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Discussion

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DISCUSSION FOLLOWING THE REMARKS OF MR. ROSENBLOOM AND MR. BURN

QUESTION, PROFESSOR KING: In the first place, one of the things that seems self-evident is that Canada is losing business which would contribute to revenue in Canada if you had a better tax system. If you had more taxpayers, you would have more people who were contributing to support the government. That seems so self-evident. Why do the legislators not grasp that fact?

ANSWER, MR. BURN: Unfortunately there is a very simple reason for that — politics. Any kind of tax reduction in Canada runs into all kinds of political flak. We are told this when we talk to government officials or politicians, “work on the backbenchers, the opposition MPs, and the press,” they say. At the moment, there is allegedly insufficient public appetite for tax reductions, particularly at the higher rates.

In fact, our New Democratic Party has, notwithstanding the situation we are in now, already announced in Ontario that their election platform is going to be to increase taxes, particularly for anybody making more than $80,000, which is only $55,000 U.S. That scares people and they are putting on their marching feet to head south. I did not really dwell much on the question of the brain drain, there are also non-tax factors involved. However, the reality is that we are talking about the graduates coming straight out of university being picked off by companies in the United States. These are people in whom we have just invested a lot of money to get them educated. They are about to add their value to society and pay taxes, but they are doing it for Microsoft as opposed to Nortel Networks.

QUESTION, PROFESSOR KING: I have a three-pronged question for David Rosenbloom. First, the Section 41 credit is always going to be year-to-year until the end of time. Second, with these pricing arrangements where you allocate costs between a U.S. parent company and the foreign subsidiary, and the extent to which those are binding the holdings of the U.S. authorities, how binding are they? Third, and maybe this itself is a two-pronged question, is there any chance that the tax authorities in the various countries will get to agree on uniform definitions of R&D to perhaps create a level playing field? Is that even desirable?

ANSWER, MR. ROSENBLOOM: Let me start with the third question first. It might be desirable, from the perspective of the United States, but it is

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not going to happen, in my opinion. One of the things that struck me in lis-
tening closely to David is that Canada clearly has a broader definition than
the United States has of what will qualify as R&D. I did not go through all of
the pressure points in our definition, but it sounds to me, even though Can-
ada's system defers to the United States in terms of complexity, that the
United States has a more liberal definition of what is included in a qualifying
expenditure. It also sounds to me, particularly in light of this work with
Revenue Canada, that Canada has a more cooperative effort than we have in
the United States. So, in terms of what we are talking about here, it seems
that, on R&D-specific material, Canada has more advantages than the United
States.

To go back to your question, Henry, I do not think the definitions are
going to be equal. I cannot see the United States subscribing to any interna-
tional definition. We might go to a few conferences on it, but frankly, I can-
not see Congress adopting an international standard.

On the cost-sharing agreements and whether they are binding, they come
in two flavors. You can do your own cost-sharing agreement. For example,
Nortel could enter into a cost-sharing agreement among Nortel Canada,
Nortel United States, Nortel France, and Nortel Brazil and claim that it
passes muster under our regulations. The problem is that our rules are fairly
tight, and you operate to some extent at your own peril, as you do in all trans-
fer pricing matters. But these cost-sharing agreements are sufficiently com-
plex and there are sufficiently few comparables of arms-length treatment. In
my opinion, taxpayers are well-advised to go into this advanced pricing
agreement (APA) procedure, which offers the possibility of getting the
Revenue Service and the other country to sign on up front.

To answer your question very specifically, Henry, if you get that agree-
ment, then the audit becomes pro forma. All the agent is doing is seeing
whether you comply with the agreement, since you submit a report every
year. Everybody I know who has an APA thinks it is the greatest procedure
since sliced bread. The problem is that getting them, particularly cost-sharing
agreements, can take three or four years.

ANSWER, MR. BURN: In fact, ours did take four years. One of the
beauties of it was that it was not just an advanced pricing agreement, but it
also retroactively covered a number of previous years under the same terms,
which was helpful to all concerned.

COMMENT, MR. ROSENBLOOM: Your first question, Henry, was
about Section 41, the R&D tax credit. There is a move every year to make it
permanent, and companies would love to make it permanent. Congress
would not speak of making it permanent, but we have been operating for at
least fifteen years under a pay-as-you-go tax budget, which means that, in
order to pass provisions that cost money, we have to raise money. That is very difficult to do.

Presumably, it is true in Canada too, and it is certainly true in the United States that our Congress loves to spend money. It does not very much like to raise money through the tax system. They are operating under those constraints. This is a fairly big-ticket item. I have not seen the most recent amounts on the tax expenditure, but they are substantial. So, I do not think it will be permanent.

