada entered into a tax treaty. Subsequent Canadian tax treaties have generally been more favourable to the developing country, and Trinidad and Tobago has also fared better with other countries since 1966. It is interesting to note that Canada's treaty with Ireland, which also dates from 1966, did provide for tax sparing in favour of Ireland. See Short, supra, note 5 at 38.

72. There were a few pre-war treaties involving eastern European countries. See, infra, note 119.

73. Japan had also recently joined the 'tax treaty club'.

74. See supra, note 70. The U.S.A. had many treaties with colonial and ex-colonial states, through extensions of its treaties with Belgium (1948) and the United Kingdom (1945). These were mostly terminated in 1983.
as the Latin American countries had earlier realized,\(^7\) was designed to meet the needs of the developed nations, presumed complementary flows of income and capital, and was therefore based on principles of reciprocity. Its objective was to facilitate the international movement of capital by eliminating double taxation, and the main method of achieving this was by the elimination or reduction of taxation in the country of source. This was all very well where investment flowed in both directions. But where the flows were essentially one-way, as in the case of the lesser-developed countries, emphasis on residence-country taxation was evidently inappropriate.\(^7\)

Further, those developing countries that sought to attract foreign investment by offering tax concessions frequently found their concessions nullified, with the benefit accruing to the country of residence of the investor, rather than to the investor itself.\(^7\)

Initially, the developing countries did not appreciate the disadvantages of the standard type of treaty that had come to be employed by the developed nations.\(^7\) Nor, in most cases, did they appear to realize that they might have sufficient bargaining power to secure a departure from the by then well-established model. In many instances newly independent countries simply inherited treaties that had been entered into by their former colonial masters,\(^7\) and the earliest post-independence treaties tended also to follow the already well-established pattern.\(^8\) Perhaps the developing countries, cast in the role of supplicants for foreign aid and investment, saw little opportunity to impose their own terms in negotiations with developed countries. Gradually, however, circumstances began to

\(^7\) Notably at the time of the drafting of the 'Mexico Model' in 1943: see supra, note 59.

\(^7\) For a full discussion, see C.R. Irish, "International Double Taxation Agreements and Income Taxation at Source" (1974) 23 Int'l & Comp. L.Q. 292.

\(^7\) By virtue of the operation of the foreign tax credit: this is discussed infra, notes 101-104 and accompanying text.

\(^7\) As mentioned above, the Latin American nations were an exception: see text accompanying note 75, supra.

\(^7\) See supra, notes 70 & 74.

\(^8\) The Canada-Trinidad and Tobago treaty being a good example: see supra, note 71.
evolution. Although it was true that there was competition among developing countries to attract foreign investment, it also became apparent that there was competition among developed countries, and more particularly among enterprises from those countries, to secure lucrative contracts in the developing world. Since the main purpose of tax treaties has traditionally been to eliminate double taxation of individuals and enterprises, and the division of tax revenue among the contracting states has been only a secondary function, the chief beneficiaries of any tax treaty with a developing country ought to be the enterprises from developed countries investing or doing business there. Such enterprises consequently had an incentive to exert pressure upon their own governments to negotiate treaties with the developing countries in which they sought to invest. This greatly increased the bargaining position of the developing countries themselves, and once two or three developed countries were prepared to accept terms more favourable to the developing countries, most of the others felt compelled to go along. In reality, there was a sort of 'domino effect' in reverse: just as to grant a special concession to one country causes others to expect the same treatment, so to secure special treatment from one enables a country better to extract the same treatment from others.

The special treatment now commonly requested by and accorded to developing countries takes two basic forms: an

---

81 Kenya, for example, cancelled (in 1973) the treaty arrangement that it had inherited from the United Kingdom, and embarked upon a program of new negotiations: see Irish, supra, note 76 at 299.

82 The Federal Republic of West Germany, Japan, and Sweden were among the first to recognize the advantages of giving special concessions to developing countries. See M.B. Carroll, "Germany, Japan and Sweden Show the United States How to Reach Tax Treaties with South American Countries" (1969) 38 Geo. Wash. L. Rev. 199; G. Bryan, "Developed Nation Tax Law and Investment in LDC's" (1978) 17 Colum. J. Transnat'l L. 221.

83 These are, of course, not the only concerns of developing countries. In particular, many countries endeavour to secure favourable treatment for their students and teachers who are training or doing research in developed countries: see Broadhurst, supra, note 63 at 689; Klock, supra, note 62 at 416. China has been especially successful in this regard: see art. 19 of the Canada–China treaty in which, for the first time, Canada has been persuaded to omit its usual proviso whereby it reserves the right to tax visiting students on income from Canadian sources. China has secured similarly generous treatment from Belgium, France, the Federal Republic of Germany, Norway, and the United Kingdom.
enlargement of source-country jurisdiction, and the preservation of investment incentives by the process that has come to be known as 'tax sparing'.

A. Source-country Jurisdiction

Three basic methods exist whereby double taxation of income flowing from one country to another may be avoided: the source country may waive its right to tax, granting an exemption to residents of other countries; the country of residence may exempt its own residents from tax on foreign-source income; and both countries may tax, but in such a way that the total tax burden is not increased. Normally this third method is achieved by the country of residence taxing foreign-source income but giving a credit for tax imposed upon that income by the country of source. Considerations of equity normally require that either the second or third method be applied. Certainly, the Royal Commission had no doubt that Canadian residents should be taxed on their world income and that "a buck is a buck," wherever it is earned. But if equity requires that foreign-source income be included in the tax base, it also requires a recognition of any tax that the income has borne in the country of source: the total tax burden should be the same, whether one's income derives from Kingston, Ontario or from Kingston, Jamaica.

