2025 ■ VOLUME 73, Nº 3

CANADIAN TAX JOURNAL
REVUE FISCALE CANADIENNE

PEER-REVIEWED ARTICLES

Digital Services Taxes, Tariffs, and Subsidies — *Chris Noonan and Victoria Plekhanova*

Unproven Allegations of Dishonesty, Wilful Blindness, or Gross Negligence: The Case for Cost Consequences in the Tax Court of Canada — *Michael H. Lubetsky*

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The Canadian Tax Foundation, an independent, not-for-profit research and educational organization, is seeking proposals for books in the areas of taxation and public finance.

Since its inception in 1945, the Foundation has published many books and articles on a wide range of subjects within its areas of interest. The Foundation seeks proposals for research projects that will

- result in a book on a single topic of interest in the area of taxation or public finance;
- be undertaken by an experienced researcher who has expertise in an area of taxation or public finance; and
- be carried out within a time frame that is reasonable, given the nature of the project.

Projects selected by the Foundation may qualify for its full or partial financial support of the research and for its underwriting of the publication costs. The Foundation retains the absolute right at its sole discretion to choose whether to support a given proposal or to publish a project.

Interested parties should send a brief written outline of a proposal, for initial consideration by the Foundation, to:

Heather Evans
Executive Director and Chief Executive Officer
Canadian Tax Foundation / Fondation canadienne de fiscalité
145 Wellington Street West, Suite 1400
Toronto, Ontario M5J 1H8

hevans@ctf.ca

For further information, please contact the director, as indicated above, or the co-chairs of the Canadian Tax Foundation Research Committee:

Kim Brooks
c/o Canadian Tax Foundation / Fondation canadienne de fiscalité

Michael Lubetsky
c/o Canadian Tax Foundation / Fondation canadienne de fiscalité

Appel de propositions de livres

La Fondation canadienne de fiscalité (FCF) / Canadian Tax Foundation, un organisme sans but lucratif indépendant de recherche et à caractère éducatif, souhaite recevoir des propositions de livres dans les domaines de la fiscalité et des finances publiques.

Depuis sa fondation en 1945, la FCF a publié de nombreux livres et articles sur divers sujets dans ses champs d'intérêt. La FCF souhaite obtenir des propositions de projets de recherche qui :

- mèneront à la rédaction d'un livresur un sujet unique d'intérêt en fiscalité ou en finances publiques;
- seront dirigés par un chercheur chevronné ayant une expertise dans un domaine de la fiscalité ou des finances publiques;
- seront effectués dans un délai raisonnable, compte tenu de la nature du projet.

Les projets qui seront sélectionnés par la FCF pourront être partiellement ou totalement admissibles à une aide financière pour la recherche et les frais de publication. La FCF se réserve le droit absolu, et à sa seule discrétion, d'appuyer une proposition particulière ou de publier un projet.

Toute personne intéressée doit faire parvenir un bref sommaire de la proposition pour examen initial par la FCF à :

Heather Evans
Directrice exécutive et chef de la direction
Canadian Tax Foundation / Fondation canadienne de fiscalité
145 Wellington Street West, Suite 1400
Toronto, Ontario M5J 1H8

hevans@ctf.ca

Pour plus d'information, veuillez communiquer avec le directeur, tel qu'il est mentionné plus haut, ou avec les co-présidentes du comité de recherche de la Fondation canadienne de fiscalité :

Kim Brooks
a/s Canadian Tax Foundation / Fondation canadienne de fiscalité

Michael Lubetsky
a/s Canadian Tax Foundation / Fondation canadienne de fiscalité

■ Recent and Upcoming Events*
■ Activités récentes et à venir*

PRAIRIE PROVINCES TAX CONFERENCE & LIVE WEBCAST
Calgary and via webcast, June 2-3, 2025

YOUNG PRACTITIONER FOCUS CONFERENCE
Virtual, September 3, 2025

BRITISH COLUMBIA TAX CONFERENCE & LIVE WEBCAST
Vancouver and via webcast, September 15-16, 2025

TAX POLICY SYMPOSIUM AND WEBCAST
October 3, 2025

ONTARIO TAX CONFERENCE & LIVE WEBCAST
Toronto and via webcast, October 27-28, 2025

ATLANTIC PROVINCES TAX CONFERENCE
Halifax, November 7-8, 2025

77TH ANNUAL TAX CONFERENCE
Calgary, November 30-December 2, 2025

* For further details on upcoming events, please visit the Canadian Tax Foundation website at www.ctf.ca. / Pour plus de renseignements, veuillez consulter le site Web de la Fondation à www.fcf-ctf.ca.

CTF CANADIAN TAX FOUNDATION
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■ Canadian Tax Journal

INVITATION TO SUBMIT

The *Canadian Tax Journal* publishes research in, and informed comment on, taxation and public finance, with particular relevance to Canada. To this end, the journal invites interested parties to submit manuscripts for possible publication as peer-reviewed articles, and it especially welcomes work that contributes to the analysis, design, and implementation of tax policies.

Articles may be written in English or French and should present an original analysis of the topic. Submitted work, or any substantial part or version thereof, must not have been previously published, either in print or online, and it must not be submitted or scheduled for publication elsewhere. The journal welcomes shorter submissions (from 4,000 to 8,000 words) focused on specific topics as well as longer submissions that analyze issues in depth.

PEER REVIEW

Submitted articles are subject to a double-blind peer review; authors' identities are not known to reviewers, and reviewers' identities are not known to authors. (Non-peer-reviewed contributions may appear elsewhere in the journal.) Final decisions on the publication of articles are made by the editors—Kim Brooks, Kevin Milligan, and Daniel Sandler—on the advice of reviewers. Reviewers are experts in the area who are chosen by the editors to provide an opinion on the publishability of the submission and to make suggestions for improvement. Submissions may be (1) accepted outright; (2) accepted if recommended revisions are made; (3) revised by the authors, as requested by the editors on the advice of reviewers, and resubmitted for further review; or (4) rejected with reasons. The time from submission to the first editorial decision is usually two months or less.

SUBMISSION DETAILS

Prospective contributors should submit a copy of the manuscript to the journal's editorial department. The preferred method of submission is by e-mail with an attached Word document. E-mail inquiries are welcome: write to CTFeditorial@ctf.ca. Contributors are responsible for providing complete and accurate citations to sources, a detailed abstract (200 to 400 words), and up to six keywords for indexing purposes.

Manuscripts accepted for publication are to be prepared in the prescribed format. For details, see the Foundation's Style and Format Guide.

Because all articles are subject to double-blind review, a separate cover page should accompany each submission. The cover page should include the author's name, e-mail and postal addresses, telephone number, and fax number. Authors should take care not to identify themselves directly or indirectly in their articles.

POLICY FORUM CONTRIBUTIONS

The Policy Forum section includes both articles commissioned by the journal editors and articles proposed by prospective authors. All articles should aim for short and rigorous analysis (3,000 to 5,000 words) and be written for an audience of policy makers, tax practitioners, and students of fiscal and tax policy. Articles may be based on original research, or they may synthesize and apply established research findings to a particular policy context.

Calls for proposals for upcoming Policy Forum sections appear on the Foundation's website and Twitter feed and are circulated by e-mail. To receive these e-mails, please contact CTFeditorial@ctf.ca and ask to have your name added to the mailing list. Proposals will be reviewed by the journal editors, and authors whose proposals are selected will be invited to prepare articles.

All Policy Forum articles are reviewed by the journal's editors prior to publication.

ACCESSING THE JOURNAL

The full text of all articles that have appeared in the *Canadian Tax Journal* since its first issue in 1953 can be found in the Canadian Tax Foundation's TaxFind database and, with a minimum one-year delay, in HeinOnline, ProQuest, and EBSCO's Business Source Ultimate database. Also, peer-reviewed articles since 1991 are publicly available on the *Canadian Tax Journal*'s Issues Index web page.

The *Canadian Tax Journal* is also indexed in Scopus, LegalTrac, EconLit, Wolters Kluwer Canada's Canadian Income Tax Research Index, Carswell's Income Tax References, Canadian Periodicals Index, and Scott's Index to Canadian Legal Periodical Literature.

■ Revue fiscale canadienne

Invitation à soumettre

La *Revue fiscale canadienne* publie des articles de recherches et des commentaires éclairés sur la fiscalité et les finances publiques, qui sont particulièrement pertinents pour le Canada. À cette fin, la Revue invite les personnes intéressées à soumettre des articles, qui seront évalués par des pairs, pour une éventuelle publication et elle accueille plus particulièrement les écrits qui contribuent à l'analyse, à la conception et à la mise en œuvre des politiques fiscales.

Les articles peuvent être rédigés en anglais ou en français et doivent présenter une analyse inédite du sujet. L'article soumis, ou toute partie ou version substantielle de celui-ci, ne doit pas avoir été publié antérieurement, que ce soit sous forme papier ou numérique, et il ne doit pas avoir été soumis ou prévu d'être publié ailleurs. La Revue accueille les soumissions plus courtes (de 4 000 à 8 000 mots) axées sur des sujets précis et également les soumissions plus longues qui analysent des problèmes en profondeur.

Révision par les pairs

Les articles soumis font l'objet d'une révision anonyme par les pairs; l'identité des auteurs n'est pas connue des réviseurs, et l'identité des réviseurs n'est pas connue des auteurs. (Les propositions non évaluées par des pairs peuvent être publiées ailleurs dans la Revue.) Les décisions concernant la publication des articles sont prises par les rédacteurs — Kim Brooks, Kevin Milligan et Daniel Sandler — à partir des conseils des réviseurs. Ces derniers sont des experts établis en la matière, ils sont choisis par les rédacteurs pour donner leur avis en ce qui concerne le bien-fondé de publier la soumission et formuler des suggestions d'amélioration. Les soumissions peuvent être 1) acceptées sans réserve; 2) acceptées sous réserve des changements recommandés; 3) révisées par les auteurs, en fonction des exigences des rédacteurs qui suivent les conseils des réviseurs, et soumises à nouveau pour une révision supplémentaire; ou 4) rejetées avec motifs. Le délai entre la soumission et la première décision de la rédaction est généralement de deux mois ou moins.

Préparation de la soumission

Les contributeurs potentiels doivent soumettre une copie de leur article à la rédaction de la Revue. La méthode de transmission privilégiée est le courriel avec un document Word en pièce jointe. Toutes demandes de renseignements par courriel sont les bienvenues : vous pouvez contacter le CTFeditorial@ctf.ca. Les contributeurs ont l'entière responsabilité de fournir les références complètes et précises des documents qu'ils citent, un résumé détaillé (200 à 400 mots) et jusqu'à six mots-clés qui seront utilisés à des fins d'indexation.

Les articles acceptés pour publication doivent être préparés selon le format prescrit. Pour en savoir plus, se rapporter au Guide de rédaction et de présentation de la Fondation.

Puisque tous les articles font l'objet d'une révision anonyme par deux personnes, une page couverture séparée doit accompagner chaque article. Sur la page couverture, inclure le nom de l'auteur, l'adresse courriel et l'adresse postale, le numéro de téléphone et le numéro de télécopieur. Les auteurs doivent s'assurer qu'il est impossible de les identifier de manière directe ou indirecte dans leur article.

CONTRIBUTIONS AU FORUM DE POLITIQUES

La section Forum de politiques comprend à la fois des articles commandés par les rédacteurs en chef de la Revue et des articles proposés par des auteurs potentiels. Tous les articles doivent présenter une analyse courte et rigoureuse (3 000 à 5 000 mots) et être rédigés pour un auditoire de décideurs, de fiscalistes et d'étudiants en politique fiscale. Les articles peuvent être fondés sur des recherches originales, ou ils peuvent synthétiser et appliquer les résultats de recherche établis dans un contexte politique particulier.

Les invitations à soumettre des propositions pour les prochaines sections du Forum de politiques sont publiées sur le site Web de la Fondation, sur le fil Twitter, et elles sont également envoyées par courriel. Pour recevoir ces courriels, veuillez communiquer avec CTFeditorial@ctf.ca et demander que votre nom soit ajouté à la liste de diffusion. Les propositions seront examinées par les rédacteurs en chef de la Revue, et les auteurs des propositions retenues seront invités à rédiger des articles.

Tous les articles du Forum de politiques sont révisés par les rédacteurs en chef de la Revue avant leur publication.

ACCÈS À LA REVUE

L'intégralité de tous les articles parus dans la *Revue fiscale canadienne* depuis son premier numéro en 1953 se trouve dans la base de données TaxFind de la Fondation canadienne de fiscalité et, après un délai minimal d'un an, dans HeinOnline, ProQuest et dans la base de données Business Source Ultimate d'EBSCO. De plus, les articles révisés par les pairs depuis 1991 sont accessibles au public sur la page Web de l'Index des numéros de la *Revue fiscale canadienne*.

La *Revue fiscale canadienne* est également indexée dans Scopus, LegalTrac, EconLit, dans la section de recherche en fiscalité canadienne de Wolters Kluwer Canada, dans la section de références de Carswell, dans le Canadian Periodicals Index et dans le Scott's Index to Canadian Legal Periodical Literature.

■ Canadian Tax Foundation

The Canadian Tax Foundation is Canada's leading source of insight on tax issues. The Foundation promotes understanding of the Canadian tax system through analysis, research, and debate, and provides perspective and impartial recommendations concerning its equity, efficiency, and application.

The Canadian Tax Foundation is an independent tax research organization and a registered charity with over 12,000 individual and corporate members in Canada and abroad. For more than 70 years, it has fostered a better understanding of the Canadian tax system and assisted in the development of that system through its research projects, conferences, publications, and representations to government.

Members find the Foundation to be a valuable resource both for the scope and depth of the tax information it provides and for its services, which support their everyday work in the taxation field.

Government policy makers and administrators have long respected the Foundation for its objectivity, its focus on current tax issues, its concern for improvement of the Canadian tax system, and its significant contribution to tax and fiscal policy.

MEMBERSHIP

Membership in the Foundation is open to all who are interested in its work. Membership fees are $468.00 a year, except that special member rates apply as follows: (a) $229.00 for members of the accounting and legal professions in the first three years following date of qualification to practise; (b) $229.00 for persons on full-time teaching staff of colleges, universities, or other educational institutions; (c) complimentary for students in full-time attendance at a recognized educational institution; and (d) $197.00 for persons who have reached the age of 65 and are no longer actively working in tax. Memberships are for a period of 12 months dating from the receipt of application with the appropriate payment.

Applications for membership are available from the membership administrator for the Canadian Tax Foundation: facsimile: 416-599-9283; Internet: www.ctf.ca; e-mail: ctfmembership@ctf.ca.

■ Fondation canadienne de fiscalité

La Fondation canadienne de fiscalité est un organisme indépendant de recherche sur la fiscalité inscrit sous le régime des œuvres de charité. Elle compte environ 12 000 membres au Canada et à l'étranger. Depuis plus de 70 ans, la FCF favorise une meilleure compréhension du système fiscal canadien et aide au développement de ce système par le biais de ses projets de recherche, conférences, publications et représentations auprès des gouvernements.

Les membres considèrent l'étendue et le détail de l'information offerte par la FCF comme une importante ressource. Ils apprécient également les autres services de la FCF qui facilitent leur travail quotidien dans le domaine de la fiscalité.

Les décideurs et administrateurs gouvernementaux respectent depuis longtemps l'objectivité de la FCF, son attention aux questions fiscales de l'heure, sa préoccupation envers l'amélioration du système fiscal canadien et son importante contribution au développement des politiques fiscales.

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Toute personne intéressée aux travaux de la FCF peut en devenir membre. Les droits d'adhésion sont de 468,00 $ par année, à l'exception des tarifs spéciaux suivants : a) 229,00 $ pour les personnes faisant carrière en comptabilité ou en droit pendant les trois premières années suivant leur admission à la profession; b) 229,00 $ pour le personnel enseignant à temps plein dans un collège, une université ou une autre maison d'enseignement; c) gratuite pour les étudiants fréquentant à temps plein une maison d'enseignement reconnue; et d) 197,00 $ pour les personnes qui ont 65 ans et plus et qui ne travaillent plus activement en fiscalité. La période d'adhésion est de 12 mois, à compter de la réception de la demande accompagnée du paiement approprié.

Il est possible de se procurer les demandes d'adhésion auprès de l'administratice responsible de l'adhésion à la FCF : télécopieur : 514-939-7353; Internet : www.fcf-ctf.ca; courriel : adminmtl@ctf.ca.

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The Foundation's publications comprise a range of forms and delivery formats. A number of the regularly issued publications are distributed without charge to Foundation members: the *Canadian Tax Journal* (4 issues), *Perspectives on Tax Law & Policy* (4 issues, delivered electronically), *Tax for the Owner-Manager* (4 issues, delivered electronically), *Canadian Tax Focus* (4 issues, delivered electronically), *International Tax Highlights* (4 issues, delivered electronically), and the annual conference report. Monographs and books may be purchased on the Foundation's website at www.ctf.ca.

Canadian Tax Journal — issued quarterly to members via www.ctf.ca (Non-Members $75 per copy, $343.75 per year).

Newsletters

International Tax Highlights — issued quarterly to members via www.ctf.ca.

Perspectives on Tax Law & Policy — issued quarterly; available to members and non-members via www.ctf.ca.

Tax for the Owner-Manager — issued quarterly to members via www.ctf.ca.

Canadian Tax Focus — issued quarterly; available to members and non-members via www.ctf.ca.

Canadian Tax Highlights — archives (2000-2019) available to members via www.ctf.ca.

Conference Reports — Reports of the proceedings of annual tax conferences (Members $40; Non-Members $95). Latest issue: 2024 (Members $40; Non-Members $350).

— *Tax Dispute Resolution, Compliance, and Administration in Canada: Proceedings of the June 2012 Conference* (Members $30; Non-Members $195)

— Collections of papers delivered at regional and special tax conferences (British Columbia, Prairie Provinces, Ontario, and Atlantic Provinces) are available in USB format (Members $445; Non-Members $495).

Finances of the Nation — Review of expenditures and revenues and some budgets of the federal, provincial, and local governments of Canada. PDFs for the years 2002-2012 are available on the CTF website at no cost. In 2014, "Finances of the Nation" began to appear as a feature in issues of the *Canadian Tax Journal*.

Monographs

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Digital Services Taxes, Tariffs, and Subsidies

Chris Noonan* and Victoria Plekhanova**

PRÉCIS

Cet article examine les taxes sur les services numériques (TSN) du point de vue du droit et de la politique du commerce international pour remettre en question les discours dominants sur leur nature protectionniste et proposer d'autres cadres pour leur évaluation. L'analyse établit tout d'abord que les droits de douane et les impôts discriminatoires sur le commerce transfrontalier des biens et des services restent permissibles en l'absence d'engagements commerciaux précis, car de nombreux gouvernements utilisent activement ces outils pour faire avancer diverses politiques. L'article démontre que les TSN peuvent servir des objectifs politiques légitimes et que, contrairement à ce qu'affirment leurs détracteurs, ni les caractéristiques du marché des plateformes ni les contextes de mise en œuvre ne corroborent les allégations d'intention protectionniste. Tout en reconnaissant que les marchés des plateformes numériques présentent souvent des tendances monopolistiques, l'article soutient que les caractéristiques structurelles des TSN et les asymétries d'information qui leur sont inhérentes rendent difficile de les utiliser efficacement comme instruments de captation de rentes ou de transfert de bénéfices. S'appuyant sur la théorie des termes de l'échange, l'analyse révèle pourquoi la plupart des pays ne tireraient probablement pas profit d'une interdiction multilatérale des TSN, et comment les TSN appliquées aux plateformes numériques peuvent améliorer le bien-être national. L'article avance que, à l'instar de l'élaboration de règles internationales relatives aux droits de douane, les règles évolueront naturellement pour coordonner les TSN, ce qui pourrait également réduire le risque d'une taxation excessive. Enfin, l'analyse introduit une perspective novatrice en examinant les TSN sous l'angle de la réglementation des subventions, offrant ainsi une autre base théorique pour leur mise en œuvre. Cette analyse exhaustive contribue au débat scientifique en apportant une compréhension nuancée des TSN dans le contexte plus vaste du commerce international et des régimes fiscaux internationaux.

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ABSTRACT

This article examines digital services taxes (DSTs) from an international trade law and policy perspective, challenging prevailing narratives about their protectionist nature and offering alternative frameworks for their evaluation. The analysis begins by establishing that tariffs and discriminatory taxes on cross-border trade in goods and services remain permissible absent specific trade commitments, with many governments actively using these tools to advance a variety of policies. The article demonstrates that DSTs can serve legitimate policy objectives, and contrary to critics' assertions, neither platform market characteristics nor implementation contexts support claims of protectionist intent. While acknowledging that digital platform markets often exhibit monopolistic tendencies, the article argues that DSTs' structural features and inherent information asymmetries typically preclude their effective use as rent-snatching or profit-shifting instruments. Drawing on terms-of-trade theory, the analysis reveals why most nations would likely not benefit from a multilateral prohibition of DSTs, and how DSTs applied to digital platforms may enhance national welfare. The article proposes that, similar to the development of international rules relating to tariffs, rules will naturally evolve to coordinate DSTs, which may also reduce the risk of excessive taxation. Finally, the analysis introduces a novel perspective by examining DSTs through the lens of subsidy regulation, offering an alternative theoretical foundation for their implementation. This comprehensive analysis contributes to the scholarly discourse by providing a nuanced understanding of DSTs within the broader context of international trade and international tax regimes.

KEYWORDS: DIGITAL SERVICES TAX ■ INTERNATIONAL TRADE ■ PLATFORM ECONOMICS ■ TERMS-OF-TRADE THEORY ■ SUBSIDIES ■ SERVICES

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INTRODUCTION

The Canadian digital services tax (DST) is a 3 percent tax on Canadian-source digital services revenue earned by certain large domestic and foreign businesses from June 28, 2024.[1] Like similar taxes imposed by other countries, this tax is a response

1 Digital Services Tax Act, SC 2024, c. 15, section 96.

to the failure of international negotiations that have sought to address the income tax challenges of digitalization, but is not itself an income tax.[2] Despite intense work to refine the international allocation of rights to tax income in the digitalized global economy,[3] the prospects of an international agreement are no closer than they were a decade ago. The United States opposes fundamental international tax reform[4] and resists meaningful reallocation of international taxing rights in the digitalized economy.[5] The tax community is now certain the United States will not approve a multilateral convention on pillar 1 of the two-pillar solution.[6] Even the Organisation for Economic Co-operation and Development (OECD) seems to have thrown in the towel.[7] With the lapse of the moratorium on DSTs on January 1, 2024, an increasing number of countries are dusting off suspended legislation or preparing to adopt a DST. The failure to implement pillar 1 relieved Austria, France, Italy, Spain, and the United Kingdom of the obligation to credit multinationals for any DST paid under an agreement with the United States,[8] and produced new rounds of diplomatic engagement. Similar initiatives from Canada and other countries were met with threats of retaliation.[9]

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2 The nature of the DST and whether it is an income tax have been contested. However, the general consensus, which is followed in this article, is that the DST is not covered by double taxation agreements. See Georg Kofler and Julia Sinnig, "Equalization Taxes and the EU's 'Digital Services Tax,'" in Werner Haslehner, Georg Kofler, Katerina Pantazatou, and Alexander Rust, eds., *Tax and the Digital Economy: Challenges and Proposals for Reform* (The Netherlands: Wolters Kluwer, 2019), chapter 6, at 134-35.

3 Richard Collier, "The Evolution of Thinking on Tax and the Digitalization of Business 1996-2018" (2023) 15:2 *World Tax Journal* (https://doi.org/10.59403/2hy4gec).

4 Assaf Harpaz, "Taxation of the Digital Economy: Adapting a Twentieth-Century Tax System to a Twenty-First-Century Economy" (2021) 46:1 *Yale Journal of International Law* 57-101, at 93-94.

5 Allison Christians and Tarcísio Diniz Magalhães, "Why Data Giants Don't Pay Enough Tax" (2023) 18:1 *Harvard Law & Policy Review* 119-82.

6 Reuven Avi-Yonah, Young Ran Kim, and Karen Sam, "A New Framework for Digital Taxation" (2022) 63:2 *Harvard International Law Journal* 279-341, at 304-16.

7 Eileen Travers, "Why the World Needs a UN Global Tax Convention," *UN News*, August 16, 2024 (https://news.un.org/en/story/2024/08/1153301).

8 "Joint Statement from the United States, Austria, France, Italy, Spain, and the United Kingdom, Regarding a Compromise on a Transitional Approach to Existing Unilateral Measures During the Interim Period Before Pillar 1 Is in Effect," *Press Release*, October 21, 2021 (https://home.treasury.gov/news/press-releases/jy0419).

9 In August 2024, the United States requested dispute settlement consultations with Canada under the United States-Mexico-Canada Agreement (USMCA) (infra note 141) regarding Canada's recently enacted DST. See United States Trade Representative, "United States Requests USMCA Dispute Settlement Consultations on Canada's Digital Services Tax," *Press Release*, August 30, 2024 (https://ustr.gov/about-us/policy-offices/press-office/press-releases/2024/august/united-states-requests-usmca-dispute-settlement-consultations-canadas-digital-services-tax). See also United States Senate Committee on Finance, "Bipartisan Finance Committee Leaders: USTR Must Tell Canada the U.S. Will Fight Discriminatory Digital Services Taxes on American Companies," October 10, 2023

Respected voices are urging the United States to calm down about DSTs[10] and cooperate with other states in finding a better way to regulate Big Tech,[11] or calling for a "plan B" following the failure of the OECD-led project.[12] The world is not short of ideas on how to do so. Christians and Magalhães identified 17 tax reform proposals circulating in the international community "which seek to rein in Big Tech."[13]

A multilateral response would be preferable, but the differences currently seem unbridgeable. The concern of governments to raise sufficient tax revenue, and to collect it from those persons and corporations that can afford to pay, is the major driver of the effort to expand the rights to tax cross-border activities. Most states perceive the current allocation of rights to tax digital business platforms as being unfair to them and their taxpayers. No proposal that increases the tax liabilities of major digital platform firms will be greeted with universal joy. Jurisdictions that are home to the platforms will inevitably object to the impact on their tax revenue and companies.

Claims and counterclaims of unfairness, multinationals free-riding, international wealth transfers, and increased costs of doing business abroad, by themselves, tend to be too open to interpretation, zero-sum, or uncompromising to provide a realistic basis for the resolution of the current standoff. The status quo will continue unless the cost of not agreeing is raised. Even scholars opposed to DSTs recognize that unilateral action may be necessary to break the current logjam.[14]

What unilateral or coordinated actions might resolve the current inability to move forward? Various approaches to increased taxation of digital platforms' supply of cross-border services have been advanced. Approaches that rely on the use of market jurisdiction data, platform end-users being an integral part of the production process, or the use of market jurisdiction networks and other infrastructure have superficial conceptual appeal but lack a clear policy rationale and/or do not unambiguously lead to easily operationalized rules. Concerns about equity among taxpayers and users of public services, monopoly rents, administrative efficiency and capacity constraints in the adoption of alternative measures, and the development of negotiating leverage are not unique to international tax law, and speak to issues that are common to other areas of international economic law and policy making.

Any unilateral logjam-breaking measure needs to take account of practical realities. Unilateral measures are more likely to establish a new equilibrium in the

(www.finance.senate.gov/chairmans-news/bipartisan-finance-committee-leaders-ustr-must-tell-canada-the-us-will-fight-discriminatory-digital-services-taxes-on-american-companies); and Janyce McGregor, "Canada's Digital Services Tax Set for a Reckoning with U.S.," *CBC News*, November 13, 2024 (www.cbc.ca/news/politics/tuesday-dst-deadline-trump-1.7380857).

10 Reuven S. Avi-Yonah, "Much Ado: Why the United States Should Calm Down About DSTs" (2023) 112:7 *Tax Notes International* 903-8, at 908.

11 Allison Christians and Tarcísio Diniz Magalhães, "17 Ways To Regulate Big Tech with Tax" (2024) 78:1 *The Tax Lawyer* 1-69.

12 Philip Baker, "Editorial: The Need for Plan B" (2023) 51:8-9 *Intertax* 542-46.

13 Christians and Diniz Magalhães, supra note 11.

14 Lilian V. Faulhaber, "Taxing Tech: The Future of Digital Taxation" (2019) 39:2 *Virginia Tax Review* 145-95, at 191.

international system if they are in the short-term interest of the jurisdictions taking unilateral actions, do not conflict with existing treaties, require modest financial and technological resources to implement, are coordinated with other states to mitigate double taxation, and are consistent with the broader international economic strategy of a state. These short-term interests include revenue raising and the potential impact on the location of production and jobs and the profits of local companies. As a unilateral measure, the DST arguably has these features. Taxes analogous to DSTs apply in other sectors,[15] and the experience of major jurisdictions has shown how the tax can be implemented and generate significant revenue,[16] which puts into perspective criticisms related to the administration of DSTs.[17] The tax may not be a perfect solution, but its widespread adoption would change the costs of no agreement.

Many criticisms of DSTs do not withstand close inspection.[18] Claims that DSTs are inconsistent with the principles of the current international tax regime[19] are

15 For example, on March 24 and 26, 2025, the Office of the United States Trade Representative (USTR) held public hearings on China's targeting of the maritime, logistics, and shipbuilding sectors for dominance, after which it found China's actions to be unreasonable (https://ustr.gov/issue-areas/enforcement/section-301-investigations/section-301-chinas-targeting-maritime-logistics-and-shipbuilding-sectors-dominance). The proposed actions in response to China's targeting included "[a] vessel operator of China to be charged a fee on the international maritime transport being provided (a) at a rate of up to $1,000,000 per entrance of any vessel of that operator to a U.S. port; or (b) per entrance of any vessel of that operator to a U.S. port, at a rate of up to $1,000 per net ton of the vessel's capacity," and "[u]pon the entrance of a Chinese-built vessel to a U.S. port, a fee to be charged to that vessel's operator on the international maritime transport provided via that vessel (a) at a rate of up to $1,500,000." See Office of the United States Trade Representative, "Proposed Action in Section 301 Investigation of China's Targeting of the Maritime, Logistics, and Shipbuilding Sectors for Dominance," 90 Fed. Reg. 10,843, February 27, 2025.

16 For example, in the period from April 1, 2023 to March 31, 2024, the DST revenue in the United Kingdom was £0.7 billion, an increase of £0.1 billion from the previous income year. See United Kingdom, HM Revenue & Customs, "Notes to the Trust Statement," in *Annual Report and Accounts 2023 to 2024* (London, UK: HM Revenue & Customs, July 30, 2024), at 193, note 2.9.

17 See, for example, Pasquale Pistone, João Félix Pinto Nogueira, and Alessandro Turina, "Digital Services Tax: Assessing the Policy Reasons for Its Introduction in the European Union" [2021] no. 4 *International Tax Studies* 1-16, at 9-10; and Marcel Olbert and Christoph Spengel, *Taxation in the Digital Economy—Recent Policy Developments and the Question of Value Creation*, ZEW—Leibniz Centre for European Economic Research Discussion Paper no. 19-010 (Mannheim: Leibniz Centre for European Economic Research, April 2019), at 1, 2, and 11.

18 Wei Cui, "The Superiority of the Digital Services Tax over Significant Digital Presence Proposals" (2019) 72:4 *National Tax Journal* 839-56; Daniel Shaviro, *Digital Services Taxes and the Broader Shift from Determining the Source of Income to Taxing Location-Specific Rents*, NYU Law and Economics Research Paper no. 19-36 (New York: New York University School of Law, September 2019), at 48-52; and Young Ran (Christine) Kim, "Digital Services Tax: A Cross-Border Variation of the Consumption Tax Debate" (2020) 72:1 *Alabama Law Review* 131-85, at 138-39.

19 Harpaz, supra note 4, at 84-85; and Roland Ismer and Christoph Jescheck, "Taxes on Digital Services and the Substantive Scope of Application of Tax Treaties: Pushing the Boundaries of Article 2 of the OECD Model?" (2018) 46:6-7 *Intertax* 573-78, at 577.

either unpersuasive, opposed to the likely international transfer of wealth, or circular and preclude significant change to the existing tax regime. Claims that DSTs discriminate against American tech giants,[20] are protectionist[21] or de facto tariffs,[22] are inconsistent with international trade and investment agreements,[23] or distort corporate decisions[24] are claims about the impact of tax changes on competitive relationships. They are inconsistent with other claims, including that the economic incidence of DSTs will fall primarily on consumers,[25] a DST will have cascading (pyramid) effects,[26] and small businesses will be disproportionately impacted.[27] The more practically focused claims about the impossibility or undesirability of ring-fencing certain digital businesses speak to uncertainty and competitive neutrality,[28] and claims about the limited revenue-generating capacity of DSTs, including as a result of retaliatory measures or overlapping taxes, are resonant of issues long discussed in trade policy.[29]

A DST is not an income tax, and analyzing it solely within an intellectual and institutional framework developed for income tax may not be helpful. A DST is often called a tariff, perhaps for rhetorical effect. Concerns about revenue, prices, and the competitive relationship between suppliers are not specific to the DST but are, in fact, the core concerns of international trade law. This article makes the argument

20 Office of the United States Trade Representative, "Initiation of a Section 301 Investigation of France's Digital Services Tax," 84 Fed. Reg. 34,042, July 16, 2019. See also Ruth Mason and Leopoldo Parada, "Company Size Matters" [2019] no. 5 *British Tax Review* 610-50, at 646-49; Daniel Bunn, "A Summary of Criticisms of the EU Digital Tax," Tax Foundation (Europe), *Fiscal Fact* no. 618, October 2018, 1-8 (https://taxfoundation.org/research/all/eu/eu-digital-tax-criticisms/); and Harpaz, supra note 4, at 88-89.

21 Ruth Mason and Leopoldo Parada, "The Legality of Digital Taxes in Europe" (2020) 40:1 *Virginia Tax Review* 175-217, at 209.

22 Gary Clyde Hufbauer and Zhiyao (Lucy) Lu, *The European Union's Proposed Digital Services Tax: A De Facto Tariff*, Peterson Institute for International Economics Policy Brief 18-15, June 2018, 1-11, at 2 (www.piie.com/publications/policy-briefs/european-unions-proposed-digital-services-tax-de-facto-tariff).

23 For example, Andrew D. Mitchell, Tania Voon, and Jarrod Hepburn, "Taxing Tech: Risks of an Australian Digital Services Tax Under International Economic Law" (2019) 20:1 *Melbourne Journal of International Law* 88-124; and Olbert and Spengel, supra note 17, at 11.

24 Bunn, supra note 20; and Matthias Bauer, *Five Questions About the Digital Services Tax to Pierre Moscovici*, ECIPE Occasional Paper no. 04/2018 (Brussels: European Centre for International Political Economy, 2018), at 1 and 11 (www.econstor.eu/bitstream/10419/202460/1/1025140117.pdf).

25 Bauer, supra note 24, at 6. See also Harpaz, supra note 4, at 84-85.

26 Bauer, supra note 24, at 7.

27 Ibid., at 8.

28 Organisation for Economic Co-operation and Development, *Addressing the Tax Challenges of the Digital Economy*, *Action 1—2015 Final Report* (Paris: OECD, 2015), at 149 (discussing neutrality as an important part of evaluating taxes on the digital economy).

29 Faulhaber, supra note 14, at 189-90.

that examining the case for DSTs through a trade policy lens is valuable and insightful,[30] even if some conclusions may be jarring for readers familiar with the international tax regime. The existing arguments have not generated a consensus. A trade policy perspective might not change the minds of those opposed to DSTs, but may make those who favour DSTs more comfortable with their decision.

The article proceeds as follows. Following this introductory section, the second section shows that tariffs and taxes on cross-border trade in goods and services are permissible unless prohibited by specific trade commitments, and many governments support retaining the ability to impose tariffs and discriminatory taxes for fiscal and other policy reasons. The third section explains how DSTs may serve legitimate purposes and how, contrary to the assertions of some observers, the nature of platform markets and the circumstances surrounding the imposition of DSTs do not support the claim that DSTs are being used for protectionist purposes. In imperfectly competitive markets, a country may use tariffs and discriminatory taxes to snatch monopoly rents and increase market share. The fourth section argues that while many markets are dominated by one or a few digital platforms, the structure of DSTs and information challenges mean that DSTs could rarely function successfully like a welfare-enhancing rent-snatching or profit-shifting tariff. The fifth section explains how the predominant economic justification for trade agreements, terms-of-trade theory, supports earlier analysis showing that most countries will not benefit from a multilateral agreement prohibiting DSTs and that a DST applied to digital platforms may improve national welfare. As experience with tariffs shows, countries will discover the need to coordinate their DSTs, which may help to restrain excesses. The regulation of and controversies surrounding subsidies are central to trade law and policy. The sixth section argues that DSTs may be usefully viewed through the lens of subsidy regulation, and doing so provides an alternative foundation for the tax. The final section concludes.

TARIFFS ON CROSS-BORDER SERVICES: CALIBRATED COMPETITION

A tariff or import duty is a state levy that is imposed on or in connection with the importation of goods.[31] The World Trade Organization (WTO) and other trade

30 The use of a trade policy framework is useful for several reasons: (1) the existing literature does not address all sources of potential discrimination; (2) much analysis tends to take the existing international tax regime as given; (3) the conceptual framework used in most analyses of cross-border taxes appears to prejudge certain issues; (4) the tools of trade policy provide a useful basis for systematically reviewing key issues; (5) the DST should not be seen through the lens of income tax and international tax should not be treated as a silo; (6) the branding of the DST as a tariff by serious news outlets cannot be dismissed as mere rhetoric; and (7) over the past few years, governments have become much more favourably inclined to adopt tariffs.

