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Taxation of Intangibles

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Abstract

This paper examines the tax treatment of intangibles in Canada and recent developments internationally. It suggests that the special features of intangibles and the rapid rise of intangibles as value-drivers in the global economy may render existing tax rules inadequate in defining Canada's tax base and/or competing for investment in research and development in Canada. Recent developments at the international level (such as the BEPS Project) and national level (such as US 2018 tax reform and changes in Japan, UK and China to implement BEPS recommendations) may point to some directions for Canada to consider.

Keywords: intangibles, BEPS, transfer pricing, digital taxation, Patent Box; GILTI; FDII; BEAT; international minimum tax; value creation

1. INTRODUCTION

In the age of innovation, digitization or knowledge-economy, intangibles are increasingly important value-drivers for corporations. For example, the portion of intangible assets in the market value of the Standard & Poor's 500 stock index is 91% in 2019, rose from 17% in 1975, 32% in 1985, 68% in 1995 and 80% in 2005. [1] In Europe and the United States, intangible investment overtook tangible investment in the global financial crisis in 2008.[2] In Canada, total investment in intangibles has grown more rapidly than total investment in tangibles over time,[3] but Canada lags behind the United States.[4]

Conceptually, intangibles can be intellectual property, such as patents, copyrights and trademarks as well as goodwill, brand recognition, know-how, licenses, data, etc. For the lack of a statutory definition in the Income Tax Act, [5] one can perhaps regard anything of value that is not tangible as an intangible for general purposes.[6] Intangibles differ from tangible assets in terms of scalability,[7] sunkenness,[8] uniqueness[9] and difficulty in valuation.. These features make the intangibles or digital economy different from the traditional economy and challenge the application of tax laws that were developed during the industrial era.

Recent debates about the taxation of intangibles and digital economy have centred on two basic questions:

1. Are the existing rules on the inter-nation allocation of taxing rights adequate in regard to value created by intangibles (the "tax base" question), and
2. To what extent can nation states engage in tax competition to retain or attract income from intangibles to their jurisdiction (the "tax competition" question)?

The tax base question concerns with the definition of tax jurisdiction of a country, rules on the deduction of expenditures on developing or acquiring intangibles, rules on the taxation of income from intangibles, transfer pricing rules and other base-protection rules. The tax competition question concerns with the use of tax incentives to attract activities that create/develop intangibles or exploit the value of intangibles.

As a result of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project launched in 2013, a value-creation paradigm has emerged, aiming to tax business profits in the country where economic activities occur and value is created. This paradigm has guided the reform measures

adopted in BEPS Actions 8-10 on transfer pricing and influenced the proposals to address the tax challenges arising in the digital economy. However, this value-creation paradigm is controversial and its application uncertain. This is particularly the case with respect to intangibles owing to the inherent difficulty in determining the value of intangibles and where value is created. There is no international consensus yet.

Some countries have adopted unilateral measures to address the taxation of intangibles. For example, the United States introduced the GILTI (global intangible low tax income), FDII (foreign-derived intangible income) and BEAT (base erosion anti-abuse tax) rules as part of the Tax Cuts and Jobs Act (TCJA) enacted in 2017. Many European countries have introduced "patent box" regimes to offer preferential tax treatment of income from patent and patent-like intangibles.[10] The United Kingdom amended rules on the recognition of cost of fixed intangible assets and patent box and incorporated OECD Guidelines.[11] Through the process of implementation of BEPS measures, China has updated its transfer pricing rules to emphasize a contribution-based analysis in determining the value of intangibles and the location of value creation,[12] and Japan has adopted the OECD approach to hard-to-value intangibles.[13]

The Act does not really specifically address intangibles. As such, general tax law and policies apply to intangibles. Canada seems to lag behind many of its peers in the OECD in this respect. Even in the area of transfer pricing where section 247 of the Act is purportedly consistent with the OECD Transfer Pricing Guidelines, at least the 1995 version of the guidelines, it is questionable whether the subsequent versions should influence the interpretation of section 247. Some consider these subsequent guidelines to have limited effect on Canadian law in the absence of legislative amendment, while the Canada Revenue Agency ("CRA") and the government of Canada were of the view that such legislative amendment was not necessary in general.[14]

This paper reviews the Canadian taxation of intangibles and canvasses major recent developments at an international level and selected country level. It urges Canada not to be complacent with the status quo and offers some ideas for moving forward.

2. INTANGIBLES: DEFINITION AND SPECIAL FEATURES

2.1 Definition

The term “intangibles” or “intangible property” is not defined in the Act. The definition of “property” in subsection 248(1) says that property can be intangible. “In principle, it does not matter whether an “intangible” is legally protected, as long as it and the realization of its value would be recognized for purposes of computing income under the Act.”[15] For purposes of specific provisions of the Act, specific types of intangibles are mentioned. For example, for the capital cost allowance rules under paragraph 20(1)(a), goodwill, license and farm quota are treated as assets in Class 14.1, while a patent, franchise, concession or license fall into Class 14, computer software is in class 12. Similarly, paragraph 212(1)(d) mentions “invention, trade-name, patent, trade-mark, design or model, plan, secret formula, process” and “information concerning industrial, commercial or scientific experience” in specifying whether the payment for the right, or the right to use, these items are subject to Canadian withholding tax.

The transfer pricing provision in section 247 makes no explicit reference to intangibles. The CRA Information Circular IC 87-2R- International Transfer Pricing (September 7, 1999), which was stated to be consistent with the 1995 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the 1995 OECD Guidelines), addresses “intangible property” issues in Part 5 without offering a definition of this term. The circular “presumes the existence of a taxable object called “intangible property” and then discusses the application of the arm’s length standard to it.[16]

The OECD Transfer Pricing Guidelines (2017)[17] states in para.6.6:

> [T]he word “intangible” is intended to address something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances. Rather than focusing on accounting or legal definitions, the thrust of a transfer pricing analysis in a case involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction.

The above definition presumes that an intangible is an asset, but not necessarily in a legal or accounting sense. It defines intangibles in a negative manner by excluding “physical asset” and

"financial" asset. It emphasizes, however, that the asset must be "capable of being owned or controlled for use in commercial activities" and has market value.

The US took a different approach. Instead of defining intangibles, for purpose of GILTI and FDII rules, intangible income is deemed to be corporate income that exceeds a deemed rate of return on tangible assets.[18]

2.2 Categories and Development of Intangibles

Intangibles can be described and classified in various ways, such as "trade intangibles", "marketing intangibles", "soft intangibles" and "hard intangibles", "routine and non-routine intangibles", "unique and valuable" intangibles, or "hard-to-value intangibles".[19] The OECD Transfer Pricing Guidelines describe the following kinds of intangibles: patents, know-how and trade secrets; trademarks, trade names and brands; licenses and similar limited rights in intangibles; goodwill and ongoing concern value, and clarify that group synergies and market specific characteristics are not intangibles as they are not capable of being owned or controlled by an enterprise.[20] Intangibles can also be categorized as marketing related (e.g., trademarks), customer-related (e.g., customer lists), artistic-related (e.g., literary works), technology-based (e.g., patents) or contract-based (e.g., license or franchise).

Some intangibles are developed in the ordinary course of carrying on business. Examples are brand recognition, goodwill and know-how. Other intangibles require specific development, such as copyrights, patents and trademark and are protected by specific intellectual property legislation. Data, especially the insights provided through applying analytics and artificial intelligence (AI) to data is a critically valuable input to all areas of business. For digital businesses, user data is critical to their success. Data is often coupled with the use of other intangible assets and the ability to sell without being physically present. Customer interfaces or platforms that use digital enablers, predictive analytical tools and AI are valuable intangibles in a business sense.

2.3 Monetization of intangibles

The value of an intangible can be monetized or realized through a transfer (disposition) of the intangible or licensing of the right to use the intangible on a stand-alone basis or as part of a

composite transaction (such as a merger or acquisition and restructuring). The value of intangibles can also be realized through the sale of goods and/or services with embedded intangibles.[21] According to a WIPO study, intangibles accounted for over 30% of the value of manufactured goods sold throughout 2000-2014, and income from intangibles increased by 75 per cent from 2000 to 2014 in real terms.[22] It was also found that the share of intangibles in the value of final goods increased more rapidly in durable goods (machinery and equipment products) than non-durable products.[23]

For tax purposes, income attributable to intangibles is often treated differently from the sale of goods or services. In the case of embedded intangibles, the challenge is to disaggregate the value of a sale of goods/services transaction to reveal the portion attributable to intangibles, or in other words, to make the invisible intangible income visible for tax purposes.

