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Sovereignty in the Modern Age

Robert Brown*
Michael Alexander**

Sovereignty is a concept as old as politics. Sovereignty means the absolute right of nations to determine and follow their own self interest and to decide for themselves all issues relating to their domestic conduct. Walter Bagehot, a 19th century English writer, put the matter rather more elegantly when he stated that: "As with the supreme monarch to which the term refers, sovereignty gives a nation three unassailable rights - the right to be consulted, the right to encourage, and the right to warn." Bagehot's summary is relevant for modern commentators, because it focused on the relations of one sovereign state with other sovereign states - sovereignties in conflict. And it points out by inference the limits of sovereignty, the limits that we are approaching evermore rapidly in today's shrinking, interdependent world.

The concept of sovereignty as involving the absolute right of nation states over their internal affairs was more useful in those bygone days when the greatest part of economic life, as well as cultural issues, was confined to a single state and there was relatively little movement of people, goods, capital and even technology and ideas between sovereign nations - and therefore less likelihood that the internal affairs of one state would impinge on another. But in today's global village, we face an enormous growth in the movements of people, technology and capital between nations, as well as explosive growth in international trade. Global trade has more than doubled - from $3.4 trillion to $7.5 trillion - in the nine years from 1985 to 1994. And these shifts towards global inter-reaction are affecting virtually every aspect of our political and social fabric - culture, human rights, education, and taxation. The trends are unmistakeable and irreversible, even if they are accompanied, in many parts of the world, by a surge of nationalism and narrow parochialism.

In this global village, with overlapping national claims, we must all make a greater effort to get along with each other and reach the difficult and painful accommodations which are necessary to resolve the conflicting claims of different sovereignties. The fundamental issue of course, is that while it is still current legal theory that countries are totally able to determine their own internal policies, these same internal

* Chairman and Senior Partner, Price Waterhouse.
** Director of Communications, Price Waterhouse.
\(^1\) WORLD ECONOMIC FORUM, World Competitiveness Report, June 1993.
policies have an impact far beyond their borders and are therefore the legitimate concern of other sovereign nations. The goal must be to resolve those conflicts peacefully, through negotiation and accommodation.

**CANADA-U.S. TRADE AND INVESTMENT**

Nowhere is this potential for both peaceful co-existence and conflict more evident than in the economic relations between Canada and the United States. These two countries remain the world’s largest international trade and investment partners, with a staggering volume of goods, services, technology, knowledge, capital, and even people flowing freely across the undefended 3,000 mile common border.

With regard to investments, the official figures show Canada’s direct investment in the United States in 1993 amounted to $65 billion, almost 60% of total Canadian direct investment: for the United States, direct investment in Canada amounted to a little under $70 billion (U.S.), only 14% of foreign direct U.S. investment.² (In fact, these statistics are misleading because they are based on book values: Canadian investment in the U.S. is more recent, on average, than U.S. investment in Canada, with the latter being worth multiples of its historic book value).

Canadian exports to the United States have grown from $94 billion in 1985 to $145 billion (Cdn) in 1993, and represent over 80% of Canada’s exports. U.S. exports to Canada in 1993 came to approximately $91 billion (U.S.) representing about 20% of U.S. exports.³ To put the trade issue in perspective, U.S. exports to Canada amount to less than 1 ½% of U.S. GDP. Canada’s exports to the United States come to about 15% of Canada’s GDP - or over 10 times the relative importance of U.S. exports to Canada. Accordingly, concerns about U.S.-Canada trade, investment and tax issues tend to be central in Canadian economic and political life, but only peripheral in the United States: Canada and the United States have an asymmetrical relationship.

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² OECD Main Economic Indicators, March 1994.
Canadian Exports

$ Billions Cdn

GLOBAL

$119B

of which $94B to U.S. 79%

of which $145B to U.S. 80%

'85

'93

Stats Can

US Exports

$ Billions U.S

GLOBAL

$421.7B

of which $85.1B to Canada 20%

'91

'93

stats Can
This tremendous and growing flow of trade and capital between our two countries is a genuine success story, and this success is rooted in general harmony and cooperation, reinforced by the recent Free Trade and NAFTA agreements. However, this extraordinary volume of cross-border activity also brings with it some inevitable strains on trade and tax issues. It is on these strains that I will concentrate in this paper, although I should say at the start that they have to be seen against a general background of success in accommodating the separate interests of each country in active cooperation for common benefits.

**INTERNATIONAL TAX RULES OF THE ROAD**

Before turning to some examination of tax issues currently in conflict between Canada and the United States, it would be helpful to define the very general rules of the road that are supposed to apply in dealing with conflicts in the taxation area between nations. These rules are found, first of all, in the actual history of international tax relations, and secondly and more specifically in the Organization for Economic Cooperation and Development (OECD) model tax treaty and its extensive commentary.\(^4\)

With respect to international capital investments, the general rule is that the host country for the investment or business has the primary right of taxing the income therefrom. The second country - the country in which the investor who provided the capital is located - may also tax that income flow from the investment, but generally on the basis of recognizing the tax of the first country. This is done in very general terms by providing a foreign tax credit, in which the country of the investor allows a credit against its own tax for the tax already paid on that income in the foreign country. Accordingly, this second country will only obtain tax revenue to the extent that its tax on such income exceeds that of the first country, the host country for the investment.

