INTERNATIONAL TRADE AND TAXATION:  
THE GATT and DOMESTIC TAX POLICY  
by  
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The thesis is that to give insufficient recognition to international trade agreements in developing tax policies can result in distortions in international trade. It is not suggested that the objective of facilitating free trade should be paramount to sovereign interests which underlie tax policy decisions. However, the proposition is that in selecting from among alternative tax policies, the policy which should be chosen is that which achieves national objectives while minimizing distortive effects on international trade.

The goals of this study are: 1) to determine whether particular tax provisions impede, distort, or otherwise have a negative and unjustifiable effect on free trade; and 2) to reflect on the intersecting role of taxation and international trade. Although many tax policies may be viewed as prima facie "discriminatory", such discrimination may be acceptable pursuant to international agreements, or overriding national interests may prevail. An attempt is made to develop a framework for examining the effects of taxation on international trade which can be used as a guide for tax policy makers in selecting policies which meet domestic criteria as well as facilitate free trade.

The thesis consists of five chapters. The first chapter sets out the methodology, conceptual framework and theoretical basis for the study. The next three chapters examine specific tax regimes in the context of the General Agreement on Tariffs and Trade (the "GATT") and underlying principles of free trade. The
tax regimes are: 1) withholding taxes for payments under software licensing arrangements; 2) research and development tax incentives; and 3) cross-border transfer pricing provisions. Chapter five summarizes the case studies and outlines approaches to fiscal harmonization under a free trade regime. The conclusion is that a GATT tax code may be an appropriate mechanism for achieving harmonization for certain tax measures. However, it is infeasible, at least in the short term, to expect a GATT tax code will be placed on the World Trade Organization's agenda. Even if such a code is attainable in the future, unilateral, bilateral and other multi-lateral approaches to eliminating distortive tax policies may be more appropriate in some cases.
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To my husband and my parents for their love and support.
CHAPTER 1
INTERNATIONAL TRADE AND TAXATION

"The topic, in my view, is an important one that has not received sufficient attention. It makes little sense to break down barriers to international trade and to pursue economic integration, whether in Europe, North America or the South Pacific, without dealing with the related tax issues." 1

Advances in international trade should not be impeded by tax policies without sound justification; yet tax policies can and do distort international trade in capital, goods, services and technology. International taxation and international trade are generally treated as independent fields of study. 2 However, 'globalization' and free trade are the order of the day and the interrelationship between domestic tax policy and international trade law takes on more importance in this global marketplace.

Governments in all corners of the world seem intent on removing all forms of barriers to trade and expanding economic unions and free trade zones in order to remain competitive in the global marketplace. 3 There can be no doubt that the complexities


2 Clearly the subject of international aspects of taxation is not new. However, until recently, it has not been necessary to consider the international ramifications of domestic taxation, beyond specific trade interventions such as customs duties. See Donald J. S. Brean, "International Issues in Taxation : The Canadian Perspective", Canadian Tax Paper No. 75 (Toronto: CTF, 1984), xiii and 1.

3 See L. Denis Desautels, "Playing with Blocs", CA Magazine, January/February 1995 (Toronto: CICA, 1995) 38, in which the Auditor General of Canada 'examines how our small, but dynamic, nation will fit into the global marketplace.'
of global trade can be overwhelming in view of varying economic, social, and political conditions; unilateral, bilateral and multilateral tax regimes add to the confusion. Yet, despite claims to taxation as a national prerogative and complexities involved in overlapping international trade agreements with tax practices, it is essential to understand the impact tax practices can have on international trade.

The thesis is that international trade law and practice is intimately, if not explicitly, intertwined with taxation; to give insufficient consideration to international trade agreements in developing national tax laws and entering into treaties can impair the ability to attain the positive goals of free trade. Therefore this study attempts to develop a framework for understanding the effects of taxation on international trade to guide tax policy makers in developing sound policies and selecting from among alternative strategies those tax measures which promote national goals and minimize counter-productive impacts on international trade objectives.\textsuperscript{4} This understanding is also relevant to furthering international fiscal harmonization.

The object of this study is the Canadian income tax system in

\textsuperscript{4} Donald J. S. Brean, "International Issues in Taxation", \textit{supra} at 1: "As countries cast tax nets beyond their borders, international fiscal overlap is inevitably created with implications for the efficiency of the world economy, for the effectiveness of domestic tax policies, and for the level and distribution of gains from international economic integration."
the broader context of Canada-U.S. trade\(^5\); the perspective has both national and international dimensions. The study focuses on specific tax regimes which may impact on research and development of technology as well as on the flow of international transfers of technology both between arm's length and non-arm's length parties.

The emphasis on tax policies which have a special relationship to technology\(^6\) is grounded in the realities of the twenty-first century marketplace. 'Globalization' was the buzz word of the 80's and early 90's; now the global marketplace is moving along the 'information highway' into the 'information era'. The information era is here and technology is the commodity of the future. Significant progress was made at the Uruguay Round of the GATT with

\(^5\) Although it may not be reasonable to equate Canada and the United States in terms of resources, wealth and power, these countries are both considered to be developed countries. Also, Canada has an established trade relationship with the United States which is significant to the Canadian economy. Trade with Mexico, though a natural extension to this study given NAFTA, has not been addressed as issues relating to trade among developed and developing nations, though important, are beyond the scope of this study.

\(^6\) The definition adopted for "technology" is that set out in C.A. Brown, "Tax Aspects of The Transfer of Technology: The Asia-Pacific Rim", Canadian Tax Paper No. 87, (Toronto: Canadian Tax Foundation, 1990) at 5 - 6: "Technology is, in the final analysis, a form of knowledge relating to information with scientific or commercial value. This knowledge may consist of know-how, concepts, methodologies, formulas, models, designs, prototypes, data bases or products embodying or utilizing such knowledge". Brown also refers to the following common definitions for technology (at 6): "technology as publicly or privately held knowledge, technology as relating to a particular stage of its development by the transferor, technology as relating to a particular stage of the technology recipient's needs for its project development, technology as relating to a particular industry, and technology as categories of intellectual property rights protected to various degrees."
regard to improved protection of intellectual property rights on a
global scale. In part this advancement should stimulate the
development of, and trade in technology through the protection and
enforcement of intellectual property rights outside the rights
holders' home jurisdiction. It seems only logical that the domestic
and international tax structures should further, rather than
impede, this progress. Yet domestic tax policies are a possible
impediment to free trade in technology.

The methodology used in this research is primarily inductive -
an attempt is made to determine general principles about the future
of tax policy formulation in the context of the global market place
by reference to specific case studies. Resource materials include
studies on taxation in the global economy by the Organization for
Economic Cooperation and Development ("OECD"), the Series on

7 The Agreement on Trade-Related Aspects of on Intellectual
Property Rights ("TRIPs") (Annex IC to the Agreement Establishing
the World Trade Organization, Uruguay Round Final Act, Marrakesh,
April 15, 1994) is the first trade agreement which provides for
comprehensive worldwide protection for and enforcement of
intellectual property rights.

8 With regard to free trade in technology, non-tariff barriers
have generally been used to control the conditions under which
market access takes place. Non-tariff barriers are more subtle in
their application and potentially more restrictive than tariffs in
their effect. Robert B. Cohen, Richard W. Ferguson, and Michael F.
Oppenheimer, Nontariff Barriers to High-Technology Trade (Boulder:
are not a separate category of non-tariff barriers (such as
quantitative restrictions, administrative barriers to trade, and
government procurement), the extent to which tax policies can have
subtle and restrictive effects on trade and come with the scope of
international trade agreements is explored.
International Taxation\(^9\), and the Canadian Tax Foundation ("CTF"), a variety of Canadian and American conference materials, and literature by accountants, lawyers, government officials and economists on international law, fiscal harmonization, tax policy, and technology. In addition, the particular case studies compel detailed analysis of Canadian Income Tax Act (the "ITA") provisions,\(^{10}\) international trade agreements, and scholarly interpretations of these documents. Case law and panel decisions of international bodies are also referred to.

The purpose of this study is twofold: The first goal is to determine whether the tax provisions under review prima facie impede, distort or otherwise have an unjustifiable discriminatory effect on the global development or international transfer of technology? Each tax practice will be examined under the General Agreement on Tariffs and Trade\(^{11}\) ("GATT") to assess how the

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\(^9\) This series is published by the Kluwer Law and Taxation Publishers in Deventer, Netherlands and is intended for use by those engaged in the practice of international taxation.

\(^{10}\) R.S.C. 1952, c. 148 as amended by S.C. 1970-71-72, c.63 and as subsequently amended.

\(^{11}\) October 30, 1947, 61 Stat. A3, T.I.A.S. No. 1700, 55 U.N.T.S. 187. The emphasis is on the GATT, despite the Canada-U.S. context, as a GATT analysis has a more global application. Reference will be made to the North American Free Trade Agreement ("NAFTA") (Ottawa: Minister of Supply and Services Canada, 1993). NAFTA came into effect on January 1, 1994 (see North American Free Trade Agreement Implementation Act, S.C. 1993, c. 44). As discussed in Robert K. Paterson and Martine N. Band, eds., International Trade and Investment Law in Canada, (2d) (Toronto: Carswell, 1994) at 2-6, the FTA [and NAFTA] "do not replace the GATT as the international legal foundation of the trading relationship between Canada and the United States. In many respects the FTA [and NAFTA] can be seen as clarifying the mutual understanding of its Parties as to their level of compliance with their GATT obligations in
practice measures up to the principles set out therein. This will require an analysis of each of the tax provisions and the relevant Articles in the GATT and the Canada-U.S. Tax Convention. The domestic tax regimes are also compared with the Organization for Economic Cooperation and Development Model Convention (the "OECD Model") when applicable, as well as other foreign tax policies which assist in illustrating and clarifying the issue under review.

The second goal of this study is much broader and goes beyond the specific examples under consideration. With the conclusion of the Uruguay Round of GATT, and the emphasis on reducing or eliminating all barriers to trade, it is worthwhile to determine the broader effect of discriminatory tax measures in the global marketplace. Therefore, with the results from the analysis described above suggestions will be made regarding the intersecting role of taxation and international trade in fiscal harmonization.

PART I: OVERVIEW

This introductory chapter provides a conceptual framework for the study. It briefly outlines the arguments for and against free trade in order to establish the basis for proposing tax policies which facilitate free trade. The conceptual framework for studying the relationship between taxation and international trade is also outlined.

Chapters 2 through 4 contain the analysis of ITA rules in specific areas of trade. Some also regard certain provisions of the FTA [and NAFTA] (such as those concerning trade in services and dispute settlement) as forerunners of future multilateral economic agreements to be developed under GATT auspices."
three areas in parallel with international tax treaties and the GATT. The case studies are: 1) the withholding tax on cross-border payments for licensed software; 2) the scientific research and development tax incentive system; and 3) the international transfer pricing regime. These chapters are both descriptive and analytical; the specific tax and trade policies under review are presented and the interplay between the particular tax policy and international trade ramifications is examined.

As mentioned previously, these provisions have been selected in part because they impact on technology development and technology transfer. The particular tax rules under review in each of the case studies are also of interest as they are controversial and continue to be the subject of ongoing debate. Canada has recently begun to renegotiate withholding tax rates with some treaty partners on payments for licensed software; the OECD, as recently as March 8, 1995, released draft recommendations on transfer pricing for multinational enterprises as the outcome of a major study in this area; and the Auditor General of Canada in his 1994 Report has been openly critical of the existing government programs and strategy for stimulating research and development.

Furthermore, although only 3 case studies are reviewed, the selected tax provisions require an analysis of a variety of GATT Articles under the approach taken thereby providing a broader basis for conclusions and recommendations. Also, each case study compels flexibility in the analysis. It is hoped that this flexibility within the suggested framework will prove useful as a starting
point for future research in this area.

Chapter 2 reviews the matter of arm's length payments for international transfers of technology in the specific context of cross-border software payments. Revenue Canada treats cross-border payments for software under licensing arrangements as royalties, and, therefore, income from property. This is contrary to the treatment proposed by the OECD Model which classifies these payments as business profits. Cross-border royalty payments are subject to withholding tax under subparagraph 212(1)(d)(i) of the ITA. Withholding tax may result in increased prices for the software to the transferee; or reduce profits or cash flows to the foreign transferor. Although Canada has recently concluded two bilateral conventions which reduce the withholding rate on these payments to 0%, the underlying characterization problem remains. Therefore, foreign software developers from countries without renegotiated tax treaties are potentially at a disadvantage vis a vis domestic producers of software. The extent to which these disadvantages may be viewed as discriminatory in international trade terms and alternative ways of minimizing or eliminating such discrimination are explored.

The focus of Chapter 3 is on the developmental stages of technology. Accordingly the tax measures under review are the tax incentives for research and development ("R&D") set out in sections 37, 127 and 127.1 and regulation 2900 of the ITA. Canada's R&D tax incentives are among the most generous in the world and are viewed as fundamental to encouraging technological development in Canada.
However, there are restrictions on the availability of these incentives which favour research carried on within Canada, by Canadian resident taxpayers carrying on business in Canada. Arguably, these tax incentives discriminate against businesses and research carried on outside of Canada\(^\text{12}\) and may be viewed as countervailable subsidies under the new GATT subsidies agreement. The question of whether these incentives are justifiable under the subsidies agreement, as well as in a purely domestic context, will be pursued. The need for revisions to the existing tax incentive system which may be more effective in achieving national goals and less vulnerable to international sanctions is also discussed.

Chapter 4 examines the pervasive problem of transfer pricing in international trade among members of a multinational enterprise. When related companies set up operations in more than one country, transfer pricing issues take on even more significance than domestic transfer pricing concerns. Canada's transfer pricing rules in subsections 69(2) and (3) of the ITA, deal with transactions between taxpayers and non-residents with whom the taxpayer is not dealing at arm's length. Although there are similar provisions for transactions between residents, these are limited in scope. The reason for the difference, of course, is that transfer pricing with non-residents results in erosion of the Canadian tax base, whereas transfer pricing with residents results only in shifting of amounts.

\(^{12}\) Brian J. Arnold, "Tax Discrimination Against Aliens, Non-Residents and Foreign Activities", \textit{supra} at 102.
between taxpayers.\textsuperscript{13} In the context of technology, arriving at a "reasonable price" for intangibles is subjective and open to abuse. Furthermore, the transfer pricing regime which has evolved places far greater burdens and potential risk of double taxation on international non-arm's length transfers than on similar domestic transfers. Arguably, these transfer pricing rules discriminate against multinational enterprises with business transactions beyond Canadian borders. Even though the OECD Model does not prohibit this type of discrimination, it is worthwhile to examine transfer pricing issues in connection with international trade in order to illuminate distortive effects which may arise and suggest improvements to the transfer pricing regime.

Finally, Chapter 5 summarizes the results of the case studies and whether these specific tax policies promote international trade. International trade considerations and sovereignty over taxation are not necessarily conflicting domains, and an acceptable balance should be attainable if the issues are addressed in a direct and coherent manner. The mechanisms and extent to which developments in domestic taxation, fiscal harmonization and international trade should converge are explored. While tax treaties provide some assistance in this regard, they are not a complete solution, and perhaps not even an adequate solution in addressing tax policy ramifications in the global market place. This research will attempt to provide support for the need for this global perspective in fiscal harmonization. It is suggested that a

\textsuperscript{13} ibid., at 105.
GATT-type tax code may be an appropriate approach for future international fiscal harmonization efforts. Further, in the interim, domestic tax policy makers, as well as those engaged in tax treaty negotiations, should be aware of the impact of their policy decisions on international trade, and of the impact international trade agreements may have on tax policies.

PART II: FREE TRADE

The starting point for this research is that "free trade" is a given; I shall not attempt to enter into the debate about whether or not free trade is a "good thing" or whether "liberal trade", "freer trade" or "managed trade" is a more accurate taxonomy for the actualities of international trade. A strict free trade approach requires no tariff or non-tariff barriers to trade. However, this discussion is based on the less pure notion that the goal of "free trade" is to minimize the amount of interference of governments in trade flows that cross national borders.14

The global marketplace is a reality which is rapidly expanding, as a few very recent examples indicate: the new World Trade Organization, successor to the GATT, came into effect on January 1, 1995; the North American Free Trade Agreement is on its way to becoming the Free Trade Agreement of the Americas; and in the autumn of 1994 the Canadian Government paved the way for

14 John H. Jackson, The World Trading System: Law and Policy of International Economic Relations (Cambridge, Mass., MIT Press, 1989) at 8 uses this definition for the notion of "liberal trade". See the discussion under "Taxation and Free Trade" regarding the necessity for adopting this less stringent definition of free trade in the context of taxation.
unprecedented trade with China. This section is limited to providing a brief overview of generally accepted theoretical basis for free trade and an outline of the main arguments for and against free trade.

Free trade is generally based on two premises: ¹⁵

1. The most efficient use of resources — and hence the maximum combined outputs — of trading nations will be achieved if trade among them is freed from arbitrary interventions by individual governments.

2. The preservation of sovereign rights as expressed in the maintenance of different politico-economic systems and sets of policies among nations is essential for increasing the welfare of the citizens of the nations concerned.

In this study, the second premise, the national objective is concerned with the particular sovereign rights to be preserved as embodied in the Canadian tax policies under review. ¹⁶

The first premise, the free trade objective, is based on the global goal of minimizing governmental interference in international trade flows which is fundamental to the GATT. ¹⁷ The

¹⁵ Hirofumi Shibata, Fiscal Harmonization under Freer Trade: Principles and Their Applications to a Canada-U.S. Free Trade Area, (University of Toronto Press, 1969) at 4. "In the field of public finance, this second premise means that a freer trade arrangement must not lead to denial of the following two differences: (1) differences that exist among nations in types and amounts of public goods and services provided by their governments, and (2) differences that exist among nations in degrees and patterns of income redistribution among fellow citizens of a sovereign nation..."

¹⁶ The objectives and criteria for evaluating national tax systems are discussed below.

¹⁷ Canada has been a strong proponent of the GATT, with the primary interest, pre-Uruguay Round, being to secure access to the U.S. market. With the Uruguay Round of GATT negotiations, Canada directed most of its efforts to achieving better access to markets outside of North America, revitalizing the overall system of
"interventions" of concern are tax policies which treat non-residents, multinational enterprises and cross-border activities less favourably than residents, domestic enterprises and activities within Canadian borders. Whether these interventions can be viewed as "arbitrary" ("discriminatory" taxation)\textsuperscript{18} will be determined by reference to standards and principles articulated in the GATT and the goal of free trade.

The GATT aims to achieve an acceptable balance between the sovereign interests of its Members and the global objective of free trade. Thus, the norm for assessing arbitrariness in this study is that established, defined and generally accepted by the GATT. Government policies which fail to achieve this balance can be viewed as an arbitrary use of sovereign power which fail to give due regard to international standards which promote free trade.

For example, tax rules which impose withholding taxes on cross-border payments for software under licensing arrangements may be viewed as arbitrary if the effect of the tax regime is contrary to the principle of non-discrimination as articulated in Article III of the GATT ("National Treatment"). Tax policies which seek to promote research and development in Canada may be viewed as arbitrary if the tax incentives create a scheme of subsidization

\textsuperscript{18} The concept of "discriminatory" taxation is addressed below.
for research and development which falls outside of internationally agreed upon parameters for such subsidization as articulated in the 1994 GATT subsidies code. Finally, a tax regime for regulating, monitoring and enforcing international transfer pricing may be viewed as arbitrary if that regime not only has undesirable consequences for multinational enterprises, but also fails to achieve the sovereign objective which the particular tax regime seeks to attain.

Free trade is considered to be beneficial to a nation because when each nation specializes in making the products that it can make most efficiently and trades for the other products it needs,\textsuperscript{19} global welfare is increased,\textsuperscript{20} though each individual nation's

\textsuperscript{19} In Canada, for example, exports of goods and services are approximately one quarter of Canada's GDP with one half of all natural resources and manufactured goods produced in Canada being exported. Canada depends disproportionately on exports of resource based products (forest products, minerals, metals, oil and gas) in which it has a comparative advantage. Canada's leading imports in the early 1990's were motor vehicle parts, passenger cars, electronic computers, telecommunications and related equipment, and apparel and accessories. 77.6% of merchandise exports in 1992 went to the U.S.; 70.6% of merchandise imports in 1992 were from the U.S. (Jock Finlayson, \textit{supra}, at 1-1 to 1-5).

\textsuperscript{20} See John H. Jackson and William J. Davey, \textit{Economic Theory and International Economic Policy}, (St. Paul, Minn.: West Publishing Co., 2d ed., 1986) at 15. This theory of international trade has its roots in David Ricardo's 'Law of Comparative Advantage' which states that a country will export products in which it has a greater or comparative advantage, and import products in which it has a comparative disadvantage. Some economists believe that this theory has ceased to be useful (see for example Robert Kuttner \textit{The End of Laissez-faire: National Purpose and the Global Economy After the Cold War} (New York: Knoff, 1991); John H. Jackson, \textit{The World Trading System: Law and Policy of International Economic Relations}, \textit{supra}, at 14 - 17 for a discussion of challenges to this classic theory. Donald J.S. Brean, "International Issues in Taxation", \textit{supra}, at 32 - 37 discusses conventional trade theory in light of the expansion of foreign
welfare will not increase equally. It is important to emphasize that all members of a country will not necessarily be better off with free trade; however, preservation of sovereign rights enables governments to ensure that all members could be made better off if the increased national income is suitably redistributed.

Based on this theory, the main arguments for and against free trade can be summarized as follows:

For

1. Consumption gains - domestically, the consumer will be able to acquire more goods at lower prices;

2. Production gains - importing products which were previously inefficiently produced domestically permits a reallocation of resources into more productive industries in which the country has a comparative advantage;

investment and concludes (at 38) that the influence of multinational enterprise and foreign ownership on trade and the efficiency of trade policy is potentially substantial, not least in Canada. These alternative perspectives are acknowledged but not explored in this research.

See John H. Jackson, The World Trading System, ibid., at 12 for economic models showing comparative and absolute advantage, and global and national gains with trade between nations. This study focuses on the global benefits to be attained from free trade under the GATT regime.


3. Economies of scale - free trade opens up larger markets, increasing demand for products and enabling lower costs to be realized with expansion of production operations;

4. Competitive domestic industry - free trade results in more direct competition between domestic and foreign producers forcing domestic production to become more efficient in order to remain competitive.

5. Domestic price stability and counter-inflationary pressures - these indirect results are achieved as a consequence of price reduction with increased supply combined with competitive pressures to control input costs.

Against

1. Foreign interference in domestic markets hinders domestic growth and standards of living.

2. Certain industries will pressure their governments to interfere with free trade in order to protect the domestic industry from foreign competition; a common form of protectionism is the tariff.

3. Tariff protection will give domestic producers a larger market share thereby creating jobs for the domestic economy.

4. Interference with free trade is necessary to protect labour in developed nations from low paid labour in developing nations.

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24 John H. Jackson and William Davey, Economic Theory and International Economic Policy, supra at 17 - 19. Also see Armando F. Beteta, supra, at 23 - 27; the author also discusses criticisms of the procedural aspects of free trade in addition to the critiques of substantial effects free trade set out here.
5. Tariffs equalize costs between the importing and exporting countries.

6. Certain trade restrictions are necessary in order to achieve national objectives.

It is suggested that the ability to access international markets for goods, services, technology and capital is critical to a nation's economic viability and standard of living. Restrictions on international trade result in less variety of products available domestically and, even if they are available, prices are likely to be inflated with the result that products are not affordable for the average consumer. Attempts to equalize costs or protect inefficient domestic industries may have some merit in the short term, but over the long term such protectionist measures will result in non-competitive industries and higher prices. Even in the short term, interfering with free trade may not be the most appropriate alternative for achieving domestic objectives.

In addition to the previous arguments against free trade, a case against free trade can be made in the absence of the following key assumptions about how the economy operates:

1. If a country has monopoly or monopsony power with regard to a commodity, a tariff or subsidy can enable the country to

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25 Joel B. Slemrod, "Free Trade Taxation and Protectionist Taxation", supra, at 13. The author also notes that a variety of non-economic arguments for trade intervention such as foreign policy or national security concerns in addition to domestic political reasons.
profit from it.  

2. If the domestic economy is distorted (due to domestic tax policy, for example), trade intervention could offset the distortion thereby increasing national income.  

3. In oligopolistic markets, it may be possible to shift some of the profits from foreign firms to domestic firms.  

4. Countervailing duties may be strategically useful as a means of discouraging other countries from using opportunistic trade policies.

Except for the distortion-offsetting argument, to the extent that national income is increased, it is at the expense of the income in the rest of the world; therefore, from a global perspective, these policies are wasteful.

When free trade is practised by all countries, world income will be maximized. Even more important however, is the result that

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26 A monopoly is the exclusive right or power to dominate the total sales of a product or service; a monopsony is a market condition where there is one buyer for a particular good or service (Blacks Law Dictionary, 5 ed., (St. Paul, Minn. West Publishing Co., 1979)). Slemrod notes that in the case of monopoly, the country ought to tax exports to drive up the world price; in the case of monopsony, a tariff should be imposed on imports to drive down the price.

27 Slemrod notes that it is generally better to eliminate the distortion that to counteract it with trade policy, because trade intervention introduces new distortions even if it reduces others.

28 An oligopoly exists where a few sellers sell only a standardized product (Black's Law Dictionary, supra). Slemrod notes that it is impractical to design a successful policy of selective intervention to take advantage of such a situation.

29 Joel B. Slemrod, "Free Trade Taxation and Protectionist Taxation", supra, at 14.
unilateral adoption of free trade will maximize the adopting country's national income, notwithstanding the trade policies of other countries. Based on the current expansion of free trade agreements, it appears that there is a continuing Canadian commitment to trade liberalization.

A conceptual framework for analyzing taxation measures in the context of free trade is set out in the next section.

PART III: TAXATION and FREE TRADE

As barriers to international trade and investment fall, and

30 ibid., at 13. Slemrod notes that even if a trading partner is subsidizing its exports, the importing country is better off not to respond by sheltering its residents from world prices; as to countering a trading partner's tariffs with tariffs of one's own "it would be just as sensible to drop rocks into our harbours because other nations have rocky coasts" (attributed to Joan Robinson, Essays in the Theory of Employment (Oxford; Blackwell, 1947) at 192). See also Donald J. S. Brean, "International Issues in Taxation", supra, at 25: "... economists are continually dismayed that principles of free trade are so readily violated. They are puzzled by policies that appear to ignore comparative advantage and the international price structure and that therefore ignore the true costs of economic intervention. Tariffs and import quotas ... are merely the least imaginative form of intervention."

31 See R.K. Paterson and M.N. Band, supra, at 2-6 regarding Canada's commitment to free trade; Donald J.S. Brean, "International Issues in Taxation", supra, at 20: "Unilateral free trade is beneficial, but multilateral free trade is better still."; Dr. A.A. Knechtle, Basic Problems in International Fiscal Law, (Deventer: Kluwer, 1979) at 6; Gilbert R. Winham, The Evolution of Trade Agreements (Toronto: University of Toronto Press, 1992) at 9 - 10. Joel B. Slemrod, ibid., at 14, summarizes the trade policy prescriptions for the United States as (i) unilateral free trade as a rule of thumb, (ii) toleration of strategic use of protectionist measures as a device to eliminate trade barriers elsewhere, and (iii) support of multilateral agreements to lower trade barriers.

32 References to international trade are generally intended to include trade in goods, services, intellectual property as well as investment. The Uruguay Round agreement on trade-related investment measures ("TRIMs") signifies that "investment is interchangeable with trade, and, more important, that trade
national economies become more integrated, the importance of international taxation for the efficient functioning of international markets becomes a main concern. This connection makes it more important than ever to consider international trade agreements in making tax policy decisions:

The broad lack of interest among general international lawyers in fiscal matters, combined with the diminishing role attributed to a conceptual and analytic study of international law, has led to an ever widening gap between the fields of international law and fiscal law.

As has often been the case in the history of international economic relations, the emergence or increase of a certain type of economic activity has drawn attention to a previously undeveloped area of law. Thus, it so happens that due to such factors as the increase in direct investment by citizens of one country in other countries, the rise in the number of persons 'living abroad', and the internationalization of trade, fiscal scholars have been confronted with the problem of taxation of foreign income and nonresident citizens.

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liberalization alone is not as effective as trade liberalization accompanied by liberalization of investment regimes" (Gilbert R. Winham, supra, at 79).

33 Joel B. Slemrod, "Free Trade Taxation and Protectionist Taxation", supra, at 28; Slemrod's discussion is restricted to the efficient functioning of capital markets. See also Douglas J. Sherbaniuk, in Donald J.S. Brean, "International Issues in Taxation", supra, at iii: "In the continuing process of trade liberalization, as classical trade restrictions such as the tariff have been dismantled, other protectionist measures assume a larger significance. One set of restrictions of increasing importance is the international fiscal system."

34 Rutsel Silvestre J. Martha, The Jurisdiction to Tax in International Law: Theory and Practice of Legislative Fiscal Jurisdiction, Series on International Taxation, No. 9 (Deventer, Kluwer Law and Taxation Publishers, 1989) at 11. See also Richard M. Bird, "Some Continuing Issues and an International Perspective" in Jack Mintz and John Whalley, eds., "The Economic Impacts of Tax Reform", Canadian Tax Paper No. 84 (Toronto: CTF, 1989) at 435: "But I do want to emphasize my view that the international dimension of taxation should be the starting point for serious tax policy analysis in an open economy such as Canada, not something to be optionally added on at the end."
It has also been noted that:\textsuperscript{35} 

Until recently, international taxation has been an arcane subspecies among American tax lawyers, and international considerations have rarely influenced the thrust of tax reform. Instead, tax rules have been crafted in consultation with domestic interest; tax incentives have been instituted to spur American individuals and companies to work toward perceived national goals; and the overall level of tax collections has been determined on the basis of American business conditions. Such a provincial approach to tax policy may have been appropriate in an earlier era, but the increasing economic integration of the world requires a more global approach to tax policy. The emphasis in recent American tax reform debates on competitiveness is only a precursor to a time in which international considerations will play a pervasive role in shaping tax policies.

Clearly, the relationship between domestic taxation and international transactions cannot be ignored.\textsuperscript{36} Tax policies take on special significance in this global marketplace.\textsuperscript{37}

\textsuperscript{35} Lawrence H. Summers, "Taxation in a Small World", in Herbert Stein, ed., \textit{Tax Policy in the Twenty-First Century} (New York: John Wiley & Sons, 1988), 64 - 75 at 64.

\textsuperscript{36} Joel B. Slemrod, "Free Trade Taxation and Protectionist Taxation", supra at 12, seeks to "recast international tax policy in parallel with the theory of international trade" and notes that "there is a potential down side to this strategy. It is that although the preference toward free trade is well established among economists, [it] is not well established elsewhere. On the contrary, the debate over trade policy continues, with the economist's view sometimes prevailing and sometimes not prevailing. The down side risk is that the ensconced prejudices and misconceptions regarding trade policy will simply be attached to the issues of international tax policy, blurring issues rather than sharpening them. But this is not really a problem, since implicitly this is already happening. To make the linkage explicit could, in my opinion, only be a plus." See also Donald J.S. Brean, "International Issues in Taxation", supra, at 9.

\textsuperscript{37} See Dr. A.A. Knechtle, supra at 9 - 10 for a discussion of competitive advantages or disadvantages due to fiscal measures which may result due to the differences in the structure of national tax systems and in rates of tax. Dr. Knechtle also highlights the dangers of multiple taxation of transnational activity on global economic development. Further, Rutsel Silvestre J. Martha, supra, at 1 states: "One fact which, whether
One of the objectives of this research is to develop a framework to assist tax policy makers in determining how specific tax measures should be selected from among alternative measures in order to achieve national objectives and minimize any distortive impacts on international trade. This emphasis on minimization, rather than elimination, is necessary for the simple reason that it is not feasible to eliminate the tax system:38

There must be tax revenue, and lots of it, and all taxes (other than those economists call "lump-sum", such as poll taxes) distort some margin of choice, such as the work-leisure choice, the consumption-saving choice, and the investment-or-not choice, and therefore are the source of inefficiency.

In selecting from among alternative tax measures it is first necessary to determine the objective(s) of the particular tax measure under review.39 Obviously, revenue raising is one of the main objectives of domestic taxation. In an international context, the revenue raising objective remains in tact, but is complicated by problems which arise in protecting a nation's share of the tax acknowledged or not, is of the utmost importance in the field of international taxation is the determinative impact of general international law on the outlook of international tax practices." Also see Donald J.S. Brean, "International Issues in Taxation", supra, at 1.

38 Joel B. Slemrod "Free Trade Taxation and Protectionist Taxation", supra at 14.

39 The following is a brief overview of the main objectives of taxation in general. Each case study will take a closer look at the applicable objective(s) sought to be attained, how successful the tax regime is attaining the objective(s), and look at alternatives to the existing tax regime which may achieve the objective(s) while minimizing undesirable impacts on international trade.
base in cross-border transactions.\textsuperscript{40} For example, withholding taxes and transfer pricing rules attempt to preserve Canadian tax revenues, but Canadian tax policies may conflict with the other nation's tax policies in these areas, thereby exposing the taxpayer to double taxation.

Tax policies are also used as a tool to promote economic objectives of growth and efficient allocation of the economy's resources.\textsuperscript{41} Tax expenditures, which are equivalent to spending programs, are aimed at achieving such economic, as well as social objectives. For example, investment tax credits for research and development are tax revenues foregone in order to stimulate research and development which, in turn, should create wealth, manage risk and improve quality of life.\textsuperscript{42}

Tax policies must be evaluated to assess whether the objectives are being attained. There are a number of criteria used in evaluating domestic tax policy which have been summarized as

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\textsuperscript{40} Donald J.S. Brean, "International Issues in Taxation", \textit{supra}, at 7, also notes that, in addition to revenue raising, taxes are levied on international trade for protection or in retaliation against protection elsewhere.

\textsuperscript{41} For a discussion of economic objectives of taxation refer to D.A. Dodge, "Economic Objectives of Tax Reform" in Jack Mintz and John Whalley, eds., \textit{supra}, at 36 - 44. For a general discussion on the use of the tax system to achieve policy objectives see Satya Poddar, "Taxation and Regulation", in Richard M. Bird and Jack M. Mintz, eds., \textit{supra}, at 71 - 96.

follows: 43

1. The tax system should be efficient or neutral. This criterion requires the tax system to apply similar (effective) rates of taxation to different activities. The efficiency argument rests on the presumption that the best allocation of resources is achieved by an unfettered market economy. If markets fail to achieve the best allocation of resources, efficient tax policy may call for corrective taxes or subsidies.

2. The tax system should be equitable. For example, it should levy taxes at the same rate on individuals or families in similar circumstances (horizontal equity) and apply appropriately higher rates of tax to well-off individuals or families than it applies to the less well-off (vertical equity).

3. The tax system should be simple. It should minimize both the administrative costs faced by the government and the compliance costs incurred by the private sector.

In evaluating international tax policy, similar criteria are used, but new issues arise. The standard of neutrality is complicated in international markets. The goal is to promote the most efficient allocation of resources on a global scale. Governments want to encourage inward investment and not encourage outbound investment. Therefore, it is necessary to distinguish between domestic and foreign investment opportunities of domestic investors as well as of foreign investors. Foreign investors should pay the same tax on income earned on an investment in Country X as a domestic investor would pay on that income earned in Country X (capital import neutrality); and domestic investors should pay the same tax on income earned on investments whether they invest at

home or abroad (capital export neutrality).  

The tax system should also be equitable with regard to international transactions. In this context, equity among taxpayers requires that tax is imposed in at least one jurisdiction, but relief from double taxation must be provided where necessary. Tax systems must also grapple with the issue of how to arrive at an equitable distribution of tax revenue on cross-border transactions among the nations involved.

Finally, simplicity remains a valid criteria in taxation of international transactions, yet administration of the tax system is even more difficult in this context due to the use of tax havens, the potential for tax avoidance and difficulties in collecting accurate and reliable information on taxpayer activities.

44 See Donald J.S. Brean, "Here of There?: The Source and Residence Principles of International Taxation", in Richard M. Bird and Jack M. Mintz, supra, 303 at 310. Capital import neutrality is concerned with the international allocation of savings and the after tax rate of return on similar investments in a particular market. Capital export neutrality is concerned with the international allocation of investment and the pre-tax rate of return.

