General Corporate — Commentary — Articles — English — Vern Krishna —, 2013-03-052 -- Foreign Revenue Laws Need Enforcement

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Search Details

Search Query:	Table of Contents

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Vern Krishna discusses the need for a mechanism to ameliorate the frictions that can arise from the interaction of different tax systems, such frictions are in the form of double taxation, double non-taxation of income, tax avoidance, and tax evasion. Tax information exchange treaties attempt to address these problems, but only with limited success.

Foreign Revenue Laws Need Enforcement

Date: April 3, 2013

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Vern Krishna

Sovereign states do not enforce the revenue laws of foreign countries. There is no universal jurisdiction in tax law. Thus, Canada neither enforces foreign revenue laws nor expects foreign jurisdictions to enforce its taxing statutes. This rule, which has ancient antecedents, creates problems in modern economies that are increasingly global. Multi-national enterprises are now the norm in business.

We need a mechanism to ameliorate the frictions that can arise from the interaction of different tax systems. Typically, such frictions are in the form of double taxation, double non-taxation of income, tax avoidance, and tax evasion. Tax information exchange treaties attempt to address these problems, but only with limited success.

Compared with European countries, Canada was relatively slow in getting into tax treaties, although once off the mark it became active in negotiating them. Understandably, given the trading and economic relationship, the Canada-U.S. Tax Convention is our most significant and complex treaty.

Double taxation is the imposition of comparable taxes in two (or more) states on the same taxpayer in respect of the same subject matter and for identical periods. Double taxation commonly arises because countries may assert taxing jurisdiction on the basis of different criteria. For example, international income may be subject to double taxation if a resident of one country earns income in another country. Countries can tax such income based upon:

- Source of the income;
- Situs of the property that gives rise to the income;
- Residence of the taxpayer who receives the income; or
- The taxpayer’s nationality or citizenship.

We refer to these multiple tax claims as “juridical double taxation.”

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For example, assume that Hank Jones, an American entertainer who is a resident of England and a non-resident of Canada, performs in Canada for FC, a foreign corporation resident in England. Jones is paid $100,000 for his performances from a bank account maintained in England. Without treaty relief, Jones could be liable for tax in three countries: for Canadian income tax as a non-resident if he is considered to be “employed in Canada”; for tax in England on the basis of his residence in that country; and in the U.S. on the basis of his citizenship.

To be sure, a country can always unilaterally relieve against double taxation of international income through its domestic tax rules. For example, a country can provide tax relief through:

- A deduction for foreign taxes paid;
- An exemption of foreign source income;
- A credit for foreign taxes; or
- Restricted taxation of income on certain forms of income.

There is, however, a financial limit to the amount of unilateral relief that a country can provide, since foreign tax credits, deductions and exemptions involve a loss of revenue to the granting country by diminishing the taxable base. These unilateral solutions also have economic implications. The exemption method, for example, is non-neutral if the income derives from a country that is a tax haven.

Similarly, credits create problems with the principle of capital export neutrality. The generally accepted criterion for tax neutrality is capital-export neutrality; that is, the taxation of foreign and domestic profits at the same total rate.

Capital-export neutrality results in the most efficient international allocation of capital resources in a manner that maximizes world production. It is also considered to be an “equitable” principle because taxpayers with the same worldwide income pay the same total amount of total tax.

Thus, capital export neutrality reflects the principle that a dollar is a dollar no matter where it is earned. For example, if Royal Bank of Canada is taxed at 45 per cent on its Canadian profit and its British subsidiary pays 25 per cent tax to the British government, Canada would have capital-export neutrality if the Canadian government levied a net tax of only 20 per cent on the bank’s British profits.

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