2.5 Valuation

Valuation of intangibles is important for tax purposes. However, valuation is often difficult, especially in transactions between members of the same corporate group. For transfer pricing purposes, the OECD Transfer Pricing Guidelines (2017) acknowledge the use of income-based valuation techniques, "especially those premised on the calculation of the discounted value of projected future income streams or cash flows derived from the exploitation of the intangible being valued"[24] and "discourage" the use of cost of development technique.[25] If there is a fair market value, the market approach is obviously the best.

3. CANADIAN TAXATION OF INTANGIBLES

The Act does not have a specific regime for intangibles. As such, basic tax principles apply to the characterization of transactions involving intangibles as giving rise to a revenue or capital amount, the deductibility of cost of developing or acquiring intangibles, the timing of deduction, and valuation. In the case of cross-border transactions, the general rules governing tax jurisdiction, withholding taxes, foreign accrual property income (FAPI) rules and transfer pricing apply to transactions involving intangibles. In addition, the Act offers "generous" incentives for conducting research and development in Canada,[26] but no incentives for exploiting intangibles in

Canada. What follows is a brief discussion of the salient aspects of the Act regarding intangibles in cross-border situations.

3.1 Characterization and Timing Rules

Paragraphs 12(1)(g) and 212(1)(d) of the Act treat payments based on production or use or any payments that are similar in nature to rent or royalties as income. Both provisions disregard the contractual arrangement or characterization. Outside these two provisions, the characterization of an amount as on revenue (or income) or capital account is governed by general principles.[27] The characterization is relatively straightforward in the case of intellectual property, such as patents, trademarks and copyrights and not so in the case of other intangibles. For example, a payment for acquiring goodwill was considered to be on capital account in *Gifford.*[28] Similarly, the cost of acquiring a franchising business, including trademarks, know-how and goodwill was considered to be on capital account in *Services Farmico Inc.*[29] On the other hand, the cost of obtaining a trademark registration or developing goodwill are generally on revenue account and currently deductible. The sale of know-how or secret process is generally on income account.[30]

The timing of recognition of the cost of intangibles or income of intangibles is also governed by general rules. For example, the cost of intangibles that is on capital account is deductible under the capital cost allowance regime.[31] The rate of depreciation is prescribed to be 5% for Class 14.1 property (goodwill), 25% for Class 44 property (patent, right to use patented information for a limited or unlimited period) and apportioned over the life of Class 14 property (patent, franchise, concession or license for a limited period in respect of property). The cost of developing intangibles on revenue account are deductible when it is incurred. Section 37 of the Act permits a taxpayer carrying on business to deduct certain expenditures made in respect of scientific research and experimental development (SR&ED) which might otherwise not be deductible under the general rules. Income from transferring or licensing intangibles is taxable when it is received or receivable under paragraph 12(1)(g) or paid or credited to a non-resident taxpayer under paragraph 212(1)(d).

3.2 Cross-border Income from Intangibles

Under the Act, residents are taxable on their domestic and foreign income and non-residents are taxable on their Canadian income.[32] In effect, income from intangibles (e.g., royalty) is subject to tax in Canada when Canada is a residence country or source country.

In the case of Canadian residents earning foreign-source royalty income, the income may be subject to withholding tax in the source country. Such withholding tax is generally creditable against Canadian tax otherwise payable.[33] However, if foreign-source royalty is earned by a Canadian resident corporation through its foreign affiliate, such income is, in effect, exempt from Canadian tax when it is earned by the foreign affiliate and when it is distributed to the Canadian resident in the form of dividends.[34] In other words, as long as the intangibles are exploited outside Canada and used in carrying on an active business in, and by a resident of, a designated treaty country, the income is free from Canadian tax at the corporate level (personal taxes on distributions remain applicable, etc.)..

In the case of non-residents receiving royalties or similar income from intangibles from a Canadian resident, the payment is subject to a 25% gross-basis withholding tax (which is reduced by an applicable tax treaty).[35] This withholding tax applies even when the payer is a non-resident of Canada as long as the payment is deductible in computing income attributable to a Canadian permanent establishment of the non-resident.[36] The underlying principle is that income from intangibles is taxable at source – where it is used. This principle is consistent with the new nomenclature –value creation principle (i.e., taxation of profits where value is created) and the policy underlying the U.S. BEAT rules.

3.3 Transfer pricing

Canadian-based or foreign-based MNEs develop and exploit intangibles through transfer pricing arrangements, such as cost sharing arrangement, contract research and development, transfer of intangibles to a central entity, related-party licensing or the sale of goods or provision of services with embedded intangibles. The facts of each of the recent transfer pricing cases reveal the role of intangibles as value-drivers, namely: tradename, design and technology to manufacture aluminum window products in *Marzen Artistic Aluminum Ltd.;* [37] know-how, secret process and name recognition and customer list, etc. in the business of distribution of pharmaceutical

medicine products and provision of hospital software technology in *McKesson;*[38] group synergy and name recognition in *General Electric Capital Canada;*[39] patent, trademark, processes and know-how in *Glaxo*;[40] and license to mine uranium, patent, process and technology related to mining, milling of uranium and production of fuel assemblies in *Cameco.*[41]

Section 247 of the Act was enacted in 1997 to largely reflect the 1995 OECD Transfer Pricing Guidelines. The CRA generally adheres to these guidelines. The charging rule in subsection 247(2) does not refer to the word "price." The courts stated that "the statutory objective underlying paragraphs 247(2)(*a*) and (*c*) of the Act is to prevent the avoidance of tax resulting from price distortions which can arise in the context of non-arm's length relationships by reason of the community of interest shared by related parties"[42] and the Act "calls for the elimination of all the distortions that arise in any given transaction between related parties".[43] Nevertheless, Canadian courts have generally interpreted section 247 as providing for an exercise of finding arm's length prices.

In *Glaxo*, the Supreme Court of Canada acknowledged that transfer pricing is not an exact science and said that in determining the arm's length price the interest of each party to the non-arm's length transaction should be considered.[44] Among the transfer pricing methods sanctioned by the OECD Transfer Pricing Guidelines (i.e., comparable uncontrolled price or CUP, resale price, cost plus, transactional net margin method or TNMM, and profit split), CUP has been used the most. The issue of intangibles or residual profit arising from intangibles has not been considered as such in any of the cases, although in *Glaxo* the reasoning in part was that the taxpayer was reasonably paying for the business relationship and future business opportunities to participate in marketing branded pharmaceutical products.

The CRA recognizes the difficulty in valuing unique intangibles or applying one-sided transfer pricing methods (CUP, resale, cost plus and TNMM) to determine an arm's length result. On CRA's view, "in most cases, both the supplier and the recipient share the risks and the benefits associated with using an intangible"[45] and arm's length pricing for the transfer of intangible property must take into account the perspective of both parties.[46] The CRA also recognizes that transfer pricing methods that depend on comparable transactions between arm's length parties may be inappropriate for unique or highly valuable intangibles. A profit split method may be the

most appropriate.[47] However, the CRA provides no guidance on special comparability factors for intangibles.

One of the controversial issues is the interpretation of paragraphs 247(2)(b)/(d) and whether, and if so, when and how a transaction can be recharacterized or substituted by an alternative transaction. Since the general approach adopted by Canadian courts is to recognize a taxpayer's transaction (typically as defined by contracts) as opposed to the economic or business substance of the transaction,[48] recharacterization or substitution requires explicit legislative stipulation. Some may think that paragraphs 247(2)(b)/(d) provide such stipulation, but the courts have not given these provisions such a reading. In *Cameco,* the Tax Court opined that that the "application of the extraordinary remedy in paragraphs 247(2)(b) and (d) is neither warranted nor appropriate in the circumstances" where the non-arm's length transaction may be unique but are "commercially rational."[49]

3.4 Preferential Tax Regimes

The Act provides for generous tax incentives to support research and development in Canada,[50] but none for owning and exploiting intangibles in Canada.[51] Canada does not have a patent boxregime.[52] On the contrary, the way in which the transfer pricing rules have been interpreted by the courts seems to suggest an implicit incentive for companies to develop intangibles in Canada aided by the general tax incentives and then transfer the intangibles resulted from such R&D to an offshore entity and avoid future Canadian taxation, subject to an exit tax on transfer. It can also be suggested that the Act provides for another implicit incentive to Canadian corporations who exploit Canadian developed intangibles offshore through the exempt dividend regime and the FAPI regime.[53]

4 TAX REFORMS ELSEWHERE

While the Canadian taxation of intangibles has remained more or less unchanged, the rest of the world is moving fast in search of new directions and basis for global solutions in the face of a rising, intangible and digital economy. This section briefly reviews the major reforms at the international level and selected country level.