45 Double taxation arises in the international context from the overlapping tax claims of both the source and residence country. See Donald S. Brean, "Here or There? The Source and Residence Principles of International Taxation", supra, at 309. The author describes 'source' and 'residence' principles at 307 - 308: The source principle of taxation of international income assigns the right to tax to the country that is the source of the capital income... Source taxes... include for most countries the corporate tax and withholding taxes on payments made to foreigners... The residence principle assigns the right to tax to the country of residence of the owners of the capital that generates the income... Although the corporate tax in the first instance is a source tax, the residence country's corporate tax may be defined on the residence principle; that is, the foreign-source income of a resident corporation is liable for (residence) tax.
A nation cannot set tax policy without taking into account the tax systems of other countries, especially its major trading partners. Therefore, any attempt to resolve a taxation issue with international dimensions should begin with an examination of the tax system of the particular country. However, it is suggested that the traditional criteria of neutrality, equity and administrative simplicity are not the paramount criteria for this examination. Although these remain valid criteria for evaluating tax policy, in recent years there has been a shift in tax philosophy which recognizes that the future development of tax policy will depend on many factors including demography, technology and development, ideology and politics, and internationalization. Indeed, efforts

46 Brian J. Arnold, "Tax Discrimination Against Aliens, Non-Residents and Foreign Activities", supra, at 7. Tax treaties and model tax conventions are a response to the lack of fit which arises between national tax systems in dealing with cross-border transactions. Also, see Donald J.S. Brean, "International Issues in Taxation", supra at 4 and 17 regarding the principle of sovereign national tax systems with a network of bilateral treaties as the primary vehicle for achieving international fiscal coordination. Tax treaties and conventions are necessary as there is no such thing as an international tax system; rather international taxation refers to the international interaction of national tax systems. Donald J.S. Brean, "Here or There? The Source and Residence Principles of International Taxation", supra at 309.

47 For a thorough discussion of each of these factors and how they are influencing tax policy see Richard M. Bird and Jack M. Mintz, supra, at 3 - 26. Also see Gary Clyde Hufbauer, U.S. Taxation of International Income; Blueprint for Reform (Washington, D.C., Institute for International Economics, 1992) at 61 for a discussion of how capital neutrality doctrine is no longer the relevant analytical approach for international tax policy issues. Joel B. Slemrod, in "Free Trade Taxation and Protectionist Taxation", supra, at 12 also moves away from the traditional doctrines: "In the hope of maximizing the gains from a fresh perspective, in what follows I will purposely not refer to the standard catch phrases of international tax policy, such as capital
are now under way to "seek new insight - indeed a new language for international tax policy by recasting it in parallel with the theory of international trade:"\(^{48}\)

\[A\]lthough international trade theory has been applied principally to policy instruments such as tariffs, quotas and dumping, tax policy can have at least as large an effect on the flow of goods across countries, the location of productive activity, and the gains from trade as these trade policy instruments. Thus it is an important object of study in its own right.\(^{49}\)

As indicated previously, the underlying premise of this research is that tax policy should facilitate, not hinder, free trade. Traditional tax policy criteria, even in the international taxation context, emphasize the interests of the particular nation. Therefore, the proposal is to evaluate national tax policy starting with an international perspective based on a fundamental feature of the international tax structure which is consistent with global free trade: non-discrimination.\(^{50}\)

The principle of non-discrimination pertains to neutrality export neutrality, capital import neutrality and national neutrality."

\(^{48}\) Joel B. Slemrod, ibid., at 12.

\(^{49}\) ibid., at 12. Slemrod identifies a second reason for studying international tax policy in parallel with international trade theory: there is a long history of reasoning pertaining to trade - the benefits of free trade, the costs of protectionism - that is fairly uncontroversial among economists ... [and] by drawing on this reasoning the murky issues involved in international taxation can be clarified.

\(^{50}\) ibid., at 21. Slemrod also identifies relief from double taxation as the other fundamental feature of the international tax structure which is consistent with global free trade.
within, as opposed to among, nations: ¹¹

A policy of non-discrimination promises equal treatment of all investors within a nation, domestic and foreign alike, and is a prerequisite of an allocatively efficient open economic system. However, as a national commitment, non-discrimination seriously constrains efforts to pursue simultaneously objectives with respect to domestic industrial structure and the domestic/foreign mix of ownership.

Canada insists on a modified version of non-discrimination. The Canadian approach is to treat all foreign investors in Canada equally but with no promise to refrain from treating the collection of foreign investors differently from Canadian investors.

Non-discrimination clauses pertaining to taxation of international transactions are generally provided for in tax treaties and commercial treaties. ¹² Discrimination generally has been defined to mean "treating persons unfavourably for reasons that are unreasonable, arbitrary or irrelevant." ¹³

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¹¹ Donald J.S. Brean, "International Issues in Taxation", supra, at 164.

¹² Kees Van Raad, supra, at 15. For example, Article 24:3 of the 1977 OECD Model Convention reads: "Stateless persons who are residents of a Contracting State shall not be subjected in either Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of the State concerned in the same circumstances are or may be subjected." Canada has reserved their position with respect to this Article. Article III:1 of the GATT reads: "The contracting parties recognize that internal taxes and other internal charges, and laws, regulations and requirements ... should not be applied to imported or domestic products so as to afford protection to domestic production.

¹³ ibid., at 11. Also discussed by Kees Van Raad, "Non-discrimination in International Tax Law", Series on International Taxation, No. 6 (Deventer, the Netherlands, Kluwer Law and Taxation Publishers, 1986) at 7 and 8: the original meaning of the verb 'to discriminate' is neutral, referring to 'distinction' and 'differentiation'; however, this neutral meaning has been replaced with the notion that the differential treatment has an unreasonable, arbitrary or irrelevant aspect to it. Kees Van Raad notes that non-discrimination is the opposite of unfavourable and
discrimination has been defined as "the unfavourable treatment of certain taxpayers and activities for reasons that are unreasonable, arbitrary, or irrelevant." Discrimination in the context of taxation and international trade refers primarily to unfavourable treatment of non-residents and foreign activities as compared with residents and domestic activities which is not justifiable on some reasonable basis. To the extent that tax treaties and international agreements articulate unacceptable differentiations, the elements of 'arbitrariness' and 'irrelevance' in the definition of discrimination are removed, and differential treatment based on the grounds specifically mentioned constitutes discrimination per

arbitrary differential treatment - an ideal which is far from clear (at 9).

54 Brian J. Arnold, "Tax Discrimination Against Aliens, Non-Residents, and Foreign Activities", supra, at 15. Donald J. S. Brean, "International Issues in Taxation", supra, at 13 states: "...treaties generally focus on withholding tax rates on interest, dividends, and other earnings on foreign capital because such taxes are levied at the border and are thus, by definition, discriminatory." This suggests that the definition of tax discrimination includes any taxes 'levied at the border'.

55 Brian J. Arnold, "Tax Discrimination Against Aliens, Non-Residents, and Foreign Activities", supra, at 11. Arnold also discusses the difference between direct and indirect tax discrimination at 15; Provisions which prima facie discriminate on the basis of a taxpayer's residence are directly discriminatory; indirect discrimination does not relate to residence, but effectively results in less favourable treatment of non-residents. Arnold provides the following examples: Canadian residents are entitled to dividend tax credits, but non-residents are not (direct discrimination); provisions that deal with Canadian-controlled private corporations and small business corporations which do not discriminate against non-resident taxpayers directly but against certain resident taxpayers that are controlled by non-residents (indirect discrimination).
Where such tax discrimination *prima facie* exists, there may well be circumstances when discrimination is justifiable, either as provided for specifically in international agreements or as part of the sovereign right to achieve an ideal tax system which meets national objectives.  

The tax measures under review will be examined to assess whether the policies discriminate against non-resident or foreign activities and have a negative effect on free trade. The specific domestic tax legislation will be first be reviewed. The analysis will move to international trade law as a basis for assessing whether discrimination exists.  

If discrimination arguably exists, the next stage is to determine whether or not such discrimination is justified.

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56 Kees Van Raad, *supra*, at 9 - 10 referring generally to Marc Bossuyt, *The Prohibition to Discriminate in International Human Rights Law* (Emile Bruylant, Bruxelles, 1976) and W. Kewenig, *The Prohibition to Discriminate in Modern Pacifist International Law* (IX Archiv des Volkerechts 137, 1961/1962) [both titles are translations by Van Raad from the original titles in French and German respectively].

57 Brian J. Arnold, "Tax Discrimination Against Aliens, Non-Residents, and Foreign Activities", *supra*, at 15 suggests that equity, neutrality, revenue and minimization of administrative and compliance problems are the appropriate criteria for determining whether discriminatory treatment is justified.

58 Donald J.S. Brean, "International Issues in Taxation", *supra*, at 164, suggests that: "To adhere to strict non-discrimination is to suppress several degrees of freedom in domestic economic policy ... and most countries are reluctant to relinquish that sovereign right. The researchable question involves the extent to which the stability, neutrality, and equity of international tax arrangements are compromised by strategic discrimination within nations." The current proposed analysis extends this 'researchable question' beyond the borders of international tax arrangements to consider the impact of tax discrimination on international trade arrangements.
If discrimination is permitted or justifiable on some basis. 59 The analysis proposed here is similar to a Charter analysis which has been used in Canadian income tax litigation. For example, under section 15(1) of the Charter, tax provisions that discriminate on the basis of race, national or ethnic origin, colour, religion, sex, age or mental or physical disability can be challenged (see Lennox Industries (Canada) v. The Queen, [1987] 1 CTC 171, 87 DTC 5041 (FCTD); Hodson v. The Queen, [1987] 1 CTC 219, 87 DTC 5113 (FCTD); Century 21 Emos Realty Inc. et al. v. The Queen, [1987] 1 CTC 340, 87 DTC 5158 (Ont.CA); Klement v. The Queen, [1987] 2 CTC, 87 DTC 5284 (FCTD); Prior v. The Queen, [1988] 1 CTC 241, 88 DTC 6207 (FCTD); Stromotich v. The Queen, [1988] 1 CTC 252, 88 DTC 6172 (FCTD); The Queen v. Kurisko, [1988] 2 CTC 254, 88 DTC 6434 (FCTD); Symes v. Canada, [1993] 4 SCR 695, [1994] 1 CTC 40, 94 DTC 6001 (SCC); Thibaudeau S. v. Canada [1994] 2 C.T.C. 2497 (FCA) on appeal to the SCC.) If an infringement of section 15(1) is found, the Court then moves to a section 1 analysis (see R. v. Oakes, [1986] 1 SCR 103, 26 DLR (4th) 200) to see if the offending provision can be saved. The section 1 analysis is a four stage test: 1. assess the objectives sought to be achieved by the impugned provision and a determination of whether they are important enough to warrant a Charter breach; 2. the Court must be satisfied that there is a rational connection between the impugned provision and the legislative objective; 3. the impugned provision should minimally impair the Charter right; and 4. there must be proportionality between the interests of society and the person whose rights have been infringed.

No country's laws prohibit tax discrimination on the basis of citizenship, residence, or the geographical source of income. "Nevertheless, many countries have chosen unilaterally not to discriminate on these bases, or to minimize such discrimination; many have entered into bilateral tax treaties that prohibit them from discriminating in certain ways against the nationals or residents of their treaty partners." (Brian J. Arnold, "Tax Discrimination Against Aliens, Non-Residents and Foreign Activities", supra, at 21; see also Dr. A.A. Knechtle, supra at 54-54).

It is suggested that where tax discrimination does exist, an analysis similar to a Charter analysis will assist in assessing whether such discrimination is justifiable. As noted by Brian Arnold, ibid. at 23, "the broad language of the Canadian Charter of Rights and Freedoms and Canadian human rights legislation is capable of applying to the tax treatment of foreigners and non-residents of Canada. However, it has not been applied in this way and it seems very unlikely that it will be. The Canadian tax system contains many discriminatory provisions... It is virtually unthinkable that Canadian courts would strike down such provisions, given that they represent clear government policy and are so
international trade law does not provide justification for a particular tax measure which appears to be discriminatory, the next question will be whether it is justifiable to maintain the status quo in light of an overriding sovereign interest. In order to justify tax discrimination on this basis, the tax measure should be rationally related to the underlying domestic objective and achieve that objective based on appropriate evaluation criteria. In addition, the domestic objective must outweigh the broader global objective of facilitating free trade. Finally, in choosing from among alternative tax measures, the goal is not necessarily to choose the absolutely least intrusive means to attain domestic objectives, but the means should come within a range which restrict free trade as little as is reasonably possible.

Tax policy plays a key role in determining how enterprises adapt their operations to remain competitive. Though discrimination is an elusive and ever changing concept, as international competition increases, it is reasonable to expect that protectionist and discriminatory taxation regimes, will not be tolerated by Canada's trading partners. The suggestion is that widespread."

60 As noted by Donald J.S. Brean, "International Issues in Taxation", supra, at 2, national policies are constrained by policies of other nations (including retaliatory policy) and by economic considerations such as comparative trade advantage and a nations need to import or capacity to export capital.

61 "Notes for an Address by the Honourable Roy MacLaren, Minister for International Trade, To the GATT Ministerial Conference in Marrakesh" (April 12, 1994), Canada and the Uruguay Round, Information Kit (Government of Canada, April, 1994) at 4. The Minister identified the following two inescapable conclusions
if nations unilaterally and consciously eliminate unjustifiable discriminatory tax practices, impediments to freer trade will be reduced. Yet Canada's income tax system: 62

... contains specific provisions that afford different, and often less favourable, treatment to some taxpayers on the grounds of nationality, residence or the geographical location of activities. To the extent that such treatment is unfavourable and the reasons for it appear to be unreasonable, arbitrary, or irrelevant, these provisions can be considered discriminatory.

The next three Chapters explore discrimination in Canada's tax system within the framework set out above.

about multilateralism: First, we must give the principles of fairness and mutual advantage new meaning. As our interests and aspirations increasingly converge, co-operation will be the only way to proceed. Second, we must work harder to leave unilateralism and protectionism behind once and for all...

62 Brian J. Arnold, "Tax Discrimination Against Aliens, Non-Residents and Foreign Activities", supra, at 1. Arnold also notes that up to the time of his study (May, 1990), the Canadian tax system had never been critically studied from the perspective of discrimination against aliens, non-residents, and foreign activities.
CHAPTER 2
CROSS BORDER SOFTWARE PAYMENTS

INTRODUCTION

This Chapter examines the Canadian tax treatment of cross-border payments for computer software under licensing arrangements in parallel with international trade concepts in the GATT. Canada has entered into international trade agreements and made amendments to domestic intellectual property legislation in order to facilitate the flow of intellectual property into Canada from abroad. However, the effect of Revenue Canada's position on the tax treatment of payments for computer software across international borders is to impede access to foreign technology, not to stimulate it.

Simply put, Canada treats these payments as royalties, and therefore income from property, whereas other international bodies

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1 The form of transaction under consideration is the straightforward delivery to a customer of pre-packaged software contained on a computer disk. The customer could be an individual who will use the software on a home computer or a business acquiring sophisticated software for use on a local area network. Payment is in exchange for the perpetual right to use the software. See Melvin S. Adess and Barbara M. Angus, "Knowledge and Technology Transfers to and from the United States: Characterization of Transfers of Computer Software" (July/August 1993) International Bureau of Fiscal Documentation at 414 - 423 for a discussion on a similar form of transaction under consideration by the Internal Revenue Service (the "IRS").

2 This paper assumes that the non-resident does not have a permanent establishment in Canada and, therefore, is not subject to Canadian taxation under Part I of the Income Tax Act. In practice, few arrangements for the supply of technology give rise to a Canadian business, unless the technology has been developed by the non-resident in the course of carrying on business in Canada (see Nathan Boidman and Bruno Ducharme, Taxation in Canada: Implications for Foreign Investment, (The Netherlands: Kluwer Law and Taxation Publishers, 1985) at 227.)
treat them as business profits.\(^3\) Royalties are subject to withholding tax in the cross-border context whereas business profits are not.

Revenue Canada has recently concluded bilateral treaty negotiations with at least two countries to eliminate withholding tax rates on such payments. However this approach skirts the issue of the underlying royalty characterization.\(^4\)

Although there is merit to a bilateral approach, it does not assist countries which either do not have treaties with Canada or have not renegotiated existing bilateral tax conventions. Therefore, it is preferable to take a principled approach to resolving the underlying issue rather than merely dealing with the symptoms on a case by case basis. Treaty negotiations, and tax policies in general, should reflect, or at least take into consideration, international developments in trade and taxation.

Thus, the purpose of this Chapter is two-fold. By examining the particular tax policy presented within the framework of GATT, further support is advanced for the view that Revenue Canada must change its stance on this policy. In addition, the broader question of what influence international agreements should have on unilateral, bilateral and multilateral taxation policies is an

\(^3\) See below "Royalty Provisions in Multilateral Tax Treaties".

\(^4\) This paper does not attempt to deal with the underlying characterization problem other than to suggest that the Canadian approach should be harmonized with the international standard to facilitate cross-border flows of software. An abundance of literature has criticized Revenue Canada's characterization of such payments as royalties which are subject to withholding tax when paid to nonresidents. Some of this literature is presented below.
underlying theme.

Part I sets the stage for the specific taxation issue under consideration with an overview of the Canadian treatment of royalty payments to nonresidents. Next, the characterization of computer software payments in multilateral taxation treaties is presented, followed by a discussion of the potential for double taxation. Part I concludes with a brief update of some recent developments in Canada's bilateral treaty negotiations in this area.

Part II develops the framework for examination of the tax policy under GATT. First the GATT principle of national treatment is outlined and some interpretive issues pertaining to that principle are presented. Then, the Canadian software royalty policy outlined in Part I is challenged within this framework to assess how it accords with this fundamental principle of international trade.

The paper concludes that Revenue Canada should bring its position on the characterization of these software payments in line with the international view, not only to harmonize tax regimes, but as a further impetus to reducing trade barriers for technology transfer.

PART I

CROSS-BORDER PAYMENTS UNDER SOFTWARE LICENSING ARRANGEMENTS

A. The Canadian approach

Software is often transferred to end users under licence

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5 The Canada - U.S. Free Trade Agreement ("FTA") and North American Free Trade Agreement ("NAFTA") incorporate Article III of the GATT regarding the principle of national treatment.
agreements which are designed to protect the interest of the software developer by restricting the end user's ability to copy the software or make changes to the source code. Revenue Canada classifies payments under these licensing agreements as royalties;

6 J.A. Chapin-Fortin, "Revenue Canada Hard on Software" (December, 1993), CA Magazine at 30.

a payment for software is viewed as a payment for the use of a secret formula.\(^8\)

Under subparagraph 212(1)(d)(i) of Part XIII of the Canadian Income Tax Act\(^9\) (the "ITA") a 25% withholding tax on payments to nonresidents is deducted at source and calculated on the gross amount of any "rent, royalty or similar payment... for the use of or for the right to use in Canada any property, invention, trade name, patent, trade-mark, design or model, plan, secret formula,\(^10\) process or other thing whatever."\(^11\) (emphasis added)

It has been suggested that this treatment may be justifiable if the foreign software company provides training, instruction or methodology concerning the software code to Canadian resident software developers who use the knowledge for commercial

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\(^8\) See C.A. Brown, supra, at 601; after the coming into force of the amendments to the Copyright Act in 1988 which specifically included computer programs within the definition of "literary work", Revenue Canada began to recognize a limited exemption from withholding tax where a payment is made to a non-resident only in respect of the right to produce or reproduce computer software. See also 212(1)(d)(vi) of the Income Tax Act.


\(^10\) The Copyright Act, R.S.C. 1986, c. C-42, as amended, includes computer programs in the definition of "literary work"; a computer program is not a "secret formula" under Canadian copyright law.

\(^11\) Interpretation Bulletin IT-303, "Know-How and Similar Payments to Non-Residents", paragraph 10, provides that the 25% withholding tax levied under subparagraph 212(1)(d)(i) of the ITA "extends to any payment, including a single or lump-sum payment, made to a non-resident for the right to use, in Canada, any property.... Such payment will be subject to tax whether or not it falls within the category of rent, royalty or similar payment".
exploitation; but "the end user of a software package gains no more knowledge about the programmer's logic or methodology than a motorist learns about automotive engineering by buying a car."\(^{12}\)

Arguably, Revenue Canada's approach does not reflect the commercial realities of these licensing agreements or the intent of the parties, and therefore it is not appropriate to subject these cross-border sales of pre-packaged software to tax.\(^{13}\) Thus, the more generally accepted view is that such payments should be treated as sale proceeds rather than royalties.\(^{14}\)

**B. Royalty Provisions in Multilateral Tax Treaties**

There are three main international model taxation agreements: the Organisation for Economic Co-operation and Development ("OECD") Model Tax Convention on Income and on Capital (the "OECD Model"), the United Nations Model Double Taxation Convention Between Developed and Developing Countries (the "UN Model") and the United

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\(^{12}\) J.A. Chapin-Fortin, *supra*, at 32 - 33.


\(^{14}\) As noted by Kenneth J. Murray, *supra*, at 27:22 Revenue Canada is studying the taxation of payments made to non-residents for the right to use software: "The reason for the study was representations that the sale of shrink-wrapped software is the sale of a product rather than a licence." Mr. Murray also notes that other countries treat software payments as sales proceeds rather than licence fees (27:23).
States Treasury Model. The focus in this section is on the OECD Model; brief reference is made to the other models.

There has been ongoing debate in the OECD for over a decade on international tax issues regarding the development and transfer of software.\(^{15}\) These debates culminated in significant amendments to the OECD Model in 1992, particularly with regard to the tax treatment of software which is now specifically addressed in the OECD Model along with revised commentary.

The revised OECD Model defines royalties as:

...payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or Model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.\(^{16}\) (emphasis added)

The guiding principles for interpretation of Article 12 of the OECD Model are summarized as follows:\(^{17}\)

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\(^{16}\) Article 12:2. Note that the words "or for the use, or the right to use, industrial, commercial or scientific equipment" were deleted in the revised OECD Model so that income from the leasing of such equipment would fall within Article 7 (Business Profits) rather than Article 12, thereby escaping withholding taxes on royalties where countries do not adhere to the OECD formulation of Article 12. See The Honourable Jan Franke, "The New OECD Model Tax Convention", Report of Proceedings of the Forty-Fourth Tax Conference, 1992 Conference Report (Toronto: Canadian Tax Foundation, 1993) 47:1 - 47:19 at 47:7.

\(^{17}\) See C.A. Brown, supra, at 595 -596; see also The Honourable Jan Franke, supra, at 47:16 - 47:17; David G. Broadhurst, Robert J. Dart and David G. Broadhurst (eds.), "Revisions to the OECD Model Convention", 40 Canadian Tax Journal 6 (Toronto: Canadian Tax
1. Payments made in connection with software represent royalties only where there is a limited grant of rights (not amounting to a change in ownership) for the commercial development or exploitation of the software.

2. Payments for software (whether "bundled" or not) that is acquired for the personal or business use of the acquirer do not represent royalties.¹⁸

3. Payments made for the alienation of all rights attached to software do not represent royalties.

4. Payments made for the purchase of some, but not all, of the rights attaching to software may result in an alienation, depending on the precise terms of the relevant contract. In those circumstances, the consideration paid does not represent a royalty.

5. If payments are made under mixed contracts (such as sales of hardware with built-in software, or sales of services with a right to use software), either the payments should be apportioned to the component parts, or where some of the parts are ancillary to the principal part, the treatment of the principal part should prevail.

6. Where a double taxation agreement provides for source taxation in respect of some, but not all, royalties, software payments that have the characteristics of royalties will normally be characterized as paid in respect of copyright.

Therefore, a payment in respect of software will rarely be a royalty payment under the revised OECD Model, even where there is only a partial transfer of rights.¹⁹

Footnote, 1992) 1347 - 1363, at 1347 - 1348 and 1357 - 1358; and the OECD Model Article 12 and commentary on Article 12, paragraphs 12 - 17 in particular.

¹⁸ As noted by C.A. Brown, supra, at 596: "Further to its statement that in most cases income from the sale of rights to software should be regarded as business income, personal service income or capital gains, the commentary says,'it is of no relevance that the software is protected by copyright or that there may be restrictions on the use to which the purchaser can put it'.

¹⁹ See footnote 25 and OECD Model, commentary to Article 12(14).
are royalties is where the transferor is the author of the software and the transferor grants partial rights to a third party to enable that third party to develop or distribute that software.20

The rationale behind the OECD Model article on royalties is to encourage and facilitate international trade.21 Even if a payment is classified as a royalty, only the state of the beneficial owner of the royalty payments has the right to tax royalties arising in a contracting state (the source country) and paid to the resident beneficial owner of the other contracting state.22 In other words, if a Canadian company makes royalty payments to a U.S. resident company, which is the beneficial owner, only the United States has the right to tax those royalties paid under the OECD Model.

The UN Model permits the use of a withholding tax where the rate has been agreed to in a bilateral treaty.23 The U.S. Treasury Model follows the OECD Model and allows for taxation in the beneficiary country only. In actual treaties signed by the U.S. the U.S. Treasury Model is generally followed except where it is dealing with a country which imposes withholding tax on royalties,24 such as the Canada-U.S. Tax Convention.25

20 OECD Model, commentary to Article 12(13).
22 Article 12:1 of the OECD Model.
23 J.S. Phillips, supra, at xxiii and 389. The UN Model permits the use of a withholding tax provided that the rate has been agreed to between the states in their bilateral treaty.
24 ibid., at 389.
C. The Problem of Double Taxation

A number of OECD members, Canada included, have expressed reservations about the complete exemption of royalties from source country taxation. In addition to reserving on this general exemption, OECD members differ in their views on what qualifies as a royalty in the first instance. In particular, Canada has asserted its intention to treat payments for the use of software as royalties which are subject to tax in Canada. As indicated above, this is exactly opposite to the OECD recommendation.

If both states in a bilateral treaty follow the OECD Model and exempt these payments from tax in the source country, no double taxation problem will arise; otherwise, the potential for double taxation exists. For example, in the case under review, cross-border payments are characterized by Revenue Canada as royalties subject to non-resident withholding tax with the following effects:

The Canadian customer generally must bear the cost of the


26 Australia, Austria, France, Greece, Italy, Japan, New Zealand, Portugal, Spain and Turkey have also expressed varied reservations about Article 12 of the OECD Model.

27 For example, Australia reserves the right to tax royalties that, under Australian law have a source in Australia (see Commentary to OECD Model, Article 12, paragraph 31) but Australian Taxation Ruling 93/12 issued on May 13, 1993 respecting the development and marketing of computer software determined that payments for a straightforward or simple use of computer software are not royalties (see Nathan Boidman, supra, at 93 per Andrew, "World Tax Scene - Australia - Computer Software Ruling," 1993/9 Intertax 448 (Sept. 1993)).

28 C.A. Brown, supra, at 596 - 597.
withholding tax; a foreign tax credit may not be available to the seller in the source country because of income-sourcing rules in that country or the lack of current taxable income.

To illustrate, a U.S. source sale arises when a U.S. software manufacturer exports software to Canada with title passing south of the border. Under these circumstances the U.S. manufacturer is not eligible for foreign tax credit on Canadian withholding tax. It is unlikely that the U.S. manufacturer is prepared to bear these costs and will, therefore, increase the price to the Canadian end-user.

29 See also Kenneth J. Murray, supra, at 27:17: "In many cases, foreign vendors will insist that the Canadian customer bear the burden of the withholding tax." Note also that the withholding tax is based on gross revenue and can result in a very high effective rate of tax on the net return to the licensor after expenses have been taken into account.


31 J.A. Chapin-Fortin, supra, at 32.

32 In the United States, the foreign tax credit is not designed to provide relief from double taxation caused by overlapping residence or overlapping source claims; it only provides relief from a conflict of U.S. residence jurisdiction with foreign source jurisdiction. See Michael J. McIntyre, The International Income Tax Rules of the United States, (Mass.; Butterworth, 1989) at 4-5.

33 Obviously this problem does not arise when the treaty withholding rate is nil. However, other foreign jurisdictions with similar sourcing rules do not have this treaty benefit. There are also ways to structure business operations to avoid the withholding tax issue entirely. For example, large foreign software vendors may choose to set up Canadian subsidiaries to sell their products in Canada. This is done under distribution agreements which can be designed to qualify for exemption from the Part XIII Canadian withholding tax. This option may not be feasible for smaller vendors. Therefore, smaller foreign companies may choose to enter into distribution arrangements with Canadian resident software distributors which are structured to meet the Part XIII exemption. Subparagraph 212(1)(d)(vi) of the ITA provides and exemption from the withholding requirement for a "royalty or similar payment on or
Even in circumstances when a foreign tax credit may be claimed, the complexities and differences in the foreign tax credit systems will often not result in full integration; a full and immediate credit for foreign taxes withheld may not be forthcoming. Further any tax credit obtained still puts the non-resident at a cash flow cost disadvantage. Therefore, the potential for double taxation is significant.

D. Recent Developments

This problem has not been overlooked on the international scene. In the United States, a coalition of 19 software developers devised a two step process to solve the problem of Canadian withholding tax on direct sales to Canadian end users:

1. The coalition would convince the [Internal Revenue... work". However, if the production site is not in Canada, the withholding tax will apply with the same results as above. Also, the alternative of direct licensing to Canadian customers would avoid the Part XIII withholding tax but may subject the non-resident to Part I tax on its sales in Canada, depending on the circumstances. A complete analysis of the various alternatives is beyond the scope of this paper; see Kenneth J. Murray, supra, at 27:28 – 27:31.

34 See R.D. Brown, "Perspective on the Taxation of Technology Transfers Between Canada and the United States", Discussion Paper prepared for Bureau of Policy Coordination, Department of Consumer and Corporate Affairs; Price Waterhouse, Toronto, 1987 wherein the author suggests that this is particularly true for new high technology companies which have substantial immediate write-offs for research and development, and access to domestic tax credits and deductions which limit its ability to claim foreign tax credits.

35 Nathan Boidman, supra, at 92. Note that certain members of the industry, such as IBM and Xerox, were opposed to this initiative purportedly on the basis that it could undermine protection of proprietary rights to their software. See also Kenneth J. Murray, supra, at 27:34 – 27:35.
Service] to issue a generic ruling taking the position that such cross-border licensing or sale of prepackaged software should be treated under US domestic law as a sale of property and not the licensing of property. Such a generic ruling would therefore treat any foreign distributor of prepackaged software (in the United States) as being in receipt of proceeds of sale and not royalties.

2. Armed with such an IRS ruling, an approach would be made to Revenue Canada to have the Canadian government adopt a similar position.

Although the IRS has not yet issued the ruling, the problem is under review and two rulings are expected to be issued at the end of 1994. The ultimate rulings will be moot as the August 31, 1994 Protocol to the Canada-U.S. treaty reduces the withholding rate on payments for the use of software to 0% from the current rate of 10%.

Changes have also been made to the Canada-Netherlands Income Tax Convention which specifically exempts payments made for the use of computer software from withholding tax.

The problem is that despite these recent treaty developments, Revenue Canada still maintains the right to tax these cross-border payments. The 1993 Canadian federal budget stated the government's intention to exempt cross-border software payments for withholding tax in its upcoming treaty negotiations, but failed to address the underlying issue of whether the software payments should be

36 Nathan Boidman, ibid., at 94.

37 March 4, 1993 Protocol to the Canada-Netherlands Income Tax Convention. Article 12(3)(a) extended the exemption from host country taxation of royalties to "payments for the use of, or the right to use, computer software." This broadened the previous exemption for royalties on software licences which granted the right to reproduce.
classified as royalties in the first instance:

Revenue Canada shows no inclination to waver in its interpretation of the current legislation. Concerned, however, that Canadian firms may not be able to "keep pace with innovative developments abroad," the government pledged in the 1993 federal budget to "negotiate, on a bilateral basis, exemptions from withholding taxes for payments made for the use of computer software."... The United States - Canada's major trading partner, especially in computer software - doesn't need a renegotiated treaty to conclude that nonresident withholding tax should not be levied on software payments.

The commitment to eliminate the withholding tax on these payments as part of upcoming treaty negotiations can be likened to treating the symptoms of a disease rather than the disease itself.\(^3^8\)

Therefore, software exporting countries which do not have treaties or which have not renegotiated treaty provisions with Canada on this matter are arguably at a competitive disadvantage, and may well be at a disadvantage for quite some time. Given Revenue Canada's reluctance to modify its position on the cross-border software licensing debate, perhaps a consideration of this policy in light of other international agreements may have some persuasive impact.

PART II

THE GATT AND WITHHOLDING TAX ON PAYMENTS FOR SOFTWARE

A. Introduction

In this Part, the question under consideration is whether Revenue Canada's position on the taxation of software has an effect on the international flow of computer software; specifically whether the effect discriminates against imported software in

\(^{38}\) J.A. Chapin-Fortin, \textit{supra}, at 33.
favour of domestically produced software. The question is posed in the context of the principle of nondiscrimination in the GATT.

B. The Principle of Nondiscrimination and its Interpretation

i. The Principle

The underlying GATT principle of nondiscrimination is embodied in Articles I and III. The principle is potentially far-reaching and has the ability to directly affect many domestic policies.

Article I contains the Most-Favoured-Nation (MFN) clause. The MFN obligation is a nondiscrimination clause which applies to goods from different exporting countries; any benefit extended by one member to another must be immediately extended to all other members.\(^{39}\)

Article III contains the national treatment obligation which is also a nondiscrimination clause but with a different emphasis. National treatment applies as between domestically produced goods and imported goods\(^{40}\) and "generally [is] designed to reinforce the basic policy of trade liberalization - minimizing governmental interference and distortion of transactions which cross borders."\(^{41}\)

The clause is in part designed to prevent the importing country from undermining the elimination of tariff import barriers vis a

\(^{39}\) There are a number of exceptions to the MFN clause. For example, the NAFTA violates the MFN obligation, but is permitted under Article 24 of GATT.

\(^{40}\) The concept of national treatment is also fundamental to the NAFTA, and its predecessor Canada/U.S. Free Trade Agreement.

vis internal governmental mechanisms.\footnote{42}

Article III:1 states that internal taxes and laws "should not be applied to imported or domestic products so as to afford protection to domestic production." It has been suggested that because of this language, it can be strongly argued that even though a tax may appear to be nondiscriminatory on its face, if it has an effect of affording protection, and this effect is not essential to the valid regulatory purpose suggested in Article XX, then the tax is inconsistent with GATT obligations.\footnote{43}

Article III:2 focuses on internal taxes and charges:

2. The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.\footnote{44}

The first sentence in Article III:2 prohibits discriminatory taxes on like products; it does not prohibit tax on imports where

\footnote{42 National treatment only applies to trade in products but the obligation to void discriminatory internal taxes applies to all products, not just scheduled ones. See also John H. Jackson, \textit{World Trade and the Law of GATT}, (Charlottesville, Virginia: The Michie Company, 1969) at 280.}


\footnote{44 As noted by K.W. Dam, \textit{The GATT Law and International Economic Organization}, (Chicago: The University of Chicago Press, 1970) at 118, paragraph 1 does not set out "principles" but only states that internal taxes should not be applied "so as to afford protection to domestic production." (emphasis added)
there is a different internal tax on like domestic products which imposes an equal or greater burden. Further, the interpretive note to paragraph 2 states that:

A tax conforming to the requirements of the first sentence of paragraph 2 would be considered to be inconsistent with the provisions of the second sentence only in cases where competition was involved between, on the one hand, the taxed product and, on the other hand, a directly competitive or substitutable product which was not similarly taxed.

Therefore, if a tax measure is inconsistent with the first sentence of paragraph 2, it is not necessary to consider the second sentence. However, even if a tax measure complies with the first sentence, it can contravene the second sentence. The second sentence deals with other internal taxes where like products are not involved but the tax discriminates between directly competitive or substitutable domestic products in fact, not in form.

ii. Interpretation of Article III

The approach for examining conformity with Article III:2 is to first determine whether the imported and domestic products are "like" (first sentence) or "directly competitive or substitutable" (second sentence); then, whether the taxation is discriminatory

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45 ibid., at 117. Note that Article II, paragraph 2(a) permits "a charge equivalent to an internal tax imposed consistently with the provisions of paragraph 2 of Article III..." on imported products.

46 Interpretive Note, Ad. Article III.

47 K.W. Dam, supra, at 118.

48 This paper does not address the interpretive issues regarding the meaning of "like" or "directly competitive or substitutable" products which are assessed on a case by case basis
In addition, there are a number of fundamental interpretative issues which must be addressed.

a. Internal Taxes: Direct, Indirect or Both

The GATT makes a fundamental distinction between tariffs and other taxes, usually called internal taxes. A tariff is a tax using the following criteria: the product's end uses in a given market; consumers' tastes and habits, which change from country to country; and the product's properties, nature and quality (see "Border Tax Adjustments", BISD 18S/97 at 101-102, paragraph 18 and "Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages", BISD 34S/83, 85 paragraph 5.6). It is assumed that this criteria is met in the specific context of under review.

