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Current Tax Issues in Canada-United States Relations: The Love-Hate Relationship Continues

*by Robert D. Brown**

I. Introduction

A review of current tax issues between Canada and the United States is a subject that gives rise to mixed emotions, just as with a man watching his mother-in-law drive his new car over the edge of a cliff. On the one hand, one is struck with the number and seriousness of the economic and tax issues that are in controversy between our two countries. On the other, one is also impressed at the huge and efficient flows of capital and trade that move confidently between our two countries, undeterred by these difficulties. Cross-border trade now amounts to over $60 billion annually, more than between any other two countries; and cross-border investment is, in the aggregate, also a world record. Somehow Canada and the United States do seem able to deal with the tax and related issues that arise between them, and the private sector is showing by its actions that it believes they will continue to amicably resolve such problems.

II. Canada-United States Tax Convention

Any discussion of current trans-border tax issues should logically start with a review of the position of the signed but unratified new United States-Canada Income Tax Convention. When the comprehensive new Income Tax Convention between our two countries was signed on September 26, 1980, it was the culmination of eight years of difficult negotiations. The governments of both countries, and many taxpayers, were agreed that the antiquated 1942 Convention was in need of substantial revision, but the large areas of real and potential conflict between economic and tax policies of the two governments meant that agreement on a new tax treaty was a complex and time consuming task.

It is now the spring of 1984, some three and a half years after the signing of the treaty, and not only is the Convention still unratified, but there is no firm indication when such ratification might take place. Indeed, it could be remarked that it may take as long to get the treaty ratified as it did to negotiate it. This paper will provide a review of some of the outstanding tax issues between Canada and the United States that have contributed to the delay in the ratification process and, hopefully,

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place these issues in perspective relative to the overall economic relations between our countries.

The new Convention, signed with some fanfare in September of 1980, is more than three times as long and many times more complex than the previous 1942 Convention. Despite its lengthy gestation, it was soon apparent that there were a number of serious difficulties with the new Convention that required a solution before the treaty could be ratified by either party. For one thing, the 31 articles of the new and complex Convention proved to be about as error prone as most new legislation drafted recently in either Washington or Ottawa, and there were numerous examples of provisions that required clarification, to put it charitably, or a rapid repair job, to put it more accurately.

In addition, the new treaty was more or less overtaken by events, the most significant of which was the enactment in 1980 of FIRPTA (the Foreign Investment in Real Property Tax Act) by the United States. While it was apparent at the time the new Convention was being negotiated that the United States would soon make more vigorous efforts to tax foreigners on the sale of U.S. real estate, the exact terms of the new U.S. legislation were not known when the Convention was negotiated. The 1980 Convention therefore contained a convoluted "mirror image" clause which would determine when one country had the right to tax gains realized by residents of the other country on indirect interests in real estate. Basically, this would permit one country to impose tax on such indirect holdings by residents of the other only if the other country would also impose its tax in the "mirror" situation with respect to its real estate owned by residents of the first country.

The new provisions were not entirely consistent with the FIRPTA legislation of 1980, and it should be noted that FIRPTA contained provisions which would overrule after 1984 any more favorable rules contained in any of the tax treaties of the United States. The result of all this, if the 1980 Canada-United States Convention had remained unchanged but been ratified in due course, would have been a very complex interaction of the present treaty (for the transitional period), the new treaty, and the FIRPTA legislation.

Another major issue which arose following the signing of the new treaty was the desire of the United States to introduce fairly stringent "treaty shopping" rules into the Canada-United States Tax Convention, with the objective of preventing residents of other countries from making indirect use of the Canada-United States Convention to avoid U.S. taxes.

The discussions between the two countries relating to these various issues consumed another two and three-quarter years, and it was not until June 14, 1983 that a lengthy protocol between the two countries was signed, significantly modifying the earlier treaty. The protocol itself has 15 articles, which modify or replace 14 of the 31 articles of the 1980 Convention. The major change in the protocol relates to the taxation of real property interests, where the treaty is brought basically in line with

FIRPTA and with the general Canadian rules on the taxation of real estate owned by nonresidents. The 1983 protocol leaves in the treaty the controversial "safe start rule" which limits taxation under the Convention to gains accrued after December 31 of the year in which the Convention enters into force.[1] This provision is not found in any other United States tax treaty, and certainly drew some criticism in the 1982 hearings before the Senate Foreign Relations Committee.

With respect to the other issue that was under discussion between the countries, the United States evidently and intelligently decided that Canada was unlikely to become a tax haven, and avoided insisting on the full rigors of its treaty shopping provisions which it has been urging on other countries.

The new treaty has, of course, since been amended by a second protocol, dated April 4, 1984 dealing with social security payments. Basically, the new rule is that social security benefits paid by one country to a resident of the other will only be taxable in the country of the recipient's residence, and then only half of the benefits will be included in income. (The treaty has also now been effectively further amended by a unique exchange of letters between Revenue Canada and the IRS relating to depreciation and other deductions allowed in respect of U.S. drilling rigs in Canadian waters).

It is therefore this revised and modified tax treaty that was considered in a hearing before the U.S. Senate Foreign Relations Committee in late April.[2] The Committee will almost certainly recommend that the U.S. Senate adopt the treaty, and that ratification could well take place in May or June.[3]

Canada has itself not started its ratification process: given the track record of the U.S. Senate in dealing with tax treaties, other countries are understandably reluctant to ratify tax treaties with the U.S. until the U.S. Senate ratifies the treaty first. Because 1984 might well be an election year in Canada, it may be difficult for the government to get the treaty through Parliament in short order, even though the treaty's approval in Canada would not seem to be controversial. However, the ratification process does appear to be going forward and should well take place in 1984.