4.1 The G20/OECD BEPS Project

4.1.1 The Value Creation Paradigm

The BEPS Project's stated goal is to "revise the rules to align them to developments in the world economy, and ensure that profits are taxed where economic activities are carried out and value is created."[54] This has been regarded as introducing the value creation paradigm.[55] "The ascendency of the value creation principle has been remarkable, as has its influence."[56] The G20/OECD BEPS Project is oriented according to this paradigm. The value creation paradigm can be understood to function as both a "negative" principle and a "positive" principle.

As a "negative" principle, value creation underlies the anti-avoidance measures –income should not be allocated to an entity in a low-tax country by MNEs through internal contracts or legal fictions unless value or profit is created there. It functions as a negative souring rule. For example, in the case of "cash box" or "IP box" situations where a central entity in a MNE group that provides financing or holds the intangibles, the profit attributable to the cash box or IP box should reflect the actual value created by the entity, not the amount contractually allocated to it by the MNE. To put it differently, profits should not be sourced to the cash box or IP box beyond the economic value created by its functions, assets or risks assumed. This is highlighted in the BEPS Final Reports on Actions 8-10 on transfer pricing (BEPS Report on Actions 8-10 puts more weight on functions than assets.

As a "positive" principle, value creation assigns taxing rights, which may not exist under the existing international tax regime, to the country where value is created. This is most notable in the debates about digital taxation and whether users/customers of digital businesses create value and business profits should be allocated to the country where users/customers are. The technical debates about digital economic presence or digital permanent establishment are purportedly animated by the value creation paradigm, although it seems that increasingly the focus is shifting toward a formulary approach that puts a greater emphasis on revenues. Ultimately, a monetization transaction is a value *exchange*, not a value *creation*, so a focus on revenues shifts the principle.

The concept of value creation is vague and difficult to be translated into tax rules. There is no international agreement on where value is created in many cases. And yet, it can be argued that

as an ideal, value creation is consistent with the principle of "economic allegiance" that has shaped the international tax system since the 1920s as well as the arm's length principle that underlies the transfer pricing rules.[57]

4.1.2 Transfer Pricing Treatment of Intangibles: BEPS Actions 8-10

The divorce between where value or profit is created and where profit is taxed has been a source of concern and conflict for many years.[58] The difficulty lies in, among others, the economic features of intangibles, the rising role of intangibles in the global value chain, and the practice of interpreting the arm's length principle to respect contractual allocations of rights and corresponding profits to intermediary entities located in nil-or-low-tax jurisdictions. For example, developing intangibles is often time-consuming, risky and capital-intensive. If the development activity is successful, the intangible created or developed can be transferred to an intermediary for relatively low prices and returns to the transferee could be large in comparison to the price paid. Moreover, the intangible may be owned legally by an intermediary entity from the outset, and its development may be contracted to a related entity for a price for services. Under the comparability analysis and the CUP method, the low transfer prices or cost-based service prices would be hard for the tax authorities to challenge. As a result, the legal owner of the intangible whose only contribution to the value of the intangible is to acquire it or fund its development may derive the income from the exploitation of the intangible that could be many multiples of the transfer price or services price paid. The future income is not linked to the cost of development or creation of the intangible. BEPS Actions 8-10 sought to address some of these issues, including ownership and entitlement to income from intangibles, valuation of intangibles, hard-to-value intangibles, cost contribution arrangements, group synergies, and profit split.

Without explicitly lifting the corporate veil or ignoring internal contracts,[59] the BEPS Report on Actions 8-10 effectively splits entitlement to intangible income between the formal legal owner (the intermediary or IP Box) and economic owners (entities that perform functions, use assets and control or assume risks related to the creation of intangible value). The Report emphasizes that the ownership of intangibles based on contracts and the conduct of the parties is the starting point in transfer pricing analysis, but not necessarily the end point.[60] The actual functions performed, assets used and risks controlled or assumed in developing intangibles play a central role in sharing income from the exploitation of the intangibles.

To address the difficulties in finding comparables for transactions involving intangibles, the BEPS Report on Actions 8-10 allows the use of economic valuation techniques that go beyond the five transfer pricing methods.[61] One such technique is the discounted value of projected future cash flows. In the case of hard-to-value intangibles, most valuable intangibles may fall into this category, the Report authorizes tax administrations to take post-transfer results into account in determining the transfer prices in certain circumstances.[62] A taxpayer can challenge the usefulness of post-transaction information by, among other things, demonstrating that the differences between actual outcomes and the projections used can be ascribed to unforeseeable events.[63]

Corporate group synergies may or may not be intangible and are typically not attributable to any specific transaction. Synergistic profit arises from deliberate concerted group actions and is a source of a MNE's residual profit (i.e., profit not attributable to any specific factor of production). The BEPS Report on Actions 8-10 states that such profit ought to be identified and allocated to those members of the MNE group whose functions or assets give rise to the synergies in proportion to their contribution to the synergy.[64] This can be achieved through reflecting the synergies in comparability adjustments so that the effects of the synergies on prices can be determined.

The BEPS Report on Actions 8-10 recognizes the importance of profit splits and global value chains, but does not provide detailed guidance, owing to the time constraint, presumably. The Inclusive Framework of BEPS published Revised Guidance on the Application of the Transactional Profit Split Method in 2018 (2018 Revised Guidance). Its assumption is that arm's length parties split profits on the basis of their relative contributions to the creation of those profits. The Revised Guidance clarifies and significantly expands the guidance on when a profit split method may be the most appropriate method. It describes that the presence of one or more of the following indicators may be relevant: each party makes unique and valuable contributions; the business operations are highly integrated such that the contributions of the parties cannot be reliably evaluated in isolation from each other; and the parties share the assumption of economically significant risks, or separately assume closely related risks. It cautions that lacking comparables alone does not justify the use of the profit split method. Profit splitting factors can be based on: assets or capital (e.g. operating assets, fixed assets such as production assets, retail

assets, IT assets, intangibles); costs (e.g. relative spending and/or investment in key areas such as research and development, engineering, marketing);[65] and other factors, such as incremental sales, or employee compensation (relating to the individuals involved in the key functions that generate value to the transaction, for example in relation to the global trading of financial instruments).

The country-by-country reporting under BEPS Action 13 may provide the necessary information and data for transfer pricing analysis and the application of the profit split method, although that is not its stated purpose. "In addition to the Local File, which should contain a detailed functional analysis of the taxpayer and its relevant associated enterprises, the MNE group's Master File might be a useful source of information relevant to the determination of appropriate profit splitting factors," such as "information on the important drivers of business profit, the principal contributions to value creation by entities within the group, and key group intangibles."[66]

The BEPS Report on Actions 8-10, which have been incorporated in the 2017 OECD Transfer Pricing Guidelines and the Revised Guidance in 2018 retain the transactional approach to applying the profit split method. They also continue to formally reject any formulary apportionment of firm profit. The identification of a specific transaction involving intangibles remains a critical preliminary step:

> The accurate delineation of the actual transaction will be important in determining whether a transactional profit split is potentially applicable. This process should have regard to the commercial and financial relations between the associated enterprises, including an analysis of what each party to the transaction does, and the context in which the controlled transactions take place.[67]

Intangibles embedded in goods or services could also in theory be disaggregated for transfer pricing analysis. In Example 24, the BEPS Report on Actions 8-10 illustrates that a software development consulting contract has two components: services and the proprietary rights in the software developed. The transfer of goodwill is often embedded in a restructuring transaction. However, no effort is made to disaggregate intangible elements of, say, branded goods.