QUESTION, MR. WOODS: One thing that struck me was that Mr. Burn described how we are way ahead of the pack, along with the Australians, on R&D measures under our Income Tax Act, but the results are not there. We are at the bottom of the pack in terms of the banks or the programs. Particularly for our American colleagues, it sounds like, and this is a gross oversimplification, but it sounds like the analysis suggests that it is because of the rest of our Income Tax Act.

Is there something wrong here that the measures in place do not compensate or mitigate for the other issues with income tax, both corporate and personal, or are there other factors in play that create two different results which do not really make intuitive sense on those two charts?

ANSWER, MR. BURN: I must admit, I am surprised that more corporations, particularly U.S. corporations, do not do more R&D in Canada. The profitable ones, at least, are subjected to substantial Canadian corporate taxes, which would obviously be offset by the SR&ED credit.

The reality is absolutely what you say, that the costs of bringing in the technicians is the challenge if they are not already in Canada. Also, the tax equalization costs in themselves are extraordinarily expensive. I think both the corporate and personal tax systems combine to take away from the value of credit.

ANSWER, MR. ROSENBLOOM: I would add on that, as I said initially, it is really a mistake to single out the R&D-specific provisions and reach any conclusions on the basis of that. It is probably very difficult, even if you go more broadly and look at the overall tax system, to draw a straight line between the tax system and why R&D is occurring in one country rather than the other. Those are big jumps in logic. People make them all the time, but I do not think they are really valid.

COMMENT, MR. ALLEN: I want to follow up on that. First, there is a tremendous tendency on the part of companies to do R&D in their domestic market, and the fact that Canada has so many companies that are foreign-

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owned or foreign-controlled accounts for the gap. For example, yesterday there was discussion about the automotive industry really not doing any R&D in Canada, and yet it has substantial business there. I think this is one factor.

A second factor is that, as David has highlighted, there are a lot of other taxes besides the income tax. If you can get a concession on income tax, that is still only one-third of your total tax bill. You have to look at the other expenses as well. It is a powerful incentive, but it just is not enough either in Canada or Australia. I think the important point, though, is that it would be that much worse without those incentives.

QUESTION, PROFESSOR DeVORETZ: After Mozart’s initial performance of the Requiem, his sponsor accused him of having too long a performance. Mozart’s reply was, “Which notes would you like me to remove?” Mr. Burn, you have described the Canadian tax system as one that is higher in every dimension. If you were allowed to be Paul Martin for a day and you were given only a small discretionary room to reduce taxes, which one would you choose to improve the R&D environment? Would it be the income tax, which would perhaps stall or forestall the movement of people out? Or, would it be the tax on business profits, which would encourage capital to move in? It seems to me those are joint problems.

So you have only got small room now. You are a real politician in this scenario; you are not bashing the feds. I would like to hear your answer because this is what is going to happen in the next budget.

ANSWER, MR. BURN: I would tell my staff it has got to be both.

COMMENT, PROFESSOR DeVORETZ: I did not let you do that.

COMMENT, MR. BURN: We have had three consecutive years now where we have done something for personal income tax, but as you are well aware, we have not done very much at the corporate levels. The provinces, Alberta in particular, are moving dramatically in the personal tax area. I think we have overtaxed our businesses for so long that, if we did not have the weak Canadian dollar to support us, we would probably now have unemployment problems in Canada way beyond what we see today.\(^3\)

If I could be there for one day, my first choice would be to follow up on Jack Mintz and the Mintz Committee’s recommendations and get the overall Canadian tax rate down to thirty-three percent. The difficulty in reducing business taxes is so challenging that, if you get one chance, you have to grab it which explains the widespread support for the recent reduction in unemployment insurance contributions.

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QUESTION, MR. TENNANT: I have two areas of questioning for David Rosenbloom. First, I wonder if you might comment on the subnational versus the national level of R&D in the United States.

Secondly, I have a question on court interpretation in the United States, which seems to be increasingly more of a factor than legislation in what really prevails. As David Burn knows very well from his chairing the Alliance of Manufacturers and Exporters Canada Tax Committee, there is a great deal of concern in Canada over a business tax situation in Michigan. This has arisen out of court interpretations such that out-of-state and foreign companies have become liable for Michigan’s single business tax where very minimal sales activity and no presence, two-day sales solicitations begins to trigger the tax. But, in this case, court interpretation has been a very big factor in changing the situation. It is also a situation in which many believe that there is an increasing proliferation of unique measures being taken by state governments that do not find themselves subject to any sort of national discipline or rational approach in the United States.

ANSWER, MR. ROSENBLOOM: This is an area about which I have only a passing knowledge, but let me comment on a couple of things.

In the United States, we have a tremendous disparity at the state level. We have important states that do not have a corporate income tax, such as Texas. A U.S. company, I would think, has a fair amount of room to move, and there is a fair amount of planning that goes on in your typical U.S. company as to where to do business in the United States so as to minimize the tax burden at the state level. I am less familiar with the degree of specific R&D incentives within the states that do have taxes. I would doubt that there is much. You probably know better than I do, David. I really do not know what California or Massachusetts do, or even if they do anything specific at all.