84 As does Canada in the case of dividends received by a Canadian corporation from an affiliate in a "listed" country: supra, notes 18-19 and accompanying text.

85 This is the method generally adopted in Canada (and in the U.S.A.), relief from double taxation being given by means of a foreign tax credit: for a comprehensive study, see R. Couzin, "The Foreign Tax Credit" in Proceedings of the 28th Tax Conference -- 1976, supra, note 56, 69. The tax credit method does not always succeed in eliminating double taxation, especially where the level of taxation is higher in the source country than in the country of residence.

86 The first method may be appropriate, and convenient, in the case of corporations, where progressive rates of tax generally do not apply and where the income will eventually be taxed in the hands of the individual shareholders.

87 Report, supra, note 1 at 483, 491ff.

88 This also achieves what is generally referred to as "capital-export neutrality." See further R.M. Bird, "International Aspects of Integration" (1975) 28 Nat. Tax J. 302.
This result can be, and commonly is, achieved unilaterally by means of the foreign tax credit, but to be fully effective it is normally necessary for host-country tax rates to be lower than the average rate of tax payable by the recipient in the country of residence. Consequently, one major objective when tax treaties are negotiated is to reduce the level of source-country taxation to ensure that double taxation will be fully eliminated, in particular by limiting the rates of withholding tax applied to transfers of income. And even where the foreign tax credit mechanism is successful in eliminating double taxation, the added complexities of having to pay tax in two jurisdictions and claim the appropriate credit may be a deterrent to international commerce. It is consequently normal to eliminate source-country taxation of income earned by non-residents from what are essentially temporary or occasional activities. This is achieved primarily by the 'permanent establishment' concept: a non-resident will be taxed on business income only if he, she, or it has a substantial connection with the source country.

These concepts and provisions work relatively well when there is a more or less equal, two-way flow of income between the contracting states. Indeed, in such circumstances it might be possible to eliminate source-country taxation entirely. But where income flows are essentially unidirectional, as is the case with the great majority of developing countries, the restriction of source-country jurisdiction simply operates to transfer revenue from the (usually poor) host country to the (usually rich) country of residence.

Developing countries, consequently, have sought to expand the scope of source-country jurisdiction beyond that provided for in

---

89 The foreign tax credit is normally restricted to the amount of tax that would otherwise be payable in the country of residence in respect of the foreign-source income. Thus, Canada restricts the amount to that of "Canadian tax otherwise payable" (CTOP): *Income Tax Act*, *supra*, note 19 at s. 125. Without such a limitation there would, in effect, be a subsidy from the residence country to the treasury of the source country. The operation of the limitation is complex, and depends upon whether a per country limitation is employed (as in Canada), or a global limitation (as in the United States). See further Couzin, *supra*, note 85.


91 For a comprehensive study of the 'permanent establishment' rules in Canada's tax treaties, see Broadhurst, *supra*, note 63 at 575.
the \textit{OECD} models\textsuperscript{92} in doing so, they have generally found Canada to be sympathetic and responsive. In part, no doubt, this can be attributed to Canada's traditionally supportive attitude to the developing world, but a more significant factor has probably been the identity of Canada's own interests with those of developing countries. In relation to the developing world, Canada is essentially an exporter of capital, but in relation to more developed countries, in particular the United States, Canada is on balance a capital-importer, and has itself adopted a 'source-country mentality.'\textsuperscript{93}

Canada's willingness to accept an expanded source-country jurisdiction is reflected in its treaties with developing countries in two main respects. First, the definition of "permanent establishment" is commonly expanded. For example, in the \textit{OECD} 1977 \textit{Model},\textsuperscript{94} a building site or construction project is treated as constituting a permanent establishment only if it is in existence for a period of at least a year; in Canada's treaties with developing countries this period is almost invariably reduced to six months and, sometimes, to as little as three months.\textsuperscript{95} Canadian contractors carrying out construction work in developing countries will consequently normally pay tax on their profits to the host country. Another example is provided by the treatment of insurance companies: in a number of Canada's treaties,\textsuperscript{96} the selling of insurance, even without the establishment of a local office, is sufficient to render taxable the profits of the insurer earned in the country of the insured.

The second, and probably more significant, method of expanding source-country jurisdiction has been by means of increasing rates of withholding tax. As has previously been observed, Canada has generally advocated relatively high rates of withholding

\textsuperscript{92}Latin American countries, in particular, have traditionally adopted a strong 'source-country' position: see Carroll, \textit{supra}, note 82; Klock, \textit{supra}, note 62 at 388.

\textsuperscript{93}See Kingson, \textit{supra}, note 34 at 1170. The same can be said of countries such as Australia and New Zealand.

\textsuperscript{94}\textit{Supra}, note 30 at art. 5.

\textsuperscript{95}E.g., in the treaties with India, Jamaica, Pakistan, and Zambia.

