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CANADIAN TAX JOURNAL
REVUE FISCALE CANADIENNE

PEER-REVIEWED ARTICLES

The Definition and Application of the Separate-Entity Approach in the OECD Transfer-Pricing Guidelines — *Jérôme Monsenego*

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Current Tax Reading — *Jinyan Li and Michael Veall*

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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.

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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 :

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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*

WOMEN IN TAX VANCOUVER NETWORKING EVENT
Vancouver, January 22, 2026

WOMEN IN TAX: RECLAIMING YOUR TIME—YES, IT'S POSSIBLE
Montreal, January 28, 2026

JOURNÉE D'ÉTUDES FISCALES
Montreal and via webcast, May 28, 2026

PRAIRIE PROVINCES TAX CONFERENCE & LIVE WEBCAST
Winnipeg and via webcast, June 1-2, 2026

YOUNG PRACTITIONER FOCUS CONFERENCE
Via webcast, September 9, 2026

BRITISH COLUMBIA TAX CONFERENCE & LIVE WEBCAST
Vancouver and via webcast, September 28-29, 2026

ONTARIO TAX CONFERENCE & LIVE WEBCAST
Toronto and via webcast, October 26-27, 2026

ATLANTIC PROVINCES TAX CONFERENCE
Halifax, November 6-7, 2026

78TH ANNUAL TAX CONFERENCE
Toronto, November 29-December 1, 2026

* 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.

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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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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.

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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).

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The Definition and Application of the Separate-Entity Approach in the OECD Transfer-Pricing Guidelines

Jérôme Monsenego*

PRÉCIS

Cet article analyse l'approche de l'entité distincte comme base théorique du principe de pleine concurrence dans les principes de l'Organisation de coopération et de développement économiques (OCDE) en matière de prix de transfert. Malgré son rôle central, ce concept manque d'une définition claire et son application semble osciller entre différentes perspectives, soit transactionnelle, basée sur l'entité et à l'échelle du groupe, ce qui pourrait remettre en question le recours sans équivoque à cette approche comme fondement théorique du principe de pleine concurrence dans les principes de l'OCDE. L'objectif de cet article est d'analyser la définition et l'application de l'approche de l'entité distincte dans les principes de l'OCDE, dans le but de clarifier sa signification, de déterminer les écarts potentiels par rapport à une analyse strictement fondée sur l'entité et d'examiner la logique, le cas échéant, qui sous-tend ces écarts.

La première conclusion de l'étude est que l'article 9 du modèle de convention fiscale de l'OCDE, qui sous-tend le principe de pleine concurrence, n'impose pas l'obligation légale d'analyser les transactions strictement au niveau des entités juridiques individuelles. Il favorise plutôt une interprétation souple visant à garantir que les transactions entre parties liées reflètent les bénéfices réalisés sur le marché. La deuxième conclusion est que les principes de l'OCDE doivent tenir compte des structures complexes des groupes et des accords intragroupe qui peuvent ne pas exister entre des parties non liées, tout en restant dans le cadre du principe de pleine concurrence. Ce paradoxe conduit à l'adoption de différentes perspectives — transactionnelle, basée sur l'entité et à l'échelle du groupe — afin de mieux se rapprocher des conditions qui peuvent exister entre des entreprises indépendantes. La nécessité d'une telle flexibilité reflète la difficulté d'appliquer une norme fondée sur le marché dans un contexte hors marché.

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ABSTRACT

This article analyzes the separate-entity approach as the theoretical basis of the arm's-length principle in the transfer-pricing guidelines of the Organisation for Economic Co-operation and Development (OECD). Despite its central role, the concept lacks a clear definition, and its application appears to fluctuate between transactional, entity-level, and group-wide perspectives, potentially calling into question an unequivocal reliance on the approach as the theoretical basis of the arm's-length principle in the OECD guidelines. The purpose of this article is to analyze the definition and application of the separate-entity approach in the OECD guidelines, with the aim of clarifying its meaning, identifying potential deviations from a strictly entity-based analysis, and examining the rationale, if any, behind such deviations.

The first conclusion of the study is that article 9 of the OECD model tax convention, which underpins the arm's-length principle, does not impose a legal requirement to analyze transactions strictly at the level of individual legal entities. Rather, it supports a flexible interpretation aimed at ensuring that related-party transactions reflect market-based profits. The second conclusion is that the OECD guidelines need to address complex group structures and intragroup arrangements that may not exist between unrelated parties, while remaining within the realm of the arm's-length principle. This paradox leads to the adoption of various perspectives—transactional, entity-based, and group-wide—to better approximate the conditions that may exist between independent enterprises. The need for such flexibility reflects the difficulty of applying a market-based standard in a non-market setting.

KEYWORDS: SEPARATE-ENTITY APPROACH ■ ARM'S LENGTH ■ TRANSFER PRICING ■ ACCOUNTING ■ FORMULARY APPORTIONMENT

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INTRODUCTION

The separate-entity approach is a concept frequently used in the field of corporate taxation, including in the area of transfer pricing.[1] It has been relied on for a long time,[2] and its use by different countries was observed as early as 1933, in the Carroll report for the League of Nations.[3] The arm's-length principle, as articulated in the OECD transfer-pricing guidelines,[4] is known for relying on the separate-entity approach as its theoretical basis. However, despite the importance of its role and its broad acceptance, the concept itself seems largely undefined, which may undermine its theoretical validity. This may stem from the widespread use of the separate-entity approach, in both domestic and cross-border contexts, for addressing a variety of issues. Furthermore, while the OECD guidelines adhere to the separate-entity approach in theory, the application of the arm's-length principle, as recommended in the guidelines, does not always strictly involve an analysis carried out at the entity level: depending on the context, the guidelines at times adopt a transactional, an entity-based, or a group-wide perspective. Eventually, given the ambiguities surrounding both the definition and the application of the separate-entity approach for transfer-pricing purposes, the correctness of an unequivocal reliance on the approach

1 The separate-entity approach, closely associated with the concept of "separate accounting," has long been a subject of interest for researchers in the fields of taxation and accounting. For a few—though by no means exhaustive—references on this topic, see, for example, M.A. Feldmann, "Separate Accounting Basis v. Apportionment" (1939) 68:5 *Journal of Accountancy* 324-28; Stanley I. Langbein, "The Unitary Method and the Myth of Arm's Length," *Tax Notes*, February 17, 1986 (www.taxnotes.com/tax-notes-federal/unitary-method-and-myth-arms-length/1986/02/17/22y4l); Jerome R. Hellerstein, "Federal Income Taxation of Multinationals: Replacement of Separate Accounting with Formulary Apportionment," *Tax Notes*, August 23, 1993; Charles E. McLure Jr., "Replacing Separate Entity Accounting and the Arm's Length Principle with Formulary Apportionment" (2002) 56:12 *Bulletin for International Taxation* 586-99; Thomas A. Gresik, "Assessing the Normative Differences Between Formula Apportionment and Separate Accounting," in Wolfgang Schön and Kai A. Konrad, eds., *Fundamentals of International Transfer Pricing and Economics* (Heidelberg, Germany: Springer, 2012), 257-65; Romero J.S. Tavares, "Multinational Firm Theory and International Tax Law: Seeking Coherence" (2016) 8:2 *World Tax Journal* 243-76; Hulya Celebi, "The Impact of Corporate Income Taxation on Location Choice of Investments: Separate Accounting Versus Formula Apportionment: 18th Annual Conference on Finance and Accounting (ACFA)," in David Procházka, ed., *The Impact of Globalization on International Finance and Accounting* (Cham, Switzerland: Springer International Publishing AG, 2018), 1-14; and Reuven S. Avi-Yonah, "Should the States Return to Worldwide Combined Reporting?" (2025) 187:2 *Tax Notes Federal* 333-38.

2 For a historical perspective, see, for example, Sunita Jogarajan, *Double Taxation and the League of Nations* (London, UK: Cambridge University Press, 2018); and Jill C. Pagan and J. Scott Wilkie, *Transfer Pricing Strategy in a Global Economy* (Amsterdam: IBFD, 1993).

3 See Mitchell B. Carroll, *Taxation of Foreign and National Enterprises*, vol. 4, *Methods of Allocating Taxable Income* (Geneva: League of Nations, 1933).

4 Organisation for Economic Co-operation and Development, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 2022) (herein referred to as "the OECD transfer-pricing guidelines," "the OECD guidelines," or "the guidelines").

as the theoretical basis of the arm's-length principle in the OECD guidelines may be called into question.

In light of such uncertainty, the purpose of this article is to analyze the definition and application of the separate-entity approach in the OECD guidelines, with the aim of clarifying its meaning, identifying potential deviations from a strictly entity-based analysis, and examining the rationale, if any, behind such deviations. The article, structured in two main parts, focuses first on the definition and then on the application of the separate-entity approach. It ends with brief conclusions.

THE DEFINITION OF THE SEPARATE-ENTITY APPROACH

This part of the article begins by describing the use of the separate-entity approach in domestic and cross-border contexts. It then examines the treatment of the approach in article 9 of the OECD model tax convention[5] and its accompanying commentary. The analysis concludes with a discussion of the statements of principle concerning the separate-entity approach as formulated in the OECD guidelines.

The Separate-Entity Approach in the Domestic and Cross-Border Contexts

To correctly identify the framework for the analysis conducted in this article, it is necessary to highlight conceptual differences in the use of the separate-entity approach between domestic and cross-border contexts.

First, in the domestic context, there is hardly an explicit statement of principle that identifies the separate-entity approach as the theoretical foundation of an income tax system. This is not surprising, since domestic tax systems typically do not formally mention the underlying principles on which they are based, even though preparatory works such as explanatory notes accompanying legislation may refer to them. The key point here is to contrast the absence of an explicit statement of principle in domestic legislation with its presence in the OECD guidelines, which, as discussed in more detail below, refer to the separate-entity approach as a theoretical foundation for the arm's-length principle, although the guidelines do bring some nuance to this statement.

Second, it has been demonstrated that the separate-entity approach is applied to varying degrees across different countries.[6] This makes it difficult to identify a unique

5 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version 2017* (Paris: OECD, November 2017) (herein referred to as "the OECD model tax convention").

6 For an exhaustive analysis of this topic, including a presentation of the different degrees with which the separate-entity approach might be applied in different countries, see Johanna Hey and Arne Schnitger, "General Report Subject 1," in International Fiscal Association, *Group Approach and Separate Entity Approach in Domestic and International Tax Law*, Cahiers de droit fiscal international, vol. 106 (The Hague: Kluwer, 2022). The authors conclude (ibid., at 50)

definition of the separate-entity approach that would be suitable to all, or even most, countries. Nevertheless, certain common features of the separate-entity approach do exist in most tax systems. To begin with, for entities that enjoy legal personality and are recognized as tax subjects, income tax is normally calculated for each individual taxpayer and paid separately by each legal entity. This is a fundamental characteristic of a corporate tax system.[7] It is rooted in both civil law, which grants certain entities legal personality, including rights and obligations, and accounting law, which requires such entities to meet obligations such as the preparation of financial statements. Taxation on an entity basis is also consistent with the concept of income, since the basic pattern of the computation of income is determined on the basis of the difference between certain revenues and costs that can be ascribed to a certain person for a given period of time.[8] Accordingly, the separate-entity approach serves as a theoretical foundation not only in jurisdictions where there is a strong link between tax and accounting, but also in those where corporate income tax is determined on the basis of rules specific to tax law. Furthermore, in most countries, the separate-entity approach serves functions particular to the field of income taxation. One illustration of this is the fact that taxation typically occurs at both the corporate and shareholder levels: each person is taxed separately, allowing for the deferral of taxation on distributions and enabling individual shareholders to be taxed on capital income rather than on income from other sources such as labour.[9] At the same time that the separate-entity approach is applied in this way, most systems also include rules designed to mitigate some of its consequences, whether domestic or cross-border. These may include provisions to avoid cascading taxation on profit distributions (that is, taxation in a chain, which may be mitigated in both domestic and

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by identifying a "hybrid situation where legislators stick to the separate entity principle but engage in group-oriented tax provisions where necessary to fix undesired tax consequences." This observation is consistent with the fact that, as evidenced by comparative research, there is no common approach with respect to the personal scope of the corporate income tax: see Daniel Gutmann, "General Report," in Daniel Gutmann, ed., *Corporate Income Tax Subjects: EATLP Annual Congress, Lisbon 30 May-1 June 2013*, EATLP International Tax Series, vol. 12 (Amsterdam: IBFD, 2015), 1-13. Instead of a common approach, there appears to be a great degree of diversity among various countries in the criteria used to determine corporate tax liability.

7 On this topic, see Johanna Hey and Arne Schnitger, "General Report Subject 1," in Cahiers de droit fiscal international, vol. 106, supra note 6, at 19, where the separate-entity approach is found to be "indispensable."

8 In contrast, the taxation of revenues or sales could more easily be applied on a transactional basis. Moreover, even within income tax systems, the computation of income does not always follow the basic pattern of a difference between revenues and costs: there may be other forms of computation of income, such as presumptive taxation, notional regimes, or specific anti-abuse rules.

9 Here, it can be emphasized that deferral may also be due to reasons other than the separate taxation of shareholders and the companies in which they own shares, such as rules applicable to the distribution of dividends.

cross-border situations) or to recognize group membership for the determination of deductible interest expenses,[10] or, conversely, rules that permit a lookthrough approach to prevent tax avoidance, such as rules on controlled foreign corporations, which apply mainly cross-border.

In a domestic context, regardless of the degree of alignment between tax and accounting, various exceptions to the separate-entity approach may be made to take into account the existence of corporate groups. Group taxation regimes, for instance, may allow the consolidation of profits and losses among group members, thereby acknowledging the group's existence for tax purposes—albeit to different extents depending on the country, since these rules are often accompanied by anti-avoidance measures such as restrictions on the transfer of losses following changes in ownership. Such exceptions to the separate-entity approach are typically limited to domestic settings, although some cross-border group taxation regimes do exist.[11] The rationale behind these exceptions is often the objective of achieving some degree of neutrality by minimizing the influence of income tax rules on corporate decision making.[12] By disregarding the legal personality of separate entities, certain domestic group taxation rules at the same time may recognize the economic unity of groups, which may be taxed as separate entities on their net income. In other words, while certain group taxation rules may constitute, stricto sensu, an exception to the separate-entity approach, they also promote a broader understanding of the notion of an entity—defined not as a legal unit but as an economic one.

Additionally, in a domestic context, the pricing of transactions between members of the same group typically may not matter when group taxation rules apply and both parties are taxed in the same country, although some countries do require arm's-length pricing in a domestic context. Even if prices deviate from market conditions, the outcome may effectively be a zero-sum result under such rules. Other domestic mechanisms, such as the ability to transfer assets below market value or to carry forward losses, also contribute to the neutrality of domestic group taxation regimes.

10 See paragraph 5(b) of article 4 of European Union, Council Directive (EU) 2016/1164 of 12 July 2016 Laying Down Rules Against Tax Avoidance Practices That Directly Affect the Functioning of the Internal Market, OJ L 193, July 19, 2016, whereby "exceeding borrowing costs" (the amount by which the deductible borrowing costs of a taxpayer exceed taxable interest revenues and other economically equivalent taxable revenues that the taxpayer receives) may be deducted beyond the limit set at article 4 of the directive if a company's equity-over-total-assets ratio is broadly equal to or higher than the equivalent group ratio. On this topic, see Chloe Burnett, "Intra-Group Debt at the Crossroads: Stand-Alone Versus Worldwide Approach" (2014) 6:1 *World Tax Journal* 40-76.

11 On this theme, see Yoshihiro Masui, "General Report," in International Fiscal Association, *Group Taxation*, Cahiers de droit fiscal international, vol. 89b (Amersfoort, the Netherlands: Sdu Fiscale & Financiële Uitgevers, 2004), 21-67.

12 On this theme see Masui, ibid., especially at 34 et seq., for nuances concerning the validity of the principle of neutrality as a theoretical basis for group taxation regimes; see also Gutmann, supra note 6, at 7-8.

Furthermore, in a domestic context and for those countries that allow it, not reassessing intercompany transactions at market conditions reinforces neutrality, when no such reassessments are required between independent companies.

The separate-entity approach also applies in a cross-border context, but it does not serve exactly the same purpose as in the domestic context, and therefore it has a somewhat different meaning. It implies, first, that different companies within the same multinational enterprise (MNE) group, resident in different jurisdictions, are taxed separately on their worldwide income, including the separate taxation of parent companies and subsidiaries. Tax treaties apply to individual legal entities, not to groups of entities, with respect to the determination of residence, the identification of the source of income, and the practical application of the distribution rules. This reflects the legal personality of certain types of entities and resembles the application of the separate-entity approach in the domestic context. However, unlike in the domestic setting, there is usually no zero-sum outcome for intercompany transactions in a cross-border context, since a country taxes only its residents, not the foreign party to a transaction, which gives rise to the need for transfer-pricing rules. As a result, the recognition of a group for the purpose of achieving tax neutrality is limited, although certain reforms aspire to cross-border group taxation;[13] neutrality is rather sought between members of groups and separate entities. Furthermore, while many countries provide measures to prevent economic double taxation on cross-border dividends and capital gains, and a few offer limited cross-border loss relief, these do not amount to a broad acknowledgment of groups from an income tax perspective. In other words, while tax rules in the domestic context tend to accept an economic definition of the separate-entity approach, in the context of transfer pricing they tend to favour a more legal definition of the separate-entity approach.

On the basis of the analysis above, it can be concluded that, in a domestic context, the separate-entity approach functions as a starting point for taxation, from which exceptions are made in an effort to achieve neutrality between separate entities and domestic groups. In a cross-border context, the separate-entity approach is similarly a starting point, but it also serves as a conceptual foundation for the application of the arm's-length principle,[14] and thus functions as a means of realizing certain objectives, particularly the allocation of the corporate tax base and the prevention of tax avoidance. Neutrality is also sought, though not between separate entities and domestic groups, but instead between separate entities and members of multinational

13 One example is the attempt at implementing a common consolidated corporate tax base in the European Union, later renamed BEFIT: see European Union, *Proposal for a Council Directive on Business in Europe: Framework for Income Taxation (BEFIT)*, COM (2023) 532 final (Brussels: EU, July 12, 2024).

14 See, for example, the OECD transfer-pricing guidelines, supra note 4, preface, at paragraph 5: "OECD member countries have chosen this separate entity approach as the most reasonable means for achieving equitable results and minimising the risk of unrelieved double taxation. Thus, each individual group member is subject to tax on the income arising to it (on a residence or source basis)."

groups. Therefore, while the same terminology is used, the definitions of the separate-entity approach in domestic and cross-border contexts are not entirely the same.

These conceptual differences in the separate-entity approach between domestic and cross-border contexts do not mean that only one version applies. The definitions are not mutually exclusive: the existence of cross-border intercompany transactions (and thus the application of transfer-pricing rules) does not exclude the application of the separate-entity approach for domestic tax purposes. In other words, the two approaches overlap, with different definitions and purposes.

The Definition of the Separate-Entity Approach in Article 9(1) of the OECD Model Tax Convention

In analyzing the definition of the separate-entity approach in the OECD guidelines, it is logical to consider first how article 9(1) of the OECD model tax convention[15] is formulated, and what recommendations are included in the commentary on it. The article does not explicitly provide a definition of, or a reference to, the separate-entity approach. However, the mechanism contained in the article is an expression of that approach, since it applies primarily at the level of entities—that is, not on a per-transaction basis or at the level of groups of entities, even though its practical application may rely on the analysis of individual transactions.

Article 9(1) provides:

> Where . . . conditions are made or imposed between . . . two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

The text of article 9(1) refers primarily to the profits of enterprises, not the price applied to transactions, the profits made on transactions, or the profits earned at the level of a group of entities. In other words, article 9(1) is formulated as an expression of the separate-entity approach, although it provides no explicit definition of, or reference to, the approach. At the same time, the text of article 9(1) mentions an analysis of the conditions (that is, the prices) of the "commercial or financial relations" (that is, the transactions) between associated enterprises, which implies that the analysis mandated by article 9(1) does not exclude a transactional focus, as long as an adjustment to the transfer prices has an impact on the profits. As argued below, such a dual-level framework (under which entity-level adjustments may be based on transactional evidence) may give rise to tensions in the application of the separate-entity approach.

This focus on entities appears consistent with the function of article 9 in the OECD model tax convention, since article 9 deals with the taxation of associated enterprises.

15 Supra note 5.

In most corporate income tax systems, enterprises—whether independent or associated—are taxed at the entity level, unless group taxation regimes impose a form of consolidation or unitary taxation. In any case, the taxation of legal entities is not applied on a transactional basis. This is a direct consequence of the separate-entity approach as it is defined for domestic law purposes, as emphasized above. Therefore, the adjustment mechanism contained in article 9 also applies at the level of the entity: only if the profits of an enterprise diverge from what would be observed between comparable independent enterprises can an adjustment to these profits be made. Without an impact on the taxable profits of an enterprise, deviations from market prices cannot be adjusted on the basis of article 9. In this respect, it has been observed in the literature that an income adjustment is possible only if "the accounts do not show the true taxable profits arising in that State."[16] This means that the primary focus is on entities rather than on transactions or groups of entities, which is consistent with the separate-entity approach.

The commentary on article 9(1) of the OECD model tax convention leads to the same conclusion, since adjustments based on the arm's-length principle are made at the entity level, not at the transaction or group level: "[T]he taxation authorities of a Contracting State may, for the purpose of calculating tax liabilities of associated enterprises, re-write the accounts of the enterprises if, as a result of the special relations between the enterprises, the accounts do not show the true taxable profits arising in that State."[17]

The Definition of the Separate-Entity Approach in the OECD Transfer-Pricing Guidelines

To analyze the definition of the separate-entity approach in the OECD transfer-pricing guidelines, one must clarify the link between article 9 of the OECD model tax convention (together with the commentary thereon) and the guidelines, in the event that the definitions of the approach in article 9 and the guidelines are found to be different. As with any article of the OECD model tax convention, one may be tempted to interpret article 9 in light of the commentary related to that article. The commentary on article 9 is brief and, as noted above, consistent with the text of the article. At the same time, it refers to the guidelines for further information on the application of the arm's-length principle. The guidelines are considered in the commentary to represent "internationally agreed principles."[18] This presentation does not thereby make the guidelines an interpretive source with a legal standing superior

16 See Georg Kofler and Jens Wittendorff, "Article 9," in Ekkehart Reimer and Alexander Rust, eds., *Klaus Vogel on Double Taxation Conventions*, 5th ed., vol. 2 (Alphen aan den Rijn, the Netherlands: Kluwer, 2022), at paragraph 74. Such a view was also taken in *Sweden v. Svenske Shell AB*, October 1991, case no. RÅ 1991 ref. 107 (Swedish Supreme Administrative Court).

17 See paragraph 2 of the commentary on article 9 of the OECD model tax convention, supra note 5.

18 See paragraph 1 of the commentary on article 9 of the OECD model tax convention, ibid.

to, or even equal to, that of the commentary. The two documents are separate, and updates may be made to the guidelines without there necessarily being full consideration of an update's interaction with the text of article 9 or the commentary. The guidelines may also be referred to in a tax treaty or a country's domestic law. Moreover, although it may appear paradoxical, it cannot be taken for granted that the guidelines have a material content that is fully consistent with the arm's-length principle, or at least with the interpretation of the arm's-length principle made by the OECD member countries, especially given that—in contrast to the model convention and its commentary—no observations or reservations are made to the guidelines.[19] Nor can it be generally assumed that countries that conclude a tax treaty containing an article similar to article 9 of the OECD model tax convention necessarily intend to interpret that article on the basis of a particular version of the guidelines, especially given the numerous, and sometimes controversial, amendments that have taken place since 1995. Therefore, the guidelines may be considered as having a lower interpretive value than article 9 and the related commentary, unless an explicit reference to the legal standing of the guidelines is made in domestic law or a tax treaty. This means that, in the event of conflicting definitions of the separate-entity approach between article 9 (and its commentary) on the one hand, and the guidelines on the other hand, the views expressed in article 9 and the related commentary should take precedence over those expressed in the guidelines.

At first sight, no risk of conflict seems to exist between article 9 and the guidelines, which are explicitly referred to in the commentary and presented as "internationally agreed principles" that serve the "application" of article 9.[20] On the basis of this simple observation, one would not expect tensions between article 9 and the guidelines, but rather a confirmation and further development of the material content of article 9.

With this background, the definition of the separate-entity approach in the guidelines can be analyzed. Paragraph 1.6 provides a relevant starting point for understanding the function of the separate-entity approach in the guidelines, although, as argued below, this is only a starting point and by no means the sole perspective on the approach provided in the guidelines. After recalling the "authoritative statement of the arm's length principle,"[21] paragraph 1.6 embeds the separate-entity approach by stating that "the arm's length principle follows the approach of treating the members of an MNE group as operating as separate entities rather than as inseparable

19 In this respect, the hard-to-value intangibles approach in chapter VI of the OECD guidelines provides an example of a recommendation that may raise compatibility issues with the arm's-length principle. On the particular case of the US commensurate-with-income standard, see Yariv Brauner, "Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes" (2008) 28 *Virginia Tax Review* 79-164, at 100-1.

20 See paragraph 1 of the commentary on article 9 of the OECD model tax convention, supra note 5.

21 OECD transfer-pricing guidelines, supra note 4, at 31, paragraph 1.6.

parts of a single unified business."[22] This sentence is one of principle, relating to the cross-border allocation of taxing rights: the separate-entity approach is presented as the opposite of a form of unitary taxation that would be applied at the group level. This can be inferred from the mention that the arm's-length principle treats the members of an MNE group "as operating as separate entities rather than as inseparable parts of a single unified business."[23] The alternative taxation principle, which has not been adopted in the guidelines, is referred to as "global formulary apportionment."[24] By being defined in opposition to formulary apportionment, the separate-entity approach seems[25] to be deemed as intrinsic to, or perhaps synonymous with, the arm's-length principle, since both the separate-entity approach and the arm's-length principle are presented as being in opposition to formulary apportionment. This is confirmed by paragraph 1.27 of the guidelines, which mentions the arm's-length principle and formulary apportionment as the two alternative taxation principles, and implies that the separate-entity approach is intrinsic to the arm's-length principle.[26]

By being defined in opposition to some form of unitary taxation, the separate-entity approach in the OECD guidelines appears to be consistent with the OECD model tax convention, since it focuses on the taxation of separate entities. However, the definition of the separate-entity approach in the guidelines is more complex than that. Paragraph 1.6 states: "Because the separate entity approach treats the members of an MNE group as if they were independent entities, attention is focused on the nature of the transactions between those members and on whether the conditions thereof differ from the conditions that would be obtained in comparable uncontrolled transactions." In other words, a link is suggested between an analysis at the entity level and an analysis of the conditions of transactions, whereby a transactional analysis would be necessary to effectively realize the separate-entity approach.

This focus on the conditions of transactions does not seem to correspond exactly to the focus on the profits of enterprises in article 9 or the earlier sentence of paragraph 1.6 of the guidelines, which presents the arm's-length principle as "treating

22 Ibid.

23 Ibid.

24 See ibid., at 34, paragraph 1.16 et seq.

25 A nuance should, however, be brought to this possible relation between the separate-entity approach and the arm's-length principle, based on the analysis conducted in this article: while the separate-entity approach is a necessary premise of the arm's-length principle, it is not strictly synonymous with it. The arm's-length principle is a method for pricing cross-border transactions, while the separate-entity approach is a theoretical foundation on which the arm's-length principle rests.

26 See the OECD transfer-pricing guidelines, supra note 4, at 37, paragraph 1.27: "Thus, the documentation and compliance requirements for an application of global formulary apportionment would generally be more burdensome than under the separate entity approach of the arm's length principle."

the members of an MNE group as operating as separate entities."[27] However, although this sentence may give rise to some confusion, it does not imply an inconsistency within paragraph 1.6, or a contradiction between the guidelines and article 9. While it is indeed the income of entities that is assessed under article 9, that income is directly influenced by the transactions entered into by a company. Since article 9 requires that the profits of associated enterprises be analyzed in light of the arm's-length principle, it is necessary to examine the intercompany transactions that influence such profits. The cumulative effect of these transactions can reveal the portion of the profits that may be affected by the association between the parties. It could also be argued that, since the purpose of article 9 is to correct the effects of market distortions on the profits of associated enterprises, the article requires an analysis of the conditions of intercompany transactions to ultimately ensure that the profits of associated enterprises reflect market conditions. In other words, analyzing the arm's-length character of transactions does not contradict the need to reach a determination of arm's-length profit; rather, it contributes to a more accurate attainment of that objective. This idea is expressed in paragraph 6 of the preface to the guidelines, which states that, "[i]n order to apply the separate entity approach to intra-group transactions, individual group members must be taxed on the basis that they act at arm's length in their transactions with each other."[28]

To conclude, the separate-entity approach is not precisely defined in the OECD guidelines, but its presentation is consistent with the objective of article 9 of the OECD model tax convention. When presenting the separate-entity approach, the guidelines do not suggest an exclusively entity-based analysis, and they acknowledge that an analysis of the conditions of transactions may be necessary to effectively realize the arm's-length principle. Therefore, the separate-entity approach does not entail a legal obligation to carry out a strict transfer-pricing analysis for each legal entity. Rather, it is a methodology that contributes to achieving the objective of article 9. This may explain why no precise definition of the separate-entity approach is provided in article 9, the related commentary, or the guidelines.

The lack of a precise definition of the separate-entity approach leaves room for different interpretations and applications, a point that it is expanded on in the next part of this article.

THE APPLICATION OF THE SEPARATE-ENTITY APPROACH

The analysis of the application of the separate-entity approach in the OECD transfer-pricing guidelines can be presented as a question: Do the guidelines prohibit, allow, or require a transactional, entity-based, or group-wide perspective when applying

27 Ibid., at 31, paragraph 1.6.

28 Ibid., at 12, paragraph 6.

the arm's-length principle? This part of the article will analyze this question, and explain the rationale behind the different perspectives adopted in the guidelines.

One of the findings of the analysis below is that the application of the separate-entity approach in the OECD guidelines appears rather nuanced and, in certain cases, paradoxical. While the overall objective of the guidelines is to implement the arm's-length principle in the most reliable manner, the realization of this objective does not rely on a strict, or even a single, application of the separate-entity approach, but rather on a flexible approach that varies between transactional, entity-based, and group-wide perspectives, depending on the type of issue at hand. This flexibility may seem at first sight unprincipled and paradoxical, and hence open to criticism at a theoretical level. On closer analysis, however, such flexibility seems necessary to enhance the accuracy of the application of the arm's-length principle, and to take stock of the reality that characterizes certain multinational enterprises with respect to the consequences of group membership, as well as the globalization, fragmentation, specialization, and integration of their activities.

Given the limited format of a journal article, the application of the separate-entity approach in the OECD guidelines cannot be analyzed in an exhaustive manner. Instead, the focus here is on several aspects of the guidelines that are considered central to a transfer-pricing analysis. To that end, this part considers the two main steps of a transfer-pricing analysis: the accurate delineation of the actual transaction, and the comparability analysis. Finally, to enrich the analysis herein, the article draws a parallel with the separate-entity approach used for the purpose of attributing profits to permanent establishments under the authorized OECD approach.

The Application of the Separate-Entity Approach for the Purpose of the Accurate Delineation of the Actual Transaction

The accurate delineation of the actual transaction is a concept introduced by the 2017 amendments to the OECD guidelines. It underpins most of the recommendations related to identifying the economic reality of an intercompany transaction. It is also central to the application of the arm's-length principle to features of multinational enterprises that are rarely observed in the open market—that is, the effects of group membership. These two issues are examined next.

Identifying the Reality of an Intercompany Transaction

Chapter I of the OECD guidelines recommends beginning a transfer-pricing analysis with a broad perspective that extends beyond the entities involved in an intercompany transaction. This is one of the main outcomes of the 2017 revision of the guidelines, which followed the work on actions 8 to 10 of the OECD's base erosion and profit shifting (BEPS) project.[29] The rationale for recommending this broader

29 Organisation for Economic Co-operation and Development, *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10—2015 Final Reports* (Paris: OECD, 2015) (herein referred to as "BEPS actions 8-10" or "BEPS actions 8-10 reports").

perspective is tied to one of the objectives of the BEPS project—namely, to "assure that transfer pricing outcomes are in line with value creation."[30] The recommendation to adopt a holistic view at the outset of a transfer-pricing analysis may also be explained by the guidelines' recognition, on the one hand, that multinational enterprises are free to determine how to structure their operations,[31] while, on the other hand, they are subject to various government policies.[32] Accordingly, a broad perspective may be necessary to fully understand a business strategy within the legal framework in which multinational enterprises operate.[33]

The inclusion of the objective to "assure that transfer pricing outcomes are in line with value creation"[34] in the guidelines resulted mainly in the need to take a holistic approach in the functional analysis and the assessment of value creation.[35] Section D.1 of chapter I concerns the identification of the commercial or financial relations between the parties, which is a prerequisite for conducting a transfer-pricing analysis. Here, the objective is to identify the economic reality—sometimes referred to as the "substance"—underlying a transaction. Chapter I makes it clear that this initial analysis should be conducted at the group level, or at least for the relevant parts of a group, to ensure that all key facts and circumstances are considered before the focus narrows to the specific company and transaction in question. Several points in the OECD guidelines can be highlighted in this respect. First, the sections addressing the identification of commercial and financial relations between the parties (paragraphs 1.33 to 1.41) recommend that the analysis should first take a broad view of the industry before examining the group and, subsequently, the specific company within it. Paragraph 1.34 states that "[t]he understanding is derived from an overview of the particular MNE group which outlines how the MNE group responds to the factors affecting performance in the sector, including its business strategies, markets,

30 See Organisation for Economic Co-operation and Development, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013), at 20. In particular, the BEPS action plan emphasized that "[i]n the area of transfer pricing, the rules should be improved in order to put more emphasis on value creation in highly integrated groups, tackling the use of intangibles, risks, capital and other high-risk transactions to shift profits." Ibid., at 14.

31 See the OECD transfer-pricing guidelines, supra note 4, at 369, paragraph 9.34: "MNEs are free to organise their business operations as they see fit."

32 See ibid., at 78, paragraph 1.152: "As a general rule, these government interventions should be treated as conditions of the market in the particular jurisdiction, and in the ordinary course they should be taken into account in evaluating the taxpayer's transfer price in that market."

33 In this respect, see Marta Pankiv, "Post-BEPS Application of the Arm's Length Principle to Intangibles Structures" (2016) 23:6 *International Transfer Pricing Journal* 463-76.

34 OECD, *Action Plan on Base Erosion and Profit Shifting*, supra note 30, at 20.

35 The expression "value creation" is used here as it is also used in the OECD guidelines and the BEPS actions 8-10 reports. However, this does not imply that it is considered a suitable concept for transfer-pricing purposes. For a critical analysis of this concept, see Jérôme Monsenego, "Value Creation and Transfer Pricing," in Werner Haslehner and Marie Lamensch, eds., *Taxation and Value Creation* (Amsterdam: IBFD, 2021), at 107-29.

products, its supply chain, and the key functions performed, material assets used, and important risks assumed."[36] This highlights the importance of taking a broad perspective at the group level to consider circumstances relevant to the group (not just the specific company), including its business strategy and supply chain, which can easily span several companies and countries. The need to take a broad perspective to properly identify business strategies is clearly illustrated with the guidance relating to financial transactions, in chapter X of the guidelines, where consideration of a multinational enterprise's "global financing policy" is emphasized.[37] One should also, according to the guidelines, consider "whether the MNE group is targeting a specific credit rating or debt-equity ratio; or whether the MNE group is adopting a different funding strategy than the one observed in its industry sector."[38] The emphasis on the strategy pursued by the whole group, as opposed to the strategy of a single entity, leaves no doubt as to the broad perspective recommended in the guidelines.

It is only after circumstances are considered at the group level that the analysis proceeds to the company level. This is clarified at paragraph 1.35 of the guidelines: "The process *then* narrows to identify how each MNE within that MNE group operates."[39] But this does not imply that there is no way back to a more holistic perspective: even when focusing on the company level, the analysis must still consider a broader perspective to assess how a specific transaction relates to the group's overall value creation.[40] In particular, a functional analysis should include an evaluation of how functions relate to "the wider generation of value by the MNE group."[41] This is also the case with respect to risks and the DEMPE functions relating to intangibles (that is, the core activities involving intellectual property: development, enhancement, maintenance, protection, and exploitation), since in both cases the control over risk and the recognition of DEMPE functions are relative, rather than absolute, notions: control over risks and DEMPE functions is assessed by measuring and comparing the relative importance of risks and functions attributed to one company with regard to what risks and DEMPE functions are attributed to other group members. To claim that a company exercises full control over risks or performs all DEMPE

36 OECD transfer-pricing guidelines, supra note 4, at 39, paragraph 1.34.

37 See ibid., at 410, paragraph 10.36.

38 See ibid., at 406, paragraph 10.16.

39 Ibid., at 39, paragraph 1.35 (emphasis added).

40 It could be wondered whether the consideration of the contribution of an enterprise to the wider generation of value by the MNE group is only theoretical, or whether it may be taken into account for a transfer-pricing analysis and have a concrete effect on the pricing. In my view, although this step primarily informs the context of the transaction, it may also exercise an influence on its pricing. If that were not meant to be the case, there would be no point in adding this dimension to the guidelines; moreover, even if this broader context were not formally required by the guidelines, in practice tax administrations, taxpayers, competent authorities, and judges may still consider it.

41 See the OECD transfer-pricing guidelines, supra note 4, at 40, paragraph 1.36.

functions, one would generally need to provide evidence that no such control over risks or DEMPE functions is exercised elsewhere in a group. This comparative assessment is not always straightforward, especially where functions are fragmented or overlap between entities; it is nevertheless necessary, especially in view of the introduction of concepts such as the control over risks, which can be assessed only by comparing the different contributions of entities involved in different risk-taking functions.

Such a holistic perspective is also reflected in the guidelines' recommendation to understand "how value is generated by the group as a whole" and identify each company's contribution to the whole "value creation,"[42] as well as their recommendations on the options realistically available to the parties. In that respect, the guidelines emphasize that "it may be necessary or useful to assess the transaction in the context of a broader arrangement of transactions, since assessment of the options realistically available to third parties is not necessarily limited to the single transaction, but may take into account a broader arrangement of economically related transactions."[43]

A broad approach is also recommended when it comes to the circumstances in which a transaction, after having been accurately delineated, may be disregarded for transfer-pricing purposes. Here again, non-recognition may take into account parameters beyond those of the parties that entered into a transaction: any potential rejection should occur only if the various arrangements, viewed as a whole and from a holistic perspective, deviate from what independent parties would have agreed on. The guidelines make clear that a transaction may be disregarded, and if appropriate replaced by an alternative transaction,

> where the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner in comparable circumstances. . . . It is also a relevant pointer to consider whether the MNE group as a whole is left worse off on a pre-tax basis since this may be an indicator that the transaction viewed in its entirety lacks the commercial rationality of arrangements between unrelated parties.[44]

For the same reason, a holistic perspective is also recommended when multinational groups restructure their operations, and a question is raised about the recognition of the accurately delineated transactions that comprise the business restructuring. In such situations, it will generally be appropriate to look at the commercial rationality of a restructuring "as a whole."[45]

42 See ibid., at 46, paragraph 1.51.

43 See ibid., at 41, paragraph 1.38.

44 See ibid., at 75, paragraph 1.142.

45 See ibid., at 370, paragraph 9.36.

To conclude, the theoretical framework contained in the guidelines recommends that a transfer-pricing analysis begin with a broad perspective that goes beyond that of the entities involved in an intercompany transaction. It is only after circumstances are considered at the group level that the analysis proceeds to the company level, although a broad perspective may be needed again, depending on the circumstances. The search for the real substance supporting a transaction, based largely on the analysis of the control over risks and the performance of DEMPE functions, calls into question the separate-entity approach as a theoretical foundation for the arm's-length principle in order to accommodate group-wide realities, since control over risks and the DEMPE functions are relative, rather than absolute, concepts: they are assessed by comparing the risks and functions of a company in the larger context of other group members involved in similar risks and functions.

While this flexible approach may be justified by the need to improve the accuracy of the delineation of the transaction, it creates uncertainty as to the scope of a transfer-pricing analysis. The guidelines do not, and probably cannot, precisely indicate when one should take a broader or a narrower perspective; how to deal with potential conflicts between these perspectives (for example, where an entity-based analysis points to a function performed by that entity, while a group-wide analysis identifies a contribution to that function by another entity); and how to use information gathered at the group level in the context of a transaction between two members of the group.

Considering the Effects of Group Membership

It can be observed that when the OECD guidelines address issues related to group membership, a tension intrinsic to the arm's-length principle appears. Such a tension could be defined as the effort consisting in taking into account the consequences of group membership, in situations that do not exist on the open market, for the purposes of pricing based on market terms. This observation is valid mainly when the consequences of group membership are sought actively, but can also be witnessed when such consequences are benefited from in a passive manner. Here, the guidelines face an insoluble problem: how to identify, measure, and price activities between associated enterprises if such activities cannot be performed by independent enterprises. This tension necessarily affects the application of the separate-entity approach, since an entity-based analysis may be impossible to reconcile with the identification, measurement, and pricing of the effects stemming from group membership. The tension that group membership creates in the operation of the separate-entity approach is not new, but it has certainly been exacerbated by the increasing level of integration among multinational enterprises made possible by globalization and digitalization, whereas group members operated more on a stand-alone basis and value chains were less interdependent when the methods for allocating taxable income were originally conceived.

The guidelines explicitly recognize the tension intrinsic to the arm's-length principle that one encounters when trying to reconcile the separate-entity approach with

the effects of group membership: "There are . . . no widely accepted *objective* criteria for allocating between associated enterprises the economies of scale or benefits of integration resulting from group membership."[46] The key concept in this sentence is the word "objective." What market forces can provide is precisely objective information that can be used for transfer-pricing purposes. Yet in the case of the benefits of group membership, there may be no possible direct reliance on market forces, which by definition cannot reflect the consequences of group membership. It is the purpose of this sentence of the guidelines to acknowledge this difficulty. Nevertheless, despite the lack of objective information provided by the market about situations that cannot exist there, the recommendations still aim at recreating the conditions that would have existed on the open market if a similar situation had arisen. This effort necessarily creates a tension in the application of the arm's-length principle, because it is intrinsically contradictory. At the same time, the existence of this contradiction is understandable and was bound to happen, because it is a direct consequence of the choice to rely on the arm's-length principle in situations that do not exist on the open market.

This tension intrinsic to the arm's-length principle directly affects the extent to which the separate-entity approach is applied. The whole issue consists in determining whether or not one should take into account elements that occur at the level of other group companies and, if so, how such external elements should be taken into account. If one were to strictly apply the separate-entity approach, these external elements would be disregarded, which is not the preferred methodology in the guidelines. Rather, nuances in the separate-entity approach have increased. There may be understandable reasons for that, such as accelerating globalization and economies of scale, as well as synergies made possible thanks to the globalized business environment, or the ease with which value chains can be fragmented across countries while functioning in an integrated manner. With phenomena such as fragmentation and integration being a reality, transfer-pricing rules need to take them into consideration in one way or another, as witnessed with the amendments made to the OECD guidelines following the BEPS actions 8-10 reports.

Despite the potentially convincing reasons such as economic integration and administrative feasibility (which this article does not address) for bringing nuance to the separate-entity approach in order to take into account certain consequences of group membership, the tension created by the choices made in the guidelines inevitably gives rise to issues regarding the extent to which one should depart from a strict entity-based analysis. This tension can be illustrated with three examples: integrated functions, synergy benefits, and financial transactions.

First, integrated functions are one of the areas where a broad perspective is clearly recommended. The guidelines emphasize that the functional analysis should be conducted with consideration of the various group companies' relative contributions to the group's overall value creation; this is particularly important in cases where a

46 See ibid., at 32, paragraph 1.10 (emphasis added).

group has fragmented its functions across several group companies, giving rise to interdependencies between such activities. As a result of the fragmentation of functions, the assumption of risk may also be shared if the control over risks results from the contributions of various parties—for example, in cases of shared control. In such situations, the purpose of the functional analysis is to identify the fragmentation of functions in order to integrate that reality into the transfer-pricing model.[47] These recommendations reflect the specialization across different stages of the value chain, a phenomenon acknowledged in both the BEPS project[48] and the guidelines.[49]

Second, synergy benefits provide an interesting example of the effect of group membership on the application of the arm's-length principle. Here, the guidelines make an effort to enforce the separate-entity approach, while acknowledging the existence of synergies arising from group membership. Indeed, on the one hand, the passive benefits of being part of a larger group—what the guidelines present as incidental benefits—generally should not result in a recognized service or a payment obligation.[50] On the other hand, more active and intentional actions—presented in the guidelines as deliberate concerted group actions—that lead to an advantage may need to be recognized and priced accordingly.[51] The benefits of such synergies should generally be shared by members of the group in proportion to their contribution to the creation of the synergy.[52] This means that synergy effects should be allocated in proportion to the group companies' role in creating those effects. This reflects the separate-entity approach, since it is each company's contribution that should be identified and measured, thereby excluding from synergy benefits the companies that have been passive.

Third, the guidance relating to intercompany financial transactions illustrates the tension between a strict application of the separate-entity approach and a broader approach that takes into account certain consequences of group membership. Here, the effects of group membership may be taken into account with respect to determining

47 See ibid., at 47, paragraph 1.55.

48 See OECD, *Action Plan on Base Erosion and Profit Shifting*, supra note 30, at 7: "As the economy became more globally integrated, so did corporations."

49 See, for example, the OECD transfer-pricing guidelines, supra note 4, preface, at paragraph 2. See also ibid., at 32, paragraph 1.9: "[T]here are some significant cases in which the arm's length principle is difficult and complicated to apply, for example, in MNE groups dealing in the integrated production of highly specialised goods, in unique intangibles, and/or in the provision of specialised services."

50 Incidental benefits are not considered services under chapter VII of the guidelines and do not justify charges under the arm's-length principle: see ibid., at 317, paragraph 7.13.

51 See ibid., at 86-87, paragraph 1.179: "In some circumstances, . . . synergistic benefits and burdens of group membership may arise because of deliberate concerted group actions and may give an MNE group a material, clearly identifiable structural advantage or disadvantage in the marketplace over market participants that are not part of an MNE group and that are involved in comparable transactions."

52 See ibid., at 81-82, paragraph 1.162.

the form, terms, and conditions of intercompany loans, as well as the group support that a borrower may receive in order to meet its financial obligations in the event of financial difficulties.[53] Moreover, while the guidance on synergy benefits mentioned above is followed with respect to the separate-entity approach where a company receives incidental benefits by virtue of group affiliation (that is, in cases of implicit support),[54] a group's credit rating may be used for the purpose of pricing an intercompany loan in situations in which outcomes are, but for the use of the group's credit rating, not reliable,[55] hence going beyond the entity's own credit rating; that is, while the stand-alone credit rating of the borrower is the starting point, a group credit rating may be considered where implicit support is reasonably expected by third parties. In addition, cash pooling provides a clear example of the tension intrinsic to the arm's-length principle when applied to intercompany transactions that mainly occur with multinational enterprises.[56] A cash-pooling arrangement may not only enable more effective liquidity management, but also lead to an enhanced return on an aggregated cash balance—two effects that, as acknowledged in the guidelines, would hardly exist between independent enterprises.[57] This is because all members in a cash-pooling arrangement may be better off thanks to that arrangement—for example, by enhancing interest rates and benefiting from membership with regard to, say, access to liquidity that may not be otherwise available.[58] Here, the guidelines recommend taking into account the wider context of the conditions of the pooling arrangement as a whole,[59] as well as the collective strategy of all the pool members,[60] consistent with the general recommendations presented above regarding the identification of the reality of an intercompany transaction. With regard to the benefits of cash-pooling arrangements, it is recommended, consistent with the guidance relating to synergy benefits in chapter I of the guidelines, to consider only the benefits arising from deliberate concerted group actions.[61] Although the recommendations on cash pooling are consistent with the rest of the guidelines, they are difficult to apply, because the transaction that is to be priced does not, by definition, exist

53 See ibid., at 418, paragraph 10.76.

54 In such a case, the effects of group support on the credit rating would not require any payment or comparability adjustment: see ibid., at 418, paragraph 10.77. This view is consistent with the guidance relating to synergistic benefits: see ibid., at 86, paragraph 1.178.

55 See ibid., at 420, paragraph 10.81.

56 The guidelines are very clear in that respect: "Determining the arm's length interest rates for the cash pool intra-group transactions may be a difficult exercise due to the lack of comparable arrangements between unrelated parties." Ibid., at 431, paragraph 10.145.

57 See ibid., at 426-27, paragraph 10.115.

58 See ibid., at 431-32, paragraph 10.146.

59 See ibid., at 427, paragraph 10.116.

60 See ibid., at 427, paragraph 10.117.

61 See ibid., at 427, paragraph 10.120.

between independent parties—which again illustrates the tension intrinsic to the arm's-length principle.

The conclusion to be drawn from the foregoing analysis is that there is no single application of the separate-entity approach in the theoretical construction of the arm's-length principle that is provided in the OECD guidelines. Conceptual distance from transactions or even entities is required to better capture the role of an entity in a group and its contribution to value chains that may span several countries. This is particularly necessary in situations where group membership makes it possible to engage in transactions, or achieve benefits, that are not available to independent companies. Yet one is still bound by the arm's-length principle. Therefore, the methodology to apply the arm's-length principle in these situations cannot be other than to try to recreate, as accurately as possible, how independent parties would act. This is the paradox of the arm's-length principle and group membership—a phenomenon that is not new, but that is exacerbated by globalization, fragmentation, specialization, and integration among multinational enterprises.

The Application of the Separate-Entity Approach for the Purpose of the Comparability Analysis

The performance of a comparability analysis begins with identifying the most appropriate transfer-pricing method, which is done on the basis of the outcome of the accurate delineation of the actual transaction. This part of the article follows this application of the arm's-length principle by focusing on the determination of a transfer-pricing method and the performance of a comparability analysis.

The Application of the Separate-Entity Approach with Respect to the Determination of a Transfer-Pricing Method

Chapter II of the OECD guidelines is dedicated to transfer-pricing methods—in particular, the selection of the most appropriate method in the circumstances of the case, and a description of the transaction-based and profit-based methods that may be adopted. Here, the separate-entity approach is not to be interpreted as a requirement for conducting a transfer-pricing analysis at the entity level. Rather, preference is given to a transaction-based perspective in the selection of the transfer-pricing method, although the profit-based methods are no longer regarded as a last-resort option. Within transactional methods, the comparable uncontrolled price (CUP) method—the most direct and thus the closest to the actual transaction—is given priority.[62] The priority given to transactional methods is understandable, since they enhance the reliability of comparisons with independent transactions. Not taking transactional methods as a starting point for the choice of a transfer-pricing method would not be fully aligned with the essence of the arm's-length principle, because it is the existence of intercompany transactions, not the fact that entities are associated,

62 See ibid., at 93-94, paragraph 2.3, and at 97, paragraph 2.15.

that creates the need for transfer-pricing rules. The adoption of a transactional perspective for the application of transfer-pricing methods is, therefore, the approach that is most consistent with the purpose of article 9 of the OECD model tax convention, as discussed above.

At the same time, the complexity of the application of the arm's-length principle sometimes makes it necessary to take a broader perspective and apply profit-based methods to approximate arm's-length conditions. The transactional net margin method (TNMM) incorporates also some degree of a transactional analysis, since it does not necessarily apply at the entity level. The TNMM measures net profits, but profits arising as a result of a transaction, rather than profits attributed to a whole entity. This distinction becomes evident when a company performs multiple functions or incurs costs unrelated to a single transaction. In such cases, the guidelines state that financial statements should be segmented, or that costs and revenues should be separately reported.[63] This ensures that the net profit of a specific transaction is determined, and can then be compared with the net profit of one or more independent enterprises engaged in comparable transactions—that is, without blending different types of transactions.[64]

In contrast, the profit split method, which is presented in the guidelines as the "transactional" profit split method, is the least direct of the profit-based methods, although it may apply to the profits arising from specific controlled transactions. There are two main explanations for this. First, the reasons for choosing the profit split method are based on parameters that may go beyond the transaction level to take into account the organization of the value chain—for example, when the parties share economically significant risks, or where operations are highly integrated.[65] Second, the profit-splitting factors are not directly transaction-based but rather rely on various parameters that are intended to capture the contribution to the profits to be split, whether the allocation key is external to the entities (for example, one based on external market data),[66] or internal to the MNE group where there is a lack of comparables.[67]

Consequently, the priority given to transactional methods over profit-based methods is consistent with the general objective of the arm's-length principle, while at the same time allowing for the flexibility made necessary by the reality of various intercompany transactions.

63 See ibid., at 119, paragraph 2.84.

64 See Jérôme Monsenego, *Introduction to Transfer Pricing*, 2d ed. (Alphen aan den Rijn, the Netherlands: Kluwer Law International, 2023), at 67-73, where the consequences of aggregating or segmenting the pricing of different transactions are illustrated with concrete examples.

65 See the OECD transfer-pricing guidelines, supra note 4, at 133, paragraph 2.133, and at 134, paragraph 2.138.

66 See ibid., at 142, paragraph 2.168.

67 See ibid., at 144, paragraph 2.174.

The Application of the Separate-Entity Approach with Respect to the Comparability Analysis

Chapter III of the OECD guidelines relates to the comparability analysis—the comparison of a controlled transaction with transactions between unrelated parties. Since the comparability analysis follows the functional analysis and the choice of a transfer-pricing method, the application of the comparability analysis will necessarily be influenced by the outcome of the preceding steps. Nevertheless, chapter III contains valuable elements for understanding the application of the separate-entity approach.

First, once the years to be covered have been determined, a comparability analysis begins with a "[b]road-based analysis of the taxpayer's circumstances."[68] This analysis is not limited to the actual transaction, but focuses on all relevant information for the entity engaged in the transaction: "It can be defined as an analysis of the industry, competition, economic and regulatory factors and other elements that affect the taxpayer and its environment, but not yet within the context of looking at the specific transactions in question."[69]

Second, after the broad-based analysis of the taxpayer's circumstances, come the review of the controlled transaction and the choice of the tested party. At this stage, the perspective taken by the guidelines is opposite to that recommended for the functional analysis, since the preferred level of analysis is the transaction, which is consistent with the priority given to the CUP method and the other transactional transfer-pricing methods. However, if the analysis becomes too detailed and risks missing the role of a given transaction in the whole value chain, a broader perspective is recommended. This methodology is explained in the guidelines as follows: "Ideally, in order to arrive at the most precise approximation of arm's length conditions, the arm's length principle should be applied on a transaction-by-transaction basis."[70] This implies that aggregated transactions should preferably be assessed separately; at the same time, the guidelines emphasize that "there are often situations where separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis."[71] Several examples relating to business strategies, which do not appear to be exhaustive, are provided; this seems reasonable, because understanding business strategies can help determine the correct extent of a transfer-pricing analysis, especially whether transactions should be assessed together or separately.[72] Such a holistic assessment is also recommended for package deals[73] and intentional setoffs.[74]

68 See ibid., at 150, paragraph 3.4.

69 See ibid., at 151, paragraph 3.7.

70 See ibid., at 152, paragraph 3.9.

71 Ibid.

72 See ibid., at 152, paragraph 3.10.

73 See ibid., at 152-53, paragraph 3.11.

74 See ibid., at 153, paragraph 3.13 et seq.

It follows from the above that the recommendation to conduct a transaction-based analysis and use transaction-based transfer-pricing methods does not mean that each transaction should be analyzed in isolation, if doing so leads to an outcome that does not reflect what would have occurred in an independent setting. The possibility of recognizing compensating adjustments or, where appropriate, aggregating multiple transactions serves as evidence that the analysis cannot always be limited to each transaction taken separately. In other words, if achieving an arm's-length outcome requires a broader perspective—such as considering multiple transactions together—this broader perspective is permitted and even encouraged in the guidelines.

The Separate-Entity Approach and the Attribution of Profits to Permanent Establishments

The authorized OECD approach for the attribution of profits to permanent establishments and the application of the arm's-length principle to intercompany transactions are two different legal frameworks functioning under the auspices of articles 7 and 9 of the OECD model tax convention. However, in both cases, reference is made to the separate-entity approach, which in the case of permanent establishments is valid both before and after adoption of the authorized OECD approach.[75] Given that the authorized OECD approach relies to a certain extent on the OECD guidelines, analyzing the application of the separate-entity approach for the attribution of profits to permanent establishments provides an interesting perspective to the topic analyzed in this article. At the same time, given that the two legal frameworks fundamentally differ over whether the entities involved have separate legal personality, the analysis below is meant only to be illustrative.

