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BACKGROUND PAPER

# HOW DO DIGITAL MULTINATIONALS LEGALLY AVOID TAX IN CANADA?

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(Background Paper)

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# EXECUTIVE SUMMARY

According to the Organisation for Economic Co-operation and Development (OECD), multinational enterprises are using increasingly aggressive practices to reduce the amount of tax they have to pay, and some of them are creating off-shore subsidiaries or shell companies. This trend has recently been exacerbated by the rapid growth of the digital economy.

In 2015, the OECD estimated that the revenue losses generated by these practices could amount to as much as US$240 billion annually worldwide, or 10% of total corporate income tax revenues. The Parliamentary Budget Officer estimates that Canada could collect $540 million in tax revenue in 2021 and double that amount by 2028 if it imposed a 3% tax on certain types of revenue generated by digital multinationals in Canada.

In a rapidly digitizing economy, governments, including the Government of Canada, are concerned that outdated international tax rules could lead to increasing tax revenue losses. These losses could prevent them from providing services to their citizens and create an unfair tax system for businesses that have to pay their taxes in the country where they generate their revenues. Many believe that international tax rules should be changed without delay, because they are based on principles established almost a century ago, when commerce required a physical presence.

In response to these concerns and at the request of the G20, the OECD, in July 2013, developed the Action Plan on Base Erosion and Profit Shifting, which listed 15 actions to reform international tax rules to curb tax avoidance by multinational companies.

In October 2019, noting that a growing number of countries no longer want to wait for an international agreement to be reached and are taking unilateral measures to tax certain multinationals, including those in the digital economy, the Secretary-General of the OECD proposed a unified approach to taxing multinationals. He hoped to restart negotiations between countries so that an international agreement could be reached by the end of 2020.

In Canada, the federal government will have to decide whether to quickly implement its own tax on multinational digital companies, often referred to as “GAFAs” in reference to Google, Apple, Facebook and Amazon, or whether to wait for the conclusion of an international agreement, which is anticipated in 2020, but is likely to be later, based on previous delays involving multilateral negotiations.

# HOW DO DIGITAL MULTINATIONALS LEGALLY AVOID TAX IN CANADA?

## 1 INTRODUCTION

According to the Organisation for Economic Co-operation and Development (OECD):

> [t]he practices multinational enterprises use to reduce their tax liabilities have become more aggressive over the past decade. Some, based in high-tax regimes, create numerous off-shore subsidiaries or shell-companies, each time taking advantage of the tax breaks allowed in that jurisdiction.[1]

This trend has recently been exacerbated by the rapid growth of the digital economy.

In 2015, the OECD estimated that the revenue losses generated by these practices could amount to as much as US$240 billion annually worldwide, or 10% of total corporate income tax revenues.[2] The Parliamentary Budget Officer estimates that Canada could collect $540 million in tax revenue in 2021 and double that amount by 2028 if it imposed a 3% tax on income generated by digital multinationals in Canada.[3] Internationally, there are growing concerns about multinational companies in the digital economy that sell billions of dollars worth of goods and services while avoiding taxation in the states where their customers and users live. Many believe that international tax rules are outdated and should be changed without delay, because they are based on principles established almost a century ago, when commerce required a physical presence.[4]

In response to these concerns and at the request of the G20, the OECD, in July 2013, developed the Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan),[5] which listed 15 actions to reform international tax rules to curb tax avoidance by multinational companies. The OECD released final reports on these 15 actions on 5 October 2015.[6] Since then, progress has been made in several areas. However, despite the efforts of the OECD and the G20, the international community has not been able to agree on how to tax multinational digital companies.