\textsuperscript{96}E.g., those with Barbados, Brazil, Indonesia, Jamaica, and Tunisia.
tax, and recorded reservations to the OECD provisions on dividends, interest and royalties,\textsuperscript{97} preferring where possible to adhere to its '15–15–15' model. In its treaties with a number of developing countries Canada has gone further and has frequently agreed to withholding tax rates in excess of 15 percent. Thus, for example, in the treaty with the Dominican Republic, the standard withholding rate is prescribed as 18 percent. In other treaties, rates on dividends are stipulated to be 25 percent,\textsuperscript{98} and, on some royalties, may be as high as 30 percent.\textsuperscript{99} More recently, Canada has been willing to depart from the normal principle of reciprocity, and to accept the levying of a higher withholding tax rate by the developing country while restricting its own withholding tax to its normal "treaty" rate of 15 percent.\textsuperscript{100}

B. Tax Sparing

Developing countries frequently seek to attract foreign investment by offering tax concessions, such as accelerated depreciation for capital investment and extended 'tax holidays' for new ventures. Where the country of residence relieves double taxation by means of an exemption for foreign-source income, such tax concessions obviously benefit the taxpayer.\textsuperscript{101} But where relief is provided by means of a foreign tax credit, the real beneficiary of

\textsuperscript{97}Supra, notes 64-66 and accompanying text. See also Broadhurst, supra, note 63 at 217.

\textsuperscript{98}E.g., the treaties with India and Kenya.

\textsuperscript{99}In the treaty with India. The treaty with Brazil prescribes a rate of 25 percent for some types of royalty payments, and that with Liberia, 20 percent. The Liberia treaty also prescribes a 20 percent rate for interest.

\textsuperscript{100}See Coulombe, supra, note 56. This is done, for example, in the treaties with Cameroon, Egypt, the Ivory Coast, Jamaica, Pakistan, the Philippines, and Thailand.

\textsuperscript{101}This is the case in Canada, when a tax concession is enjoyed by a foreign subsidiary in a "listed" country: any dividend paid out of active business income is received by the Canadian parent as being from exempt surplus and is not subject to Canadian tax. See supra, notes 18-19, and accompanying text; Coulombe, supra, note 56 at 299. Tax sparing in respect of a subsidiary's profits is nevertheless valuable if those profits are not repatriated directly to the Canadian parent, but are diverted through a holding company situated in a non-treaty country.
any tax concession by the host country will be the treasury of the country of residence, unless 'tax sparing' is adopted.

For example, if a Canadian corporation carries on a business in another country through a branch operation, it is taxable in Canada on its profits earned by the branch, with a credit for the tax paid to the other country in respect of those profits. If the other country exempts those profits from tax, or reduces the normal rate of tax thereon, the effect is simply to reduce the amount of credit claimable against Canadian tax. It is consequently not the corporation, but rather the Canadian government, that benefits from the tax concession.\(^{102}\) In order to restore the benefit of tax concessions, tax sparing is required: in effect, the country of residence gives a foreign tax credit for the tax that would have been paid to the host country if not for the host country's grant of relief. A variant of this approach is provided by what is commonly, and somewhat misleadingly, described as the 'matching credit' system.\(^{103}\)

As with tax sparing, a tax is deemed to have been paid to the host country and to be creditable in the country of residence, but this relief is not linked to any specific tax concession. For example, the rate of withholding tax on dividends, interest or royalties may be deemed to be 20 percent, regardless of the rate, if any, actually imposed in the source country.\(^{104}\)

---

\(^{102}\) The position is more complex in the case of operations conducted by a subsidiary corporation: see ibid. Initially, the tax relief will be enjoyed by the subsidiary. If the parent corporation receives dividends from the subsidiary tax-free, then the benefit of the concession is effectively transferred to the parent. If, however, the dividend constitutes taxable income of the parent, with a credit for the underlying tax paid by the subsidiary, then ultimately the beneficiary is the government of the parent's residence. However, if residence-country tax is deferred until dividends are actually remitted, the corporate group continues to enjoy the benefit of the concession during the period of deferral. See S.S. Surrey, "International Tax Conventions: How They Operate and What They Accomplish" (1965) 23 J. Tax. 364; Kingson, supra, note 34 at 1262.

\(^{103}\) For an analysis of the different approaches to tax sparing, see H.W.T. Pepper et al., "Tax Relief Provisions between Developed and Developing Countries" (1972) 12 Eur. Tax. I/3; R.J. Vann and R.W. Parsons, "The Foreign Tax Credit and Reform of International Taxation" (1986) 3 Aust. Tax F. 131; Bryan, supra, note 82.

\(^{104}\) An interesting approach is that taken by the Federal Republic of Germany in some of its treaties, in respect of dividends received from subsidiaries. The underlying tax that is creditable against the dividend, is deemed to be the same amount it would be under German law. Effectively this exempts the dividend from German tax: see K.C. Wrede, "Germany:
At the time of the Royal Commission Report, none of Canada's tax treaties contained tax-sparing provisions, though the Commission recognized the desirability of negotiating treaties with developing countries and expressly accepted the concept of sparing. This was then comparatively novel, but has since become a common feature in treaties between developed and developing countries, with the notable exception of the treaties of the United States. Canada now routinely grants tax-sparing credits in its treaties with developing countries. Generally the relief takes the form of a credit for tax waived or reduced under some specific provision of the host country's legislation, normally in relation to business profits. For example, in the recent treaty with the People's Republic of China, credit is given for tax that would have been payable but for the operation of sections 5 and 6 of China's Joint Venture Income Tax Law and sections 4 and 5 of its Foreign Taxation of Foreign Source Income" [1984] Intertax 392.

105Canada's first treaty with a developing country was that with Trinidad and Tobago, signed in 1966. The treaty contained no tax-sparing provision. However, a limited form of tax sparing was provided in the treaty with Ireland, also signed in 1966: supra, note 71.

106Report, supra, note 1 at 531.