31 The terms "tariff" and "duties" are not defined by the World Trade Organization (WTO). Article II(1)(b) of the General Agreement on Tariffs and Trade 1947 (herein referred to as "GATT") regulates "ordinary customs duties" and "all other duties or charges of any kind

agreements limit the tariffs that countries can apply on imported goods. Disciplines on tariffs are supported by other international rules, including the Harmonized Commodity Description and Coding System developed by the World Customs Organization,[32] the WTO Customs Valuation Agreement,[33] and commitments on customs procedures. The DST is sometimes criticized as a "tariff" on digital services.[34] This could be dismissed as mere anti-DST rhetoric. Rhetoric, however, is not without impact and is often used in an attempt to foreclose discussion and support specific positions.[35] These claims sharply contrast with the traditional neglect by international organizations of the possibility of applying indirect taxes to cross-border trade in services. Under both the tax and trade regimes, the DST is characterized as an indirect tax. Indirect taxes have been internationally coordinated in a light-handed manner with the destination principle under the trade regime and generally fall outside the scope of double taxation treaties. The OECD Tax Committee has not been deeply engaged with cross-border issues arising from indirect taxes.[36] A decade ago, the WTO Secretariat entirely dismissed the possibility of applying tariffs to services.[37]

The claim that the DST is a tariff presumably aims to link the DST with negative connotations. Tariffs may be welfare-reducing and discriminatory, and are often associated with populism, economic nationalism, and trade wars. In certain circumstances, however, tariffs may be welfare-enhancing and politically advantageous. Recently, the use of tariffs as policy and political tools has captured the imagination

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imposed on or in connection with . . . importation." "Other duties or charges" is not defined by the WTO but is a catchall term that includes "any fee or charge that is in connection with importation and that is not an ordinary customs duty," nor an internal tax, anti-dumping duty, countervailing duty, or fees or charges commensurate with the cost of services rendered. *Dominican Republic—Import and Sale of Cigarettes*, WT/DS302/R, as modified by WT/DS302/AB/R, adopted May 19, 2005, at paragraphs 7.85, 7.79, and 7.113. Some regional trade agreements have included definitions along these lines. See, for example, CPTPP, infra note 140, at article 1.3; and USMCA, infra note 141, at article 1.5.

32 The International Convention on the Harmonized Commodity Description and Coding System entered into force on January 1, 1988. The harmonized system comprises more than 5,000 product groups arranged in a logical structure and supported by rules to facilitate the uniform classification of goods. Over 98 percent of world merchandise trade is classified in terms of the harmonized system, which is updated every five to six years.

33 World Trade Organization, Agreement on the Implementation of Article VII of the General Agreement on Tariffs and Trade 1994.

34 See, for example, Hufbauer and Lu, supra note 22; and Mark Johnson, "A Global Minimum Tax on Firms Is Finally Taking Shape but Another Much-Trumpeted Tax Reform Looks Destined To Fall Apart," *The Economist*, November 13, 2023.

35 Victoria Plekhanova and Chris Noonan, "Strategic Narratives in International Tax Policy Making: BEPS Action 1 and the Stability Argument" (2023) 71:2 *Canadian Tax Journal* 355-86.

36 See, however, Organisation for Economic Co-operation and Development, *The Role of Digital Platforms in the Collection of VAT/GST on Online Sales* (Paris: OECD, June 2019).

37 World Trade Organization, *World Trade Report 2012: Trade and Public Policies: A Closer Look at Non-Tariff Measures in the 21st Century* (Geneva: WTO, 2012), at 73-75 and 78.

of many policy makers. In May 2024, President Biden announced a 100 percent tariff on imported electric vehicles from China.[38] As a candidate, President Trump promised to impose tariffs of 60 percent or more on all Chinese products and 10 percent on all other products if he regained the presidency.[39] In the six months after his inauguration, beginning on February 1, 2025, the president has used tariffs to pursue a range of economic and non-economic policy objectives. The non-economic objectives have ranged from stemming the flow of illicit drugs into the United States to stopping the prosecution of former Brazilian president Jair Bolsonaro.[40] In an executive order of April 2, 2025, a 10 percent tariff was imposed on imports from all countries, with higher tariffs on imports from countries with significant trade deficits with the United States.[41] Since then, some countries have engaged in negotiations with the United States and product-specific exceptions have been recognized. On the basis of these developments, President Trump adjusted the tariff rates on July 31, 2025.[42]

These tariffs breach the WTO obligations of the United States. If the DST is judged against tariff practice, taxes on revenue earned on the cross-border supply of digital services do not look exceptional. The United States' opposition to the DST on the grounds that it is like a tariff or is discriminatory should be viewed in light of its use and the threatened use of similar measures on goods for revenue raising, industrial policy, and other policy reasons. Doing so highlights the inconsistency of the US position and the need to consider both tariffs and the DST in a broader geoeconomic context.

38 United States, White House, "President Biden Takes Action To Protect American Workers and Businesses from China's Unfair Trade Practices," *Fact Sheet*, May 14, 2024.

39 Rebecca Picciotto, "Trump Floats 'More Than' 60% Tariffs on Chinese Imports," *CNBC*, February 4, 2024 (www.cnbc.com/2024/02/04/trump-floats-more-than-60percent-tariffs-on-chinese-imports.html).

40 United States, White House, "President Donald J. Trump Amends Duties To Address the Flow of Illicit Drugs Across Our Northern Border," *Fact Sheet*, July 31, 2025 (www.whitehouse.gov/fact-sheets/2025/07/fact-sheet-president-donald-j-trump-amends-duties-to-address-the-flow-of-illicit-drugs-across-our-northern-border); and United States, White House, "President Donald J. Trump Addresses Threats to the United States from the Government of Brazil," *Fact Sheet*, July 30, 2025 (www.whitehouse.gov/fact-sheets/2025/07/fact-sheet-president-donald-j-trump-addresses-threats-to-the-united-states-from-the-government-of-brazil).

41 Presidential Executive Order 14257 of April 2, 2025, "Regulating Imports with a Reciprocal Tariff To Rectify Trade Practices That Contribute to Large and Persistent Annual United States Goods Trade Deficits," published in *Federal Register*, vol. 90, no. 65, April 7, 2025, 15041-15109.

42 United States, White House, "Presidential Memoranda: Clarification of Exceptions Under Executive Order 14257 of April 2, 2025, as Amended," *Presidential Actions*, April 11, 2025 (www.whitehouse.gov/presidential-actions/2025/04/clarification-of-exceptions-under-executive-order-14257-of-april-2-2025-as-amended); and Presidential Executive Order 14326 of July 31, 2025, "Further Modifying the Reciprocal Tariff Rates," published in *Federal Register*, vol. 90, no. 149, August 6, 2025, 37963-37992.

Although they are subject to distinct legal regimes, tariffs and indirect taxes on the supply of services across the border share functional similarities, and both are neither presumptively prohibited nor bad. While a tariff need not be physically collected at the border,[43] the charge is imposed because the goods cross the border. Tariffs are discriminatory because they are not imposed on competing domestic products. The GATT, in principle, draws a distinction between border charges and internal taxes. The former are regulated by GATT article II:1(b) and the latter by the national treatment obligation in GATT article III:2. Any charge or tax must fall under one or other of these provisions. However, characterization is not always straightforward.[44] If an internal tax is discriminatory, it may be prohibited under GATT article III:2, subject to any available exceptions. The level of internal taxes is not regulated, but taxes cannot be discriminatory, while tariffs discriminate against foreign products, but the level of discrimination is regulated. A siloed approach to determining whether a measure is discriminatory is common in international economic law. A tariff on imports from country A, for example, is not legally justified under the WTO merely because country A imposes tariffs on the same products imported from country B, or otherwise engages in practices that close or distort its markets for that or any other product.[45]

Depending on its design—in particular, whether it could theoretically apply to domestic service suppliers—a DST may be more accurately viewed as an internal tax than as a "tariff." A general international legal infrastructure to regulate and limit taxes on cross-border trade in services does not currently exist. Unlike imported goods, the discriminatory treatment of the cross-border supply of service is not necessarily inconsistent with the WTO and other international trade agreements. The complex system for scheduling commitments that may discriminate against foreign services and service suppliers, and the concept of discrimination itself, provide space for further development of the regulatory regime. A tax that impacts certain firms more than others because of the structure of the tax will not necessarily be discriminatory.[46]

The WTO aims for a substantial reduction but not the elimination of tariffs.[47] Article II of the GATT and the Understanding on the Interpretation of Article II:1(b)

43 *China—Measures Affecting Imports of Automobile Parts*, WT/DS339/AB/R, Appellate Body Report, adopted January 12, 2009, at paragraph 162.

44 Ibid.

45 See, however, United States, White House, "Reciprocal Trade and Tariffs," February 13, 2025.

46 Chris Noonan and Victoria Plekhanova, "Taxation of Digital Services Under Trade Agreements" (2020) 23:4 *Journal of International Economic Law* 1015-39, at 1031-33. Statements made by the Trump administration indicate that the US concern with the DST goes beyond whether a tax is discriminatory. United States, White House, "Defending American Companies and Innovators from Overseas Extortion and Unfair Fines and Penalties," February 21, 2025.

47 GATT article XXVIII bis. Under GATT article XXIV(8)(b), tariffs should be eliminated on substantially all trade between the parties to a free trade agreement.

of the GATT 1994 provide for the scheduling and binding of "ordinary customs duties" and "other duties or charges." Once bound, tariffs cannot be unilaterally increased above the level at which they were bound. Around 99 percent of tariffs are bound in developed countries, while the extent varies in other countries, ranging from 100 percent in Brazil and China to 74.4 percent in India and as low as 13 percent in Cameroon and Chad. Even where tariffs are bound, the actual applied rate of import duty may be (somewhat) lower than the bound rate. As a result, many importing countries have a degree of legal flexibility with their tariffs.[48] More than 97 percent of ordinary customs duties are ad valorem, where the amount of the duty is based on the customs value of the imported goods. A "specific" duty is based on the volume, weight, or number of units imported. A "compound" duty is a combination of ad valorem and specific duties. Notwithstanding the prevalence and diversity of tariffs, the sky has not fallen. To support the use of ad valorem tariffs, the WTO and other agreements set out a variety of methods for the determination of customs value,[49] classification of goods,[50] and customs procedures. If the DST becomes established, experience with goods suggests that international agreement on a common approach to aspects of the tax may be needed.

Tariffs are not only widely used but are potentially significant sources of government revenue. Even if tariff revenue is only 2 or 3 percent of total US federal government tax revenue,[51] the amount collected has achieved political salience under the Trump and Biden administrations, and at US$100 billion in 2022, it cannot be dismissed as small. The Tax Foundation estimates that the 10 percent universal tariff proposed by President Trump would raise about US$2 trillion over 10 years, and a 20 percent tariff US$3.3 trillion.[52] The amount of revenue collected from DSTs in Europe has been significant and has helped to maintain an interest in imposing the

48 For tariff profiles for each WTO member, see World Trade Organization, International Trade Centre, and United Nations Conference on Trade and Development, *World Tariff Profiles 2023* (Geneva: WTO, 2023). The average bound and most-favoured-nation (MFN) applied tariff rates in 2021 were 37.4 percent and 8.9 percent for all products, 54.4 percent and 14.8 percent for agricultural products, and 27.6 percent and 8.9 percent for non-agricultural products. Ibid., at 220.

49 Supra note 33.

50 International Convention on the Harmonized Commodity Description and Coding System, supra note 32.

51 United States, Congressional Research Service, *U.S. Tariff Policy: Overview* (Washington, DC: CRS, January 11, 2021) (https://crsreports.congress.gov/product/pdf/IF/IF11030/3); and Statista, "Customs Duty Revenue and Forecast in the United States from 2000 to 2035," November 18, 2024 (www.statista.com/statistics/217526/revenues-from-customs-duty-and-forecast-in-the-us/).

52 Erica York, "Revenue Estimates of Trump's Universal Baseline Tariffs," *Tax Policy Blog*, Tax Foundation, November 6, 2024 (https://taxfoundation.org/blog/trump-tariffs-revenue-estimates/); and David Lawder, "Trump Upended Trade Once, Aims To Do So Again with New Tariffs," *Reuters*, January 17, 2025 (www.reuters.com/markets/us/trump-upended-trade-once-aims-do-so-again-with-new-tariffs-2025-01-16/).

tax. From a revenue perspective, tariffs are often viewed as a second-best and more distortionary option and inferior to progressive direct taxes. The real-world alternative policy options may differ between countries, but for many they will be limited. The successful negotiation of changes to the suboptimal international tax regime seems improbable at this time. Not all direct taxes are progressive, and many countries raise revenue through both direct and indirect taxes.[53] Virtually all taxes are distortionary to some degree and influence individual and corporate behaviour. Taxes targeting monopoly rents, as DSTs are claimed to do, may be less distortionary. The maximization of tariff revenue may be incompatible with other policy objectives, in particular the development of domestic industry.

The General Agreement on Trade in Services (GATS) does not regulate "tariffs" on services as such. Trade in services can be supplied through any of four modes. Two modes of trade in services do not necessarily involve the cross-border supply of a service but supply through the commercial presence of a service supplier in another WTO member (mode 3) or the temporary movement of natural persons (mode 4). Where services are supplied across borders (modes 1 and 2), a tax may be imposed on or in connection with that supply. Whether or not such taxes are consistent with the GATS will largely depend on each member's specific market access and national treatment commitments and the design of the tax in question. In trade in goods, the GATT seeks to channel all protection into customs duties, so that after a good crosses the border, regulations and taxes are competitively neutral between local and imported goods. The GATS limits the types of permissible market access barriers but leaves it open to members on how they may discriminate. The imposition of value-added tax (VAT) at a higher rate on a digital service supplied to consumers by a supplier based abroad than on a service supplied by a similar locally based supplier is prima facie discriminatory, but it will be inconsistent with the GATS only where a member has committed not to discriminate against that precise service in its schedule of commitments.[54]

53 Organisation for Economic Co-operation and Development, "Global Revenue Statistics Database" (www.oecd.org/tax/tax-policy/global-revenue-statistics-database.htm).

54 World Trade Organization, General Agreement on Trade in Services (herein referred to as "GATS") (www.wto.org/english/docs_e/legal_e/gats_e.htm). The obligation in GATS article II to impose taxes on an MFN basis in principle applies to all trade in services falling within the scope of the GATS, but members were able to list exemptions at the time the WTO was established; article XIV(e) carves out certain measures resulting from agreements to avoid double taxation, and the general and security exceptions in articles XIV and XIV bis may also apply. The national treatment obligation in GATS article XVIII applies only to trade in services for which members have made specific commitments, and even then, any commitment is subject to the broad exemption for direct taxes from the national treatment obligation in article XIV(d), as well as the other general and security exceptions. The applicability of specific commitments to measures affecting many digital services is contested. See Ines Willemyns, *Digital Services in International Trade Law* (Cambridge, UK: Cambridge University Press, 2021), chapters 4 and 5.

Although DSTs are usually structured to apply to both domestic and foreign firms, in most if not all countries the tax will apply primarily or even solely to foreign firms. The concentration of large digital platforms in a few countries and the financial thresholds for the application of the DST mean that few or no domestic firms will need to pay the tax. Even if a relevant non-discrimination commitment has been made, the DST may not breach the trade agreement.[55]

A DST may be imposed on an input, such as advertising, used in the production of another good or service. The DST might then result in "tax pyramiding."[56] Such taxes are criticized as inefficient but are accepted as legal and legitimate taxes in several contexts. In many countries, VAT is a charge on the price of imported goods, including any customs duty payable. An issue for carbon border tax adjustment mechanisms is whether energy taxes would be "taxes occultes" (hidden taxes), which are taxes on inputs used in the production of goods.[57] The absence of serious concern about tax pyramiding in the literature on carbon border adjustments may reflect the fact that any inefficiency is simply accepted as the price of addressing an important policy concern. The same is arguably true of the DST.

In summary, the GATS regime does not assume that discrimination should be prohibited and accepts that members may have policy or political reasons for maintaining discriminatory measures. Some free trade agreements prohibit all or most discrimination but permit the parties to schedule exceptions.

Most governments have therefore demonstrated their desire to retain the ability to discriminate against at least some foreign goods and services. Tariffs and discriminatory taxes create winners and losers. Consumers will typically pay more for goods subject to tariffs, while domestic producers benefit from less competition from foreign products. How we assess these effects will depend on our conception of social well-being. In standard economic models, tariffs create welfare losses for the economy because they produce deadweight losses. Tariffs encourage consumers to shift from lower-cost foreign producers to higher-cost domestic producers, and domestic consumption of goods will fall as prices rise.

Knowing these facts, governments still impose tariffs for a variety of reasons, including to protect and promote domestic industry and employment,[58] respond to

55 Noonan and Plekhanova, supra note 46, at 1031-33.

56 Young Ran (Christine) Kim and Darien Shanske, "State Digital Services Taxes: A Good and Permissible Idea (Despite What You Might Have Heard)" (2022) 98:2 *Notre Dame Law Review* 741-813, at 800-1.

57 General Agreement on Tariffs and Trade, "Border Tax Adjustments: Report of the Working Party Adopted on 2 December 1970," L/3464, at paragraph 15. There is a large literature. See, for example, Alice Pirlot, *Environmental Border Tax Adjustments and International Trade Law* (Cheltenham, UK: Edward Elgar, 2017).

58 Dani Rodrik and Charles Sabel, "Building a Good Jobs Economy," in Danielle Allen, Yochai Benkler, Leah Downey, Rebecca Henderson, and Josh Simons, eds., *A Political Economy of Justice* (Chicago: University of Chicago Press, 2022), 61-95.

domestic political pressure and lobbying,[59] raise tax revenue,[60] offset environmental or other externalities, and enhance national security,[61] or as a form of economic coercion.[62] The WTO Appellate Body has stated that "[t]ariffs are legitimate instruments to accomplish certain trade policy or other objectives such as to general fiscal revenue. Indeed, under the GATT 1994, they are the preferred trade policy instrument."[63]

Research into the liberalization of trade in services suggests the potential for gains and the complementary role of services to trade in goods and the facilitation of international production.[64] The general view of economists is that the economic policy recommendations on trade in goods generally apply to services as well, albeit recognizing that many services markets exhibit market failures. If that is correct, the taxation of revenue earned from the cross-border supply of services may or may not be welfare-reducing. The conclusion of the standard trade policy model that tariffs reduce welfare depends on the assumption that markets are workably competitive—something that is not the case in markets where many digital platforms operate. The implications of this are explored in the fourth and fifth sections of this article. Before we can address those implications, it is necessary to consider the DST from the perspective of the exporting country.

DIGITAL INDUSTRY PROTECTION AND DEVELOPMENT

The United States and commentators have claimed that DSTs are protectionist. Protectionism is sometimes defined as the restriction of imports from other countries, but this is too broad. All trade agreements recognize legitimate policy reasons for restricting trade. As the name suggests, a trade policy measure is not protectionist if a domestic industry is not being shielded from import competition. While protectionism is more a rhetorical claim than a legal category, a credible claim of protectionism may delegitimize the measures of the importing country and serve to

59 Pinelopi Koujianou Goldberg and Giovanni Maggi, "Protection for Sale: An Empirical Investigation" (1999) 89:5 *American Economic Review* 1135-55.

60 Julia Cagé and Lucie Gadenne, "Tax Revenues and the Fiscal Cost of Trade Liberalization, 1792-2006" (2018) 70:1 *Explorations in Economic History* 1-24.

61 Sam Flemming, Demetri Sevastopulo, and Claire Jones, "How National Security Has Transformed Economic Policy," *Financial Times*, September 4, 2024 (www.ft.com/content/6068310d-4e01-42df-8b10-ef6952804604).

62 Anthony Zurcher and Ione Wells, "Co-operate or Else: Trump's Colombia Face-Off Is Warning to All Leaders," *BBC*, January 27, 2025 (www.bbc.com/news/articles/cglynrxjyl5o).

63 *European Communities—Customs Classification of Frozen Boneless Chicken Cuts*, WT/DS269/AB/R, WT/DS286/AB/R, adopted September 27, 2005, at paragraph 199.

64 Brian Copeland and Aaditya Mattoo, "The Basic Economics of Services Trade," in Aaditya Mattoo, Robert M. Stern, and Gianni Zanini, eds., *A Handbook of International Trade in Services* (Oxford, UK: Oxford University Press, 2008), 84-129; and Joseph Francois and Bernard Hoekman, "Services Trade and Policy" (2010) 48:3 *Journal of Economic Literature* 642-92.

justify countermeasures or other actions taken by the exporting country. Whether a measure is protectionist may be disputed, and measures can be both protectionist and advance a legitimate policy, such as environmental protection. Even with these difficulties, however, the complaint that the DST is protectionist does not withstand scrutiny, because the tax is unlikely to enable domestic firms to compete against those targeted with it.

Governments that have introduced or considered a DST have not always identified a single justification for the tax. The rationale provided by the United Kingdom for its DST, for example, invoked both equity and efficiency concerns. HM Treasury and HM Revenue and Customs considered that large multinational platform firms with customers in the United Kingdom have failed to make a just contribution to the provision of public goods in the United Kingdom, and the DST is a fast response to the problem.[65] By contrast, the DST developed by Maryland in the United States was intended to raise revenue for specific public purposes.[66] The need to raise tax revenue or address concerns about free-riding multinationals does not lead unambiguously to a DST or provide much guidance on the scope and details of such a tax. As a consequence, concerns about fair competition and administration have assumed a greater role in the debate.

The economic case for a unilateral reduction of tariffs has always been subject to recognized exceptions. These exceptions align with the rationales advanced for the DST that were noted in the introduction to this article. Tariff protection has been repeatedly shown to be responsive to increasing import penetration.[67] However, sectors where import penetration is high tend to enjoy less protection, because domestic producers gain relatively little compared to the consumer welfare costs.[68] The digital platforms targeted by DSTs frequently have significant import penetration and often a dominant market position in the importing country, which would make them less likely targets for policies designed to protect rival domestic platforms. The United States has nonetheless claimed that DSTs are discriminatory and protectionist—in particular, that the thresholds for the application of the DST in Europe have

65 United Kingdom, HM Revenue & Customs, "Digital Services Tax," March 11, 2020 (www.gov.uk/government/publications/introduction-of-the-digital-services-tax/digital-services-tax). See also United Kingdom, HM Treasury and HM Revenue & Customs, *Digital Services Tax: Consultation* (London, UK: HM Treasury and HM Revenue & Customs, November 2018), at paragraphs 1.10 and 1.11.

66 Kim and Shanske, supra note 56.

67 Lucy M. Goodhart, "Industry-Level Protection," in Lisa L. Martin, ed., *The Oxford Handbook of the Political Economy of International Trade* (Oxford, UK: Oxford University Press, 2015), 159-76.

68 Gene Grossman and Elhanan Helpman, "Protection for Sale" (1994) 84:4 *American Economic Review* 833-50; Goldberg and Maggi, supra note 59; and Kishore Gawande and Usree Bandyopadhyay, "Is Protection for Sale? Evidence on the Grossman-Helpman Theory of Endogenous Protection" (2000) 82:1 *Review of Economics and Statistics* 139-52.

been set at a level so that predominantly digital platforms will be caught.[69] Arguably, even if they are intended to protect European firms, the thresholds minimize compliance and administrative costs by targeting only the largest cross-border service suppliers. Whether the thresholds, rates, and other conditions of a particular DST would be consistent with the non-discrimination obligations of a country under the GATS is likely to remain legally uncertain for some time.

A DST is not a great industrial development tool for digital platforms, which suggests that the United States' claim of discrimination is more rhetorical in nature. Industrial policy measures may be justified in the face of dynamic learning effects or positive externalities, which are features of the digital economy.[70] Skepticism about industrial policy among economists has focused on the ability of governments to administer such policies and a distrust of the political process rather than on the underlying economics. While industrial policy has traditionally focused on manufacturing, the promotion of service industries is likely to play a more prominent role in the future, for several reasons.[71] Services now account for most of the economy in most countries and have become the site of the "good jobs" that are often the focus of industrial policy, and there are few countries that do not wish to develop their digital sectors. There is little evidence of the benefits of sectoral policies for services, but "the economic rationales for industrial policy—externalities, coordination failures, specialized public inputs—are general" and apply to services.[72]

The markets of many countries may not be large enough for digital platform firms to achieve the economies of scale necessary to compete against giant tech platforms in the local or overseas markets. The minimum efficient scale varies between digital services. While ride-hailing and online trade platforms often have competitors in local markets, local companies are connected to firms that deploy their technology across multiple jurisdictions. Google's search engine dominates most national markets where it is allowed to compete. Digital platform firms have high fixed costs but low marginal costs and benefit from significant economies of scale and scope. Where

69 Office of the United States Trade Representative, *Report on France's Digital Services Tax Prepared in the Investigation Under Section 301 of the Trade Act of 1974* (Washington, DC: USTR, December 2, 2019).

70 While the case can be made for industrial policy in distorted markets, the effects may be small when demand is inelastic or policies are uncoordinated: Oleg Itskhoki and Benjamin Moll, "Optimal Development Policies with Financial Frictions" (2019) 87:1 *Econometrica* 139-73; Dominick G. Bartelme, Arnaud Costinot, Dave Donaldson, and Andrés Rodríguez-Clare, *The Textbook Case for Industrial Policy: Theory Meets Data*, NBER Working Paper no. 26193 (Cambridge, MA: National Bureau of Economic Research, August 2019); and Ahmad Lashkaripour and Volodymyr Lugovskyy, "Profits, Scale Economics, and the Gains from Trade and Industrial Policy" (2023) 113:10 *American Economic Review* 2759-2808.

71 Réka Juhász, Nathan Lane, and Dani Rodrik, "The New Economics of Industrial Policy" (2024) 16 *Annual Review of Economics* 213-42.

72 Ibid.; and Nathaniel Lane, "The New Empirics of Industrial Policy" (2020) 20:2 *Journal of Industry, Competition and Trade* 209-34.

cultural and regulatory barriers are not significant, global expansion can occur quickly because services can be supplied to the people and businesses of a country with relatively little physical presence in that country. A DST is therefore questionable as an industrial policy strategy for many digital services, which in turn suggests that protectionism is not the dominant motive behind DSTs.

Protectionism may not be entirely absent from policy decisions in relation to DSTs. The scope and features of existing DSTs cannot be explained in terms of their headline rationale(s). The political economy of trade policy suggests that organized sectors are more likely to receive protection than unorganized sectors.[73] Two organized and concentrated industries, notably news media and financial services, were excluded from the scope of the DST in France and the United Kingdom.[74] The fact that these two industries, which may compete against target companies, are excluded from the DST, suggests that the protection of domestic industries is not the primary purpose of the DST. Protection of these industries may also have a legitimate policy purpose.

Non-economic policies, including data protection and sovereignty, protection of national culture and language, national security, and regulation of hate speech and other morally offensive material, have been prominent in the discussion of digital trade and audiovisual services.[75] The absence of a level playing field between the conventional news media and the news aggregation services of Google and Facebook has also been cited as a justification for a DST. The news aggregation services of Facebook and Google have resulted in a substantial decline in advertising revenue for traditional news media, which is threatening the existence of many companies, the plurality of media, and the reporting of local news. Australia cited the bargaining power imbalances and the need for the news media to be fairly remunerated for the content they generate to help sustain public interest journalism as justifications for its Treasury Laws Amendment (News Media and Digital Platforms Mandatory Bargaining Code) Act.[76] If a DST has the purpose of protecting democracy or national

73 Grossman and Helpman, supra note 68. The relationship between increased market concentration and political influence and lobbying is generally recognized. Luigi Zingales, "Towards a Political Theory of the Firm" (2017) 31:3 *Journal of Economic Perspectives* 113-30; and Bo Cowgill, Andrea Prat, and Tommaso M. Valletti, *Political Power and Market Power*, CEPR Discussion Paper no. 17178 (London, UK: Centre for Economic Policy Research, June 2021).

74 Chris Noonan and Victoria Plekhanova, "Digital Services Tax: Lessons from the Section 301 Investigation" [2021] no. 1 *British Tax Review* 83-115.

75 Willemyns, supra note 54; Mira Burri, ed., *Big Data and Global Trade Law* (Cambridge, UK: Cambridge University Press, 2021); and Anu Bradford, *Digital Empires: The Global Battle To Regulate Technology* (Oxford, UK: Oxford University Press, 2023).

76 Parliament of the Commonwealth of Australia, House of Representatives, "Treasury Laws Amendment (News Media and Digital Platforms Mandatory Bargaining Code) Bill 2021: Explanatory Memorandum," at paragraph 1.1.

security, it is not (purely) protectionist. These legitimate national concerns may outweigh any benefits of liberalization.

A DST may not be the theoretically optimal policy measure to achieve many objectives. In some circumstances, however, a DST may be the best policy tool available, both practically and politically, to achieve specific objectives. If a DST is not protectionist, what economic policy goals might it serve? The answer may lie in the frequently observed fact that digital platform markets are often imperfectly competitive and subject to other distortions.

TAXING SUPRACOMPETITIVE PROFITS: RENT SNATCHING AND PROFIT SHIFTING BY GOVERNMENTS

Where domestic competition is limited, reducing tariffs can be an important source of competitive pressure on local firms, incentivizing them to reduce costs and price more competitively.[77] Taxes on cross-border services would likewise be expected to reduce the competitive pressure from foreign service suppliers. However, where foreign service suppliers have significant market power, the effects of the imposition of taxes on cross-border trade are more complex.

In an economy with multiple distortions, the introduction of an additional distortion, such as a tariff or a tax, may enhance or reduce welfare, depending on whether it augments or offsets the effects of existing distortions. The removal of one among multiple distortions may either increase or decrease welfare. Much of modern trade takes place in imperfectly competitive markets. Where a firm has market power, it has an incentive to raise prices and reduce output below the level that would prevail in a competitive market. A dominant digital services supplier is likely to engage in supracompetitive pricing and thereby extract monopoly rents from consumers or advertisers. The "price rise" or "output reduction" may take the form of a price-adjusted reduction in the quality of the service. For example, a platform may reduce the level of privacy protection, which may create the opportunity to increase advertising revenue.

Most DSTs will apply only to the largest digital platform firms. While digital platform firms might have competed for market share early in their lives, many digital markets are prone to "tipping," because of supply-side economies of scale and network effects, and are now dominated by the firms that achieved the fastest growth in the early life of the market. Limits on interoperability and data mobility, exclusivity arrangements, and other conduct have helped to protect large incumbents from new market entrants and fringe firms. Significant impediments to entry and expansion, and active steps to hinder rivals, have affected the level and nature of competition in many digital services markets, which support ongoing supracompetitive profits.

77 Pinelopi K. Goldberg and Nina Pavcnik, "The Effects of Trade Policy," in Kyle Bagwell and Robert W. Staiger, eds., *Handbook of Commercial Policy*, vol. 1A (Amsterdam: North Holland, 2016), 161-205.

Whether the major digital platforms have substantial market power and earn monopoly rents has been contested, but the evidence for market power now seems incontrovertible. Competition law enforcement and court decisions in the European Union, the United States, and other countries have established that Google,[78] Facebook,[79] Apple,[80] and Amazon[81] have significant market power. The United Kingdom's Competition and Market Authority (CMA) investigation of online platforms and digital advertising, for example, found that Google's return on capital was 40 percent, more than four times the cost of its capital (9 percent). Facebook's return on capital was even greater, at 50 percent. The CMA concluded that the profitability of both Google and Facebook has been well above any reasonable estimate of what we would expect in a competitive market for many years.[82] In other markets within the scope of DSTs, such as online travel agencies, the market structure is oligopolistic rather than dominated by a single firm and may not support such high levels of supracompetitive profits.[83]

78 See, for example, *United States v. Google, LLC*, Case no. 1:20-cv-3010-APM (US District Court for the District of Columbia, Memorandum of Opinion, August 5, 2024) (Google has monopoly power in general search services, search advertising, and general search text advertising markets); *Google LLC v. European Commission*, Case T-612/17, EU:T:2021:763, at paragraph 119 ("Google does not dispute the fact that it holds a dominant position on the 13 national markets for general search services"); upheld on appeal, *Google LLC v. European Commission*, Case C-48/22 P judgment, EU:C:2024:14; and *Epic Games, Inc. v. Google, Inc.*, MDL Case no. 3:21-md-02981-JD (US District Court for the Northern District of California, December 11, 2023) (jury verdict finding that Google engaged in monopolization and restraint of trade in the worldwide [excluding China] market for Android app distribution and Android in-app billing services for digital goods and services).

79 See, for example, *Meta Platforms Inc and Others v. Bundeskartellamt*, Case C-252/21, EU:C:2023:537; and *Federal Trade Commission v. Facebook, Inc.*, Civil Action no. 1:20-3590-JEB (US District Court for the District of Columbia, June 28, 2021) (Facebook alleged to possess monopoly power in the market for personal social networking services).

80 See, for example, Tripp Mickle and Adam Satariano, "Apple Fined $2 Billion by the E.U. for Using App Store To Thwart Competition," *New York Times*, March 4, 2024. But see *Epic Games, Inc. v. Apple Inc.*, Case no. 4:2-cv-05640-YGR (US District Court for the Northern District of California, September 10, 2021).

81 See, for example, *Amazon Marketplace and AT.40703—Amazon Buy Box*, Case AT.40462, Commission decision, December 20, 2022; *Federal Trade Commission v. Amazon.com, Inc.*, Case no. 2:23-cv-01495, filed September 26, 2023 (Amazon alleged to have monopoly power in the online superstore market and the market for online marketplace service).

82 United Kingdom, Competition and Markets Authority, *Online Platforms and Digital Advertising: Market Study Interim Report* (London, UK: CMA, 2019), at paragraph 59.

83 Herbert Hovenkamp, "Antitrust and Platform Monopoly" (2021) 130:8 *Yale Law Journal* 1952-2050. But see *The Office Cantonal des Faillites de la République et du Canton de Genève Acting in Its Capacity as Representative in the Bankruptcy of Amoma SARL v. Expedia Inc.*, Case no. 2:23-cv-00983-BJR (US District Court for the Western District of Washington, February 1, 2024) (denying motion to dismiss).

If the major digital platforms have substantial market power, a DST may enhance the welfare of the state imposing the tax. Several scholars have developed the idea that a DST would allow location-specific rent earned by digital platforms to be captured by the countries in which such rent arises.[84] The argument is a trade policy staple. In the face of a foreign monopoly, whether the monopoly is a single enterprise or a cartel, there are some policy measures a small country[85] could take that might improve its welfare.[86] Under reasonable assumptions about the form of the demand curve, there is a positive, non-prohibitive optimal tariff that the importing country could impose, which would trade off gains in captured foreign rents against the domestic distortion that results from a fall in the foreign firm's supply price.[87] The tariff raises the price that the monopolist will charge consumers in the domestic market, which reduces the consumer surplus. The monopolists' profits also decline, however, and the home country collects additional revenue by taxing domestic competitors of the monopolists. The so-called rent-snatching tariff is welfare-enhancing for the market jurisdiction where the revenue collected is greater than the consumer surplus lost.

The real world is not so simple, though. Mitchell Kane and Adam Kern point out that location-specific rent is not always measurable and does not always originate from a single location.[88] The impost and level of a DST are not precisely calibrated to the rents earned by the digital platforms earned in any jurisdiction. Most DSTs adopt a rate linked to an assumed ordinary rate of return from the revenue generated (occasionally with some accommodation to low-margin businesses because of fairness and ability-to-pay concerns)[89] rather than estimates of market power or monopoly profits.

However, Kane and Kern go too far in asserting that to allocate taxing rights in relation to such rent we need to rely on a general theory of global distributive

84 Wei Cui, "The Digital Services Tax: A Conceptual Defence" (2019) 73:1 *Tax Law Review* 69-111. DST-like policies may also be used to achieve specific regulatory aims: Simon Anderson and Özlem Bedre Defolie, "Hybrid Platform Model: Monopolistic Competition and a Dominant Firm," July 23, 2022, at 3 (https://ssrn.com/abstract=3867851).

85 A small country is typically modelled as one that faces a perfectly elastic demand for its exports and a perfectly elastic supply for its imports. With respect to supplies by a foreign monopolist, the small country is unable to affect the monopolist's marginal cost or to influence the monopolist's pricing decisions in the rest of the world.

86 Chris Noonan, *The Emerging Principles of International Competition Law* (Oxford, UK: Oxford University Press, 2008), at 154.

87 Neil Vousden, *The Economics of Trade Protection* (Cambridge, UK: Cambridge University Press, 1990), at 122-25; and Ronald W. Jones and Shumpei Takemori, "Foreign Monopoly and Optimal Tariffs for the Small Open Economy" (1989) 33:9 *European Economy Review* 1691-1707.

88 Mitchell A. Kane and Adam Kern, "The Use and Abuse of Location-Specific Rent" (2023) 76:2 *Tax Law Review* 277-324.

89 Finance Act 2020 (UK), 2020 c. 14, sections 48 and 49.

justice.[90] No other international tax rules have been required to or would meet such criteria, even if there were a generally accepted theory of global distributive justice. Cross-border tax policy is driven by calculations of national interest, just like the attachment of some countries to the status quo.

Although rent-snatching tariffs will improve the national welfare of the importing country, in theory a consumption tax would be a better policy, and optimal price controls would be better still.[91] As a tax on revenue earned or a proxy for revenue earned in a country, a non-discriminatory DST is akin to a consumption tax, albeit one that is sometimes imposed on intermediate services. The use of price controls to prevent foreign rent extraction by digital platforms is impracticable.[92] The detection of supracompetitive pricing is complex in the case of two-sided markets, where the profit-maximizing price may be zero or even negative on one side of the market. Google and Facebook provide their core services to end-consumers for "free," but they charge advertisers for the right to target advertising at consumers and collect data from them, in order to provide a more valuable service to advertisers. In these circumstances, the usual remedy for monopoly pricing—price regulation—may make less sense. The regulation of pricing on the advertisers' side of the market may also be difficult owing to jurisdictional limitations and the need to secure information about a platform's costs. In these circumstances, a DST may be an appropriate measure to mitigate the harm from supracompetitive pricing of cross-border services. A counterargument is that profits in the current period need to be seen in the context of possible losses in previous periods before the dominant firm vanquished its rivals. However, the digital platform is likely to have tax credits in its home jurisdiction for any losses it incurred in attempting to expand in a foreign market, which reduces the risk of unfair treatment of digital platforms.

A country may be too small to influence the behaviour of giant digital platforms through direct regulation, including non-price terms and conditions, such as those related to data protection. The different responses of Google and Facebook to the introduction of laws requiring payment for reproducing news coverage in Spain, Germany, France, and Australia suggest that while the tech companies have significant market power and there are limits to what other, even medium-sized countries, can achieve, the outcome will be the result of intense bargaining.[93] The tough response likely reflects the platforms' concerns about the setting of a global precedent,

90 Kane and Kern, supra note 88, at 277.

91 Carsten Kowalczyk, "Monopoly and Trade Policy" (1994) 36:1-2 *Journal of International Economics* 177-86.

92 Jean Tirole, "Competition and the Industrial Challenge for the Digital Age" (2023) 15 *Annual Review of Economics* 573-605.

