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2015-12-02

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Delivery Details

Date: January 8, 2019 at 3:15 p.m.
Delivered By: VERN KRISHNA
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Corporate Tax Centre - In this latest article from Professor Vern Krishna, Professor discusses a variety of subsidies from a trade subsidy, indirect subsidy to direct cash subsidy and how they can be used.

A Subsidy by any Other Name (Vern Krishna)
Date: December 2, 2015

Subsidies can offend international trade agreements. A trade subsidy is pecuniary aid, generally in the form of a grant or contribution of money. The aid can take the form of direct cash grants or indirect tax subsidies. Indirect subsidies may reduce tax rates or offer tax base reductions through accelerated write-offs. Each form ultimately reduces the cost of production, but some are more efficient than others. Thus, if one can wrap a direct cash subsidy into an indirect tax subsidy and hide its economic effect, one might achieve the same result and not violate international trade agreements.

The direct cash subsidy is the easiest to understand and, therefore, regulatory bodies scrutinize them the most carefully. The concept is simple. The government simply sends a cheque to the qualifying candidate or business enterprise. Alternatively, a government can subsidize an enterprise through a development bank, such as the Canada Development Corporation (CDC), through interest free or low cost loans. In some circumstances, the grant may be refundable, but even so, few enterprises repay them in any event. Government subsidies can conflict with international trade rules. If they do, the government may have to defend itself before the World Trade Organization (WTO) and face sanctions. Thus, planning subsidies require careful camouflage to avoid trade sanctions.

Although direct trade subsidies offend under the WTO rules, one can indirectly achieve the same result through tax concessions. Tax concessions typically take two forms, rate adjustments and accelerated write-offs. The objective of tax concessions is to reduce the cost of production and improve the rate of return on invested capital.

A rate adjustment can offer a partial or complete tax holiday for a limited or indefinite time. The government simply says that a particular industry or type of corporation in a particular region need not pay any taxes for a certain number of years. For example, years ago, the Ontario government granted small Canadian corporate businesses carrying on an active business in Ontario a tax holiday for three years. In other circumstances, the federal government has granted tax holidays for mining operations, manufacturing and processing, etc. The theory underlying a tax holiday is to indirectly provide financial assistance through the tax system to enterprises that meet certain criteria. The criteria can be political, economic, social or cultural.

A tax holiday need not be a complete holiday. A government may simply reduce the rate of tax from its normal corporate rate to a nominal amount for an indefinite period. Governments do not like tax holidays. Worse still, they do not like tax holidays that permanently reduce the tax rate to zero. Thus, the OECD issued its Report on *Unfair Tax Competition* and published a list of so-called “black list” countries (a.k.a. tax havens) because they do not levy corporate taxes. The OECD says that this is unfair to countries that levy high taxes because businesses will migrate from the high tax jurisdictions to low tax countries.

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They say that this is unfair. Everyone should have high tax rates to protect against the flight of capital. The Report identified Canada as a mild offender.

Indirect subsidies through tax credits and fast write-offs also work well. Thus, one can achieve through a tax subsidy exactly the same result that one achieves through a direct cash subsidy. Trade experts, however, do not look too closely at tax subsidies. They live in the world of direct trade rules.

Which works best—direct trade subsidies, tax holidays or indirect tax subsidies? In fact, they all work in exactly the same way, but with varying degrees of government intervention. Each method reduces the cost of production so that the subsidized enterprise can compete better (and even unfairly) in domestic or international markets. If the unfair competition is only in the domestic market, the problem does not attract the attention of the WTO. If the subsidy violates global trade rules, however, the government of a competitor country can bring charges and seek compensation or trade sanctions against the offending country.

Governments will not publicly admit the reality of tax subsidies. There is little doubt as to their purpose and economic objectives, however, and the courts recognize them for what they do. The Supreme Court of Canada approved the following characterization of certain manufacturing and processing incentives:

> … It is clear from the total context of the legislation, including the passages from the *House of Commons Debates* to which I have referred, that Parliament’s objective in enacting the legislation was encouragement of increased production of manufactured and processed goods to be placed on the domestic and international markets in competition with foreign manufacturers. That that is the activity which Parliament sought to encourage is, to my mind, plain from the Debates. It is equally plain that Parliament intended to benefit manufacturers and processors who engaged in those activities. *In other words, the relevant statutory provisions were designed to give Canadian manufacturers and processors an advantage over their foreign competitors in the domestic and foreign markets*. It is also clear that Parliament had in mind specific target groups and specific target activities. The legislation was not intended to benefit every manufacturing activity or every manufacturer.

The Supreme Court merely acknowledges what tax legislators have known all along. Subsidies offend trade rules. If, however, one can wrap a direct cash subsidy into an indirect tax subsidy and hide the economic effect through fast write-offs, one can achieve exactly the same end, but without violating international trade rules. Whether in writing the law or in complying with it, form usually prevails over substance except when a court retrospectively says that substance should prevail over form on the particular facts.

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