107It appears to have been pioneered by the Federal Republic of Germany and Sweden. Provisions appear in the Germany–India and Sweden–Israel treaties, both of 1959: see further the survey in Pepper et al., supra, note 103.

108Tax-sparing provisions were included in the draft treaties with India and Israel, but were rejected by the U.S. Senate: see W.A. Slowinski, T.M. Haderlein & D.I. Meyer, "International Tax Treaties: Where are we? -- Where are we going?" (1965) 5 Va. J. Int'l L. 133. Since then, the United States has refused to grant tax-sparing treatment. For reviews of the U.S. position, see Surrey, supra, note 102; S.S. Surrey, "Factors Affecting U.S. Treasury in Conducting International Tax Treaties" (1968) 28 J. Tax., 277; Kingson, supra, note 34; Klock, supra, note 62; Rosenbloom & Langbein, supra, note 34.

109For a review, see N. Boidman, "Some Current Issues with Treaty Tax-sparing Provisions" [1985] Bull. for Int'l Fisc. Doc. 387. Since 1975, the only exception appears to be the treaty with Sri Lanka. There is, of course, no accepted definition of "developing": Canada accords 'developing country' treatment to such countries as Israel, Romania, and Spain, as well as Ireland, discussed supra, notes 71 & 105.

110Treaty signed on May 12, 1986.
Enterprise Income Tax Law. In a few instances, Canada has adopted the matching credit method, generally by deeming a tax at the rate of 15 percent to have been withheld on dividends, interest or royalties regardless of the rate, if any, actually withheld.

As already observed, with the exception of the United States, tax sparing has become standard practice around the world and there are even examples of countries that are both recipients and grantors of tax sparing. In a number of instances tax sparing is provided on a reciprocal basis, which raises an interesting possibility. It is, after all, not only developing countries that offer tax advantages and holidays in order to attract or stimulate investment. In particular, developed countries may quite legitimately do so in order to attract investment in their less-developed regions. One may therefore ask whether foreign enterprises, induced to invest in those regions, should not also enjoy the benefit of tax concessions granted by the host country, without having that benefit nullified by paying correspondingly more tax in their countries of residence. There may, indeed, be a case for a more generalized form of tax sparing.

---


112 Supra, note 104 and accompanying text. This method is favoured by most continental European countries, especially in respect of rates of withholding tax. Those countries are more inclined to exempt foreign business profits from tax, thus avoiding the need for tax sparing.

113 See the treaties with Brazil and the Philippines. China is particularly favoured, receiving both types of credit.

114 Singapore receives tax-sparing treatment from the Netherlands, Sweden, and the United Kingdom, and grants it to the People's Republic of China. Ireland and Spain have frequently obtained tax sparing from more developed countries (as they do from Canada) and they grant it to lesser-developed countries.

115 For example, in the Finland-Spain, Ireland-Zambia, Italy-Greece, and (curiously) Romania-Sri Lanka treaties.
V. TREATIES WITH SOCIALIST COUNTRIES

As we have seen, until the 1950s, and in the case of Canada until 1966, the tax treaty network was confined almost exclusively to the relatively advanced, capitalist nations, most of which were members of the OECD. The picture was altered dramatically by the entry of the developing nations of Africa, Asia and the Caribbean onto the international fiscal stage. A second major expansion of the treaty network occurred, largely in the past decade, with the conclusion of more than one hundred treaties by the socialist, or 'state trading', nations of eastern Europe and by the People's Republic of China. So far, Canada has been comparatively slow to participate in this development, having treaties only with Romania (1978), the USSR (1985) and China (1986).

Tax treaties are not exactly a novelty for the countries of eastern Europe. Indeed, Hungary was a party to what is generally considered to have been the world's first income tax treaty, and entered into a number of other treaties in the period prior to the Second World War; the Soviet Union also concluded a tax treaty with Germany in 1925. These early treaties apart, most of which have long since ceased to be operative, the modern movement can

---

116 By the end of 1986, Romania had entered into 22 bilateral tax treaties; Poland 17; China and Hungary, each, 16; Czechoslovakia 15; Bulgaria 10; the German Democratic Republic and Yugoslavia, each, 10; and the USSR, 8. These countries, with the exception of China and Yugoslavia, are also parties to two multilateral treaties adopted by members of the Council for Mutual Economic Assistance (CMEA). See infra, note 141 and accompanying text.

117 Most active have been the countries of western Europe, notably Austria, Denmark and Sweden, and (rather surprisingly) Cyprus. The United States (like Canada) has treaties with Romania, the USSR, and China; and also with Hungary and Poland: see F.W. Brownell & T.J. Johnson, "Tax Conventions with Poland, Romania and the U.S.S.R." (1976) 8 Law & Pol'y Int'l Bus. 763.

118 That of 1899, between Austria, Hungary, and Prussia.

119 For example, treaties with Czechoslovakia (1925) and Poland (1928), and a treaty with Sweden (1936) that continued in force until replaced in 1982. For a review of Hungary's tax treaties, see T. Nagy, "Taxation of Individuals, Companies in the non-Socialist Sector and Foreign Legal Entities" (1980) 20 Eur. Tax. 341.
be said to have really begun with the conclusion of the treaty between the United States and the Soviet Union in 1973.\textsuperscript{120} This treaty is somewhat skeletal in nature, being considerably shorter than the OECD models, and no doubt reflected the limited objectives of the parties. At that time, the Soviet Union generally exempted from income tax the income earned there by foreign nationals and (insofar as they were permitted to exist at all) by foreign enterprises.\textsuperscript{121} By contrast, its citizens employed in other countries were normally taxable in those countries on income earned there and, as citizens, were also taxable at home, without the benefit of any foreign tax credit. The principal aim of the Soviet Union, consequently, appears to have been to secure exemption from tax, or a reduction of tax, for its citizens working (principally for state trading agencies) in the United States. In this, they were only partially successful.\textsuperscript{122} Nevertheless, the treaty can be said to have given a signal to the other countries of eastern Europe and to have paved the way for the numerous subsequent treaties that have been concluded.