75 Different countries have for a long time been applying the separate-entity approach to treat permanent establishments (PEs) as independent entities, as emphasized by the League of Nations in its 1933 report (League of Nations Fiscal Committee, *Report to the Council on the Fourth Session of the Committee*, League of Nations doc. C.399.M.204.1933.II.A (Geneva: League of Nations, 1933), at 4242): "[F]or tax purposes, permanent establishments must be treated in the same manner as independent enterprises operating under the same or similar conditions, with the corollary that the taxable income of such establishments is to be assessed on the basis of their separate accounts." See also Ekkehart Reimer, "Article 7," in *Klaus Vogel on Double Taxation Conventions*, supra note 16, vol. 1, at paragraph 123: "Since the early days of treaty rules on business profits (and long before the OECD started its work resulting in the 2010 integration of the AOA [authorized OECD approach] into today's Article 7(2) OECD MC [model convention]), the PE threshold has always been connected to the idea that the PE should be imagined as a separate enterprise." The application of the separate-entity approach to permanent establishments has also been emphasized by the Canadian Federal Court of Appeal in *Cudd Pressure Control Inc. v. The Queen*, 98 DTC 6630. For an in-depth analysis, see David A. Ward, "Attribution of Income to Permanent Establishments" (2000) 48:3 *Canadian Tax Journal* 559-76.

Under the authorized OECD approach, the separate-entity approach is used for the purpose of attributing profits to permanent establishments.[76] It may appear contradictory to apply the separate-entity approach to permanent establishments, since a permanent establishment is, by definition, not a legal person. For that reason, the separate-entity approach is used only as a guiding principle for taxation purposes. To that end, the authorized OECD approach presents the theoretical basis for the attribution of profits to permanent establishments as the "functionally separate entity approach."[77] To avoid any confusion, the OECD report makes clear that this approach is based on a fiction—that of attributing profits to a permanent establishment as if it were a separate and independent enterprise.[78]

Therefore, under the authorized OECD approach, the separate-entity approach is not strictly applied, as illustrated by the fact that no withholding taxes may be levied on payments (for example, for the use of intangible property) made between different parts of the same legal entity.[79] Rather, the authorized OECD approach applies a flexible interpretation of the separate-entity approach. On the one hand, conceptual distance is taken from the profits of the enterprise to which the permanent establishment belongs: profits may be attributed to a permanent establishment even though the enterprise as a whole has never made profits; conversely, no profits may be attributed while the enterprise as a whole has made profits.[80] On the other hand, this distance facilitates a closer alignment with comparable independent entities—for example, the attribution of free capital is primarily dependent on the

76 It should be emphasized that the previous wording of paragraph 2 of article 7 of the OECD model tax convention, supra note 5, was already designed on the basis of the separate-entity approach, referring to "a distinct and separate enterprise." This reflects a consensus that has existed since "at least the 1930s": see Philip Baker and Richard S. Collier, "General Report," in International Fiscal Association, *The Attribution of Profits to Permanent Establishments*, Cahiers de droit fiscal international, vol. 91b (Amersfoort, the Netherlands: Sdu Fiscale & Financiële Uitgevers, 2006), at 26. This does not mean, however, that the separate-entity approach is followed to the same extent in the previous and current versions of article 7, since there are different degrees of independence on the basis of which a permanent establishment may be taxed. Moreover, it should be pointed out that the UN model tax convention does not adopt the authorized OECD approach. Therefore, the authorized OECD approach is far from being applicable in all tax treaty contexts.

77 See Organisation for Economic Co-operation and Development, *2010 Report on the Attribution of Profits to Permanent Establishments* (Paris: OECD, July 2010), at 12, section B-1.

78 See ibid., at 13, paragraph 11: "The hypothesis by which a PE is treated as a functionally separate and independent enterprise is a mere fiction necessary for purposes of determining the business profits of this part of the enterprise under Article 7. The authorised OECD approach should not be viewed as implying that the PE must be treated as a separate enterprise entering into dealings with the rest of the enterprise of which it is a part for purposes of any other provisions of the Convention."

79 See ibid., at 53, paragraph 203.

80 See paragraph 11 of the commentary on article 7 of the OECD model tax convention, supra note 5.

significant people functions exercised by the permanent establishment,[81] not on the capitalization of the entity to which the permanent establishment belongs. However, this methodology is not systematic, making the use of the separate-entity approach flexible, as in certain cases the authorized OECD approach recommends adopting an entity-based approach—for example, when taking into account the same creditworthiness as the enterprise to which the permanent establishment belongs, or when measuring the importance of functions performed by the permanent establishment relative to those performed by the whole entity.

It can be seen, then, that the authorized OECD approach adopts a flexible application of the separate-entity approach, by both considering and disregarding entity-based factors. Moreover, the authorized OECD approach does not always adopt the same application of the separate-entity approach as the OECD guidelines do for transfer-pricing purposes, as illustrated by the fact that a permanent establishment generally enjoys the same creditworthiness as the enterprise to which it belongs,[82] whereas the OECD guidelines do not generally recommend taking into account the creditworthiness of the whole group when pricing an intercompany loan.[83]

CONCLUSION

The separate-entity approach is a central concept in the field of transfer pricing: it provides the theoretical foundation for the arm's-length principle, which functions as a methodological standard to enforce the separate-entity approach. However, despite this central role, the definition of the separate-entity approach is ambiguous given its widespread use in both domestic and cross-border contexts. Moreover, when it comes to its application in the OECD guidelines, the separate-entity approach appears as a fluctuating concept that functions more as a means than an end, eventually putting into question its validity as a theoretical basis for transfer-pricing rules. It can be wondered to what extent the separate-entity approach may be sustained as MNE groups operate more globally, interactions between members of such MNE groups increase, and the OECD guidelines in many instances recommend an analysis that places more weight on how functions are performed and interact.

One conclusion of this study is that the separate-entity approach in article 9 of the OECD model tax convention does not entail a legal obligation to strictly carry out a transfer-pricing analysis per legal entity. It is rather a guiding principle that

81 Under the authorized OECD approach, a permanent establishment should have sufficient capital to support the functions it undertakes, the assets it economically owns, and the risks it assumes. Since free capital follows risks (see OECD, *2010 Report on the Attribution of Profits to Permanent Establishments*, supra note 77, at 32, paragraph 91), and risks follow functions, it will primarily be the functions exercised by the permanent establishment that determine the free capital needed to support the activities of the permanent establishment.

82 See ibid., at 33, paragraph 99.

83 See the OECD transfer-pricing guidelines, supra note 4, at 418, paragraph 10.77.

contributes to the achievement of the objective of article 9—that is, ensuring that the profits of associated enterprises are adjusted to approximate the profits of arm's-length enterprises. Since the separate-entity approach is only a guiding principle, it is not surprising that its practical application, as recommended in the OECD guidelines, does not always adhere strictly to an entity-based analysis: indeed, the guidelines contain recommendations that lean toward both a transactional and a group-wide perspective, depending on the issue at hand. This does not reveal an inconsistency within the guidelines, or an incompatibility between the guidelines and article 9, when adherence to a strict entity-based analysis may prevent either a sufficiently precise analysis at the transactional level, or a sufficiently broad analysis that takes into account the effects of group membership. Rather, the deviations from a strict application of the separate-entity approach that are recommended in the OECD guidelines are meant to ensure that the arm's-length principle can be applied with greater accuracy.

A second conclusion of this study is that the separate-entity approach is a guiding principle even in situations that may not exist between independent enterprises, which is due to the theoretical choice to always rely on the arm's-length principle. This choice also has practical consequences, since the different approaches recommended in the guidelines—transactional, entity-based, and group-based—eventually need to be combined and applied for the purpose of pricing intercompany transactions. The OECD guidelines do not, and probably cannot, provide clear recommendations in this respect, which leads to uncertainty resulting from the paradox of applying to associated enterprises a methodology that should, but may not be able to, rely on market forces. Accordingly, a transfer-pricing analysis will always contain some uncertainty as to what perspective to adopt and how to combine different perspectives.

These observations lead to questioning whether the reliance on the separate-entity approach in the OECD guidelines is theoretically valid. This issue is not a new one—it was already observed in the early work of the League of Nations—but it has been exacerbated by the development of various effects related to group membership, made possible by globalization and digitalization, that were much less obvious when the separate-entity approach was originally adopted by certain countries as a profit allocation method. This brings one back to the fundamental issues of principle related to the taxation of multinational enterprises. Outside the field of transfer pricing, the separate-entity approach seems to be slightly declining, as illustrated, to take a few examples, by the adoption of controlled foreign corporation rules in the European Union's anti-tax-avoidance directive,[84] the use of group ratios for interest limitation purposes,[85] jurisdictional blending under the OECD's global anti-base erosion

84 See Council Directive (EU) 2016/1164, supra note 10, articles 7 and 8.

85 See ibid., article 4, paragraph 5(b).

(GloBE) rules,[86] and the reallocation mechanism under some of the proposals made by the Inclusive Framework on BEPS in order to address the tax challenges arising from the digitalization of the economy.[87] However, in the field of transfer pricing, the main alternative to the separate-entity approach and the arm's-length principle—that is, global formulary apportionment—can hardly be better grounded in theory: a formula presupposes making a choice as to its elements. It appears impossible to design a formula that is objectively deemed to be theoretically valid, or at least more valid than the separate-entity approach and the arm's-length principle, which are characterized by an intrinsic objectivity and neutrality—that of letting market forces steer the pricing of intercompany transactions. Therefore, despite the issues that are raised by the application of the separate-entity approach in the field of transfer pricing, this approach can hardly be ruled out solely on the grounds of conceptual weaknesses, since the main alternative rests on a less convincing theoretical foundation.

86 See Organisation for Economic Co-operation and Development, *Tax Challenges Arising from the Digitalisation of the Economy—Global Anti-Base Erosion Model Rules (Pillar Two)* (Paris: OECD, 2021), especially chapters 2-5.

87 See in particular the amount A proposal, which reallocates a portion of certain groups' taxable profits to countries where there may not be a resident legal entity. See Organisation for Economic Co-operation and Development, *Multilateral Convention To Implement Amount A of Pillar One* (Paris: OECD, October 11, 2023).

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Tax Treaty Arbitration: An Unacceptable Surrender of National Sovereignty or an Expression of Sovereign Power?

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PRÉCIS

La publication en 2016 par l'Organisation de coopération et de développement économiques d'un projet de convention multilatérale visant à modifier des milliers de conventions fiscales bilatérales mondiales a été étonnamment bien reçue par la communauté internationale. De nombreux États ont en effet signé, ratifié et mis en œuvre la convention. L'un des éléments les plus controversés de la convention est l'ajout aux mesures de règlement des différends prévues dans les conventions bilatérales — un processus connu sous le nom de procédure amiable —, d'une procédure d'arbitrage obligatoire quand le processus conventionnel ne permet pas d'arriver à un accord. Contrairement à la procédure amiable, qui n'impose pas de parvenir à un accord final, la procédure d'arbitrage obligatoire peut garantir le règlement d'un différend lié à une convention. Bien que l'article sur l'arbitrage ait été ratifié par la plupart des pays développés, de nombreux pays en développement ont émis des réserves à son sujet, indiquant qu'ils ne l'intégreraient pas dans leurs conventions bilatérales. Au centre des nombreux arguments avancés par les opposants à l'arbitrage obligatoire dans les conventions fiscales bilatérales figure l'idée qu'accepter l'arbitrage obligatoire revient à un abandon inacceptable de leur souveraineté. Cependant, lorsqu'on l'examine d'un œil critique dans le contexte des conventions fiscales, cet argument et tant d'autres perdent de leur pertinence ou s'avèrent fallacieux. Cet article propose qu'une meilleure approche consiste à considérer la conclusion d'une convention fiscale comme un exercice de souveraineté fiscale. Ainsi, tout accord visant à réduire les droits d'imposition ou d'autres droits dans la convention devrait être vu comme un élément de cet exercice de souveraineté pour obtenir les avantages ou les bénéfices que les parties recherchent dans le cadre d'une convention accordant des droits mutuels et imposant des obligations mutuelles aux signataires souverains.

ABSTRACT

The release in 2016 by the Organisation for Economic Co-operation and Development of a draft multilateral treaty to modify thousands of global bilateral tax treaties was

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met with surprisingly strong support by the international community, with many states signing, ratifying, and implementing the treaty. One of the treaty's most contentious elements is the addition to the dispute resolution measures in bilateral treaties, a process known as mutual agreement procedure, of a mandatory arbitration procedure that is to be available where agreement cannot be reached under the conventional process. In contrast to the mutual agreement procedure, which includes no requirement that a final agreement be reached, the mandatory arbitration procedure can provide a guaranteed resolution of a treaty dispute. Although the arbitration article has been ratified by most developed countries, many developing nations have noted reservations to it, indicating that they will not incorporate it into their bilateral treaties. Central to the many arguments that have been put forward by opponents of mandatory arbitration in bilateral tax treaties is the argument that agreeing to mandatory arbitration would amount to an unacceptable surrender of sovereignty. However, when viewed critically in the context of tax treaties, this and many other concerns fall away or are revealed to be red herring arguments. A better view, this article suggests, is that entering into a tax treaty is an exercise of fiscal sovereignty, and any agreement to reduce taxing or other rights in the treaty should be seen as an element of that exercise of sovereignty to gain the benefits or advantages the parties seek through a treaty that grants mutual rights to and imposes mutual obligations on sovereign signatories.

KEYWORDS: TAX TREATIES ■ MANDATORY ARBITRATION ■ DISPUTE RESOLUTION ■ MULTILATERAL INSTRUMENT (MLI)

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INTRODUCTION

Arbitration, and more often than not binding arbitration, is a common feature of bilateral treaties. A treaty without a dispute resolution mechanism may be a recipe for enduring conflict. Most bilateral tax treaties nevertheless have no mandatory arbitration or dispute resolution process, and instead provide a means for the two parties to the treaty to discuss the issue through designated officials from the tax authorities of each jurisdiction known as "competent authorities." The absence of any mandatory dispute resolution mechanism in most tax treaties is striking, given the potential consequence of double taxation of the same income by both parties to the treaty if disputes intended to be covered by the treaty are not resolved.

Under accepted international sovereignty and tax principles, whenever there is a cross-border investment or business activity, both the country in which the investor or business owner is resident and the country that receives the investment or hosts the business activity can claim and exert full taxing rights over the profits generated by the investment or activity. In the absence of a bilateral agreement between countries on either side of the investment or activity, the profit source country—that is, the country in which the investment is located or the business activity takes place—has the first opportunity to enforce its tax claim. In effect, that leaves the country in which the investor or business owner is resident with residual taxing rights only, unless the country of residence is willing to ignore the source country's tax on cross-border income and contemplate full double taxation of the profits.

It is common, however, for both capital-exporting and capital-importing countries to enter into bilateral treaties that divide the taxing rights between them. Capital-importing countries effectively surrender some taxing powers in return for other perceived benefits from the treaty. While all bilateral tax treaties provide a mechanism for negotiation between the tax authorities of both jurisdictions when there is a dispute over the division of taxing rights under the treaty, most do not contain a mandatory dispute resolution procedure, leaving the risk that competing claims for the right to tax profits might not be resolved. This article asks a seemingly simple question: Should countries agree to mandatory binding arbitration in their bilateral tax agreements?

Contemporary international law experience might suggest that a treaty is only as good as its dispute resolution mechanism. In recent years, that conclusion has found widespread support among tax officials in wealthier economies and international organizations, and support for mandatory arbitration clauses in bilateral tax treaties has grown. Proponents of mandatory arbitration view it, not as a replacement for the negotiation system found in most tax treaties, but as a supplement to that system, providing a means of resolving a tax treaty dispute where the negotiation path has failed to achieve a mutually agreed outcome.[1] This view is not shared by all

1 Carlo Garbarino and Marina Lombardo, "Arbitration of Unresolved Issues in Mutual Agreement Cases: The New Para. 5, Art. 25 of the OECD Model Convention, a Multi-Tiered Dispute Resolution Clause," in Michael Lang et al., eds., *Tax Treaties: Building Bridges Between Law and Economics* (Amsterdam: IBFD, 2010), 459-80, at 480.

international tax treaty experts, however. Specifically, critics of the proposal have cautioned developing countries to avoid signing on to the mandatory arbitration section of their treaties,[2] arguing that mandatory arbitration amounts to an unacceptable surrender of fiscal sovereignty that would be disadvantageous to these countries.[3]

An important question to be explored in any analysis of the arguments against inclusion of a mandatory arbitration provision in tax treaties is whether critics' objection to the feature is based solely on features of mandatory arbitration, or whether it is influenced by their dislike of treaties themselves, which undeniably shift some taxing rights from capital-importing nations to capital-exporting nations.

Until recently, the question was primarily of interest to academics and outside observers. Although bilateral tax treaties date back over 150 years,[4] and possibly more than 200 years in one view,[5] the question of dispute resolution and in particular agreement to incorporate provisions for mandatory arbitration was rarely a consideration for most countries. The model templates used as the starting point for treaties set out a simple negotiation procedure with no arbitration or guaranteed decision included. The issue became pressing for most countries, however, with the widespread adoption of a 2016 multilateral agreement to collectively revise most existing bilateral treaties. The treaty, sponsored initially by the Organisation for Economic Co-operation and Development (OECD) but subsequently endorsed by more nations outside the OECD in the context of an OECD "inclusive framework" initiative, includes an optional measure that would incorporate mandatory arbitration into all of a signatory's existing bilateral treaties, subject to agreement of the treaty partners. When countries signed on to the multilateral agreement, they had to decide whether to endorse or reject the mandatory arbitration clause.

This article explains the dilemma faced by signatories to the multilateral treaty and the reasons for reluctance by many, particularly lower-income capital-importing nations, to embrace a feature common to bilateral and multilateral treaties outside the tax context. It suggests that the answer to the question whether countries should agree to mandatory arbitration in their tax treaties is nuanced: for some countries, the approach may be advisable; for others, reservations may be warranted but the issue should be resolved on its merits, without viewing agreement as surrender of any sovereignty.

The article proceeds in five parts. The following two parts describe the history of the debates about the resolution of tax treaty disputes, drawing attention to key

2 ActionAid, "ActionAid Briefing on the Multilateral Convention To Implement Tax Treaty Related Measures To Prevent Base Erosion and Profit Shifting" (https://actionaid.org/sites/default/files/20170601taxbriefing2.pdf), at 3.

3 Martin Hearson and Todd N. Tucker, "'An Unacceptable Surrender of Fiscal Sovereignty': The Neoliberal Turn to International Tax Arbitration" (2023) 21:1 *Perspectives on Politics* 225-40.

4 Sunita Jogarajan, "The Conclusion and Termination of the 'First' Double Taxation Treaty" [2012] no. 3 *British Tax Review* 283-306.

5 Andrey Savitskiy, "Tax in History: The First Tax Treaties: In Search of Origins" (2021) 49:6/7 *Intertax* 569-85 (https://doi.org/10.54648/taxi2021058).

players and arguments. The first part focuses on the 20th century, during which possible methods for resolving tax treaty disputes were considered but in practice bilateral treaties almost inevitably followed the model treaties published by the OECD and United Nations, with no mandatory resolution required. The second part turns to the 21st century, where the story changes. After a century of relatively settled approaches to dispute resolution, interest in a more developed and compulsory mechanism for resolving treaty disputes grew. That interest came from business organizations, some academics, a few high-income countries, and ultimately from the OECD. The end result was a multilateral treaty that enables countries to include mandatory arbitration in all of their treaties with one action (assuming that the treaty partner agrees). Building from the historical review in the first two parts, the third part summarizes the advantages and disadvantages of the permissive approach to dispute resolution by competent authorities, which was favoured until recently, and the mandatory resolution approach, which is now favoured by many countries. The article then turns to the arguments made by opponents of mandatory binding arbitration in their tax treaties. The closing part offers provocative reflections on the challenge for middle- and low-income countries of the ongoing international norm setting by the OECD in the international tax field.

DIVIDING TAXING RIGHTS

Bilateral tax treaties are among the world's most common treaties, with over 3,000 in place and more being signed every year.[6] Their widespread implementation is a consequence of the overlap of national income tax systems in the case of cross-border investments and human mobility. A pair of foundational principles common to income tax systems around the world are that resident taxpayers are assessable on their global income, and that non-resident taxpayers may be taxed by a jurisdiction on the income they derive that has a connection to that jurisdiction. There are, as a result, two (or more) claims to tax the same income in the case of cross-border investments: the investment destination, based on that country's recognized right to tax income derived from sources in the jurisdiction, and the investor's country of residence, based on its right to tax residents on their worldwide income.

The resulting layers of taxation, which can equal 100 percent or more of the income generated by a cross-border investment, may do more than merely inhibit cross-border investment and business activity; they could put a stop to that activity entirely. Not surprisingly, jurisdictions adopted unilateral solutions to assist in integrating the taxation of cross-border income soon after their adoption of the income tax, which happened in most developed countries during or soon after the First World War. The US federal income tax preceded the conflict by a year.[7]

6 Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version 2014* (Paris: OECD, 2014).

7 The Underwood-Simmons Tariff Act of 1913 (also known as "the Revenue Act of 1913"), Pub. L. no. 63-16, enacted October 3, 1913, United States, Revenue Act of 1913.

In the design of these early integration systems, countries accepted that the source jurisdiction's right to tax income from cross-border business and investment arrangements would remain unfettered. Taxing rights were ceded by the residence state. Residence states implemented one of three systems. Following the lead of the United States, many adopted a foreign tax credit system, subjecting the resident's foreign income to tax along with their domestic-source income, but providing a credit for any foreign tax payable on the foreign income.[8] Other jurisdictions, such as France, exempted foreign income from tax at residence. A third approach, adopted for a time by the United Kingdom, provided a deduction for the foreign tax, essentially treating the tax as another cost of business. Because the third approach provided only partial relief for the foreign tax, which created a competitive disadvantage for firms with operations abroad, the United Kingdom pivoted to the US-style foreign tax credit at an early stage.[9] Many countries adopted integration methods that were hybrids, borrowing from more than one of these models, with design features differing on the basis of the country where source activities were undertaken or the type of income earned.

These unilateral responses addressed the problem of layers of taxation that created disincentives to participation in income-producing foreign activities, but the resolution favoured the interests of source states. If the activity flows between countries were roughly even, no serious fiscal consequences followed, as countries gained revenue on the swings that they lost on the roundabouts. But if the activity flows between countries were uneven, the resolution of the risk of double taxation benefited capital-importing countries over capital-exporting ones.

As might be expected, capital-exporting countries soon sought a new deal—a negotiated sharing of taxing rights over income from cross-border investments and business activities. However, bilateral solutions proceeded slowly, with countries anxious to avoid the confusion and distortions that an array of uncoordinated and possibly incompatible bilateral treaties might entail. The preferred solution of the world's major capital-exporting countries was a single model tax treaty that could be used as the basis for bilateral treaties.

The countries that had adopted income taxes during the first two decades of the 20th century delegated the task of developing a global response to the dual claims of taxing rights over profits from cross-border investments and business activities to the League of Nations shortly after its formation. The initial efforts of the League to develop a multilateral global treaty, or even to bring bilateral treaties under the umbrella of the international law model for other types of treaties that relied on an

8 The leading work on the development of the US foreign tax credit system is Elisabeth A. Owens, *The Foreign Tax Credit: A Study of the Credit for Foreign Taxes Under United States Income Tax Law* (Cambridge, MA: Law School of Harvard University, 1961).

9 John F. Avery Jones, "The History of the United Kingdom's First Comprehensive Double Taxation Agreement," in John Tiley, ed., *Studies in the History of Tax Law*, vol. 3 (Oxford, UK: Hart, 2009), 229-80, at 255-56.

independent, international juridical system for dispute resolution, gathered little momentum, however.[10] Encountering strong resistance to global solutions by members concerned that the broad approach would impinge on national sovereignty rights, the League quickly pivoted to the much more modest goal of developing a model bilateral treaty with no dispute resolution mechanism outside the treaty.

Over the following two decades, largely depending on political circumstances and who could attend meetings of the group drafting the model, particularly following the outbreak of the Second World War and at its end, the model treaty veered from one favouring capital-importing countries to one favouring capital-exporting jurisdictions. The final version prepared by the League, in one of its final actions, was released in 1946 after a meeting in London where wealthier countries dominated attendance. Not surprisingly, the model shifted many of the taxing rights over cross-border income to the capital-exporting countries.[11]

Following the post-war transition of the League of Nations to the United Nations, the latter institution inherited the League's draft tax treaty model and independently studied the impact of double taxation issues on international investment flows, but it made no progress on the League's work on a model bilateral treaty. That project largely sat in abeyance until it was resumed by the Organisation for European Economic Co-operation (OEEC), the body overseeing the Marshall Plan's post-war reconstruction of Europe.[12] The OEEC released a draft treaty in 1961, which was inherited by its expanded and international successor body, the OECD, representing the world's wealthiest nations. That draft treaty, released in 1963, refined the final League of Nations draft model.[13] The OECD model consciously favoured the interests of capital-exporting nations, since the model resulted in parity between source countries and residence countries only if cross-border investments and business activities were roughly even in both directions. For this reason, the preface to the model noted that it should only be used as the basis for treaties between developed countries.

10 These developments are comprehensively set out in Sunita Jogarajan, *Double Taxation and the League of Nations* (Cambridge, UK: Cambridge University Press, 2018); see also, for example, Ke Chin Wang, "International Double Taxation of Income: Relief Through International Agreement 1921-1945" (1945) 59:1 *Harvard Law Review* 73-116 (https://doi.org/10.2307/1335505).

11 "Model Bilateral Convention for the Prevention of the Double Taxation of Income and Property," in League of Nations, Fiscal Committee, *London and Mexico Model Tax Conventions: Commentary and Text*, League of Nations document no. C.88.M.88.1946.II.A (Geneva: League of Nations, 1946) (herein referred to as "the London draft convention"), articles XVII, XIX.

12 The treaty initiative of the OEEC and the hiatus in the UN's role are detailed in Nikki J. Teo, *The United Nations in Global Tax Coordination: Hidden History and Politics* (Cambridge, UK: Cambridge University Press, 2023).

13 Organisation for Economic Co-operation and Development, *Draft Double Taxation Convention on Income and Capital* (Paris: OECD, 1963).

The OECD model quickly became the model for all treaties entered into by OECD nations. Concerns over the impact of the model grew as member states began to expand their treaty networks to include less-developed countries, prompting the UN to enter the field for the first time in the late 1960s. The UN group of experts issued an initial report in 1969[14] and a second in 1970;[15] these were followed by a manual for negotiating treaties between developed and developing countries,[16] and finally, in 1980, a model for tax treaties between developed and developing countries.[17] The model was largely based on the OECD model framework but included some modest shifts of taxing rights from residence (capital-exporting) treaty partners to source (capital-importing) nations.[18] The differences between the OECD and UN models were narrowed over subsequent years as the OECD model adopted some anti-avoidance features from the UN model that OECD members had started to incorporate into their treaties.[19]

In addition to the primary goal of dividing taxing rights, the model treaties and negotiated bilateral treaties based on them contained a number of additional features, such as an agreement to share taxpayers' financial information and to provide assistance with the collection of tax. And because bilateral tax treaties inevitably led to disputes between parties concerning their interpretation and application, bilateral treaties provided a dispute resolution mechanism.

In contrast to international treaties in most other areas of law, the dispute resolution article in both the OECD and UN model tax treaties had no mechanism to ensure final resolution of any dispute between the treaty partners. The relevant article of the OECD model simply provided for what were referred to as "competent authorities"

14 United Nations, Ad Hoc Group of Experts on Tax Treaties, *Tax Treaties Between Developed and Developing Countries: First Report*, UN publication no. ST/ECA/110 (New York: United Nations, Department of Economic and Social Affairs, 1969).

15 United Nations, Ad Hoc Group of Experts on Tax Treaties, *Tax Treaties Between Developed and Developing Countries: Second Report*, UN publication no. ST/ECA/137 (New York: United Nations, Department of Economic and Social Affairs, 1970).

16 United Nations, Department of International Economic and Social Affairs, *Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries*, UN publication no. ST/ESA/94 (New York: United Nations, 1979).

17 United Nations, Department of International Economic and Social Affairs, *United Nations Model Taxation Convention Between Developed and Developing Countries*, UN publication no. ST/ESA/102 (New York: United Nations, 1980) (herein referred to as "the UN model (1980)").

18 Michael Lennard, "The UN Model Tax Convention as Compared with the OECD Model Tax Convention—Current Points of Difference and Recent Developments" (2009) 15:1 *Asia-Pacific Tax Bulletin* 4-11.

19 For example, both model treaties allowed source countries to retain full taxing rights over gains on the sale of real property, but, prior to 2005, only the UN model also included such a provision in respect of sales of interests in interposed holding companies "the property of which consists directly or indirectly principally of immovable property" in the source country: UN model (1980), supra note 17, article 13(4).

of each country to endeavour to resolve conflicting views of the application of the treaties using a "mutual agreement procedure." The process generally had no timetable and no consequences if the process continued indefinitely (or failed).

The implications for taxpayers of this approach in the event of ongoing disagreement in the mutual agreement process were illustrated in the treaty interpretation dispute involving Pierre Boulez in the 1980s that may have resulted in penal-like level of taxation of the taxpayer caught in the dispute.[20] Mr. Boulez, a well-respected orchestra conductor, was a citizen of France and a resident of Germany. Through an intermediary company, he entered into a contract with a record company requiring him to conduct an orchestra in New York, with the recordings of the music becoming the property of the record company. The contract between the record company and Mr. Boulez used ambiguous language, indicating that he would be remunerated for his services by way of royalties from the sale of records.

The United States and Germany agreed on the effect of relevant parts of the treaty. Under the treaty, the source country (in this case, the United States) had first taxing rights over remuneration for services, with the residence country being required to provide a credit for any tax levied, while the residence country had exclusive taxing rights over royalty income. The countries differed on whether the payments in question were for services or were a royalty. The US tax authority characterized the income as payments for personal services and assessed Mr. Boulez for US income tax on the full amount of the payments, while the German tax authority characterized the same amounts as royalties and imposed German income tax on the payments. Each of the competent authorities insisted that its country's interpretation was the correct one and, as a result, the characterization of the payments was not resolved by the competent authorities.[21]

THE FIRST CENTURY OF TAX TREATY LAW

The story of tax arbitration reaches back to the beginning of international arbitration and the First Hague Peace Conference in 1899. The conference looked for ways to resolve international disputes before they escalated to armed conflicts, and turned

20 See further Konstantinos Taramountas, "The Mutual Agreement Procedure: Coordinating the Global Tax Orchestra" (2019) 4 *LSE Law Review* 39-62, at 42; Klaus Vogel, "Double Tax Treaties and Their Interpretation" (1986) 4:1 *International Tax and Business Lawyer* 1-85, at 4, 61, and 65; and David R. Tillinghast, "The Choice of Issues To Be Submitted to Arbitration Under Income Tax Conventions" (1994) 22:4 *Intertax* 159-66, at 160. Details of the negotiations between German and US authorities are not published. Mr. Boulez's attempts to overturn the US income tax assessments may be found in *Boulez v. CIR*, 83 TC 584 (1984) and *Pierre Boulez v. CIR*, 810 F 2d 209 (1987).

21 It appears that a unilateral action may have eventually provided relief from double taxation for Mr. Boulez. Picciotto suggested that "it seems that the German authority eventually allowed a credit for the US tax paid." See Sol Picciotto, *International Tax Disputes: Between Supranational Administration and Adjudication*, ICTD Working Paper 55 (Brighton, UK: International Centre for Tax and Development, August 2016), at 9, note 10.

to arbitration as a solution, drawing on positive outcomes from ad hoc international arbitration instances in the previous century.[22] The result was the creation of the Permanent Court of Arbitration in 1898, a body established with the goal of averting war, though most of the initial cases brought before the body concerned commercial matters, including a tax dispute, the *Japanese House Tax* arbitration.[23]

The *Japanese House Tax* dispute concerned the imposition of a Japanese tax on land holdings of foreign powers and turned on the interpretation of provisions under treaties of commerce and navigation concluded shortly before the end of the Russo-Japanese war. The case was initiated under a protocol to the treaties signed in 1902 and decided by the three-member panel in favour of Great Britain, France, and Germany, with the Japanese member of the tribunal dissenting from the decision.[24] The decision is relevant to some of the concerns raised in the current international tax dispute resolution debates. The perception of at least some members of the Japanese community was that the arbitration process was untrustworthy and unfair to "colored people."[25] Other commentators have raised similar concerns about biases because decision makers fail to appreciate the consequences of different cultural norms on the weighing of relevant factors in advance of decision making.[26] While

22 Particularly influential were the Jay Treaty arbitration panels appointed to resolve disputes between the United States and Great Britain, concerning border issues with a Canadian colony at the close of the 18th century, and the later Alabama claims arbitration resolving another dispute between the United States and Great Britain. The former are reviewed in Richard B. Lillich, "The Jay Treaty Commissions" (1963) 37:2 *St. John's Law Review* 260-83; the Alabama claims decision is reproduced in "Alabama Claims of the United States of America Against Great Britain, Award Rendered on 14 September 1872 by the Tribunal of Arbitration Established by Article I of the Treaty of Washington of 8 May 1871" (2012) 29 *Reports of International Arbitral Awards* 125-34.

23 *Japanese House Tax (Germany, France and Great Britain v. Japan)*, Award of the Tribunal of Arbitration Constituted in Accordance with the Protocols, signed at Tokyo on August 28, 1902, by Japan of the one part, and Germany, France, and Great Britain of the other part, PCA Case no. 1902-02 (The Hague, 22 May 1905).

24 See further Ilias Bantekas, "Interstate Arbitration in International Tax Disputes" (2017) 8:3 *Journal of International Dispute Settlement* 507-34, at 512 (https://doi.org/10.1093/jnlids/idx003); Katerina Perrou, *Taxpayer Participation in Tax Treaty Dispute Resolution* (Amsterdam: IBFD, 2014), chapter 1, at section 1.2.1; and Manley O. Hudson, "The Permanent Court of Arbitration" (1933) 27:3 *American Journal of International Law* 440-60, at 449.

25 Kisaburo Yokota, "International Adjudication and Japan" (1973) 17 *Japanese Annual of International Law* 1-18, at 4.

26 Christine Gray and Benedict Kingsbury, "Developments in Dispute Settlement: Inter-State Arbitration Since 1945" (1992) 63:1 *British Yearbook of International Law* 97-134, at 112. Illustrating the limitations of arbitration as a definitive resolution of disputes, the dispute in the *Japanese House Tax* case (supra note 23) continued for many years (until 1937) after the arbitral award in respect of the application of other property taxes to foreign leasehold property: Yasuo Ishimoto, "International Arbitration in the Meiji Era" (1963) 7 *Japanese Annual of International Law* 30-37, at 35-37.

great efforts may be made to achieve truly neutral arbitrations,[27] the risk of unconscious bias remains.

International support for arbitration waned in the period preceding the First World War[28] but was revived in its aftermath. Efforts to build international law institutions for the settlement of disputes, including arbitration, led to the establishment of the International Court of Arbitration in 1923 under its umbrella organization, the International Chamber of Commerce, and the enactment of the Geneva Protocol of 1923 on Arbitration Clauses[29] and the Geneva Convention of 1927 on the Execution of Foreign Arbitral Awards.[30] The public international arbitration initiatives paralleled landmark efforts at internationalization and institutionalization of arbitration in private international law.[31]

Prior to the First World War, national income tax systems were rare, though state or provincial governments in federal countries such as Canada, Australia, and the United States often had subnational income taxes, and a small number of European jurisdictions had similar taxes in place, particularly the United Kingdom and German states prior to unification. The adoption of income taxes was accompanied by the development of tax treaties, which often built on the precedent of treaties to prevent double taxation with respect to estate and inheritance taxes.[32] As discussed above, with a notable exception, the early income tax treaties contained no formal dispute resolution process, although they often included a clause indicating that differences would be resolved by way of a non-binding, negotiation-based process.[33] That exception was the 1926 income tax agreement between the United Kingdom and the Irish Free State, which included a mandatory and binding arbitration measure in the event that the countries' tax authorities were unable to resolve disputes together.[34]

27 Arno E. Gildemeister, "The Independence and Impartiality of Arbitrators," in Werner Haslehner et al., eds., *Alternative Dispute Resolution and Tax Disputes* (Cheltenham, UK: Edward Elgar, 2023), 240-59.

28 Steven Harris, "Taming Arbitration: States' Men, Lawyers, and Peace Advocates from the Hague to the War" (2017) 19:3 *Journal of the History of International Law* 362-96, at 378.

29 Protocol on Arbitration Clauses, signed at Geneva, September 24, 1923, entered into force July 28, 1924; published in (1924) vol. 27, no. 678 *League of Nations Treaty Series* 157.

30 Convention on the Execution of Foreign Arbitral Awards, signed at Geneva, September 26, 1927, entered into force July 25, 1929; published in (1929-1930) vol. 92, no. 2096 *League of Nations Treaty Series* 301.

31 Michael John Mustill, "Arbitration: History and Background" (1989) 6:2 *Journal of International Arbitration* 43-56, at 48-49.

32 Sunita Jogarajan, "Prelude to the International Tax Treaty Network: 1815-1914 Early Tax Treaties and the Conditions for Action" (2011) 31:4 *Oxford Journal of Legal Studies* 679-707, at 683.

33 Zvi Altman, *Dispute Resolution Under Tax Treaties* (Amsterdam: IBFD, 2005), at section 1.2.1.1; and Hans Mooij, "Tax Treaty Arbitration" (2019) 35:2 *Arbitration International* 195-220, at 198.

34 See the Agreement Between the British Government and the Government of the Irish Free State in Respect of Double Income Tax, signed by UK Chancellor of the Exchequer and Ministry of Finance on April 14, 1926, set out in Finance Act 1926 (UK), no. 35 of 1926, first schedule. At the time, the United Kingdom regarded the Irish Free State as a dominion in

Although the mechanism for resolving disputes in the interpretation and application of treaties has been relatively consistent for a century, alternatives have been a topic of discussion in the design of model treaties over that era. The initial model income tax treaty developed by the League of Nations started with a report by an external committee of experts on taxation matters appointed by the League's Financial Committee in 1923. The committee's report, delivered two years later,[35] included a brief discussion of possible processes for resolving disagreements over taxing rights. The authors noted that multilateral treaties generally provided for consideration of disputes by a specialist tribunal with a right of appeal to a higher authority such as the Permanent Court of International Justice,[36] and suggested that an appropriate specialist tribunal would need to be created if this route were to be followed. A further report two years later repeated this advice.[37]

Subsequently, the League's council appointed a significantly enlarged technical committee, including a representative from the United States, which was not a member of the League, charged with the task of preparing a model bilateral income tax treaty for the allocation of taxing rights over income from cross-border investment and business. The committee reported in 1928, releasing an initial draft model bilateral treaty, which provided contracting states with the option to appeal unresolved disputes to a technical body to be appointed by the League of Nations, and a further option to agree to be bound by decisions of the body.[38]

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the British empire, and considered agreements within the empire as not constituting treaties of an international nature. The Anglo-Irish articles of agreement of 1921 registered at the League of Nations in 1924 (see also the subsequent agreement included in the Agreement Between Great Britain and the Irish Free State, Amending and Supplementing the Treaty of December 6, 1921, Between Great Britain and the Irish Free State, signed at London, December 3, 1925; published in (1926) vol. 44, no. 1088 *League of Nations Treaty Series* 263 (registered on February 8, 1926)) thus included a note of dispute from the United Kingdom and a reply by the Irish Free State. See Heather J. Harvey, *Consultation and Co-operation in the Commonwealth: A Handbook on Methods and Practice* (New York: Oxford University Press, 1952), at 282-83, discussed in Anne Twomey, *Federal Parliament's Changing Role in Treaty Making and External Affairs*, Department of the Parliamentary Library Research Paper no. 15 (Canberra: Department of the Parliamentary Library, 2000), note 105. A binding arbitration measure was also included in a succession duty convention between Czechoslovakia and Romania in 1934. See Altman, supra note 33, at section 1.2.1.2.3.

35 League of Nations, *Double Taxation and Tax Evasion: Report and Resolutions Submitted by the Technical Experts to the Financial Committee*, League of Nations document F.212 (Geneva: League of Nations, February 1925).

36 Ibid., at 29.

37 League of Nations, *Double Taxation and Tax Evasion: Report Presented by the Committee of Technical Experts on Double Taxation and Tax Evasion*, document C.216.M.85 (London: League of Nations, April 12, 1927).

38 See "Bilateral Conventions for the Prevention of Double Taxation in the Special Matter of Direct Taxes," in League of Nations, *Double Taxation and Tax Evasion: Report Presented by the General Meeting of Government Experts on Double Taxation and Tax Evasion*, document C.562.M.178.1928.II (London: League of Nations, October 31, 1928), at 7, article 14.

There was some dissension from the proposal in the 1928 draft treaty to establish an independent appeal body to consider treaty disagreements,[39] and a revised draft released in 1943 omitted the option to appeal to an independent adviser or decision maker,[40] as did a third draft released in 1946.[41] The first iteration of the League's model, released in 1928, followed the pattern of earlier income tax treaties and set out what, as noted earlier, is now referred to as a mutual agreement procedure as the basis for resolving disputes. The procedure was a "*pactum de negotiando*," with no obligation on the parties to reach a result in any particular case, though it did leave open an option for the parties to elevate the disagreement to any arbitral or judicial body, including the Permanent Court of International Justice.[42]

Significantly, the mutual agreement procedure could be invoked only where differing interpretations had led to double taxation. It could not be used where the taxpayer had been subject to taxation in only one country and sought to invoke the process to shift the taxing rights to the other country (which might result in double non-taxation if the income in question were exempt in the other country). Under the later versions of the model, in 1943 and 1946, if taxpayers had concerns about the interpretation and application of the relevant tax treaty, procedurally, the route to resolve them was to appeal to their domestic tax authority, which could then consult directly with the competent authority of the other state "with a view to reaching an agreement."[43]

Alongside the model bilateral income tax treaty efforts of the League of Nations, a rapidly expanding country practice was emerging.[44] In the absence of any higher review authority as envisaged in the League of Nations draft, almost all treaties (except the UK-Irish Free State agreement, as noted earlier) provided for consultations between national authorities but with no voluntary or mandated resort to arbitration should they not be able to come to an agreement.[45] Some treaties were silent

39 Altman, supra note 33, at section 1.3.1.1.5.

40 "Model Bilateral Convention for the Prevention of the Double Taxation of Income," in League of Nations, Fiscal Committee, *London and Mexico Model Tax Conventions: Commentary and Text*, document C.88.M.88.1946.II.A (London: League of Nations, November 1946) (herein referred to as "the Mexico draft convention"), articles XVI-XVII.

41 London draft convention, supra note 11.

42 John F. Avery Jones, Charles J. Berg, Henri-Robert Depret, Maarten J. Ellis, Pierre Fontaneau, Raoul Lenz, Toshio Miyatake, Sidney I. Roberts, Claes Sandels, and Jakob Strobl, "The Legal Nature of the Mutual Agreement Procedure Under the OECD Model Convention—Part I" [1979] no. 6 *British Tax Review* 333-53, at 337.

43 Mexico draft convention, supra note 40, article XVI(2); London draft convention, supra note 11, article XVII(2).

44 See the listing in Mitchell B. Carroll, *Prevention of International Double Taxation and Fiscal Evasion: Two Decades of Progress Under the League of Nations* (Geneva: League of Nations, 1939), annex II.

45 Yariv Brauner, "International Tax Treaty Dispute Resolution, the Mutual Agreement Procedure, and the Promise of Mandatory Arbitration for Developing Countries," in Yariv Brauner, ed., *Research Handbook on International Taxation* (Cheltenham, UK: Edward Elgar, 2020), 191-216, at 197.

on the resolution of disputes,[46] while others employed completely permissive language (for example, "may come to an agreement")[47] or quasi-mandatory language (for example, "shall come to an understanding")[48]—language that is now understood to provide authorities with a duty to make some attempt to settle such claim, but not to compel a resolution.[49] Neither alternative provided guides to resolution should agreement not be reached.

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46 See, for example, the 1945 US-UK treaty, which remained silent on this issue until a 1966 protocol to the treaty: the Convention Between the United States of America and the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Washington, DC on April 16, 1945, entered into force July 25, 1946, no. I:76, 6 UNTS 189 (herein referred to as "the 1945 US-UK treaty"). The omission of any dispute resolution language was quite unfortunate in the eyes of some observers. See, for example, Jones, supra note 9, at 267. See also the Convention and Protocol Between the United States of America and France on Double Taxation, signed at Paris on April 27, 1932, entered into force on April 9, 1935; published in (1935-1936) vol. 164, no. 3795 *League of Nations Treaty Series* 211; 49 Stat 3145, USTS 885, in *Treaties and Other International Agreements of the United States of America*, vol. 7, *(Bilateral Treaties, 1776-1949: Denmark-France)* (compiled by Charles I. Bevans), at 977 (www.loc.gov/item/lltreaties-ustbv007). See also the Convention and Protocol Between the United States of America and France, Signed at Paris, April 27, 1932, *Treaty Series* 885 (https://history.state.gov/historicaldocuments/frus1932v02/d187). By contrast, the later 1939 US-France and US-Sweden treaties contained a limited mutual agreement provision: the Convention Between United States and France and Protocol on Double Taxation, signed on July 25, 1939 entered into force on January 1, 1945, article 25, 59 Stat 893; USTS 988; and the Convention Between the United States and Sweden and Protocol on Double Taxation: Income and Other Taxes, signed on March 23, 1939, entered into force January 1, 1940, article XX; published in (1939-1940) vol. 17, no. 4661 *League of Nations Treaty Series* 199; 54 Stat 1759; USTS 958.

47 See the Convention Between France and Sweden for the Avoidance of Double Taxation and for the Establishment of Rules for Reciprocal Administrative Assistance in the Case of Direct Taxes, signed on December 24, 1936; published in (1938) vol. 184, no. 4241 *League of Nations Treaty Series* 35 (English version noted as "Translated by the Secretariat of the League of Nations, for information") (registered on January 1, 1938), article 15 (French: "peut s'entendre").

48 Ibid., protocol, article VI ("In the event of difficulties or disputes arising in connection with the application of the provisions of Articles 3, 4, and 5 of the Convention [broadly, the articles relating to permanent establishments and maritime and air transport profits], the supreme revenue authorities shall come to an understanding. . . ." In French, the official language of the text of the treaty, the last phrase reads "les autorités fiscales suprêmes s'entendraient . . ."—that is, it uses the future conditional tense, whereas, by contrast, the future plain tense is used in other contexts involving "shall" in the English translation of this treaty. See also, for example, the Convention Between the Kingdom of Romania and the Czechoslovak Republic Concerning Double Taxation in Connection with Succession Duties, signed at Bucharest, June 20, 1934; published in (1935-1936) vol. 168, no. 3902 *League of Nations Treaty Series* 249 (registered on May 26, 1936), article 6: "the dispute shall be submitted ["sera soumis" in French, the official language of the text of the treaty] to whatever technical organisation the Fiscal Committee of the League of Nations may determine").

49 See Andre A. Aversa, "International Tax Allocations and Treaty Relief Through Competent Authority Procedures" (1966) 19:1 *Tax Executive* 15-30, at 16-17.

Not surprisingly, few tax treaties were concluded during the course of the Second World War (a notable exception being the 1945 US-UK tax treaty, signed weeks before the end of hostilities in Europe), but attention returned to the question of treaties and dispute resolution following the end of the conflict. In 1949, the Netherlands proposed to the Fiscal Commission of the UN Economic and Social Council, the successor body to its League of Nations counterpart, the establishment of a tax chamber in the International Court of Justice or a separate specialist international tax court, a proposal that garnered little support.[50] Two years later, a congress of the International Fiscal Association, an organization that, at that time, was composed mostly of tax professionals and government officials from developed economies, promoted serious discussion of arbitration of international income tax disputes,[51] but the discussion had no influence on country policies.

When the OEEC created its Fiscal Committee in 1956, that body picked up the project. As discussed above, the committee generated several reports on tax treaties and prepared a draft model bilateral income tax treaty that was inherited by the OECD.[52] The mutual agreement procedure provision in the 1963 draft merely required the tax authorities to work together to resolve disputes, with no explanation of what might happen if they failed to do so. While the resolution by the OECD Council adopting the model treaty did include an instruction to the body's Fiscal Committee to examine the arbitration issue,[53] this led to no proposals for an alternative to the conciliatory mutual agreement procedure set out in the original model.

In the years immediately following the release of the 1963 draft, there was some modest discussion of the process for resolving treaty disputes, but none of those discussions resulted in changes to the treaty model. A business and industry advisory committee to the OECD in 1971 put forward a suggestion for tax treaty arbitration, but the idea was dropped over the following years.[54] Scholarship by academics

50 Altman, supra note 33, at section 1.3.1.3.

51 Gustaf Lindencrona and Nils Mattsson, *Arbitration in Taxation* (Deventer: Kluwer, 1981), at 29.

52 H. David Rosenbloom and Stanley I. Langbein, "United States Tax Treaty Policy: An Overview" (1981) 19:3 *Columbia Journal of Transnational Law* 359-406, at 367-68; and Altman, supra note 33, at section 1.3.1.4.1.

53 Giovanni Rolle, "Economic Double Taxation of Cross-Border Income in the Internal Market: A Study on Conflicts of Qualification and Evaluation of Transactions Between Corporate Entities" (PhD dissertation, KU Leuven, Faculty of Law and Criminology, 2019) (https://lirias.kuleuven.be/2861407&lang=en), at 171. The commentary to the 1963 draft also included reference to the possibility of contracting parties seeking an opinion from the OECD Fiscal Committee on the meaning of a treaty provision and referring matters to "certain persons" acting as arbitrators for opinion. See Mooij, supra note 33, at 199.

54 Carl S. Shoup, "International Arbitration of Transfer Pricing Disputes Under Income Taxation," in Alan M. Rugman and Lorraine Eden, eds., *Multinationals and Transfer Pricing* (London: Routledge, 1985), chapter 15, at 291 and 293, citing Organisation for Economic Co-operation and Development, *Additional Studies Concerning the Mutual Agreement Procedure: Report of the Committee on Fiscal Affairs*, Working Group Report no. 22 (Paris: OECD, 1972);

advocating a role for mandatory arbitration also gained no immediate traction.[55] The Royal Commission on Taxation in Canada proposed that determining the "existence and degree" of double taxation should be the responsibility of a tribunal with a representative of each country and a third member chosen by them.[56] Given that tax treaties received only five pages of attention in what was otherwise a massive royal commission report, it is perhaps not surprising that the proposal generated no action.

The release of a US model bilateral tax treaty in 1977 saw an expansion of mutual agreement procedure text from the OECD model,[57] but the US model adopted similar language in terms of resolving disputes. A revision of the OECD model the same year also saw a change to the language of the mutual agreement article, but the model continued to lack any resolution mechanism should there be no agreement between the two competent authorities. Additionally, none of the work leading up to the 1980 UN model tax treaty suggested changes to the OECD model mutual agreement provision, and the provision in the UN model mirrored its OECD companion. A few years later, in 1982, an OECD report on transfer pricing—the use of inflated or deflated prices for intragroup supplies to shift profits from higher-tax to lower-tax jurisdictions—recorded concerns raised by multinational enterprises (MNEs) about the protracted nature of the mutual agreement procedure and the possibility that states might resolve cases in rough-and-ready ways en masse, but dismissed the option of mandatory arbitration as a dispute resolution mechanism on the grounds that the mutual agreement procedure was widely recognized as efficient, flexible, and suitable.[58]

While arbitration remained off the menu for model treaties, the problem of never-resolved tax treaty disputes was well known, epitomized by the *Boulez* case noted earlier.[59]

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see also G.K. Kwatra, "Arbitration in International Tax Disputes: A New Approach" (1988) 5:4 *Journal of International Arbitration* 151-64, at 158 (https://doi.org/10.54648/joia1988053). This working group, staffed by delegates from France and Switzerland, had reported on the mutual agreement procedure on a preliminary basis in 1965 and 1966, the former jointly with a second working group staffed by delegates from Austria and Sweden: Rolle, supra note 53, at 171.

55 Lindencrona and Mattsson, supra note 51.

56 Canada, *Report of the Royal Commission on Taxation*, vol. 4 (Ottawa: Queen's Printer, 1966), at 569-70 and 577.

57 Jeanne N. Covington, "Dispute Resolution Under Tax Treaties: Current and Proposed Methods" (1989) 24:2 *Texas International Law Journal* 367-88, at 373-75.

58 "Transfer Pricing, Corresponding Adjustments and the Mutual Agreement Procedure [derestricted in October 1982]," in Organisation for Economic Co-operation and Development, *Transfer Pricing and Multinational Enterprises: Three Taxation Issues, Reports of the OECD Committee on Fiscal Affairs* (Paris: OECD, 1984), 9-42, at 9, 18, and 38-39. The report followed from Organisation for Economic Co-operation and Development, "Transfer Pricing and Multinational Enterprises: Report of the OECD Committee on Fiscal Affairs," approved on May 16, 1979.

59 Supra note 20.

The impasse in the *Boulez* dispute had a profound effect on the two treaty partners involved, and in 1985, a year after the US courts heard Mr. Boulez's appeal seeking relief from double taxation, Germany and Sweden initialled a tax treaty that included a measure for the resolution of disputes by the International Court of Justice through a reference in the treaty to the European Convention for the Peaceful Settlement of Disputes of 1957.[60] The following year, the United States and Germany replaced their tax treaty with one providing an arbitration option to resolve disputes,[61] a shift that was largely founded on an effort to expedite the resolution of existing unresolved tax treaty disputes.[62] Arbitration was also added to the US-Mexico treaty by way of protocol in 1992,[63] and to the US-Canada tax convention in 1995 by way of protocol.[64] The US-Canada provision did not go into effect, however, and the change on a more limited basis was made in a 2007 protocol to the 1980 treaty, which received the relevant exchange of notes on September 21, 2007.[65] Significantly,

60 See Joseph H. Guttentag and Ann E. Misback, "Resolving Tax Treaty Issues: A Novel Solution" (1986) 40:8/9 *Bulletin for International Taxation* 350-57, at 350. The provisions of the treaty are described in Leif Mutén, "New Germany-Sweden Tax Convention Examined" (September 1992) 5 *Tax Notes International* 531-35.

61 Convention Between the Federal Republic of Germany and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, signed at Bonn on August 29, 1989, as amended by the protocol signed on August 29, 1989, entered into force on August 21, 1991 and effective on January 1, 1990; 1708 UNTS 3.

62 The protocol to this treaty also directly addressed (ibid., at paragraph 11) the issue confronted in *Boulez*, supra note 20, providing in relation to article 12 on royalties that "[w]here an artiste resident in one Contracting State records a performance in the other Contracting State, has a copyrightable interest in the recording, and receives consideration for the right to use the recording based on the sale or public playing of such recording, then such consideration shall be governed by this Article." See Tillinghast, supra note 20, at 160.

63 US-Mexico: Protocol to the Convention Between the Government of the United Mexican States and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed on September 18, 1992, entered into force on December 28, 1993, article 18(b); 2453 UNTS 221.

64 US-Canada: Protocol Amending the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington on September 26, 1980, entered into force on August 16, 1984 [1469 UNTS 189], as amended by the protocols signed on June 14, 1983 [2121 UNTS 364] and March 28, 1984 [2121 UNTS 387], signed on March 17, 1995, entered into force on November 9, 1995, article 14(2); 2030 UNTS 236 (herein referred to "the US-Canada tax convention").

65 Protocol Amending the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital, signed at Washington on September 26, 1980, as amended by the protocols signed on June 14, 1983 and March 28, 1984, signed on September 21, 2007, entered into force on December 15, 2008, article 21(1); TIAS 08-1215.2. See further Maya Ganguly, "Tribunals and Taxation: An Investigation of Arbitration in Recent US Tax Conventions" (2012) 29:4 *Wisconsin International Law Journal* 735-77; and Elizabeth Peters and H. David Rosenbloom, "From Arbitration to Zero Withholding: A Primer on the Canada-U.S. Treaty Protocol" (2008) 51:7 *Tax Notes International* 603-12.

however, the 1996 US model treaty omitted any measure to resolve disputes should the parties not come to agreement notwithstanding the direction for them to do so ("the Contracting States shall endeavor to resolve by mutual agreement").[66]

The limited instances of treaties with mandatory or optional final resolution procedures prior to 2000 were exceptions to the rule. In the eyes of some, the period was marked by notable efforts on the part of national governments to concede taxation rights under pressure from MNEs, by allowing tax haven transactions that relied on tax treaty provisions, perhaps as a tax competition strategy.[67] As the history above reveals, unlike low- and middle-income countries, business advocacy groups have always had a seat at the tax treaty-making table. But if multinational taxpayers are influential in tax treaty design, why did they pay so little attention to, or have such little impact on, the design of the dispute resolution provisions in tax treaties?