If the exchange of instruments of ratification takes place in 1984, the treaty will generally have effect:

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[1] Provided that the resident of the other territory, or a related party, owned the property on September 26, 1980.

[2] The treaty protocols were considered at an April 26 Committee hearing and on May 8, 1984, voted on and recommended for ratification by the full Senate.

[3] The treaty was approved by the U.S. Senate and the Canadian Parliament in June and July, 1984, respectively, and instruments of ratification were exchanged on August 16, 1984, on which date the treaty entered into force. 2 TAX TREATIES (CCH) paras. 9918, 9919. Treasury Department News Release R-2818, August 17, 1984 announcing the ratification of the treaty is reprinted at *id.* para. 9919.

1. For tax withheld at source, with respect to amounts paid or credited on or after the first day of the second month following the date on which the Convention enters into force;

2. For other taxes, with respect to taxable years beginning on or after January 1, 1985.

If the old treaty is more favorable than the new treaty, it will apply for the first taxable year to which the new treaty would otherwise apply.

III. Income Tax Conventions Interpretation Act

A rather unexpected blip in the tax relations between our two countries over the past year has been Canada's Income Tax Conventions Interpretation Act, originally tabled in the House of Commons on June 23, 1983. To explain the reasons for this rather extraordinary legislation, it is necessary to step back and consider the position of tax treaties under the Canadian Constitution. In Canada, unlike the United States, international treaties have no special constitutional procedures with respect to ratification. After the signing of any international treaty, Parliament must pass legislation to implement the treaty: the legislation simply states that the terms of the treaty are to have effect, until amended or repealed, notwithstanding any other provision of Canadian law. The legislation to "ratify" a treaty is therefore an ordinary bill which goes through the full processes in both the House of Commons and the Senate before receiving royal assent and becoming law.

Of course, notwithstanding the standard statement that the provisions of a treaty will take precedence over any legislation, Parliament remains supreme. It is open for the Parliament of Canada, in any subsequent enactment, to override any provision of any previous law, including legislation adopting tax or other treaties. But because of the specific wording in the legislation which implements new treaties, Parliament must in general make a conscious decision to override the terms of a valid tax treaty: unless Parliament specifically states that some enactment is to take effect notwithstanding the terms of the treaty, then the treaty rules will continue.

The question addressed by the Income Tax Conventions Interpretation Act, still before Parliament, relates to the interpretation of terms in a tax treaty which are not defined, or fully defined, in the treaty itself. The Canadian revenue authorities were thrown into disarray by a 1982 decision of the Supreme Court of Canada in *The Queen v. Melford Development Company*.[4] The situation was essentially that a German corporation received fees from a Canadian company for guaranteeing debt of the Canadian enterprise. Under the terms of the 1956 Canada-Germany tax treaty that was in effect at the relevant time, Canada could not tax industrial or commercial profits of a German enterprise unless it had a perma-

[4] 82 D. Tax 6281 (1982).

nent establishment in Canada (which this one did not), but did have the right to impose a withholding tax on "interest" paid from Canada to a resident of Germany. Article II(2) of the 1956 tax treaty between Canada and Germany also provided that "any term not otherwise defined . . . shall, unless the context otherwise requires, have the meaning which it has under the laws in force in the territory of the state . . . ."

In 1956, when the treaty was adopted, guarantee fees paid by a resident of Canada to a German or other foreign corporation would not have been regarded as interest, either under the terms of the Income Tax Act or general Canadian law. Such payments would, in general, be regarded as industrial or commercial profits and exempt from Canadian withholding tax. However, in 1974, Canada expanded the definition of interest for nonresident withholding tax purposes to include, amongst other things, guarantee fees. The question raised in the *Melford* case was whether this subsequent expansion of the term interest under the general provisions of the Income Tax Act should be read as modifying the meaning of interest under the Canada-Germany tax treaty.

In its 1982 decision, the Supreme Court held that it should not, and that the term interest, under the terms of the Canada-German Tax Convention, was to be generally interpreted based on the definition of interest as it existed under Canadian tax law at the time the treaty was adopted, i.e., 1956. A subsequent change in that definition by the Parliament of Canada was not to be regarded as modifying the definition in the treaty, since to permit this was to regard a government as unilaterally changing important provisions of the treaty.

There has been some considerable discussion about the decision of the Supreme Court in the *Melford* case, and there are some commentators that have remarked that, in other countries, terms set out in international tax treaties which are not defined within the terms of the treaty, are frequently considered to have the meaning that they have under the current domestic legislation as amended from time to time. But the real problem of the *Melford* decision, as far as Canada was concerned, was not a minor issue relating to guarantee fees, but rather the fact that the decision could be regarded as putting Canada into a straight jacket which would force it back to the bargaining table with another country every time Canada wanted to make some amendment in its tax legislation which might have an impact on any of the provisions of the treaty. We are now churning out over 100 pages of amendments to our tax legislation even in a dull year, and these changes frequently involve fairly major modifications to our tax rules, including the blocking of newly discovered loopholes. It can therefore be appreciated that Canada did not want to be put in the position of not being able to modify, for treaty purposes, standard definitions.