Prior to 1973 there was no real precedent for a tax treaty between countries with market and non-market economies.\textsuperscript{123} Some commentators took the view that the differences between the economic and fiscal systems were such as to make the negotiation of tax treaties impossible; others considered that these differences made

\textsuperscript{120}For comment, see Brownell & Johnson, supra, note 117; Doman, "East-West Tax Treaties" (1982) 10 Int'l Bus. Law., 162. The U.S.-USSR treaty was, in fact, preceded by one between the Federal Republic of Germany and Poland (1972); and Romania entered into three treaties in 1973.

\textsuperscript{121}The Soviet tax reforms of 1978 introduced taxation of foreigners residing or doing business in the USSR and brought the system closer to that of western nations. See J.E. Martínez, "Soviet Personal Taxation of Foreigners" (1981) 19 Colum. J. Transnat'l L. 445. For a comprehensive review of taxation in the USSR, see M.A. Newcity, Taxation in the Soviet Union (New York: Praeger, 1986).

\textsuperscript{122}A limited exemption for Soviet journalists was secured. Of the other countries with which the USSR has concluded treaties, it appears that only Denmark has given a broad exemption from tax for Soviet citizens working there. Canada does not even give the usual exemption for journalists: see Newcity, \textit{ibid.} at 880. Another curiosity of the Canada-USSR treaty is the provision dealing with directors' fees. There cannot be many Soviet citizens directing Canadian companies, and at present it does not seem possible for a Canadian to be a director of a Soviet company, at all.

\textsuperscript{123}See Brownell & Johnson, supra, note 117 at 770.
treaties all the more necessary. In any case, so long as western countries had little investment in the countries of the socialist bloc, and their own citizens were frequently exempt from tax there, there was little incentive for the conclusion of tax treaties. The situation changed dramatically as a result of the economic reforms carried out in several of the eastern European countries from about 1968 onwards: doors were opened to foreign business and investment, and tax systems were reformed along lines more familiar to western eyes. Much the same can be said of the economic reforms introduced in China since 1978. In consequence, the treaties entered into by socialist countries since 1973 have been able to conform fairly closely to the OECD model. Unlike the developing countries, the socialist countries have not been greatly concerned with enlarging source-country jurisdiction; presumably, with currency and price controls available to them, they feel able to ensure that they receive a fair share of any profits generated by foreign investment. In particular, withholding tax rates tend to be low and, in some cases, the tax is waived altogether. Especially is this so with respect to withholding taxes on payments of interest, where the objective of the socialist countries appears to be to facilitate the negotiation of loans from western banks. In all, the experience of the past decade or so suggests that the socialist


126 See Easson & Li, supra, note 111.

127 China is an exception, being a developing country as well as a socialist one. As already observed (supra, notes 83, 111 & 113), in its treaty with Canada, China obtained tax sparing and favourable treatment for its students. Romania has also been accorded tax sparing in a number of its treaties, including the one it has with Canada.

128 For example, in the Austria-Bulgaria, Austria-USSR, Cyprus-Bulgaria, Cyprus-USSR and Finland-Hungary treaties. Canada has preferred to retain its usual 15-15-15 rates (Romania) or 15-15-10 (USSR), but has reduced its rates on interest and on intercorporate dividends in its treaty with China: see M. Jack, "Canada-China Double Tax Agreement" (1986) 34 Can. Tax J. 1449.
countries are eager to negotiate tax treaties with capitalist states and that such treaties present no insurmountable difficulties.

VI. CURRENT TRENDS AND FUTURE PROSPECTS

The final Part of this paper will briefly review a number of other issues that can be expected to influence the tax treaty policy of Canada, and of other countries, during the remainder of this century. No claim is made, however, to the possession of a crystal ball.

A. Expanding the Treaty Network

The tax treaty network, as we have seen, now extends to most corners of the globe, and covers countries with a variety of economic systems and in various stages of economic development. Two areas of the world, however, have remained largely unaffected: Latin America and the Middle East.

1. Latin America.

It is remarkable that the Carter Commission expressly singled out, as countries with which Canada should soon negotiate tax treaties, Brazil, Mexico, and Venezuela. Canada did conclude a treaty with Brazil in 1984, but still has no treaty with Mexico or Venezuela, nor with any other country of Hispanic America, apart from the Dominican Republic. Indeed, Latin America has largely stood aside from the tax treaty movement, ever since the failure to gain general acceptance for the Mexico model treaty. Brazil now has a number of tax treaties, with Canada and western European

---

129 Report, vol. 4, supra, note 1 at 569. See also Smith, supra, note 4 at 297, anticipating new treaties with Latin American countries.

130 Canada's only South American tax treaty, apart from that with Brazil, is with Guyana.

131 Supra, note 59.
countries, though not with the United States, and Argentina has recently emerged onto the tax treaty stage. These apart, there appear to be only two further examples — the treaty between Peru and Sweden (1966) and the one between Ecuador and the Federal Republic of Germany (1982).