While the primary influencers of tax treaty policy, the designers of the UN and OECD model treaties, remained to be persuaded of the merits of compulsory arbitration in the closing decades of the 20th century, support for the approach was developing. Pressure from businesses mounted. In 1984, for example, the International Chamber of Commerce prepared a document on the resolution of international tax conflicts that urged the establishment of an international tax court in the long run and a mandatory arbitration process in the intervening period.[68] Three years later, a representative from a developing country on the United Nations Ad Hoc Group of Experts on International Co-operation in Tax Matters called for the establishment of an international arbitration system to resolve treaty disputes,[69] and the issue was considered at length by the group the following year, in 1988. A majority of the UN

66 United States, Model Income Tax Convention of September 20, 1996: Convention Between the United States of America and --- for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, article 25(3) (herein referred to as "the 1996 US model treaty").

67 "The motives that inspired governments to selectively encourage offshore leakages were often extremely limited and short-sighted, while the consequences were extensive and long-ranging": Vanessa Ogle, "Archipelago Capitalism: Tax Havens, Offshore Money, and the State, 1950s-1970s" (2017) 122:5 *American Historical Review* 1431-58, at 1433. See also Vanessa Ogle, "'Funk Money': The End of Empires, the Expansion of Tax Havens, and Decolonization as an Economic and Financial Event" (2020) 249:1 *Past & Present* 213-49 (https://doi.org/10.1093/pastj/gtaa001); N.D.B. Connolly, "The Enduring, Gilded Periphery: Colonialism and Grand Cayman in Capital's Atlantic World" (2020) 19:2 *Journal of the Gilded Age and Progressive Era* 206-16; and Sol Picciotto, "Technocracy in the Era of Twitter: Between Intergovernmentalism and Supranational Technocratic Politics in Global Tax Governance" (2022) 16:3 *Regulation & Governance* 634-52 (https://doi.org/10.1111/rego.12351).

68 International Chamber of Commerce, "The Resolution of International Tax Conflicts" (1984) 24:10 *European Taxation* 337-40.

69 Noted in United Nations, Department of International Economic and Social Affairs, *International Co-operation in Tax Matters*, *Report of the Ad Hoc Group of Experts on International Co-operation in Tax Matters on the Work of Its Third Meeting*, STA/ESA/185 (New York: United Nations, 1987), at paragraph 69.

group at that time was reluctant to recommend arbitration as a way of resolving disputes between competent authorities, but conceded that some solution was needed to overcome the impasse when authorities simply agreed to disagree. A halfway measure, the group suggested, might be for both parties to seek advice from a mutually acceptable source, though the members noted the limitations of any approach short of a mandatory resolution system.[70]

An important development in the final decade of the 20th century was the adoption of an EU arbitration convention in 1990, effective from January 1, 1995.[71] The sole explicit reference to income tax in the early versions of the constituent treaty of the European Union was an invitation to member states to negotiate among themselves to prevent double taxation, a measure removed from the treaty in its current form.[72] A 1976 proposal for an EU directive to establish an arbitration regime for intra-EU transfer-pricing disputes was abandoned[73] when member states created a multilateral treaty outside the EU umbrella to forestall EU intervention.[74] The mandatory arbitration measure in the multilateral treaty effectively overrode the bilateral treaty resolution measures in bilateral treaties between EU members. Further, albeit less direct, support for arbitration came with the adoption of the North American Free Trade Agreement in 1994, with commentators suggesting mandatory tax arbitration clauses could be used to enhance the goals of that trilateral treaty.[75]

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70 United Nations, Department of International Economic and Social Affairs, *Contributions to International Co-operation in Tax Matters*, STA/ESA/203 (New York: United Nations, 1988), chapter 4, under the heading "Resolving International Tax Disputes," at paragraphs 147-53.

71 European Union, 90/436/EEC: Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises, OJ L 225/10, August 20, 1990. See Shafi U. Khan Niazi and Richard Krever, "Is Integration of Income Taxation Possible in the EU?" (2015) 30:2 *Australian Tax Forum* 455-70, 467-68; and H.M. Pit, "Commission Initiative To Improve Dispute Settlement Mechanisms Within the European Union—The EU Arbitration Convention (90/436)" (2016) 56:11 *European Taxation* 507-23 (discussing also European Commission 2015 proposals for improvement of the convention). See also European Council, Council Directive (EU) 2017/1852 on Tax Dispute Resolution Mechanisms in the European Union, OJ L 265/1, October 10, 2017, discussed in Jasna Voje, "The Limits to the Participation of the Taxpayer in Tax Dispute Resolution Procedure Under the Dispute Resolution Directive" (2020) 48:2 *Intertax* 157-76 (https://doi.org/10.54648/taxi2020015).

72 European Union, Consolidated Version of the Treaty on the Functioning of the European Union, OJ C 326/47, October 26, 2012. See further Luc Hinnekens, "The Uneasy Case and Fate of Article 293 Second Indent EC" (2009) 37:11 *Intertax* 602-9; and Ben J.M. Terra and Peter J. Wattel, *European Tax Law*, 6th ed. (Alphen aan den Rijn, the Netherlands: Wolters Kluwer Law & Business, 2012), at 14-16.

73 Lindencrona and Mattsson, supra note 51, at 30.

74 Luc Hinnekens, "The Tax Arbitration Convention: Its Significance for the EC Based Enterprise, the EC Itself, and for Belgian and International Tax Law" (1992) 1:2 *EC Tax Review* 70-105, at 82-83 (https://doi.org/10.54648/ecta1992012).

75 Arthur J. Cockfield, "Tax Integration Under NAFTA: Resolving the Conflict Between Economic and Sovereignty Interests" (1998) 34:1 *Stanford Journal of International Law*

The potential consequences of double taxation in the absence of mandatory arbitration in tax treaties may be significant and the risk of double taxation may affect cross-border investment decisions. However, in the event that negotiation fails and there is no mandatory resolution, the double taxation outcome is not a certainty. A solution outside the treaty—unilateral abandonment of taxing rights where a treaty has been adopted to jointly divide those rights—is possible.[76] A solution within the treaty appears to be a more logical policy path, however, and in the period following the *Boulez* case, some countries gradually moved to modify existing treaties to include a mandatory arbitration measure, or adopted new treaties with this measure. Support for the concept quickly escalated in the 21st century, as explained further below, ending with the inclusion of a mandatory arbitration provision in the 2016 multilateral treaty that could potentially modify almost all existing bilateral treaties to include a guaranteed resolution of treaty disputes.

A NEW CENTURY AND THE RISE OF MANDATORY ARBITRATION

The first decade of the 21st century witnessed increasing interest in mandatory arbitration. Although the OECD and UN may have been slow to get on board, individual countries were moving to embrace mandatory arbitration. The US-Germany treaty, which in 1989 had incorporated optional arbitration following the *Boulez* case, was amended by protocol in 2006 to replace the optional arbitration clause with one providing for mandatory arbitration.[77] Interest in the United States and its treaty partners in arbitration was no doubt enhanced by the increased focus by the United States on MNE transfer-pricing arrangements, a tax treaty issue particularly likely to give rise to disputes between taxpayers and tax authorities.[78]

39-73, at 68-69. For further discussion that is both supportive and skeptical of the impact of the mandatory arbitration provision, see H. David Rosenbloom, "Sovereignty and the Regulation of International Business in the Tax Area" (1994) 20 *Canada-United States Law Journal* 267-72; and H. David Rosenbloom, "Mandatory Arbitration of Disputes Pursuant to Tax Treaties: The Experience of the United States," in Michael Lang and Jeffrey Owens, eds., *International Arbitration in Tax Matters* (Amsterdam: IBFD, 2016), chapter 7 (https://doi.org/10.59403/2mybtt4007).

76 As noted earlier, supra note 21, it appears that double taxation was ultimately avoided in the case by means of unilateral relief offered by the German tax authority.

77 Protocol Amending the Convention of August 29, 1989 for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, with a Related Joint Declaration, signed at Berlin on June 1, 2006, entered into force on December 28, 2007, article XIII.

78 Hugh J. Ault, "Recent Treaty Developments in the Arbitration of International Tax Disputes," in Philip Baker and Catherine S. Bobbett, eds., *Tax Polymath: A Life in International Taxation, Essays in Honour of John F. Avery Jones* (Amsterdam: IBFD, 2010), 297-312, at 298, text accompanying notes 4-5.

The International Chamber of Commerce renewed its call for international tax arbitration in early 2000,[79] while the US-Germany treaty, as noted earlier, was modified by the 2006 protocol to replace optional arbitration with mandatory arbitration.[80] The move was supported by both treaty officials and the US business community[81] and was reflected in some later US treaties.[82] The US model tax treaty included a mandatory arbitration provision in its 2016 iteration.[83]

The most important development, however, was the shift by norm-setting international organizations like the OECD and UN toward support for arbitration. After a public consultation meeting in late 2003 to consider proposals for resolving international tax disputes, the OECD released a report in mid-2004 that, following the "clear preference" of the business community,[84] was supportive of the arbitration process.[85] That report committed the OECD to future work on the feasibility of a mandatory submission (not resolution) of unresolved bilateral treaty disputes to

79 Mario Züger, "ICC Proposes Arbitration in International Tax Matters" (2001) 41:6 *European Taxation* 221-24. The ICC and other proposals for reform of the mutual agreement procedure at the time were also discussed in Aurora Ribes Ribes, "Compulsory Arbitration as a Last Resort in Resolving Tax Treaty Interpretation Problems" (2002) 42:9 *European Taxation* 400-4.

80 Ault, supra note 78, at section 2, note 11, citing Robert Goulder, "Mandatory Arbitration Receives Warm Reception at Senate Foreign Relations Hearing" (2007) 116:4 *Tax Notes* 251-52; and Jérôme Monsenego, "Designing Arbitration Provisions in Tax Treaties: Reflections Based on the US Experience" (2014) 42:3 *Intertax* 163-68, at 164 (https://doi.org/10.54648/taxi2014017).

81 Opening statement of international tax counsel Manal Corwin before the Senate Committee on Foreign Relations, November 10, 2009, cited in Monsenego, supra note 80, at 164, note 13; and US Department of the Treasury, "Testimony of Treasury International Tax Counsel John Harrington Before the Senate Committee on Foreign Relations on Pending Income Tax Agreements," *Press Release*, July 17, 2007, cited in Rosenbloom (2016), supra note 75, at section 7.3, note 14.

82 See further Rosenbloom (2016), supra note 75, at section 7.3, and associated notes 16-17 (referring to US treaties with Belgium, France, Germany, and Canada and the then pending treaty with Switzerland, indicating that arbitrations had been used only under the Canada treaty, with all of the outcomes in the estimated three to eight such matters favouring the United States).

83 US Department of the Treasury, "Treasury Announces Release of 2016 U.S. Model Income Tax Treaty," *Press Release*, February 17, 2016. See William Byrnes, "Analysis of the New US Model Tax Treaty," *Kluwer International Tax Blog*, February 25, 2016 (https://kluwertaxblog.com/2016/02/25/analysis-of-the-new-us-model-tax-treaty).

84 Organisation for Economic Co-operation and Development, *Improving the Process for Resolving International Tax Disputes* (Paris: OECD, Centre for Tax Policy and Administration, 2004), at 29-31.

85 Ibid. See further Hugh J. Ault, "Improving the Resolution of International Tax Disputes" (2005) 7:3 *Florida Tax Review* 137-51, at 141-42; and Tarini Chaudhary, "History of Arbitration in Tax Treaty Law," in Alicja Majdanska and Laura Turcan, eds., *OECD Arbitration in Tax Treaty Law* (Vienna: Linde, 2018), 1-25, at 14.

a supplemental dispute resolution mechanism, as well as to an exploration of what a mandatory resolution process might look like for countries that were interested in committing to that supplemental dispute resolution option. The 2004 report was followed by a discussion draft in early 2006.[86] By that point, there were only a little more than 60 bilateral treaties with an arbitration option (and, more rarely, mandatory arbitration).[87] Separately, the secretary general of the Permanent Court of Arbitration had drawn attention to the availability of the Permanent Court as a venue for the settlement of international tax disputes.[88] The 2006 discussion draft reiterated the concerns raised by private sector representatives.[89] It identified potential benefits of deploying supplementary dispute resolution as encouraging greater use of mutual agreement procedures, ensuring efficient resolution efforts by competent authorities (because of the time limit before cases would be put to arbitration, for example), and reducing the likelihood of expensive, possibly conflicting, domestic processes.[90]

Important refinements in the approach took place as a result of an OECD public consultation meeting in Tokyo held a month after release of the 2006 discussion draft. By this point, there was strong momentum in favour of mandatory arbitration as the preferred mechanism to resolve treaty disputes, but resistance by taxpayer representatives led OECD drafters to modify their treaty amendments to provide an escape clause for taxpayers unhappy with an arbitration decision. The compromise wording made an arbitration decision binding on the tax authorities, subject to acceptance by the taxpayer or, in the language subsequently used in the model treaty, "a person directly affected" by an arbitration decision.[91]

86 Organisation for Economic Co-operation and Development, *Proposals for Improving Mechanisms for the Resolution of Tax Treaty Disputes: Public Discussion Draft* (Paris: OECD, February 2006).

87 See Altman, supra note 33, at section 1.2.2.1.2, noting that most of these treaties had been entered into by the Netherlands, United States, and Canada in the 1990s with a variety of other countries, including Kazakhstan, Pakistan, Ecuador, and Eastern European countries.

88 Sed Crest, "New Way To Resolve International Tax Disputes" (2005) 16:5 *International Tax Review* 24-25 (interview with Permanent Court of Arbitration Secretary-General Tjaco van den Hout).

89 OECD, supra note 86, at 4.

90 Ibid.

91 The provision was sharply criticized in Allison Christians, "Your Own Personal Tax Law: Dispute Resolution Under the OECD Model Tax Convention" (2009) 17:2 *Willamette Journal of International Law and Dispute Resolution* 172-85, at 181. Christians criticized the subsequent revision of the UN model, which included a similar escape clause, for the same reasons: see Allison Christians, "Putting Arbitration on the MAP: Thoughts on the New U.N. Model Tax Convention" (2012) 66:4 *Tax Notes International* 351-53, at 352.

A finalized OECD report was released in 2007,[92] followed by a revised model treaty in 2008.[93] It included the mandatory arbitration provision with the taxpayer escape mechanism and a rule that arbitration decisions could be published only with the permission of the taxpayer involved and competent authorities, a feature that had received particular criticism in the 2006 draft.[94] The change to mandatory arbitration was viewed with some skepticism by many countries, and many noted their reservations to the final version.

It was not long before the UN followed, with recommendations by the UN's Committee of Experts in 2010 proposing the adoption of a mandatory arbitration dispute resolution mechanism as an alternative formulation of the mutual agreement procedure article,[95] a feature that appeared in the UN treaty in the following year.[96] In addition to offering mandatory arbitration as one option in the mutual agreement procedure article, the UN approach differed from the OECD's in three ways: it provided the competent authorities with more time (three years versus two), it empowered competent authorities (rather than taxpayers) to invoke arbitration, and it allowed competent authorities to depart from the results of arbitration within six months if they jointly agreed on an alternative solution.

The 2010 UN review of the issue provides an excellent overview of the concerns often articulated by policy makers who have reservations about mandatory arbitration.

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92 Organisation for Economic Co-operation and Development, *Improving the Resolution of Tax Treaty Disputes (Report Adopted by the Committee on Fiscal Affairs on 30 January 2007)* (Paris: OECD, Centre for Tax Policy and Administration, February 2007). See further Marcus Desax and Marc Veit, "Arbitration of Tax Treaty Disputes: The OECD Proposal" (2007) 23:3 *Arbitration International* 405-30 (https://doi.org/10.1093/arbitration/23.3.405); and Jeffrey Owens, "OECD Proposal To Improve the Resolution of Tax Treaty Disputes" (2007) 47:6 *European Taxation* 270-72.

93 Organisation for Economic Co-operation and Development, "Articles of the Model Convention with Respect to Taxes on Income and on Capital" (Paris: OECD, 2010); see further Ault, supra note 78, at 301, accompanying text in note 15.

94 Criticism of the potential secrecy aspect is set out in Michael J. McIntyre, "Comments on the OECD Proposal for Secret and Mandatory Arbitration of International Tax Disputes" (2006) 7:9 *Florida Tax Review* 622-50. The importance of publication was also later emphasized in Ana Paula Dourado and Pasquale Pistone, "Some Critical Thoughts on the Introduction of Arbitration in Tax Treaties" (2014) 42:3 *Intertax* 158-60, at 160. See also Bantekas, supra note 24, at 532-34. Criticism of other aspects of the provision can be found in John Connors and Barbara Delputte, "Alternative Dispute Resolution in International Tax Law—The View of Business," in *International Arbitration in Tax Matters*, supra note 75, chapter 3, at section 3.3.2.2.

95 United Nations, Committee of Experts on International Cooperation in Tax Matters, *Report by the Subcommittee on Dispute Resolution: Arbitration as an Additional Mechanism To Improve the Mutual Agreement Procedure*, document no. E/C.18/2010/CRP.2 (Geneva: UN, October 2010).

96 See Chaudhary, supra note 85, at 19-21, noting also the extensive review of the new provisions in United Nations, Committee of Experts on International Cooperation in Tax Matters, *Secretariat Paper on Alternative Dispute Resolution in Taxation*, document no. E/C.18/2015/CRP.8 (Geneva: UN, October 8, 2015).

Those concerns include evidence that the number of unresolved cases is small and primarily between OECD countries; the time to reach competent authority resolution is generally shorter when one of the parties to the treaty is a non-OECD country; countries wish to retain decision-making authority (sovereignty) over their tax decisions; national law may present legal barriers to some forms of arbitration; parallel domestic remedies may be more appropriate; arbitration may be costly for states; a lack of expertise in developing countries' competent authorities may make it difficult for countries to adequately represent their positions in briefs; the selection of arbitrators may reflect bias; and abusive cases may not be appropriate for arbitration.[97]

Academic assessments of these developments and the desirability of mandatory arbitration were mixed with supporters[98] and countered by those with modest or serious reservations about the system[99] as well as those with alternative solutions such as the use of a tax specialist ombudsman.[100] Among other arguments, supporters cited mandatory arbitration as a useful incentive for authorities to reach a compromise.[101]

The most significant development by far in the story of mandatory arbitration and tax arrived in 2016 when the OECD opened for signature a multilateral treaty that would potentially modify all existing bilateral treaties to include mandatory arbitration as the mechanism for dispute resolution.[102] Its genesis was a move by the OECD in the late 1990s to identify and sanction, if only by way of naming and shaming, those jurisdictions participating in what it labelled "harmful tax competition" behaviour, its euphemism for tax havens used by individuals and companies resident in OECD member countries seeking to avoid or evade tax. Terminology shifted

97 United Nations, supra note 95, at 4-11.

98 See, for example, Rosenbloom (2016), supra note 75; Bantekas, supra note 24, at 534; and Pasquale Pistone, "General Report," in Michael Lang et al., eds., *Tax Treaty Arbitration* (Amsterdam: IBFD, 2020), 1-35.

99 See, for example, McIntyre, supra note 94; Christians, "Your Own Personal Tax Law," supra note 91; Christians, "Putting Arbitration on the MAP," supra note 91; and Brian J. Arnold, "The Scope of Arbitration Under Tax Treaties," in *International Arbitration in Tax Matters*, supra note 75, chapter 5.

100 Katerina Perrou, "The Ombudsman and the Process of Resolution of International Tax Disputes—Protecting the 'Invisible Party' to the MAP" (2018) 10:1 *World Tax Journal* 99-129.

101 See, for example, comments of US Treasury International Tax Counsel in 2007 Senate Committee proceedings, quoted in Micah Burch and Luke Nottage, "Novel Treaty-Based Approaches to Resolving International Investment and Tax Disputes in the Asia-Pacific Region" (2011) 18 *Australian International Law Journal* 127-40, at 136-37, also citing Marlies de Ruiter, a Dutch tax official, in "Supplementary Dispute Resolution" (2008) 48:9 *European Taxation* 493-99, at 499, who quoted a predecessor in the role as observing, "[W]e love arbitration but we never use it."

102 Organisation for Economic Co-operation and Development, Multilateral Convention To Implement Tax Treaty Related Measures To Prevent Base Erosion and Profit Shifting, adopted November 24, 2016, entered into force July 1, 2018 (herein referred to as "the multilateral convention," "MLI," or "the multilateral instrument").

slightly from "harmful tax competition" to "harmful tax practices" when the OECD released its first list of tax havens in 2000. The program was largely curtailed, however, with the election of George W. Bush as US president in late 2000 and the effective withdrawal of US support for the OECD initiative.

The US attitude was reconsidered following the September 11, 2001 terrorist attacks on the United States and the realization by American authorities that international terrorism was aided by the undisclosed movement of funds through tax havens.[103] At the inaugural meeting of Group of Twenty (G20) leaders in November 2008, the United States joined other leaders in calling for the OECD to address the problem of tax haven secrecy by bringing the target jurisdictions into a tax information exchange regime.

The next meeting of the G20 leaders in 2009 took place in the midst of a global financial crisis triggered by the collapse of Lehman Brothers, a US-based financial services firm. The G20 leaders endorsed the OECD's tax transparency and information exchange program, prompting the organization to expand its activities to address tax base erosion and profit shifting more generally. The broader scope of the OECD's work was sanctioned by G20 leaders at their 2012 summit, leading the OECD to develop an "action plan" to address the identified weaknesses and revenue leakage elements of the global income tax system.[104] The OECD's plan was formally labelled its "base erosion and profit shifting" (BEPS) program.

An early proposal for the simultaneous amendment of multiple treaties was the adoption of a multilateral "framework" that could provide a precedent for individual treaties to be amended.[105] A variation of this approach was considered by the OECD in a document setting out a proposal to address "triangular" treaty problems, in which income sourced in one jurisdiction is derived by a branch or permanent

103 Meeting of G-20 Finance Ministers and Central Bank Governors, "G-20 Finance Ministers and Central Bank Governors," *Communiqué*, Ottawa, November 16-17, 2001 (https://g20.utoronto.ca/2001/2001communique.pdf); Mark P. Hampton and John Christensen, "Offshore Pariahs? Small Island Economies, Tax Havens, and the Re-Configuration of Global Finance" (2002) 30:9 *World Development* 1657-73 (https://doi.org/10.1016/S0305-750X(02)00054-2); and Kerrie Sadiq and Richard Krever, "Actions To Counter Base Erosion and Profit Shifting: A General Report," in Kerrie Sadiq, Adrian Sawyer, and Bronwyn McCredie, eds., *Tax Design and Administration in a Post-BEPS Era: A Study of Key Reform Measures in 18 Jurisdictions* (Birmingham, UK: Fiscal Press, 2019), 1-24, at 2.

104 Sadiq and Krever, supra note 103.

105 John Avery Jones and Philip Baker, "The Multiple Amendment of Bilateral Double Taxation Conventions" (2006) 60:1 *Bulletin for International Taxation* 19-22. A third, and unattributed, author of the paper was Mike Walters, who at the time was head of international tax at the UK Inland Revenue and chairman of Working Party 1 of the OECD and, as a government official, was unable to join the proposal paper as a named contributor; see Philip Baker, "The Multilateral Convention To Implement Tax Treaty Related Measures To Prevent Base Erosion and Profit Shifting" [2017] no. 3 *British Tax Review* 281-84, at 281.

establishment of a foreign company where the branch is located in a second country and the company to which it belongs is situated in a third country.[106]

An alternative approach, suggested in 2010 by Victor Thuronyi at the International Monetary Fund, for the adoption of a multilateral treaty would simultaneously modify many or most of the world's thousands of bilateral tax treaties,[107] an idea included in the action plan program released by the OECD in 2013[108] and in the more detailed action plan released in October 2015.[109]

The idea of a multinational tax treaty had been around since the first consideration of cross-border tax issues by the League of Nations, and had been revised to some extent by a widely circulated and cited academic paper in the early 1990s,[110] other work early in the 21st century,[111] and a wave of literature a decade into the century.[112]

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106 OECD, supra note 86, at 37 and 41; on triangular treaty problems, see John Avery Jones and Catherine Bobbett, "Triangular Treaty Problems: A Summary of the Discussion in Seminar E at the IFA Congress in London" (1999) 53:1 *Bulletin for International Taxation* 16-20.

107 Victor Thuronyi, "Tax Treaty Templates," in Arthur J. Cockfield, ed., *Globalization and Its Tax Discontents: Tax Policy and International Investments*, *Essays in Honour of Alex Easson* (Toronto: University of Toronto Press, 2010), chapter 12. Thuronyi's proposal did not address dispute resolution mechanisms.

108 Organisation for Economic Co-operation and Development, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013).

109 Organisation for Economic Co-operation and Development, *Developing a Multilateral Instrument To Modify Bilateral Tax Treaties*, *Action 15—Final Report* (Paris: OECD, October 2015) (herein referred to as "the action 15 final report").

110 Richard Vann, "A Model Tax Treaty for the Asian-Pacific Region? (Part I)" (1991) 45:3 *Bulletin for International Fiscal Documentation* 99-111 and ". . . (Part II)" (1991) 45:4 *Bulletin for International Fiscal Documentation* 151-63. See also, generally, John Gerard Ruggie, "Multilateralism: The Anatomy of an Institution" (1992) 46:3 *International Organization* 561-98.

111 Nils Mattsson, "Multilateral Tax Treaties—A Model for the Future?" (2000) 28:8/9 *Intertax* 301-8, at 307 (https://doi.org/10.54648/273294), noting the potential value of "a system where representatives of contracting states were induced to settlements where they were not directly involved themselves," and citing that author's 1981 book on arbitration with Lindencrona (Lindencrona and Mattsson, supra note 51).

112 From the extensive literature, see, for example, Thomas Rixen, "Bilateralism or Multilateralism? The Political Economy of Avoiding International Double Taxation" (2010) 16:4 *European Journal of International Relations* 589-614 (suggesting that self-enforcing properties of agreements in coordination games may mean that the mutual agreement procedure would be sufficient without a larger third-party enforcement regime); Sunita Jogarajan, "A Multilateral Tax Treaty for ASEAN—Lessons for the Andean, Caribbean, Nordic and South Asian Nations" (2011) 6:1 *Asian Journal of Comparative Law* 1-23; Kerrie Sadiq, "The Inherent International Tax Regime and Its Constraints on Australia's Sovereignty" (2012) 31:1 *University of Queensland Law Journal* 131-46; and Thomas Renard, "Partnerships for Effective Multilateralism? Assessing the Compatibility Between EU Bilateralism, (Inter-) Regionalism and Multilateralism" (2016) 29:1 *Cambridge Review of International Affairs* 19-20 (noting also that bilateralism in the foreign affairs field, for example, can undermine efforts at multilateral regional integration). More recently, for strong support of the benefits of multilateralism in dampening incentives for treaty shopping, see Vincent Arel-Bundock, "The

Paralleling discussion of a multilateral treaty was discussion of the merits of a multilateral international or regional tax authority.[113]

The OECD proposal, largely echoing the work of Thuronyi, was fundamentally different in scope from alternative formulations of a multilateral treaty, in that it proposed to leave in place and build on the world's complex web of bilateral treaties, using the multilateral treaty to simultaneously amend all existing treaties to the extent that treaty partners also adopted the multilateral amendment instrument.

At their 2015 meeting, G20 leaders expressed support for the OECD's multilateral treaty proposal and called on the organization to expand the initiative to include all interested non-OECD members. Shortly afterward, the organization released studies on the use of arbitration to resolve tax treaty disputes[114] and its study of the legal issues that adoption of a multilateral treaty would entail,[115] and at the same time announced that further work would take place in the context of an "inclusive framework" that would include more than 100 countries. The resulting multilateral treaty, formally titled the Multilateral Convention To Implement Tax Treaty Related Measures To Prevent Base Erosion and Profit Shifting, but more commonly and informally referred to as the "multilateral instrument" or "MLI," which included a provision for mandatory arbitration, was released for signature in 2016.[116] The mandatory arbitration measure is optional; countries can exclude the provision by way of reservation when signing the MLI, or exclude its operation when agreeing that the MLI will apply to their bilateral treaty.[117] Only 33 of the MLI's 105 signatory countries

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Unintended Consequences of Bilateralism: Treaty Shopping and International Tax Policy" (2017) 71:2 *International Organization* 349-72; and Tarcísio Diniz Magalhães, "The OECD Multilateral Instrument: Challenge or Opportunity of Multilateralism in International Tax?" in Joanna Wheeler, ed., *The Aftermath of BEPS* (Amsterdam: IBFD, 2019) 161-94 (with subsequent discussion on the multilateral convention itself: MLI, supra note 102).

113 See, for example, Vito Tanzi, "Is There a Need for a World Tax Organization?" in Assaf Razin and Efraim Sadka, eds., *The Economics of Globalization: Policy Perspectives from Public Economics* (Cambridge, UK: Cambridge University Press, 1999), 173-86; Dale Pinto and Adrian Sawyer, "Building Bridges Between Revenue Authorities: Would a World Tax Organisation Be a Key Facilitator?" (2011) 4 *Journal of Applied Law and Policy* 25-40; Nolan Sharkey, "A South East Asian Tax Organisation" [2013] no. 2 *British Tax Review* 175-91; Arthur J. Cockfield, "The Rise of the OECD as Informal 'World Tax Organization' Through National Responses to E-Commerce Tax Challenges" (Spring 2006) 8 *Yale Journal of Law and Technology* 136-87; and Thomas Rixen, "Institutional Reform of Global Tax Governance: A Proposal," in Peter Dietsch and Thomas Rixen, eds., *Global Tax Governance: What Is Wrong with It and How To Fix It* (Colchester, UK: ECPR Press, 2016), chapter 15.

114 Organisation for Economic Co-operation and Development, *Making Dispute Resolution Mechanisms More Effective, Action 14—2015 Final Report* (Paris: OECD, 2015).

115 The action 15 final report, supra note 109.

116 See MLI, supra note 102.

117 See further Chris Noonan and Victoria Plekhanova, "Mandatory Binding Dispute Resolution in the Base Erosion and Profit Shifting (BEPS) Two Pillar Solution" (2023) 72:2 *International and Comparative Law Quarterly* 437-76.

to date have agreed to incorporate at least some components of the arbitration provisions. Those countries include Australia, Barbados, Canada, France, Germany, Ireland, Italy, Japan, the Netherlands, Spain, and the United Kingdom. Not included in the signatories of the MLI is the United States, but it separately incorporated mandatory arbitration into its model bilateral tax treaty. About two-thirds of MLI signatory countries, including Brazil, Chile, China, India, Indonesia, Kenya, Mexico, Nigeria, Norway, Poland, Russia, South Africa, and Vietnam, have signed the agreement but chose not to add the arbitration provision.

The default design element of the MLI arbitration provisions was a "last best offer" arbitration system, often described as "baseball" arbitration, with both sides putting forward their position or "offer" and the arbitrators choosing between them, although the arbitration article provides tax treaty partners with the option to choose another arbitration method. The baseball arbitration method has vocal critics,[118] and even some supporters of the MLI in general are troubled by it, with one critic describing it as "the most bizarre of provisions."[119] Whatever the views about the optimal arbitration method, almost overnight the notion of mandatory arbitration had moved from a fringe idea adopted by a handful of countries in a limited number of treaties to a mainstream norm or approach in the group of most developed economies.

Following the signing of the MLI, pressure on tax policy makers to form a view on the value of mandatory arbitration was for a time heightened by the OECD's effort to promote an alternative system for the allocation of taxing rights over the profits of multinational enterprises. Under current global norms, the profits of multinational enterprises are allocated on a country-by-country basis on the basis of a mythical separation of the parts of an enterprise into independent units that are imagined to conduct business with each other on an arm's-length basis. The alternative proposed by the OECD, largely under pressure from European members and commonly referred to as "pillar 1," would measure the global income of a multinational enterprise as if it were a single unit and allocate shares to companies using a formula that looks at the factors that give rise to profits, similar to the formulary apportionment system used in the United States to allocate the profits of US companies across state borders for state income tax purposes. The OECD proposal includes a requirement to agree to mandatory binding arbitration in some circumstances,[120] with the proposed mechanism similar to, but arguably more complex than, that set out in the MLI.[121] Interest in pillar 1 has largely faded, however, with supporters conceding that the proposals

118 See, for example, Chloe Burnett, "International Tax Arbitration" (2007) 36:3 *Australian Tax Review* 173-90, at 182. See also Picciotto, supra note 21.

119 William W. Park, "Tax and Arbitration" (2020) 36:2 *Arbitration International* 157-220, at 205.

120 Spyridon E. Malamis and Qiang Cai, "International Tax Dispute Resolution in Light of Pillar One: New Challenges and Opportunities" (2021) 75:2 *Bulletin for International Taxation* 94-107.

121 See, for example, Organisation for Economic Co-operation and Development, *Public Consultation Document, Pillar One—A Tax Certainty Framework for Amount A, 27 May-10 June 2022* (Paris: OECD, 2022).

are unlikely to ever be adopted globally in the face of strong opposition by the United States.

RED HERRINGS AND OVERSTATED CONCERNS

The primary concerns raised about mandatory arbitration from the perspective of developing countries—the paucity of unresolved disputes and aspects of the arbitration process, particularly those that revolve around the different levels of resources available to tax administrations from high-income and low-income countries—can be used to support arguments both in favour of and against adoption of mandatory arbitration.

Six separate arguments have been made, sometimes strongly, in support of the view that developing countries should not agree to mandatory arbitration in tax treaties. On closer examination, all six might be viewed as "red herring" concerns—that is, superficially compelling but exposed as weak, or at least overstated, when the substantive arguments are considered more carefully.

Developing Countries Face Systematic Disadvantages Under a Mandatory Arbitration System

Critics of OECD-recommended solutions to issues often view the issue in the context of a broader concern about the disadvantages that developing countries face in the development of international tax policy.[122] In the case of the dispute resolution issue, there is no doubt that better-resourced competent authorities will do better in any dispute resolution process.[123] Importantly, however, observers who argue that developing countries are at a disadvantage in dispute resolution are usually highlighting problems with the current system that compels a resolution of disputes, but not challenging the view that mandatory resolution is the only guarantee that the tax treaty mutual agreement procedure will lead to a solution.[124]

One factor that likely has an impact on developing nations' perceptions of the risks involved in tax treaty arbitration is the experience of some countries with arbitration concerning investment treaties.[125] There seems to be little doubt that investment

122 Gautham S. Mukundan, "The Illusion of Inclusivity: Analysing the Psychological Factors Affecting Developing Countries in Consensus-Driven International Tax Negotiations" (2025) 79:3 *Bulletin for International Taxation* 92-99.

123 Michelle Markham, "The Timely Resolution of Mutual Agreement Procedure Disputes—Secrets of Success?" (2023) 77:5 *Bulletin for International Taxation* 213-28.

124 Gabriel Aliu, "Modern International Tax Dispute Resolution—An African Perspective on the Mutual Agreement Procedure, Arbitration, and the Future" (2024) 52:6/7 *Intertax* 476-92.

125 See, for example, Kevin P. Gallagher and Elen Shrestha, "Investment Treaty Arbitration and Developing Countries: A Re-Appraisal" (2011) 12:6 *Journal of World Investment & Trade* 919-28, questioning the work of Susan D. Franck, "Development and Outcomes of Investment Treaty Arbitration" (2009) 50:2 *Harvard International Law Journal* 435-89.

treaty arbitration has led to asymmetrical outcomes.[126] This may reflect the arbitration process itself, or it may reflect the extent to which investment destinations gave up sovereign rights in a bid to attract further investment. To the extent that the problem lies in the arbitration process, remedies are available, including using more arbitrators from developing countries[127] and changing the geographic basis of the process.[128]

In essence, a developing country that is concerned that it lacks the expertise of developed countries must weigh the risk of being prejudiced in arbitration proceedings against the risk of discouraging potential investors with the prospect of facing unresolvable treaty disputes if treaties do not provide a compulsory dispute resolution option. It might be argued, however, that an affected country has already weighed the risks and made a choice when it entered into a tax treaty in the first place. Even if the treaty has no compulsory arbitration measure, it will have a mutual agreement procedure in place, and all the disadvantages that a less well-resourced tax administration will face in an arbitration proceeding will arise similarly in an ordinary mutual agreement procedure. It would be odd that a country that has accepted a treaty with a mutual agreement procedure, knowing its limitations, would conclude that those limitations outweigh the benefits of a treaty if a dispute escalates from an ordinary mutual agreement procedure to an arbitration procedure.

Perhaps undermining the concerns of critics who argue that mandatory arbitration puts developing countries at a disadvantage is the UN's endorsement of mandatory arbitration as an option for the mutual agreement procedure in its 2011 iteration of a model tax convention. In recent years, the UN has moved with remarkable vigour to reclaim a role in international tax policy development and international tax cooperation. The assertion of a greater role for the organization, led by developing countries seeking to shift influence from the OECD to less-developed nations, has not led to any changes to the model treaty. However, the question of dispute resolution mechanisms has emerged in 2025 as an important issue that developing countries wish to see addressed in a future UN convention on international tax cooperation.[129] Until this process plays out, the UN has kept open the option of mandatory arbitration in treaties between developed and less-developed nations.

126 Gus Van Harten, "Arbitrator Behaviour in Asymmetrical Adjudication: An Empirical Study of Investment Treaty Arbitration" (2012) 50:1 *Osgoode Hall Law Journal* 211-68.

127 Franck, supra note 125; and Lee A. Sheppard, "De-FANGed, Part 6: Out of Africa" (2021) 104:7 *Tax Notes International* 746-48.

128 Yariv Brauner, "The Latin American Opposition to Mandatory Arbitration in Tax Treaties: Origins, the Calvo Doctrine, and a Reappraisal" (2019) 22:3 *Florida Tax Review* 866-84.

129 Nana Ama Sarfo, "The U.N. Tax Convention Eyes Dispute Resolution" (2025) 117:9 *Tax Notes International* 1445-48.

Mandatory Arbitration Amounts to a Surrender of a Sovereign Right

The second and perhaps most frequently and strongly made argument against developing countries in particular agreeing to mandatory arbitration in bilateral tax treaties rests on the view that mandatory arbitration is an unacceptable surrender of an important element of national sovereignty, the power to tax.[130] Viewed in the context of bilateral treaties generally and the elements of tax treaties specifically, the sovereignty concern appears to be a true red herring argument. To begin with, it is often raised by commentators in jurisdictions that have readily ceded sovereignty in a host of other fields in bilateral or multinational agreements in order to achieve global environmental, diplomatic, criminal, territorial, and trade objectives. Fiscal sovereignty is, no doubt, an important element of national sovereignty, but it is not clear why one element of this national right should never be surrendered when so many others are given up for the sake of global standards. The case for "tax exceptionalism" is difficult to sustain.[131]

Concern over the proportion of arbitration outcomes that favour wealthier capital-exporting countries in treaties such as investment treaties may discourage countries from adopting this form of treaty dispute resolution. It is, however, difficult to assert that agreeing to abide by the decisions of an independent arbitrator constitutes an unacceptable surrender of national sovereignty in the context of treaties in which a nation cedes its rights to unilaterally control key aspects of economic, environmental, military, transport, and other policies.

The fiscal sovereignty argument against using mandatory arbitration is particularly difficult to sustain when the issue is considered in the context of the substance of tax treaties—agreements in which countries surrender some of their most important taxing rights. In return for some perceived benefits, such as access to information or sending a signal to investors that the jurisdiction plays by the commonly accepted international rules, tax treaty signatories agree to caps on their sovereign right to impose taxes on different types of investment income and to forgo entirely their taxing rights over some types of business profits. Having ceded the most important aspect of fiscal sovereignty—the unfettered right to levy taxes on income sourced in the country—a country's concern that an independent arbitrator might be asked to resolve disputes over the interpretation of the treaty seems at best puzzling.[132] Indeed, it could be argued that a country risks undermining all the benefits it sought to achieve by entering into a tax treaty and surrendering sovereign taxing rights if it then refuses to compromise on a dispute resolution mechanism needed to assure domestic

130 Gaëtan Zeyen, "When Taxation Meets Arbitration: Recent Initiatives To Introduce and Promote Arbitration in International and European Taxation" (2017) 45:11 *Intertax* 722-31.

131 Alfredo Gutiérrez Ortiz Mena, "A Case for Mandatory Tax Arbitration: Justice Gutiérrez Ortiz Mena's Keynote Speech at the 2024 IBA Annual Conference" (2024) 116:4 *Tax Notes International* 613-18, at 616-17.

132 Brauner, supra note 128.

and foreign investors and businesses that a system is in place to guarantee the resolution of disagreements arising from different national interpretations of a treaty. Compared with the ceding of taxing rights, the outsourcing of dispute resolution to a neutral arbitrator seems to be a relatively peripheral surrender of sovereign power.

The fiscal sovereignty argument against using mandatory arbitration to resolve treaty interpretation and application disputes is also difficult to sustain when considered in terms of contemporary international law and comity principles. The ceding of taxing powers in bilateral tax treaties is undertaken in the context of an unwritten international social compact to achieve a stable global allocation of taxing rights.[133] Exercising sovereign power to enter into bilateral treaties and forgoing taxing rights is a signal that a jurisdiction has elected to participate in the global economy. Once a nation exercises its sovereign right to join the global economic system, it has become part of a broader community, in which isolated tax actions are "neither possible nor desirable."[134] The vast majority of tax treaties were adopted with no certain mechanism to resolve disputes, indicating that countries found value in them even in the absence of such a mechanism. Disputes that could not be resolved through the mutual agreement procedure were truly outliers, notable exceptions to the general rule. Disagreement over the preferred dispute resolution methodology is at best a relatively small sovereignty concern for countries that ceded much more when they opted to join the global tax treaty network.

There are also practical reasons why the exercise of tax sovereignty necessarily means cooperation and compromise. In order to tax residents on their worldwide income, a country must have intelligence on the holdings of its residents abroad—information that is available only to the tax authorities in the jurisdictions in which the investments are located. Put simply, "to remain sovereign in the international tax area, states must cooperate,"[135] and if the only way that tax sovereignty can be

133 Allison Christians, "Sovereignty, Taxation and Social Contract" (2009) 18:1 *Minnesota Journal of International Law* 99-153.

134 Michelle Markham, "Mandatory Binding Tax Arbitration—Is This a Pathway to a More Efficient Mutual Agreement Procedure?" (2019) 35:2 *Arbitration International* 149-70, at 157, quoting Allison Christians, *Sovereignty, Taxation, and Social Contract*, University of Wisconsin Law School, Legal Studies Research Paper series no. 1063 (Madison, WI: University of Wisconsin Law School, 2008), at 43; see also Qiang Cai, "Behind Sovereignty: Concerns About International Tax Arbitration and How They May Be Addressed" [2018] no. 4 *British Tax Review* 441-64; and Werner Haslehner and Michael Kobetsky, "Arbitration After BEPS," in Georg Kofler, Ruth Mason, and Alexander Rust, eds., *Thinker, Teacher, Traveler: Reimagining International Tax—Essays in Honor of H. David Rosenbloom* (Amsterdam: IBFD, 2021), chapter 16.

135 Samuel Johnston, "Multilateral Tax Convention To Prevent Base Erosion and Profit Shifting" (2017) 23 *Auckland University Law Review* 384-93, at 392; and Dirk Broekhuijsen and Henk Vording, "The Multilateral Tax Instrument: How To Avoid a Stalemate on Distributional Issues?" [2016] no. 1 *British Tax Review* 39-61. See also Xueliang Ji, "The Changing Paradigm of International Tax Dispute Settlement: What Are the Promises and Challenges of Mandatory Arbitration for China?" (2020) 21 *Oregon Review of International Law* 117-54, at 135-43.

exercised in a global economy is by cooperation that entails a division of taxing rights and resolution of disputes, countries may regard this as an appropriate exercise of national sovereignty. When used properly, particularly in respect of information-sharing features, tax treaties may be seen as a way of enhancing sovereignty by enhancing the taxing capacity of the state.[136] Ceding the power to unilaterally resolve bilateral disputes may be an appropriate application of sovereign power to acquire essential intelligence data.

Some observers question the wisdom of bilateral tax treaties generally,[137] while others have argued that for developing capital-importing countries, the tradeoffs are insufficient to offset the loss of revenue from limiting or forgoing entirely taxing rights over particular types of income, when most of the benefits could be achieved through other mechanisms.[138] To be clear, however, these are reservations about the wisdom of tax treaties for these nations, not about whether the exercise of sovereignty by a country entering into a tax treaty that divides taxing rights between two jurisdictions can at the same time be a loss of sovereignty in respect of agreement on the means of settling disputes over the division of taxing rights. There is little doubt that developing countries are at a disadvantage in the course of tax treaty negotiations,[139] but once they have entered into treaties with eyes open, concerns over the allocation of taxing rights provide no support for concerns that bringing independent adjudication to dispute resolution reduces national sovereignty.

Endorsement of a Mandatory Arbitration Option Undermines the Independence of the Courts

The third red herring argument raised against mandatory arbitration in tax treaty disputes is that arbitration offers an opportunity to bypass the ordinary appeal process through tax tribunals or courts. The mutual agreement procedure in tax treaties provides taxpayers that are unhappy with an assessment by a treaty partner with two possible paths if the taxpayer's objection to the assessment is dismissed by the tax authority in the partner country. In the absence of a treaty, the only option open to the taxpayer is to appeal the assessment through the tribunal or judicial system in the

136 Miranda Stewart, *Tax and Government in the Twenty-First Century* (Cambridge, UK: Cambridge University Press, 2022), at 254.

137 John F. Avery Jones, "The David R. Tillinghast Lecture—Are Tax Treaties Necessary?" (1999) 53:1 *Tax Law Review* 1-38; and Alex Easson, "Do We Still Need Tax Treaties?" (2000) 54:12 *Bulletin for International Taxation* 619-25.

138 Kim Brooks and Richard Krever, "The Troubling Role of Tax Treaties," in Geerten M.M. Michielse and Victor Thuronyi, eds., *Tax Design Issues Worldwide* (Alphen aan den Rijn, the Netherlands: Kluwer Law International, 2015), 159-78.

139 Yariv Brauner, "Tax Treaty Negotiations: Myth and Reality" (2021) 4:8 *International Tax Studies* 2-33.

other country. However, where a treaty is in place, the taxpayer can approach its competent authority and request that it engage with its counterpart in the treaty partner to amend (or withdraw entirely) the assessment it received from the treaty partner. If the competent authorities are unable to reach agreement and the dispute is subject to mandatory arbitration, the taxpayer has pursued a remedy completely outside the judicial system in both jurisdictions.

A bedrock element of rule-of-law principles is the right of a citizen to have disputes with the government adjudicated by a wholly independent judiciary. The taxpayer seeking assistance from its home-country tax authority to dispute a source-country assessment never loses that right. If the taxpayer is unhappy with the results of arbitration, and an assessment that it hoped to see withdrawn remains in effect after the arbitration, the taxpayer still has full access to independent, constitutionally protected courts to pursue its objection to a decision of a foreign tax authority. The fact that two governments agreed to be bound by the decision of an arbitrator rather than leave a mutual agreement procedure dispute unresolved has no impact on the legal rights of the taxpayer.

The process does, however, have an impact on the ability of the source-country government to have the merits of its arguments considered by a court if an arbitrator rules against its attempt to levy an assessment against a non-resident. While a tax authority has no standing to bring an action in court to confirm the merits of an assessment, it does have standing to defend its actions in court should the taxpayer dispute the assessment. However, if the taxpayer relies on a mutual agreement procedure that ends with an arbitrator's decision, and the decision is in the taxpayer's favour, the source-country's tax authority has lost the opportunity to defend its position in court. Does it undermine the constitutional independence of its courts if the source-country government loses access to judicial review of its decisions?

An alternative form of this question is to ask whether the rule-of-law principle that guarantees persons the right to judicial review of a government's directives affecting their actions or property is matched by the right of a government to defend its actions in court against individuals. The key to answering this question lies in the different relationships that taxpayers and governments have with the law. A taxpayer is subject to the law, and when it believes the law is being wrongly applied, it has a right to appeal the government's action. The taxpayer cannot unilaterally change the law to affect its appeal path, however. The government, in contrast, makes the laws. It can guarantee itself the right to defend its actions in court, or it can decide that its policy objectives are better achieved if it enters into a treaty that replaces its appeal path with an alternative dispute resolution mechanism. Its decision does not affect the constitutional independence of the courts or the right of persons affected by government actions to appeal those actions. A government that makes laws affecting persons' rights can at any time impose restrictions on the steps that it can take to apply those laws. Similarly, it can remove the restrictions at any time it concludes that the benefits of a treaty with mandatory arbitration to provide certainty for investors are outweighed by other considerations.

Taxpayers Lose Rights in a Mandatory Arbitration Treaty Dispute Resolution Process

The fourth red herring argument raised against mandatory arbitration in tax treaty disputes concerns the removal of taxpayers from the dispute resolution process. In a normal tax dispute appealed through the courts, taxpayers can cross-examine the tax authority that levied the disputed assessment and obtain discovery of the evidence used by the authority to reach its assessment decision. In contrast, once a treaty application dispute is elevated to the mutual agreement procedure, the taxpayer loses the right to access the materials that both tax authorities use in the procedure or present in an arbitration if the dispute is resolved by arbitration.[140] Observers who view full participation by taxpayers in the dispute resolution process as an essential right argue that it is unjust to have a dispute resolved without this participation and access.

A taxpayer who values access to this information can appeal assessments in one or both of the treaty partners through the ordinary court system. The taxpayer who seeks a mutual agreement procedure instead is making a conscious decision to forgo that access. Having made that decision, the taxpayer hopes for a resolution and has demonstrated a willingness to forgo these ordinary trial rights for the resolution.

Should it make a difference if the taxpayer merely hopes for a resolution in the case of a treaty with a mutual agreement procedure and no mandatory arbitration option, or is certain of a resolution because the treaty has this option? The fact that the taxpayer has opted for a mutual agreement procedure resolution indicates that the taxpayer is willing to voluntarily step out of direct involvement in the resolution process and to forgo access to the documented arguments of both parties. If it is an acceptable tradeoff for a taxpayer to obtain the possibility of a resolution under a treaty's conventional mutual agreement procedure, it cannot be seen as an unacceptable loss of dispute resolution rights if a taxpayer opts to obtain a guaranteed resolution of a dispute under a treaty's mandatory arbitration provision.

Finally, at least in the mandatory arbitration process set out in the MLI, the outcome of mandatory arbitration is binding on the tax jurisdictions, not the taxpayer. The taxpayer retains the option of rejecting the outcome and simply appealing the disputed tax assessment through the ordinary appeal system.

140 See, for example, *McCabe v. HMRC*, [2020] UKUT 266, involving a taxpayer who sought, unsuccessfully, to sight evidence presented by the UK tax authorities in a mutual agreement procedure concerning the application of the residence "tiebreaker" rule in the UK-Belgium tax treaty (the competent authorities agreed that the taxpayer was resident in the United Kingdom).

Disputes Over Gaps in a Treaty Should Not Be Subject to Mandatory Resolution

A fifth red herring argument that is made against mandatory arbitration rests on a view that there is no need to resolve disputes resulting from gaps in treaties. Most treaty disputes deal with issues directly covered by the treaties, particularly transfer-pricing disputes. Sometimes, however, disagreements such as that in the *Boulez* case arise because of gaps in the treaty. For example, both countries may agree on how the treaty applies to royalties and how it applies to personal service income, but they may differ on the characterization of a particular receipt, with one treating it as a royalty and the other treating it as personal service income. On the one hand, it could be argued that the treaty was designed to help the parties to address the cross-border friction in interpretation and that taxpayers should expect the treaty to resolve the issue, not leave it solely to domestic law, whereby one country taxes a receipt fully as a royalty and the other taxes it fully as personal service income, with neither recognizing the other's characterization. On the other hand, it could be argued that the treaty was never designed to resolve the issue. In some ways, this is analogous to the null state: the circumstances where there is no tax treaty.

It might be argued that forcing a resolution in this scenario should be a cause for concern. Under one view, if governments think the gaps should be filled, they could have agreed to do so in the treaty or supplementary notes. If they did not think the gaps should be filled, they will not come to agreement.[141] In assessing the case for requiring countries to fill those gaps through dispute resolution, it is important to remember that the major purpose of tax treaties is to allocate taxing rights. In the absence of a treaty, the source country (usually the capital-importing jurisdiction) would have primary initial taxing rights over all types of income. Capital-importing nations forgo some taxing powers in a treaty in pursuit of other hoped-for gains. The resulting reallocation of primary taxing rights will have a differential impact on countries, depending on whether they are capital-importing or capital-exporting jurisdictions. For some kinds of income (such as business income attributable to a permanent establishment, income from personal services, and capital gains), tax treaties give primary taxing rights to the capital-importing country. For other kinds of income (such as dividends, interest, and royalties), treaties place a cap on the capital-importing country's taxing rights. For still other kinds of income (including business income where there is no permanent establishment), treaties remove the capital-importing country's right to tax entirely. "Over-interpreting" a treaty to address issues that have not been addressed in the treaty, and then requiring countries

141 As Michael Lennard appreciates, "tax treaties are not just about avoiding double taxation in vacuo, rather they are about avoiding it in a certain way—the way agreed between the parties, in accordance with an agreed balance of source country and residence country taxing rights." See Michael Lennard, "Transfer Pricing Arbitration as an Option for Developing Countries" (2014) 42:3 *Intertax* 179-88, at 179 (https://doi.org/10.54648/taxi2014021).

to pursue mandatory arbitration, may result in an unwanted erosion of revenue for one of the two countries.

Put another way, under this view, just because there is a tax treaty does not mean that the governments have committed to relieving taxpayers of every mismatch in the application of the countries' tax provisions, or of every uncertainty in the sourcing or allocation of taxing rights, even if the result is egregiously unfair, such as full double taxation of the same income in two countries. Under this view, the circumstances in which mandatory arbitration should apply might be restricted to cases where the treaty was designed to solve the issue under dispute. Otherwise, forcing resolution undermines the limits of the agreed treaty bargain.

The contrary argument is similar to a common argument on the resolution of disputes over gaps in domestic tax rules. It is, of course, impossible for legislators to explicitly address every possible commercial transaction or arrangement in tax legislation: lacunae are inevitable. As a result, if taxpayers do not agree with an attempt by tax authorities to fit their arrangement into the spirit of the law, it is left to the judiciary to determine the application to a transaction of words of the law that on their face bypass an arrangement that may have been carefully crafted precisely so that it would fall into the cracks between explicit taxing measures. Two arguments have been made. One view is that judges should be sympathetic to taxpayers seeking to shield their gains from taxation unless the legislature has been sufficiently clever to anticipate and legislate for the transaction in question.[142] The second view assumes that judges have a responsibility to interpret tax law in a manner that achieves the intention of the legislature that enacted the law, and to resolve disputes in a manner consistent with the purpose of income tax law, namely, to assess and levy a tax on gains derived by taxpayers.[143]

The analogy for tax treaties is clear. It is quite impossible for the negotiators who settled on the words of a tax treaty to know fully their own tax system and the tax law of the treaty partner, and thus to anticipate and address every possible cross-border transaction or investment structure. A treaty allocates taxing rights, sometimes fairly and sometimes very unfairly, with an explicit objective of avoiding double taxation,[144] and it can be argued that the treaty should provide an avenue for independent

142 As Learned Hand J explained it: "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." See *Helvering v. Gregory*, 69 F 2d 809 (2d Cir. 1934), at 810.

143 Neil Brooks, "The Responsibility of Judges in Interpreting Tax Legislation," in Graeme S. Cooper, ed., *Tax Avoidance and the Rule of Law* (Amsterdam and Sydney: International Bureau of Fiscal Documentation and Australian Tax Research Foundation, 1997), 93-129; and Kim Brooks, "The Ethical Tax Judge," in Robert F. van Brederode, ed., *Ethics and Taxation* (Singapore: Springer Nature, 2020), 397-412.