In a universe where corporate tax rates are tending to converge, there is frequently little additional tax room left to the second country. Indeed, for a multitude of reasons, very few countries derive significant tax revenues from the taxation of foreign source income. (In practice, the host country for the investment has an incentive to increase its tax burden up to the taxes that would be levied on the income in the country of the investor, since by so doing they do not provide any disincentive to the investor but merely mop up tax revenues that would otherwise go to another nation.) There is, however, an alternative approach to this issue, in which the country of the investor short circuits all of the necessarily complex calculations underlying the foreign tax credit, and simply provides an exemption for foreign source income.

A number of influential commentators in the United States several decades ago argued vociferously that the primary right of tax should belong to the country from which the capital came. This was at a time when the United States was a huge capital exporter, but the fall of the United States from that position to a debtor nation appears to have silenced the arguments in support of this approach in the United States.

With respect to international trade there is first of all a general rule that a country will not tax a foreign business unless that foreign business has a “permanent establishment” in its territory. This means that businesses which merely export goods and services to a second country, without establishing any permanent presence there, are not subject to tax in that second territory. This rule perhaps is based more on convenience than taxation philosophy, but in fact it is a rule that is absolutely essential at reducing international conflicts on which countries should tax the income associated with international trade: other approaches lead quickly to chaos and conflict.

There is another important basic rule of the road with respect to international trade, and that relates to determining how the total income from an international business should be allocated amongst the countries in which that international business is conducted. The rule specifies that “arm’s length” prices for goods and services, and for capital, should be applied to determine the income earned by that international business in separate territories. For example, if a whisky manufacturer in Canada exported its products in bulk to the United States, where the whisky was then bottled and resold, the whisky manufacturer would be called upon to set a fair and independent price at which the bulk whisky from Canada is transferred to its United States subsidiary, so that the income of both the Canadian producer, and the U.S. distributor, would be determined on the basis of that arm’s length transfer price. Each corporate identity will therefore earn a “fair” return on the activities which it carries on. This rule seems eminently sensible, but the difficulty is in applying it. There is a huge and growing percentage of international trade that is carried on between members of the same corporate group, in circumstances where there is simply no objective arm’s length price available in other markets. The goods and services being sold between the affiliates are frequently semi-finished products or sold in quantities and under trade conditions which have no counterpart elsewhere. There are various approaches involving reference to a fair division of the overall profit or rate of return test that can be used to construct a “fair value” in such cases, but the results tend to be less than totally precise. Of course, any uncertainties with respect to transfer prices are bound to lead to conflicts between revenue-hungry governments over how the international tax pie should be divided up.
INTERNATIONAL TAX TREATIES

Despite these and other international tax rules, there remain a host of possible conflicts, as well as opportunities for hardship and avoidance, with respect to the inter-reaction of the differing tax systems of two countries to a common income or capital flows, or to a business that spans the two jurisdictions. To solve and reconcile these differences, countries around the world have entered into international tax treaties - the total is now over 2,000\(^5\) - to provide definitive rules as to how the transfer of goods, services, income and capital between the signatories is to be treated. These international tax treaties have the objectives of:

- resolving difficulties, anomalies and hardships due to differences between the tax systems;
- defining with clarity the tax rights of each of the two signatories, so it becomes clear which country has the right to tax and when (The corresponding relief provided by the other jurisdiction may also be noted);
- providing favored status, such as lower withholding tax rates, than would otherwise apply in the absence of the treaty;
- allowing the exchange of information, and reducing avoidance.

The overall purpose of tax treaties is to facilitate trade and investment between the countries, and therefore they are an extremely important building block in the new global system of commerce and investment. Without them, the flow of capital, technology and knowledge, as well as goods and services, between nations would be severely hindered, and aggregate global wellbeing diminished.

THE U.S. APPROACH TO TAX TREATIES

The U.S. has traditionally adopted a different approach to negotiating tax treaties than have other governments. The U.S. seems much more concerned that its agreements represent an extension of U.S. policies. Tax treaties have therefore been used in an effort to reward "good" foreign countries and reinforce U.S. foreign policies. Other countries are more likely to simply want to strike a deal with another country in order to help their own exporters and investors. As in other areas of its international policies, the U.S. tends to be less flexible in its approach to tax treaties than other nations. The U.S. has its own model tax treaty, and - in good part - expects other countries to conform to its norms. The result of course is that the United States has not been wildly successful in negotiating tax treaties. The number of tax treaties actually in force with the U.S. are fewer than the number entered into

\(^5\) Revenue Canada Taxation, Provincial/International Relations Division, April 1994.
by any of the U.S.'s major trading partners (except Japan)\(^6\) and the treaties that it does negotiate frequently require years of acrimonious negotiations to conclude.

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**International Tax Treaties**

![International Tax Treaties Chart]

**Revenue Canada**

**Canada-United States Tax Relations**

The generally constructive, but oft turbulent, story of the Canada-U.S. tax relations reflects these international norms but is strongly influenced by special influences that arise between the two countries. First of all, the enormous volume of trade and investment between the two countries is so large, as to necessarily give rise to complexities and special circumstances. The task of reconciling tax issues between the countries therefore becomes more difficult.