Article III:2 has the object and purpose of promoting non-discriminatory competition among imported and like domestic products; it was designed with the intention that internal taxes on goods should not be used as a means of protection (Pierre Pescatore, William Davey and Andreas F. Lowenfeld, Handbook of GATT Dispute Settlement (U.S.A.: Transnational Juris Publications, Inc., 1991) at 28 - 29). See also Article III:1 and footnote 51.

"Japan - Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages", BISD 34S/83, 85 at paragraph 5.5.

The common distinction in a GATT analysis is between tariff and nontariff barriers to trade. The distinction between tariffs and nontariff barriers is particularly relevant as the GATT philosophy regarding nontariff and tariff barriers is quite different; a contracting party is not required to reduce tariffs in the absence of a special agreement whereas the general principle with respect to nontariff barriers is one of immediate abolition (see K.W. Dam, supra, at 19). The GATT makes no general provision for negotiations on the reduction of nontariff barriers; see, however, Articles IV(d) and XVII. Tariffs have historically been a preferred method to restrain trade for a variety of reasons. In addition to being easier to administer, a tariff is highly visible and does not prohibit imports (although tariffs do effectively limit consumer options). See also John H. Jackson and William J. Davey, supra, at 366 for a discussion of why international trade policy generally favoured tariffs over all other types of import restraints.
or duty levied on imports and payable by the importer to the government of the importing country. Internal taxes or other internal charges imposed at the time or point of importation, are regarded as an internal tax or internal charge and are subject to the provisions of Article III.

It is not entirely clear whether Article III applies to direct as well as to indirect taxes. The difference between these categories can be described as follows:

The theory is that a direct tax is a tax which is really paid by the person on whom it is legally imposed. It is assessed according to the personal 'ability to pay' and is related to facts which are regarded as being an objective and lasting expression of the tax paying capacity (eg. residence, landed property). The tax burden is distributed according to the economic capacity of the taxpayers which manifests itself particularly in the capital (wealth) and income of the latter. An indirect tax, on the other hand, is a tax which is imposed on one person, but paid partly or wholly by another; eg. it is levied on the trade and shifted on to the consumers. Indirect taxes are aimed at assessing the ability to pay taxes indirectly and related to the momentary tax paying capacity. The tax burden is distributed among the consumers in accordance with their expenditure.

52 K.W. Dam, ibid., at 115.

53 See John H. Jackson and William J. Davey, supra, at 364 for a discussion of the three types of tariffs: ad valorem, specific and mixed.

54 Interpretive note, Ad Article III. The interpretive note refers to taxes levied on both imported and like domestic products, but gives no guidance where like domestic products are not involved. Note that the national treatment obligation in Article III is divided into those relating to taxation and those relating to various other regulations.

55 Arnold A. Knechtle, Basic Problems in International Fiscal Law, (The Netherlands: A.A. Knechtle, 1979) at 210 (n.40). See also Black's Law Dictionary (St. Paul Minn., West Publishing Co. 1979) for the definition of "tax" (direct taxes are assessed on the
The classification into direct and indirect taxes is controversial;\(^{56}\) it is not always clear whether a tax belongs to one or the other category.\(^{57}\) The issue of whether a tax is passed through to the eventual consumer is particularly problematic.\(^{58}\)

The terms "directly" and "indirectly" arguably do not refer to "direct" and "indirect" taxes,\(^{59}\) though it is possible to argue property, person, business or income of those who pay them; indirect taxes are levied on commodities before they reach the consumer and are paid by those upon whom they ultimately fall as part of the market price of the commodity); Canadian constitutional law cases generally refer to the test set out by J.S. Mill, *Principles of Political Economy*, (Boston: Little & J. Brown, 1848) Book V, Chapter 2. Direct taxes typically include personal and corporate income taxes; indirect taxes include the excise and sales taxes.

\(^{56}\) It is worth noting that the mere description or categorization of a tax under the domestic law is not determinative of whether the tax is subject to the requirements of Article III. See "European Economic Community; Regulation on Imports of Parts and Components", BISD S37/132, 193 (May 16, 1990) paragraph 5.7 which arrives at this conclusion in regard to the "description or categorization of a 'charge'" and of "the 'product subject to a charge'". The author submits that the same treatment would be accorded to descriptions of taxes under the internal law.


\(^{59}\) K.W. Dam, *supra*, at 124. As the author notes, a tax which applies directly to products is, in fact, an indirect tax, whereas a tax which applies indirectly to products is a direct tax.
that the "directly or indirectly" language is broad enough to cover the discriminatory effects of direct taxes. The common interpretation is that the reference to "products" in Article III implies that it is only indirect taxes which are within the scope of Article III. Also, the predecessor to Article III did not appear to apply to direct taxes.

If direct taxes are excluded from Article III, the following consequences arise:

... a domestic income [direct] tax may not be offset by any [indirect] tax on imported products, [and] an income [direct] tax levied on importers or foreign sellers need not offset any domestic tax.

Further, consider the following discussion on whether certain income tax privileges are covered by Article III:

For instance, suppose Xonia grants an immediate income

60 Pierre Pescatore, William Davey and Andreas F. Lowenfeld, supra, at 29. Although the authors suggest that this argument could be made, they go on to say that the framers of GATT probably did not have this interpretation in mind as they generally distinguished between indirect, product-related taxes and other, direct taxes.

61 K.W. Dam, supra, at 124. Indirect taxes are generally considered to be borne by the consumer, as compared with direct taxes (such as income taxes) which are absorbed by the seller. An interpretation that indirect taxes are the taxes covered by Article III is consistent with these economic assumptions.

62 ibid., at 124 - 125. The author refers to the Analytical Index, at 19, regarding a statement in the reports on the Havana Conference which indicates that the particular article in the Havana Charter did not apply to income taxes.

63 ibid., at 125. The latter point is important because [direct] taxes on the local income of foreign sellers are common and are frequently limited only by the requirement that the foreign seller have a "permanent establishment" in the taxing country. In addition, such [direct] taxes are often calculated on a different basis from taxes on local enterprises.
tax deduction equal to the price of a certain machine for each such machine purchased from a domestic firm, but no such deduction for machines imported. If the deduction or exemption were from a tax on the machine (indirect tax), then presumably it would violate Article III. But as an exemption to a tax on the firm (direct tax), would it also violate Article III? Clearly the protectionist effect of such a privilege, even when it concerns income taxes on a firm, is often decisive. But it can be argued from the language of Article III, paragraph 2, that such exemption is not from a tax "on the product". Can it be argued that it amounts in effect to an "indirect" tax or charge? Or is this one of the major loopholes of GATT? Certainly practices of many countries would be affected by any attempt to close this loophole. 64

The net effect of excluding direct taxes from Article III can be summarized in the following chart:

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<th>Tax on Imports</th>
<th>Domestic Tax</th>
<th>Article III Applies?</th>
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<td>indirect</td>
<td>indirect</td>
<td>yes</td>
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Although it appears that Article III may have been originally intended to apply only to indirect taxes, 65 this interpretation is not clear and would result in a large loophole, which is difficult to justify. This issue is further complicated by difficulties in classifying a particular tax as direct or indirect.

b. Policy Purpose

GATT panels have considered whether the policy purpose of an internal tax or charge is relevant in interpreting the text of Articles I, II, III and the Note to Article III. It has been expressed that the relevant fact is not the policy purpose attributed to the charge or tax, but whether the charge is due on importation, at the time or point of importation or whether it is


65 For a discussion on whether Article III:2 applies to indirect taxes only, see generally K.W. Dam, supra, at 124-125.
collected internally:  

the tax adjustment rules of the General Agreement distinguish between taxes on products and taxes not directly levied on products; they do not distinguish between taxes with different policy purposes.

c. Extent of Effect on Trade

In "United States - Taxes on Petroleum and Certain Imported Substances" the GATT panel determined that Article III:2 applies whether or not adverse trade effects occur. The first sentence of Article III "obliges contracting parties to establish certain competitive conditions for imported products in relation to domestic products. Unlike some other provisions in the General Agreement, it does not refer to trade effects." Therefore:

A change in the competitive relationship contrary to [Article III:2] must consequently be regarded ipso facto as a nullification or impairment of benefits accruing under the General Agreement. A demonstration that a measure inconsistent with Article III:2, first sentence, has no or insignificant effects would therefore... not be a sufficient demonstration that the benefits accruing under that provision had not been nullified or impaired...

With regard to Article III:2, second sentence, small tax differences can also influence the competitive relationship, but the existence of protective taxation must be established on a case

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66 BISD 34S/136 at 161; see also "Belgian Family Allowances" BISD 1S/59 at 60; 25S/49, 67 and "E.E.C. Regulation on Imports of Parts and Components", 37S/132 at 192, 193.


68 ibid.
by case basis and there may be a minimum level below which a tax
ceases to have the protective effect prohibited by Article III:2,
second sentence.  

C. Withholding Tax and Article III:2

Before embarking on an analysis of whether the taxation is
discriminatory or protective under Article III:2, the fundamental
interpretative issue of the category of tax is examined.  

i. Withholding Tax - Direct or Indirect?

For domestically produced software, income tax is imposed on
royalty revenue through the corporate tax system. These revenues
form part of the net income calculation and corporate income tax is
paid on the net income; this is a direct tax.

The enforcement process is quite different for foreign royalty
payments. The withholding tax mechanism is arguably more akin to
a sales tax on a product than to a tax on income which is imposed
on a firm. The amount to be withheld is based on the gross revenue
generated from a single payment for a particular product, without
any deduction for expenses.

69 "Japan - Customs Duties, Taxes and Labelling Practices on
Imported Wines and Alcoholic Beverages", BISD 34S/83, 85 at
paragraph 5.11.

70 As noted previously the first issue is whether the domestic
and foreign products are "like" or "directly competitive or
substitutable"; it is assumed that this criteria is met. Policy
and minimal effect arguments are also not pursued since they are
not relevant to this analysis as discussed in the previous section.

71 See R. v. Caledonian Collieries, [1928] A.C. 358, which
distinguished between an income tax and a gross revenue tax. The
Alberta Mine Owners Tax Act provided that every mine owner should
be subject to a tax of 2% of gross revenue received by him during
the year. The Privy Council held that this was an indirect tax as
The interpretation of a tax as direct or indirect comes up frequently in the Canadian context of the allocation of taxing power between the federal and provincial governments. In *C.P.R. v. A.G. Saskatchewan*, [1952] 2 S.C.R. 231, Rand J. adopted the following test for determining whether a tax is indirect (at 252):

If the tax is related or relatable, directly or indirectly to a unit of the commodity or its price, imposed when the commodity is in the course of being manufactured or marketed, then the tax tends to cling as a burden to the unit or the transaction presented to the market.

Alternatively, the general tendencies of a tax and the common understanding as to those tendencies can be examined in assessing whether a tax is direct or indirect.

The amount of withholding is directly related to the price of the software; it is based on the gross revenue or the price of the software. The tax must be withheld when the payment is made - when the software is marketed in Canada. Therefore, the tax tends to cling as a burden to the unit or the transaction presented to

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72 A large body of Canadian case law exists on this topic. Although Canadian case law would not be directly relevant to a GATT challenge, the general principles articulated are of some guidance. For a comprehensive review of the Canadian law in this area, see G.V. LaForest, "The Allocation of Taxing Power Under the Canadian Constitution", 2d. Canadian Tax Paper No. 65, (Toronto: Canadian Tax Foundation, 1981).


the market and, as such, has the characteristics of an indirect tax.

Further, it is suggested that the foreign taxpayer will tend to pass the amount of tax on to the customer, just as customs duties tend to enter into the price of a product. The amount of the tax is readily identifiable and the price can easily be adjusted for the tax. It is reasonable to conclude that such an adjustment would be made and the general tendency would be to pass the tax along. Any such tax shift would not entail a circuitous process as would be required to pass corporate income taxes on in the price of goods produced and sold domestically.

On the other hand, there are a number of arguments which support the view that such a tax is direct. First, it is more likely than not that it is the foreign software developer who is intended to bear the incidence of the tax, not the Canadian

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Kenneth J. Murray, supra, at 27:17 notes that in many cases, foreign vendors will insist that the Canadian customer bear the burden of the withholding tax. He also refers to Revenue Canada guidelines on how the withholding is to be calculated "in this situation"; the specific Round Table question in which this calculation was set out referred to gross-up clauses in loan agreements where the interest payment is subject to withholding (see Revenue Canada Round Table, Report of Proceedings of the Forty-Fifth Tax Conference, 1993 Conference Report, (Toronto: Canadian Tax Foundation, 1994) Question 31 at 58:16. The grossed-up total of withholding tax is calculated by applying the following formula:

\[
\text{Required Payment} = \left[ \frac{\text{tax rate}}{100} - \text{tax rate} \right] \times \text{payment.}
\]

An example is also provided: for a payment of $1,000 at a withholding rate of 15% the required payment of withholding tax is:

\[
\left[ \frac{15}{100} - 15 \right] \times 1,000 = $176.47
\]
consumer. However, if the person who ultimately pays the tax, the end user, is not the one who is intended to bear the burden, the tax is indirect.

Second, if the tax can easily be passed on, it may not be passed on in an identifiable form. If the price is buried in the price of the goods, even an economic tendency to pass on a tax may not be sufficient to make the tax indirect.

ii. Internal Taxes - Direct and Indirect?

It is has not been specifically articulated by a GATT panel that internal taxes are limited to indirect taxes. When the GATT was drafted, the focus of attention was on the reduction of tariff barriers to trade; arguably not much thought was given to the potential impact of classifying a particular tax as direct or indirect. Therefore, there is some room for flexibility in

76 Subsection 212(1) in Part XIII of the ITA states: "Every non-resident person shall pay an income tax of...". Subsection 215(1) requires a person to withhold when the person "pays or credits or is deemed to have paid or credited an amount on which an income tax is payable under [Part XIII]", however, the payer is entitled to recover the amount from the non-resident (see Kenneth Murray, supra, at 27:26). Therefore, it appears that it is the non-resident who is intended to bear the burden of the tax, not the Canadian consumer.


interpreting the language, despite the prevailing view that the provision is intended to apply only to indirect taxes. Should the language be given as broad an interpretation as is reasonably justified?\(^79\) Should the meaning which is least trade restrictive be adopted?

As previously discussed, the "directly or indirectly" language in Article III may be broad enough to include direct taxes.\(^80\) It would have been easy enough to use the words "indirect taxes" in the place of "internal taxes" in Article III if it was intended to exclude direct taxes from this provision.

Furthermore, even if Article III was originally intended to apply only to indirect taxes, interpreting the language in the global market of today requires a broader, more flexible approach which recognizes the advances made in the reduction of trade barriers. Twenty-five years ago it was noted that some of the GATT provisions were outdated:

> [S]ome of the provisions of GATT have become outdated because, as tariffs have declined, other modes of protection of domestic industry have become relatively more important, and these have sometimes "slipped through" the intricacies of the complex GATT language. One example is the border tax adjustment. Others include certain subsidies, the import deposit scheme, and the "loyalty rebate."\(^81\)


\(^80\) See Pierre Pescatore, William Davey and Andreas F. Lowenfeld, supra, at 29.

The view that the GATT provisions were viewed as outdated in 1969 is even more pronounced going into the 22nd century. Another example which could be added to the foregoing list is an interpretation of internal taxes being limited to indirect taxes - a major loophole in the GATT with potentially far reaching impact on tax policies. Tax policies should not be an impediment to international trade when significant advances in facilitating the international flow of intellectual property have been made. Yet this could be the result if direct taxes slip through the GATT cracks because they do not conform to certain language drafted half a century ago.

Finally, on January 1, 1995 the new World Trade Organization (the "WTO") took over the reigns from the GATT to pursue further advances in international trade. Perhaps under the auspices of the WTO a broader interpretation of the meaning of "internal taxes" is feasible.

iii. Discriminatory Taxation

If the tax in issue is classified as an indirect tax, or if it

82 The WTO incorporates the new agreement on trade-related aspects of intellectual property rights ("TRIPs") which establishes standards of protection for intellectual property rights; it is the most comprehensive international agreement in this area to date. (Agreement on Trade-Related Aspects of Intellectual Property Rights, including Trade in Counterfeit Goods, Annex IC to the Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, GATT document MTN/FA (UR-93-0246) (1993)). The TRIPs also provides for enforcement of these standards under national law and contains provisions for accessing the WTO's dispute procedures. See Jock A. Finlayson, "Canada and International Trade Regulation: The General Agreement on Tariffs and Trade", in Robert K. Paterson and Martine M. Band, International Trade and Investment Law in Canada, 2d., (Toronto: Carswell, 1994) at 1-56 - 1-57.
is classified as a direct tax and Article III is interpreted to address direct taxes, it must be determined whether the taxation is discriminatory.\(^{83}\)

In "Italian Discrimination Against Imported Agricultural Machinery"\(^{84}\) the GATT panel considered the standard in Article III:4 that imported products be subject to "treatment no less favourable" than that accorded domestic products in applying internal law. The panel was of the view that this standard requires effective equality of opportunities. This focus on effect in the context of the principle of national treatment should apply equally to internal taxes as to other internal law. Thus, it is necessary to establish whether the effects of the tax are discriminatory.

Classifying a payment for a software licence as a royalty is the same for domestic and foreign licensing arrangements. Prima facie, the tax treatment may not appear to be discriminatory simply because there is a different enforcement procedure in place for collecting the taxes. However, it is not the enforcement mechanism of the withholding for the tax on the royalty revenue which is discriminatory; it is the effect of such withholding.

In addition, although the withholding tax applies only to

\(^{83}\) Under the assumption that like products are involved, it is only necessary to determine whether the tax is discriminatory under the first sentence. The second sentence applies if the products are directly competitive or substitutable. For further discussion on the this point, see Part B. above "The Principle of Nondiscrimination and its Interpretation".

\(^{84}\) BISD. 7S / 60.
imports, "a tax applying to imports only is not unlawful [within Article III:2] if another, but different, internal tax imposes an equal or greater burden on like domestic products." Therefore, it is necessary to establish that the effect of withholding is that a greater tax burden is placed on imported software in comparison with the income tax on domestic software.

In the domestic sphere, software royalties form part of the net income calculation for income tax purposes; the tax payment is based on net income and no withholding is required. In the cross-border transfer of software, withholding tax is calculated on the gross amount paid. Thus, the withholding tax can represent a very high rate of tax on the net return to the software vendor after expenses are taken into account; the tax withheld on behalf of the non-resident could well exceed what would be charged if the income was taxable as income in Canada and have the effect of being discriminatory.

Further, as discussed in Part I, withholding tax on royalty payments may result in double taxation when non-residents have little or no opportunity to use the foreign tax credit, or similar mechanism, to offset Canadian withholding taxes. Such double taxation subjects the imported software to taxes in excess of those applied to domestic software, contrary to Article III:2.

85 K.W. Dam, supra, at 117.
86 J.S. Phillips, supra, at xxiii - xxiv.
87 As discussed in Part I, even when a foreign tax credit may be claimed, there is often not full integration and, at a minimum, a cash-flow disadvantage exists.
Also:

...by virtue of double taxation the transfer of technology ceases to be of interest if the required minimum income cannot be achieved ... the situation deteriorating due to taxation of the gross amount of some income, eg. ... royalties. Thus the taxpayer will act according to tax rather than economic criteria, and as a result initiative will be restrained and efficient enterprises will find it harder to operate.  

In other words, the foreign producer may find it is not economically viable to transfer technology to Canada or may decide to pursue more tax advantageous business structures to effect such transactions:

The underlying assumption of the General Agreement — indeed, the argument for free trade in general — is that local laws and regulations should not make the location of industry a factor in trade. To say that part of the foreign industry must be moved to the [domestic country] for the foreign product to have the same competitive position as the domestic product is to concede that the legislation in question distorts international trading patterns and serves to "afford protection to domestic production."  

In summary, a strong argument can be made that the effect of the withholding tax mechanism is to discriminate against foreign software in favour of domestic software; this is contrary to the principle of national treatment in Article III.

iv. Justifiable Discrimination

An internal tax which is discriminatory may still come within a GATT exception and not be prohibited. These exceptions are briefly canvassed in this section. It is worth bearing in mind that


89 K.W. Dam, supra, at 130.
these exceptions can be a form of hidden protectionism.

First, discriminatory taxes which were in effect on October 30, 1947 may be continued, but not increased.\textsuperscript{90} In the particular case under review, the provisions of the Income Tax Act which were in force in 1947 did not include the "secret formula or process" language relied upon by Revenue Canada to treaty payments for software licences as royalties.\textsuperscript{91}

Second, it is clear that the principle of national treatment must also be balanced with national policy goals. This overriding right of sovereignty to promote domestic policy goals is acknowledged in Articles XX (General Exceptions) and XXI (Security Exceptions). These Articles recognize that there are various governmental measures which are based on legitimate policies not necessarily designed for purposes of restraining imports. Legitimate policy goals, including those mentioned Article XX prevent a measure from being inconsistent with GATT obligations. It is unlikely that either of these Articles applies to the tax under review, unless a national security interest arises in a particular software transaction.

From a domestic perspective, it appears that Revenue Canada's objective in imposing this withholding tax is to maintain control over such cross-border payments in order to preserve the Canadian tax base. Certainly the withholding tax mechanism is rationally

\textsuperscript{90} \textit{ibid.}, at 119.

\textsuperscript{91} See \textit{The Income War Tax Act}, c.97 R.S.C. 1927 ss. 24 and 25; \textit{The Income Tax Act}, c. 52 S.C. 1948, s. 96(e) and \textit{The Income Tax Act}, c. 148 R.S.C. 1952, s. 106(6).
related to achieving this objective, and is effective in achieving it. However, this case study suggests that this domestic objective does not outweigh the broader domestic and international objectives of facilitating free trade in technology. With the recent Canadian treaty re-negotiations reducing the withholding tax rate to nil in for these payments, and given the generally accepted international position on this matter, it is suggested that there is little justification for Revenue Canada to continue to maintain this policy.

The alternatives are to: 1) maintain the status quo and continue pursuing treaty re-negotiations on a case by case basis; or 2) to treat these payments as business profits, not income from property. It is suggested that the latter alternative is a more principled alternative to reducing withholding rates to nil, while promoting free trade in technology and the principle of non-discrimination in the GATT.

CONCLUSION

In this case study, withholding tax puts the foreign software producer at a disadvantage vis a vis domestic software producers who are not subject to the withholding tax; this is contrary to the national treatment principle in GATT. It also results in foreign technology being less accessible to the Canadian consumer. The Canadian purchaser of software may be penalized with increased prices for, or reduced access to, foreign software. This is contrary to the objective of Canadian government to facilitate the free flow of technology.
While Revenue Canada has made some progress in the area of cross border software payments with the U.S. and the Netherlands through renegotiated tax treaties, perhaps it is time to accept the international norm and stop treating these payments as royalties. Bilateral treaty negotiations certainly go some way to ameliorating the underlying problem but are not a cure all. Revenue Canada should bring its position on the characterization of these software payments in line with the international view, not only to harmonize tax regimes, but as a further impetus to reducing trade barriers for technology transfer.
CHAPTER 3
RESEARCH AND DEVELOPMENT

The global economy is increasingly driven by knowledge-based industries. According to the Secretariat for Science and Technology Review, in constant-dollar terms, global production by high-technology industries more than doubled between 1980 and 1990. This compares with a 23 percent increase in other manufacturing industries. Research and development is a vital tool in the leap from a resource-based economy to one based on meeting consumer needs for services and products. It is an integral part of any nation's global competitiveness.¹

INTRODUCTION

Research and development ("R&D" or scientific research and experimental development, "SR&ED") can be viewed as a commodity, a stock of accumulated knowledge derived from R&D expenditures that depreciates as new products and processes replace old ones.² R&D conducted in one sector can have productivity enhancing effects on the performing sector as well as other sectors, and can contribute indirectly to productivity growth in the external economy through its interaction with other inputs and through the interaction of supply and demand.³

The importance of commercial, high-technology initiatives to

¹ L. Denis Desautels, Auditor General of Canada, Report of the Auditor General of Canada to the House of Commons, 1994 vol. 1 (Ottawa: Ministry of Supply and Services, Canada, November 22, 1994) at 1-17 (the "1994 AG's Report"). See also Michael Wilson, Minister of Finance, Canada, Department of Finance, Budget Papers, Budget Speech, May 23, 1985, at 7; and Research, Development and Economic Growth (Canada: Ministry of State, Science and Technology, 1985) at 1, regarding the Canadian government's priority in encouraging research and development.

² Pierre Mohnen, The Relationship Between R&D and Productivity Growth in Canada and Other Major Industrialized Countries (Ottawa: Ministry of Supply and Services, Canada, 1992) at 3.

³ Ibid., at 3.
the international competitiveness, economic health and growth in productivity of a nation has long been recognized. In Canada, continual changes to the ITA reflect the government's desire and commitment to stimulate research and development activities in Canada. Indeed, Canada's tax incentives for R&D are generally seen as among the most generous in the world and Revenue Canada


continues to amend administrative practices in order to facilitate access to these incentives.\(^7\)

The rational for providing tax support for R&D is based generally on the "spillover" of R&D benefits into the external economy and the inability of the performers of R&D to recover their investment.\(^8\) Based on the tendency for private industry to underfund long-term, high risk R&D, government involvement and assistance in initiating private innovation in R&D has been seen as

\(^{7}\) See Roy Shultis, supra for an overview of Revenue Canada's responsibilities, administrative practices, communication and publication initiatives, and program results for R&D.

\(^{8}\) W.S. Clark, et.al., supra, at 32:3. Mohnen, supra, at 3 discusses spillover effects: "First, externalities may occur because a downstream user derives direct benefit from the R&D without having to pay the full value of the input - as when a bank purchases personal computers that enable it to streamline operations. In this example, the benefits to the bank measured against the cost of the computers are worth substantially more to the bank than the price paid for them. Also, qualitative improvements may not be entirely reflected in the new price of an enhanced product or service because of competition, monitoring costs and, frequently, limited or incomplete information on the part of the developer with respect to the real value of the enhanced product to the end user. The second type of spillover relates to the inspiration a research project, technical discovery or innovation in one sector can stimulate in another sector. New ideas often trigger new avenues of research and render established methods uneconomical or inefficient. For example, the development of synthetic fibre technology by the chemical industry found wide application in the textile industry. Research undertaken by NASA focusing on space exploration, cleared the way for many innovations and new developments in the automobile and computer industries. A distinction is thus made in the literature between private and social rates of return, i.e., those that are appropriated by the developer or performer and those that cannot be appropriated. In the latter case, society at large enjoys a maximum rate of return at apparent minimum cost." Mohnen also concludes, at 43, that the spillover effects can be substantial generating social rates of return 50 to 100 percent in excess of the private rates of return.
essential to attaining a socially optimum level of R&D. To this end, the Canadian governments commits approximately $1 billion in tax incentives for R&D per year, representing over 10 percent of the annual federal revenues from corporation income tax, for three basic purposes:

...creating wealth, managing risk and improving quality of life, and advancing knowledge through basic research. Wealth creation involves, for example, the development of new technologies to increase the competitiveness of the Canadian economy. Managing risk and improving quality of life includes research to support regulation in environmental health areas... Advancement of knowledge involves basic scientific research.

PART I
RESEARCH AND DEVELOPMENT TAX INCENTIVES

A. The Canadian System

i. Overview

The relevant tax rules pertaining to research and development are contained in ITA section 37, 127 and 127.1 and regulation

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9 J. Hutchison, supra, at 26:1; W.S. Clark, et.al., supra, at 32:3; T. Routley, supra, at 24:2; and Canada, Department of Finance, Budget Papers, Research and Development Policies: A Paper for Consultation, April 1983, 11.


2900. Subsection 37(2) contains special provisions for current research and development expenditures incurred outside of Canada.

Information Circular 86-4R3 sets out Revenue Canada's views on research and development and discusses the following three essential criteria for R&D, all of which must be met in order for a project to be eligible for the R&D tax benefits: scientific or technological uncertainty, scientific or technological advancement, and scientific and technical content. For example, with respect

12 Only federal R&D incentives are considered here, although a number of provinces, including Ontario, Nova Scotia, and Quebec, have incentives for R&D. (See W.S. Clark, et.al., supra at 32:13 - 32:15 for an summary of the federal R&D tax credits, distribution of federal credits by rate and province, and an overview of the provincial incentives.) This Chapter is based on amendments to the ITA up to Bill C-9, An Act To Amend the Income Tax Act, which received royal assent on May 12, 1994 (now S.C. 1994, c.8). This Bill implemented measures contained in the December 2, 1992 economic statement and the April 26, 1993 federal budget. Bill C-27, An Act To Amend the Income Tax Act, the Income Tax Application Rules, the Canada Pension Plan, the Canada Business Corporations Act, the Excise Tax Act, the Unemployment Act, and Certain Related Acts, received royal assent on June 15, 1994. This Bill (now SC 1994, c.21) includes one measure from the February 22, 1994 federal budget pertaining to new R&D filing deadlines which are not addressed here.

13 "Scientific Research and Experimental Development", August 29, 1986, updated as IC 86-4R2, August 29, 1988, and IC 86-4R3, May 24, 1994. The first release provided two industry specific papers which are not included in IC 86-4R3: Appendix B.1 Application Paper - Computer Software and Appendix B.2 Application Paper - Food and Beverage. Per J. Hausch, supra at 14:7, fn 30, the computer software application paper is being revised and will be reissued separately as a supplement. Also refer to Western Plywood Co. Ltd. v. MNR, 51 DTC 392 (TAB); International Nickel Co. of Canada Ltd. [No.2] v. MNR, 71 DTC 5332 (FCTD); and Sass Manufacturing Limited v. MNR, 88 DTC 1363 (TCC) which deal with the definition of scientific research for tax purposes. For an overview of the first IC 86-4, see T. Routley, supra, at 24:8 - 24:11.

14 For further discussion of these criteria, see J. Hausch, supra, at 14:8; Information Circular IC 86-4R3, supra, Part 6 "Criteria for Identifying Eligible Activities in Computer Science
to computer software: 15

The development of a new software application will be eligible for SR&ED only if there is an identified technological uncertainty and the project attempts to resolve that problem.

Uncertainty in software or systems development may be due to an operating environment that places special and unusual demands on the system. For example, technological challenges may arise when response times are critical and transaction volumes are high. The development of new or improved tools or processes to solve this technological problem may be SR&ED. The application of new tools or a new application of standard tools may indicate uncertainty. System uncertainty may occur where new technologies are combined or where known technologies are combined in a new way. Where a change in one area affects performance in other areas, system uncertainty may exist.

If the solutions to these problems add to the knowledge of computer technology within the context of the business environment of the taxpayer, a technological advancement is achieved and the project may be SR&ED.

The scientific and technological content is generally achieved if the project is undertaken by qualified personnel using a systematic approach such as SDLC (system development life cycle). As with any project, this systematic approach must be supported by documentation of the plan and of the design, build, test, evaluate and modify cycle.

In addition, certain basic tests must be met for a taxpayer to be entitled to claim benefits under the ITA: 16


15 J. Hausch, supra, at 14:9.

- the SR&ED activities must be carried on in Canada;\textsuperscript{17}
- the SR&ED must be related to a business\textsuperscript{18} of the taxpayer;
- where the activities are undertaken by third parties\textsuperscript{19}, (other than parties performing R&D on behalf of the taxpayer), the taxpayer must have the contractual right to exploit the results;\textsuperscript{20}
- the taxpayer must claim the benefits by filing a prescribed form.\textsuperscript{21}

Finally, as a preliminary consideration, research and development activities must come within the meaning of the term "scientific research and experimental development" as defined in regulation 2900(1):

systematic investigation or search carried out in a field of

\textsuperscript{17} Subsection 37(1). See subsection 37(2) for the tax treatment of current expenditures incurred on R&D carried on outside Canada.

\textsuperscript{18} Subparagraph 37(1)(a)(i), clause 37(1)(a)(iii)(A), paragraph 37(8)(b), and paragraph 37(8)(c). Interpretation Bulletin IT-151R4, "Scientific Research and Experimental Development", August 16, 1993, paragraphs 8 and 9; and Al Katiya, supra, at 325: "To meet this test the taxpayer must show that the R&D, if successful, will result in some direct and beneficial application to a business that is carried on by the taxpayer."

\textsuperscript{19} Subparagraph 37(1)(a)(ii). See D. Duncan, supra, at 47:4 - 47:8 for a discussion of Revenue Canada's position regarding payments to "approved" entities. J. Hausch, supra, at 14:2, FN 6: "The words "on behalf of" imply direct supervision and control of the work. It is often difficult to evaluate whether a payment is eligible under subparagraph 37(1)(a)(i) or 37(1)(a)(ii)."

\textsuperscript{20} Subparagraph 37(1)(a)(ii); Claude Desy, ed., Access to Canadian Income Tax (Markham, Ont.: Butterworths) (looseleaf), paragraph C20-1060; Interpretation Bulletin IT-151R4, supra, paragraph 12; and Revenue Canada Round Table, 1993 Conference Report, supra, Question 2, at 58:2 - 58:3.

\textsuperscript{21} Form T661(E) (rev. 93), "Claim for Scientific Research and Experimental Development Expenditures Carried on in Canada"; Interpretation Bulletin IT-151R4, supra, paragraph 6; J. Hutchison, supra, at 26:16 - 26:17.
science or technology by means of experiment or analysis, that is to say,

(a) basic research, namely, work undertaken for the advancement of scientific knowledge without a specific practical application in view,

(b) applied research, namely, work undertaken for the advancement of scientific knowledge with a specific practical application in view,

(c) experimental development, namely, work undertaken for the purposes of achieving technological advancement for the purposes of creating new, or improving existing, materials, devices, products or processes, including incremental improvements thereto, or

(d) work with respect to engineering, design, operations research, mathematical analysis, computer programming, data collection, testing and psychological research where that work is commensurate with the needs, and directly in support of the work described in paragraph (a), (b) or (c), but does not include work with respect to

(e) market research or sales promotion,

(f) quality control or routine testing of materials, devices, products or processes,

(g) research in the social sciences or the humanities,

(h) prospecting, exploring or drilling for, or producing, minerals, petroleum or natural gas,

(i) the commercial production\(^{22}\) of a new or improved material, device or product or the commercial use of a new or improved process,

(j) style changes, or

(k) routine data collection.

ii. The R&D Pool - Deductible Expenditures

Section 37 and regulation 2900 describe what constitutes qualifying R&D for Canadian income tax purposes and provide various rules for the computation of R&D expenditures.\(^{23}\)

[T]hese provisions detail the tax treatment of current and capital expenditures as well as the apportionment of expenditures between eligible and non-eligible activities. Specifically, to ensure that a taxpayer's Canadian SR&ED expenditure pool is increased only to the extent of an amount incurred from SR&ED activities, clause 37(7)(c)(ii)(A) [now clause 37(8)(a)(ii)(A)] requires that the expense (capital or current) substantially relate to the prosecution of SR&ED or the provision of premises, facilities, or equipment for the prosecution of SR&ED. Thus, where a taxpayer can demonstrate that an expenditure was incurred, substantially (generally interpreted to be 90 percent or more) for the prosecution of SR&ED or the provision of SR&ED facilities for the prosecution of SR&ED, the entire amount of the expenditure may be added to the SR&ED expenditure pool. Where a capital expenditure does not meet the substantial test, none of the costs related to it qualifies as SR&ED. A current expenditure may, however, be added to the SR&ED pool by virtue of clause 37(7)(c)(ii)(B) [now subclause 37(8)(a)(ii)(B)(II)], provided that the expenditure is directly attributable to the prosecution of SR&ED facilities pursuant to regulations 2900(2) and (3).

The following expenditures are "directly attributable" to the prosecution of R&D:\(^{24}\)

(a) the cost of materials consumed in such prosecution;

(b) where an employee directly undertakes, supervises or supports such prosecution, the portion of the amount incurred for salary or wages of the employee that can reasonably be considered to be in respect of such prosecution; and

(c) other expenditures, or those portions of other expenditures, that are directly related to such prosecution

\(^{23}\) Al Katiya, supra, at 310.

\(^{24}\) Regulation 2900(2) which applies for the purposes for clause 37(8)(a)(i)(B) and subclause 37(8)(a)(ii)(B)(II) [note typographical error in the regulation refers to subclause 37(8)(a)(ii)(A)(II) which does not exist in the ITA]. See Karen Wensley, supra, at 31:5 - 31:6 regarding expenditures directly attributable to SR&ED; and Imapro Corporation v. The Queen, 92 DTC 6487 (FCTD).
and that would not have been incurred if such prosecution had not occurred.