Two main reasons for this dearth of treaties may be given. First, the Latin American countries have traditionally asserted a source-based tax jurisdiction and imposed high rates of withholding tax. For the most part, they have not been prepared to reduce source-country taxation to a level acceptable to the OECD member states. Second, five countries are members of the Andean Pact. These countries have their own multilateral tax treaty, as well as an agreed model treaty to be adhered to in conventions with non-member states: this model generally prescribes source-only jurisdiction and is obviously unacceptable to most other countries.

2. The Middle East

The other area largely untouched by tax treaties is the Middle East. With the exception of a number of treaties con-

\[^{132}\text{For the history of the abortive negotiations between Brazil and the United States, see Kingson, supra, note 34 at 1160, 1263; and Klock, supra, note 62 at 388, 396.}\]

\[^{133}\text{A treaty has been signed with the United States, but has not yet been ratified. Argentina also has treaties with France and the Federal Republic of Germany.}\]

\[^{134}\text{Canada's treaty with Brazil permits certain royalty payments to be taxed at 25 percent. It also contains the matching credit form of tax sparing, deeming tax to have been withheld at a rate of either 25 or 20 percent. It is noteworthy that the Sweden-Peru treaty provides for source-only taxation of dividends and interest.}\]

\[^{135}\text{The present members are Bolivia, Colombia, Ecuador, Peru, and Venezuela. Chile was an original member, but left in 1977.}\]


\[^{137}\text{Apart from Egypt and Israel, both of which have a substantial number of tax treaties.}\]
cluded by France and one by the Federal Republic of Germany, the only treaties in this area are somewhat curious: those between Cyprus and Kuwait, Libya and Malta, and Jordan and Romania.

The willingness of the more developed countries to accept an expanded source jurisdiction on the part of developing nations would suggest that satisfactory compromises could be arrived at to bring the countries of Latin America into the treaty network, especially since Argentina and Brazil are now pointing the way. As to the Middle East, flows of income have in recent years become increasingly two-way, which should make the conclusion of tax treaties mutually attractive.

B. Multilateral Conventions

Mention has been made of the multilateral tax treaties entered into by the member countries of the Council for Mutual Economic Assistance (CMEA), and of the Andean Pact. The CMEA treaties are largely concerned with the activities of state-trading agencies and their employees in the territories of other member states, and emphasize taxation on the basis of residence, with widespread exemptions for non-resident individuals and corporations. The Andean treaty, by contrast, provides principally for taxation in the country of source.

---

138 France has treaties with Iran, Jordan, Kuwait, Lebanon, and Saudi Arabia. The Federal Republic of Germany also has a treaty with Iran.

139 Cyprus, as has already been seen, has been especially active in concluding treaties with the countries of eastern Europe: see W.G. Kuiper, "Cyprus: Turntable Between East and West" (1984) 24 Eur. Tax. 175.


141 The treaties of Miskolc (1977) and Ulan Bator (1978), concerning respectively the avoidance of double taxation of the income and assets of individuals, and of legal entities. The signatory states are Bulgaria, Czechoslovakia, the German Democratic Republic, Hungary, Mongolia, Poland, Romania, and the USSR. For commentary, see Newcity, supra, note 121 at 887; J. Gluchowski, "International Taxation Agreements of the Polish People's Republic with the Eastern and Western Countries" (1984) 13 Polish Y.B. Int'l L. 135 at 141ff.

Both of these treaties have rather special features and would not appear to be adaptable to the international community at large. Of greater interest and potential is the Nordic Convention, since the economic and fiscal systems of the signatory states, and the provisions of the Convention, adhere more closely to generally accepted international norms. This has led some commentators to suggest that the Nordic Convention might serve as a model for the future, with a single multinational convention replacing many of the existing bilateral arrangements. As has been pointed out, the twenty-four members of the OECD have concluded, in all, well over 200 tax treaties among themselves, nearly all of them based closely upon the OECD models. However, even the Nordic Convention proved difficult to negotiate and fails to provide uniform solutions to all of the problems. At present, therefore, a broader multilateral convention, even if restricted to OECD members, seems a very distant prospect.

The situation might change, however, if the member states of the European Community were to conclude a tax convention, as envisaged by article 220 of the EEC Treaty. The feasibility of such a convention has been studied from time to time, but progress has been minimal. The conditions for the adoption of a convention would, however, become far more favourable if the various proposals for directives to harmonize the systems of direct taxation were to be

---

143 Signed in Helsinki in 1983. The member states are Denmark, Finland, Iceland, Norway, and Sweden. An earlier (1972) convention provided for reciprocal administrative cooperation among the tax officials of those states.


145 Hamaekers, ibid. at 99.

146 See Easson, supra, note 33 at 193.
adopted, in particular those concerning the taxation of corporate profits and distributions, and the tax treatment of parent–subsidiary relationships.\^{147}

C. Treaty Shopping and Treaty Abuse

As has been seen, tax treaty provisions vary widely from one country to another and, despite the fact that many countries have their own model treaties to be adhered to wherever possible, no two treaties entered into by the same country are quite identical. This factor, combined with the comparative ease with which a corporation can be established in most countries,\^{148} has led to the development, particularly over the past twenty years, of new and sophisticated methods of tax planning. The tax haven pure and simple (though these may not be the most appropriate adjectives) still has its uses, but countries are increasingly adopting anti-haven rules.\^{149} The tax-planning focus has consequently shifted, and great emphasis has been placed upon the search for favourable treaty provisions, or a combination of provisions, and the use of ‘stepping stones’ for shifting income from its source to its ultimate destination. One of the best known examples, until recently, involved income flowing by the route United States–Netherlands Antilles–Netherlands–Canada,

\^{147}Two proposed directives (on mergers and on parent–subsidiary relationships) were submitted by the Commission of the European Communities to the Council of Ministers in 1969, and a further proposal, on corporation tax systems, was submitted in 1975. The proposals have subsequently been substantially amended, but do not appear likely to be adopted in the near future.