Secondly, a very large proportion of trade between Canada and the United States is inter-company trade - between parents and subsidiaries, or between affiliates. This means that perhaps even more of the trade than usual is carried on in goods and services where it is more difficult to find an objective arm's length price, thereby increasing the potential for disagreement between the two territories on how income

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\(^6\) *Id.*
should be allocated.

From the Canadian viewpoint, a particular issue is that Canadian exports to the United States, and American investment in Canada is a dominant feature of our economy. Over 80% of our exports go to the United States and perhaps two-thirds of our foreign investment comes from the United States.\(^7\) But as previously noted, the United States finds that its exports to Canada and investment in Canada are important but not dominant parts of its overall trade. The result is an imbalance in the way that the two countries think about tax and other issues related to their international relations: in Canada, these issues with the U.S. tend to be of dominant importance in public policy while in the United States the same issue can be merely one of a number that have to be addressed in the realm of international relations, and even then is clearly subservient to domestic concerns.

There are of course other potential clashes caused by differences in attitude, or even philosophy between the two nations. The United States, as the world's largest economy and the only remaining super power, naturally considers that it has more of a right than most to determine the rules of the road that apply to its international trade and investment. In other words, the U.S. is much more likely, perhaps because of its concentration on internal concerns, to prefer to follow its own policies even if they diverge from norms in international economic matters. (I am certainly not implying of course that the U.S. is the only country that does this: Canada and every other country also do so, but are perhaps less able to be successful at it than is the United States.) In a word, the United States has been known to throw its weight around, and is basically less sensitive (and perhaps less knowledgeable) about the concerns and interests of other countries.

Canada of course has its own hangups, and is determined to adopt measures affecting economic policy to maintain its cultural and political independence, most particularly from the United States: this is considered a natural counter-balance to the pull of economic gravity from Canada being in the U.S. orbit. Canada also tends to be more pragmatic about trade and tax issues, because its focus is to make trade work.

ARE FOREIGNERS RIPPING OFF THE U.S. TREASURY?

One particular issue worth a special mention is the continuing belief of a number of politicians in the United States that foreign companies are diverting revenue from the United States to their home country, with a consequent major loss of tax revenues to the United States. This is an issue that has been referred to frequently and with great fervor by U.S. politicians and commentators, including President Clin-
ton. In his pre-election platform, he pledged to get an additional $45 billion a year out of foreign investors through rigorous enforcement of the tax rules, with this proposal being followed up by an idea for a "minimum tax" on U.S. businesses owned by foreigners. (Both ideas basically, and thankfully, went nowhere.)

The sometime U.S. obsession that foreign companies are massively underpaying their fair share of U.S. taxation has, like most wrong ideas, some germ of truth as its basis. A large number of international companies, including those that are U.S. owned, have quite legally taken advantage of international tax rules to earn income in tax havens and other low tax jurisdictions, as well as taking other measures to reduce their total tax bill on international income. But there is still no credible evidence that, as a group, foreign investors in the United States are systematically avoiding gargantuan amounts of U.S. tax.

Over the past 20 years, the United States has gradually moved from the world's major capital exporter to a substantial net importer of capital. Perennial U.S. federal deficits have been financed, in good part, through the sale of securities to foreigners as the U.S. has struggled in vain to put its fiscal house in order. The U.S. federal deficit is allegedly declining to an extraordinarily high $220 billion, and the United States is naturally concerned about this (although the U.S. deficit is still only about half as high, in relative terms, as are Canada's).

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8 Tax Management Transfer Pricing magazine, 1-6-93.
9 OECD World Economic Outlook, No. 54 (Dec. 1993).
It is appropriate that the United States will wish to take all measures to maximize its tax revenues to try to overcome these deficits. But the reality is that the United States has relatively low corporate rates of tax, rates that are no higher than those prevailing in most of its trading partners, including Canada. Accordingly, there is no obvious reasons for many foreigners to divert income from the United States back to their home territories in order to save taxes. (I do accept of course that there are occasions when this diversion of income can be tax-effective, as well as noting that there are instances in which income has been shifted to tax havens).

The United States has a relatively low tax burden by international standards, even though this is not widely recognized in the United States, particularly around April 15. The general level of U.S. corporate income taxes is at least comparable to that of its major trading partners. The United States also has no national sales tax, has relatively low personal income taxes, has extremely low taxes on gas, tobacco and certain other products, and overall has a tax burden that most other countries around the world would envy: the U.S. citizens pay a lower proportion of their income on taxes than do their counter-
parts in almost all of the major countries that do business with the United States.  