The following expenditures are directly attributable to the provision of R&D facilities, premises or equipment:\(^\text{25}\)

(a) the cost of maintenance and upkeep of such premises, facilities or equipment; and

(b) other expenditures, or those portions thereof, that are directly related to that provision and that would not have been incurred if those premises or facilities or that equipment had not existed.

The taxpayer is permitted to claim an immediate deduction of up to 100% of the amount of both current and capital expenditures\(^\text{26}\) added to its R&D pool in computing its income the taxation year. The deduction may be applied against income from any source with any unused portion remaining in the pool to be carried forward indefinitely.\(^\text{27}\)

iii. Investment Tax Credits

The ITA contains generous investment tax credit ("ITC") provisions for qualified R&D expenditures\(^\text{28}\) other than prescribed expenditures\(^\text{29}\) at rates ranging from 20% to 30%.\(^\text{30}\) Unused...

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\(^{25}\) Regulation 2900(3) applies for the purposes of subclause 37(8)(a)(ii)(B)(II) [note typographical error in the regulation refers to subclause 37(8)(a)(ii)(A)(II) which does not exist in the ITA].

\(^{26}\) See paragraph 37(1)(a) for current expenditures; 37(1)(b) for capital expenditures.

\(^{27}\) See subsection 37(1); and Interpretation Bulletin IT-151R4, supra, paragraphs 15 - 25 regarding current expenditures and paragraphs 26 - 30 regarding capital expenditures. The deduction is subject to overall limitations in subsection 37(1).

\(^{28}\) Subsection 127(9) defines "qualified expenditure".

\(^{29}\) Regulation 2902.
investment tax credits can be carried back three years or forward for ten years.\(^{31}\) Beginning after 1993, ITC claims may be used to fully offset federal income taxes otherwise payable.\(^{32}\) It is also possible to obtain a refund of taxes paid or deemed to have been paid for purposes of the refund, in certain circumstances.\(^{33}\)

For taxation years ending after December 2, 1992, the provisions regarding overhead costs that can be allocated to R&D projects for ITC calculations were simplified. Before December 2, 1992 only incremental overhead, costs that would not have been incurred if the R&D had not been carried on, could be claimed. Now, the system provides for a notional overhead amount called the "prescribed proxy amount".\(^{34}\)

\(^{30}\) Subsection 127(9) defines "specified percentage". Subject to transitional rules, the February 22, 1994 federal budget proposed to amend the rates in Atlantic Canada from 30% to 20% for expenditures incurred after 1994.

\(^{31}\) Subsection 127(9), definition of "investment tax credit". Note that qualified expenditures before April 20, 1983 only had a five year carry forward period.

\(^{32}\) Subsection 127(5). Previously claims for non-refundable ITCs were limited to 75 percent of federal taxes otherwise payable for a taxation year plus 3 percent of taxable income subject to the small business deduction (the "annual investment tax credit limit").

\(^{33}\) Subsection 127.1(1). See "CCPCs - Enhanced ITCs" below.

\(^{34}\) Subsection 127(9), definition of "qualified expenditure" and Regulations 2900(4) to (10) set out how to determine the salary base, 65% of which is the "prescribed proxy amount" (subject to an overall cap set out in regulation 2900(6)). The proxy election is optional, but must be filed within new filing deadlines set out in subsection 37(10) on form T661. For further discussion of the proxy election, see J. Hausch, supra, at 14:15 – 14:16; Al Katiya, supra, at 317 – 322; K. Wensley, supra, at 31:12 – 31:14; and W.S. Clark, et.al., supra, at 32:19 –32:23.
The proxy amount is a qualifying expenditure only for ITC purposes, it is not added to the R&D pool. If the proxy election is made, the costs which may be treated as R&D costs for the subsection 37(1) pool do not include administrative salaries, travel, office expenses and facilities maintenance, which are replaced by the proxy amount.

A "qualified expenditure" is defined in subsection 127(9) of the ITA and includes both current and capital expenditures on R&D carried on in Canada. However, an expenditure which is deductible under subsection 37(1) may not necessarily be a qualified expenditure for the ITC. Qualified expenditures which are added to the subsection 37(1) pool and which are included in the ITC claim calculation are:

- the cost of purchasing or leasing property that is all or substantially all used for R&D activities (other than general purpose office equipment and furniture);

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35 Actual overhead will either been deducted in the current year as an ordinary business expense or may be capitalized and eligible for capital cost allowance.

36 See Interpretation Bulletin IT-151R4, supra, paragraph 46. For example, qualified expenditures do not include prescribed expenditures in Regulation 2902.

37 Clause 37(8)(a)(ii)(B).

38 "Substantially all" is generally considered to mean at least 90 percent. See Interpretation Bulletin IT-151R4, supra, paragraphs 8, 14, 29; Douglas Wood v. MNR, 87 DTC 312; and Kenneth J. Murray, "Complying With the R&D Rules", in "Income Tax Enforcement, Compliance, and Administration", Corporate Management Tax Conference 1988, (Toronto: Canadian Tax Foundation, 1988) 6:1 - 6:17, at 6:2 - 6:4 for a discussion of the "substantially all" requirement and its interpretation by the Department and by the courts.
- expenditures in respect of R&D directly undertaken on behalf of the taxpayer (e.g. payments to contractors, subcontractors, approved research association and universities);
- capital expenditures for R&D equipment (other than general purpose office equipment and furniture);
- salaries and wages of employees directly engaged in R&D activities;\(^{39}\)
- cost of materials consumed in R&D;
- \(\frac{1}{2}\) of the cost of leasing property that is primarily\(^{40}\) used in R&D activities.

ITC claims are based on the above R&D expenditures plus the prescribed proxy amount. ITCs may also be earned on "shared-use equipment"\(^{41}\) at one-half the taxpayer's rate for R&D expenditures.

Eligible corporations that incur large R&D expenditures early on in a project can maximize the related tax benefits by claiming

\(^{39}\) Salaries do not have to be paid to be eligible for ITCs as qualifying expenditures (Al Katiya, supra, at 326; Interpretation Bulletin IT-151R4, supra, paragraph 17 and Revenue Canada Round Table, 1993 Conference Report, supra, Question 4 at 58:4 - 58:5.)

\(^{40}\) "Primarily" means more than 50 percent, but less than 90 percent.

\(^{41}\) Shared-use equipment is new equipment purchased after December 2, 1992 that is used more than 50 percent but less than 90 percent of its operating time in qualifying R&D activities, and the balance devoted to non-qualifying activities. See J. Hausch, supra, at 14:17; Al Katiya, supra, at 314 - 316; K. Wensley, supra, at 31:14 - 31:16; subsection 127(9) (definitions of "qualified expenditure", "first term shared-use-equipment", and "second term shared-use equipment"), subsection 127(11.1)(e), subsection 127.1(2) (definition of "refundable investment tax credit"), and subsection 127(11.2). Such ITCs cannot be claimed on buildings and pilot plants and equipment that will be used in commercial production after the start up phase (regulation 2900(11)).
ITCs during that period and deferring the deduction from the R&D pool to later years.\textsuperscript{42}

iv. Capital Expenditures

As mentioned previously, expenditures for capital assets\textsuperscript{43} used all or substantially all for R&D may be immediately deducted from income. Prior to December 2, 1992, all or substantially all meant that 90 percent of the useful life of the asset must be used for R&D or that 90 percent of the cost of the asset was consumed in, or attributable to the time during which the property was used for R&D activities. After this date, this requirement will be met if it was intended that the assets would be used for R&D during all or substantially all of its operating time in its expected useful life, or all or substantially all consumed R&D activities in

\textsuperscript{42} Kenneth J. Murray, "Recent Developments in R&D Tax Incentives", \textit{supra}, at 9:20: "This can be accomplished by deferring only the amount of R&D expenditures required to reduce taxable income to a level just below the $200,000 [annual business limit] limitation for federal tax purposes. The tax on this income can be offset by federal ITCs... The benefits of this strategy are generated by two factors. The first is that the company has greater access to the low rate of federal tax. The second is that it may be possible to use the additional deductions deferred to subsequent years to keep at least one additional year's taxable income below $200,000. For qualifying corporations, this will increase the subsequent year's ITC rate by 15 percent (from 20 to 35 percent on the first $2 million of R&D expenditures) and allow the ITCs on the expenditures to be refunded if they are not used to offset taxes payable." Note that there have been recent amendments to the availability of the enhanced rate for qualifying corporations (Canadian-controlled private corporations) which are discussed below under "Recent Developments".

\textsuperscript{43} Other than land and buildings or leasehold interest in buildings (subparagraph 37(8)(d)(i); note the exception for "prescribed special-purpose building" as defined in regulation 2903.
Certain Canadian-controlled private corporations (CCPCs) are eligible for an enhanced ITC rate of 35 percent, subject to certain limits. The ITC can be used to offset all federal taxes for the year with any excess 100 percent refundable for current expenditures, 40 percent refundable for capital expenditures. The amount refunded reduces the balance of the R&D pool. Therefore, CCPCs have a variety of tax planning opportunities requiring a careful mix of claims for investment tax credits, section 37 deductions, loss carrybacks or carryforwards and capital cost allowance.

vi. Foreign R&D

Research and development which is carried on outside of Canada

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45 Subsections 127(10.1) and (10.2); *Interpretation Bulletin IT-151R4*, paragraphs 61 and 64 - 67; J. Hausch, *supra*, at 14:18 - 14:19; and Al Katiya, *supra*, at 324 - 325.

46 Paragraph 127(11.1)(e) and subsection 127.1(2) (definition of "refundable investment tax credit"). The CCPC is subject to a taxable income test to determine eligibility for the enhanced rate. In addition, the 35 percent rate only applies up to the CCPCs annual expenditure limit (subsection 127(10.2)); for R&D expenditures in excess of this expenditure limit, the ITC rate is reduced to 20 percent. For an overview of these limits and an example of how to calculate the expenditure limit, refundable and non-refundable ITC, see J. Hausch, *supra*, at 14:19 - 14:20.

47 This reduction of the R&D pool effectively includes the ITC refund in income in subsequent years by reducing the balance of deductible expenditures.

48 For an example see Kenneth J. Murray, "Complying With the R&D Rules", *supra*, at 6:16 - 6:17.
does not benefit from many of the R&D tax incentives. The costs of such R&D activities are not included in the R&D pool under subsection 37(1), and are not qualified expenditures for ITCs.

There are special rules for current expenditures for foreign R&D set out in subsection 37(2).49 Current expenditures for foreign R&D are deductible only in the year incurred and cannot be carried forward.50 The nature and location of the activities will indicate where R&D is carried on for the purposes of subsections 37(1) or 37(2).51

According to Revenue Canada, the only foreign expenditures that are included in subsection 37(1) are:52

- the cost of capital equipment imported to Canada for SR&ED;
- the cost of materials imported to Canada for SR&ED;
- the wage, travel, training, and conference costs for employees receiving SR&ED training outside Canada; and
- the wage and travel costs for employees investigating foreign technology that relates to an SR&ED project in Canada.53

49 There are no special rules for capital expenditures in these circumstances; they are not deductible under section 37 (Interpretation Bulletin IT-151R4, supra, paragraph 38).


51 Interpretation Bulletin IT-151R4, supra, paragraph 38.

52 J. Hausch, supra, at 14:21.

53 Wage and travel costs of Canadian employees sojourning outside of Canada during testing and data collection qualify only under subsection 37(2) (Revenue Canada Round Table, 1993 Conference Report, supra, Question 1, 58:1 - 58:2; the Department has also taken the position that travel, including salary or wages and related benefits, of a Canadian employee undertaking foreign travel relating to R&D carried on outside of Canada qualifies under
There have been recent ITA changes which affect foreign testing and data collection. Testing and data collection is now included in the definition of SR&ED in regulation 2900(1)(d). Previously, these costs were included in subsection 37(1) if they were for support activities for a Canadian R&D project. Now that testing and data collection are included in the definition of SR&ED in regulation 2900, the costs of foreign testing and data collection must be included in subsection 37(2) even if necessary to a Canadian R&D project. Therefore, the impact of this change has been to include the costs of foreign testing and data collection in subsection 37(2), even if they are necessary to a Canadian R&D project.54

vii. Summary

Qualifying R&D expenditures carried on in Canada are pooled and may be deducted as claimed (ie. may be indefinitely carried forward) including expenditures for certain capital assets which may be immediately deducted from income for tax purposes. Certain R&D expenditures, including an amount for overhead, may also be eligible for an ITC to reduce taxes otherwise payable. ITCs claimed and refunded reduce the R&D pool available for deduction in a taxation year.55 CCPCs are eligible for an enhanced ITC rate of

subsection 37(2).) Also see Kenneth J. Murray, "Complying with the R&D Rules", supra, at 6:11 - 6:12.

54 J. Hausch, supra, at 14:20.

55 Other government assistance received or receivable in respect of R&D expenditures must also be applied against the balance in the pool or included in income under paragraph 12(1)(x).
35%, subject to certain limits. A 100 percent refund of the enhanced ITC is available for current R&D expenditures; 40 percent for certain capital expenditures. The refund mechanism provides a significant advantage to CCPCs as a source of cash and as an additional tax planning tool.

Only current expenditures for R&D carried on outside of Canada are deductible from income and only in the year incurred.

B. Recent Developments

The February 22, 1994 federal budget contained a number of proposals relating to R&D. In particular, some restrictions were proposed on enhanced incentives for CCPCs for taxation years commencing after 1995. By linking the small business deduction to taxable capital for an associated group of companies, access to R&D refunds will be limited for larger CCPCs.\(^5^6\)

The February 27, 1995 federal budget also proposed a number of amendments to the R&D rules. In particular, the eligibility rules for R&D expenditures for information technology (including the use of software, hardware and communication technology to collect, process, store and disseminate information) are to be reviewed. Based on the outcome of this review, it is proposed that such expenditures incurred by financial institutions and securities dealers for information technology R&D will not qualify as R&D for

\(^{56}\) This consequence arises due to the flow through of small business deduction annual business limit calculations to the determination of the ITC rate. See J. Hausch, supra, at 14:22 - 14:23 for a description of this proposed amendment and other proposed amendments in the February 22, 1994 federal budget which may impact on R&D activities.
tax purposes. This proposal arose out of concern that most of Canada's largest banks were claiming the benefits of these R&D incentives for software development that may have been performed even without the incentives.\footnote{Stikeman's Canadian Federal Budget, February 27, 1995, Canada Tax Service (Toronto: Carswell, 1995) at 1-16 to 1-17. Also refer to T. Corcoran, "R&D Tax Credit a Fiasco Waiting to Happen", The Globe & Mail (16 December 1994).}

\textbf{PART II}

\textbf{SUBSIDIES AND THE URUGUAY ROUND}

\textbf{A. Introduction}

Subsidization refers to the practices of governments whereby financial assistance or other incentives are provided to producers and/or exporters.\footnote{Robert K. Paterson and Martine M.N. Band, et. al., International Trade and Investment Law in Canada (2d), (Toronto: Carswell, 1994) at 8-5.} Although subsidization is a non-tariff trade barrier of increasing significance, there is still a lack of international consensus regarding the nature of subsidies.\footnote{ibid., at 8-5. For a discussion of the definition of subsidy under Canadian law, refer to R. Paterson and M. Band, at 8-55 ff. and American Farm Bureau Association v. Canadian Import Tribunal, [1990] 2 S.C.R. 1324.}

There are two sub-categories of subsidy: the "export" subsidy which is granted only on goods destined for export; and "domestic" or "production" subsidies which are granted for the manufacture or production of goods regardless of their ultimate destination.\footnote{ibid., at 8-5.} Subsidies for research and development might be viewed as domestic
subsidies or export subsidies, depending on the circumstances.\textsuperscript{61}

The 1979 Subsidies Code\textsuperscript{62} did not attempt to define "subsidies", but sought to regulate subsidies depending on how negatively they impacted on trade.\textsuperscript{63} The 1979 Subsidies Code recognized that many domestic subsidies were "widely used as important instruments for the promotion of social and economic policy objectives"\textsuperscript{64} and permitted subsidies "used by governments to promote important objectives of national policy".\textsuperscript{65} The Code outlined six desirable policy goals including subsidies "to encourage research and development programmes, especially in the field of high-technology industries".\textsuperscript{66}

The 1994 Agreement on Subsidies and Countervailing Measures

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{61} ibid., at 8-5; the authors suggest that domestic subsidies "might include research and development grants to industries." The argument that R&D tax incentives might be viewed as export subsidies is developed below.
\item \textsuperscript{62} Agreement on Interpretation and Application of Articles VI, XVI and XXIII, Anti-Subsidies Code, GATT (1980), BISD, 26th Supp., at 56 (the "1979 Subsidies Code").
\item \textsuperscript{63} See 1979 Subsidies Code, Article 8. The three effects which could attract compensatory measures under the 1979 Subsidies Code were: 1. injury to the domestic industry of another GATT Member; 2. nullification or impairment of GATT benefits; or 3. serious prejudice to the interests of another Member. Also see R. Paterson and M. Band, \textit{supra}, at 8-6 to 8-8 for an overview of the 1979 Subsidies Code; Gary C. Hufbauer and Joanna Shelton Erb, \textit{Subsidies in International Trade}, (Cambridge, MA: MIT Press, 1984), Chapter 2; and John J. Barcelo, "Subsidies, Countervailing Duties and Anti-dumping After the Tokyo Round" (1980), 13 \textit{Cornell Int. L.J.} 257.
\item \textsuperscript{64} 1979 Subsidies Code, Article 11.
\item \textsuperscript{65} 1979 Subsidies Code, Preamble.
\item \textsuperscript{66} 1979 Subsidies Code, Article 11(1)(d).
\end{itemize}
\end{footnotesize}
(the "SCM Agreement") attempts to refine, clarify and enforce the previously vague distinctions between subsidies that distort trade and those that do not. These refinements may have implications for Canadian R&D tax incentives and high-technology policy.

This Part provides an overview of the SCM Agreement with an emphasis on its R&D provisions.

B. The SCM Agreement

i. Overview

The new SCM Agreement, unlike its predecessor, defines and categorizes subsidies and establishes a binding dispute resolution procedure for each category of subsidy.

A "subsidy" is defined according to two tests:


68 George Kleinfeld and David Kaye, supra, at 43.


70 SCM Agreement, Article 1.1 deems a subsidy to exist if:

(a)(1) there is a financial contribution by a government or any public body within the territory of a Member... i.e. where:

(i) a government practice involves a direct transfer of funds (eg. grants, loans and equity infusion), potential direct transfers of funds or liabilities, (eg. loan guarantees);
government must either contribute financially, directly from the
government or through another public body or mechanism, or provide
income or price support; and 2. the contribution or support must
confer a benefit upon the recipient.

Further, in order for a subsidy to be subject to disciplinary
action it must meet a specificity test; it must be limited to
certain industries or companies. If the granting authority
explicitly limits access to a subsidy to certain enterprises, it is
specific. If a subsidy is granted on the basis of objective
criteria or conditions, which are clearly spelled out and
strictly adhered to, and there is no reason to believe that the
(ii) government revenue that is otherwise due is foregone
or not collected, (eg. fiscal incentives such as tax
credits) [except where like products destined for
domestic production are similarly exempt from duties or
taxes; SCM Agreement; footnote 1];

(iii) a government provides goods or services other than
general infrastructure, or purchases of goods;

(iv) a government makes payments to a funding mechanism,
or entrusts or directs a private body to carry out one or
more of the type of functions illustrated in (i) to (iii)
above, which would normally be vested in the government
and the practice, in no real sense, differs from
practices normally followed by governments; or

(a)(2) there is any form of income or price support in the
sense of Article XVI of the GATT 1994; and

(b) a benefit is thereby conferred.

71 SCM Agreement, Article 1.2. Also see Article 2 for a
detailed test for determining specificity.

72 SCM Agreement, Article 2(a).

73 SCM Agreement, Article 2(b); eligibility for the subsidy
must be automatic.
subsidy is in fact specific, it is not subject to discipline. However, notwithstanding any appearance of non-specificity, other factors may be considered such as: use of the subsidy program by a limited number of certain enterprises, predominant use of the subsidy program by certain enterprises, disproportionately large amounts to certain enterprises, or the discretion exercised by the granting authority in providing the subsidy.74

The SCM Agreement identifies three levels of subsidy: prohibited ("red light"), actionable ("yellow light") and permissible ("green light"). This is referred to as the "traffic light" approach to subsidies.75 Each category gives rise to different dispute resolution procedures and permissible countervailing measures.76

74 SCM Agreement, Article 2(c). Also see Gary Horlick and Peggy Clarke, "The 1994 WTO Subsidies Agreement", Annual International Trade Update, Georgetown University Law Center, (June 1994).

75 See George Kleinfeld and David Kaye, supra, at 44. The authors note that the SCM does not explicitly refer to this traffic light approach, but this metaphor has been in use since the Tokyo Round (refer also to T. Stewart, supra, at 830 and 855.)

76 See SCM Agreement, Articles 4 and 7. Also see George Kleinfeld and David Kaye, supra, at 46, and footnotes 20 - 22, for a summary of these provisions; In the case of prohibited or actionable subsidies, a Member initiates the process of WTO dispute resolution by requesting consultations with the allegedly offending government. (In the case of actionable subsidies, a complaining Member must also show evidence of the negative effects caused by the subsidy; Article 7.2). If the parties do not reach a "mutually acceptable solution" with a certain period (30 days for prohibited subsidies, and 60 days for actionable subsidies; Articles 4.4 and 7.4), either may refer the matter to the Dispute Settlement Body (DSB) for resolution by a panel under WTO rules. If a panel is convened, it will review the facts and submit a report first to the parties and then to the DSB for adoption. If the panel finds the existence of a prohibited subsidy, "it shall recommend that the
The red light prohibits "subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance including those illustrated in Annex I" and "subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods". \footnote{77} Annex I to the SCM Agreement sets out an illustrative list of export subsidies including:

(e) The full or partial exemption, remission or deferral specifically related to exports, of direct taxes\footnote{78} or social welfare charges paid or payable by industrial or commercial enterprises.

And

(f) The allowance of special deductions directly related to exports or export performance, over and above those granted in respect to production for domestic consumption, in the calculation of the base on which direct taxes are charged.

The yellow light cautions governments against granting subsidizing Member withdraw the subsidy without delay" (Article 4.7); in cases involving actionable subsidies, a finding by the panel of adverse effects would obligate the offending Member to "remove the adverse effects" or "withdraw the subsidy" (Article 7.8). Either party to a panel determination may choose to appeal it to an Appellate Body, whose report the DSB may accept or reject. Subsequent to these procedures, if a Member does not follow the DSB recommendations, the DSB "shall grant authorization to the complaining Member to take appropriate countermeasures" (Articles 4.10 and 7.9. Note that as an alternative to multilateral enforcement of subsidies disciplines, Members also have the option of imposing countervailing duties on imports benefiting from prohibited or actionable subsidies under domestic law if the requirements of Part V (Articles 10 - 23) are met (footnote 35).

\footnote{77} SCM Agreement, Article 3.

\footnote{78} SCM Agreement, footnote 58 defines "direct taxes" for the purpose of the Agreement as "taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property". Also "remission" of taxes includes "the refund or rebate of taxes."
subsidies which cause "adverse effects" to the interests of other Members.  

"Adverse effects" are defined in Article 5.1 as: "(a) injury to the domestic industry of another Member; (b) nullification or impairment of benefits accruing directly or indirectly to other Members under GATT 1994...; and (c) serious prejudice to the interests of another Member." Serious prejudice will arise only in certain limited circumstances. For example, serious prejudice is deemed to exist in the case of subsidies to cover operating losses sustained by an industry. However, serious prejudice would not be found if the Member demonstrates that the subsidy in question has not resulted in any of the effects enumerated in paragraph 3 of Article 6, including import- or export-distorting effects, or when the effect of the subsidy is to increase the world market share of the subsidizing country in a particular subsidized primary product or commodity.

Finally, Article 8, the green light, stipulates that subsidies which are not specific, or are specific but are within one of the following classes of subsidies, are not actionable under certain

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79 SCM Agreement, Article 5.

80 "Serious prejudice" is defined in SCM Agreement Article 6 and includes threat of serious prejudice (SCM Agreement, footnote 13).

81 SCM Agreement, Article 6.1(b).

82 R. Paterson and M. Band, supra, at 8-9, fn. 28; and SCM Agreement, Article 6.3. Also refer to SCM Agreement Article 6.7 for other exceptions to the serious prejudice provisions.
conditions: assistance for research activities conducted by firms or by higher education or research establishments on a contract basis, assistance to disadvantaged regions within the domestic territory of the subsidizing government's territory pursuant to a general framework of regional development; and assistance to promote adaptation of existing facilities to new environmental requirements. However, these subsidy programs are subject to notification requirements.

ii. R&D Subsidies

As mentioned above, the 1979 Subsidies Code supported government financing of R&D programs. However, governments were cautioned to "weigh, as far as practicable... possible adverse effects on trade" and Members were permitted to countervail foreign R&D subsidies that harmed their domestic industries.

The SCM Agreement reduces the threat of countervailing action for green light subsidies. Fundamental research of a non-

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83 SCM Agreement, Article 8.1. Products containing less than a one percent ad valorem subsidy are also not countervailable under Article 11.9.

84 See "R&D Subsidies" below for further discussion.

85 SCM Agreement, Article 8.3.

86 1979 Subsidies Code, Article 11(3).

87 1979 Subsidies Code, Article 11(2).

88 Imports benefiting from industry or product specific R&D subsidies were not exempted from countervailing duties. See George Kleinfeld and David Kaye, supra, at 46 - 47. The authors also refer to the following U.S. cases involving foreign R&D subsidies: Optic Liquid Level Sensing Systems from Canada, 44 Fed. Reg. 1728 (1979); Certain Steel Products from Belgium, 47 Fed. Reg. 39304 (1982); Agrexco v. United States, 604 F. Supp. 1328 (1985).
commercial and non-industrial nature conducted by educational and research establishments falls outside the SCM Agreement as long as such research is targeted toward the "enlargement of general scientific and technical knowledge not linked to industrial and commercial objectives." 89

Assistance for research activities conducted by firms or by educational or research establishments on a contract basis with firms is also permitted 90 for up to 75 percent of certain costs of "industrial research" 91 or 50 percent of certain costs of "pre-competitive development activity". 92 Therefore, any subsidy beyond the pre-competitive development stage becomes actionable requiring a demonstration of adverse effects.

Only five categories of R&D costs qualify for green light


90 SCM Agreement Article 8.2(a). Where a project contains both industrial research and pre-competitive development activity, the allowable level of non-actionable assistance shall not exceed the simple average (62.5 percent) of the two categories, calculated on the basis of all eligible costs (SCM Agreement, Article 8, footnote 30).

91 "Industrial research" is planned search or critical investigation aimed at discovering new knowledge with the objective that such knowledge may help in the development of new or improved products, processes or services (SCM Agreement, footnote 28).

92 "Pre-competitive development activity" transforms industrial research into a "plan, blueprint or design for new, modified or improved products, processes or services" including the first non-commercial prototype. Note that routine or periodic alterations of existing products is considered to go beyond the terms of the green light. (SCM Agreement, footnote 29).
treatment:93

1. personnel, including researchers, technicians and support staff employed exclusively in research activity;

2. instruments, equipment, land and buildings used exclusively and permanently for the research activity;94

3. consultancy and equivalent services used exclusively for the project, including bought in research, technical knowledge and patents;

4. overhead costs incurred directly as a result of the research activity; and

5. the cost of materials, supplies and other operating expenses incurred directly as a result of the research activity.

If a subsidy is not actionable under Article 8, it is still open to challenge under other provisions in the SCM Agreement which apply equally to all subsidies, including R&D subsidies. In such cases, an Article 8 green light subsidy could be converted into a red light violation.95 Article 3, for example, regarding subsidies contingent on export performance or on the use of domestic over imported goods applies equally to government assistance for R&D.96 Further, Article 9.1 provides for a challenge of a program which is

93 SCM Agreement, Article 8.2(a)(i)-(v) and George Kleinfeld and David Kaye, supra, at 48. The allowable levels of non-actionable assistance is established by reference to the total eligible costs incurred over the duration of the particular project.

94 Except when "disposed of on a commercial basis".

95 George Kleinfeld and David Kaye, supra, at 49.

96 ibid., at 49.
consistent with Article 8 if the subsidy causes "serious adverse effects to the domestic industry [of another Member] such as to cause damage which would be difficult to repair".

There are a few other provisions in the SCM Agreement pertaining to R&D subsidies which are of interest. Article 25 encourages Members to provide notification of any subsidy granted or maintained; notification is not mandatory. If a government wants to question another Member's R&D subsidy a review by the WTO Secretariat may be requested, followed by a request for binding arbitration. Finally, the SCM Agreement requires the WTO Committee on Subsidies and Countervailing Measures to review the Article 8 R&D subsidy rules, including the definitions of the categories, within 18 months of the Agreement entering into force.

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97 The dispute resolution procedures are modified in these circumstances as set out in SCM Agreement Articles 9.1 - 9.4.

98 "Serious adverse effects" is not defined in the SCM Agreement. See above for Article 5 definition of "adverse effects" and Article 6 definition of "serious prejudice". George Kleinfeld and David Kaye, supra, at 50, note that the U.S. government position is that the serious adverse effects standard is higher than the normal serious prejudice or injury standard.

99 SCM Agreement, Article 25.2 and footnote 35. Article 25.3 states that notifications must specify the form of a subsidy, its amount, policy objective, duration and impact on trade. Notification for R&D subsidies, in particular, should be sufficiently detailed to permit other Members to determine whether the project satisfies the conditions of Article 8 (Article 8.3).

100 SCM Agreement, Article 8.4 and 8.5.

101 SCM Agreement, footnote 25. Note that U.S. Trade Representative, Mickey Kantor, has stated that the Clinton Administration intend to use the review "to ensure the provision has not been abused." (Hearing of the House Subcommittee on...
PART III
CANADIAN R&D TAX INCENTIVES: DISCRIMINATORY SUBSIDIES?

In this Part an assessment is made as to whether Canada's R&D tax incentives are discriminatory based on whether such incentives would be subject to discipline under the SCM Agreement. Possible justifications for any such discrimination are explored, as well as factors to consider in revising Canadian R&D tax incentives.

A. Free Trade, Discrimination and R&D Tax Incentives

As discussed previously, free trade is based on two premises: the free trade objective and preservation of national interests. All subsidies are antithetical to free trade causing trade-distorting effects on a global level. Yet, as indicated above, subsidization has not been subject to outright GATT prohibition, in recognition of overriding sovereign objectives:

Rather, the GATT objective has been to manage and reduce current levels of subsidization in world trade and to establish minimum standards for the retaliatory countervailing

Commerce, Consumer Protection and Competitiveness, 23 March 1994 as cited in George Kleinfeld and David Kaye, supra, at 47, footnote 31).

102 See Chapter 1.

103 R. Paterson and M. Band, supra at 8-5 and 8-63. The authors note that "the question of whether or not the use of subsidies to foster domestic prosperity is economically advisable in the long term remains open. By contrast, arguments have also been made that there may well be net gains to a domestic economy from foreign subsidies and net losses from the imposition of countervailing duties."

104 ibid., at 8-5. Also refer to Kenneth Dam, The GATT Law and International Economic Organization (London: University of Chicago Press, 1970), Chapter 7, for a general discussion on subsidies.
duty measures that subsidies often provoke. No attempt has been made to give a precise definition of what a subsidy is in vacuo. Rather, the issue of subsidization is viewed as a factual or contextual one, the focus being upon its ultimate effect on the international market. Adhering to the concept that some domestic subsidies are legitimate tools of domestic economic planning and development, they are, for certain purposes, treated somewhat more flexibly under GATT than are export subsidies.

Notwithstanding a flexible GATT attitude, Canada must also be aware of U.S. opinion on the SCM Agreement as the United States remains the only nation which uses countervailing duty laws to any significant extent.105 Despite the Clinton Administration's support for expansion of green light provisions for R&D subsidies,106 the U.S. Administration intends to maintain an aggressive approach to R&D subsidies. For example, the Administration has determined that:107

...subsidies which exceed the green light parameters... will be countervailable in full, not just with respect to the amount of assistance which exceeds the green light levels.

Further U.S. trade negotiators insist that the R&D provisions of the SCM Agreement:108

105 R. Paterson and M. Band, supra, at 8-63.
106 See George Kleinfeld and David Kaye, supra, at 50 - 56.
107 ibid., at 53: "In other words, if a government provides industrial research assistance beyond the 75 percent cap, or pre-competitive development assistance beyond the 50 percent cap, or if a portion of the funding involves unauthorized expenditures under Article 8, the United States will, under domestic law, countervail the full measure of government assistance to the project." The authors note however, that under these circumstances, an Article 8 subsidy would be classified as an Article 5 actionable subsidy for which countermeasures, if authorized, have to be "commensurate with the degree and nature or the adverse effects determined to exist."
108 ibid., at 54.
... protect the type of technology programmes the United States currently has, while excluding the type of development and production assistance which other countries typically grant.

If foreign abuses of the green light provisions will not be tolerated by the United States, this likely means Canada's R&D programs will be subject to careful monitoring by the United States.\(^{109}\) Indeed, the Canadian government has recognized that along with the greater certainty provided by the SCM Agreement for promoting government objectives in R&D, comes the risk that levels of assistance in excess of the articulated thresholds will expose the entire subsidy to countervailing action.\(^{110}\)

There are certain features of the Canadian tax system related to R&D which may be vulnerable to attack as contrary to the free trade ideal underlying the SCM Agreement. In particular, the enhanced ITC for CCPCs will now be assessed for such discrimination within the framework set out in the SCM agreement.

Article 1.1 of the SCM Agreement deems a subsidy to exist if "government revenue that is otherwise due is forgone or not collected".\(^{111}\) The specific example given is fiscal incentives such as tax credits; ITCs for R&D conducted by CCPCs can be used to

\(^{109}\) See Mark A.A. Warner and Alan M. Rugman, supra, at 405 - 412 regarding the U.S. National Competitiveness Act, 1993 and U.S. technology which, in part, provides for a mechanism to monitor foreign technology capabilities relative to the U.S. and to identify and respond to "competitive opportunities and challenges" (at 406).


\(^{111}\) SCM Agreement, Article 1.1(a)(1)(ii).
offset all federal taxes for the current year with any excess 100 percent refundable for current expenditures, 40 percent refundable for capital expenditures.

Article 1.1 also requires that a benefit is conferred. Clearly, CCPCs benefit from being able to deduct ITCs from taxes payable from all sources, from the potential for cash flow from refunds, and from the flexibility provided within the system to tax plan with the ITCs in combination with section 37 deductions, loss carrybacks or carryforwards and capital cost allowance. Therefore, the subsidy deeming provisions set out in Article 1.1 appear to apply to ITCs for CCPCs.\textsuperscript{112}

However, Article 1.2 of the SCM Agreement also requires that such subsidies be "specific" in accordance with the provisions of Article 2, before the subsidy is subject to the provisions relating to prohibited subsidies, actionable subsidies or countervailing measures. In turn, Article 2 states that a subsidy must be specific to an enterprise or industry or group of enterprises or industries within the jurisdiction of the granting authority. In particular:\textsuperscript{113}

\begin{quote}
Where the granting authority, or the legislation pursuant to which the granting authority operates, explicitly limits access to a subsidy to certain enterprises, such subsidy shall be specific.
\end{quote}

The enhanced rate for ITCs is expressly limited to certain

\textsuperscript{112} Note that the same conclusion can be reached regarding ITCs for non-CCPCs, even though the refundable aspect is not present in that case.

\textsuperscript{113} SCM Agreement, Article 2.1 (a).
enterprises, those enterprises being eligible CCPCs. Also, any subsidy which falls within the provisions of Article 3, is deemed to be specific.