So Canada's response was the introduction into Parliament of the Income Tax Conventions Interpretation Act on June 23, 1983. This Act, short and simple on its face, would basically have overruled the *Melford*

decision: it stated in any tax convention, whether ratified before or after the passage of this Act, terms which are not defined (or to the extent not fully defined) would have the meaning that the term has for the purposes of the Income Tax Act as amended from time to time. Specific provisions would ensure that the definitions of "Canada" and "real property" in any tax treaty were to be read in accordance with the then current definition of these terms under Canadian law, and further that the computation of business profits attributable to a branch of a nonresident were to be computed in accordance with general Canadian tax rules.

But the main problem with the 1983 Interpretation Act was its infinitely retrospective nature: it would have applied, for all open taxation periods of all taxpayers, to the interpretation of any of Canada's tax treaties in all previous as well as all future years. It is understood that prior to the introduction of the 1983 version of the Act, officials of the Department of Finance in Canada did contact a number of Canada's treaty partners, including the United States, to ask for their views on the approach that should be taken to the interpretation of tax treaties. The majority evidently agreed that undefined terms in the treaty should generally be interpreted in accordance with current domestic legislation, and that they had no particular objection to Canada confirming this in its legislation. Nonetheless, the 1983 Income Tax Conventions Interpretation Act did raise a storm of protest from taxpayers, most importantly in the United States, as soon as its provisions were understood. The main issue with respect to the United States related to two issues in the resource area. First under the 1942 Convention, Canada has in general the right to tax industrial or commercial profits of a U.S. enterprise only if it has a permanent establishment in Canada, and the definition of Canada for this purpose was not the up-to-date definition which includes the continental shelf. Accordingly, U.S. drilling ships and other contractors operating off the east coast of Canada were contending that they were not operating "in Canada" under the definition in the protocol in the 1942 treaty, and hence, regardless of Canada's subsequent extension of its territorial claims, were not liable for tax in Canada. The second issue concerned the fact that the 1942 treaty provided that where a U.S. enterprise had a permanent establishment in Canada, the net profits of that establishment could be taxed in Canada, after specifically allowing as a deduction "all expenses . . . reasonably allocable to the permanent establishment . . . ."[5] Of course, Canada now disallows as a deduction most provincial royalties paid in respect of resource extraction (and grants instead certain resource allowances) but U.S. enterprises carrying on branch operations in the oil and gas industry in Canada could and did contend that,

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[5] Convention for Modifying and supplementing the Convention and Accompanying Protocol of Mar. 4, 1942 for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion in the case of Income Taxes, June 12, 1952, United States-Canada, art. I, para. (a), 2 U.S.T. 2236, T.I.A.S. No. 3916.

under the terms of the 1942 Convention all of their expenses in Canada should be allowed as a deduction, including provincial royalties.

The dispute on the above two resource issues was not merely one of semantics. Even though the number of affected taxpayers in the United States was rather small, the amounts involved were understood to amount to many hundreds of millions of dollars of disputed tax. The U.S. businesses naturally resented having the rug jerked out from under their feet in their tax disputes by the retroactive Canadian legislation, and did not hesitate to beat a path to Washington to complain about the situation. The complaints were noted not merely by the administration, but by some of the senators who might be involved in the ratification process. Some interesting discussions followed between the two governments, and the U.S. objections to the retroactive axing of the tax claims of U.S. enterprises could have proved a road block to the ratification of the 1980 Convention.

Fortunately, this block now appears to have been removed, with the introduction of a revised Notice of Ways and Means Motion on April 5, 1984 setting out the text of a new Income Tax Conventions Interpretation Act. The new Act parallels to a large extent the 1983 version that was not proceeded with by Parliament, but it does have one major change: the new legislation is not retroactive, and only applies after June 23, 1983 (the date of introduction of the previous version of the bill). For withholding tax, the new proposed legislation is applied to amounts paid or credited after June 23, 1983 and with respect to other taxes, to all taxation years ending after June 23, 1983.

The new version does contain other changes from the 1983 version, including yet another Canada definition which tends to parallel that in the 1980 Canada-United States tax treaty rather than the definition extracted from other Canadian legislation. What the new Income Tax Conventions Act will do, if and as enacted, is to ensure that from 1983 onward, the *Melford* decision will be overridden under the Canadian law, but that U.S. and other foreign taxpayers will have the right to rely upon *Melford* in any litigation or disputes with Revenue Canada up until 1983. It is understood that Revenue Canada is in the process of settling, on a favorable basis, at least the majority of issues concerning the resource activities of U.S. taxpayers in years through 1983, all at some considerable cost to the Canadian Treasury.

IV. Foreign Investment Review Agency

One of the running sores in Canada-United States relations is Canada's on again, off again jingoistic attitude towards foreign investment, primarily as reflected in our Foreign Investment Review Act (FIRA) and National Energy Policy. The Foreign Investment Review Agency has been around now for some ten years, and while foreign investors have grown used to it, they still regard it with something less than affection. Basi-

cally, whenever a foreigner wishes to acquire control of an existing Canadian enterprise, or whenever a foreign controlled Canadian enterprise wishes to start a new business, it must secure the advance approval of the Canadian government. To secure such approval it is necessary to show that the action would "benefit" Canada—an obviously subjective term.