\^{148}'Treaty shopping' is not confined to cases where corporations are employed. One of the earliest recognized instances occurred in Johansson v. United States (1964), 336 F.2d. 809 (5th Cir.). In that case, an American court refused to recognize Mr. Ingemar Johansson, the Swedish former world champion heavyweight boxer, who had earned large sums winning, and then losing, his title in the U.S.A., as a resident of Switzerland, and his claim to rely upon the Switzerland–U.S.A. tax treaty was rejected. See Slowinski, Haderlein & Meyer, supra, note 108 at 142.

\^{149}Such as the FAPI (Foreign Accrual Property Income) rules in Canada, or the U.S. "Sub-part F" rules. See further B.J. Arnold, "The Taxation of Controlled Foreign Corporations: Defining and Designating Tax Havens" (1985) 33 Can. Tax J. 445.
rather than flowing directly from the United States to Canada. Commonly, 'stepping stones' are employed to take advantage of lower rates of withholding tax, or to change the nature of a particular source of income (for example, to convert royalties or interest into dividends); occasionally advantage may also be taken of some particular feature, such as the special treatment of a Swiss partnership, a Danish cooperative, or a Cypriot offshore company.

Sophisticated treaty-shopping practices have had two major effects upon tax treaty policy. First, there have been created a number of new types of tax haven. Unlike the classic fiscal paradise, typically a small island with a warm climate where no one pays tax at all, and which consequently has no tax treaties, the modern haven for the most part charges normal rates of income tax but offers one or more special advantages combined with an extensive network of tax treaties. Thus, for example, the treaty network that Cyprus has established with eastern European countries provides for exemption from, or low rates of, withholding tax on dividends, interest and royalties. This, in combination with its own generous treatment of foreign-owned companies established in Cyprus, would seem to make Cyprus an attractive stepping stone for corporations from other countries with which Cyprus has a tax treaty, wishing to do business in eastern Europe.

A variety of techniques have been used, often referred to by colourful names such as the "Antilles Loop," "Dutch Treat," "Dutch Sandwich," and so on. In the past four years the United States has renegotiated its treaties with the Netherlands and the Netherlands Antilles; the arrangement between the Antilles and the Netherlands has been revised; and the treaty between Canada and the Netherlands has been renegotiated: see V. Morgan, "The Pending Canada–Netherlands Tax Treaty: The Dutch Treat is Over" (1984) 32 Can. Tax J. 760; "The New Canada–Netherlands Tax Treaty" (1986) 34 Can. Tax J. 872; J.J.O.M. Vermeer, "Netherlands Holding Companies and the New Canada–Netherlands Income Tax Convention" in Proceedings of the 37th Tax Conference -- 1985 (Toronto: Canadian Tax Foundation, 1986) 22:1. The Netherlands Antilles were also popular for other purposes, e.g., to invest in real estate in the United Kingdom: see R. Moore, "Sunset over the Antilles" (1986) 26 Eur. Tax. 325.

See the examples given by M. Grundy, The World of International Tax Planning (New York: Cambridge University, 1984) 71ff.

See Kuiper, supra, note 139. Cyprus and Malta also appear to offer openings to some countries of the Middle East. See Vella, supra, note 140. Judging from their rather curious treaty networks, one suspects that Romania and Sri Lanka are up to something. Could Romania become the first tax haven in the communist world?
Second, this practice of treaty shopping has led in turn to attempts to prevent 'treaty abuse' and undue tax avoidance. The United States, which has probably suffered the greatest revenue losses as a result of treaty shopping by its own multinational corporations, has been especially active in seeking to control such abuse, exerting considerable pressure upon some of its treaty partners (notably the Netherlands Antilles, the Netherlands and Switzerland) to renegotiate existing treaties in order to close loopholes and prevent further tax avoidance and, where this has failed, renouncing certain of its treaties unilaterally. A new provision has also been included in the United States' own model tax treaty, the general intent of which is to restrict treaty shopping by restricting the benefit of the treaty to what might be considered to be genuine residents of the other country. Not surprisingly, what happens in the United States almost inevitably has its repercussions in Canada. In order to further its own policies — and, in the present case, the legitimacy of these is not in question — the United States seeks to influence Canada's position vis-à-vis other countries, and the position of those countries vis-à-vis Canada. Thus, for example, the treaty renegotiations between Canada and the Netherlands could not but be influenced by the renegotiations that

---

153 See Kingson, supra, note 34 at 1276; Rosenbloom & Langbein, supra, note 34 at 395. A new treaty between the Netherlands Antilles and the United States was signed in 1986 and contains a unique treaty-shopping article. There may still, however, be advantages in forming a Netherlands Antilles subsidiary or holding company: see S.A. Nauheim & P.H. Jacobson, "Proposed United States–Netherlands Antilles Income Tax Treaty: New Opportunities for Foreign Investment in U.S. Real Estate" (1986) 15 Tax Mgmt. Int'l J. 462.