Tax Revenue

As a % of GDP

<table>
<thead>
<tr>
<th>Country</th>
<th>1980</th>
<th>1992</th>
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<tbody>
<tr>
<td>Canada</td>
<td></td>
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<tr>
<td>U.S.A.</td>
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OECD

Canada too is struggling with huge deficits: the combined federal and provincial deficits this year will amount to $70 billion, far worse in relative terms than the corresponding figure in the United States. Even worse, Canadian tax rates and burdens are already relatively high by international standards making it more difficult for Canada to bring its deficit problem under control through further increases in taxes. The United States, with its relatively low burden of tax, could if it wished eliminate its deficit through higher domestic taxes and still have a tax burden that would not be out of line with most of its major trading partners. Of course, the fact that the U.S. could get out of its deficit problems through higher taxes does not mean that such higher taxes could or even should be imposed; it simply means that the U.S. has an

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10 Borne out in summaries of World Economic Forum, World Competitiveness Report, supra note 1.
11 Revenue Canada.
12 Unlike most OECD members, the U.S. has no Value Added Tax.
option in this area that is not likely available to Canada. In fact, U.S. taxpayers feel that they already bear a heavy burden of taxation and substantially higher taxes are, at the moment, not a political possibility in the United States. In addition, there are legitimate fears that any such major tax increase would gravely injure the U.S.'s economic recovery. This, however, does illustrate that U.S. fiscal approaches have a domestic focus, and even though U.S. trade balancing and deficit control policies have been partial failures, the domestic imperative of keeping down domestic taxes has led the U.S. to use foreign capital as one of the whipping boys in the deficit debate. For similar reasons, the U.S. continues to tend to blame a large part of its massive trade imbalance on unfair foreign trade practices instead of on its own problems.

In the tax area, the U.S. combines some efficiencies in tax administration with some clear failures in tax design. The U.S. has an antiquated and perverse tax system, which:

- places heavy weight on income taxes, which apply to export earnings
- has very low reliance on consumption or sales taxes, which do not apply to exports
- has a full double taxation of corporate income, once when earned by the corporation and again when distributed as a dividend
- does not generally favor savings

With these inefficiencies, the U.S. might turn part of its attention inward in seeking the solution for some of its trade problems.

**Profitability of Subsidiaries**

With respect to the issue of tax base shifting between Canada and the United States, it is interesting to contrast the position of U.S. subsidiaries in Canada, and Canadian subsidiaries in the United States. The U.S. subsidiaries in Canada tend to be older, to have asset bases which were in part acquired many years ago, and to have established markets. Canadian subsidiaries in the United States tend, on the whole, to be more recently founded: they have frequently purchased their asset base recently, and in current dollars, and they have tended to finance a larger part of that with borrowed money than U.S. subsidiaries in Canada which can operate in part through retained earnings. In these circumstances, it is not surprising that U.S. subsidiaries in Canada may tend to earn a higher rate of return on assets and sales than corresponding and similar Canadian owned enterprises in the United States, leading to the impression that U.S. income may be under-reported.

Of course, one could get into some interesting international conundrums about the correct way to apportion interest and some other fungible charges in an international business, but the point is still valid that the relative unprofitability of some foreign-owned enterprises in the United States is based on the highly competitive U.S. markets, high levels of indebtedness, high asset prices, and in some cases lower levels
of profitability in the United States relative to other countries.

**CANADA FEARS U.S. TAX AGGRESSIVENESS**

In Canada, as well as in other countries abroad, there are growing fears of U.S. fiscal aggressiveness as the United States continues to seek to improve its trade position internationally, and even its domestic fiscal balance, through attacks on established trade and tax norms. Canada has a particular perception that we may be unfairly affected by the fallout from the U.S. punitive approach to Japanese trade policies.

Canada, of course, has its own set of problems, basically a continuing Canadian ambivalence about our economic relationships with the United States. On the one hand, Canada wants the benefits of close U.S. association and even liked “special status” when we were able to obtain it. Most Canadians admire the overall success of the United States, including the dedication and drive of its entrepreneurs, and the commitment to innovation of its economy.

But at the same time, Canada does want to preserve some independence of action and fears U.S. influence. The Canadian ego is also frequently bruised by the fact that our country feels ignored in U.S. political circles, while in Canada, issues relating to the United States tend to dominate our news and our concerns. The new Canadian administration under Prime Minister Chretien is committed to maintaining more of an independent position with respect to relations with the U.S. than was its predecessor. The basic Canadian policy of friendly and open relations with the U.S. remains unchanged, but Mr. Chretien is determined not to be perceived as subservient to U.S. interests. As former Canadian Prime Minister Pierre Trudeau once said, sharing a border with the U.S. is like sleeping with an elephant.

**U.S.-CANADA TAX CONFLICTS**

It is against this background that I turn now to reviewing some particular issues in Canada-U.S. tax relations. The big news in international tax issues these days is transfer prices - the determination of the basis on which the total income of a multinational business is divided up amongst the territories in which it carries on operations.

**TRANSFER PRICES**

In the broad area of international allocation of taxable income, the U.S. has undeniably the most sophisticated, the most complex and the lengthiest tax rules, backed up by the most capable enforcement. This is not to say, however, that the U.S. system is perfect. In fact, a number of commentators, including myself, feel that the U.S. codified approach can create a bureaucratic nightmare of uncertainty and perversity. But the U.S. has addressed, more concretely than any other
country, the transfer price issue, and very largely it has done so in the context of aggressively seeking to expand the U.S. tax base.