4.1.3 Intangibles and Digital Taxation: Inclusive Framework on BEPS

Intangibles drive the digital transformation of the economy. Digitized business models differ from traditional business models in three key respects: scale without mass, heavy reliance on intangible assets, and the importance of data, user participation and their synergies with intangible assets.[68] Measured by existing tax rules, income of global digital businesses can be located nowhere and everywhere, creating issues of taxing rights allocation, intern-nation tax competition and stateless income. BEPS Action 1 aimed at tackling these challenges. However, because these challenges "are emblematic of wider vulnerabilities in the international tax system" they "cannot be addressed by small scale reforms but rather ask for a more fundamental reconsideration."[69] Solution requires comprehensive work that covers the overall allocation of taxing rights through revised profit allocation rules and revised nexus rules, as well as anti-BEPS rules.

Recognising the importance of reaching consensus on the "solutions" and that building consensus takes time, the BEPS Final Report on Action 1[70] contains no solutions. It merely describes the challenges and teases out the policy framework and potential options for addressing both the base erosion and profit shifting issues as well as broader policy issues. The Inclusive Framework on BEPS, working through its Task Force on the Digital Economy, carries on the search for global solutions and published an Interim Report in March 2018,[71] a Policy Note in January 2019,[72] a public consultation document in February 2019[73] and a Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from the Digitisation of the Economy (Programme of Work Report) in May 2019.[74] The Programme of Work provides a path to finding a solution in 2020 and the G20 process is expected to provide the political momentum for its adoption. The goal is to devise rules that "should not result in taxation where there is no economic profits nor should they result in double taxation".[75]

On the question of allocation of taxing rights (i.e., creating a new tax base nexus regime), the Programme of Work Report describes three proposed nexus tests – user participation, marketing intangibles, and significant economic presence. These tests posits that value is created by users/customers or in market jurisdictions and that those jurisdictions' taxing right is not dependent upon the existence of a physical business presence. To attribute profit to such market jurisdictions, the Report discusses proposals that go beyond the existing transactional,

comparability-based transfer pricing methods and focus, instead, on the profits of a MNE group (business line or regional segmentation). These proposals include: (a) a modified profit split method that would allocate a portion of an MNE group's non-routine profit to the market jurisdiction; (b) fractional apportionment of the profit of the MNE group; (c) distribution-based approaches, such as specifying a baseline profit in the market jurisdiction for marketing, distribution and user-related activities.[76]

On the question of tax base protection, the Programme of Work Report describes a global anti-base erosion proposal that consists of two inter-related rules: a) an income inclusion rule that is similar to the US GILTI rule – the resident country "would tax the income of a foreign branch or a controlled entity if that income was subject to tax at an effective rate that is below a minimum rate"; and b) a tax on base eroding payments rule that is similar to the US BEAT rules and "would operate by way of a denial of a deduction or imposition of source-based taxation (including withholding tax), together with any necessary changes to double tax treaties, for certain payments unless that payment was subject to tax at or above a minimum rate."[77]

4.1.4 Harmful Tax Competition and BEPS Action 5

The value creation paradigm says that a country has the right to tax profits generated in that country. Once a country has such taxing rights, under the principle of tax sovereignty, it can decide not to tax such income or tax it at a preferential rate, subject to any minimum tax consensus that may emerge. Because of the potential positive spillover effects on innovation, economic growth and employment, many countries offer tax incentives to encourage R&D and to earn income from patents and patent-like intangibles (i.e., the so-called "patent box" rules). Difficulties in locating value creation and quantifying the value created in a country make it challenging to determine if these tax incentives result in poaching another country's tax base, constituting harmful tax practices.

BEPS Report on Action 5 introduced a minimum standard – the substantial activity or modified nexus requirement-- for assessing if a preferential tax regime is harmful. If a country's preferential tax regime grants benefits to a taxpayer to the extent that the taxpayer undertook the core income-generating activities required to produce the income covered by the preferential

regime, it is not deemed harmful. The nexus approach in the context of patent box regimes uses R&D expenditure as a proxy for activity. [78]

4.2 Alternative Directions – The IMF Paper

The *Corporate Taxation in the Global Economy* paper published by the IMF in 2019 (IMF Paper)[79] confirms the progress made through the BEPS Project. It argues, however, tax competition, allocation of taxing rights across countries and unilateral tax measures are among the fundamental issues that remain unaddressed. It also considers the value creation principle to have "proved an inadequate basis for real progress."[80] To achieve fundamental change to current norms, the IMF Paper proposes the following alternatives: (a) minimum taxes on outbound investment and/or inbound investment (the latter is more pertinent for capital-importing countries); (b) replacing the existing transfer pricing methods with a residual profit allocation method that would allocate a normal return to source countries and split the residual profit on a formulaic basis; (c) introducing destination-based taxation that would allocate taxing rights to destination (market) jurisdictions. In this regard, that work is more transparent than the work to date of the OECD/G20.

Since residual profit arises primarily from the value of intangibles and intangibles-heavy businesses are not limited to digital companies, the IMF Paper correctly zeros in on the allocation of residual profit as the main issue in taxing MNEs. Directionally speaking, or in principle, the residual profit allocation proposals in the IMF Paper are similar to the modified profit split method, fractional apportionment method and the distribution-based method in the Programme of Work Report by the Inclusive Framework on BEPS. A global consensus is critical to the adoption of this new direction. The key to reaching such global consensus may be in the hands of a small number of countries. According to the IMF Paper, "resident profit is highly concentrated among a small number of firms: about one-third of all residual profit accrues to the largest one percent … and is also concentrated among firms headquartered in a few economies (notably the U.S., U.K., Japan, China, and Hong Kong SAR)".[81]

4.3 Country Developments

4.3.1 United States

The introduction of the GILTI,[82] FDII[83] and BEAT[84] rules ushered in a new way of thinking about taxing intangibles. This new thinking is reflected in how to conceptualize intangible income and how to source it between the creation/development country and the market country.

Conceptually, the United States abandoned defining intangibles or intangible income prescriptively. Instead, for purpose of the GILTI and FDII rules, intangible income is defined indirectly as a residual: corporate income that is not tangible income is intangible. Tangible income is deemed to be 10% of the adjusted tax cost of tangible depreciable property used to produce the income.[85] In other words, intangible income does not have to come from intangible assets. Any income exceeding the deemed tangible income is deemed to be generated by intangibles. The residual definition applies to the value/income of the enterprise, not a specific transaction involving intangibles. Even though the new conceptualization of intangible income is not directly relevant to the transfer pricing rules, the effect of these new rules is to render transfer pricing rules and the arm's length principle less relevant. It addresses the inherent difficulty in identifying and valuing intangibles for tax purposes.

As to sourcing or allocating intangible income, the United States adopted, in effect, a 50/50 split of intangible income between creation/development country and market countries. Technically, GILTI is added to the existing controlled foreign corporation (CFC) rules and subject to U.S. tax, albeit at an effective rate of 10.5% (i.e., half of the nominal corporate tax rate[86]), on an imputation basis in the hands of the U.S. shareholder.[87] If intangibles are not exploited through foreign subsidiaries, but directly by US corporations through sales of goods or services, another new category of income, FDII, is created. FDII is taxed at a lower effective tax rate (13.125%, which is slightly higher than 50% of the nominal rate of 21%). When foreign-created intangibles are exploited in the United States, the BEAT rules may apply the income from such intangibles where it escapes US tax under the normal rules as a result of deductions for base-eroding payments of royalties, service fees or interest to non-resident related parties. Conceptually, GILTI and FDII look at the United States as a creation/development jurisdiction and the BEAT

rules look at the United States as a market jurisdiction. Intangible income is sourced to both creation/development jurisdiction and market jurisdiction on an equal footing.

The GILTI, FDII and BEAT rules provide a more simple, or one might say "elegant" solution, at least conceptually, to taxing intangible income than the BEPS project by ignoring the fiscal effect of contracts and legal fictions and certain traditional transactional sourcing principles. The GILTI, FDII and BEAT function as minimum taxes, or arbitrary sourcing rules, or as defensive measures against concentrating income in low-tax jurisdictions. They do have a certain arbitrariness, but so do all formulary approaches.

In terms of tax competition for R&D and intangible income, the US TCJA provides an incentive for foreign-based MNEs to locate R&D activities and holding of intangibles in the United States through FDII rules as the lower tax rate is competitive, even compared to countries with patent box regimes. On the other hand, the TCJA will change the expensing of R&D expenditures regime to a five-year amortization regime, starting in 2022. [88]

4.3.2 United Kingdom

The United Kingdom has introduced some reforms concerning intangibles, including the diverted profits tax, the revised patent box rule, deduction of cost of intangible fixed assets and digital service tax.