93 Bradford, supra note 75, at 351-52. See also Competition Policy International, "'Digital Regulator Must Have Power To Force Google & Facebook To Pay for News' Says CMA," April 13, 2021 (www.competitionpolicyinternational.com/digital-regulator-must-have-power-to-force-google-facebook-to-pay-for-news-says-cma/).

competition among media, the consequences of short-term disruptions to media, and other factors. As explained below, even small countries have a degree of market power in relation to many large platforms. Common unilateral action will also strengthen the position of small countries against retaliation.

Structural features of digital markets may provide a further justification for a DST, at least in larger countries. Since the 1970s, product differentiation and economies of scale have been seen as important determinants of international trade.[94] If firms from different countries compete in imperfectly competitive markets, government policy actions might be able to shift profits from the foreign firm to the home firm, and thereby produce a gain in national welfare.[95] Policy intervention may not only transfer rents but also tilt markets in favour of domestic firms, resulting in higher market shares for those firms. Tariffs or subsidies can be used to shift profits toward the intervening country when firms possess market power and use their market power in the presence of barriers to entry to earn supracompetitive profits.[96] Research and development subsidies, for example, may be able to shift profits from foreign rivals to domestic firms under a variety of forms of competition. A DST, which may be analyzed as a tariff on foreign firms or as a subsidy to local firms, may be a tool that can be used for rent shifting. The appropriate policy action will depend on the nature of competition between firms.

94 Elhanan Helpman and Paul R. Krugman, *Market Structure and Foreign Trade: Increasing Returns, Imperfect Competition, and the International Economy* (Cambridge, MA: MIT Press, 1985); Gene M. Grossman, ed., *Imperfect Competition and International Trade* (Cambridge, MA: MIT Press, 1992); and Barbara J. Spencer and James A. Brander, "Strategic Trade Policy," in Steven N. Durlauf and Lawrence E. Blume, eds., *The New Palgrave Dictionary of Economics*, 2d ed. (New York: Macmillan, 2008), 6389-94.

95 James A. Brander and Barbara J. Spencer, "Export Subsidies and International Market Share Rivalry" (1985) 18:1-2 *Journal of International Economics* 83-100; Jonathan Eaton and Gene M. Grossman, "Optimal Trade and Industrial Policy Under Oligopoly" (1986) 101:2 *Quarterly Journal of Economics* 383-406; and James A. Brander, "Strategic Trade Policy," in Gene M. Grossman and Kenneth Rogoff, eds., *Handbook of International Economics*, vol. 3 (Amsterdam: North-Holland, 1995), chapter 27. The earlier duopoly models have been generalized to cover multiple firms supplying differentiated products: Ralph Ossa, "Profits in the 'New Trade' Approach to Trade Negotiations" (2012) 102:3 *American Economic Review* 466-69; and Arnaud Costinot, Andrés Rodríguez-Clare, and Iván Werring, "Micro to Macro: Optimal Trade Policy with Firm Heterogeneity" (2020) 88:6 *Econometrica* 2739-76.

96 Anthony J. Venables, "Trade and Trade Policy with Imperfect Competition: The Case of Identical Products and Free Entry" (1985) 19:1-2 *Journal of International Economics* 1-19; Anthony Venables, "Trade and Trade Policy with Differentiated Products: A Chamberlain-Ricardian Model" (1987) 97:387 *Economic Journal* 700-17; Ralph Ossa, "A 'New Trade' Theory of GATT/WTO Negotiations" (2011) 119:1 *Journal of Political Economy* 122-52; David De Remer, *The Evolution of International Subsidy Rules*, Université Libre de Bruxelles Working Paper no. 2013-45 (Brussels: Université Libre de Bruxelles, 2013) (https://core.ac.uk/display/18621714); Ralph Ossa, "Trade Wars and Trade Talks with Data" (2014) 104:12 *American Economic Review* 4104-46; and Kyle Bagwell and Robert W. Staiger, "Delocation and Trade Agreements in Imperfectly Competitive Markets" (2015) 69:2 *Research in Economics* 132-56.

If economies are internal to a foreign firm exporting goods to customers in a market country, a tariff may increase the sales of a domestic firm supplying substitutable goods, and the resulting production expansion will increase its economies of scale. The foreign firm will experience a contraction in sales and higher per-unit costs. The domestic firm will improve its competitiveness relative to the foreign firm. The resulting equilibrium will depend on a range of factors. However, each country's firms have an interest in preventing foreign firms from encroaching into their market. In addition to tariffs, a host of other regulatory measures, such as data protection, can serve to segregate markets. Assessing the welfare effects of intervention is not straightforward, but the possibility may be politically attractive. Most country markets are too small to allow for the exploitation of global economies of scale. China, the European Union, India, and the United States are of course in a different league.

It is difficult to precisely estimate the relevant demand and supply elasticities. They will not be the same for all digital platforms and may vary over time. Under existing legislation, the DST rate is set by statute and applies to all firms within the same category. The practicalities of administration and constitutional concerns are likely to mean that DST tax rates are often not optimal. However, Google and Facebook have substantial market power in most countries where they operate, which means that DST on Internet advertising revenue could be welfare-enhancing from the perspective of the taxing country.

TERMS-OF-TRADE THEORY AND CUSTOMER-BASED MARKET POWER

Economic Basis for Agreement

Neither industry development nor monopoly rents earned by digital platforms are clear drivers of DSTs. Another rationale for a DST, and the regulation of DSTs linked to imperfectly competitive markets, requires specific attention at a time when the United States is looking to adopt a uniform baseline tariff on all imports. The previous section of this article looked at the options of an importing country facing a digital platform firm with market power. This section shifts the focus to the situation where the importing country has market power and is able to affect its terms of trade.[97] Terms-of-trade or optimal tariff theory is the dominant economic justification for the WTO and other trade agreements as opposed to liberalization per se.[98]

97 "Terms of trade reflect the relative price between a country's exports and imports, and are measured as the ratio of the export price index to the import price index. Terms of trade indicate whether a country can purchase more or fewer imports for the same amount of exports. An increase in export prices relative to import prices signals an improvement in terms of trade." Organisation for Economic Co-operation and Development, "Terms of Trade" (www.oecd.org/en/data/indicators/terms-of-trade.html).

98 Harry G. Johnson, "Optimum Tariffs and Retaliation" (1954) 21:2 *Review of Economic Studies* 142-53; Wolfgang Mayer, "Theoretical Considerations on Negotiated Tariff Adjustments" (1981) 33:1 *Oxford Economic Papers* 135-53; and Kyle Bagwell and Robert W. Staiger, "An

Scott Bessent, in the Senate hearing for confirmation as US Secretary of the Treasury, referred to optimal tariff theory in defence of President Trump's plan to impose tariffs on all imports into the United States.[99] Both tariff and non-tariff measures can be used by an importing country with market power in international trade to pocket terms-of-trade gains.[100] These are national welfare gains that come at the expense of other countries, and by reciprocally agreeing to give up tariffs, the parties to a trade agreement can improve their welfare. In essence, an import tariff reduces the demand for imports. When an import tariff is imposed by a large country, the world price for its imports will be reduced relative to the price for its exports. In addition to producing a terms-of-trade effect, the positive tariffs shift more resources toward more profitable industries, potentially generating profit-shifting effects.

Without an international agreement on tariffs, states have an incentive to increase tariffs to extract wealth from their trading partners. Consumers in market jurisdictions will suffer a welfare loss from higher prices and the deadweight loss from the distortion of production and consumer decisions. The market jurisdiction government, however, gains the additional tariff revenue. Whether the tariff benefits the market jurisdiction depends on the amount of the rent that the country can extract from foreign producers by forcing them to drop their prices to continue exporting to the market jurisdiction, as well as on the size of the deadweight loss. The foreign country loses in this scenario because an amount of their producers' surplus is transferred in the form of tariff revenue to the market jurisdiction government, and because the tariff distorts foreign production and consumption decisions. When exports are supplied perfectly elastically, so that the export supply curve is horizontal, the imposition of a tariff will have no effect on foreign prices, in which case the market jurisdiction will lose from the imposition of a tariff. In general, the welfare effects of a tariff will depend on the steepness of the export supply curve.

Economic Theory of GATT" (1999) 89:1 *American Economic Review* 215-48. The idea dates back to the 19th century: Robert Torrens, *The Budget: A Series of Letters on Financial, Commercial, and Colonial Policy* (London, UK: Smith, Elder, 1844) (https://archive.org/details/budgetseriesofle00torruoft/page/n5/mode/2up); and John Stuart Mill, *Essays on Some Unsettled Questions of Political Economy* (London, UK: Parker, 1844) (https://archive.org/details/essaysonsomeunse00millrich/page/n7/mode/2up).

99 United States Senate Committee on Finance, "Hearing To Consider the Anticipated Nomination of Scott Bessent, of South Carolina, To Be Secretary of the Treasury," January 16, 2025 (www.finance.senate.gov/hearings/hearing-to-consider-the-anticipated-nomination-of-scott-bessent-of-south-carolina-to-be-secretary-of-the-treasury).

100 Kyle Bagwell and Robert W. Staiger, "Domestic Policies, National Sovereignty, and International Economic Institutions" (2001) 116:2 *Quarterly Journal of Economics* 519-62; Kyle Bagwell and Robert W. Staiger, "Will International Rules on Subsidies Disrupt the World Trading System?" (2006) 96:3 *American Economic Review* 877-95; Kyle Bagwell and Robert W. Staiger, "What Do Trade Negotiators Negotiate About? Empirical Evidence from the World Trade Organization" (2011) 101:4 *American Economic Review* 1238-73; and Robert W. Staiger and Alan O. Sykes, "International Trade, National Treatment, and Domestic Regulation" (2011) 40:1 *Journal of Legal Studies* 149-203.

The terms-of-trade theory of trade cooperation generally applies to trade in services.[101] To the extent that international trade in services takes place through foreign direct investment, the ability and incentive to manipulate the terms of trade are reduced.[102] A DST, however, is generally applied to large cross-border service suppliers that are mostly based offshore and supply their primary services through a subsidiary of a digital multinational firm operating in a low-tax jurisdiction.[103] Therefore, where the market country has a degree of international market power and the subject digital platforms are located offshore, a country's terms of trade might be improved through a DST.

The terms-of-trade theory of trade agreements posits that the WTO provides value to its members by reducing inefficiency.[104] Some economists go further to argue that a "trade agreement can be valuable to governments, but only if in the absence of an agreement governments would attempt to shift costs onto one another and as a consequence adopt inefficient unilateral policies."[105] If correct, a pillar 1-type prohibition on DSTs is valuable to prevent taxes designed to improve terms of trade. Since most countries are predominantly importers of services supplied by digital platforms subject to DST, mutual benefits from such an agreement seem unlikely. The terms-of-trade argument has also been less successful in explaining the existence of preferential trade agreements than the creation of the WTO. In short, it is difficult to make an economic case for a multilateral agreement prohibiting DSTs, like that contained in the October 2021 statement encouraged by the OECD.[106] The economic benefits that may arise from a DST affecting a country's terms of trade deserve more attention.

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101 Copeland and Mattoo, supra note 64, at 84.

102 Emily J. Blanchard, "Foreign Direct Investment, Endogenous Tariffs, and Preferential Trade Agreements" (2007) 7:1 *B.E. Journal of Economic Analysis & Policy* 1-52; and Francois and Hoekman, supra note 64.

103 The text is an abstraction from reality. Subsidiaries of either an ultimate parent or one of the main companies in a group that is in charge of a particular service are often present in a market jurisdiction. For example, the parents of Australian subsidiaries of Google and Facebook are in the United States. US platform firms conduct non-US sales through sales hubs located in low-tax jurisdictions and deal with sales in a particular region. Subsidiaries in market jurisdictions are either sales agents of these sales hubs or providers of marketing and technical support services to these hubs. In other words, subsidiaries in market jurisdictions derive either a sales commission or a service fee.

104 Kyle Bagwell and Robert W. Staiger, "The World Trade Organization: Theory and Practice" (2010) 2 *Annual Review of Economics* 223-56.

105 Kyle Bagwell, Chad P. Bown, and Robert W. Staiger, "Is the WTO Passé?" (2016) 54:4 *Journal of Economic Literature* 1125-1231, at 1144.

106 Organisation for Economic Co-operation and Development, "Statement on a Two-Pillar Solution To Address the Tax Challenges Arising from the Digitalisation of the Economy," OECD/G20 Base Erosion and Profit Shifting Project, October 8, 2021 (www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.pdf).

Optimal Taxes and Their Incidence

While trade theory cannot justify an agreement eliminating DSTs, work to identify optimal tariffs is relevant to determining the level at which a DST might be imposed. If a market jurisdiction sought to take advantage of its market power, the theory of optimal taxation suggests that the price markup over marginal cost should be inverse to the price elasticity of demand.[107] A good or service's price elasticity of demand is a measure of how sensitive the quantity demanded of the good or service is to its price. When the price rises, the quantity demanded falls. The more elastic the product's demand is, the smaller should be the markup if it is to be efficient.[108] An "optimal" tariff would be inversely proportional to import demand elasticity. Governments generally have not applied the theory to natural monopolies because of equity concerns that would arise from its application.

Research has explored the elasticity of demand for a country and demand for a specific good or service. The estimated export supply elasticities for several countries indicate upward-sloping export supply curves.[109] One survey of the literature concluded that "there is abundant evidence of substantial market power, but its presence varies greatly from industry to industry and country to country."[110] An estimation of the median optimal tariffs for Canada, China, India, Japan, Korea, MERCUSOR, the European Union, Russia, and the United States produced a range of 52.9 percent (Russia) to 60.0 percent (United States).[111] Estimates of elasticities of substitution are subject to significant uncertainty.[112] Nonetheless, these results suggest that a high DST could be welfare-enhancing for some market jurisdictions.

Empirical studies have not been able to confirm who bears the cost of "optimal" tariffs, or indeed the impact of tariff changes generally, with much certainty.[113] The 2018 tariffs imposed by the United States on imports from China, for example,

107 Grossman and Helpman, supra note 68.

108 F.P. Ramsey, "A Contribution to the Theory of Taxation" (1927) 37:145 *Economic Journal* 47-61.

109 Christian Broda, Nuno Limão, and David E. Weinstein, "Optimal Tariffs and Market Power: The Evidence" (2008) 98:5 *American Economic Review* 2032-65.

110 Bagwell et al., supra note 105, at 1149. See also Rodney D. Ludema and Anna Maria Mayda, "Do Terms-of-Trade Effects Matter for Trade Agreements? Theory and Evidence from WTO Countries" (2013) 128:4 *Quarterly Journal of Economics* 1837-93; and Asrat Tesfayesus, "Liberalization Agreements in the GATT/WTO and the Terms-of-Trade Externality Theory: Evidence from Three Developing Countries" (2016) 24:5 *Review of International Economics* 1000-22.

111 Ralph Ossa, "Quantitative Models of Commercial Policy," in *Handbook of Commercial Policy*, vol. 1A, supra note 77, 207-59, at 245.

112 Ibid., at 226.

113 Liliana Winkelmann and Rainer Winkelmann, "Tariffs, Quotas and Terms-of-Trade: The Case of New Zealand" (1998) 46:2 *Journal of International Economics* 313-32 (New Zealand); Douglas Irwin, *Tariff Incidence: Evidence from U.S. Sugar Duties, 1890-1930*, NBER Working Paper no. 20635 (Cambridge, MA: National Bureau of Economic Research, October 2014) (United States); Chris Edmond, Virgiliu Midrigan, and Daniel Yi Xu, "Competition, Markups, and the Gains from International Trade" (2015) 105:10 *American Economic Review* 3183-3221

appear to have been largely passed on to consumers.[114] The economics of digital platforms is more complex than that of many commodities.

While establishing the elasticities and level of passthrough in digital services markets will be empirically challenging, even small countries may have market power in relation to digital platforms and may benefit from terms-of-trade tariffs. First, after global digital platforms enter a market, the marginal cost of supplying their digital services to a small country is likely to be small, because of the very substantial economies of scale and scope that digital platforms benefit from within the scope of a DST.[115] Serving small markets is therefore likely to be profitable for digital platforms.

Second, denial of access to consumer data would significantly reduce advertising revenue from a market, perhaps by 50 to 70 percent.[116] Where a country restricts access to its citizens' online attention, digital platforms cannot recoup the revenue lost by supplying the same service to customers in another country. Each country controls a unique opportunity for digital platforms to profit and possesses some degree of market power. The partial accommodation of the demands of the Australian government by Facebook and Google's fine for no longer displaying news snippets in France is consistent with medium-sized countries having not insignificant market power.[117] Australia's Competition and Consumer Commission concluded a three-year battle to make Facebook and Google pay for news after the Internet groups signed deals with publishers that could be worth about AU$200 million (US$155.33 million) a year.[118]

(Taiwan); Jan De Loecker, Pinelopi K. Goldberg, Amit K. Khandelwal, and Nina Pavcnik, "Prices, Markups, and Trade Reform" (2016) 84:2 *Econometrica* 445-510 (India); and Mary Amiti, Mi Dai, Robert C. Feenstra, and John Romalis, *How Did China's WTO Entry Affect U.S. Prices?* NBER Working Paper no. 23487 (Cambridge, MA: National Bureau of Economic Research, 2017) (China).

114 Mary Amiti, Stephen J. Redding, and David E. Weinstein, "The Impact of the 2018 Tariffs on Prices and Welfare" (2019) 33:4 *Journal of Economic Perspectives* 187-210; Doireann Fitzgerald, "How Exporters Respond to Tariff Changes," in Meredith A. Crowley, ed., *Trade War: The Clash of Economic Systems Endangering Global Prosperity* (London, UK: CEPR Press, 2019), 51-56; and Alberto Cavallo, Gita Gopinath, Brent Neiman, and Jenny Tang, "Tariff Pass-Through at the Border and at the Store: Evidence from US Trade Policy" (2021) 3:1 *American Economic Review: Insights* 19-34.

115 See also Wolfram F. Richter, *The Economics of the Digital Services Tax*, CESifo Working Paper no. 7863 (Munich: Center for Economic Studies and ifo Institute, 2019), at 3 (www.econstor.eu/bitstream/10419/207254/1/cesifo1_wp7863.pdf).

116 Daniel J. Gilman and Liad Wagman, "The Law and Economics of Privacy," August 24, 2023 (https://ssrn.com/abstract=4551394).

117 On February 25, 2021, the Australian government enacted legislation for the News Media and Digital Platforms Mandatory Bargaining Code. Michelle Meagher, "Australia's Move To Tame Facebook and Google Is Just the Start of a Global Battle," *The Guardian*, February 24, 2021 (www.theguardian.com/commentisfree/2021/feb/24/australia-facebook-google-global-battle-governments-journalism).

118 Competition Policy International, "Google & Facebook To Pay for Media Content Under New Australian Law," June 1, 2021 (www.competitionpolicyinternational.com/google-facebook-to-pay-for-media-content-under-new-australian-law/).

The price that consumers pay for the main services supplied by Google and Facebook is zero, because of the two-sided market. The optimal price for search and social network services may even be negative.[119] Consumers put high value on services provided by Google and Facebook but are reluctant to make even a micro-payment for the use of the service.[120] The cost of a DST is therefore more likely to be passed on to advertisers, because charging consumers would involve a radical change of business model and consumers will not pay for these services. Empirical findings on the economic incidence of income tax show that an increase in corporate tax rates had a sizable effect on advertising prices across countries.[121] This suggests that Google or Facebook will charge advertisers a higher price to compensate for DST. Whether advertisers will be able to pass the cost on to end-consumers will depend on the circumstances. If Google and Facebook are not fully exploiting their market power, theory suggests that they are likely to absorb some of the increase. Platforms such as marketplaces, online travel agencies, and streaming services that charge end-consumers for their services may be better positioned to pass on the cost of DST to businesses and consumers.

One study prepared for the Computer and Communications Industry Association (CCIA), the membership of which includes the largest digital platforms, predicted that only 5 percent of the burden of the French DST would fall on the large digital platforms, while 55 percent would be passed on to consumers and 40 percent would be passed on to businesses that used the platforms.[122] The assumptions made in the CCIA model, including about the nature of competition in markets dominated by one firm, are questionable. Investors did not think that the platforms would be able to pass on all of the cost of DST.[123] The model's predictions also do not appear to be

119 Tirole, supra note 92.

120 See, for example, Pinar Akman, "A Web of Paradoxes: Empirical Evidence on Online Platform Users and Implications for Competition and Regulation in Digital Markets" (2022) 16:2 *Virginia Law and Business Review* 217-92; and Jeffrey T. Prince and Scott Wallsten, "How Much Is Privacy Worth Around the World and Across Platforms?" (2022) 31:4 *Journal of Economics and Management Strategy* 841-61. Interestingly, while individuals require large payments to stop using social media, a large fraction of users may derive negative welfare from social media but continue to use it because the cost of individually not using it is high. Guy Aridor, Rafael Jiménex-Durán, Ro'ee Levy, and Lena Song, "The Economics of Social Media" (2024) 62:4 *Journal of Economic Literature* 1422-74.

121 Andrea Lassmann, Federica Liberini, Antonio Russo, Ángel Cuevas, and Ruben Cuevas, "Global Spillovers of Taxation in the Online Advertising Market: Theory and Evidence from Facebook," February 26, 2024 (https://ssrn.com/abstract=4739236).

122 Julien Pellefigue, *The French Digital Service Tax: An Economic Impact Assessment* (Paris: Deloitte and Taj, March 22, 2019) (https://blog.avocats.deloitte.fr/content/uploads/2020/03/dst-impact-assessment-march-2019.pdf).

123 Daniel Klein, Christopher A. Ludwig, and Christoph Spengel, "Taxing the Digital Economy: Investor Reaction to the European Commission's Digital Tax Proposals" (2022) 75:1 *National Tax Journal* 61-92, at 86.

entirely supported by the different reactions of the major platforms in response to the introduction of DSTs in Europe.[124] Amazon announced that it was going to increase fees for sellers in France and the United Kingdom following the introduction of a DST in both countries.[125] The headline may not necessarily reflect the longer-term outcome nor indicate 100 percent passthrough. Economic theory suggests that tax increases are more likely to be passed on in competitive markets than in markets dominated by a single firm.[126] However, even dominant platforms may not be charging a full monopoly price and therefore may have an incentive to pass on some of the tax. If Google and Facebook are currently exploiting their market power, higher prices will lead to an unprofitable drop in sales, and both firms will absorb at least some of the cost of the tax.

Where both the market state and the digital platform have market power, the outcome may depend on the business strategy of the platform and both country-specific and global factors. Concern for precedents and the need to create exceptions to global systems means that digital platforms may be initially reluctant to absorb any additional tax. A tax increase in one market might also be passed on to send a "political" message to the local or other governments, even if doing so does not maximize profit in the short term. A DST may increase the marginal costs of a digital platform operating in a country and raise its fixed costs as a result of the need to establish compliance systems.

Administration and Coordination Challenges

The implementation of an optimal tariff is subject to some well-known limitations.[127] Apart from the difficulty in identifying and administering the optimal rate, the main concern relates to foreign countries adopting similar taxes. Governments probably cannot implement a tariff that optimally matches the relevant elasticities. Trade economists have also tended to assume that officials are overly influenced by industry.

The rollout of multiple DST regimes will create challenges for governments and affected multinationals. For most countries, these are coordination issues rather than a risk of retaliatory DSTs harming export interests. Companies headquartered in the

124 Jake Kanter, "Amazon, Facebook, and Google Come Out Swinging After Being Slammed with an 'Unjustifiable' New Tax on Their Sales," *Business Insider*, August 14, 2019 (www.businessinsider.com/amazon-facebook-and-google-lobby-french-digital-services-tax-2019-8).

125 Daniel Bunn, "Who Will Ultimately Pay the Digital Services Tax in the UK? Amazon Passes the Cost Along to Sellers," August 4, 2020 (https://taxfoundation.org/blog/who-will-ultimately-pay-the-uk-digital-services-tax-amazon-passes-the-cost-along-to-sellers/).

126 Kai A. Konrad, Florian Morath, and Wieland Müller, "Taxation and Market Power" (2014) 47:1 *Canadian Journal of Economics* 173-202.

127 For example, Thomas M. Humphrey, "Classical and Neoclassical Roots of the Theory of Optimum Tariffs" (July/August 1987) 73 *Federal Reserve Bank of Richmond Economic Review* 17-28 (www.richmondfed.org/~/media/richmondfedorg/publications/research/economic_review/1987/pdf/er730402.pdf).

United States are the primary but not the sole targets of DSTs. The United States has not retaliated by imposing a DST on foreign companies as per the classic criticism of optimal tariffs, but has sought (so far) to use threats of tariffs on goods to pressure governments not to implement DSTs. The longer-term success of this strategy is not certain,[128] and the existing legal instruments are ill-suited for challenging the taxes of other countries and lack legitimacy.[129] The OECD has sought to present the threat of trade sanctions in response to DSTs as a reason for not imposing DSTs, even if sanctions are inconsistent with the WTO.[130] The implicit endorsement of WTO-inconsistent actions should be seen as problematic for an international organization, especially one that aims to contribute "to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations."[131]

Whether or not DSTs are welfare-enhancing will also depend on the coordination between countries imposing them. The international regime regulating trade in goods indicates that a number of supporting agreements may improve the transparency and predictability of DSTs and reduce the risk of international disputes. Widespread implementation of DSTs might require rules the equivalent to the classification and valuation of goods. Headline rates of DSTs provide a misleading impression about the certainty and transparency of the tax. The scope of the activities covered by a DST may become less clear as technology and markets change. Clarity is likely to require discussion between digital platforms and tax authorities. Even if DSTs of different countries have a similar scope, the risk of double taxation for some transactions exists without some coordination between jurisdictions. The need for coordination in the implementation of DSTs to prevent undesirable double taxation and improve enforcement may reduce the risk of politicians setting suboptimally high DST rates and/or ratcheting up rates over time. Many jurisdictions appear to be coalescing around a DST rate of about 3 percent, with the possibility of a lower rate for low-margin businesses. If DSTs are seen as a proxy for undertaxed corporate income, that may provide a focal point for jurisdictions setting DST rates in the face of the uncertainty about the optimal rate of DST for rent snatching or changing the terms of trade. Transparency obligations for DSTs can go a long way in reducing disputes and protectionism.

128 Noonan and Plekhanova, supra note 74.

129 Stephen E. Shay, "Trade Enforcement Tools and International Taxation: A Digital Services Tax Case Study," in Julien Chaisse and Cristián Rodríguez-Chiffelle, eds., *The Elgar Companion to the WTO* (Cheltenham, UK: Edward Elgar, 2023), 535-50. See also Peter A. Glicklich and Heath Martin, "Not Whether but When and How: US Response to Unilateral Digital Taxation," *Bloomberg Tax*, October 30, 2019 (https://news.bloombergtax.com/daily-tax-report-international/not-whether-but-when-and-how-u-s-response-to-unilateral-digital-taxation).

130 Plekhanova and Noonan, supra note 35.

131 Convention on the Organisation for Economic Co-operation and Development, signed at Paris on December 14, 1960, article 1(c).

In summary, while both digital platforms and market jurisdictions possess a degree of market power, the operationalization of a DST that is able to surgically shift or extract monopoly rents seems a remote possibility. Nonetheless, terms-of-trade theory supports the obvious conclusion that most countries will not benefit from a multilateral agreement prohibiting DSTs and that a DST may enhance national welfare. The need to coordinate may positively constrain the development of DSTs.

SUBSIDIES AND ANTI-SUBSIDY MEASURES

Evolving Subsidy Regulations

The regulation of and controversies surrounding subsidies are central to trade law and policy. A DST may be usefully viewed through the lens of subsidies regulation, and doing so uncovers an alternative foundation for this tax. In the real world of trade in services, the boundaries between tariffs, internal taxes, tax breaks, and subsidies are not always sharp. A DST can be viewed as a tariff, an internal tax, a subsidy, or an anti-subsidy measure. The concept of a "subsidy" is a legal construct. It is broader and more complicated than the concept used in simple trade models. Article 1 of the WTO Agreement on Subsidies and Countervailing Measures (ASCM) contains an important definition, which differs from the concept of state aid in article 107 of the Treaty on the Functioning of the European Union (TFEU), section 2 of the Subsidies Control Act 2022 (UK), and the OECD's estimates of government "support" for agriculture and fishing.[132] The concepts of a subsidy in the ASCM and state aid in the TFEU reflect value judgments and economic assumptions and are applied in different institutional settings. Both definitions, however, focus on distortions in the competitive relationship between products as opposed to any other economic, social, or environmental impact.

Implicit in the ASCM definition of a subsidy is some form of de jure or de facto discrimination against foreign firms, which forms the basis of many of the justifications for and criticisms of DSTs. A subsidy may take the form of a direct or de facto tax exemption.[133] A tax applicable to some firms in select industries may be seen as either a subsidy or a discriminatory measure. For this reason, article III:8(b) of the GATT excludes the "payment of subsidies exclusively to domestic producers" from

132 Luca Rubini, *The Definition of Subsidy and State Aid: WTO and EC Law in Comparative Perspective* (Oxford, UK: Oxford University Press, 2009); and Organisation for Economic Co-operation and Development, *Agricultural Policy Monitoring and Evaluation 2024: Innovation for Sustainable Productivity Growth* (Paris: OECD, 2024) (www.oecd.org/content/dam/oecd/en/publications/reports/2024/11/agricultural-policy-monitoring-and-evaluation-2024_b4c72370/74da57ed-en.pdf).

133 World Trade Organization, Agreement on Subsidies and Countervailing Measures (herein referred to as "ASCM"), article I:1(1)(b) ("a subsidy shall be deemed to exist if . . . government revenue that is otherwise due is forgone or not collected (e.g., fiscal incentives such as tax credits) . . . and a benefit is thereby conferred"); and *Commission v. Ireland and Others*, Case C-465/20 P, EU:C:2024:724, at paragraphs 74-77, 372, and 373.

the scope of the national treatment obligation applicable to trade in goods. While WTO members have not been able to agree on anti-subsidy rules for services under the GATS, subsidies may be prohibited if they are discriminatory under article XVII of the GATS. The tests under article I of the ASCM and de facto discrimination are not the same, but a substantial overlap exists. Under either test, uncertainty exists about when a de facto discriminatory tax is prohibited. This is simply the recognition of "the empty formalism of our categories of government revenues and expenditures."[134]

Legal definitions of subsidies have product and geographic dimensions. Some subsidy rules apply to industrial goods, some apply to agricultural goods, some apply to goods and services, and so forth. Most subsidy rules are concerned with cross-border distortions in competitive relationships. The classic goods subsidies complaints relate to subsidies provided by country A to its entities selling goods in country B in competition with products from country B, or subsidies provided by country A to its entities selling goods in country A in competition with imports from country B. The country with an industry facing competition from subsidized imported goods may either challenge the subsidy under the WTO or unilaterally impose countervailing duties on the imported goods in accordance with the ASCM.[135] Countervailing duties are a tax imposed on certain foreign goods but not local goods. By not taxing local products, the country imposing the countervailing duties provides the equivalent of a subsidy to the local industry, even though the duties are a counter-subsidy measure.

The European Union and the United States have signalled their interest in regulating subsidies to services that impact their home markets.[136] The European Union now includes provisions on competition policy, including subsidies, in many of its trade agreements.[137] In these agreements, the ASCM concept of a subsidy is extended to services.[138] The "WTO Plus" subsidy disciplines of the European Union's trade agreements are paired with exemptions and justifications not present in the ASCM,

134 Edward D. Kleinbard, *We Are Better Than This: How Government Should Spend Our Money* (Oxford, UK: Oxford University Press, 2015), at 252.

135 GATT article VI; and ASCM part V.

136 See, for example, Joint Statement on Trilateral Meeting of the Trade Ministers of the United States, Japan, and the European Union, September 25, 2018 (https://ustr.gov/about-us/policy-offices/press-office/press-releases/2018/september/joint-statement-trilateral).

137 Leonardo Borlini, "Subsidies Regulation Beyond the WTO: Substance, Procedure and Policy Space in the 'New Generation' EU Trade Agreements," in Giuliana Ziccardi Capaldo, ed., *The Global Community: Yearbook of International Law and Jurisprudence 2016* (Oxford, UK: Oxford University Press, 2017), 145-74.

138 See, for example, article 12.5.1 of the Free Trade Agreement Between the European Union and the Republic of Singapore (herein referred to as "the EU-Singapore FTA"), [2019] OJ L 294/3; and article 10.5.1 of the Free Trade Agreement Between the European Union and the Socialist Republic of Viet Nam, [2020] OJ L 186/3.

which results in a broader and more textured anti-subsidy landscape.[139] The Comprehensive and Progressive Agreement for Trans-Pacific Partnership[140] and the United States-Mexico-Canada Agreement[141] regulate non-commercial assistance given to state-owned enterprises. While the provisions track much of the language of the ASCM, they apply to both goods and services.[142] The agreement in principle of the China-EU Comprehensive Agreement on Investment, announced on December 30, 2020, provides for transparency on subsidies for services.[143] The international regulation of subsidies granted to suppliers of services is now widely accepted if not fully internalized. The geographic scope of subsidies regulation has also been expanding.

In a heated WTO dispute relating to the reduction in taxable income derived from exports, both the European Union and the United States took the view that the ASCM does not provide for a territorial limitation on where the benefits from a subsidy must accrue, and therefore foreign subsidies may fall under the agreement.[144] The EU's Foreign Subsidies Regulation unilaterally extends the scope of the prohibition against harmful subsidies beyond the cross-border supply of subsidized goods.[145] Subsidies

139 Annex 11-A of the EU-Singapore FTA, supra note 138, for example, exempts subsidies that can be granted "where they are necessary to achieve an objective of public interest, and where the amounts of the subsidies involved are limited to the minimum needed to achieve that objective and their effect on the trade of the other Party is limited." These include "subsidies to companies entrusted with the operation of clearly defined services of general economic interest, provided that such subsidies are limited to the cost of providing such services." EU-Singapore FTA, annex 11-A, section 2(f). The exemption recognizes the decision in *Altmark Trans GmbH and Regierundspräsidium Magdeburg v. Nahverkehrgesellschaft Altmark GmbH, and Oberbundesanwalt beim Bundesverwaltungsgericht*, Case C-280/00, [2003] I-7747.

140 Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), effective December 30, 2018. The original parties (Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, and Vietnam) have been joined by the United Kingdom, with formal applications from China, Taiwan, Ecuador, Costa Rica, Uruguay, Ukraine, and Indonesia, and expressions of interest from other countries.

141 USMCA (also known as the Canada-United States-Mexico Agreement), effective July 1, 2020.

142 See Leonardo Borlini and Peggy Clarke, "International Contestability of Markets and the Visible Hand: Trade Regulation of State-Owned Enterprises Between Multilateral Impasse and New Free Trade Agreements" (2021) 26:3 *Columbia Journal of European Law* 84-130.

143 EU-China Agreement in Principle, section III, subsection 2, article 8 and annex thereto (https://trade.ec.europa.eu/doclib/press/index.cfm?id=2237). Ratification by the European Parliament has been suspended in response to human rights issues in China.

144 *United States—Tax Treatment for "Foreign Sales Corporations"—Recourse to Article 21.5 of the DSU by the European Communities*, WT/DS108/RW, adopted January 29, 2002, F-25, Q43, at paragraphs 154-55.

145 European Union, "Regulation (EU) 2022/2560 of the European Parliament and of the Council of 14 December 2022 on Foreign Subsidies Distorting the Internal Market," OJ L 330/1. The first decision has been taken under the regulation: European Commission, "Commission Conditionally Approves the Acquisition of Parts of PPF Telecom by e&, Under the Foreign Subsidies Regulation," *Press Release*, September 24, 2024. See Victor Crochet and

from country A to support investment, the production of goods, or the supply of services by entities of country A in country B that affect competition in country B may be investigated. The EU claims that the adoption of countermeasures under its Foreign Subsidies Regulation is consistent with the WTO, but not all agree.[146]

In recent years, the European Union and the United States have applied countervailing duties to goods produced in country A by entities that have received subsidies from China. For example, the European Commission has imposed countervailing duties on goods imported into the EU that were produced in Egypt and Indonesia by firms receiving Chinese subsidies.[147] The cases involved a broad range of subsidies, including tax reductions and exemptions. The legality of these actions under the ASCM has been questioned.[148] The Foreign Subsidies Regulation also applies to financial contributions provided by "a private entity whose actions can be attributed to the third country, taking into account all relevant circumstances."[149]

Depending on its design, a DST may be viewed as a subsidy granted to local digital firms or as a response to a foreign subsidy provided to the supplier of cross-border digital services. While not functionally identical to a countervailing duty, a DST may be a response to a subsidy provided to, say, a US firm that supplies digital services through a wholly owned subsidiary in country B (such as Ireland, Luxembourg, or Singapore) to consumers in country A.

Support provided to digital platform firms through a low tax burden on income earned at home or abroad may be a subsidy in relation to services supplied abroad.

Marcus Gustafsson, "Lawful Remedy or Illegal Response? Resolving the Issue of Foreign Subsidization Under WTO Law" (2021) 20:3 *World Trade Review* 343-66; Csongor István Nagy, "The EU's New Regime on Foreign Subsidies: Has the Time Come for a Paradigm-Shift?" (2023) 57:6 *Journal of World Trade* 889-908; and Wolfgang Weiss and Cornelia Furculita, *Open Strategic Autonomy in EU Trade Policy: Assessing the Turn to Stronger Enforcement and More Robust Interest Representation* (Cambridge, UK: Cambridge University Press, 2024), chapter 9.

146 Malte Frank, "The EU's New Foreign Subsidy Regulation on Collision Course with the WTO" (2023) 60:4 *Common Market Law Review* 925-58.

147 European Commission, "Commission Implementing Regulation (EU) 2020/776 of 12 June 2020," OJ L 189/1 (Egyptian glass fibre fabric); "Commission Implementing Regulation (EU) 2020/870 of 25 June 2020," OJ L 201/1 (Egyptian glass fibre products); and "Commission Implementing Regulation (EU) 2022/443 of 15 March 2022," OJ L 88/24 (Indonesian stainless steel cold-rolled flat products).