In October 2019, noting that a growing number of countries no longer want to wait for an international agreement to be reached and are taking unilateral measures to tax certain multinationals, including those in the digital economy, the OECD Secretary-General proposed a unified approach to taxing multinationals in order to restart negotiations between countries for an international agreement to be reached by the end of 2020.[7]

This publication provides an overview of Canadian corporate tax legislation to explain how some multinational digital companies (often referred to as "GAFAs" in reference to Google, Apple, Facebook and Amazon) can legally avoid Canadian taxes. It then analyzes some of the measures proposed by the OECD in the BEPS Action Plan. Finally, it summarizes the unilateral measures that the European Union (EU), France and the United Kingdom (U.K.) have recently developed to tax digital multinationals.

## 2 OVERVIEW OF CANADIAN CORPORATE INCOME TAX LEGISLATION

In Canada, the income tax corporations pay depends on their residency for tax purposes. Corporations resident in Canada must pay Canadian tax on their global income, while foreign corporations are liable for Canadian tax only on income from a business in Canada.[8] As will be explained in the next section, it is easy for multinationals in the digital economy to avoid paying Canadian taxes while respecting current legislation, which, according to many observers, is inadequate for the modern economy.

### 2.1 CORPORATION TAX RESIDENCY

Under section 250(4) of the *Income Tax Act* (ITA), a company is generally deemed to be resident in Canada for tax purposes if it is incorporated in Canada.[9] A company could also be resident in Canada for tax purposes under common law, which has established that a company is resident in the country in which its central management and control is exercised.[10] Usually, central management and control of a company is exercised where the members of the board of directors meet and hold their meetings. For Canadian tax authorities, a foreign company must neither be incorporated in Canada nor exercise central management and control in Canada.

It should be noted that bilateral tax treaties, including those to which Canada is a party, generally define corporate residency for the purposes of that treaty. Since tax treaties have priority over domestic legislation, each of the applicable treaties should be referred to in order to determine a corporation's residency. For example, pursuant to section 250(5) of the ITA, where a corporation that would otherwise be resident in Canada is, under Article IV of the Canada–United States Income Tax Convention, resident in the United States because it was incorporated there, that company is deemed to be resident in the United States for tax purposes.[11]

### 2.2 TAXATION OF FOREIGN COMPANIES UNDER DOMESTIC LEGISLATION

Section 2(3)(b) of the ITA provides that a foreign corporation that "carried on a business in Canada" as defined in section 253 of the Act is subject to Canadian income tax on its income earned in Canada through that business. This basic rule of

corporate income tax liability respects a recognized international tax principle, that of a country's right to tax income from activities carried out within its borders.[12]

Under section 253 of the ITA, a non-resident corporation will be deemed to carry on business in Canada if it:

> (a) produces, grows, mines, creates, manufactures, fabricates, improves, packs, preserves or constructs, in whole or in part, anything in Canada …;
>
> (b) solicits orders or offers anything for sale in Canada through an agent or servant, whether the contract or transaction is to be completed inside or outside Canada or partly in and partly outside Canada.

Foreign companies that use a transactional website to offer their products or services to potential customers in Canada do not need an agent or servant. Therefore, section 253(b) of the ITA cannot be applied to these companies.[13]

Finally, even if the federal government were to amend section 253 of the ITA to make foreign companies engaging in e-commerce subject to income tax, this amendment would not apply to foreign corporations resident in a country with which Canada has a bilateral tax treaty, as is explained in the next section.[14]

### 2.3 IMPACT OF BILATERAL TAX TREATIES

Even where it is established that a foreign corporation carries on business in Canada under domestic legislation, the corporation can generally be exempted from Canadian tax and pay tax only in its country of residence if it meets two conditions: first, if it is a resident of a country with which Canada has a tax treaty and, second, if it does not carry on business in Canada through a permanent establishment as defined in the tax treaty in question.