The state tax rates tend to be fairly low. Remember, the other point that David did make is about the deductible. So, on an after-tax basis, it is only sixty-five percent of what it otherwise would be for a U.S. company because of the deductible. There are some high-tax states where I am sure plenty of R&D goes on, and I am sure that does enter into the burden, but I do not have a sufficient grasp on what the states are doing to address that. I doubt that they are doing much, but I do not really know.

Insofar as the Michigan single business tax is concerned, I assume it is the application of the Michigan state taxes that we are talking about. There is no discipline. We have, just as you do, a federal system. There is, of course, some kind of ultimate recourse for unconstitutionality, but that has not

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proved to be very available in the Barclays case and the cases that went to the Supreme Court on the California Unitary Tax.\footnote{See Barclays Bank PLC v. Franchise Tax Bd., 512 U.S. 298 (1994).}

Actually, this leads me to a comment on what David said. I think he is somewhat underestimating the overall effect of state taxation on people doing business in the United States. I would have thought it would be somewhat higher. U.S. companies do spend a lot of time engaged in state tax planning. I personally do not, and I am less familiar with it than perhaps I should be to answer your question. But, undeniably, it is a factor in the United States, and it is never going to be subject to discipline at the federal level.

QUESTION, MR. TENNANT: And how influential are the courts?

ANSWER, MR. ROSENBLOOM: Let me come back to that. I am not sure where that comment is coming from. Courts have always played a very big role in the application of our system.

I am familiar with the differences between the United States and Canada at the federal level, and one of the big differences in the United States, and it is always strange to Canadian tax folks, is that we have a fairly substantial body of non-statutory common law of taxation. We are regularly, although not always, looking beyond what seems to be going on to ask ourselves what is going on in substance as opposed to form. From a Canadian viewpoint, that can produce all sorts of weird results. All of that law is judge-made law, not statutory law. So the courts have always played a big role.

At the state level you may be seeing more court activity than there was previously. I think state tax administrators have woken up in the last ten or fifteen years, but the federal level and federal courts have always been important and still are.

QUESTION, MR. KERESTER: David Rosenbloom, is the expense of obtaining advanced pricing agreements so high that it is impractical for small businesses in the United States?

ANSWER, MR. ROSENBLOOM: It depends on what you mean by a small business. I actually have experience with getting an APA for a small biotech company. My reaction was that it is high in the sense that you have to make a concentrated effort to get it. This company was like all biotech companies in that it was convinced it was going to come up with a cure for cancer within six months and wanted to be sure the United States would not tax it. That was basically their motivation. Getting this APA took a fair amount of effort, but it has now been in place for six years and it is about to be renewed.
I think you have to do a fair comparison. There is no doubt that there is an expense. It probably cost this company three or four hundred thousand dollars to get the APA, but they save themselves audits, which they regularly had previously, not only on the transfer pricing, which was involved in the APA, but on everything else. It simply is not worth the while of the IRS to go see these guys once the transfer price is off the table. So I would say the savings are quite substantial, and, as far as I can see, it is going to be carried forward.

QUESTION, MR. YOSOWITZ: What is the status of confidentiality of APAs?

ANSWER, MR. ROSENBLOOM: That is a great question! We have a lawsuit going on in the United States that has been brought by the Bureau of National Affairs, which publishes the daily tax report, for disclosure of APAs.\footnote{See \textit{BNA, Inc. v. Internal Revenue Service} et al., D.D.C. Nos. 96-376, 96-2820, 98-1473 (1999).} What I think people are worried about is not just the APAs, but also the background documents. We actually are involved in that case on behalf of a bunch of APA recipients and some general business companies as \textit{amicus curiae.} The case is before a magistrate in the U.S. District Court. Several countries, Canada being one of them, have been very concerned about this question.

Personally, I think that this is ultimately something of a tempest in a teapot. It is easy to get all excited about it, but I lived through the hullabaloo about making private letter rulings public in the United States, probably twenty-five years ago, when every Chicken Little in the United States said the sky was going to fall. We have been living with that ever since, and as far as I can tell, it has not inconvenienced anybody.

There is a difference between APAs and letter rulings. The information tends to be, but is not always, more sensitive and more current. But as long as you have a reasonable redaction process where you can remove the name of the company and anything that even hints at what is going on, you can make the documents public. It may not be everything that the voyeurs would like to have, but you can make something public without really disclosing anything about the company. That is the way the letter ruling process is working. I have to believe that, when the dust settles, that is the way this is going to work, too.

COMMENT, PROFESSOR KING: Well, this has been a great session. I want to thank both David Rosenbloom and David Burn. We want to show our appreciation for them.