148 Victor Crochet and Vineet Hegde, "China's 'Going Global' Policy: Transnational Production Subsidies Under the WTO SCM Agreement" (2020) 23:4 *Journal of International Economic Law* 841-63; Luca Rubini, *Are Transnational Subsidies Regulated by EU and WTO Law? The General Court Has Spoken (Case T-480/20 and Case T-540/20)*, RSC Policy Paper 2023/09 (Florence: European University Institute, Robert Schuman Centre for Advanced Studies, 2023); Ding Ru and Yiqian Xiang, "Emerging Rules on Cross-Border Subsidies: A Typological Analysis and Proposals for China's Approach" (2022) 12:2 *Journal of WTO and China* 45-79; and Weihuan Zhou and Victor Crochet, "Attribution to the State: A Critique of Cross-Border Subsidies" [2024] UNSWLRS 18 [University of New South Wales Faculty of Law Research Series].

149 "Regulation (EU) 2022/2560 of the European Parliament," supra note 145, article 3(2)(c).

Consider the European Court of Justice's decision in *Commission v. Ireland and Others*.[150] The profits in question were received from intellectual property licences by two companies incorporated, but non-resident for tax purposes, in Ireland. Ireland and Apple claimed that the profits were generated by employees of other companies in the Apple group—in particular, the parent company of the group Apple Inc. based in the United States—that did not pay tax in Ireland. Importantly, the profits were not taxed in the United States.[151] The tax break could in principle come from supplying the services indirectly through a low- or no-tax jurisdiction. The use of low-tax jurisdictions as part of a tax-planning strategy by platform firms supplying services overseas is commonplace. When combined with a lower effective rate of corporate tax paid by these firms compared to the rate paid by firms supplying in the domestic market or the overseas market without intermediaries in low-tax jurisdictions, these tax-planning strategies may evidence financial support by the home state.

Market jurisdictions arguably have a moral right and a political imperative to respond to such support with anti-subsidies measures, including by introducing a countervailing duty on the cross-border supply of services, to level the playing field. That duty will de facto operate as a subsidy to domestic businesses facing unfair competition from foreign businesses that use third countries (low-tax jurisdictions) to minimize their overall tax burden and therefore gain a competitive advantage over their rivals. While DSTs do not require that supplies be made through low-tax jurisdictions, they have arisen as a response to international tax-planning arrangements that use low-tax jurisdictions. A platform firm can avoid the allegations of being subsidized by making supplies directly from its home jurisdiction, assuming that it is subject to normal tax rates.

A DST imposed on foreign firms and not domestic firms may be a discriminatory tax or a subsidy. It may also be justified. If an undistorted market is the appropriate benchmark, assessment of the efficiency or equity of a subsidy affecting the cross-border supply of services requires a multi-market perspective. If a DST is a potential subsidy to any competing local firms, the "subsidy" provided to smaller or local firms in the market jurisdiction should, as a matter of fairness, be seen in light of the level of support provided to DST-targeted digital platform firms in both their home and low-tax jurisdictions. In some circumstances, a DST might be an appropriate countermeasure. While a comparison across jurisdictions is not how anti-subsidy rules are framed in trade law, such comparisons are the grist of trade negotiations.

150 Supra note 133.

151 Richard Collier, "A Bad Apple Ruling," September 13, 2024, Oxford University Centre for Business Taxation (https://oxfordtax.sbs.ox.ac.uk/article/bad-apple-ruling). See also Reuven S. Avi-Yonah, "Once More: Digital Services Taxes Should Be Creditable" (2024) 115:9 *Tax Notes International* 1357-61, at 1357, note 3: "Not paying tax to either the United States or to market jurisdictions is how $3 trillion was accumulated by U.S. multinational enterprises in low-tax jurisdictions between 2004 and 2017."

New Subsidy Reality

Industry support has grown dramatically in the United States in recent years. The Biden administration oversaw the passage of the CHIPS and Science Act, the Inflation Reduction Act, the Infrastructure Investment and Jobs Act, and the American Rescue Plan Act. These programs provide for hundreds of billions of dollars in subsidies for US businesses, many in the form of tax credits or reductions and/or actions inconsistent with the United States' WTO obligations.[152] Industrial policy interventions tend to rise with a country's per capita income.[153] Before the recent return to industrial policy, Brazil, France, Germany, Japan, South Korea, Taiwan, and the United States were estimated to spend between 0.3 and 0.7 percent of their respective gross domestic product on industrial policy, significantly behind China's spending of 1.5 percent.[154] Europe and North America are not shy about using inefficient and protectionist policy measures. Every country wants its own digital tech giants.

Trade and subsidy policies may have a variety of objectives, including equity, regional cohesion, diversity, and security, and need not be linked to the existence of a market failure.[155] China, the European Union, and the United States have adopted subsidies as a strategic response to subsidies adopted by other major powers.[156]

152 Daniel C.K. Chow, "Why the United States Wants and Needs a Permanently Crippled World Trade Organization" (2025) 59:2 *Journal of World Trade* 187-212.

153 Juhász et al., supra note 71.

154 Frank Bickenbach, Dirk Dohse, Rolf J. Langhammer, and Wan-Hsin Liu, *Foul Play? On the Scale and Scope of Industrial Subsidies in China*, Kiel Policy Brief no. 173 (Berlin: Kiel Institute for the World Economy, April 2024) (www.ifw-kiel.de/publications/foul-play-on-the-scale-and-scope-of-industrial-subsidies-in-china-32738/); Chiara Criscuolo, Guy Lalanne, and Luis Díaz, *Quantifying Industrial Strategies (QuIS): Measuring Industrial Policy Expenditures*, OECD Science, Technology and Industry Working Paper no. 2022/05 (Paris: OECD, 2022) (https://dx.doi.org/10.1787/ae351abf-en); and Gerard DiPippo, Ilaria Mazzocco, Scott Kennedy, and Matthew P. Goodman, *Red Ink: Estimating Chinese Industrial Policy Spending in Comparative Perspective* (Washington, DC: Center for Strategic and International Studies, May 2022) (www.csis.org/analysis/red-ink-estimating-chinese-industrial-policy-spending-comparative-perspective). In the United States, many of the incentives are provided at the state and local government levels. Cailin Slattery and Owen Zidar, "Evaluating State and Local Business Incentives" (2020) 34:2 *Journal of Economic Perspectives* 90-118; and Cailin Slattery, "Bidding for Firms: Subsidy Competition in the U.S.," May 13, 2024 (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3250356).

155 *Republic of Austria v. European Commission*, Case C-594/18 P, EU:C:2020:742, at paragraph 67 (state aid may still be compatible with the internal market in the absence of a market failure).

156 Simon J. Evenett and Johannes Fritz, *Subsidies and Market Access: Towards an Inventory of Corporate Subsidies by China, the European Union and the United States* (London, UK: CEPR Press, 2021), at 6-7.

"Strategic autonomy" has become a centrepiece of EU trade policy.[157] In the United States, trade policy makers are preoccupied with "decoupling," "reshoring," and (formerly) "friend-shoring."[158] By raising tariffs on or subsidizing certain goods or services, employment in or the well-being of disadvantaged regions may be protected. The distributional concerns within the European Union may appear to be protectionism in the view of foreign suppliers. These developments put in perspective claims that DSTs should not be used because they may be protectionist or discriminatory. The developments also suggest that the playing field will not be levelled by attempts to eliminate subsidies linked to platform services.

A broad approach to "subsidies" is required because the prevalence of different support mechanisms varies among countries. Low-, medium-, and high-income countries tend to favour different industrial policy instruments.[159] The pattern reflects many factors, including tax-raising constraints, domestic political processes, administrative capacity, and international obligations. The combination of international obligations on tax and trade has also limited the policy responses available to governments that want to increase the limited income tax that most digital platforms pay to them.

The economic case for the international regulation of subsidies is not straightforward.[160] The difficulty of classifying real-world tax measures as tariffs, internal taxes, subsidies, and/or anti-subsidy measures should make us wary of assuming that a tax applicable to some firms within an industry is necessarily harmful to economic welfare. The GATS does not prohibit subsidies for services.[161] WTO members are

157 See, for example, European Union, "Proposal for a Regulation of the European Parliament and of the Council Establishing a Framework of Measures for Strengthening Europe's Semiconductor Ecosystem (Chips Act)," COM/2022/46 final; and European Commission, "European Chips Act" (https://commission.europa.eu/strategy-and-policy/priorities-2019-2024/europe-fit-digital-age/european-chips-act_en).

158 See, for example, United States, White House, "CHIPS and Science Act Will Lower Costs, Create Jobs, Strengthen Supply Chains, and Counter China," *Fact Sheet*, August 9, 2022; and Atlantic Council, "Transcript: US Treasury Secretary Janet Yellen on the Next Steps for Russia Sanctions and 'Friend-Shoring' Supply Chains," *New Atlanticist*, April 13, 2022 (www.atlanticcouncil.org/news/transcripts/transcript-us-treasury-secretary-janet-yellen-on-the-next-steps-for-russia-sanctions-and-friend-shoring-supply-chains/).

159 Réka Juhász, Nathan Lane, Emily Oehlsen, and Verónica C. Pérez, *The Who, What, When, and How of Industrial Policy: A Text-Based Approach*, STEG Working Paper no. 050 (London, UK: Structural Transformation and Economic Growth, January 2023) (https://steg.cepr.org/sites/default/files/2023-01/WP050%20JuhászLaneOehlsenPérez%20TheWhoWhatWhenAndHowOfIndustrialPolicy.pdf).

160 Alan O. Sykes, "The Questionable Case for Subsidies Regulation: A Comparative Perspective" (2010) 2:2 *Journal of Legal Analysis* 473-523.

161 A variety of GATS rules apply to subsidies: article I (MFN), article III (transparency), article VIII (monopolies and exclusive suppliers), and article XXIII(3) (non-violation complaints).

unlikely to agree on disciplines for subsidies for services any time soon.[162] It is unclear why DSTs should be singled out for prohibition beyond the non-discrimination obligations in the GATS and other trade agreements.

The contest over DSTs is primarily structured around revenue raising, domestic distributional concerns, perceptions of platform free-riding, and competitiveness concerns. The top concern of market jurisdictions is the ability to raise sufficient revenue. In a world of aggressive and evolving tax-planning strategies that erode national tax bases, fewer broad distributional policies can be implemented. Market jurisdictions and many of their people are also concerned about the inequities resulting from giant digital platforms earning substantial profits in market jurisdictions without paying significant income tax in these jurisdictions and having much lighter overall tax burdens than stand-alone firms and many other non-digital businesses. The root of many of these concerns is the subsidies that these digital platforms receive in the form of undertaxation. The DST allows jurisdictions to mitigate the effects of such subsidization.

The imposition of DST also helps to create a level playing field between local and foreign digital platforms and between digital platforms and traditional media. The conventional separate-entity approach to taxation arguably has not allowed effective (and fair) taxation of digital multinationals and many cross-border service suppliers. Amount A in the OECD's pillar 1 solution was a global acknowledgment of the undertaxation of digital multinationals in market jurisdictions, and of the practical necessity of looking at a multinational group for the purposes of specifying a right to tax the group's supply activities in individual market countries. In light of the inability of the United States to implement pillar 1, a DST may be the best reasonably available alternative to the reallocation of taxing rights related to income from the cross-border supply of digital services. DSTs do not trespass on the territory occupied by the current international tax regime, and, if they are coordinated through either unilateral or collective action, will not lead to juridical double taxation.

The new willingness to target subsidies granted to firms that supply cross-border services raises questions about the tax practices to which the DST is at least in part a response. Aspects of international corporate tax rules of the United States have been successfully challenged in the GATT and WTO as export subsidies.[163] Unilateral

162 Pierre Sauvé and Marta Soprana, *Learning by Not Doing: Subsidy Disciplines in Services Trade*, E15 Task Force on Rethinking International Subsidies Disciplines, Think Piece (Geneva: International Centre for Trade and Sustainable Development and World Economic Forum, April 2015); and Pietro Poretti, "Waiting for Godot: Subsidy Disciplines in Services Trade," in Marion Panizzon, Nicole Pohl, and Pierre Sauvé, eds., *GATS and the Regulation of International Trade in Services: World Trade Forum* (Cambridge, UK: Cambridge University Press, 2008), 466-88.

163 The foreign sales corporations dispute is contained in a large number of panel, Appellate Body, and arbitrator decisions in the WTO. *United States—Tax Treatment for "Foreign Sales Corporations," Second Recourse to Article 21.5 of the DSU by the European Communities*, WT/DS108/AB/RW2, adopted March 14, 2006, at paragraphs 1-11, contains reference to earlier decisions. See, generally, Michael Daly, *Is the WTO a World Tax Organization? A Primer on WTO Rules for Tax Policymakers* (Washington, DC: International Monetary Fund, March 2016).

measures in response to foreign services subsidies are not constrained by the ASCM definition of a subsidy. Multinationals that avail themselves of sophisticated tax-planning opportunities that are not open to wholly domestic digital services firms may well be perceived as being subsidized in one or more jurisdictions, whether or not the total amount of a group's tax is "normal."

CONCLUSION

Much of the debate over DSTs has been characterized by a veneration for the privileges that the existing international tax architecture confers on the cross-border supply of digital services and a simplistic and outdated view of certain trade policy measures. The legitimacy and widespread use of trade tools and industrial policies often have been ignored. A total ban on imposing duties on the cross-border supply of services would be in sharp contrast with the WTO approach to trade in goods and services and the recent surge in the use of tariffs for a variety of trade and other policy reasons. In light of the widely acknowledged problems with the international tax system, the multilateral community should not seek to eliminate the DST but allow it to provide the impetus for the negotiation of a new international framework for the transparent and coordinated use of taxes on the cross-border supply of digital services.

If market jurisdictions conceptualize their DSTs as a response to the market power of digital platforms, a negative externality from the point of view of the platform's home state may be generated. At present, however, this negative externality is a response to the subsidy created by the undertaxation of global digital platform firms, which has supported the foreign market penetration and domination of the digital platform firms. This subsidy is an outcome of tax policies of home and low-tax jurisdictions and, sometimes, market jurisdictions. The undertaxation of digital platforms also needs to be seen in light of the United States' advocacy of free cross-border movement of data and immunity for the content carried on the platforms. The externalities created by DSTs and the United States' undertaxation of its own digital platform firms could be eliminated by an agreement, which was the unrealized aim of pillar 1.

Multilateral regimes benefit smaller and weaker countries. They also benefit the powerful. In addition to reducing negotiation and transaction costs, multilateral regimes benefit hegemons that need to find a way not to exploit weaker nations once they are trapped by relationship-specific sunk costs or become vulnerable to exclusion.[164] If they cannot resist the possibility of exploitation, smaller countries will stay away from the negotiating table. Under the OECD-managed Inclusive Framework,

164 John McLean, "Size, Sunk Costs, and Judge Bowker's Objection to Free Trade" (1997) 87:3 *American Economic Review* 400-20; Bagwell and Staiger, supra note 98; Judith Goldstein and Joanne Gowa, "US National Power and the Post-War Trading Regime" (2002) 1:2 *World Trade Review* 153-70; and Kyle Bagwell, Robert W. Staiger, and Ali Yurukoglu, "Quantitative Analysis of Multiparty Tariff Negotiations" (2021) 89:4 *Econometrica* 1595-1631.

130 or so countries were convinced to accept a moratorium on DSTs pending the finalization of details and ratification of the pillar 1 treaty. The United States reneged on the agreement by signalling that it would not ratify any resulting agreement and threatening jurisdictions that moved to implement a DST after the expiry of the moratorium. Jurisdictions implementing or considering a DST in 2021 have lost several years and collectively billions in tax revenue. By agreeing to the October 2021 two-pillar solution, the members of the Inclusive Framework incurred relationship-specific sunk costs. Their vulnerability to opportunistic behaviour by the United States was apparent to many commentators at the time. Subject to broader international relationship concerns, many jurisdictions may feel "once bitten, twice shy" about any OECD-mediated proposal from the United States for further discussions on tax responses to the digitalization of the economy. Pragmatism suggests that the countries seeking to reform the international tax regime should implement a DST, if they have not already done so, while trying to revise the rules governing the cross-border taxation of income in the digitalized economy.

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Unproven Allegations of Dishonesty, Wilful Blindness, or Gross Negligence: The Case for Cost Consequences in the Tax Court of Canada

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PRÉCIS

La Loi de l'impôt sur le revenu et la Loi sur la taxe d'accise imposent des pénalités aux contribuables qui manquent à leurs obligations « consciemment » ou « dans des circonstances équivalant à une faute lourde » (« pénalités pour faute lourde »). La jurisprudence a établi un seuil élevé pour la « faute lourde », estimant qu'elle exige que le contribuable ait fait preuve d'« un degré important de négligence qui corresponde à une action délibérée ». Il incombe au ministre du Revenu national de prouver les faits justifiant l'imposition d'une pénalité pour faute lourde.

Depuis 2018, dans les appels relatifs aux pénalités pour faute lourde qui ont obtenu un jugement, la Cour canadienne de l'impôt a annulé complètement les pénalités dans environ 30 pour cent des cas, au motif qu'il n'y avait pas de non-conformité de la part du contribuable ou que la non-conformité du contribuable était involontaire et ne résultait pas d'un degré important de négligence qui corresponde à une action délibérée.

Au civil, comme l'a confirmé la Cour suprême du Canada, il peut y avoir des effets négatifs sur les dépens si une partie qui allègue une fraude ou une conduite malhonnête ne parvient pas à prouver ses allégations (« la règle des dépens liés à la fraude »). Le présent article soutient que la Cour de l'impôt devrait adopter la règle des dépens liés à la fraude et permettre aux contribuables de demander des dépens majorés lorsque l'État ne s'acquitte pas de son fardeau de la preuve dans le cadre d'un litige concernant une pénalité pour faute lourde. Permettre aux contribuables de demander par présomption ces dépens inciterait, espérons-le, le ministre à faire preuve d'une plus grande prudence dans ses décisions d'imposer ou de contester des

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pénalités pour faute lourde, ce qui contribuerait à éviter la situation regrettable — dont il existe de nombreux exemples inquiétants — où des pénalités pour faute lourde sont proposées ou imposées aux contribuables de manière déraisonnable et abusive.

ABSTRACT

The Income Tax Act and the Excise Tax Act impose penalties on taxpayers who fail to comply with their obligations "knowingly" or "under circumstances amounting to gross negligence" ("KGN penalties"). The case law has established a high threshold for "gross negligence," holding that it requires the taxpayer to have shown "a high degree of negligence tantamount to intentional acting." The minister of national revenue bears the onus to prove the facts supporting the imposition of a KGN penalty.

Since 2018, in appeals of KGN penalties that proceed to judgment, the Tax Court of Canada has completely vacated the penalties approximately 30 percent of the time, on the basis that either there was no non-compliance by the taxpayer, or the taxpayer's non-compliance was unintentional and did not result from a high degree of negligence tantamount to intentional acting.

In the civil courts, as endorsed by the Supreme Court of Canada, adverse cost consequences can result when a party alleges fraud or dishonest conduct and fails to prove the allegations ("the fraud costs rule"). This article argues that the Tax Court should adopt the fraud costs rule and allow taxpayers to claim enhanced costs when the Crown fails to meet its burden of proof when litigating a KGN penalty. Allowing taxpayers to presumptively claim such costs would, it is hoped, motivate the minister to take greater care when deciding whether to assess and litigate KGN penalties, which would in turn help to avoid the unfortunate situation—of which many troubling examples exist—of KGN penalties being unreasonably and improperly proposed or imposed on taxpayers.

KEYWORDS: CIVIL PENALTIES ■ GROSS NEGLIGENCE ■ COSTS ■ TAX COURT OF CANADA ■ TAX LITIGATION ■ STATISTICS

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> *A party who alleges serious misconduct against another in a civil lawsuit must be prepared to prove such allegations or reap the consequences in the form of an order for special costs.*
>
> *Gichuru v. Smith*, 2014 BCCA 414, at paragraph 79

> *Where unfounded allegations of fraud or improper conduct seriously prejudicial to the character or reputation of a party are made in an action, a court may depart from the usual scale of costs and award costs on a solicitor-and-client scale. . . . A plaintiff who proceeds in this manner must be prepared for the cost consequences if the allegations turn out to be unfounded.*
>
> *Henley v. Henley*, 2021 NLCA 46, at paragraph 38, citing *James v. Canadian Trust of the Church of Jesus Christ of Latter Day Saints* (1998), 165 DLR (4th) 227 (BCCA), at 240 , citing *Mele v. Thorne Riddell* (1997), 32 OR (3d) 674 (Gen. Div.), at 677

INTRODUCTION

Various provisions of the Income Tax Act[1] and the Excise Tax Act[2] empower the minister of national revenue to assess penalties on taxpayers who fail to comply with their fiscal obligations either "knowingly" or "under circumstances amounting to gross negligence" (herein referred to as "KGN penalties"). The case law has consistently endorsed a high threshold for the imposition of KGN penalties under the "gross negligence" prong—holding that it requires a taxpayer to have shown "a high degree of negligence tantamount to intentional acting, an indifference as to whether the law is complied with or not."[3]

Taxpayers can challenge KGN penalties in an appeal before the Tax Court of Canada, in which event the minister bears "the burden of establishing the facts justifying the assessment of the penalty."[4] In recent years, as documented in this article, the Tax Court has found for the taxpayer in approximately 30 percent of KGN penalty appeals that proceed to judgment, on the basis that either (1) there was, in fact, no non-compliance by the taxpayer, or (2) the taxpayer's non-compliance was unintentional and did not result from "a high degree of negligence tantamount to intentional acting."

1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "ITA").

2 RSC 1985, c. E-15, as amended (herein referred to as "ETA").

3 *L Venne v. The Queen*, [1984] CTC 223 (FCTD), at 234. This definition of "gross negligence" has been cited in more than 400 cases to date.

4 ITA subsection 163(3); ETA subsection 285.1(16). A celebrated case on the burden of proof is *Van Der Steen v. The Queen*, 2019 TCC 23, at paragraphs 87-90, a case involving alleged kickbacks made to a donor that, if they existed, disentitled the taxpayer from claiming charitable gift tax credits. In the absence of evidence either proving or disproving the kickbacks, Justice Sommerfeldt held, Solomonically, that the minister could disallow the donations (since the taxpayer failed to disprove the kickbacks), but could not reopen statute-barred years to do so or impose KGN penalties (since the minister failed to prove the kickbacks).

The civil courts have long established a principle—most recently endorsed by the Supreme Court of Canada in *Hamilton*[5]—that adverse cost consequences can result when a party alleges that another party has engaged in fraud, dishonesty, or other "improper conduct seriously prejudicial to the[ir] character or reputation,"[6] and then fails to prove those allegations (referred to herein as "the fraud costs rule"). Failure to prove such allegations could disentitle the accusing party to costs if they are otherwise successful in their claim, or else entitle the accused party to enhanced costs—potentially on a solicitor-client or substantial indemnity basis—if the claim against them is rejected.

While the Federal Court and the Federal Court of Appeal recognize and apply the fraud costs rule, the Tax Court does not appear to have ever done so—quite possibly because it has never been asked. However, the fraud costs rule should apply in the Tax Court in a similar manner to that in the civil courts, and allow taxpayers to claim enhanced costs when the Crown fails to meet its burden of proof when litigating a KGN penalty.[7] Allowing taxpayers to presumptively claim such costs would, it is hoped, motivate both the minister and the Crown to take greater care when deciding whether to assess and litigate KGN penalties, which would in turn help to avoid the unfortunate situation—of which many troubling examples exist—of KGN penalties being improperly proposed or imposed, including in some cases simply to extort concessions from the taxpayer with respect to other tax adjustments.

In support of this argument, this article summarizes the origin and scope of the fraud costs rule, the principles applicable to KGN penalties, the procedure for challenging KGN penalties in the Tax Court, and how the Tax Court generally awards costs. It then provides an overview of recent case law in the Tax Court involving KGN penalties, with reference to a database compiled for this article. From this basis, the article discusses how the fraud costs rule might have applied in recent KGN penalty cases that were the subject of reported costs orders. The article concludes with a lament about the misuse and abuse of KGN penalties and urges the adoption of measures to protect taxpayers.

THE FRAUD COSTS RULE

The fraud costs rule originated in the English courts of equity in the 19th century, with seminal cases including *Forester*[8] and *Parker*.[9] *Forester* was a claim based on an

5 *Hamilton v. Open Window Bakery Ltd.*, 2004 SCC 9.

6 *Re Bisyk (No. 2)* (1980), 32 OR (2d) 281 (HC), at 287; *131843 Canada Inc. v. Double "R" (Toronto) Ltd.*, [1992] OJ No. 3879, at paragraphs 9-10; and *Paciorka v. TD Waterhouse*, 2008 CanLII 6646 (ONSC), at paragraph 16.

7 This article will leave to further scholarship, and potentially case law, the questions of (1) how much of a costs enhancement should be available in such circumstances, and (2) the extent to which the fraud costs rule should apply when the Crown pleads that a taxpayer engaged in conduct deserving of a KGN penalty but abandons the claim prior to trial.

8 *Forester v. Read* (1870), LR 6 Ch. App. 40.

9 *Parker v. McKenna* (1875), LR 10 Ch. 96.

alleged failure to comply with a binding settlement agreement, while *Parker* was an action to set aside certain corporate transactions on the grounds of improper self-dealing by the directors. In both cases, the plaintiffs included in their pleadings serious allegations of fraud that ultimately proved unfounded. The plaintiff's claim in *Forester* was dismissed and the plaintiff was ordered to pay a defendant's costs on a solicitor-client basis as a result of the unnecessary and unproven allegations of fraud.[10] In *Parker*, the plaintiff's claim based on improper self-dealing was successful, but the plaintiff was disentitled to costs and instead was ordered to pay costs to the defendant.[11]

The Supreme Court of Canada considered the fraud costs rule, and its application against the Crown, in the 1914 case of *Clement*.[12] *Clement* concerned disputed travel allowances claimed by a judge of the Supreme Court of British Columbia. The judge signed a certificate stating that he resided in Grand Forks, which entitled him to the travel allowances. The Crown, claiming that the judge actually resided in Vancouver, sued for repayment of the allowances and for a "declaration of fraud" against the judge. The Exchequer Court agreed that the judge resided in Vancouver and thus had to repay the allowances, but declined to issue any declarations in respect of the judge's state of mind for claiming to reside in Grand Forks.[13]

The Supreme Court of Canada—on an equal 2-2 division—dismissed the judge's appeal, but without costs.[14] Justice Anglin (as he then was) and Justice Idington did not interfere with the Exchequer Court's finding that the judge resided in Vancouver during the periods in question, and voted to dismiss the appeal.[15] Justice Duff (as he then was) would have allowed the appeal in part to reflect his view that the judge resided in Vancouver except with respect to a three-month period in 1908,[16] while Justice Brodeur would have allowed the appeal in full with costs to the judge.[17] However, the justices all agreed that the Crown's allegations of fraud were either unsupported or unnecessary.[18] Accordingly, Justice Duff held that the judge should not

10 *Forester*, supra note 8, at 42-43.

11 *Parker*, supra note 9, at 122-24.

12 *R v. Clement* (1914), 6 WWR 414 (SCC).

13 Ibid., at 415-17.

14 The case report concludes with the notation "Appeal dismissed" (ibid., at 451), rather than "Appeal dismissed with costs" (in contrast to, for example, *Vancouver Power Co. v. Hounsome* (1914), 49 SCR 430, at 439, in the same reporter).

15 *Clement*, supra note 12, at 422, per Idington J, and ibid., at 426 and 443, per Anglin J.

16 Ibid., at 422 and 426.

17 Ibid., at 451.

18 Ibid., at 419, per Idington J: "[T]here seems, I most respectfully submit, no reason for our dealing with that matter"; ibid., at 425, per Duff J: "The question of misconduct was treated as being outside the proper issues in litigation"; ibid., at 443, per Anglin J: "[T]he Crown has failed to establish the charge of fraud"; and ibid., at 451, per Brodeur J: "I fail to see how the appellant would be charged with fraud."

have to pay costs for the appeal,[19] while Justice Anglin, in reliance on a variety of authorities including *Parker*, would have gone further and relieved the judge from paying costs in the lower court.[20]

Some 90 years later, the Supreme Court of Canada issued its unanimous decision in *Hamilton*, which remains the leading Canadian case on the fraud costs rule. In *Hamilton*, the court endorsed the principle that solicitor-client costs are appropriate when a party alleges fraud or dishonesty when they have "access to information sufficient to conclude that the other party was merely negligent and neither dishonest nor fraudulent":[21]

> In *Young v. Young*, [1993] 4 S.C.R. 3, at p. 134, McLachlin J. (as she then was) for a majority of this Court held that solicitor-and-client costs "are generally awarded only where there has been reprehensible, scandalous or outrageous conduct on the part of one of the parties." An unsuccessful attempt to prove fraud or dishonesty on a balance of probabilities does not lead inexorably to the conclusion that the unsuccessful party should be held liable for solicitor-and-client costs, since not all such attempts will be correctly considered to amount to "reprehensible, scandalous or outrageous conduct." However, *allegations of fraud and dishonesty are serious and potentially very damaging to those accused of deception. When, as here, a party makes such allegations unsuccessfully at trial and with access to information sufficient to conclude that the other party was merely negligent and neither dishonest nor fraudulent (as Wilkins J. found), costs on a solicitor-and-client scale are appropriate*: see, generally, M. M. Orkin, *The Law of Costs* (2nd ed. (loose-leaf)), at para. 219.[22]

As can be seen from this passage in *Hamilton*, the fraud costs rule does not apply "inexorably" when an allegation of fraud, dishonesty, or other misconduct relating to a litigant's character goes unproven. In *Abt Estate v. Ryan*,[23] the Alberta Court of Appeal set out what it described as the "well-established analytical framework governing unfounded allegations of fraud,"[24] listing seven criteria that a trial judge should consider in deciding whether such allegations should generate cost consequences:

> There is a well-established analytical framework governing unfounded allegations of fraud. The trial judge should analyze:
>
> 1. the nature of the allegation made, and whether the particular circumstances of the party against whom the allegation was made were such as to make the implication of the allegation more serious;

19 Ibid., at 426.

20 Ibid., at 427 and 443.

21 *Hamilton*, supra note 5, at paragraph 26.

22 Ibid. (emphasis added).

23 2020 ABCA 133. The Alberta Court of Appeal cited and referred to this list in *Sunridge Nissan Inc. v. McRuer*, 2023 ABCA 128, at paragraph 49.

24 *Abt Estate*, supra note 23, at paragraph 61.

2. what, if any, information supportive of the allegation was known to the party making the allegation;
3. the strength and reliability of that information as it was known, or should have been known, by the party making the allegation;
4. the steps taken by the party making the allegation to verify the information upon which the allegation was based;
5. when the information was made known to the party making the allegation, whether additional information subsequently became known and whether the allegation was modified, or withdrawn to reflect the new information;
6. the timeliness of any such modification or withdrawal; and
7. whether the party making the allegation knew, or should have reasonably known, the allegation's implications for the party against whom it was made.[25]

The Federal Court of Appeal endorsed and applied the fraud costs rule in the wrongful dismissal case of *Fraser*, upholding an award of solicitor-client costs to the employee, and also awarding solicitor-client costs in the appeal, after the employer doggedly pursued allegations of improper conduct that proved to be unfounded.[26] The Federal Court of Appeal subsequently reiterated the holding of *Fraser* in *Exeter*[27] and, most recently, in *Amer*.[28]

The Federal Court has also long applied the fraud costs rule, albeit with the nuance that, instead of solicitor-client costs, unproven allegations of fraud or wrongful conduct more typically lead to an enhanced costs award based on column IV of the Federal Court Tariff (as opposed to the more typical column III).[29]

Finally, although the Tax Court does not appear to have ever applied the fraud costs rule, in *Austin*[30] Justice Sarchuk suggested, in obiter dicta, that the rule could apply in proceedings before the court, allowing for costs on a solicitor-client basis in circumstances involving "an allegation of fraud when none is proven at trial."[31]

25 Ibid.

26 *Bank of Nova Scotia v. Fraser*, 2001 FCA 267, at paragraph 9.

27 *Exeter v. Attorney General of Canada*, 2014 FCA 119, at paragraph 12.

28 *Amer v. Shaw Communications Canada Inc.*, 2023 FCA 237, at paragraph 87.

29 See, for example, *Andrews v. McHale*, 2016 FC 624, at paragraph 116: "[T]he Respondent is correct that Mr. Andrews' affidavit contains a number of allegations of fraudulent representations, undertakings and activities, as well as dishonesty, on the part of Mr. McHale. I am persuaded by the Respondents' argument that these unproven allegations made by Mr. Andrews militate in favour of a substantial costs award"; *Anani v. Royal Bank of Canada*, 2020 FC 870, at paragraphs 78-84; and *Sealand Marine Electronics Sales and Services Ltd. v. M/V Inuksuk I (Ship)*, 2022 FC 1013, at paragraphs 43-47 and 53-59.

30 *Austin (R.) v. Canada*, [1993] 2 CTC 2425 (TCC).

31 Ibid., at 2431.

OVERVIEW OF KGN PENALTIES

KGN penalties most commonly arise under ITA subsection 163(2) and ETA section 285 (as well as equivalent provisions under provincial tax legislation).[32] These penalties apply when a taxpayer "knowingly, or under circumstances amounting to gross negligence, has made or has participated in, assented to or acquiesced in the making of a false statement or omission in a return, form, certificate, statement or answer."[33] Other KGN penalties that have received judicial consideration include those imposed for failure to file certain information returns,[34] as well as third-party civil penalties.[35]

The case law has long recognized that the expression "knowingly, or under circumstances amounting to gross negligence" entails "a mental element" on the part of the taxpayer that is sufficiently blameworthy to justify the imposition of a penalty.[36] In particular, in making a false statement or omission in a return, the taxpayer must either

- *know* about the false statement or omission in the return (that is, the taxpayer must have had "subjective knowledge that he was making a false statement");[37] or
- demonstrate *gross negligence* in allowing the return to be submitted with the false statement or omission.

The leading case on the meaning of "gross negligence" in this context is the Federal Court Trial Division decision in *Venne*, in which Justice Strayer defined "gross negligence" as "a high degree of negligence tantamount to intentional acting, an indifference as to whether the law is complied with or not."[38] In *Venne*, the

32 For example, Ontario's Taxation Act, 2007, SO 2007, c. 11, schedule A, section 121(2).

33 ITA subsection 163(2). ETA section 285 is substantially identical, although it includes the word "invoice" and uses a different verb tense.

34 ITA subsections 162(10) and 162(10.1). See, for example, *Azmayesh-Fard v. The King*, 2025 TCC 20, at paragraphs 42-45; under appeal.

35 ITA subsection 163.2(2); ETA subsection 285.1(2). See generally *Guindon v. Canada*, 2015 SCC 41.

36 See, for example, *Tang v. The Queen*, 2017 TCC 168, at paragraph 53: "According to the very wording of subsection 163(2) of the Act, two elements are required for a penalty to apply: (1) a mental element ('knowingly, or under circumstances amounting to gross negligence') and (2) a material element ('has made . . . a false statement or omission in a return')." Similar language appears in many other decisions.

37 See, for example, *Peck v. The Queen*, 2018 TCC 52, at paragraph 44; *De Geest v. The Queen*, 2019 TCC 33, at paragraph 48; and *Saunders v. The Queen*, 2019 TCC 39, at paragraph 47. Similar language appears in other decisions.

38 *Venne*, supra note 3, at 234.

taxpayer's tax returns contained numerous flagrant factual errors, but because the taxpayer kept excellent records of his business activities and entrusted the task of preparing his tax returns to a bookkeeper whom he considered qualified, he had not exhibited such an indifference as to be considered "grossly negligent." In *Findlay*,[39] the Federal Court of Appeal approved the *Venne* definition of "gross negligence," which has since been cited in more than 400 decisions.

The case law has likewise repeatedly held that "gross negligence" means more than the simple "neglect" or "carelessness" that can permit the minister to reopen a statute-barred period under the ITA or ETA.[40] There exist numerous illustrations in the case law—including the Federal Court of Appeal decision in *Deyab*—where the court concluded that a taxpayer had demonstrated negligence sufficient to reopen a statute-barred year, but not "gross negligence" sufficient to justify the application of a KGN penalty.[41]

The case law has also recognized "wilful blindness" as a trigger for the application of KGN penalties, sometimes conceptualizing "wilful blindness" as a form of "knowing" and other times as a form of "gross negligence" (or even both).[42] Essentially, "wilful blindness" entails "deliberate ignorance,"[43] such that "the evidence must prove on a balance of probabilities that the [taxpayer] subjectively knew that the false statements in the Return and the Request were probably false but deliberately chose not to make further inquiries because he subjectively knew or strongly suspected that the inquiries would provide him with the knowledge that the statements were indeed false."[44] In the recent case of *Tshibungu*, Justice Ezri compared wilful blindness with the choice to take the "blue pill" in the movie *The Matrix*.[45]

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39 *Findlay v. Canada*, 2000 CanLII 15344 (FCA), at paragraphs 21-22.

40 ITA subparagraph 152(4)(a)(i); ETA paragraph 298(4)(a).

41 *Deyab v. Canada*, 2020 FCA 222; leave to appeal to the Supreme Court of Canada dismissed June 10, 2021. For other examples, see *Venne*, supra note 3, at 228 and 223-36; *Semenov v. The Queen*, 2018 TCC 58, at paragraph 76; *Nicosia v. The King*, 2022 TCC 143, at paragraphs 35-39; *Lapierre v. The King*, 2023 TCC 152, at paragraphs 30-32; and *994552 NWT Ltd. v. The King*, 2025 TCC 55, at paragraphs 35-38: "The penalty provisions are a different kettle of fish from that of misrepresentation" (ibid., at paragraph 35).

42 For a comprehensive discussion on the meaning of "wilful blindness" and whether it conceptually constitutes a form of "knowing" rather than a form of "gross negligence," see Mark Stevens, "False Statement or Omission Penalties in Canadian Tax Law" (2024) 72:1 *Canadian Tax Journal* 33-64. Stevens argues, convincingly, that wilful blindness is better analyzed as a variant of "knowledge" that should not be confounded with "gross negligence."