However, the agency's operations and procedures were significantly revised in 1983, when Canada's economic gurus suddenly decided that discouraging foreign capital and technology was not too bright an action for a country with a 12% unemployment rate. An expanded fast track review procedure was introduced for smaller takeovers, and the agency's procedures and attitudes were substantially overhauled, with the result being the elimination of its backlog of pending cases. FIRA now deals with applications more sympathetically, and as rapidly as any government agency, which is to say not really very fast at all but still a considerable improvement over the situation of two years ago. The result of this shift in policy has been a reduction in the irritation level abroad relating to FIRA.

FIRA, of course, has also had its nose bloodied on a couple of occasions in the last few months. It has not been particularly successful in court on the enforcement of the FIRA rules. In a recent case, a U.S. company established a Canadian distributorship, first by establishing a Canadian subsidiary and later by selling a 51% interest to its Canadian sales manager. The U.S. company still retained a large degree of control (with a buy-out in favor of U.S. company on manager's death and the right to nominate one of the directors). The application by FIRA to have the investment outlawed was dismissed on the basis that the Canadian company was 51% Canadian controlled. It appears that the courts have a more formal view than FIRA of the meaning of control, and FIRA may have to accept that some partial shifts in ownership involving nonresidents really do not result in a non-resident acquiring control of a Canadian enterprise in such a manner as to make the ownership shift reviewable.

Furthermore, Canada has bowed to a United States-inspired GATT action, and agreed to modify its FIRA rules so as to avoid demanding commitments for a preferential treatment of Canadian produced goods and services as a price of FIRA approvals. Of course, Canada still requires companies to show that a change in control will be beneficial to Canada, and therefore will still have regard to commitments relating to Canadian investments, jobs and exports. The result is that this change in FIRA rules may really not represent much of a Canadian backdown.

There can be no question that FIRA is now displaying a more conciliatory and positive attitude to foreign investment, and there is also no question that its administration is now both fairer and faster. The Honorable Marc Lalonde, Canada's Minister of Finance, pointed with pride in a recent U.S. speech (April 11, 1984) that the approval rate of FIRA—the percentage of applications which it approves—has risen to 97% in recent

months from its ten year average of 92%. The ratios are slightly misleading, since many applicants whose requests would not be approved are discouraged by the process, and withdraw the application before it can be formally turned down. (See Table I).

Table I

FIRA

Approval Rate of Applications to FIRA

		Applications			
		Resolved			Approval
	Approved	Total	Withdrawn**	Net	Rate %
1983-84*	871	973	73	900	96.8
1982-83	924	1,079	95	984	93.9
1981-82	513	719	125	594	86.4
1980-81	448	586	75	511	87.7
1979-80	687	797	52	745	92.2
1978-79	576	659	39	620	92.9
1977-78	541	602	36	566	95.6
1976-77	319	398	33	365	87.4
1975-76	114	159	23	136	83.8
1974-75	63	02	18	85	84.0
Total	5,056	6,064	568	5,496	92.0

Source: Foreign Investment Review Act - Annual Reports

* Preliminary figures for the period April 29, 1983 - April 27, 1984. All other figures cover the period March 1 - April 30.

** Applications withdrawn after receipt but before decision by the Governor in Council.

But despite these changes, FIRA is still regarded with some dismay by a number of foreign investors.[6] It is not so much the actual rules themselves that have this influence, but the existence of the organization and the review procedure, and the well-known fact that the administration of FIRA has gone through cycles of ferocity and meekness over the past few years. Despite the generally high level of confidence of foreign investors in Canada and the Canadian economy,[7] foreign investors are aware that they require more than just an initial approval in order to take over an existing Canadian business or to set up a new one. They recognize that, even after they are through the door, FIRA rules may create considerable awkwardness and cost for them in the future, by requiring new applications if the Canadian business wished to expand in a new line of activity.

[6] The recent FIRA rejection of two important Japanese applications relating to western Canada coal operations has created some controversy inside and outside of Canada.

[7] Confirmed in an April 1984 Conference Board survey.

Further, if at any future time there is a shift in the control of the parent company abroad, this will result in a reviewable change in the control of its Canadian subsidiary, and FIRA can pounce on this to extract new commitments. And even the expedited agency procedure still results in delays in dealing with critically important business issues and leaves the unpleasant task of trying to haggle with federal bureaucrats over the type of commitments necessary to secure FIRA approval.

The Foreign Investment Review Agency is not going to go away, regardless of which party forms the next government in Canada. The very existance of the agency is a reflection of Canadian fears of foreign economic domination, living as we do in a country that has the highest degree of foreign ownership of any developed nation. But FIRA, even in its cut down and cuddly bear friendly version, does cost Canadians something and we should all recognize the price of our independence.

V. National Energy Policy

Another burr under the saddle in Canada-United States relations has been the National Energy Program (NEP) and its blatant efforts to "Canadianize" the oil and gas industry. However, recent months have seen the settlement of some resource related issues. An exchange of letters has solved, in probably a rather extra legal way, the tax issues relating to depreciation or capital cost allowance on U.S. drilling ships operating off Canada's east coast. The agreement regulates the amount of depreciation claimable for Canadian tax purposes on such vessels, eliminates any "recapture" of such allowance when the rigs leave Canadian waters, and deals with the taxation of "mobilization" and other payments. The elimination of any retroactive application to the Income Tax Conventions Interpretation Act has also eased the particular problems of a number of U.S. taxpayers with resource interests in Canada.