144 The preamble to the US-Canada tax convention, for example, states that it is a convention "for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital." See the US-Canada tax convention [1469 UNTS 189], supra note 64.

arbitrators to interpret the treaty in a manner consistent with its objects, in the same way that judges have a responsibility to interpret domestic tax law in a way that is consistent with its goals. Just as a court might decide that a gain belongs to taxpayer A as a matter of property law but should be treated as income of taxpayer B to achieve the aim of the income tax law,[145] or that a gain is not income under provincial or state property or trust law but should be considered income for federal income tax purposes,[146] an arbitrator might conclude that treating a gain as a royalty or as personal service income for the purpose of a treaty achieves the goal of the treaty in relieving double taxation in the most equitable fashion.

Mandatory Arbitration Might Result in Double Non-Taxation

A sixth red herring argument against the use of mandatory arbitration is that the practice could lead to double non-taxation if income is allocated to a jurisdiction in which it will not be taxed, or to taxation in one country where the income was meant to be excluded from the tax base of the other country. Thus, for example, a developing country would find it equally inappropriate if, on the one hand, income that it sought to tax was allocated under mandatory arbitration to a treaty partner that exempted the gains from tax, and if, on the other hand, income that it promised to exempt from tax under concessions in domestic law in order to attract foreign investment was allocated to and taxed in the treaty partner.

There would be little international support for the view that it would be unfair if a capital-exporting nation prevailed in taxing residents on their worldwide income even though the source of some of the income was a jurisdiction that promised to exempt locally sourced income from local taxation. Equally, there would be little support for taxpayers who sought to avoid income tax completely by arguing that taxing rights over their income should be allocated solely to the jurisdiction that exempts the income from tax. Under conventional mutual agreement procedures, countries could simply agree to disagree if one country proposed an allocation that could lead to double non-taxation.[147] This issue was raised prior to discussions on the design of the MLI, and the OECD responded to concerns with changes to its model treaty and the MLI. The preambles to both the MLI and the OECD model bilateral treaty now state that the treaty is not to be used to create opportunities for double non-taxation. Although the mandatory arbitration provisions in the MLI are optional, the preamble qualification that treaties are not to be used to create opportunities for non-taxation of income is not: it applies automatically if the MLI is

145 *Helvering v. Horst*, 311 US 112 (1940).

146 *Merchants' Loan & Trust Co. v. Smietanka*, 255 US 509 (1921), at 515. See further Marjorie E. Kornhauser, "The Origins of Capital Gains Taxation: What's Law Got To Do with It?" (1985) 39:4 *Southwestern Law Journal* 869-928.

147 As Michael McIntyre speculates, "I suspect that the majority of the unresolved cases [are cases of potential double non-taxation]. I have no data on unresolved cases. . . . But I have known a lot of tax administrators over the years." See McIntyre, supra note 94, at 627.

applied to a bilateral treaty. This is true even for those countries that did not agree to include the mandatory arbitration provisions in the MLI when they signed on to the agreement. In a sense, the rapid spread of the MLI and its growing uptake (105 jurisdictions had signed on to the agreement by October 2025) and agreed application to bilateral treaties are making the concern that mandatory arbitration in tax treaties could lead to double non-taxation of income an increasingly moot point. There will, to be sure, be cases in which countries deliberately negotiate a double non-taxation outcome through a tax-sparing agreement, but an explicit recognition of this as an intended outcome in specific cases does not have an impact on the general rule governing arbitration.

FACTORS COUNTRIES SHOULD TAKE INTO ACCOUNT WHEN CONSIDERING MANDATORY ARBITRATION

If it is conceded that the most common objections to mandatory arbitration are weak at best, the MLI offers an easy route to including mandatory binding arbitration in tax treaties. Should countries take it?

The benefit is clear for taxpayers, who are guaranteed a resolution of tax treaty disputes and provided with certainty as to their tax obligations. To the extent that this certainty positively affects investors' perception of a jurisdiction's tax system, it might be welcomed by capital-importing nations. But before jumping on board the MLI mandatory arbitration train, jurisdictions need to understand just how great is the risk of disputes not being resolved and what the consequences of non-resolution might be. They should also be aware of the factors that might militate in favour of (or against) agreeing to mandatory binding arbitration.

The Magnitude of Unresolved Disputes as a Consequence of the Permissive Approach

Although the vast majority of tax treaties have no mandatory arbitration measure, the available evidence suggests that the problem of unresolved treaty disputes is not significant.[148] For example, around 77 percent of mutual agreement procedure cases concluded in 2023 were fully resolved (either through the procedure or a domestic process) and a further 9 percent were withdrawn by the taxpayer. Only 4 percent of such cases concluded in 2022 were left unresolved. Given the relatively small number of unresolved disputes, the significant and ultimately successful pressure from the business community to convince the OECD and later the UN to incorporate mandatory arbitration as features of their model treaties, and the determination of the OECD to push for its inclusion in the MLI, seem surprising at first look.

The reality, however, is that cases such as *Boulez* involving an individual are exceptions to the rule; most unresolved tax treaty mutual agreement procedures involve

148 Organisation for Economic Co-operation and Development, "2023 Mutual Agreement Procedure Statistics" (www.oecd.org/ctp/dispute/mutual-agreement-procedure-statistics.html).

large multinational corporations.[149] Apart from the immediate fiscal stakes for the taxpayer, the potential implications for those companies and others aware of the unresolved disputes of ongoing difficulties may be significant. If cross-border investment or business is significant and the capital-importing state represents a very large market for investment or sales, an investor may be willing to bear the risk of unresolved disputes and possible double taxation. This may also be true in the case of an investor in a lower-income country who is seeking access to local natural resources. It may be less likely to apply to a multinational firm looking at a range of possible developing countries for other types of investments. It is not surprising that research indicates a positive correlation between the relative speed of resolution of tax treaty disputes and the attractiveness of jurisdictions to foreign investors,[150] though no cause and effect has been empirically demonstrated. The relatively low rate of unresolved mutual agreement procedure cases overall may mask the risk for some countries of being perceived as a member of the risk-of-no-resolution club.

A related consideration is the time required to resolve mutual agreement procedure disputes. Prior to the spread of mandatory arbitration as a result of the MLI, the time to resolve cases was relatively long—approximately 32 months for transfer-pricing cases (disputes about the price nominated by a multinational enterprise for transactions between parts of the enterprise in two different jurisdictions) and 18 months for other cases.[151] While this may not be dramatically out of line with the length of time it takes to resolve domestic tax disputes in many countries, it can seem long for enterprises that are required to provide shareholders with regular updates on tax disputes that may affect profit levels. In this context, the timelines provided in the MLI for the commencement of mandatory arbitration—two years from the time the mutual agreement procedure commences[152]—may become one of the factors taken into account by investors. The time limitation not only may provide guidance to investors on the maximum dispute resolution period, but also will no doubt encourage the parties to reach agreement at an earlier stage.

The Arbitration Process

The small number of unresolved treaty disputes may be relevant to the consideration of mandatory arbitration by developing countries in two other respects. Almost all reported unresolved disputes take place in the context of disputes between developed

149 Carolina del Campo, "General Report," in International Fiscal Association, *Dispute Resolution in International Tax Matters*, Cahiers de droit fiscal international, vol. 101a (The Hague: IFA, 2016), 53-54.

150 Xixi Zhang and Matthias Petutschnig, *Mutual Agreement Procedure and Foreign Direct Investments: Evidence from Firm-Level Data*, WU International Taxation Research Paper series no. 2023-06 (Vienna: Vienna University of Economics and Business, 2023).

151 Organisation for Economic Co-operation and Development, "2021 Mutual Agreement Procedure Statistics."

152 MLI, supra note 102, article 19, at paragraph 1(b).

jurisdictions with sophisticated tax administrations. This may reflect the absence of a functioning competent authority in some developing jurisdictions, or the more limited ability of tax administrations in less-developed countries to dispute a taxpayer's claim for treaty relief in the first place. If a tax administration lacks the resources to effectively consider the merits of taxpayers' treaty claims, questions about dealing with unresolved bilateral negotiations are irrelevant. If, however, middle- and low-income jurisdictions believe that their tax administrations are able to evaluate treaty claims and are able to enter into mutual agreement procedure negotiations, the choice of mandatory or permissive resolution becomes relevant.

A first issue to consider is the arbitration process. The default arbitration models set out in the MLI have two notable features: (1) each country drafts a brief that is its "last best offer," and (2) a panel of three "neutral" experts chooses a side. No reasons are offered and one brief must be accepted over the other. There are two risks for middle- and lower-income countries. First, better resourced and more experienced tax administrations likely are able to prepare a better brief. While there are, to be sure, talented staff in tax administrations around the world, it is not illogical to assume that tax administrations in higher-income jurisdictions are more likely to have access to experience and human and other resources (for example, economists, editors, privileged information, software, and private databases) than others.[153] A high-income country's "better brief" might win over a lower-income country's brief even if its fundamental argument is not as strong. There is also a risk that in negotiations between competent authorities facing the prospect of mandatory arbitration, lower- or middle-income countries might concede issues because they feel ill-prepared to dispute them, or because of pressure tactics deployed by higher-income countries.

Second, even "neutral" or independent experts might bring their own biases to bear in their decisions (and because they do not need to explain those decisions, that bias is impossible to identify after the fact). Even where each country chooses one "neutral" expert and those experts choose a third panel member from outside the country, it will likely be the case that the experts have been educated in high-income states, perceive briefs by high-income states to be "better" (whether because high-income states have more resources and experts to produce those briefs, or because those trained in tax have an implicit high-income-country bias), and may well lean in favour of high-income countries for reasons other than the strength of the briefs' arguments.[154] It is quite possible that some low-income countries, especially, will not be able to identify an independent expert who might be inclined to see the issues from that country's perspective. In those cases, all three of the experts may have high-income-country training and interpretive inclinations.

153 There is general acceptance that many countries have limited experience with treaty dispute resolution mechanisms and that capacity building is necessary. See, for example, del Campo, supra note 149; and Pistone, supra note 98, at 33.

154 Lennard, supra note 141, at 183.

There are some ways to ameliorate the concerns about the different capacities and resources of treaty partners in resolving disputes. One possibility is to explicitly level the process by way of, for example, a permanent international tax tribunal composed of adjudicators from across the country and sector spectrum who could provide reasons for their decisions that would add legitimacy and accountability to the process. More radically, the OECD and UN could build a default into their dispute resolution mechanisms:[155] where a dispute is about the allocation of taxing rights, the default could be to favour the capital-importing state, since it is the party ceding revenue as a result of the application of the treaty. This approach might be problematic, however, where the capital-importing country has voluntarily forgone its taxing rights in domestic legislation by way of tax concessions, holidays, or tax-free zones.

These approaches may change the equation in the longer term, but in the immediate term lower-income countries might reasonably assume that they are likely to be at a disadvantage compared to their high-income counterparts when putting their case to an arbitration panel that is more likely than not to regard the higher-capacity state as being in a better position to develop a persuasive argument.[156] The concern that an arbitrator will necessarily favour the arguments of the better-endowed treaty partner may be exaggerated, however. The arbitrators will be acceptable to both signatories to the treaty, and it is possible that the panel will recognize the imbalance in resources and possibly provide some compensation in the decision-making process, as is often the case with judges faced with unequally resourced litigants.

At this point, it is impossible to speculate as to how mandatory arbitration in treaties between developed and less-developed nations might play out. Nevertheless, cautious lower-income countries could start their evaluation of arbitration options with the assumption, supported by many critics, that the dice are loaded against them in a mandatory arbitration scenario. In this case, the relevant question becomes: Having entered into a tax treaty and voluntarily forgone some taxing rights in return for other anticipated benefits, is a capital-importing country likely to be better off if tax treaty disputes are left unresolved, or if they are resolved by an arbitrator who may be influenced by the resources devoted to the dispute by a wealthier treaty partner? As with the initial decision to give up some taxing powers to achieve perceived benefits from a treaty, it may be the case that giving up further taxing rights to provide investors with a guarantee of dispute resolution may be a tradeoff worth contemplating. Similarly, if the concern is that arbitration might favour the more developed and better-resourced country, the concern might be even greater that the mismatch of resources could be even more likely to lead to undesirable agreements

155 This suggestion is in the spirit of Maya Forstater's "MLI for Development." See Maya Forstater, *Tax and Development: New Frontiers of Research and Action*, CGD Policy Paper 118 (Washington, DC: Centre for Global Development Policy Paper, 2018), at 3.

156 Carlos Protto, "Mutual Agreement Procedures in Tax Treaties: Problems and Needs in Developing Countries and Countries in Transition" (2014) 42:3 *Intertax* 176-78.

if there is no prospect of intervention by independent parties, however vulnerable they may be to different quality presentations.

A second factor that might prompt caution is the non-transparent aspect of mandatory arbitration. A fundamental principle of just dispute resolution is that the process must demonstrate transparent, reasoned decision making. It is important that the process provide an opportunity for policy makers and citizens who care about ensuring that decisions that affect often high-income taxpayers (including corporations), and that sometimes have substantial consequences for the revenue-raising capacity of states, to scrutinize the resolution of disputes in order to ensure the integrity of the legal system and rule of law. In many cases before domestic courts, where judgments are handed down with written reasons, it is possible to see that judges have found elements of the arguments offered by each side to be compelling. These kinds of nuanced decisions—ones that might more appropriately take into account the overall tax consequences in the light of the relevant treaty and underlying domestic law of the parties to the treaty—are not available in "last best offer" or "baseball" arbitration regimes, and are challenging to achieve in other arbitration systems.

Viewed in this light, mandatory arbitration, particularly the default baseball model, in which both sides make an offer and the arbitrator chooses between them without reasons, appears particularly undesirable. At the same time, however, it must be conceded that exactly the same concerns about unequal resources and the absence of transparency can apply equally to dispute resolution through a mutual agreement procedure that does not involve mandatory arbitration. The imbalance in resources is equally likely to have an impact on outcomes in the permissive resolution system, and the absence of reasoning is equally a feature of permissive resolutions of treaty disputes. These concerns are not convincing arguments against mandatory arbitration; rather, they are factors that countries might consider when entering into a bilateral treaty, whatever dispute resolution system is adopted.

There is one critical feature of mandatory arbitration that is not an equal concern with a permissive dispute resolution system. Unlike the negotiators from competent authorities, an arbitration panel may have inadequate (or no) understanding of the underlying domestic tax systems of the two countries. The panel's decision, therefore, may accord with a superficial understanding of the treaty by experts on the model treaty, or even the text of the treaties in the two jurisdictions, but lack rich understandings of the related domestic cases, administrative positions, or non-tax legal context. As a result, the outcome may not reflect the understandings and expectations of the two tax authorities who negotiated the treaty in light of their understandings of their own tax systems. There is, of course, an opportunity for authorities to provide arbitrators with this background, but once again the differing resources of administrations may have an impact on the ability of developing countries to make their case as effectively as their counterparts from wealthier nations. Once more, the issue comes down to a choice—is it in the country's long-term interest to risk leaving a taxpayer's claims unresolved, or to risk arbitration in a dispute with a better-resourced administration?

MOVING FORWARD

While there are many sympathetic to the interests of lower-tax jurisdictions who argue that tax treaties are unnecessary and often even undesirable for these jurisdictions, less-developed countries commonly perceive some benefits to losing taxing rights as a result of entering into treaties. Although there are probably more possibilities to enter into bilateral tax treaties than there are existing bilateral tax treaties, the more than 3,000 treaties do cover most of the world's trade and investment, and generally countries have entered into treaties with their main trade and investment partners. In making sense of the need for a dispute resolution mechanism, it is worth returning to the range of objectives that tax treaties serve. They allocate taxing rights between states, facilitate the exchange of information, prevent double taxation by requiring the residence country to provide relief by way of credit or exemption for source-country tax, promote international trade and investment by preventing tax discrimination against non-residents, and resolve disputes about the residence of taxpayers through the application of a tiebreaker rule. Treaties also include provisions that serve internal purposes—for example, provisions that aim to reduce the avoidance opportunities created by the design of the treaties themselves.

Countries that do not sign on to the mandatory arbitration clause under the MLI are scarcely outliers in the tax world. And while it may be helpful for taxpayers (perhaps ultimately only a small number of them) to have their disputes with tax authorities resolved in ways that reduce the overall tax they pay, the world has not yet come to a halt because countries have had to rely solely on permissive resolution or domestic mechanisms in the event that these failed to solve the disputes. However, as more countries move to adopt a mechanism for the certain resolution of disputes, the absence of a guarantee that disputes can be addressed may become another factor in the long list of factors that multinational enterprises consider when directing business activities and investments.

In an ideal world, and perhaps even in the medium- to long-term future, tax treaty disputes might be resolved in the manner originally envisaged by the League of Nations—by an independent, transparent decision-making body (a special tribunal with a right of appeal to a body with appropriately qualified experts), established to address directly some of the accountability and capacity issues that have been raised by those concerned with the baseball arbitration model in particular. In the present moment, however, countries that have entered into bilateral treaties must decide whether to adopt mandatory dispute resolution or retain permissive resolution mechanisms in their existing treaties.

Strong arguments have been made cautioning developing countries in particular to avoid adopting the current mandatory resolution option. The model of secret binding arbitration that seems uniquely designed to offer high-income taxpayers (and high-income states) a low-cost, low-accountability mechanism for managing cross-border taxpayer assessments does seem problematic in many respects. However, it is not clear that the alternative of no certain resolution provides a better choice for developing countries. Much of the concern of critics appears to derive

from their objections to tax treaties for developing countries, agreements that probably unnecessarily constrain their domestic tax bases. This concern provides no guidance for the best path forward once a country has ignored the cautions against signing bilateral treaties and agreed to trade some taxing rights for other perceived benefits. Many of the arguments in favour of permissive resolution over mandatory arbitration are at best ambiguous, with points both supportive of and critical of mandatory arbitration. Other arguments are truly red herrings that do not stand up well to rigorous examination.

It appears that few unresolved treaty disputes involve lower-income countries. As noted, however, this is not necessarily a positive sign; it may reflect concessions in the negotiation phase by less well-resourced tax administrations, which might be more prepared to maintain their preferred positions if they knew that failure to concede points would lead to third-party arbitration. Perhaps the most needed contribution at the moment is a proposal designed by the UN or the OECD for an alternative to the baseball arbitration model set out in the MLI, so that countries hesitant to embrace mandatory arbitration because of concerns over the baseball arbitration system will have a more defensible alternative.

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Policy Forum: Editors' Introduction—Tax Policy for New Governments

The governments of Canada and the United States saw changes in leadership in early 2025, with Prime Minister Mark Carney and President Donald Trump taking positions at the top of their respective governments. In some ways, there might have been a sense of continuity with these new leaders—Carney leads a government of the same political party as his predecessor and Trump previously held the job. But policy developments in 2025 have not felt continuous. President Trump has shaken the world with disruptive trade and tax policies. Added to those policy disruptions, the Carney government is challenged by the technology shock of artificial intelligence (AI), a housing and jobs crisis for younger Canadians, and a lingering productivity malaise that has slowed growth prospects. In this Policy Forum, we have brought together three articles that aim to provide advice to Canada's new government on how to mitigate and respond to these risks.

In the first article, Steve Suarez surveys the landscape of Canadian tax policy, looking for weaknesses and opportunities given the reality of a much more aggressive United States. Suarez covers a wide range of tariff and tax policy issues. For tariffs, he argues that we should be wary of making a short-term "deal" and keep our eyes on the more important long-term Canada-United States-Mexico Agreement. For the taxation of digital services, Suarez warns that the scope for this kind of tax on US businesses is limited under the current US administration, which will view such moves as hostile. In the same way, moves toward a system of carbon border adjustments to advance carbon pricing may have some benefits, but are subject to the whims of the White House in how they might be interpreted. Suarez also provides detailed coverage of income tax issues, including the international taxation aspects of the tax legislation recently passed in the United States. The big-picture advice for Canada is to keep our eyes on our goals: promoting a growing Canadian economy and protecting our tax base.

The second article, by Devan Mescall and Nathalie Johnstone, considers risks to the Canadian labour market caused by a confluence of aggressive US tariff policy and disruptions caused by AI. The authors focus specifically on employment and productivity and how the tax system might be used to counter the impact of AI and tariffs. They develop a framework for assessment and scrutinize several potential tax expenditure options, ranging from tax support for new hiring and apprenticeships to enhanced tax relief for human capital investments. In the face of potential unemployment rates hitting double digits in the short term, they argue that a long-term focus on employment and productivity is the best path forward.

In the final article, Paul Kershaw presents a strong case for modernizing old age security (OAS). Even though expenditures on OAS will soon approach $100 billion per year, the program leaves hundreds of thousands of seniors in poverty. Through simulations of six feasible policy alternatives, Kershaw argues that a more effective means-tested program that phases out OAS for higher-income seniors could help to relieve seniors' poverty and at the same time lower the fiscal burden of the program. The savings forecasted by Kershaw's proposals would help Canada's current situation by freeing up fiscal resources for other uses and improving social solidarity among young people by moving the needle on fairness across generations.

Kim Brooks
Kevin Milligan
Daniel Sandler
Editors

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Policy Forum: International Tax Policy—When the Gloves Come Off

Steve Suarez*

PRÉCIS

Les nations se font concurrence sous diverses formes. De plus en plus, la politique fiscale fait partie de cette concurrence, car les pays cherchent à attirer chez eux les activités économiques (et les avantages qui en découlent, tels que les emplois et les recettes fiscales) qui existent (ou pourraient être créées) dans d'autres pays, tout en conservant les activités économiques qui existent déjà à l'intérieur de leurs frontières. Jamais les activités économiques n'ont été aussi axées sur les services et les formes numériques, qui ont de moins en moins de liens physiques avec une juridiction donnée et sont de plus en plus susceptibles de se déplacer d'un pays à l'autre. La flambée des droits de douane en Amérique, en 2025, reflète l'accélération de l'utilisation des systèmes fiscaux comme arme dans le cadre de la plus grande concurrence à laquelle se livrent les nations. Les États-Unis, en particulier, se sont montrés tout à fait prêts à utiliser diverses incitations et dissuasions fiscales pour influencer à la fois les décisions du secteur privé (à l'intérieur et à l'extérieur de leurs frontières) et les choix politiques d'autres pays. Cet article examine l'état passé et présent de la concurrence fiscale internationale dans différentes formes d'imposition.

ABSTRACT

Nations compete among themselves in various forms. Increasingly, tax policy is one such area, as countries seek to attract to themselves economic activity (and resulting benefits such as jobs and tax revenue) that exists (or could be created in) other countries, while retaining such economic activity as already exists within its borders. Never has economic activity been so skewed toward services and digital forms that have less and less physical connection to any particular jurisdiction and are increasingly capable of moving from one country to another. America's 2025 tariff outburst reflects the accelerating weaponization of tax systems within the larger competition among nations, and the United States in particular has shown itself quite willing to use various tax incentives and disincentives to shape both private sector decision making (within and outside its borders) and the policy choices of other countries. This article examines the past and present state of international tax competition among various different forms of taxation.

KEYWORDS: COMPETITION ■ INTERNATIONAL ■ TAX POLICY ■ TARIFFS ■ UNITED STATES ■ CARBON TAXES

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In most cases, a country's domestic tax policy is directed primarily at raising revenue while not unduly discouraging economic activity. A more robust tax policy seeks to actively incentivize commercial activity that a country sees as desirable and worthy of support, both to raise more long-term tax revenue and to protect its tax base from the potential relocation of that activity to a more attractive jurisdiction (there is considerably more that Canada could be doing in this latter regard).[1] More aggressive still are tax policy choices meant to (or that simply will) "beggar thy neighbour," whether by encouraging businesses or people in other countries to relocate or by other means.

Recent events have brought into focus the importance of tax policy (including tariffs) as both a source of international conflict and a potential means of impacting the economies of other countries and even (in more extreme cases) projecting power. Most notably, the US administration under President Trump has been accused of seeking to "weaponise the U.S. tax system to apply pressure on countries, like France and Britain, that are [themselves] slapping special taxes on American technology giants."[2]

Some countries deploy tax policy to attract economic activity that would otherwise be located in other countries, or to tax residents of other countries (directly or indirectly) in ways that seem "fair" to it. The tax policy of some countries may result in the erosion of another country's tax base. In some cases, a country may consider its residents to have been put at an unfair disadvantage relative to another country's residents because of the latter country's tax policy, while in other cases, a country may use its tax policy to try to "level the playing field" with residents of another country in some way (the distinction between these two situations can be rather subtle). This article considers how various taxes (sales taxes, tariffs, digital services taxes, income taxes, and carbon taxes) have been designed or imposed in a manner that other countries may perceive as being directed "at" them or levied at their expense.

1 Steve Suarez, *Productivity, Innovation and How Canada's Tax System Can Help* (Toronto: Borden Ladner Gervais LLP, 2025) (www.blg.com/-/media/insights/2025/documents/blg-productivity-innovation-and-canadas-tax-system-aug-2025-2.pdf).

2 Liam Proud, "US Tax Weaponisation Launches Messy European Fight," *Reuters*, February 5, 2025 (www.reuters.com/breakingviews/us-tax-weaponisation-launches-messy-european-fight-2025-02-04).

SALES TAXES

Sales taxes (as they are understood in the traditional sense) tend to be a relatively uncontentious area of tax in intercountry terms. The value-added tax (VAT) has been adopted in one form or another by the vast majority of countries.[3] As a result, VAT-style taxes produce relatively little friction between nations.

The exception, of course, is the United States—or at least its current leadership. Included in its list of grievances used to justify "fair and reciprocal" tariffs were VATs, defined for this purpose as "a type of consumption tax that is levied on the incremental increase in value of a good or service at each stage of the supply chain."[4] Exactly why VATs are considered unfair to US exporters is unclear: in virtually all VAT systems, imported goods are treated the same as (that is, bear the same rate of VAT as) goods produced domestically, thus creating no VAT difference on imports. This is the fundamental difference between tariffs and VATs: VATs do not discriminate on the basis of the country of production.

Sadly, this nuance seems lost on the economic leadership in the White House. For example, White House Deputy Chief of Staff Stephen Miller had the following to say on this issue:

> Other nations all around the world use the VAT to get an unfair trade advantage against the United States.
>
> Did you know when you ship a car from the United States to Europe, if they let it in at all because they have many nontariff barriers, between the VAT and duties, that car is taxed at 30%? The German car—or a European car sent [to] America is taxed at 2.5%—or basically 0. This is a major reason why the U.S. auto industry has been getting hammered and hemorrhaging jobs for so long.
>
> It is massively unfair treatment, and the president's making clear that we are going to pursue a policy of reciprocity. In other words, if we're getting charged 30% by Europe, we need to charge them 30% in return. If they want to be charged less than 30, they're going to have to lower their barrier, which is that it's fair and equal and, yes, reciprocal treatment.[5]

The idea that most of the world's countries (including virtually all members of the Organisation for Economic Co-operation and Development [OECD]) have adopted VATs for the purpose of obtaining a trade advantage against the United

3 Organisation for Economic Co-operation and Development, *Consumption Tax Trends 2024: VAT/GST and Excise, Core Design Features and Trends* (Paris: OECD, 2024).

4 The White House, "Reciprocal Trade and Tariffs," February 13, 2025 (www.whitehouse.gov/articles/2025/02/reciprocal-trade-and-tariffs).

5 Tim Hains, "Miller: Trump Trade Action Against Europe Will Offset EU Regulations and VAT Taxes on American Products," *Real Clear Politics*, February 9, 2025 (www.realclearpolitics.com/video/2025/02/09/miller_trump_trade_action_against_europe_will_offset_eu_regulations_and_vat_taxes_on_american_products.html), quoting Fox News Channel's "Sunday Morning Futures" transcript.

States is laughable, and it is little wonder that many commentators, particularly in Europe, view objections to VATs as merely a "negotiating ploy."[6]

A somewhat more plausible (if ultimately incorrect) objection to VATs from an international fairness perspective is the assertion that they function as an export subsidy, since exporters in VAT countries can claim a rebate or input tax credit for VAT paid on their production expenses, including on goods manufactured for export, thus giving them an advantage on goods produced for export. From time to time this argument has been tried on for size in one form or another.[7] Apart from the obvious answer that the United States can level the playing field by adopting a VAT like the rest of the world any time it wants, the fact remains that border-adjusting VATs in this manner has been determined by the World Trade Organization (WTO) not to distort trade or to constitute an export subsidy. The debunking of the myth that VATs are an export subsidy is most persuasively explained by Americans themselves,[8] thus making VATs a basis for imposing tariffs "complete nonsense."[9]

TARIFFS

At the other end of the spectrum from sales taxes are tariffs, which are essentially sales or consumption taxes levied on specific goods imported from specific countries. While tariffs are usually levied on the ostensible basis of allowing domestic manufacturers to compete with foreign importers on equal terms, the reality is often quite different. Never has this been more apparent than with the Trump administration's global tariff blitzkrieg,[10] said to be justified by a grab bag of claims ranging from the plausible to the specious (particularly in Canada's case).[11]

6 Philip Blenkinsop, "Why Trump Has Thrown VAT into the Trade Stand-Off," *Reuters*, February 21, 2025 (www.reuters.com/world/us/why-trump-has-thrown-vat-into-trade-stand-off-2025-02-21), quoting Niclas Poitiers.

7 See, for example, Richard Asquith, "Trump Right About Discriminatory VAT for Wrong Reason?" *VAT Calc*, February 14, 2025 (www.vatcalc.com/global/trump-right-about-discriminatory-vat-for-wrong-reason).

8 See, for example, Martin Feldstein and Paul Krugman, "International Trade Effects of Value-Added Taxation," in Assaf Razin and Joel Slemrod, eds., *Taxation in the Global Economy* (Chicago: University of Chicago, 1990), 263-82; and Sean Bray, Jared Walczak, and Erica York, "The European VAT Is Not a Discriminatory Tax Against US Exports," *Tax Foundation*, February 12, 2025 (https://taxfoundation.org/blog/trump-reciprocal-tariffs-eu-vat-discriminatory).

9 Greg Iacurci, "As Trump Readies Reciprocal Tariffs, Economists Say 'Value-Added Taxes' Aren't a Trade Barrier," *CNBC*, March 31, 2025 (https://cnb.cx/4j5as5c).

10 For a recent detailed discussion of the various US tariffs in place, see Erica York and Alex Durante, "Trump Tariffs: Tracking the Economic Impact of the Trump Trade War," *Tax Foundation*, October 31, 2025 (https://taxfoundation.org/research/all/federal/trump-tariffs-trade-war).

11 US Embassy and Consulates in Canada, "Fact Sheet: President Donald J. Trump Imposes Tariffs on Imports from Canada, Mexico, and China," February 3, 2025 (https://ca.usembassy.gov/fact-sheet-president-donald-j-trump-imposes-tariffs-on-imports-from-canada-mexico-and-china).

Depending on the circumstances (including the sales tax system in the importing country), tariffs may be borne by any or all of the following: the foreign exporter (through a price reduction), the domestic importer, or, if the importer is not the end-user, the importer's customers (both direct and indirect). The recent US experience seems to have been that, *so far*, it is largely US businesses (and to a lesser degree consumers) who have been bearing the cost of US tariffs[12] (75 percent or more, by some measures),[13] which is both broadly consistent with the results produced by tariffs that were increased in the first Trump administration,[14] and rather different from President Trump's assertion that it would be foreign producers "eat[ing]" them.[15] To date, Canada (protected as it is for now by the Canada-United States-Mexico Agreement [CUSMA])[16] has done well not to overreact by rushing into a poor deal in response to US attempts to weaponize its tariff system against the rest of the world. If President Trump wants to tax US residents and businesses and increase prices in America, let him have at it.

DIGITAL SERVICES TAXES

While the United States may have a trade deficit in goods with many other countries, it is also the largest exporter of services in the world and ran a trade surplus in services[17] of nearly $300 billion in 2024.[18] Digital services in particular are dominated by US-based multinational corporations. Given the extent to which the global economy has evolved beyond traditional bricks-and-mortar commerce, and the resulting deficiencies of using the "permanent establishment" concept as a nexus for taxation in this area, it is not surprising that other countries found their inability to tax the income of non-resident service providers under current rules so frustrating.

12 See "Now We Know Who's Paying the Tariffs," *Wall Street Journal*, August 14, 2025 (www.wsj.com/opinion/now-we-know-whos-paying-the-tariffs-081f461d).

13 See Eleanor Pringle, "Trump Said Foreign Countries Would 'Eat' Tariffs—But U.S. Consumers and Businesses Will Actually Pay 75% at Best," *Yahoo Finance*, August 11, 2025 (https://finance.yahoo.com/news/trump-said-foreign-countries-eat-101540949.html).

14 See, for example, Alex Durante, "Who Pays Tariffs? Americans Will Bear the Costs of the Next Trade War," *Tax Foundation*, February 19, 2025 (https://taxfoundation.org/blog/who-pays-tariffs).

15 Lucien Bruggeman, "Trump Pushes Back Against Economic Anxieties in ABC Interview, Says China 'Probably Will Eat Those Tariffs,'" *CBC News*, April 29, 2025 (https://abcnews.go.com/US/trump-pushes-back-economic-anxieties-abc-interview-china/story?id=121278001).

16 Office of the United States Trade Representative, "United States-Mexico-Canada Agreement" (https://ustr.gov/trade-agreements/free-trade-agreements/united-states-mexico-canada-agreement).

17 Patricia Cohen, Adam Satariano, Eshe Nelson, and Jeanna Smialek, "Countries Targeted by Trump's Tariffs May Strike Back at U.S. Services," *New York Times*, April 2, 2025 (www.nytimes.com/2025/04/02/business/economy/tariffs-foreign-goods-tariffs-us-services.html).

18 Jenny Gross and Keith Bradsher, "What Is the Value-Added Tax That Trump So Despises?" *New York Times*, April 3, 2025 (www.nytimes.com/article/trump-vat-tax-europe.html).

Enter the digital services tax (DST). In 2018, the European Commission proposed to establish a 3 percent DST on online advertising, digital intermediary activities, and sales of user data as a temporary measure, pending agreement on the allocation of taxing rights under pillar 1 of the OECD's base erosion and profit shifting (BEPS) initiative. The proposal failed, but individual EU countries such as France, Italy, the United Kingdom, and Spain adopted DSTs along broadly similar lines. Canada soon followed with its tragically ill-advised adoption of a DST, despite its unique trade vulnerability to the target's tax: the United States and its digital services multinationals.

The United States objected to this de facto reallocation of taxing rights on a variety of bases. Among the reasons given:

- DSTs violate international norms with regard to the required nexus for taxing non-residents;[19]
- DSTs violate international trade rules (both WTO and bilateral trade agreements);[20]
- in a related argument, DSTs of the type enacted to date are inherently discriminatory against US-based multinationals, because virtually all in-scope taxpayers are based in the United States; and
- DSTs lead to double taxation (a claim addressed below).

The US reaction to the Canadian DST was swift, broad-based, almost uniquely bipartisan, and forceful, culminating in a blizzard of tariff threats and in particular the much-discussed "revenge tax" under section 899 of the Internal Revenue Code,[21] directed at jurisdictions levying taxes that are discriminatory or unfair (from a US perspective), including DSTs and, especially, undertaxed profit rules (UTPRs) enacted under the OECD's pillar 2 global anti-base erosion (GloBE) rules.[22]

Although IRC section 899 was ultimately dropped from the One Big Beautiful Bill Act[23] (OBBBA) enacted by the United States in July 2025, following an agreement[24]

19 For example, European DSTs such as France's purport to rely on IP addresses: see Stephanie Soong, "U.N. Delegates Float New Nexus Ideas for Tax Convention Protocol" (2025) 119:7 *Tax Notes International* 1108-9.

20 In the case of CUSMA, see Office of the United States Trade Representative, "United States Requests USMCA Dispute Settlement Consultations on Canada's Digital Services Tax," *Press Release*, August 30, 2024.

21 Internal Revenue Code of 1986, as amended (herein referred to as "IRC").

22 Organisation for Economic Co-operation and Development, "Global Anti-Base Erosion Model Rules (Pillar Two)" (www.oecd.org/en/topics/sub-issues/global-minimum-tax/global-anti-base-erosion-model-rules-pillar-two.html).

23 Pub. L. no. 119-21 (July 4, 2025) (www.congress.gov/bill/119th-congress/house-bill/1/text).

24 See United States, Department of the Treasury, "G7 Statement on Global Minimum Tax," *Statements & Remarks*, June 28, 2025 (https://home.treasury.gov/news/press-releases/sb0181).

with the rest of the Group of Seven (G7) to effectively exclude US-parented groups from pillar 2 measures, DSTs remain an outstanding issue. While Canada thankfully folded its DST tent owing to tariff threats from the United States (albeit at the last possible minute and while receiving no benefit for doing so),[25] most other countries have not given up their taxes.[26] The tariff agreements reached between the United States and both the United Kingdom and the European Union do not include the removal of DSTs, nor do they prevent the EU from following through on its earlier threat to tax US-sourced services by way of "a levy on the advertising revenues of digital services."[27]

Given the evidence that US multinationals were (and are) simply passing on the costs of DSTs to their customers in the countries imposing them,[28] one wonders why these countries do not simply increase their VAT rate on such services and thereby eliminate most or all of the US DST objections (extension of nexus rules, discriminatory trade practice, etc.).[29] Better yet, DST countries could consider donning the sheep's clothing and reframing their DSTs as a US-style base erosion and anti-abuse tax (BEAT).[30] For now, the United States continues to view DSTs as an egregious and discriminatory exercise of extraterritorial taxation on US residents, and is not entirely unjustified for doing so.[31]

25 See Canada, Department of Finance, "Canada Rescinds Digital Services Tax To Advance Broader Trade Negotiations with the United States," *News Release*, June 29, 2025.

26 See Jonathan Curry, "DSTs Expected To Play a Bigger Role in Trade Talks" (2025) 119:3 *Tax Notes International* 477-79.

27 See Roula Khalaf, Henry Foy, and Andy Bounds, "EU Could Tax Big Tech if Trump Trade Talks Fail, Says von der Leyen," *Financial Times*, April 10, 2025 (www.ft.com/content/fba18bd9-46f9-4736-89f3-976afe3abf7a).

28 See, for example, Alison Simpson, "How Canada's Digital Services Tax Is Hurting Small Businesses," *Globe and Mail*, November 17, 2024 (www.theglobeandmail.com/business/commentary/article-how-canadas-digital-services-tax-is-hurting-small-businesses); and Ryan Finlay, "It's Time for the United States To Move on from the DST Feud," *Tax Notes*, September 11, 2023 (www.taxnotes.com/featured-analysis/its-time-united-states-move-dst-feud/2023/09/08/7h8g7).

29 See in this regard, for example, Leopoldo Parada, "Balancing DSTs and Geopolitics: The European Dilemma" (2025) 119:7 *Tax Notes International* 1013-22, at 1020: "[U]nlike a DST, VAT is inherently nondiscriminatory and fully compatible with EU law, because it applies equally to all businesses supplying digital services, regardless of their country of origin. This legal compatibility helps avoid the risk of trade disputes or challenges under WTO rules, which have been a concern with DSTs in the past, especially considering past section 301 investigations by the United States."

30 Patrick Driessen, "Is the U.S. BEAT a Digital Services Tax?" (2025) 119:3 *Tax Notes International* 415-18.

31 For a further examination of this issue, see Wei Cui, "The Logic of the Revenge Tax" (2025) 119:1 *Tax Notes International* 19-28.

INCOME TAXES

There are any number of ways in which a country can seek both to protect its own tax base and to make itself more attractive as a location for launching a new business or expanding an existing one. Canada has certainly been very active in trying to protect its base:

> [I]t can be quickly noted that the tax laws of the writer's country (Canada) are characterized no less, if not more, than those of the United States by a predilection, all too frequently, to establish unprecedented frontiers when taxing investors and the business community (to say nothing of the often zealous audits and mechanical-literal interpretational approach of Canada's tax administration). . . . Canada was the first country to legislate mechanical thin-capitalization rules (1972). It was also the first nation to legislate: (1) tax on departing residents (1972), beefed up in 1996 to virtually ring-fence the country; . . . (2) antiavoidance rules respecting offshore fund investment (1984), . . . now being augmented to potentially apply to any foreign investment); and (3) tax on nonresidents selling shares of foreign companies which own certain domestic (in this example, Canadian) property.
>
> Canada was also the first nation to adopt treaty rules to tax real estate company shares (contrary to the OECD Model Tax Convention, prior to its recent revision). . . . And Canada was the second country (following only the United States) to adopt stringent foreign income attribution rules (1972, with effect in 1976). . . . As well, Canada has insisted, contrary to the OECD and most other countries, on imposing at least a 10 percent withholding tax on interest and only recently stopped taxing (under treaty) most, but not all, forms of royalties.
>
> So the United States is hardly alone in crafting far-reaching (perhaps overreaching?) tax systems which spur multinational tax planning, etc.[32]

In its scope and vehemence, the US "revenge tax" in proposed IRC section 899 was an unprecedented projection of tax policy power on steroids. There was no doubt whatsoever that it was a loaded weapon aimed at countries enacting DSTs, UTPRs, and any other tax deemed to be "unfair" to Americans, as determined by Americans. For residents of offending countries, it would have increased rates of (1) withholding tax on fixed, determinable, annual, or periodical (FDAP) income such as dividends, interest, and royalties; (2) income tax on effectively connected income; and (3) tax on dispositions of US real property interests. It would also have subjected US subsidiaries of residents of offending jurisdictions to a so-called super-BEAT, which would have dropped various existing BEAT exclusions, such as that for payments already subject to US withholding tax. Most notably, it worked,[33] although the scale of the

32 Nathan Boidman, "Inversions, Earnings Stripping—Thin Capitalization and Related Matters—An International Perspective" (March 2003) *Tax Notes International* 879-904, at 881.

33 "Today, we have two new agreements to digest—one regarding the future of pillar 2, the other involving the Canadian digital service tax. They follow the same script. I claim no joy in saying this, but both deals were capitulations. The United States gave away next to nothing and, in return, gained exactly what it wanted." See Robert Goulder, "Goodbye, Section 899, We Hardly Knew Ye" (2025) 119:2 *Tax Notes International* 325-28, at 325.

damage it would have inflicted on foreign entities to whom it would have applied if it had been enacted is likely such as to cause non-US residents to seriously reconsider making further US investments.[34]

Since a country offering a foreign tax credit to its residents for taxes paid in another country is (to that extent) effectively forgoing its own right to tax the same income, the creditability (or not) of foreign taxes constitutes another potential international tax flashpoint. The recent and ongoing tussle between the United States and various other countries over the imposition of DSTs illustrates this issue. The United States views such taxes as discriminatory (since US multinationals are the principal subjects) and continues to apply pressure on various fronts to eliminate them. Since a foreign DST would not be creditable under US tax rules[35] (which the United States has no intention of changing), the United States is essentially faced with either offering a foreign tax credit and subordinating its right to tax, or not offering a credit and thereby subjecting its residents to double taxation. Liking neither option, the United States is instead pursuing a policy of using other means at its disposal (including tariffs and the "revenge tax" described above) to force other countries to drop their DSTs.

The basic principle underlying a country's decision to defer its own right to tax its residents by issuing a foreign tax credit is based on the presumption that the crediting country believes it to be in its own interest to encourage its domestic companies to expand into other countries—for example, to allow them to scale up and become stronger, and thereby more competitive internationally. At least until relatively recently, this presumption appears to have been borne out by the available evidence:

> A more common worry among some Canadians is how Canadian direct investment abroad affects Canadian employment. The Panel found no clear evidence that direct investment abroad leads to an export of jobs or increases unemployment in a capital exporting country like Canada. Rather, outbound direct investment appears to move employment away from low-value-added jobs and toward higher-value-added work.[36]

This core principle is reflected in the following statement from the Department of Finance describing the choices inherent in Canada's international tax policy:

> Canada has had to struggle with two conflicting goals. The goal of economic efficiency argues for a system which preserves capital export neutrality. This is achieved when foreign source income is subject to the same effective tax rate as domestic source income,

34 See, for example, Mindy Herzfeld, "One Big (Not So) Beautiful Way To Discourage International Investment" (2025) 118:9 *Tax Notes International* 1333-38.

35 See, for example, Reuven S. Avi-Yonah, "Should Digital Services Taxes Be Creditable?" (2024) 113:11 *Tax Notes International* 1469-72.

36 Panel recommendations from Advisory Panel on Canada's System of International Taxation, *Final Report: Enhancing Canada's International Tax Advantage* (Ottawa: Department of Finance, December 2008), at 15, section 3.13.

> leaving taxpayers indifferent, at least from a tax perspective, as to whether they invest inside or outside of Canada. Conversely, the goal of competitiveness argues for capital import neutrality. This requires that a Canadian investing in a foreign country be subject to tax at the same effective rate as a resident of that country. From a tax perspective, this ensures a level playing field between Canadian and non-Canadian businesses operating internationally. . . .
>
> [I]n order to preserve the international competitiveness of Canadian businesses, active business income that is earned offshore by a foreign affiliate is not required to be accrued and is subject to tax only in the foreign jurisdiction. Furthermore, where such income is earned in a "listed country" (basically countries with which Canada has entered into a tax treaty) it may be repatriated (i.e., paid back as a dividend) to Canada on a tax-free basis. The ability to receive dividends from a foreign affiliate on a tax-free basis is intended, at least in part, as a proxy for the foreign tax credit that would have been available to the Canadian company if it had carried on its business through a foreign branch rather than a subsidiary. It also helps to ensure that there is no tax impediment to corporations re-investing their foreign earnings in their Canadian operations.[37]

Canada's system of taxing active business income earned by foreign subsidiaries of Canadian corporations adopts this approach by effectively exempting such income from Canadian tax by means of the exempt surplus system in section 113 of the Income Tax Act,[38] on the basis that "the overriding principle guiding Canada's taxation of outbound direct investment should be to ensure that the Canadian tax treatment of foreign-source business income does not disadvantage Canadian businesses investing abroad when compared with their foreign competitors."[39] Tilting the playing field toward domestic investment is not a tax policy goal in Canada.

Recent developments suggest that this benign view of supporting international expansion by domestic corporations no longer prevails in the United States, where the current administration seems to see business investment as a zero-sum game, where every dollar invested outside the country is a dollar not invested in America—and which hence explains the imposition of prohibitive tariffs on imported goods to encourage (if not force) increased manufacturing in the United States.

A country's choices as to when to offer a foreign tax credit can materially impact the attractiveness of investing in foreign operations, potentially tilting the taxpayer's decision toward domestic expansion instead. For many years, the basic requirement for a foreign tax to be creditable in the United States was that it have the "predominant character of an income tax in the U.S. sense."[40] In 2020, proposed regulations

37 Department of Finance response in Canada, *Report of the Auditor General of Canada to the House of Commons 1992* (Ottawa: Supply and Services, 1992) (https://publications.gc.ca/collections/collection_2015/bvg-oag/FA1-1-1992-eng.pdf), chapter 2, at 2.61.

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

39 Panel recommendations from Advisory Panel on Canada's System of International Taxation, supra note 36, at 12, section 3.7.

40 Former IRC reg. sec. 1.901-2.

were issued by the Internal Revenue Service to significantly increase the requirements for a foreign tax to qualify as creditable for US income tax purposes,[41] eventually resulting in final regulations issued in 2022 that have been deferred indefinitely.[42] A country wishing to make foreign investment less attractive for its residents can adjust various elements of its foreign tax credit regime to make it more difficult to claim (or reduce the amount of) a foreign tax credit. For example, it might

- change its sourcing rules that define what constitutes foreign-source income;
- impose a country-by-country limitation on computation, rather than allow a global calculation where excess credits from income earned in one country can be used against tax on income from another; and
- require more domestic expenditures to be allocated to reduce foreign-source income.

It would not be surprising to see the current US administration push forward on these rules, in furtherance of its onshoring agenda. If this occurs, US residents will effectively face a higher tax cost on foreign expansion.

The changes made in the OBBBA[43] are mixed in this regard. On the one hand, the regime for taxing the foreign-source income of controlled foreign corporations (CFCs)—formerly known as "global intangible low-taxed income" (GILTI); now rebranded as "net CFC tested income" (NCTI)—removed the 10 percent exemption for net deemed tangible income return, and increased the effective tax rate on NCTI to 14 percent. These changes tax CFC income more comprehensively than previously, and lend credence to the US assertion that its system of taxing CFC income is actually more onerous and effective in combatting base erosion than is pillar 2.[44] On the other hand, the OBBBA also reduced the range of expenses that must be deducted in computing NCTI for foreign tax credit purposes, and increased the amount of credit claimable from 80 percent of foreign taxes to 90 percent.[45] On balance, when considered in conjunction with the export subsidy created by the expansion of the foreign-derived intangible income (FDII) regime to include domestic investment in tangible assets (for example, plant and equipment), the government's intention is

41 See Brent Felten, "Regulations Create a New Approach to the Creditability of Foreign Taxes," *Tax Advisor*, September 1, 2024 (www.thetaxadviser.com/issues/2024/sep/regulations-create-a-new-approach-to-the-creditability-of-foreign-taxes).

42 See Mindy Herzfeld, "What Role for International Tax in a Trump Tariff World?" (2025) 118:2 *Tax Notes International* 211-15.

43 Supra note 23.

44 See, for example, Mindy Herzfeld, "The United States' Sharp Turn Toward Tax Unilateralism" (2025) 118:7 *Tax Notes International* 959-63.

45 Mindy Herzfeld, "The OBBBA's International Revenue Raisers, Losers, and Fixes" (2025) *Tax Notes International* 529-34, at 530.

very clearly to use its tax system to incentivize investment in US-situs facilities, especially those that are used to generate foreign-source income.[46]

One country's choices in its tax system can also impact the extent to which the tax is effectively borne by another country through the latter's foreign tax credit rules. The large corporations tax (LCT) in former ITA part I.3 was a form of corporate alternative minimum tax (that is, a tax on corporations without positive taxable income for the year), levied as a capital tax. The LCT was deductible for Canadian tax purposes from the 3 percent corporate income tax surtax. Because it was a capital tax, the LCT would generally not have been eligible for a foreign tax credit in most other countries (including the United States) in the case of a non-resident carrying on business in Canada (or through an entity that was fiscally transparent or included in a domestic group in the non-resident's home country), nor would the elimination of double taxation article of a tax treaty between Canada and such other country typically cover such a tax.

Although Canada may have been indifferent as to whether LCT was deductible against corporate surtax or vice versa, non-residents were not. They successfully prevailed upon the minister of finance to reverse the order and make the corporate surtax deductible against the LCT, ostensibly on the basis that doing so was in Canada's interest because a reduced foreign tax credit in the non-resident's home country "may have an adverse effect on the investment decisions of foreign corporations in regard to their Canadian operations."[47] In the press release announcing the change, the minister stated: "Reversing the direction of crediting avoids this result without reducing Canadian tax revenues. . . . In doing so, foreign parent companies in the United States and a number of other countries that have foreign tax credit systems will be able to obtain recognition abroad for a larger portion of the Canadian taxes for which they are liable."[48]

Perhaps the most notable example of an internationally controversial Canadian tax policy is the ITA subparagraph 95(2)(a)(ii) recharacterization rule, which treats as "active business income" the interest or licensing income earned by financing or licensing subsidiaries from related non-Canadian group members carrying on businesses. As Canada essentially forgoes its right to tax active business income earned by foreign affiliates by way of the exempt surplus system in ITA section 113, the recharacterization of such amounts does not materially affect Canadian tax revenues, but rather facilitates base erosion payments in other countries where Canadian multinationals carry on business through foreign subsidiaries. As Professor Wilkie has noted, this "infamous and, sometimes controversial, rule . . . enables the debasement

46 Richard Rubin, "U.S. Exporters Get Welcome Surprise in Trump Tax Law," *Wall Street Journal*, July 29, 2025 (www.wsj.com/business/u-s-exporters-get-welcome-surprise-in-trump-tax-law-525ef529).

47 Canada, Department of Finance, "Change in Crediting of Special Taxes on Large Corporations," *News Release* 92-016, February 21, 1992, at 1.

48 Ibid.

of other countries' treasuries," with the United States undoubtedly being the foremost victim.[49]

Canada has also shown itself willing to use its tax system to encourage (or coerce) foreign countries to cooperate. For example, the tax information exchange agreement (TIEA) initiative launched by Canada sought to "enhance . . . Canada's ability to collect tax information from other jurisdictions"[50] by both

- expanding the exempt surplus regime to include active business income earned by a foreign affiliate residing in a country that has agreed to a TIEA with Canada, to incentivize non-treaty countries to sign a TIEA with Canada; and
- penalizing those that do not sign a TIEA with Canada by subjecting income earned in such countries by subsidiaries of Canadian taxpayers to accrual-basis Canadian taxation, "[t]o increase the incentive for countries to enter into TIEAs with Canada."[51]

This (typically Canadian) modest display of force has been remarkably successful, with 24 TIEAs in force as of 2025,[52] with another signed and a further 5 under negotiation.

CARBON TAXES

The policy of pricing carbon as a means of combatting pollution (and more recently climate change) has been around for some time. In 2007, Alberta became the first North American jurisdiction[53] to use a carbon levy as a way of forcing large emitters to reduce greenhouse gases, via the Specified Gas Emitters Regulation (replaced in 2018 by the Carbon Competitiveness Incentive Regulation).[54] Certain other provinces and some US states subsequently joined this initiative.

The international tax policy element of carbon taxes is a somewhat more recent phenomenon, as carbon taxes evolved from anti-pollution measures into a tool in the battle against climate change. Different countries have developed widely disparate policies on limiting carbon emissions from domestic activities, ranging from "do

49 Scott Wilkie, "Pillar 2—'What's It All About?'" (2023) 110:4 *Tax Notes International* 499-510, at 501, note 4.

50 Canada, Department of Finance, 2007 Budget, Tax Measures: Supplementary Information, March 19, 2007, at 419.

51 Ibid., at 422.

52 Canada, Department of Finance, "Tax Information Exchange Agreements" (www.canada.ca/en/department-finance/programs/tax-policy/tax-information-exchange-agreements.html).

53 Julia-Maria Becker, "Carbon Pricing—Keeping Alberta Competitive Since 2007," *Pembina Institute*, March 12, 2019 (www.pembina.org/blog/carbon-pricing-keeping-alberta-competitive-2007).

54 Government of Alberta, "Carbon Competitiveness Incentive Regulation" (www.alberta.ca/carbon-competitiveness-incentive-regulation).

nothing" to regulation to various levels of carbon pricing. This creates the potential for an unlevel playing field, where businesses in one country are subject to carbon taxes that their competitors in other countries are not. To the extent that this difference is reflected in the prices of competing goods, businesses in the do-nothing countries have an unfair trade advantage. Country-specific taxes on goods imported from those countries (border carbon adjustments, or BCAs) seek to address this issue. BCAs have been described as follows:

> A BCA is a carbon pricing mechanism on goods that cross the border. From an economic perspective, it seeks to ensure that where a good that is not subject to effective carbon pricing crosses the border, measures at the border remove any competitive advantage that unpriced imports might have relative to priced domestic goods.
>
> Properly constructed, a BCA levies a price on the imported goods equal to the domestic carbon charge for certain goods, particularly in emissions-intensive trade-exposed (EITE) sectors *minus* any carbon charges already paid on the good[s]. (Otherwise, there would be a double taxation of the carbon.)
>
> BCAs may take the form of an import charge [or] a rebate on exports.
>
> - An **Import Charge** on imported goods reflects the difference in the carbon price associated with that particular good between the two countries (*i.e.* the origin country vs. import country).
> - An **Export Rebate** levels the playing field whereby domestic goods originally exposed to domestic carbon pricing for their emissions are provided with a difference in pricing when they export their goods to countries with differing carbon pricing schemes.[55]

The most notable BCA to date is the EU's carbon border adjustment mechanism (CBAM), which became effective in October 2023. It is described by the EU's Directorate-General for Taxation and Customs Union as follows:

> The Carbon Border Adjustment Mechanism (CBAM) is the EU's tool to put a fair price on carbon emitted during the production of carbon-intensive goods that are entering the EU, and to encourage cleaner industrial production in non-EU countries.[56]

Although the CBAM is ostensibly designed to "encourage" reduced carbon emissions in selective carbon-intensive industries, its impact on that score has been decidedly muted to date.[57] As a practical matter, the CBAM is a tax on carbon-intensive

55 See Rambod Behboodi and Owen Clarke, "Carbon Pricing or Depricing? Global Implications of Carbon Measures in Canada," *BLG*, October 25, 2024 (www.blg.com/en/insights/2024/10/carbon-pricing-or-depricing-global-implications-of-carbon-measures-in-canada).

56 European Commission, "Carbon Border Adjustment Mechanism" (https://taxation-customs.ec.europa.eu/carbon-border-adjustment-mechanism_en).