154 See P.T. Kaplan, "Reasons, Old and New, for the Erosion of United States Tax Treaties" [1986] Brit. Tax Rev. 211 at 225. The U.S. Congress has also expressed a willingness to enact treaty 'overrides' (i.e., to enact legislation that expressly prevails over a conflicting provision in an existing treaty) unless the treaty in question contains adequate provision to prevent treaty abuse: ibid. at 214.


156 The most drastic provision relates to holding or investment companies. The United States seeks to deny the benefits of the treaty to these companies where more than 25 percent of shares are owned or controlled by non-residents of the other country. While preventing some common abuses, this provision would also hit at the activities of legitimate joint ventures.
were taking place between the United States and Canada on the one hand, and the United States and the Netherlands on the other.\textsuperscript{157}

D. \textit{International Cooperation against Avoidance and Evasion}

International tax avoidance and evasion, and the problems caused by transfer-pricing practices by multinational enterprises,\textsuperscript{158} have also become of increasing concern in recent years. Originally, the primary function of tax treaties was accepted to be the elimination of double taxation; nowadays, the elimination of tax evasion appears to be a consideration of at least equal importance to the governments that negotiate the treaties. In this respect, Canada and the United States have taken the lead, establishing comprehensive procedures for the exchange of information and for conducting joint or simultaneous audits and investigations of taxpayers,\textsuperscript{159} and providing a mutual agreement procedure for resolving transfer-pricing disputes.\textsuperscript{160} The European Community has also been active, adopting two directives dealing with exchange of information and mutual cooperation to prevent tax avoidance and evasion.\textsuperscript{161}

\textsuperscript{157}See Hausman, \textit{supra}, note 124; Vermeer, \textit{supra}, note 150.


\textsuperscript{161}See Easson, \textit{supra}, note 33 at 201. See also the proposed directive on transfer pricing, \textit{ibid.} at 194.
E. Unitary Tax

One of the issues that complicated the renegotiation of the Canada–United States treaty,162 and relations between the United States and other countries generally, was the introduction by a number of the states, most notably California, of the unitary system of taxing corporate income. This system, essentially, combines two theories: an enterprise that carries on business in a number of jurisdictions should have its profits allocated among those jurisdictions according to an appropriate formula,163 and where a number of corporations are related and effectively form part of a group, that group should be regarded, for the purposes of the apportionment, as constituting a single enterprise. Both propositions seem eminently reasonable, at any rate if the formula adopted to apportion income is a fair and proper one.164 Administratively, however, the system turned out to be something of a nightmare, with large multinational corporations having to produce accounts for numerous subsidiaries around the globe.165 Pressure was brought upon the United States by a number of countries currently engaged

---


164The formulae are usually based upon weighting of turnover, assets and payroll. It is clear that the weighting can be manipulated to maximize revenue. E.g., a jurisdiction with high wage rates may attach extra weight to payroll. Consequently, if formulae vary from one jurisdiction to another, there may be over- or under-taxation.

in treaty renegotiations\textsuperscript{166} to persuade the offending states to at least exempt foreign multinationals from the scope of the unitary tax system and, though the issue is not fully resolved, there does appear to have been a retreat, on the part of most states, to the "water's edge".\textsuperscript{167} The experience with unitary taxation has perhaps been an unfortunate one, since in many respects the system affords a preferable alternative to the present one, whereby profits of multinational enterprises have to be allocated to, and identified with, branches or establishments in the various countries where operations are conducted. In addition, unitary taxation eliminates most of the problems associated with transfer pricing and might well provide a suitable basis for a future multilateral tax convention.

F. Tax Reform

The initial theme of this paper was to consider the consequences, for Canada's tax treaty policy, of the recommendations of the Carter Commission and of the tax reforms subsequently adopted in the light of those recommendations. One conclusion to emerge from this examination has been that a reform of a country's domestic tax system will almost inevitably have an impact upon its international position, frequently necessitating the renegotiation of its existing treaties and generally affecting its bargaining position in future negotiations.\textsuperscript{168} At the same time, while the process of reform is actually under way, the surrounding uncertainty makes negotiation difficult and frequently delays the conclusion of tax treaties.

The other broad conclusion to emerge is that we live in an increasingly interdependent environment. Certainly a country like

\textsuperscript{166}Notably Canada, the Netherlands, and the United Kingdom. The United Kingdom went so far as to enact retaliatory legislation: See Schlenger, \textit{ibid.} at 466ff.

\textsuperscript{167}See Bird & Brean, \textit{supra}, note 163.

\textsuperscript{168}Of recent tax reforms, those in Australia have probably had the most far-reaching international consequences. See Vann & Parsons, \textit{supra}, note 103 at 144, 211; R. Krever, "Tax Reform in Australia: Base-Broadening Down Under" (1986) 34 Can. Tax J. 346. By contrast, the reforms proposed for Canada in June, 1987 would seem to have a lesser impact on the international scene.
Canada cannot unilaterally pursue either a domestic or an international tax policy. Obviously, as the Carter Commission itself recognized, Canada must always keep at least one eye upon what is happening in the United States, and American positions or trends may well have an influence upon Canada's relationships with other countries — a typical example being the renegotiation of the treaty with the Netherlands. But what happens elsewhere may also have a ripple effect. Thus, corporate tax reforms in France and the United Kingdom affected Canada's relationship with the United States, and a tax-sparing provision in a treaty between the Federal Republic of Germany and India began a trend that has been reflected in close to a thousand tax treaties since then. It seems that it is no longer possible to separate the purely domestic from the international aspects of tax reform: taxation has, indeed, become a truly international subject.