43 *Wynter v. Canada*, 2017 FCA 195, at paragraph 13.

44 *Peck*, supra note 37, at paragraph 46. This passage has been cited in numerous subsequent cases.

45 *Tshibungu v. The King*, 2025 TCC 74, at paragraph 62: "The protagonist's choice in the movie, The Matrix, to take the red pill and learn the truth of his reality or take the blue pill and live in blissful ignorance has entered pop culture as a metaphor for wilful blindness."

To impose KGN penalties, the minister must prove that the taxpayer acted knowingly or else demonstrated gross negligence.[46] The Supreme Court of Canada, in *Guindon*, endorsed the following explanation of the minister's burden:

> The burden is to prove on a balance of probability such an indifference to appropriate and reasonable diligence in a self-assessing system as belies or offends common sense.[47]

In *897366 Ontario*, Associate Chief Justice Bowman (as he then was) confirmed that gross negligence penalties are to be imposed only "in the clearest of cases" following a "serious and deliberate consideration by the taxing authority of the taxpayer's conduct," including "assiduous scrutiny of the evidence."[48]

The jurisprudence has further established that in cases of alleged gross negligence, the benefit of the doubt should go to the taxpayer. For example, in *Farm Business Consultants*,[49] a decision confirmed by the Federal Court of Appeal, Justice Bowman stated:

> A Court must be extremely cautious in sanctioning the imposition of penalties under subsection 163(2). Conduct that warrants reopening a statute-barred year does not automatically justify a penalty and the routine imposition of penalties by the Minister is to be discouraged. . . . Moreover, where a penalty is imposed under subsection 163(2) although a civil standard of proof is required, *if a taxpayer's conduct is consistent with two viable and reasonable hypotheses, one justifying the penalty and one not, the benefit of the doubt must be given to the taxpayer and the penalty must be deleted*.[50]

Similarly, in *Gosse*, Justice Sarchuk noted that "[i]t is settled law" that gross negligence penalty provisions must "be construed so as to give the party sought to be penalized the benefit of the doubt."[51]

In the context of third-party adviser penalties, ITA subsection 163.2(1) has codified the test for gross negligence set out in *Venne* under the term "culpable conduct,"[52] which is defined as "conduct, whether an act or a failure to act, that (a) is tantamount to intentional conduct; (b) shows an indifference as to whether this Act is complied with; or (c) shows a wilful, reckless or wanton disregard of the law."

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46 ITA subsection 163(3); ETA subsection 285.1(16).

47 *Guindon*, supra note 35, at paragraph 60, citing *Sidhu v. The Queen*, 2004 TCC 174, at paragraph 23. This passage has been cited in numerous subsequent decisions, including by the Federal Court of Appeal in *Deyab*, supra note 41, at paragraph 62.

48 *897366 Ontario Ltd. v. The Queen*, 2000 CanLII 246 (TCC), at paragraph 19.

49 *Farm Business Consultants Inc. v. Canada*, [1994] 2 CTC 2450 (TCC), at 2457; aff'd 96 DTC 6085 (FCA). This passage has been cited in numerous subsequent decisions, including *Wood v. Canada*, 2022 FCA 60, at paragraph 34; and *994552 NWT*, supra note 41, at paragraph 36.

50 *Farm Business Consultants*, supra note 49, at 2457 (TCC) (emphasis added).

51 *Gosse v. The Queen*, 2001 CanLII 783 (TCC), at paragraph 17.

52 *Guindon*, supra note 35, at paragraphs 57-61.

The foregoing review makes clear that liability for KGN penalties results from morally blameworthy behaviour by a taxpayer, whether in the form of intentional dishonesty or a disregard for the law that "offends common sense."[53] Accordingly, being accused by the minister of having engaged in conduct sanctionable by a KGN penalty necessarily puts at issue the integrity and character of the taxpayer.

CHALLENGING KGN PENALTIES IN THE TAX COURT

A taxpayer can, in accordance with various timelines and procedural requirements, challenge the assessment of KGN penalties in an appeal to the Tax Court. Generally speaking, appeals involving aggregate amounts at issue under $25,000 (for the ITA) or $50,000 (for the ETA) can follow the informal procedure; other appeals follow the general procedure.[54] As of around 2022, informal procedure cases "represent 40 percent of the court's inventory."[55]

Appeals commence with an exchange of "pleadings," including a "notice of appeal" from the taxpayer, a "reply" from the Crown,[56] and (under the general procedure) an optional "answer" from the taxpayer.[57] The reply from the Crown is required to set out (among other things) "the findings or assumptions of fact made by the Minister when making the assessment," "any other material fact," "the issues to be decided," "the statutory provisions relied on," "the reasons the respondent intends to rely on," and "the relief sought."[58] Under the "open court" principle, the Crown's reply, like all Tax Court pleadings and evidence tendered at trial, is presumptively public.[59]

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53 Ibid., at paragraph 60.

54 Tax Court of Canada Act, RSC 1985, c. T-2, sections 18(1) and 18.3001(c).

55 Hon. Eugene Rossiter and Wayne Adams, "Fireside Chat with Chief Justice Eugene Rossiter of the Tax Court of Canada," in Pooja Mihailovich and John Sorensen, eds., *Tax Disputes in Canada: The Path Forward* (Toronto: Canadian Tax Foundation, 2022), 28:837-50, at 28:839 and 28:847.

56 Under the Department of Justice Act, RSC 1985, c. J-2, section 5(d), the attorney general of Canada has "the regulation and conduct of all litigation for or against the Crown or any department, in respect of any subject within the authority or jurisdiction of Canada." In informal procedure appeals, however, the minister (represented by litigation offers at the Canada Revenue Agency) has the statutory responsibility to prepare the reply, in which case it acts as agent for the attorney general of Canada. See generally *Narivontchik v. The Queen*, 2020 TCC 60.

57 Tax Court of Canada Rules (General Procedure), SOR/90-688a (herein referred to as "TCC rules (GP)"), rules 49(1) and 45.

58 Ibid., rule 49(1); Tax Court of Canada Rules (Informal Procedure), SOR/90-688b (herein referred to as "TCC rules (IP)"), rule 6(1).

59 See *John Doe v. The King*, 2023 TCC 92, at paragraph 18; and *Future Electronics Inc. v. The King*, 2024 TCC 77, at paragraph 21 et seq.: "As a general rule, the public can attend hearings and consult court files and the press is also free to inquire and comment on the workings of the courts. In order to obtain permission to override this principle, a party must meet a compelling burden of proof."

It follows that, in an appeal against an assessment of KGN penalties, if the Crown chooses to defend the assessment—a decision that, as a practical matter, will generally be made by a "litigation officer" in the Canada Revenue Agency (CRA) Appeals Division[60]—the Crown must allege in the reply that the taxpayer has engaged in unlawful conduct with the high degree of blameworthiness required for the imposition of KGN penalties. As previously described, such allegations necessarily put the taxpayer's integrity and character at issue in a public document.

Of course, not every exchange of pleadings leads to a trial and judgment. Through the discovery process, the Crown may gather new evidence that will lead it to abandon the claim for KGN penalties, or the taxpayer (or, in some cases, the taxpayer's heirs) may come to realize that the Crown's case is not worth contesting. The taxpayer and the Crown may also reach a settlement agreement over all tax issues, which may include an agreement to reduce or eliminate KGN penalties.

However, other cases will proceed to trial and judgment, in which event the Crown's accusations with respect to the taxpayer's character will be formally aired and evaluated in a public forum.

COSTS IN THE TAX COURT

Until 1984, ITA subsection 171(3) barred the Tax Court from awarding costs on the disposition of an appeal. The 1984 budget proposed authorizing the Tax Court to award up to $1,000 in costs to successful taxpayers, in order to "increas[e] the access by taxpayers to a forum in which disagreements with tax assessments can be resolved in an expeditious manner."[61] The proposed $1,000 cap was soon dropped,[62] and in late 1984 Parliament repealed ITA subsection 171(3) and amended the Tax Court of Canada Act to authorize the court, "on the disposition of an appeal, [to] award costs to the appellant in the manner and to the extent provided for by rules made pursuant to section 20."[63]

60 Jennifer J. Smith and Andrea M. Ryer, "'I Object!': The Objections Process at the Canada Revenue Agency," in *Tax Disputes in Canada*, supra note 55, 7:201-36, at 7:232-33.

61 Canada, Department of Finance, 1984 Budget, Supplementary Information, February 15, 1984, at 14 (https://publications.gc.ca/collections/collection_2016/fin/F1-23-1984-eng.pdf).

62 Canada, House of Commons, Minutes of Proceedings and Evidence of the Standing Committee on Finance, Trade and Economic Affairs, 32d Parl., 1st sess., May 22, 1984, at 23.

63 Bill C-7, An Act To Amend the Income Tax Act and Related Statutes, received first reading on November 22, 1984, and has since been enacted, in substantially the same form, as SC 1984, c. 45, sections 71 and 104, enacting amendments to sections 18 and 20 to the Tax Court of Canada Act, supra note 54. The salient provision is found today at section 20(1.1)(j).

In general procedure cases, rule 147[64] today contemplates four broad levels of costs:

- "party and party costs," determined with reference to the tariff set out at schedule II, tariff B of the TCC rules (GP) (herein referred to as "the tariff"), which serves as the default costs level;[65]
- "lump sum" or other costs fixed at the Tax Court's discretion,[66] including the judge-made "partial indemnity" category, which can cover a percentage of a litigant's actual costs;[67]
- "substantial indemnity costs," defined as "80% of solicitor and client costs," which are generally awarded against litigants who (subject to certain conditions) reject a settlement offer and then obtain a less favourable result at trial;[68] and
- "solicitor and client costs," which are awarded in cases of "reprehensible, scandalous or outrageous conduct" by a party in the litigation.[69]

Recent scholarship has reviewed in some detail recent controversies and trends with respect to how the Tax Court awards costs.[70] This article need not review that scholarship, other than to note an apparent absence thus far of any discussion of the fraud costs rule. This absence might be attributable to the fact that, prior to the Tax Court's 2012 decision in *Velcro*, costs awards tended to adhere closely to the tariff.[71] In *Velcro*, however, the court rejected the proposition that it was bound to award costs

64 TCC rules (GP), supra note 57.

65 Ibid., rules 147(3.1) to (3.4) and 154.

66 Ibid., rule 147(4).

67 The term "partial indemnity" was apparently inspired by Ontario's Rules of Civil Procedure, RRO 1990, Reg. 194, which use the term in place of "party and party costs" (see, for example, rule 1.04(4)). See *General Electric Capital Canada Inc. v. The Queen*, 2010 TCC 490, at footnote 1.

68 TCC rules (GP), supra note 57, rules 147(3.1) to (3.8).

69 *Young v. Young*, [1993] 4 SCR 3, at 134; and *Canada v. Martin*, 2015 FCA 95, at paragraph 26.

70 See Derrick Hosanna and Erica Hennessey, "The Death of the Tariff: A Review of the Tax Court's Discretionary Approach to Costs Awards" (2020) 68:2 *Canadian Tax Journal* 409-38; Timothy Fitzsimmons and Patrick Lindsay, "Costs as a Tool To Improve Canada's Tax Dispute Process," in *Tax Disputes in Canada*, supra note 55, 16:461-92; Jenna Clark and Nalini Persaud, with contributions from Laura Alescio, "Enhanced Costs Awards in the Tax Court of Canada: At What Cost?" in *Tax Disputes in Canada*, supra note 55, 17:493-521; and David Jacyk and Tatum Miller, "Tax Court Costs Awards: A View from the Trenches," in *Report of Proceedings of the Seventy-Sixth Tax Conference*, 2024 Conference Report (Toronto: Canadian Tax Foundation, 2025), 12:1-14. See also Justice Ouimet's exposition of the law in *Bowker* (TCC costs), infra note 122.

71 *Velcro Canada Inc. v. The Queen*, 2012 TCC 273, at paragraphs 2-21; see Hosanna and Hennessey, supra note 70, at 411-12; and Clark et al., supra note 70, at 17:498-500.

in accordance with the tariff save in exceptional cases—a holding that has made possible a wider range of costs awards.

Rules 147(1) to (3) endow the court with discretion over costs that may be awarded either for or against the Crown, and set out a wide range of factors that the court may consider when awarding costs, including

- "the importance of the issues";
- "the conduct of any party that tended to shorten or to lengthen unnecessarily the duration of the proceeding";
- "whether any stage in the proceedings was . . . improper, vexatious, or unnecessary"; and
- "any other matter relevant to [the matter] of costs."[72]

In addition, rule 147(5) grants the court "the discretionary power" to, among other things, "award all or part of the costs on a solicitor and client basis."

Any one of these prongs can provide a basis for the application of the fraud costs rule, which essentially provides that a party in litigation should not make accusations of dishonest or morally reprehensible conduct without being able to prove them. Such allegations are improper, vexatious, or unnecessary, lengthen the proceedings, and can have significant financial and non-financial implications for the appellant.

In informal procedure cases, costs are generally awarded only in "exceptional circumstances."[73] As discussed below,[74] whether an unproven allegation of fraud or dishonesty should constitute an "exceptional circumstance" triggering the fraud costs rule in informal procedure cases remains an open question.[75]

Finally, it bears noting that a party must request costs in order to receive them.[76] Accordingly, the fact that the Tax Court does not seem to have ever applied the fraud costs rule does not necessarily create an obstacle to doing so in the future.

SURVEY OF RECENT KGN PENALTY CASES

To provide a basis for high-level observations about the current state of KGN penalty appeals, a variety of English- and French-language searches on CanLII.org were

72 TCC rules (GP), supra note 57, rules 147(1), (2), and (3)(g), (i), and (j).

73 See *Atlantic Thermal Star Limited v. The Queen*, 2016 TCC 135, at paragraphs 59-63; *Roy v. The Queen*, 2019 TCC 110, at paragraph 18; TCC rules (IP), supra note 58, rule 10; and Tax Court of Canada Rules of Procedure Respecting the Excise Tax Act (Informal Procedure), SOR/92-42, rule 9.

74 See the discussion of *Callaghan*, infra note 141 and related text.

75 Some practitioners might sardonically note that such occurrences seem to occur far too often to qualify as "exceptional."

76 *Balogun v. Canada*, 2005 FCA 350, at paragraphs 1-3; and *Exeter v. Canada (Attorney General)*, 2013 FCA 134, at paragraphs 11-12 and 17.

used to compile a database of reported final decisions in appeals involving contested KGN penalties.[77] The database aspires to include all such cases decided by the Tax Court between January 1, 2018 and March 31, 2025; the cutoff date of 2018 was chosen because it produced more than 100 reported decisions, which seemed to be a suitably large sample. The cases included in the database are listed in the appendix to this article.

The cases are coded according to the following characteristics:

- whether the case followed the general procedure or the informal procedure;[78]
- the number of ITA and ETA case files involving disputed KGN penalties disposed of by the decision;[79]
- whether there was an appeal of the decision and, if so, the result;[80]

77 The database excludes cases in which the Crown conceded the deletion of all contested penalties, such as *Anand v. The Queen*, 2019 TCC 119, at paragraph 3: "During the hearing, counsel for the Respondent conceded that the Respondent had failed to establish circumstances that justified the imposition of the gross negligence penalty and he consented to judgment in favour of the Appellant on this point." Such belated concessions might arguably justify application of the fraud costs rule.

Also excluded from the database are the following cases: *Exacte v. The Queen*, 2018 TCC 137, at paragraphs 44 and 47 (appeal dismissed for want of prosecution, albeit with a comment from the court that the fact that KGN penalties were at issue weighed against dismissal of the appeal); *Wilson v. Canada*, 2019 FCA 155, at paragraphs 15, 18-19, and 26 (appeal dismissed for failure to file an amended notice of appeal in accordance with the court's directions); *Choptiany v. The King*, 2022 TCC 112 (appeals allowed following repeated failures from the Crown to comply with rules of discovery); *Aitchison Professional Corporation v. The Queen*, 2018 TCC 131 and *Bourgeois v. The Queen*, 2018 TCC 5 (appeals against derivative liability assessments under ITA section 160 decided for reasons unrelated to the merits of the underlying assessment); and *Datta v. The King*, infra note 168 (discussed in the addendum to this article).

78 If a single reported decision disposed of a combination of general procedure and informal procedure appeals, it was tallied as a general procedure case—for example, *Qi v. The King*, 2024 TCC 86.

79 When a single decision disposed of multiple case court files—some involving KGN penalties and others not—the court files in which KGN penalties were not put at issue were generally excluded, including the following: *Wall v. The Queen*, 2019 TCC 168 (excluding docket nos. 2013-3996(GST)G and 2013-3997(GST)G); *Porisky v. The Queen*, 2024 TCC 84; under appeal (excluding docket nos. 2012-3780(IT)G and 2012-3782(IT)G); *Agracity Ltd. v. The Queen*, 2020 TCC 91 (excluding docket no. 2014-1526(IT)G); *Xue v. The Queen*, 2020 TCC 72; sub nom. *Coastridge Enterprises*; aff'd 2022 FCA 78 (excluding docket no. 2015-5443(GST)G); and *Tyskerud v. The Queen*, 2019 TCC 84 (excluding docket nos. 2014-4386(GST)I and 2016-236(CPP)).

80 If the Federal Court of Appeal reversed the Tax Court's disposition of the KGN penalties, the case was coded in accordance with the decision of the Federal Court of Appeal, as in *Deyab*, supra note 41 (KGN penalties vacated).

- whether the disputed KGN penalties were completely vacated;[81] and
- whether the Tax Court issued a reported supplemental decision with respect to costs.

Consolidated appeals involving multiple taxpayers who received different results with respect to KGN penalties were split into separate entries in the database and coded separately.[82]

In addition, the cases in which KGN penalties were wholly vacated are assigned to one of three categories:

- category I: cases in which the taxpayer conceded the tax adjustments on which KGN penalties were imposed, and disputed only the penalties;
- category II: cases in which the taxpayer unsuccessfully (or with only partial success)[83] challenged the tax adjustments on which the KGN penalties were imposed, but was found not to have demonstrated the degree of culpability required for KGN penalties; and
- category III: cases in which the taxpayer successfully challenged the entirety of the underlying tax adjustments on which KGN penalties were imposed, such that the KGN penalties were automatically negated.

The database reveals the following:

- Around 70 percent of all dispositions occurred in general procedure cases.[84] Given that general procedure files make up only around 60 percent of the Tax Court's total workload,[85] it would follow that KGN penalty disputes arise

81 Cases in which KGN penalties were *not* completely vacated include those in which KGN penalties were vacated in respect of particular adjustments, and/or the underlying adjustments on which KGN penalties were imposed were reduced. In some of these cases, the overall reduction in KGN penalties was very significant. See, for example, *Gee v. Canada*, 2021 FCA 215, at paragraphs 1-2.

82 Four cases fall into this category: *Malkaya v. The Queen*, 2022 TCC 89; *Khanna v. Canada*, 2022 FCA 84; *Canada v. Rattai*, 2022 FCA 106; and *Mahdi v. The Queen*, 2018 TCC 149. The first three involved husband-and-wife couples, and in each case KGN penalties were ultimately upheld against the husband but dismissed against the wife. The fourth case involved two close friends who retained the same accountant who unfortunately got them involved in a "de-taxing" scheme; KGN penalties were vacated against one of the taxpayers, and for one out of two taxation years for the other.

83 Category II includes some cases in which a taxpayer obtained very significant reductions of the underlying liabilities and the cancellation of KGN penalties with respect to the remainder; see, for example, *Gabriel v. The King*, 2024 TCC 166, at paragraphs 79-82 (reducing disputed adjustments made by the minister from $224,614 to $3,543, and vacating KGN penalties). Such cases might arguably be better included in category III.

84 One hundred and eight out of 155 dispositions.

85 Rossiter and Adams, supra note 55, at 28:839 and 28:847.

disproportionately in general procedure cases. This result is not surprising, given that larger errors or omissions are, ceteris paribus, more likely to evidence gross negligence or wilful blindness. Moreover, KGN penalties may themselves increase the amount at issue in a tax dispute to a level above the applicable informal procedure thresholds.

- Around 83 percent of all dispositions, in both general procedure and informal procedure cases, involved ITA rather than ETA case files.[86] This figure aligns with the overall proportion of ITA and ETA case files in the Tax Court.[87]
- KGN penalties were wholly vacated in slightly more than 30 percent of dispositions, in both general procedure and informal procedure cases and both ITA and ETA cases.[88]
- Most cases in which KGN penalties were wholly vacated fall into category II or category III.[89] Category II cases represented, by far, the most such cases under the informal procedure;[90] category II and III cases were more evenly split under the general procedure.[91]

CASE STUDIES: KGN PENALTY CASES WITH REPORTED COSTS AWARDS

The Tax Court issued a supplemental reported costs award in five of the cases included in the database that were won by the taxpayer (one of which was subsequently reversed by the Federal Court of Appeal). None of these decisions referred to the fraud costs rule—apparently because it was not raised by the successful appellants—although each case potentially offered compelling grounds for doing so.

All five cases offer useful illustrations of how the fraud costs rule might work in practice.

Fuhr v. The King (Category III)

Fuhr v. The King[92] concerned income tax reassessments issued to a corporation and its individual shareholder on the basis of a net worth analysis of the individual

86 One hundred and twenty-nine out of 155 dispositions: 90 out of 108 general procedure dispositions, and 39 out of 47 informal procedure dispositions.

87 As of March 23, 2023, as reported on the Tax Court's web page summarizing its annual reports, the Tax Court had 8,328 active ITA case files and 1,584 active ETA case files. See Tax Court of Canada, "Annual Reports," under the heading "Statistics" (www.tcc-cci.ca/en/pages/about/reports-and-statistics).

88 Forty-eight out of 155 dispositions: 33 out of 108 general procedure dispositions, and 15 out of 47 informal procedure dispositions; and 40 out of 129 ITA dispositions, and 8 out of 26 ETA dispositions.

89 Out of 48 dispositions, 7 fell into category I, 23 into category II, and 18 into category III.

90 Eleven out of 15 dispositions.

91 Twelve and 15 out of 33 dispositions, respectively.

92 2024 TCC 43 (herein referred to as "*Fuhr* (merits)"); and *Fuhr v. The King*, 2025 TCC 27 (herein referred to as "*Fuhr* (costs)") (collectively referred to herein as "*Fuhr*").

shareholder. The CRA reopened statute-barred years to reassess the shareholder for unreported income and shareholder benefits, and the corporation for unreported income and disallowed expenses, with KGN penalties for both taxpayers.[93]

Justice St-Hilaire (as she then was) vacated all of the reassessments on their merits. With respect to the individual shareholder, Justice St-Hilaire found the CRA's net worth analysis to have been "seriously flawed,"[94] such that the Crown was unable to identify any misrepresentations in the taxpayer's returns "with any degree of specificity and soundness."[95] Justice St-Hilaire also noted that the Crown made no submissions whatsoever with respect to the KGN penalties.[96]

With respect to the corporation, Justice St-Hilaire found that the Crown's case was based on "pure conjecture."[97] She noted that the only basis for the CRA's refusal of the disallowed expenses was that "no supporting documents were provided to the auditor," concerning which she held that "a lack of documentation supporting expenses is not in and of itself proof that the expenses were not incurred or that they were not incurred for the purpose of gaining income."[98] Justice St-Hilaire concluded that "[b]ald assertions that [the corporation] made misrepresentations based on a lack of documentation provided to the auditor in support of the business expenses claimed are insufficient," such that the Crown had not proven that any misrepresentations had been made.[99]

Following judgment, the taxpayers requested partial indemnity costs equal to 60 percent of their solicitor-client costs, on the grounds of the extreme tenuousness of the Crown's case (especially against the corporation), as well as on the basis of a settlement offer. Justice St-Hilaire largely agreed with the taxpayers' submissions, but reduced the costs award to 40 percent of solicitor-client costs to take into account the lack of credibility of much of the individual taxpayer's testimony.[100]

The fraud costs rule was apparently not brought to Justice St-Hilaire's attention,[101] which is unfortunate because the case potentially called for its application. If the Crown's substantive tax claim was so unmeritorious as to attract the sanction of an enhanced costs award, the fact that the Crown decided to defend KGN penalties

93 *Fuhr* (merits), supra note 92, at paragraphs 4-5 and 23.

94 Ibid., at paragraph 53.

95 Ibid., at paragraph 54.

96 Ibid., at paragraph 55: "Pursuant to subsection 163(2) of the ITA, the Respondent has the burden of establishing the facts that justify the assessment of a penalty. I note that the Respondent made no submissions on the penalties imposed on Tim Fuhr. In any event, in light of the findings above, the assessment of penalties is no longer in issue."

97 Ibid., at paragraph 25.

98 Ibid., at paragraph 28.

99 Ibid., at paragraph 31.

100 *Fuhr* (costs), supra note 92, at paragraphs 40-42.

101 Ibid., appellants' costs submissions dated May 23, 2024 (herein referred to as "*Fuhr* costs submissions") (obtained, with thanks, from counsel to the taxpayer).

tacked onto such unmeritorious tax claims arguably demanded further cost consequences. One might speculate that had the taxpayers included the fraud costs rule in their submissions, the court may have been more inclined to accede to their initial request.[102]

Duffy v. The Queen (Category III)

Duffy v. The Queen[103] concerned income tax reassessments issued to a married couple and a corporation they jointly owned, involving "various items of allegedly unreported income, allegedly mischaracterized income and disallowed expenses."[104] The dispute originally encompassed more than $500,000 of adjustments over four taxation years—three of which were statute-barred—and was intended to require four days of trial. However, in the immediate lead-up to trial, the parties met and each made a wide range of concessions, which included vacating all of the assessments of the statute-barred years, and reducing the adjustments at issue in the one remaining taxation year to 10 contested adjustments totalling around $30,000, plus KGN penalties.[105] Following a one-day hearing—during which the Crown adduced no evidence whatsoever in support of the penalties—Justice Sommerfeldt found for the taxpayers on the substantive issues, thereby negating the KGN penalties automatically.[106]

Following judgment, the taxpayers requested substantial indemnity costs, primarily on the basis that the Crown had intentionally delayed the proceedings by failing to make timely concessions, and also on the basis of a rejected settlement offer. Justice Sommerfeldt noted that the Crown's position with respect to 4 of the 10 contested adjustments was unreasonable and should also have been conceded in the period leading up to trial, which may have resulted in a complete settlement.[107]

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102 In fairness to the Crown, the taxpayer in *Fuhr* had some serious credibility problems, with Justice St-Hilaire documenting how the taxpayer's testimony "defied common sense and credibility" (*Fuhr* (merits), supra note 92, at paragraph 51). One may speculate that the taxpayer's dissembling is what motivated the assessment of the KGN penalties and the attempt to defend them at trial. That said, the fact that a taxpayer is evasive or lacks credibility does not, in and of itself, justify the imposition of penalties. See, for example, *Lust v. The Queen*, 2009 TCC 577, at paragraphs 4, 8, 10, 15, and 17; the taxpayer in the case was "secretive" and evasive during the CRA audit, declined to testify at trial, and produced documentary evidence that was "vague, self-serving and of very little evidentiary value," but the court nevertheless vacated KGN penalties on the ground that the Crown had not met its onus of proof. See *Lust*, ibid., at paragraph 15.

103 2019 TCC 75 (herein referred to as "*Duffy* (merits)"); and *Duffy v. The Queen*, 2020 TCC 135 (herein referred to as "*Duffy* (costs)") (collectively referred to herein as "*Duffy*").

104 *Duffy* (merits), supra note 103, at paragraph 1.

105 Ibid., at paragraphs 6-8; and *Duffy* (costs), supra note 103, at paragraphs 4-6.

106 *Duffy* (merits), supra note 103, at paragraphs 69-70.

107 *Duffy* (costs), supra note 103, at paragraph 8: "Given that the auditor acknowledged during her direct examination that there had been an error, it is peculiar that such acknowledgment was not made on the previous day, when the Parties were conducting their settlement

Ultimately, however, Justice Sommerfeldt decided that substantial indemnity costs were not indicated, although he did decide to deviate from the tariff and award partial indemnity costs equal to approximately 50 percent of the taxpayer's solicitor-client costs, primarily on the basis of the Crown's belated and refused concessions and rejection of the taxpayer's settlement offer.[108]

The fraud costs rule was apparently not brought to Justice Sommerfeldt's attention,[109] which is again unfortunate given that the case also arguably called for its application. It is difficult to understand why the Crown, after agreeing on the eve of trial to concede over 90 percent of the amounts at issue, as well as to vacate all of the contested reassessments with respect to statute-barred years, tenaciously clung to its position with respect to KGN penalties, but then did not introduce any evidence in support of them. One might speculate that had the taxpayers included the fraud costs rule in their submissions, the court may have been more inclined to accept their request for substantial indemnity costs, and send the message that KGN penalties should never be put at issue without a compelling basis for doing so.

Hansen v. The Queen (Category II)

Hansen v. The Queen[110] concerned primarily whether a taxpayer could claim the principal residence exemption in respect of five houses that he bought and sold between 2007 and 2012.[111] Three of the taxation years were statute-barred, and for all taxation years the minister assessed KGN penalties on all of the adjustments resulting from the disallowance of the principal residence exemption.[112]

Justice D'Auray noted that whether amounts from the sale of a residence should be treated as business income rather than a capital gain eligible for the principal

negotiations"; ibid., at paragraph 9: "Mr. Duffy was successful in persuading me that the CRA could not have it both ways. Again, it is peculiar that, during the settlement negotiations the day before the hearing, the CRA and the Respondent persisted in adhering to asymmetrical accounting treatment"; ibid., at paragraph 15: "Simply by looking at the reverse side of a T3 slip, one may see that Box 42 is used to describe an amount that represents a distribution or return of capital"; ibid., at paragraph 17: "The Appellants were successful in respect of this item, in part because the auditor failed to bring her audit file with her to the hearing and in part because counsel for the Respondent did not cross-examine Mr. Duffy. Those factors (i.e., not bringing the audit file to the hearing and not cross-examining Mr. Duffy) suggest that the Respondent's position in respect of the motor vehicle expenses was not strong. At the hearing, I was left wondering why this item was not conceded by the Respondent during the settlement negotiations"; and ibid., at paragraph 48.

108 Ibid., at paragraphs 55-56.

109 *Duffy*, supra note 103, appellants' cost submissions dated May 31, 2019 (obtained from the court).

110 2020 TCC 102 (herein referred to as "*Hansen* (merits)"); and *Hansen v. The Queen*, 2021 TCC 39 (herein referred to as "*Hansen* (costs)") (collectively referred to herein as "*Hansen*").

111 *Hansen* (merits), supra note 110, at paragraphs 1-2.

112 Ibid., at paragraph 4.

residence exemption was ultimately a question of fact for which "there is no hard and fast rule."[113] With respect to the statute-barred years, she noted that the taxpayer and his family physically lived in each of the houses and "had a *bona fide* belief that the sale of the houses qualified for the principal residence exemption."[114] Accordingly, even if the taxpayer was incorrect with respect to the tax treatment of the sales, he had not demonstrated negligence justifying the reopening of statute-barred years or, a fortiori, the imposition of KGN penalties.[115]

With respect to the non-statute-barred years, Justice D'Auray found that the taxpayer had a primary or secondary intention when purchasing the homes to resell them at a profit, thereby disallowing him from claiming the principal residence exemption.[116] However, Justice D'Auray vacated the KGN penalties with respect to those years, noting the taxpayer had obtained professional advice when filing his tax returns and had demonstrated conduct "of a reasonable person in the same situation."[117]

After trial, the taxpayer sought substantial indemnity costs primarily as a result of two settlement offers, as well as the various factors set out in rule 147 of the TCC rules (GP). Justice D'Auray ultimately awarded the taxpayer 85 percent of actual legal costs as of the date of his first settlement offer—partly because of the undue delay by the Crown in making certain concessions, and its complete disregard of the taxpayer's second settlement offer.[118] However, Justice D'Auray only awarded costs equal to the tariff for the period prior to the settlement offer.[119]

The fraud costs rule was apparently not brought to Justice D'Auray's attention;[120] indeed, it might not have had a significant impact on the ultimate costs award, which already exceeded the "substantial indemnity" level (at least for the period following the making of a settlement offer). However, the rule's application was arguably justified in this case. Principal residence cases can entail some degree of subjectivity and judgment. Consequently, it can be very difficult to prove that a taxpayer demonstrates "negligence"—much less "gross negligence" or even "wilful blindness"—by taking the position that the house in which the taxpayer *actually lives* is their principal residence.[121] Given that the onus of proof to sustain KGN penalties lies with the minister,

113 Ibid., at paragraph 84.

114 Ibid., at paragraph 87.

115 Ibid., at paragraphs 93 and 109-30.

116 Ibid., at paragraphs 101-6.

117 Ibid., at paragraphs 125 and 127-28.

118 *Hansen* (costs), supra note 110, at paragraphs 45-48.

119 Ibid., at paragraph 51.

120 Ibid., appellant's written submission on costs dated November 13, 2020 and appellant's reply submissions dated November 23, 2020 (obtained from the court).

121 For examples of situations where KGN penalties were upheld in principal residence disputes, see *Wall*, supra note 79, at paragraphs 15-19: "It is unclear whether Mr. Wall lived in any of the Three Homes. Considering all of the evidence, it is my view, on a balance of probabilities,

and given that the taxpayer is entitled to receive the benefit of the doubt, the Crown surely knew or should have known that its claim in the *Hansen* case with respect to KGN penalties was speculative at best. The fact that the Crown nevertheless chose to impugn the taxpayer's name and reputation by litigating KGN penalties arguably could have justified the application of the fraud costs rule.

Bowker v. The Queen (Category I)

The taxpayer in *Bowker v. The Queen*[122] was an elderly, retired assistant pastor, whose husband got connected with a "de-taxer" organization, DeMara Consulting Inc. ("DeMara"). The husband met with DeMara and presented the taxpayer with some forms to sign. The taxpayer had complete trust in her husband—who managed both of their annual tax filings—and she signed the forms. DeMara then filed on the taxpayer's behalf—apparently without her knowledge or authorization—an amended tax return claiming fictitious losses. The CRA reassessed the taxpayer to disallow the losses and impose KGN penalties (the amounts of which represented over five years' worth of her taxable income).[123] The taxpayer conceded the disallowance and contested only the KGN penalties.

Justice Ouimet found, as a fact, that the taxpayer was not aware that the amended tax return had even been filed on her behalf, and that she had not received any indication that she should inquire into the accuracy of her tax filings. The Tax Court agreed that she had been negligent in not investigating further the forms that her husband gave her to sign, but not grossly negligent, given that "her conduct did not markedly depart from what would be expected from a reasonable and responsible taxpayer in the circumstances."[124] Accordingly, the Tax Court vacated the KGN penalties.[125]

The taxpayer moved for costs equal to 50 percent of her legal fees up to the date of a written settlement offer that was rejected,[126] and 80 percent thereafter. Justice

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that he did not"; ibid., at paragraphs 185-203; and *Mann v. The King*, 2023 TCC 151, at paragraph 85; aff'd 2024 FCA 149: "A long term CRA employee with knowledge of the Act could not believe that simply sleeping at a property is sufficient to constitute that property the person's principal residence, while also not designating it as such in the pertinent return."

122 2021 TCC 14 (herein referred to as "*Bowker* (merits)"); and *Bowker v. The Queen*, 2022 TCC 43 (herein referred to as "*Bowker* (TCC costs)"); rev'd 2023 FCA 133 (herein referred to as "*Bowker* (FCA costs)") (collectively referred to herein as "*Bowker*").

123 *Bowker* (TCC costs), supra note 122, at paragraph 53.

124 *Bowker* (merits), supra note 122, at paragraph 59.

125 Ibid., at paragraphs 70-71.

126 *Bowker* (TCC costs), supra note 122, at paragraph 41. The settlement offer would have substituted the strict liability penalty under ITA subsection 162(7) for the KGN penalty at subsection 163(2). Justice Ouimet believed that this proposal was principled and could have been accepted by the minister, which weighed in support of an enhanced costs award (*Bowker* (TCC costs), ibid., at paragraphs 65-67). As discussed below (see infra note 136 and related text), the Federal Court of Appeal held that Justice Ouimet erred on this point.

Ouimet issued a lengthy judgment that reviewed in some detail the Tax Court cost regime. After declining to award costs on a full indemnity or substantial indemnity basis, Justice Ouimet determined that a partial indemnity award equal to 75 percent of the taxpayer's incurred legal fees would be appropriate on the basis of the various factors set out in rule 147 of the TCC rules (GP).[127]

The fraud costs rule was apparently not brought to Justice Ouimet's attention.[128] However, echoes of the rule appear in his discussion of "Other Matters Relevant to the Question of Costs,"[129] where Justice Ouimet recognized that "[a] gross negligence penalty should not be imposed lightly by the Minister. Gross negligence is a serious allegation that must meet the high threshold of subsection 163(2) of the *ITA* and of the case law. A gross negligence penalty should only be applied in exceptional circumstances."[130] Justice Ouimet then reviewed in some detail the process through which the CRA Appeals Division decided to confirm the KGN penalties assessed of the taxpayer, and noted that the CRA officers never sought to meet her, which had the effect of unnecessarily prolonging the proceedings in the Tax Court:[131]

> Lastly, I am of the view that in this case, [there] were numerous facts that should have prompted the CRA to interview the Appellant. Considering the nature of the reassessment, the amount of the gross negligence penalty and the ongoing CRA cases with DeMara, it was necessary to proceed with caution in order not to unduly and unnecessarily prolong the proceeding. This made establishing key facts even more important in order to determine whether the Appellant had simply been negligent or grossly negligent.
>
> The Minister's conduct prior to the beginning of the proceeding weighs in favour of an increased assessment of costs.[132]

The Federal Court of Appeal reversed Justice Ouimet's costs order and remanded the question of costs back to the Tax Court,[133] holding that Justice Ouimet had erred by

1) specifying that partial indemnity costs generally fall in the range of 50 to 75 percent of solicitor-client costs;[134]

127 *Bowker* (TCC costs), supra note 122, at paragraphs 39-40 and 88-92.

128 Ibid., written submissions of the appellant: motion for costs dated October 5, 2021 (obtained, with thanks, from counsel to the taxpayer).