57 See Javier Flórez Mendoza, Oliver Reiter, and Robert Stehrer, *Impacts of the EU Carbon Border Adjustment Mechanism*, SUERF Policy Brief no. 1066 (Vienna: European Money and Finance Forum, January 2025), at 1 and 8: "Global CO_2 emissions are marginally reduced, although

goods from specific countries designed and acting as a response to other countries' carbon-pricing policies relative to those of the jurisdiction implementing the tax.[58]

In the 2020 fall economic statement, the Canadian government announced its interest in "exploring the potential of border carbon adjustments," commenting as follows:

> Border carbon adjustments are about levelling the playing field across jurisdictions on carbon pricing: they propose to establish a carbon fee on imports from countries that do not have carbon pricing so that those products face the same costs as those supplied by domestic producers who pay a price on carbon pollution.
>
> The government will work with like-minded economies, including the European Union and our North American partners, to consider how this approach could fit into a broader strategy to meet climate targets while ensuring a fair environment for businesses.[59]

This announcement was followed by a Department of Finance consultation that identified four potential objectives for BCAs, one of which was "maintaining the competitiveness of domestic industries,"[60] and described the two forms such BCAs could take—an import charge or an export rebate. The 2024 fall economic statement reiterated the government's commitment to "advancing" BCAs,[61] stating that "the government is now working with key emissions intensive, trade exposed sectors to assess the domestic emissions intensity of their Canadian production."[62] The new

---

they minimally increase in the EU due to specialisation effects. . . . Summarising, our results indicate a small positive environmental impact at the global level, as the introduction of the EU CBAM reduces overall CO_2 emissions by reducing production of goods in countries with high CO_2 intensities and by increasing production in countries with low CO_2 intensities. The effect on global emissions is, however, relatively small."

58 Indeed, in a June 2024 address, Canada's special envoy to the EU and ambassador to France and Monaco, Stéphane Dion, described Canada's system of carbon pricing as "an export tool," on the following basis: "European legislation stipulates that if an explicit carbon price has actually been paid outside the EU, it must be recognized. Consequently, the carbon price paid in Canada by Canadian exporters must be taken into account when determining the European carbon charge." See Government of Canada, "Carbon Pricing as an Asset for Canadian Exports to Europe" (www.international.gc.ca/country_news-pays_nouvelles/2024-06-13-france.aspx?lang=eng). Dion went on to describe the CBAM (quite accurately) as an example of "carbon tariffs." Ibid.

59 Canada, Department of Finance, Fall Economic Statement, November 30, 2020, at 92, section 3.3.2.8.

60 Canada, Department of Finance, "Exploring Border Carbon Adjustments for Canada" (www.canada.ca/en/department-finance/programs/consultations/2021/border-carbon-adjustments/exploring-border-carbon-adjustments-canada.html).

61 Canada, Department of Finance, Fall Economic Statement, December 16, 2024, at 156, section 2.4.

62 Ibid.

minority government elected in the spring of 2025 seems to have adopted this policy. Its election campaign plan stated:

> **Promote fair competition with our trading partners by developing a Carbon Border Adjustment Mechanism.** Companies that take their climate responsibilities seriously should be treated fairly. So we will work with reliable partners to ensure fairness for Canadian industries and better economically integrate Canada with allies in the fight against climate change. This approach would focus on ensuring the competitiveness of Canada's most energy-intensive, trade-exposed sectors, and protect Canadians who work in industries such as steel and aluminum.[63]

Whether the government follows through on this initiative, and in what form, remains to be seen. As with many elements of Canadian economic policy, much depends on what the United States does. Because Canada's trade with the United States is concentrated in the sectors most targeted by BCAs, as one study[64] noted, the economic effect of BCAs on Canada will be dramatically impacted by whether or not the United States participates.

Interestingly, there is some support in the United States for introducing BCAs. In April 2025, two Republican senators proposed legislation (the Foreign Pollution Fee Act of 2025)[65] that would impose a tax on various imports from countries with low environmental costs on domestic producers. A frequently asked questions document issued by one of the sponsoring senators included the following:

> The Foreign Pollution Fee Act is a strategic trade and manufacturing policy designed to counter unfair trade practices related to the environment, ensuring U.S. manufacturers can compete on a level playing field. U.S. manufacturers, for example, spend an average of $17,200 per employee on environmental compliance, while competitors in countries like China and Russia often avoid such costs. . . .
>
> Several energy- and emissions-intensive sectors are included: steel, aluminum, cement, glass, fertilizer, hydrogen, solar components, and certain battery inputs. Each product is tied to a specific Harmonized Tariff Schedule (HTS) code, generally at the 6-digit level or more detailed. . . .

63 Liberal Party of Canada, *Canada Strong—Mark Carney's Plan: Unite*, *Secure*, *Protect*, *Build* (Ottawa: Liberal Party of Canada, 2025) (https://liberal.ca/wp-content/uploads/sites/292/2025/04/Canada-Strong.pdf), at 46.

64 Y.-H. Henry Chen, Hossein Hosseini Jebeli, Craig Johnston, Sergey Paltsev, and Marie-Christine Tremblay, *An Investigation into the Effects of Border Carbon Adjustments on the Canadian Economy*, Staff Working Paper 2023-27 (Ottawa: Bank of Canada, May 2023), updated March 2024.

65 To Amend the Internal Revenue Code of 1986 To Impose a Fee on Certain Products Imported into the United States Based on the Pollution Intensity Associated with the Production of Such Products, and for Other Purposes, S 1325, 119th Cong., 1st sess., introduced in the US Senate (April 8, 2025), short title: Foreign Pollution Fee Act of 2025.

> The bill imposes a fee on imports of certain energy-intensive goods based on the pollution intensity of their production. If foreign producers emit more pollution per ton of product than the U.S. baseline for covered goods, they will pay a fee at the U.S. border. The bigger the gap is, the higher the fee.[66]

As with the EU CBAM, if enacted, this BCA is anticipated to have "minimal effect on global emissions" but would "protect US manufacturing of covered products": so much for fighting climate change.[67] At the same time, the US government "unequivocally rejects" a carbon emissions tax on large ships travelling internationally, to which dozens of other countries agreed,[68] warning the adopting countries that the United States will "not hesitate to retaliate or explore remedies for our citizens" if it does not get its way.[69] What is a "fair" amount of CO_2 emissions? Whatever the United States says, apparently.

CONCLUSION

The role of tax policy as an element of economic competition between nations has never been more evident than it is today, in particular owing to its aggressive deployment by the United States. Canada's new government would be wise to carefully consider when and on what terms it wishes to push the limits of its tax system, as its recent DST experience illustrates. We certainly need to make Canada an attractive place to do business, while remembering that what we do to others, others can choose to do to us.

66 Bill Cassidy, US Senator for Louisiana, "Frequently Asked Questions: Foreign Pollution Fee Act of 2025" (www.cassidy.senate.gov/wp-content/uploads/2025/04/Foreign_Pollution_Fee_FAQs_2025.pdf), at 1-2.

67 Kevin Rennert, Mun Ho, Katarina Nehrkorn, and Milan Elkerbout, *Projected Effects of the Foreign Pollution Fee Act of 2025*, Issue Brief 25-07 (Washington, DC: Resources for the Future, May 2025), at 1.

68 International Maritime Organization, "IMO Approves Net-Zero Regulations for Global Shipping," April 11, 2025 (www.imo.org/en/mediacentre/pressbriefings/pages/imo-approves-netzero-regulations.aspx).

69 US Department of State, Office of the Spokesperson, "Joint Statement on Protecting American Consumers and Shipping Industries by Defeating the International Maritime Organization's 'Net-Zero Framework' aka Global Carbon Tax," *Press Release*, August 12, 2025.

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https://doi.org/10.32721/ctj.2025.73.4.pf.mescall

Policy Forum: Tax Policy for Strategic Advantage—Building Canada's Human Capital Edge in the AI and Tariff Economy

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PRÉCIS

Le marché de l'emploi canadien vit une grande transition en raison des progrès de la technologie de l'intelligence artificielle (IA) et de la nouvelle approche de l'administration américaine à l'égard des droits de douane et du commerce. Si aucun changement notable n'est apporté à la politique intérieure, une augmentation du taux de chômage pourrait entraîner des répercussions négatives sur l'économie et les communautés du Canada, ainsi que sur la santé et le bien-être de sa population. Dans cet article, nous passons en revue des études antérieures afin d'élaborer un cadre nous permettant de cartographier les effets probables des niveaux de chômage sur l'économie, les communautés et le bien-être individuel. Nous analysons les effets potentiels des droits de douane et de l'adoption de l'IA sur le marché du travail canadien entre 2025 et 2030 à l'aide d'une analyse de scénarios, et nous constatons que le résultat le plus probable est un taux de chômage dépassant les 9 pour cent. Pour relever ce défi, il faut adopter une approche intégrée dans toutes les politiques gouvernementales, y compris la politique fiscale, afin de renforcer les piliers économiques qui soutiennent les entreprises, de favoriser le perfectionnement des compétences et de la formation, et de stimuler la création de valeur pour les entreprises en employant des talents canadiens. Nous répertorions les facteurs de réussite essentiels pour les incitations fiscales aux entreprises, proposons des politiques à adopter dans l'avenir et recommandons des changements politiques audacieux afin d'accroître les investissements dans le capital humain et d'aider le Canada à prospérer à l'ère de l'IA et des droits de douane.

ABSTRACT

The Canadian job market faces a significant transition as a result of the advancement of artificial intelligence (AI) technology and a new approach to tariffs and trade by the US administration. Without meaningful change in domestic policy, an increase in unemployment rates may have a negative impact on Canada's economy, communities, and the health and well-being of individuals. In this article, we review prior studies to

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develop a framework that allows us to map the probable impacts of unemployment levels on economies, communities, and individual wellness outcomes. We analyze the potential impact of tariffs and AI adoption on the Canadian job market between 2025 and 2030 using scenario analysis, and find that the most likely outcome is an unemployment rate peaking above 9 percent. Addressing this challenge requires an integrated approach across government policies, including tax policy, to strengthen the economic pillars supporting business enterprises, to advance the development of skills and training, and to drive the creation of enterprise value by employing Canadian talent. We identify critical success factors for corporate tax incentives, suggest prospective policies, and recommend bold policy changes to elevate investment in human capital and help Canada to thrive in an era of AI and tariffs.

KEYWORDS: TARIFFS ■ LABOUR ■ TAX INCENTIVES ■ ARTIFICIAL INTELLIGENCE ■ HUMAN RESOURCES ■ UNEMPLOYMENT

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Employment is the keystone on which Canada's society and economy are built. It is an essential pillar of social cohesion, individual well-being, and national prosperity. Yet, the Canadian labour environment faces a looming rogue wave: the simultaneous and potentially compounding impacts of tariff-induced industrial contraction and artificial intelligence (AI)-driven workplace transformation. Like overlapping waves arriving in phase, these forces threaten to amplify one another, creating an economic trough deeper than either might produce on its own.

This article argues that Canada stands at a crossroads. As structural disruptions alter the fabric of the labour market, the nation must proactively reorient its policy levers to safeguard employment and maintain productivity. Chief among these levers is tax policy. Where traditional tax systems have long favoured capital investment through accelerated depreciation and investment credits, the government must elevate the importance of employment of Canadian labour in the creation of enterprise value.

We propose a re-engineering of Canada's tax policy to put employment and workforce development at the centre of economic strategy. Drawing on a historical analysis of global tax incentive programs both successful and unsuccessful, we identify criteria for effective corporate tax incentives and outline specific, evidence-informed tax policy proposals that are designed to promote hiring, retention, and skills development in key economic areas with a focus on improving Canada's labour productivity.

Ultimately, this article contributes to the national conversation by articulating how tax policy can be leveraged not merely to raise tax revenue, but to shape a more resilient and value-driving productive Canadian labour market. In doing so, it reframes the role of government from passive responder to proactive architect of a workforce strategy that will define Canada's competitiveness in the AI and tariff era. The stakes are high, but so is the potential for policy to catalyze a transformative national advantage.

IMPACTS OF HIGH UNEMPLOYMENT ON CANADIAN SOCIETY

Decades of research have catalogued wide-ranging impacts across sustained levels of unemployment. For example, analyses of US data suggest that a single percentage point increase in unemployment raises property crime rates between 1 and 4 percent, while other studies have found that prolonged periods of high unemployment (greater than 27 months) among young workers are correlated with increased substance abuse, already a challenge for many Canadian communities.[1]

Economically, when productive workers are idle, the national economy operates inside its production frontier, leading to a lower gross domestic product (GDP).

1 Steven Raphael and Rudolf Winter-Ebmer, "Identifying the Effect of Unemployment on Crime" (2001) 44:1 *Journal of Law and Economics* 259-83 (https://doi.org/10.1086/320275); Ming-Jen Lin, "Does Unemployment Increase Crime? Evidence from U.S. Data 1974-2000" (2008) 43:2 *Journal of Human Resources* 413-36.

Okun's law, applied in the Canadian context, provides a rough estimation that a 1 percent increase in the unemployment rate results in a 2.6 percent decline in GDP.[2] Such an impact can be felt throughout society.

Additionally, government budgets are significantly impacted as tax revenues fall and social safety net expenses rise in countries, such as Canada, that depend heavily on individual income tax (which generated 54 percent of federal revenues in 2024) and provide strong social safety nets.[3] This dual risk was significant enough in 2020 that the federal government introduced the Canadian emergency wage subsidy to mitigate a large, looming unemployment threat as a result of the COVID-19 pandemic.[4] Table 1 highlights evidence from research on social, health, and economic impacts across levels of unemployment.

CURRENT CANADIAN UNEMPLOYMENT SETTING

In the Canadian context, the "tipping point" at which economic, social, and individual impacts become more apparent is around 8 or 9 percent. Below this level, the country has historically managed without strain. Figure 1 shows the history of Canada's unemployment rate over the past 35 years. As of June 2025, Canada's unemployment rate was estimated to be 6.9 percent (or 5.7 percent when adjusted to US concepts),[5] compared with the US unemployment rate of 4.1 percent (by US concepts). It would be reasonable to conclude that the current Canadian unemployment rate is at elevated but not alarming levels on average, though notable subpopulations of Canadian society are experiencing higher unemployment than the national average.[6] There are signs that Canada's new federal government should be concerned. Table 2 compares unemployment rates across member countries of the Organisation for Economic Co-operation and Development (OECD) as of May 2025. Of the 36 countries reporting, Canada ranks 9th highest.[7] Its reported rate is above the average unemployment rate of Group of Seven (G7) countries (4.43 percent), OECD

2 Kimberly Beaton, *Time Variation in Okun's Law: A Canada and U.S. Comparison*, Working Paper 2010-7 (Ottawa: Bank of Canada, 2010), at 4.

3 Canada, Department of Finance, *Annual Financial Report of the Government of Canada Fiscal Year 2023-24* (Ottawa: Department of Finance, 2024).

4 Canada, Office of the Parliamentary Budget Officer, "Legislative Costing Note: Canada Emergency Wage Subsidy (CEWS) for Employers with Reduced Revenues," April 30, 2020 (https://distribution-a617274656661637473.pbo-dpb.ca/3017c93ee5698b0cd903bcec1aa5848e53df9f8fc71ea5b82b8a334efc3a2552).

5 Statistics Canada, "Labour Force Survey, June 2025," *Daily*, July 11, 2025 (www150.statcan.gc.ca/n1/daily-quotidien/250711/dq250711a-eng.htm).

6 These subpopulations include youth (14.2 percent), recent post-secondary graduates (10.3 percent), recent immigrants (12.6 percent), Indigenous persons (9.8 percent), and workers in Newfoundland and Labrador (9.9 percent). Ibid.

7 Note that the OECD data are for May 2025, when the Canadian unemployment rate was at 7.0 percent. A rate of 6.9 percent was measured in June 2025, as reported in figure 1.

TABLE 1 Unemployment Rates and Economic, Social, and Health and Well-Being Outcomes

Unemployment rate	Economic outcomes	Social outcomes	Health and well-being outcomes
1-2% (extremely low)	Economy "overheating." Labour shortages rampant; virtually full employment. Businesses struggle to hire, which may curtail growth.	Generally positive social mood owing to plentiful jobs. Labour strikes possible as workers feel empowered to demand more pay.	Overall mental health high (work provides purpose; wage gains boost morale).
3-4% (very low)	Economy near full capacity. Likely aligns with a strong GDP; rising productivity as firms invest to alleviate labour shortage.	Low unemployment correlates with reductions in crime. Social programs see less strain owing to increased tax revenue and more disposable income.	Low unemployment broadly improves population mental health. Individuals have increased job security and job options, reducing financial stress.
5-6% (moderate/normal)	Healthy economy benchmark. Often considered "optimal" or natural range in Canada historically (6% NAIRU estimate).[a] GDP at potential; minimal cyclical slack. Best-case scenario economically: balanced growth, low inflation.	Society experiences primarily low frictional unemployment (short transitions). People generally feel secure; social stability is high. Post-secondary enrollment is neither unusually high nor low.	Baseline mental health outcomes. A small fraction of the workforce is unemployed at any time, often for the short term.
7-8% (elevated)	Indications of slack in the economy. GDP likely a couple of percentage points below potential. Cyclical downturn risk: higher unemployment owing to weaker demand. Government sees higher EI payouts and lower tax revenue. Wages stagnate. Workers have less bargaining power.	Noticeably higher joblessness. Families may see more members unemployed, increasing financial strain. Poverty and property crime begin to rise. Social assistance programs (food banks, etc.) report more clients. Youth find it harder to get first jobs; more may extend education. Generally, public concern about jobs grows, but not full-blown crisis.	Mental health impacts accumulate. Beyond 6.5% unemployment, population-level measures of distress tick up.[b] Health-care providers may see more cases of depression/anxiety linked to job loss, further burdening social programs.

(Table 1 is continued on the next page.)

TABLE 1 Continued

Unemployment rate	Economic outcomes	Social outcomes	Health and well-being outcomes
9-10% (high)	Serious recession or stagnation. GDP gap 4-5% below potential.[c] Long-term unemployment has potential to exceed 25%. Skills mismatch worsens as people are out of work longer.	Social strain becomes significant. Historically, 10% unemployment correlates with large increases in poverty.[d] Property crime likely up noticeably. Social unrest; risk of protests, strikes, etc. increases.	Widespread psychological toll. With unemployment at 10%, many people know someone (or are themselves) unemployed for extended periods. Mental health providers see increases in caseloads. Life satisfaction surveys show a dip.
12-15% (very high)	A major economic crisis, even a depression in some regions. Many businesses fail. Investment plunges. Governments face fiscal crisis with tax revenues well down and spending on EI/welfare well up. Brain drain likely as workers emigrate to find jobs elsewhere.	Societal emergency. Unemployment at 12-15% affects most communities. Family structures strain: marriage rates often drop sharply. Political volatility increases. Social cohesion frays. Those employed might resent high taxes for welfare; those unemployed feel marginalized.	Rates of clinical depression and anxiety could reach highs. Suicide and overdose epidemics are real threats. Physical health may deteriorate. Life expectancy stalls or declines when unemployment stays very high (owing to poverty, stress, and reduced health-care access).[e]
≥20% (crisis level)	Depression-level unemployment nationally. Economy operating far below capacity. Banking system may be failing. Government may be forced to take extraordinary measures. Consumer confidence may collapse as even those with jobs cut spending out of fear.	Mass hardship. Relief lines (as at soup kitchens in the 1930s) become common. Political instability is high. Property crime may peak. Social unrest and riots possible. Emigration skyrockets.	Collective trauma related to economic uncertainty and hardship. Large proportion of youth with no prospect of work may develop a sense of hopelessness.

(Table 1 is concluded on the next page.)

TABLE 1 Concluded

GDP = gross domestic product; NAIRU = non-accelerating inflation rate of unemployment; EI = employment insurance.

a Carolyn A. Wilkins, *A Look Under the Hood of Canada's Job Market* (Ottawa: Bank of Canada, 2019).

b John A. Kaufman, Leslie K. Salas-Hernández, Kelli A. Komro, and Melvin D. Livingston, "Effects of Increased Minimum Wages by Unemployment Rate on Suicide in the USA" (2020) 74:3 *Journal of Epidemiology and Community Health* 873-74.

c Kimberly Beaton, *Time Variation in Okun's Law: A Canada and U.S. Comparison*, Working Paper 2010-7 (Ottawa: Bank of Canada, 2010).

d US data suggest that a 1 percent increase in unemployment relates to a 0.5 percent increase in poverty. Hilary W. Hoynes, Marianne E. Page, and Ann Huff Stevens, "Poverty in America: Trends and Explanations" (2006) 20:1 *Journal of Economic Perspectives* 47-68.

e Alexander Kentikelenis, Marina Karanikolos, Aaron Reeves, Martin McKee, and David Stuckler, "Greece's Health Crisis: From Austerity to Denialism" (2014) 383:9918 *Lancet* 748-53.

countries (4.94 percent), and members of the European Union (5.90 percent). Collectively, this suggests that, relative to comparative countries, Canada is in a more precarious position to weather the forthcoming impacts of increased tariffs and AI-driven transition.

POTENTIAL IMPACT OF TARIFFS AND AI TRANSITION ON CANADIAN UNEMPLOYMENT

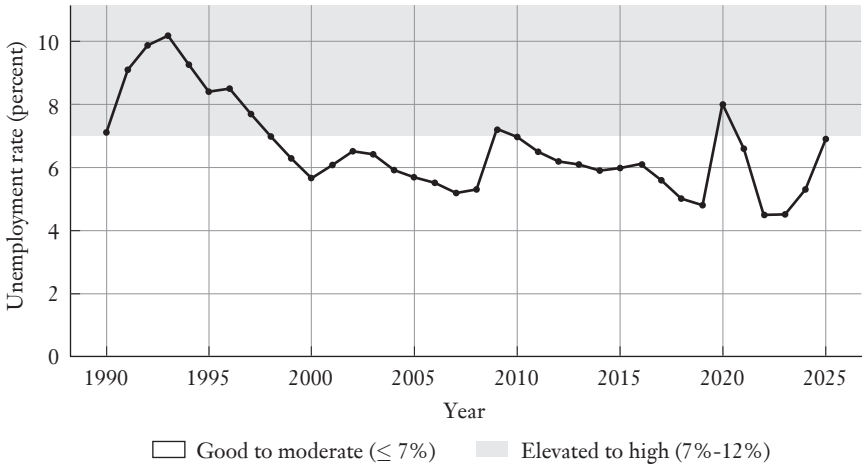
Forecasting changes in unemployment is an inherently uncertain exercise, and it becomes even more uncertain when external factors such as an evolving global trade regime and disruptive technologies are considered. Nonetheless, scenario analysis can help bound and consider the possibilities.

Impact of the New US Administration's Tariffs on Canadian Unemployment

Canada's trade relationship with the United States is critical for the domestic labour market. The recent change in American leadership and its approach to global trade has resulted in Canadian goods facing increased US tariffs, which can reduce demand for Canadian goods and lead to layoffs in affected industries. Although the ultimate level of tariffs and their impact on Canadian jobs remain uncertain, an increase in tariffs above historical rates is likely.[8] The market expects US tariffs to negatively affect the employment rate. Scotiabank forecasts Canadian unemployment to rise to 7.2 percent in 2025 and to remain elevated before coming down in 2027 if the tariffs

8 John Paul Tasker, "Carney Says a U.S. Trade Deal Without Some Tariffs Is Unlikely," *CBC News*, July 15, 2025 (www.cbc.ca/news/politics/carney-trade-deal-tariffs-unlikely-1.7585280).

FIGURE 1 Canadian Unemployment Rates, 1990-2025



Source: Data from Statistics Canada table 14-10-0020-01 (formerly CANSIM 282-0004), "Unemployment Rate, Participation Rate and Employment Rate by Educational Attainment, Annual."

outlined by the Trump administration in April 2025 remain constant.[9] Without tariff impacts, Scotiabank forecasts a peak unemployment rate of 6.9 percent in 2025, decreasing through 2026, and down to 5.8 percent in 2027.[10] The Financial Accountability Office of Ontario forecasts an additional 0.7 percent in unemployment as a result of tariffs, leading to an unemployment rate of 7.7 percent by 2029.[11]

Impact of AI Adoption on Canadian Unemployment

Alongside tariffs, the rise of AI is the second major wave poised to disrupt Canada's labour market. This wave is fundamentally different from past technological shifts in both scale and scope, in that white-collar and highly educated workers are as vulnerable as blue-collar workers. Statistics Canada estimates that 60 percent of Canadian jobs are highly exposed to the effects of AI adoption and anticipates that just

9 René Lalonde and Farah Omran, "Higher Growth Is Possible: Impact of Temporary vs. Permanent Tariffs on U.S. and Canada," *Scotiabank Global Economics Insight & View*, May 8, 2025, 1-3.

10 Ibid.

11 Nicolas Rhodes, Edward Crummey, Jay Park, Yefei Zhang, Andy Zhu, and Paul Lewis, *The Potential Impacts of US Tariffs on the Ontario Economy* (Toronto: Financial Accountability Office of Ontario, 2025).

TABLE 2 Unemployment Rates Worldwide, May 2025

Country	Unemployment rate
Spain	10.80
Sweden	9.00
Colombia	8.85
Finland	8.70
Turkey	8.40
Greece	7.90
Estonia	7.80
France	7.10
Canada	*7.00*
Latvia	6.90
Luxembourg	6.70
Belgium	6.50
Italy	6.50
Lithuania	6.50
Portugal	6.30
Romania	5.80
Austria	5.30
Denmark	5.30
Slovak Republic	5.30
Norway	4.60
Croatia	4.50
Hungary	4.30
United States	4.20
Australia	4.06
Ireland	4.00
Slovenia	3.90
Netherlands	3.80
Germany	3.70
Iceland	3.60
Bulgaria	3.50
Poland	3.30
Israel	3.15
Czechia	2.80
Mexico	2.76
Korea	2.70
Japan	2.50
OECD average	4.94
G7 average	4.43
European Union average	5.90

OECD = Organisation for Economic Co-operation and Development; G7 = Group of Seven.

Note: Data from Organisation for Economic Co-operation and Development, OECD Data Explorer (https://data-explorer.oecd.org), monthly unemployment rates for May 2025.

over half of those jobs are at risk of being replaceable by AI.[12] This is corroborated by industry experts. For example, an AI safety and research firm, Anthropic, warns that "AI could wipe out *half* of all entry-level white-collar jobs" (roles in technology, finance, consulting, and administration) "and spike unemployment to 10-20% in the next 1-5 years."[13] Notable companies such as Hewlett Packard, Dropbox, and Meta have made layoffs in 2025 citing AI efficiencies.

More moderately, a Delphi survey of experts forecast that AI is likely to raise unemployment in advanced economies by about 3 percentage points by 2030, after considering that some job displacements will be offset by the creation of new jobs and roles.[14] More pessimistically, Goldman Sachs estimated that 300 million jobs globally could be lost or severely degraded by AI.[15] For Canada, whose economy accounts for about 2 percent of global GDP, that could translate to 4-6 million jobs impacted, which would be equivalent to a massive shock of up to 20 percent unemployment. On the basis of these assessments, in table 3 we outline the best-case, worst-case, and most likely case scenarios for unemployment rates as a result of the impacts of both tariffs and AI transition.

Rogue Wave Phenomenon

Table 3 considers the impacts of tariffs and AI separately and predicts in the most likely scenario that unemployment will peak at 9.1 percent. However, since tariff increases and the AI transition are occurring at the same time, there is a potential for a larger negative interaction effect, leading to a higher peak of unemployment or a longer economic recovery. This potential amplification of negative effects is akin to the oceanographic concept of constructive interference, where waves meet in phase and create a larger rogue wave with more devastating power. An economic rogue wave may be created by the interaction of tariff and AI impacts with weak consumer demand or a loss of capital across all areas of society, as both blue-collar and white-collar employees change spending habits and withdraw savings beyond levels seen in past recessions. The potential summative and rogue wave impacts of tariffs and AI on unemployment are shown in figure 2.

12 Tahsin Mehdi and René Morissette, *Experimental Estimates of Potential Artificial Intelligence Occupational Exposure in Canada*, catalogue no. 11F0019M—No. 478 (Ottawa: Statistics Canada, 2024).

13 Jim VandeHei and Mike Allen, "Behind the Curtain: A White-Collar Bloodbath," *Axios*, May 28, 2025 (www.axios.com/2025/05/28/ai-jobs-white-collar-unemployment-anthropic) (emphasis in original).

14 William Halal, Jonathan Kolber, and Owen Davies, "Forecasts of AI and Future Jobs in 2030: Muddling Through Likely, with Two Alternative Scenarios" (2016) 21:2 *Journal of Futures Studies* 83-96.

15 Jack Kelly, "Goldman Sachs Predicts 300 Million Jobs Will Be Lost or Degraded by Artificial Intelligence," *Forbes*, March 31, 2023 (www.forbes.com/sites/jackkelly/2023/03/31/goldman-sachs-predicts-300-million-jobs-will-be-lost-or-degraded-by-artificial-intelligence).

TABLE 3 Estimated Impact of Tariffs and AI on Canadian Unemployment Rates

	Best case	Most likely case	Worst case
Assumptions for tariffs	No or minimal new tariffs.	A peak of 7.7% unemployment, reflecting the probability of some lost coverage under CUSMA.[a]	Double the expected impact of the most likely case, reflecting a significant loss of coverage under CUSMA.
Assumptions for AI	Minimal net impact on jobs created and lost related to AI.	An increase of 3% in unemployment, less half of that amount in new jobs created by AI, for a net increase of 1.5%.[b]	An increase of 10% in unemployment, less half of that amount in new jobs created by AI, for a net increase of 5%.[c]
Analyses			
Current unemployment rate (2025)	6.90%	6.90%	6.90%
Impact of tariffs (2025-2030)	−1.10%	0.70%	1.50%
Impact of AI (2025-2030)	0.00%	1.50%	5.00%
Net impact: peak unemployment (2025-2030)	5.80%	9.10%	13.40%

AI = artificial intelligence; CUSMA = Canada-United States-Mexico Agreement.

a Nicolas Rhodes, Edward Crummey, Jay Park, Yefei Zhang, Andy Zhu, and Paul Lewis, *The Potential Impacts of US Tariffs on the Ontario Economy* (Toronto: Financial Accountability Office of Ontario, 2025).

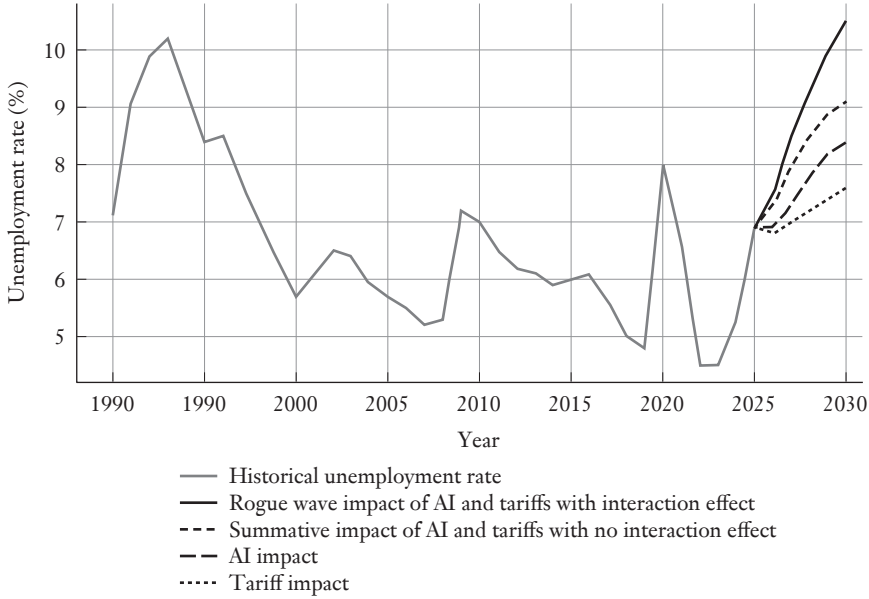
b William Halal, Jonathan Kolber, and Owen Davies, "Forecasts of AI and Future Jobs in 2030: Muddling Through Likely, with Two Alternative Scenarios" (2016) 21:2 *Journal of Futures Studies* 83-96.

c Jim VandeHei and Mike Allen, "Behind the Curtain: A White-Collar Bloodbath," *Axios*, May 28, 2025 (www.axios.com/2025/05/28/ai-jobs-white-collar-unemployment-anthropic).

AN INTEGRATED HUMAN CAPITAL DEVELOPMENT STRATEGY

Collectively, the analyses above highlight the economic and societal risks during this period of significant trade and technological transition. If Canada is to avoid the worst scenarios and seize the opportunities in this evolving labour landscape, it requires a coordinated strategy that involves education and skills training, policies supporting business innovation, strong social safety nets, and, crucially, a reorientation

FIGURE 2 Potential Summative and Rogue Wave Impacts of Tariffs and AI on Unemployment



AI = artificial intelligence.

Notes: Data for 1990-2025 are from Statistics Canada table 14-10-0020-01 (formerly CANSIM 282-0004), "Unemployment Rate, Participation Rate and Employment Rate by Educational Attainment, Annual." Data for 2025-2030 are based on table 3, column 2, where the unemployment impacts by 2030 are projected to be an additional 0.70 percent due to tariffs and an additional 1.5 percent due to AI. The summative impact of tariffs and AI with no interaction effect is an additional 2.2 percent, while a rogue wave demonstrates both a summative and an interaction effect, resulting in an additional 3.4 percent unemployment.

toward investment in human capital. Within this integrated framework, corporate tax policy can play a pivotal role by influencing employer behaviour. To tilt incentives toward labour, tax policy must avoid incentivizing the maintenance of non-productive employment, and instead creatively reward companies for enhancing the value created by jobs, through retraining as well as the creation of new employment that focuses on increased productivity. The economy remolded by AI enhancement and shifting global trade will require new job skills and impose new demands on the Canadian workforce. The following sections explore how specific tax measures can encourage employers to retain and expand their workforces, and develop the critical human capital needed in this new economic environment. To make a successful transition, Canada will need all of its policies to support three key economic pillars to ensure labour market resilience in an evolving economy. These pillars are:

- *Developing talent and skills.* Canada's well-educated workforce has long been a strength of the Canadian economy. The business and technological evolutions being driven by tariffs and AI will require individuals and businesses to identify opportunities and develop talent and new skills in order to improve productivity.
- *Promoting enterprise destination innovation.* Canada will need businesses to choose to operate in Canada. Government policies will need to be aimed at retaining, attracting, and developing new businesses.
- *Enhancing enterprise value through the employment of Canadian talent.* Canada will need to persuade businesses that their enterprise value can be enhanced and maximized by employment of the Canadian workforce.

TAX POLICY AS A CRITICAL ELEMENT OF HUMAN CAPITAL DEVELOPMENT STRATEGY

As we turn now to detailing specific tax policy measures, we do so with the understanding that these measures are part of a broader ensemble of policy responses required to support the evolving economy. For corporate tax policy to be effective, the government should be mindful of the following criteria for effective corporate tax incentives:

- *Additionality versus redundancy.* The fundamental metric for the success of any incentive is additionality, or the extent to which the incentive induces behaviour that would not have occurred otherwise. In contrast, redundancy is the extent to which the beneficiary of an incentive would have acted the same in the absence of the policy. High redundancy is a sign of an ineffective incentive.
- *Targeted at market failures or distressed areas.* The most effective incentives are those that are aligned with clear market failures or needs, yielding a greater return on public investment.
- *Financial materiality of the incentive.* An incentive must be meaningful enough to alter corporate behaviour. Small or irrelevant incentives tend to be ignored.
- *Timing of benefit.* Incentives that provide immediate or very prompt financial benefits are more effective than those with delayed, uncertain, or complicated payouts.
- *Administrative simplicity and transparency.* The ease of using an incentive affects firm participation. Overly complex criteria, voluminous paperwork, or uncertainty about qualification will deter engagement, especially by smaller firms.
- *Complementary business environment.* Tax incentives work best as a complement to, not a substitute for, sound economic conditions.
- *Resistance to gaming.* A well-designed incentive minimizes opportunities for firms to game the system in ways that do not actually produce the intended benefit.
- *Monitoring and evaluation.* Clearly communicated and effective processes for monitoring and evaluating the results of tax incentives help to establish expectations of participants and improve the overall effectiveness of the incentives.

- *Predictability and sustainability*. Incentives that create a predictable outcome over a longer term have been proven to be more effective than incentives that are short term and lack a clear outcome.

HISTORICAL EXAMPLES OF TAX INCENTIVES FOR CORPORATE INVESTMENT IN LABOUR

Governments around the world have often turned to tax incentives to encourage businesses to hire, retain, or upskill workers. These policies have been met with mixed success. In this section, we discuss three notable tax policies that succeeded in stimulating labour investment and three that failed, and we analyze the reasons for their outcomes by applying the criteria above. We assess the tax incentives for the criteria on a scale ranging from "very good," where the policy met the criteria completely, to "very poor," where the policy completely failed to meet the criteria.

Successful Corporate Tax Incentives: Three Examples

New Jobs Tax Credit, United States, 1978-79

Widely cited as a success, the new jobs tax credit (NJTC) offered a 50 percent tax credit on the first $4,200 of wages for each net new job a firm created above its previous year's employment. This effectively subsidized new hires by up to $2,100 (in late 1970s dollars). The credit was temporary and capped at $25,000 per firm (or 48 employees). Despite being short-lived, the NJTC had a significant impact.[16] In the two years that the program operated, private employment rose by more than 11 percent, and formal evaluations attributed up to 670,000 jobs created by early 1978 directly or indirectly as a result of the credit.[17]

Why it succeeded: The NJTC was financially material and focused on net new hires, maximizing additionality. It was also relatively simple for firms to claim, reducing takeup barriers.

Additionality	*Targeting*	*Financial materiality*	*Timing*	*Simplicity*	*Complementary environment*	*Resistance to gaming*	*Monitoring*	*Predictability*
Good	Fair	Good	Good	Good	Fair	Fair	Fair	Poor

Payroll Tax Cuts for Low-Wage Workers, France, 1990s-2000s

Starting in the 1990s, France substantially reduced employer social security contributions for low- and minimum-wage workers to combat very high unemployment among low-skilled employees. These reductions effectively functioned as targeted payroll tax incentives for hiring and retaining low-wage employees. The reductions

16 John Bishop, "Employment in Construction and Distribution Industries: The Impact of the New Jobs Tax Credit," in Sherwin Rosen, ed., *Studies in Labor Markets* (Chicago: University of Chicago Press, 1981), 209-46, at 212-13.

17 Ibid.

were large, with employer contributions for minimum-wage workers cut by up to 26 percent. Research found this policy to be successful in expanding low-wage employment, increasing employment by 2.08 percent in 1995.[18]

Why it succeeded: The policy was a bold, substantial reduction in labour costs and was targeted at the margin where unemployment was concentrated (low-skilled jobs). It was also sustained over time, creating predictability, thus giving firms confidence to adjust their practices.

Additionality	*Targeting*	*Financial materiality*	*Timing*	*Simplicity*	*Complementary environment*	*Resistance to gaming*	*Monitoring*	*Predictability*
Very good	Very good	Good	Good	Fair	Fair	Fair	Fair	Good

Payroll Tax Cut for Young Workers, Sweden, 2007-2009

Sweden undertook a policy experiment by reducing the employer payroll tax by 50 percent for workers aged 25 and under (introduced in 2007 and expanded in 2009). The goal was to fight high youth unemployment by making it cheaper to hire young people. Empirical evaluation indicates that the policy achieved measurable success, as the youth unemployment rate fell by an estimated 2-3 percentage points.

Why it succeeded: The policy was financially material, as Sweden has a high payroll tax, and was consistent over time, which created predictability, allowing businesses to plan.

Additionality	*Targeting*	*Financial materiality*	*Timing*	*Simplicity*	*Complementary environment*	*Resistance to gaming*	*Monitoring*	*Predictability*
Very good	Very good	Good	Good	Good	Fair	Fair	Fair	Good

Failed or Less Effective Tax Incentives: Three Examples

Work Opportunity Tax Credit, United States, Beginning in 1996

Investigative reports have found that the work opportunity tax credit (WOTC) is largely used by temporary employment agencies and high-turnover employers to claim credits for hires who stay only a short time.[19] The credit requires 120 hours of work for a partial credit and 400 hours for the full credit. The design of the credit has been exploited, as some employers hire a qualifying worker, claim the credit after

18 Thomas Breda, Luke Haywood, and Haomin Wang, "Equilibrium Effects of Payroll Tax Reductions and Optimal Policy Design" (December 2024) 91 *Labour Economics* 1026-46 (https://doi.org/10.1016/j.labeco.2024.102646).

19 Susan N. Houseman, "Labor Policy Evaluation: Lessons from the American Experience," presented at the seminar on Benchmarking European Labour Market Policies, Rome, Italy, October 3, 1997; and Emily Corwin, "A Tax Credit Was Meant To Help Marginalized Workers Get Permanent Jobs. Instead It's Subsidizing Temp Work," *ProPublica*, August 23, 2022 (www.propublica.org/article/work-opportunity-tax-credit-temp-permanent-employment).

the minimum period, then let the worker go. Recent data show that nearly a quarter of WOTC-certified jobs were with temp staffing firms, suggesting that a lot of these hirings did not result in stable employment.

Why it failed: The policy is easily gamed owing to the short retention requirement. It lacks a mechanism to ensure longevity of employment and rewards employers by allowing a cyclical hiring and firing process, and thus fails to create additionality.

Additionality	*Targeting*	*Financial materiality*	*Timing*	*Simplicity*	*Complementary environment*	*Resistance to gaming*	*Monitoring*	*Predictability*
Poor	Good	Fair	Good	Fair	Fair	Poor	Poor	Good

Restriction of Special Taxation Act, South Korea, 2017

In 2017, South Korea introduced a policy reform that came to be popularly known as the "robot tax." The Restriction of Special Taxation Act reduced the generosity of an existing tax credit for corporate investments in productivity-enhancing technologies. The tax credit for such investments was lowered from 3 percent to 1 percent for large firms, and from 7 percent to 5 percent for small and medium-sized enterprises. The primary motivation for this change was growing concern related to rapid automation, particularly the risk of job displacement. It was one of the first real-world attempts to adjust tax policy in response to the labour market impacts of automation, and it sparked international debate about how governments can and should respond to the growing role of AI and robotics in the economy.

Why it failed: It may be an overstatement to say that this policy failed, but its broad impact and effectiveness are unclear. On the one hand, a study provided evidence that the pace of automation slowed and that some employment increased after the policy was introduced.[20] On the other hand, governments should be cautious about protecting jobs by discouraging investment in technology and innovation, especially where productivity is affected. Such a policy approach could reduce the competitiveness of industry in the medium and long run. This is particularly true in the case of AI, where incentives to slow or delay adoption could have larger and more severe long-term impacts on Canadian labour productivity.

Additionality	*Targeting*	*Financial materiality*	*Timing*	*Simplicity*	*Complementary environment*	*Resistance to gaming*	*Monitoring*	*Predictability*
Uncertain	Poor	Fair	Fair	Poor	Poor	Poor	Fair	Fair

The Small Business Hiring Credit, Canada, 2010

The small business hiring credit (SBHC) was introduced in Canada in the 2011 federal budget and was applied retroactively to 2010 employer activity. The SBHC was

20 Donglk Kang, Jung Hyuk Lee, and Simon Quach, "The Welfare Effects of a Robot Tax: Evidence from a Tax Credit for Automation Technologies in Korea" (October 2024) (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=5005128).

a temporary measure designed to support small business job creation in the aftermath of the global financial crisis. The incentive, targeted at employers who paid $10,000 or less in employment insurance (EI) premiums in 2010, automatically provided up to $1,000 to eligible businesses that increased their EI premiums in 2011.

Why it failed: The incentive was not financially material, so most businesses did not notice or bother altering their behaviour. After the incentive expired, the government introduced initiatives that provided broader and more material reductions in payroll costs for small businesses.

Additionality	*Targeting*	*Financial materiality*	*Timing*	*Simplicity*	*Complementary environment*	*Resistance to gaming*	*Monitoring*	*Predictability*
Poor	Poor	Poor	Fair	Fair	Fair	Fair	Fair	Fair

PROSPECTIVE TAX POLICY MEASURES FOR EMPLOYMENT AND WAGE INCENTIVES

In this section, on the basis of current contexts and the historical evidence considered above, we identify a number of prospective tax policy measures that Canadian federal policy makers could implement individually or together to increase productivity and enterprise value through the employment of Canadian talent. The ultimate effectiveness of any prospective policy will depend on the ability of the policy to meet the criteria used above to evaluate the success and failure of other tax incentive initiatives. We provide an assessment of the potential for each policy to meet each of the corporate tax incentive effectiveness criteria. Our assessments of the opportunities for the policy to meet the criteria range from "highly likely," where a policy has a high likelihood of meeting the criteria, to "highly unlikely," where the likelihood of meeting the criteria is very low.

It should be noted that while our focus is on federal corporate tax policy levers, some options could involve payroll taxes or coordination with provincial policies.

Incentivizing New Hiring

The 150 Percent Canadian Talent Deduction

The Canadian talent deduction (CTD) would allow businesses to deduct 150 percent of all eligible salaries and benefits paid to Canadian-resident employees from their taxable income. The goal of the policy is to increase Canada's international competitiveness as a source of value-enhancing labour and create a powerful financial incentive for firms to hire, retain, and invest in skilled Canadian workers, while levelling the playing field between capital investment and human capital investment. An approach like this is critical in an AI-enhanced economy where white-collar jobs—positions that currently are primarily internal to organizations—are likely to be outsourced to global hubs of specialized labour that can scale the advantage and efficiency offered by AI. Such an incentive may give Canada a competitive edge in becoming a destination for skilled-labour hubs to offer AI-enhanced services globally. Eligibility rules, payroll reporting integration, and potential caps or clawbacks for

non-compliance would be essential to manage fiscal risks and ensure impact. Still, the CTD represents a bold, forward-looking investment in Canadian people that treats labour as an asset, not a liability.

Additionality	*Targeting*	*Financial materiality*	*Timing*	*Simplicity*	*Complementary environment*	*Resistance to gaming*	*Monitoring*	*Predictability*
Likely	Likely	Highly likely	Fair	Fair	Fair	Fair	Fair	Likely

Youth Employment and Apprenticeship Tax Credit

The youth employment and apprenticeship tax credit would provide specialized refundable tax credits to businesses for hiring workers under age 30 in permanent positions or certified apprenticeships, offering a tax credit of up to 40 percent over the first two years of employment. Policies to support this demographic are particularly important. Workers under the age of 24 are currently facing a high unemployment rate of 14.2 percent, up from a benchmark average of 10.8 percent from 2017 to 2019.[21] This cohort includes recent post-secondary graduates who are attempting to start their careers; if their careers are delayed for an extended period, these workers may become overshadowed by older cohorts who are already building experience, and by younger cohorts who will be graduating with more current skills. The youth employment and apprenticeship tax credit would address concerns about persistently high youth unemployment rates while building a skilled future workforce.[22]

Additionality	*Targeting*	*Financial materiality*	*Timing*	*Simplicity*	*Complementary environment*	*Resistance to gaming*	*Monitoring*	*Predictability*
Highly likely	Highly likely	Likely	Likely	Unlikely	Fair	Fair	Fair	Likely

Incentivizing Employee Retention

Human Capital Dividend Deduction

The human capital dividend deduction would allow companies to deduct shareholder dividend payments only if a threshold share of profits has been invested in the development of human capital. The deduction would align owner/investor rewards with Canada's human capital development strategy, ensuring that profit distribution includes meaningful consideration of employee development and long-term organizational capability building. The policy would ensure that workforce development is prioritized in corporate financial decision making and would align shareholder

21 Statistics Canada, "Labour Force Survey, January 2025," *Daily*, February 7, 2025, table 14-10-0287-01 (www150.statcan.gc.ca/n1/daily-quotidien/250207/g-a002-eng.htm).

22 Note that the concept of this incentive could be expanded to other demographics with higher than average unemployment, including recent immigrants and Indigenous people.

returns with broader stakeholder benefits. The incentive would create an opportunity for progressive tax savings through increased deductibility of dividends, in line with how firms increase performance relative to peers and industry benchmarks in terms of four critical aspects of Canadian labour investment and value development: retention, new hiring, training, and targeted AI-displaced retraining and retention. Given the novelty of the human capital dividend deduction policy, we provide a framework for illustrative purposes in the appendix to this article.

Additionality	*Targeting*	*Financial materiality*	*Timing*	*Simplicity*	*Complementary environment*	*Resistance to gaming*	*Monitoring*	*Predictability*
Likely	Likely	Highly likely	Fair	Very unlikely	Fair	Very unlikely	Unlikely	Likely

Incentivizing Investment in Development and Training

Human Capital Investment Credit

The human capital investment credit would offer a refundable, enhanced tax credit of 150-200 percent of expenditures for investments in employee education, reskilling, upskilling, and apprenticeship programs. This policy would treat workforce training as an investment on par with investments in research and development and AI, countering the bias toward automation-only investment strategies while building long-term productivity. The policy would make human capital investment financially competitive with automation investment and support comprehensive skill development, although high credit rates create significant fiscal costs that may be difficult to sustain.

Additionality	*Targeting*	*Financial materiality*	*Timing*	*Simplicity*	*Complementary environment*	*Resistance to gaming*	*Monitoring*	*Predictability*
Highly likely	Highly likely	Likely	Likely	Fair	Fair	Fair	Fair	Likely

All of the prospective tax policy measures for employment and wage incentives suggested above have the potential to make a positive impact on unemployment. The effects of increased tariffs and AI transformation on labour will be felt across most countries and intensify the competition to be the location of choice for businesses that provide productive jobs. Given this competition, we recommend that the new Canadian government consider bold tax policies that can motivate employers to invest in the development of Canadian talent and the creation of new jobs that enhance enterprise value. In an economic environment where AI technology has the potential to eliminate the value-relevance of specific jobs, a policy approach that provides tax incentives for firms that choose to retrain or educate their current workforce for new positions will not only mitigate job losses but also improve the country's competitiveness and lead large corporations to consider Canada in their operations. A tax policy that is effective in creating enterprise value with Canadian labour would not only reduce the social and health costs of unemployment but also its rate, and

Okun's law suggests that a tax policy that reduces the unemployment rate by 1 percent would generate a 2.6 percent increase in Canadian GDP.[23]

CONCLUSION

Changes in the trading relationship between Canada and the United States have created material threats to Canadian employment. The combination of this challenge with the emerging challenge of technological transition driven by AI has the potential to create a rogue wave of unemployment in Canada that we estimate could range as high as 13.8 percent. These challenges require an integrated approach that focuses on innovation and entrepreneurship to support new employment-providing enterprises, training, and skills development in order to ensure that Canada has a value-creating workforce that can meet the needs of an evolving economy, and incentivizes current businesses to create value by employing Canadian talent. Changing corporate behaviour is challenging, so the Canadian government should ensure that any incentives that it develops consider tax benefits that are financially material, prompt, sustainable, and predictable so that they generate corporate behaviour that is additional, targeted, and can be accounted for, while being administratively clear and effort-minimizing. Considering these factors and the potential magnitude of the challenges ahead, we recommend that the government boldly reconsider the importance of labour investment in the Canadian tax system, as it has with capital investment in the past, and adopt tax incentives to make Canada a global leader in valuing and partnering with business in the investment and development of Canadian human capital to drive value in the new economic environment.

APPENDIX: HUMAN CAPITAL DIVIDEND DEDUCTION—ILLUSTRATION

Executive Summary

The human capital dividend deduction framework conditions corporate dividend tax treatment on employment performance metrics. Companies that meet workforce retention and development thresholds qualify for partial dividend deductibility, aligning shareholder returns with human capital investment.

Core Mechanism

Under current tax law, corporations pay dividends from after-tax profits without deductibility benefits. The human capital dividend deduction framework introduces conditional deductibility such that qualifying companies can deduct up to 100 percent of dividend payments or receive equivalent tax credits based on employment performance metrics.

23 Beaton, supra note 2, at 4.

The framework encourages companies to maintain and retrain employees during technological transitions rather than pursue immediate workforce reductions.

Performance metric	*Industry baseline*	*High performance*	*Measurement method*
Employee retention rate	≥80% annually	≥90% annually	T4 slip continuity tracking
Net new hiring rate	Maintain workforce	≥5% growth	Year-over-year payroll analysis
Training investment	1.5% of payroll	≥2.5% of payroll	Audited expense documentation
AI-displaced worker retention	40% retained/ retrained	≥60% retained/ retrained	Role reassignment records

Deductibility Scale and Tax Benefits

The framework employs a graduated benefit structure that links performance achievement to dividend deductibility levels. Companies that meet baseline thresholds in all four metrics qualify for 50 percent dividend deductibility. Meeting high-performance standards across all metrics enables 100 percent deductibility, so that dividends are effectively treated as deductible business expenses.

Partial compliance yields proportional benefits, with 25 percent deductibility for meeting two metrics and 75 percent for meeting three high-performance standards. This structure incentivizes comprehensive workforce investment rather than selective metric optimization.

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https://doi.org/10.32721/ctj.2025.73.4.pf.kershaw

Policy Forum: Better Late Than Never—Policy Options for Modernizing OAS and Retirement Tax Credits

Paul Kershaw*

PRÉCIS

Le système de revenu de retraite au Canada doit être modernisé. En 2025, la Sécurité de la vieillesse (SV) versera plus de 18 000 $ par an aux couples retraités dont le revenu familial est de 182 000 $, tout en laissant près de 400 000 Canadiens âgés sous le seuil de la pauvreté. Avec un coût annuel de 86 milliards de dollars, la SV est le plus gros transfert fédéral et la plus grande source d'augmentation des nouvelles dépenses, ce qui alourdit le déficit de fonctionnement. Les jeunes Canadiens versent aujourd'hui de 20 à 40 pour cent de plus en impôts sur le revenu pour assurer une retraite confortable aux personnes âgées que ce que payaient autrefois les baby-boomers, tandis que les programmes pour le logement, la garde d'enfants et l'éducation postsecondaire reçoivent relativement peu de nouveaux fonds.

S'appuyant sur le plan de réforme présenté par le premier ministre Chrétien au milieu des années 1990, sur un récent examen de la vérificatrice générale et sur une nouvelle modélisation par microsimulation, cet article évalue six options stratégiques visant à recalibrer les seuils de récupération de la SV et à éliminer progressivement les crédits d'impôt en raison de l'âge et pour revenu de pension. L'analyse montre que la réorientation des prestations versées aux retraités financièrement à l'aise, c'est-à-dire ceux dont les revenus dépassent les 100 000 $, permettrait d'économiser entre 14 et 19 milliards de dollars par année. Cela représente une somme suffisante pour éliminer la pauvreté chez les personnes âgées, accroître les investissements dans les jeunes générations et réduire le déficit sans augmenter les impôts. Ces réformes visant à assurer la sécurité du revenu de retraite seraient un exemple parfait de « mieux vaut tard que jamais » pour faire avancer les multiples priorités énoncées dans la lettre de mandat du premier ministre Carney.

ABSTRACT

Canada's retirement income system requires modernization. In 2025, old age security (OAS) will deliver over $18,000 annually to retired couples with household incomes of $182,000, while still leaving almost 400,000 older Canadians below the poverty line.

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At a cost of $86 billion per year, OAS is the largest federal transfer and the biggest source of new spending growth, driving the operating deficit. Younger Canadians now contribute 20-40 percent more in income taxes toward seniors' healthy retirements than baby boomers once paid, while programs for housing, child care, and post-secondary education receive relatively little new money.

Drawing on the reform blueprint advanced by Prime Minister Chrétien in the mid-1990s, a recent auditor general review, and new microsimulation modelling, this article evaluates six policy options to recalibrate OAS recovery thresholds and phase out the age and pension income tax credits. The analysis shows that redirecting benefits from financially secure retirees with six-figure incomes could free up $14 billion to $19 billion annually—enough to eliminate seniors' poverty, expand investments in younger generations, and reduce the deficit without raising taxes. These reforms to retirement income security would be a textbook case of "better late than never" to advance multiple priorities in Prime Minister Carney's mandate letter.

KEYWORDS: POPULATION AGING ■ OLD AGE SECURITY ■ TAX EXPENDITURES ■ FISCAL POLICY ■ POVERTY ■ YOUTH

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In his mandate letter to the federal Cabinet,[1] Prime Minister Carney committed to helping Canadians to get ahead, bringing down costs, catalyzing a modern housing industry, and reducing unnecessary government spending. As federal policy makers pursue this agenda, retirement income subsidies warrant immediate attention. The old age security (OAS) recovery tax threshold and the age and pension income tax credits are now misaligned with demographic pressures, and with fiscal and equity priorities. All three were flagged for reform in the 1990s when the Chrétien government[2] warned that OAS needed redesign to manage population aging and to reduce burdens on younger generations.