Article 3 are the red light subsidies; those subsidies which are prohibited under the SCM Agreement and subject to the most stringent remedial provisions. Article 3 prohibits subsidies which are contingent in law or in fact, whether solely or as one of several other conditions, upon export performance. Article 3 also prohibits subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic goods over imported

\[114\] Note that Article 2.1(b) of the SCM Agreement, states that "Where the granting authority, or the legislation pursuant to which the granting authority operates, establishes objective criteria or conditions governing the eligibility for, and the amount of, a subsidy, specificity shall not exist, provided that the eligibility is automatic and that such criteria and conditions are strictly adhered to. The criteria or conditions must be clearly spelled out in law, regulation, or other official document, so as to be capable of verification." Although the criteria governing the eligibility for the enhanced ITCs may be said to meet these requirements, footnote 2 of the SCM Agreement goes on to state: "Objective criteria or conditions, as used herein, mean criteria or conditions which are neutral, which do not favour certain enterprises over others, and which are economic in nature and horizontal in application, such as number of employees or size of the enterprise." Therefore, the criteria for CCPCs qualifying for enhanced ITCs are not "objective" according to the SCM Agreement as certain enterprises, CCPCs, are favoured.

\[115\] This Article should be considered for other R&D tax incentives which are arguably not enterprise or industry specific. In such cases, the provisions of Article 3 must be examined closely to see whether or not the subsidy would be deemed to be specific under Article 2.3.

\[116\] Article 8 green light subsidies for R&D will be addressed below. Note that the SCM Agreement does not directly address conflicts between Articles 3 and 8. However, the Article 3 prohibition is absolute and Article 8 does not provide for a waiver, either directly or indirectly, of Article 3 constraints. (See George Kleinfeld and David Kaye, supra, at 59).
goods.

With respect to subsidies contingent on export performance, an illustrative list is provided in Annex I to the SCM Agreement. Annex I includes the full or partial exemption, remission or deferral specifically related to exports, of direct taxes paid or payable. Arguably, the provisions related to R&D tax incentives generally are related to exports, as one of the stated purposes of providing such incentives is to create wealth by developing new technologies to increase the competitiveness of the Canadian economy. To the extent that such competitive activity is directed to global markets for the R&D technology, these incentives may be viewed as being related to exports.

Alternatively, with respect to the domestic content requirements of Article 3, participation in R&D assistance which is limited to CCPCs, or contingent on R&D being conducted in Canadian based facilities or otherwise favouring Canadian inputs, may be subject to an SCM challenge. Even though certain foreign-source inputs are permitted, a dispute resolution panel could construe

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117 SCM Agreement, Annex I, paragraph (e). Direct taxes is defined to include taxes on all forms of income. Note that paragraph (f) of Annex I, pertains to special deductions directly related to exports or export performance over and above those granted for domestic production, in calculating the tax base on which direct taxes are charged. This provision may be applicable with regard to the immediate write off of capital expenditures for Canadian R&D, if it can be argued that these deductions are directly related to stimulating export performance in high technology industries, for example.

118 As discussed above, there are restrictions on the foreign expenditures which are eligible for inclusion in the section 37 pool and for the ITC claim. Deductions for foreign R&D are also severely restricted under subsection 37(2).
barriers to participation by foreign-owned companies, along with national objectives of job creation and preservation and enhancing Canadian competitiveness in the particular industry, as manifestations of an implicit domestic content requirement.\textsuperscript{119}

Therefore, it is arguable that Canadian R&D tax incentives for CCPCs are discriminatory and come within the prohibited subsidy provisions of the SCM Agreement.

As a further alternative, although the Article 3 prohibition appears to override the provisions of Article 8, it is worthwhile to consider whether the certain R&D tax incentives come within the green light provisions related to R&D. Article 8 non-actionable subsidies are those subsidies which are not specific, or which are specific but meet all of the conditions provided for in Article 8. With respect to research activities, the assistance must not cover more than 75 percent of the costs of industrial research or 50 percent of the costs of pre-competitive research. The various Canadian R&D tax incentives may well exceed these limits, alone or in combination, depending on the circumstances. Further, it may be that the types of research which qualify under the Canadian R&D tax

\textsuperscript{119} See George Kleinfeld and David Kaye, \textit{supra}, at 59 for such an argument pertaining to the United States R&D initiatives for the Partnership for a New Generation of Vehicles (PNGV). The PNGV is a partnership between the government and the "big three" (General Motors, Ford and Chrysler) U.S. auto-makers to develop technologies that improve fuel efficiency and emissions control and "to help ensure the U.S. jobs are not threatened" and that "pursuit of such goals will translate into a demand for U.S. products, not foreign products" (at 57 - 58). Also see Mark A.A. Warner and Alan M. Rugman, \textit{supra}, for an analysis of recent U.S. antitrust and R&D policy initiatives under NAFTA, the GATT and other international instruments.
rules are broader than those under the SCM Agreement. For example, a project must meet three criteria (scientific or technological uncertainty, scientific or technological advancement, and scientific or technical content) to be eligible for R&D tax incentives, but these criteria have been applied broadly, as in the case of Canadian banks accessing the tax incentives for certain software development.\(^\text{120}\) On the other hand, it may be that the definitions in the SCM Agreement will be construed more narrowly, thereby restricting the R&D green light subsidy provisions to research activities which are aimed at "new knowledge".

Finally, with respect to Article 8, assistance is limited exclusively to enumerated costs which are much more restricted than costs enumerated in the ITA. For example, Article 8 requires that costs of personnel, instruments, equipments, land and buildings, and consultancy be used \textit{exclusively} for research activity. On the other hand, the ITA provisions generally require that qualified expenditures be \textit{all or substantially all} used for R&D activities. The proxy provisions for overhead may be contrary to the SCM

\(^{120}\) In 1994 several Canadian banks filed taxpayer requested adjustments for R&D expenditures made back to 1986 in the field of computer software (1994 AG's Report, \textit{supra}, vol. 6 at 32-15). The fact that these claims were not filed until eight years after the expenditures were incurred suggests that such R&D was performed, and would be performed, in spite of any tax incentives. The February 27, 1995 budget proposes a close examination of the R&D system with regard to these applications for about $300 million in R&D tax credits (see Clyde Graham, "Government will Get its Share of Bank Profits, Martin Says", Ottawa (CP), December 15, 1994.) Also refer to Linda McQuaig, \textit{Behind Closed Doors} (Markham, Penguin Books, 1987) Chapter 9, for a discussion of the scientific research tax credit "quick flips" of the mid-1980's for another example of abuse of previous the tax provisions for research and development.
Agreement requirement that additional overhead costs must be incurred directly as a result of the research activity. Also, the ability to deduct expenditures for capital assets intended to be used in R&D activities may go beyond the eligible cost parameters set out in Article 8 of the SCM Agreement.

It should be noted that even if such incentives do meet the green light provisions and are not prohibited subsidies, reviews of these incentives can still be requested under the SCM Agreement.121 Also, if neither Article 8 nor Article 3 applies, the yellow light actionable subsidies provisions may be used to launch a complaint in cases where another Member is able to establish that the use of any subsidy has injured the domestic industry of that Member, caused serious prejudice to the interests of that Member, or otherwise nullified or impaired benefits accruing to that Member under the GATT.

In conclusion, there are reasonable grounds for anticipating that the United States, in particular, will be monitoring Canadian R&D programs, including tax incentives, to ensure compliance with the SCM Agreement. The above assessment, though cursory, indicates that there are reasonable arguments to be made that such subsidies may be prohibited under the SCM Agreement. In other words, the R&D tax incentives may be viewed as discriminating against non-residents and foreign activities and contrary to the free trade objective. The next section considers whether tax incentives for R&D are justifiable notwithstanding any such discrimination.

121 See SCM Agreement Articles 9.1 and 8.5.
B. Justifiable Incentives?

It may be that WTO Members may be deterred from challenging other Members' R&D subsidy programs for a number of reasons. First, an "uneasy truce" could prevail while each Member pursues their own exclusionary R&D initiatives.\textsuperscript{122} It is not uncommon for such tax incentives to be restricted to domestic research activities\textsuperscript{123} and most industrialized countries rely on the income tax system as an efficient and equitable means of delivering R&D support.\textsuperscript{124} Second, the beneficial spillover effects of one country's R&D may be seen to outweigh the negative effects of any such subsidy forestalling the initiation of dispute resolution mechanisms.\textsuperscript{125} Third, R&D tax incentive programs may quite simply come within the bounds of the SCM Agreement. Finally, it may be that even if tax

\textsuperscript{122} George Kleinfeld and David Kaye, \textit{supra}, at 60.
\textsuperscript{123} Brian J. Arnold, "Tax Discrimination Against Aliens, Non-Residents, and Foreign Activities: Canada, Australia, New Zealand, the United Kingdom, and the United States", \textit{Canadian Tax Paper No. 90} (Toronto: Canadian Tax Foundation, 1991) at 102.
\textsuperscript{124} W.S.Clark, et.al., \textit{supra}, at 32:5.
\textsuperscript{125} see Laura D'Andrea Tyson, \textit{Remarks before the Economic Strategy Institute}, Federal News Service, 9 March 1994, as quoted in George Kleinfeld and David Kaye, \textit{supra}, at 56: "On the issue of whether or not our position in the GATT, the Uruguay Round, on R&D subsidies would touch off a subsidy competition, I think... this is one area where economic theory would suggest that the spillover benefits from R&D subsidies - both the global spillover benefits and the local spillover benefits - are measured to be very high - You don't want international rules to discourage subsidies which would actually generate benefits, not just for you but for the world. And this is just an effort to try and figure out where that line would be. No one exactly knows where it will be, but... we took a sensible position in those negotiations to draw the line to allow governments to support these programmes, but to set some limits on how they could support."
incentives for research and development can be viewed as being discriminatory and contrary to the free trade ideal, these incentives may be justifiable based on overriding domestic objectives.

It is submitted that in the case of R&D, the stated national objectives must be of primary concern due to the profound significance of these activities to the social and economic aims of Canada. However, even within this purely domestic context there are arguments to be made that the existing R&D tax incentives cannot be justified as either being rationally connected with, or capable of achieving, these stated national objectives.

In evaluating tax incentives for research and development, it is important to emphasize that these incentives are essentially public spending programs delivered through the tax system by way of foregone tax revenues:\textsuperscript{126}

It is generally accepted that, as indirect government spending programs, such provisions must be evaluated on the basis of budgetary rather than tax policy criteria. It makes no sense to assess tax expenditure provisions on the basis of tax policy criteria such as equity, neutrality, or revenue. Tax expenditures are inherently and intentionally inequitable and non-neutral; they are designed to benefit certain taxpayers or activities in preference to others. Further, they are intended not to raise revenue, but rather to spend it in the form of forgone tax.

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Although tax expenditures that discriminate against aliens, non-residents or foreign activities cannot be justified on the basis of tax policy criteria, they are nevertheless tax provisions in the sense that they form part of the tax legislation. As a result, they are covered by the non-discrimination article in bi-lateral tax treaties. Since,

\textsuperscript{126} Brian J. Arnold, "Tax Discrimination Against Aliens, Non-Residents, and Foreign Activities", \textit{supra}, at 128 - 129.
however, tax expenditures are in substance indirect spending programs, it is inappropriate to assess them on this basis; as stated above, they must be judged by reference to budgetary criteria. Accordingly, a tax expenditure that discriminates against aliens, non-residents, or foreign activities may be justified if an equivalent direct public spending program that discriminates in the same way can be justified. For example, direct public spending to encourage scientific research in Canada would be seen by most people as desirable public policy. The restriction of the program to research in Canada would be viewed as an essential feature of the program for several reasons, including the cost of funding research outside Canada and the benefits of the spending program for Canadian universities and other research institutions and for Canadian research scientists.

Therefore, one criteria for R&D evaluating and justifying tax incentives is whether these "expenditures" are achieving the stated objectives of wealth creation, managing risk and improving quality of life, and advancing knowledge through basic research. Despite the recognized need for R&D, the effectiveness of tax incentives in stimulating R&D is not conclusive.\textsuperscript{127} Studies have been done which measure the impact of tax incentives on the "user cost" of R&D capital and combining this measurement with an estimate of the sensitivity of R&D capital investment to changes in its user cost.\textsuperscript{128} These studies are used to support the statement that Canada has one of the most generous tax incentive structures for

\textsuperscript{127} See the 1994 AG's Report, \textit{supra}, vol. 6 at 32-16 to 32-17 regarding the lack of information available in the Department of Finance and Revenue Canada to be able to monitor and evaluate tax incentives on a systematic basis.

\textsuperscript{128} W.S. Clark, et.al., \textit{supra}, at 32:8 - 32:10 for an overview for a number of these studies. Also see D. McFetridge and J. Warda, \textit{supra}; J. Warda, \textit{supra}; and P. Mohnen, \textit{supra}.
R&D in the world.\textsuperscript{129}

However, generosity of tax incentives does not necessarily result in the socially optimal level of R&D being attained, which is the goal which provides the economic rationale for such tax incentives in the first place. It is difficult to establish the effectiveness of tax-based incentives for R&D and whether these tax expenditures are actually creating technologically innovative products or whether the incentives have any influence on business decisions.\textsuperscript{130} It is also difficult to estimate the impact of changes in the user cost from tax incentives on the investment

\textsuperscript{129} W.S. Clark, et.al., \textit{supra}, summarize Warda's "B-index" studies at 32:17. The "B-index" is an analytic tool used to rank the relative attractiveness of a country's R&D tax system. It accounts for the influence of R&D tax credits on the after-tax cost of undertaking R&D as well as the influence of income tax rates in determining both the value of qualifying R&D deductions and the after-tax value of the returns from R&D. Other things being equal, the lower the B-index, the greater the amount of R&D a firm will undertake. Canada has the lowest B-index of developed countries. See D. McFetridge and J. Warda, \textit{supra}, for the initial study which examined the favourableness of the Canadian tax system toward R&D; and the follow-up study by J. Warda, \textit{supra}, which concludes, at 18 "that relative to other countries examined, Canada's tax treatment of R&D remains the most favourable because it offers the taxpayer a variety of benefits at both the federal and provincial levels." Note that Warda's study is limited to the B-index analysis and does not address the adequacy of R&D tax treatment in Canada.

behaviour of R&D performers and on broader spillover effects.\textsuperscript{131}

One recent study has even concluded that there is strong evidence that higher rates of return are obtained on privately-funded R&D than on publicly funded R&D.\textsuperscript{132}

A further justification for Canada's generous R&D tax incentives is that the after-tax cost of performing R&D in Canada offers significant competitive advantages to Canadian R&D performers. These advantages, it is suggested, may be exploited by Canadian companies to "carve a niche" for themselves in performing R&D for foreign based corporations, and multinational enterprises ("MNEs") should consider having R&D operations centralized in Canada to take advantage of these competitive advantages.\textsuperscript{133}

\textsuperscript{131} W.S. Clark, et.al., \textit{supra}, at 32:8. The authors refer to a number of studies and, in particular Jeffrey Berstein, "The Effect of Direct and Indirect Tax Incentives on Canadian Industrial R&D Expenditures" (September, 1986), \textit{12 Canadian Public Policy} 438-48. As summarized at 32:10, using 1984 parameters, Berstein "estimates that a 1 percent rise in the (effective) R&D tax credit rate reduces the user cost of R&D capital by 0.07 percent. Combining this result with his empirical findings indicates that a 1 percent increase in the (effective) R&D tax credit rates stimulates the demand for R&D capital by about 0.01 percent, or over $1.045 million in the short run, based on an estimated R&D capital stock figure in 1984 of $10 billion. When the induced output supply effect is taken into account, the stimulus is as high as $2.2 million, depending on the assumed sensitivity of output demand to price changes. In relation to budgetary cost, the R&D tax credit rate is found to create $.80 of additional R&D expenditures per dollar of forgone (federal and provincial) tax revenues. When output expansion effects are taken into account, the additional R&D expenditures are found to increase by more than the dollar cost to government."

\textsuperscript{132} P. Mohnen, \textit{supra}, at 44.

\textsuperscript{133} See Kenneth J. Murray, "Recent Developments in R&D Tax Incentives", \textit{supra}, at 9:21 for a calculation of after-tax cost to a large US company of performing R&D in house or contracted out to another large US R&D performer versus the after tax cost to
However, given differences in national tax systems, and the interaction of those systems, it may be difficult to use such tax expenditures to induce foreign firms to move their R&D activities to Canada.\textsuperscript{134} Also, if a MNE carries out R&D activities in a low-tax jurisdiction, the effective after-tax cost of that R&D is greater than it if were done in a high tax country due to the relatively higher value of the tax incentives in the high tax country. Therefore, all other things being equal, the global tax-minimizing strategy of an MNE would require R&D to be performed in the high-tax country and the technology to be transferred to another division of the MNE in a low tax country at a minimal transfer price.\textsuperscript{135} Consider the following:\textsuperscript{136}

In regard to Canada's position as host to many foreign-owned subsidiaries, the charge is frequently made that these subsidiaries do not do the amount of R and D in Canada that could be expected of them given their size and industrial character. Since Canada is the "low-tax country" from the vantage point of most subsidiaries here, this allocation of R and D activity appears to be consistent with the global tax-minimizing strategy outlined above. However, it is an empirical question whether domestic taxation or the international structure of taxation influence, either positively or negatively, the current state of Canada's aggregate R and D effort. That state, to be a bit more specific, is reflected in the fact that R and D expenditure in Canada as a percentage of GNP accounts for approximately half what it is in other industrialized countries. The private industrial sector undertakes about 40 percent of the total amount of R and D.

\begin{itemize}
  \item[\textsuperscript{134}] D. McFetridge and J. Warda, \textit{supra}, at 91 - 92.
  \item[\textsuperscript{135}] See Chapter 4 for a discussion of transfer pricing.
\end{itemize}
Another consideration in seeking to justify R&D tax incentives is that, despite Canada offering some of the most generous domestic tax policies regarding R&D expenditures, the relatively poor investment in research and development by Canadian private industry may be explained primarily by the small Canadian market:  

Canadian industry is at a comparative disadvantage in R and D. The expected benefits from innovation are small due to the size of the Canadian market and likewise the cost of R and D, similar to any overhead, is high on a unit basis because it must be spread over a smaller income base. It is questionable whether Canadian tax incentives, despite various forms and increasing generosity, are able to offset substantially these fundamental cost considerations.

The international structure of taxation encourages the growth of foreign investment in Canada. Multinational firms in Canada are generally research-intensive. Although this brings technology to Canada, it does not bring as much of the process for developing technology as might be expected. The reason is that multinational corporations centralize their research activity, which usually means they do it at home. While this is primarily explained by the economics of R and D, an additional consideration is the fact that incentives for R and D in the home country do not apply to research done abroad. Of course, research done in Canada is rewarded by Canadian tax write-offs. One can conclude that R and D carried out by foreign subsidiaries in Canada either must be done here because of particular local conditions or is done here essentially to capitalize on tax incentives that exceed incentives at home. In the first case, incentives become gifts. In the second, the gifts are the incentive. In either case, Canada pays to have R and D carried out here when it could receive the technological benefits at no extra fiscal cost.

Finally, it has been suggested that the possibility exists that in all countries R&D activities that are socially beneficial are not undertaken because they are not privately beneficial - a

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137 ibid., at 135 - 136. Also see 1994 AG's Report, supra, vol. 6 at 9-12 regarding Canada's poor performance in science and technology.
problem that cannot be solved by Canada alone:  

Indeed, as already indicated, it is not necessarily in Canada's interest to provide for substantially more generous tax treatment of R&D than do other industrial countries. In a world where technology can be developed in one location and used without compensation in many others, one may appeal to the taxpayers of a small country to provide a high level of support for R&D on altruistic grounds. An appeal based on self-interest would be much more difficult to sustain.

Research and development are important to Canada's economic growth rate, yet stimulating R&D depends on more than the provision of tax incentives:  

Tax incentives for R and D ventures are one useful policy tool. However, alone they will tend to be relatively ineffective in enhancing Canada's R and D efforts and in turn the ability of Canadian firms to compete internationally.

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138 D. McFetridge and J. Warda, supra, at 91.


140 Lazar, *ibid.*, suggests, at 71 - 73, that "government could enhance its R and D tax incentives by undertaking programs aimed at rationalizing Canadian firms and increasing their domestic markets to enable them to grow large enough to support a continuous R and D program independently... Thus a major component of an overall industrial strategy should be a package or programs that enhances the procurement and supply potential for Canadian firms in the domestic economy." Lazar suggests a number of options to this end including: the federal government could direct all its purchasing, wherever possible and reasonable, towards Canadian-controlled firms and foreign controlled firms that comply with a code of good corporate behaviour; the federal government could insist that its crown corporations pursue the same procurement policy; the federal government could use its regulatory agencies to try to increase the share of the domestic market available to Canadian-controlled firms of foreign firms meeting the code of good corporate behaviour; the federal government could explore the feasibility of restructuring the corporate tax system to encourage companies to increase their use of Canadian firms as suppliers of capital goods and parts; and any firm receiving government loans, grants or other forms of assistance should be required by contract to give preferential access to Canadian suppliers. Lazar is also of the view, at 79,
Factors such as historical and corporate development, social structures, cultural factors, international marketing capabilities, and government policies aimed at promoting exports, investment, entrepreneurship and private enterprise, as well as developing human capital through science, education and manpower policies all impact on the level of R&D.\textsuperscript{141} Therefore, it is worthwhile to explore alternatives to the existing R&D tax programs.

C. The Need For Revision

In 1994, the National Advisory Board on Science and Technology recommended that the government of Canada manage its investment in science and technology as a distinct strategic asset. It appeared to the Board that budget decisions of the federal government have "reflected historical incrementalism rather than strategic management of a national asset." It also appeared to the Board that "the government lacks the capability to allocate science and technology resources in a way that reflects broad government objectives."\textsuperscript{142} On June 28, 1994, the Minister of Industry and the Secretary of State for Science, Research and Development, launched a major review of federal science and technology activities. This study is expected to provide a critical basis for

\begin{itemize}
  \item \textsuperscript{141} \textit{ibid.}, at 59.
  \item \textsuperscript{142} 1994 AG's Report, \textit{supra}, vol. 1, at 1-18.
\end{itemize}
Canada's future R&D strategy.\textsuperscript{143}

Thus, it appears that the existing R&D tax incentive program is far from immutable. If the current tax incentive program is not meeting the stated objectives, and if there is a possibility that Canadian R&D tax initiatives may be subject to disciplinary action under the SCM Agreement, the system is in need of revision.

Given that Canada has only modest resources to invest in science and technology compared with other developed nations, it is essential that resources be invested in areas of greatest need and potential payback.\textsuperscript{144} Yet the current R&D tax incentives are not well focused.\textsuperscript{145} For example, it has been shown that higher rates of return are obtained from basic research than from applied research or development,\textsuperscript{146} from company financed R&D over publicly funded R&D\textsuperscript{147} and from R&D geared to new processes as

\textsuperscript{143}\textit{ibid.}, vol. 6 at 9-12. This Report is expected to be complete in 1995, but was not available at the time of writing.

\textsuperscript{144}\textit{ibid.}, vol. 6, 9-16. The Report suggests the need to boost cooperation between federal and provincial governments, industry and universities. A central office to monitor technology projects throughout the government is also recommended.

\textsuperscript{145}\textit{ibid.}, vol. 6, at 9-16 to 9-17.

\textsuperscript{146} P. Mohnen, \textit{supra}, at 44, concludes that basic research is likely to have the highest social rates of return and be less privately-appropriable.

\textsuperscript{147}\textit{ibid.}, at 44; Mohnen concludes that despite the strong evidence of a higher rate of return on privately-funded R&D, useful public support in basic research is important for "total factor productivity growth", and that the knowledge contribution from government agencies and research labs is a significant determinant of R&D intensity.
opposed to new products. Further, although the spillover effects of R&D are substantial, it may be more effective to target R&D support at certain key sectors of the economy where these social rates of return are the highest.

Another factor that has been determined to be extremely important in achieving high rates of return on R&D support, is the scientific knowledge base:

In this respect, the location of research labs near certain types of academic research centers, the funding of academic research and, where possible, the locational concentration of academic facilities in order to induce private research might be wise decisions...

Policy decisions for stimulating R&D should take these factors into consideration as well as international agreements such as the SCM Agreement to ensure that revised tax incentives are more effective at achieving national objectives while minimizing the exposure of such programs to international sanctions.

CONCLUSION

To succeed in the global marketplace businesses must have either a strategic interest in the R&D efforts of others which can

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148 ibid., at 43.
149 ibid., at 43. Mohnen's study concluded that these key sectors include chemicals, non-electrical machinery and scientific instruments.
150 ibid., at 44.
151 See Mark A.A. Warner and Alan M. Rugman, supra who suggest that Canada should "pursue an appropriate international discipline for protectionist investment, anti-trust and R&D policies" notwithstanding recent U.S. initiatives which may violate fundamental principles in the GATT (at 428).
be incorporated into their own operations,\textsuperscript{152} or indigenous R&D leading to new product development or technological advancements which enable more efficient production.\textsuperscript{153} Tax support for indigenous R&D is believed to assist technological development in a number of ways:\textsuperscript{154}

1. direct benefits to the R&D performer of increased knowledge leading to reduced unit production costs and the development of new products and processes for sale or application;
2. benefits of spinoff technological applications;
3. pushing firms to technological frontiers allowing them to imitate quickly; and
4. spillover benefits conferred upon those conducting the R&D.

Despite Canada's generous tax incentives for R&D, Canadian industry has performed poorly over the past 20 years relative to other industrial nations.\textsuperscript{155} If Canada's R&D tax policies are open to attack under the SCM Agreement, subject to abuse by taxpayers, and not achieving the stated objectives, it is timely that Canada's overall strategy for R&D is being reviewed. It may be that Canada's R&D tax incentives are not the most effective

\textsuperscript{152} Government policies which enhance market access and facilitate flow of capital influence the adoption and diffusion of new technology. W.S. Clark, et. al., \textit{supra}, at 32:3.

\textsuperscript{153} \textit{ibid.}, at 32:2.

\textsuperscript{154} \textit{ibid.}, at 32:3 - 32:4.

means of stimulating research and development in Canada. The Canadian government does not have the luxury of being able to afford to support all R&D; Canada has modest resources to invest in R&D compared with other industrialized countries so must ensure they are spending effectively.

Given the importance of R&D to Canada's economic and social agenda, these national objectives must be given priority over the free trade objective, but the latter should not be disregarded. The SCM Agreement establishes parameters regarding what its signatories consider to be acceptable subsidization for R&D, and promotes general principles of free trade. To the extent that these parameters and principles are adaptable to a revised Canadian agenda for R&D, the SCM Agreement may provide useful guidelines in revising Canadian tax incentives for R&D while limiting exposure of these incentives to international sanction.
CHAPTER 4
TRANSFER PRICING

Transfer pricing is one of the most controversial tax issues of the 1990s. During the last decade, national barriers to the free flow of international trade and investment have been substantially eased and in many cases removed altogether. The globalization of the economy has provided multinational enterprises with increased opportunities to minimize tax by selectively allocating income and expenses among domestic and foreign entities. National governments have become increasingly concerned about protecting their domestic tax bases from this type of tax avoidance. Moreover, both governments and multinational enterprises must confront the problem of allocating tax revenues among countries on an equitable basis.1

INTRODUCTION

Many transactions take place between members of multinational

enterprises ("MNEs"), including sale of goods, licensing of intangibles and the provision of services. It has been estimated that major MNEs will have, at any one time, in excess of 200 transactions between entities which may be sensitive to transfer pricing in a number of countries. The term "transfer pricing" is

2 1979 Report, supra, at 11, footnote 2. The OECD has not found it necessary to define precisely the expression "multinational enterprise" in reference to transfer pricing guidelines, but refer to the OECD Guidelines for Multinational Enterprises, paragraph 8:

A precise legal definition of multinational enterprises is not required for the purposes of the guidelines. These usually comprise companies or other entities whose ownership is private, State or mixed, established in different countries and so linked that one or more of them may be able to exercise a significant influence over the activities of others and, in particular, to share knowledge and resources with the others. The degree of autonomy of each entity in relation to the others varies widely from one multinational enterprise to another, depending on the nature of the links between such entities and the fields of activity concerned.

Also see Jill C. Pagan and J. Scott Wilkie, Transfer Pricing Strategy in a Global Economy (The Netherlands: IBFD Publications, 1993), at 22 - 26 for an overview of the essentials of a MNE.

3 Rarely will there be transactions between entities of a multinational enterprise which involve the sale or purchase of finished goods without any support services, or at least without implicit transfers of intellectual property and other intangibles developed within a MNE. Examples include the sharing of costs for the development of technology, or know-how, and how intra-group pricing of the finished products or services reflects this; and the establishment of the price for access to technology, or know-how, or product distribution, or production rights, as, for example, reflected in the basis of a royalty rate charged for a licence. (Jill C. Pagan and J. Scott Wilkie, supra, at 99).

4 Jill C. Pagan and J. Scott Wilkie, supra, at 102. Also see Donald J.S. Brean, "Here or There: The Source and Residence Principles of International Taxation", in "Taxation to 2000 and Beyond", Canadian Tax Paper No. 93 (Toronto: Canadian Tax Foundation, 1992) 303 at 321 which estimates more than 70% of Canada-US bilateral trade is non-arm's length intra-firm trade (Brean cites Alan M. Rugman, Multinationals and Canada-United
generally used to describe the measurement and reporting of corporate profits for tax purposes arising from transactions between members of a MNE.\(^5\) An acceptable transfer price is one that results in income to the transaction participants which is reasonably commensurate with their productive capacities as members of, and with their actual contributions to, the economic unit.\(^6\)

It is generally accepted that tax factors may affect the prices charged for transfers between members of a MNE.\(^7\) Indeed, shrewd selection of a transfer price may enable a MNE to increase overall after tax earnings by shifting profits to low tax jurisdictions. This ability to manipulate transfer prices may theoretically put MNEs at a comparative advantage over domestic firms.\(^8\) However, the Canadian and international transfer pricing

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\(^{5}\) Jill C. Pagan and J. Scott Wilkie, *supra*, at 99 - 100.

\(^{6}\) *ibid.*, at 229.

\(^{7}\) 1979 Report, *supra*, at 7. Tax factors may also affect the nature of the payments.

\(^{8}\) G.F. Mathewson and G.D. Quirin, *Fiscal Transfer Pricing in Multinational Enterprises* (Toronto: University of Toronto Press, 1979) at 1. The authors conclude, however (Chapter 9) that there is an offsetting nature to taxes and tariffs (if transfers prices are manipulated so as to result in high profits in a low tax jurisdiction, the tariff at the border will be high which offsets the low income tax). This self-policing mechanism disappears as tariff barriers are eliminated. See also 1994 Draft, Part I, *supra*, at 171 regarding offsetting incentives in setting values for
regimes attempt to remove any incentive MNEs may have to manipulate transfer prices for tax purposes. Indeed, in economic terms, transfer pricing has the potential to be as great, or greater, a trade barrier than customs duties and may reduce global welfare. Further, the ITA rules relating to transfer pricing, distinguish between residents and non-residents, and appear on customs and income tax purposes.


10 Robert Z. Aliber, "Transfer Pricing: A Taxonomy of Impacts on Economic Welfare", in A. Rugman and L. Eden, eds., *Multinationals and Transfer Pricing* (London: Croom Holm, 1985), 82-97, at 96: "If corporate tax rates are identical across countries, no incentive exists to manage transfer pricing to shift income among tax jurisdictions; after-tax rates of return are identical. If tax rates are raised or lowered in one country, a wedge is driven between before-tax rates of return in the several countries, and capital flows towards the country with the lower tax rates. The consequence of this shift adjustment is that economic welfare declines on both a global basis and in the higher tax country. The impact of transfer pricing by the multinational firm to shift income from the high tax jurisdiction to the low tax jurisdiction is to undo partially or reverse the welfare-reducing impact of the increase in the tax rate, so less production is diverted from this jurisdiction. Transfer pricing also reduces the reserves of the tax collector in the high-tax jurisdiction while increasing economic welfare. The distribution of the gains realized from the tax savings attributable to transfer pricing depends on the competitiveness of goods markets and of factor markets; if taxes are shifted forward, the gains will be realized by the consumers in the form of lower prices. This result appears pervasive across the various measures that segment national markets. Measures that segment national markets for goods or factors raise economic welfare in the country adopting these measures but at the expense of global welfare. Transfer pricing tends to lessen the global welfare-reducing impact of these measures, and thus undercuts the efforts of the state to exercise its monopoly power. Criticisms of transfer pricing as a welfare-decreasing activity are exercises in misplaced concreteness."
their face to discriminate against non-residents.\textsuperscript{11}

This Chapter reviews and evaluates the Canadian ITA rules, and relevant international provisions, pertaining to transfer pricing to determine the potentially discriminatory consequences of the current transfer pricing regime on the allocation of resources and economic activity of MNEs.\textsuperscript{12}

PART I

THE NATURE OF TRANSFER PRICING

Transfer pricing is an important issue for tax authorities and MNEs alike. Tax authorities face potential erosion of their tax base, loss of tax revenues and incur time and expense administering and investigating compliance with transfer pricing provisions. MNEs are confronted with uncertainty in selecting and applying transfer pricing methods (despite tax authority efforts to delineate how and when to apply acceptable methods), high compliance costs and risk of penalties, interest and double taxation.\textsuperscript{13}

Despite the importance of transfer pricing, the current


\textsuperscript{12} Unlike the previous two Chapters, this Chapter does not engage in a detailed analysis of any particular GATT provision. Rather the sovereignty / free-trade dichotomy is explored generally through examination of a variety of transfer pricing issues which may affect MNEs thereby shifting the balance in favour of protectionism over free trade.

\textsuperscript{13} See L. Franko, M. Patton, J. Wheeler and C. Triplett, "The International Tax Showdown", \textit{The International Tax Journal}, Vol.20, No.3, Summer 1994, 1 for an informative, open forum debate on transfer pricing issues, particularly the U.S. regulations and the impetus behind those regulations.
transfer pricing regime lacks a coherent definition of the very nature of transfer pricing: 14

A consequence of this is that firms (MNEs), even outside the context of deliberate pricing manipulation, find it difficult to detect a sufficiently coherent underlying regulatory theme to allow them to assess the fiscal aspects of their organizations in a reliable strategic way. An effective transfer pricing rule, or at least the recognition among national tax authorities of the significance of transfer pricing regulations... would reduce the ability of national jurisdictions to disguise the use of the tax system to achieve other political and economic objectives.

Therefore, it is important at the outset to consider the nature of transfer pricing before evaluating the existing regime's impact on MNEs. 15

A. The Tax Avoidance Perspective

Transfer pricing has its roots in anti-avoidance, yet as a system used to price transfers between related entities it is essentially a neutral concept. 16 In the international context transfer pricing is often used in a negative way to allude to a pricing decision by a MNE which shifts income from one member of

14 Jill C. Pagan and J. Scott Wilkie, supra at 238.

15 It is generally agreed that the broad purpose of transfer pricing rules is to ensure that the allocation of income and expenses of a MNE among its members is reasonable. Although there is agreement about this general purpose, there is no general agreement about whether these rules should be regarded as anti-avoidance rules or as basic income measurement rules. See B. J. Arnold and T. E. McDonnell, supra, at 904.

16 Despite its anti-avoidance roots, transfer pricing does not include a motive test; it is an objective test of whether the pricing of a transaction reflects arm's length dealings. Jill C. Pagan and J. Scott Wilkie, supra, at 52.
the group to another to take advantage of different tax regimes. Although the overall pre-tax profitability of the MNE is not affected, the shifting of profits between entities in different countries results in the tax base of one country shrinking to the benefit of the other. Thus, transfer pricing is often viewed as way to avoid or minimize taxation, thereby maximizing profits of the MNE as a whole.

In order to maintain the integrity of the tax base, Canada seeks to prevent this type of tax avoidance by requiring an arm's length price for transfers of goods, services and intangibles between members of a MNE. An anti-avoidance focus will inevitably result in adjustments which will increase taxable profit and,

17 ibid., at 15. See also Donald J.S. Brean, "International Issues in Taxation: The Canadian Perspective", Canadian Tax Paper No. 75 (Toronto: Canadian Tax Foundation, 1984) at 108 - 110 for a discussion of incentives for transfer pricing manipulations beyond minimizing the overall income tax liability of a MNE.

18 Jill C. Pagan and J. Scott Wilkie, supra, at 17. The authors note that by the mid-1970's, increased communication and technological advances meant that developed nations (generally high tax countries) had a problem preserving their tax base. This recognition led to the development of transfer pricing expertise and other means to attack the use of tax havens (such as the Canadian "foreign accrual property rules"). However, general transfer pricing guidelines, as set out in the 1979 Report, are equally applicable to transactions between entities in developed countries or entities in developed and developing countries (1979 Report, supra, at 10).