For example, Article VII of the *Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital*[15] provides that:

> [t]he business profits of a resident of a Contracting State shall be taxable only in that State unless the resident carries on business in the other Contracting State through a permanent establishment situated therein. If the resident carries on, or has carried on, business as aforesaid, the business profits of the resident may be taxed in the other State but only so much of them as is attributable to that *permanent establishment*. [Author's emphasis]

According to Article V of the Convention, the term "permanent establishment" means a fixed place of business through which the business of a resident of a Contracting State is wholly or partly carried on. It includes especially:

(a) a place of management;

(b) a branch;

(c) an office;

(d) a factory;

(e) a workshop; and

(f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

Section 6(a) of Article V of the Convention states that the use of facilities for the purpose of storage, display or delivery of goods or merchandise by a non-resident corporation does not constitute a permanent establishment. Similarly, the Canada Revenue Agency (CRA) is of the opinion that a website does not constitute a permanent establishment because of its intangible nature. However, a server that hosts a website could be a permanent establishment, according to the CRA.[16]

## 3 DEVELOPING AN INTERNATIONAL AGREEMENT

The current network of bilateral tax treaties, which includes more than 3,500 treaties,[17] is based on principles designed in the 1920s to eliminate the double taxation that may occur in the case of cross-border trade and investment. In other words, it aims to prevent two states from taxing the same business for the same income. According to experts, bilateral tax treaties are successful in preventing double taxation. However, in an increasingly globalized and digitized economy, the current network of bilateral tax treaties can also enable zero taxation resulting from interactions between more than two countries.[18]

The March 2019 decision of the Paris administrative court of appeal in the case involving Google Ireland Ltd. illustrates this situation.[19] In this case, the French tax authorities ordered Google Ireland Limited to pay €1.1 billion in taxes on revenue from advertising sales in France through limited liability company Google France. In its decision, the Paris administrative court of appeal ruled that Google Ireland Limited was not subject to tax in France because it carried on business there without using a permanent establishment under Article 4 of the France–Ireland tax treaty. Google France did not constitute a permanent establishment, in particular because it did not have the power to conclude contracts on behalf of Google Ireland Limited. In a 2017 article, authors Gérard Haas and Florian Perretin noted the effectiveness of the technique used by the GAFAs: emptying branches established in a state of their substance so that they cannot be considered permanent establishments by the tax authorities of the country in which they do business.[20]

In response to this situation, the final report on the OECD/G20 BEPS Action Plan, entitled “Developing a Multilateral Instrument to Modify Bilateral Tax Treaties,” concluded that it is desirable and feasible to have a multilateral instrument that would enable states to swiftly amend their bilateral tax treaties in order to implement the measures developed under the BEPS Action Plan.[21] In November 2016, some 100 countries and seven international or regional bodies concluded negotiations on the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*, more commonly known as the Multilateral Instrument (MLI).

On 7 June 2017, 76 countries, including Canada, gathered in Paris for the official signing of the MLI. According to the OECD, the MLI will help combat base erosion and profit shifting in several ways:

> Abuse of tax treaties is an important source of base erosion and profit shifting (BEPS). The MLI helps the fight against BEPS by implementing the tax treaty-related measures developed through the BEPS Project in existing bilateral tax treaties in a synchronised and efficient manner. These measures will prevent treaty abuse, improve dispute resolution, prevent the artificial avoidance of permanent establishment status and neutralise the effects of hybrid mismatch arrangements.[22]

In Canada, Parliament passed Bill C-82, An Act to implement a multilateral convention to implement tax treaty related measures to prevent base erosion and profit shifting, which received Royal Assent on 21 June 2019.[23] The MLI, which came into force in Canada on 1 December 2019, will apply to some of Canada’s tax treaties starting in 2020, depending on when co-signatories of these treaties with Canada individually approve the MLI and deposit their instruments of ratification with the OECD. On 29 August 2019, Canada filed a list of its reservations to certain articles of the MLI.[24] It should be noted that the tax treaty in question will not apply to articles that are subject to reservations by either co-signatory. To date, 94 countries are signatories to the MLI.[25] It is important to note that the United States is not a signatory.