129 Ibid., at paragraph 75.

130 Ibid., at paragraph 79.

131 Ibid., at paragraphs 81-87.

132 Ibid., at paragraphs 86-87.

133 Following the remand, the issue of costs was settled without an order being issued (confirmed by counsel to the taxpayer, personal communication, April 3, 2025).

134 *Bowker* (FCA costs), supra note 122, at paragraph 25.

2) "double-counting" the fact that the taxpayer was entirely successful under the "result of the proceeding" prong of rule 147(3)(a);[135]
3) holding that the CRA could have agreed to substitute a penalty under ITA subsection 162(7) for one under subsection 163(2), since (among other things) subsection 162(7) "would not apply to the case of returns that were filed when required but were negligently prepared";[136] and
4) not providing the Crown with an opportunity to address the issue of whether the CRA should have interviewed the taxpayer before confirming the assessment of the KGN penalties.[137]

The Federal Court of Appeal showed some skepticism about Justice Ouimet's finding that the failure of the CRA to interview the taxpayer somehow lengthened the proceeding and militated in favour of a higher costs award.[138] However, the court conspicuously declined to rule on the point and instead allowed the issue to be dealt with more fully on remand.

The Federal Court of Appeal also observed, in obiter dicta, that "[t]he penalty imposed by subsection 163(2) is not a discretionary penalty" and that "[a]s long as the [minister] was satisfied that the [taxpayer] had been grossly negligent, he was bound to give effect to the statutory penalty."[139] These statements, taken literally and out of context, seem to suggest that the CRA has a statutory obligation to assess and zealously litigate all KGN penalties to verdict whenever an official at the CRA with carriage of an audit or appeal subjectively believes that a taxpayer has demonstrated gross negligence. This reasoning, however, fails to take into account the separate, statutory obligation on the minister to prove the facts in support of a penalty, with the taxpayer being entitled to the benefit of any doubt. Accordingly, if the minister determines that the onus may not reasonably be expected to be met given the evidence available, the minister has the legal authority—if not the obligation—to forgo KGN penalties. Indeed, as a practical matter, the deletion of KGN penalties is a recognized way for the minister and the Crown to seek to settle disputes with taxpayers on a principled basis, as in the *Fuhr* case discussed above, where the Crown made a settlement offer (which was ultimately rejected) to settle the dispute on the basis that the KGN penalties at issue would be deleted.[140]

135 Ibid., at paragraphs 33-37.

136 Ibid., at paragraphs 43, 52-54, and 67-68.

137 Ibid., at paragraphs 69-79.

138 Ibid., at paragraphs 73-78.

139 Ibid., at paragraphs 59 and 61.

140 *Fuhr* costs submissions, supra note 101, at 4. Another such offer was made by the Crown in *Porisky v. The King*, 2025 TCC 66, at paragraphs 20-21: "The respondent made a written settlement offer to the appellants a few weeks before trial, proposing to concede the section 160 appeal numbered 2012-3780(IT)G and vacate the gross negligence penalties on the three GST appeals. . . . However, the proposed settlement was ultimately better than the actual result, in which the three GST appeals were dismissed and the penalties upheld."

Callaghan v. The Queen (Category II—Informal Procedure)

Callaghan v. The Queen[141] was an informal procedure case concerning losses claimed by a married couple from 2008 to 2014 in respect of a food business that they co-founded after winning a national chili recipe contest. They reported more than $40,000 in revenues over that time period, but significantly higher expenses.[142] By 2017—a taxation year not before the court—the business had started turning a profit.[143] The CRA disallowed the losses incurred from 2008 to 2014 on the basis that their activities constituted a hobby rather than a business, and reopened four statute-barred years and assessed KGN penalties on all adjustments.[144] Deputy Judge Jorré held that the taxpayers operated an actual business starting at least in 2012, and reasonably and genuinely believed that they were carrying on business together starting in 2008.[145] Accordingly, he held that they exhibited no negligence justifying the reopening of the statute-barred years and, a fortiori, the imposition of KGN penalties in any of the years at issue.[146]

It bears noting that although the *Callaghan* case was heard under the informal procedure, the total amounts at issue for the two taxpayers, taking into account all of the different taxation years as well as provincial taxes, came to well over $200,000.[147]

"Hobby versus business" cases, like principal residence cases, tend to involve some degree of subjectivity and judgment, such that it can be very difficult to prove that a taxpayer demonstrates "negligence"—much less "gross negligence," and even further less an actual intent to deceive—by taking the reporting position that activities that are clearly commercial in nature constitute a "business." This is especially the case when those commercial activities eventually blossom into a profitable enterprise. Given that the onus of proof to sustain KGN penalties lies with the minister, and given that the taxpayer is entitled to receive the benefit of the doubt, it is very difficult to understand what made the Crown believe that the KGN penalties in the *Callaghan* case were defensible.

The taxpayers requested costs equal to approximately 65 percent of their actual legal expenses,[148] primarily on the basis that the taxpayers were almost entirely successful and should receive a reasonable costs award in light of the actual amounts at issue, which vastly exceeded the usual thresholds for an informal procedure appeal.[149]

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141 2020 TCC 28 (herein referred to as "*Callaghan* (merits)"); and *Callaghan v. The Queen*, 2021 TCC 35 (herein referred to as "*Callaghan* (costs)") (collectively referred to herein as "*Callaghan*").

142 *Callaghan* (merits), supra note 141, at paragraph 5.

143 Ibid., at paragraph 57.

144 Ibid., at paragraphs 1-3.

145 Ibid., at paragraphs 71 and 95-97.

146 Ibid., at paragraphs 94-99.

147 *Callaghan* (costs), supra note 141, at paragraph 4 and footnote 12.

148 Ibid., at paragraph 1.

149 Ibid., costs submissions of the appellants dated August 7, 2020; and ibid., reply costs submissions of the appellants dated November 9, 2020 (obtained from the court) (collectively referred to herein as "*Callaghan* costs submissions").

Deputy Judge Jorré agreed that a costs award was in order, but held that, in informal procedure cases, any costs award must take into account the tariff set out in rule 11 of the TCC rules (IP).[150] He thus awarded costs in accordance with that tariff, which came to about one-fifth of the amount requested.[151]

In obiter dicta, Deputy Judge Jorré did suggest the court would potentially depart from the rule 11 tariff in informal procedure cases "to take account of circumstances that are not provided for while taking account of section 11 of the rules."[152] The fraud costs rule was apparently not brought to Deputy Judge Jorré's attention,[153] and one might speculate that, had the taxpayers done so, the court may well have seen a basis to allow their request for 65 percent of their actual legal expenses.

CONCLUSION

As noted by Justice Boyle in *Jolly Farmer*, the Crown should not be obliging members of the public to go to court for no good reason, and if the Crown does so anyway, cost consequences should be expected to follow:

> There are perhaps some arguments and some cases that the Canada Revenue Agency just should not pursue. The Crown is not a private party. By reassessing a taxpayer and failing to resolve its objection, the Crown is forcing its citizen/taxpayers to take it to Court. If the Crown's position does not have a reasonable degree of sustainability, and is in fact entirely rejected, it is entirely appropriate that the Crown should be aware it is proceeding subject to the risk of a possibly increased award of costs against it if it is unsuccessful. The Crown is not a private party and tax litigation is not a dispute like others between two Canadians. This is the government effectively pursuing one of its citizens. There will be many times when the Crown will lose cases in circumstances where prior to the hearing the Crown was not fully aware of the taxpayer's evidence or could not test its credibility, or could not fully understand the taxpayer's position. There will be times when the Crown unsuccessfully pursues new or novel arguments. None of those appear to have been the case here.[154]

150 Ibid., at paragraphs 38-39: "Given the scheme of the *Informal Procedure Rules*, including the absence of anything like subsection 147(4) of the *General Procedure Rules*, cited above, that flexibility does not mean that the court can simply ignore the Tariff of costs set out in section 11. I must take account of the Tariff in determining costs."

151 The court awarded $6,000 out of about $32,264 requested (ibid., at paragraphs 1 and 73).

152 Ibid., at paragraph 70.

153 *Callaghan* costs submissions, supra note 149. Deputy Judge Jorré did briefly observe that the fact that penalties were at issue did not constitute an exceptional circumstance warranting a departure from the tariff; however, when his comment is read in context, he was apparently referring to their impact on the overall complexity of the case, rather than on whether KGN penalty cases should potentially trigger cost consequences per se. *Callaghan* (costs), supra note 141, at paragraph 65: "The fact that there are issues regarding penalties and potentially statute barred years adds to the number of issues but does not in and of itself create particular complexity different from other appeals of similar difficulty."

154 *Jolly Farmer Products Inc. v. The Queen*, 2008 TCC 693, at paragraph 26.

Justice Boyle's comments apply with even greater force to cases involving KGN penalties, which put at issue not merely an amount of tax owed, but also a taxpayer's character and integrity. In addition, public accusations by the government of dishonesty can have serious impacts—both financial and non-financial—on the taxpayer's relationships with banks, creditors, suppliers, customers, business partners, boards of directors, shareholders, employers, or employees. As has been repeatedly held in the case law, KGN penalties should be assessed and, if disputed, litigated to verdict, only if the evidence supporting them is compelling.

Regrettably, it appears that these principles have yet to be internalized by the CRA or the Crown. Practitioners report anecdotally how CRA auditors seem to propose and assess KGN penalties as a matter of routine in respect of any significant adjustment, without a proper analysis of their appropriateness,[155] even in circumstances where (1) a taxpayer has relied on reputable advisers to maintain their books and prepare their returns; (2) the taxpayer has an otherwise impeccable record of fiscal compliance; and/or (3) the adjustment results from a bona fide difference of opinion or matter of judgment, such as valuation, residency, characterization, or reasonability.[156] Even worse, CRA auditors use the threat of penalties to pressure taxpayers to make concessions—including concessions that may be completely unwarranted—with respect to substantive tax issues, as recently noted by Justice D'Arcy in *Marine Atlantic*:[157]

> I am troubled by the CRA's conduct. The CRA should never threaten penalties to force a GST registrant to accept the CRA's allocation method. The law is clear: the CRA cannot simply substitute its approach for that of the Appellant, and there may be more than

155 The CRA's audit manuals require the preparation and approval of a "penalty recommendation report" whenever a KGN penalty is *proposed*, whether or not it is ultimately assessed. Canada Revenue Agency, *GST/HST Audit and Examination Manual 2016-01* (available on *Taxnet Pro*) (herein referred to as "GST/HST audit manual"), at section 75.1.7: "When a penalty has been proposed to the registrant, even if the penalty is not ultimately applied, you are still required to prepare a report"; and Canada Revenue Agency, *Income Tax Audit Manual* (available on *Taxnet Pro*) (herein referred to as "income tax audit manual"), at sections 11.6.1 and 11.6.2: "If a penalty under subsection 163(2) of the *Income Tax Act* is proposed, a Penalty Recommendation Report must be prepared and approved by the designated authority."

156 The author has personally dealt with numerous examples of such situations.

157 Indeed, the CRA's aggressiveness with respect to KGN penalties may well increase in light of the incoming government's campaign promise to "strengthen enforcement" at the CRA, with its fiscal and costing plan projecting a further $3.75 billion in "penalties and fines" collected through to the 2028-29 fiscal year. Liberal Party of Canada, "Canada Strong: Build" (https://liberal.ca/cstrong/build); and Liberal Party of Canada, "Canada Strong: Fiscal and Costing Plan," April 2025 (https://liberal.ca/wp-content/uploads/sites/292/2025/04/Canada_Strong_-_Fiscal_and_Costing_Plan.pdf). Media inquiries for an explanation of what the $3.75 billion consists of or how the figure was calculated were apparently declined; see Michelle Schriver, "Liberals' Plan for Revenue from Tax Penalties Called into Question," *Investment Executive*, April 28, 2025 (www.investmentexecutive.com/news/industry-news/liberals-plan-for-revenue-from-tax-penalties-called-into-question).

> one method that is fair and reasonable in the circumstances. The Appellant was proposing a methodology that it had developed after a substantial review of its operations. In such a situation, it is inconceivable that the Appellant's conduct met the standard for a gross negligence penalty. It appears that the CRA was using the threat of penalties to force the Appellant into accepting the CRA's 15.57%, the calculation of which was not explained to the Court and not explained to the Appellant.[158]

Contributing to the problem is that the CRA audit manuals—which serve as primary points of reference for CRA auditors—misstate the law on KGN penalties in some significant respects. For example, they repeatedly conflate the tests for simple and gross negligence,[159] and they claim that a taxpayer can have "knowledge" of an error or omission for the purpose of ETA section 285 or ITA subsection 163(2) if the taxpayer simply "had the means of obtaining the knowledge."[160] This latter statement is obviously wrong as a legal proposition and, if taken literally (which, it appears, some CRA officials do), it can support a finding of gross negligence against practically any civilly competent taxpayer.

Further contributing to the problem is that, even though the Department of Justice Act entrusts the attorney general of Canada with the regulation and conduct of litigation against the federal Crown,[161] the Department of Justice generally acts as if the CRA is its "client" from whom it takes "instructions" in Tax Court appeals.[162] Consequently, if an intransigent CRA litigation officer decides, against legal advice, to defend the assessment of KGN penalties before the Tax Court, counsel at the Department of Justice generally proceed as if they are obligated to do so regardless of the merits of the position. The Department of Justice's deference to CRA litigation officers deprives taxpayers of an important safeguard against the misuse of enforcement power by the CRA, and might be compared with empowering officials in a police department to "instruct" Crown prosecutors as to which charges to pursue

158 *Marine Atlantic Inc. v. The King*, 2023 TCC 95, at paragraph 141. See also the related costs award reported in *Marine Atlantic Inc. v. The King*, 2024 TCC 51, at paragraphs 59-68.

159 For example, income tax audit manual, supra note 155, at section 11.6.2(9) states: "After a complete review of the facts, circumstances, and relevant documents, draw a conclusion on whether the taxpayer *knew or ought to have known* there were false statements or omissions. . . . To support the imposition of a penalty under subsection 163(2), the audit evidence in favour of the penalty must be stronger than the audit evidence against it. More specifically, the facts and audit evidence gathered should show that: *the taxpayer was negligent*" (emphasis added).

160 GST/HST audit manual, supra note 155, at section 75.1.1.1; and income tax audit manual, supra note 155, at section 28.4.2: "had in effect the means of knowledge."

161 Department of Justice Act, supra note 56, section 5(d). See *Garber v. The Queen*, 2005 TCC 635, at paragraphs 36-37; aff'd on other grounds 2006 FCA 177 (holding that the Department of Justice was entitled to repudiate a settlement reached by the Department of National Revenue); and Daniel Sandler, "Settling Tax Disputes: Is It All About the Money?" in *Tax Disputes in Canada*, supra note 55, 14:411-35, at 14:422-23.

162 See Smith and Ryer, supra note 60, at 7:232-33: "The ultimate decisions on the conduct of litigation, such as whether to propose or agree to a settlement offer, rest with litigation officers and their supervisors."

and which to drop against an accused.[163] Such an arrangement would not be considered acceptable in the criminal context, where it has been long recognized that "separating the investigative and prosecutorial powers of the state is an important safeguard against the misuse of both."[164]

By definition, KGN penalties are punitive. They seek to deter and punish, through the imposition of potentially onerous financial sanctions,[165] taxpayer non-compliance that is intentional or "tantamount to intentional." Such culpable conduct from a taxpayer—at least where the non-compliance is wilful or attributable to wilful blindness—could also potentially support a criminal prosecution for tax evasion or fraud.[166] However, in stark contrast to the pursuit of a criminal prosecution, the minister can assess KGN penalties without obtaining warrants to seize evidence, without respecting the taxpayer's right to remain silent, without informing the taxpayer without delay of their right to retain and instruct counsel, without having to prove the facts justifying the penalties beyond a reasonable doubt, and without having to demonstrate to a judge's satisfaction that the penalty is reasonable and proportionate to the offence. Adoption and rigorous application of the fraud costs rule by the Tax Court would offer a small but potentially meaningful way to restore the balance. Furthermore, while the overall budgetary impact of adopting the fraud costs rule would presumably be immaterial from the government's point of view, the Crown can be quite sensitive to being on the receiving end of significant adverse costs awards, especially when the awards attract media attention.[167] Consequently, applying the fraud costs rule in Tax Court proceedings would, it is hoped, have the very welcome and salutary effect of imposing greater discipline on the Crown, and potentially the CRA, in ensuring that KGN penalties are assessed and litigated only in circumstances where they are clearly warranted.

Ultimately, Parliament empowered the Tax Court to award costs in order to enable taxpayers to seek justice in the Tax Court when they believe that the minister has

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163 The author thanks one of the two anonymous peer reviewers of this article for this analogy.

164 *R v. Davey*, 2012 SCC 75, at paragraph 37, citing Ontario Ministry of the Attorney General, *Report of the Attorney General's Advisory Committee on Charge Screening, Disclosure, and Resolution Discussions*, chaired by Arthur Martin (Toronto: Queen's Printer for Ontario, 1993), at 39; and *R v. Regan*, 2002 SCC 12, at paragraphs 159-61, Binnie J, dissenting, specifically at paragraph 160, citing Ontario Ministry of the Attorney General, supra, at 39.

165 Recall that the KGN penalties imposed on the taxpayer in *Bowker* represented five years' worth of her taxable income. *Bowker* (TCC costs), supra note 122, at paragraph 53.

166 Thomas Boddez and Gregory DelBigio, "Criminal Tax Evasion: Review and Update," in *Report of Proceedings of the Sixty-Fourth Tax Conference*, 2012 Conference Report (Toronto: Canadian Tax Foundation, 2013), 38:1-28, at 38:5-11; and Andy Noroozi, "Les infractions fiscales : évasion selon les lois fiscales ou fraude selon le Code criminel?" (2015) 35:2 *Revue de planification fiscal et financière* (JuriBistro eDoctrine), at section 1-2. See also Stevens, supra note 42, at 39-41.

167 See Julius Melnitzer, "Tax Court Raises Spectre of McCarthyism, Socks Crown with Solicitor-Client Costs," *Financial Post*, January 19, 2015 (https://financialpost.com/legal-post/tax-court-raises-spectre-of-mccarthyism-socks-crown-with-solicitor-client-costs). The decision itself is reported as *Simard v. The Queen*, 2015 TCC 2.

erred in establishing their fiscal liabilities. Taxpayers can, however, balk at appealing KGN penalties, even ones that they consider to be ill-founded, not only because of the cost, but also because doing so requires them to make public the minister's determination that they engaged in the kind of culpable wrongdoing that is required for a KGN penalty. Adoption of the fraud costs rule can give taxpayers an incentive to challenge ill-founded KGN penalties, and to ensure that such penalties are reviewed and vacated—which can benefit not only the taxpayers who have been penalized improperly, but also the public at large, who can benefit from greater care and discipline from the CRA in the administration and enforcement of the ITA and ETA.

ADDENDUM: DATTA V. THE KING

While this article was in production, the Tax Court issued its decision in *Datta v. The King*,[168] which was a costs order that followed an unreported oral decision rendered from the bench on May 23, 2024. At issue in *Datta* was whether the taxpayer had $105,190 in unreported business income and, if so, whether he was liable to a KGN penalty. Justice Wong found entirely for the taxpayer, holding that "the unreported income should not have been attributed to him and as a result, he was also not grossly negligent."[169] The taxpayer sought costs on a combined partial/substantial indemnity basis.

Justice Wong noted that the fact that KGN penalties had been tacked onto a substantive tax adjustment that the taxpayer successfully disputed was a factor that "favours increased costs":

> The appellant was wholly successful in that I found the unreported income should not have been attributed to him and as a result, he was also not grossly negligent. It was open for me to find that the income should have been attributed to him while also finding him not to have been grossly negligent. Therefore, this was not an all-or-nothing situation.
>
> As a result, this factor favours increased costs.[170]

However, Justice Wong also noted that "gross negligence penalties are commonly litigated before this court" and that there was "no evidence" that any stage in the litigation was improper, vexatious, or unnecessary, or taken through negligence, mistake, or excessive caution.[171] Ultimately, Justice Wong awarded costs in accordance with the tariff.

The fraud costs rule does not appear to have been brought to Justice Wong's attention, which is unfortunate since the case may well have justified its application, although the potential impact of the fraud costs rule is difficult to assess without more information about the basis for the CRA's assessing position.

168 2025 TCC 79; under appeal to the Federal Court of Appeal, docket no. A-237-25.

169 Ibid., at paragraph 6.

170 Ibid., at paragraphs 6-7.

171 Ibid., at paragraphs 10-11 and 21.

APPENDIX REPORTED FINAL DECISIONS INVOLVING APPEALS OF DISPUTED KGN PENALTIES, JANUARY 1, 2018 TO MARCH 31, 2025

TCC decision date	Appellant	Neutral citation	Appellate treatment	Separate reported costs award	Procedure	Dispositions		KGN penalties wholly vacated	Taxpayer victory category
						ITA	ETA		
2018-01-05	*Kajtor*	2018 TCC 6			General	1	0	Y	I
2018-01-05	*Cyr*	2018 CCI 4	aff'd 2019 FCA 14		Informal	2	0	N	
2018-01-10	*Rousseau*	2018 CCI 9			Informal	1	0	N	
2018-01-31	*Isah*	2018 TCC 28			Informal	1	0	N	
2018-03-12	*Peck*	2018 TCC 52			General	1	0	N	
2018-03-21	*Semenov*	2018 TCC 58			Informal	2	0	Y	II
2018-03-22	*Jensen*	2018 TCC 60			General	1	0	N	
2018-03-26	*Goheen*	2018 TCC 62	aff'd 2019 FCA 104		General	1	0	N	
2018-04-17	*Manhue*	2018 TCC 71			General	1	0	N	
2018-07-17	*Coutu*	2018 CCI 143			Informal	1	0	N	
2018-07-23	*Mahdi [Sabet Mahdi]*	2018 TCC 149			General	1	0	Y	I
2018-07-23	*Mahdi [Khaled Lashin]*	2018 TCC 149			General	1	0	N	
2018-08-28	*Tavernier*	2018 TCC 173			General	1	0	N	
2018-10-12	*Bradshaw*	2018 TCC 246			General	1	0	N	
2018-10-16	*Phénix*	2018 TCC 204			Informal	1	0	Y	I
2018-11-14	*Seepersad*	2018 TCC 226			Informal	2	0	N	
2018-11-23	*Xia*	2019 TCC 30	aff'd 2020 FCA 35		Informal	1	0	N	
2019-01-03	*Bradshaw*	2019 TCC 1			General	1	0	N	
2019-01-17	*9081-2769 Québec*	2019 CCI 14			Informal	1	0	N	

(The appendix is continued on the next page.)

APPENDIX CONTINUED

TCC decision date	Appellant	Neutral citation	Appellate treatment	Separate reported costs award	Procedure	Dispositions		KGN penalties wholly vacated	Taxpayer victory category
						ITA	ETA		
2019-01-22	*Stewart*	2019 TCC 22			General	2	0	Y	III
2019-01-23	*Van Der Steen*	2019 TCC 23	aff'd (without reference to penalties) 2020 FCA 168		General	1	0	Y	II
2019-02-01	*De Geest*	2019 TCC 33	aff'd 2022 FCA 22	2023 FCA 7	General	1	0	N	
2019-02-13	*Phillip*	2019 TCC 37			Informal	1	0	N	
2019-02-20	*Saunders*	2019 TCC 39			Informal	1	0	N	
2019-02-28	*Owda*	2019 TCC 46			Informal	1	0	Y	II
2019-03-27	*Ansems*	2019 TCC 66	appeal discontinued (docket no. A-89-19)		General	3	0	N	
2019-04-04	*Duffy*	2019 TCC 75		2020 TCC 135	General	3	0	Y	III
2019-04-25	*Tyskerud*	2019 TCC 84			Informal	1	0	N	
2019-06-04	*Buday*	2019 TCC 128	motion for extension of time to appeal to FCA dismissed (docket no. 21-A-16)		Informal	2	3	N	
2019-06-10	*Bordonaro*	2019 TCC 130			Informal	1	0	N	
2019-06-25	*Bygrave*	2019 TCC 138			Informal	1	0	Y	III
2019-07-09	*Deyab*	(unreported)	rev'd in part 2020 FCA 222; leave to appeal to SCC dismissed		General	1	0	Y	II
2019-08-14	*Wall*	2019 TCC 168	aff'd 2021 FCA 132		General	1	0	N	

(The appendix is continued on the next page.)

APPENDIX CONTINUED

TCC decision date	Appellant	Neutral citation	Appellate treatment	Separate reported costs award	Procedure	Dispositions		KGN penalties wholly vacated	Taxpayer victory category
						ITA	ETA		
2019-08-28	*Robinson*	2019 TCC 181			Informal	1	0	Y	II
2019-08-28	*9194-2359 Québec*	2019 CCI 179			General	0	2	N	
2019-09-03	*St-Yves*	2019 CCI 186			General	1	0	N	
2019-09-26	*Wardlaw*	2019 TCC 199			General	1	0	N	
2019-10-22	*Fry*	2019 TCC 236			Informal	1	0	N	
2019-11-05	*Hide and Seek Bailiff Services*	2019 TCC 251			Informal	0	1	Y	II
2019-11-07	*Stone*	2019 TCC 253			General	1	0	N	
2019-11-19	*Gee*	(unreported)	aff'd 2021 FCA 215		General	1	0	N	
2019-12-11	*Smith*	2019 TCC 274			Informal	2	0	Y	II
2019-12-12	*Dow & Duggan Log Homes International (1993)*	2019 TCC 280	aff'd 2021 FCA 66		General	0	1	N	
2019-12-20	*Binjamin*	2019 TCC 287	aff'd 2022 FCA 164		Informal	0	1	N	
2020-01-21	*Khanna [Dennis]*	(unreported)	aff'd 2022 FCA 84		General	1	0	N	
2020-01-21	*Khanna [Veeru]*	(unreported)	rev'd 2022 FCA 84		General	1	0	Y	I
2020-01-21	*Frank-Fort Construction*	2020 CCI 6			General	0	1	Y	I
2020-02-11	*Callaghan*	2020 TCC 28		2021 TCC 35	Informal	2	0	Y	II
2020-02-12	*Lin*	2020 TCC 26			General	4	0	N	
2020-03-12	*Strachan*	2020 TCC 37	aff'd 2022 FCA 85		Informal	1	0	N	
2020-03-13	*Saini*	2020 TCC 38			General	1	0	N	

(The appendix is continued on the next page.)

APPENDIX CONTINUED

TCC decision date	Appellant	Neutral citation	Appellate treatment	Separate reported costs award	Procedure	Dispositions		KGN penalties wholly vacated	Taxpayer victory category
						ITA	ETA		
2020-07-09	*Hamel*	2020 CCI 48			General	1	0	N	
2020-07-16	*Lavigne*	2020 TCC 57			General	1	0	N	
2020-07-17	*Rattai [Daniel]*	2020 TCC 55	rev'd 2022 FCA 106		General	1	0	N	
2020-07-17	*Rattai [Cynthia]*	2020 TCC 55			General	1	0	Y	I
2020-07-23	*Hilderman*	2020 TCC 58			General	2	0	N	
2020-07-23	*Pierre Juneau Rénovations*	2020 CCI 54	appeal dismissed for delay (docket no. A-217-20)		Informal	1	0	N	
2020-07-24	*Tong*	2020 TCC 70			General	1	0	Y	III
2020-07-27	*Xue*	2020 TCC 72	aff'd 2022 FCA 78		General	2	0	N	
2020-08-04	*Mandel*	2020 CCI 76			Informal	1	0	N	
2020-08-19	*Wood*	2020 TCC 87	aff'd 2022 FCA 60		General	1	0	N	
2020-08-27	*Agracity*	2020 TCC 91			General	1	0	Y	III
2020-09-14	*Hansen*	2020 TCC 102		2021 TCC 39	General	1	0	Y	II
2020-09-18	*Auto Maculate*	2020 TCC 105			Informal	4	2	N	
2020-12-01	*Heno*	2020 TCC 127			Informal	1	0	N	
2021-03-02	*Bowker*	2021 TCC 14		2022 TCC 43; rev'd 2023 FCA 133	General	1	0	Y	I
2021-03-25	*Paletta Estate*	2021 TCC 11	rev'd 2022 FCA 86; leave to appeal to SCC dismissed		General	1	0	N	

(The appendix is continued on the next page.)

APPENDIX CONTINUED

TCC decision date	Appellant	Neutral citation	Appellate treatment	Separate reported costs award	Procedure	Dispositions		KGN penalties wholly vacated	Taxpayer victory category
						ITA	ETA		
2021-08-06	*Vocan Health Assessors*	2021 TCC 49			General	0	1	N	
2021-10-14	*Service de consultation dentaire Planident*	2021 CCI 67			General	2	0	N	
2021-12-22	*Stewart*	2021 TCC 94			General	1	0	Y	II
2022-03-17	*Mediclean*	2022 TCC 37			General	0	1	Y	II
2022-06-07	*Liang*	2022 TCC 55			Informal	1	0	N	
2022-07-29	*Chan*	2022 TCC 87			Informal	1	0	Y	III
2022-08-05	*Malkaya [Bulent]*	2022 TCC 89			General	1	0	N	
2022-08-05	*Malkaya [Rukiya]*	2022 TCC 89			General	1	0	Y	II
2022-10-25	*Lapierre*	2023 TCC 152			Informal	1	0	Y	II
2022-11-04	*2227414 Ontario*	2022 TCC 133			Informal	0	1	Y	III
2022-11-17	*3143971 Nova Scotia*	2022 CCI 138			General	1	0	N	
2022-11-30	*Nicosia*	2022 TCC 143			General	1	0	Y	II
2022-12-28	*Bousfield*	2022 TCC 169			General	1	1	N	
2023-01-19	*2093271 Ontario*	(unreported)	aff'd 2024 FCA 50		General	4	0	N	
2023-03-10	*Goldbar*	2023 TCC 30			General	2	0	Y	III
2023-05-05	*O'Hagan*	2023 TCC 52			Informal	1	0	N	
2023-05-09	*MF Electric*	2023 TCC 60			General	1	0	N	
2023-05-10	*Werstein*	2023 TCC 64			General	1	0	N	
2023-05-18	*Jamieson*	2023 TCC 69			General	1	0	N	
2023-07-13	*Osborne*	2023 TCC 98			General	1	0	N	

(The appendix is continued on the next page.)

APPENDIX CONTINUED

TCC decision date	Appellant	Neutral citation	Appellate treatment	Separate reported costs award	Procedure	Dispositions		KGN penalties wholly vacated	Taxpayer victory category
						ITA	ETA		
2023-07-18	*Yadgar*	2023 TCC 104	aff'd 2024 FCA 107; leave to appeal to SCC dismissed		General	1	0	N	
2023-07-27	*Fransen*	2023 TCC 107			General	1	0	N	
2023-08-17	*Les Planches murales Jenleau*	2023 CCI 120			General	0	2	N	
2023-09-12	*LBL Holdings*	2023 TCC 130			General	0	1	Y	III
2023-09-20	*Fiera Foods Company*	2023 TCC 140			General	0	1	Y	III
2023-10-18	*Belval*	2023 CCI 149			General	1	0	N	
2023-10-18	*Dubé*	2023 CCI 148			General	1	0	N	
2023-10-24	*Mann*	2023 TCC 151	aff'd 2024 FCA 149		General	1	0	N	
2023-12-29	*Abbass*	2023 TCC 169			General	1	0	Y	III
2024-02-14	*Demchynski*	2024 TCC 18	aff'd 2025 FCA 72		General	1	0	N	
2024-02-16	*He*	2024 TCC 21			General	1	0	N	
2024-03-14	*Encore Cellular*	2024 TCC 35			General	0	1	N	
2024-04-11	*Fuhr*	2024 TCC 43		2025 TCC 27	General	2	0	Y	III
2024-05-27	*Entrepôt Frigorifique International*	2024 CCI 78			General	0	1	Y	III
2024-05-27	*SPE Valeur Assurable*	2024 CCI 79	pending (docket no. A-223-24)		General	2	0	N	
2024-06-12	*Qi*	2024 TCC 86			General	3	1	N	

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APPENDIX CONCLUDED

TCC decision date	Appellant	Neutral citation	Appellate treatment	Separate reported costs award	Procedure	Dispositions		KGN penalties wholly vacated	Taxpayer victory category
						ITA	ETA		
2024-07-18	*Porisky*	2024 TCC 84	pending (docket no. A-282-24)	2025 TCC 66	General	2	3	N	
2024-07-31	*Kumar*	2024 TCC 105			Informal	1	0	Y	II
2024-08-23	*Di Mauro*	2024 TCC 111		2025 TCC 52	General	2	0	N	
2024-09-05	*Fijal*	2024 TCC 116			General	2	1	Y	II
2024-09-19	*Karlozian*	2024 TCC 121	pending (docket no. A-327-24)		General	1	0	N	
2024-12-19	*Gabriel*	2024 TCC 166			General	1	0	Y	II
2025-01-15	*De Pellegrin*	2025 CCI 7			General	1	0	Y	II
2025-02-06	*Azmayesh-Fard*	2025 TCC 20	appeal discontinued (docket no. A-83-25)		General	1	0	N	

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Policy Forum: Foreign Buyers and Local Housing Affordability—Indications from Vancouver

Thomas Davidoff*

PRÉCIS

Malgré la crise du logement sévissant à Vancouver et surtout à Toronto, la construction de copropriétés est au point mort. Cette situation a suscité des questions sur l'efficacité des taxes sur les acheteurs étrangers, qui étaient censées rendre les logements plus abordables pour les résidents canadiens au point de réduire l'accessibilité en rendant la construction de copropriétés non rentable. Dans cet article, un modèle simplifiant l'analyse fondamentale de Favilukis et Van Nieuwerburgh (2021) démontre que les acheteurs étrangers peuvent favoriser ou entraver l'accessibilité au logement pour la population locale selon que l'offre de logements est élastique ou inélastique, que les acheteurs étrangers paient plus cher que la population locale pour les mêmes logements, que la demande étrangère est forte et que les acheteurs étrangers occupent ou louent les logements à des résidents canadiens ou revendent les contrats de préconstruction à l'approche de l'achèvement des travaux. Une analyse informelle des données et des calculs approximatifs laissent entendre qu'en l'absence de taxes sur les logements vacants, les acheteurs étrangers dans les régions métropolitaines de Vancouver et de Toronto ont probablement nui à l'accessibilité locale, mais qu'en présence de taxes sur les logements vacants, les interdictions ou les taxes visant les acheteurs étrangers pourraient aggraver l'accessibilité pour la population locale.

ABSTRACT

With condominium construction stalled despite severe housing affordability problems in Vancouver and particularly Toronto, attention has turned to the question of whether foreign buyer taxes may have overshot the goal of making homes more affordable for domestic residents, to the point of reducing affordability by making condo development unprofitable. In this article, a model that simplifies the foundational analysis in Favilukis and Van Nieuwerburgh (2021) shows that foreign buyers help or hinder domestic affordability depending on whether housing supply is elastic or inelastic, whether foreign buyers overpay for units in the same buildings as locals, how

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intense foreign demand is, and whether foreign buyers occupy units or instead rent them to locals or flip pre-construction contracts near building completion. Casual data analysis and back-of-the-envelope calculations suggest that, in the absence of empty homes taxes, foreign buyers in Greater Vancouver and Toronto likely hindered local affordability, but that, in the presence of empty homes taxes, foreign buyer bans or taxes may worsen affordability for locals.

KEYWORDS: HOUSING ■ ASSET TAXES ■ COMMODITY TAXES ■ URBAN ■ FINANCE

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INTRODUCTION

Taxes and restrictions on foreign purchases of residences have been implemented in multiple jurisdictions worldwide with the stated purpose of making homes more affordable for domestic residents. For example, in extending a ban on foreign purchases of Canadian residential real estate, Finance Canada stated in a press release: "For years, foreign money has been coming into Canada to buy up residential real estate, increasing housing affordability concerns in cities across the country, and particularly in major urban centres. Foreign ownership has also fueled worries about Canadians being priced out of housing markets in cities and towns across the country."[1]

There are theoretical and empirical reasons to expect foreign buyer taxes to succeed in reducing local housing prices, many of which are detailed in a comprehensive study by Favilukis and Van Nieuwerburgh.[2] The disincentive to purchase homes should reduce the number of buyers considering purchasing properties, and lower the willingness to pay among remaining foreign buyers, and hence lower prices. This reduction in prices hurts landlords and incumbent property owners through lost property value and rents, but makes home ownership more affordable for locals who

1 Canada, Department of Finance, "Government Announces Two-Year Extension to Ban on Foreign Ownership of Canadian Housing," *News Release*, February 4, 2024.

2 Jack Favilukis and Stijn Van Nieuwerburgh, "Out-of-Town Buyers and City Welfare" (2021) 76:5 *Journal of Finance* 2577-2638.

do not yet own homes. There may be also an associated loss of construction jobs. The analysis in Favilukis and Van Nieuwerburgh does not consider the effect of reciprocal taxes on domestic residents who may wish to purchase property overseas.[3]

In this article, I analyze how taxes on foreign home buyers affect housing affordability for locals. A simple model shows that three key parameters determine the direction of that effect: the elasticity of housing supply with respect to price, the extent to which foreign buyers outbid locals, and the extent to which foreign buyers occupy homes. I gather evidence on the magnitude of these parameters and then use the model and likely parameter values to analyze the conditions under which foreign housing taxes help or hurt affordability.

Existing studies on the impact of the entry and exit of foreign buyers on local home prices present estimated effects that are all positive and range from modest to quite large, as summarized in Davidoff and Zheng.[4] Li et al., Gorback and Keys, Pavlov and Somerville, and Badarinza and Ramadorai[5] find that, within metropolitan areas, submarkets exposed to foreign buyers see larger price increases when the types of foreign buyers prone to buy in those submarkets face increased incentives to buy overseas. Dachis et al., Best and Kleven, Kopczuk and Munroe, and Davidoff and Leigh find,[6] as a general matter, that increasing transaction taxes on housing purchases leads to fewer transactions and lower prices. Hartley et al., Andolfatto and Rekkas, Du et al.,

3 It is not obvious that a target country would wish to reciprocate to disincentivize the host country's tax. For example, China, the source of most foreign buyers in Canada prior to the recent spate of taxes (see, for example, Darcy Matheson, "Majority of Foreign Buyers from China, New Real Estate Data Reveals," *CTV News*, July 7, 2016 (www.ctvnews.ca/vancouver/article/majority-of-foreign-buyers-from-china-new-real-estate-data-reveals/)), has made efforts to discourage capital flight.