Above all, the relatively depressed state of the oil and gas industry in Canada, particularly with respect to conventional western exploration and development, has meant that some of the American companies that were allegedly "forced" out of Canada in 1981 and 1982 must now be very pleased with the amounts that they received on Canadian takeovers of their assets, and their fellow countrymen still operating in Canada might indeed wish that they had been so lucky as to have been compelled to sell out at the top of the market. All in all, the heat abroad about the NEP now seems to have died down at least a bit.

However, a new issue may arise with respect to the current U.S. takeover fever for oil companies, involving Socal's bid for Gulf, and other U.S. bids involving the Getty interests, Superior Oil, and other enterprises. Under the FIRA legislation, changes in the control of a U.S. parent corporation with a Canadian subsidiary or operations requires FIRA approval because the move also results in a change in the control of the Canadian operation. The Canadian government could use this require-

ment as an opportunity to force further divestitures by United States companies of equity interests in Canadian resources.

But the Canadian government may be rather shy, for a number of reasons, about adopting any hard-line attitude in this area. For one thing, it could imperil the gradual improvement in Canada-United States economic cooperation, just at a time when Canada does not need new and divisive arguments with its neighbor. For another, the cost to Canada of any major takeover of additional U.S. oil and gas interests could be staggering. The price tag on the Canadian assets of all of the U.S. companies involved as takeover candidates could be as high as $8 billion, and the outflow of anything approaching this amount of capital from Canada at this time would put downward pressure on the Canadian dollar and upward pressure on Canadian interest rates. Just before a general election, neither of these two effects will seem particularly attractive to the government. Further, if the enterprises are taken over by Canadian corporations, the net result will be a substantial decrease in Canadian tax revenues, due to the deduction of very large amounts of interest by the acquiring corporations. It will be interesting to see how FIRA and the government handle this particular hot potato, though FIRA has already indicated in the case of the Gulf acquisition a mildly conciliatory attitude.

VI. Unitary Taxation

One of the main Canadian complaints about U.S. tax policies relates of course to the unitary tax issue. About thirteen U.S. states now impose corporate income taxes on a more or less "unitary" basis—that is, such states tax a portion of the world-wide profits of any business that is considered unitary, rather than just the profits arising within the state or even an allocated share of the profits of the enterprise from its U.S. operations. The continued and even growing use of the unitary tax method as applied to foreign multinationals with subsidiaries or operations in the United States has raised a storm of protest and objection from virtually all of the developed countries. Foreign enterprises caught in the unitary web contend that:

1. The unitary tax method, when applied to foreign multi-nationals, tends to result in higher state taxes primarily because it sweeps manufacturing and other profits earned outside of the United States into the U.S. tax net;[8] and

2. The system involves administrative complexities and uncertainties, with just one of them being the requirement to restate worldwide consolidated profits of a foreign enterprise to a basis acceptable for U.S. accounting and tax reporting.

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[8] This is implicitly confirmed in the estimates by the states of a large revenue loss if unitary taxation is outlawed.

While the U.S. Administration is not unsympathetic to the complaints of foreign multinationals, it finds itself on the horns of a dilemma. President Reagan, as it happens, was Governor of California at the time that the unitary tax principle was introduced. Because of this, and because President Reagan is a strong defender of state rights, the Administration finds it difficult to support legislation or new treaties which would restrict the right of the states to impose taxes on a unitary basis. However, the Administration also recognizes that the unitary tax issue is a severe irritant to investors from Japan, the United Kingdom, Europe, Canada and elsewhere, and has even become such a major issue as to imperil the ability of the United States to negotiate acceptable tax treaties and other economic arrangements with other countries abroad. Japanese corporations are threatening to boycott further investment in California and other United States states imposing taxes on the unitary basis. The Netherlands has put a halt to further negotiations with the United States on a new United States-Netherlands tax treaty, which is dearly desired by the U.S. administration to block some tax loopholes, until some satisfactory answer comes forward on the unitary question. Legislation has actually been introduced into the House of Commons in the United Kingdom which would provide discriminatory treatment for U.S. corporations headquartered in states which utilized the unitary tax approach. Canada too has joined the chorus of protests and representations on the issue, and all in all President Reagan and his advisors realize that they have been stuck with a political and economic hot potato.

Hopes of a judicial solution to the impass were dashed when the Supreme Court held, in its recent decision in *Container Corporation of America v. Franchise Tax Board*,[9] that the application of state income taxes on a unitary basis to a U.S. multinational did not violate the "foreign commerce" clause in the U.S. Constitution. The Supreme Court carefully left open the question of whether the application of state taxes on the unitary approach to a foreign multinational might be ruled unconstitutional, but it may well take several years to maneuver an appropriate case before the Supreme Court for a decision.

The U.S. Administration did, of course, find that solution dearly beloved of all governments when faced with difficult decisions: it appointed a twenty-member blue ribbon task force to investigate the issue. The task force included representatives of state governments, business and federal government and it is not suprising that with such diverse membership, it would have a hard time reaching any decisions. The report of the task force was originally slated for late February, but because of disagreements, this deadline could not be met. Earlier this week the group agreed to issue its report and publicly announce its divergent views.

The task force has failed to achieve consensus on the basic issues

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[9] 103 S. Ct. 2933 (1983).

facing it. Since the group consists of state and domestic industry representatives, its conclusions are divided along the same lines. The state representatives are prepared to endorse the "water's edge" principle of state taxation, under which the state would only tax an allocated portion of the U.S. profits of an enterprise. However, this endorsement is provisional upon the acceptance of state taxation of dividends paid to the U.S. corporations by their foreign subsidiaries. Industry representatives on the other hand made it clear that they could accept the water's edge principle but not the taxation of foreign source dividends.