The MLI has the effect of simultaneously renegotiating thousands of bilateral tax treaties,[26] which could otherwise take years under the traditional negotiating process. There is no doubt that the MLI is an important milestone in the evolution of the international tax system, but it remains to be seen whether it will achieve all its objectives. Its adoption by 94 countries, with the potential for additional countries, is an important achievement; its scope, however, is limited by the absence of the United States, the world’s largest economic power, and by the fact that other OECD members, including Canada, have accepted only a limited set of provisions at this time.

The MLI can be an important tool in fighting base erosion and profit shifting, but it is not a panacea. The ultimate objective of the BEPS Action Plan is to conclude a more comprehensive international agreement on the taxation of multinationals, including digital multinationals, that would include the United States. However, negotiations have been difficult and, until very recently, were stalled.

### 3.1 FURTHER NEGOTIATIONS ON THE PROPOSED UNIFIED APPROACH OF THE ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

On 31 May 2019, the countries and jurisdictions that are members of the OECD/G20 Inclusive Framework on BEPS[27] adopted a program of work to set out the steps to be taken to reach an international agreement on collecting taxes from digital multinationals.[28] The G7 finance ministers adopted the program in June 2019. This was the first time that all G7 countries, including the United States, had agreed on the principle of taxing the activities of digital multinationals, even if these did not have a "physical presence" in a given jurisdiction. The program of work is based on two main pillars:

- revision of the rules related to the link between a company and a jurisdiction and to the allocation of profits (Pillar 1); and
- global anti-base erosion proposal (Pillar 2).

On 9 October 2019, with a view to relaunching difficult negotiations between countries and reaching an international agreement by the end of 2020, the OECD published a public consultation document reflecting the latest developments in its work on the tax challenges arising from the digitalization of the economy and providing a proposal for a unified approach.[29] The proposal aims to ensure that certain multinational companies pay income tax in countries where they have activities involving consumers even if they are not physically present. According to the OECD, a separate public consultation meeting on issues related to Pillar 2 was planned for December 2019.

On 31 January 2020, the countries and jurisdictions that are members of the OECD/G20 Inclusive Framework on BEPS reaffirmed their commitment to find a long-term solution to tax challenges resulting from the digitization of the economy, and they announced the continuation of negotiations to reach an agreement by the end of 2020.[30]

## 4 EUROPEAN COMMISSION, FRANCE AND UNITED KINGDOM

As the international community has been slow to agree on how to tax multinationals, particularly digital ones, some countries and international bodies have put their own measures forward to tax multinational digital enterprises.

### 4.1 EUROPEAN COMMISSION

In March 2018, the European Commission, the executive body of the EU, announced two legislative proposals, largely based on the OECD's work. The proposals were designed to ensure that digital multinationals pay their fair share of income taxes.

The first proposal addressed broadening the definition of the term "permanent establishment" to include situations where an enterprise is engaged in significant economic activity through a "digital presence." This would enable EU member states to tax profits that are generated within their borders, even if a company does not have a physical presence there. Under this proposal, a digital platform would be deemed to have a virtual permanent establishment in an EU member state if it fulfilled one of the following criteria:

- it generates more than €7 million in annual gross income in a member state;
- it has more than 100,000 users in a member state in a fiscal year; or
- it has generated more than 3,000 business contracts for digital services with active users in a fiscal year.[31]

The second proposal would apply an interim tax on revenue generated from activities where users play a major role in value creation, such as revenue:

- generated from selling online advertising space;
- generated from digital intermediary activities which allow users to interact with other users and which can facilitate the sale of goods and services among them; and
- generated from the sale of data from user-provided information.[32]

Tax revenue would be collected by EU member states where the users are located, and the tax would only apply to companies with a minimum total annual worldwide revenue of €750 million and EU revenue of €50 million. Based on the European Commission's estimates, €5 billion in revenue a year could be generated for EU member states if the tax were applied at a rate of 3%.[33]

On 12 March 2019, the proposal for a European tax on digital multinationals was supported by 24 of the 28 EU countries. However, because the proposal required unanimous support, it was suspended. Ireland, Sweden, Denmark and Finland opposed the proposal. However, according to the European Commissioner for Economic Affairs:

> If we have not been able to reach an international agreement by 2020, we must continue to push forward. The European Commission has no intention of withdrawing its proposal from the table. This is not the end; it has not died.[34]

### 4.2 FRANCE

On 11 July 2019, the French Senate passed a law introducing a 3% tax on the revenue of digital multinationals from sales generated in France. Only companies with annual revenue exceeding €750 million worldwide and €25 million in France are affected by this measure. This tax applies to income from targeted online advertising, sales of data for advertising purposes and intermediary services connecting Internet users. The tax does not, however, apply to direct sales to consumers online. According to the policy document, this measure is to be temporary, and France will repeal it should an international agreement be reached.

In response to France's digital services tax, the Office of the United States Trade Representative launched an investigation under section 301 of the United States *Trade Act of 1974* to determine whether the tax amounted to unfair trade practices. On 26 August 2019, at the G7 summit in Biarritz, France, the media reported that French and U.S. representatives had reached an agreement on the new French tax. Under the terms of the agreement, France would repay companies the difference between its digital services tax and any other tax or levy resulting from a possible international agreement.[35] According to French government estimates, the tax would generate annual revenue of €400 million in the first year and €650 million in 2022.[36]

On 1 October 2019, following the imposition of the digital services tax in France, U.S. company Amazon increased the commission it collects from French companies selling products through its platform in France from 15% to 15.45%, or by 3%. Amazon expected many of these companies to increase the price of their products sold online as a result of the tax. Such a price increase could have reduced the price gap that generally exists between products sold online by multinational digital companies and products sold by retailers that have permanent establishments in France and that, consequently, must pay taxes there.

However, following the World Economic Forum in Davos, Switzerland, in January 2020, France, which was facing possible repercussions from the United States, chose to delay the application of this tax. In return, the Americans suspended the trade sanctions that they had threatened to impose on French products, such as wine.[37]

### 4.3 UNITED KINGDOM

On 29 October 2018, the U.K. proposed a digital services tax as part of its 2018 budget.[38] The tax would be levied starting on 1 April 2020 at a rate of 2% of the revenue of particular digital companies that derive value from their interactions with U.K. users. The tax would apply to search engines, social media platforms and online marketplaces that generate revenue from U.K. users. The term "user" is broadly defined and includes interactions such as making a payment or simply browsing the site, which generates "clicks."

The tax would apply only to companies whose annual revenue attributable to the participation of U.K. users exceeds £25 million and those activities (search engines, social media platforms and online marketplaces) that generate global annual revenue of at least £500 million. The measure also provides an exemption for unprofitable companies, as well as a reduced tax rate for companies with very low profit margins. Details on this tax will be provided in a bill expected to be introduced in the U.K. Parliament in April 2020. Like the French government, the U.K. government has committed to eliminating its own digital services tax once an appropriate international agreement has been put in place.

The U.K. government estimates that the digital services tax could generate an annual revenue of £275 million in 2020 and £440 million in 2024.[39]

## 5 NEXT STEPS

The efforts undertaken at the meeting of G7 finance ministers in Chantilly, France, in July 2019, at the G7 Summit in Biarritz, France, which ended in August 2019, and at the World Economic Forum in Davos, Switzerland, in January 2020, seem to indicate that all the countries and jurisdictions that are members of the OECD/G20 Inclusive Framework on BEPS are closer than ever to reaching an international agreement to implement an international tax on the revenue of multinational enterprises, including digital ones.

In its 2019 election platform, the Liberal Party of Canada, which formed a minority government following the election, pledged to ensure that "tech giants pay corporate tax on the revenue they generate in Canada."[40] In 2020, the federal government will have to decide whether to swiftly implement its own tax on the services of multinational digital companies or wait for the conclusion of an international agreement, which is anticipated in 2020 but may be delayed, based on the slowness of past multilateral negotiations.

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