19 Section 69 of the ITA is discussed below. Such anti-avoidance tax legislation is common throughout the world and has been the topic of much debate internationally, particularly in recent years due to changes in the U.S. transfer pricing regulations. See Jill C. Pagan and J. Scott Wilkie, supra at 17 - 22 for an overview of the history of transfer pricing. Also see the 1979 Report, supra; 1984 Report, supra; and the 1993 Report, supra.
therefore, domestic tax revenues. Ironically, such an approach on a global scale may result in double taxation and reduce global after tax profits of the MNE.20

B. The Income Measurement Perspective

Transfer pricing by MNEs may be used not only to minimize taxes but also to improve the efficiency of worldwide operations.21 To suggest that MNEs make transfer pricing decisions primarily to minimize tax liability is not substantiated. Accounting, marketing, business policy, international business, economics and finance, performance evaluation and legal considerations also impact on transfer pricing decisions.22 For example, tax considerations are unlikely to be paramount where MNEs are subject to conflicting pressures from various government departments,23 where different members of the MNE are subject to scrutiny by minority

20 Jill C. Pagan and J. Scott Wilkie, supra, at 32.


23 1979 Report, supra, at 8. For example, customs authorities or exchange control offices in the home and host countries.
shareholders, or where members of the MNE have considerable autonomy and managers are evaluated on their performance.  

An alternative, and more balanced, view considers transfer pricing merely as part of the operational pricing structure of a MNE which is governed by commercial considerations, not by the desire to avoid taxation:  

Today transfer pricing is about the allocation of income of a MNE between nations. It applies to virtually all international transactions within a MNE world group and, because of technological advancements and split functions, a MNE has more international transactions than ever before. Tax avoidance, if present, is at the margins, not at the centre.  

C. Conclusion  
The nature of transfer pricing is a contentious issue, yet it is a fundamental determination which impacts issues about regulation. Presumably if transfer pricing rules are considered to be anti-avoidance rules, they should only be applied in abusive  

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25 Jill C. Pagan and J. Scott Wilkie, supra at 15 - 16. Also see the 1979 Report, supra, at 9: "It is important to bear in mind, moreover, that the need to adjust the actual price to an arm's length price, in order to arrive at a proper level of taxable profits, arises irrespective of any contractual obligation undertaken by the parties to pay a particular price or of any intention of the parties to minimise tax. Hence, the consideration of transfer pricing problems should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes."
cases.\textsuperscript{26} If transfer pricing rules are basic income measurement rules, they would apply in every case where there are transactions between associated enterprises.\textsuperscript{27} Yet, as the next Part of this Chapter will attempt to demonstrate, the present system, rooted in anti-avoidance, is not limited to abusive cases:\textsuperscript{28}

The need to address the problem of allocation of income of a MNE for taxation purposes cannot be ignored. The global economy is developing apace and the problem of transfer pricing moving towards taking a disproportionate amount of time and effort of both taxpayer and tax gatherer... In general, there is recognition that the problem exists, but because it is so complex and there is no easy solution, discussion tends to descend into analysis of the detail of methodology and lose sight of the real issue... Taxation in this area is an art, and no amount of complex methodology can turn it into an exact science.

In my opinion, it is preferable to view the nature of transfer pricing as concerned with the international allocation of resources, value and profit within a MNE, rather than primarily as a vehicle for tax avoidance. However, this does not mean that an even more complex and detailed set of rules and compliance procedures is necessary. Rather, by understanding the nature of

\textsuperscript{26} B. J. Arnold and T. E. McDonnell, \textit{supra} at 904 and at 919: "The need for international cooperation may be somewhat less important if transfer-pricing rules are considered to be anti-avoidance rules that apply only in abusive situations. In either case, however, such cooperation is much more important today than it was when the OECD last considered transfer-pricing rules." Further, it has been suggested that perhaps a less detailed set of rules would be required if transfer pricing rules are viewed as anti-avoidance rules (at 919). Whether this is the true is debatable in light of U.S. transfer pricing developments (see footnote 83, \textit{infra}, for a list of sources on U.S. transfer pricing regulations).

\textsuperscript{27} ibid., at 904.

\textsuperscript{28} Jill C. Pagan and J. Scott Wilkie, \textit{supra}, at 16.
transfer pricing in this way, a more clearly defendable transfer pricing regime could be developed to enable MNEs to conduct their business in the global economy while:  

- reducing "fiscal nationalism" with respect to the analysis of transfer prices and the formulation of tax policy in this area;

- having the capacity to generate a level of international tax harmonization by diminishing fiscal nationalism;

- recognizing the economic nature of MNEs, and incidentally reducing the value of engaging in pricing manipulation directed to "tax avoidance";

- recognizing and preserving national tax bases according to the economic characteristics of national economies;

- limiting the intervention of tax regulations in business decisions;  

and

- addressing the movement of income and profits through MNEs without giving undue concern to national tax systems and without requiring the adoption of contentious formulary methods of income allocation to replace existing transfer pricing methods. 

The following discussion of discrimination in the transfer pricing regime is based on the nature of transfer pricing as concerned with the international allocation of resources, rather than with tax avoidance. To the extent that the transfer pricing regime seeks to preserve national tax bases, transactions among members of MNEs are open to protectionist and discriminatory

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29 ibid., at 236 - 237 for a more complete description of these possible outcomes.

30 ibid., The authors suggest that this benefit may be limited to developed economies.

31 ibid., The authors suggest that the substantial relocation by MNEs of economic activity in response to tax considerations would, presumably, remain of concern to governments, but not on transfer pricing grounds.
measures which would have no parallel for similar domestic transactions. Part II reviews key principles, methods and procedural aspects of the existing transfer pricing system with a view to identifying unreasonable, arbitrary or irrelevant standards or procedures which have a negative impact on global trading by MNEs. Part III considers whether any such discrimination in the existing transfer pricing system is justifiable in light of the overriding objective of protecting the domestic tax base and considers alternatives which may more equitably balance the interests of tax authorities and MNEs thereby facilitating global trade.

PART II
DISCRIMINATION IN THE TRANSFER PRICING REGIME

The thesis is that the existing transfer pricing rules have a protectionist orientation; they are aimed at maintaining national fiscal sovereignty without sufficient recognition of the impact the system has on MNEs. A potential outcome of this emphasis is to decrease the efficiency and effectiveness of MNE operations and reduce the positive effects of setting up global operations which otherwise benefit from free trade.

In this Part, the following questions are used to evaluate Canada's transfer pricing legislation, and how it operates within the international transfer pricing regime, to assess whether the legislation discriminates against MNEs:

A. To which taxpayers do transfer pricing provisions apply?
B. What transactions are affected?
C. How is the transfer price determined?

D. What are the consequences of transfer price adjustments?

E. What compliance measures are required to enforce the provisions? What other steps, such as advance pricing agreements, are suggested to avoid application of the provisions?

A. To which taxpayers do transfer pricing provisions apply?

The transfer pricing rules for transactions between residents and non-residents are set out in section 69 of the ITA:

(2) Where a taxpayer has paid or agreed to pay to a non-resident person with whom the taxpayer was not dealing at arm's length as price, rental, royalty or other payment for or for the use or reproduction of any property, or as consideration for the carriage of goods or passengers or for other services, an amount greater than the amount (in this subsection referred to as "the reasonable amount") that would have been reasonable in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length, the reasonable amount shall, for the purpose of computing the taxpayer's income under this Part, be deemed to have been the amount that was paid or is payable therefor.

(3) Where a non-resident person has neither paid nor agreed to pay to a taxpayer with whom the person was not dealing at arm's length as price, rental, royalty or other payment for or for the use or reproduction of any property or as consideration for the carriage of goods or passengers or for other services, an amount equal to or greater than the amount that would have been a reasonable amount in the circumstances if the non-resident person and the taxpayer had been dealing at arm's length, that reasonable amount shall, for the purposes of computing the taxpayer's income under this Part, be deemed to have been received or receivable by the taxpayer therefor. (emphasis added)

Subsection 69(2) means, in effect, that the amount that the

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Other ITA provisions which may be applicable in a particular case, but which are not addressed here, include section 67 (which disallows unreasonable expenses), subsection 245(1) (the general anti-avoidance provision which deals with undue or artificial reductions of income), subsection 15(1) (shareholder appropriations) and Part XIII (tax on income from Canada of a non-resident).
Canadian taxpayer has paid or agreed to pay to the non-resident may not, for tax purposes, exceed a reasonable arm's length price; subsection 69(3) means that the amount (including a nil amount) a non-arm's length, non-resident has paid or agreed to pay to a Canadian taxpayer may not, for tax purposes, be less than a reasonable arm's length price. These provisions apply on a transaction by transaction basis.

The ITA transfer pricing provisions require certain transactions to occur at a reasonable price in circumstances where a resident and non-resident are not dealing at "arm's length". The arm's length test contains both factual and substantive components and embraces natural persons and corporations.


34 ibid., paragraph 56. This approach is necessary as the ITA applies to each transaction between the various related parties and not to any general measure of profitability.

35 ibid.. Note that prior to May 9, 1985, this provision only applied if the taxpayer was carrying on business in Canada. "Arm's length" is defined in section 251 of the ITA; also see Interpretation Bulletin IT-419, "Meaning of Arm's Length" (July 10, 1978).

36 "Related persons" (ie. persons connected by blood relationship, marriage or adoption; paragraph 251(2)(a)) do not deal at arm's length.

37 Relationships between individuals and corporations, or among corporations depend on "control" to determine whether the parties deal at arm's length (see subsections 251(1) to (5)). "Control" is a factual determination not defined in the ITA, but by case law, and generally means ownership of more than 50% of the shares of a corporation having full voting rights. See Nathan Boidman, "Canadian Perspectives on Intercompany Transfer Pricing", Tax Management, Special Report, Vol. 2, No. 1, Report No. 5, May 12, 1993 (Washington, D.C.: BNA, 1993) at 6, footnote 14.
Parties not dealing at arm's length include, for example, transactions between a parent and subsidiary or between any two corporations controlled by the same person or group of persons.\(^{38}\)

These rules are different from, but substantially similar to, the rules with respect to non-arm's length transactions between resident taxpayers set out in subsection 69(1).\(^{39}\)

Although the tests for assessing whether an arm's length relationship exists do not differentiate between foreign and domestic persons, the application of the transfer pricing rules is restricted to transactions between a resident taxpayer and a non-

\(^{38}\) Facts must be carefully analyzed to assess whether strategic alliances, joint ventures or transactions with loosely associated parties would be at arm's length. To the extent that different countries impose varying standards in assessing when transfer pricing provisions come into play, uncertainty exists for the MNE and the opportunities or pitfalls will depend upon the facts and circumstances of each case (see Jill C. Pagan and J. Scott Wilkie, *supra*, at 44).

\(^{39}\) Subsection 69(1): Except as expressly otherwise provided in this Act,
(a) where a taxpayer has acquired anything from a person with whom the taxpayer was not dealing at arm's length at an amount in excess of the fair market value thereof at the time the taxpayer so acquired it, the taxpayer shall be deemed to have acquired it at that fair market value;
(b) Where a taxpayer has disposed of anything
   (i) to a person with whom the taxpayer was not dealing at arm's length for no proceeds of for proceeds less than the fair market value thereof at the time the taxpayer so disposed of it, or
   (ii) to any person by way of gift *inter vivos*, the taxpayer shall be deemed to have received proceeds of disposition therefor equal to that fair market value; and
(c) where a taxpayer has acquired property by way of gift, bequest or inheritance, the taxpayer shall be deemed to have acquired the property at its fair market value at the time the taxpayer so acquired it.
The tax regime for pricing transactions between residents and non-residents differs from that among residents, and is prima facie discriminatory. The nature and extent of such discrimination is explored in the following sections.

B. What transactions should be affected?

Subsections 69(2) and 69(3) are much broader than subsection 69(1) in the range of transactions that are affected:

Some transactions between residents - dispossession and acquisitions of property - are subject to similar rules. Many similar transactions between residents at less or more than an arm's length price are not adjusted to an arm's length amount, although they may result in other disadvantageous tax consequences. The reason for the difference, of course, is that transfer pricing with non-residents results in erosion of the Canadian tax base, whereas transfer pricing with residents results only in the shifting of amounts between taxpayers.

Further, the transfer pricing rules apply to transfers of services, tangible and intangible property, when: a) a taxpayer has paid or agrees to pay to a non-resident, non-arm's length person, an amount greater than a reasonable amount; and b) a non-resident, non-arm's length person has neither paid or agreed to pay a

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40 Subsections 69(2) and (3) override section 69(1) in the case of transactions between Canadian taxpayers and non-residents (Information Circular 87-2, supra, paragraph 6).

41 Brian J. Arnold, "Tax Discrimination Against Aliens, Non-Residents and Foreign Activities", supra, at 12.

42 Ibid., at 105.

43 Ibid., at 105, footnote 214: "For example, if a corporation performs services for a shareholder for less than fair market value, the benefit conferred must be included in the shareholder's income under subsection 15(1)." Payment for services is specifically included in subsections 69(2) and 69(3).
reasonable amount to a taxpayer.\footnote{44} In these circumstances, the taxpayer's taxable income is presumably less than it would otherwise be, had the transaction occurred with an arm's length person. Therefore, the provisions are drafted in such a way that the only transactions which are affected are those where transfer pricing adjustments lead to an increase in profit for the taxpayer, with a corresponding increase in the domestic tax base. It is submitted that restricting the application of the transfer pricing rules in this way discriminates against MNEs \textit{vis a vis} similar domestic transactions:\footnote{45}

Two independent business entities with a long history of doing business together may find some arrangements or business dealings far more profitable to one than to the other. However, over the years they average out... However, transfer pricing legislation ... does not technically accept averaging out over the years, so MNEs are potentially at a disadvantage. Prices may be adjusted for those transactions where intra-group prices may be said not to meet the arm's length criteria and result in a decrease in income or increase in expenditure; no regard would be given to similar transactions in previous years where pricing may have resulted in greater profit than appropriate if a strict arm's length price were to be substituted.

Therefore, by including a broader range of transactions and applying only to transactions which increase the domestic tax base, the cross-border transfer pricing rules can be viewed as discriminatory.

C. How is the transfer price determined?

The transfer pricing rules provide that "the reasonable

\footnote{44} The question of what a "reasonable amount" is will be addressed below.

\footnote{45} Jill C. Pagan and J. Scott Wilkie, \textit{supra}, at 51.
amount", the amount that would have been reasonable in the circumstances, shall be deemed to have been the amount that was paid or payable. This reasonable amount is rooted in the arm's length principle. The presumption is that a reasonable arm's length price would be a fair market value and the most persuasive evidence of this amount is from the market to which the transfer is made.

This section provides an overview of the arm's length principle.

46 Subsections 69(2) and 69(3); Information Circular 87-2, supra, paragraphs 5 - 7.

47 The arm's length principle is discussed below. See generally ibid., paragraph 9; 1979 Report, supra; 1984 Report, supra; 1993 Report, supra; Article 9(1) of the OECD Model; and "Tax Treaties between Developed and Developing Countries" (United Nations, 1978) at 62.

48 Revenue Canada uses the same theories and principles of transfer pricing to determine fair market value under section 69(1) for domestic non-arm's length transactions (Information Circular 87-2, supra, paragraph 5). However, the language of subsections 69(2) and 69(3) "of both a reasonableness standard and a circumstantial context suggests a basis for accepting intra-group pricing that may depart from "fair market value" as interpreted conventionally for arm's length transactions, but nevertheless may be appropriate taking into account the nature and characteristics of a multi-national enterprise, provided that there is no evidence of a tax avoidance motivation." (J. Scott Wilkie, "Transfer Pricing: Realizing Corporate Goals", Tax Aspects of Canada-United States Business Transactions (Mississauga: Insight Press, 1991) Tab 5 at 12).

49 The arm's length price is determined from the perspective of the transferor's destination market which may or may not be equal to "fair market value", the standard which is imposed in a purely domestic non-arm's length transaction. Information Circular 87-2, supra, paragraph 7 gives the example of a supplier attempting to increase market share, so the supplier might temporarily establish an arm's length price that was below fair market value. See also J. Hofert Limited v. MNR, 62 DTC 50 (TAB); Indalex Limited v. The Queen, 86 DTC 6039 (FCTD), 88 DTC 6053 (FCA); and The Queen v. Irving Oil Limited, 91 DTC 5106 (FCA); and Jill C. Pagan and J. Scott Wilkie, supra, at 233.
principle and the generally accepted methods for arriving at the arm's length transfer price. Problems with the arm's length principle as well as difficulties in applying the prescribed methods are discussed in the context of discrimination against MNEs.

i. Arm's length principle

When independent entities conduct business with each other, market forces generally determine the conditions of their commercial and financial relations. MNEs can distort these market forces in a number of ways, including shifting profits from one jurisdiction to another in order to reduce the overall tax burden. The arm's length principle tries to eliminate this effect by treating each member of a MNE as a separate entity.\(^{50}\)

On January 7, 1994 the Department of Finance issued a Press Release\(^{51}\) to clarify the Canadian rules and guidelines for determining transfer prices between members of an international corporate group. Canada requires transfer prices to conform to the "arm's length principle" that prices for transactions between members of a MNE\(^{52}\) be equivalent to those which would be set by two


\(^{51}\) Press Release 93-003, "Transfer Pricing Rules and Guidelines Clarified".

\(^{52}\) Transactions between members of a MNE are also referred to as the "controlled transaction". For a discussion on whether or not the arm's length principle necessitates the existence of a transaction in order to apply see B.J. Arnold and T.E. McDonnell,
unrelated companies engaged in the same or similar transactions under the same or similar conditions in the open market. The arm's length principle has been incorporated in all Canadian tax treaties and is officially recommended by the OECD.  

There are a number of reasons why the arm's length principle has been officially recommended. Market forces of supply and demand are considered to be the best way to allocate resources and reward effort. Also, the arm's length principle provides broadly equal treatment for MNE groups and independent enterprises thereby avoiding the creation of tax advantages by concentrating economic power in large MNE groups. Finally, the arm's length principle has been applied with success in practice.

There are a number of problems with the arm's length principle. MNEs may engage in transactions which independent enterprises would not engage in making it difficult to apply the

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53 See the 1979 Report, supra; the 1984 Report, supra; the 1993 Report, supra; and the 1994 Draft Part I, supra, which favour the arm's length method and reject a global method of apportionment (discussed below). It has been suggested that the tension between these two approaches is viewed as largely political and it is recognized that there are a variety of methods for resolving transfer pricing issues. (B.J. Arnold and T.E. McDonnell, supra, at 920). There is substantial concern about the use of predetermined formulas to allocate income among members of a MNE and it is unclear whether the arm's length principle permits the use of profit based methods in addition to the transaction based methods which are discussed in section ii) below. For a discussion see B.J. Arnold and T.E. McDonnell, supra, at 905-906.


arm's length principle where comparable transactions do not exist in the market place. It is unlikely that a truly comparable uncontrolled transaction will be available for such comparison, especially in the case of intangibles. It is also unlikely that there is going to be a single arm's length price; rather there will be a commercially feasible range of prices. The arm's length principle is also inherently flawed in that it adopts the separate entity approach which may not account for economies of scale or the inter-relation of diverse activities by MNEs. When comparable transactions do exist, a significant amount of data is required in order to compare these transactions to activities of the MNE. This data may be inaccessible, incomplete and difficult to interpret when the MNE is establishing transfer prices, but Revenue Canada will compare the information after the fact when relevant data is


57 If it is recognized that the arm's length principle contemplates an acceptable range of prices, rather than a single "right" price, it may be necessary to develop "safe harbour" rules for prices falling within the acceptable range. See B.J. Arnold and T.E. McDonnell, ibid., at 915 and at 915 - 916 regarding safe harbour rules generally; and 1994 Draft, Part II, ibid., at paragraphs 204 - 233 in which the OECD does not recommend the use of safe havens.

58 For example, the arm's length principle is difficult to apply in allocating costs for research and development activities carried on by one member of the MNE for the benefit of one or more other members of the MNE (see the 1979 Report, supra, at 45 - 71).
easier to obtain and identify.\textsuperscript{59} Finally, to the extent that Revenue Canada uses industry-wide standards to assess an arm's length price, it is unlikely that these standards will reflect the particular circumstances of the MNE and the transaction under review.\textsuperscript{60}

An alternative to the arm's length approach is formulary apportionment.\textsuperscript{61} Formulary apportionment refers to global or direct methods of profit allocation, or fixing transfer prices by reference to a predetermined formula based on factors such as sales, payroll and assets.\textsuperscript{62} Advocates of this approach claim that

\textsuperscript{59} Emilio Romano, \textit{supra}, at 4. See also Amp of Canada, Ltd. \textit{v. The Queen}, 87 DTC 5157 (FCTD); and Crestbrook Forest Industries Limited \textit{v. The Queen}, 91 DTC 5521 (FCA) regarding taxpayers seeking disclosure of documents used by Revenue Canada.

\textsuperscript{60} There may be sound business reasons for establishing a transfer price which is at odds with the "industry standard", such as to gain entry into a market. The "reasonable in the circumstances" language of subsections 69(2) and (3) provides some measure of protection for the MNE in this regard.

\textsuperscript{61} See B.J. Arnold and T.E. McDonnell, \textit{supra}, at 904 - 908. This method is also referred to as the unitary approach because it treats members of a MNE as a member of a single, unified business rather than as a separate entity under the arm's length approach. The 1994 Draft, Part I, \textit{supra}, cautions (at 185 - 186) that global formulary apportionment methods (which use a formula that is predetermined for all taxpayers to allocate profits) should not be confused with profit methods (which compare, on a case by case basis, the profits of one or more associated enterprises with the profit experience that comparable independent enterprises would have sought to achieve in comparable circumstances). These global methods are also distinguished from cases of selected application of a formula developed by both tax authorities in cooperation with a MNE after careful analysis of the particular facts and circumstances (for example, under mutual agreement procedures or advance pricing agreements).

\textsuperscript{62} See Jill C. Pagan and J. Scott Wilkie, \textit{supra}, at 32 regarding the distinction between profit allocation under an arm's length transfer pricing system (in which a functional analysis of
it would provide greater administrative convenience, reduced compliance costs and certainty for taxpayers. Advocates also believe that this approach is more in line with economic reality of the highly integrated relationships among members of MNEs.\textsuperscript{63}

The OECD has rejected this approach as producing arbitrary results and being incompatible with Articles 7 and 9 of the OECD Model which broadly accepts the arm's length basis.\textsuperscript{64} However, the most significant problem with global formulary apportionment is said to be the potential for double taxation due to lack of international consensus and coordination on the predetermined formulae and composition of the tax unit.\textsuperscript{65} Other perceived problems with global methods include compliance costs and data requirements, lack of uniform accounting standards and lack of


\textsuperscript{64} The 1979 Report, \textit{supra}, at 14, reports that the result is arbitrary because these methods disregard market circumstances, the particular circumstances of the MNE and management's allocation of resources. Therefore, these methods are said to lead to an allocation of profit which may bear no sound relationship to economic facts (see the 1979 Report at 14 for examples). However, this result is also possible under the arm's length standard, particularly with regard to intangibles where comparable arm's length transactions are unlikely to exist.

\textsuperscript{65} 1994 Draft, Part I, \textit{supra}, at 186 - 187. Similar problems of double taxation also exist under the arm's length principle, however, regarding differing standards and lack of consistency in application of methods. If compensating adjustments are not forthcoming, double taxation will result. These concerns are discussed below.
flexibility in applying pre-determined formulae.

Overall, strict application of either standard is likely to be unreasonably costly and burdensome for MNEs, requiring an undue amount of time and effort to support an arbitrary transfer price which may still be subject to adjustment. It is suggested that the following methods for determining an arm's length price exacerbate these problems. In an attempt to make transfer pricing less arbitrary by imposing specific transfer pricing methods, a less arbitrary result is not necessarily the outcome.

ii. Methods for Determining an Arm's Length Price

a. Transfer of Goods; Acquisitions or Dispositions of Intangibles

There are three generally accepted methods for determining an arm's length price for the transfer of goods, and the acquisition or disposition of intangibles: the comparable uncontrolled price, resale price and cost-plus methods.\(^{66}\)

\(^{66}\) Information Circular 87-2, supra, paragraph 13. Methods for establishing an arm's length price for the use of intangibles (the "arm's length royalty rate") are discussed below and at paragraphs 40 through 47 of Information Circular 87-2.

The primary method to establish an arm's length price is to arrive at an exact comparable uncontrolled price which is either:

i. the price a group member charges an arm's length party for the same item, in the same quantity, under the same conditions and in the same market; or

ii. the price set by two third parties for the same item, in the same quantity, under the same conditions and in the same market.

In cases where differences in circumstances between a controlled and uncontrolled transaction do not affect price, or are minor or can be reasonably quantified, it is appropriate to use an inexact comparable uncontrolled price. Where exact or inexact comparable uncontrolled prices are not available, Revenue Canada will generally accept either of the "resale minus" or "cost plus" transactional methods. The resale

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5106 (FCA) (leave to appeal to SCC denied Sept. 1991); Consolidated Bathurst Limited v. The Queen, 85 DTC 5120 (FCTD); Stubart Investments Limited v. The Queen, 84 DTC 6305 (SCC); Indalex Limited v. The Queen, 83 DTC 89 (TRB); Spur Oil Ltd. v. The Queen, 81 DTC 5168 (FCA); Dominion Bridge Co. Ltd. v. The Queen, 75 DTC 5150 (FCTD), aff'd 77 DTC 5367 (FCA); J. Hofert Ltd. v. MNR, 62 DTC 50 (TAB); and Central Canada Forest Products Ltd. v. MNR, 52 DTC 539 (TAB). A number of these cases are discussed by Robert A. Friesen in "Contemporary Issues in Cross-Border Transactions", Report of Proceedings of the Thirty-Eighth Tax Conference, 1986 Conference Report (Toronto: Canadian Tax Foundation, 1987) 22:1 - 22:7; and see Memorandum, Rulings Directorate, "Subsidiary Doing Business in Canada - Transfer Pricing" (December 1, 1992).

68 Press Release No. 93-003, supra, "Backgrounder".

69 Information Circular 87-2, supra, paragraph 14. Factors which may be used in assessing comparability include product definition, quantity, quality, market definition, credit terms, reliability of supply, trade levels, and other terms of trade.

70 For United States examples where courts have not accepted the proposed comparable, see Lilly & Co. v. Comm'r, 84 TC 996 (1985), 856 F.2d 855,88-2 USTC 85,457 (7th Cir. 1988); G.D. Searle & Co. v. Commr, 88 TC 252 (1987), Hospital Corporation of America
The minus method is used where no acceptable comparable exists and the taxpayer adds little value to a product. This approach begins with an arm's length sales price and deducts an appropriate mark-up to cover the taxpayers costs and earn a profit. By comparison, the cost plus method begins with the cost of the product and adds on an appropriate mark-up.

Where neither the uncontrolled price methods nor the transactional methods can be applied, group profits should be allocated based on a proper remuneration of functions performed by different entities within the corporate group. Possible other methods include some form of profit split analysis, or global methods based on a variety of factors important to a pricing decision, or yield or rate of return analysis.

It has been suggested that whether or not a comparable exists, tax authorities and courts will be concerned about some notion of

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See Information Circular 87-2, supra, paragraphs 15 and 17 for comments on the word "appropriate" in this context.

Press Release 93-003, supra, and Information Circular 87-2, ibid.

Jill C. Pagan and J. Scott Wilkie, supra, at 38. The authors note that these other methods are more directly related to a facts and circumstances review of affected taxpayers, but, as discussed above, are generally denounced by tax authorities and the OECD.
Not only do the recent US court cases suggest at least an underlying sensitivity, if not objective, in this regard, but there are a number of instances where officials of tax authorities have unofficially accepted that the issue of profit split is always present. For example, at an International Fiscal Association Canadian branch conference in May 1991, an official of the Canadian revenue authorities, expressing his remarks as personal views, commented that the standard four tests are perhaps not a productive analytical premise and observed that there may be a tendency to favour some sort of profit split on the basis of "common sense". He suggested, in this connection, that the conventional methodologies may fail to give adequate recognition to elements of integrated operation and that, notwithstanding reservations about a profit split approach, the inadequacies of other methods are driving the analysis in this direction.

Despite the general opposition to a profit split method, in practice it is taken into account by Revenue Canada in evaluating transfer prices:

The most frequently used is the group profit allocation method. Although denigrated internationally (by the OECD), in practice the profit split approach is applied quite frequently... as a last resort. Gross profits realized from the non-arm's length sales to the customer are aggregated and divided amount the related parties. This allocation of profits can be accomplished in a number of ways such as proportion of Canadian sales to group sales or Canadian costs to group costs. It is extremely important that the allocation formula be reasonable and reflect all material facts and circumstances of the case. In addition, it is advisable to have objective evidence such as ... industry profit statistics to support the proprietary allocation.

It appears that Revenue Canada acknowledges that transfer pricing analysis is fundamentally factual and the ultimate purpose of the transfer pricing analysis is to evaluate prices in light of actual economic circumstances with the result being a fair and

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74 *ibid.*, at 94.

75 Revenue Canada auditing guidelines as quoted in Jill C. Pagan and J. Scott Wilkie; *ibid.*, at 109 - 110.
reasonable attribution of group profit among members. The presumption is that a specific, thoughtfully and thoroughly considered and documented commercial transfer pricing strategy is a basis and rationale for intercompany pricing rather than a retrospective explanation or plausible justification to meet Revenue Canada's purposes.  

b. Use of Intangibles

Transfer pricing problems relating to transactions involving use of intangibles are especially problematic due to the unique nature of most intangibles. Comparable transactions are often not available, yet the intangible may be very valuable and profitable so the consequences of pricing are significant. It has been suggested that any attempt to value intangibles by reference to the 

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76 ibid., at 230 - 231. The authors refer to the Revenue Canada view that pricing statements "should be based on a thorough functional analysis of the activities and contribution of each group member and should clarify and quantify the various factors which were considered in establishing the transfer prices. eg. technical assistance, access to technology, reward for economic risk, financing assistance, etc." (Information Circular 87-2, supra, paragraph 15).


78 B.J. Arnold and T.E. McDonnell, supra, at 908. The use of comparables is considered to be the preferred method, but there is disagreement about whether comparables should be viewed broadly or narrowly. In addition, it is difficult for one taxpayer to know the profit potential of another taxpayer's intangible property, the profit potential of intangibles may be attributable to many organizational factors that are difficult to segregate, and if the royalty established for intangible property is too low, should the royalty be adjusted or should a tax be imposed on an imputed gain on the original transfer of the intangible. Revenue Canada requires the use of an arm's length comparable royalty where available (Information Circular 87-2, ibid., paragraph 46).
arm's length principle is unlikely to be workable. In many cases there is no objective economic solution to the intra-corporate transfer pricing problem for intangibles and the allocation of profits within a MNE must be seen as arbitrary.

In the absence of comparable transactions, Revenue Canada expects comparisons with royalty rates in the same industry or a similar industry involving relatively similar products, similar market conditions and similar licensing arrangements. In practice, the transfer pricing method applied will likely be some form of profit split.

The United States transfer pricing regulations specifically allow for the use of a profit split method: the comparable profit method ("CPM"). Unlike the resale minus and cost plus methods,

79 B.J. Arnold and T.E. McDonnell, ibid., at 906. The treatment of intangibles under formulary apportionment also came under scrutiny: "One possibility is to treat intangibles as an attribute of the entire enterprise; therefore, the income from and expenses associated with intangibles would be allocated on the basis of the other factors. Another possibility is to take the costs of developing intangibles into account as assets. Such an approach may be justifiable because the country that allows deductions for the costs of research and development has a legitimate claim to tax the profits of the enterprise attributable to exploiting the intangibles."

80 Donald J.S. Brean, "International Issues in Taxation", supra, at 111.

81 Information Circular 87-2, supra, paragraph 45. The taxpayer should also be prepared to demonstrate the reasonableness of intercompany royalties (paragraph 47).


83 A review of the US transfer pricing regulations is beyond the scope of this paper. Refer to Dora K. Cheng, "Transfer Pricing: U.S Regulations and OECD Discussion Draft Compared", Tax
the CPM allocates income among group members on the basis of comparable profits rather than comparable prices. Use of the CPM is

not acceptable for Canadian tax purposes as it may not generate a transfer price which is in accordance with the arm's length principle.84 Further, the CPM does not account for the relationships between members of an international group and the functions carried on by the members. Finally, double taxation is a possibility with the CPM method, if it is applied by all countries, as the total of the allocations to the various countries could easily exceed the total income of the group.85 Unfortunately, Revenue Canada's position on the CPM may, in itself, lead to double taxation where the IRS reassess a U.S. affiliate company using the CPM rules, and Revenue Canada does not provide a corresponding adjustment.86

iii. Transfer Pricing and Customs Valuation

There is a lack of coordination between customs valuation and transfer pricing on the international scene which has been

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84 Press Release No. 93-003, supra. This would occur where there are factors which make profit performance comparisons defective including: varying cost efficiencies such as differences in age of plant and equipment; differences in the quality of management; differences in the cost of capital where some companies rely substantially on internally generated funds, while others may borrow heavily; and the degree of business experience since mature companies will generally have different results than start-up companies.

85 ibid.. This over taxation could arise because each country would compare results with independent firms operating in its jurisdiction.

86 See section D.) "Consequences of Transfer Price Adjustments" below.
identified, but not remedied. For example, the use of uncontrolled comparables for customs valuation purposes is much more restricted than for transfer pricing purposes. This may result in an arm's length comparable used to set transfer prices for income tax purposes while another method is used for customs valuation purposes. Also, time limits for reappraising value for customs purposes are likely to expire long before an income tax audit even begins. If Revenue Canada reduces the transfer price to the Canadian buyer, a corresponding reduction in customs value may

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87 1994 Draft, Part I, supra, at 171 - 172; Lorraine Eden, "Free Trade, Tax Reform, and Transfer Pricing", supra, at 100 -101; Robert F. Lindsay, supra, at 20:14; Donald J.S. Brean, "International Issues in Taxation", supra, at 105 - 106; G. F. Mathewson and G.D. Quirin, supra, at 15 - 16; and Emilio Romano, supra, at 4 - 5: "The alternative mechanisms that each system provides for the determination of the relevant price in transactions between related parties are different in many respects. Some differences are due to the very nature of the taxable base. An example of this situation is the exclusion of the value of any "assist" provided from the country of importation from the customs value of an imported good. Some other differences could be harmonized, making the customs rules for identical or similar goods, and the resale and reconstructed value criteria, as close as possible to their corresponding tax methods. The integration of income tax pricing adjustments with duties and sales taxes is common in Mexico where direct and indirect taxes, as well as customs duties, are administered by the same authorities... The savings and increased efficiency obtained from such structure are complemented by the ability to make complimentary adjustments on indirect taxes and duties payable by a taxpayer as a consequence of income tax adjustments."

88 B.J.Arnold and T.E.McDonnell, supra, at 906, report that the following questions were raised at the Invitational Conference on Transfer Pricing for future research during a discussion concerning the GATT rules for determining the value of goods for custom purposes: 1. Are there aspects of the GATT rules that could be usefully adopted for income tax purposes? 2. Should the income tax and GATT rules be coordinated in some way; and 3. More generally, can trade considerations assist the development of workable transfer pricing rules. (emphasis added).
not be forthcoming from customs officials and the MNE could be subject to excess taxation.\footnote{Robert F. Lindsay, supra, at 20:15. The Canadian Customs Act, R.S.C. 1985 (2nd Supp), c.1, does not currently permit downward adjustments of valuation for customs purposes after importation where there have been transfer price adjustments (Norman C. Loveland, supra, at 6 and paragraph 48(5)(c) of the Customs Act).}

Revenue Canada's position on this issue is as follows: \footnote{Denis Lefebvre, "Recent Revenue Canada Initiatives", Report of Proceedings of the Forty-Fifth Tax Conference, 1993 Conference Report (Toronto: Canadian Tax Foundation, 1994), 6:1 at 6:8.}

As a result of the integration of both Customs and Taxation into one department coupled with the initiation of the advance pricing concept, we have received a number of inquiries as to whether or not the department would recognize and accept one "valuation" or "price" for both customs and taxation purposes. There are benefits to be gained by our major importing clients (and similarly for those importers in other countries) from the implementation of such an approach. However, there are many points to consider (for example, domestic legislative requirements and international commitments and treaties such as the general agreement on tariffs and trade). Because the implications of being able to secure a "one figure" approach that would satisfy all areas are far reaching, I do not believe that we will be able to arrive at a "quick and simple answer" to this particular issue. (emphasis added)

It is of interest to note the Agreement on Implementation of Article VII (Valuation for Customs Purposes) of the GATT. \footnote{BISD (26 Supp.) 116.} The preamble recognizes the need for "a fair, uniform and neutral system for the valuation of goods for customs purposes that precludes the use of arbitrary or fictitious values" and which is "based on simple and equitable criteria consistent with commercial practices and valuation procedures". Article 7:2(g) specifically
disallows customs values based on "arbitrary or fictitious values". The fact that the buyer and seller are related is not considered, in itself, to be grounds for regarding the transaction value to be unacceptable:

In such case the circumstances surrounding the sale shall be examined and the transaction value shall be accepted provided the relationship did not influence the price. If... the customs administration has grounds for considering that the relationship influenced the price, it shall communicate its grounds to the importer and he shall be given a reasonable opportunity to respond.