From the viewpoint of state revenue, the real money lies in the unitary taxation of United States-based corporations, not foreign multinationals, and the states are, not surprisingly, unwilling to give up their claim to tax the foreign source income. The states' proposal could easily result in a higher tax burden to the United States-based corporations than worldwide unitary tax: the water's edge formulae for allocating corporate group income would not permit dilution by the inclusion of foreign-based assets and payroll, and yet the proposal would include the foreign income repatriated by way of dividends. Both factions have made it clear that their support of the water's edge proposal was contingent upon the acceptance of their collateral position on foreign-based dividends. This is cold comfort to foreign multinationals who would be relatively satisfied with a water's edge solution for foreign companies under either approach.

In December the task force agreed not to seek federal legislation to resolve the issue. Therefore, when the report is issued and presented to the President it will be, aside from being inclusive, merely in the form of guidelines to state governments. The issues will be resolved at that level only, under the political and economic pressures already in place.

All of this leaves Canada and the other major trading and investment partners of the United States at something of a standoff: the U.S. Administration, while sympathetic to the objections against unitary tax, is not prepared to recommend direct federal intervention, and the Congress would not likely give such measures strong support in any event. There is no early solution in sight, but as long as the issue remains, the United States will find its treaty and tax negotiations with other countries will go less smoothly and less satisfactorily.

VII. Foreign Investment in Real Property Tax Act

Another difficulty in the current tax relations between Canada and the United States relates to the U.S. Foreign Investment in Real Property Tax Act, adopted by the U.S. in 1980. The Act represents a very serious attempt by the United States to ensure that foreign investors pay tax on the gains realized, directly or indirectly, on dispositions of U.S. real estate. However, over three years after the legislation was adopted by Congress, foreign investors are still finding that the actual terms of the legis-

lation are difficult to comprehend, and the reporting requirements are, to put it simply, a maze with no exit. The Internal Revenue Service has been labouring mightily to issue regulations relating to the administration of FIRPTA, but despite several false starts, they still have not been able to come out with anything that sounds very practical to the IRS, let alone taxpayers.

When the U.S. adopted more stringent methods to tax foreigners on the sale of U.S. realty, it had essentially two choices in terms of the administration of the provisions. It could have adopted the Canadian model, which requires purchasers of real estate to make enquiries as to whether the vendor is a nonresident. If such reasonable enquiries show that the vendor is a nonresident, then under Canadian law the purchaser is required to either have the vendor produce a tax clearance certificate, or to withhold a percentage of the sale price and remit that to Revenue Canada as a deposit against the vendor's tax liabilities. The U.S. Congress considered, but rejected, this approach as imposing too much in the way of paper work on U.S. purchasers. Instead, it opted for an approach that would require the nonresident to file voluminous reports, post security, and take other actions to ensure the ultimate collection of the tax.[10] It is now becoming increasingly apparent that Congress made the wrong decision, and the present U.S. legislation can be criticized for being both too severe in its tax bite on nonresidents and an administrative horror for all concerned.

VIII. Miscellaneous Issues

Of course, the close economic relations between Canada and the United States mean that there are a host of other issues that are always under discussion or in controversy between the two countries. There is a lengthy list of such issues at the moment, including such items as the following:

1. The U.S. is still angry at Canada's disallowance of the cost of Canadian advertising on U.S. border television stations, with this anger being continually fanned by an extraordinarily effective lobby of U.S. television station owners. (Given the electronic nature of present political campaigns, all politicians treat television station owners with a very substantial amount of respect). However, the U.S. Congress now seems to be a bit more resigned to recognizing Canada's cultural sovereignty, and they may well settle for striking back at Canada with a measure that would disallow the cost of U.S. advertising on Canadian border stations.

2. There are offshore fishing and jurisdictional issues in dispute between the two countries, including the Georges Bank boundary dispute relating to the east coast continental shelf, now before the World Court.

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[10] Current legislation before Congress proposes to switch the emphasis in FIRPTA to a withholding basis.

3. There are environmental issues, the most important of which is Canada's continued irritation at the glacial speed with which the U.S. is moving to clean up the Great Lakes, and to deal with its share of the acid rain problem.

4. There are always problems about the Canada-United States autopact, as the winds of change and fortune mean that the pact results in net employment and economic benefits first to one country and then to the other. At the moment, Canada is probably in a pretty fair position, and hence it is not making noises. Rather, both Canada and the United States seem likely to join in an unholy alliance to keep out the more efficient Japanese producers.

5. There is Canadian irritation at the continued efforts of the United States to extend its laws around the world. The latest irritation related to successful U.S. court actions to force Canadian banks, just because they have subsidiaries in the United States, to compel their other subsidiaries in the Caribbean to supply their bank records on suspected U.S. tax evaders to the IRS.

6. Finally, a number of Canadians and others abroad are discouraged at the delays in the U.S. Senate, which is now routinely taking three or four years to ratify a treaty (and kicking up a lot of fuss in the process) and that has a track record of rejecting almost one half of the treaties presented to it.