The Diverted Profits Tax was introduced in Finance Act 2015[89] as a base-protection measure. It targets large MNEs that use so-called "contrived" arrangements to avoid UK tax through taking advantage of existing transfer pricing rules, permanent establishment test or mismatches. It protects the UK taxing rights over intangible income in circumstances where the UK is a market jurisdiction, such as where: (a) a UK resident company pays royalties or service fees to an intermediary intangibles holding company in a low-tax jurisdiction in respect of intangibles created/developed by a company in the United States; or (b) UK customers pay for the use of intangibles or purchasing intangibles-embedded goods or services.[90] The Diverted Profits Tax also seeks to protect the UK tax base where the UK is a creation/development jurisdiction in cases such as the following:

> [A] UK company (UKCo) trades across Europe in the development, manufacturing and selling of widgets. UKCo owns all intellectual property (IP) related to the widget. UKCo

> jointly develops new patentable IP with a third party company in the UK. UKCo has the opportunity to buy out the third party once the development is completed. A group decision is made to establish a new connected company in a low tax jurisdiction (IPCo) and funds are made available to IPCo to acquire the patentable IP which will subsequently be licensed back to UKCo. IPCo provides IP protection and management activities in relation to the IP and takes the associated risk of ownership. IPCo then charges a royalty to UKCo for access to the patents.[91]

As a member of the OECD, the UK has effectively imported the OECD Transfer Pricing Guidelines into its transfer pricing rules by explicitly requiring the Guidelines to be used in interpreting the domestic rules.[92] For accounting periods beginning after 1 April 2018 the 2017 OECD Transfer Pricing Guidelines are now explicitly incorporated into UK law. The profit split method is the commonly used method in assessing highly integrated businesses or transactions involving valuable intangibles.

The UK uses tax incentives to encourage R&D in the UK as well as to locate intangible income in the UK. The Intangible Fixed Assets regime introduced in 2002 applies to intangible fixed assets (including goodwill) created or acquired from an unrelated party. It allows a deduction from income for capitalised expenditure at a rate of 6.5% per annum in respect of assets acquired on or after 1 April, 2019. Qualifying assets include patents, registered designs, copyright or design rights, plant breeders' rights or a license (excluding a license for the use of computer software).[93] The UK patent box scheme was introduced in April 2013 and allows UK companies to elect to pay a reduced rate of corporate tax on profits derived from the exploitation of patents and certain other types of intellectual property (e.g., supplementary protection certificates for pharmaceutical products). In response to the BEPS Action 5 Report, the UK revised the patent box regime in 2016 by incorporating a modified nexus approach by which the amount of tax relief available will depend on the extent to which the R&D leading to the patented invention (or a product embodying it) was carried out in the UK.

The UK has proposed an interim digital service tax to take effect from April 2020. It is a 2% excise tax on revenues derived from UK customers for using/participating social media platforms, search engines or online marketplaces. [94]

4.3.3 Japan

Japan has recently implemented BEPS measures regarding country-by-country reporting, earnings stripping, CFC and transfer pricing.[95] With respect to transfer pricing, Japan has incorporated BEPS Report on Actions 8-10 (and thus 2017 OECD Guidelines) as well as the 2018 Revised Guidance on hard-to-value intangibles.[96] It has added the discounted cash flow method as a new transfer pricing methodology. This method will be used as a basis for presumptive taxation by the tax authorities. The tax authorities are authorized to make an assessment for transactions involving hard-to-value intangibles to the extent that the ex post valuation outcome differs by 20% or more from the actual transaction value (based on the ex ante valuation). Exceptions for such assessment apply where a taxpayer submits documents that prove the difficulties of an accurate ex ante valuation by showing, for example, the discrepancy was de to a disaster or similar event that was difficult to predict or that the arm's length price was calculated by taking the probability of the event into consideration.

Japanese CFC rules may also affect the taxation of intangibles.[97] In 2017, Japan included in CFC rules all income that is earned by a foreign related company that is a paper company, a cash box, or a blacklist company[98] that is subject to a corporate tax rate of less than 30 percent of the Japan tax rate. All the CFC income calculations are made at the entity level basis. The 2019 tax reform expanded the definition of cash box company by including a company with insurance premiums from unrelated parties of less than 10% of gross premiums and narrowed the definition of paper company by excluding specified holding companies that have substantive economic activities.

Japan offers R&D tax credits to corporations.[99] Recent tax reforms have enhanced these tax credits. For example, the 2017 tax reform expanded the scope of eligible R&D expenses to include development costs for the Internet of Things, big data and artificial intelligence. The 2019 tax reform increased the tax credit limitation from 25% of corporate income tax liability to 40% and eligible expenses for the open innovation type of R&D credit is extended to contract R&D provided by large-sized enterprises. Japan does not have a patent box regime.

4.3.4 China

Chinese taxation of intangibles is, in principle, consistent with the norms reflected in the OECD Transfer Pricing Guidelines, the spirit of the BEPS Project, reflecting the arm's length principle

and the value creation idea. The definition of intangibles is aligned with the BEPS Report on Actions 8-10. However, the Chinese approach to applying the arm's length principle and determining value creation is less constrained by contractual terms and conditions and the existence of separate entities. It allows the use of more flexible, enterprise-based profit methods and emphasizes functions performed in China[100] by adhering to the doctrine of substance-over-form.[101]

In addition to the five methods in the OECD Guidelines, the State Taxation Administration has the power to use any other reasonable methods,[102] including: "the cost method, the market method, the income method and other asset appraisal methods, as well as other methods that can reflect the principle of profit-matching the places where the profit and economic activities occur and where the value is created."[103] In the case of intangibles, a value contribution method is sanctioned. Under this method, the consolidated profits of an MNE group are allocated across the value chain to members of the group located in different countries based on an analysis of how the value creation contributions have been made to such group profits.

The Chinese transfer pricing practice focuses more on value contribution through functions performed, risks assumed and assets used in the business operations. In allocating residual profit, not only firm-specific intangibles are considered, but also location-specific advantages, such as location savings and market premium.[104] In addition to the DEMPE (development, enhancement, maintenance, protection and exploitation) functions recognized in the OECD Transfer Pricing Guidelines, China considers "promotion" as an important function regarding market-related intangibles. China also regards global value chain analysis[105] to be very important:

> When determining the contribution made to the value of intangibles and the corresponding allocation of returns to the enterprise and its related parties, a comprehensive analysis should be conducted on various value creation factors, including the global operation processes of the enterprise group, fully considering the value contribution made by each party to the development, enhancement, maintenance, protection, exploitation and promotion of the intangibles, how the value of the intangibles is realized, and the interaction of the intangibles with other functions, assets and risks of the other business within the enterprise group.
>
> Participants that are merely the legal owners of the intangibles, without making any contribution to the value of the intangibles, should not be entitled to share any returns derived from the intangibles. Participants that only contribute funding or capital, without performing any functions or assuming corresponding risks in the development and exploitation of the intangibles, should only be entitled to a reasonable return on capital.[106]

Base-eroding royalty payments are expected to reflect changes to the functions performed, risks assumed or assets employed by the enterprise and its related parties during the exploitation of the intangibles.[107] Any royalty paid by an enterprise to an entity that is merely the legal owner of the intangibles, without making any contribution to the value of the intangibles may be denied of deduction in computing Chinese taxable income.

Income from China-created intangibles is taxable in China to the extent that it is earned by a Chinese resident enterprise. Where such income is earned by a foreign corporation, it is taxable in China only when the income is repatriated to China by way of dividends. China's CFC rules do not currently apply to intangible income *per se*.[108]

China offers tax incentives to the creation/development and exploitation of intangibles. For example, 150% of actual R&D expenditures are deductible.[109] Income from transfer of qualifying technology may be exempt from tax or taxed at half of the nominal corporate tax rate of 25%.[110] Income of "advanced and new technology" enterprises is taxed at the reduced rate of 15%.[111]

5 NEXT STEPS FOR CANADA

5.1. Status quo in a disruptive world?

The rapid and significant changes at the global level and country level suggest that doing nothing is unlikely a wise option for Canada. It is true that Canada has actively participated in the BEPS Project and implemented some of the BEPS measures, such as country-by-country reporting and is a signatory to the [MLI]. It is also true that Canada, being a member of the OECD and neighbor to the United States, has limited options available. But, the status quo may not serve Canada's interest as effectively as it should in terms of defining and protecting Canada's taxing rights and competing with other countries for R&D activities and intangible income location.