A number of other countries, including Canada, see the United States and its revised Section 482 regulations\(^{13}\) and numerous other developments, as edging away from accepted international norms in an approach that could have the effect of eroding their own tax base in favor of that of the United States. Indeed, the Canadian authorities became so apprehensive about the new U.S. income allocation rules that Revenue Canada took the virtually unprecedented step, in January 1994, of noting the developments in the United States, and publicly announcing that transfer prices and other issues that might be determined under the new U.S. rules would not necessarily be regarded as acceptable for Canadian tax purposes since Canada did not support the basis on which the U.S. rules were prepared.\(^ {14}\) This warning gun by the Canadian tax authorities means that taxpayers engaged in international trade between Canada and the United States are put in considerable jeopardy. Regardless of what basis they follow in determining the allocation of income flowing from trade between Canada and the United States, they run the risk of having the tax authorities of one or the other, or perhaps both countries, objecting to the basis. This situation is particularly severe with respect to any possible alleged understatement of U.S. income, since the U.S. rules contain horrendous penalty provisions.

The U.S. has adopted an innovative advance pricing determination procedure, in which taxpayers can obtain advance clearance of pricing methodology on trans-border transactions - but of course these taxpayers have no assurance that such pricing methods would be accepted by Canada or any other foreign government. In the case of Canada-U.S. trade, taxpayers who find the two governments at loggerheads on how the income pie should be divided up can have reference to the competent authority provisions in the existing Canada-U.S. tax treaty, but again without assurance that the two governments, evidently committed to different methodologies, can come to an agreement (The taxpayer has no right to compel the governments to reach an agreement in a Canada-U.S. transfer price dispute, and hence has no assurance against economic double taxation. However, in the past the component authority provision has worked relatively effectively, if slowly.).

The angels are not all on one side in this conflict of views. Other countries, including Canada, have been in the past notoriously lax about international transfer pricing issues. Further, the adherence to an "arm's length" price standard for international income allocations can

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13 Temporary regulations issued under Internal Revenue Code Section 482, Jan. 21, 1993.
legitimately be challenged in an era where increasingly there is no market-determined independent arm's length price to which to refer, even indirectly. But because the U.S. is in the lead in both the sophistication that approaches international pricing issues, and the resources that it expends in policing such issues, it is nevertheless likely to obtain a net advantage in enforcement activities with other countries with less developed tax capabilities. To the United States, this is not seen as unfair or untoward, while to others it seems like a threat to their domestic tax base and economic wellbeing.

The intensive U.S. efforts on transfer pricing issues are of course in part a legitimate response to over-exuberant international tax planning and the diversion of income to tax havens or low tax jurisdictions. But overall, the approach of the U.S. has tended to create more difficulties in pricing issues between the U.S. and other jurisdictions than apply generally in the tax relations between countries.15

FOREIGN TAX CREDIT

The U.S. foreign tax credit is a complex part of the U.S. tax code. In general terms, the U.S. foreign tax credit rules have been changed on a number of occasions in recent years, to limit the tax credit available to U.S. companies in respect of the foreign taxes paid on their income. The result of course is an inducement for U.S. companies to shift income from abroad into the United States, since increasingly they have failed to obtain full credit against their U.S. tax for foreign taxes paid and therefore can be subject to "double taxation" on foreign source income. Some of the changes in the foreign tax credit computations under the Internal Revenue Code do rest on a reasonable intellectual basis, but again they tend to be in advance of - or at least different from - those employed by other countries, and inevitably they give rise to concerns abroad as to the motivation for such changes.

UNITARY TAX

A particular thorn in the side of foreign investors in the United States is the so-called unitary tax issue. In past years, a number of states in the United States, and most notably California, adopted a unitary tax approach to the taxation of corporate income. This approach was to ignore all issues of arm's length pricing, and instead to calculate the base for - say California corporate tax - as a portion of the worldwide income of an entire associated corporate group, if any member of

15 These and subsequent comments regarding overall U.S. tax relations with other countries are related to general directions enunciated in a U.S. policy paper entitled, "Tax Compliance in a Global Economy - Statement of Policy and Action Plan," co-authored by the Hon. Leslie B. Samuels, Assistant Secretary (Tax Policy) U.S. Department of Treasury; and the Hon. Margaret Milner Richardson, Commissioner, Internal Revenue Service. (Dec. 1993).
that group did any business in California. (The position of the worldwide income that was regarded as being earned in California was determined by applying a formula percentage to total consolidated income, with that percentage being determined by factors related to the percentage of revenue, wages and/or assets in the jurisdiction to total consolidated revenue, wages, and assets. Of course, the unitary approach was applied precisely because it tended to increase corporate tax revenues - allegedly up to $500 million a year in California alone. The unitary tax approach was particularly resented by foreign based multinationals who felt that this approach was a clear contradiction of the arm's length apportionment basis in their tax treaties with the United States, a basis on which international tax harmony depended, as well as being a blatant effort by California and some other states to garner revenue.

This is an old issue in California, and other states using this approach have moved away from it in recent years. California itself largely abandoned the concept last October, showing that its economic recession and the resentment of foreign companies had helped drive home the cost of being different in the international tax game. But the fact that this method was applied for many years, without the intervention of the U.S. federal government, is still a major irritation abroad, and it is the subject of a tax case recently heard before the U.S. Supreme Court - the Barclays/Colgate case. The issues are complex, but, if the Supreme Court decides in favor of California (as expected) and rules out tax refunds on the unitary assessments on multinationals in past years, a number of foreign countries may retaliate, and raise taxes on U.S. corporations doing business in their jurisdictions. While Canada has supported the opposition to the unitary tax method, we are not likely to join in such retaliation, but the fallout could mean a new international tax war with adverse implications to trade and investment around the world.