1 Canada, Office of the Prime Minister, "Mandate Letter," May 21, 2025 (www.pm.gc.ca/en/mandate-letters/2025/05/21/mandate-letter).

2 Canada, Department of Finance, 1995 Budget, Budget Plan, February 27, 1995, at 56-58.

OAS[3] currently delivers about $18,000 in annual subsidies to retired couples with household incomes of $182,000. Yet, in 2025, this $86 billion program still leaves nearly 400,000 seniors in poverty.[4] Canada's auditor general[5] recently concluded that Ottawa lacks the ability to evaluate whether OAS meets its goals. This lack of oversight is especially troubling, because the failure to secure adequate revenue for the program decades ago now drives the federal operating deficit. Meanwhile, younger Canadians contribute 20-40 percent more in income taxes[6] toward baby boomers' healthy retirements than boomers paid for retirees in the 1970s. The OAS system also embeds age discrimination in fiscal policy: its subsidies are clawed back for retired couples at a far higher income threshold than are benefits for families with children. These problems help to explain why recent polling finds that three-quarters[7] of Canadians support redirecting some OAS funds from financially secure retirees toward other priorities.

The age and pension income tax credits further illustrate the need for reform. Costing $7 billion annually,[8] these underscrutinized credits are buried in the tax code, and inaccessible to the lowest-income seniors. Their funds would be better used to backstop revenue required to pay for rising OAS expenditures.

In short, this article makes the case for a classic "better late than never" reform. Guided by the auditor general's findings and the Chrétien-era blueprint, I show how recalibrating the OAS recovery threshold and phasing out inefficient tax credits could yield more than $14 billion annually. These funds could advance various priorities aligned with the Carney government's mandate, such as eliminating seniors' poverty, supporting Build Homes Canada, boosting productivity-enhancing investments, reducing the operating deficit, and lowering child-care and post-secondary costs to help restore "the bargain that hard work means a good life" for millennials and Gen Z.[9]

3 Government of Canada, "Old Age Security Pension Recovery Tax" (www.canada.ca/en/services/benefits/publicpensions/old-age-security/recovery-tax.html).

4 Statistics Canada, Infographics, "Income of Canadians, 2023," May 1, 2025 (www150.statcan.gc.ca/n1/pub/11-627-m/11-627-m2025020-eng.htm).

5 Office of the Auditor General of Canada, *Reports of the Auditor General of Canada to the Parliament of Canada*, *Report 11: Programs To Assist Seniors* (Ottawa: Office of the Auditor General of Canada, 2024).

6 Generation Squeeze, "The Generational Gap in Who Pays, and Who Benefits, from Our Income Tax Dollars" (www.gensqueeze.ca/heavier_tax_burden).

7 Generation Squeeze, "Most Canadians Support Our Plan To Update a 75 Year Old Program and Fix the Federal Budget" (www.gensqueeze.ca/oas_poll_2024).

8 Canada, Department of Finance, *Report on Federal Tax Expenditures: Concepts*, *Estimates and Evaluations 2024* (Ottawa: Department of Finance, 2024).

9 Liberal Party of Canada, *Canada Strong—Mark Carney's Plan: Unite*, *Secure*, *Protect*, *Build* (Ottawa: Liberal Party of Canada, 2025), at 30.

THE AUDITOR GENERAL'S CALL FOR AN OAS REVIEW

Canada's most expensive federal program—OAS—is not being properly evaluated. That is the blunt conclusion from Auditor General Karen Horgan's 2024 report.[10] Her office found that Employment and Social Development Canada (ESDC), which oversees OAS, was unable to assess whether the program meets seniors' needs. "The department collected information and data about seniors, but it did not analyze it,"[11] she concluded, and ESDC has not updated its understanding of OAS's purpose since the program was created in 1952.

When it was introduced, OAS delivered $40 per month (about $443 today) to residents 70 years of age and older[12]—at a time when average life expectancy was 69 years.[13] Today, Canadians become eligible at age 65 and live to an average age of 83. Over the years, OAS payments increased faster than inflation, so that they now offer $728 per month for seniors age 65 to 74, and $800 for those 75 and older.[14] These increases were introduced alongside a growing retirement system that includes the Canada Pension Plan (CPP), launched in 1966; the guaranteed income supplement (GIS), added to OAS in 1967; and generous tax shelters such as the age[15] and pension income[16] tax credits created in 1987, and income splitting in 2006.[17]

Together, these policies are working relatively well to reduce financial insecurity among seniors. According to Canada's official poverty measure,[18] 5 percent of seniors are poor, compared with 11 percent of children and 12 percent of working-age adults. Nevertheless, with Ottawa spending $86 billion on OAS and another $7 billion on the age and pension income credits in 2025, there is no reason for any senior to remain in poverty.

Retired couples with six-figure household incomes often receive more than $20,000 from CPP and another $18,000 from OAS. Their receipt of CPP is justified, as I show below, because governments adapted that program decades ago so that

10 Office of the Auditor General, supra note 5.

11 Ibid., at 6.

12 June Dewetering, *The Old Age Security Fund*, document no. MR-58E (Ottawa: Library of Parliament, Parliamentary Research Branch, March 14, 1990).

13 Macrotrends, "Canada Life Expectancy (1950-2025)" (www.macrotrends.net/global-metrics/countries/can/canada/life-expectancy).

14 Government of Canada, "Old Age Security: How Much You Could Receive" (www.canada.ca/en/services/benefits/publicpensions/old-age-security/benefit-amount.html).

15 Canada, Department of Finance, *Report on Federal Tax Expenditures: Concepts, Estimates and Evaluations 2023* (Ottawa: Department of Finance, 2023), at 73.

16 Ibid., at 255.

17 Canada Revenue Agency, "Pension Income Splitting" (www.canada.ca/en/revenue-agency/services/tax/individuals/topics/pension-income-splitting.html).

18 Statistics Canada table 11-10-0135-01 (formerly CANSIM table 206-0041), "Low Income Statistics by Age, Sex and Economic Family Type."

Canadians prepay into CPP in decent proportion to their eventual benefits. OAS, however, is not a prepay system. It is a government subsidy paid to whomever is eligible. This includes individuals earning more than $140,000, and couples nearing $300,000, for whom OAS clawback rules do not fully eliminate benefits.

The generous eligibility rules for OAS are the result of outdated policy. ESDC failed to adapt OAS in light of rising retirement wealth,[19] especially for older homeowners, and the evolution of other pension programs. Since the CPP was designed to replace retirement income regardless of one's affluence, there is no need for OAS to continue subsidizing rich and poor retirees alike. This is especially so, since Ottawa claws back the Canada child benefit[20] from families with children once household income exceeds $81,222, yet begins to claw back OAS from retired couples only when their combined income surpasses $181,994.[21]

CPP REFORM UNDERTAKEN BUT OAS REFORM LEFT INCOMPLETE

In the 1970s, baby boomers paid taxes during a period when seven working-age adults supported each retiree. Now, in retirement, boomers expect comparable or better supports with only three working-age Canadians per senior. Failure to plan fully for this demographic shift has profound consequences for public finances, and for young taxpayers. There is little fiscal room left from economic growth to invest in younger Canadians, and large unpaid bills are being passed to millennials, Gen Z, and their offspring.

Federal budgets from 1995 to 1998 show that the Chrétien government anticipated this looming imbalance. It took bold steps on adapting CPP, but knowingly left OAS reform unfinished. Reviewing this history helps us to empathize with today's political leaders, who inherited fiscal risks that their predecessors recognized but did not address.

The 1995 federal budget warned: "[T]he percentage of persons over age 65 will nearly double over the next 40 years—from 12 per cent of the population [in the mid-1990s] to about 23 per cent by the year 2030."[22] The budget explicitly observed that the worker-to-retiree ratio would fall to 3:1, down from 5:1 at the time (and 7:1 when baby boomers were young adults). Public spending on OAS and the Canada and Quebec pension plans was projected to increase from 5.3 percent of gross domestic product in 1993 to more than 8 percent by 2030. In response, the government

19 Statistics Canada, "Survey of Financial Security, 2023," *Daily*, October 29, 2024 (www150.statcan.gc.ca/n1/daily-quotidien/241029/dq241029a-eng.htm).

20 Canada Revenue Agency, "Canada Child Benefit: How Much You Can Get" (www.canada.ca/en/revenue-agency/services/child-family-benefits/canada-child-benefit-overview/canada-child-benefit-we-calculate-your-ccb.html#estimate).

21 Government of Canada, supra note 3.

22 1995 Budget, supra note 2, at 56.

launched a "federal-provincial review of the CPP" and promised a paper on ensuring OAS sustainability.[23]

The 1996 budget advanced the case for CPP reform. "Unless changes are made to the CPP, today's younger Canadians and future generations will be asked to pay almost three times more than people are paying now for the same CPP pensions,"[24] the budget stated. It continued: "Steps should be taken now to ensure that future generations are not faced with unreasonable burdens, and to assure young Canadians that the CPP will be there for them when they retire."[25]

The same budget announced plans to replace OAS with "a new Seniors Benefit" by 2001.[26] The new benefit would increase support for lower-income retirees; preserve benefits for those with incomes up to around $70,000 (in 2025 dollars); and reduce benefits for those with incomes above this threshold. Eligibility for the new benefit would be determined on the basis of household income, not individual income. Funds spent through the age and pension income credits were to be repurposed to help offset reform costs.

By 1997, the government started a six-year process to increase CPP premiums by 68 percent,[27] and reported progress on the new seniors benefit in the 1997[28] and 1998[29] budgets. Thereafter, something changed. As the government made progress to eliminate the federal deficit, spent its political capital defending CPP reforms, and faced criticism for taxing the windfall that some seniors received when mutual insurance companies converted to stock ownership,[30] OAS reform disappeared from budget documents starting in 1999.

CPP reform stands as a landmark decision for intergenerational fairness. It asked baby boomers to prepay more for their own benefits, safeguarding the program for future generations. By contrast, abandoning OAS reform imposed large and growing costs on boomers' children and grandchildren.

Eventually, in 2012, Prime Minister Harper renewed plans to reform OAS. His government planned to raise the eligibility age from 65 to 67—starting in 2023, long after many boomers retired. The fiscal consequences of inaction since the 1990s

23 Ibid., at 57.

24 Canada, Department of Finance, 1996 Budget, Budget Plan, March 6, 1996, at 64.

25 Ibid.

26 Ibid., at 65.

27 Canada Revenue Agency, "Calculate Payroll Deductions and Contributions: CPP Contribution Rates, Maximums and Exemptions" (www.canada.ca/en/revenue-agency/services/tax/businesses/topics/payroll/payroll-deductions-contributions/canada-pension-plan-cpp/cpp-contribution-rates-maximums-exemptions.html).

28 Canada, Department of Finance, 1997 Budget, Budget Plan, February 18, 1997, at 117.

29 Canada, Department of Finance, 1998 Budget Plan, February 24, 1998, at 107.

30 Informant interview about this consultation paper: Canada, Department of Finance, *Demutualization Regime for Canadian Life Insurance Companies: Consultation Paper* (Ottawa: Department of Finance, August 1998).

would have been deeply entrenched in Ottawa's budget by that timeline, even if the government of Justin Trudeau had not reversed the Harper plan.

OAS AND THE FEDERAL OPERATING DEFICIT

In 2014, the year before Justin Trudeau became prime minister, OAS cost $44 billion per year.[31] According to the 2024 federal fall economic statement,[32] OAS will cost $86 billion in 2025—a $42 billion annual increase in the space of a decade. This growth is identical to the 2025 federal deficit projected in the same fiscal update (which at time of writing remains the most recent financial accounting tabled by the federal government).

No other program has grown so rapidly. Since 2014, the Canada child benefit has risen by $15 billion; employment insurance by $11 billion; and child care by $8 billion. Nor is any other program projected to grow as dramatically in the years ahead. By 2029, annual OAS spending will reach $104 billion,[33] widening its fiscal footprint even further.

There is no escaping the fact that OAS dominates the federal balance sheet. It is the primary reason why Canada has little "fiscal powder" with which to fight the tariff war, as Chrystia Freeland lamented in her resignation letter from the role of finance minister.[34] OAS is also the largest source of "inflationary deficit spending"[35] against which Mr. Poilievre routinely rails in his capacity as leader of the official opposition.

THE TAX SHIFT TO YOUNGER CANADIANS

The Chrétien government recognized that "many hands made light work" half a century ago when the share of working-age Canadians relative to retirees was much larger. The heavier tax burden predicted for younger people today is now upon us. Using Statistics Canada's Social Policy Simulation Database and Model (SPSD/M), I compare income taxes paid by 35-year-olds in 2022 (the most recent data) with those paid in 1976, holding income constant in real terms. (Full results are available on the website of Generation Squeeze,[36] the university-community collaboration I lead

31 Canada, Department of Finance, 2015 Budget, Budget Plan, April 21, 2015, at 368, table 5.2.6.

32 Canada, Department of Finance, Fall Economic Statement, December 16, 2024, at 201, table A1.8.

33 Ibid.

34 "Read Chrystia Freeland's Letter of Resignation from Trudeau's Cabinet," *CBC News*, December 16, 2024 (www.cbc.ca/news/politics/chrystia-freeland-resignation-letter-1.7411607).

35 Pierre Poilievre, *X* post, July 30, 2025 (https://x.com/PierrePoilievre/status/1950582857770147916).

36 Generation Squeeze, supra note 6.

that seeks to advance generational fairness so that every Canadian can count on a healthy childhood, good home, secure retirement, and livable planet.)

Income tax rates have generally declined over the last half-century. Middle earners in Ontario making $54,000 in 2022 paid 15.2 percent in combined federal and provincial income taxes. Their 1976 counterparts paid 17.6 percent, or $1,260 more. High earners with $240,000 in income pay 36.9 percent today, compared to 38.1 percent in 1976—saving the contemporary taxpayer $2,800. Similar patterns appear across provinces.

Despite lower overall rates, millennials now contribute more income taxes toward retirees' medical care and OAS than baby boomers did at the same age. Seniors made up 8 percent of the population in 1976; today, they comprise 19 percent. The share of public revenue allocated to seniors' medical care rose from 5 percent to 9.5 percent over that period, and OAS spending increased from 5.4 percent to 5.9 percent.

As a result, today's middle-earning millennials in Ontario pay $276 more in income taxes each year toward healthy retirements than did boomers with comparable incomes in 1976—a 28 percent increase. High-earning young Ontarians pay $4,124 more—a 43 percent increase. These figures will climb further as Canada approaches peak population aging.

Meanwhile, lower overall tax rates mean that many retired baby boomers now contribute less to supporting younger generations than their own parents did. This imbalance helps to explain why undergraduate tuition[37] is more expensive now than when boomers were young (after adjusting for inflation), and why child care and housing receive little new federal spending by comparison with OAS.[38]

Addressing these age inequities requires governments to speak frankly with voters about tradeoffs between three options: changing taxes, reducing subsidies for affluent boomers, or increasing immigration to shore up the working-age tax base. Recent debate in Ottawa has moved in the opposite direction. In late 2024, the Bloc Québécois used its leverage over the minority Trudeau government to push OAS increases for rich and poor seniors alike,[39] while Ottawa ratcheted down immigration targets[40]—all without mention of the tax implications for the three younger Canadians supporting each retiree.

37 Statistics Canada table 37-10-0003-01 (formerly CANSIM table 477-0021), "Canadian Undergraduate Tuition Fees by Field of Study (Current Dollars)."

38 Generation Squeeze, "Analysis of the 2024 Federal Budget" (www.gensqueeze.ca/analysis_2024_federal_budget).

39 Paul Kershaw, "The Bloc Québécois Threatens the Finances of Millennials and Gen Z," *Globe and Mail*, September 27, 2024 (www.theglobeandmail.com/investing/personal-finance/young-money/article-the-bloc-quebecois-threatens-the-finances-of-millennials-and-gen-z).

40 Immigration, Refugees and Citizenship Canada, "Government of Canada Reduces Immigration," *News Release*, October 24, 2024.

REVISITING THE CHRÉTIEN-ERA REFORMS TO RETIREMENT INCOME TAX CREDITS

Reforming the age and pension income tax credits offers a politically pragmatic entry point for modernizing retirement income policy. Unlike direct OAS payments, these credits lack symbolic resonance with voters because they are details of the tax system that go unnoticed by many. Phasing them out and reallocating their value to offset growing OAS costs would be a low-risk, high-impact strategy for better aligning retirement income supports with today's fiscal and demographic realities.

Both credits are *non-refundable*. Generally, people with incomes below about $25,000 will not receive the age or pension income credits, as income statistics from the Canada Revenue Agency[41] confirm (see also figure 1). Among claimants of the age credit, 39 percent report incomes below $25,000; for the pension income credit, 17 percent do. These data reveal that many of the lowest-income retirees gain little or nothing from these credits, despite meeting income eligibility. Redirecting funds from these two tax expenditures to the OAS/GIS system would improve income security for economically marginalized retirees.

The age credit costs $5.5 billion per year.[42] This is equivalent to Ottawa's entire 2023 investment in $10-a-day child care—a sum widely celebrated as historic. The credit shelters $8,790 of income from taxation for those over 64, delivering a maximum benefit of $1,319 for retirees with moderate incomes between $24,495 and $44,325. While the credit gradually declines thereafter, it still delivers benefits to retirees with incomes over $100,000. In light of Statistics Canada findings[43] that many younger people are delaying or forgoing parenthood owing to financial pressures caused by the growing gap between housing costs and earnings, the age-based design of this tax shelter appears increasingly arbitrary, especially when those over age 64 have the most wealth[44] and least poverty of any age group.[45]

The pension income credit costs Ottawa $1.5 billion annually.[46] It enables any retiree to shelter $2,000 in pension income from taxation, saving up to $300 for seniors with income above $24,495, and does not decline in value as income rises.

41 Canada Revenue Agency, "T1 Final Statistics 2023 Edition (for the 2021 Tax Year)" (www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/income-statistics-gst-hst-statistics/t1-final-statistics/2021-tax-year.html#tables_in_PDF).

42 Canada, Department of Finance, supra note 8, at 38.

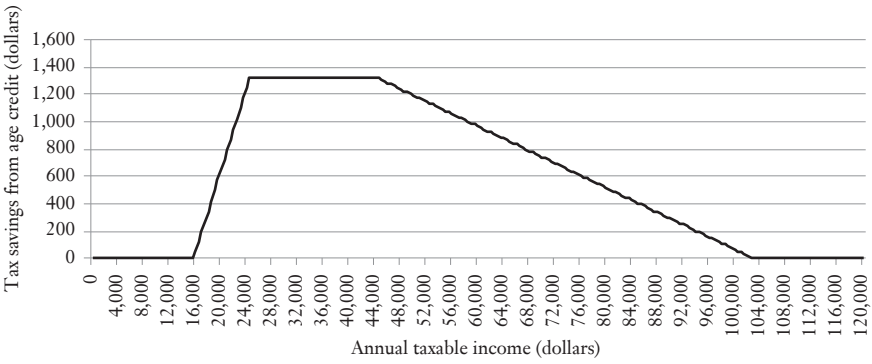
43 Statistics Canada, "Navigating Socioeconomic Obstacles: Impact on the Well-Being of Canadian Youth," *Daily*, September 20, 2023 (www150.statcan.gc.ca/n1/daily-quotidien/230920/dq230920a-eng.htm).

44 Statistics Canada, "Distributions of Household Economic Accounts, Wealth: Interactive Tool," see 2025 Q1 (www150.statcan.gc.ca/n1/pub/71-607-x/71-607-x2020006-eng.htm).

45 Statistics Canada table 11-10-0135-01, supra note 18.

46 Canada, Department of Finance, supra note 8, at 38.

FIGURE 1 Age Credit Value, 2024: Single Taxpayer Claiming the Basic Personal Amount



Source: Author calculations.

This credit privileges pension income over earnings from paid work, even though low-wage workers face higher risks of poverty and housing insecurity than retirees.

Following through on the Chrétien government's 1996 plan to repurpose these credits could save $7 billion annually.[47] Implementing this change in the next budget would create fiscal space and time for the more politically difficult task of revising OAS, or increasing taxes on affluent retirees who benefit from OAS subsidies for which they did not fully prepay.

SIX MODELLED OPTIONS FOR OAS REFORM

To evaluate practical alternatives for OAS reform, I contracted for Statistics Canada to model six options using SPSD/M. The first five options adjust the clawback threshold and rate. The sixth restores the previously legislated increase in OAS eligibility age. Table 1 summarizes the results.

Options 1 and 2 retain individual income as the basis for clawback, but lower the threshold to $70,000—the inflation-adjusted value of the $40,000 threshold proposed for the Chrétien government's seniors benefit. These options would affect roughly 15 percent of Canada's 8 million seniors, or about 1.2 million people. Option 1 maintains the current tax recovery (clawback) rate of 15 percent, phasing out OAS at around $130,000 of individual income. It would reduce government spending

47 Paul Kershaw, "Ottawa Should Preserve Funding for OAS by Eliminating Outdated Tax Shelters for Retirees," *Globe and Mail*, October 14, 2023 (www.theglobeandmail.com/investing/personal-finance/young-money/article-ottawa-should-preserve-funding-for-oas-by-eliminating-outdated-tax).

TABLE 1 Old Age Security Reform Options

Option	Clawback unit	Clawback threshold, 2025	Clawback rate	Eligibility age	Aggregate OAS savings, 2025	Percentage of seniors who would receive less	Number of seniors who would receive less	Average OAS reduction	Average reduction after tax
1	Individual	$70,000	Current 15%; OAS phases out at ~$130,000	65	$2.3 billion	15	~1.2 million	~$2,000	~$1,300
2	Individual	$70,000	29%; OAS phases out at $100,000	65	$4.0 billion	15	~1.2 million	~$3,600	~$2,400
3	Household	$100,000	Current 15%; OAS phases out at ~$160,000	65	$6.8 billion	20	~1.5 million	~$4,300	~$2,900
4	Household	$90,000	Current 15%; OAS phases out at ~$150,000	65	$9.0 billion	24	~1.9 million	~$4,700	~$3,100
5	Household	~$79,000 (same as CCB)	Current 15%; OAS phases out at ~$140,000	65	$12.0 billion	34	~2.7 million	~$4,400	~$3,000
6	Individual	~$90,000	Current 15%; OAS phases out at ~$150,000	67	$7.3 billion	11	~900,000	up to ~$8,700	na

OAS = old age security; CCB = Canada child benefit.

Note: This analysis is based on Statistics Canada's Social Policy Simulation Database and Model. The assumptions and calculations underlying the simulation were specified by the author in the fall of 2024, and the responsibility for the use and interpretation of these data is entirely that of the author.

Source: Statistics Canada, "The Social Policy Simulation Database and Model (SPSD/M)" (www.statcan.gc.ca/en/microsimulation/spsdm/spsdm).

by $2.3 billion in 2025—less than 3 percent of the total OAS/GIS budget. The average OAS reduction is about $2,000 per impacted individual, which they experience as a $1,300 loss after income taxes, because OAS is a taxable benefit.

Option 2 increases the clawback rate to 29 percent, phasing out OAS at $100,000 of individual income. It would save $4 billion per year, about 5 percent of the annual OAS/GIS budget. Impacted individuals would forgo about $3,600 from OAS, or $2,400 after income tax.

Options 3 to 5 shift the recovery tax threshold from individual to household incomes, aligning with the spirit of the Chrétien-era plan. Under option 3, the clawback would begin at $100,000 and OAS would disappear near $160,000, affecting about 20 percent of seniors. Option 4 would lower the household threshold to $90,000 (matching today's individual amount), with benefits ending around $150,000. This change would impact 24 percent of seniors. Option 5 proposes to start the OAS clawback at the 2024 Canada child benefit threshold of $79,000. In this option, OAS would phase out completely at around $140,000 of household income, affecting 34 percent of seniors. These options would reduce OAS spending by $6.8 billion, $9 billion, and $12 billion, respectively, in 2025, or 8 to 14 percent of the 2025 OAS/GIS budget. Impacted seniors would lose on average $4,300 to $4,700 from their annual OAS subsidy, or about $3,000 after tax.

Option 6 would restore the Harper government's plan to raise OAS eligibility age from 65 to 67. Had this plan not been repealed, 900,000 Canadians age 65 and 66 would now be ineligible for OAS. Since most receive the maximum benefit, typical individuals would forgo around $8,700, with after-tax losses depending on their other income. The total government savings for 2025 would be $7.3 billion, or 8 percent of the current OAS/GIS expenditure.

All six models retain the tax provision allowing seniors to split income with spouses. On its own, this tax expenditure will cost $2.2 billion in 2025.[48] SPSD/M modelling shows that income splitting adds another half a billion dollars to the annual cost of OAS, as higher-income spouses shift income both to reduce tax liability and to qualify for greater OAS benefits. Introduced after the Chrétien era, income splitting could have joined the age and pension income credits on the list of tax expenditures slated for reform in the 1990s. It has since been critiqued for undermining gender equality and being unavailable to younger Canadians, raising concerns about systemic ageism.

REPURPOSING SAVINGS TO ELIMINATE SENIORS' POVERTY AND ADVANCE INTERGENERATIONAL PRIORITIES

The fiscal room created by the six modelled OAS reform options is substantial. Even the least ambitious scenario (option 1) yields annual savings of $2.3 billion—

48 Canada, Department of Finance, supra note 8, at 249.

sufficient to virtually eliminate seniors' poverty in Canada by enhancing existing income supports.

Currently, 5 percent of Canadian seniors—approximately 400,000 people—fall below the official poverty line, the market basket measure (MBM). The MBM defines poverty for a single adult as half the value of the "reference family"[49]—roughly $25,000 annually, varying slightly by region. According to Statistics Canada, "deep poverty" (incomes below 75 percent of the MBM) is "relatively rare for those aged 65 years and older."[50]

Accordingly, I estimate that an annual supplement of $5,000 for poor seniors (delivered by the GIS system) would be sufficient to virtually eliminate poverty among Canadians over age 64. This reform would cost $2 billion annually. To smooth benefit reductions for seniors just above the poverty line, I anticipate another half a billion dollars would likely be required, bringing the total annual cost to approximately $2.5 billion.

Options 3 through 6 would generate savings well in excess of this amount, enabling not only the elimination of seniors' poverty, but also an acceleration of funding to reduce affordability pressures for millennials and Gen Z—as emphasized in the Liberal 2025 election platform. According to the 2024 federal budget, the government plans by 2028 to increase annual spending by $1 billion for post-secondary education, $2 billion for housing, and $3 billion for child care.[51] Options 3 through 6 could double the planned increases for post-secondary and housing, and expand the child-care investment by 50 percent. Even after covering these reinvestments, reform options 4 and 5 would leave room to allocate funds to other policy objectives, such as strengthening national defence, financing the transition to a low-carbon economy, or reducing the operating deficit.

STRONG PUBLIC SUPPORT FOR REFORMING OAS

A majority of Canadians support redesigning OAS to reduce payments to financially secure retirees and reallocate savings to eliminate seniors' poverty, help younger generations, and reduce the deficit, according to a recent poll by Research Co. for Generation Squeeze.

Before answering the poll, respondents were provided with key facts about OAS: full benefits of approximately $8,700 are paid to individuals with annual incomes up to $90,000, and the benefit phases out slowly beyond that point. Even individuals earning over $140,000, or couples with combined incomes exceeding $250,000, still

49 Michael Hatfield, *Constructing the Revised Market Basket Measure*, document no. T-01-1E (Hull, QC: Human Resources Development Canada, Applied Research Branch, Strategic Policy, April 2002) (https://publications.gc.ca/collections/Collection/MP32-30-01-1E.pdf), at 1.

50 Marc-Antoine Dionne and Lucie Raymond-Brousseau, *Deep Income Poverty: Exploring Dimensions of Poverty in Canada* (Ottawa: Statistics Canada, 2025), at 5.

51 Generation Squeeze, supra note 38.

receive public subsidies. For context, the survey noted that median income[52] for individual Canadians is around $43,000 a year.

After reviewing these facts, 71 percent of Canadians, including 69 percent of seniors, supported ending OAS payments for retirees with incomes above $100,000, provided that the savings were redirected to increase supports for low-income seniors. Support was similarly strong for reinvesting savings in other priorities such as housing, child care, and post-secondary education. Deficit reduction also received majority support, albeit lower (around 57 percent).

The poll did not just invite respondents to consider generalities. It offered specific tradeoffs to consider. The option receiving the most support would ask the "one in four retirees in households with incomes of $100,000 or higher to accept smaller OAS payments that would reduce their after-tax income by approximately $3,200." This idea was supported by 74 percent of Canadians and 76 percent of seniors. Support crossed party lines: over 70 percent of Liberal, Conservative, and New Democratic Party voters agreed. (Note that later SPSD/M modelling refined the estimate to reveal that only one in five retirees would be subject to this change.)

More generally, the poll revealed that 64 percent of Canadians, including an equal share of seniors, believe that the OAS recovery tax threshold should be no higher than the $79,000 household income threshold used for the Canada child benefit in 2024. The survey was conducted October 19 to 21, 2024 and sampled 1,002 Canadian adults. It carries a margin of error of ±3.1 percentage points, 19 times out of 20. All survey questions and results are publicly available.[53]

OAS REFORM SUPPORTED BY FINANCIALLY SECURE RETIREES

When sharing research with parliamentarians, I often encounter skepticism about polling. To reinforce public support for OAS reform, my team at Generation Squeeze has collected qualitative data—inviting financially secure retirees to publicly declare their willingness to receive less. These allies represent voters who could stand beside any politician proposing OAS change, helping to dispel fears of a backlash from seniors. Together with the poll results, their calls for action help provide the political cover needed for politicians to pursue OAS reform.

Some, like Victor, have written to the Canada Revenue Agency asking to return their OAS subsidy, only to be told that there is no mechanism to do so. Others express

52 Statistics Canada table 11-10-0239-01 (formerly CANSIM table 206-0052), "Income of Individuals by Age Group, Sex and Income Source, Canada, Provinces and Selected Census Metropolitan Areas."

53 Generation Squeeze, "Survey on OAS in Canada—October 2024" (https://assets.nationbuilder.com/gensqueeze/pages/6495/attachments/original/1729622634/GenSqueeze-OAS-poll-Oct2024_ResearchCo.xlsx?1729622634).

concern on video. Beth is "embarrassed"[54] that we claw back subsidies for families with children at a lower income level than for seniors: "I just don't know how we justify that."[55] Mary reflects: "I have seen how our society's social safety net favours seniors over working-age adults and children through generous OAS clawback levels, seniors' income splitting, and prescription drug coverage for seniors. . . . As a boomer, a senior, and a physician, I and many others like me believe the government has an urgent moral responsibility to redress this glaring inequity."[56] Or consider Harry, who says: "It makes no sense to me that I receive old age security. I'm not poor. I'm not struggling. And yet I receive a bonus every month simply for being a senior."[57]

Even the Canadian Association of Retired Persons (CARP), the largest seniors' advocacy organization in Canada, has invited Ottawa to reorganize OAS so that it delivers more of its current spending to retirees in need, not those who are affluent. Appearing on CBC Radio's "The Current,"[58] CARP president Rudy Buttignol said: "[W]hat we're talking about is social benefits, seniors benefits for those that need it most. There is an issue about income thresholds, and I think that's where the debate should be on. You know, when is a senior's income considered sufficient? So, that's where I think the discussion should be. But the fact is that there's a big cohort of seniors that struggle and live on OAS and the guaranteed income supplement as well and require that."[59]

CONCLUSION

The 1950s design of OAS is dragging down today's federal budget, letting down low-income retirees and younger generations alike. It leaves 400,000 seniors in poverty, even as it delivers $18,000 a year to retired couples with household incomes around $180,000. Younger Canadians now pay more taxes to support seniors than today's retirees previously paid for their elders. But this solidarity is not matched by equally urgent investments in housing, child care, or post-secondary education. All the while, ballooning OAS costs fuel the deficit, leaving unpaid bills for millennials and Gen Z to pay. Public opinion reflects a growing discomfort with this imbalance: most

54 Generation Squeeze, "Canadians Want To Fix Old Age Security: Beth Jefferson Thinks We Should Give More to Families" (www.youtube.com/watch?v=AdTUpnHrIB8), at 0:08.

55 Ibid., at 0:53.

56 Generation Squeeze, "Canadians Want To Fix Old Age Security: Perspective from Mary Peirson" (www.youtube.com/watch?v=GD7rz2wTu-U), at 0:11 and 0:56.

57 Generation Squeeze, "Canadians Want To Fix Old Age Security: Harry Grossmith Shares His Thoughts" (www.youtube.com/watch?v=7xtt4EXKjQ4), at 0:29.

58 CBC Radio, "The Current," hosted by Matt Galloway, "Friday October 4, 2024 Full Transcript," October 7, 2024 (www.cbc.ca/radio/thecurrent/friday-october-4-2024-full-transcript-1.7344934).

59 Ibid., per Rudy Buttignol.

Canadians agree that OAS is out of step with Canadian values about supporting those in need. Three-quarters support revising the OAS clawback threshold, echoing a reform first proposed by the Chrétien government in 1996.

The purist in me favours aligning the OAS recovery threshold with the clawback for the Canada child benefit—around $80,000, indexed to inflation. There's no compelling reason the clawback for retirees should be more generous than the clawback for families raising children. And this option would save the most money. However, on the basis of the communications testing conducted in our national polling, I recommend that Ottawa adopt a more pragmatic alternative: a household income threshold of $100,000. This option received the strongest support across age groups and regions. By increasing the generosity of OAS for single seniors, it could also attract a powerful constituency of older adults who could offset opposition from some financially secure retired couples. There is also a communications rationale to organize OAS reform around a narrative that asks only retirees with "six-figure household incomes" to accept a little less OAS to eliminate seniors' poverty, and to help younger generations.

Shifting the OAS recovery threshold to $100,000 of household income would save nearly as much as the Harper government's plan to increase the eligibility age from 65 to 67. While I initially supported the Harper government's proposal, my thinking has evolved. Raising the eligibility age is a blunt tool: it removes benefits from nearly a million seniors, including some living close to the poverty line. In contrast, adjusting the clawback threshold achieves comparable fiscal savings while continuing to protect economically vulnerable Canadians age 65 and 66.

In sum, implementing the Chrétien-era vision for retirement income reform today is a textbook case of "better late than never." Phasing out the age and pension income tax credits could yield $7 billion annually to stabilize OAS revenues. Shifting the OAS recovery tax threshold from individual to household income could save another $7 to $12 billion per year. In total, these reforms would free up $14 to $19 billion to meet what Prime Minister Carney describes as "a generational challenge": "[b]ringing down costs for Canadians and helping them to get ahead," "[m]aking housing more affordable," and "[s]pending less on government operations so that Canadians can invest more in the people and businesses that will build the strongest economy in the G7."[60]

Eliminating seniors' poverty, helping younger generations afford life's major costs, and freeing up funds for other national objectives is a win-win-win opportunity. It deserves to rise to the top of Canada's domestic policy agenda.

60 Canada, Office of the Prime Minister, supra note 1.

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Finances of the Nation

THE GLOBAL FINANCIAL CYCLE AND CANADIAN BOND MARKETS—IMPLICATIONS FOR PROVINCIAL BORROWERS

*Kyle Hanniman**

For almost 60 years, the Canadian Tax Foundation published an annual monograph, Finances of the Nation, *and its predecessor,* The National Finances. *In a change of format, the 2014* Canadian Tax Journal *introduced a new "Finances of the Nation" feature, which presents annual surveys of provincial and territorial budgets and topical articles on taxation and public expenditures in Canada.*

This article examines implications of the global financial cycle for Canada's public sector borrowers, with a particular emphasis on the borrowing conditions of Canadian provinces. It makes three broad points. First, even relative to other advanced economies, Canada, and the government of Canada in particular, has done well by the global financial cycle. In a world of trade imbalances and uncertainty, investors need safe assets, and Canada's wealth, political stability, and open capital markets have made government of Canada bonds a natural haven. Second, the provinces have also done well by the global financial cycle, but their bonds are riskier and less liquid than government of Canada debt, which explains why their spreads tend to increase with global volatility, and why, if volatility becomes too severe, the provinces occasionally struggle to borrow. Volatility-related premiums are lower among provinces with relatively large and liquid pools of debt, and higher—if the volatility is associated with a significant drop in oil prices—among oil-producing provinces. Third, the global financial cycle is evolving, and one of the most important developments is the growing vulnerability of central governments. Sovereign bond yields no longer reliably fall in the face of adverse conditions, and in some cases they even increase. These developments appear to stem from a combination of technical factors and growing concerns about sovereign credit risk, particularly in the United States. They also represent a fundamental shift in the pricing of traditionally safe assets and expose the government of Canada and provinces to a number of unknown risks.

The underlying data for the Finances of the Nation *monographs and for the articles in this journal will be published online in the near future.*

KEYWORDS: BONDS ■ BANK OF CANADA ■ FISCAL POLICY ■ PUBLIC DEBT ■ PROVINCIAL GOVERNMENT ■ FEDERAL-PROVINCIAL

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Global financial markets are far more integrated and complex than they have ever been, exposing today's domestic economies to unprecedented levels of financial risk. While these risks have many dimensions, many appear to operate as part of a global financial cycle:[1] co-movements of asset prices, capital flows, leverage, and financial aggregates around the world.

In this article, I examine implications of the global financial cycle for Canada's public sector borrowers, with a particular emphasis on provinces. I begin by discussing the relative vulnerability of Canada's public sector borrowers, and then present an empirical analysis of the relationship between the global financial cycle and two key dimensions of provincial borrowing conditions: the additional spread, or interest rate premium that the provinces pay over the federal government, and the provinces' access to bond markets. I then reflect on the recent evolution of the global financial cycle, and what it means for public sector borrowers and policy makers.

I make three broad points. First, even relative to other advanced economies, Canada, and the government of Canada in particular, has done well by the global financial cycle. In a world of trade imbalances and uncertainty, investors need safe assets,[2] and Canada's wealth, political stability, and open capital markets have made government of Canada bonds a natural haven. Not only has this allowed the federal government to borrow at lower rates than it otherwise could, but it has also meant that those rates tend to fall when domestic or global conditions deteriorate, or when Canadians need them to fall most.

Second, the provinces have also done well by the global financial cycle, but their bonds are riskier and less liquid (or costlier to trade on secondary markets) than government of Canada debt. This explains why their spreads tend to increase with

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1 Hélène Rey, "Dilemma Not Trilemma: The Global Financial Cycle and Monetary Policy Independence," presented at Global Dimensions of Unconventional Monetary Policy: Annual Economic Policy Symposium, sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, August 21-24, 2013.

2 Ricardo J. Caballero, Emmanuel Farhi, and Pierre-Olivier Gourinchas, "The Safe Assets Conundrum" (2017) 31:3 *Journal of Economic Perspectives* 29-46.

global volatility, and why, if volatility becomes too severe, the provinces occasionally struggle to borrow, as they did during the 2008 global financial crisis, various stages of the eurozone debt crisis from 2010 to 2012, the global commodity crash of 2015-16, the 2018 "taper tantrum," and the early stages of the 2020 COVID-19 pandemic. Volatility-related premiums are lower among provinces with relatively large and liquid pools of debt (a tendency that becomes statistically significant only after 2014), and higher—if the volatility is associated with a significant drop in oil prices—among oil-producing provinces.

Third, the global financial cycle is evolving, and one of the most important developments is the growing vulnerability of central governments. Sovereign bond yields no longer reliably fall in the face of adverse conditions, and in some cases they even increase. These developments appear to stem from a combination of technical factors (including reduced market-making capacity and forced selling among price-sensitive investors) and growing concerns about sovereign credit risk, particularly in the United States. They also represent a fundamental shift in the pricing of traditionally safe assets and expose the government of Canada and provinces to a number of unknown risks.

I develop the first three points in the next three sections, and reflect on their policy implications in the concluding section.

THE GLOBAL FINANCIAL CYCLE AND ITS IMPLICATIONS FOR CANADA'S PUBLIC SECTOR BORROWERS

Financial liberalization has been on the rise for the past 50 years, both within countries and globally. The financial sector now makes up a much larger share of gross domestic product in advanced economies, and of many emerging and developing market economies as well. The financial sector has also become much more complex and interconnected. One of the consequences of this is an increase in systemic risk, or the risk that failure or tightening in one area of the financial system will spread to another.

While these dynamics come in many forms, they often operate as part of a global financial cycle: synchronized movements of asset prices, capital flows, leverage, and financial aggregates cross borders. These co-movements have been linked to a small number of global factors[3]—including generalized risk aversion in global capital markets, and the monetary policies of wealthy economies, especially the United States. They also tend to be highly pro-cyclical, and to inflict the greatest damage on emerging and developing market economies, where periods of falling interest rates and risk aversion often trigger significant, and self-amplifying, booms

3 Sarah Bauerle Danzman, W. Kindred Winecoff, and Thomas Oatley, "All Crises Are Global: Capital Cycles in an Imbalanced International Political Economy" (2017) 61:4 *International Studies Quarterly* 907-23 (https://doi.org/10.1093/isq/sqx054); and Silvia Miranda-Agrippino and Hélène Rey, "The Global Financial Cycle" (2022) 6 *Handbook of International Economics* 1-43 (https://doi.org/10.1016/bs.hesint.2022.02.008).

in capital inflows and asset prices, and periods of rising interest rates and risk aversion often result in busts.[4]

Advanced economies are better insulated, and even benefit from the global financial cycle in important ways, but there is also a clear hierarchy of borrowers within them. At the top of the hierarchy are central governments. They issue safe assets:[5] bonds that are expected to retain their value under adverse conditions. Investors pay a premium for this protection, which allows the issuer to borrow at lower rates.[6] Yields on safe assets also tend to fall during periods of domestic or global distress, as demand for liquidity and safety increases. With this comes a number of other benefits, including a tremendous amount of insulation from the vicissitudes of global markets, and the ability to run countercyclical fiscal and monetary policies.

The foundations of the government of Canada's safety are three. The first is the lack of credit or default risk.[7] Canada enjoys triple-A ratings with the two most important credit-rating agencies, Moody's and Standard and Poor's, and an AA+ rating with Fitch.[8] Neither the major rating agencies nor bond markets assign any meaningful probability of default to the government of Canada.

The second is liquidity, or the ease with which investors can convert large quantities of bonds to cash without affecting the price. Canada's bond market is one of deepest and most liquid in the world, especially relative to the economy's size.

The third is shared faith, or coordination of beliefs. Safe assets are safe because investors believe they are safe, note Brunnermeier, Merkel, and Sannikov,[9] and believe other investors feel the same way. One factor that helps to support those beliefs is Canada's reserve currency status.[10] The Canadian dollar is one of eight official

4 Erik Wibbels, "Dependency Revisited: International Markets, Business Cycles, and Social Spending in the Developing World" (2006) 60:2 *International Organization* 433-68 (https://doi.org/10.1017/S0020818306060139).

5 Caballero et al., supra note 2.

6 Markus K. Brunnermeier, Sebastian A. Merkel, and Yuliy Sannikov, *Debt as Safe Asset*, NBER Working Paper 29626 (Cambridge, MA: National Bureau of Economic Research, 2022).

7 Default risk refers to the probability of a borrower failing to service its debt in full and on time over a given time horizon. Credit risk is a slightly broader concept that encompasses both default risk and credit spread risk, where the latter refers to the risk that a bond's value will decline relative to other securities in an investor's portfolio. These declines can occur if "(a) the market requires a higher spread due to a perceived increase in the risk that the issuer will default" or because "(b) companies that assign ratings to bonds will lower a bond's rating." See Frank J. Fabozzi, *Fixed Income Analysis*, 2d ed. (Hoboken, NJ: Wiley, 2007), at 421.

8 Only eight other countries have triple-A ratings with both Moody's and Standard and Poor's. They are Australia, Denmark, Germany, the Netherlands, Switzerland, Norway, Sweden, and Singapore.

9 Supra note 6.

10 Lukasz Pomorski, Francisco Rivadeneyra, and Eric Wolfe, "The Canadian Dollar as a Reserve Currency" (Spring 2014) *Bank of Canada Review* 1-11.

reserve currencies recognized by the International Monetary Fund, and the fifth-largest by official reserve holdings.[11]

Of course, not all advanced economy sovereign bonds are created equal, and no one would argue that Canada enjoys the exorbitant privilege of the United States. But it is privileged, and, like the United States, its privilege has gone hand in hand with a fairly consistent current account deficit.[12] But perhaps this is no surprise. In a world of persistent trade imbalances—and considerable risk and uncertainty—investors need safe havens,[13] and Canada's wealth, political stability, and relatively deep and open capital markets make it a natural choice.[14]

All Canadian borrowers benefit from Canada's status to some degree, but the privileges—and vulnerabilities—vary considerably from one sector to another. For example, private corporations that issue risky bonds, or whose assets are expected to depreciate under adverse conditions, can generally expect their borrowing costs to rise with volatility in global markets. The provinces and most other public sector borrowers fall somewhere in between. They issue relatively safe assets, but when compared to the government of Canada, two differences stand out.

The first is credit risk. The provinces rely on a narrower and more volatile tax base than the federal government. More fundamentally, they do not own the central bank and cannot necessarily rely on the Bank of Canada to act as a lender or market maker of last resort (or at least not to the same extent that the government of Canada can). This asymmetry is mitigated, to some degree, by implicit federal supports. A provincial government default would have potentially devastating consequences for the Canadian economy, given the provinces' sizable presence in domestic and international capital markets. It would also undermine Ottawa's capacity to realize its social welfare commitments, given the importance of provincial solvency for the quality of social services such as health care. Most investors are betting, therefore, that the federal government is unlikely to let a province default, as my interviews

11 The four largest are the US dollar, the euro, the British pound, and the Japanese yen. The remaining three, after Canada, are the Australian dollar, the Swiss franc, and the Chinese renminbi. Canada's relative position remained unchanged from 2013 to 2024, the last year for which International Monetary Fund data on the currency composition of official foreign exchange reserves are available.

12 Even the United States' deficit has tended to be far larger and more persistent.

13 Matthew C. Klein and Michael Pettis, *Trade Wars Are Class Wars: How Rising Inequality Distorts the Global Economy and Threatens International Peace* (New Haven, CT: Yale University Press, 2020).

14 Christopher Abbott, "Consumption and Commodities: The Political Economy of Canada's Growth Model" (PhD dissertation, Department of Political Studies, Queen's University, 2025); and Bruno Feunou, Jean-Sébastien Fontaine, James Kyeong, and Jesus Sierra, *Foreign Flows and Their Effects on Government of Canada Yields*, Staff Analytical Note 2015-1 (Ottawa: Bank of Canada, November 2015).

with a number of provincial bondholders strongly suggest.[15] But implicit supports do not entirely insulate provinces from markets. There is always some possibility that Ottawa could fail to pull a teetering province from the brink, which is why borrowing conditions continue to reflect basic differences in economic and fiscal fundamentals.

The second difference is liquidity—the biggest determinant of which is the volume of bonds outstanding. With over $1 trillion worth, the federal government's stock of bonds is the largest in Canada. Among the provinces, the volumes vary considerably, ranging from $3 billion for Prince Edward Island to $265 billion for Quebec and $409 billion for Ontario in 2023.[16]

Figure 1 illustrates the implications of these differences for average borrowing costs. It compares the average five-year spread that the provinces and other public sector borrowers paid over the government of Canada on their Canadian-dollar debt from April 25, 2024 to April 23, 2025. The spreads are measured in basis points, where 1 basis point refers to 0.01 percent interest paid on an annual bond. The figure suggests four tiers. The first is the Canada Housing Trust (CHT), the financing arm of the Canada Mortgage and Housing Corporation.[17] It benefits from an explicit federal guarantee and a relatively large and liquid pool of debt. Next are the majority of provinces. Unlike the CHT, their guarantees are merely implicit, and with the exception of Ontario, their debts are costlier to trade than CHT's as well. The third is major municipal borrowers, including a number of cities, the South Coast British Columbia Transit Authority (TransLink), and the Municipal Finance Authority of BC (which borrows on behalf of British Columbia's municipalities, regional districts, and regional hospital districts).[18] Like the provinces, municipalities benefit from an implicit guarantee (albeit from provinces rather than from the federal government).[19] But unlike provinces, municipalities are subject to hierarchical rules, including provincial prohibitions on operating deficits. The upshot is

15 Kyle Hanniman, "Is Canadian Federalism Market-Preserving? The View from Bond Markets," in Elizabeth Goodyear-Grant, Richard Johnston, Will Kymlicka, and John Myles, eds., *Federalism and the Welfare State in a Multicultural World* (Montreal and Kingston, ON: McGill-Queen's University Press, 2019), 49-72.

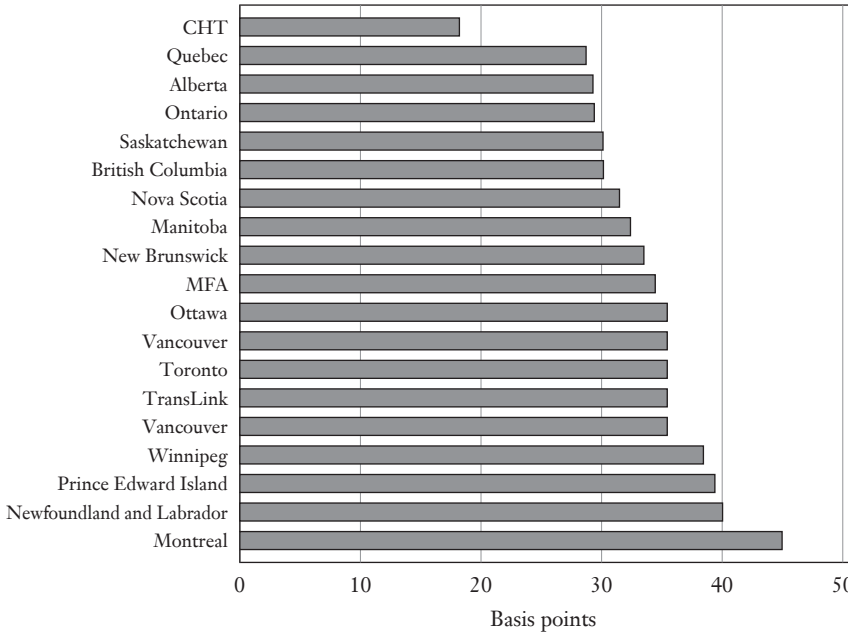
16 These figures come from government finance statistics or the same data used to calculate provinces' share of the provincial bond market in the regression analysis below.

17 The other major agency that provides borrowers with an explicit federal guarantee is Export Development Canada. Its spreads are difficult to compare, however, since it issues primarily in US dollars.

18 TransLink (www.translink.ca); and Municipal Finance Authority of BC (https://mfa.bc.ca). Vancouver is the only municipality in British Columbia with the right to borrow in its own name.

19 The ratings of the Municipal Finance Authority of BC are further backed by the joint and several guarantees of local debt by the issuer's regional district. CHT and the Municipal Finance Authority of BC are the only issuers in the figure with triple-A ratings.

FIGURE 1 Average Five-Year Bond Spreads over the Government of Canada



CHT = Canada Housing Trust; MFA = Municipal Finance Authority of BC.

Notes: The figure displays the average five-year bond spreads of the Canada Housing Trust, the provinces, selected municipalities, and two municipal agencies (TransLink and the Municipal Finance Authority of BC) over the government of Canada. The data are indicative spreads or estimates of what a given borrower would pay if it were to issue a bond on a given day. The averages cover the period from April 25, 2024 to April 23, 2025. The spreads are measured in basis points, where 1 basis point refers to 0.01 percent annual interest paid on a bond.

Sources: BMO Capital Markets and author's calculations.

significantly lower debt ratios, which often gives municipalities an advantage in terms of credit ratings but a disadvantage in terms of liquidity premiums. At the bottom are Prince Edward Island and Newfoundland and Labrador, the provinces with the lowest ratings and some of the most illiquid debt.

THE GLOBAL FINANCIAL CYCLE AND PROVINCIAL GOVERNMENTS

In this section, I examine the relationship between the global financial cycle and two key dimensions of provincial borrowing conditions: relative borrowing costs, or spreads, and market access.

The Global Financial Cycle and Provincial Bond Spreads

The literature has identified a clear link between the global financial cycle and generalized risk sentiment in global financial markets.[20] Investor sentiment cannot be measured directly, so the empirical literature relies on proxies. The most common proxy in analyses of government bond spreads is the spread between yields on risky corporate and US government bonds.[21] Figure 2 plots Moody's corporate Baa spread (the grey line) alongside Ontario's 10-year spread over the government of Canada (the black line). Not surprisingly, Ontario's spread is narrower, but it clearly correlates with the corporate series, and both tend to increase in the face of a number of well-known global shocks, including the global financial crisis of 2008, various stages of the eurozone debt crisis from 2010 to 2012, the sharp decline in global commodity prices in 2015-16, the taper tantrum of 2018, and the onset of the COVID-19 pandemic in early 2020.

Ontario is only one province. But as we can see from figure 3, the correlation holds for other provinces as well, ranging from 0.7 for Alberta to more than 0.8 for Ontario and Quebec.

Impressive as they are, however, the correlations arguably understate the effects of the global financial cycle, depending on how broadly one defines it. Sharp increases in market volatility often coincide with sharp declines in global commodity prices,[22] including the price of oil,[23] and these declines have been known to tighten financial conditions in countries that rely heavily on commodity exports.[24] This

20 Rey, supra note 1.

21 Kerstin Bernoth, Jürgen von Hagen, and Ludger Schuknecht, "Sovereign Risk Premiums in the European Government Bond Market" (2012) 31:5 *Journal of International Money and Finance* 975-95 (https://doi.org/10.1016/j.jimonfin.2011.12.006); Lorenzo Codogno, Carlo Favero, and Alessandro Missale, "Yield Spreads on EMU Government Bonds" (2003) 18:37 *Economic Policy* 503-32; Mark Hallerberg and Guntram B. Wolff, "Fiscal Institutions, Fiscal Policy and Sovereign Risk Premia in EMU" (2008) 136:3/4 *Public Choice* 379-96; Jan Lemmen, *Managing Government Default Risk in Federal States*, Financial Markets Group Special Paper 116 (London, UK: London School of Economics, Financial Markets Group, 1999); Ludger Schuknecht, Jürgen von Hagen, and Guido Wolswijk, "Government Risk Premiums in the Bond Market: EMU and Canada" (2009) 25:3 *European Journal of Political Economy* 371-84 (https://doi.org/10.1016/j.ejpoleco.2009.02.004); and Alexander Schulz and Guntram B. Wolff, "The German Sub-National Government Bond Market: Structure, Determinants of Yield Spreads and Berlin's Forgone Bail-Out" (2009) 229:1 *Journal of Economics and Statistics* 61-83.

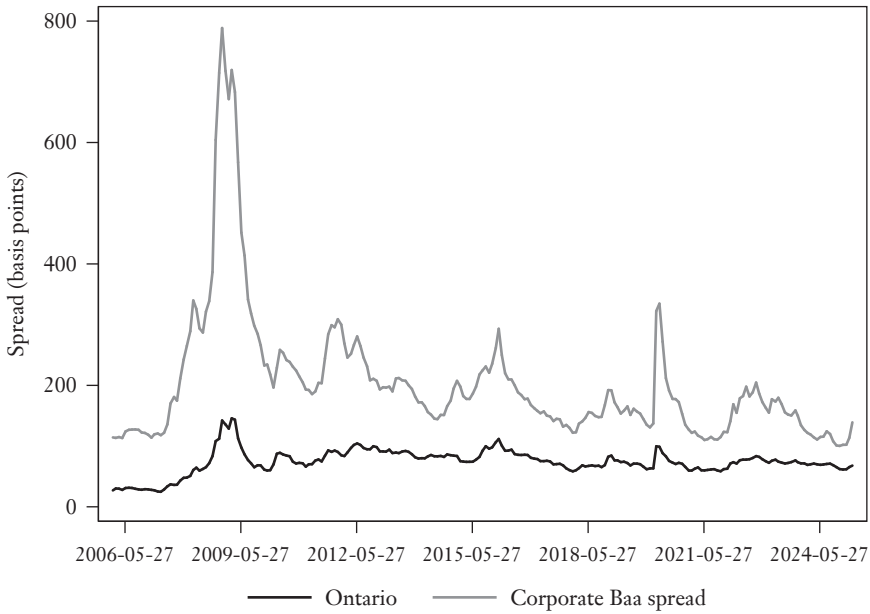
Another common measure is the Chicago Board Options Exchange Volatility Index (VIX), commonly known as the fear gauge, which measures the implied volatility of S&P 500 stock options.