It can, of course, be argued that in political theory most of these issues should really not impact the negotiation or ratification of a tax treaty between two countries, or the development of closer tax cooperation. However, in the real world, political issues such as this are of considerable importance to both of the governments. Even more to the point, such political issues as those just mentioned, together with the broader concerns of U.S. business regarding Canadian economic jingoism as reflected in the NEP and FIRA, will certainly be reflected in views expressed in the ratification process in the U.S. Senate for the new Canada-United States treaty. On balance, this miscellaneous crowd of issues probably seems less irritating, from a U.S. viewpoint, than it did a year or two ago, and on this account the tax treaty ratification process in the U.S. Senate may well go a bit more smoothly.

IX. U.S. Tax Reform

I should mention one more indirect tax issue between Canada and the United States, and that is the influence that past and pending major changes in the U.S. system will have on Canadian tax law. Few Canadians fully appreciate the very major reforms in U.S. tax legislation that have been enacted in the last couple of years, and the major further changes contained in, for example, the tax bills that have been produced by the U.S. Senate and the House Ways and Means Committee. The Senate version alone of this year's revenue bill is over 1,000 pages long. Faced with a

multi-billion dollar deficit, the Congress is working fitfully and with a great deal of political bias at tightening the U.S. tax net, so as to squeeze additional dollars to cover the sea of red ink that Washington is swimming in.

There is a general reluctance on the part of both Congress and the Administration to see major direct tax hikes and there is a clear political limit on the extent to which welfare programs can be cut back. The result is that Congress is concentrating on closing down perceived tax loopholes and undeserved advantages in an effort to close its budget gap. The U.S. tax system is getting squeaky clean—at least relatively speaking—and the bad news for Canadian taxpayers is that these changes are likely to have a very direct impact on tax policy in Canada. The federal government has laid back in terms of vigorous new tax initiatives after its debacle with the November 1981 budget, but the new moves in the United States will likely move the Canadian government—regardless of the party in power—to bring in major new initiatives at some point over the next two or three years. To some degree, Canadians would have the United States to thank for such a possible tightening of our tax net.

X. CONCLUSION

In presenting this lengthy listing of tax and related issues between Canada and the United States, it is easy to give the impression of continued sharp conflict between our two countries. Indeed, on a number of the issues that I have discussed—including FIRA, the National Energy Program, unitary tax, and others—there are substantial differences between our two governments, and these differences are not likely to be easily resolved, given the reality that each will and must pursue policies that benefit its taxpayers and enterprises. But in this review of current tax issues, it is all too easy to dwell upon the negative aspects of our tax, trade and investment relations.

The positive side of the story also needs to be considered. The total volume of both trade and investment between Canada and the United States is larger than between any other two countries in the world. And this huge volume of bilateral trade and investment flows, for the greater part, without important hinderances from either government. Indeed, taking a bit broader perspective, it appears that the trade between our two countries, while subject to some protectionist pressures, is likely to benefit from a gradual extension of duty-free or other concessionary rules, and that various impediments to bilateral investment are, gradually, easing.

One of the most noteworthy achievements in the economic relations between our two countries was the negotiation of the new Canada-United States tax treaty in 1980. Even though the treaty has had two protocols even before its ratification, and even though that ratification process is likely to be slow and rather painful, nevertheless the treaty does resolve a

number of important policy issues between the two governments, and provides a more certain framework for continuing trade and investment between our two countries. The treaty is certainly the most comprehensive tax treaty ever entered into between two countries. Its very length and complexity stand both as a recognition of the size and sophistication of cross-border investment and trade, and as a recognition of the difficulties of reconciling different policy points of view.

And of course there are differences in basic tax policies between our two countries. Canada has traditionally viewed itself as a capital importer, and with very important concerns about the implications of foreign investment in and control over the Canadian economy. Accordingly, Canada has sought to derive the greatest possible benefit from this foreign investment by reserving the right to tax it as heavily as possible in the circumstances. For example, Canada's basic policy for many years was to require a minimum 15% withholding tax on dividends and interest paid abroad from Canada, a relatively high level of tax by international standards but one that was justified from a Canadian perspective because we needed tax revenues from the substantial inflow of foreign capital.

The United States, on the other hand, traditionally viewed itself as a capital exporting company, and hence was anxious to implement policies to protect the interests of American corporations abroad, and to favor the right of the capital exporting country to share in the taxes imposed on the earnings of such capital exports. The United States, as an exporter of capital, therefore favored low rates of withholding tax in treaties on dividends and interest, because its citizens and its treasury had more to gain from such actions.

But life teaches us that situations change. The United States has found itself in a sea of balance of payments deficits, covered by a flood of new foreign investment in the United States. Its tax interests are no longer quite so clearly those of a capital exporter: it now has to address issues such as ensuring that foreign capital pays its fair share of U.S. taxes. And the rising tide of imports of both money and goods are leading to new feelings of protectionism in the United States.

In Canada, the converse has been the case, as the increase of a percentage basis of Canadian investment abroad each year since 1975 has exceeded new foreign direct investment in Canada. While Canada still needs large supplies of foreign capital, it is being obtained increasingly through governments and major Canadian corporations selling debt abroad, and not through the traditional imports of equity capital. Canadian investment outside of Canada, while still only a fraction of foreign investment in Canada, is now growing rapidly. And Canadian investment outside of Canada, is now increasing far more in percentage terms than the total of all foreign investment— direct and portfolio—in Canada. For example, in the nine years from 1975 through 1983, Canadian direct investment abroad grew by 273%, while foreign investment in Canada increased by only 94%. To put it into other terms, Canadian foreign invest-

ment abroad in 1975 was only 28% of foreign investment in Canada, while by 1983, Canadian foreign direct investment of almost $40 billion was over half (54.8%) of foreign direct investment of $73 billion in Canada. (See Table 2).