**Withholding Taxes**

A major irritant to the U.S. in the continuing tax policy conflict with Canada has been the fact that Canada has generally higher withholding taxes on income flows to the United States than the so-called OECD norms. It is indeed true that Canada does have higher withholding taxes, in a number of areas, on income flows to the United States than would be recommended as the norm under the OECD model treaty. Of course, the withholding tax rates on Canadian income flows abroad have been dropping in recent years, as have those of other countries, as part of an overall program to facilitate international investment. Some four years ago, Canada finally opted to offer other countries a withholding tax rate of 5% on dividend flows from direct investments in Canada, on a reciprocal basis, bringing this critical fea-
ture of Canadian tax policy in line with the OECD. However, Canada was only prepared to phase-in this lower rate, down from the then-standard 10% in the U.S. and many other tax treaties, over a period of four years.

In general, Canada has been reluctant to drop its withholding tax rates as low as the United States (and some other countries) would like. The first concern is revenue: cutting withholding tax rates means giving up scarce tax dollars at a time of sky-high deficits. And it means giving up revenue in an unbalanced way. Canada is a debtor nation and income flows of dividends, rents, royalties and interest from Canada to abroad are far greater than the corresponding flows into Canada. Lowering taxes on such flows therefore involves Canada giving up bigger benefits to other countries, notably the United States, than its own corporations and citizens would obtain. Of course, it can be argued - and it has been by the United States - that such lowering of tax rates is simply part of the global trend to facilitate international capital investment, and implement the philosophy underlying NAFTA. The U.S. would contend that Canada would benefit from such a move; however, with its ambivalent view of foreign investment, Canada is not entirely sure that it wants to totally facilitate incoming capital, at least not to the extent of giving up important tax rights on it.

U.S. Estate Taxes

Estate taxes are a particular, if relatively minor, issue in Canada/U.S. tax relations, but serve an excellent illustration of how differences in the tax systems of two countries can create tax issues. The United States has a general estate tax, levying fairly substantial taxes on the estates of deceased U.S. citizens, and foreigners owning certain types of property in the United States. However, the U.S. does not impose any tax on the unrealized appreciation of capital assets held by a deceased at the date of death. Those assets are generally taken over, at current fair value, by the beneficiaries of the deceased and so the capital gains tax that would have applied on this appreciation is forgiven. Canada on the other hand has no general estate tax or succession duties at death, nor do the Canadian provinces. Instead, Canadians are taxed on the deemed realization of all of their capital assets, at fair value, at the date of death, with some limited postponement rules.

The two different approaches have their adherents, but the real issue is that the difference in tax policy can lead to particular cases of "double tax" since, in estates subject to both jurisdictions, the Canadian deemed realization tax is not offsettable against U.S. estate tax, and the U.S. estate tax is not creditable against Canadian capital gains tax.

When the U.S. extended its estate tax grasp in 1988, a larger number of Canadians became subject to U.S. estate tax on certain U.S.
assets, including most notably Canadian snowbirds owning real estate in Florida and other U.S. southern states. The concern has been so widespread as to actually induce some Canadians to give up their U.S. properties, with a possible depressing influence on certain local real estate markets.

**Culture**

Another issue in tax relations between Canada and the United States is the vexing subject of culture. Canadian tax rules favor Canadian ownership of media and "cultural" businesses, hampering the ability of U.S. operators to extend their operations to Canada. For example, advertising placed by Canadians in even a Canadian publication that has primarily foreign content can be disallowed for Canadian tax purposes. The U.S. views these policies as discrimination against the U.S. and its enterprises. There is of course a basic difference in Canadian and American viewpoints: the United States not unnaturally views movies, television and video, recorded music and general entertainment as a business, and it is a business at which the U.S. clearly excels. Canada tends to look upon such matters as impacting culture, and it is the clear basis of Canadian policy to retain Canadian flavor in this area and prevent Canadians from being swamped with imports from the United States. All these perennial conflicts are brought into a sharper focus within the context of a worldwide recession, political upheaval, and widespread uncertainty.

**Extra-Territoriality**

The United States, in the tax area as well as other areas, tends to cast its tax net around the world. The U.S. is more active in the tax field outside its own border than any other country:

- The U.S. is one of the few countries to use citizenship as well as residence as a basis of taxation. Hundreds of thousands of U.S. citizens living and working abroad remain liable for U.S. taxes, with inevitable complexities created in the tax relations between the U.S. and other nations.
- The U.S. is the only country to routinely send tax auditors abroad, to check the income of U.S. citizens and companies.
- The U.S. requires a far greater amount of reporting on the foreign operations and investments of its companies than do other countries. The result is that, again, there is more likely to be an inter-reaction of U.S. and foreign tax law and policies, and strains on international relations.