22 Miranda-Agrippino and Rey, supra note 3.

23 Afees A. Salisu, Rangan Gupta, and Riza Demirer, "Global Financial Cycle and the Predictability of Oil Market Volatility: Evidence from a GARCH-MIDAS Model" (April 2022) 108 *Energy Economics* (https://doi.org/10.1016/j.eneco.2022.105934).

24 Daniela Campello, *The Politics of Market Discipline in Latin America: Globalization and Democracy* (New York: Cambridge University Press, 2015).

FIGURE 2 10-Year Ontario and Corporate Baa Spreads



Notes: The black line is the interest rate spread that Ontario paid over the government of Canada on a 10-year bond from the beginning of 2006 until the end of 2024. It comes from BMO Capital Markets. The grey line is the spread between yields on Moody's seasoned corporate Baa bonds and 10-year US treasuries. Both series are measured daily and in basis points, where 1 basis point refers to 0.01 percent annual interest paid on a bond.

Sources: BMO Capital Markets; Federal Reserve Bank of St. Louis; and author's calculations.

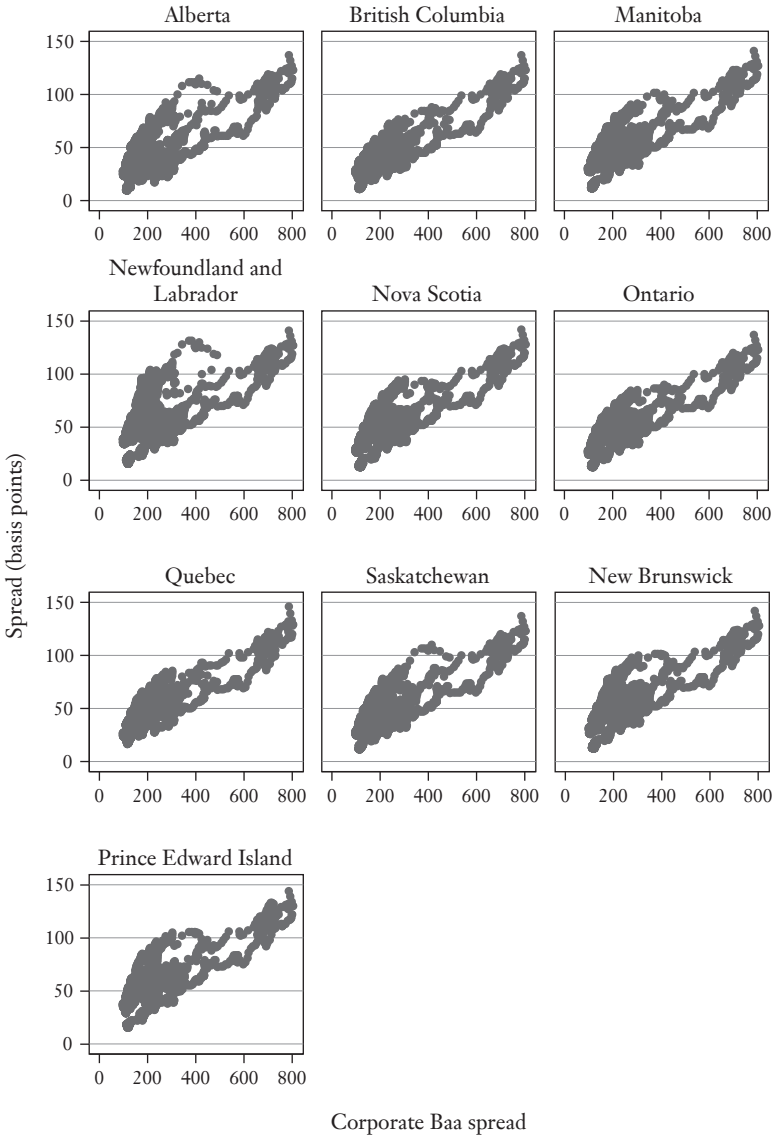
might generate additional costs for provincial borrowers, particularly Alberta, Newfoundland and Labrador, and Saskatchewan, which rely heavily on natural resource revenues. Figures 4A and 4B suggest that this is, in fact, the case. They compare the change in provincial spreads, relative to Ontario, the sector's benchmark issuer, after the provinces were hit with negative oil price shocks in 2015-16 and 2020.

Next, I examine these relationships in a regression framework. The following fixed-effect model provides a baseline:

$$Spread_{it} = \alpha + \beta_1 Baa_t + \beta_2 OS_1 + \beta_3 OS_2 + \beta_4 BO_{it} + \beta_5 CR_{it} + \beta_6 (Baa_t * BO_{it}) + \beta_7' (OS_t * \mu_i) + \beta_8' (OS_t * \mu_i) + \mu_i + \lambda_t + e_{it}.$$

$Spread_{it}$ refers to the spread, measured in basis points, that province i pays over the government of Canada at month t on a bond of the same maturity. The data come

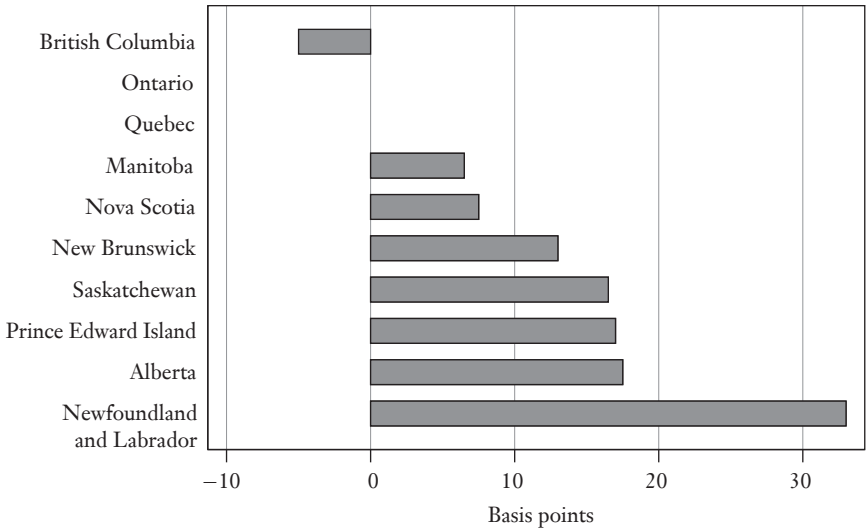
FIGURE 3 10-Year Corporate Baa and Provincial Bond Spreads



Notes: The figure plots Canadian provinces' 10-year bond spreads over the government of Canada against Moody's 10-year corporate Baa spread over US treasuries from the beginning of 2006 to the end of 2024. Both series are measured daily and in basis points.

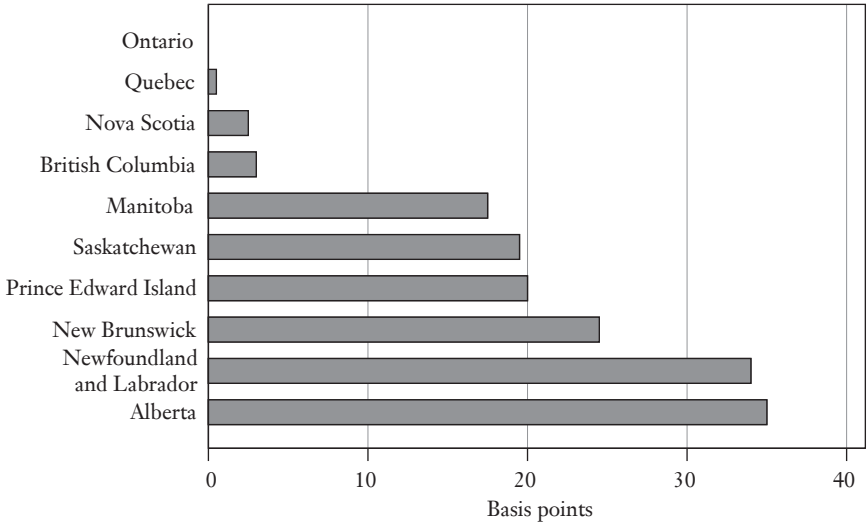
Sources: BMO Capital Markets; Federal Reserve Bank of St. Louis; and author's calculations.

FIGURE 4A Change in Provinces' 10-Year Spread over Ontario After the 2015-16 Oil Shock



Note: See the notes to figure 4B.

FIGURE 4B Change in Provinces' 10-Year Spread over Ontario After the 2020 Oil Shock



Notes: Figures 4A and 4B display the change in provinces' 10-year spreads relative to Ontario from the month prior to the oil shock to the last month of the shock, as defined in the regression analysis. The spreads are measured in basis points, where 1 basis point refers to 0.01 percent annual interest paid on a bond.

from BMO Capital Markets, a major market maker and underwriter of provincial debt, and represent BMO's estimate of what a province would pay if it were to issue a bond on a given day. BMO began estimating daily spreads for the nine largest provinces in January 2006, and for Prince Edward Island in November 2006. But for the purposes of the regression, I rely on monthly averages, given the infrequent or slow-moving nature of some of the regressors. Spreads are available on 5-, 10-, and 30-year maturities, and rather than favouring one over the other, I estimate separate models for each tenor. Descriptive statistics are shown in table 1.

Baa_t is the proxy for risk aversion identified above: the spread between yields on 10-year corporate bonds rated Baa, or one notch above investment grade, by Moody's and 10-year US treasuries. As with the dependent variable, I calculate monthly averages from daily observations.

OS_1 takes a value of 1 for the first negative oil shock, or the months of September 2015 to March 2016, while OS_2 takes a value of 1 for the second, or March and April 2020.[25] μ_i are province effects, which I interact with the shock dummies.

BO_{it} refers to province i's share of the provincial bond market at month t, which provides a rough proxy for liquidity. I was unable to find a single measure for the period under study. Accordingly, I rely on government finance statistics (GFS) data from 2007 to 2023 and an older Statistics Canada series[26] for 2005 and 2006.[27] Because the GFS data are available only annually, I linearly interpolate the monthly averages. I also interact BO_{it} with the corporate spread to examine whether liquidity moderates the effects of risk aversion.

CR_{it} refers to credit risk, or the average monthly credit rating of province i at time $t + 6$. Unlike debt, deficits, and other measures of credit risk, credit ratings are available daily (even if they change infrequently), which makes it easier to compute monthly averages. Ratings also provide a relatively clean and encompassing measure of credit risk, making them ideal for the objective at hand—which is comparing and controlling for the effects of credit risk broadly rather than isolating its individual components. One common criticism of ratings is that they tend to lag changes in economic and fiscal conditions. Accordingly, I control for ratings at time $t + 6$, or six months into the future, which turns out to be a slightly better predictor than ratings at time t.[28] I calculate the averages in three steps: (1) converting ratings from

25 The 2020 shock begins with the steep monthly decline in oil prices in March and ends in April, the month before prices begin to recover. The 2015-16 shock also ends at a trough, but does not begin until August 2015, several months after oil prices had begun to decline, since it was only then that the declines began to roil financial markets.

26 The series is called "bonds outstanding by currency of payments and issuers," and the measure relies only on direct and guaranteed provincial bonds.

27 Although the data series does not begin until 2006, 2005 data are needed to interpolate the monthly values for 2006.

28 Controlling for the rating at time $t + 6$, rather than time t, does not affect the sign of the coefficients, but it does slightly increase their magnitudes in all 9 models, and their t-statistics in 7 of 9 models.

TABLE 1 Descriptive Statistics for Variables Included in the Regression Analysis

Variable	Mean	Standard deviation	Minimum	Maximum
5-year spread	47.7	19.0	10.2	126.0
10-year spread	77.5	24.6	13.8	170.1
30-year spread	91.2	24.1	27.2	181.5
Corporate spread	202.4	111.0	100.0	788.5
Percentage of bonds outstanding	10.0	13.5	0.27	47.1
Average credit rating	4.3 (AA−)	1.36	0.67 (A−)	7 (AAA+)

Notes: Calculations are based on monthly averages for the period January 2006 to December 2023, or the same sample included in the regression analysis. Spread data for Prince Edward Island do not begin until November 2006.

Moody's, Standard and Poor's, and Morningstar DBRS[29] into numeric scales (where 7 denotes a rating of AAA and 0 denotes a rating of BBB+); (2) adding and subtracting 0.5 for positive and negative outlooks, respectively; and (3) averaging the scales.

λ_t are year dummies. α is the intercept. β_1, β_2, β_3, β_4, and β_5 are the coefficients for Baa_t, OS_1, OS_2, BO_{it}, and CR_{it}, respectively. β_6 is the coefficient for the interaction between Baa_t and BO_{it}, and β'_7 and β'_8 are the coefficients for the interactions between the provincial dummies and the first and second oil shocks, respectively. e_{it} is a stochastic error term.

Regression Results

The regression results are reported in table 2. Estimates for the full model (or the model specified above) appear in models 3, 6, and 9 for 5-, 10-, and 30-year spreads, respectively. The table also includes fixed-effects estimates without the oil shock dummies, and their provincial interactions (columns 2, 5, and 8), and random effects (columns 1, 4, and 7).

I begin with the effects of risk aversion, or the corporate Baa spread, and its interaction with liquidity. As we can see from the sign, the costs of risk aversion actually appear to increase with liquidity. As I explain below, this counterintuitive result is likely spurious. For now, I simply note that the effect of the corporate spread is large. If we focus on the full models and assume an average level of liquidity (or a provincial market share of 10 percent), then a standard deviation increase of 1 in the spread (or an increase of 111 basis points) increases provincial borrowing costs by 17 basis points on a 5-year bond, 19 basis points on a 10-year bond, and 15 basis points on

29 These are the only three agencies that rate all 10 provinces. Fitch rates British Columbia, Saskatchewan, Ontario, and Quebec.

TABLE 2 Determinants of Provincial-Federal Bond Spreads

	5-year			10-year			30-year		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Risk aversion	0.157***	0.158***	0.153***	0.183***	0.183***	0.177***	0.138***	0.142***	0.136***
	(129.27)	(142.08)	(142.39)	(84.96)	(90.54)	(80.86)	(28.45)	(35.20)	(31.45)
Credit rating ($t+6$)	−3.79***	−3.939**	−3.575**	−6.39***	−5.983*	−5.590*	−9.63***	−8.397*	−8.040*
	(−9.05)	(−2.74)	(−2.82)	(−6.40)	(−2.35)	(−2.37)	(−5.08)	(−2.12)	(−2.11)
Liquidity	−0.0443	0.0117	0.0924	−0.102	0.259	0.334	−0.343*	−0.0493	0.00895
	(−1.47)	(0.02)	(0.17)	(−1.33)	(0.25)	(0.34)	(−2.35)	(−0.03)	(0.01)
Liquidity * Risk aversion	0.00003	0.00002	0.00006	0.0002	0.00017	0.00024	0.0006*	0.00022	0.0003
	(0.55)	(0.29)	(0.74)	(0.82)	(0.65)	(0.86)	(1.97)	(0.64)	(0.82)
Oil shock 1			5.219***			2.863			2.048
			(6.81)			(1.82)			(1.19)
Oil shock 2			−3.593			−10.14*			−11.59
			(−1.35)			(−2.15)			(−1.56)
Oil shock 1 * Newfoundland and Labrador			7.319***			14.72***			12.70***
			(9.35)			(11.61)			(7.35)
Oil shock 2 * Newfoundland and Labrador			23.59***			34.83***			42.52***
			(26.11)			(17.55)			(15.52)
Oil shock 1 * Alberta			6.733***			11.33***			12.13***
			(12.00)			(10.68)			(9.01)
Oil shock 2 * Alberta			15.56***			24.94***			27.09***
			(7.17)			(6.43)			(5.12)

(Table 2 is continued on the next page.)

TABLE 2 Continued

	5-year			10-year			30-year		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Oil shock 1 * Saskatchewan			4.675***			11.68***			14.78***
			(8.09)			(8.19)			(7.38)
Oil shock 2 * Saskatchewan			15.95***			27.15***			32.58***
			(11.37)			(8.94)			(7.41)
Oil shock 1 * Prince Edward Island			5.925***			12.40***			11.64***
			(11.68)			(14.62)			(11.01)
Oil shock 2 * Prince Edward Island			11.07***			20.10***			22.52***
			(5.45)			(4.65)			(3.48)
Oil shock 1 * Manitoba			6.754***			11.25***			12.25***
			(15.88)			(12.28)			(10.55)
Oil shock 2 * Manitoba			9.369***			17.41***			21.49***
			(6.40)			(5.73)			(4.89)
Oil shock 1 * New Brunswick			8.118***			9.555***			11.78***
			(13.94)			(9.67)			(9.23)
Oil shock 2 * New Brunswick			9.714***			19.17***			22.34***
			(6.76)			(6.00)			(4.78)
Oil shock 1 * Nova Scotia			6.715***			9.291***			11.02***
			(14.22)			(10.25)			(9.81)
Oil shock 2 * Nova Scotia			5.631**			10.94**			13.07*
			(3.10)			(2.74)			(2.19)

(Table 2 is concluded on the next page.)

TABLE 2 Concluded

	5-year			10-year			30-year		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Oil shock 1 * British Columbia			1.270**			1.505			2.693
			(3.18)			(1.48)			(1.92)
Oil shock 2 * British Columbia			5.481***			9.108**			8.664*
			(4.43)			(3.25)			(2.10)
Oil shock 1 * Quebec			1.021*			0.352			1.760
			(2.38)			(0.47)			(1.82)
Oil shock 2 * Quebec			0.895			0.597			0.989
			(0.86)			(0.25)			(0.27)
Constant	14.19***	12.61	8.040	35.31***	16.54	12.10	81.67***	60.81	57.26
	(6.63)	(0.40)	(0.28)	(7.28)	(0.32)	(0.25)	(9.61)	(0.81)	(0.79)
Overall R^2	0.918	0.922	0.930	0.920	0.926	0.934	0.823	0.897	0.906
Between R^2	0.950	1.000	1	0.945	1	1	0.938	1.000	1
Within R^2	0.917	0.917	0.926	0.919	0.920	0.928	0.805	0.879	0.890
FE	No	Yes	Yes	No	Yes	Yes	No	Yes	Yes
N	2,150	2,150	2,150	2,150	2,150	2,150	2,150	2,150	2,150

Notes: t-statistics are in parentheses. * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$. The dependent variable is the average monthly spread that a province would pay over the government of Canada. All models include fixed year effects. FE refers to fixed province effects. Neither year nor province fixed effects are reported.

a 30-year bond. If we examine the effects across the empirical range of the corporate spread, the effects are 104, 122, and 94 basis points, respectively.

Consider, by contrast, the relatively modest effects of a change in provincial ratings. A one-unit decrease (or an average downgrade of one notch) increases borrowing costs from 4 to 8 basis points in the full models, while a standard deviation decrease, or a decrease of 1.3 notches, raises them only 5 to 10 points. If we measure the effects in terms of standard deviation changes within provinces, which is the most appropriate approach when controlling for fixed provincial effects, the estimates are even smaller, ranging from 1 to 4 basis points on a 10-year bond for nine provinces, to 8 basis points for Alberta (which is the only province with a more variable rating than the provincial sample).

As I note above, sharp increases in global risk aversion have been known to correlate with sharp declines in commodity prices, which might result in even higher spread increases among resource-dependent provinces. To test this, in figures 5A and 5B I report the effects of the 2015-16 and 2020 oil shocks on each province's 10-year spread, while controlling for the variables listed in model 6 of table 2.[30]

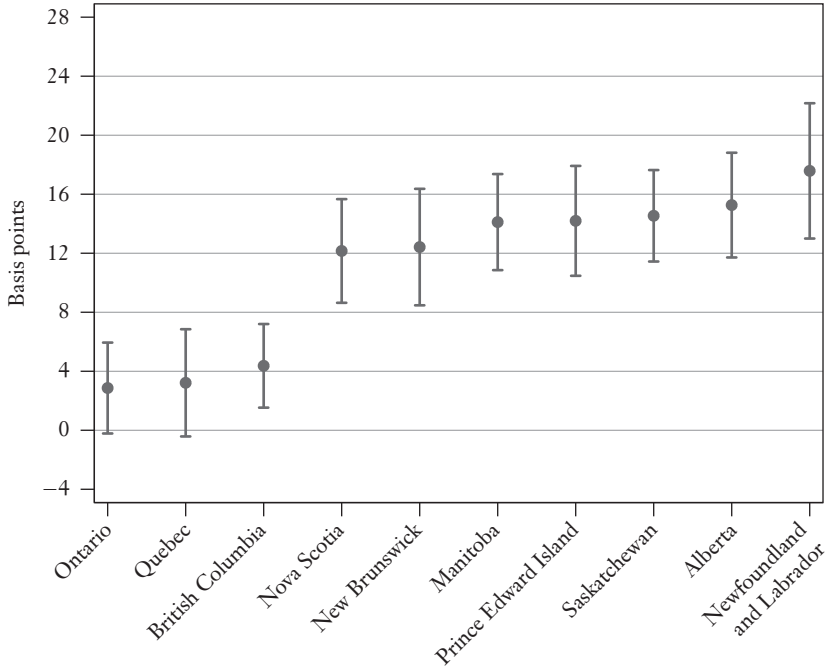
In both instances, the oil-producing provinces fare relatively poorly. They incur the three largest increases in 2020, and three of the four largest increases in 2015-16, though it is only in 2020 that they represent a statistically distinct group (or, more precisely, two statistically distinct groups—namely, Newfoundland and Labrador, which incurs the highest increase, and Alberta and Saskatchewan, which incur the next highest). The effects, while substantial, are notably smaller than the bivariate estimates in figures 4A and 4B. One reason for this is the fact that I have controlled for ratings at time $t + 6$, or at a time when ratings have had a chance to incorporate the effects of shocks that hit oil-producing provinces hardest. From a certain perspective, therefore, the regression estimates underestimate the effects of the shocks on oil producers. From another perspective, though, they help to distinguish the real or more enduring effects of the shock from the sorts of fleeting or psychological effects associated with financial cycles.

The outcomes for Ontario and Quebec are also notable. Both provinces faced negligible and statistically insignificant premiums from the first shock, and actually appear to have benefited, in relative terms, from the second. This is hardly surprising. As the two largest provincial borrowers in Canada—and, indeed, the developed world[31]—they were less affected by the flight to liquidity than others, though their

30 The effects are calculated by summing the effects of the oil shocks and their provincial interaction terms. For Ontario, the reference case, I simply report the estimates for the shocks.

31 S&P Global (www.spglobal.com/en). As of January 2025, the 10 largest subnational borrowers in the developed world were (1) Ontario, (2) Quebec, (3) North-Rhine Westphalia (Germany), (4) New South Wales (Australia), (5) New York state, (6) Victoria (Australia), (7) Queensland (Australia), (8) British Columbia, (9) California, and (10) Alberta. Manitoba was 17th. Ontario is the second-largest subnational issuer in the entire world, just behind the Chinese province of Guangdong (S&P 2025).

FIGURE 5A Effects of the 2015-16 Oil Shock on Provinces' 10-Year Bond Spreads (with 95 Percent Confidence Intervals)



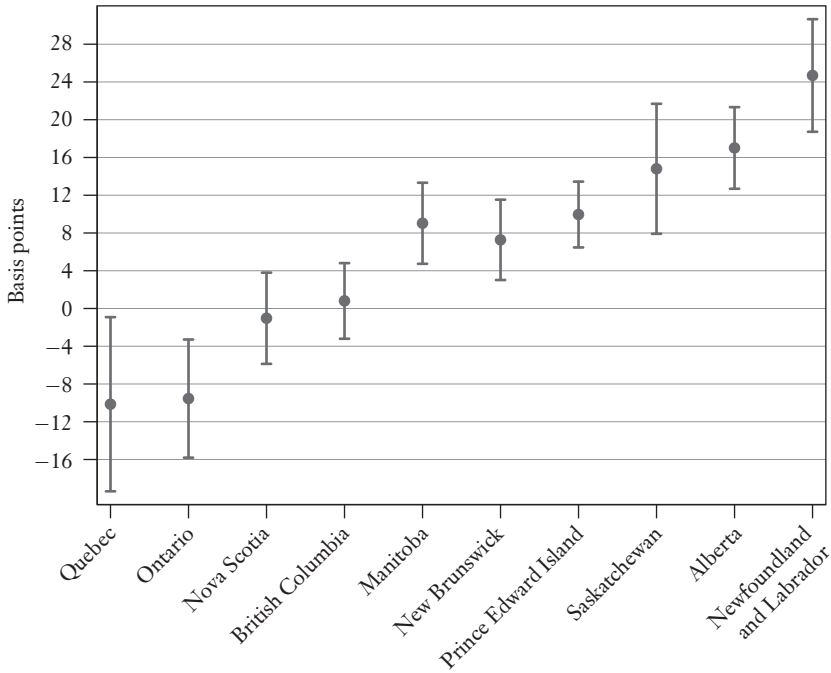
Note: See the notes to figure 5B.

spreads increased with corporate spreads—or our measure of generalized risk aversion—as well.

If liquidity was helpful during the oil shocks, it should be helpful during periods of financial volatility more generally. However, we fail to find any evidence of this. Indeed, liquidity provides clear and statistically significant reductions in spreads only in model 7 of table 2, while the interaction effects suggest that the benefits of liquidity consistently decrease as global volatility rises. What accounts for these counterintuitive results?

One possibility is a failure to account for an important structural break. The oil shock of 2015 was a potential watershed in domestic capital markets, since it was only then that we began to see evidence of severe, if sporadic, dysfunction in provincial markets (with the exception of the global financial crisis). As I explain below, these periods were generally short-lived. But it increased market demand for liquidity, according to underwriters I spoke to at the time, and clearly caught the attention of the Bank of Canada, which began expressing concerns about the growing vulnerability of Canadian markets to global liquidity shocks. I will have more to say about the

FIGURE 5B Effects of the 2020 Oil Shock on Provinces' 10-Year Bond Spreads (with 95 Percent Confidence Intervals)



Notes: Figures 5A and 5B display the estimated effects of major negative oil shocks, along with their 95 percent confidence intervals, on provinces' 10-year bond spreads. The point estimates are the sum of the oil shock coefficients and their provincial interaction effects from model 6 in table 2.

underlying causes of these developments below. For now, I examine the possibility of a structural break by regressing spreads on liquidity—and controlling for risk aversion and credit ratings—by year. The findings, which appear in table 3, suggest that 2015 was, in fact, a critical juncture, because it is only then that liquidity begins to exert a consistently negative and statistically significant effect.[32]

Given this, I decided to re-examine the interaction between risk aversion and liquidity across two periods: 2006-2014 and 2015-2023. The conditional effects, which appear in figures 6A and 6B, reveal a negative relationship between liquidity and spreads, as well as a positive interaction between liquidity and global volatility.

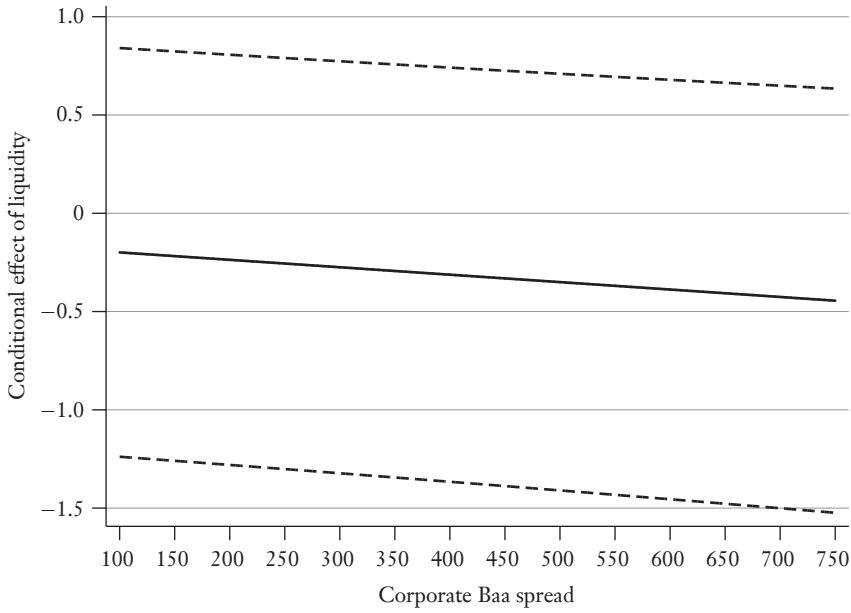
32 This is in sharp contrast to the estimates for risk aversion and average credit ratings, which are statistically significant—and take their expected sign—in nearly every instance. See tables A1 to A3 in the appendix for estimates for these statistical controls.

TABLE 3 Effects of Liquidity on Federal-Provincial Bond Spreads, by Year, 2006-2023

Year	5-year	10-year	30-year
2006	0.0724	0.227*	0.274*
	(−1.37)	(−2.36)	(−2.97)
2007	0.0415	0.113	0.158
	(−0.93)	(−1.5)	(−2.04)
2008	0.000326	0.0396	0.0576
	(−0.01)	(−0.43)	(−0.57)
2009	−0.0329	−0.0438	−0.145
	(−1.44)	(−0.67)	(−1.80)
2010	0.0397	0.0924**	0.0321
	(−1.51)	(−3.49)	(−0.59)
2011	0.0483**	0.0732	0.0354
	(−3.28)	(−2.05)	(−0.61)
2012	0.0413	0.0741	0.0363
	(−1.84)	(−1.06)	(−0.33)
2013	0.0413*	0.0654	0.0142
	(−2.91)	(−1.2)	(−0.15)
2014	0.0493**	0.0458	−0.00914
	(−3.68)	(−0.94)	(−0.12)
2015	−0.107***	−0.218***	−0.299***
	(−5.02)	(−6.10)	(−12.28)
2016	−0.312**	−0.584**	−0.749***
	(−4.29)	(−4.77)	(−6.04)
2017	−0.151*	−0.337**	−0.498***
	(−3.06)	(−3.88)	(−5.02)
2018	−0.128*	−0.272*	−0.387**
	(−2.53)	(−2.94)	(−3.73)
2019	−0.153**	−0.337**	−0.492***
	(−3.58)	(−3.66)	(−4.96)
2020	−0.248**	−0.477***	−0.693***
	(−3.84)	(−1.37)	(−5.33)
2021	−0.0906	−0.177*	−0.331**
	(−1.94)	(−1.37)	(−4.67)
2022	−0.0972*	−0.200**	−0.337***
	(−2.66)	(−1.37)	(−5.58)
2023	−0.0874	−0.145	−0.281*
	(−1.92)	(−1.37)	(−2.83)

Notes: *t*-statistics are in parentheses. * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$. Estimates refer to the effects of liquidity on provinces' monthly bond spreads by year. All models control for average credit ratings and risk aversion. Each year contains 120 observations, with the exception of 2006, which is missing 10 monthly observations for Prince Edward Island. The full results are available in the appendix.

FIGURE 6A Conditional Effect of Liquidity on Provincial Bond Spreads, 2006-2014



Note: See the notes to figure 6B.

But it is only in the second period—2015-2023—that liquidity effects are statistically significant, as shown in table 4. The magnitude of the interaction effect, while by no means massive, is also far from trivial, with a 7-point increase in a province's share of the provincial bond market (or roughly Alberta's increase from 2015 to 2021) reducing borrowing costs by 6 to 14 basis points, depending on the maturity of the bond and the level of risk aversion.

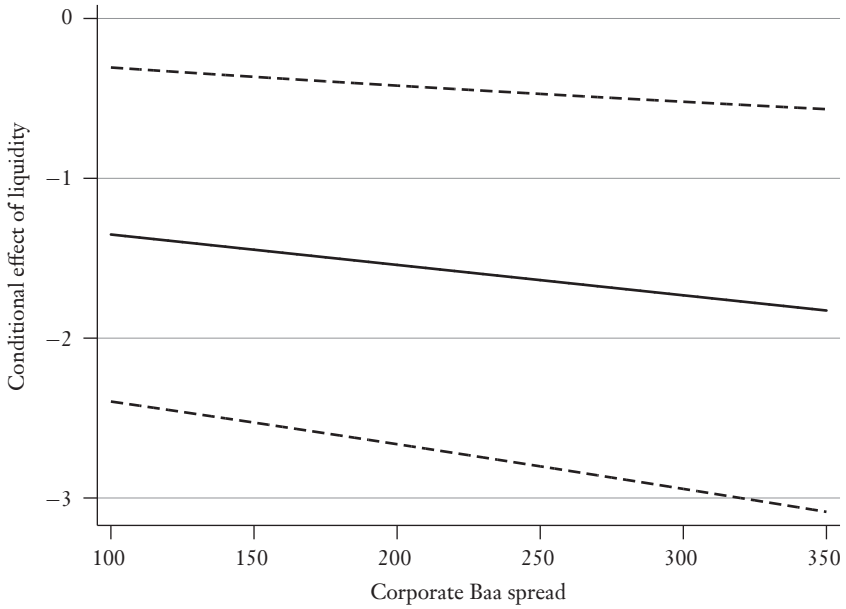
The Global Financial Cycle and Market Access I: 2008-2019[33]

In many respects, bond spreads are the least of provinces' concerns. If volatility in global capital markets becomes too severe, provinces may struggle to borrow. This is precisely what we saw after the Lehman Brothers' default after 2008, and during the early stages of the COVID-19 pandemic in early 2020, as well as two lesser crises, namely, the global commodity bust of 2015-16 and the taper tantrum of late 2018.

To appreciate the nature of the struggle, it helps to understand how the provinces typically borrow. The bulk of provincial bond issues are publicly syndicated: the

33 This section relies heavily on Hanniman, supra note 15.

FIGURE 6B Conditional Effect of Liquidity on Provincial Bond Spreads, 2015-2023



Notes: The solid line is the effect of liquidity (or a province's percentage of the provincial bond market) on 10-year spreads conditional on Moody's corporate Baa spread. The dashed lines are the upper and lower bounds of the 95 percent confidence intervals. Figure 6A refers to estimates for the period 2006-2014 (model 2 in table 4), and figure 6B refers to the period 2015-2023 (model 5 in table 4). The horizontal axis covers the full range of the corporate spread for the period in question. The estimates come from model 2 in table 4.

provinces sell the bonds to a group of investment banks or underwriters, who resell the debt to a broad base of investors. The process really works only if there is a liquid market for outstanding provincial debt. If there is not, it is difficult for underwriters to identify a market-clearing price, making them reluctant to bear the risk.

This does not necessarily preclude a deal, of course, since provinces can always pay a premium above the unreliable market indications. But provinces often choose to sit out such periods and to rely instead on treasury bills and other short-term instruments. Although this approach increases short-term refinancing risk, it avoids overpaying on long-term bonds and spooking investors with desperate spread concessions. It also spares provinces the risk of a failed bond issue—an unlikely but by no means implausible outcome, given the intense selling pressure that investors have faced during recent liquidity events (discussed below).

Fortunately, these time-outs are typically short-lived. But not always. In 2015-16, Newfoundland and Labrador went six months without issuing a long-term bond, despite significant borrowing need. The reasons, according to my discussions with

TABLE 4 Determinants of Provincial-Federal Bond Spreads, by Period, 2006-2014 and 2015-2023

	2006-2014			2015-2023		
	5-year	10-year	30-year	5-year	10-year	30-year
	(1)	(2)	(3)	(4)	(5)	(6)
Risk aversion	0.155***	0.180***	0.139***	0.220***	0.268***	0.249***
	(131.93)	(73.48)	(32.86)	(30.71)	(26.01)	(28.70)
Credit rating ($t + 6$)	−3.988**	−5.110**	−7.069***	−5.820***	−9.207***	−11.66***
	(−2.66)	(−2.69)	(−4.52)	(−4.85)	(−5.35)	(−5.10)
Liquidity	−0.387	−0.148	−0.784	−0.765	−1.266	−1.507
	(−0.68)	(−0.28)	(−1.87)	(−1.91)	(−1.95)	(−1.72)
Liquidity ∗ Risk aversion	−0.000275***	−0.000378*	−0.000607**	−0.00108***	−0.00165***	−0.00160***
	(−5.98)	(−2.48)	(−2.60)	(−3.36)	(−3.61)	(−4.81)
Within R^2	0.9414	0.9585	0.9496	0.893	0.8802	0.8295
Between R^2	1	1	1	1	1	1
Overall R^2	0.944	0.9614	0.9566	0.9071	0.9120	0.8998
FE	Yes	Yes	Yes	Yes	Yes	Yes
YE	Yes	Yes	Yes	Yes	Yes	Yes
N	1,070	1,070	1,070	1,080	1,080	1,080
Provinces	10	10	10	10	10	10

Notes: t-statistics are in parentheses. * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$. The dependent variable is the average monthly spread that a province would pay over the government of Canada. FE refers to fixed province effects and YE to year effects, neither of which are reported.

underwriters, were three. The first was the shock to global oil prices, which contributed to a general rise in financial volatility and forced all provinces to step away from markets for a series of two- to three-week periods, but hit the oil-producing provinces the hardest. The second was the hit to Newfoundland and Labrador's credit rating, which was already among the sector's lowest. The third was the relative illiquidity of the province's debt. One of the best predictors of liquidity is the number of bonds outstanding, and Newfoundland and Labrador has fewer than most. The upshot, according to underwriters, was a sharp rise in the province's latent risk premium, but an inability to determine what, exactly, that premium should be, given the limited trading of the province's debt in secondary markets. Understandably, Newfoundland and Labrador opted to step back and rely on cash management bills—the consequence of which was a sharp rise in its short-term debt and refinancing risk, as can be seen in figure 7.

By the second quarter of 2016, volatility in global capital markets had subsided and provinces and municipalities, including Newfoundland and Labrador, regained uninterrupted access to bond markets. But they would experience another series of two- to three-week disruptions in late 2018, when the US Federal Reserve announced plans to raise interest rates and taper asset purchases made under its quantitative easing program (which accounts for the second spike in Newfoundland and Labrador's short-term debt in figure 7). The announcement sent shock waves throughout global financial markets and provided another example of the vulnerability of provincial governments to the vicissitudes of global markets. But the most profound effects of the global financial cycle were yet to come.

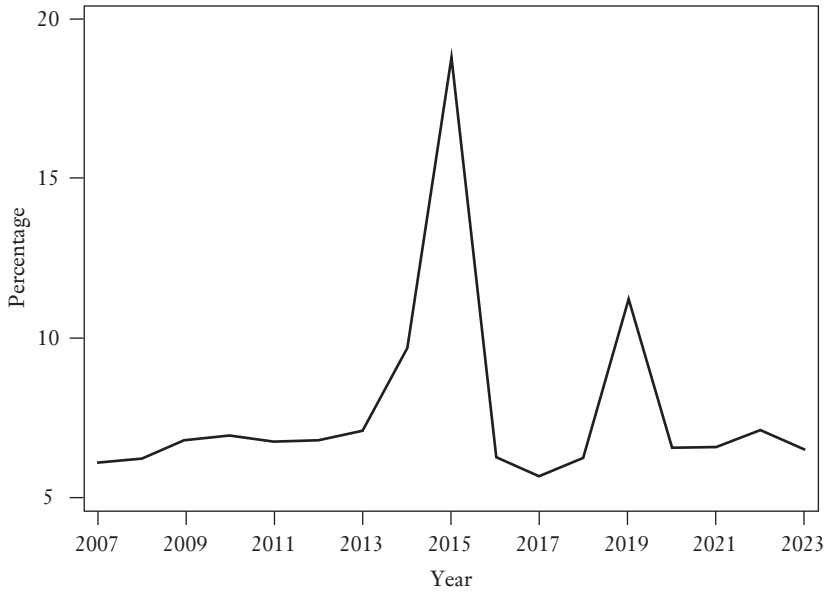
The Global Financial Cycle and Market Access II: COVID-19 and the Bank of Canada's Intervention[34]

In early 2020, governments around the world began closing large parts of the economy in order to prevent the spread of the COVID-19 virus. The initial reaction of bond markets in Canada and around the world was exactly what we would expect: yields on sovereign bonds plunged while spreads on risky assets, including provincial bonds, surged. But this was no ordinary crisis. What began in February as a standard "flight to liquidity" quickly escalated into a "dash for cash," with investors ditching even the world's safest and most liquid assets, including US treasuries and government of Canada bonds.[35] Needless to say, this was not a good environment in which to

34 This section relies heavily on Kyle Hanniman, "Backstopping Provincial Debt: How the Bank of Canada Made Its Move," *C.D. Howe Institute Intelligence Memos*, April 28, 2020 (https://cdhowe.org/publication/kyle-hanniman-backstopping-provincial-debt-how-bank-canada-made-its-move); and Kyle Hanniman, "Pandemic Fiscal Federalism and Future Prospects," in Kathy L. Brock and Geoffrey Hale, eds., *Managing Federalism Through Pandemic* (Toronto: University of Toronto Press, 2023), 173-91.

35 Financial Stability Board, *Holistic Review of the March Market Turmoil* (Basel, Switzerland: Financial Stability Board, November 2020) (www.fsb.org/wp-content/uploads/P171120-2.pdf).

FIGURE 7 Short-Term Debt as a Percentage of Total Debt, Newfoundland and Labrador, 2007-2023



Source: Statistics Canada, "Government Finance Statistics."

borrow. Not a single provincial bond was issued from February 20 to March 18, despite the sector's surging needs. What is more, the provinces' usual well of crisis liquidity, the short-term money markets, had also dried up.

Provinces like Ontario, with more than $30 billion in liquid reserves, could afford to wait out the drought. Others, however, including Newfoundland and Labrador, were running out of cash. Premier Dwight Ball's leaked letter to the prime minister in March 2020 captures the province's desperation: "To put it bluntly, our recent attempts to finalize our borrowing program, both short term and long term, have been unsuccessful. We have no other [resources] to raise the necessary funds to maintain the operations of government, including our health care system. . . . Our Province has run out of time. Your attention is urgently required."[36]

The prospect of provincial default was untenable. The government of Canada had to respond. But how? Manitoba premier Brian Pallister, whose province was rapidly depleting its rainy day fund, suggested the establishment of a standing federal

36 Government of Newfoundland and Labrador, Office of the Premier, letter to the Prime Minister of Canada, March 20, 2020 (www.documentcloud.org/documents/6823548-Letter-to-Prime-Minister.html).

credit mechanism to lend to provinces at federal rates, a proposal that all 10 premiers supported.[37]

Ultimately, however, it was the Bank of Canada that came to the rescue, launching nearly a dozen liquidity and asset purchase programs from March 12 to April 12.[38] Many of the measures supported provincial debt markets indirectly, including the bankers' acceptance purchase facility, which freed up dealer banks' balance sheets to buy provincial debt, and large-scale purchases of government of Canada bonds, which stabilized the financial system's benchmark asset. The Bank of Canada also took two measures to support provincial debt markets directly: (1) the provincial money market purchase (PMMP) program, which began buying up to 40 percent of each province's short-term debt offerings on primary markets on March 25; and (2) the provincial bond purchase program (PBPP), a one-year commitment to buy up to $50 billion of provincial bonds with maturities of 10 years or less on secondary markets. The PBPP began buying provincial bonds on May 7.

The effects were dramatic. The provinces' 10-year bond spreads fell an average of 21 basis points the day the PBPP was announced,[39] and they continued to fall, albeit in a less dramatic and linear fashion, in the months that followed.

Just how critical the PMMP and PBPP were to stabilizing provincial bond markets is difficult to say. Most agree that the PMMP was essential when it was first introduced, while the need for the PBPP has been debated.[40] The provinces were borrowing at a torrid rate when the PBPP was announced—issuing more than $8 billion the previous day and $20 billion for the month of April, shattering previous daily and monthly records. Even Newfoundland and Labrador, widely reported to be running out of cash, managed to issue $500 million in 5- and 30-year bonds in early April, while Alberta managed to issue $300 million in 100-year bonds at 3.06 percent in June.

However, the Bank of Canada would have been aware of details most observers were not. While issuance was spectacular, market conditions were anything but. Secondary trading was thin and provincial bonds had few buyers—precisely the conditions that provinces and their underwriters usually try to avoid. But this time was different: borrowing needs were soaring, the economy was experiencing its fastest contraction on record, and a pandemic was afoot. So, the provinces ventured out, stockpiling liquidity just as quickly as markets would supply it. However, rather than raising it through the standard, publicly syndicated format, they placed nearly all of

37 Government of Manitoba, "Canada's Premiers Support Provincial Borrowing Initiative Championed by Manitoba," *Press Release*, April 6, 2020.

38 Mark Rendell and David Parkinson, "'Are We Going To Be Able to Pull This Off?': How the Bank of Canada Doused a Financial Fire Last Spring," *Globe and Mail*, March 27, 2021 (www.theglobeandmail.com/business/article-are-we-going-to-be-able-to-pull-this-off-how-the-bank-of-canada-doused).

39 Hanniman, "Backstopping Provincial Debt," supra note 34.

40 Warren Lovely and Taylor Schleich, "RIP PBPP" (2021) 5:24 *National Bank of Canada Financial Markets* 1-4 (www.nbc.ca/content/dam/bnc/en/rates-and-analysis/economic-analysis/market_view_210218.pdf).

it privately with a small number of well-heeled investors. This gave lenders considerable leverage, which they used to extract exotic tenors and spread concessions.[41] The level and pace of issuance were not a sign of market strength, in other words, but a combination of market weakness and provincial desperation. It was against this backdrop that the Bank of Canada decided to act.

Ultimately, the PBPP bought roughly 50 percent of the program's $50 billion bond limit, and it expired on schedule on May 6, 2021. The PMMP was wound down in November 2020.

THE GLOBAL FINANCIAL CYCLE IS EVOLVING

As I showed in the previous section, the global financial cycle is evolving. Two developments stand out. The first is the growing severity and frequency of market disruptions, beginning with the partial closure of provincial bond markets in 2015-16. The second is the growing vulnerability of sovereign borrowers. The most dramatic example was the 2020 dash for cash. But we also saw it in the market reactions to the United Kingdom's proposed mini-budget in 2022, and the announcement of President Trump's "Liberation Day" tariffs in April 2025. Both resulted in sharp increases in yields on traditionally safe assets. What accounts for these developments?

1. *Shifting investor base.* Growing shares of government bonds are held by nonbank financial institutions. Rather than loading up on sovereign debt during periods of volatility, these investors are often forced to sell it—whether to unwind leveraged positions in the case of hedge funds, or to meet redemptions or margin calls in the case of asset managers.[42] This shift has been evident in a wide range of sovereign bond markets, including Canada's,[43] and has been linked to disruptions in provincial bond markets as well.[44]
2. *Reduced market-making capacity.* Just as forced selling has increased, the capacity of banks to modulate it has declined. This is partly a consequence of the substantial growth in the sovereign and corporate bond markets in recent years.[45] But it is also a consequence of the additional capital and liquidity

41 By spread concessions, I mean spreads in excess of the unreliable indications that underwriters were receiving from secondary markets.

42 Bank for International Settlements, *BIS Annual Economic Report, June 2025* (Basel, Switzerland: BIS, 2025); and International Monetary Fund, *Global Financial Stability Report: Enhancing Resilience amid Uncertainty* (Washington, DC: IMF, April 2025).

43 David Cimon, Jean-Philippe Dion, Jean-Sébastien Fontaine, and Jabir Sandhu, *Will Asset Managers Dash for Cash? A Summary of the Implications for Central Banks*, Bank of Canada Staff Discussion Paper 2025-5 (Ottawa: Bank of Canada, 2025); and Adam Epp and Jeffrey Gao, *Are Hedge Funds a Hedge for Increasing Government Debt Issuance?* Bank of Canada Staff Discussion Paper 2025-7 (Ottawa: Bank of Canada, 2025).

44 Tiff Macklem, Timothy Lane, Lawrence Schembri, Paul Beaudry, and Toni Gravelle, *Financial System Review 2021* (Ottawa: Bank of Canada, May 2021).

45 Bank for International Settlements, supra note 42.

requirements that dealer banks have faced in the aftermath of the global financial crisis, which have increased their balance sheet constraints.

3. *Emergence of credit and inflation risk.* Government debts and deficits in most advanced economies are large and growing, while global interest rates have risen from historic lows. For countries that borrow in their own currency, the risk of technical default is still virtually nil. The real fear, however, is fiscal dominance: a situation in which central banks are forced to compromise their inflation targets in order to keep government borrowing affordable. As students of emerging markets know, the strategy does not work. Rather than lowering borrowing costs, it merely results in higher inflation premiums. Neither Canada nor the majority of advanced economies are at this point. However, markets are growing increasingly sensitive to changes in fiscal fundamentals as pressures for higher spending and lower taxes, and the number of reckless policy decisions and proposals, all increase.
4. *Developments in the United States.* US treasuries are the world's benchmark asset. If yields on treasuries rise, yields on other assets will rise as well. What is new is the reason why yields are increasing. It used to be primarily because of changes in the federal funds rate and growth expectations. Increasingly, however, it is also driven by technical factors (including forced selling and reduced market-making capacity) and concerns about inflation and credit risk. The best evidence of this was the double depreciation of the US dollar and US treasuries after the announcement of the "Liberation Day" tariffs—a reaction one expects of emerging-market assets, not the world's pre-eminent reserve currency and benchmark financial asset.

Of course, if US treasuries become too risky, their benchmark status may be lost. Until recently, this possibility seemed almost inconceivable. But under Trump 2.0, virtually every source of dollar supremacy—whether it is fiscal probity, the rule of law, data integrity, government functionality, or central bank independence—is under attack. Whatever the long-term implications of this development might be, the short-term consequences are likely to be fraught with enormous uncertainty, volatility, and risk.

CONCLUSION

In this article, I have identified a clear relationship between provincial borrowing conditions and the global financial cycle. Global risk aversion contributes to higher provincial spreads and can even result in loss of market access. The spread increases tend to be higher among oil-producing provinces, particularly when spikes in global risk aversion are associated with negative oil shocks, and lower among provinces such as Ontario and Quebec with relatively liquid pools of debt. I have also argued that the global financial cycle is evolving. We see it in the growing frequency and severity of financial disruptions, and the growing vulnerability of sovereign borrowers to global shocks and domestic policy decisions.

What can provinces do to mitigate the risks and challenges associated with the global financial cycle? One rarely discussed measure is prudent debt management. On this score, the provinces fare quite well. They rely on fixed rather than variable interest rate debt; assume virtually zero foreign-currency risk; and have done an excellent job of extending the average weighted maturity of their bonds, a measure that has helped to protect their budgets from rising interest rates. Most provinces also stay well ahead of their annual borrowing schedules, helping to bolster their cash buffers in the event of another liquidity crisis.

But it is not just how you borrow; it is also how much. And although the sector's ratio of debt to GDP is slightly lower than it was pre-pandemic, it remains high by historical standards, has begun to rise again recently, and is likely to continue to rise on account of rising health-care costs.[46] The question before the provinces and the federal government is how to reverse this trend while ensuring that other objectives—including adequate provision of provincial services and investments in infrastructure—are met.

This will require significant levels of fiscal capacity and discipline. The problem, as I have argued elsewhere,[47] is that Canada's system of fiscal federal governance fails to supply enough of either. The vertical fiscal imbalance robs provinces of revenues and fiscal capacity, while the belief, widely held among provincial bondholders, that Ottawa is unlikely to let a province default undermines fiscal discipline. The risk, with the emergence of the Bank of Canada as a lender and market maker of last resort, is that the incentives for fiscal discipline will erode even further.

The risk is not lost on the Bank of Canada, which recently undertook a review of its exceptional policy actions during the pandemic, along with a series of changes that it would consider if similar measures were needed again.[48] These changes include broader use of penalty rates[49] and greater clarity around exit conditions, both measures with the potential to limit moral hazard among provinces and other borrowers. But deliberations are still in their early stages, and plenty of questions about the viability and wisdom of various policy options remain. If this article achieves anything, I hope it is to encourage broader engagement with these issues.

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46 Trevor Tombe, "Provincial Finances Are in Worse Shape Than the PBO Suggests," *The Hub*, September 19, 2024 (https://thehub.ca/2024/09/19/trevor-tombe-provincial-finances-are-in-worse-shape-than-the-pbo-suggests/).

47 Kyle Hanniman, "Fiscal Federalism, Governance, and Provincial Debt," in André Lecours, Daniel Béland, Trevor Tombe, and Eric Champagne, eds., *Fiscal Federalism in Canada: Analysis, Evaluation, Prescription* (Toronto: University of Toronto Press, 2023), 176-91; and Kyle Hanniman, "COVID-19, Fiscal Federalism and Provincial Debt: Have We Reached a Critical Juncture?" (2020) 53:2 *Canadian Journal of Political Science* 279-85.

48 Bank of Canada, *Review of the Bank of Canada's Exceptional Policy Actions During the Pandemic* (Ottawa: Bank of Canada, January 17, 2025).

49 A penalty interest rate is an interest rate that is considered attractive under distressed market conditions but unattractive under normal ones.

APPENDIX

TABLE A1 Determinants of Provincial-Federal Bond Spreads, by Year, 2006-2023 (5-Year Bonds)

Year	Liquidity	Risk aversion	Credit rating ($t+6$)	R^2
2006	0.0724	0.275***	−1.528**	0.674
	(1.37)	(12.06)	(−4.77)	
2007	0.0415	0.207***	−1.029***	0.936
	(0.93)	(133.12)	(−5.03)	
2008	0.000326	0.136***	−1.213***	0.932
	(0.01)	(136.85)	(−9.07)	
2009	−0.0329	0.170***	−2.560***	0.981
	(−1.44)	(104.68)	(−10.42)	
2010	0.0397	0.220***	−3.335***	0.361
	(1.51)	(25.71)	(−5.55)	
2011	0.0483**	0.127***	−3.325***	0.888
	(3.28)	(25.54)	(−8.41)	
2012	0.0413	−0.0321***	−4.496***	0.665
	(1.84)	(−6.59)	(−9.57)	
2013	0.0413*	0.205***	−4.011***	0.782
	(2.91)	(16.4)	(−14.32)	
2014	0.0493**	0.0629*	−5.071***	0.908
	(3.68)	(2.51)	(−14.03)	
2015	−0.107***	0.446***	−3.372***	0.721
	(−5.02)	(30.63)	(−12.79)	
2016	−0.312**	0.177***	−6.121***	0.889
	(−4.29)	(24.47)	(−7.29)	
2017	−0.151*	0.491***	−3.850***	0.863
	(−3.06)	(19.55)	(−8.14)	
2018	−0.128*	0.198***	−3.139***	0.74
	(−2.53)	(19.86)	(−7.45)	
2019	−0.153**	0.347***	−3.051***	0.871
	(−3.58)	(52.21)	(−9.00)	
2020	−0.248**	0.199***	−5.153**	0.889
	(−3.84)	(18.49)	(−4.24)	
2021	−0.0906	0.308***	−2.822***	0.736
	(−1.94)	(34.51)	(−7.78)	
2022	−0.0972*	0.124***	−2.763***	0.67
	(−2.66)	(23.71)	(−5.60)	
2023	−0.0874	0.107***	−3.192***	0.756
	(−1.92)	(16.77)	(−7.88)	

Notes: *t*-statistics are in parentheses. * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$. The dependent variable is the average monthly spread that a province would pay over the government of Canada.

TABLE A2 Determinants of Provincial-Federal Bond Spreads, by Year, 2006-2023 (10-Year Bonds)

Year	Liquidity	Risk aversion	Credit rating ($t+6$)	R^2
2006	0.227*	0.365***	−3.48***	0.787
	(2.36)	(8.92)	(−8.07)	
2007	0.113	0.178***	−2.470***	0.909
	(1.5)	(49.04)	(−8.56)	
2008	0.0396	0.164***	−2.922***	0.944
	(0.43)	(61.92)	(−6.63)	
2009	−0.0438	0.191***	−5.318***	0.976
	(−0.67)	(55.48)	(−11.80)	
2010	0.0924**	0.346***	−4.963***	0.559
	(3.49)	(52.48)	(−10.60)	
2011	0.0732	0.207***	−5.215***	0.881
	(2.05)	(38.32)	(−7.73)	
2012	0.0741	−0.0307*	−6.942***	0.725
	(1.06)	(−2.96)	(−10.08)	
2013	0.0654	0.198***	−6.127***	0.843
	(1.2)	(9.23)	(−10.14)	
2014	0.0458	0.0368**	−6.654***	0.902
	(0.94)	(3.55)	(−12.50)	
2015	−0.218***	0.540***	−5.658***	0.89
	(−6.10)	(23.52)	(−13.68)	
2016	−0.584**	0.244***	−9.470***	0.873
	(−4.77)	(36.3)	(−5.90)	
2017	−0.337**	0.593***	−6.199***	0.869
	(−3.88)	(13.44)	(−9.48)	
2018	−0.272*	0.266***	−5.268***	0.79
	(−2.94)	(16.55)	(−9.51)	
2019	−0.337**	0.359***	−5.328***	0.855
	(−3.66)	(20.9)	(−9.56)	
2020	−0.477***	0.224***	−8.170***	0.9
	(−5.30)	(17.87)	(−6.29)	
2021	−0.177*	0.173***	−4.728***	0.798
	(−3.02)	(5.17)	(−6.49)	
2022	−0.200**	0.225***	−4.565***	0.82
	(−4.00)	(19.43)	(−5.36)	
2023	−0.145	0.0965***	−5.820***	0.822
	(−2.12)	(6.47)	(−6.59)	

Notes: t-statistics are in parentheses. * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$. The dependent variable is the average monthly spread that a province would pay over the government of Canada.