4 Thomas Davidoff and Keling Zheng, *Foreign Buyer Tax Impacts on Submarkets: Evidence from Canada* (Vancouver: University of British Columbia, 2024).

5 Zhimin Li, Leslie Sheng Shen, and Calvin Zhang, "Local Effects of Global Capital Flows: A China Shock in the U.S. Housing Market" (2024) 37:3 *Review of Financial Studies* 761-801 (https://doi.org/10.1093/rfs/hhad067); Caitlin S. Gorback and Benjamin J. Keys, *Global Capital and Local Assets: House Prices, Quantities and Elasticities*, Working Paper 27370 (Cambridge, MA: National Bureau of Economic Research, 2020); Andrey Pavlov and Tsur Somerville, "Immigration, Capital Flows and Housing Prices" (2020) 48:3 *Real Estate Economics* 915-49; and Cristian Badarinza and Tarun Ramadorai, "Home Away from Home? Foreign Demand and London House Prices" (2018) 130:3 *Journal of Financial Economics* 532-55 (https://doi.org/10.1016/j.jfineco.2018.07.010).

6 Ben Dachis, Gilles Duranton, and Matthew A. Turner, "The Effects of Land Transfer Taxes on Real Estate Markets: Evidence from a Natural Experiment in Toronto" (2012) 12:2 *Journal of Economic Geography* 327-54 (https://doi.org/10.1093/jeg/lbr007); Michael Carlos Best and Henrik Jacobsen Kleven, "Housing Market Responses to Transaction Taxes: Evidence from Notches and Stimulus in the U.K." (2018) 85:1 *Review of Economic Studies* 157-93 (https://doi.org/10.1093/restud/rdx032); Wojciech Kopczuk and David Munroe, "Mansion Tax: The Effect of Transfer Taxes on the Residential Real Estate Market" (2015) 7:2 *American Economic Journal: Economic Policy* 214-57; and Ian Davidoff and Andrew Leigh, "How Do Stamp Duties Affect the Housing Market?" (2013) 89:286 *Economic Record* 396-410 (https://doi.org/10.1111/1475-4932.12056).

and Pavlov et al.[7] collectively find that foreign buyer taxes in Australia, Canada, and New Zealand led to lower prices. Hilber and Schöni[8] find that banning second-home construction in desirable second-home locations in Switzerland did reduce the prices of primary residences and increased the prices of second homes.

As Favilukis and Van Nieuwerburgh observe,[9] foreign buyers may not leave homes empty, but rather rent them out to locals. In their calibration, this changes the social welfare effect of foreign buyers from negative to slightly positive. The positive supply effect of out-of-town buyers is moderate because local investors are highly price-sensitive in their demand for rental properties, and out-of-town buyers represent a small share of overall capital investment. In this way, foreign buyers represent a slightly positive form of capital accumulation. This is a salient consideration, as British Columbia has imposed significant taxes on empty homes and vacation properties in urban areas while also imposing significant taxes on foreign buyers, and the Canadian federal government has both imposed taxes on empty homes owned by foreigners and temporarily banned the purchase of single residences by foreigners.[10]

At the time of writing, the markets for condominiums in Vancouver and Toronto are so weak that construction has stalled, with many projects cancelled.[11] In these markets, condominiums are typically financed in part by pre-construction sales ("pre-sales"), which commonly take place several years prior to completion of a building. While slumping pre-sales are indicative of falling prices, the ratio of condo ownership costs to incomes remains almost at record levels, according to RBC Economics.[12] The drop in condo pre-sales and hence construction starts has led some observers to suggest that the policy of taxing of foreign buyers has overshot the goal of making homes

7 Jonathan S. Hartley, Li Ma, Susan Wachter, and Albert Alex Zevelev, "Do Foreign Buyer Taxes Affect House Prices?" (2024) *Journal of Real Estate Research* 1-27; David Andolfatto and Marie Rekkas, "Estimating the Effect of Metro Vancouver's 2016 Foreign Buyers Tax on City-Level Real Estate Prices," February 28, 2024 (https://dx.doi.org/10.2139/ssrn.4617778); Zaichao Du, Hua Yin, and Lin Zhang, "Foreign Buyer Taxes and House Prices in Canada: A Tale of Two Cities" (March 2022) 55 *Journal of Housing Economics* (https://doi.org/10.1016/j.jhe.2021.101807); and Andrey Pavlov, Tsur Somerville, and Jake Wetzel, "Foreign Buyer Taxes and Housing Affordability" (2023) 52:3 *Real Estate Economics* 928-50.

8 Christian A.L. Hilber and Olivier Schöni, "On the Economic Impacts of Constraining Second Home Investments" (July 2020) 118 *Journal of Urban Economics* (https://doi.org/10.1016/j.jue.2020.103266).

9 Supra note 2.

10 The currently very weak state of condominium pre-sales hints at a relatively modest supply of local capital. Overall residential supply has not declined by as much, likely as a result of significant investment from the Canada Mortgage and Housing Corporation (CMHC) in purpose-built rental apartment finance.

11 Canada Mortgage and Housing Corporation, "Condominium Apartment Market Risks in Toronto and Vancouver," *CMHC*, June 10, 2025 (www.cmhc-schl.gc.ca/observer/2025/condominium-apartment-market-risks-toronto-vancouver).

12 Robert Hogue, "Improving Housing Affordability in Canada Takes a Backseat," *RBC*, March 31, 2025 (www.rbc.com/en/thought-leadership/economics/canadianhousing/housing-affordability/improving-housing-affordability-in-canada-takes-a-backseat).

more affordable for domestic residents, leading to a negative supply response larger than the positive demand response on prices from foreign buying, such that locals have been adversely affected.[13] It is thus worthwhile asking whether there is empirical evidence supporting the idea that foreign buyers, particularly in the presence of empty homes taxes, may have positive welfare effects, and whether banning or taxing foreign buyers may have adverse effects on housing affordability for locals.

There are several channels through which foreign buyers could have positive affordability effects. First, according to Favilukis and Van Nieuwerburgh,[14] foreign buyers may rent houses to locals, particularly in the presence of an empty homes tax. Second, foreign buyers may purchase condominiums in the pre-sale phase of condo development and then assign their contracts prior to building completion. The presence of foreign pre-sale purchasers would raise pre-sale prices, encouraging the supply of condominiums, but without increasing the demand for built homes. Foreign purchaser investment should have a net positive effect on affordability for end users, with an adverse competition effect for locals who wish to occupy homes purchased through the pre-sale channel.

A third way in which foreign buyers could have a beneficial effect on housing affordability for local condo buyers is if foreign buyers have a relative preference for quality, and if there is a high degree of vertical differentiation within buildings. In these circumstances, foreign buyers could make projects more profitable than they would otherwise be, increasing supply but without crowding out local demand. This would be a positive "pecuniary externality." For example, it has been suggested that a non-trivial fraction of condo developer profits come from lavish penthouse units commonly sold to international buyers. If 20 floors of a condominium become profitable only because the 21st floor penthouse is sold to an overseas buyer, local buyers lose when the sale of that unit is banned. By contrast, if foreign buyers compete at the same price for the same units as local buyers, or if their purchases are concentrated in entirely different locations, that cross-subsidy does not arise. Even a relative taste for new construction among foreigners could improve the affordability of older units for locals, consistent with Australia's policy of exempting new construction from foreign buyer taxes and bans.[15]

This article proceeds as follows. After this introduction, I provide background on recent policies aimed at limiting foreign buying in Canada. I then reduce the considerations described above to a single equation governing the direction of the affordability impact of foreign buyers. Next, I review some available evidence on the extent to which the channels alluded to above are operative in the Vancouver

13 See, for example, Kerry Gold, "B.C. Developers Push Back on Foreign Buyer Restrictions," *Globe and Mail*, April 10, 2025 (www.theglobeandmail.com/real-estate/vancouver/article-bc-developers-push-back-on-foreign-buyer-restrictions).

14 Supra note 2.

15 See Australian Taxation Office, "Banning Foreign Purchases of Established Dwellings," May 21, 2025 (www.ato.gov.au/about-ato/new-legislation/in-detail/international/banning-foreign-purchases-of-established-dwellings).

housing market, and perform some back-of-the-envelope calculations of the net effect on housing affordability under different policy regimes. In the final section, I summarize and conclude.

BACKGROUND: TAXATION AND REGULATION OF FOREIGN BUYING AND EMPTY HOMES IN CANADA

In 2016, the province of British Columbia imposed an additional property transfer tax of 15 percent on foreign buyers (that is, those who are not Canadian citizens, permanent residents, or BC provincial nominees) of residential property in Greater Vancouver. The tax was subsequently expanded to other metropolitan areas in the province and its rate was increased to 20 percent. In 2017, a similar tax was imposed on foreign buyers in the Greater Golden Horseshoe area of Ontario.

British Columbia's foreign buyer tax legislation included a provision allowing the city of Vancouver to impose a tax on homes not used as primary residences by the owner or rented to long-term tenants; the tax was brought into effect in 2017. The rate of this tax has moved over time, and currently stands at 3 percent of property value in each year of vacancy.[16] A similar speculation and vacancy tax was added in 2018 on housing in metropolitan areas of the province. The rate of this tax for property owners who are foreign or earn most of their income overseas (currently 2 percent, rising to 3 percent in 2026) is higher than it is for Canadian residents (currently 0.5 percent, rising to 1 percent in 2026).[17] Such taxes have been matched elsewhere, including in multiple jurisdictions in Ontario; and in 2022, the federal government introduced the underused housing tax, at the rate of 1 percent of value, which is assessed only on non-primary residences owned by foreign nationals.

Effective January 1, 2023, the federal government banned foreign nationals from purchasing residential property in Canadian census metropolitan areas (CMAs) or census agglomerations with populations greater than 10,000. The ban, initially set to expire in 2025, has been extended to January 1, 2027.[18]

A SIMPLE FRAMEWORK FOR EVALUATING FOREIGN BUYER EFFECTS ON LOCAL HOUSING AFFORDABILITY

Suppose that foreign buyers have infinitely elastic demand for housing units at a price of p_f, which is assumed in any relevant equilibrium to be greater than the willingness

16 City of Vancouver, "Empty Homes Tax" (https://vancouver.ca/home-property-development/empty-homes-tax.aspx).

17 See Government of British Columbia, "Tax Rates for the Speculation and Vacancy Tax" (https://www2.gov.bc.ca/gov/content/taxes/speculation-vacancy-tax/how-tax-works/tax-rates).

18 See Canada Mortgage and Housing Corporation, "Prohibition on the Purchase of Residential Property by Non-Canadians Act," *CMHC*, March 27, 2023 (www.cmhc-schl.gc.ca/professionals/housing-markets-data-and-research/housing-research/consultations/prohibition-purchase-residential-property-non-canadians-act).

to pay among locals that comes from the demand curve $q_l(p_l)$. The fraction of buyers who are foreign in each building, denoted α, would be 100 percent, but is instead determined by a government policy, here assumed to be exogenously chosen.[19] I ignore the distinctions among the price per unit paid by locals, p_l, the "user cost" per year associated with that price, and market rent. Taxes and political preferences for one form of tenure or the other would affect these costs differently.

If $\alpha > 0$ and $p_f > p_l$, developers charge different prices to foreign and local buyers in the same buildings. This pricing differential could arise through at least two channels. First, foreign buyers might demand higher-quality units—for example, penthouses for which they have a much greater willingness to pay than locals do—but have relatively little interest in lower-floor, standard units. Relative demand for new versus older units would have the same consequence over time.[20] Second, developers might market a fraction of pre-sale units overseas, and the law of one price might not force equality of pricing if foreign buyers are constrained in their ability to participate in ordinary pre-sale or resale markets.[21]

The supply of housing units is given by a function $q_s(\bar{p})$, increasing in price. $\bar{p}$ is the average price at which homes are sold, where $\bar{p} \equiv [1 - \alpha]p_l + \alpha p_f$.

Some fraction of housing units purchased by foreign buyers are rented out to locals, and some pre-sale buyers flip their homes prior to occupancy. Call z the fraction of units purchased by foreign buyers that are unavailable to locals. The magnitude of z might be taken as a measure of how important affordable home ownership is, beyond rental affordability. A large z value could thus indicate that having local consumers rent from foreign owners is seen as undesirable by policy makers, whereas $z = 0$ might indicate that converting owner units to rental units is not undesirable.[22]

Equating supply and demand for local buyers yields the following equation:

$$[1 - \alpha z]q_s([1 - \alpha]p_l + \alpha p_f) = q_l(p_l). \tag{1}$$

Developers will supply more units the higher the average price per unit paid by locals and foreign buyers, weighted by the locals' and foreign buyers' share of all

19 Favilukis and Van Nieuwerburgh, supra note 2, allow foreign demand to be affected by the local price and by a time-varying exogenous factor; α is akin to the latter.

20 Because some buyers are willing to compete for higher-quality units but may be willing to substitute with lower-quality units, there are effects of increasing prices even for very high quality units on the prices of lower-quality units. That complication is addressed in Favilukis and Van Nieuwerburgh, supra note 2.

21 An allegedly common practice; see, for example, Martin MacMahon, "Did Developer Intend To Give Overseas Buyers First Shot at Vancouver Project?" *CityNews Vancouver*, June 6, 2017 (https://vancouver.citynews.ca/2017/06/06/developer-intend-give-overseas-buyers-first-shot-vancouver-project).

22 Indeed, policy makers have implemented a range of policies designed to convert homes from owner-occupied to rental, such as favourable financing from the Crown corporation CMHC for rental housing, and local zoning policies that allow more density for purpose-built rental apartments than for condominium buildings.

units built. Implicit differentiation of equation 1 indicates that the effect on local prices of a small increase in the foreign buyer share is

$$\frac{dp_l}{d\alpha} = -\frac{-zq_s + [1-\alpha z]q'_s[pf - pl]}{[1-\alpha z][1-\alpha]q'_s - q'_l}. \tag{2}$$

The denominator of the right-hand side of equation 2 is positive as long as supply slopes up and local demand slopes down in price. The numerator of the right-hand side of equation 2 is negative, so price falls with an increase in the permitted foreign share, if

$$\text{sign}\left(\frac{dp_l}{d\alpha}\right) = \text{sign}\left(1 - \underbrace{\frac{q'_s p_l}{q_s}}_{\text{Supply elasticity}} \times \underbrace{\frac{p_f - p_l}{\bar{p}}}_{\text{Foreign price premium}} \times \underbrace{\frac{1-\alpha z}{z}}_{\text{Domestic occupancy intensity}}\right). \tag{3}$$

To summarize the analysis, allowing a little more foreign buying will improve housing affordability when

- the supply of homes is highly responsive to prices;
- foreign buyers pay much more than locals for units in the same buildings; and
- most units in new buildings are occupied by locals in a way that the government appreciates—that is, there are few foreigner owners (α is low), or foreign owners commonly flip pre-sale contracts near building completion or rent to locals, and that arrangement is not viewed as objectionable (z is low).

SOME EVIDENCE ON THE DETERMINANTS OF FOREIGN BUYER AFFORDABILITY EFFECTS

We have seen that the affordability effect of foreign buyers depends on three key parameters: the elasticity of supply, the foreign buyer price premium, and the intensity of domestic occupancy of homes. I now review available evidence on these parameters to determine whether there are realistic circumstances under which foreign buyers do improve local affordability.

How Elastic Is Supply in Foreign-Buyer-Heavy Markets?

Foreign buyers can improve affordability through their effective subsidy of new supply. That effect will be stronger in markets in which supply is responsive to prices. Paixão provides a list of Canadian CMAs by housing supply elasticity (estimated from one-year differences in prices and quantities), and figure 1 plots that elasticity against non-resident ownership.[23] The non-resident ownership data are for the year 2018

23 Nuno Paixão, *Canadian Housing Supply Elasticities*, Staff Analytical Note 2021-21 (Ottawa: Bank of Canada, 2021). As in Paixão, two outliers with extremely high supply elasticities are omitted from figure 1.

and come from the Canadian Housing Statistics Program (CHSP) table.[24] The CHSP measure of the fraction of property owners who do not reside in Canada is an imperfect approximation of buyers who would be deemed foreign for tax purposes.

The absolutely and relatively modest supply elasticities in markets like Toronto and Vancouver, where foreign buying is concentrated, suggest that foreign ownership may have adverse affordability consequences if it is not paired with limits on empty homes (moving z toward zero in the context of equation 3). This may reflect foreign buyers' concentration in large markets. It is worth remarking, though, that non-resident ownership was modest in all large Canadian CMAs as of 2018, with such ownership in Vancouver being by far the highest, at 6.3 percent.

Do Foreign Buyers Pay More for Units in the Same Building?

Equation 3 suggests that foreign buyers can have a positive supply effect when the units in which they stimulate supply are largely occupied by locals (where αz is close to zero). If foreign buyers pay higher prices than locals primarily because they occupy different buildings from locals, it is not easy to see a positive supply effect for locals, since these buildings will strain local contractors, increasing construction costs.

Foreign buyers might pay more than locals for units in the same building, either by being charged different prices for the same units or by purchasing luxurious or newer (and pre-sale) units within buildings. We cannot observe whether the law of one price is violated—for example, through differential pre-sale pricing overseas.

The question of whether foreign buyers purchase higher-quality units within buildings than local buyers can be answered somewhat with available data, at least for the resale market, if not for the critical pre-sale market. Figure 2 uses data taken from condominium resales in Greater Vancouver between 2010 and 2023, provided by BC Assessment. The year of transaction is measured on the horizontal axis, and the variance of the natural logarithm of transaction prices by year is measured on the vertical axis. The black line plots the variance of all transaction prices. The grey line plots the variance of mean prices across buildings.[25] The dashed black line plots the mean variance of log transaction prices within buildings.

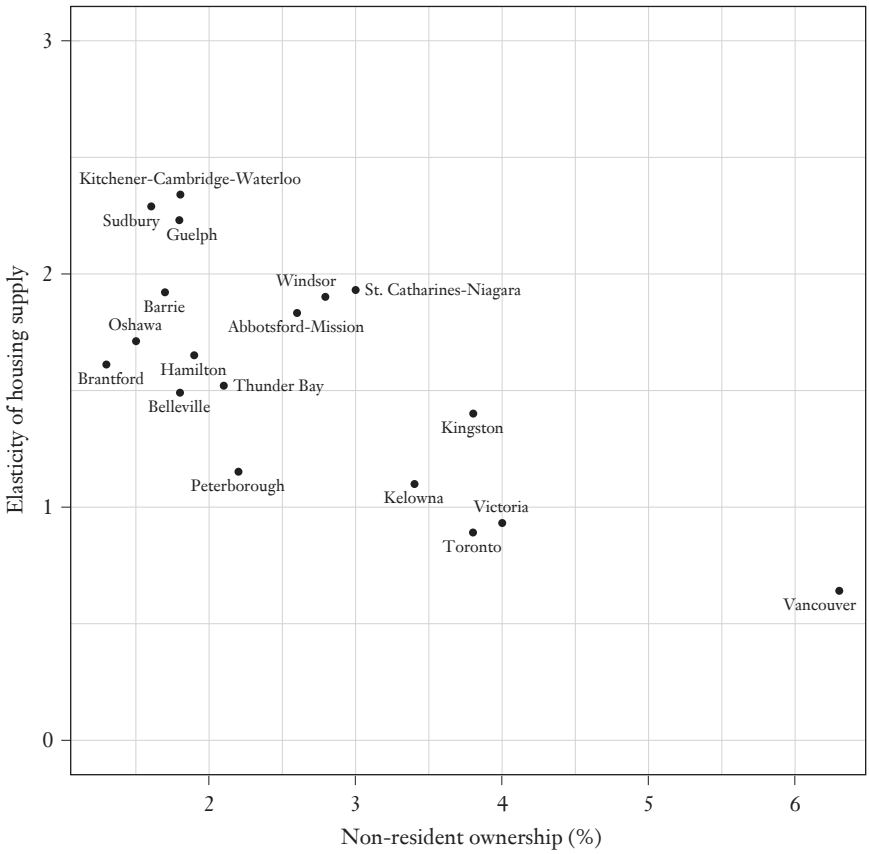
The dashed vertical line in figure 2 marks the implementation of British Columbia's foreign buyer tax in July 2016. Consistent with foreign buyers demanding more expensive units (as non-resident buyers do in the CHSP data),[26] the overall variance of prices drops sharply in the years following implementation of the tax, consistent

24 Statistics Canada table 46-10-0027-01, "Residency Participation of Residential Properties, by Property Type and Period of Construction," July 30, 2025.

25 If there were only one transaction for each building with a transaction in a given year, the solid black and grey lines would coincide.

26 See also Guy Gellatly and René Morissette, *Non-Resident Ownership of Residential Properties in Toronto and Vancouver: Initial Information from the Canadian Housing Statistics Program*, catalogue no. 11-626-X—No. 078 (Ottawa: Statistics Canada, 2017).

FIGURE 1 Non-Resident Ownership and Housing Supply Elasticity in Canadian CMAs



CMA = census metropolitan area.

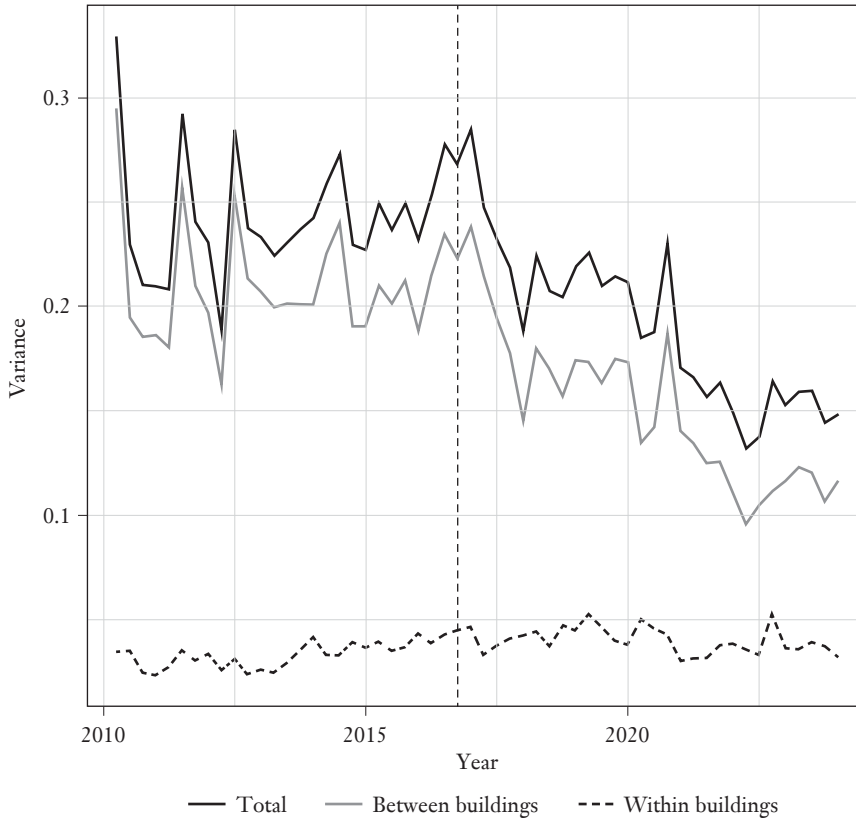
Note: The charted values of elasticities were merged on CMA names by ChatGPT.

Sources: Nuno Paixão, *Canadian Housing Supply Elasticities*, Staff Analytical Note 2021-21 (Ottawa: Bank of Canada, 2021); and Statistics Canada table 46-10-0027-01, "Residency Participation of Residential Properties, by Property Type and Period of Construction," July 30, 2025, for 2018 estimates.

with the loss of an important luxury segment of the market. However, the reduction in price variance appears to be almost entirely driven by a reduction in price variance across buildings, rather than within buildings. This suggests that foreign buyers did not play a large role in within-building price variance.

Figure 3 restricts the analysis in figure 2 to transactions in buildings less than five years old, since foreign buyers may have been concentrated in new buildings (as non-resident buyers are in the CHSP data), and new building prices may be more salient

FIGURE 2 Variance Decomposition of Log Resale Transaction Prices, Greater Vancouver, 2010-2023



Note: The dashed vertical line marks the implementation of British Columbia's foreign buyer tax in July 2016.

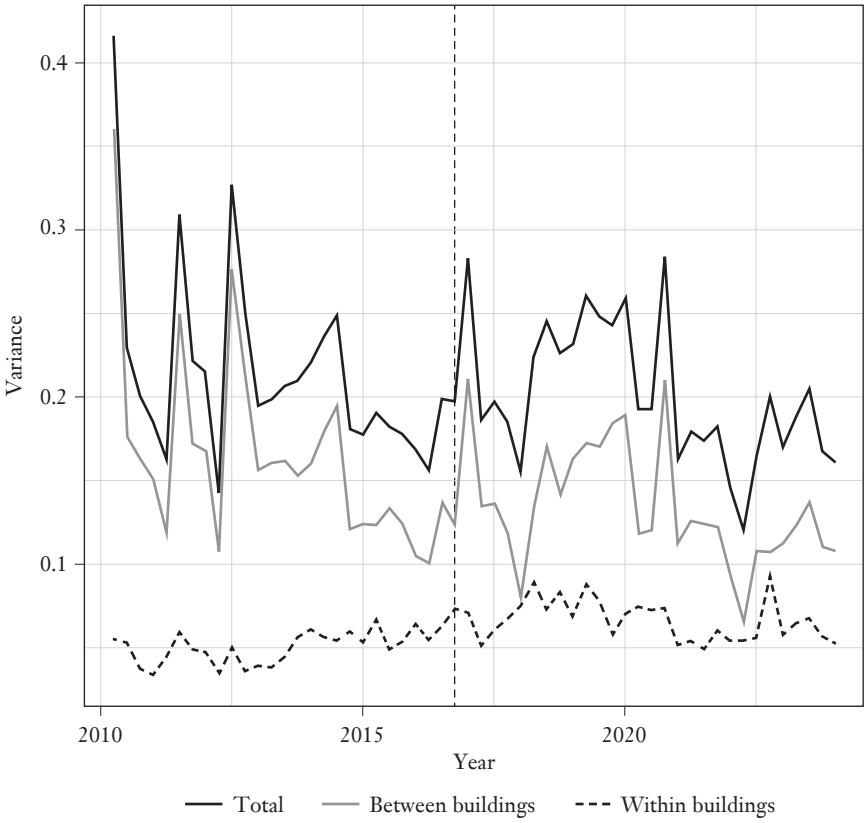
Source: Transaction data provided by BC Assessment.

to the pre-sale pricing that presumably drives developer supply choices. Again, there is little support for the notion that removing foreign buyers reduced within-building price variation.[27]

Another indicator of within-building versus between-building price variation comes from CHSP data comparing assessed values of properties owned by resident versus non-resident owners. For years starting with 2018, the CHSP has used its

27 In both figures, there is evidence of rising within-building price variation during the period prior to 2016 when foreign buying was likely growing, but no clear pivot around the time of implementation of the foreign buyer tax.

FIGURE 3 Variance Decomposition of Log Transaction Prices, New Buildings Only, Greater Vancouver, 2010-2023



Notes: The dashed vertical line marks the implementation of British Columbia's foreign buyer tax in July 2016. This figure shows the same variance decomposition of log transaction prices as figure 2, but only resale transactions for units in buildings less than five years old at the time of sale.

Source: Transaction data provided by BC Assessment.

access to ownership data on Canadian residences and their owners to publish statistics on ownership by residency status in Canada. Unfortunately, the stock measure is not readily available prior to 2018, including years prior to the implementation of British Columbia's foreign buyer tax. Between 2018 and 2022, the number of non-resident owners in the Vancouver CMA grew from 24,135 to 26,350, but fell as a share of all owners from 9.6 percent to 9.0 percent.

Although we cannot observe building-level data, we can ask what fraction of price differences in the value of units owned by non-residents versus residents is explained by variation across versus within municipalities, and by non-residents' propensity to

own newer homes. Overall, among condominiums in the Vancouver CMA, non-residents' homes in 2018 had a mean value of $790,000 versus $630,000 for the homes of residents of Canada, a difference of more than 25 percent.

However, in a regression of log mean value by period of construction and municipality on dummies for municipality, hence conditioning on broad location, the coefficient on non-resident owner versus resident owner is just 0.064, so the large majority of value is explained by location. Adding dummies for ranges of years in which buildings were completed reduces the estimated log difference between residents and non-residents to just 0.017. Thus, within buildings of the same age in the same general location, non-residents own units that are roughly identical in value to those owned by residents, leaving little scope for extra payment for fancier units (differences in price paid in pre-construction would not show up in these assessed values).

The fact that non-residents own newer units than residents might be seen as a form of differentiation in quality within buildings. That is, if residents are less willing than non-residents to pay for new units, non-residents may stimulate supply by paying more for new units that drive supply, leaving older units for resident buyers over time.[28]

It is important to note that CHSP statistics are an approximation (possibly biased) of foreign ownership, because some owners who live overseas are Canadian citizens or permanent residents, and hence exempt from foreign buyer taxes. In addition, some Canadian residents are not yet landed immigrants, and hence are subject to the foreign buyer tax.

Stock and Flow of Foreign Purchases in Greater Vancouver

When the share of foreign buyers, α, is small, so that most homes are purchased (and occupied) by locals, any inducement to build by foreign buyers paying premium prices (possibly for premium apartments in less demand among locals) is likely to be positive for local affordability.

The apparent decline in the stock of foreign ownership as a share of all residences (as proxied by residency) is matched by a declining share of the flow into ownership. The BC provincial government started collecting data on the nationality of residential property buyers shortly before implementing the additional property transfer tax of 15 percent on foreign buyers in mid-2016. In the month prior to implementation of the tax (July 2016), 15 percent of purchases in Metro Vancouver involved foreign participation. In the years since, the shares have been as shown in table 1. The COVID-19 pandemic and attendant social and economic impacts and the national foreign buyer ban have likely contributed to the decline over time in foreign participation.

28 A caveat is that some of the difference in age of property owned may be attributable to non-resident purchases growing over time. If the order of controls is reversed, in a regression of log mean value on just the period of construction dummies, the coefficient on non-resident ownership is −0.065, so the difference in building age explains as much of the value difference as municipality does, and is unlikely to be mostly explained by differential dates of purchase.

TABLE 1 Share of Residential Transactions in Metro Vancouver with Foreign Participation

Year	Share of transactions with foreign participation
	percent
2017	3.7
2018	2.9
2019	2.0
2020	1.4
2021	1.1
2022	1.3
2023	0.9
2024	0.9

Source: Government of British Columbia, "Data Catalogue" (https://catalogue.data.gov.bc.ca).

Are Foreign Buyers' Homes Left Empty?

The variable z in equation 3 represents the fraction of foreign-owned homes that are not occupied by locals, either because they are used as secondary residences by foreign buyers, or because the government assigns less weight to housing for not-yet-landed immigrants. When this fraction is larger, foreign buying is less helpful to affordability. It is difficult to know what fraction of the housing stock represents primary residences for not-yet-landed immigrants, but the fraction of homes that are left empty for most of the year is measured by nationality status by the BC Ministry of Finance as part of its administration of the province's speculation and vacancy tax.

Owners of homes that are not primary residences are subject to extra taxes in certain jurisdictions in Ontario and British Columbia, and foreign owners of Canadian homes that are left vacant for more than half a year are subject to the federal underused housing tax. In Vancouver, there is a third empty homes tax, levied by the city. If these taxes are high enough, units will be rented or sold to locals (such that z is close to zero), or the tax revenue should be sufficient to leave locals better off than they would be if the unit were owned by a local resident. However, if empty homes taxes are set at too low a level, foreign owners may leave homes empty, and the tax revenue may not be sufficient to compensate locals for the loss of housing stock.

In the presence of the BC empty homes tax regime, foreign non-resident owners who retain their properties most commonly rent them out to locals. According to the BC Ministry of Finance's 2019 review of the speculation and vacancy tax,[29] of the 3,709 foreign owners who were deemed to be subject to the empty homes tax in 2018, a large majority no longer held empty homes a year later. In 2019, 1,205 of these foreign owners subject to the speculation and vacancy tax transitioned to renting

29 British Columbia, Ministry of Finance, "Speculation and Vacancy Tax Annual Mayors' Consultation—Technical Briefing, 2019 Tax Year," December 2019.

their homes, 1,413 sold their property, 951 remained subject to the tax, and 66 transitioned to using the home as a primary residence. Perhaps through "burnout," a little more than half of the 1,308 foreign owners who were deemed to be subject to the tax in 2020 remained subject to the tax in 2021.[30] Overall, for the 2021 taxation year, roughly 5.5 percent of declared foreign owners' homes were deemed empty. Of the remaining 94.5 percent, it is not clear what fraction corresponded to the non-local measure z: it is a political question whether a non-permanent resident living in a home regularly should be deemed to be part of the local demand curve.

Back-of-the-Envelope Calculations of Foreign Buyer Effects on Affordability

With a rough idea of plausible magnitudes of key parameters in equation 3 in hand, we can perform back-of-the-envelope calculations to suggest the net effect of foreign buying on housing affordability for locals in the Greater Vancouver context. As described above, the magnitude of the product of three terms being greater than or less than 1 determines whether a small increase in foreign buying improves or worsens local affordability, per equation 3.

For Greater Vancouver, at Paixão's estimate of a supply elasticity of 0.65,[31] the product of the terms representing the premium paid by foreign buyers and domestic occupancy intensity in equation 3 would have to be roughly 1.5 or greater to yield a positive effect of foreign buyers on local prices. We do not know either of the components of that product, but there is evidence that the foreign buyer premium within buildings is not large on account of purchases of different units. Also, foreign buyers represented roughly 15 percent of the market over a sampled period prior to implementation of British Columbia's foreign buyer tax. At a 10 percent foreign buyer premium and $1 - \alpha = 0.85$, the local occupancy of foreign-owned units z would have had to satisfy the following:

$$\underbrace{0.65}_{\text{Vancouver supply elasticity}} \times \underbrace{0.1}_{\text{Modest foreign price premium}} \times \underbrace{\frac{1 - 0.15z}{z}}_{\text{Domestic occupancy}} \geq 1 \tag{4}$$

$$z \leq \frac{0.65 \times 0.1}{1 + 0.65 \times 0.1} \approx 0.06 \tag{5}$$

Notably, even with the speculation and vacancy taxes in British Columbia, in 2021 roughly 5.5 percent of foreign-owned homes were deemed empty. This suggests, consistent with equation 5, roughly zero local affordability effect of foreign buying at the pre-foreign buyer tax levels of investment, and a modestly positive effect with almost no foreign buying. This suggests that either a foreign buyer tax or a vacancy tax, but not both, is required to avoid adverse foreign buying impacts on local affordability. Prior to implementation of the empty homes and speculation and vacancy

30 Ibid.

31 Supra note 23.

taxes, foreign buying likely generated adverse effects on locals that a tax or a ban on ownership would have mitigated.

CONCLUSION

A simple model of foreign purchases in Canadian housing markets reinforces natural intuitions that foreign buyers can act to stimulate supply, and thus enhance affordability for locals, when the foreign buyers are a small part of the market, when they pay much more than local residents would for homes in the same buildings, when housing supply is elastic with respect to price, and when a large fraction of foreign-purchased homes are rented to locals or sold soon after building construction is completed. In this framework, pre-construction purchases by foreign (or domestic) buyers, followed by assignment to local buyers prior to building completion, should have purely positive affordability effects, so "flipping" taxes such as British Columbia's should presumably exempt pre-sales.

Foreign buyers in Canada are concentrated in housing markets with relatively low supply elasticities, and most of the variation in the value of condominiums owned by non-residents is explained by location and building age, not by differences in unit quality. These facts suggest that, in the absence of empty homes taxes, foreign buyers are unlikely to provide significant affordability benefits to locals through a net supply channel, unless they face significant price discrimination in the pre-construction market. However, in the presence of empty homes taxes, a large majority of foreign owners appear to either use homes year round, rent them to locals, or sell them. Empty homes taxes thus seem likely sufficient to avoid the adverse affordability effects of foreign ownership, and in their presence it is not out of the question that the imposition of further taxes or restrictions on foreign buying may harm affordability.

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International Tax Planning

Co-Editors: Ken Buttenham and Ian Bradley*

THE IMPACT OF CHANGES IN THE CANADIAN TAX LANDSCAPE ON CAPITAL INVESTMENTS IN CANADA

*Kaitlin Rogers and Catherine Kornek***

ABSTRACT

Recent changes in the Canadian tax landscape may have a negative impact on foreign investment in Canada. This article provides an overview of the key tax considerations relevant for foreign corporations making capital investments in Canada. Overall, the authors believe that recent tax changes create additional regulatory barriers that may deter future capital investments in Canada, which are already on the decline.

KEYWORDS: CCA ■ GLOBAL MINIMUM TAX ■ INTEREST DEDUCTIBILITY ■ INCENTIVES ■ TAX ACCOUNTING ■ PARTNERSHIPS

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Personal Tax Planning

Co-Editors: Chris Watt Bickley,* Sonia Gandhi,** Dino Infanti,*** and Bessy Triantafyllos****

CROSS-BORDER ISSUES AND PLANNING POINTS—FOREIGN TRUSTS AND CORPORATIONS

*George Gonzalez and Patrick McCormick*****

Canadians with a property ownership structure that includes non-US trusts and/or corporations who intend to become US tax residents may be subject to various income tax and information reporting requirements imposed on foreign trusts and corporations under US tax law. This article discusses several key issues to be considered prior to relocation, and suggests potential planning points to address the pertinent issues.

KEYWORDS: CFC ■ CROSS-BORDER ■ INTERNATIONAL TAXATION ■ PFIC ■ GILTI ■ SUBPART F

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Planification fiscale personnelle

Corédacteurs de chronique : Chris Watt Bickley*, Sonia Gandhi**, Dino Infanti*** et Bessy Triantafyllos****

ENJEUX ET POINTS DE PLANIFICATION TRANSFRONTALIERS — FIDUCIES ET SOCIÉTÉS ÉTRANGÈRES

*George Gonzalez et Patrick McCormick*****

Les Canadiens dont la structure de propriété comprend des fiducies et/ou des sociétés non américaines et qui ont l'intention de devenir résidents fiscaux américains peuvent être assujettis à diverses obligations en matière d'impôt sur le revenu et de déclaration de renseignements imposées aux fiducies et aux sociétés étrangères en vertu du droit fiscal américain. Cet article traite de plusieurs questions clés à prendre en considération avant un déménagement et suggère d'éventuels points de planification pour aborder les enjeux pertinents.

