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Discussion Following the Remarks of Mr. Robert Brown and Mr. George Goodrich

Discussion

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QUESTION, Professor King: When a country enters the Common Market, it has to put in a value-added tax. Do you see anything in the future for Canada and the U.S. pertaining to whether there is a necessity for moving into a similar system? Is there any parallel that we see in the EEC that needs to be kept in mind here?

ANSWER, Mr. Brown: That’s a rough question. I think that if there was a meaningful free-trade area between Canada and the United States, certain aspects of our tax policy would have to be reconciled. I do not think that there would be any requirement for us both to get into a value-added tax system or totally reform our tax legislation, but we would require more harmonization of tax rules.

We would have to take a hard look at the hidden tax issue in the service area of our treaty, with particular focus on the transfer of technology. This is how Europe got into the value-added tax system in the first place. Some of the Europeans wanted a domestic tax system resulting in a hidden tax on imported transactions, or a hidden subsidy on exports, and those issues have got to be resolutely addressed in any sort of free-trade negotiations.

Canada is actually looking at a value-added tax now and a modified version is also under consideration by the U.S. Senate. I wouldn’t like to assess its chances in either country. I would point out that in the EEC one of the prime reasons the value-added tax was pushed and adopted was not only to harmonize the tax system, but to give the EEC, itself, enough revenue to pay for its hideously unfortunate and myopic agricultural subsidies. If you ever want to talk about combining the agricultural boondoggles in Canada and the United States, we will need a new layer of taxes to provide for that.

ANSWER, Mr. Goodrich: I don’t need to add a lot to that, except to tell you that about seven years ago I participated in a White Paper that was submitted to the Treasury discussing whether or not the U.S. should implement a value-added tax at that point in time. On a superficial basis, there is a lot of merit to adopting the value-added tax. The development in the EEC, as Mr. Brown mentioned, is one positive aspect. While I have grave doubts as to whether the adoption of this system will go any further than the discussion stage in the Senate, if we don’t get some tax reform in other areas, the Administration might just pop it on us as an alternative.
QUESTION, Professor King: I have a question concerning your discussion of parent-subsidiary relationships and the collection of royalties.

Naturally, the U.S. tax authorities wanted to get as much in royalties to U.S. patent companies as possible and the Canadian authorities resisted. Let's take a case where there is no comparable independent third party transaction. Can you enlighten us on how this would work out? You have got a product that finds no parallel and you have got a parent subsidiary relationship where the parent controls the subsidiary. How do you develop an appropriate royalty relationship in that situation?

ANSWER, Mr. Brown: There is a new Revenue Canada bulletin that isn't officially released yet in Canada (but you can get a hold of it if you want to) and the department suggests that the appropriate level of royalties should be determined by looking at all sorts of factors, such as: prevailing royalty rates in the industry, terms of the license, geographic limitations, exclusivity rights, singularity of the invention, the periods that it is likely to remain unique, technical assistance, know-how, and the ratio of profits by the two parties (that is, how much profit the Canadian producer is going to make relative to how much profit was made in the United States), and so on.

These are easy factors to list, but very difficult factors to determine. Taxpayers are typically thrown back into looking at what is customary in the industry. In some industries, for example, it is normal to charge a 4 or 5% royalty, but it might be difficult to justify this on either side of the fence; nevertheless, it tends to be usable. Unusual situations where either a higher or lower royalty tends to be called for are where you get into problems.

COMMENT, Mr. Goodrich: It seems hard for me to believe that you can't find or draw some analogy to come up with a comparable or uncontrolled pricing structure. You are bound to find a related industry or transaction from where you can draw a comparable ROI rate or pricing structure. If not, you use your imagination.

QUESTION, Mr. Wolfe: We heard this morning that the export of people is pretty important to the export of technology and it will have to be controlled. Is there anything in the current direction of tax reforms that would be a disincentive for companies moving individuals around North America? I think it is going to be important, particularly in the service direction.

ANSWER, Mr. Goodrich: This particular tax reform doesn't have to go after that. I think every other one since 1976 has. Don't talk too loud about it—it might come up in the new proposal.

QUESTION, Mr. Ellis: We have been dealing largely with taxes in one direction or another. Could you give us a little insight into what the taxation of cross licensing might be? Are there advantages from that?

ANSWER, Mr. Brown: If you are dealing with arms length cross
licensing, then you have a bag of tax consequences. However, at least you are out of the related party issues which get extraordinarily complex. Provided that you don’t transfer capital rights, but, instead, license each other, the tax consequences or the complications are of a lower order of magnitude.

However, what must be avoided at all costs is a possible tendency from both tax authorities to impute royalties in each direction. For example, a U.S. manufacturer and a Canadian manufacturer get together and decide to share patents. They plan to share everything. In this situation, there is a possibility that the transaction could be restructured by the tax authorities to say that you are really paying that guy a ten million dollar royalty, he is paying you a ten million dollar royalty, and both governments want to withhold tax on it. That has not been a huge problem to date, but could be, however, with the new U.S. tax law. Canada, to date, hasn’t gone after it.

To comment on the people problem, there are some tax rules in our two countries that do inhibit the export of people and they, essentially, try to impose a North American tax regime on individuals who are going abroad temporarily. If you go abroad for long enough, in the U.S. one year and Canada two years, you can get more favorable tax treatment. The short-term export of people, though, tends to leave you with a North American tax rate and that could press you out of some foreign jobs.

COMMENT, Mr. Goodrich: Just to comment on cross licensing, prior to 1984 everything that Mr. Brown said would hold true equally as well in the United States. Keep in mind this deem transfer rule and deem sale rule. In the cross licensing arrangement, now, where you are not providing consideration, it is likely the IRS would take the approach that you have an outbound transfer of technology without consideration, and you would have this deem sale rule and hypothetical income. It’s not clear. They are 100 pages in length which means that we will be discussing them three years from now and still won’t understand them. The point is that they may contain some clarifications in them right now, but I would be extremely concerned about cross licensing at the present time.