TABLE A3 Determinants of Provincial-Federal Bond Spreads, by Year, 2006-2023 (30-Year Bonds)

Year	Liquidity	Risk aversion	Credit rating ($t+6$)	R^2
2006	0.274*	0.0132	−4.898***	0.778
	(2.97)	(0.14)	(−6.96)	
2007	0.158	0.129***	−4.244***	0.829
	(2.04)	(36.88)	(−12.42)	
2008	0.0576	0.133***	−4.946***	0.963
	(0.57)	(33.63)	(−9.26)	
2009	−0.145	0.136***	−7.489***	0.951
	(−1.80)	(28.46)	(−11.07)	
2010	0.0321	0.303***	−5.628***	0.576
	(0.59)	(78.05)	(−7.52)	
2011	0.0354	0.144***	−5.663***	0.843
	(0.61)	(18.73)	(−5.95)	
2012	0.0363	−0.0479**	−7.520***	0.709
	(0.33)	(−4.37)	(−6.82)	
2013	0.0142	0.166***	−6.681***	0.764
	(0.15)	(7.64)	(−6.21)	
2014	−0.00914	0.104***	−6.987***	0.856
	(−0.12)	(6.34)	(−9.52)	
2015	−0.299***	0.534***	−6.513***	0.917
	(−12.28)	(22.02)	(−15.75)	
2016	−0.749***	0.191***	−10.84***	0.892
	(−6.04)	(23.65)	(−7.54)	
2017	−0.498***	0.803***	−8.102***	0.886
	(−5.02)	(10.77)	(−9.87)	
2018	−0.387**	0.316***	−7.194***	0.833
	(−3.73)	(17.6)	(−10.74)	
2019	−0.492***	0.376***	−8.012***	0.884
	(−4.96)	(23.58)	(−13.20)	
2020	−0.693***	0.200***	−11.57**	0.841
	(−5.33)	(18.03)	(−4.68)	
2021	−0.331**	0.365**	−8.006**	0.805
	(−4.67)	(4.43)	(−4.44)	
2022	−0.337***	0.235***	−7.490**	0.832
	(−5.58)	(15.83)	(−4.28)	
2023	−0.281*	0.0946***	−10.04***	0.899
	(−2.83)	(5.22)	(−6.52)	

Notes: *t*-statistics are in parentheses. * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$. The dependent variable is the average monthly spread that a province would pay over the government of Canada.

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Selected US Tax Developments

Co-Editors: Peter A. Glicklich* and Michael J. Miller**

BRUYEA CONFIRMS TREATY-BASED CREDITS FOR US CITIZENS IN CANADA—A SEQUEL TO CHRISTENSEN

*Jonathan Rhein and Zaira Cortés****

US citizens residing in Canada have faced uncertainty whether foreign tax credits can be used against the US net investment income tax. While US domestic law does not permit it, the US Court of Federal Claims in two cases, *Christensen* and *Bruyea*, held that US tax treaties with France and Canada create a foreign tax credit against the net investment income tax. With these cases now on appeal, the Federal Circuit will review the decisions of the Court of Federal Claims. A final decision in *Bruyea* will affect Canadian-resident US citizens evaluating future credit positions and refund claims with respect to the net investment income tax.

KEYWORDS: DOUBLE TAXATION ■ FOREIGN TAX CREDITS ■ FOREIGN TAXES ■ INDIVIDUAL INCOME TAXES ■ TAX CASES ■ TAX TREATIES

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1 Jonathan Rhein, "Canadian Residents Who Are US Citizens May Be Able To Credit Canadian Taxes Against the US Net Investment Income Tax," Selected US Tax Developments feature (2023) 71:4 *Canadian Tax Journal* 1171-76.

2 *Christensen v. US*, No. 20-935T (Fed. Cl. September 13, 2023).

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Current Tax Reading

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

Don Drummond, "Tax Reform To Raise Canada's Pitiful Productivity" (2025) 18:19 *SSP Briefing Papers* [University of Calgary School of Public Policy] 1-8

While it was not announced in the federal budget of November 2025, I feel reasonably confident that tax reform is coming to Canada. It may begin with a formal commission, or it may be rolled out as a series of on-the-fly measures by a government currently led by an economist, but it is coming, and it will be overdue.

Don Drummond, one of Canada's leading policy economists, begins this briefing paper with headline numbers of the sort now familiar to many: he cites estimates indicating that Canada's productivity per hour of labour dropped from 90 percent of US productivity in the 1980s to less than 70 percent of US productivity in 2021. (By way of disclosure, I note that Drummond has served on the steering committee of the Productivity Partnership/Partenariat productivité,[1] a research program that I direct.)

In considering these numbers, it is worth noting that the measured productivity performance of most countries has been left in the dust by the United States, though generally not by as much as Canada's has. To some extent, US growth over the past few decades has been fuelled by the extraordinary capacity of successive US administrations to run large federal budget and social security deficits,[2] but it must also be

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1 See the website www.productivitypartnership.ca.

2 The United States' federal deficit is roughly $2 trillion and its accumulated debt is close to $40 trillion. About a fifth of that debt is intra-governmental debt, including that owed to the Old-Age and Survivors Insurance Trust Fund. Fund trustees projected that the fund would be depleted in 2023, after which it would be able to pay only 77 percent of benefits. United States, Department of Treasury, Fiscal Data, "What Is the National Deficit?" (https://fiscaldata.treasury.gov/americas-finance-guide/national-deficit); United States, Department of Treasury, Fiscal Data, "What Is the National Debt?" (https://fiscaldata.treasury.gov/americas-finance-guide/national-debt); and Social Security Administration, "Social Security Board of Trustees: Projection for Combined Trust Funds One Year Sooner Than Last Year," *Social Security Matters* blog, June 20, 2025 (https://blog.ssa.gov/social-security-board-of-trustees-projection-for-combined-trust-funds-one-year-sooner-than-last-year).

admitted that Canada's overall budget picture is not as superior as comparisons at the federal level would suggest, because of considerable deficits and debt at the provincial and municipal government levels.[3]

Drummond's main concern is with taxes that have blunted incentives in Canada, particularly the incentive to invest. He advocates lowering general corporate income tax rates, from 15 percent to 13 percent, and lowering the second personal income tax bracket rate, from 20.5 percent to 15 percent. He recommends paying for these measures by a shift to consumption taxes—specifically, by increasing the goods and services tax (GST) rate from 5 percent to 7 percent. He proposes changes in the scientific research and experimental development tax credit to shorten lags in the delivery of the credit and to make it refundable, in order to improve its incentive properties;[4] a preferential tax rate on income from Canadian-generated intellectual property; and targeted measures to encourage venture capital. He also favours increasing the incentives for helping small businesses to grow, noting that the lower federal tax rate of 9 percent for small businesses, compared with the 15 percent rate for larger business, may be "considered a large subsidy for firms that remain small."[5] Finally, he argues that a review of the corporate tax system should consider a general investment tax credit and a proposal by Jack Mintz[6] that would make profits that are reinvested in Canada exempt from tax.

Drummond's recommendations are consistent with proposals that emphasize investment—for example, his own joint work with Robson and Laurin,[7] as well as proposals by Mintz (mentioned above), Trevor Tombe,[8] and the Coalition for a Better Future.[9] There are also other proposals that are not necessarily incompatible,

3 The Organisation for Economic Co-operation and Development estimates that all US government debt is 122.9 percent of gross domestic product, while in Canada the comparable number is 107.3 percent. In any case, it can be argued that regardless of any comparisons with any country, it is in Canada's interest to be more productive, permitting a higher standard of living and maintenance of the safety net.

4 William B.P. Robson, Don Drummond, and Alexandre Laurin, *Putting Canada's Economy First: The C.D. Howe Institute's 2025 Shadow Budget*, C.D. Howe Institute Commentary no. 679 (Toronto: C.D. Howe Institute, March 2025).

5 At 7.

6 Jack Mintz, "A Proposal for a 'Big Bang' Corporate Tax Reform" (2022) 15:7 *SPP Research Papers* [University of Calgary School of Public Policy] 1-26.

7 Robson et al., supra note 4.

8 Trevor Tombe, "DeepDive: What a Pro-Growth Tax Reform Might Look Like," *The Hub*, June 24, 2024 (https://thehub.ca/2024/06/24/deepdive-what-a-pro-growth-tax-reform-might-look-like).

9 Coalition for a Better Future, *Off Target: Canada's Uncertain Path to a Better Future—Coalition for a Better Future Scorecard Update* (Ottawa: Coalition for a Better Future, March 2025) (https://static1.squarespace.com/static/63dbf842797d5000eb7ede22/t/67dcdec74e4345378f098ba3/1742528208486/Coalition+2025+Scorecard+Report-English_web.pdf).

although perhaps they take reform ideas in different directions. Social Capital Partners,[10] for example, favour tax proposals to stimulate local and community investment, especially for employee-owned firms. Fuss and Palacios[11] recommend incentives but also argue more for changes in personal income taxation. Specifically, they propose eliminating $32 billion of tax expenditures—including the Canada employment credit, the non-taxation of health and dental benefits, the child-care expense deduction, the deduction for union and professional dues, the employee stock option deduction, the age credit, pension income splitting, the pension income credit, the medical expense tax credit, the disability tax credit, the charitable donation tax credit, and the tuition tax credit—in order to reduce marginal personal income tax rates. They aim for the same 15 percent second bracket that Drummond aims for, along with a reduction in the top federal bracket, from 33 percent to 29 percent.

I remain doubtful[12] that big tax paradigm shifts such as a return to a 7 percent GST are in the cards, even though I personally believe that they would improve Canada's productivity outlook. More probable in my view is that future investment incentives, whatever they turn out to be, will be largely paid for with borrowed money. The path of ballooning federal deficits, particularly given the current government's commitment to raise defence spending, is riskier than the one that Drummond proposes, but it is, sadly, the more likely one.

MV

Guy Lacroix and Pierre-Carl Michaud, "Tax Incentives and Older Workers: Evidence from Quebec's Tax Credit for Career Extension" (2025) 51:3 *Canadian Public Policy/Analyse de politiques* 265-83 (https://doi.org/10.3138/cpp.2024-058)

This is an article that makes me feel more optimistic. It presents detailed empirical work showing that a particular Quebec tax preference was ineffective. It also reports that the evidence cited in the article was acknowledged to be a contributing factor in the government's decision to remove a significant feature of the tax preference. Research mattered!

In 2012, the government of Quebec implemented a non-refundable tax credit to encourage workers aged 65 and older to remain employed. The maximum credit was increased over time to about $1,600 and could function as a wage subsidy of up to 11 percent for low-income earners (though it was clawed back to zero for those

10 Social Capital Partners, *Social Capital Partners' 2025 Federal Pre-Budget Submission* (Toronto: Social Capital Partners, August 2025).

11 Jake Fuss and Milagros Palacios, *Enhancing Economic Growth Through Federal Personal Income Tax Reform* (Vancouver: Fraser Institute, 2024).

12 See Michael R. Veall, "Biting Off More Than We Can Chew: Against Incorporating a Paradigm Shift in a Growth-Oriented Tax Reform" (2023) 4:4 *Perspectives on Tax Law & Policy* 11-13.

earning more than $60,000, with some variation depending on age). Concurrently, eligibility was extended to lower ages over time until, by 2019, the credit could be claimed by workers as young as 60. The associated tax expenditure was projected to reach almost $400 million by 2024.

During this period, the labour market participation of older workers increased—an effect that could potentially be attributed to the program. However, a confounding factor in the analysis of the program was an earlier trend for labour market participation of older workers in Quebec. Was the increase in participation dating from 2012 an effect of the policy, or was it just a continuation of the earlier trend? Lacroix and Michaud begin their investigation with a comparison to Ontario, which had no such program, and with confidential, anonymized data from Statistics Canada's Labour Force Survey, which allows precise identification of the age of workers—clearly, a critical factor in such analysis. The authors found no robust evidence that the program had an effect on employment of the older population. However, they found that the trends in Ontario that predated the policy were dissimilar to the trends in Quebec, which led them to consider other forms of analysis.

These other forms of analysis, like the original analysis, tried to incorporate the timing of entry into program eligibility as well as changes in the program over time. However, doing this is more complicated than using Ontario as a control group and Quebec as a treated group. For example, if pre-eligible (younger) individuals in Quebec are used as a control group while eligible individuals in Quebec are used as a treated group, there is an obvious problem: the control group will eventually become the treated group. The resulting econometric issues are complex but, suffice it to say, the authors again found no robust evidence that would suggest that the program had either an economically or a statistically significant effect.

In terms of policy, the difficulty is familiar—namely, achieving additionality. Presumably, the architects of such a program would ideally like to target older individuals who would be swayed by the tax incentive to remain or become employed but who would choose to not be employed without the tax incentive. That would demonstrate additionality and make the program cost-effective. The problem, however, is that everyone eligible will receive the tax preference, and the authors' results suggest that the number of people who were actually incentivized by the program was very small, so that it scored poorly in terms of bang for the buck, whether the goal was more employment or more tax revenue. The issue of additionality is also considered, in a different context, in my discussion of Borenstein and Davis, further below.

As mentioned above, after this research was largely completed but before it was published, the Quebec minister of finance removed program eligibility for those aged 60 to 62, citing these research findings. The evidence regarding the program's ineffectiveness is largely the same for those aged 65 and older, but at least the number of low-income workers at that age is much smaller. As a result of the change, the program cost has been significantly reduced.

MV

Ross Hickey, A. Abigail Payne, and Justin Smith, "Tax-Reported Charitable Giving in Canada, 1987-2018" (2025) 51:3 *Canadian Public Policy/Analyse de politiques* 284-97 (https://doi.org/10.3138/cpp.2024-050)

This article uses anonymized tax microdata to describe trends in tax-reported charitable giving in Canada since the late 1980s. The authors report that in 2019 Canadians claimed charitable donations of just over $10 billion, with a median personal donation of $310. Because the data are longitudinal, the authors can study how individual observations vary over time and by individual characteristics. The article is descriptive with charts and tables. It is a must-read for those interested in trends in Canadian charitable giving, who I expect would urge the authors to update the analysis to include more recent years.

The most important finding is probably that real average donations have been essentially flat over this period. They did rise from the mid-1990s to the financial crisis of 2008, but in subsequent years they fell back to pre-crisis levels. Until the crisis, charitable donations were a steady fraction of overall income, but since then that fraction has fallen. Moreover, the percentage of Canadians who reported any charitable contributions has fallen over time, and more recently the decline has accelerated.

In the early 1990s, the top 10 percent of income earners gave roughly 38 percent of all reported donations. That share rose to 51 percent of all donations by 2018. The top 0.01 percent of income earners (that is, the top ten-thousandth) gave 2.2 percent of all reported donations in 1990, and that value rose to 8.4 percent by 2018. Among those with high incomes, average donations increased, as did the variability in donation amounts across individuals.

The authors observe that, over people's lifetimes, giving as a fraction of income increases steadily with age, but the share of people who give reaches a maximum at a relatively young age. For example, of those born in 1980, the share of individuals with tax-reported donations has already flattened: its maximum of 30 percent was reached in 2016, when this cohort was 36 years of age. Of course, it is possible that this plateau will only be temporary and an upward trend will resume, but this was not the pattern for earlier cohorts. Of those born in 1940, the share of givers hit a maximum of 52 percent in 1990, when they were 50 years old, then plateaued for several years before falling fairly sharply. The trend over time has been consistent, with a lower maximum share for each new cohort and an earlier year of achievement of that maximum.

The authors conduct a special analysis for sets of filers who are observed in the longitudinal data continuously for 10 years. They find that people who give tend to give every year, or close to that, with people with higher incomes being more likely to follow this pattern. Of those who do not give every year, there are relatively few who give roughly half the time; more commonly, such individuals report gifts almost every year or every few years.

There are large differences by province. In 2018, for example, Albertans had average reported gifts of $700 while those from Quebec, outliers on the low end,

had average reported gifts of about $150. Income plays a role but cannot completely explain such a difference. The authors provide no new evidence on provincial disparities but point to the findings of other researchers, who indicate that the difference is religiosity, with Quebec being the least religious province. Manitobans have the highest reported gifts as a share of income, giving about $8 out of every $1,000 of income. Residents of the other western provinces are also in the top four. In this ranking, Prince Edward Island and Ontario finish next. It is striking that the provincial trends over time are so similar in all respects. Average reported donations in all provinces have been flat or falling as a percentage of income, while the share of the population that reports donations has fallen by 10 to 15 percentage points, with current shares roughly in the range of 30 to 35 percent.

MV

Tazia Khushboo, "The Cost of Standing Up to Protectionism: Price and Welfare Impacts of Canada's 2018 Retaliatory Tariffs" (2025) 51:3 *Canadian Public Policy/Analyse de politiques* 319-43 (https://doi.org/10.3138/cpp.2025-006)

The recent imposition of tariffs by the Trump administration and the retaliatory tariffs imposed by Canada have reminded us all that tariffs are taxes, though Canada does not seem poised to increase their use as a revenue raiser, even as the United States appears to be using its own tariffs as a kind of national sales tax. Most current discussion of tariffs in Canada has been focused on the best way to respond to US tariffs. This article examines Canada's experience with tariffs in 2018 during the first Trump administration.

The downside of Canadian tariffs on US goods is that they can increase prices for Canadian buyers. Suppose, for example, that there are acceptable substitutes for the tariffed goods that are only marginally more expensive. These can be Canadian goods or goods imported from countries other than the United States. If a US producer is to continue to sell into Canada, it will not be able to pass the cost of the tariff through to Canadian buyers, and the economic welfare losses to Canadians will be minimal. Suppose, however, that there are no acceptable substitutes for the tariffed goods. The cost of the tariff will then be fully passed through into the price charged in Canada, which will increase the economic welfare losses to Canadians.

The author consolidates data from a variety of sources. One key source is Canadian International Merchandise Trade data, which include values, quantities, and units of imports for various products by country and by month. She then uses World Integrated Trade Solution data to determine the tariff rate that would have applied to US goods imported into Canada. The author also includes the retaliatory tariffs: 25 percent on steel and 10 percent on other targeted goods, including aluminum products, selected agricultural goods, and selected consumer goods. The pre-tariff value of imports of these goods was about $16 billion. Canada imposed the tariffs on July 1, 2018 and removed them on May 20, 2019.

The author's method involves comparing the prices of goods that were tariffed with the prices of non-tariffed goods, before and after the imposition of the tariffs.

Allowance is therefore made for changes over time that may have been unrelated to the tariffs. The key finding is that the prices to importers of goods tariffed by Canada rose one-to-one with the tariffs. Hence, the estimation indicates that the cost of the tariffs was fully passed through. There was no mitigation of the welfare loss to Canadians from partial passthrough.

There is some nuance, however. The full passthrough finding appears to be, to some extent, the result of some products having full passthrough, some having less than full passthrough, and some having more than full passthrough. While it is useful for the author to have reported this caveat, the aggregate results and the assumption of competitive markets are used for the welfare analysis. The import elasticity of the targeted goods is estimated at 2.6: that is, a 1 percentage point increase in price as a result of the tariffs is estimated to reduce demand for those goods by 2.6 percentage points. With that value and full passthrough, the deadweight loss associated with the tariffs can be estimated at roughly $0.46 billion. Given that the tariffs raised $1.75 billion in revenue, this suggests that the tariffs' deadweight loss was about 26 percent (0.46 ÷ 1.75). Interestingly, this figure is very comparable to the deadweight loss associated with many taxes and even may be on the low side. However, tariffs specifically target the users of the tariffed goods, and hence most would judge them to be less equitable than more broadly based taxes.

MV

William A. Scott, Jennifer Winter, Alaz Munzur, and Katharina Koch, "Developing a Climate Change Mitigation Policy Inventory for Canada"
(2025) 51:2 *Canadian Public Policy/Analyse de politiques* 109-23
(https://doi.org/10.3138/cpp.2024-051)

Assuming that Canada will continue to attempt to contain carbon emissions, if only to honour its obligations under the Paris Agreement, it is unfortunate that the consumer-facing carbon tax is no longer available as a tool. I am apparently one of the few who mourn its loss. In that context, this extremely useful article deserves attention. The authors have developed a dynamic inventory of 341 different climate policies enacted by governments of various levels in Canada. Although the carbon tax was not designed to be the most important part of Canada's plan to reduce carbon emissions—the carbon pricing and restrictions imposed on large emitters are much more important—it was an instrument with a much lower cost per tonne of CO_2 reduction than, say, electric vehicle mandates.[13] Creating an inventory of the myriad policies aimed at reducing carbon emissions is a useful step toward determining the relative efficiency of different measures. It is the expectation of most economists that 341 incompletely coordinated policies, many of which dictate the means of carbon

13 See Ross McKitrick, "Economic Implications of a Phased-In EV Mandate in Canada" (2024) 57:4 *Canadian Journal of Economics* 1434-58.

reduction instead of allowing firms to find their own lowest-cost ways of achieving the same reductions by other means, will prove to be a very expensive way for Canada to meet its target.

MV

Severin Borenstein and Lucas W. Davis, "The Distributional Effects of US Tax Credits for Heat Pumps, Solar Panels, and Electric Vehicles" (2025) 78:1 *National Tax Journal* 263-88 (https://doi.org/10.1086/733564)

On the topic of climate change mitigation policies, this article is part of a forum on environmental tax policy in the United States. Its findings are completely consistent with the Canadian literature as far as I can tell. The authors find that US federal personal income tax credits for clean energy technologies go primarily to those with high incomes. The bottom three income quintiles receive about 10 percent of all such credits, while the top quintile receives about 60 percent. For electric vehicles, the top quintile receives more than 80 percent.

One reason for this lack of progressivity is that the tax credits were non-refundable and about 40 per cent of US households do not pay federal income tax. US clean energy tax credits totalled $47 billion from 2006 to 2021. Another is that renters and landlords are ineligible for tax credits aimed at heat pumps and other energy-efficient investments.

The authors then turn to what they call "non-additionality." Recall the earlier discussion of the article by Lacroix and Michaud, who found that a Quebec tax preference to encourage employment at older ages may have been given largely to those who would have worked anyway without the incentive. Here, the issue is whether the tax credits cause households to make clean energy investments, or whether they provide a subsidy for clean energy investments that would have been made without the subsidy. The main approach in this study is to graph changes in the sales of heat pumps, residential solar panels, and electric vehicles over time while noting when the corresponding tax credits changed in value.

The authors begin by studying the sales of heat pumps. They find no consistent pattern between varying levels of tax credits (including periods when there was no tax credit) and shipments of US heat pumps. Turning to residential solar panels, they conclude that tax credits probably played a significant role in boosting sales. With respect to electric vehicles, they note that the tax credit for Tesla and GM products was phased out in 2019 and 2020, when each manufacturer hit their ceiling of 200,000 vehicles; this limit was subsequently removed by the Inflation Reduction Act of 2022. The tax credit phaseout appears to be clearly associated with a pause in the growth rate of electric vehicle sales; growth resumed when the ceiling was eliminated.

Overall, the authors conclude that the evidence for the effectiveness of the clean energy tax credits is mixed, with some evidence showing that the credits encouraged the adoption of clean energy technologies. But the authors do not attempt to analyze the economic and environmental return on the credits. They do note that

in 2024 there was a move to a "point-of-sale" subsidy for electric vehicles[14] that would not require buyers to apply for the subsidy by filing personal income taxes. They note that subsidies that are more immediate and direct, and hence more easily accessed, are likely to be more effective in increasing uptake of clean energy technologies.

MV

Bradley T. Heim, "Evaluating the Cost-Effectiveness of Individual Income Tax Incentives" (2025) 78:1 *National Tax Journal* 115-67 (https://doi.org/10.1086/733313)

This article, like the preceding article, is about US tax-based incentives, but it considers a broader range of incentives than those focused on clean energy investment. A tax measure is considered ineffective if it does not sufficiently change the targeted behaviour, either with respect to the "extensive" margin (the choice whether to participate in an activity at all, such as whether an employer opts to provide employee health insurance) or with respect to the "intensive" margin (the choice of degree of participation, such as the breadth of coverage offered by an employer who provides health insurance to employees). In this article, a tax measure is judged ineffective if its cost to the treasury is greater than the dollar value of the change in behaviour that it appears to have induced.

Using this standard, the author analyzes a wide variety of tax measures. Tax preferences for charitable giving, for saving and health insurance among the self-employed, for state and local taxes, and possibly for the Affordable Care Act's premium tax credit (a refundable credit that helps individuals and families cover their health insurance premiums) are judged effective. But about half of the incentives are found not to be cost-effective, including incentives for housing, education, employer-sponsored health insurance, and retirement savings among employees.

The author also discusses the Tax Cut and Jobs Act of 2017 (TCJA), which limited the deduction for state and local taxes and for mortgage interest, while almost doubling the standard deduction (reducing the inclination of individuals to itemize and hence utilize particular deductions). The author emphasizes that the caps will limit the effectiveness of a deduction because, once an individual hits the cap, there is no longer an effect along the intensive margin as described above. Of course, the increase in the standard deduction also reduced the importance of ineffective deductions. Nonetheless, the TCJA left untouched the deductions that the author finds ineffective—those for education, employer-sponsored health insurance, and retirement savings among employees.

MV

14 At 284.

David R. Agrawal, Marie-Laure Breuillé, and Julie Le Gallo, "Tax Competition with Intermunicipal Cooperation" (2025) 78:1 *National Tax Journal* 5-43 (https://doi.org/10.1086/733246)

This article compares the tax competition behaviour among municipalities in France that are members of the same "establishment for intermunicipal cooperation"[15] (EIMC) with the behaviour of those that are not. The main finding is that a 1 percentage point decrease in the average tax rate of a municipality leads to an estimated reduction in the average tax rate of 0.58 percentage points for a proximate municipality not in the same EIMC. But since the estimate for a municipality in the same EIMC is only 0.31 percentage points, this suggests that the EIMC reduces tax competition. The authors address the possibility of feedback—that is, that taxation behaviour affects EIMC cooperation rather than the other way around—by using methods that consider the historical roots of most EIMCs. The authors suggest that their methods could be used to analyze tax competition across other jurisdictions, such as nations within the European Union.

MV

Wojciech Kopczuk, "Shifting and Other Problems with Taxable Income Elasticity: Joel Slemrod's Contributions to What We Know About Taxing Ourselves" (2025) 78:3 *National Tax Journal* 751-66 (https://doi.org/10.1086/736579)

In one of five articles in a forum dedicated to the outstanding American public finance economist Joel Slemrod, one of his most well-known students, Wojciech Kopczuk, emphasizes the role of Slemrod's work on the elasticity of taxable income (ETI) framework. Slemrod's work stresses that individuals (or their accountants) can often shift income around or incorporate new deductions so that, for example, a large estimated personal income tax ETI initially associated with the Tax Reform Act of 1986 was primarily due to shifts of corporate tax income into the personal income tax system, as the rate on the latter had become more attractive. Other large ETIs might not reflect changes in actual labour supply, saving, or investment behaviour, but rather changes in the utilization of tax shelters or havens.

While this article would largely be of interest to economists such as myself who have estimated these elasticities, an important point is that even though a tax change with a large ETI might not change real behaviour, such as labour supply, it still means that an increase in tax rates will have diminishing positive and perhaps even negative effects on government revenues. For most current ETI estimates for Canada, raising tax rates is unlikely to have a large effect on government revenues. Rather, if the policy goal is to raise revenue, the more likely approach is to reduce tax preferences.

15 At 5.

Kopczuk also covers Slemrod's important contributions to the study of high-income taxpayers and inequality, tax compliance, and enforcement, as well as his impact on the analysis of what is called bunching. The latter work involves deducing tax responses by examining where taxpayers' reported incomes (or deductions) lie relative to kinks and discontinuities in tax schedules—for example, in the common finding that numerous taxpayers have incomes bunched just below the threshold income for the application of a particular tax. These are just some examples of Slemrod's immense and lasting contribution to the study of taxation policy.

MV

Kerry Harnish, *Bench Strength: Judging a Century of Tax Avoidance in Canada* (Toronto: Sutherland House Experts, 2025)

This book discusses the evolution of judicial approaches to tax avoidance in Canada from 1938 to 2019 through an analysis of the decisions of "the bench." The bench includes nine judges of the Supreme Court of Canada: four from the pre-Charter era (justices Patrick Kerwin, Douglas Abbott, Wilfred Judson, and Ronald Martland); four from the Charter era (justices Bertha Wilson, Frank Iacobucci, John Major, and Marshall Rothstein); and Justice Brian Dickson, whose tenure straddled the two eras.

In addition to describing and discussing the decisions by the bench, the author provides some interesting biographical details of the judges and the social, economic, and political factors that may have influenced their decisions. For example, the author refers to the following facts or factors in describing Justice Bertha Wilson: she was a member of the socialist New Democratic Party; she was appointed by Liberal Prime Minister Pierre Trudeau; and, prior to her appointment to the court, she headed up legal research for one of Canada's most prominent corporate-commercial tax law firms, for which "she would be feted on Bay Street for injecting a strong commercial interest outlook into her opinions, including the application of a strict interpretive approach to statutory income tax law."[16] The author notes that Justice Wilson's "contextualized approach in tax cases rests on the 'context of business requires certainty' despite the context and purpose of the statutory income tax law,"[17] and argues that the importance of her minority opinion in *Stubart Investments*[18] "cannot be overstated."[19]

In commenting on Justice Wilson's decision in *Stubart Investments*, the author highlights the fact that it was Wilson who elevated Lord Tomlin's dictum—"Every man is entitled if he can to order his affairs so as that the tax attaching under the

16 At 209.

17 Ibid.

18 *Stubart Investments Ltd. v. The Queen*, [1984] 1 SCR 536.

19 At 212.

appropriate Acts is less than it otherwise would be"[20]—into a deeply entrenched principle in Canadian tax law. The author states:

> Wilson also sought statutory authority for the proposition that the *Duke of Westminster* decision did not apply even though the Supreme Court had not expressly applied it before in a majority income tax decision. It appears that no one, including the litigants, realized that the Court did not follow the principle from 1938 onward in income tax avoidance cases.[21]

The author assesses the impact of the *Stubart Investments* as follows:

> The Supreme Court's decision in *Stubart Investments* represents the start of a dramatic shift in its approach to tax avoidance. The Court pivoted 50 years on back to the 1935 British *Duke of Westminster* principle. It is almost inexplicable unless one keeps in mind that the enactment of the *Charter* in 1982 signaled to the judiciary in legal terms that Canada had shifted to a rights-driven era from a duty-bound era, which shift was being accompanied by an economic shift to *laisse-faire*.[22]

In addition to the shift in judicial approach to tax avoidance in *Stubart Investments*, the author identifies other shifts, including:

- pre-Charter judges had more tax expertise (for example, Justice Abbott was the minister of finance who oversaw the 1948 tax reform);
- the Charter-era judges were more pro-taxpayer and emphasized taxpayers' rights rather than their obligations;[23] and
- after the enactment of the Charter, the Supreme Court's approach to the interpretation of tax law shifted "from requiring that transactions be consistent with commercial substance and reality to emphasizing the legal form of a taxpayer's legal relations."[24]

During the Charter era, "it took Parliament to enact a GAAR [general anti-avoidance rule] to get the Supreme Court to actually apply the true TCP (textual, contextual and purposive interpretation) approach."[25] The author discusses the

20 *Inland Revenue Commissioners v. Westminster (Duke)*, [1936] AC 1, at 19 (HL) (also known as "*Duke of Westminster*").

21 At 219.

22 At 227.

23 At 3.

24 At 2.

25 At 414.

GAAR decisions by Justice Major (*Canada Trustco* and *Mathew*)[26] and Justice Rothstein (*Copthorne Holdings*).[27] He claims that a "significant incongruity exists between *Canada Trustco* and *Mathew*," and that the reason for the incongruity is "obscured by the difficulty in understanding the facts in *Canada Trustco* in commercial, legal and income tax terms."[28] The misunderstandings of the transactions in that case include:

- the treatment of the sale-leaseback transaction concerning exempt property that provides no commercial financing as an ordinary sale-leaseback transaction;
- the non-recognition of a defeased loan for commercial or regulatory purposes as a loan for tax purposes because of its legal substance; and
- the treatment of a cost that is not incurred commercially as "magically satisfy[ing]" the income-earning purpose test for tax law purposes.

The result of these misunderstandings was that Canada Trustco's "commercial return gambit came out of Canada's treasury."[29] However, the author remarks that "[i]f *Canada Trustco* reveals the alchemy of paper becoming gold, the elixir of tax avoidance was no panacea for a bunch of Canadian tax lawyers in *Mathew*."[30]

As for *Copthorne*, the author takes issue with Justice Rothstein's treatment of GAAR as an interpretive rule: "It is highly questionable that Parliament intended the GAAR to be a rule of interpretation; it is certainly not written as such."[31] Rather, as a substantive rule, GAAR is meant "to deny abusive tax avoidance arrangements that survive a textual, contextual and purposive interpretation of the provisions in issue, and the [Income Tax Act] read as a whole."[32]

In addition to examining the decisions, the author provides statistical data on the judges and the Supreme Court, the results of each judge's approach to income tax, and a comparison of the results in pre-Charter and Charter-era cases.

Overall, this book reminds readers of the importance of understanding each court decision in its historical context and appreciating the influences of the Charter and other laws on tax law. As noted by Brian Arnold in the foreword, this book "is a unique contribution to tax literature."[33]

JL

26 *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54; [2005] 2 SCR 601; and *Mathew v. Canada*, 2005 SCC 55.

27 *Copthorne Holdings Ltd. v. Canada*, 2011 SCC 63.

28 At 319.

29 At 323.

30 At 333.

31 At 352.

32 Ibid.

33 Ibid., at xi.

International Fiscal Association, *Cahiers de droit fiscal international*, vol. 109A, *Residence for Corporate Income Tax Purposes* (Rotterdam: IFA, 2025)

International Fiscal Association, *Cahiers de droit fiscal international*, vol. 109B, *Improper Use of Tax Treaties and Source Taxation: Policy, Practice and Beyond* (Rotterdam: IFA, 2025)

***Bulletin for International Taxation* (2025) 79:9/10** (Special issue on Studies on International Fiscal Law by the International Fiscal Association, 77th Congress Lisbon 2025)

These publications are reviewed together because they all relate to the International Fiscal Association (IFA) 2025 Lisbon Congress. Volume 109A of *Cahiers de droit fiscal international* contains a general report by João Félix Pinto Nogueira, an EU report by Adam Zalasiński, and branch reports, including one from the Canadian branch authored by Marshall Haughey and Rémi Danylo.[34]

The general report provides a high-level overview of the concept of corporate residence in modern income tax systems and the considerable diversity across jurisdictions in determining corporate residence under domestic law (for example, the interplay of incorporation, governance, and other criteria). It identifies a clear trend of expanding the scope of the concept in domestic law. At the treaty level, the report notes a progressive shift to using the mutual agreement procedure (MAP) as a tiebreaker and expresses concern with the shift because MAP "prevents taxpayers from anticipating the tax consequences of their (often genuine and needed) behavior."[35] The report also provides an assessment of whether the concept is still fit for purpose and whether reforms should be undertaken to address the challenges posed by digitalization and globalization (such as indeterminacy and legal uncertainty owing to geographically dispersed meetings and virtual meetings, as well as a progressive divorce between the exercise of management and operational activities and a corresponding detachment of corporate residence from the jurisdiction that provides most of the public goods to a corporation).[36] Meanwhile, the report recognizes the "ongoing territorialization of tax systems," which "fundamentally alters the traditional role and significance of the residency concept."[37] It recommends legislative reforms to replace subjective interpretation criteria with "clear and objective standards."[38]

The Canadian branch report considers the statutory and common-law tests for determining corporate residence for income tax purposes as well as the definition of residence and tiebreaker rules in Canadian tax treaties. It explains that the

34 At 273-94.

35 At 19.

36 At 104.

37 At 108.

38 At 117.

common-law test of "central management and control" is more complex in a digital environment that allows for remote decision making. It notes that the common-law test requires consideration of both the form and the substance of a corporation's activities, including the existence of an "economic nexus" between the corporation and the jurisdiction.[39] The report provides an excellent overview of the treatment of corporate residence in Canada's 94 tax treaties, including the resolution of dual- or multiple-residence problems through MAP and the consequences of residence for income tax purposes.

Volume 109B of *Cahiers* contains a general report by Eivind Furuseth and Jinyan Li, an EU report by Ivan Lazarov, and 42 branch reports. The focus of the volume is on treaty shopping and how source states address treaty shopping through domestic and treaty-based anti-abuse rules.

The general report first provides a conceptual and legal framework for analyzing the issue of improper use of tax treaties from a source state's perspective. It notes the difficulty in drawing the line between proper and improper use of a tax treaty provision by taxpayers, because the taxpayer's use needs to be evaluated by reference to the intended use by the contracting states and source states, which may have different objectives (for example, some use tax treaties to promote foreign investment while some others emphasize protection of source-based taxing rights). The report also explains the challenge in evaluating improper use of tax treaties because of the dual nature of tax treaties (contractual and statutory). The report then synthesizes the branch reports, shows that most jurisdictions have adopted treaty-based anti-abuse measures, including the principal purpose test (PPT),[40] and recognizes the divergence in treaty interpretation and the application of domestic general anti-avoidance rules (GAARs) to treaty shopping. An interesting contribution of the general report to the body of literature on treaty shopping is the critical review of some leading judicial decisions on treaty shopping, especially those by courts in Argentina, Canada, India, Switzerland, and the United Kingdom. The report cautions that, on the basis of existing case law and judicial approaches to treaty interpretation, the global PPT standard is likely applied differently in different countries.

39 At 278. The majority decision of the Supreme Court of Canada in *Canada v. Alta Energy Luxembourg SARL*, 2021 SCC 49, rejected the argument that residence in a treaty country (Luxembourg) requires the company to owe economic allegiance to the country.

40 The PPT is contained in article 29(9) of Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version 2017* (Paris: OECD, November 2017) (herein referred to as "OECD model tax convention"); article 29(9) of United Nations, Department of Economic and Social Affairs, Financing for Sustainable Development Office, *Model Double Taxation Convention Between Developed and Developing Countries 2021* (New York: United Nations, 2021); and article 7(1) of Organisation for Economic Co-operation and Development, Multilateral Convention To Implement Tax Treaty Related Measures To Prevent Base Erosion and Profit Shifting, released on November 24, 2016 (www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.pdf).

The Canadian branch report, by Rebecca Potter and Jaskirit Randhawa, follows a five-part general directive: (1) the line between proper and improper use of tax treaties and an overview of domestic anti-abuse rules targeting treaty abuse; (2) country practices; (3) dispute resolution mechanisms; (4) policy; and (5) future initiatives and direction. It explains that Canada emphasizes source-based taxation and has implemented many anti-abuse measures recommended by the base erosion and profit shifting (BEPS) project of the Organisation for Economic Co-operation and Development (OECD) and the Group of Twenty (G20). The report analyzes Canadian anti-treaty abuse rules, including the domestic GAAR, the PPT in Canadian treaties, and leading cases such as *Crown Forest*[41] and *Alta Energy*.[42] It also provides an overview of dispute resolution mechanisms, including arbitration and the accelerated competent authority procedure, and the guidance provided by the Canada Revenue Agency (CRA) to aid practitioners in identifying treaty abuse. It makes some important observations, including that "[c]ourts have generally upheld the use of GAAR in treaty situations"[43] and that this "has reinforced the idea that tax treaties should not be interpreted in a way that undermines the integrity of Canada's tax system."[44]

The special issue of *Bulletin for International Taxation* contains articles written by the president of IFA, Guglielmo Maisto,[45] and by Portuguese authors regarding international tax issues in Portugal, such as residence under article 4 of the OECD model tax convention, the concept of beneficial ownership, tax controversies, the fight against corporate indebtedness (boosting equity with tax incentives) and the limitation of interest deduction, and the tax treatment of groups. The article by Maisto examines the key interpretive issues under the OECD's pillar 2—the global minimum tax (GMT)—and is thus of potential interest to Canadian readers.

Maisto identifies five interpretive issues: general principles of interpretation, taxable persons, pillar 2 and tax treaties, penalties, and anti-abuse rules. His analysis of the general principles is particularly illuminating because the global anti-base erosion (GloBE) model rules do not include general rules of interpretation, out of respect for the divergence in domestic traditions. The key issue is the role of "soft law"[46]

41 *Crown Forest Industries Ltd. v. Canada*, [1995] 2 SCR 802.

42 Supra note 39.

43 At 290.

44 Ibid.

45 Guglielmo Maisto, "President's Welcome: Reflections on and Issues with the Global Minimum Tax—A Tribute to the 2025 Global IFA Travelling Lectures" (2025) 79:9/10 *Bulletin for International Taxation* 289-303.

46 Ibid., at 290.

(such as OECD administrative guidance)[47] in interpreting the model rules that have been transposed into domestic legislation, including the Global Minimum Tax Act[48] (GMTA) in Canada. Maisto notes the following different approaches taken by countries in transposing the model rules and the role of soft law:

- The EU GloBE directive refers to the model rules in its provisions and notes that member states should use the OECD GloBE Implementation Framework guidance as their reference.
- The preamble to the Spanish implementing law refers to consistency with the GloBE directive and, when third countries are involved, with the GloBE model rules.
- The German implementing legislation allows OECD administrative guidance to be systematically transposed in domestic legislation after the end of the financial year in which these rules are intended to take effect.
- The South African implementing legislation provides for a delegation to the Ministry of Finance to consider, through a notice in the *Gazette*, the application of documents released by the Inclusive Framework, as contemplated in the definitions in OECD administrative guidance, commentary to the model rules, and the safe-harbour rules, for the purpose of its domestic pillar 2 legislation. It further provides that such notice shall lapse after a period of two years unless provided otherwise by Parliament.
- The Italian implementing legislation addresses the matter of accounting principles and concepts, stating, "Unless expressly stated to the contrary or unless the context otherwise requires, terms and accounting concepts adopted in this Section shall be interpreted coherently and be given the meaning given to them by the compliant or authorized accounting principle."[49]

Given the importance of synchronizing the interpretation of domestic GMT legislation in various countries in achieving the object and purpose of the GMT, it would make sense for countries to remain as close as possible to the global agreement.[50] However, Maisto notes that the dynamic incorporation of the OECD's work into

47 Organisation for Economic Co-operation and Development, *Tax Challenges Arising from the Digitalisation of the Economy—Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two)* (Paris: OECD, 2023) (herein referred to as "OECD administrative guidance").

48 SC 2024, c. 17, section 81.

49 Maisto, supra note 45, at 292.

50 Ibid., at 291.

domestic legislation is a "remarkable feature"[51] of the GMT legislation and raises issues when subsequent OECD guidance goes beyond mere interpretation.

JL

Domenico Imparato, Reuven S. Avi-Yonah, and Doron Narotzki, *No Trade Wars Without Taxation—Who's To Blame, and What Comes Next?* Law & Economics Working Papers no. 300 (Ann Arbor, MI: University of Michigan Law School, August 2025) (https://repository.law.umich.edu/law_econ_current/300)

US President Trump has been waging trade wars with most countries around the world since January 2025. Why? How do these trade wars reveal the fundamental deficiencies in the US tax system or fiscal architecture? How can the trade-tax relationship be reimagined so that the United States is able to construct a more equitable, sustainable, and competitive position in the global economy? This article addresses these questions.

While it is too early to assess the effect of the trade wars on the US economy and the US trade relationship with its trading partners, the article notes the inflationary effect on consumer prices in the United States and the fact that tariff-based protectionism tends to be anti-productive. The article examines three interrelated dimensions of the trade war: reshoring production to the United States; promoting fair trade; and raising revenue. For each dimension, the article claims that the interaction between tariffs and the tax system reveals deeper distortions. The US corporate income tax system, until 2017, adopted a worldwide tax approach (that is, imposing US tax on dividends received by US shareholders from their foreign corporations and on passive income earned through controlled foreign corporations). US corporations offshored their productive activities and investment to take advantage of lower costs and market conditions in foreign countries as well as to avoid US income taxes. Because the United States lacks a value-added tax (VAT) regime that rebates consumption taxes on exports and does not embed territoriality in the corporate tax system, it resorted to various corporate tax measures to maintain tax competitiveness, such as the domestic international sales corporation, the foreign sales corporation, and extraterritorial income exclusion, all of which were ruled by the World Trade Organization to be incompatible with the principles of the General Agreement on Tariffs and Trade.

The deficiencies in the US tax system cannot be addressed through tariffs or trade wars, according to the article. Given the fact that VAT plays a dominant role in the fiscal architecture of many countries, the United States' continued reliance on income taxation places its exporters at a structural disadvantage. The article recommends that the United States reform its corporate tax system by adopting a

51 Ibid.

VAT-equivalent regime (cash flow taxation). It argues that true trade reform requires tax reform.

JL

Michael J. Graetz, "Fixing a 100-Year-Old Mistake" (2025) 119:6 *Tax Notes International* 933-38

Michael J. Graetz, "Sovereignty, Sins, and the Reassertion of Primary Taxing Rights by the United States" (2025) 117:8 *Tax Notes International* 1301-14

Michael Graetz is one of the leading tax law scholars in the United States. In these two articles, he argues that the United States should correct a 100-year-old mistake by abandoning its worldwide tax and foreign tax credit system and reassert its primary taxing rights over income from intellectual or intangible property (IP), which it has long conceded to other countries.

According to the author, the 100-year-old mistake was committed in 1918 when the United States enacted a credit for foreign taxes paid by US companies in order to encourage US investments abroad, and thereby relinquished its taxing rights to most foreign-source income. Even though other countries reciprocated with their own foreign tax credits or exemptions for active business income earned by foreign subsidiaries, and the US 2017 tax reform shifted the US system toward territoriality, Graetz maintains that the US tax system is "generous"[52] and that the foreign tax credit rules, especially for mobile income taxed at a low rate abroad, should be reassessed. He reiterates a question he raised three decades ago—namely, in addressing US international tax policy, "[w]hat policies will improve the well-being of our citizens and residents?"[53] Even if pillar 2 co-exists with the US rules on GILTI (global intangible low-taxed income, now renamed net controlled foreign corporation tested income, or NCTI),[54] the tax system still encourages offshoring and profit shifting. Even if pillar 2 collapses, in Graetz's view, unilateral efforts to capture taxes on income from intangible property created and developed in the United States, such as the diverted profits taxes and the Australian royalty rules, show that if the United States does not tax such income, other countries will. "We can no longer afford to allow foreign countries to claim taxes on valuable IP created or developed here."[55]

In the second article, Graetz explains why and how the "archaic U.S. source rules"[56] and "other 'original' sins,"[57] such as cost sharing, should be reformed and

52 At 933.

53 At 935.

54 At 936.

55 At 938.

56 At 1306.

57 At 1305.

US primary taxing rights reasserted. To avoid being "sitting ducks,"[58] he suggests changes to the sourcing of royalties and other IP income; modernizing subpart F of the Internal Revenue Code—similar to the Canadian foreign accrual property income (FAPI) rules—to include income earned abroad from IP predominantly developed or created in the United States, or modernizing the foreign tax credit rules to create a separate limitation for IP income; and introducing a worldwide allocation system for interest expenses (for example, using ratios of debt to sales or assets), which might be less costly for the US treasury than the 30 percent of EBITDA (earnings before interest, taxes, depreciation, and amortization) standard adopted in 2017. Graetz recognizes the potential problem of double or multiple taxation of IP income and acknowledges that "[u]pending century-old arrangements is never easy or problem free,"[59] but he argues that the "time has come for the United States to reassert its primary taxing rights previously granted to foreign countries."[60]

JL

Yariv Brauner, "The Foundations of International Taxation: Knocked from Post to Pillars" (2025) 58:1 *Akron Law Review* 39-61

Craig A. Hillier and Yulia Kirillova, "Unstable Foundations: The Legal and Political Fragility of OECD Pillar 2" (2025) 119: *Tax Notes International* 1305-11

There is no "international tax law" in the sense of public international law in the form of multilateral conventions. Tax law remains local or national. However, internation tax relations are governed by about 4,000 bilateral double tax treaties, all of which follow a model convention that was originally developed in the 1920s and 1930s under the auspices of the League of Nations, subsequently maintained and "perfected" by the OECD, and modified by the United Nations. The theoretical framework and basic principles underlying the model convention can, therefore, be regarded as the foundations of the international tax regime.

Brauner's article explains the foundational principles and the shift away from them in the recent international tax reforms, commonly known as OECD/G20 BEPS project. BEPS 1.0 culminated in a number of best practices and minimum standards for countries to implement in order to protect their national tax bases. BEPS 2.0 went further by creating two new regimes for taxing the profits of large multinational enterprises (MNEs), known as pillar 1 and pillar 2. Pillar 1 introduces a new nexus test that replaces the traditional test for the physical presence of taxpayers within a jurisdiction to enable that jurisdiction to tax the profit generated remotely. Pillar 2 imposes a GMT on MNEs' profits at the effective tax rate of 15 percent, regardless of where the

58 At 1310.

59 At 1314.

60 Ibid.

profits are earned. Brauner challenges the OECD position that these reforms are merely pragmatic compromises in response to the pragmatic challenges arising from the digital economy.

He argues that the two pillars introduce innovations that are "difficult to reconcile, as a matter of principle, with the foundational tenets of the international tax regime."[61] For example, the "longest standing consensus norm at the basis of the international tax regime"[62] is "to minimize and, when possible, eliminate double taxation"[63] and to follow the arm's-length standard. The two pillars are not about eliminating double taxation and have adopted formulary apportionment methods that have long been regarded as contradictory to the arm's-length principle. Also, the two-pillar reforms show "a sharp departure of the OECD from the traditional soft law and agreement base of the international tax regime"[64] and a "turn to new forms of coercion."[65] Brauner is also critical of the new dispute resolution and tax law enforcement assistance measures as departures from the traditional administration of international taxation. He explains that one of the reasons for these departures is that the OECD, which has been the caretaker or norm setter of the international tax regime, was "in a survival mode during the BEPS project."[66] However, "that cannot justify dragging the entire regime to that place."[67]

The deficiencies of the current international tax regime in taxing MNEs' profits in the digitalized and global economy are well known, and incremental reforms have been undertaken at national and international levels. So, what are the negative impacts of the two-pillar reforms? Brauner argues that the reforms can have longer-term impacts on the stability and legitimacy of the international tax regime. He expresses hope that a UN-led multilateral arrangement, if duly supported by OECD member states, can be a solution.

Hillier and Kirillova analyze pillar 2 specifically and demonstrate how pillar 2's foundations are unstable. Pillar 2 is designed to achieve the intended objective of taxing MNEs' profits at a global minimum tax rate through the interplay of three rules: the income inclusion rule (IIR), which allows the residence country of the parent entity of the MNE group to tax profits that are not taxed up to the minimum rate; the undertaxed profits rule (UTPR), which allows the residence country of a constituent entity (such as a sister company of a low-taxed company in a different jurisdiction) to tax a proportion of the low-taxed profits of an entity in a low-tax jurisdiction; and a qualified domestic minimum top-up tax (QDMTT), which allows

61 At 41.

62 At 42.

63 Ibid.

64 Ibid.

65 Ibid.

66 At 60.

67 Ibid.

the residence country of an otherwise low-taxed entity to impose a top-up tax on the domestic entity to bring its tax rate up to the global minimum rate. Among the three rules, the QDMTT is a "defensive" rule, in that the country in which the profits are earned can tax such profits at the global minimum rate to pre-empt the application of the IIR or UTPR in other countries in cases where the tax rate under normal domestic tax law is lower than the global minimum rate as a result of domestic tax incentives or other reasons. As between the IIR and UTPR, the UTPR is applicable only if the IIR is not applied to low-taxed profits.

Hillier and Kirillova show that pillar 2 threatens national tax sovereignty by imposing uniform minimum tax requirements that override legitimate sovereign economic policies. They argue that the UTPR raises "serious treaty compatibility issues,"[68] and that the compromise reached among Group of Seven countries to exclude US-parented MNE groups from the UTPR undermines the credibility of the UTPR as a globally uniform enforcement mechanism. In their view, pillar 2 "represents an ambitious but flawed attempt to reform international taxation."[69]

Canada has implemented pillar 2 through the GMTA. It remains to be seen how the "flaws" identified by Brauner and Hillier and Kirillova will affect the application of the GMTA.

JL

United Kingdom, House of Commons, Committee of Public Accounts, *Collecting the Right Tax from Wealthy Individuals: Fortieth Report of Session 2024-25*, report no. HC 827 (London, UK: House of Commons, July 2025) (https://committees.parliament.uk/publications/48823/documents/256443/default)

In an age of growing income inequality, taxing the ultra-rich is not only a tax enforcement and policy issue, but also a political issue. There have been calls at national and international levels (such as the G20, the UN, and the International Monetary Fund/World Bank) for new measures for taxing wealthy individuals through better enforcement of existing rules or creating a new global minimum tax on the ultra-wealthy that can be akin to the pillar 2 GMT on large MNEs.[70] In this report, the UK House of Commons' Committee of Public Accounts highlights the main findings of its review of the collection of taxes from wealthy individuals.

The report states that His Majesty's Revenue and Customs (HMRC) collected £5.2 billion in tax revenue from wealthy individuals in 2023-24, which was a significant increase from £2.2 billion in 2019-20. However, the "scale of this success suggests either non-compliance among the wealthy has got worse, or that previous

68 At 1308.

69 At 1311.

70 For a recent reporting, see Nana Ama Sarfo, "Finance Ministers Evolve Approach for Taxing the Ultrawealthy" (2025) 120:5 *Tax Notes International* 739-43.

estimates of the extent to which they were avoiding tax were too low."[71] The report also states that "HMRC does not know how many billionaires pay tax in the UK or how much they contribute overall."[72] Also, HMRC has no overview of an individual's total wealth and faces challenges in getting all the data it needs to risk assess and target wealthy people. The report further notes that HMRC has increasingly focused on complex, high-value cases, but 46 percent of cases closed with no yield in 2023-24, and there were only 25 prosecutions. With more investments in HMRC, it is expected that more resources will help HMRC to recruit staff and invest in technology and, it is hoped, recover more taxes in the future.

One wonders how well the CRA has been doing on collecting taxes from the wealthy. A report from an oversight committee would inform Canadians. Also, if there are no reliable data on how much tax the wealthy are paying now, how can a new tax system work?

JL

Samuel Singer and Allison Christians, *The Case for Fixing the Unprincipled Residence Tax Exemption*, Osgoode Legal Studies Research Paper no. 5325396 (Toronto: York University, Osgoode Hall Law School, 2025) (http://dx.doi.org/10.2139/ssrn.5325396)

The principal residence exemption (PRE) under paragraph 40(2)(b) of the Income Tax Act[73] is arguably the best-known and best-liked tax subsidy in Canada. Many Canadians put most of their savings into their homes and enjoy the tax-free treatment of the gains when the homes are sold. Is the PRE overly generous? Is it open to misuse or abuse? Is there a case for fixing it? This paper considers these questions and makes the case for reform.

The case for reform is made on the basis of careful examination of the historical context and justifications for the PRE, evidence on the economic distortions and inequitable distributive outcomes of the PRE, and alternatives that can achieve the intended policy objectives. Recognizing that the politics around the PRE are too sensitive to make its repeal feasible, the paper suggests alternative modifications such as imposing a per-sale or lifetime cap on the amount of exempt gains, converting the exemption into a tax credit, or providing some assistance to renters. The paper ends by repeating the question about the PRE that was raised in 1983: "Are there any politicians, bureaucrats, or potential royal commissioners who are brave enough to try again?"[74]

JL

71 At 1.

72 Ibid.

73 RSC 1985, c. 1 (5th Supp.), as amended.

74 At 40, referring to Edwin C. Harris, "A Case Study in Tax Reform: The Principal Residence" (1983) 7:3 *Dalhousie Law Journal* 169-93, at 192-93.