The importer only has to demonstrate that the value "closely

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92 GATT, Analytical Index: Guide to GATT Law and Practice, 6th ed., (1994) at 240. The Agreement on Implementation of Article VII of the GATT was signed on April 12, 1979 and entered into force on January 1, 1981. The text of the Agreement and the Protocol appear at 26S/116. The Agreement sets out five acceptable valuation methods, ranked in a hierarchical order: "The primary basis for customs value under the Agreement is "transaction value" as defined in Article 1: 'the price actually paid or payable for the goods when sold for export to the country of importation', subject to certain specified adjustments (eg. the cost of packaging, and royalties related to the goods being valued that the buyer must pay as a condition of sale). When the customs values cannot be determined under the provisions of Article 1, there should normally be a process of consultation between the customs administration and the importer with a view to arriving at a basis of value under Article 2 (transaction value of identical goods) or Article 3 (transaction value of similar goods). When the customs value cannot be determined on this basis, resort may be made to deductive value (Article 5) or computed value (Article 6), at the choice of the importer. Article 7 provides a fall-back method: using reasonable means consistent with the principles and general provisions of this Agreement and of Article VII of the [GATT] and on the basis of data available in the country of importation." There are a number of other specifically disallowed bases for customs valuation including: (a) the selling price in the country of importation of goods produced in such country; (b) a system which provides for the acceptance for customs purposes of the higher of two alternative values; (c) the price of goods on the domestic market of the country of exportation; and (d) the cost of production other than computed values which have been determined for identical or similar goods in accordance with the provisions of Article 6.

93 Article 1:2 of the Agreement on Implementation deals with related parties.
approximates" to any one of four enumerated methods,\(^9^4\) and the methods, or "tests" are to be used at the initiative of the importer and only for purposes of comparison; substitutive values may not be established under these provisions.

To the extent that in the future there is harmonization of valuations for customs and income tax purposes, current prescribed transfer pricing methods which result in arbitrary values being substituted for commercial transfer prices may have to be eliminated, revised, or, at a minimum, applied more flexibly at the option of the MNE, and in a more restricted manner for transfer pricing adjustments at the hands of tax authorities.

iv. Conclusion

The generally accepted methods for determining "the reasonable amount" or arm's length price, do not adequately deal with the economic characteristics of a MNE. MNEs exist to avoid the economic restrictions of independent dealing,\(^9^5\) yet for income tax purposes are effectively penalized by Revenue Canada which ignores this economic reality and imposes an artificial, and in most cases, arbitrary arm's length price.

It is highly unlikely that unconnected parties carry out transactions under exactly the same circumstances as controlled transactions. If they did, the whole economic rationale for a MNE

\(^{9^4}\) The four methods are basically the exact comparable, inexact comparable, resale minus and cost plus methods.

\(^{9^5}\) Jill C. Pagan and J. Scott Wilkie, supra, at 227.
would be in doubt.\textsuperscript{96} Where comparable transactions do exist, a great deal of time and expense is required to make adjustments to inexact comparables in order to arrive at an acceptable price—despite the commercial realities of the arrangement. MNEs may become preoccupied with satisfying tax authorities and end up using a transfer pricing methodology that is commercially ineffective.\textsuperscript{97}

Finally, lack of harmonization of acceptable methods by countries may lead to double taxation, lack of consistent application of acceptable methods may lead to double taxation, and lack of coordination with customs valuations may lead to excess taxation.

Overall, the transfer pricing methods are arguably arbitrary and uncertain (despite their systematic approach), require an unreasonable amount of time and effort to produce and substantiate (by MNEs and taxation authorities), may be redundant or irrelevant for customs valuations (depending on how particular government authorities apply valuation standards), and can leave a MNE open to possible double taxation.

D. What are the effects of transfer pricing adjustments?

Because of problems inherent in valuing intangible property, intangibles are particularly vulnerable to transfer pricing adjustments.\textsuperscript{98} Research and development ("R&D") activities

\textsuperscript{96} ibid., at 27.
\textsuperscript{97} ibid., at 28.
\textsuperscript{98} The sensitivity to potential tax leakage due to underlying technology transferred abroad is seen in the US super-royalty provisions of the 1986 Tax Reform Act (Pub.L. no. 99-514, 100 Stat.
conducted in a high tax country with substantial tax incentives for R&D, followed by licensing of all rights to the technology or product to a company located in a low tax country with a large tax treaty network, is a likely situation for a transfer pricing adjustment dispute.\textsuperscript{99} Computer software licensing agreements have also been identified as being highly vulnerable to the imposition of transfer pricing adjustments by the tax authorities of various countries due to problems inherent in valuing computer software.\textsuperscript{100} Indeed, one of the major issues faced by both foreign and Canadian developers in cross-border licensing situations is attacks by the tax authorities on the quantum of the royalty set between related parties.

A further problem arises with the U.S. transfer pricing rules which allow the IRS to make periodic adjustments of predetermined prices of intangible property under agreements for more than one year in order ensure that such prices are "commensurate with the income" earned for the use of such property. Where the income


earned or cost savings exceed 20% of the amount estimated at the time the agreement was entered into, the agreed upon price will be adjusted.\(^{101}\) Canada considers this approach to be in contradiction of the arm's length principle to the extent that it involves a yearly retrospective reappraisal of profits.\(^{102}\) Revenue Canada will not generally provide a corresponding adjustment in cases where such a periodic adjustment is made\(^{103}\) with the following consequences:\(^{104}\)

Unilateral transfer-pricing adjustments, which increase the profit of one company and do not reduce the profit of the other company correspondingly, may result in double taxation.

As a transfer pricing adjustment may well be in excess of what treaty partners of the United States regard as an arm's length amount under their transfer pricing rules, even the

\(^{101}\) Press Release 93-003, \textit{supra}.

\(^{102}\) B.J. Arnold and T.E. McDonnell, \textit{supra}, at 908. Canada's view is in line with the OECD. Periodic adjustments are also considered to be tantamount to disregarding the contractual arrangement entered into by the parties, though others argue that arm's length parties would not ordinarily transfer valuable intangibles or would provide for a variable royalty.

\(^{103}\) Press Release No. 93-003, \textit{supra}, "Backgrounder". Where this happens, taxpayers may seek relief through competent authority procedures (see Article XXVI and the Canada-U.S. Tax Convention and Information Circular 71-17R3, "Requests for Competent Authority Consideration - Double Taxation Issues"); The Canadian rules suggest that periodic adjustments not contemplated in a user contract probably are not consistent with the arm's length test and a functional analysis that depends upon knowledge of a counter-party's profits may be inconsistent with the pricing behaviour of unrelated parties (Jill C. Pagan and J. Scott Wilkie, \textit{supra}, at 116). See also B.J. Arnold and T.E. McDonnell, \textit{supra}, at 915. Mexico is also of the view that retrospective adjustments on payments made between associated enterprises for the use of intangibles in order to make them "commensurate with income" should not be applied (see Emilio Romano, \textit{supra}, at 6 - 7).

"corresponding adjustment" provisions in tax treaties may not fully remove the risk of double taxation.

Therefore, an upward transfer price adjustment by the IRS will result in double taxation unless Revenue Canada grants a compensating adjustment. The Canada-U.S. Tax Convention provides a measure of protection against double taxation by providing that the other treaty partner shall make a compensating adjustment if it agrees with the transfer pricing adjustment that was made.\textsuperscript{105} There is no guarantee that such adjustments will be made and in cases where large compensating adjustments are requested, there is likely to be substantial resistance due to the corresponding loss of tax revenue.\textsuperscript{106}

Where these treaty provisions are not sufficient to resolve a dispute between interested parties, the taxpayer may request competent authority consideration under the mutual agreement

\textsuperscript{105} Canada-U.S. Tax Convention, Article IX:3. Jill C. Pagan and J. Scott Wilkie, \textit{supra}, at 29; and 39: Tax treaties can impact on transfer pricing in the following ways: First, they can define a particular basis for allocation of income and through the treaty network facilitate agreement on an international standard. Second, they can identify the transactions to which the basis will apply. Third, they can provide for resolution of disputes. Finally, they can provide a method for mutual assistance between the tax authorities involved.

\textsuperscript{106} \textit{Ibid.}, at 170. The authors also discuss the importance of considering well in advance whether a compensating adjustment will likely be required when involved in a transfer pricing dispute (at 181 - 182). For example, it may be important to avoid having the arm's length price issue determined by the courts as such determination may severely restrict the flexibility of the tax authority in that country when seeking compensating adjustments from the foreign tax authority. Limitation periods must also be borne in mind, however, as it may be necessary to commence certain actions in order to keep open access to all dispute resolution avenues.
article.\textsuperscript{107} The mutual agreement procedure requires the competent authorities, which have broad, discretionary powers,\textsuperscript{108} to consider the case and resolve it in a manner that will avoid double taxation.\textsuperscript{109} However, the countries are only required to endeavour to reach agreement, it is not mandatory that they do so. Even if an agreement is reached, it can take many years to conclude.\textsuperscript{110} Finally, the taxpayer is not directly involved in the discussions between the competent authorities, which usually deal with more than one case at a time. Therefore there is concern that issues affecting one taxpayer may be bargained away in order to settle the issues affecting other taxpayers.\textsuperscript{111}

Although the competent authority provisions have generally worked well in the Canada/U.S. context, concerns have arisen over delays in reaching decisions and it is believed that under NAFTA, the number of transactions between members of a MNE will likely be

\textsuperscript{107} Information Circular 87-2, \textit{supra}, paragraph 52. Also see Information Circular 71-17R3, \textit{supra}, for a more detailed discussion of the procedures and acceptability of requests for competent authority consideration.

\textsuperscript{108} Emilio Romano, \textit{supra}, at 8.

\textsuperscript{109} See also Article XXV of the OECD Model. Article 2103 of the NAFTA establishes the priority of bilateral tax conventions in income tax matters generally. For a European perspective on the EEC Arbitration Convention for elimination of double taxation arising from transfer pricing adjustments, see Pilar Moina Gomez-Arnau, "Spanish Rules on Transfer Pricing", (Winter, 1995) 21 \textit{The International Tax Journal} 1, 15 - 30.

\textsuperscript{110} Jill C. Pagan and J. Scott Wilkie, \textit{supra}, at 183. See also pages 214 - 218.

\textsuperscript{111} B.J. Arnold and T.E. McDonnell, \textit{supra}, at 916.
of such a magnitude as to require changes to the existing regime.\textsuperscript{112}

Additional concerns arise under the "Exchange of Information" articles between contracting parties.\textsuperscript{113} The tax authorities have access to confidential information which could be of interest to a taxpayer's commercial rivals. Yet, in most cases the taxpayer has no right to be advised in advance of an exchange of that information and is open to the risk that the tax authorities will disclose commercially sensitive information.\textsuperscript{114} Furthermore, when Revenue Canada bases its assessment of arm's length prices on information obtained from third parties, it is unlikely that the taxpayer will have access to that confidential information until legal proceedings have commenced.\textsuperscript{115}

In conclusion, transfer pricing adjustments lead to a very real risk of double taxation which the existing dispute settlement

\textsuperscript{112} See Norman C. Loveland, \textit{supra}, at 5 - 6; and Jill C. Pagan and J. Scott Wilkie, \textit{supra}, at 26 regarding tax authorities generally devoting more time and resources to dealing with transfer pricing inquiries.

\textsuperscript{113} Article XXVII of the Canada-U.S. Tax Convention.

\textsuperscript{114} Jill C. Pagan and F. Scott Wilkie, \textit{supra}, at 19; Germany is one of the few countries which provides that the taxpayer has a right to be advised in advance of an exchange of such information. The authors review international pressures and developments regarding exchange of information (at 20).

\textsuperscript{115} Revenue Canada will seek written permission from the third parties to disclose the information to the taxpayer involved, but if permission is not granted, disclosure is prohibited under section 241(1) of the ITA until legal proceedings have commenced (\textit{Information Circular 87-2, supra}, paragraph 48). Also see \textit{Amp of Canada, Ltd. v. Her Majesty the Queen}, 87 DTC 5157 (FCTD) and \textit{Crestbrook Forest Industries Limited v. Her Majesty the Queen}, 91 DTC 5521 (FCTD), 92 DTC 6187 (FCA).
procedures may not alleviate. Further, MNEs have to contend with risk of disclosing their own confidential information to support their transfer price while having restricted access to confidential information in the tax authority's hands.

E. Compliance and Prevention

This section briefly reviews the main compliance requirements and preventative measures that arise in a cross-border transfer pricing situation.

i. Compliance

There are two aspects to compliance: a) the reporting requirements placed on the taxpayer and corresponding ability of the taxpayer to be able to obtain the necessary reporting information; and b) penalties for non-compliance or under-reporting of income.\(^\text{166}\)

Form T106, "Corporate Information Return of Non-arm's Length Transactions with Non-resident Persons", requires certain basic information be filed for reporting non-arm's length activities between Canadian corporation taxpayers and non-resident persons.\(^\text{167}\) The form is required whenever a Canadian corporate


\(^{167}\) The form is required to be filed pursuant to section 233.1 of the ITA. See B.J.Arnold and T.E. McDonnell, \textit{ibid.}, at 913-914 for a discussion on information requirements for transfer pricing
taxpayer has any non-arm's length transactions with a non-resident person. The form must be filed within six months from the end of each taxation year, separate from the corporation income tax return. A separate T106 must be filed for each non-resident person with which the reporting corporation engaged in non-arm's length transaction during its taxation year. Although the form is not particularly onerous, it does impose a burden which is not required in a similar domestic situation, and which gives Revenue Canada a useful tool in identifying potential audit areas.

There are penalties for failure to file the T106 form. In addition to the penalties for failure to file an information return, every corporation that fails to file, and does not comply with a demand to file within 90 days after the demand was served, is liable for a penalty of $1,000 for each month or part of cases.

Including transactions for which there was a non-monetary or nil consideration.

Companies are also encouraged to contemporaneously document the basis for selecting a transfer pricing method and the steps taken in establishing a price. (Press Release 93-003, supra, "Backgrounder"). See also B.J. Arnold and T.E. McDonnell, supra, at 914 for a discussion of various "unreasonable" and "unproductive" reporting requirements including contemporaneous documentation and pre-filing of additional transfer pricing information at the audit level; and 1994 Draft, Part II, supra, Chapter VIII regarding problems with and guidelines for documentation requirements.

Subsection 162(10).

Under subsection 162(7), a taxpayer is liable for a penalty equal to the greater of $100 or $25 multiplied by the number of days (not exceeding 100), during which the failure continues, for failure to file an information return. The penalty applies in respect of each failure, so if multiple forms are required, the penalty applies to each form which was not filed.
a month, not exceeding 24 months, during which the failure continues. This penalty has no application other than in the cross-border context.

Penalties may also be exigible relating to under-filing of taxable income.\footnote{Subsection 163(2) applies to false statements or omissions. See also Jill C. Pagan and J. Scott Wilkie, supra, at 71.} Although such penalties also apply in a purely domestic context, the MNE is at a disadvantage due to application of the arm's length standard. Since the "reasonable amount" is a matter of opinion, it is questionable whether a taxpayer should be liable for penalties if an increase in taxable income is the result of an adjustment even though the original price could reasonably be argued to be at arm's length. The application of transfer pricing penalties may produce an incentive to overstate income in the jurisdiction levying the penalty causing distortions in what may otherwise be an appropriate transfer price.\footnote{See Norman C. Loveland, supra, at 4; U.S. transfer pricing penalties which create an incentive to overstate U.S. income and understate Canadian income (also 1994 Draft, Part II, supra, at paragraph 141). See Carlton M. Smith, "New US Transfer Pricing Penalty Regulations Require Contemporaneous Documentation of Pricing Decisions" (1994), 42 Canadian Tax Journal 4, 1136, for further information on US penalty regulations.} These concerns do not arise in the domestic context.

Interest charges may apply to any additional taxes levied as the result of a transfer pricing adjustment. This is problematic in that the taxpayer has not necessarily had the use of the money for the period that interest is being charged; rather another tax authority has had use of the money. Even assuming a corresponding
adjustment will eventually be agreed upon, a MNE may be penalized by a lack of symmetry in interest provisions between the two tax authorities concerned.\textsuperscript{124}

ii. Prevention

Revenue Canada has set out the following guidelines to avoid transfer pricing problems with the Department:\textsuperscript{125}

10. To the extent possible, taxpayers are encouraged to design their intercompany pricing so that, for example, a product is transferred at a reasonable arm's length price for the product itself, and if there are also benefits or services being transferred, as is common in the operations of a multinational group, each is identified as a separate transfer and is subject to a separate evaluation and intercompany charge. A separate identification and valuation of the various products and services will not only facilitate the audit of international transactions but will also, where an income tax treaty or convention is in force, assist the treaty partners in their negotiations to avoid double taxation.

11. If the above approach is not practical or proves unrealistic in terms of the manner in which the particular industry conducts its business, then the taxpayer should be prepared to provide, in a comprehensive statement of intercompany pricing policy, the basis on which transfer prices are established worldwide. Such a statement should be based on a thorough functional analysis of the activities and contributions of each group member, and should clarify and quantify the various factors which were considered in establishing the transfer prices, e.g. technical assistance, access to technology, reward for economic risk, financing, etc. (emphasis added)

Section 15(53)9.5(1) of the Revenue Canada Operations Manual also indicates the importance of a pricing plan and the burden on

\textsuperscript{124} See Jill C. Pagan and J. Scott Wilkie, supra, at 72 - 73. The authors note that the basis for charging interest in the first place is that the taxpayer has had the use of the money for the extra period and it is not unreasonable to expect the tax authority to be compensated in the form of interest.

\textsuperscript{125} Information Circular 87-2, supra.
the tax authority to also provide detailed documentation: \(^1\)\(^2\)\(^6\)

The taxpayer is usually considered expert in his own business. He need only establish a prima facie case that the intercompany pricing arrangements are reasonable and the onus then falls on the Minister to prove otherwise. Therefore, any adjustments of intercompany prices must be very well documented, researched and supported by evidence. (emphasis added)

Therefore, the key to prevention appears to be in well supported, extensive documentation of transfer pricing methods which is resource intensive and expensive, especially for large MNEs, \(^1\)\(^2\)\(^7\) and for taxation authorities.

Another way to prevent transfer pricing disputes is through the advance pricing agreement ("APA"). An APA is an advance binding agreement between a company and the government of Canada \(^1\)\(^2\)\(^8\) on the acceptability of the pricing methodology to be used by the company. \(^1\)\(^2\)\(^9\) The purpose of this type of advance ruling has been described as an opportunity for the taxpayer to convince the tax authority that its commercial pricing policy is sensitive to fair income allocation among the countries concerned and is not a

\(^1\)\(^2\)\(^6\) As reproduced in Jill C. Pagan and J. Scott Wilkie, supra, at 84 - 85.

\(^1\)\(^2\)\(^7\) ibid., at 18.

\(^1\)\(^2\)\(^8\) And perhaps between the governments of one or more other countries.

\(^1\)\(^2\)\(^9\) Press Release 93-003, supra, "Backgrounder"; and Draft Information Circular, "International Transfer Pricing: Advance Pricing Agreements (APA) Procedures and Guidelines", May 21, 1993 ("Draft Information Circular"); see 1994 Draft, Part II, supra, paragraphs 234 - 276 regarding APAs, their advantages and disadvantages and the overall conclusion that it is too early to make a final recommendation on whether the use of APAs should be expanded (at paragraph 272).
candidate for an adjustment under the transfer pricing provisions.\textsuperscript{130} APAs are also restricted to future specified non-arm's length transactions for a specified period of time.

Revenue Canada announced the APA program on July 29, 1993\textsuperscript{131} and began consulting on draft guidelines.\textsuperscript{132} Key differences

\textsuperscript{130} Jill C. Pagan and J. Scott Wilkie, \textit{supra}, at 206. The purpose is not to strike a "deal" on pricing policy. Draft Information Circular, \textit{supra}, states the purpose of APAs: "to promoted voluntary compliance, uniformity and self-assessment by providing taxpayers with specific guidelines on how transfer pricing methods are to be determined and applied."


\textsuperscript{132} See Denis Lefebvre, \textit{supra}, at 6:7 - 6:8. See also Jill C. Pagan and J. Scott Wilkie, \textit{supra}, at 198 - 205 for general procedures on obtaining and administering APAs; and Kathleen Matthews, "U.S. and Canadian Officials Discuss APAs in the Global Trading Context", \textit{Tax Notes International}, May 23, 1994, 1362 for general comments on APAs. It is of interest to note that, with reference to Chapter 4, the issue of characterization of software
between the APA procedure and the normal transfer pricing audit include:\textsuperscript{133}

\ldots the abandonment of adversarial attitudes, a reliance on the veracity of material submitted, and the need to consider future events and projections as well as historical data. Our experience during the pilot project cases was one of consultation and cooperation among all parties, including taxpayers, national and district tax representatives, legal counsel, and the competent authorities.

According to Revenue Canada, the Department is committed to the APA concept and has received favourable feedback and a high level of interest from clients; the Department anticipates that the level of requests for bilateral and multilateral APA's "will surpass our initial expectations".\textsuperscript{134}

There are a number of possible advantages in using the APA procedure. APAs can potentially limit costly and time consuming transfer pricing disputes, double taxation, and penalties, when MNEs address these pricing policy issues in advance of the transactions. Even if a transfer pricing dispute does not arise,

\textsuperscript{133} Denis Lefebvre, \textit{ibid.}, at 6:8. For a description of the APA process in Canada, refer to \textit{Draft Information Circular}, supra.

\textsuperscript{134} Denis Lefebvre, \textit{ibid.}, at 6:8. There were originally two pilot cases and by late 1993 Revenue Canada was actively pursuing 7 cases covering a wide range of industries from computer distribution to financial institutions. As of August, 1994 there were 16 Canadian APAs in process, 15 involving the United States (see John Turro, "U.S. Tax Officials Brief ABA Tax Section's International Committees", \textit{Tax Notes International}, May 23, 1994 at 1366 and Norman C. Loveland, \textit{supra}, at 7). As of August, 1994, Mexico had received 8 unilateral APA requests, several of which are anticipated to become bilateral when finalized (Emilio Romano, \textit{supra}, at 6).
any audit by Revenue Canada would likely be simplified. Further, a measure of certainty is achieved regarding the MNEs transfer pricing method, which should facilitate business planning.

However, there are several problems with APAs. APAs are not always practical for transactions with a short-term commercial life, or for companies which do not have the time or resources to compile and negotiate and APA. Disclosure of information that would not normally be disclosed could be problematic in cases of controversial or aggressive pricing structures in the transaction under review, previous transactions, or transactions with an

135 See Norman c. Loveland, ibid., at 7; Jill C. Pagan and J. Scott Wilkie, supra, at 205 - 206 for the following suggestions as to when an application for an APA may not be in the taxpayers best interests: 1. a taxpayer has an exceptionally strong case that the pricing policy meets the arm's length criteria (in which case it is unlikely to be cost-effective to use the APA procedure); 2 a low or no-tax country is involved (as the home tax authority may not be easily satisfied); 3. the transactions and pricing structure are extremely complex and of short to medium term duration; 4. the tax authority has insufficient resources to process the application within a reasonable period of time; 5. the taxpayer is pursuing a tax aggressive pricing policy; and 6. the transaction is one of a certain kind which is currently being litigated in another case. On the other hand, an APA may be appropriate in the following cases: 1. a taxpayer has a good, but not indisputable, case that its pricing policy should be acceptable; 2. the transactions involve two countries which take an aggressive stance on transfer pricing and competent authority proceedings could be expected to be instigated; 3. the transactions are extremely integrated and incapable of easy allocation on a country-source basis of profit apportionment; 4. the transactions have a long-term life; and 5. certainty of taxation implications is of particular importance.

136 Carole Gouin, Director General, International Tax Programs Directorate, in an address to the ABA Tax Section, conceded that the concern for most corporations considering entering into an APA regarding the opening of books for prior years was valid. She noted that Canadian auditors responsible for a company's file are part of the APA team and "won't close their eyes" and issue a blank check governing prior years (as reported in John Turro, "U.S. Tax Officials Brief ABA", supra, at 1367). Also, several levels of
otherwise high degree of confidentiality. As Revenue Canada can only process a limited number of APAs in a given time period, there is no guarantee an APA will be reached even if the MNE has a transaction which is a suitable candidate for an APA. If APA negotiations do proceed but are abandoned or unsuccessful, the taxpayer will have expended substantial resources\textsuperscript{137} and potentially compromised its position in any litigation that may result\textsuperscript{138}. Further, if the APA is accepted, onerous annual reports must be filed, yet the taxpayer is still open to being audited, and Revenue Canada may cancel an APA at any time and disclosure may ensue (ie. Revenue Canada, foreign tax authorities, and foreign tax authorities to foreign tax payers, their treaty partners and the public), as well as disclosure to Revenue Canada of issues that may never have arisen in the course of a normal audit and to foreign tax authorities of issues that may never have arisen in the course of a normal foreign audit (see Janice A. McCart, \textit{supra}, 40:29).

\textsuperscript{137}The taxpayer will have to spend considerable internal resources in order to compile the information required for an APA. Further Revenue Canada will levy a user charge for each APA request or renewal and the taxpayer is required to absorb the cost of independent experts. See \textit{Draft Information Circular, supra}. See also Nathan Boidman, "The Role of Advance Rulings in International Transfer Pricing", \textit{supra}, at 1564; and "Foreign Income, s.482 - Special Problems", v. 116 \textit{Tax Management Inc.}, Dec. 16, 1991 (Washington D.C.: BNA, 1991), at 64 - 116, which discusses the United States APA process and substantially similar problems to those outlined here, but in the U.S. context.

\textsuperscript{138}The taxpayer is required to provide a detailed explanation and analysis of each proposed transfer pricing method including extensive and detailed information about the applicant (history, organizational structure, nature and scope of operations, transaction flows, relevant financial and tax data). In addition, information used to establish the transfer pricing methodology has to be submitted including functional analyses, profitability measurements, economic studies, general industry trends, and available information on competitors and comparable or similar businesses (\textit{Draft Information Circular, ibid.}).
retroactively under certain conditions.\textsuperscript{139} It is also worthwhile to consider the ramifications of the possibility that Revenue Canada's view will have significant influence in commercial pricing decisions; APAs may recognize or ignore the existence and legitimacy of transfer pricing rules in reaching a particular pricing agreement. Clearly, APAs should not be viewed as a substitute for developing a sound transfer pricing system.\textsuperscript{140}

iii. Conclusion

Advance pricing agreements, compliance measures (recommended and required), penalties, and interest add up to a system which encourages MNEs to address potential transfer pricing transactions well in advance of, or contemporaneous with, the time the transactions are undertaken. Although this regime may have beneficial effects from an internal accounting and corporate management perspective, such compliance and prevention measures require an extensive amount of complex documentation. Experts may

\textsuperscript{139} Draft Information Circular, ibid. Annual reports must describe actual operations for the year and demonstrate the extent of compliance with the terms and conditions of the APA. Audits will not reevaluate the transfer pricing method itself, but focus on establishing if taxpayers have complied with the terms and conditions of the APA, and the reliability and accuracy of the representations in the APA and annual reports. They will also test the accuracy and consistency of how the transfer pricing method is applied along with the supporting data, and the continuing relevance and soundness of critical assumptions. An APA can be cancelled if, for example, there is fraud or misrepresentation in providing information during the APA process, or if the taxpayer fails to comply with the terms and conditions of the APA.

\textsuperscript{140} See Jill C. Pagan and J. Scott Wilkie, \textit{supra}, at 185 - 187. The authors also set out examples of actual APAs at 187 - 193. The 1994 Draft, Part II, \textit{supra}, sets out a number of additional potential problems with APAs at paragraphs 258 - 270, including problems from the tax authority's perspective.
be required to assist in preparing this information, and it can be problematic obtaining the necessary comparable data. Time and resources that could otherwise be spent on business operations are incurred by MNEs to satisfy the tax authorities even when the MNE has not been motivated by tax avoidance considerations.\textsuperscript{141}

GATT Article VIII, "Fees and Formalities Connected With Importation and Exportation", recognizes the need for minimizing the incidence and complexity of import and export formalities and for decreasing and simplifying import and export documentation requirements. Although this Article may be viewed as applying only to customs formalities, it does recognize that documents and documentation can pose a potential barrier to trade. It is suggested that the transfer pricing documentation requirements outlined above may well be a significant barrier to intra-firm trade in many cases.

\textbf{PART III}

\textbf{JUSTIFICATION FOR DISCRIMINATION AND ALTERNATIVES}

\textbf{A. Summary of Discrimination of the Transfer Pricing Regime}

The very nature of transfer pricing, rooted as it is in anti-avoidance, has developed in such a way as to bias the existing regime against MNEs and in favour of the tax authorities. The following is a brief summary of such discrimination as identified

\textsuperscript{141} 1994 Draft, Part I, \textit{supra}, at 157: "In the case of MNEs, the need to comply with laws and administrative requirements that may differ from country to country creates additional problems. The differing requirements may lead to a greater burden on an MNE, and result in higher costs of compliance, than for a similar enterprise operating solely within in single jurisdiction."
above:

1. The ITA rules *prima facie* discriminate against MNEs by applying differently to nonresident-resident transactions than to resident-resident transactions.

2. International transfer pricing rules apply to a wider range of transactions than similar domestic rules.

3. The ITA rules are drafted in such a way that the only transactions potentially affected are those where transfer pricing adjustments lead to an increase in the domestic tax base.

4. The arm's length principle, which underlies the transfer pricing regime, ignores the very essence of MNEs by treating each member as an independent entity.

5. Use of the prescribed transactional methods (comparable uncontrolled price / royalty, resale minus, and cost plus) are often not applicable or achievable, and can produce arbitrary results.\footnote{142} This is particularly problematic for intangibles.

6. Lack of coordination between transfer prices and customs valuations can result in different valuations for different purposes which is illogical and unfair as it can result in duplication of work, arbitrary values, excess taxation, and uncertainty for the taxpayer.

7. The compensating adjustment procedures do not go far enough in preventing double taxation which can create an impediment

\footnote{142} Donald J.S. Brean, "Financial Dimensions of Transfer Pricing", in A. Rugman and L. Eden, eds., *supra*, at 149.
8. Compliance requirements, advance pricing agreements, penalties and interest impose tremendous burdens on time, information systems, experts, and compliance costs on both the taxpayer and tax authority.

B. Justifiable Discrimination?

Even if transfer pricing rules discriminate against non-residents, any such discrimination may be justifiable if the transfer pricing rules are rationally connected to a national objective and that national objective outweighs the global objective of free trade. It is submitted that although the transfer pricing rules are clearly connected with the national objective of maintaining the domestic tax base, there is some doubt as to whether this goal can be said to outweigh the objective of facilitating free trade, particularly when Canada continues to expand its international free trade commitments.

It is worthwhile to recall from Chapter 1 the two premises on which free trade is based: 1. the most efficient use of resources will be achieved if trade is free of arbitrary interventions by individual governments (the free trade objective); and 2. the preservation of sovereign rights is essential for increasing the welfare of the citizens of the nations concerned (the national

In this case, MNEs seek to allocate resources efficiently, and set transfer prices accordingly, without arbitrary intervention by legislation including transfer pricing legislation. On the other hand, the main objective of the transfer pricing regime is to secure the domestic tax base by ensuring that MNEs are not able to manipulate transfer prices in order to shift taxable profits out of Canada.

In face of Canada's mounting national debt, the importance of maintaining Canada's tax base is self-evident. However, the objectives of maintaining domestic tax bases and of promoting free trade do not necessarily conflict. Presumably businesses which thrive under a free trade regime will have increased profits which will increase the tax base. MNEs which operate profitably in Canada, create jobs and stimulate the domestic economy, thereby creating additional tax revenues from a number of sources in addition to tax revenues from the MNE itself. Transfer pricing legislation may have the unintended effect of ultimately reducing the tax base if MNEs pull operations out of, or do not establish operations in, Canada. Furthermore, if the costs of administering and enforcing transfer pricing legislation outweigh the tax revenues preserved, the legislation does not promote either objective. Consider the following:

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144 The sovereign right under review is the legitimate right of the government of Canada to tax the profits of a taxpayer based upon income and expense that can reasonably be considered to arise within Canada. See the 1994 Draft, Part I, supra, at 157.

If one powerful country in the world economy decides to go it alone and investigate every cross-border transaction of MNEs within its tax jurisdiction, then all the other countries would be forced to apply their transfer pricing provision with equal force; failure to do so would result in a loss of their fair share of taxation on all cross-border transactions involving that country. However, reciprocity [stepping up the application of transfer pricing when an entity in the aggressor country is involved] cannot be a large-scale or long-term international solution. It would mean discrimination against all MNEs with operations in the country which applied the aggressive stance. Not only is discrimination in direct contravention of the tenet that a taxation system must be operated even-handedly, but it could also be against the national interest of those countries which encourage foreign investment.

... in the final analysis a highly aggressive approach is unlikely to be in any country's interest. Compliance costs could well exceed the marginal tax revenue and there could be a consequent effect in limiting benefit from the global economy. MNEs in general might be inclined to concentrate investment in countries without an aggressive enforcement policy and MNEs based in the aggressor country would be at a competitive disadvantage in world markets because of harsher tax treatment. (emphasis added)

It has also been suggested that preservation of the tax base through transfer pricing legislation (the national objective) may not be economically efficient (the free trade objective):\(^{146}\)

The MNE itself regards international tax rate differentials and exchange controls imposed by nation states as exogenous market imperfections to which transfer pricing is a legitimate internal response. On the other hand, nation states view the power to manipulate transfer prices as a method of evading legal obligations, thus eroding national sovereignty.

It is clear that most of the contributors to this volume would

\(^{146}\) A. Rugman and L. Eden, eds., supra, at 9 - 10 also note, however, that some authors are of the opinion that without international harmonization of government tax, commercial and regulatory policies, regulation of transfer pricing is necessary on efficiency grounds. The various studies presented, demonstrate that unregulated transfer prices may be either more or less efficient than regulated ones. Even though a clear efficiency rationale does not exist, some contributors view transfer pricing regulation to be necessary on distributional grounds.
agree that, in the presence of natural market imperfections but in the absence of government induced market imperfections, transfer pricing is efficient, and therefore regulation, on efficiency grounds, is unnecessary.

Therefore, it is reasonable to conclude that the protectionist national objective does not, and should not, outweigh the free trade objective.

C. Alternatives

Even if the transfer pricing rules are rationally connected to the national objective, and if the need to preserve the tax base does outweigh that of facilitating free trade for MNEs, there are alternatives to enable Canada to achieve the national objective, while alleviating some of the discriminatory aspects of the transfer pricing regime and facilitating MNE operations in the global economy.

The focus in this section is on the general nature of transfer pricing and on points 4 through 8 summarized above. The following brief comments apply to points 1 through 3.

First, although the ITA provisions prima facie discriminate against MNEs, the provisions are not in violation of Article 24:5 of the OECD Model ("Nondiscrimination") since that provision is subject to specific exceptions for transactions between related parties.\textsuperscript{147} The existence of a provision which differentiates

\textsuperscript{147} Canada has reserved its position on Article 24 in any event. (see OECD Model, Article 24 Commentary, paragraph 61). There is similarly no breach of Article XXV:7 of the Canada-US Tax Convention. The Canada-U.S. Tax Convention is the only Canadian tax treaty that contains a provision comparable to OECD article 24(5); ordinarily treaties expressly recognize transfer pricing by related parties as an exception to the non-discrimination article (B.J. Arnold, "Tax Discrimination Against Aliens, Non-residents, and
between residents and non-residents is not necessarily overly protectionist; it is the application of the provision which can be problematic. On the second point, the fact that the international transfer pricing rules apply to a wider range of transactions than similar domestic provisions can also be justified to the extent that domestic transactions are taxed under other provisions in the ITA. Finally, is the fact that the only transactions which are potentially affected are those where transfer pricing adjustments increase the domestic tax base. This discrimination can be justified in that there is little real risk of MNEs being penalized by adjustments which increase profits in Canada, without obtaining adjustments initiated by the Canadian tax authorities to reduce profits in Canada. This is likely to be the case due to the interests of other jurisdictions in maintaining their tax bases, and seeking transfer pricing adjustments which would decrease profits in Canada, if a compensating adjustment was permitted.\footnote{148}

On the other hand there are several suggestions for other aspects of the transfer pricing regime which may benefit both MNEs and tax authorities.