**Canada U.S. Tax Treaty**

The traditional way to resolve tax conflicts between jurisdictions is
a tax treaty, and, by and large, Canada and the United States have been able to resolve the majority of the tax issues between them in a peaceful and constructive manner. It is only against this background that we note the tax issues where the two countries have not yet been able to reach agreement and which are still festering sores on the general body of reasonably healthy economic cooperation.

The first tax treaty between Canada and the United States was signed back in 1940, and it took another 40 years before the two countries got together to revise and expand their tax agreement in the present 1980 treaty. The new treaty was no sooner signed than various issues required further amendments, but the task of further updating the tax treaty - which is a continuing task in a fast changing world - has languished since the mid-1980's. In fact, the two countries have been in negotiations on revisions to the present treaty since 1988, but, despite numerous meetings, the two jurisdictions are still relatively far apart on a number of critical issues. Of course, any tax treaty changes involving such immense volumes of trade and investment will take awhile to negotiate because of the complexities of the issues involved and the sensitivity of not only the economic but the political tradeoffs required. Five years of treaty negotiations are a mere blink of a gnat's eye in terms of the glacial speed of bureaucrats, but the fear is that it could take many more years before the two countries are able to come to an agreement on the resolution of important tax issues that are outstanding between them.

**Issues Agreed**

The discussions to date are understood to have led to some measure of agreement between the parties on particular points. The most important agreement is on withholding taxes on direct dividends - dividends paid by subsidiaries in one country to parent companies and other substantial shareholders in the other where the rate of withholding tax will be reduced from the present 10% to 5%. At Canada's insistence, this reduction in withholding tax will only be achieved at the rate of 1% a year, and even then this countdown of withholding tax rates will not begin until agreement is achieved on a revised treaty. The cut in dividend withholding rates provides larger dollar benefits to U.S. investors, since the U.S. has more in the way of direct investment in Canada than does Canada in the United States. The delay in reaching agreement on the treaty is therefore costing major American investors significant amounts, together with a substantial amount of chagrin as Canada has managed to renegotiate its tax treaties with other countries to permit their investors to begin to enjoy lower withholding tax rates from Canada while U.S. investors can only dream about these future benefits.
Withholding Tax Rates

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<td>Interest</td>
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<td>Royalties</td>
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The discussions between Canada and the United States have also led to a preliminary agreement to provide some limited relief for Canadians from U.S. estate tax: the changes are not likely to give Canadian snowbirds with Florida condominiums a complete exemption, but they are understood to provide some elements of relief. In addition, the two parties have agreed on a zero withholding on some software payments, and possibly on certain types of arm’s length royalties.

Issues Not Resolved

Unfortunately, there is a fairly significant list of issues on which the two sides have not reached agreement. In terms of what the U.S. wants out of the treaty which Canada to date has not been prepared to concede, the list includes:

- The U.S. would like a lower withholding tax on some interest payments between the two countries. At present, most interest on long-term debt paid abroad from Canada is exempt from withholding tax, but a tax of 10% is levied on most short term interest (including interest on current bank borrowings) and on non arm’s length payments. The U.S. would like this rate reduced to 5% (or actually 4.99% due to the vagaries of some U.S. internal tax rules), or possibly 0%, and this is strongly supported by U.S. banks. Canada is resisting, on the grounds it would involve some net revenue loss from Canada and perhaps on the basis that some level of withholding tax on short term interest is necessary to preserve an independent monetary policy in Canada.
• The U.S. is also seeking lower withholding taxes (likely 5% or 0%, from the present 10%) on non arm’s length royalties - typically payments from Canadian subsidiaries to their U.S. parent companies. This change, it is contended, would result in a freer technology flow across the border, benefitting both Canada and the United States.

• With respect to the arguments for lower withholding on both interest and certain royalties, Canada may be apprehensive that any further lowering of withholding tax rates may encourage American companies to institute new levels of charges to Canadian affiliates, with a consequent erosion of the Canadian tax base.

• The U.S. also wants to introduce a so-called “anti treaty-shopping” clause in the treaty, which would limit treaty benefits on flows from the United States to Canadian companies owned by Canadians. However, Canada has objected to the particular language being sought by the United States, which could place some Canadian companies in which third party nationals have a strong interest, at a disadvantage. And of course there are the perennial cultural issues where the U.S. may be seeking some relaxation on Canadian rules relating to the media.

• In the negotiations, Canada is probably still seeking a somewhat better break on estate tax for Canadians owning U.S. assets. Canada also wants better treatment of the U.S. branches of Canadian banks and insurance companies, because these entities have been hard hit by recent U.S. tax changes relating to interest and other factors.

Throughout, Canada has been arguing that its sovereignty, its cultural identity, and its tax base must be preserved, while the U.S. has been seeking to break down the remaining rules restricting Canada-U.S. investment and to bring the Canada-U.S. trans-border tax more in accordance with the OECD norms.

The two sides met again in Ottawa in June but various conflicts remain, primarily because of not only the different interests of the two parties, but because of different views on what sovereignty in the tax area really means. The U.S. has taken a view that sovereignty means generally lower rates of tax in treaties, but still preserves the basic U.S. right to administer its tax system domestically as it chooses. Canada believes that legitimate sovereignty includes a concern for a preservation of the Canadian identity, both from a cultural and an economic viewpoint.