There are also no easy choices among: a) the BEPS approach to transfer pricing and OECD Transfer Pricing Guidelines, which have been explicitly incorporated into domestic legislation in Australia, Japan and UK; b) BEPS proposals regarding digital taxation and broader reform proposals in the IMF Paper; c) US taxation of intangibles through minimum taxes; and d) the Chinese approach though value-contribution based methodology cloaked in the pragmatic

interpretation of the arm's length principle. What follows are some tentative ideas for exploration.

5.2 Value Creation and the Canadian notion of source

The value creation idea could be said to have been reflected in the Canadian income tax system since its inception, despite the fact that the Act does not define "source" or prescribe specific source rules.[112] The *Income War Tax Act* (1917) adopted two proxies for Canadian source business profits: Canadian residence of a company (which nominally goes beyond source but with foreign tax credits and the exemption regime effectively doesn't) and carrying on business in Canada by non-residents. Before royalties earned by non-resident became taxed under the withholding tax regime in 1948, they were deemed to be income from carrying on business in Canada.[113] In order to protect this notion of source, the *Income War Tax Act* and the Act contain numerous anti-avoidance rules, including transfer pricing and FAPI in regard to deflected Canadian business profits.

However, the existing rules reflect value creation factors of an agricultural and industrial economy. For example, paragraphs 253(a) and (b) mention "produces, grows, mines, creates, manufactures, fabricates, improves, packs, preserves or constructs, in whole or in part, anything in Canada" and "solicits orders or offers anything for sale in Canada through an agent or servant". Should Canada wish to tax certain revenues derived from a digital economy, these provisions can be amended to add activities or manifestation of value (such as user/customer participation, or even just revenues). The withholding tax rules could conceivably be broadened to capture income from exploiting intangibles that are not current captured by paragraph 212(1)(d) and certain base-eroding payments. However, the somewhat ironic position must be acknowledged that Canada, like many other countries, has for decades exempted certain royalties – presumably in order to facilitate access to the relevant intangibles, or just for practical reasons (such as in the context of "shrink-wrapped" intangibles).

While the inbound rules mentioned above could be improved to ensure Canadian taxation of Canadian-source intangible income or revenues, the outbound rules may also receive some rethinking. The current rules separate corporate income into three main pools: passive property income, foreign active business income, and Canadian base eroding business income. Intangible

income derived by entities of an MNE group is generally in the active business income pool under the FAPI and foreign affiliate rules. If the subsequent income derived from Canadian-created intangibles with tax subsidies falls outside the Canadian corporate tax base when it is earned and when it is repatriated, such outcome can be justified as a tax subsidy to holding and exploiting intangibles outside Canada. Unless this is a deliberate policy decision to retain the status quo, Canada could try to capture a greater portion of the intangible income.

5.3 Residual Profit and Canadian Transfer Pricing Rules

On the basis of Canadian case law on transfer pricing, the courts seem to have treated section 247 as a kind of prescriptive rule and not given it a broader interpretation as a general rule intended to protect Canadian-source business profits. The origin of section 247 is section 3(2) of the Income War Tax Act (1917). Adjusting related- party transaction prices was a means of ensuring that Canadian profits were not shifted to another country through self-serving contracts between the two parties. Section 247(2) was drafted broadly and avoided using the word "price". The Act, as a whole, has an ambivalent attitude towards legal fictions[114] and many corporate tax rules were intended to render, in effect, the separate corporate existence irrelevant for tax purposes. A broader interpretation of section 247 is possible and could, arguably, address the issue of residual profit attributable to intangibles. However, there is little indication that Canadian courts would be prepared to adopt such approach. To ensure the transfer pricings are effective, Canada should consider clarifying the role of OECD Transfer Pricing Guidelines in interpreting section 247 At a minimum, Canada should clarify its current position on "cash-boxes" and "minimally functional entities", and any change should be applied only prospectively, as with the changes to the US rules and others. Canada should also consider reforms on the incentive side – or at least seek to balance in some ways tax base considerations with competitiveness and efficiency considerations.

In brief, while the status quo may be inadequate, Canada has difficult but important decisions to make with respect to the future, which it should approach with caution but also with an open mind.

[1] Robert Asselin and Sean Speer, *A New North Star: Canadian Competitiveness in an Intangibles Economy* (Public Policy Forum, April 2019) *https://ppforum.ca/wp-content/uploads/2019/04/PPF-NewNorthStar-EN4.pdf* at 25. See also Ocean Tomo, Intangible Asset Market Value Study, https://www.oceantomo.com/intangible-asset-market-value-study/.

[2] Jonathan Haskel and Stian Westlake, *Capitalism without Capital: The Rise of the Intangible Economy* (Princeton, N.J.: Princeton University Press, 2017).

[3] John R. Baldwin, Wulong Gu, and Ryan Macdonald, *Intangible Capital and Productivity Growth in Canada (*Statistics Canada Economic Analysis Division) (2019), at (http://www.statcan.gc.ca/reference/copyright-droit-auteur-eng.htm). The ratio of intangible investment to tangible investment increased from 0.23 in 1976 to 0.66 in 2008. The largest component of intangible investment was economic competencies, innovative property, software and computerized information.

[4] Asselin and Speer, supra note 1.

[5] RSC 1985, c.1 (5th Supp.), as amended (hereinafter the "Act").

[6] From a measurement standpoint, economists classify intangibles into three broad categories: computer related, innovative properties, and company competencies. See Haskel and Westlake, supra note 2.

[7] BEPS Inclusive Framework, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS* describes the features of the digital economy:

> *Scalability* means intangible assets can be used repeatedly and in multiple places at the same time, unlike tangible assets. The scalability of knowledge derives from a key feature of ideas — namely, that non-rivalry, and powerful network effects fuel scalability. Scalability is important in the modern economy, as it has been crucial to the success of companies like Google, Facebook, and Microsoft, as well as to creating barriers to potential competitors of these firms.

[8] Sunkenness refers to the fact that intangible assets, especially knowhow or trademark have value as part of their owner's business, but not to anybody else as the law prohibits others from using such intangibles.

[9] Intangibles tend to be unique and their value lies in their uniqueness. Intangibles are considered "non-rival" production factors that differ from rival factors like capital, land or labour. See Wolfram F Richter, "Aligning Profit Taxation with Value Creation", CESifo Working Paper No.7589, February 2019, online: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3374581.

[10] See headings 3.4 and 4.3.2.

[11] OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (hereinafter "OECD Transfer Pricing Guidelines"). Since their first release in 1979, these guidelines have been amended several times, notably 1995, 2010 and 2017.

[12] See heading 4.3.4 below.

[13] See heading 4.3.3 below.

[14] See, for example, Jacques Bernier and Brad Rolph, "Canada" in IFA (2017), vol.2., *The Future of Transfer Pricing*. In the [2016] Federal Budget, the Department of Finance essentially reserved on following the revised OECD TP Guidelines on so-called "cash boxes", and "minimally functional entities", among other things.

[15] J. Scott Wilkie, "Canada: Transfer Pricing" in IBFD Database, heading 5.1.

[16] Ibid.

[17] *OECD Transfer Pricing Guidelines*, supra note 11.

[18] See heading 4.3.1 below.

[19] OECD Transfer Pricing Guidelines (2017), supra note 11 at para.6.15-6.17.

[20] Ibid., paras.6.30 and 6.31.

[21] The value of intangibles is linked to exploitation of intangible property rights and is dependent on the associated legal rights. Unlike tangible property, intangibles are not subject to wear and tear and the useful economic life is dependent on a combination of complex factors, such as the period of monopoly granted by intellectual property laws.

[22] World Intellectual Property Organization (WIPO), World Intellectual Property Report 2017: Intangible Capital in Global Value Chains, https://www.wipo.int/pressroom/en/articles/2017/article_0012.html.

[23] Wen Chen, Bart Los and Marcel Timmer, "Factor Incomes in Global Value Chains: The Role of Intangibles" (2018), online: http://www.iariw.org/copenhagen/timmer.pdf.