MOTS CLÉS : SEC ■ TRANSFRONTALIER ■ IMPOSITION INTERNATIONALE ■ SPEP ■ GILTI ■ SOUS-PARTIE F

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Corporate Tax Planning

Co-Editors: Miguel Boissonneault,* Mark Brender,**
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ALLOCATION OF SAFE INCOME TO STOCK DIVIDEND SHARES ISSUED TO AN INDIVIDUAL

*Ken Hauser*****

Intercorporate dividends arising on the redemption of preferred shares are a frequent aspect of transactions that are undertaken to purify an operating company of its non-active assets. This article discusses three methods of allocating the operating company's safe income to the accrued capital gain on stock dividend shares originally issued to an individual that are transferred to a holding company prior to their redemption. The author discusses the absence of legislative guidance, limited jurisprudence, and uncertain administrative guidance of each allocation method, and how this lack of clarity may affect the allocation methods chosen by the recipient corporate taxpayer as well as the associated risks of reassessment.

KEYWORDS: CAPITAL DIVIDEND ACCOUNT ■ CORPORATE REORGANIZATIONS ■ HOLDING COMPANIES ■ PREFERRED SHARES ■ REASONABLE ■ REDEMPTION

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Current Tax Reading

Co-Editors: David G. Duff, Jinyan Li, Alan Macnaughton, and Michael Veall*

Marion Brivot, Suzanne Paquette, and Zachary Huxley, "Navigating the Spectrum of Aggressiveness: Social Dynamics and Anxieties in Tax Planning" (2025) 114:4 *Accounting, Organizations and Society* 1-16 (https://doi.org/10.1016/j.aos.2025.101589)

In this study, the authors report their findings from semi-structured interviews with 33 experienced Canadian tax professionals (mostly CPAs) regarding how they understand aggressiveness in tax planning and where they situate themselves on the aggressiveness spectrum.

Initially, the study's aim was to explore the ethical reasoning processes of tax practitioners. However, as the interviews progressed, it became apparent that the dominant themes were not traditional ethical considerations (such as moral principles, values, or codes of conduct). Instead, the discussions centred on the concept of tax-planning aggressiveness and the emotions of discomfort and anxiety that tax professionals experience when making decisions about such aggressiveness. The authors, drawing on the work of philosopher Charlie Kurth, mined the interviews for information on how anxiety affected practitioners' decision making in tax-planning matters.

Two types of anxiety were found to be most prominent: punishment anxiety, which stems from the fear of being punished; and practical anxiety, which relates to the fear of overlooking key information relevant to a decision. In the context of tax planning, punishment anxiety relates to the potentially negative consequences for themselves, their firms, and their clients if their tax planning is challenged by the CRA—an outcome that is problematic in itself and, in extreme cases, one that could result in a publicly disclosed tax dispute leading to public criticism, censure, and reputational loss. Practical anxiety, by contrast, is the unease associated with the possibility of not "getting it right," not only technically but morally.[1]

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1 At 8 and 11.

Practical anxiety has two dimensions: technical correctness and ethical acceptability. Concerns about whether a particular tax-planning option is technically correct may cause some options to be excluded from consideration. Conversely, moral considerations may expand the range of planning options considered. This occurs because the moral dimension of tax planning is seen through a client-service lens: aggressiveness ensures that taxpayers' rights are upheld and that they pay no more tax than the law requires. To quote the article: "If [tax professionals] assess a client's position as aggressive yet justifiable, practical anxiety propels them to diligently gather pertinent information to fortify the client's stance."[2]

The overall conclusion of the study is that decisions about aggressiveness in tax planning are shaped not just by rational assessments of risk but also by emotions. To the authors' knowledge, this is the first study to document the socio-affective dimension of aggressiveness in tax planning.

A.M.

Tisha King, "First Things First: Using Anchoring Bias To Examine the Effect of Penalty Severity and Social Norms on Tax Compliance" (2025) 197:4 *Journal of Business Ethics* 785-809

Could publicizing information about the tax gap—the amount of taxes owed but not collected—hurt tax compliance? In other words, might individuals note the large size of the tax gap, conclude that "tax evasion is everywhere," and then use this as a justification to evade taxes themselves? That is a key question examined in this research. Although the findings are not definitive, there is reason for concern.

In study 1, which was a survey of 331 Canadian taxpayers, respondents were presented with a situation where a self-employed business owner was found guilty of evading $10,500 in taxes, which had to be repaid. The question concerned the appropriate additional penalty. Respondents were asked to rate various penalties, ranging from a $100 fine to a $21,000 fine and a 48-month jail term, on an 11-point scale ranging from "too lenient" to "too harsh." The penalty rated at the midpoint of this scale was a penalty of $10,500, equal to 100 percent of the tax evaded. This suggests that respondents viewed this penalty as appropriate for the offence.

Study 2 was an experiment involving 300 Canadian participants. They were presented with a situation where a self-employed business owner, Finley, is aware of a COVID-19 relief program but does not qualify because Finley's income is too high. Participants were then given information about a recent tax evasion case paralleling the one in study 1 in which the penalty (based on a random assignment to participants) was either the 100 percent penalty or a $200 fine. These penalties had been determined, on the basis of the study 1 results, to be (in the terms used by the article) an "appropriate penalty" and a "lenient penalty," respectively.

Also through a random assignment, some participants were told the following: "Recently, Finley learned in the news that the amount of personal income taxes that

2 At 11.

should be collected by the Canada Revenue Agency (CRA), and are never reported or collected, is $8.7 billion."[3]

Participants were then asked, on an 11-point scale from "strongly disagree" to "strongly agree," the extent to which they agreed that Finley would submit a claim for the COVID-19 benefit.

This experiment produced two key findings: (1) compliance will be higher under the appropriate penalty than under the lenient penalty; and (2) this effect persists even when participants are given information about the tax gap.

Thus, this study offers two insights for the CRA: first, penalties that are perceived as appropriate rather than overly lenient can improve tax compliance; and, second, information about the size of the tax gap does not appear (at least at first glance) to have any negative effect on compliance.

A nuance in the research design suggests an important caution regarding the tax-gap finding: when information about the tax gap was presented to participants *before* the information about the penalty for tax evasion, the positive effect of an appropriate penalty on tax compliance was weakened. The explanation for this outcome is the principle that information presented first is more salient. In other words, information that is "buried" rather than highlighted will be given comparatively little attention. In social science literature, this is called "anchoring bias."

The real-world implication of this information-ordering effect seems to be that some individuals may focus on tax-gap information whose main insight is that the government fails to catch tax evaders—concluding, on that basis, that tax evasion is a low-risk activity. One possible CRA response would be to reduce the salience of tax-gap information—for example, by not releasing such information close to tax-filing deadlines.

A.M.

Louis Lévesque, *Not All Quiet on the Equalization Front in Canada* (Regina: Johnson Shoyama Graduate School of Public Policy, 2024) (www.schoolofpublicpolicy.sk.ca/documents/research/policy-briefs/equalisation-policy-paper_final.pdf)

In June 2024, Newfoundland and Labrador filed, in its provincial supreme court, a constitutional challenge to key provisions of the current equalization system run by the federal government. This challenge will likely end up in the Supreme Court of Canada, eventually. This legal process could prompt the federal government to undertake a comprehensive review of equalization.

This paper addresses the key elements of this constitutional challenge from an economic perspective. The main finding is that conflicting economic interests—particularly when it comes to the treatment of national resource revenues—make it nearly impossible for provinces to reach common ground on these issues. Thus, the newly elected federal government may choose to leave the program as it is.

3 At 795.

One possible outcome is that the government's broad desire for expenditure restraint will lead to the removal of the floor provision, which, as the paper shows, has added $1 billion to the cost of the program in 2024-25.[4] The paper concludes that there is no policy basis for this provision: "The rationale enunciated in the 2009 budget to protect against sudden reductions in payments has little merit since that the program operates on a three-year moving average which already smooths out fluctuations."[5] Provinces that do not receive equalization criticize the floor payments as excessive generosity. Ontario would be the biggest loser if floor payments were abolished: the article shows that more than one-half of the $1 billion in floor payments goes to Ontario.[6]

The article identifies an issue that will eventually need to be addressed—namely, how fiscal capacity is measured, particularly as it relates to hydro-electricity revenues. Generally speaking, the lower a province's measured fiscal capacity, the higher its equalization revenues will be. Fiscal capacity for non-resource revenues is measured by applying a common set of tax rates to all provinces (the "representative tax system"), ensuring that a province's choice not to levy a particular tax does not result in inequitable treatment. For resource revenues, by contrast, the actual revenues raised are used for this measurement. This difference is important for hydroelectric revenues.

The issue is that Quebec charges the lowest electricity rates in Canada, and it has by far the largest hydroelectricity resources. The paper notes that higher prices would encourage more efficient use of this resource, but it would also reduce equalization: "In the current program, an increase in [Hydro-Québec's] profits of $100M results in a decrease in equalization payments received by Quebec of about $70M, a 70% recovery."[7] Thus, the current treatment of hydroelectric revenues may encourage hydro-producing provinces to maintain inefficiently low electricity prices. Given the substantial equalization payments going to Quebec, this is a sensitive issue for other provinces.

The paper also notes that the ideal measure of fiscal capacity for all natural resource revenues (including hydroelectricity) would be the economic rent that could potentially be obtained from these resources, net of the associated development costs. In practice, however, applying this concept may be impossible.

A.M.

4 At 12, table 2.

5 At 10.

6 At 12, table 2, shows that $576 million of the total floor-payment cost of $1.057 billion goes to Ontario in 2024-25. Another $331 million goes to Quebec, and Manitoba is a distant third at $54 million.

7 At 8.

Matthew Lesch and Jim McCambridge, "The Alcohol Industry, the Tobacco Industry, and Excise Taxes in the US 1986-89: New Insights from the Tobacco Documents" (2022) 22:946 *BMC Public Health* 1-12

The political dimensions of tax policy formulation are often ignored or treated as unimportant. For example, proposals to require mandatory consultation on tax changes before budget announcements may fail to account for the opening this creates for those who stand to be negatively affected by the possible tax changes—enabling them to mobilize opposition and perhaps prevent the proposal from ever making it into a budget.[8]

This neglect of the political dimension is partly owing to the fact that information about political factors is typically obtained through interviews with policy actors.[9] However, court settlements can also yield detailed disclosures that facilitate political analysis, as in the case of the data used in this study. In particular, this study employs the tobacco documents archive, which is described as "an archive of 14 million documents created by tobacco companies about their advertising, manufacturing, marketing, scientific research and political activities, hosted by the [University of California, San Francisco] Library."[10] The goal was to examine the role of tobacco and other industries in shaping US excise tax policy debates at the federal and state levels in the late 1980s. Given the volume of documents involved, the researchers could not read every document; instead, keyword searches were employed to isolate the relevant documents.

The study mainly examines the operation of the Coalition Against Regressive Taxation (CART), which was formed in March 1986 by business groups concerned about possible tax increases, with the tobacco industry as the pre-eminent member. Much of the study focuses on how CART managed to stay together despite internal conflicts arising from the divergent economic interests of its founding groups.

The case study examined in most detail is CART's successful campaign against proposition 5 in Oregon, which would have increased the tax on malt beverages (including beer) and cigarettes. A key part of the strategy was the decision to keep the tobacco industry—although it was active in funding CART—on the sidelines in the public debate. As one document noted, "We must recognize the prevailing anti-smoking sentiment and the possibility that audiences might automatically 'tune-out' messages which represent smokers."[11] Furthermore, because the beer industry itself

8 For such a proposal, see Brian Arnold, "What a Way To Run a Country," *The Arnold Report*, posting no. 300, February 25, 2025.

9 For example, see Matthew Lesch, "Playing with Fiscal Fire: The Politics of Consumption Tax Reform" (PhD dissertation, University of Toronto, Department of Political Science, 2018), reviewed in this feature, (2023) 71:3 *Canadian Tax Journal* 935-39.

10 Truth Tobacco Industry Documents (www.industrydocuments.ucsf.edu/tobacco), see the home page.

11 At 5.

fell "very low on the trust spectrum," CART consultants considered it important to build connections with groups outside the two industries, particularly organized labour and general anti-sales-tax groups.[12]

This information regarding the public's trust in different groups was obtained through public opinion surveys, which were also used to design the advertising campaigns against the tax change. In particular, because proposition 5 included a specific proposal to spend the increased tax revenue on intercollegiate athletic programs, the advertising focused on a soft spot in public support of the program—the view that other policy priorities were more important. This focus on public opinion research is a particularly interesting part of the article, given that the public rarely learns about how industry groups conduct this private research and use it to design campaigns to influence tax policy.

A.M.

Matthew Lesch and Heather Millar, "Crisis, Uncertainty and Urgency: Processes of Learning and Emulation in Tax Policy Making" (2022) 45:4 *West European Politics* 930-52 (www.tandfonline.com/doi/pdf/10.1080/01402382.2021.1949681)

The economic downturn from 2007 to 2009, commonly called the "great recession," led directly to the attempts in Ontario and British Columbia, in the late 2000s, to abolish their provincial sales taxes and replace them with an add-on component to the goods and services tax (GST), creating a combined tax called the harmonized sales tax (HST). Ontario moved first, successfully implementing the change, while British Columbia—slower to come forward with its proposal—was ultimately unsuccessful. Past research by one of this article's authors (Lesch) examined these efforts at GST harmonization, largely through personal interviews with the key policy actors.[13] This article reviews the information reported in that past research, using an analytical framework for understanding how governments respond to crises,[14] and it proposes two pathways for moving from crisis to policy change.

The first pathway posited by the article ("policy learning") suggests that under conditions of high uncertainty about the causes of policy problems, policy makers may re-examine their policy beliefs and update their policy preferences accordingly. Uncertainty thus supports learning, leading to policies previously considered

12 At 6.

13 Reviewed in this feature (2023) 71:3 *Canadian Tax Journal* 929-47, at 935. Unfortunately, this research (and, hence, the current paper) did not cover Prince Edward Island, which adopted the HST effective April 1, 2013. An account of why PEI adopted the HST remains to be written.

14 Perhaps we are at just such a crisis again today. A recent article suggests that the current tariff controversy emerging from the United States could inspire the three remaining provinces with provincial sales taxes (British Columbia, Saskatchewan, and Manitoba) to opt for harmonization with the GST. See Giorgina Chum, "PST: An Interprovincial Trade Barrier" (2025) 15:2 *Canadian Tax Focus* 4-5.

unworkable. Just as the health crisis of COVID-19 led to the new policy option of encouraging or mandating mask-wearing, economic crises can lead to major turning points in tax policy—in this case, the entire replacement of one tax with another. With the second pathway identified in the article ("bounded emulation"), the crisis leads policy makers to consider available and familiar options, such as measures already taken by other jurisdictions.

The paper proposes that if a crisis generates high problem uncertainty and moderate urgency, policy learning is the more likely pathway. High uncertainty causes policy makers to devote significant resources to consulting experts, including those outside government, while the moderate time frame (months or years rather than days or weeks) allows them to do so. In contrast, when a crisis involves moderate problem uncertainty and high urgency, bounded emulation is more likely.

The paper then applies this framework to the problem of GST harmonization. In Ontario, the great recession was viewed as an almost existential threat to the province's economy. As an Ontario finance minister recalled:

> The world's economy was going to hell in a hand-basket. Ontario was one of the places where the Great Recession was going to have a huge impact. Not just on [its] financial institutions . . . but the auto sector and manufacturing sector were heading for disaster.[15]

This created a situation of high problem uncertainty ("what should be done?"), but with sufficient time to solve the problem. As Lesch's previous research documented, advice from experts inside and outside the government led the Ontario premier at the time to reconsider the importance of GST harmonization. This was an instance of policy learning.

In contrast, the situation in British Columbia was perceived by the premier and his advisers as short-term: the economy was expected to rebound. But there was a short-term policy problem—the prospect of a $1.3 billion government deficit. Conveniently, the federal government had offered British Columbia a subsidy of $1.6 billion if it followed Ontario and harmonized with the GST. Because this amount would solve the short-term deficit problem, the BC government moved quickly, announcing GST harmonization largely without input from experts and without support for the change mobilized within the business community. Thus, a situation featuring moderate problem uncertainty but high urgency led to the strategy of bounded emulation, which was to follow Ontario's lead and harmonize with the GST.

A.M.

George R. Zodrow, *Advanced Introduction to Taxation* (Cheltenham, UK: Edward Elgar, 2025)

This volume is one of a series of books intended to be introductions to major fields in the social sciences, business, and law. The intended readership is undergraduate

15 At 939.

and graduate students of economics encountering the field of taxation for the first time, as well as scholars and policy makers. However, this is not a typical economics textbook: there is almost no mathematics, and the theoretical points are made verbally, without the aid of graphs. Nonetheless, the book offers plenty of rigorous analysis. The following sentence, for example, appears within the opening pages of the book's first chapter: "For an excise tax imposed in a single market, the excess burden of the tax is determined by the triangular area bounded by the pre-tax supply curve and the compensated demand curve between the pre-tax and post-tax market-clearing demands."[16] As such language suggests, the book is probably most useful for readers with an extensive economics background who are looking for a short overview of taxation economics, perhaps as a refresher of material studied years ago. Copious footnotes and an extensive bibliography add to the book's value for such readers

The book is quite short—just 185 pages, plus a bibliography—but it manages to provide overviews of many current policy issues. For example, it devotes three pages to the elasticity of taxable income (ETI),[17] three pages to marginal effective tax rate analysis,[18] two pages to the taxation of digital services,[19] and four pages to carried interest.[20] Each of these short sections provides references to key papers. Few people are likely to read the book from start to finish, but many will gain significant insight into current debates by reading individual chapters or examining these short overviews.

A.M.

Xavier Dufour-Simard, Pierre-Carl Michaud, and Michael Smart, *Is the Elasticity of Taxable Income Mostly an Income Effect?* Working Paper no. 4 (Montreal: Jacques-Parizeau Research Chair in Economic Policy, March 2025)

An important measure of how individual taxpayers respond to tax changes is the ETI.[21] Previous literature, with few exceptions, has estimated the ETI while assuming that the income effect of tax changes is zero. However, this approach leaves out an important element of the possible behavioural response. Consider two reforms that produce the same change in the top marginal tax rate but apply at different income thresholds: one begins at a low threshold and the other begins at a high threshold. Both reforms induce the same substitution effect on reported taxable incomes, but they have different effects on total tax liability. Thus, tax rate reforms with different

16 At 7.

17 At 34-36.

18 At 83-85.

19 At 102-3.

20 At 131-34.

21 See Louis Perrault, *Costing Personal Income Tax Changes: The Role of the Elasticity of Taxable Income* (Ottawa: Office of the Parliamentary Budget Officer, November 2024).

thresholds have different income effects on taxpayers, even when they have identical substitution effects. This article devises an econometric strategy that captures both income and substitution effects.

The empirical analysis examines reforms in Canada's four largest provinces (Ontario, Quebec, Alberta, and British Columbia), which increased top marginal tax rates by two to five percentage points in the 2013-2016 period. Taxpayers in Saskatchewan and Manitoba, where the top rate did not change during this period, serve as the control group. The feature of these reforms that enables the new estimation method is the variation in the income thresholds at which the new, higher rates applied, ranging from $100,000 to $300,000 of taxable income. Roughly speaking, income effects can be measured by comparing the response of a taxpayer to two reforms that have the same change in top rate but differ in the threshold at which the rate change applies.

The results show that increases in average tax rates have a strong negative effect on reported income.[22] This may be interpreted as a strong and positive income effect. However, the paper's theoretical analysis suggests that the same behavioural change could also result from greater taxpayer attention to more salient tax reforms.

From a policy point of view, the key result is that the increases in provincial top marginal tax rates examined in this article likely decreased tax revenue. In other words, the current system is on the "wrong side of the Laffer curve": decreasing tax rates would raise tax revenue and thereby make everyone better off.

The article notes that this effect may be limited to increases in top marginal tax rates at the provincial level. An increase in the federal top rate—or a coordinated increase across provinces—could have a positive effect on revenue, since taxpayers find it much harder to move across national borders than across provincial ones. However, the study's research design cannot address this question.

A.M.

Stanley L. Winer, *Reassignment and the Power To Tax in a Federal State: Canada, 1867-2024*, CESifo Working Paper no. 11678 (Munich: Center for Economic Studies and Ifo Institute for Economic Research, 2025)

Rory Gillis, "Federalism and Vertical Tax Competition" (2025) *American Journal of Comparative Law* (forthcoming) (https://doi.org/10.1093/ajcl/avaf003)

Both of these articles examine how the allocation of taxing power within a federation comes about over time as a result of social and economic forces, rather than examining how taxing power should be allocated according to normative criteria. The Winer paper deals exclusively with Canada, while the Gillis article considers Canada, the United States, Australia, and Switzerland.

22 Most of the econometric results in the paper relate to total income (line 150 of the T1 return), as past literature has considered this to be more policy-relevant than taxable income.

In Winer's paper, table 1 provides a seven-page summary of key events, from 1867 to 2024, in the assignment of fiscal instruments in Canada, with an emphasis on provincial tax structures. This helpful year-by-year summary shows how the allocation of tax fields has varied over time—showing, for example, when each province began to occupy (or vacated) particular tax fields. The opening section of the paper creates a narrative from this table, focusing on wartime tax rentals, succession duties, provincial retail sales taxes, and the HST. The table and the narrative together demonstrate that the reassignment of tax and other policy instruments between federal and provincial governments is a normal, recurring feature of Canadian fiscal history. The remainder of the paper presents a theory of how tax structures evolve in a liberal democratic federation, arguing that political actors adjust policy instruments to maximize their chances of being re-elected.

Gillis's article begins by noting that the share of subnational governments in a country's total tax revenue varies substantially among the four countries examined: Australia is at the low end (19 percent), Canada at the high end (54 percent), and the United States and Switzerland in between (46 percent and 52 percent, respectively). These percentages reflect the long-term effects of vertical tax competition—the efforts of one level of government to unilaterally expand its share of a tax base that is constitutionally assigned to two (or more) levels of government.[23] Because the revenue potential of any given tax base is finite, one government's gain comes at the expense of another.

The main proposition of Gillis's paper is that national (federal) governments are likely to out-compete subnational governments in the long run, unless restricted by specific legal or cultural constraints. Although subnational governments are usually the first to implement novel taxes, national governments typically expand their tax shares substantially during wars or fiscal crises (as in Canada during the Second World War), and these higher shares of tax revenue tend to remain high after the emergency has passed.

A major reason for national governments' greater success is their ability, in times of national emergency, to make what Gillis calls a "two-step offer." First, the national government announces that it will increase its tax rates in a given field—effectively forcing subnational governments to lower their rates, given public sentiment about the national emergency. Second, it offers cash transfers to subnational governments that reduce their tax rates.

Gillis's proposition—that national governments out-compete subnational governments—applies best to Australia, where, as noted above, subnational governments collect only a small proportion of tax revenue. But how does Gillis's proposition

23 The more commonly known form of tax competition is horizontal tax competition, in which governments at the same level compete for tax revenue. This may include country-to-country competition (such as tax havens drawing revenue from industrialized countries) or competition among provinces (for example, the "Alberta advantage").

account for Canada, where the subnational share is the highest among the four countries?

In short, Gillis's explanation is that "Australia has no equivalent to Quebec. . . . No [Australian] state, however, has been willing to force the [national government's] hand by unilaterally imposing an income tax at substantial rates."[24] This is a reference to Quebec's 1954 decision to enact legislation imposing a provincial income tax. Quebec was in an advantageous political position: its voters blamed the federal government for double taxation, and the province controlled 28 percent of the seats in the federal House of Commons. As a result, the federal government backed down and made accommodations with Quebec.[25] For reasons of fairness, the federal government was then compelled to extend a revised version of its two-step offer—a version less profitable, from the government's perspective—to the other provincial governments, setting the pattern for years to come. The result was a growing share of tax revenue for subnational governments—a trend that has continued over time.

Thus, Canada presents a case where the exception proves the rule, ultimately supporting Gillis's proposition: "Only a few highly motivated subnational governments are likely to accept significant short-term losses, and even fewer will have the right political conditions at home and within the larger federation to support long-term resistance."[26]

A.M.

Reuven S. Avi-Yonah and Christine Kim, *The International Tax Revolution*
(Cambridge, UK: Cambridge University Press, 2025)

This book, based mostly on published articles authored or co-authored by the first author, argues that the last decade has witnessed the creation of a new international tax regime.

After a short introduction, chapter 1 outlines what the authors regard as the two basic principles of the "Ancien" international tax regime established by the famous four economists report commissioned by the League of Nations: (1) a benefit principle according to which active income would be taxed primarily in the source state and passive income would be taxed primarily in the residence state; and (2) a single tax principle according to which income should be subject to neither double taxation nor double non-taxation.

Chapter 2, based on an article that Avi-Yonah published in the *Harvard Law Review* in 2000,[27] argues that globalization and increased capital mobility led to the decline

24 At 31.

25 At 25.

26 Ibid.

27 Reuven S. Avi-Yonah, "Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State" (2000) 113:7 *Harvard Law Review Association* 1573-1676.

of this ancient regime after the 1970s, as tax havens made it increasingly difficult for residence states to tax passive income, and tax competition among source states drove down taxes on active income—eroding the single tax principle, and creating a fiscal crisis in which the capacity of developed countries to finance the postwar welfare state is diminished. According to the authors, the best response to this development is to reverse the traditional benefits principle by granting source states primary jurisdiction over passive income (through withholding taxes), and residence states primary jurisdiction over active income (through coordinated controlled foreign corporation rules in states where multinational enterprises are located). In this way, the authors argue, countries can overcome the dilemma in which they must either reduce the size of the welfare state in order to enjoy the economic advantages of globalization or retreat from globalization in order to preserve the welfare state.

Chapters 3 to 6 explain what the authors regard as the key changes that have led to the creation of a new international tax regime. Chapter 3 reviews initiatives introduced after the global financial crisis to end bank secrecy and promote effective information exchange, beginning with unilateral initiatives by the United States—the Foreign Account Tax Compliance Act (FATCA) and legal action against Unique Broadband Systems Inc.—and culminating in the multilateral competent authority agreement on the automatic exchange of tax information based on a common reporting standard (CRS) commencing in 2017. Chapter 4 discusses the "early revolution" of the Organisation for Economic Co-operation and Development (OECD) base erosion and profit shifting project (BEPS 1.0), considering each of the BEPS actions and emphasizing their limits as an effective response to the decline of the ancient regime. Chapter 5 examines unilateral and multilateral responses to digitalization, including digital services taxes (DSTs) and the OECD's pillar 1 proposal, arguing, among other things, that the new taxing right in amount A of pillar 1 is revolutionary, since it abandons the traditional permanent establishment (PE) threshold for taxing business income as well as the separate-entity approach and arm's-length principle for computing business profits. Chapter 6 reviews the global minimum tax contemplated by the OECD's pillar 2 proposal, arguing that it changes the international tax regime by operationalizing the single tax principle that was articulated in the League of Nations report but never fully implemented.

Finally, chapter 7 assesses the prospects for pillar 1 and pillar 2, and chapter 8 considers whether the changes to the international tax regime are truly revolutionary, or more evolutionary in nature. According to the authors, although pillar 1 is "unlikely" to succeed, countries will rely on other approaches to tax digital service enterprises, including DSTs, withholding taxes based on article 12B of the UN model treaty, anti-abuse rules like Australia's multinational anti-avoidance law (MAAL) or the United Kingdom's diverted profits tax, and unilateral apportionment rules that would override tax treaties. In contrast, the authors conclude, pillar 2 is likely to survive, despite non-participation by the United States and China, given the EU directive requiring all member states to adopt pillar 2 by the end of 2024 and the implementation by Australia, Canada, Switzerland and the United Kingdom. As a result, they conclude, although the new international tax regime is "less revolutionary"

than might be imagined, it includes so many new elements that it cannot be regarded as "a mere evolution."[28]

The International Tax Revolution provides an impressive overview of key developments in international taxation over the past 15 years. While I am sympathetic to concerns about harmful tax competition and the fiscal crisis of the welfare state, I find the analysis unconvincing in three respects.

First, it is not clear that the international tax regime has ever embraced the idea of a "single tax principle" in the sense that income must be taxed somewhere, nor that pillar 2 implements this principle in a substantive sense. On the contrary, measures in BEPS 1.0 to address double non-taxation were directed at *unintended* double non-taxation (for example, from tax treaty shopping and hybrid mismatches), and the substance-based income exclusion (SBIE) in the global minimum tax suggests that pillar 2 is best understood as an instrument to limit profit shifting *without economic substance* (consistent with the OECD's longstanding initiatives on "harmful" tax competition), not an expression of a substantive single tax principle and a measure to prevent all tax competition. For these reasons, although BEPS 1.0 and pillar 2 make significant changes to the international tax regime, they are not as significant as the authors of this book suggest.

Second, it is also not clear that the international tax regime ever allocated primary jurisdiction over active income to the source state and primary jurisdiction over passive income to the residence state, nor that the allocation of tax jurisdiction was based solely on the benefits principle. On the contrary, tax treaties generally allocate primary (though often limited) tax jurisdiction to source states over active *and* passive income, and residual tax jurisdiction to residence states over all income whether active or passive—and do so not solely on the basis of a benefits principle of tax fairness, but also on the basis that source states are entitled to a share of income generated from activities in the jurisdiction (including income generated from the use of digital services) and the principle that residents (at least individual residents) should be subject to tax on their worldwide incomes as a matter of horizontal equity. For these reasons, the authors' proposal to have source states tax passive income and residence states tax active income is also not revolutionary, given that this currently occurs through source state withholding taxes and residence state taxes on worldwide income (as well as controlled foreign corporation rules).

Third, in (over)emphasizing the benefits principle and the single-tax principle as pillars of the traditional international tax regime, the authors downplay other key elements, the most important of which are (1) the permanent establishment threshold for taxing business income; (2) the separate-entity approach for multinational enterprises; (3) the arm's-length principle for adjusting the profits of associated enterprises; and (4) traditional rules limiting the exchange of tax information and

28 At 264.

assistance in the collection of taxes. To the extent that pillar 1 is revolutionary, it is surely so not because it affects a benefits principle or single-tax principle, but because it abandons the PE threshold and allocates profits based on formulary apportionment, not the arm's-length principle. In addition, the most revolutionary feature of the global minimum tax is surely its abandonment of the separate-entity approach (illustrated most clearly, and controversially, through the undertaxed payments (profits) rule [UTPR]), not its implementation of a single tax principle. Most revolutionary of all, perhaps, is the automatic exchange of tax information, which makes it much more feasible for states to tax their residents on offshore income.

D.G.D.

Mindy Herzfeld, "What Role for International Tax in a Trump Tariff World?"
(2025) 118:2 *Tax Notes International* 211-15

This article considers whether the Trump administration's approach to international trade and investment could also have implications for international tax rules, in particular the foreign tax credits that have been a central feature of the US international tax regime for more than a century.

Explaining that the foreign tax credit (FTC) reflects a "general conviction that U.S. overseas investment produces a net positive benefit both for the companies that make those investments and for the U.S. economy"[29] in general, Herzfeld notes that the Trump administration's tariffs and accompanying messaging "reflect a worldview counter to the one that led to U.S. adoption of an FTC and its 100-year history,"[30] according to which "U.S. investment in other countries hurts—rather than benefits—the U.S. economy and American workers."[31] From this perspective, it follows that US tax policy should not be neutral between foreign investment and US investment (capital export neutrality), but should actively discourage foreign investment by not crediting foreign taxes on foreign source income derived by US taxpayers.

Because the FTC is provided through the Internal Revenue Code (IRC), which is enacted by Congress, Herzfeld observes that it is more difficult for the Trump administration to eliminate the credit than it is to impose tariffs under emergency powers granted by Congress. Nonetheless, she explains, "the executive has plenty of tools available to dilute the benefits of the FTC"[32] through administrative measures. One approach would be to adopt regulations prescribing the conditions under which foreign taxes qualify as creditable taxes, requiring that they closely adhere to the US income tax. Another approach would be to require a greater allocation of domestic expenses to foreign-source income, making the FTC limitation more stringent.

29 At 211.

30 Ibid.

31 Ibid.

32 Ibid.

Although these measures might be challenged under tax treaties, which require the United States to provide a credit against foreign income taxes, Herzfeld notes that these treaty provisions (like those in Canada's tax treaties) are subject to the caveat that the credit is subject to domestic law "as it may be amended from time to time without changing the general principle hereof."[33] In addition, she explains, since the "later-in-time rule" in section 7852(d) of the IRC provides that newer domestic laws override tax treaties, "taxpayers probably shouldn't put too much faith in tax treaties' protections"[34] if Congress acts to revise US international tax rules to reflect the Trump administration's approach to international tax policy.

Whether the US Congress would be willing to repeal what Herzfeld regards as "a century-old tax provision that has underpinned U.S. economic growth and prosperity and contributed to the competitiveness of U.S. companies in practically every sector"[35] remains to be determined—though the absence of any such measure in the recently enacted One Big Beautiful Bill Act (OBBBA) suggests that it is not on the current agenda. On the contrary, Herzfeld observes, Trump voters who supported tariffs did not express their views on the FTC, and Republican members of Congress who are unwilling to challenge the Trump administration on tariffs are less likely to "go on the record in repealing a tax provision that significantly benefits multinational companies with operations in their states and districts."[36] As a result, administrative restrictions on the scope of the US FTC seem more likely than legislative repeal.

D.G.D.

Wei Cui, "The Logic of the Revenge Tax" (2025) 119:1 *Tax Notes International* 19-28

Anyone who has read anything by Wei Cui will know that he is a contrarian. In keeping with this predilection, Cui defends the now abandoned "revenge tax" in the One Big Beautiful Bill Act (OBBBA) passed by the US House of Representatives on May 22 as "a defensible and ultimately acceptable approach"[37] for addressing the UTPR in the pillar 2 global minimum tax, as well as DSTs.

For readers who are not familiar with the revenge tax, proposed section 899 of the IRC would have imposed retaliatory measures in the form of withholding taxes and increases to the base erosion and anti-abuse tax (BEAT) on investors and enterprises based in "discriminatory foreign countries" with "unfair foreign taxes."[38] Although the concept of an unfair foreign tax was broadly defined to include any tax

33 At 213.

34 Ibid.

35 Ibid.

36 At 214.

37 At 19.

38 Ibid.

that is extraterritorial, discriminatory, or "enacted with a public or stated purpose indicating the tax will be economically borne, directly or indirectly, disproportionately by United States persons,"[39] the legislation was specifically aimed at UTPRs and DSTs, which were defined as per se unfair foreign taxes if they applied to US persons or controlled foreign corporations more than 50 percent of the votes or value of which are owned by US persons.

As those who followed the rise and fall of proposed section 899 know, the measure sparked considerable anxiety on Wall Street that it would reduce foreign investment in the United States, and it was removed from the OBBBA after the G7 agreed to a "side-by-side" arrangement under which US multinationals would be excluded from the UTPR in respect of their domestic and foreign profits.

For Cui, the "logic" of the revenge tax turns on US market power "both in the world demand for capital and in the supply of financial services to global investors,"[40] which allows it to act "like all monopolists and monopsonists"[41] to extract economic surpluses from its suppliers and customers. To the extent that the United States "holds more market power in capital markets than it does in the markets for most types of imported goods,"[42] he maintains, "the likelihood of a tax on these tax bases being borne by foreigners"[43] is higher than the likelihood that taxes on imported goods (tariffs) will be borne by foreigners rather than domestic consumers. As a result, he argues, the revenge tax was a more effective measure to challenge "unfair foreign taxes" than tariffs.

In addition, Cui contends, whatever arguments might be made for the UTPR as a backstop to the income inclusion rule (IIR) or for DSTs as a way to tax the value created by users of digital services, these taxes also constitute an exercise of market power—collectively, in the case of the UTPR, by countries in which multinational enterprises (MNEs) derive substantial profits; and individually, in the case of DSTs, by any country in which providers of digital services derive location-specific rents from the nonrival deployment of zero-marginal-cost digital technology. As a result, Cui suggests, the exercise of US market power through the revenge tax is no less justified than the exercise of market power by other countries through UTPRs and DSTs.

Although interesting and provocative, the article leaves many questions unanswered. First, if US taxes on foreign investors and enterprises are borne primarily by foreigners, why does the United States not rely on these kinds of taxes more generally, why was the revenge tax conditional on "unfair foreign taxes," and why did it exclude key exemptions for foreign investors such as the portfolio interest exemption, and source tax exemptions for notional principal contract payments and capital gains?

39 At 25.

40 At 20.

41 Ibid.

42 At 21.

43 Ibid.

Perhaps the impact of these taxes on the supply and cost of capital is greater than Cui acknowledges.

Second, if the revenge tax was an effective measure to counteract "unfair foreign taxes," why was it jettisoned after the Group of Seven (G7) agreed to exclude US multinationals from the UTPR, without any agreement (except by Canada) to abandon DSTs—which the United States will presumably continue to oppose through trade sanctions? Indeed, since some accommodation with the United States on pillar 2 was necessary once the Biden administration failed to secure its approval in the US Senate, it is more likely that the side-by-side arrangement gave the Trump administration the pretext to drop the revenge tax just as dropping the revenge tax gave the rest of the G7 a pretext for agreeing to the side-by-side arrangement on pillar 2.

Finally, and most significantly, Cui's analysis avoids any discussion of the potential merits of the UTPR as part of the pillar 2 global minimum tax or DSTs as a way to tax the value created by users of digital services—which might be helpful to assess the merits of the revenge tax as a response to these measures. Indeed, although Cui's views on the global minimum tax are unclear, he has defended DSTs in other writing as an efficient way to tax location-specific rents of digital service providers. For this reason, it is odd that Cui endorses the revenge tax as a measure that encourages mutual cooperation to reciprocally reduce taxes that can impede "the flow of services and capital."[44]

D.G.D.

44 At 27.