Fundamentally there is need to reach international agreement on the role of transfer pricing in the global economy. Tax

\footnote{148 The problem which remains, however, is when these compensating adjustments are not forthcoming. The compensating adjustment mechanism is discussed below.}
avoidance is not always at the centre of MNE pricing policies and transfer pricing must lose its tax avoidance taint if it is to mature successfully and relate to a global economy.\textsuperscript{149} This shift to a global focus from a national focus is key to developing a transfer pricing framework which reflects global commercial realities.\textsuperscript{150}

A broader meaning of arm's length could alleviate some of the difficulties within the existing regime by providing for maximum flexibility.\textsuperscript{151} Already acceptance of an arm's length range, rather than a specific arm's length price, has been recommended by the OECD in the 1994 Draft. Also, a wider range of methodologies, such as profit split methods, could be viewed as acceptable within


\textsuperscript{150} Jill C. Pagan and J. Scott Wilkie, \textit{ibid.}, at 27; a national perspective uses methodology for establishing individual transaction profit whereas a global perspective focuses on consolidated results. This is particularly pertinent where certain functions of an MNE are so globalized or centralized that there is no acceptable method of allocating revenues and expenses on a national basis yet the national tax system forces allocation of national profit on a basis which does not follow economic reality. The authors note that although there are still taxpayers who may be trying to obtain a tax advantage by pricing strategies, it can be argued that a firm stand against those taxpayers may encourage MNEs to be more responsible in this area.

\textsuperscript{151} \textit{ibid.}, at 30. For example, the United Kingdom and the Netherlands take an extremely businesslike approach to arm's length and transfer pricing. Transfer pricing reviews proceed by analyzing the transaction and accepting what on reasonable evidence appears to be a fair price. An agreement is struck and compliance costs are kept within reason. On the other hand, the United States approach has been to collect maximum tax regardless of compliance cost and apply the arm's length criteria on the basis of strict and complex methodology.
a broader conception of arm's length. This would be a step in overcoming problems associated with using methodologies which ignore the realities of the integrated global economy:  

Integrated international operations have an economic rationale viewed in totality; by their very nature they are incapable of rational division into the non-interdependent transactions that conventional transfer pricing methodologies rely on.

... No matter how much objective or scientific rule formulation is imposed by national tax systems, the key is functional analysis on an individual facts and circumstances basis... The difference is that, where integrated operations are concerned the three conventional methods [comparable uncontrolled price, resale price and cost-plus] are not an end in themselves, but merely a point of departure exemplary or indicative of possibly useful guidelines.

The 1994 Draft recognizes the use of profit methods in cases where data is not adequate to apply transaction-based methods reliably. If the objective of transfer pricing is to allocate income of a MNE between competing nations, a functional analysis of each member's contribution in terms of reward for risk and economic contribution should be recognized by tax authorities. When profit split methods are based on facts and circumstances, this functional analysis can be argued to be within the wider definition of arm's length and reflect the integrated nature of MNEs.

The compensating adjustment and dispute resolution process

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152 ibid., at 101-102. The authors discuss this issue further at pages 99 - 102.

153 1994 Draft, Part I, supra, at 179 - 185. The profit split and comparable profit method are discussed, but are still generally discouraged and there are "substantial concerns" with the comparable profit method in particular.

154 Jill C. Pagan and J. Scott Wilkie, supra, at 41.

could also benefit from revisions to eliminate the possibility for double taxation. Competent authorities should be required to reach agreement within a specified time frame. In the event that agreement is not reached, binding arbitration may provide a more workable, and equitable, alternative to the present treaty system for disputes: \textsuperscript{156}

As tariffs are being eliminated and foreign investment restrictions are being lifted throughout the world, additional harmonization is becoming more and more important. In this context, binding dispute mechanisms will have to be introduced. International cooperation in tax matters is in its initial stages and will have to adapt itself to a highly integrated world economy.

Efforts should also be made to harmonize customs valuations and transfer prices, review the need for penalties on transfer pricing except in abusive cases, and ensure that interest is deductible on payment of tax assessments in transfer pricing cases. \textsuperscript{157}

\textsuperscript{156} Emilio Romano, \textit{supra}, 8; Mexico approves of arbitration as a means to avoid double taxation. Also see B.J. Arnold and T.E. McDonnell, \textit{supra}, at 916 - 919; Janice McCart, \textit{supra} at 40:32 - 40:38; Jill C. Pagan and J. Scott Wilkie, \textit{supra}, at Chapter 7; and Carl S. Shoup, "International Arbitration of Transfer Pricing Disputes Under Income Taxation", in A. Rugman and L. Eden, eds., \textit{supra}, at 291 - 309. 1994 Draft, Part II, \textit{supra}, at paragraphs 277 - 281 recommends that it is "appropriate to analyze again and in more detail whether the introduction of a tax arbitration procedure would be an appropriate addition to international tax relations." Also refer to the European Economic Community Arbitration Convention which came into force January 1, 1995 (discussed in Chapter 5).

\textsuperscript{157} See also Norman C. Loveland, \textit{supra}, at 5 - 6 for suggestions raised in the context of NAFTA. Loveland also recommends trilateral arrangements between NAFTA parties to provide relief from double taxation by competent authorities on transfer price assessments based on final profit realized on multiple transactions in vertically integrated corporate production lines.
These modifications to the transfer pricing regime should also result in reduced burdens on time, information systems, experts, and compliance costs for both the MNEs and tax authorities through a more flexible system which reflects commercial reality.

CONCLUSION

International harmonization will be the key to resolving transfer pricing issues. The Canadian Finance Minister has identified the need to address international transfer pricing

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158 In addition to the problems identified, which require international harmonization, are the following concerns: B.J. Arnold and T.E. McDonnell, supra, at 916, discuss the importance of harmonization regarding safe harbours, which are relevant with the acceptance of an arm's length range; Jill C. Pagan and J. Scott Wilkie, supra, at 44 and 45 discuss the lack of consistency between countries as to the attitude of the tax authority toward transfer pricing provisions; two countries may have identical transfer pricing legislation, yet apply the law quite differently. It is fundamental to a successful competent authority solution that apparent differences be carefully analyzed and not be permitted, effectively, to impose a measure of transfer pricing hegemony by exploiting formal or non-substantive differences; Emilio Romano, supra, at 5: "Harmonization should also be oriented to the foreign tax credit provisions in each country as they have a serious impact on the transfer pricing policies of multinational companies. An increasing number of such companies are in an excess foreign tax credit position as a result of recent changes in their domestic legislation. In some cases this is due to a reduction on [sic] the income tax rate in their country of residence, but in other cases it is because of changes in the rules that attribute the country of source to particular items of income, the allocation of expenses to foreign vis-a-vis local income, as well as other provisions that raise additional tax revenues by reducing the amount of foreign taxes that can be credited, but increase the risk of double taxation. In this [sic] circumstances, the allocation of profits between jurisdictions with similar rates for multinational companies facing an excess foreign tax credit position is no longer a tax neutral decision. There is a clear incentive to transfer profits to the country of residence of the group in order not to face a [sic] double taxation."
issues on a multi-lateral basis:159

We must work together with our major trading partners to develop common approaches to transfer pricing problems in order to minimize conflicts between tax administrations and provide greater certainty for taxpayers. For these reasons, Canada supports the work that the OECD has done to develop a consistent set of guidelines and we will continue to work with the United States and other OECD countries to examine where further clarification is needed.

The 1994 Draft has made some changes since the 1979 Report and 1984 Report to reflect the increased globalization of national economies. Such amendments and ongoing discussion about transfer pricing recognize the need to continue to think about transfer pricing rules and how they should evolve in light of the following objectives:160

- income of MNEs must be allocated fairly between competing nations

- the basis of allocation must be accepted internationally

- the need to recognize a range of acceptable prices in analysis and methodology used to arrive at arm's length price

- a balance must be achieved between certainty and flexibility

- the system must be cost effective to administer and collect

- the system must be fair.

The goal of evaluating and revising the transfer pricing regime should ultimately be to achieve an appropriate balance between the free trade objective and the sovereign right to


160 Jill C. Pagan and J. Scott Wilkie, supra, at 34 - 35. Also see W. Abdallah, supra, at 10, for 5 criteria for an effective transfer pricing system.
taxation which accurately reflects how MNEs operate in the global economy.
CHAPTER 5
CONCLUSIONS & RECOMMENDATIONS

INTRODUCTION

Two goals for this study were declared the outset: 1) to determine whether the tax provisions under review prima facie impede, distort or otherwise have an unjustifiable discriminatory effect on free trade; and 2) to reflect on the intersecting role of taxation and international trade in advancing global fiscal harmonization. The tax provisions selected were chosen with the underlying theme of facilitating the international development of, and trade in, technology. However, it is hoped that the analytical framework and recommendations proposed here will be useful for a broader range of tax policy analysis.

This Chapter summarizes the conclusions reached in each of the case studies followed by a discussion of the need for fiscal harmonization and suggestions for approaches to harmonization as we move into the twenty-first century.

PART I: SUMMARY AND CONCLUSIONS

A. Case Study Summaries

In Chapter 2, Revenue Canada's policy of treating cross-border payments for software under licensing arrangements as royalties was examined. The result of this characterization under the ITA is that such payments are subject to withholding tax. Under the OECD Model these payments are treated as business profits, and are not subject to withholding tax. Although Canada has recently renegotiated bilateral tax treaties with the United States and the
Netherlands reducing this withholding rate to zero percent, the underlying characterization issue remains.

The question of whether this Canadian tax policy can be viewed as discriminatory was examined with reference to Article III of the GATT which contains the national treatment provisions. National treatment applies as between domestic goods and imported goods and is designed to reinforce the basic policy of minimizing governmental interference in cross-border transactions. As Article III applies to "internal" taxes, the meaning of "internal" taxes was considered along with the question of whether withholding taxes are "internal" taxes. Arguments were advanced suggesting that it is possible for withholding taxes to come within the scope of Article III.

The effect of the withholding tax on the transactions under review was determined to be discriminatory in that it imposed a greater tax burden on imported software in comparison with domestic software. This burden is due to: 1) the higher effective rate of tax which arises from calculating the withholding on gross amount of payments; 2) the potential for double taxation; or 3) at a minimum, a cash flow disadvantage.

The conclusion reached is that there is no justifiable basis for Revenue Canada's policy in this area. It is unlikely that the GATT exceptions would apply to allow for this discrimination. Further, the national objective of maintaining control over cross-border payments in order to preserve the tax base does not outweigh the objective of facilitating international trade in technology.
Given that Revenue Canada has begun to eliminate withholding taxes on a case-by-base basis, a more principled approach would be to reform the underlying characterization to come in line with the international norm. This would require minimal revenue sacrifice, especially if withholding rates are going down to nil in any event, while signifying Canada's commitment to cross-border trade in technology, as well as to fiscal harmonization efforts.

Chapter 3 examines the Canadian tax incentives for research and development ("R&D"). Research and development are critical to Canada's international competitiveness, economic health and productivity. To this end, Canada has implemented a program of tax incentives which are among the most generous in the world. Yet, in 1991 Canada ranked fourteenth among the 24 OECD countries in R&D spending as a percentage of gross domestic product; its effort in research and development was lower than that of all G-7 countries except Italy.¹ These statistics suggest that the present annual commitment of $1 billion in tax expenditures on R&D is not effective in meeting the objective of stimulating R&D.

In addition to domestic concerns about the effectiveness and direction of Canada's R&D tax incentives, there is a risk that these tax incentives may be subject to international sanctions under the new subsidies code, the SCM Agreement, concluded in the Uruguay Round of GATT. Chapter 3 reviewed the key points of the

ITA tax provisions for research and development as well as the relevant SCM Agreement provisions. In particular, investment tax credits ("ITCs") available to certain Canadian corporations were examined under the SCM Agreement to see if these ITCs are countervailable subsidies. The tentative conclusion was that these tax incentives may be viewed as countervailable subsidies (i.e. discriminatory) in certain circumstances. As the United States seems to be maintaining an aggressive stance with regard to subsidies in whatever form, it is reasonable to expect that Canadian R&D subsidies will not escape the attention of American watchdogs.

If Canadian R&D tax incentives are not effective at achieving the stated domestic objectives and, if these incentives are open to possible countervailing duties under the terms of international agreements, there is a clear need for revisions of the current program of tax expenditures for R&D. On June 28 1994, the Minister of Industry and the Secretary of State for Science, Research and Development launched a major review of federal science and technology activities in order to:²

... help determine how federal spending in science and technology can best be applied to creating economic growth and jobs within the context of sustainable development, enhancing the quality of life and advancing knowledge.

The Auditor General strongly supported this initiative in his 1994 Report. He also emphasized that Canada has limited resources which must be spent in a cost effective way focusing on those

sectors of the economy that are most promising in terms of potential value added and that will yield the maximum return. It is suggested that in devising a R&D strategy, international agreements should be considered as both a possible guideline for future revisions to the R&D tax incentives and to limit exposure to international sanctions for Canadian R&D tax initiatives. However, in this case, the domestic objectives for promoting R&D are considered to be paramount to the free trade objective.

Finally, Chapter 4 reviewed the current international transfer pricing regime. Transfer pricing for transactions between members of multinational enterprises ("MNEs") has been an ongoing source of international controversy. To the extent that the transfer pricing regime seeks to preserve the domestic tax base, transactions among members of MNEs are open to protectionist and discriminatory measures which have no parallel for similar domestic transactions and fail to recognize the economic nature of MNEs.

The ability of MNEs to manipulate transfer prices in order to achieve beneficial tax results has given rise to a transfer pricing regime which is rooted in anti-avoidance. The very nature of transfer pricing as being rooted in anti-avoidance is a contentious issue. A more preferable view is that transfer pricing is concerned with the international allocation of resources, value and profit within a MNE, rather than primarily as a vehicle for tax avoidance.

Unlike the previous two Chapters, this case study did not undertake an analysis of the tax regime pursuant to a specific GATT
provision. Rather key principles, methods and procedural aspects of the existing transfer pricing system were studied with a view to identifying unreasonable or arbitrary standards and procedures which could have a negative impact on global trading by MNEs. A number of conclusions were reached which were characterized as discrimination in the existing system against MNEs:

1. The ITA rules *prima facie* discriminate against MNEs by applying differently to nonresident-resident transactions than to resident-resident transactions.

2. International transfer pricing rules apply to a wider range of transactions than similar domestic rules.

3. The ITA rules are drafted in such a way that the only transactions potentially affected are those where transfer pricing adjustments lead to an increase in the domestic tax base.

4. The arm's length principle, which underlies the transfer pricing regime, ignores the very essence of MNEs by treating each member as a independent entity.

5. Use of the prescribed transactional methods (comparable uncontrolled price / royalty, resale minus, and cost plus) are often not applicable or achievable, and can produce arbitrary results. This is particularly problematic for intangibles.

6. Lack of coordination between transfer prices and customs valuations can result in different valuations for different purposes which is illogical and unfair as it can result in duplication of work, arbitrary values, excess taxation, and uncertainty for the taxpayer.
7. The compensating adjustment procedures do not go far enough in preventing double taxation which can create an impediment to cross-border transactions.

8. Compliance requirements, advance pricing agreements, penalties and interest impose tremendous burdens on time, information systems, experts, and compliance costs on both the taxpayer and tax authority.

The conclusion reached was that the foregoing aspects of the transfer pricing regime could not be justified in light of the national objective of maintaining the domestic tax base. Even though the transfer pricing rules are rationally related to this objective, alternative approaches to transfer pricing are available which would enable Canada to achieve this objective while alleviating some of the discriminatory aspects of the transfer pricing regime. These recommendations were advanced, with the overall conclusion being that the ultimate key to resolving transfer pricing issues is international harmonization of transfer pricing rules.

B. Conclusions

What this research has attempted to do is to evaluate specific aspects of the Canadian income tax system in terms of international principles and norms set out in the GATT. Tax policies which are prima facie discriminatory and in some way have a negative impact on international trade may well be justifiable under international agreements or in light of an overriding sovereign interest. However, if they are not justifiable, and even if they are, policy
decisions may benefit from this sort of review by shifting the approach and criteria for evaluating tax policy to a process which is more applicable to the global marketplace. This approach also highlights potential outcomes of tax policy decisions which Canada's trading partners may view negatively from a free trade perspective.

The intent is not to promote free trade at the expense of overriding sovereign interests. Rather, the recommended approach is to look at a range of available alternatives for any particular tax policy and select from among those alternatives the policy that best achieves the underlying national objectives, based on appropriate criteria, while minimizing potential distortive effects on free trade. The explicit linking of international trade and tax policy in the decision making process ensures that, at a minimum, domestic and international concerns are thoroughly canvassed. In each of the case studies examined, alternatives exist which may achieve a preferable balance between domestic and international concerns from both a domestic and international perspective.

The next section considers the intersecting role of tax policy and international trade agreements in approaches to fiscal harmonization.

PART II: RECOMMENDATIONS

The views presented by authorities on public finance in a forward looking analyses of taxation is that:

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3 Donald J.S. Brean, "Here or There? The Source and Residence Principles of International Taxation", in R. Bird and Jack Mintz, eds., Canadian Tax Paper No. 93 (Toronto: Canadian Tax Foundation,
tax policy must take full and explicit account of the fact that the world economy is become increasingly integrated and national economies are becoming ever more interdependent.

This Part considers how to approach convergence of tax policy and international trade policy.

A. GATT Tax Code

Two fundamental features of the international tax structure are relief from double taxation and non-discrimination; these features are consistent with global free trade. It has been suggested that the future may hold a GATT-type arrangement on international tax issues, a General Agreement on Tariffs, Trade and Taxes (a "GATTT"). Although the existing GATT does contain provisions which have application to certain domestic tax policies, such as those dealing with internal taxes, customs duties, and some of the subsidies provisions, there is no comprehensive code which deals with matters of direct taxation. A GATTT would emphasize the relationship between trade and taxation in the broader sense of focusing on protectionist tax policies and the impact of domestic taxation on trade flows.


The evolution of a GATT-type tax code⁶ may be similar to the General Agreement on Trade in Services (GATS), which was very controversial, and thought by many to be infeasible to implement:⁷

There was... a wide range of views concerning the necessity and advisability of extending the GATT to cover services. Some members of the Group expressed concern over the complexity of services and the existence of other international organizations whose functions covered various important service sectors. Other members felt that work in this area was premature and doubted the feasibility of extending the GATT to services. There was, however, no opposition to further "exploratory" work by the Secretariat, and the parties agreed that a report on the activities of other organizations' work in the area of services should be prepared for consideration at a future meeting of the group.⁸

As a result of the exploratory work, and due to the increasing

⁶ As with the GATS, consideration would have to be given to whether an agreement on taxation would come under the auspices of the GATT or under a separate code, such as the subsidies code. Less developed countries, which initially opposed the inclusion of trade in services in GATT negotiations, proposed the GATT Code approach so that each party would have the option of becoming a signatory to the agreement at the end of the negotiations or at a later date. This allowed a party to participate in negotiations and in the end not sign the agreement without jeopardizing gains made in other negotiations (Terence P. Stewart, ed., The GATT Uruguay Round: A Negotiating History (1986-1992) vol. 2, (Cambridge, MA: Kluwer Law and Taxation Publishers, 1993), at 2361 - 2362).

⁷ For the negotiating history of the GATS, see Terence P. Stewart, ed., ibid., at 2335 - 2662. The Uruguay Round of GATT (launched September 20, 1986 during a special session of the GATT at Punta del Este, Uruguay) was the first attempt to address the elimination or reduction of barriers and distortions in trade in services. Prior to the 1970's trade in services was viewed as a matter of domestic commerce and subject only to the rules and regulations of each country (2341, 2342).

⁸ Terence P. Stewart, ed., supra, at 2345. Note that the Central Product Classification system lists over 600 different types of "services" (See Reference List of Sectors, GATT Doc. No. MTN.GNS/W/50 (Apr. 13, 1989). The efforts to bring services to the multilateral negotiating table began in 1980 and culminated in the GATS, Annex 1B to the Agreement Establishing the World Trade Organization, Uruguay Round Final Act, Marrakesh, April 15, 1994.
importance of services to world trade, multilateral negotiations were undertaken by the GATT Members to reduce or eliminate barriers and distortions in trade in services.\textsuperscript{9} Similarly, it can be argued that despite opposition to a similar agreement on taxation,\textsuperscript{10} given

\textsuperscript{9} Although GATT parties were divided on whether a multilateral system should be developed to govern trade in services, a multilateral system was recommended on the grounds that world trade in services was on the rise, and that without a multilateral system, discriminatory bilateral and regional rules would develop (Terence P. Steward, ed., \textit{supra}, at 2348).

\textsuperscript{10} See Emilio Romano, \textit{Taxation in the North American Free Trade Area}, paper presented at International Fiscal Association, 1994 Annual Congress, Toronto at 1 - 4 regarding taxes and trade in NAFTA: Article 2103 of NAFTA provides for the coordination of the NAFTA with existing bilateral tax conventions and a balance between tax policy and the prevention of international trade discrimination. However, unqualified application of the principle of non-discrimination (national treatment and most-favoured-nation) was not considered to be appropriate because it would impose standards that could significantly affect generally accepted tax policy measures and because direct taxation is already covered by bilateral tax treaties. For example, the imposition of national treatment of income taxes raised concerns regarding: 1) differences in imposing and collecting income taxes for certain categories of taxpayers (eg. withholding taxes on certain payments to non-residents); 2) the income tax may make valid distinctions among taxpayers in different circumstances (eg. residents and non-residents); 3) distinctions in the design or application of indirect taxes (eg. sales taxes) are seldom justifiable on tax policy grounds and, therefore, may be for the purpose of restricting international trade; and 4) income taxes usually contain provisions designed to ensure equity, progressiveness, income redistribution and other social and economic objectives. MFN treatment raised the following concerns: 1) tax conventions are entered into on a bilateral basis reflecting the particular preferences and circumstances of the parties; and 2) it would require that the advantages accorded to one treaty be extended to signatories of other tax treaties. Submitting income taxes to the dispute settlement provisions of NAFTA was raised the following concerns: 1) duplication of dispute resolution mechanisms; 2) dispute settlement mechanisms would provide for legally binding solutions; 3) the settlement of tax disputes would be left in the hands of persons without expertise in tax policy; and 4) access to an additional forum for dispute settlement was thought to undermine the treaty process.
the importance of taxation to world trade it is a proper concern of
the GATT. 11

Studies on trade in services prepared by thirteen GATT Members
showed that: 12

1. A clear definition of trade in services was lacking and
that trade in services data were incomplete.

2. Heavy regulation is common in many service industries.. and
that the variety of regulations maintained by the
different countries complicated trade in services.

3. A wide variety of trade barriers impeded trade in
services...

4. The importance of services requires countries to reassess
the role which trade in services play in the formulation of
trade policy. Specifically, the United States and United
Kingdom called for negotiation of a multilateral framework
similar to the GATT for trade in services.

Parallels can be drawn to taxation matters: 1) there is no
clear definition of what a "tax" is; 2) taxation is heavily
regulated and the variety of regulations maintained by different
countries complicates international trade; 3) a wide variety of tax
policies impede trade in goods, services, capital and technology;
and 4) the importance of taxation suggests that countries should

11 In the early 1980s the United States persuaded the OECD to
conduct a study on trade in services which provided the initial
groundwork for the movement to include trade in services in
multilateral trade negotiations. Also the GATT Consultative Group
of Eighteen (composed of 18 GATT Signatories and organized to study
ways of improving the GATT system) met in 1980 and considered a
document prepared by the GATT Secretariat which analyzed the link
of certain services with trade in goods. The Group determined that
the document "demonstrated an essential link between trade in goods
and certain services" and suggested that trade in services might by
a "proper concern of the GATT" (Terence P. Steward, ed., supra, at
2345).

12 ibid., at 2347.
reassess the converging role of taxation and trade policy.

A GATT tax code would initially require definition and categorization of taxes as well as identification of taxes that may be appropriate for inclusion in such a code.\(^{13}\) A number of well established GATT principles should be the starting point,\(^{14}\) such as transparency, national treatment and non-discrimination, although such principles may have to be adapted to taxation. Also any such agreement would have to consider appropriate exceptions to the basic obligations to take into account sovereign concerns of Members as well as special treatment for developing countries. Existing international arrangements would have to be considered. A GATTT would be a prospective code, with Members identifying tax laws which are impediments to trade and conducting negotiations on the basis of reciprocity.\(^{15}\)

\(^{13}\) Due to difficulties in assessing the potential effects of an overall non-discrimination provision for taxation, for example, it will be necessary to attempt to identify tax policies for which non-discrimination and a high level of harmonization and compliance would be beneficial to the global community. Despite the difficulties inherent in such a task, the identification of items that are subject to negotiation is a basic issue that needs to be settled at the outset. Note that similar "coverage" issues arose in the GATS negotiations: whether the GATS should cover all services or whether certain service sectors should be excluded from coverage. (Terence P. Stewart, ed., supra, at 2363).

\(^{14}\) Jock A. Finlayson, "Canada and International Trade Regulation: The General Agreement on Tariffs and Trade" in Robert K. Paterson and Martine M.N. Band, eds., International Trade and Investment Law in Canada (2d) (Toronto: Carswell, 1994) at 1-9 for an overview of basic GATT principles.

\(^{15}\) Reciprocity is a system of continuous trades or swaps of measures to liberalize (or restrict) trade such as was used in GATT tariff negotiations. (John H. Jackson, The World Trading System: Law and Policy of International Economic Relations, (Cambridge, MA: The MIT Press, 1989) at 305; and Jock Finlayson, ibid., at 1-9.
The European Economic Community (the "EEC") has been grappling with harmonization of taxation since 1962, with the report of the Neumark committee. Little significant progress was made until 1990, which marked a turning point in the role of direct taxation in the EEC. In assessing which tax measures may be appropriate for a GATT, the EEC Guidelines on Company Taxation are insightful:

According to the guidelines, any form of corporate taxation is

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16 The Treaty Establishing the European Economic Community, signed at Rome on March 25, 1957 (reproduced in Treaties Establishing the European Communities, abridged ed. (Luxembourg: Office for Official Publications of the European Communities, 1987), contains a number of provisions relating to indirect taxation, but does not explicitly refer to direct taxation. It also does not define direct or indirect taxation. For an overview of harmonization of direct taxation in the EEC see Alex Easson, "Harmonization of Direct Taxation in the European Community: From Neumark to Ruding", 40 Canadian Tax Journal 3 (Toronto: Canadian Tax Foundation, 1992) 600 - 638.

17 The EEC Reports on Tax Harmonisation, trans. H. Thurston (Amsterdam: International Bureau for Fiscal Documentation, 1963). The committee was chaired by Professor Dr. Fritz Neumark. A. Easson, ibid., at 604. The Neumark report was concerned primarily with the impact of direct taxation on conditions of competition and recommended that the first phase of tax harmonization in the EEC deal with the taxation of dividends and interest and with the problem of double taxation. The second phase of tax harmonization was to include the reform of company taxation systems.

18 ibid., at 610.


20 A. Easson, supra, at 626.
likely to bring about economic distortions, and this justifies the harmonization of corporate tax systems with the community to ensure complete tax neutrality. There are, however, good reasons why the community should hold back on the harmonization of corporate tax systems, "particularly in view of the principle of subsidiarity" and "member states should be free to determine their tax arrangements, except where these would lead to major distortions". (emphasis added)

"Subsidiarity" means:21

that the Commission has chosen not to interfere in every field of economic life, but to intervene only when it is necessary to attain the specific objectives agreed by the member states... For the rest, the market forces play.

In the NAFTA context, Article 2103 was drafted as a general carve-out of tax measures from the Agreement. Except for specific circumstances, direct taxes were left to the domain of bilateral tax treaties; non-discrimination provisions required in order to prevent international trade discrimination through taxation are to be included in bilateral or multilateral tax treaties.22 However, the following tax harmonization issues have been identified in the NAFTA23 context:24

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21 ibid., at 625.

22 See Emilio Romano, supra, at 3 - 4; and NAFTA Article 2103 and Annex 2103.4

23 In the EEC, the Ruding Committee concluded that priority should be given to the following: i) removing those discriminatory and distortionary features of national tax arrangements that impede cross-border business investment and shareholding; ii) setting a minimum level for the statutory corporation tax rate and common rules for a minimum tax base to limit excessive tax competition among member states to attract mobile investment; and iii) encouraging the maximum transparency of any tax incentives granted by member states to promote investment. The Ruding committee did not include among its list of priorities the harmonization of corporate tax regimes although it observed that the adoption of a common system remained a desirable long-term objective merit further consideration. (Alex Easson, supra, at 629).
1. Some of the fiscal differences between Canada, the United States and Mexico, have potential distortionary effects on the international allocation of resources as well as on the trade patterns for the region. This, in turn, may affect the competitiveness of the trade block with respect to others.

2. Under these circumstances, it is essential that authorities of the three countries analyze the potentially most harming aspects in order to make the necessary efforts towards tax harmonization on these issues.

3. The desirability to achieve neutrality in respect to both capital export and import, makes it convenient to engage in the necessary efforts to harmonize not only the tax rates but also the taxable bases...

5. As a first stage in harmonizing the direct tax systems, and in according [sic] with the effort undertaken and recommendations [by the Ruding Committee], it would be convenient to pursue the following:

   - Elimination of withholding taxes on dividends paid by

   24 Emilio Romano, supra, at 11 -12. Also see Norman C. Loveland, Harmonization of Tax Under the North American Free Trade Agreement, paper presented at the International Fiscal Association, 1994 Annual Congress, Toronto, August 31, 1994, regarding tax harmonization and Canadian tax aspects of cross-border reorganizations, mergers and acquisitions under NAFTA; and Paul R. McDaniel, "Tax Policy in the North American Free Trade Zone" (Professor of Law, New York University, 1994) [unpublished] for discussion of both an incremental approach to meshing tax and trade policy within the NAFTA zone as well as a more sweeping approach to revision of the corporate tax systems of the NAFTA Members. McDaniel identifies and discusses numerous provisions in tax legislation and tax treaties that potentially impede the ability of NAFTA countries to achieve their free trade objective. Subject to verification by quantitative analysis, he ranks the urgency for addressing these issues as follows, Category A being the most urgent (at 70 - 71):

   Category A: elimination of withholding taxes, coordination and simplification of transfer pricing rules and procedures, harmonization of source rules for income and deductions, elimination of taxation of cross-border taxes on corporate formations, reorganizations and liquidations.

   Category B: harmonization of tax base.

   Category C: harmonization of provisions mitigating international double taxation, elimination of limitation of benefits articles in US tax treaties for intra-NAFTA zone investments and operations, and harmonization of corporate / shareholder tax regimes.
subsidiaries to parent corporations...

- Elimination of withholding taxes on interest and royalty payments between related enterprises.

- Setting common rules and procedures to determine transfer prices.

- An analysis of the instances in which it would be convenient to allow the compensation of losses, horizontally and vertically within a multinational corporation with enterprises in two or more of the NAFTA countries.

Similarly, a GATTT may be a useful forum for certain taxation issues on which it is appropriate, and necessary, for the international community to achieve harmonization and where the ability to enforce compliance with a GATTT would be beneficial.

Although it is unrealistic to expect that a GATTT could achieve broad based tax harmonization, at least in the foreseeable future, there are areas where a GATTT may be more appropriate than the current system of bilateral tax treaties and model tax conventions. For example, of the three case studies examined, transfer pricing may be adaptable to international codification and would likely benefit from the ability to access binding dispute mechanisms to effectively deal with transfer pricing disputes. In the EEC, an Arbitration Convention25 was adopted with the objective of eliminating double taxation arising out of cross-border transfer pricing disputes.26 This convention is not as comprehensive in scope as the OECD Model on double taxation, as it relates only to double taxation resulting from the adjustment of profits of


26 Also see Paul McDaniel, supra, who ranks transfer pricing as among the most urgent tax matters to address (at 70).
associated enterprises, yet it seems to "provide a better procedure for achieving the desired result." \(^{27}\)

B. Unilateral and Bilateral Approaches

As it is unrealistic to expect a GATTT arrangement, no matter what the scope, in the immediate future, it is necessary to continue to pursue unilateral and bilateral harmonization efforts. \(^{28}\)

Tax harmonization is the ideal solution. However, national differences are so great that harmonization is not a realistic possibility. Unilateral and bilateral limitations on discrimination against non-residents and foreign activities represent an important and feasible, although second-best, course of action for most countries.

In his address to the GATT Ministerial Conference in Marrakesh on April 12, 1994, The Honourable Roy McLaren, Minister for International Trade, stressed Canada's commitment to developing a strong international trading system. He emphasized that the GATT has been the cornerstone of Canada's trade policy, \(^{29}\) and that countries must work harder to leave unilateralism and protectionism behind. \(^{30}\) In today's global marketplace, it is not sufficient for Canada to implement tax policies without considering the broader systems of international trade. Taxes can have a significant

\(^{27}\) A. Easson, *supra*, at 618.


\(^{29}\) *Canada and the Uruguay Round: Information Kit*, (Ottawa: Government of Canada, April, 1994) at 1.

\(^{30}\) *ibid.*, at 4.
effect on international trade flows and, to the extent possible, domestic tax policies should unilaterally undertake to promote free trade. While international trade agreements seek to remove barriers to trade, domestic tax regimes should not create new, or maintain unjustifiable existing, barriers — even ones that may "slip through" the GATT or other international trade agreements.

Tax treaties attempt to harmonize national tax systems in order to eliminate international double taxation, prevent tax avoidance and to allocate revenues between nations. However, international taxation issues often focus on the self-interested goal of ensuring the domestic tax system is competitive. Yet:

Despite the development of double-taxation agreements, many governments continue to believe that capital income taxation at the international level involves significant distortions


and serious enforcement problems. The current agreements have several general shortcomings. One is that they are bilateral, thus the terms of the agreements, particularly in respect to matters such as withholding tax rates, vary considerably across countries. A second problem is that double-taxation agreements do little to reduce tax exportation and smooth out differences in effective tax rates on capital.

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If current methods of tax coordination have failed, what is there left for countries to do? McLure$^{34}$ and Leechor and Mintz$^{35}$ have argued in favour of an international or regional agreement to coordinate taxes (as McLure calls it, a "GATT for tax").

Although the future may hold a GATT for tax, the existing treaty network is likely to be around for a long time and may be the most appropriate mechanism for addressing a number of tax issues. In this bilateral context, it is suggested that there must be a shift in focus from protectionism to one in which international trade agreements are considered in developing domestic and international tax policy. This shift in focus will aid in ensuring that advances in international trade are not impeded by developments in domestic or international taxation.

Of the case studies examined, Canada has reduced the withholding tax on payments for licensed software to nil in two bilateral tax treaties. However, Canada should go further and take the unilateral step of characterizing these payments as business profits to coordinate policies with the broader international


taxing community. This would not only achieve a measure of fiscal harmonization but, as was indicated, would remove distortive effects on such transfers of technology. Thus, a combination of cooperative unilateral and bilateral approaches can be used to effectively address particular tax measures.

SUMMARY

The recurring theme in this paper has been the balancing of the 2 basic premises of free trade set out in Chapter 1:

1. The most efficient use of resources of trading nations will be achieved if trade among them is free from arbitrary interventions by individual governments; and

2. The preservation of sovereign rights as expressed in the maintenance of different politico-economic systems and sets of policies among nations is essential for increasing the welfare of citizens of the nations concerned.

This free trade perspective of tax policies has provided an alternative framework for considering domestic and international tax systems. Ideally fiscal harmonization in free trade areas should ensure that trade among member countries is not distorted by tax policies. Domestically, this means choosing from among alternative tax policies those that least interfere with free trade while achieving the national policy objectives.36

An integrated and flexible approach is required to deal with the international aspects of convergence of taxation and

36 See Hirofumi Shibata, Fiscal Harmonization under Freer Trade: Principles and Their Applications to a Canada-U.S. Free Trade Area (Toronto: University of Toronto Press, 1969) at 4 - 8.
international trade. Although unilateral tax policies, tax treaties, and model tax conventions, are the traditional approaches for dealing with international taxation issues, attention is now being given to alternative multilateral approaches for effectively and meaningfully managing the convergence of taxation and free trade.

Further research is needed in order to assess how various tax policies measure up to international trade principles and obligations, and how to best approach convergence on a multilateral scale. Quantification of tax policy distortions on trade is also necessary to clearly identify tax measures of highest priority. Some suggestions have been advanced as a starting point for work on a GATT tax code. The objective of such research should be to continue to work toward a principled approach to harmonizing not only international taxation, but also international taxation and international trade, while balancing the sovereign interests of individual nations.
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