[24] OECD Transfer Pricing Guidelines (2017), supra note 11 at 6.153.

[25] Ibid., at 6.142.

[26] For further discussion, see David Regan and Paul Stepak, "Canada" in IFA Cashier … (2015) 193; Kenneth J. McKenzie, "The Big and the Small of Tax Support for R&D in Canada" (2012) The School of Public Policy, SPP Research Papers, vol.5, Issue 22); Jenkins, Tom. 2011. "Innovation Canada: A Call to Action." Panel Report of the Review of Federal Support to Research and Development. Ottawa. Available online: http://rd-review.ca/eic/site/033. nsf/eng/home

[27] Jack Bernstein, "Canadian Intangibles, Noncompete Payments, and Allocations of Purchase Price" (March 26, 2012) *Tax Notes Int'l* 1011; Blake Murray, Richard Tremblay, and Susan Wooles, "The Tax Treatment of Intangibles" (2010) Vol.58 (Supp.) *Canadian Tax Journal* 201; Janice McCart and Rob O'Connor, "Canada" in IFA Cashier, vol.1 Transfer pricing and intangibles (2007) 133.

[28] *Gifford v. Canada*, [2004] 1 S.C.R. 411, 2004 SCC 15.

[29] 79 DTC 208 (TRB).

[30] *The Queen v. Canadian General Electric Company Limited*, DTC 5070 (FCA).

[31] Paragraph 20(1)(a) of the Act and supporting Income Tax Regulations.

[32] Subsections 2(1) and (2) and section 3 for residents and subsections 2(3) and sections 212 and 219 for non-residents.

[33] Section 126 of the Act.

[34] This is the case where the royalty payments were received by a foreign affiliate that is the legal owner of intangibles from another foreign affiliate which uses the intangibles in its active business in a treaty country. The royalty income is not FAPI (s.95(2)(a)) and thus free from the imputation rules under section 91 and the dividends qualify for exempt dividends for purposes of subsection 113(1).

[35] Even though Article 12 of the OECD Model Convention allocates exclusive taxing rights to the residence country, Canada's treaty policy has not followed it. See Brian J. Arnold and Jacques Sasseville,

"A Historical Perspective on Canada's Tax Treaties," in Jinyan Li, J. Scott Wilkie and Larry Chapman, eds. *Income Tax at 100 Years: Essays and Reflections on the Income War Tax Act* (Toronto: Canadian Tax Foundation, 2017), 11:1-11:53.

[36] Subsection 212(13.2) of the Act.

[37] *Marzen Artistic Aluminum Ltd. v. R.* 2016 FCA 34, affirming 2014 TCC 194.

[38] *McKesson Canada Corp. v. R,* TCC 404.

[39] *General Electric Capital Canada Inc. v. R.*, 2010 FCA 344.

[40] *GlaxoSmithKline Inc. v. R.*, 2012 SCC 52.

[41] *Cameco Corporation v. The Queen*, 2018 TCC 195

[42] *Marzen*, supra note 37, para.47.

[43] Ibid., para.48.

[44] *Glaxo*, supra note 40 at paras.61-63.

[45] CRA IC 87-2R, International Transfer Pricing, para.139.

[46] Ibid., para.140.

[47] Ibid., para.141-146.

[48] Landmark decisions by the Supreme Court of Canada include *Shell Canada Ltd v. Canada*, [1999] 3 SCR 622, and *Singleton v. Canada*, 2001 SCC 61.

[49] *Cameco*, supra note 41 at paras.716 and 726.

[50] Supra note 26.

[51] Nick Pantaleo, Finn Poschmann and Scott Wilkie, "Improving the Tax Treatment of Intellectual Property Income in Canada" (2013) (C.D. Howe Institute Commentary No.379).

[52] Quebec has a patent box regime effective 1 January 2017.

[53] See above text accompanying note 34.

[54] OECD, *Information Brief – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD Publishing, 2015), at 3, online: https://www.oecd.org/ctp/beps-reports-2015-information-brief.pdf.

[55] See, for example, Allison Christians, "Taxing According to Value Creation" (June 18, 2018) *Tax Notes International*, 1079-83; Michael P. Devereux, and Vella, John, "Value Creation As the Fundamental Principle of the International Corporate Tax System", European Tax Policy Forum Policy Paper (July 31, 2018), available at SSRN: https://ssrn.com/abstract=3275759, at 1; Mindy Herzfeld, "The Case against BEPS: Lessons for Tax Coordination" (2017) vol. 21, no. 1 *Florida Tax Review* 1-59, at 42; Johanna Hey, "'Taxation where value is created' and the OECD/G20 Base Erosion and Profit Shifting initiative" (April/May 2018) *Bulletin for International Taxation* 203; S.C. Morse, "Value Creation: A Standard in Search of a Process" (2018) 72 *Bulletin for International Taxation* 196, at 204-5; Itai Grinberg, "User Participation in Value Creation" (2018) issue 4 *British Tax Review* 407-21; and Frans Vanistendael, "An Octogenarian on Value Creation" (June 18, 2018) vol. 90, no. 18 *Tax Notes International* 1385.

[56] Devereux and Vella, ibid., at 1.

[57] See Stanley I. Langbein and Max R. Fuss, "The OECD/G20-BEPS-Project and the Value Creation Paradigm: Economic Reality Disemboguing into the Interpretation of the 'Arm's Length' Standard" (2018) Vol.51, No.2 *The International Lawyer* 259.

[58] Richard S. Collier and Joseph L. Andrus, *Transfer Pricing and the Arm's Length Principle after BEPS* (Oxford 2018) at 212.

[59] See Scott Wilkie, "New Rules of Engagement? Corporate Personality and the Allocation of "International Income" and Taxing Rights" in Brian J. Arnold, ed. *Tax Treaties After the BEPS Project: A Tribute to Jacques* Sasseville (Canadian Tax Foundation 2018) 349; and Richard Vann, "Taxing International Business Income: Hard-Boiled Wonderland and the End of the World," (2010) 2 *World Tax J.* 291.

[60] OECD/G20, "Aligning Transfer Pricing Outcomes with Value Creation: BEPS Actions 8-10 Final Reports (2015)" (hereinafter "BEPS Report on Actions 8-10), paras.6.35-6.36.

[61] Collier and Andrus, supra note 58 at 215.

[62] See BEPS Report on Actions 8-10, supra note 60 at para.6.190.

[63] Ibid., para.6.193.

[64] Ibid., paras.6.30, 1.157-1.163.

[65] 2018 Revised Guidance notes in para. 2.171 that "while costs may be a poor measure of the value of intangibles contributed … the relative costs incurred by parties may provide a reasonable proxy for the relative value of those contributions where such contributions are similar in nature …"

[66] 2018 Revised Guidance, ibid. para.2.173.

[67] Ibid., para.2.125.

[68] OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS.*

[69] International Monetary Fund (2019), *Corporate Taxation in the Global Economy,* Policy Paper No 19/007, Washington D.C. (IMF Paper).

[70] OECD/G20 Base Erosion and Profit Shifting Project, *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*.

[71] Supra note 68.

[72] OECD (2019), *Addressing the Tax Challenges of the Digitalisation of the Economy – Policy Note,* as approved by the Inclusive Framework on BEPS on 23 January 2019.

[73] OECD (2019), Public Consultation Document, *Addressing the Tax Challenges of the Digitalisation of the Economy*, 13 February – 6 March 2019.

[74] OECD (2019), https://www.oecd.org/tax/beps/programme-of-work-to-develop-a-consensus-solution-to-the-tax-challenges-arising-from-the-digitalisation-of-the-economy.pdf/

[75] Ibid., paras. 39-44.

[76] Ibid., paras.28-38.

[77] Ibid., para.56.

[78] BEPS Report on Action 5 also contains a framework for improving transparency in the use of tax rulings and a peer review process. OECD/G20 Base Erosion and Profit Shifting Project, Counting Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance (2015).

[79] IMF Paper, supra note 69.

[80] Ibid. at para.31.

[81] Ibid. at para.95.

[82] Sections 951A of the Internal Revenue Code.

[83] Section 250 of the Internal Revenue Code.

[84] Section 59A of the Internal Revenue Code.

[85] section 954(b)(4) of the Internal Revenue Code.