Table 2

	1975	1976	1977	1978	1979	1980	1981	1982	1983
Foreign Direct Investment in Canada (billions)									
U.S.	$29.67	$31.92	$34.72	$38.35	$42.77	$48.68	$51.20	$52.70	$56.50*
Total	37.39	40.31	43.68	48.23	54.26	61.64	65.20	67.70	72.50*
Canadian Direct Investment Abroad (billions)									
U.S.	5.56	6.09	7.07	8.9	12.10	16.40	21.63	**	**
Total	10.53	11.50	13.44	16.25	20.03	25.80	32.70	35.90*	39.30*

Source - Statistics Canada
* Unpublished preliminary estimates by Statistics Canada.
** Not yet available.

The result of these trends is that Canada is also in a period of transition in terms of its tax policies. The agreement by Canada to accept a 10% withholding tax on direct investment dividends in the new Canada-United States tax treaty is not only a concession to American demands for lower withholding taxes, but is also a recognition that such lower withholding taxes, in the long run, could also be in Canada's best interest.[11] And even though Canada has refused to lower its general withholding tax rates on interest, in fact Canadian tax law contains exemptions for both interest on all government obligations, and interest paid on arm's length debt of five years or more. The great bulk of Canada's foreign interest bearing obligations are in fact exempted from Canadian withholding tax under these two provisions.

Tax planning in Canada is also about to face something of a transition. In the past, because Canada was a capital importing country, insistent on high rates of withholding tax on income payments outside of Canada, Canadian corporations investing abroad had to anticipate high rates of withholding tax on their foreign income coming back to Canada. Nobody would grant Canadian investors a low rate of withholding tax on the repatriation of their income, when Canada insisted on a high withholding tax on payments from Canada.

Accordingly, Canadians became some of the most artful dodgers in the world at using other countries' bilateral tax treaties to obtain tax concessions and benefits which they could not obtain by using their own treaties. This led Canadians to develop such major pieces of domestic culture as the double dip, the Dutch treat, the Netherlands sandwich and other exotica. Canadians used the tax treaties of other countries, most notably

[11] Canada will likely renegotiate its treaties with other developed countries to allow a 10% withholding on direct investment dividends.

the United States-Netherlands tax treaty, and features of other countries' tax legislation to arrange reasonable overall tax impacts on their foreign investments. But Canadian business is gradually recognizing that this environment is changing. The United States has a very firm position against "treaty shopping"—the use of tax treaties between two countries to achieve allegedly unintended benefits by nationals of a third country.

The European Economic Community also dislikes such backdoor use of treaties and the related use of intermediary holding companies. The United States is busily trying to renegotiate its tax treaty with the Netherlands and the result of this negotiation (presently slowed down by the unitary tax dispute) will almost certainly be a regime that will not make it as easy for Canadian companies to benefit from low rates of withholding tax by floating their investments through the Netherlands. Indeed, it is likely that the Canada-Netherlands tax treaty, when it is renegotiated—likely following the settlement of the United States-Netherlands tax issues—will eliminate the favored Article VII.[12]

The result will be, after some transitional period, that Canadian investors will no longer be able to float equity investments through Holland without payment of Dutch withholding taxes. The United States is also trying to restructure its treaty arrangements with the Netherlands Antilles, and while this has become entangled with domestic politics, the result again cannot be favorable to foreign investors. The further nail in the coffin was the announcement, just two weeks ago, of a proposed revision in the Netherlands-Antilles tax treaty, which would see dividends paid by Dutch companies to Netherlands' parent corporations being subject to a 7 ½ % Dutch withholding tax after 1984. This change will eliminate the use of a Netherlands Antilles parent/Netherlands subsidiary/U.S. sub-subsidiary types of structure (and its alternatives) to extract income on a low tax basis from the United States.

Of course, it is too early to say that the age of international tax gimmickry is dead. The Swiss Alps will withstand the assaults of the international tax gatherers for quite a few more years, and there are still plenty of intriguing possibilities around in the use of third country treaties. But the writing is on the wall, and Canada and Canadian business now have a more substantial interest in negotiating advantageous tax treaties with the United States and other countries. It is helpful in this regard that we already have a fair head start.

In this period of transition, it is a positive and encouraging sign that the tax and trade issues between our two countries seem on the whole to be moderating in severity. Despite many difficulties, we have succeeded in negotiating a new Canada-United States tax treaty, and with a good deal of luck we may even be able to get it ratified within the next year or so. However unappreciative taxpayers may be, we have an effective system of

[12] Providing exemption from tax on certain dividends out of foreign source income paid by a company in one country to a parent in the other.

cooperation between Revenue Canada and the IRS, involving so-called simultaneous audits of multinational corporations, particularly those with tax haven interests. We have somehow managed to provide taxpayers on both sides of the border with a fair degree of security and confidence with respect to their cross border investments and trade. With some difficulty, we have managed in each country to fend off most of the efforts at narrow protectionism. Each of our two countries has its own separate interests and concerns, and I do not want to imply that these will not give rise to sharp, even bitter disputes. But the goodwill demonstrated on each side in the past and at the present stands as an indication that we will somehow muddle through and deal with such issues as they arise in a positive and constructive manner.