WITHHOLDING TAXES - TARIFFS ON KNOWLEDGE AND CAPITAL?

The discussions taking place between Canada and the United States may illustrate some further differences of viewpoints between the countries on international tax issues. The United States may argue, with some considerable intellectual support, that in a free trade area where countries have already agreed that goods may freely pass across
borders without payment of tariffs, it is inconsistent with these policies that there should be the equivalent of a tariff on the transfer of knowledge, technology and capital across borders. Withholding taxes levied on payments of interest, dividends and royalties are in fact equivalent to tariffs, and have the same effect as tariffs in restricting the free flow of technology, knowledge and capital across international boundaries. (Such withholding taxes may not represent an additional net tax cost to the recipient if he can obtain full credit for them in his country of residence, but in an increasingly complicated world, many recipients will not be able to obtain such a tax offset, and hence the withholding tax, to these people, does represent an additional tax and therefore a barrier.)

Within the European economic community, there has been careful attention to the need to dismantle and ultimately eliminate withholding taxes and other tax barriers on income flows, at the same time that tariffs and other barriers for the free exchange of goods are being eliminated. The United States may therefore legitimately raise the question of why its free trade agreements with Canada should not be accompanied by a movement towards zero withholding tax rates on interest, dividends and royalties. But Canada might respond that the elimination of tariffs (and the ultimate elimination of withholding taxes) within the EEC have occurred in a regime that has a binding international mechanism for resolving trade and tax disputes between parties, therefore adding substance and assurance to the working of an effective free trade arrangement. Canada at the moment certainly feels that even its free trade arrangements with the United States have a less-than-satisfactory dispute reconciliation arrangement, and certainly would argue that there is no mechanism for a binding independent arbitration of international tax disputes under agreed standards. Indeed, Canada could point out that the United States has been adamantly opposed to such binding dispute resolution approaches, on the grounds that they derogate from national law and national sovereignty. With its fears about the transfer pricing issues and its concerns on other fronts, Canada might be unwilling to tread down the path towards free trade in capital and technology without some assurance of the existence of effective, and therefore independent and binding, dispute reconciliation processes.

**INTERNATIONAL TRANSFER PRICES**

An issue that would certainly have been mentioned in the tax treaty discussions, but probably not resolved in that arena, is the continuing concern of Canada, along with other U.S. trading partners, about the international transfer pricing issues. The U.S. approach, as conveyed in the proposed 1994 Section 42 regulations, is viewed by many as moving away from the basic "arm's length" criteria in inter-
national trade while the U.S. feels that its changes simply provide a more sophisticated and effective way of dealing with international tax avoidance. A tax treaty is not necessarily the way to resolve such transfer pricing concerns, as the U.S. has always felt that its transfer pricing rules were largely a domestic issue and not subject to modification in international agreements. Taxpayers would prefer a more effective way of resolving international transfer price disputes, but the U.S. again has always ruled out binding arbitration on such issues which it regards as relating to the application of U.S. domestic law.

**TRADE ISSUES**

It is beyond the scope of this paper to deal with the perennial trade issues in conflict between Canada and the United States - wheat, softwood, steel, etc. - but it is worth noting that tax issues must be set against the background of these continuing trade disagreements and that in particular Canada has some concern about the continuing commitment of the U.S., in a highly politicized domestic environment, to actually implement effective, independent arbitration of disputes under international rules.

**CONCLUSION**

As I said at the outset, it is all too tempting and too easy to concentrate on the difficult issues that inevitably arise in respect of the conflicting sovereignties of Canada and the United States. In fact, the vast majority of transactions of all sorts that occur between our two countries are dealt with, for tax purposes, effectively and with appropriate coordination between the two jurisdictions. However, it is the exceptions that get the noise and it is the exceptions that sometimes create ripples in the otherwise harmonious relations between the two countries, ripples that can grow and cause some ultimate rocking of the boat.

In a world that is still based on the absolute sovereignty of nation states, both Canada and the United States preserve the ultimate rights of sovereignty, in the tax as well as in other areas. These rights are, however, beginning to fray around the edges as each country binds itself, more and more, into an international web of treaties, agreements, policies and understandings that gradually begin to restrict its freedom of decision, not merely on international issues but inevitably extending into so-called domestic matters which have international ramifications. Both Canada and the United States are finding, as are all other countries, that while the ultimate concept of sovereignty remains, the cost of sovereignty keeps on going up. The right to be independent is still there but the exercise of that right, in any arbitrary way, is bound to cost any country more and more as the global community assumes further
shape and authority.

It is against this background of the urgent incentives to reconcile tax differences that conflicts between the United States and Canada should be noted. Most of the tax conflicts between Canada and the United States have been worked out between the two countries, primarily through the tax treaty, and the remaining differences should be dealt with in the same way.

It will require a commitment to cooperation and the willingness on both sides to appreciate the viewpoint of the other in order to make this cooperation effective. The will to be cooperative is certainly there: what is needed in the future is more understanding and more commitment to reconciliation, in order to achieve the common benefits of economic cooperation.

**Other Sources**
   *(Used for purposes of comparison)*

2. International Trade Databank, Department of External Affairs and International Trade Canada (EAITC)