[86] For US tax purposes, section 250 provides a deduction for 37.5% of FDII and 50% of GILTI. Since the nominal rate of 21%, the effect of these deductions is to reduce the tax on FDII to 13.125% and 10.5% on GILTI (with FTCs available).

[87] GILTI is taxable to the extent that it exceeds each U.S. shareholder's net CFC income and foreign taxes paid on the GILTI are creditable against US tax.

[88] These are expenditures under section 174 of the Internal Revenue Code.

[89] The Diverted Profits Tax rules are contained in Part 3 of Finance Act 2015. Proposed revisions to these rules are found in Finance Bill 2018-19. See HM Revenue & Customs, Policy Paper, Diverted Profits Tax amendments, 29 October 2018, online: https://www.gov.uk/government/publications/diverted-profits-tax-changes/diverted-profits-tax-amendments.

[90] HM Revenue & Customs, Diverted Profits Tax: Guidance, December 2018, (UK DVP Guidance 2018), examples at 32 (IP held offshore with little economic substance), at 37 (avoiding UK tax presence).

[91] Ibid., at 45. The diverted profits would be those that UKCo would have made if it had acquired the intangible itself.

[92] The domestic transfer pricing legislation is set out in Part 4 of the Taxation (International and Other Provisions) Act 2010 (TIOPA 2010). Section 164 of the TIOPA 2010 confirms that the UK transfer pricing provisions are to be construed in alignment with Article 9 of the OECD Model Tax Convention and its associated transfer pricing guidelines. For each revised OECD Guidelines to become effective in the UK the Treasury will have to issue a respective order. For further discussion on UK transfer pricing, see Andrew J. Casley, "United Kingdom Transfer Pricing" in IBFD Database.

[93] For more background, see HMRC *Review of the corporate Intangible Fixed Assets regime* (19 February, 2018) calling for public consultation and a *Summary of Responses* to the consultation (7 November 2018).

[94] See UK Government, Policy Paper: Digital Services Tax: Budget 2018 brief, online: https://www.gov.uk/government/publications/digital-services-tax-budget-2018-brief.

[95] On March 27, 2019, the National Diet passed the bill for the 2019 tax reform, which contains revisions to several international issues, including transfer pricing, surplus stripping rules to implement BEPS Action 4 and CFC rules.

[96] See Johan Hagelin and Shunichi Muto, "The OECD/G20 Base Erosion and Profit Shifting Initiative and the 2019 Tax Reform in Japan: Revisions to the Earnings Stripping Rules and the Introduction of Hard-

to-Value Intangibles into Transfer Pricing" (May 2019) *Bulletin for International Taxation* 230. For general discussion, see Karl Gruendel, Katsuko Shioya, Mark Brandon, "Japan Transfer Pricing" in IBFD Transfer Pricing database.

[97] Japan introduced CFC rules 1978. See Brian J. Arnold, Taxation of Controlled Foreign Corporations: An International Comparison (Canadian Tax Foundation 1986); Daniel Sandler, Tax Treaties and Controlled Foreign Company Legislation: Pushing the Boundaries (Kluwer Law International, 1998), ch.27.

[98] Paper companies are companies with no substance or without its own administration or management where the head office is; cash box companies are companies where passive income over total assets is less than 30 percent and securities, loans, and receivables over total assets are less than 50 percent; and companies based in a black list territory according to the OECD standards.

[99] OECD, "R&D Tax Incentives: Japan 2018, online: www.oecd.org/sti/rd-tax-stats-japan.pdf.

[100] Chinese transfer pricing provision is similar to Article 9 of the OECD Model, stating: "If a business transaction between an enterprise and a related party does not comply with the arm's length principle, thus reducing the taxable income or revenue of the enterprise or the related party, the tax authorities shall be empowered to make adjustments using reasonable methods"; see Enterprise Income Tax Law of the People's Republic of China (2007), art.41. For the text of this law and the implementation rules, see Jinyan Li, *International Taxation in China: A Contextualized Analysis* (IBFD 2016), Appendix A.

[101] For example, State Taxation Administration Circular Guo Shui Fa [2009] No. 2, "Measures for the Implementation of the Special Tax Adjustment (trial)" states in Article 93:

> "The tax authorities should adopt the substance-over-form principle in determining whether an enterprise has made a tax avoidance arrangement and comprehensively examine the following factors:
> (1) the form and substance of an arrangement;
> (2) the creation time and implementation period of an arrangement;
> (3) the implementation method of an arrangement;
> (4) the relationship between each of the steps or components of an arrangement;
> (5) the changes in each party's financial situation involved in an arrangement;
> (6) the tax consequences an arrangement."

[102] Ibid., 32-35.

[103] State Taxation Administration Public Notice [2017] No. 6, "Public Notice on Issuing the Administrative Measures for Special Tax Investigation and Adjustment and Mutual Agreement Procedures", Article 22. This article explains each of the method as follows:

> "The cost method refers to the appraisal method in which the value of the tested target is determined by appraising the costs of establishing a similar asset under the current market price based on a replacement or recreation principle. The cost method is applicable to appraising the value of assets that can be replaced.
>
> The market method refers to the appraisal method in which the value of the tested target is determined by making a direct comparison or comparable analysis between the tested target and the recent transaction prices of the same or similar assets in the market. The market method is applicable to situations where comparable transaction information of the same or similar assets as compared to the appraisal target can be identified in the market.
>
> The income method refers to the appraisal method in which the forecasted income is discounted to determine the value of the tested target. The income method is applicable to appraising the

taxpayer's overall assets or a single asset whose future income can be forecasted. When using the income method to appraise the value of intangible property, a reasonable estimate of the length of the intangible property's limited economic life should be made."

[104] The Chinese position is stated in the United Nations Practical Manual on Transfer Pricing for Developing Countries (2017) (United Nations 2017), 10.3. Article 27 of Public Notice [2017] No.6 states: "When tax authorities analyse and evaluate whether the related-party transactions of the investigated enterprise are in accordance with the arm's length principle, if the selected comparable companies are in a different environment than the investigated enterprise, location-specific advantages such as location savings, market premiums, etc., should be evaluated and a reasonable method should be used to determine the amount of additional profit attributable due to the location-specific factors."

[105] State Taxation Administration, Public Notice [2016] No. 42, Public Notice on Matters Regarding Refining the Filing of Related-Party Transactions and Administration of Contemporaneous Transfer Pricing Documentation" requires value chain analysis to include the following information in country-by-country reporting:

(1) Flows of business, goods and materials, and capitals within the group, including design, development, manufacturing, marketing, sales, delivery, billing and payment, consumption, after-sale service, recycling, other processes related to goods, services or other relevant underlying targets of the related-party transactions and all the parties involved.

(2) Annual financial statements of each of the aforementioned parties for the immediately preceding fiscal year.

(3) Measurement and attribution of value creation contributed by location specific factors.

(4) Allocation policies and actual allocation results of the group's profits in the global value chain.

[106] Public Notice [2017] No.6, Article 30.

[107] Ibid., arts. 31 and 32. For example, if a Chinese manufacturer pays a royalty fee based on a fixed percentage of sales in its early stage of operations, it would not be reasonable for the same royalty fee to be paid after a long period of time as the value generated by the IP in the manufacturing process is expected to decrease over time and/or the value is enhanced by the Chinese manufacturer through a process of trial and error. See Cheng Chi, Xiaoyue Wang, Kelly Liao, Mimi Wang and Rafel Miraglia, "TP in China: All the Data in the World", (Nov.28 2017) International Tax Review, online: https://www.internationaltaxreview.com/Article/3772240/TP-in-China-all-the-data-in-the-world.html?ArticleId=3772240

[108] Li, supra note 100, 363-374.

[109] Chinese Enterprise Income Tax Regulations, supra note 100, art. 95.

[110] Ibid., art. 90.

[111] Chinese Enterprise Income Tax Law, supra note 100, art.28.

[112] See Jinyan Li and J. Scott Wilkie, "Source of Income and Canadian International Taxation" in Li, Wilkie and Chapman, supra note 35, 10.1-10:42.

[113] Ibid., at 10:14-15.

[114] Angelo Nikolakakis, "The Ambivalent Relationship Between the Income Tax Act and the Separate Entity Principle" in Li, Wilkie and Chapman, supra note 35, 12:1-19.